LAW AND PRACTICE OF MODERN ISLAMIC FINANCE IN AUSTRALIA

by

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Thesis submitted in fulfilment of the requirement for the degree of Doctor of Philosophy

University of Western Sydney

School of Law

December, 2007

DEDICATION

This dissertation is dedicated to my most beloved parents “Zainab Begum” and “Abu Tahir Muhammad Nazir” (have Allah’s Mercy on their souls and grant them eternal happiness and peace in Paradise), without whose sole contribution I could not achieve anything in my life.

ACKNOWLEDGEMENTS

At the outset, all praise be only to Allah, the Omnipotent to accept this effort and to consider it for His sake only without Whose Grace this work would have not been accomplished.

I would like to express my profound thanks to my Principal Supervisor Professor Razeen Sappideen, Foundation Professor of Law and Postgraduate Law Program Head, for patiently supervising the whole of this work and frequently providing constructive suggestions throughout my period of study at the University of Western Sydney from 2004 to 2007. I am deeply grateful to my co-supervisor Dr. A. K. M. Masudul Haque for his invaluable assistance and encouragement. Needless to say, for any error and omission in this study I hold myself fully responsible.

I whole heartedly appreciate the staff of the Inter-Library Loan Service of the University library as well as the secretaries of the School of Law who offered much needed support during this lengthy and sometimes difficult project. My heartfelt appreciation is extended to every one else who encouraged and helped me to complete this thesis, especially my oldest brother Professor Dr. Abu Bakr Rafique Ahmad, my colleague Dr. Aysun Goktepe, my son in law Barrister Salman Badrul Hasan and UNSW Law student Tamim Rahman.

I owe my greatest debts and thanks to my dearest wife Sufia, my children Raghib, Ghalib, Tahnia, Jumana and Labib, and my daughter in law Fahmida for their truly extraordinary patience and emotional support. I am also greatly indebted to University of Western Sydney for providing me UWSPRA scholarship to undertake this valuable study.

STATEMENT OF AUTHENTICATION

As the author of this dissertation I hereby declare that it entirely results from my own investigation undertaken in fulfillment of the requirement for the degree of Doctor of Philosophy at the School of Law, the University of Western Sydney. It has not previously been submitted fully or partially for any degree at this university or any other university.

I further declare that all the ideas and arguments expressed in this study are exclusively of my own. However, in order to support my own ideas where the ideas and views of others are expressed or referred to, due acknowledgements have been made through mentioning relevant sources and references in appropriate manner.

Signed……..

Abu Umar Faruq Ahmad

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ABBREVIATIONS AND ACRONYMS

AAOIFI:	Accounting and Auditing Organization for Islamic Financial Institutions.
AASB:	The Australian Accounting Standards Board.
ABC:	Arab Banking Corporation.
ACCC:	The Australian Competition and Consumer Commission.
ANZ:	Australia and New Zealand (Banking Group Limited).
APRA:	Australian Prudential Regulatory Authority.
ASIC:	Australian Securities and Investments Commission.
ASX:	Australian Stock Exchange.
AUD:	Australian Dollar.
BCBS:	Basel Committee on Banking Supervision.
CBA:	Commonwealth Bank of Australia.
CD:	Certificate of Deposits.
CE:	Christian Era.
DM:	Diminishing Musharaka.
DP:	Diminishing Partnership.
EU:	European Union.
FA:	Finance Act.
FDIC:	Federal Deposit Insurance Corporation.
FSA:	Financial Services Authority.
FSMA:	*Financial Services and Markets Act 2000* (UK).
FSRB:	Financial Services Reform Bill.
FTSE:	Financial Times and the London Stock Exchange (UK stock index).
GCC:	Gulf Cooperation Council.
GCIBFI:	General Council for Islamic Banks and Financial Institutions.
GDP:	Gross Domestic Product.
GBP:	Great Britain Pound (Pound Sterling).
HM:	Her Majesty.
HMRC:	Her Majesty's Revenue and Customs (UK).
HP:	Hire Purchase.
HSBC:	Hong Kong and Shanghai Banking Corporation.
IAS:	International Accounting Standards.
IB:	Islamic Bank.
IBs:	Islamic Banks.
ICFAL:	Islamic Co-operative Finance Australia Limited.
IFI:	Islamic Financial Institution.
IFIs:	Islamic Financial Institutions.
IFSB:	Islamic Financial Services Board (Malaysia).
IFSP:	Islamic Financial Services Provider.
IFSPs:	Islamic Financial Services Providers.
IICG:	Islamic Investment Company of the Gulf.
IIFM:	International Islamic Financial Market.
IISCA:	Islamic Information and Support Centre of Australia.

IMB:	Ijara Muntahia Bittamleek.
LIBOR:	London Interbank Offered Rate.
MCCA:	Muslim Community Co-operative (Australia) Limited.
MCCU:	Muslim Community Credit Union.
NAB:	National Australia Bank.
NASDAQ:	National Association of Securities Dealers Automated Quotation (system).
NOW:	Negotiable Order of Withdrawal (Accounts).
NSW:	New South Wales.
PBUH:	Peace Be Upon Him.
PLS:	Profit and Loss Sharing.
PWSBH:	Perbadanan Wang Simpanan Bakal-Bakal Haji.
RBA:	Reserve Bank of Australia.
RMBS:	Residential Mortgage-Backed Securities (Australia).
SDLT:	Stamp Duty Land Tax (UK).
SER:	Shared Equity and Rental.
SFE:	Sydney Futures Exchange (Australia).
SPV:	Special Purpose Vehicle (financial).
SSB:	Shari`ah Supervisory Board.
S2L:	Sale to Lease.
TSB:	Trustee Savings Bank.
UAE:	United Arab Emirates.
UBK:	United Bank of Kuwait.
UCCC:	Uniform Consumer Credit Code.
UK:	The United Kingdom.
UNSW:	University of New South Wales.
USA:	The United States of America.
USD:	The United States Dollar.
VAT:	Value Added Tax.

ABSTRACT

The dissertation seeks to contribute to the existing body of work in the area of Islamic finance by examining the extent of divergence in practice of Islamic financing from the traditional Shari`ah in the Australian context. To this end, the dissertation presents a discursive analysis of the regulation of Islamic Finance in Australia in terms of (a) the financing instruments used, (b) certainty of transactions between participants in the system, and (c) institutional risk management of Islamic Financial Institutions (IFIs). The methodology chosen for the study is through the Shari`ah, where law, finance, economics and business form a single dimension only, even though a very significant one. Examination of the issues of this study is undertaken through the literature in the relevant field as well as the author's personal expertise and working experience with several Islamic banks (IBs) and IFIs for a considerable period of time, in addition to his active involvement with at least two of Islamic Financial Services Providers (IFSPs) in Australia.

In line with the above, the objectives of this project are two-fold: First, to analytically study the extent to which IFSPs of Australia differ from the traditional Shari`ah in their current practices of Islamic legal financial system by their use of different financial products and techniques. Second, to create awareness and transparency about the various products and instruments used by IFSPs of Australia. The investigations have been conducted through: a) developing a methodological approach to introduction of the sources of the Shari`ah, main Schools of Islamic Jurisprudence and the application of the Shari`ah principles of financial transactions to Islamic finance, b) elucidating theories of financial regulations and historical

evolution of financial products aiming at providing the contextual background required for the research, c) examining the practice and compliance requirements of Islamic finance in the Australian legal context, and d) examining the extent to which IFSPs in Australia adhere to the strict notion of Islamic financing in three areas the author has selected to examine namely housing, motor vehicles and consumer goods financing.

One of the main conclusions is that Australia being a country with a highly diversified and multicultural society there is a strong desire and growing demand among and from nearly 350,000 Muslims living in this country, for a fully fledged Islamic bank (IB) to function, and the Superannuation and investment funds to establish in line with the tenets of the Shari`ah. This would not only help strengthen the Australian economy through creating an opportunity to bring in significant foreign direct investments into Australia but also build up its existing trade and economic ties with the neighbouring Muslim countries. The author believes the Australian government should take necessary steps to enable these growing opportunities to be pursued in this country. The author therefore, recommends that given the success of Islamic banking and finance practice under the existing legal and regulatory environment in the UK, the consideration be given to the adoption of the UK model of regulatory framework for Islamic banking and finance into Australia. In this regard, the relevant regulations may be developed by the Australian regulatory regime so as to make Islamic finance a viable alternative system of financing for Muslims in Australia.

Another research problem of this study indicates that due to the unfamiliarity of the relatively new Islamic financial system, IFSPs in Australia have not been able to play the expected role

in the development of Australian economy through mobilising funds and attracting more customers. In this connection, the author suggests IFSPs to take an intensified program to familiarise the public and policy makers with an overview of the Islamic finance and of the financial services and products they use in Australia.

The author also recommends that IFSPs' conventional counterparts in Australia such as National Australia Bank Limited (NAB), Australia and New Zealand Banking Group Limited (ANZ), Westpac Banking Corporation, Commonwealth Bank of Australia (CBA), St George Bank Limited and other similar banks introduce Islamic retail banking services side by side with conventional banking facilities being offered to prospective customers, since other global banking institutes such as HSBC (Honk Kong and Shanghai Banking Corporation), Citibank, Standard Chartered Bank have already entered these markets in a significant manner through their trans-national banking subsidiaries.

CHAPTER 1

INTRODUCTION

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INTRODUCTION

1.1 The Research Problem

This study explores the interrelation between the Shari`ah,[1] the Australian financial regulatory system, and the Basel Prudential Standard Requirements[2] with respect to Islamic banking practice in Australia. The underlying objective of the study is to critically evaluate the extent to which the Islamic Shari`ah has been followed by IFSPs in Australia. With this in view, the project will examine the following.

1. The extent of divergence of Islamic financing practice in Australia from the traditional Shari`ah*;* [3]
2. In relation to 1 above, the impact of Banking and Financial Services Regulation on Islamic banking and financing practice in Australia;
3. What further legislative measures and changes are needed to accommodate Islamic financing practice into Australian society so as to make it a truly viable alternative system of financing for Muslims in Australia;
4. To what further extent must Islamic Finance adapt itself to be a viable alternative to conventional forms of financing in Australia.

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1 The comprehensive nature of the *Shari`ah* is due to the belief that the law must provide all that is necessary for a person's spiritual and physical well-being.

2 It is an attempt to reduce the number of bank failures by tying a bank's capital adequacy ratio to the riskiness of the loans it makes. The first such attempt to do this worldwide was made by the Basel Committee on Banking Supervision (BCBS) in 1988. In 1998, "Basel II" was proposed, using much more sophisticated risk classifications.

3 The *Shari`ah* is understood as Islamic law or the code of Muslim conduct outlined by the Qur'an and the *Sunnah* of Prophet Muhammad (pbuh).

While the practice of Islamic financing is a very broad umbrella, this study will focus on the most sought after forms of Islamic financing in Australia, namely, housing, motor vehicle, and consumer goods financing. While this dissertation is not a comparative study of Islamic and non-Islamic Financial Institutions in Australia, comparisons will be made where necessary to clarify the current practice of IFSPs in Australia.

INTERNATIONAL BACKGROUND

Islamic Finance has emerged in recent decades as one of the most important developments in the financial world.[4] Since all affairs of Muslims including economic, political, religious and social fall under the jurisdiction of Islamic legal system there has always been a demand for financial products and services that conform to the tenets of the Shari`ah.[5] With the development of viable Islamic alternatives to conventional finance, Muslims are beginning to find Shari`ah compliant solutions to their financial needs.[6]

IFIs claim to use transactions that are motivated by traditional Islamic structures. Most of the financial products and techniques they use today can be traced back to pre-Islamic period.[7] It was practised in most parts of the Islamic world throughout the Middle Ages, promoting

4 Ayub, Muhammad, G. n.d. *Understanding Islamic Finance*, an unpublished book.
5 Lewis, Mervyn K. 2006. "Accountability and Islam", paper presented at 4th International Conference on Accounting and Finance in Transition, Adelaide, April 10-12.
6 Muslims in Islamic societies have traditionally viewed the *Shari`ah* as essential to their religious outlook. However, for Muslims living in non-Islamic societies the *Shari`ah* ceases to be relevant as law, but remains a source of personal ethics (for example, the avoidance of pork and alcohol, and the use of *Shari`ah*-compliant financial services).
7 A historical study of the literature of Islamic financial law reveals that these products are not all referred to in the texts of the *Shari`ah*. Most were either pre-Islamic or approved later on by Muslim jurists – in certain cases with certain rules or conditions added to already existing commercial practice to make sure that basic legal concepts were not violated. There is a basic, legal maxim within the realm of Islamic financial law: *all transactions are permissible except if indicated otherwise*.

trading activities with the advancement of credit.[8] Between the eighteenth and the first half of the twentieth centuries, almost the entire Muslim world was colonised by European countries, and consequently the economic and financial affairs of these colonies came to be administered according to the rules of the coloniser. Between Indonesia's independence in 1945 and Algeria's independence in 1963, most if not all, Muslim countries became independent.[9] This enabled Islamic countries to start re-examining their financial services industry and set up financial systems in accordance with the principles of the Shari`ah. This development ultimately helped laying the foundation of modern Islamic finance.

Following independence, a number of interest free saving and loan providing societies are reported to have been established in the Indian subcontinent during 1940s, with efforts to arrange finance for business enterprises being set up later. Examples include the establishment of a Savings Bank in the Egyptian town of Mit Ghamr in 1963, and the establishment of Perbadanan Wang Simpanan Bakal-Bakal Haji (PWSBH) or the Muslim Pilgrims Savings Corporation in Malaysia[10] in 1963, the Philippine Amanah Bank in 1973 and the Dubai Islamic Bank in 1975.[11] By 1985, 27 more banks had been established in the Gulf region. Many more followed all over the Islamic world. Islamic investment companies and Islamic insurance companies also began to appear in the late 1970s. In the 1990s a number of Islamic mutual funds appeared with many of them being managed by reputed

8 Iqbal, Zamir. 1997. "Islamic Financial Systems", *Finance & Development*, June, vol. 34, No. 2, International Monetary Fund. The World Bank Website, available at: http://www.worldbank.org/fandd/english/0697/articles/0140697.htm, (accessed June 30, 2005).

9 See "Islamic Capital Market Fact Finding Report". 2004. *The Islamic Capital Market Task Force of the International Organisation of Securities Commissions*, July. p.14.

10 An institution for Muslims in Malaysia to save for their Hajj (pilgrimage to Makkah) expenses.

11 Siddiqi. M. Nejatullah. 2001. "Islamic Banking and Finance", UCLA International Institute Website, available at: http://wwww.international.ucla.edu/article.asp?parentid=15056, (accessed February 19, 2005).

Western firms.[12] Attempts were also made by various countries to establish Islamic banking systems as part of their system. Pakistan "Islamised" its banking between 1979 and 1985 through a series of Ordinances issued by the Federal government and a number of circulars issued by the State Bank of Pakistan, the country's central bank.[13] Iran and Sudan converted their entire financial systems to become an interest-free system.[14] However, a majority of Muslim countries have developed their Islamic banking system alongside the existing conventional banking system.

While the global value of total assets managed according to Islamic principles is still relatively small, these are growing at a pace well above 15 per cent annually which, if sustained, will eventually lead to amounts that are a significant proportion of global GDP.[15] Approximate estimates place it at about USD260 billion according to estimates provided by the General Council for Islamic Banks and Financial Institutions (GCIBFI).[16] A further USD 200 billion to USD 300 billion is managed by the Islamic banking branches, windows, and

12 References to 'Western' are primarily to financial institutions and techniques, and expectations that predominate in the Europe and countries of the Western world that have Western influence.
13 Husain, Ishrat. 2004. "Evolution of Islamic Banking", available online at: http://www.hallagulla.com/vb3/post1528496.html#post1528496, (accessed February 19, 2005).
14 Siddiqi, M. Nejatullah. n.d. "Recent History of Islamic Banking and Finance", *Lecture series 2,* Anderson Graduate School of Management, University of California, available online at: http://siddiqi.com/mns/Lecture2.htm.
15 See Helena Bachmann. 2002. "Banking on Faith", *Time Magazine*, December 09, vol. 160, No. 24.
16 Incorporated in May 2001 the Bahrain based GCIBFI is an international autonomous non-profit corporate body aimed at promoting the Islamic financial industry in theory and practice, and improving multilateral understanding between Islamic banks, their customers and the public at large. For detailed information on the activities of the GCIBFI see http://www.islamicfi.com/english/AlMajlis_Chamber/Our_Activities/index.asp?ID=69772

subsidiaries of international banks in the world's major financial centres such as New York, London, Paris,Geneva and Tokyo.[17] Although small in terms of the total global assets managed by these financial intermediaries, the growth rate is impressive.[18] The proponents and promoters of Islamic finance and banking are routinely characterising this growth as explosive. See for examples:

> "The market for Islamic Banking is worth more than USD $200 billion and is expected to grow at 13 to 16 per cent a year over the next eight to ten years. The target market consists of more than 1.2 billion Muslims and the business is expected to have explosive growth".[19]

> "Mutual funds constitute one of the fastest growing areas of Islamic finance. Opinions vary over the total value of equity funds under Islamic management with estimates ranging from $1,000 million to $3,000 million. However, there is no dispute that the industry is expanding rapidly. ... The growth of the sector has been explosive".[20]

This is a clear recognition of the viability of Islamic financial industry and its firm significance in today's banking worldwide.

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17 Figures of between $2000 and $300 billion are commonly cited for the existing market size as an annual growth rate of around 15%. These figures need to be considered as indicative only and not as an actual estimate of the industry's size. Samuel L. Hayes of Harvard University points out that assessing the market size is near impossible because the information is scattered and hidden as a good bit of the money that is being managed for Islamic investors is off-balance sheet. According to Bank Negara Malaysia Chairperson Zeti Akhter, "to date (as on 30 August 2007), the total assets of global Islamic financial system are estimated to exceed US$1 trillion, and it is among the fastest growing financial segment in the international financial system with an estimated annual growth of 15-20 percent". See Bernama. 2007. September 7, available on Malaysian National News Agency website at:
http://www.bernama.com/bernama/v3/news_business.php?id=282217

18 Banker Middle East. 2003. "Drawing the Roadmap for Islamic Banking", available online at:
http://www.bankerme.com/bme/2003/dec/islamic_banking.asp, (accessed February 12, 2006).

19 Archer, Simon; Ahmed, Rifaat and A. Karim. 2002. "Introduction to Islamic Finance", in Simon Archer, Rifaat Ahmed and Abdel Karim (eds.), *Islamic Finance: Innovation and Growth*, London: Euromoney Books. p.4.

20 The Institute of Islamic Banking and Insurance, available on Institute's website, at:
http://www.islamic-banking.com/news/uae/archive/funds_grow_1199.php, (accessed February 12, 2006).

During the last two decades the Islamic financial industry has become increasingly diverse, including commercial, investment and offshore banks, mutual insurance and investment funds. Its customers have spread over the US, Europe, the Far East and Australia where IFSPs operate alongside conventional financial institutions.[21] Also, many conventional banks opened Islamic banking branches and subsidiaries that specialise in Islamic financial products.

According to a recent Euromoney report:

> "Over the past 12 to 24 months the global market for Islamic banking services has expanded and the sector has perhaps the greatest potential for growth of any current sector of international finance. Products that are compliant with the Shari`ah are gaining wider understanding and acceptance and are making inroads into the mainstream of financial products".[22]

As a result of the growing significance of Islamic finance, IFSPs have developed a vast range of products designed to serve this growing market, including housing and consumer finance, business loans, and project funding. In recent times, Malaysia and Bahrain have been instrumental in launching tradable securities so as to provide the much needed liquidity and a secondary market for institutional investors in the Islamic finance market.[23] Several 'Islamic

21 To date total four Islamic financial institutions including two Co-operatives have been set up in Australia. They have been providing non-bank financial services in line with the principles of the *Shari`ah*.

22 Euromoney Institutional Investor. 2005. *Islamic Finance Review 2005,* London: Euromoney. The review is a collection of articles from leading bankers, lawyers, regulators and investors. Research and Market's website, available at: http://www.researchandmarkets.com/reports/c12606, (accessed February 12, 2006).

23 See Muhammad Ayub. n.d. "Securitisation, *Sukuk* and Fund Management Potential to be Realized by Islamic Financial Institutions". Available online at: http://www.kantakji.org/fiqh/Files/Finance/Paperpresentedat05.pdf

equity' investment funds have also been launched, with both FTSE[24] and Dow Jones[25] providing indices to monitor this growing market. Islamic finance has been also extended to insurance (*Takaful)*[26]*,* capital markets, and all types of financial intermediation. It also covers large and small, specialised and diversified, traditional and innovative, national and multinational, regulated and freewheeling banks and non-banking institutions.[27] It is an area that has grown to become an increasingly sizeable sector within the global financial market and has gained great interest as a feasible and efficient alternative model of financial intermediation. This is a reflection of the increasing wealth and capacity of investors, both Muslims and non-Muslims, to seek and invest in new financial products that serve their need. The creation of institutions such as the Islamic Financial Services Board (IFSB),[28] Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI),[29] International Islamic Financial Market (IIFM),[30] General Council for Islamic Banks and Financial Institutions (GCIBFI) and alike has given rise to expectations that the constraints and obstacles facing this industry will be tackled in a systematic and informed manner.

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24 Incorporated on 25 September 1995, FTSE is an independent private limited company owned equally by the Financial Times and the London Stock Exchange International. The FTSE Global Islamic Indices track over 1,000 companies from 29 countries, offering investment in no less than 24 currencies spread across more than 30 different sectors. Available online at: http://www.tii.com/core/bprofile.htm, (accessed August 30, 2004).

25 The Dow Jones Islamic Indexes include stocks from 34 countries and cover 10 economic sectors, 18 market sectors, 40 industry groups and 70 subgroups. Available online at: http://www.investaaa.com, (accessed August 30, 2004).

26 *Takaful* literally means mutual responsibility or joint-guarantee, a pact among a group of persons to indemnify a member of this group if he suffers a specified calamity or loss. It is an alternative to conventional insurance under which participants pay a defined amount into a common pool and donate compensation to the damaged participating members. See Khalid Rashid. 1993. "Islamisation of Insurance - A Religio-Legal Experiment in Malaysia", *Religion and Law Review,* vol.2, issue1, pp.16-40. See also, Muhammad Nejatullah Siddiqi. 1985. *Insurance in an Islamic Economy,* Islamic Foundation. pp.40-41.

27 Warde, Ibrahim. 2000. *Islamic Finance in the Global Economy*, Edinburgh University Press. p.7.

28 The IFSB was established in 2002 aiming to serve as an international standard setting body of regulatory and supervisory agencies with vested interest to ensure the soundness and stability of the Islamic financial services industry. At present, it has 65 members which include, among others, 19 regulatory and supervisory bodies, the World Bank, International Monetary Fund, Islamic Development Bank, Asian Development Bank and Bank for International Settlements. See for details, IFSB website, available at: http://www.ifsb.org.

29 Registered in Bahrain in March,1991 the AAOIFI is an Islamic international autonomous non-profit making corporate body that prepares accounting, auditing, governance, ethics and the *Shari`ah* standards for Islamic financial institutions. For more information see the AAOIFI's website, available at: http://www.aaoifi.com/index.html

30 Headquartered in Bahrain, the IIFM became operational in April, 2002 aimed at ensuring the continued growth of Islamic banking and finance as a viable alternative to the conventional financial system. For elaboration on the services and products of the IIFM see its website, available at: http://www.iifm.net/services-*Shari`ah*.php

NATIONAL BACKGROUND

Despite the global potential demand for Islamic banking and financial market the prospective demand for the Islamic financial market in Australia is uncertain and difficult to measure. As far as the number of Muslim population in Australia is concerned there are 340,392 Muslims in Australia, being Islam is the third largest religion after Christianity and Buddhism, representing 1.7% of the population.[31] The Australian Muslim community is drawn from more than 70 different countries,[32] is ethnically and linguistically diverse, and geographically scattered, making the marketing of Islamic financial products a major challenge.Though the national demand for Islamic finance is uncertain, in specific geographic areas, several institutions offer Islamic financial services in response to local demands.[33] Local Muslims and non-Muslims can now invest and borrow in interest free transactions according to the tenets of the Shari`ah. In July 2003 the *Weekend Australian* reported that Prime Minister John Howard had endorsed a shared partnership scheme between home buyers and banks which was very similar to schemes already being used by IFIs.[34] In addition, a report published in *The Australian* on October 20, 2006 disclosed that National Australia Bank (NAB) will look at introducing Islamic financing into its product range to capture an "untapped" market that could be worth millions of dollars. It also declared offering an AUD 25,000 post-graduate scholarship to a member of the Muslim community for the year 2007 to further NAB understands of Islamic banking.[35]

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31 Australian Bureau of Statistics: *2006 Census Data – Religious Affiliation*, available online at: http://www.abs.gov.au (accessed June 30, 2007).
32 Australian Government, Department of Foreign Affairs and Trade. n.d. "Islam in Australia", available on DFAT Website at: http://www.dfat.gov.au/publications/terrorism/chapter3.html, (accessed August 12, 2007).
33 At present, the IFSPs' are mainly located in Victoria and New South Wales in Australia.
34 Hussein, Jamila. 2006. "Islam's Shariah and Australian law", *The Brisbane Institute*, February, available online at: http://www.brisinst.org.au/resources/brisbane_institute_shariah.html, (accessed January 4, 2007).
35 Kerbaj, Richard. 2006. "NAB eyes 'untapped' Islamic finance market", *The Australian*, available online at: http://www.theaustralian.news.com.au/story/0,20867,20612928-2702,00.html (accessed January 4, 2007).

There are currently three key IFSPs in Australia that offer these services; typically *Murabaha, 'Ijara*, and *Musharaka* financing, which are generally used to purchase cars, homes, consumer durables and small businesses. Besides, the concept of Islamic finance is comparatively new in Australian society, and thus it has not been fully understood even by many Australian Muslims. Consequently, there is a need for both Muslims and non-Muslims to be informed on how the practices of IFSPs in Australia differ from conventional ones especially in the three major areas of housing, motor vehicles, and consumer goods financing in Australia. It is expected that such a process will provide the incentive needed for conventional finance providers to consider establishing Islamic banking branches and subsidiaries in Australia and to access this layer of funds for their competitive use.

While insignificant in comparison with the major financial services providers in Australia, the Australian IFSPs are now playing an important role,[36] and their customers[37] now include non-Muslims interested in the services provided by these institutions.[38] In the aftermath of the Asian economic trauma, Australia stands out as an investment opportunity as well as a financial centre. Through using IFSPs' financial services and investment vehicles their customers can reinforce the message that they are significant players in the global services economy. Consequently, in recent years, some international financial institutions like HSBC

36 According to a recent report provided by the Muslim Community Cooperative Australia Ltd. (MCCA) - one of Australia's leading IFSPs, its overall financial performance for the year 2003-2004 has been remarkable in comparison to the previous financial year. By June 2004, MCCA had a total of 5,824 active members and on average more than 60 new members were registered every month. In the financial year ending 30th June 2004, its revenues increased by 19.45%, profit from ordinary activities grew by 50.64%, total assets increased 11.22%, net asset had increased by 4.89% and there was an increase in share capital by 4.74%. See MCCA, "Financial Highlights for the Year Ended 30th June 2004", Treasurer's Report.

37 The two synonyms 'customers' and 'customers' have been used interchangeably and referred to the same persons/entities throughout this study although there seems to be a slight technical difference between the two as 'customers' are transaction-based and thus they are transient and mercurial associations, while the 'customers' are relationship-based and as such are long-term associations.

38 Saeed, Abdullah. 2001. "The Muslim Community Cooperative of Australia as an Islamic Financial Service Provider", Abdullah Saeed and Shahram Akbarzadeh (eds.), *Muslim Communities in Australia*, Sydney: University of New South Wales Press. p.189.

and Citibank are considering the introduction of Islamic banking branches and subsidiaries in Australia.[39] ANZ Banking Group Limited - a major Australia and New Zealand based international financial services group has already been offering Islamic financial services in some Muslim countries. In addition, it established special Islamic banking counters or branches in Western countries to capture these significant funds.[40]

1.2 Justification for Thesis

There is extensive trade between Australia and neighbouring countries such as Malaysia and Indonesia, who have been making significant inroads into the Islamic financial landscape.[41] Australia has also good trade relations with the Middle East particularly the Gulf States. A submission to the Joint Parliamentary Standing Committee on Foreign Affairs, Defence and Trade, on how to improve Australian business performance and maximise the opportunities for growth of its trade to middle-eastern countries, comments:

> "Islamic Banks throughout the Middle East and Malaysia, utilising the principles of Islamic banking and finance have proved successful over the years". [42]

39 Datamonitor Report. 2004. *Australian Mortgages 2004*, September, Datamonitor Website, available at: www.datamonitor.com/~ee1532b3e34d4986932858d8d0acf4ac~/Products/Free/Report/DMFS1726/010DMFS1726.pdf (accessed September 12, 2006).

40 The ANZ Group is originated in the UK in 1835 when the Bank of Australia was established by Royal Charter. ANZ in the UK now operates as a division of the Australia and New Zealand Banking Group Limited and is regulated by FSA (Financial Services Authority) in conduct of its investment business. Islamic finance is one of its major products. See for details, "ANZ United Kingdom – Country Information", available online at: http://www.anz.com/uk/countryinfo.asp

41 For example, along with its Western-style banks, Malaysia has become the epicentre for Islamic-style financial services and has set the benchmark for Islamic banking in the Asia Pacific region. See *The Australian*. 2007. January 16, available online at: http://www.theaustralian.news.com.au/story/0,20867,19383776-36181,00.html (accessed January 17, 2007).

42 Ayan, Abdul. 2004. "Inquiry into Australia's Trade and Investment Relationship with the Economies of the Gulf States", *A Submission to the Joint Standing Committee on Foreign Affairs, Defense and Trade: Parliament of Australia*, Melbourne, February 26. p.10.

The submission proceeds:

> "From an Australian perspective it is possible to approach these principles (*the principles of Islamic banking and finance*), particularly in relation to investment as ethical investment. From that point of view, ethical investments may be incorporated into a broader scheme or strategy of attracting investment funds from the Gulf States to Australia. It is very likely that such flexibility will enable Australia to capture a larger share of the investment outflow from these states than would otherwise be the case. Some investors may require validation by a Muslim knowledgeable in the field that their funds and the returns made on those funds have the ethical investment criteria and are in essence Halal".[43]

Given the geographical proximity of Australia to several Muslim majority nations, and given that some of its banks have the global presence to attract substantial business from the Middle-East; Islamic finance is a well of untapped potential. This requires practitioners, investors, traders and exporters to familiarise themselves with current Islamic finance practices in order to undertake business with Muslim customers and to engage in cross-border trade finance. In this connection, some common beliefs on Islamic finance need to be explained and clarified.

> First, that because *riba*[44] is forbidden in the Shari'ah - the Islamic legal system, Islamic finance is a non-productive system of financial management, which encourages the unproductive hoarding of assets.[45]

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43 *Ibid.*

44 Muslim jurists have defined *riba* as 'all forms of gain or profit which were unearned in the sense that they resulted from speculative or risky transactions and could not be precisely calculated in advance by the contracting parties'. See Frank E. Vogel and Samuel L. Hayes, III. 1998. *Islamic Law and Finance: Religion, Risk and Return*, The Hague: Kluwer Law International, pp.71-95. See also, Nabil A. Saleh. 1992. *Unlawful Gain and Legitimate Profit in Islamic Law*, 2nd ed., London: Graham & Trotman. pp.11-43. In the legal terminology of the *Shari`ah*, *riba* has been defined as "an increment, which, in an exchange or sale of a commodity, accumulates to the owner or lender without giving in return an equivalent counter value or recompense (*'iwad*) to the other party". See Al-Sarakhsi. 438H. *Al-Mabsut*. Egypt: Matba`ah al-Sa`aadah.

Secondly, the view that a financial system is not viable without interest and there exist no alternatives to interest-based investments.

Thirdly, that as Islamic financial system is predominantly based on contracts drawn up in the 7th century, it stands as an obstacle to the application of 21st century financing techniques; and

Fourthly, there is inadequate appreciation of the difference between trade and *riba* as set by the Shari`ah which while permitting the former, prohibits the latter. This is because in interest-based markets, money that accrues interest is viewed as a commodity like any other, and financial transactions are therefore categorised as trade.

This study proposes to respond to these and similar misperceptions held about Islamic finance. Since the study is mainly concerned with the Islamic finance industry in the Australian context, it will examine the relevant issues in light of the current practices of IFSPs in Australia.

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45 Prior to Islam the Judeo-Christian religious tradition had also banned interest in its original versions. See for example, Psalm 15:5 "Those who do not charge interest on the money they lend, and who refuse to accept bribes to testify against the innocent. Such people will stand firm forever". Leviticus 25: 36 "Do not demand an advance or charge interest on the money you lend them. Instead, show your fear of God by letting them live with you as your relatives". Nehemiah 5:7 "You are oppressing your own relatives by charging them interest when they borrow money!" Exodus 22:25 "If you lend money to a fellow Hebrew in need, do not be like a money lender, charging interest". Nevertheless, Christian theologians, responding to the rise of modern capitalism in Europe, no longer oppose charging interest on the money lent. The current Christian position on the issue is that money is viewed as a store of value and medium of exchange, and as such can be lent legitimately at interest rates determined by willing borrowers and lenders in open markets, as distinct from rates charged by loan sharks. For more elaboration on this issue see Bryan Bissell, "The Necessity of Biblical Economics", available online at: www.eslmission.org/resources.

1.3 Objectives of the Study

At the core of Islamic finance and banking is the balancing of material and spiritual welfare and maximisation of social benefit. Islamic finance seeks to address the issue by abolishing the concept of *riba* and *gharar*[46] from financial transactions. This is achieved through the adoption of a number of financing techniques and structures by IFSPs aimed to avoid *riba* and *gharar*.

The performance of IFSPs in Australia depends heavily on the extent to which the practice of these institutions adheres to Islamic legal principles and reflects well-established Islamic principles for financial transactions. Given this underlying requirement, the objective of this study is to investigate the degree of the Shari`ah compliance by IFSPs of Australia. In other words, this study will attempt to discover the extent to which IFSPs of Australia differ from strict Shari`ah compliance in their current practices of Islamic legal financial system by their use of different financial products and techniques. The purpose of this study is also to create awareness and transparency about the various products and instruments used by IFSPs of Australia.

The practice of modern Islamic finance in Australia has been chosen as the area of study because like in other parts of the globe, Islamic finance in Australia has been growing rapidly since it was first introduced in 1989 with Muslim Community Co-operative (Australia) Limited, better known as MCCA. Since then, a number of IFSPs have come into existence in

46 Literally, *gharar* means risk, uncertainty, and hazard. Technically, it is an element of deception either through ignorance and faulty description of the commodity or in its price, in which one or both parties stand to be deceived through ignorance of an essential element of exchange. Although the term *gharar* may equate to uncertainty and risk, these are things which occur in the normal course of doing business. But in the *Shari`ah*, the prohibition of *gharar* is related to its insistence on fair and ethical dealings, and on its lack of tolerance for unjustified enrichment.

the Australian financial services market during the past decade and some international financial institutions are also considering the introduction of Islamic banking branches and subsidiaries. [47]

To the author's knowledge no other study such as that attempted here exists, suggesting an urgent need for this investigation. With the above in mind, this study seeks to:

1. Undertake a comparative study of the following areas of finance in Australia: housing, motor vehicles, and consumer goods financing as practised by both Islamic and conventional finance in Australia;
2. Investigate the extent to which IFSPs in Australia adhere to the strict notion of Islamic financing in the three selected areas mentioned above;
3. Review the Shari`ah compliant issues vis-à-vis the ideals and actual practices of IFSPs of Australia under the existing regulatory environment.
4. Provide a comprehensive picture of Islamic finance practices in Australia in the context of Australian society.
5. Help expand Islamic finance which the Australian vibrant Muslim community can use comfortably as it meets their religious as well as market requirements.

1.4 Methodology of the Study

The methodology chosen for the study is through the Shari`ah, where law, finance, economics and business form a single dimension only, even though a very significant one.

47 Mirza, Malik and Halabi, Abdel. 2003. "Islamic Banking in Australia: Challenges and Opportunities", *Journal of Muslim Minority Affairs,* 23(2). p.8. See also, Elsayed, Kandil. 1997. "Islamic Finance: The Australian Experience", *Insight,* the Australian Foundation for Education and Welfare, Sydney.

Keeping this in mind, the study is heavily drawn from author's personal expertise and working experience with several Islamic banking and financial institutions for a considerable period of time, in addition to his active involvement with at least two of IFSPs in Australia. Given this, the methodology adopted in this study is as follows:

1. Examine the Australian legal framework within which IFSPs function in Australia.
2. Analyse the practice and functions of IFSPs in Australia with a view to determining the extent of their Shari`ah compliance.

For this purpose it:

a) analyses all accessible data such as annual reports, financial statements and other publications of IFSPs, as well as other regulatory compliance sources;

b) collects primary data to elicit information related to the working of the institutions and the practices followed by them; and

d) accesses all available data on the internet.

3. Examine the impact of the Banking Prudential requirements on IFSPs in Australia;
4 Examine the impact of the financial disclosure provisions of the corporations law with regard to Accounting and Auditing ; and
5. Examine the Revenue Law implications to Australian Financial Institutions.

There are several limitations to this study. All relevant data and information needed for the study could not be obtained by the author due to the limited access to IFSPs' data and information, and unavailability of adequate information in their official websites and other publications. Since the nature of any such studies involves the compliance - with the Shari`ah or otherwise - in the form of interviews or large-scale surveys the method employed in this study is a mixture of direct observation from the Shari`ah perspectives and author's personal experience, curiosity and association with this industry. Also, this study does not attempt to evaluate the economic efficiency and profitability or otherwise, of IFSPs in Australia.

1.5 Benefits of the Study

The present study is expected to make a significant contribution to the existing literature on Islamic finance law in Australia in general, and to Australian Islamic banking regulation law in particular. It will help create the legal framework that allows IFSPs in Australia to operate without relying on interest rate structures. Research into Islamic finance and Muslim communities has other national benefits as well. It will help strengthen Australia's existing trade and economic ties with its neighbouring Muslim countries and the wider Muslim world which can only benefit from a better understanding of the growing influence of Islamic business practices. Moreover, it will provide greater insights on how to tap into a small but very significant pool of funds to help Australian society and its economic development. Also, it will create an opportunity to bring in significant foreign direct investments into the country. Given this, the benefit of the study can be summed up as follows:

(1) Familiarise policy makers and the public with an overview of the Islamic financial services available to Muslims living in Australia and of the financial products and instruments used by IFSPs in Australia;

(2) Provide information on fundamental differences that may exist in the practices of Islamic and conventional financial services providers in Australia;

(3) Identify any differences in the current practices of Islamic finance from the traditional Shari`ah, namely in the areas of financing houses, motor vehicles and consumer goods.

(4) Inspire conventional bankers to incorporate Islamic financing structures into their credit packages.

(5) Change the stereotyped view many people have of Islam and Islamic finance.

1.6 The Plan of the Study

This study is divided into a number of chapters and sections. The organisation of the chapters of the study is as follows:

Chapter 1 provides an overview of the issues of Islamic finance. It also introduces the underlying background to the theory and practice of modern Islamic finance in order to provide the contextual background needed for the study.

Chapter 2 examines the primary, secondary and supplementary sources of the Shari`ah – the Islamic legal system.

Chapter 3 examines the application of the Shari`ah with special reference to main Schools of Islamic Theoretical Jurisprudence. It also sheds light on the application of financial transactions in Islamic legal system. In this connection, the Islamic legal maxims for financial transactions as well as philosophy and rules of transaction in Islamic law are dealt with.

Chapter 4 discusses the definition and categories as well as the key objectives and principles of financial regulation.

Chapter 5 elucidates historical evolution of both conventional and Islamic financial products and instruments, as well as the state of the art of Islamic financial products.

Chapter 6 highlights the Islamic finance practice in the Australian legal context. To this end, it discusses the developmental and regulatory issues of Islamic finance in Australia.

Chapter 7 examines the compliance requirements of IFSPs in Australia. This includes prudential standard requirements, compliance with core principles, disclosure and transparency requirements and consumer credit code of Islamic finance in Australia.

Chapter 8 undertakes a critical analysis of the financial instruments used by IFSPs in Australia with respect to housing, automobiles and consumer goods financing.

Chapter 9 investigates the extent of divergence of IFSPs in Australia from the traditional Shari`ah in their financial transactions. In this regard, a comparative study of Islamic and conventional finance is made with respect to housing, motor vehicles, and consumer goods financing.

Chapter 10 examines the appropriateness of the new UK regulatory framework for Islamic Banking and Finance, for adoption into Australia to make Islamic Finance viable alternative to conventional forms of financing in Australia.

Chapter 11 concludes the study with the summary and analytical findings of the study followed by an analysis of the implications of those findings for the field of modern Islamic finance in Australia from the perspectives of laws, regulations and practice. It also offers some suggestions and recommendations in line with the objectives of the study and for further research.

The study concludes with references cited and a glossary of Arabic terms used in it.

CHAPTER 2

THE SOURCES OF THE SHARI`AH – THE ISLAMIC LEGAL SYSTEM

CHAPTER 2

THE SOURCES OF THE SHARI`AH – THE ISLAMIC LEGAL SYSTEM

2.1 The Shari`ah: An Overview

The appreciation of the sources, fundamentals and application of the Shari`ah is imperative to understand law and practice of modern Islamic finance since they stem from this tradition. Before embarking on to the Shari`ah it is helpful to briefly explore the ideological framework of Islam since the reader has to firstly understand what Islam connotes, in an attempt to gain understanding of Islamic finance. Furthermore, to understand Islamic law, one must first understand the basic tenets of Islam. The Arabic word 'Islam' derives from *'aslama* which literally means 'to submit'; and its root word is *s-l-m* that stands for peace.[48] In a very comprehensive sense, Islam is the way of life ordained by Allah for mankind through all of His Prophets, the finality of which gained with the message of Prophet Muhammad (PBUH).[49] The Shari`ah is the path to receive this message.[50] In Islam, Allah is the source of authority and the sole sovereign lawgiver.[51] The Shari`ah as Muslims believe is Divine and eternal, not in letter but rather in spirit.[52]

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48 See Hans Wehr. 1976. *A Dictionary of Modern Written Arabic*, New York. pp.424-425.

49 The abbreviation 'pbuh' stands for 'peace and blessings be upon him' (i.e. Prophet Muhammad), which is the meaning of the Arabic phrase *'salallahu alaihi wasallam'*. Muslims are required to utter this phrase after mentioning the name of the Prophet Muhammad as ordained by Allah in the Qur'an. See Al-Qur'an, 33:56. [The numbers in parentheses are those of the *surah*s (chapters) followed by the *ayah*s or the shortest division of the Qur'anic text (but not the verse as the term 'verse' is not appropriate since the Qur'an is not poetry rather it is rhythmic)].

50 Esposito, J.L. 1985. *Islam: The Straight Path*. New York: Oxford University Press. p.39.

51 See Al-Qur'an: 12:40, also 7:54. [The numbers in parentheses are those of the *surah*s (chapters) followed by the *ayah*s or the shortest division of the Qur'anic text or the verse. (The term 'verse' is not appropriate since the Qur'an is not poetry rather it is rhythmic.)]

52 Faruqi, Ismail R. 1988. "Islamisation of Knowledge: Problems, Principles and Perspectives", *Islam: Sources and Purpose of Knowledge.* Virginia: International Islamic Institute of Thought. p.34.

The Shari`ah refers to the Islamic legal system or tradition, otherwise known as Islamic law or law of Islam.[53] The Shari`ah is an all-inclusive code of conduct, fundamental to the moral, ethical, spiritual, social as well as legal aspects of a Muslim's private or public life.[54] Islamic law represents one of the world's great legal systems. Like Judaic law, which influenced Western legal systems, Islamic law originated as an important part of the religion. Although the Shari`ah differs from Western legal tradition in many respects there are some similarities as well. Like most Western legal systems the Shari`ah is a positive system of law and not merely religious law. Additionally, both systems apply judge made law using the case law method in their own peculiar ways.[55]

The word Shari`ah literally means 'the clear, well-trodden path to water' or a 'break in a riverbank allowing access to water' that leads to a main stream, a drinking place, and a road or the right path.[56] From this meaning, the Shari`ah was used to refer to a path or a passage that leads to an intended place, or to a certain goal. Etymologically, *Sahri`ah* is derived from the root *shara`a,* which means 'to introduce' or 'prescribe,' and is the canonical law of Islam as put forward in the Qur'an[57] and the *Sunnah*,[58] and elaborated by the analytical principles

53 Terms such as 'Islamic legal system', 'Islamic law', and 'law of Islam' have been used interchangeably in this entire work to refer to the *Shari`ah.* However, in no where the term '*Shari`ah*' is used in this regard as the *Shari`ah* extends beyond law and it is the totality of religious, political, social, domestic and private life, and as such calling it '*Shari`ah*' can be misleading. For detailed discussion on this argument see *Encyclopaedia of the Orient*, available online at: http://i-cias.com/e.o/sharia.htm, (accessed July 20, 2007).

54 Shahid, F. Hassan. 2005. "Re-examining Primary and Secondary Sources of Shariah", *The American Muslim*, April-June, available online at: http://www.theamericanmuslim.org/2005apr_comments.php?id=736_0_38_72_C, (accessed July 20, 2007).

55 See "The Logic of Legal Reasoning in Religious and Non-Religious Cultures: The Case of Islamic Law and Common Law", *The Cleveland State Law Review*. 1986. vol.34, No.1. pp.79-80. Reprinted in *Comparative Legal Cultures*, (Csaba Varga ed.), Hampshire: Dartmouth Publishing Co., 1992. pp. 401-418.

56 Baalabakki, Rohi. 1992. *Al-Mawrid: A Modern Arabic-English Dictionary*, Beirut: Dar El-Malayin, 4th ed. p.669.

57 The Holy Book that Muslims believe is the Word of Allah as revealed to the Prophet Mohammad (pbuh). The more elaboration on the Qur'an will follow in Sub-section 2.2.1.1.

58 The traditions (i.e. sayings, judicial decisions and customs) of the Prophet Muhammad. The detailed discussion on the *Sunnah* will follow in Chapter 2 of this study.

of the *madhahib*[59] or Schools of Islamic law. By its origin, nature, and purpose it is intimately bound up with the religious ethic. Therefore, Islamic law, in theory, is not restricted to any specific fields of law.

Given the above, the Shari`ah conceptually refers to a set of rules, regulations, teachings and values governing the lives of Muslims. The Shari`ah embraces worship, morals and conduct. It also embraces the political, social and economic and other spheres. As a means of regulating society, the Shari`ah attempts to secure the rights of all human beings and by so doing, enjoins upon them certain responsibilities geared towards protecting these rights.[60]

The Shari`ah is defined as the laws and way of life prescribed by Allah - the Supreme Lawmaker for His servants. Thus, the Shari`ah deals with the ideology and faith; behaviour and manners; and practical daily matters.[61] The Shari`ah as dictated by Muslim lawmakers is believed to be merely a human estimation of the Divine and eternal correct path. By doing so they are not, thus, actually creating right or wrong actions, but to a certain extent trying to deduce Divine will.[62]

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59 Plural of *madhhab* which is derived from the root *'dhahaba'*. Literally means: 'to go' or 'to take as a way'. Technically, a scholar's choice in regard to a number of interpretive possibilities in deriving the rule of Allah from the primary texts of the Qur'an and the Sunnah on a particular question. In a larger sense, a *madhhab* represents the entire school of Islamic jurisprudence of a particular jurist. The term *madhhab* is translated in this study as 'juristic school of Islamic law', 'school of Islamic jurisprudence', 'school of Islamic law', 'Islamic school of law' 'Islamic school of thought', 'religio-legal thought,' and 'Islamic jurisprudential school'.

60 See Zamir Iqbal, *supra* note 8.

61 See the Qur'an 5:48. It says: "To each among you, we have prescribed a law and a clear way".

62 See Wikipedia website under the word "Sharia", available online at: http://en.wikipedia.org/wiki/Sharia

The Shari`ah is as complex as the Common Law.[63] In other legal systems, where there differences of interpretation and emphasis may occur due to the changes in place and circumstance the need for re-evaluation of old rules in the light of modern conditions is felt in the case of Islamic law as well. This can be done in the latter without sacrificing the basic principles laid down in the Qur`an and the *Sunnah*. However, unlike the common law court, the Shari`ah court is not based on case law; the judge does not have to follow precedents and is not bound by the decision of previous cases. The judge applies the verdict of Allah by virtue of his knowledge of the Shari`ah.[64]

Although the Shari`ah is one of the three major world legal systems: Roman [civil] law, Islamic law, and common law in the modern world,[65] it is the complete legal system of only a very few countries namely Saudi Arabia, Iran, Sudan and some states in Nigeria that implement its criminal law.[66] The majority of Muslim countries have mixed legal systems. Most countries of the Middle East and North Africa maintain a dual system of secular courts and religious courts, in which the religious courts mainly regulate marriage and inheritance. They have adopted aspects of the civil law or Common Law systems in areas of public law. In Australia, Muslim migrants bring the Shari`ah with them as their private law, and in only a very few instances does it come into conflict with Australian law.[67] In the area of family law, the *Marriage Act*1961 permits Muslims to marry in compliance with both Australian and

63 Even though contemporary writings on Islamic transactions law always cite Canonical Texts i.e. the Qur'an and the *Sunnah* to support their opinions, Islamic transactions law is at heart a common-law system. Indeed, contemporary developments in Islamic finance owe more to contemporary juristic understandings of the Canonical Texts, and previous juristic analyses, than they owe to the Canon itself. See for more discussion on this argument, Mahmoud A. El-Gamal, "Interest and the Paradox of Contemporary Islamic Law", Houston: The Rice University Department of Economics, The Rice University Website available at: http://www.ruf.rice.edu/~elgamal/files/interest.pdf.

64 Hamzeh, A. Nizar. 1994. "Qatar: The Duality of the Legal System", *Middle Eastern Studies*, London, vol.30, No.1, January. pp.79-90

65 Gamal Moursi Badr. 1978. *Islamic Law: Its Relation to Other Legal Systems*, 26 Amer. J. Comp. L. p.187.

66 See Jamila Hussein, *supra* note 34.

67 *Ibid.*

Islamic law at the same time.[68] Australian Muslims are now allowed to maintain interest free transactions with the local IFIs in accordance with the tenets of the Shari`ah.

2.2 The Sources of the Shari`ah

In order to have an insight into the complexity of the Islamic legal financial system the reader has to comprehend the ideas behind the different sources of Islamic legal system. As the Shari`ah is believed in theory, to regulate all aspects of private and public life and form the basis of political theory it goes far beyond the limits of any Western financial law code. Since the bases of Islamic law and jurisprudence have been laid down in the Shari`ah mainly in its revealed sources i.e. the Qur'an and the *Sunnah*, thus immutable and absolute, but not rigid; it is unchanging in its requirements, but not too tight in procedures and practices. It is adaptable to different situations and circumstances while its rules are adaptable and suitable to all times and environments.[69]

The Shari`ah has several sources from which needs to draw its guiding principles. It does not rely upon one source for its broad knowledge base. The whole corpus of the Shari`ah code has been drawn from two major sources: (1) the primary sources, and (2) the secondary

68 See "Commonwealth of Australia Law", under Section 26 of the Marriage Act1961. Commonwealth of Australia Law website available at:
http://www.comlaw.gov.au/comlaw/Legislation/ActCompilation1.nsf/0/CEA0997407C6D261CA25717E00812B91?OpenDocument

69 Unlike the Bible or Torah, the Qur'an has remained virtually unchanged since its inception. Although it was translated by the Prophet Muhammad to whom it was revealed, the original Arabic language has not changed its meaning and has in fact helped preserve the Arabic language so that it is found in its ancient form even today. All versions of the Qur'an are said to be identical and thus, study of the legal mandates of the Qur'an are easy to ascertain without argument on the content of the original text. Argument on what the Qur'an states on a matter then merely resides on the interpretation of the text.

sources. The primary sources of the Shari`ah are: i) *Al-Qur'an*[70] and ii) the *Sunnah* or tradition of Prophet Muhammad (PBUH). The secondary sources of the Shari`ah mainly include i) the *'Ijma`* or the scholarly consensus; and ii) the *Qiyas* or decision by analogical reasoning. There are some disputes among jurists on the usage of the secondary sources of the Shari`ah namely the *'Ijma`* and the *Qiyas.* The Shi`i School[71] vehemently rejects the *'Ijma`* and the *Qiyas* as secondary or derived sources of the Shari`ah. According to Shi`a, the sources of the Shari`ah are the Qur'an, anecdotes of the Prophet's[72] practices and those of the 12 *Imams*, [73] and the intellect *(`aql).* While Sunni Schools consistently base their *Ijtihad*[74]on these secondary sources since the purpose of *Ijtihad* stems from certain basic principles.[75]

While the Qur'an, the *Sunnah,* the *'Ijma`* and the *Qiyas* have been considered as the main sources (i.e. primary and secondary sources) of the Shari`ah by all Schools of Islamic Law and jurisprudence (*Hanafi*s, *Maliki*s, *Shafi`i*s and *Hanbali*s), there are other principles considered as a source of the Shari`ah by some Muslim scholars. These additional principles are considered as supplementary sources.[76] However, one has to acknowledge the fact that

70 The use of Al-Qur'an and the Qur'an has been used interchangeably throughout this work to mean the Devine Book Qur'an revealed to the Prophet Muhammad.

71 A detailed discussion on the Sunni and Shi`i Schools of Islamic Law will follow in this study in Chapter 3.

72 The word 'Prophet' is referred in this study to Prophet Muhammad the Final Messenger of Allah.

73 Literally, imam is 'leader'. According to the Shiite belief, imams are the representatives of Allah and are infallible and therefore should be obeyed in all matters and under all circumstances. The Sunni school, on the other hand, does not hold any such belief.

74 Literally, 'Ijtihad is 'effort'. Technically, it is the intellectual effort of Muslim jurists to reach independent religio-legal decisions. Sub-section 2.2.3.5 of this study discusses on `Ijtihad in more elaboration.

75 These principles include: 1) Allah is All-Powerful, All-Knowing, 2) Allah created laws for humankind and only He has the authority to do so, 3) Allah appointed messengers to convey the laws to humankind, 3) Allah appointed imams to guide humankind about the laws.

76 Bassiouni gives an example of how some scholars might classify Islamic sources of law as: 1. Chief Sources, which includes: the *Qur'an*, the *Sunnah,* the *'Ijma`,* and the *Qiyas;* 2. Supplementary Sources, which includes: the *Istihsan,* the *Istislah*, and the *`Urf*. However, According to Hamidullah, these are: a. The Qur'an; b. the Sunnah; c. the orthodox practice of the early Caliphs; d. the practice of other Muslim rulers not repudiated by the juristic consults; e. the opinions of celebrated Muslim jurists; f. the arbitral awards; g. the treaties, pacts and other conventions; h. the official instructions to commanders, admirals, ambassadors and other states officials; i. the internal legislation for conduct regarding foreign relations and foreigners; and j. the *`Urf*. For details see M. Cherif Bassiouni. 1982. "Sources of Islamic Law, and the Protection of Human Rights in the Islamic Criminal Justice System", *The Islamic Criminal Justice System*, M. Cherif Bassiouni (ed.), London: Oceana Publications, Inc.

these supplementary sources are greatly controversial. Some jurists and legal scholars view them as acceptable sources of the Shari`ah and treat the decisions established on their basis as obligatory, while others do not agree with this view. The controversial sources referred to are: the *`Urf* or customary practice of the community; the *Istihsan* or Juristic preference; the *Maslaha* or public interest; the *Istishab* or legal presumption; and the *Ijtihad* or individual reasoning.[77] If the law is given directly in the primary sources, one cannot sort to the secondary and supplementary sources, except for the detailed explanation of the texts in the Qur'an and the *Sunnah*. Similarly, if the matter can be resolved from the secondary and supplementary sources, one cannot move to sources next to it, and so on.

2.2.1 The Primary Sources

The Shari`ah is essentially derived from the Qur'an and the *Sunnah* of the Prophet Muhammad (PBUH). There is no disagreement among Muslims that the Qur'an is the basis of the Shari`ah and that its specific provisions are to be observed, and the *Sunnah* is complementary source to the Qur'an and consists of the sayings of the Prophet and accounts of his deeds. Therefore, the Qur'an and the *Sunnah* are considered to be the fundamental or the primary sources which are consulted in order to gain the legal position for the matters of law. Through the system developed by the Islamic law, the life and biography of the Prophet as well as his teachings as have come down to followers of Islam through his companions'

77 There are other sources as well outside the sources mentioned here. They include Arab Bedouin law, commercial law from Makkah, and the law of some conquered nations such as Roman and Jewish law. See for details, *Encyclodictionalmanacapedia*, under the topic "Sharia", available online at: http://www.answers.com/topic/sharia

traditions, the *hadith*,[78] form a significant part of the law. An in depth discussion on the two primary sources of the Shari`ah is as follows.

2.2.1.1 *Al-Qur'an*

Al-Qur'an is the main source of reference for establishing the fundamental principles and laws of Islam covering basically every aspect of the religion. It provides the basis for a practical code of conduct for everyday living as far as social etiquette and behaviour and human relations are concerned. It also contains the framework for the matters of faith.

The word *Al-Qur'an* literally means 'the reading' or 'the recitation'. It is the first most important source of the Shari`ah. Muslims believe that the Qur'an is the literal word of Allah and culmination of Allah's revelation to mankind, revealed to the Prophet Muhammad (PBUH) over a period of 23 years through the angel Gabriel.[79] Although the major parts of the Qur'an was revealed in accordance with the episodes occurred during the time of the Prophet, and through questions asked and answered by him, the Qur'an was used as a source of his own teaching and arbitration. It is therefore, difficult to understand the Qur'an's true spirit unless one is familiar with the historical background involving a particular ruling. The

78 According to scholars of Prophetic Tradition the *hadith* stands for 'what was transmitted on the authority of the Prophet, his deeds, sayings, tacit approval, or description of his physical appearance'. However, the term was used sometimes in much broader sense to cover the narrations about the companions of the Prophet and successors to his companions as well. See M. M. Azami, "Studies in *Hadith* Methodology and Literature", *Compendium of Muslim Texts,* quoted in 'Hadith', available online at: http://www.usc.edu/dept/MSA/

79 See Al-Qur'an, 26:193.

linguistic complexities of Qur'anic Arabic must also be comprehensively understood before laws are formulated.[80]

The verses which deal with the legal matters are not many as mentioned by Imam Al-Suyuti for instance, that five hundred verses of the Qur'an have legal connotation.[81] It had attracted criticism from non-Muslim Orientalists to undermine legal and legislative nature of the Qur'an. The main controversy seems to centre around the question whether legal injunctions of the Qur'an were mainly revealed in accordance with the need arose for lawmaking on administrative and legislative issues when the Prophet established a government in Medina,[82] or the legal injunctions of the Qur'an form a coherent and consistent body. In fact, the verses of the Qur'an were not concerned simply with offering spontaneous solutions to particular problems that had arisen, but they aim to fit the solution into a theoretical framework.[83]

Given this, the contents of the Qur'an cannot be categorised according to topics rather its various topics appear in unanticipated places and in no specific thematic order. This fact has led many thinkers to conclude that the Qur'an is an inseparable whole, thus its legal segments should not be interpreted in isolation from its ethical teachings.[84]

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80 Irshad, Abdal Haqq. 2002. "Islamic Law: An Overview of its Origin and Elements", *The Journal of Islamic Law and Culture*, vol.7, No.1. pp.27-82.

81 Al-Suyuti, Jalal al-Din. 1987. *Al-'Itqan fi `Ulum al-Qur'an*, Beirut: Dar al-Kutub al-`Ilmiyyah, vol.1. p.6.

82 Also transliterated into English as Madinah; officially Al- Madinah Al-Munawwarah, is a city of western Saudi Arabia, and serves as the capital of Al-Madinah Province. It is the second holiest city in Islam, and the burial place of Prophet Muhammad. The ancient name of Medina was Yathrib which was later renamed *Madinatur Rasul* (the city of the Prophet) after the Prophet's migration to this city.

83 From this premise there is a principle in Qur'anic exegesis that is commonly accepted and applied by the majority of exegesist, which says: "The rule is to be interpreted from the generality of the expression and not from the specific occasion" (*Al-'ibratu bi 'umumi al-lafzi la bikhususi al-sabab*).

84 See M. M. Al-Azami. 2003. *The History of the Qur'anic Text from Revelation to Compilation: A Comparative Study with the Old and New Testaments*, Leicester: UK Islamic Academy.

Out of 350 verses of the Qur'an pertaining to the legal matters, around 140 relate to theoretical and practical obligations such as faith and devotion to Allah, ritual prayer, charity, fasting, pilgrimage, and so on. Another 70 verses are dedicated to marriage, divorce, paternity, child guardianship, inheritance etc. The set of laws concerning commercial and or financial transactions comprise the subject matter of another 70 verses, and above 10 of economic affairs. While close to 30 verses relate to crimes and punishment, another 30 discuss the issues concerning justice and fairness, equality and impartiality, facts and evidences, roles and responsibilities of citizens, and consultation in administrative affairs.[85] It is possible to draw a legal verdict from the parables and historical passages of the Qur'an. Some of the previous decrees of the Qur'an were also abrogated and replaced because of the latest circumstances, although the jurists have disagreements regarding the scope and precise introduction of this abrogation.

Given the above statement regarding the Qur'an, it can be concluded that the Qur'an is not a set of laws, rather it is a book of general guidance which treats legal matters with much integration to the codes of values and ethics. This makes the Qur'an an eternal guidance appropriate to the entire mankind without the limit of time and space.

85 *Ibid.*

2.2.1.2 The *Sunnah*

The *Sunnah* of the Prophet Muhammad (PBUH) is the second source of the Shari`ah.[86] The *Sunnah* is the established practice of the Prophet Muhammad (PBUH) first witnessed by his companions, and subsequently reported through the transmission of *ahadith*.[87] In other words, the *Sunnah* is the teaching and exemplary conduct of the Prophet Muhammad (PBUH), including his sayings, acts, and implicit approval of the conduct of his companions and some of the customs of Arabian society. The *Sunnah* corroborated the rulings of the Qur'an; explained some of the injunctions, laws and practical matters which are briefly reported in the Qur'an; and gave some rulings regarding matters not unequivocally stated in the Qur'an.

The Prophet Muhammad's (PBUH) verdict on what is legally recognised and what is not, strikes an equal balance with the Qur'an. The sayings of the Prophet, as the Qur'an indicates, are inspired by Allah,[88] and submission to them is every believer's obligation.[89] Therefore, the Prophet's sayings were setting standards for those who truly heard them. However, successive Muslim generations who received the Prophet's words through different sources had to establish their accuracy before acknowledging them as setting standards.

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86 The Qur'an itself indicated the authority of *Sunnah* as a source of the *Shari`ah* as next to it. For example, the words of the Prophet, as the Qur'an declares, are divinely inspired (Al-Qur'an, 53:3), and obedience to them is every Muslim's duty (*ibid*, 4:80; 59:7). However, there were some disagreements on the exact meaning and authority of the *Sunnah* until the jurist Imam Shafi`i addressed the issue in the early ninth century. The Shafi`i school of law emphasised the normative status of *Sunnah* as a source of revelation which explained and supplemented the Qur'an. See M. Hashim Kamali. 2000. "Law and Society: The Interplay of Revelation and Reason in the Shariah", *Oxford History of Islam,* Oxford University Press.

87 Whereas *Sunnah* is the established practice of the prophet, *ahadith* (the plural of *hadith*) are merely reports of words or deeds that may or may not have originated from the Prophet Muhammad. Hence, the two cannot be used synonymously, as is often the case.

88 See Al-Qur'an, *supra* note 81 at 53:3.

89 Al-Qur'an, 4:80; 59:7.

There are some *Sunnah* of the Prophet that are based on a particular culture and tradition, and this type of *Sunnah* is not considered as legislation for Muslims at all. This type refers to his preference in food, ways of talking, looking and walking, and the colour and type of his dress, etc. This type of *Sunnah* is known as non-legislative *Sunnah* and it is not a part of the religion, meaning Muslims are not obliged to follow it.

However, the *Sunnah* and the Qur'an interrelate in many ways. With regards to its relation with the Qur'an the *Sunnah* may:

1. Merely endorse the Qur'an;
2. Illuminate components of the Qur'an having different meanings;
3. Detail common rulings of the Qur'an;
4. Contain verdicts about which the Qur'an did not speak. In these cases it is not only an explanation and supplement to the Qur'an, but it represents an independent source of the Shari`ah.

Contrary to the above mentioned definition of *Sunnah* given by the Sunnis, the Shiites' definition includes the sayings, deeds, and implied approvals of the Prophet and the *Imam*s. Also, contrary to the viewpoint which holds that the prospect of *Wahi* or Divine revelation stopped with the demise of the Prophet Muhammad (PBUH), the Shiites view that Divine revelation is persistent to be passed on after the Prophet's passing away, through the line of their acknowledged *Imams*. Given this position, Shiite jurists upheld that in addition to the

Qur'an and the *Sunnah*, the statements of their *Imams* constituted Divine revelation and therefore obligatory law.[90]

2.2.2 The Secondary Sources

As discussed earlier in this section that apart from the primary sources the entire body of the Shari`ah code has also been derived from its secondary sources. These sources are regarded as law and rules of interpretation of the Qur'an and the *Sunnah* which follow in accordance with a generally accepted jurisprudential scheme. A brief discussion on these secondary sources will follow in subsequent sub-sections.

2.2.2.1 The *'Ijma`* or Scholarly Consensus

The Arabic term *'Ijma`* literally means 'collecting' or 'assembling'. It is also used for consensus, that is, acceptance of a particular matter by a specified group of people. In the terminology of the Shari`ah, *'Ijma`* refers to the consensus of the community of those practicing Islam, or of those learned in the relevant topic. The Shari`ah outlines specific means of consensus decision making which Muslims are to follow in making and enforcing law. According to the Sunni School of jurisprudence the *'Ijma`* is considered one of the fundamental sources of the Shari`ah. It was based on the principle that when no unambiguous direction was given by the Qur'an or the *Sunnah* on a principle of law the consensus of the community would be sought. All four Sunni Schools accept this principle as

90 See M. Hashim Kamali, *supra* note 86.

the basis of the Shari`ah and regard each of it as approved although they differ with regard to the particular importance each School attaches to *'Ijma`* relative to the Qur'an and the *Sunnah*.[91]

The dogma of *'Ijma`* was introduced in the 8th C.E. in order to standardise legal theory and practice and to overcome individual and regional differences of opinion.[92] However, there are great differences of opinion as to up to what period in the history of Islam *'Ijma`* can be accepted. Some scholars assert that only the *'Ijma`* of the companions of the Prophet Muhammad (PBUH); others, that of those who were not only companions but descendants of the Prophet, can be accepted; whilst other accept the *'Ijma`* of the dwellers in Medina among his companions during his lifetime. The majority of Muslim jurists, however, appear to think that *'Ijma`* may be collected in every age.[93]

There is no agreement among jurists as to which statements in the Qur'an and the *Sunnah*, if any, provide validation for the notion of *'Ijma`*. Generally the jurists see a justification for the notion in the Qur'anic verses: 2:143, 3:103, 3:110, 4:59 and 4:115. The Prophetic *hadith* 'The people of my nation will never get together on an error' is often cited as support for the authority of *'Ijma`*.[94] However, this *hadith* attributed to the Prophet is not entirely authentic for the following reasons.

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91 Hughes, Thomas Patrick. 1996. "Ijma", *A Dictionary of Islam*, Laurier Books Ltd.; New ed., June. Also available online at: http://muslim-canada.org/ijtahad.pdf

92 See "Islamic Religion", *Crystalinks*, available online at: www.crystalinks.com/islamic.html, (accessed August 20, 2005).

93 See Thomas P. H, *supra* note 91.

94 See Muhammad b. Isa al-Tirmidhi, *Jami` al-Tirmidhi*. 1999. Vol.4, No. 2167. Riyadh: Darus Salaam. The full text of the *hadith* reads on the authority of `Abdullah Ibn `Umar from the Prophet who said: "Verily my Ummah would not agree (or he said: "the Ummah of Muhammad") would not agree upon error and Allah's hand is over the group and whoever dissents from them departs to Hell".

1. A ruling rendered on a specific event in a particular period may not necessarily address the same issue sufficiently in another time.
2. It does not recognise the need for a continuos flow of fresh interpretations of the rulings of the Shari`ah, particularly when there appears to be a contradiction between its stated goals and varied applications.
3. One of the purposes of *'Ijma`* is to limit differences and to prevent them from disintegrating the Muslim society. But *'Ijma`* has not been as effective in ensuring cohesion of the society and in providing answers to new questions.
4. It is often extremely difficult to know whether or not *'Ijma`* on a matter has taken place. In other words, it is not known exactly what *'Ijma`* is or what it is saying.

The perceptions established in the *'Ijma`* are not found unequivocally in the Qur'an or the *Sunnah*. Islamic judges are able to examine the *'Ijma`* for many possible solutions which can be applied in a modern technical society.[95] They are free to create new and innovative methods to solve social problems based upon the concepts found in the *'Ijma`*. These judges have great discretion in applying the concepts to a specific problem within the limits set by the Qur'an and the *Sunnah*.[96]

95 The Shi`as however would prefer to look to *imams* and to meet this need. But the acceptance of any particular *imam* will finally also depend on the acceptance and consensus of the followers.
96 Madkoar, M. Salam, "Human Rights from an Islamic Worldview: An outline of *Hudud, Ta'zir* & *Qisas*", available online at: http://www.iol.ie/~afifi/Articles/hrights.htm (accessed August 15, 2007).

2.2.2.2 The *Qiyas* or Decision by Analogical Reasoning

Among the standard bases on which Islamic legal system is built, while the Qur'an, the *Sunnah* and the *'Ijma`* are easy to identify the *Qiyas* has been identified by various terms with widely disparate meanings, as *ra'y* or juristic opinion*, Ijtihad* or the exercise of independent reasoning and otherwise.

Literally, the Arabic word *Qiyas* means, 'comparing with' or 'judging by comparing with a thing'. In Islamic legal technical term it is analogical reasoning as applied to the deduction of juridical principles from the Qur'an and the *Sunnah.*[97] In other words, *Qiyas* is the attempt through analogical reasoning to determine how the principles of the Qur'an and the *Sunnah* could be applied to a situation not clearly addressed through these sources. It is used as judicial reasoning to apply a recognised law to new circumstances not covered in the original law. As an example of analogy in Islam, Muslims are not allowed to drink wine, but narcotics and solid intoxicating substances are not mentioned in the Qur'an and *Sunnah.*[98] Jurists have applied this disallowance by making an analogy to other liquid intoxicants and drugs. They stated that the Islamic sources gave as the reason for prohibiting wine that it intoxicates. Given this original ruling, other intoxicating substances were also outlawed by analogy.

In pure legal terms, The *Qiyas* are new cases or case law which may have already been decided by a higher judge. The Shari`ah judge can use the legal precedent to decide new case law and its application to a specific problem. The judge can use a broad legal construct to

97 Encyclopaedia Britannica Online, "Qiyas", available at: http://www.britannica.com/eb/article-9062126/*Qiyas*
98 See Al-Qur'an, 2:219, 5:90, and 7:33.

resolve a very specific issue. For example, a computer crime or theft of computer time is not found in the Qur'an or *Sunnah*. The act of theft as a generic term is prohibited so the judge must rely on logic and reason to create new case law or *Qiyas*.

2.2.3 The Supplementary Sources

The supplementary sources are those which are referred to in order to resolve the matters of law which have no specific mention in the Qur'an and the *Sunnah* of the Prophet Muhammad (PBUH) and in the secondary sources of the Shari`ah. In other words, the supplementary sources are employed when no definite legal standpoint can be reached from either the primary or the secondary sources. A detailed discussion on these supplementary sources is as follows.

2.2.3.1 The *`Urf* or Customary Practice of the Community

Scholars are almost unanimous in their opinion that *`Urf* or custom is not only the oldest source of law, but also an important one that has shaped the different legal systems in traditional societies.[99] Literally, *`Urf* is the custom and common usage of a community. It has been defined in Islamic law and jurisprudence as recurring practices which are acceptable to people of sound nature. The word *`Urf* is mentioned in the Qur'an, mostly to mean 'good', 'adherence to Allah's injunctions' though,[100] it has been used in the sense of custom also in

99 Rene David and J. E. C. Brierly. 1978. *Major Legal Systems in tile World Today: An Introduction to the Comparative Study of Law*, New York. p.423. See also, Henry W. Ehrmann. 1976. *Comparative Legal Cultures*, New Jersey: Prentice-Hall. p.21.

100 See Al-Qur'an, 7:199

some places in the Qur'an with regard to maintenance of children.[101] The Shari`ah, therefore, has in principle approved custom in determination of rules regarding lawful (*halal*) and unlawful (*haram*). Muslim jurisprudent also adopted *`Urf* in the determination of the rulings of the Shari`ah.

A rule propounded by the jurists is that what is proven by *`Urf* is alike that proven by the Shari`ah. However, this rule is applicable when the *`Urf* of Muslim societies is not in conflict with the rules, essence and spirit of the Shari`ah. With regard to the *`Urf* of non-Muslim societies it must be examined with much care. Maliki like Hanafi Islamic School of law makes use of *`Urf* and considers it a legal principle in respect of matters about which there is no definitive text from the Qur'an and the *Sunnah.* It appears that the Shafi`i School also takes *`Urf* into consideration when there is no definitive text, but it forbids acting by custom when it is opposed to a legal text, or is not suggested by it. This indicates that the Shafi`i occasionally adopt *`Urf*, but with the precondition that a legal text suggests it or does not contradict it.

The established customs in Arabia in the lifetime of the Prophet Muhammad (PBUH) and which were not overruled by the Prophet are treated to have received his tacit approval and considered as a part of the *Sunnah*. An example of this is payment of blood money to the family of murdered by *`Aqilah*, where payment of blood money has been agreed upon.[102]

101 See Al-Qur'an, 2:233

102 The dogma of *al-'Aqilah* had been practised among the primitive Arab tribes, in which it was an implied mutual agreement among the tribes that, if anyone is killed by mistake by a person of a different tribe, the murderer's paternal relative used to take the responsibility to make a mutual contribution for the purpose of paying the blood money on behalf of the murderer, to the victims' relatives. This doctrine later recognised by the Prophet Muhammad in one of his judgments against a woman from the tribe of Huzail. This is a foundation doctrine based on which today's Islamic insurance practices have been developed.

Another example of making use of *`Urf* or custom is taken from an instance when the Prophet said to the wife of Abu Sufyan, "Take from the property of Abu Sufyan what is adequate for you and your child in a normal manner". In this *hadith* custom is clearly made the basis of a legal decision.

The *`Urf* is validated when the following conditions are met:

1. *`Urf* must be common and recurrent.
2. It must be in practice at the time of transaction.
3. The *`Urf* must not contradict the rules, essence and spirit of the Shari`ah. Therefore, if drinking wine, gambling, or infanticide[103] is accepted by custom this does not mean that they are valid.
4. It must not contravene the terms of a valid agreement according to the Shari`ah. So, what is accepted by custom is tantamount to a stipulated agreement. However, if a contractual stipulation, for example, overrules *`Urf,* it is the contract that should be followed. For instance, if the custom of a certain country that men pay half the dower after consummating marriage, and if the concerned parties agree that a man will pay the entire dower in advance, then *`Urf* is abrogated.

2.2.3.2 The *Istihsan* or Juristic Preference

'Istihsan literally means 'to deem something preferable'. In broad sense, *Istihsan* means to see quite independently, without taking similar cases into account, what is nearest to the truth

103 The practice of killing newborn infants. The 'Infanticide Act' is the name for a number of laws introduced into UK law that recognised the special nature of the killing of an infant child by its mother during the early months of life.

and to justice, and to give one's opinion according to one's inclination and intellect approve. In its juristic sense, *Istihsan* is a method of exercising personal opinion in order to stay away from any strictness and injustice that might result from literal application of law. In other words, it is a deviation, on a certain issue, from the rule of a precedent to another rule for a more relevant legal reason that requires such deviation.

The following different definitions have also been given by the jurists for *'Istihsan*:

1. Issuing a verdict by jurisprudent only because it seems fine to him.

2. An argument in the jurisprudent's mind which he cannot express it in words.

3. Substituting any arguments for the accepted facts for the benefit of the people.

As an important source of Islamic law and jurisprudence *Istihsan* is an integral part of the Shari`ah, as such it has played a prominent role in adaptation of Islamic law to the changing needs of society. The majority of jurists such as Hanafi, Maliki and Hanbali jurists have accepted *Istihsan*. The principle of *Istihsan* is developed by Hanafi School. The Malikis developed a similar principle of equitable jurisdiction which they termed *Istislah*. However, in contrast to the Hanafis the Malikis never took full advantage of this form of judicial preference or equitable jurisdiction but applied it very cautiously. On the contrary, Imam Al-Shafi`i and some other and Zahiri scholars[104] have rejected it as a method of deduction.[105]

104 Zahiri is a School of thought in Islamic jurisprudence. The founder of this school is Dawud b. Ali al-Zahiri al-Isfahani, better known as al-Zahiri because of his insistence on sticking to the zahir or literal meaning when interpreting religious texts of the Qur'an and the Sunnah.

105 Ibn al-Nadim, *Kitab al-Fihrist (The catalogue).* n.d. p. 216, cited in Omar A. Farrukh, "Zaharism", available online at: http://www.tebyan.net/index.aspx?pid=27066

The decision of Umar b. Khattab – the second Caliph of Islam, in order to suspend penalty (penalty that prescribed by the Qur'an and *Sunnah*) of amputation of hand during famine has been mentioned an example of *Istihsan*. Here positive law of Islam was suspended as an exceptional measure in an exceptional situation. A new example of *Istihsan* is given by Kamali. Oral testimony was the standard form of evidence in Islamic law. However, now-a-days in some cases photography, sound recording and laboratory analysis have become more reliable means of proof. Here is a case of *Istihsan* by which method these means of proofs can be given preference over oral testimony in many cases.[106]

2.2.3.3 The *Maslaha* or Public Interest

Maslaha is literally defined as seeking the benefit and repelling harm. In juristic sense, the consideration of public interest is known as *Maslaha.* This method of deriving Islamic ruling is to make laws to protect public interest, provided it is not contrary to the spirit and objectives of the Shari`ah. The Shari`ah aims at achieving society's well being as defined by public interest. In Islam it is regarded as seeking or promoting something which is useful, or removing something which is harmful. *Maslaha* method of Islamic legal system may be applied in cases where neither textual law is available, nor *is Qiyas* possible.

Maslaha was invoked by the Maliki School as a valid source of juridical decision. Other Schools of law such as Hanbali and Hanafi also accept this principle of deriving legal rules as well as the Shafi`i School of law though the latter School basically discards this principle in its original meaning. However, a group of minority scholars have seriously disagreed with

106 See M. Hashim Kamali. 2003. *Principles of Islamic Jurisprudence*. The Islamic Texts Society. p.334.

this method. To meet the new situations in the changing world, *Maslaha* is being considered as major instrument in the hands of jurists of Islam. On the basis of *Maslaha*, the companions of the Prophet Muhammad (PBUH) are reported to have decided to issue currency, to establish prisons and impose agricultural land tax.

Imam Abu Ishaq al-Shatibi al-Maliki (d.790 C.E.) - a great scholar of Islam in his famous book, *al-Muwafaqaat fi 'Usul al-Shari`ah* (The Congruences of the Sources of the Divine Law) classifies *Maslaha* into three categories, which he calls the essentials (*daruriyaat*), the complementary (*hajiyaat*) and the embellishments (*tahsiniyaat*).[107] These categories of *Maslaha* are briefly discussed as under:

I. Daruriyaat (The Essentials)

The Essentials (*daruriyaat*) is defined as interests of lives which people essentially depend upon, comprising the five objectives of *Shari'ah* namely, faith; life; intellect; posterity and wealth. Some scholars assert that the *daruriyaat* elements are by definition absolutely necessary for the proper implementation of religious and mundane affairs of individuals, such that their destruction will be impetuous for creating disorder in society. Thus, the protection of these five essentials reflects the effective way of preserving the Shari`ah.[108]

II. Hajiyaat (The Complementary)

The complementary interests (*hajiyaat*) supplement the essential interests and refer to interests whose neglect leads to hardship but not to total disruption of the normal

107 See Al-Shatibi. 1975. *Al-Muwafaqat fi 'Usul al-Shari`ah*, Cairo: Al-Maktabah Al-Tijariyyah Al-Kubra, vol.4.
108 See M. Hashim Kamali. 1989. "Sources, Nature and Objectives of the *Shari`ah*", *The Islamic Quarterly*. pp. 215-235.

order of life. In other words, these interests, other than the five essentials, are needed in order to alleviate hardship, so that life may be free from distress and predicament. An example is seen in the sphere of economic transaction where the Shari`ah validated certain contracts such as the *Bai` Salam*[109] and also that of lease and hire (*'Ijara*) because of the people's need for them, notwithstanding a certain anomaly that is attendant in both.

III. Tahsiniyaat (The Embellishments)

The embellishments (*tahsiniyaat*) refer to interests whose realisation leads to refinement and perfection in the customs and conduct of people at all levels of achievement. For example, the Shari`ah encourages charity to those in need beyond the level of the obligatory *zakah*. In customary matters and relations among people, the Shari`ah encourages gentleness, pleasant speech and manner, and fair dealing.

Many Islamic legal scholars[110] view that above classification implies how methodology of *Maslaha* can be used to derive new rulings from the Shari`ah, to meet the changing needs of

109 *Bai` al-salam* is in principle a simple pre-paid forward sale. It is used much for seasonal agricultural purchases, but can also be used to buy other commodities in cases where the sellers need working capital before they can deliver or even, produce manufactured goods. Most often, this type of credit is used to finance the production of raw material, where the advance payment made by the bank is used to buy, for example, the seeds, and repayment is made against the sale of the crop. The pre-determined price is generally lower in that case than the spot price. See UNCTAD. 2006. *Islamic Finance and Structured Commodity Finance Techniques: Where the Twain Can Meet*, an UNCTAD study, May 29.

110 Such as M. Hashim Kamali (1989), M. Umar Chapra (2000), I. A. Khan Nyazee (2000), Michael Mumisa (2002), Ziauddin Sardar (2003), and Wael B. Hallaq (2004). See for a detailed discussion, M. Hashim Kamali, *supra* note 106. See also, M. Umer Chapra. 2000. *The Future of Economics: An Islamic Perspective*, Leicester: The Islamic Foundation; I. A. Khan Nyazee. 2000. *Islamic Jurisprudence* (*Usul al-Fiqh*), Islamabad: Islamic Research Institute Press; Michael Mumisa. 2002. *Islamic Law: Theory and Interpretation*, Maryland: Amana Publications; Inayatullah, Sohail and Gail Boxwell. 2003. *Islam, Postmodernism and Other Futures: A Ziauddin Sardar Reader*, Sohail Inayatullah and Gail Boxwell (eds.). London: Pluto Press; Wael B. Hallaq. 2004. *A History of Islamic Legal Theories: An Introduction to Sunni Usul al-Fiqh,* Cambridge: Cambridge University Press.

society and to solve various contemporary problems relating to social and economic endeavours.

2.2.3.4 The *Istishab* or Legal Presumption

Istishab literary means 'companionship'. In the terminology of Islamic jurisprudence *Istishab* means legal presumption or presumption of existence or non-existence of facts. It can be used in the absence of other evidences. *Istishab* presumes continuation of a fact (e.g. marriage or a transfer of ownership) till the contrary is proved. However, the continuation of a fact would not be proved, if the contract is of temporary nature (for instance, *'Ijara* or lease). Because of its basis in probability, *Istishab* is not a strong ground for presumption of the rules of the Shari`ah. Hence, when it comes in conflict with evidence the latter takes priority.

Following are some important legal maxims on *Istishab*:

1. *Certainty can not be disproved by doubt*. For instance, after making ablution, the state of ritual purity is presumed to continue till it is vitiated. A mere doubt that it is vitiated is not sufficient to nullify the purity.
2. *Presumption of original freedom from liability*. For example, every person is presumed to be innocent (free from liability) until the contrary is established by evidence.
3. *Permissibility is the original state of things*. Something that is not forbidden by the Qur'an or the *Sunnah* is presumed to be permissible.

Among the four Schools of Sunni Islamic law the Hanbalis used this latter maxim to rule that prospective spouses are at liberty to enter stipulations in the marriage contract including a condition that the husband should remain monogamous. The Hanbalis are alone on this because the scholars from other Schools consider such a condition to amount to a superimposition on the enactments of the Shari`ah. For example, one cannot say that as Muslims we can pray six times a day because there is nothing against it in the sources. Regarding ritual performances and devotional matters, anything is not allowed unless permitted by the Prophet, i.e. no one can invent a ritual.

2.2.3.5 The *Ijtihad* or Independent Reasoning

Literally, *Ijtihad* means 'striving' or 'exerting to the utmost' or 'the exercise of independent reasoning'. In the term of Islamic legal system however, it refers to the intellectual effort made by Muslim scholars and jurists in order to reach independent religio-legal decisions if the authentic Islamic legal sources available are not decisive on the particular question in hand, keeping in view the spirit and overall framework of Islam. The area of *Ijtihad* is the area in which Islam is silent and one must use one's common sense, intellect and experience to arrive at an opinion that should be in conformity with the spirit of Islam. For example, matters like test-tube babies, organ donation and cloning are some of the recent developments in science and one needs to know whether they are permitted by religion or not. It is in such matters that need for *Ijtihad* arises.

The term *Ijtihad* has originated from a conversation that is reported to have taken place

between the Prophet Muhammad (PBUH) and one of his companions Muadh b. Jabal at the time when the latter was being sent by him to govern the territory of Yemen. While asking him by the Prophet how would he judge the cases that come to him and were not found in the Qur'an nor in the Sunnah, Muadh replied that he would exercise his judgment *('ajtahidu bi ra'yi*).111 From the Arabic word *'ajtahidu* the term *Ijtihad* is derived.

There is a difference of opinion among Sunni Schools of jurisprudence as to what Ijtihad is, and as to how it is to be conceived. Imam Al-Shafi`i, in his famous book, Al-Risalah112 insists that the only valid *Ijtihad* according to *hadith* is *Qiyas*. But some other Sunni jurists did not recognise *Ijtihad* as being exclusively *Qiyas;* they also counted *Istihsan*, *Istislah* and *Ta'awwul* [113] as valid. However, according to the Shiites, this kind of *Ijtihad* is not permitted in the Shari`ah.

Obviously, the validity of *Qiyas* and *Ijtihad* can be studied from two angles. Firstly, from the aspect from which one looks at them as the sources of Islamic legislation, and place it alongside the Qur'an and the *Sunnah.* Or alternatively, from the aspect that *Qiyas* and *Ijtihad* are means for deriving the real rulings. In other words, it is possible to perceive *Qiyas* as either a substantive (element in law), or a methodological (principle).

111 That means: "I will employ my own thought, ability and tact". See Ahmad b. Shuaib Al-Nasa'i, 1992. *Sunan Al-Nasa'i*, hadith no. 1327, Beirut: Dar al-Ma`arifah.

112 The first book is written on the Usul al-Fiqh or Principles of Islamic Jurisprudence by Imam Shafi`i, the founder of the Shafi`i legal school. The English translation of this book is *Treatise on the Foundations of Islamic Jurisprudence*. 1987. Majid Khadduri (trans.), Cambridge: The Islamic Texts Society.

113 The word *'ta'awwul'* is derived from the root *a-w-l*, which means 'explanation' or 'interpretation'. Technically, a symbolic and allegorical form of interpretation to explain the inner and concealed meanings of the text of the Qur'an or the *Hadith*. Although a ruling may have been reached in one of the textual bases for a precept of the *Shari`ah*, in the text of the Qur'an or the *Sunnah,* one still has the right, for some reason, to dispense with the contents of the text and to give priority to one's own independent opinion.

In the jurisprudence, *Qiyas* and *Ijtihad* are invalid in both of the above senses. In the first sense, the reason is that there is not a single ruling which is not given in the Qur'an and the Sunnah; and in the second case, the reason is that *Qiyas* and *Ijtihad* are kinds of assumption which lead to many errors. The fundamental opposition of and Sunni legists in the matter of *Qiyas* is in the first sense, although the second aspect has become more famous among the scholars of *Usul al-Fiqh*[114] or the Principles of Islamic Jurisprudence.

114 '*Usul* is plural of '*Asl* which literally means 'proof', 'root', 'origin' and 'source'. Here the word *'usul* denote rules or principles on which a branch of knowledge may be founded and thus *'usul al-fiqh'* has been translated in this work as the 'principles of Islamic jurisprudence'. However, some writers have described it as 'the science of the sources and methodology of the law' which is correct though but seems to be incomplete. So far the definition of *Usul al-Fiqh* is concerned it has been defined by some scholars as "the aggregate, considered per se, of legal proofs and evidence that, when studied properly, will lead either to certain knowledge of a *Shari`ah* ruling or to at least a reasonable assumption concerning the same; the manner by which such proofs are adduced, and the status of the adducer". See Fakhr Al-Din Al-Razi, *Al Mahsul Fi `Ilm Usul al-Fiqh*. 1979. Taha Jabir Al-`Alwani (ed.), Riyadh: Imam Muhammad Ibn Sa`ud Islamic University, 1st ed., vol.1.p.94.

CHAPTER 3

THE APPLICATION OF THE SHARI`AH – THE ISLAMIC LEGAL SYSTEM

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Islamic law as it is seen in its modern form did not exist in the time of Prophet Muhammad (PBUH); it came into existence during the first century of Islam and was gradually developed by the Muslim jurists. After the Prophet's migration to Medina when he was called upon to decide disputes in his own community, he continued to act as an arbitrator.[115] During his lifetime, legal problems and cases that occurred were decided without any debate by resorting to *him* who relied on his inspired interpretation of the Divine revelation, or on his personal opinion confirmed later on or corrected by revelation.[116] The first successors of Prophet Muhammad (PBUH) - the Caliphs of Medina acted a great extent in their function as supreme rulers and administrators, as the lawgivers of the Islamic community. Nevertheless, the objective of this administrative legislation was not to modify the existing customary law beyond what the Qur'an had done; rather to organise the newly conquered territories and to assure the viability of the enormously expanded Islamic state. Afterwards, the Prophet's companions had to infer and deduce legal prescriptions by projecting known information from the first codes of Islamic understanding of life and reality.[117] Including four Caliphs of Islam namely Abu Bakr, Umar, Usman and Ali as well as the Prophet's wife Aisha nearly thirty companions had expertise in matters related to Islamic legal doctrines.[118] Umar, Ali

115 Schacht, Joseph. 1970. "Law and Justice", *The Cambridge Encyclopaedia of Islam*, New York: Fordham University Website, available at: http://www.fordham.edu/halsall/med/schact/.html, (accessed January 5, 2006).
116 Faruqi, Ismail R. and Lois Lamya. 1986. *The Cultural Atlas of Islam*, New York: MacMillan Publishing Company. p.279
117 Hasan, Ahmad. 1970. *The Early Development of Islamic Jurisprudence*, Islamabad: Islamic Research Institute. p.7.
118 *Ibid.*

and Aisha played a significant role in the advancement of Islamic legal system, since the two early Schools of Islamic law derived their legal doctrines from the verdicts of these distinguished companions among other legal experts.[119]

A century after the demise of the Prophet, there had been a vacuum in the field of Islamic law because of death of all his companions. There evolved some Islamic jurists[120] and scholars who set out to canonise the *Sunnah* in order to systemise the development of Islamic law. Towards the end of the first century of Islam, Imam Abu Hanifa in Kufa and Imam Malik in Medina founded religio-legal thoughts, named after them as the Hanafi and the Maliki Schools. In the following century, the two other great Schools were founded - the Shafi`i School of Imam Al-Shafi`i in Egypt and the Hanbali School of Imam Ahmad b. Hanbal in Baghdad. These Islamic Schools were developed during the course of the 8th century AD in the large centres of Islamic learning.[121] The differences between the four famous Jurists Abu Hanifa, Shafi`i, Malik and Ahmad b. Hanbal derive from their differences on principles. They differ in dogmatics and the interpretation of Qur'an regulations, i.e. the practical rules in the life of the individual.[122] Each Muslim belongs to one or another School of thought and adheres to the regulations of his faith in accordance with individual regulations of his particular School of thought. The above mentioned Schools share most of their rulings, but differ on the particular *hadith*s they accept as authentic.

119 *Ibid.*
120 Islamic jurists are the Islamic legal scholars who can give authoritative legal opinions, verdicts or judgements southt.
121 See Jany Janos. 2005. "The Four Sources of Law in Zoroastrian and Islamic Jurisprudence", *Islamic Law and Society*, vol.12, No.3. pp.291-299.
122 *Ibid.*

Among the above mentioned four main Schools of Islamic Jurisprudence the Hanafi are considered the most liberal, although from a financier's perspective, this may not always be the case. Whereas the Hanbalis are generally considered as the most conservative Malikis are generally considered moderately liberal. Shafi`is are generally considered relatively conservative though in finance they can be rather liberal. For example, in accordance with the Hanafi and Hanbali Schools, *Mudaraba*[123] can be restricted to a fixed term, after which it will be separated, while the Shafi`i and Maliki Schools do not allow for this. Or in the case of a *Bai` al-Salam*, the Hanafi School considers that in order for the *Salam* to be valid, the underlying commodity must be available in the market at the time the contract is signed. While according to the three other Schools, it is only necessary that it should be available at the time of delivery. Hanafi and Shafi`i do not allow the sale of the usufruct of an asset, while Hanbali and Maliki, which consider usufruct as a property, allow to selling it. Shafi`i allows debt re-sale, which is not allowed by Hanafi and Hanbali, and only under very strict conditions it is allowed by the Maliki School.[124]

Other than what has been prescribed in the above all of the scholars and their Schools are either not comprehensive in the sense that they do not contain all aspects of the Shari`ah or their rulings have not been preserved intact in a reliable form. That is why the majority of the Muslim community belongs to any of these four Islamic Schools of law, and if a layman adopts any one of these Schools in the matter of interpretation of the Shari`ah, his obligation

123 *Mudaraba* is profit-sharing for trade financing. In *Mudaraba* the *rabb* al-mal, or sleeping partner entrusts money to the *mudarib* or managing trustee. The *mudarib* is to use the funds in an agreed manner and then return to the *rabb al-ma*l the principal and a pre-agreed share of the profits, over an agreed period of time. The *mudarib* is not allowed to guarantee either the capital or the profits.

124 See Jany Janos, *supra* note 121.

of following the Shari`ah is discharged. Furthermore, most scholars from medieval times until modern times aligned themselves with one of the four major Schools of Islamic jurisprudence. However, in modern times many scholars do not believe it necessary to belong to any single School of Islamic jurisprudence.[125]

3.1 The Sunni and Shi`a Juristic Schools of Islamic Law

Generally, there are two main Islamic Schools of law - the Sunni and the Shiite.[126] They are broadly similar, because they are derived from the same sacred sources. However, some Schools take a strict or literal approach to the texts while others allow for purposive or contextual interpretation. Given this, the difference between the Sunni and Shi`a Schools is not greater than the difference among the different Sunni Schools themselves.

The Sunni institution of Islamic thought represents around 85-90% percent of all Muslims at present, while the Shi`a belief encompasses the rest of the Muslim world.[127] The diverse characteristic features of two institutions in essence drawn from different approaches to authority. The Sunni discipline believes, based on explicit provisions of the Qur'an and the *Sunnah*, that Muslims are to be governed by *'Ijma`* through an elected head of state, in accordance with democratic norms. The Shi`a institution, however, believes that the

125 See Frank E. Vogel, and Samuel L. Hayes III. *Supra* note 44. pp.34-41.

126 The Shiites refer to the followers of the descendents of the Prophet in general and of Ali – his cousin and son-in-law, in particular. Given this, a Shi`a is seen primarily as a Muslim who recognises the leadership of the caliphate to rest with Ali and his descendants. Some Sunni scholars are known to have considered the Shiites as non-Muslims mainly fuelled by the possible misunderstandings about concepts. However, renowned Al-Azhar theological School in Egypt - one of the main centres of Sunni scholarship in the world, announced on July 6, 1959 that "The is a School of thought that is religiously correct to follow in worship as are other Sunni Schools of thought". The verdict is available online at: http://i5.photobucket.com/albums/y152/Biryani/azher.jpg

127 Bassiouni, Cherif M. 1988. *Introduction to Islam*, Chicago: Rand McNally.

Muslims' leader, whom they refer to as the *Imam*, must be a descendant of the Prophet Muhammad (PBUH). The Shi`a concept is the basis for an inherited chain of command in the convention.

The Shiites believe in the fundamental principles of Islam as they are stated in the Qur'an and the teachings of the Prophet. They also believe in all the rules whose inclusion in Islam is self-evident and whose recognition is required for being a Muslim and the denial of which excludes the person from Islam.[128] The most important of all differences between the two relates to the interpretation of the Qur'an. The Sunni jurisprudence is based on a literal meaning of the Qur'an whereas Shiites look more to its spirit. In other words, Shi`a jurisprudence is based on *ta'wil*[129] or esoteric interpretations of the Qur'an which goes beyond its literal meaning rather only the implicit, whose ultimate meaning is known only to Allah and can not be comprehended directly through human thought alone.[130] The Sunni and Shi`a Schools evolved as a consequence of political division on the succession of the Prophet after his death, which gave rise to philosophical differences between them. Each of these Schools has different sources of jurisprudence that have resulted in a non-uniform jurisprudence, although the key elements of Islamic law, guided by the teachings of the Qur'an and *Sunnah*, are the same throughout the Schools.[131]

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128 Jawad Chirri, Muhammad. n.d. *The Shi'ites Under Attack,* Michigan: The Islamic Center of America.

129 An interpretation of the Qur'an which includes attribution of spiritual meanings to the text by the interpreter. In this respect, its method is different from *tafsir* or the conventional exegesis of the Qur'an which do not usually contradict the conventional interpretations. Instead, they discuss the inner levels of meaning of the Qur'an.

130 Riches, John and Miceli Christian. 2002. "Trusts and Sharia Law", *The Tact Review,* issue No. 20, July, The Association of Corporate Trustees Website, available at: http://www.trustees.org.uk/review-index/Sharia-Law-Trusts-and-Sharia-law.php (accessed April 2, 2005).

131 Islamic jurisprudence is not a fixed body of rulings that are divinely revealed in the Qur'an and *Sunnah* rather an ever-changing body of human rulings. There are numerous examples in jurisprudence of transactions that were forbidden and then rendered permissible based on juristic preference (*istihsan*), even though juristic decision by analogical reasoning (*Qiyas*) would render them forbidden. Most of the differences in opinion between Imam Abu Hanifa, his two companions ('Abu Yusuf and Muhammad), and Zufar, rest on the introduction of such innovations based on juristic preference.

The Shari`ah has influenced the legal systems of modern Muslim countries to differing extents. For example, Bangladesh which has a predominantly Hanafi Sunni population, has a secular legal system based on British model.[132] Conversely, the family laws and criminal laws of most Arab countries are based largely on the Shari`ah.[133] Many of these laws and legal systems do not follow exactly the teachings of any specific School of law. However, in court, the regulations of the respective School of thought of the country are applied. In some areas, legislation may have access to the traditions of different Schools or they amend the rules of the traditional Shari`ah.[134]

There are essentially two components to Islamic law: the *`ibadaat* or devotional matters;[135] and the *mu`amalaat* or civil transactions.[136] The Schools of law do not differ to a large extent in devotional matters though juristic differences among these Schools arise by and large in the area of the civil transactions. The first component deals with purely religious matters while the second component contends with the same traditional legal matters as the common law and Roman law systems.[137]

132 The fundamental source of law in Bangladesh is the Constitution of the People's Republic of Bangladesh, 1972 as amended from time to time by the elected Parliament conforming to the tenets of the Constitution. Bangladesh does not have any 'Shariah Law' as such. Rather certain provisions are codified into legislation, such as the Muslim Family Law Ordinance and provisions of the Sharia`h are not unchangeable but subject to reinterpretation based on the needs of the time.
133 Uhlman, Kristine. 2004. "Overview of Shari'a and Prevalent Customs in Islamic Societies - Divorce and Child Custody", *ExpertLaw*, January.
134 See Gamal M. Badr, s*upra* note 65.
135 The devotional matters are usually studied under the six main headings of cleanliness (*tahara*), ritual prayer (*salah*), fasting (*sawm*), the pilgrimage to Makkah (*hajj*), legal alms (*zakah*), and struggle (*jihad*).
136 The civil transactions are generally studied under the five headings of transactions involving exchange of values, equity and trust, matrimonial law, civil litigation, and administration of estates. Crimes and penalties (*`uqubaat*) are often studied under a separate heading next to *`ibadaat* and *mu`amalaat*.
137 See Gamal M. Badr, *supra* note 65.

3.1.1 The Main Sunni Juristic Schools

The main Sunni juristic Schools of Islamic law were established by four Muslim jurists of the ninth to eleventh centuries namely Imam Abu Hanifa (702-767 C.E.), Malik (717-801 C.E.), Al-Shafi`i (767-820 C.E.) and b. Hanbal (778-855 C.E.). These classical Schools, referred to respectively as the Hanafi, Maliki, Shafi`i and Hanbali, are followed by a number of Muslim countries either totally or partly. They are considered as generally accepted Sunni authority for Islamic jurisprudence.[138] Albeit there are differences in interpretation of the Shari`ah among these authorities, they are all accepted as justifiable and well-founded. The founders of these various Schools systematised the collections of *hadith*, dividing them by subjects and interpreting their meanings as well as applying them to legal issues.

There are quite a few areas of considerable disagreement between the main Sunni Schools. The key concern is the interpretation of the Qur'an, especially which part is to be viewed as abrogated by later part, and to what extent the Qur'an and the Sunnah abrogate each other. There are also differences on the meaning and connotation of particular Qur'anic words. A second area of disagreement is around the acceptance and interpretation of *hadith*. There is wide variety of opinion on the authenticity of various *hadith,* especially those reported by a single narrator, and on their interpretation. A third major area of difference deals with the status accorded to rationalist doctrines in the various Schools. There was a great deal of disagreement between the schools on the validity and scope of application of the methods of consensus *'Ijma'*, *Qiyas*, *Ra'y*, and *Ijtihad*. There are additional areas of difference on subsidiary matters that are beyond the scope of this study.

138 There are other Schools that have not been famous but accepted at their time. Such Schools are like Zahiri, Sufian al-Thawri, Sufi an b. `Uyaina, Laith b. Sa`aad – to name a few.

The following is a brief discussion on all of these main Schools.

3.1.1.1 The Hanafi School

The Hanafi School of Islamic jurisprudence was founded by Numan b. Thabit, known as Imam Abu Hanifa and became the School of law of the Caliph dynasty of Abbasids (750-1258 C.E.). It spread from Baghdad, the capital of the Abbasid dynasty, eastwards as far as India. The Hanafi School became the official School of law of the Ottoman Empire. Today, it can be found mainly on the Balkans, in the Caucasus, Afghanistan, Pakistan, Central Asia, India, China, Bangladesh, Turkey and the area of the Fertile Crescent.[139] In Austria, the Muslim community of the Hanafi School has officially been acknowledged by the state.[140]

The Hanafi School recognises the four sources of jurisprudence as established by Muhammad b. Idris Ash-Shafi`i (known as Imam Al-Shafi`i), but adds two more sources: personal reasoning to solve a problem and the abandonment of one legal decision for another which is considered to be more appropriate or relevant with regards to society. The Hanafi School is the most liberal of all Schools of law. It is considered to have more reason and logic than the other Schools.

The Hanafi School accepts the Qur'an, *Sunnah, Qiyas,* and *`Ijma'* as the sources of the Shari`ah. However, it emphasises the use of *Qiyas,* and also adds *Ra'y* or personal opinion and the principle of selecting from several options the legal decision that would most ease

139 Otterman, Sharon. 2005. "Islam: Governing Under Sharia", available on Council on Foreign Relations website at: http://www.cfr.org/publication/8034/islam.html (accessed March 14, 2005).

140 In 1988, the government amended the 'Law of Islam' to recognise all the Islamic theological schools in addition to the Hanafi School, which was covered by previous legislation. This led to increased rights and privileges for Austria's Muslims. See for details, Beshir Abdel-Fattah. 2004. "Muslims in Austria: The Early Recognition of Religious Rights", *The International Politics Journal,* available online at: http://www.siyassa.org.eg/esiyassa/ahram/2004/4/1/FILE4.htm

Istihsan or unnecessary hardship. The Hanafi School is criticised by the other schools for emphasising speculative opinion at the cost of hadith. It generally shows more respect for personal freedom and is milder in its treatment of non-Muslims and war captives. The most famous and authoritative textbook of Hanafi School are the *Zahir al-Riwayah* by Muhammad b. Hasan al-Shaybani, the *Al-Kafi [fi Furu` al-Hanafiyyah]* by Hakim Marwazi, the *Al-Mabsut* by Shams al-Din al-Sarakhsi, and the *Al-Hidayah*[141] by Burhan al-Din 'Ali al-Marghinani.[142]

3.1.1.2 The Maliki School

The Maliki School of jurisprudence was founded by Abdullah Malik b. Anas, known as Imam Malik, a leading jurist from Medina. Malik b. Anas is said to have particularly regarded as important the old pre-form of legal School of Medina as the "city of the Messenger of Allah"[143] and the legal discourse of the local jurists. The Maliki School which emerged as a counter-current to the Hanafi Islamic School of law spread mainly to North Africa - Tunisia, Algeria and Morocco, Spain and to several areas in West Africa as well as Central Africa. His doctrine is recorded in the *Al-Muwatta'*. Today, the Maliki School may also be found in Egypt, Mauritania, Nigeria, West Africa, Kuwait and Bahrain (Table 1).

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141 The English translation of Al-Hidayah is *The Hedaya: Commentary on the Islamic Laws*, 2 vol., (Charles Hamilton trans.), New Delhi: Kitab Bhavan, reprinted 1985.

142 The more famous ones are *al-Wafi fi al-Furu`* by Nasafi, *Bada'i`i al-Sana'i`i* by Kassani, *Hashiyah* of Ibn `Abidin, *Radd al Muhtar `ala ad-durr al Mukhtar* by Al-Hasafki. See for details, Patrick Sookhdeo. 2006. "Issues of Interpreting the Koran and Hadith", *Connections,* vol.5, No. 3. The USA: George C. Marshall European Center for Security Studies.

143 'The Messenger of Allah' has been referred throughout this work to Prophet Muhammad (pbuh). The word 'messenger' (*Rasul*) is used interchangeably with the word 'prophet' (*Nabi*) in the Qur'an. The reason seems to be that the 'prophet' in Islam has two capacities: he receives information from Allah, and he imparts that message to mankind. He is called *Nabi* in the first capacity and *Rasul* in the second capacity, with one difference. The word *Rasul* has a wider significance, being applicable to every messenger in a literal sense; and the angels are called Divine Messengers (*Rusul*), because they are also bearers of the Divine messages when complying with His Will.

The Maliki school is more conservative in its emphasis on *Sunnah,* though it adds the criterion of *Istislah* or public interest to the four main sources of the Shari`ah as a basis for its legal judgments. However, the scholars of *Usul al-Fiqh* are in agreement that *Istislah* is not a proof in respect of devotional matters *(`Ibadaat*) and in respect of specific Shari`ah injunctions like shares of inheritance.[144] It also gives greater consideration to *`Urf* or regional customs than do the other schools. The major treaties of Maliki School are *Al-Mudawwanah* by Asad al-Furat, which was later edited by Sahnun as *Al-Mudawwanah al-Kubra*, *Idah al-Masalik [`ala Qawa`id al-Imam Malik]* by Ahmad al Wansharisi, *Hashiyah [`ala Mukhtasar al-Khalil]* by Muhammad Al Kharshi, *Bidayat al-Mujtahid* by Ibn Rushd al-Andulusi.[145]

3.1.1.3 The Shafi`i School

The Shafi`i School of Islamic jurisprudence was founded by Muhammad b. Idris, widely known as Imam Al-Shafi`i. Imam Al-Shafi`i was a pupil of Malik b. Anas and Imam Abu Yusuf, who was the student of Imam Abu Hanifa, and tried to reconcile the Maliki and the Hanafi Schools of law. However, from this attempt Shafi`i School of law evolved.

The Shafi`i School emphasises *Qiyas* and *'Ijma`* and utilises only the four roots of law in arriving at legal decisions. It rejects *Istihsan* and *Maslaha* as forms of interference with the Shari`ah. The School is more selective in its recognition of the *Sunnah*, which it viewed as the only valid interpretation of the Qur'an. Imam Al-Shafi`i put forward his teaching in his famous treaties *Al-Risalah* and *Kitab al-Umm* which contains seven volumes. Important

144 Ibraheem, Yahya. 2005. "Lessons In Usool And Fiqh", available online at: http://uiforum.uaeforum.org/showthread.php?t=2274
145 See Patrick Sookhdeo, *supra* note 140.

Shafi`i manuals are Imam al-Nawawi's book *Minhaj al-Talibin*, which is a standard work in Egypt, Malaysia, and Indonesia; and Imam al-Suyuti's *Al-'Ashbah wa 'al-Naza'ir.*[146]

Imam Al-Shafi`i is said to have worked mainly in Baghdad and Cairo, his School of law therefore, spread particularly in those cities. Up until the arrival of the Shiite Fatimids Shafi`i jurisprudence was applied in Egypt. The Shafi`i School of law then spread to Syria, Khorasan and Bukhara. Today, it can be found mostly in Indonesia, East Africa, Southern Arabia, South East Asia, Yemen, Malaysia, Singapore, the Philippines, Somalia, Djibouti, Tanzania, Kenya and Uganda. The most distinguished feature of the Shafi`i School of Islamic jurisprudence is the fact that it recognises as sources of jurisprudence only the four sources as established by Imam Al-Shafi`i.[147]

3.1.1.4 The Hanbali School

The Hanbali School of Islamic jurisprudence was founded by Ahmad b. Muhammad b. Hanbal. He is the author of an extensive encyclopaedia of *hadith* collection called *Al-Musnad,* which contains approximately 80,000 *hadith*s.[148] Ahmad b. Hanbal was a pupil of Imam Al-Shafi`i and became famous as the defender of the doctrine that the Qur'an was the non-created word of Allah. For this belief, he was imprisoned and persecuted by the Abbasid Caliph Al-Mamun who believed in the doctrine of the creation of the Qur'an. The Hanbali School of law constituted a counter-reaction to this doctrine.[149]

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146 *Ibid.*
147 Schirrmacher, Christine. 1994. "Islamic Jurisprudence and its Sources", available online at: http://www.steinigung.org/artikel/islamic_jurisprudence.htm
148 *Ibid.*
149 Haddad, G.F. 2000. "The Uncreatedness of the Divine Speech the Glorious Qur'an", Living Islam website, available at: http://www.livingislam.org/uncrq_e.html

The Hanbali School of law is the most literal and traditionalist among the other schools, limiting the use of analogy and human reasoning, demanding that all legal decisions be based only on a literal interpretation of Qur'an and the *Sunnah* and rejecting tools of adaptation such as *Istihsan* and *Maslaha*. Hanbalis preferred weak *hadith* to strong analogy. According to some Hanbali legal scientists, *'Ijma`* was only permissible between the Prophet's companions. The works of the thirteenth-century scholar Ibn-Taymiyah are extensively used by Hanbalis.

Up until the 18th century the Hanbali Islamic School does not appear to have had any significant geographical expansion. Then the Hanbali follower Muhammad b. Abdul Wahhab (1703-1792 C.E.) revived the Hanbali School. In doing so, he helped to establish the influence of this School of law in Africa, Egypt and India, but above all and in the long run on the Arabian Peninsula.[150] In the Hanbali School of law the analogical deduction (*Qiyas*) is to a large decree restricted. This School of law can today be found mainly in Saudi Arabia, Qatar and the United Arab Emirates.

The development of the legal body in all Schools of Islamic jurisprudence heavily relied on two principles: First is the condition that any formulation of the legal method at any time must be justifiable by referring to the Qur'an and the *Sunnah*. Second, followers of each School must remain loyal to their own practice, taking into consideration of the interpretive

150 Muhammad b. 'Abd al-Wahhab founded a radical reform movement based on the Hanbali School of thought and on IbnTaymiyah's teachings. He rejected all innovations that occurred after the third Islamic century, and urged a return to the Qur'an and Sunnah in an attempt to understand and implement their fundamentals. He condemned Sufis and as apostates for adopting superstitious innovations, and urged the renewal of abandoned original model of Islam - that only principles of the Qur'an and *Sunnah* were ultimately binding, and that decisions made by later medieval scholars lacked authority. See Patrick Sookhdeo, *supra* note 140.

achievements of older master. The law had to be acceptable by reference to the continuity and the established identity of the School. Scholars were to uncover their way back to the meaning of revelation only through tradition.

Islam as viewed by its scholars, does not oblige any of its followers to follow a particular School of law or jurisprudence but grants to every Muslim the right to adhere initially to any School which has been correctly transmitted and whose precepts are documented in specific books, and that the adherent of any of these Schools may shift to another one without there being any objection to his so doing.[151] Given this underlying principle Shaikh Mahmood Shaltoot, one of the Sunni world's most revered scholars and the then head of the renowned Al-Azhar University Theological School in Egypt states in his *fatwa* or religious verdict as under:

> "1. Islam does not require a Muslim to follow a particular *Madhhab* (School of thought). Rather, we say: every Muslim has the right to follow one of the Schools of thought which has been correctly narrated and its verdicts have been compiled in its books. And, everyone who is following such *Madhahib* [Schools of thought] can transfer to another School, and there shall be no crime on him for doing so.
>
> 2. The Ja`fari Shi`i School of thought, which is also known as "al-al- Imamiyyah al-Ithna `Ashariyyah" (i.e. The Twelver Imami Shiites) is a School of thought that is religiously correct to follow in worship as are other Sunni Schools of thought. Muslims must know this, and ought to refrain from unjust prejudice to any particular School of thought, since the religion of Allah and His Divine Law (the Shari`ah) was never restricted to a particular

151 Bagley, F. R. C. 1960. "The Azhar and Shiism", *England Muslim World*, vol.50. pp.122-29.

School of thought. Their jurists (*Mujtahidun*) are accepted by Almighty Allah, and it is permissible to the "non-Mujtahid" to follow them and to accord with their teaching whether in worship (*Ibadat*) or transactions (*Mu`amalat*)".[152]

3.1.2 The Shi`a Juristic Schools

The Shi`a juristic Schools were gradually evolved and paralleled in most respects that of the Sunnis. The Shi`a attributed much of their decisive juristic thinking to Ja`afar b. Muhammad Al-Baqir As-Sadiq (700-765 C.E.), who was the sixth *Imam* of the twelve designated *Imams* of the School of *ahl al-bayt* (the Prophet Muhammad's [PBUH] family).[153] But the crucial moment in the history of this institution comes with the demise of the twelfth *Imam*. He was the last infallible *Imam* of Shi`a according to their belief and, during the period of his absence they are, like the Sunnis, committed to an elucidative judgment of the law, based on Qur'an and the *Sunnah*, and the prerogative of an academic elite.

The Shi`as proclaim the succession of the Imamate of `Ali - the Prophet Muhammad's (PBUH) cousin to his prophecy with no interruption. They also believe that after the Prophet Muhammad (PBUH), the only true leader of the Muslims, at a given time, is an *Imam*, who, like the Prophets, is directly appointed by Allah. The *Imam* must be a direct descendent of the family of the Prophet Muhammad (PBUH). Like the Prophets, the *Imam*'s rulings should be obeyed under any circumstances. Shi`a also regard the *Imam* to be an autonomous source of religious behaviour with the same standing as the Qur'an and the *Sunnah* and must

152 The above fatwa was announced on July 6, 1959 from Al-Azhar University, Cairo. It was also subsequently published in the Daily *Al-Sha`ab*, Egypt: July 7, 1959, and the Daily *Al-Kifah*, Lebanon: July 8, 1959. See also, Muhammad Jawad Chirri. 1986. *Inquiries about Islam*, Michigan: the Islamic Centre of America.

153 Shi`as are normally used to refer to *Ithna `Ashariyah* or the Twelvers since they are the 'orthodox' variant of Shiites. In extended usage, Shi`as can refer to other groups as well.

therefore be obeyed in the same way.[154] This means that any behaviour contradicting the instructions of the *Imam* is just as sinful and punishable as behaviour contradicting the Qur'an and the *Sunnah*. The Shi`a School takes Islamic legal rulings issued by the early jurists to certain extent more seriously, owing to its strong hierarchical structure ruled by their *Imams*.[155] On the other hand, the *Imam*s are also more flexible, in a sense that every one of them enjoys substantial authority to modify a verdict according to his judgment.

The Shiites consist of three main Schools. (1) The Ja`afari (*Imami*, or Twelver Shi`as), (2) Zaidi (the Fiver), and (3) Isma`ili Schools. They are subdivided into several groups, the largest of which being the Ithna `Ashari (*Imami,* or Twelve Shi`as), named after their belief in the Twelfth *Imam*, Mohammad b. Hasan Al-Mahdi.[156] The phrase "Twelve Shi`as" or "Twelvers" is used interchangeably with "Ja`afari" and "*Imami*" in various literature. They are merely different names for the same School of law. Today the Twelve Shi`as can be found mainly in Iraq, Iran and the Indo-Pakistan area, as well as minority groups in Afghanistan, Lebanon, Central Asia, Turkey, Bahrain and in the Gulf States.[157]

An important manual of Shi`a is *Al-Kafi [fi 'ilm al-din]* by Muhammad b. Ta`qub al-Kulayni. Other important manuals were *Man La-Yahdurhu al-Faqih* by Ibn-Babawayh and *Tahdhib*

154 Eliash, Joseph. 1969. "The Ithna'ashari-Shi'i Juristic Theory of Political and Legal Authority", *Studia Islamica*, No. 29. pp.18-20.

155 Literally, *Imam* means 'leader'. The *Imam* has important connotations in Islamic tradition. In the Shi`i context, *Imam* is a divine status like Prophethood, but as long as Prophet Muhammad is the last prophet, there would be no prophets after him and so the *Imam*s are not Prophets but only *Imam*s who is able to lead mankind in all aspects of life. According to belief, an *Imam* is a leader that must be followed since he is appointed by Allah.

156 These Twelve *Imam*s are (1) *Imam* 'Ail b. Abi Talib, (2) *Imam* Hasan b. Abi Talib, (3) *Imam* Husain b. Abi Talib, (4) *Imam* Ali b. Husain, (5) *Imam* Muhammad b. Ali, (6) *Imam* Ja`afar b. Muhammad, (7) *Imam* Musa b. Ja`afar, (8) *Imam* `Ali b. Musa, (9) *Imam* Muhammad b. `Ali, (10) *Imam* 'Ali b. Muhammad, (11) *Imam* Hasan b. `Ali, and (12) *Imam* Muhammad b. Hasan.

157 Kinney, Jay. 2004. "Islam as Other", *Islamherald*, available online at: http://www.islamherald.com/asp/explore/stereo/st_islam_as_other.asp (accessed July 15, 2004).

al-Ahkam and *Al-Istibsar* by al-Tusi. The most widely used manual among the Shi`a is *Wasa'il Al-*by Hurr al-`Amili.

The following Table shows the names of North Africa and Middle Eastern countries where Sunni and Shi`a Muslims follow different Juristic Schools of Islamic law:

Table 1

Schools of Islamic Law followed by Muslims in North Africa and the Middle East

Algeria	The predominant School is the Maliki. There is an `Ibadi (Shi`i) minority as well.
Bahrain	The Ja`afari majority with Shafi`i and Maliki minorities.
Egypt	Hanafi and Shafi`i (Sunni)
Iran	Ja`afari and Hanafi
Iraq	Ja`afari and Hanafi
Jordan	Hanafi majority
Kuwait	The Maliki is the official School with a significant Ja`afari minority.
Lebanon	Majority of Muslims are Hanafi or Ja`afari.
Libya	The Maliki is the predominant School.
Mauritania	The Maliki majority
Morocco	Maliki majority
Oman	Oman is the only state in which the `Ibadi School is the predominant. There are also Sunni and Shi`a minorities.
Palestine	Hanafi majority
Qatar	Hanbali majority
Saudi Arabia	Hanbali majority, Ja`afari minority
Sudan	Maliki School prevailed until it was consolidated into Ottoman Empire through Egyptian rule, during which time Hanafi School became dominant.
Syria	Hanafi majority with Ja`afari and Shafi`i minorities
Tunisia	Maliki majority
Turkey	Hanafi majority; the Kurds of Turkey follow the School of Shafi`i.
United Arab Emirates	Maliki and Hanbali majorities with `Ibadi minority.
WesternSahara	Maliki majority
Yemen	Shafi`i majority; Zaidi minority

Source: Amin, S. H. 1985. *Middle East Legal Systems,* Glasgow: Royston Limited; El-Hakim.1994. *Yearbook of Islamic and Middle Eastern Law*, vol.1; Anderson, Norman. 1955. *Bulletin of the School of Oriental and African Studies*, 17; Mahmood, T. 1995, *Statutes of Personal Law in Islamic Countries*, 2nd ed., New Delhi: India and Islam Research Council; Redden, K. 1990. *Modern Legal Systems Cyclopaedia*, vol.5, Buffalo, NY.

3.2 The Application of the Shari`ah Principles of Financial Transactions to Islamic Finance

The theory of Islamic finance is an old notion though today's form of Islamic finance is a very young discipline. From a modern perspective, Islamic finance refers to financial market transactions, operations and services that comply with Islamic ethics and principles. The Islamic laws on financial transactions are part of the branch of the Shari`ah known as *Fiqh al-Mu`amalaat*, [158] or the 'laws of human interaction' in Islamic legal term which constitutes an important branch of law dealing with issues related to all kinds of financial transactions.[159] One of the underlying characteristics of Islamic financial system is that it is based on keeping in view of certain social objectives for the benefit of society as a whole.[160] Like other religions the socio-economic justice is central to the Islamic way of life. While the conventional financial system mainly focuses on the economic and financial features of transactions, the Islamic system lays the same importance on the ethical, social, religious, economic and financial market dimensions. That is to boost economic and social justice for the good of society in its entirety.[161] For example, Islam imposes a compulsory financial commitment called *zakah*: this is a wealth obligation to be taken from the well-to-do and given to the underprivileged. One of the purposes of *zakah* described in the Quran is that the wealth does not become a thing to circulate only among the rich people.[162] In this context, financial markets should operate to enable both an increase in wealth and economic growth, and also its equitable distribution.

158 Literally, *fiqh* means "knowledge", "understanding" and "comprehension"; and *mu`amalat* means "civil transactions".
159 *Fiqh al-Mu`amalat* includes in addition to financial transactions the following: endowments; laws of inheritance; marriage, divorce, child care; foods and drinks; Penal punishments; warfare and peace and judicial matters (including witnesses and forms of evidence).
160 See Zamir Iqbal, *supra* note 8.
161 *Ibid.*
162 The Qur'an, 59:7

The following remarks made by Imam Al-Ghazali in this regard are worthy of mention:

> "The very objective of the Shari`ah is to promote the well-being of the people, which lies in safeguarding their faith (*din*), their self (*nafs*), their intellect (`*aql*), their posterity (*nasl*), and their wealth (*mal*). Whatever ensures the safeguard of these five serves public interest and is desirable and whatever hurts them is against public interest and its removal is desirable".[163]

Given this, the Islamic system of financial management can in effect only be fully appreciated in the context of Islamic concepts relating to the role of community and individual; wealth distribution; the concept of money; social and economic justice; and poverty alleviation.[164]

There are basically three components of an Islamic financial system.

1. The human being as vicegerent of Allah in this earth should seek its bounties that bestowed on him and from the wealth he obtained should enjoy his own share.
2. He should be generous to others and use his portion of wealth for himself as well as for the benefit of his fellow-beings.
3. His behavior should not be willfully destructive to others.[165]

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163 Al-Ghazali, Abu Hamid as quoted in M. Umer Chapra. 2000. *The Future of Economics: An Islamic Perspective*, p.118, UK: The Islamic Foundation. See also M. Hashim Kamali. 1998. "*Maqasid Al-Shariah*: The Objectives of Islamic Law", Newsletter of the Association of Muslim Lawyers and the Islamic Foundation's Legal Studies Unit, vol.3, issue 1, April-June. pp.13-19.

164 See Zamir Iqbal, *supra* note 8.

165 Hairetdinov, Ravil. n.d. "Islamic Financial System", *Iqtisad Journal of Islamic Economics,* Yogyakarta, Indonesia, available online at: http://islamic-world.net/economics/financial_system_01.htm# (accessed August 20, 2007).

3.2.1 Islamic Legal Maxims for Financial Transactions

In line with the above introduction, in this section the fundamental principles of the Shari`ah with regard to commercial and financial transactions are discussed. They are also considered as significant legal maxims of Islamic law. These maxims that are defined as "general rules which apply to all of their related particulars" are abstract statements of the rules and principles of Islamic legal system.[166] They stem from the detailed reading of the rules of Islamic jurisprudence on particular themes and issues developed by the jurists in the course of history. They differ from modern statutory rules which are concise and devoid of detail. They are expressive of the goals and objectives of the Shari`ah.[167]

Regardless of the common trend in legal maxims to be inter-scholastic, juristic Schools of Islamic law are not agreed upon all of the maxims and there are some on which the Schools of thought are diverged. The Shi`i School has its own collections of legal maxims, but aside from some differences in style, the thematic arrangement in its collections is very much similar to those of their Sunni counterparts.[168]

The contents of the maxims are occasionally extracted from the Qur'an or the *Sunnah* but the wordings of certain maxims are taken to greater refinement and perfection.[169] Some legal maxims are of general application, whereas others might apply to a particular area of Islamic

166 See Mahmassani, Subhi. 1961. *Falsafat at-Tashri' fil-Islam: The Philosophy of Jurisprudence in Islam* (Farhat I. Ziadeh trans.), Lieden: E.J. Brill. p. 151.

167 Abu Sulayman, Abd al-Wahhab. 1978. "An-Nazriyyah wal-Qawa`id fil-Fiqh al-Islami", *Mujallah Jami`iyyah al-Malik `Abdal-`Aziz*, No.2, May. p.53.

168 *Ibid.*

169 The most comprehensive and broadly based of all maxims are the normative legal maxims, which apply to the entire range of Islamic law and jurisprudence without any specification. The Schools of Islamic thought are generally in agreement over them. Maxims such as "Harm must be eliminated" and "Acts are judged by the intention behind them" belong to this category of maxims. See for details M. Hashim kamali. n.d. *Qawa'id Al-Fiqh: The Legal Maxims of Islamic Law*, publication by Association of Muslim Lawyers, U.K.

jurisprudence, such as devotional matters, civil transactions, contracts, litigation and court proceedings.[170] However, due to the limited scope of the study it will discuss only the maxims related to the financial transactions.

Before replicating and using these maxims to solve the problems related to contemporary financial transactions the following prerequisites may be relevant for their correct application.

1. The interpretation and application of the Islamic legal maxims may be made only by the Shari`ah scholars along the lines of need of time if the Qur'an, the *Sunnah* as well as the consensus of early jurists do not provide any ruling on that specific issue. For example, the legal opinion in regard to profit-sharing in a joint venture is that:

> "Profit is to be distributed according to the agreement but loss is to be borne in proportion to capital contribution".[171]

In this ruling the ratio of the distribution of profit according to agreement can be reviewed in light of business conditions. It may be left to the partners to decide the ratios of profit-sharing. The liability of loss, however, has to be borne strictly in proportion of capital contribution since this rule enjoys the juristic consensus.

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170 *Ibid.*

171 See M. Taqi Usmani. 1999. "The Concept of Musharakah and Its Application as an Islamic Method of Financing", *Arab Law Quarterly*, vol. 14, No. 3, pp. 210.

2. As mentioned earlier in this study that the rulings of the Shari`ah aim at doing well to human beings and removing harm. The Qur'an and the *Sunnah* should be the criteria of judgment with regard to those benefits and harms and they are not entirely left to the judgment of man. In cases where benefits and harms are not pointed out in these two primary sources of the Shari`ah human intellect guided by sound reasoning, experience, prevalent practice and sound judgment of scholars will judge the virtue or vice of any act. It is sound judgment based on in depth knowledge of the Shari`ah that will decide for instance, which forms of present day trades and activities should be prohibited and which should be allowed and protected by law.

3. The contingency of the state of affairs sometimes necessitates outlawing a legitimate act and allowing an illegal act in order to protect public interest. Among these two extreme situations, the latter is graver than the former. The preferable way is to preserve the indispensable illegality of the act even when it is unavoidable to have recourse to it under compulsion of circumstances government, for instance, may be bound to pay interest on credit purchases of military hardware. Despite this compulsion, however, it should not be disregarded that payment of interest is unlawful and that serious thought should be given to get rid of that situation as soon as practicable.

The general Shari`ah legal maxim is that a particular activity is permissible unless there is a clear prohibition against it. This is reflected in the law on financial transactions. The Shari`ah compliant financial services emphasise the ethical, social and religious dimensions of

financial transactions to enhance equity and fairness for the general good of society. With the above prerequisites the maxims that seem to be relevant to the financial transactions may be briefly reproduced in the following.[172]

3.2.1.1 Intentions and Acts

The first principle in this respect reads as following: *"Acts are judged by the intention behind them (Al-'umuru bi-maqsadiha)"*. This principle is a rephrasing of the renowned *hadith* that states: "Acts are valued in accordance with their underlying intention" (*Innamal-'a`amaalu bin-niyyaat*).[173] This is a comprehensive maxim that has implications that the scholars have discussed in various areas, including devotional matters, commercial transactions and crimes. The element of intent often plays a crucial role in differentiating, for example, a murder from erroneous killing, theft from inculpable appropriation of property, and the figurative words that a husband may utter to conclude the occurrence or otherwise of a divorce.

The rule embodied in this maxim although been applied by early jurists mostly on acts of rituals, it is equally applicable to other spheres of activity including financial transactions. It is actual acts and policies rather than proclamations that determine the intention. This is so because of a sub-rule which governs contractual obligations. This reads as follow. *"Contracts are to be understood in relation to their intention and substance, not by the words and phrases used (Al-`ibratu fil-`uqudi lil-maqasidi wal-ma`ani la lil-'alfazi wal-*

172 Many of the Islamic legal maxims described in this study are based on the written sources available only in the Arabic language. The most widely available summary of *Shari`ah* maxims in the English language is the *Majallat Al-Ahkam Al-`Adliya*h and *the Majallat Al-Ahkam Al-Shar`iyyah*. The former treatise is a summary of certain principles of the *Shari`ah* as applied by the Hanafi School of Islamic jurisprudence in the former Ottoman Empire and countries that were formerly part thereof. It was officially adopted in the Ottoman Empire. While the latter the *Majallat Al-Ahkam Al-Shar`iyyah* is a summary of certain principles of the *Shari`ah* as applied by the Hanbali School of Islamic jurisprudence.

173 Bukhari and Muslim, cited in Al-Qaradawi, Yusuf. 1997. *The Lawful and the Prohibited in Islam (Al-Halal Wal Haram Fil Islam),* Kamal El-Helbawy, M.Moinuddin Siddiqui and Syed Shukry (trans.), Indianapolis: American Trust Publications; 1st ed. p.178.

mabani)". For example, the *kafalah* implies coextensive liability while transfer of debt implies discharge of the principal debtor.[174] If a contract of transfer of debt is made with the condition to hold the principal debtor liable in case the transferee fails to discharge the debt, contract even though termed as a contract of transfer of debt will be treated as a contract of *kafalah*. Similar will be the treatment of a contract of *kafalah* in case the principal debtor is discharged after contract of *kafalah* is signed.

In case the banks declare their policy of financing customers on non-interest bases it would be necessary to do so and not merely continue the same practice and seeking to rationalise it in Islamic terms by changing the relevant nomenclature such as calling it "buy-back" or "mark-up". Likewise, it will not be permissible for the banks to practice *Musharaka* and *Mudaraba* in such a way as to ensure a fixed rate of return[175] for the banks while the liability of bearing loss or an uncertain amount of remaining profit is transferred to the working partner.

3.2.1.2 The Doubt and Certainty

The basic rule that resolves the conflict between doubt and certainty is contained in the principle that reads: *"Certainty is not overruled by doubt (Al-yaqinu la yazulu bish-shakk)"*. This rule rejects the effect of doubt that disturbs the original position. This rule is of great significance in the event of controversy on rights and obligations of contending parties in the absence of a proof on either side. The benefit of doubt arising out of a controversial position

174 In *kafalah* a person joins another person in undertaking certain obligation. Consequently, both persons become jointly liable to meet any claim that may arise from this obligation.

175 Rate of return is calculated by expressing the economic gain (usually profit) as a percentage of the capital to produce it. When Islamic banks are evaluating a project to decide whether to go ahead with it, they estimate the project's expected rate of return and compare it with their cost of capital.

can never go to a person on whom the onus of proof lies; thus the position of an indebted person even after his death will not be affected by doubt as to a probable discharge of debt. Likewise a claim as to the discharge of a debt will not be rejected on the basis of presumption to the contrary.

The rule, if read with its following sub-rules, provides a broader canvas of its application.

(a) *"As to incorporeal matters that do not prove themselves, the basic principle (presumption) is that they do not exist (Al-'aslu fis-sifatil-`aarida al-`adam)"*. For instance, a partner has no right to assume a minimum rate of profit earned by his business partner and claim his share in that profit as different from the amount stated to have been actually earned by the partner. The sub-rule provides that in case the working partner declares a certain amount of profit no more will be presumed unless the contrary is proved to be a fact.

(b) The above sub-rule is further strengthened by another sub-rule that says: *"No reliance (should be made) on mere imagination (la `ibrata lit-tawahhum)"*.

(c) Another rule is that of *"the norm (of the Shari`ah) is that of non-liability i.e. freedom from obligation (Al-'aslu bara'atudh-dhimmah)"*.

Given the above sub-rules, in case of loss in business a partner cannot allege wilful neglect and require the latter to indemnify him for the loss unless he proves the contrary. Failing this proof the partner will not be personally made liable to the loss or to indemnify the other partner. Any doubt affecting his position of freedom from liability will be untenable. No arbitrary judgment of the contender would be acceptable.

3.2.1.3 The Removal of Harm

This principle reads: *"Harm may neither be inflicted nor be reciprocated (la darara wa la dirar)"*. Essentially, the principle states that while engaging in the economic and business activities, a firm is prohibited from inflicting injury or causing grief to others.[176] This most important rule of the Shari`ah is based on a Prophetic Tradition which says: "There should be neither harming nor reciprocating harm".[177] This guiding rule, reads with its sub-rule, *"wrong is to be undone* (*Ad-dararu yuzal)*" provides a guideline to regulate the entire financial system in such a way that prohibits harm imposition and discourages retaliation. Among the juristic arguments deriving from the above Prophetic Tradition is: if someone has caused damage to another party's property, it is not permissible for the affected party to retaliate by damaging the property of the person. This is because such action is deemed to aggravate the damages without any benefits in return, hence it is harmful. The alternative is paying compensation to the same value of the damaged property so as to avoid further harm to the property of the owner.

The foregoing basic rule of the Shari`ah is treated as a pillar of Islamic law. The rule forms the basis of the laws of option, inhibition, return of defective merchandise, pre-emption, requital, compensation, indemnity etc. This also allows individuals to act unilaterally to protect themselves or others from harm. For example, in case the buyer of perishable goods absents himself without taking possession of the purchased goods the seller, in order to

176 Abu Zahrah Muhammad. 1958. *Usul al-Fiqh*, Beirut: Darul Fikr Al-Arabi.
177 Cited in Al-Bugha, Mustafa and Muhyiddin Misto. 1998. *A Discussion on An-Nawawi's 40 Hadith,* Kuala Lumpur: Prospecta Printers Sdn. Bhd. pp.346-366.

protect himself and the buyer from loss, has a right to unilaterally revoke the contract of sale and sell the goods to some other party lest the commodity should perish.

The application of the above principle has the following prerequisites:

(a) *"Let the ancient rest on its age (Al-qadimu yutraku `ala qadimihi)"*. It is not permissible based on this to prevent the livestock from grazing in public pasture which has been in use since a long time. These rights have to be guaranteed unless their exercise is harmful to general interest. This is so because of the operation of another rule that reads: *"Harm is harm even though it be ancient"*.

(b) *"Unlawful things are to be prevented irrespective of benefit (Dar'ul mafasidi 'awla min jalb al-manafi`i)"*. There may be situations in which an act might have certain benefits while it produces corruption and inequity. In such a case the Shari`ah would ban that act despite the benefits that it might apparently yield. Thus if an age-old canal is causing water logging and salinity; it should not be allowed to flow simply on account of previously held rights.

There may be situations in which a trade, technique or a policy is not unlawful but involves both benefit and harm; such situations are governed by the following subsidiary rules:

(1) *"Harm is eliminated to the extent that is possible (Ad-dararu yudafa`u bi-qadril-'imkan)"*. A practical manifestation of this maxim is the validation of the option of defect (*khiyar al-'ayb*) in Islamic law, which is designed to protect the buyer against

harm. Therefore, when a customer buys a car and then discovers that it is substantially defective, he has the option to revoke the contract. For there is a legal presumption under the Shari`ah that the buyer concluded the contract on condition that the object of sale was not defective.

The following further rules present the practical guidelines:

(2) *"Harm is not eliminated by another harm (Ad-dararu la yuzalu bid-darar)"*. For instance, if a buyer gets a faulty article he is given the option to return the goods. But if the purchased article has developed similar fault while in possession of the purchaser he will lose his option to return the goods because, in order to protect himself from harm, he will also be harming the seller. This would amount to repelling harm by causing a similar harm.

(3) *"A greater harm is eliminated by means of a lesser harm (Ad-darar al-'ashaddu yuzalu bid-darar al-'akhaff)"*. The rule says that in cases where the choice is between two harmful alternatives the one fraught with less harm may be chosen. For example, in case a customer loses his coin in a slot, his coin may be allowed to go waste rather than to dismantle the machine which has much greater value than the coin. But in case a very expensive piece of jewellery is lost in a less expensive washing machine of a laundry its recovery, then, requires damage to the machine; the same will be effected to recover the piece of jewellery that is more expensive than the machine.

(c) The rule in the case of conflict between a particular harm and a general harm is that *"a specific harm is tolerated in order to prevent a more general one (Yutahammal ad-darar al-khaas li-dafa` al-darar al `aam)"*.

In addition, there is another rule which contains the same spirit but is laid down in different words. It reads as *"The lesser of two evils is to be chosen (Yukhtaru 'ahwan al-shararain)"*. This rule of choosing lesser evil gives the government wide powers to impose restrictions and controls on traders and members of other professions, and to regulate ownership and consumption.

3.2.1.4 The Rules of Necessity

The first principle in this regard reads as: *"necessity justifies that which may be unlawful (Ad-daruratu tubihul-mahzurah)"*. It is on the basis of this rule that the jurists validate demolition of an intervening house to prevent the spread of fire to adjacent buildings, just as they validate dumping of the cargo of an overloaded ship to prevent the danger (or *darar*) to the life of its passengers.

The second principle on necessity declares: *"necessity is measured in accordance with its true proportions (Ad-daruratu tuqaddaru bi-qadriha)"*. Given this maxim of the Shari`ah, if the court orders the sale of assets of a negligent debtor to pay his creditors, it must begin with

the sale of his movable goods if this would suffice to clear the debt, before selling his real property.[178]

3.2.1.5 Offering and Obtaining

The ruling that governs offering and obtaining is ruled by the principle: *"What is haram to take is haram to give (ma hurrima 'akhdhuhu hurruma 'i`ata'uhu)"*. As a consequence of the above, another rule is that *"What is unlawful to do is unlawful to demand (ma haruma fi`luhu haruma talabuhu)"*. The rule along with its effect is applicable not only to financial transactions like taking of interest, but also for non-financial transactions like accepting professions that are not approved by the Shari`ah.

3.2.1.6 Benefit versus Liability

The relationship between the right to enjoy benefit from a property and the liability to incur loss due to proprietorship is governed by a number of rules that carry great significance in transactions of commercial nature. In cases where commercial nature is not involved the plain rule is that *"What is permissible in law cannot be a cause for liability (Al-jawazu insharayna fid-damaan)"*. In cases, however, where commercial considerations are involved the rule provides that *"No reward without risk (Al-ghurmu bil-ghunm)"*. That is to say that a person who obtains the benefit of a thing, takes upon himself also the loss from it.

The above general rule is based on the Prophet's saying: *"In any benefit lies a liability (Al-kharaju bid-daman)"*. This means that any benefits (i.e. profit) derived from a transaction

178 As-Sabuni, `Abd ar-Rahman. 1982. *Al-Madkhal al-Fiqhi wa Tarikh at-Tashri` al-Islami*, Cairo: Maktabah Wahbah. p. 89.

must be accompanied with the liability arising from a potential loss. Given this maxim, the yields of trees, animals, etc., belong to those who are responsible for their upkeep and maintenance.

Another principle that also has the same bearing is: *"The blessings of a thing are in proportion to the evils thereof and vice versa (Al-ni`matu bi-qadrin niqmah)"*. This principle implies that if the commodity is not yet possessed by the buyer, is lost; it is the seller but not the buyer who would have to bear the loss because the former enjoys possession. Likewise, renting out one's house on the condition that the tenant would be liable to the value of the house if the same is damaged due to flood or earthquake is also a contravention of the rule because the owner who is earning its rent should also bear the loss.

3.2.1.7 The Role of Custom

The Shari`ah principle with regard to custom and usage says: *"Custom is a source of judicial decisions (Al `adatu muhkamah)"*. This means custom is to be taken as a judicial decision to establish a rule of law. Another maxim in this connection reads: *"What is proven by custom is like that which is stipulated by the text (Al-ma`arufu `urfan kal-mashruti shartan)"*. Also, *"The usage of people is a proof that must be acted upon (Isti`malun-nasi hujjatun yajibul-`amalu biha)"*. Nevertheless, the conditions that qualify custom and usage to have a decisive force are:

1. The custom and usage should be compliant with the rulings of the Shari`ah. For instance, the practice of giving and taking interest on loan has a common custom but it is forbidden and cannot be accepted.

2. The custom which is most widely prevalent and operative is to be relied upon. For example, food grain that was traded in the early Islamic period was measured but it is now universally weighed, instead of being measured. Therefore, all calculations whether for trading or for purposes of payment will be made in terms of the prevalent units of weight.
3. Credence is to be given to that which is publicly and generally operative, and not to what is rare.

Subject to the conditions laid down above the main rule of custom and usage shall be made applicable. For example, in case a person authorises another to sell something on his behalf without laying down conditions as to sale price and unit of currency, the agent will be treated to be bound by conventional rules of charging a reasonable price and prevalent currency. Thus, in this and similar cases the detail understood by common usage would not need to be mentioned.

3.2.1.8 The Limitation

There are some contracts in Islamic banking and finance practice like that of *Bai` Salam* which may be adduced by some to support the existing practices of *Murabaha*, in which the sale takes place without possessing the goods actually being transferred and without the seller even having the capacity to deliver the goods. The legal maxim that determines the Shari`ah position of such contracts is contained in the rule *"What is proved to be opposed to analogy cannot form the basis of further analogy (ma thabata `ala khilafil-qiyasi fa ghairuhu `alaihi la yuqas)".*

In other words, if a contract/transaction is legalised in non-compliance of the basic principles of the Shari`ah the legality of such contract/transaction shall not be adduced by way of analogy in support of a similar other contract. The contracts like *Mudaraba*, *Bai` Salam* etc., which cannot be otherwise justified on the basis of analogy were allowed by the Prophet. The legality of these transactions is of an exceptional character and hence it may not be cited as an evidence for supporting any other contracts.

3.2.2 Philosophy and Rules of Transaction in Islamic Law

The Islamic financial system is an integral part of Islamic law that can only be understood in the context of Islamic attitudes towards ethics, wealth distribution, social and economic justice, and the role of society or the state. Principles encouraging risk sharing, individual rights and duties, property rights and the sanctity of contracts are all part of the Islamic code underlying the banking system. Muslims believe that human beings are Allah's representatives on the earth who act accordingly as His trustees. The absolute ownership of Man's property is not recognised in Islam. Therefore, transactions in Islamic legal financial system should be carried out in both individual and corporate levels in accordance with the Shari`ah. Individual interest is not the *sine qua non* in this system rather the interest of the public is based on bottom-line considerations.[179]

Given the above attitude of Islam towards mankind, the core principles underlying Islamic financial system revolve around the concept of equity and fairness. Islamic financing is

179 See The Organisation of the Pilgrims Management and Fund Board of Malaysia. 1995. *Tabung Haji as an Islamic Financial Institution of Investment Resources: The Mobilisation of Investment Resources in an Islamic Way and the Management of Hajj*, Jeddah: Islamic Research and Training Institute, 1st ed. p.13.

characterised with not just obtaining benefits or maximisation of profits but also seeking promotion of social justice and moral economy. The philosophy of transaction in Islamic law stems from a set of rules and laws referred to as the Shari`ah, governing economic, social, political, and cultural aspects of Islamic societies.[180] These rules and regulations administer the rights and obligations of those involved in the financial markets. They also may form the basis of regulation and legislation pertaining to financial markets.

The rules of transaction in Islamic legal system can be summarised as follows.

3.2.2.1 *Riba*-Free Transactions

As the *riba* is prohibited in Islam all types of financial contracts and transactions are required to be free from *riba*.[181] The jurists base this banning on arguments of social justice, equality, and property rights. Social justice demands that borrowers and lenders share both rewards and losses in an equitable fashion and that the process of wealth accumulation and distribution in the economy be fair and representative of true productivity. The question of *riba* has been addressed in literature of Islamic finance with much elaboration and there is a near consensus about the meaning and implications of *riba*.

180 Khan, S. Mohsin and Mirakhor, Abbas. 1992. "Islam and the Economic System", *Review of Islamic Economics*, vol.2, No.1. pp.1-2.

181 There is complete unanimity among all Schools of law in Islam that the term *riba* stands for interest of all its types and forms. See The Report of the Council of Islamic Ideology. 1983. "Elimination of Interest from Economy", *Money and Banking in Islam,* Ziauddin A., M. Iqbal, and M. F. Khan (eds.). Islamabad: Institute of Policy Studies. p.183.

3.2.2.2 Transactions Free From *Gharar*

All forms of contracts and transactions must be free from *gharar* or excessive uncertainty.[182] This implies that contracting under conditions of excessive uncertainty is not permissible. Contracting under *gharar* is similar to gambling.[183] The Prophetic *hadith*, in addition to prohibiting gambling or games of chance, also prohibits trading in *gharar*. Islamic scholars have identified the conditions and highlighted situations that involve excessive uncertainty and consequently, outlaw a contract.[184] Also, transactions should be devoid of any ignorance from both parties. Therefore, contracting parties should have perfect knowledge of the counter values intended to be exchanged as a result of their transactions.

The Hanafi School of Islamic Jurisprudence defines *gharar* as "that whose consequences are hidden". While the Shafi`i legal School defines *gharar* as "that which admits two possibilities, with the less desirable one being more likely". The Hanbali School defines it as "that whose consequences are unknown" or "that which is undeliverable, whether it exists or not". On the other hand, the Zahiri School says that "g*harar* is where the buyer does not know what he bought, or the seller does not know what he sold". The contemporary Islamic legal scholar Mustafa Al-Zarqa states that "*gharar* is the sale of probable items whose existence or characteristics are not certain, due to the risky nature that makes the trade similar to gambling".[185]

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182 The Qur'an has clearly forbidden all business transactions, which cause injustice in any form to any of the parties. It may be in the form of hazard or peril leading to uncertainty in any business, or deceit or fraud or undue advantage.

183 The reason is that gambler is ignorant of the result of the gamble.

184 *Gharar* is of three kinds: a) excessive, which vitiates the transaction; b) minor, which is tolerated; and c) moderate, which falls between the other two categories. Any transaction can be classified as forbidden activity because of excessive *gharar*.

185 "Islamic Banking", *The Wikipedia*, available online at: http://en.wikipedia.org/wiki/Islamic_banking#Islamic_laws_on_trading (accessed March 2, 2007).

There are a number of *ahadith* that forbid trading in *gharar* or transactions that are based on *gharar*.[186] Jurists have sought many complete definitions of the term. They also came up with the concept of *gharar yasir* or minor risk.[187] What *gharar* is, exactly, was never fully decided upon by the Muslim jurists. This was mainly due to the complication of having to decide what is, and is not a minor risk. Derivatives instruments such as stock options have only become common relatively in recent times. Some IBs provide brokerage services for stock trading and perhaps even for derivatives trading.

3.2.2.3 Contracts Void of *Qimar* and *Maysir*

The Qur'an and the *Sunnah* explicitly forbid gains made from gambling[188]or games of chance (*Qimar)*.[189] An uninformed speculation (*Maysir)*[190] in its worst form is also akin to gambling. The term speculation always involves an attempt to predict the future outcome of an event. But the process may or may not be backed by collection, analysis and interpretation of relevant information. The relevant experts in financial institutions will assume risk after making a proper assessment of risk using the required information. All business decisions involve speculation in this sense. It is only the gross absence of value-relevant information or

186 This *ahadith* often give specific examples of *gharar* transactions such as selling the birds in the sky or the fish in the water, the catch of the diver, an unborn calf in its mother's womb, the sperm and unfertilised eggs of camels etc.

187 Financial transactions with minor risk are deemed to be permissible while a transaction with a non-minor risk is deemed to be unlawful.

188 In Islam, gambling is considered as a great evil of the society and immensely harmful to the wellbeing of the human social order. As such, it categorically prohibits all forms of gambling, so that the human society is saved from its ill-effects and harms. The Prophet emphasises its prohibition to such an extent that even considering taking part in gambling is regarded to be blameworthy. The jurists and scholars unanimously agree upon the prohibition of gambling. See Abu Bakr Al-Jassas. 1994. *Ahkam al-Qur'an*, Dar Al-Kutub Al-`Ilmiyyah, Beirut, vol.1. p.329.

189 The Arabic noun *Al-Qimar* derives from *qamar* (the moon) which increases at times and decreases at other times. It has been given this name due to the possibility of that each one of the gamblers may lose his wealth to his counterpart, and also gain from the wealth of the other. See Ibn `Abidin. 1987. *Radd al-Muhtar` ala al-Durril-Mukhtar* (Answer to the Perplexed: An Exegesis of 'The Choicest Gems'), Beirut: Dar Ihya' al-Turath al-'Arabi, vol.6. p.403.

190 The literal meaning of the term *Maysir* is 'to achieve something without putting any effort in it', which explains the principle on account of which gambling is prohibited in Islam. Any monetary gain which can be earned too easily so much so that one does not have to work for it is unlawful.

conditions of excessive uncertainty that makes speculation akin to a game of chance and hence, forbidden.

3.2.2.4 Sanctity of Contracts

Islam upholds contractual obligations and the disclosure of information as a sacred duty. This feature is intended to reduce the risk of asymmetric information and moral hazard. It also provides basic liberty to enter into transactions.[191] Involvement of an element of compulsion for either of the parties invalidates the contract.[192] However, this basic rule does not entail uncontrolled liberty to contract and may be given up when there is a transaction with other rules and regulations requiring unequivocal rulings.

3.2.2.5 Non-Interference in Price Fixation

Islam envisages a free market where prices are determined by forces of demand and supply. There should be no interference in the price formation process even by the regulators. However, some scholars admit of its permissibility which is subject to the condition that price fixation is intended to combat cases of market irregularities caused by impairing the conditions of free competition.[193] It is an obligation that the forces of demand and supply should be real and free from any artificial component. Islam therefore, disapproves any efforts to manipulate prices through causing fake scarcity of supply. Similarly, any attempt to

191 See Al-Qur'an, 2:275.
192 See Al-Qur'an, 4:29.
193 To name one of these scholars is Imam Ibn Taymiyyah. See Mohammed Obaidullah. 2002. "Islamic Risk Management: Towards Greater Ethics and Efficiency", *International Journal of Islamic Financial Services*, vol.3, No. 4. January-March.

bid up the prices by creating artificial demand is considered unethical and thus illegitimate.[194] Such an action of bidding up the price without an intention to take delivery is not permissible.

3.2.2.6 Fair Prices of Commodities

Prices that are an outcome of free play of forces of demand and supply without any intervention or manipulation are believed to be fair. However, in cases where pricing is based on a valuation exercise the difference between the price at which a transaction is executed and the fair price (which is determined by the valuation experts) will make transaction null and void.[195]

3.2.2.7 Release of Adequate Information

Release of inaccurate information as well as hiding crucial information breach the rules of Islamic business ethics. As such, transactions must be free from any falsification in order to be considered Islamic. The institution of a transparent market is therefore, rather important and transactions should be executed within the market after taking into account all relevant information. Given this, Islamic business ethics necessitate that all information pertinent to expected cash flows and asset appraisal should be equally available to all investors/shareholders in the market.[196]

194 The Prophet is reported to have condemned the hoarders when he said: "No one hoards but the traitors (i.e. the sinners)". See Sunan Abu Da'ud, Hadith No. 2990, quoted in Sabahuddin Azmi. n.d. "An Islamic Approach to Business Ethics", available online at: http://www.renaissance.com.pk/Mayviewpoint2y5.htm

195 See Mohammed Obaidullah, *supra* note 189.

196 See Sabahuddin Azmi, *supra* note 190.

3.2.2.8 Devoid of Harm

This refers to the possibility of a third party being unfavourably affected by a contract between two parties. If a contract between two parties carried out with their mutual consent is detrimental to the interests of a third party, then it may enjoy certain rights and obligations.[197]

Now one may question in this regard that how to prioritise various rules of Islamic financial transactions mentioned above should there be a conflict. The Islamic legal financial system has a clear scheme of priorities in legislation. Where there is a clear injunction in the Qur'an, for example, in the form of prohibition of interest and games of chance, these must be observed at all costs. Next in importance are the rules that follow from the *Sunnah a*nd *'Ijma`* or consensus, in that order.[198]

3.3 Application of Products in Islamic Financial System

Islamic financial products are aimed at investors who want to comply with the Shari`ah. The most distinguishing component of Islamic finance as illustrated in the Shari`ah is the banning of interest regardless of the purpose for which it is given and regardless of the rates at which it is charged whether it is nominal or excessive, simple or compound, fixed or floating. Other components include the emphasis on equitable contracts, the linking of finance to

197 See Mohd Daud Bakar. 2003. "Contracts in Islamic Commercial and Their Application in Modern Islamic Financial System", *Iqtisad Journal of Islamic Economics*, Yogyakarta, Indonesia, available online at: http://islamic-world.net/economics/contract_01.htm (accessed March 18, 2007).
198 See Mohammed Obaidullah, *supra* note 189.

productivity, the desirability of profit sharing, and the prohibition of gambling.[199] The Shari`ah also commands that all financial transactions be based on real economic activity; and forbids investment in unethical sectors such as tobacco, alcohol, gambling, pornography, armaments and the like.[200]

IFIs provide a broad range of financial services, such as fund mobilisation, asset allocation, payment and exchange settlement services, and risk transformation and mitigation. All these specialised financial intermediaries perform transactions using the Shari`ah compliant financial instruments. While the main types of Islamic financial instruments are conceptually simple, they may become complicated in practice as some financial institutions combine aspects of two or more types of instruments to suit customer requirements.[201]

3.3.1 Islamic Modes of Financing

Usually IBs offer their depositors four classes of accounts: 1) current, 2) savings, 3) investment, and 4) special purpose investment accounts. In current and savings accounts capital is guaranteed and available for withdrawal at any time; and involves no payment to the customer on the deposit. Whereas in investment accounts deposits remain with the bank for an agreed period and a financial return is paid. On the asset side, IBs engage in

199 Ahmad, Abu Umar Faruq. 2003. *Islamic Banking in Bangladesh*. Unpublished Master's Thesis, available on University of Western Sydney website at: http://library.uws.edu.au/adt-NUWS/public/adt-NUWS20030723.130611/index.html

200 For example, in a landmark judgment announced in 1999, the Supreme Court of Pakistan held that any form of interest, defined as "the pre-determined, fixed and time-related increase over and above the principal of a loan or debt", was un-Islamic and hence prohibited. However, this judgment was overturned by the Supreme Court in its review jurisdiction and the case was remanded for re-trial on the grounds that arguments should be heard on whether modern-day interest is indeed oppressive and should be prohibited outright.

201 El Qorchi, Mohammed. 2005. "Islamic Finance Gears up", *Finance and Development*, IMF Quarterly Magazine, December, vol. 42, No. 4.

investment and trading activities according to the various contracts available.[202] On the deposit side, funds are mainly mobilised on the basis of a *Mudaraba* contract or an interest-free loan contract.

Islamic modes of financing are either (i) Equity-based financing which falls under the category of profit-and-loss sharing (PLS), or (ii) Debt-based financing which can be categorised under non-profit-and-loss sharing modes. A brief discussion on each of these categories is summarised as under.

3.3.1.1 Equity-based Financing Modes

Equity-based financing include mainly the: a) *Musharaka* and b) *Mudaraba* modes of financing.[203]

A. *Musharaka* is an equity participation contract under which a financial institution and its customer contribute jointly to finance a project. Ownership is distributed according to each party's share in the financing.

B. *Mudaraba* is a trustee-type finance contract under which one party provides the capital for a project and the other party provides the labour. Profit sharing is agreed between the two parties to the *Mudaraba* contract and the losses are borne by the provider of funds except in the case of misconduct, negligence, or violation of the conditions agreed upon by the financial institution.

202 A detailed discussion on these contracts will follow later in this study.
203 A detailed discussion on Musharaka and Mudaraba moods of financing will follow later on in this study.

Musharaka and *Mudaraba* are supposedly the main conduits for the outflow of funds from IBs and IFIs. The *Musharaka* principle is invoked in the equity structure of IBs and is similar to the modern concepts of partnership and joint stock ownership.[204] In so far as the depositors are concerned, an IB acts as a *mudarib* which manages the funds of the depositors to generate profits. The bank may in turn use the depositors' funds on a *Mudaraba* basis in addition to other lawful modes of financing. The bank may also enter into *Musharaka* contracts with the users of the funds, sharing profits and losses, as mentioned above.

3.3.1.2 Debt-based Financing Modes

Debt-based financing modes include the following mode of financial transactions:

A. *Bai` Murabaha*, B. *Bai` Salam*, C. *Istisna`a* D. *'Ijara* and *'Ijara wa 'Iqtina* and E. *Qard Hasan.* [205]

A. *Bai` Murabaha* is a purchase and resale contract in which a tangible asset is purchased by an IB at the request of its customer from a supplier, with the resale price determined based on cost plus profit mark up.

B. *Bai` Salam* is a purchase contract with deferred delivery of goods (opposite to *Murabaha*), which is mostly used in agricultural finance.

C. *Istisna`a* is a pre-delivery financing and leasing instrument used to finance long-term projects.

204 See Munawar Iqbal and David T. Llewellyn (eds.). 2002. *Islamic Banking and Finance: New Perspectives on Profit Sharing and Risk*, London: Edward Elgar Publishing Ltd. p.272.

205 Chapter 8 of this study will elaborately discuss on these debt-based financing modes of Islamic financial institutions.

D. *'Ijara* and *'Ijara wa 'Iqtina* or Lease and Lease Purchase. *'Ijara* is a leasing contract whereby a party leases an asset for a specified rent and term. It can be structured as a lease-purchase contract whereby each lease payment includes a portion of the agreed asset price and can be made for a term covering the asset's expected life.

E. *Qard Hasan* (benevolent loan) is an interest-free loan contract that is usually collateralised.

Among the above mentioned two categories of Equity-based and Debt-based financing modes Islamic finance favours Equity-based financing over the other. The classical Equity-based financial instruments in Islamic commercial law - the *Musharaka* (partnership) and *Mudaraba* (profit sharing) can be compared to the contemporary devices of venture capital, investment management and project financing. In financial markets, investing in stocks and equity funds is permitted under the Shari`ah but must conform to certain principles and guidelines. Similar to ethical or socially responsible investment, the Shari`ah compliant investment has developed to screen out undesirable companies based on the nature of their business or level of involvement with interest. Preferably, equity investments should be in entirely the Shari`ah compliant entities and the screening mechanism has been built up to promote Islamic investments in conventional markets as much as possible. Islamic scholars discourage speculation and preclude short selling, conventional debt instruments and derivatives.

CHAPTER 4

THEORIES OF FINANCIAL REGULATION

CHAPTER 4

THEORIES OF FINANCIAL REGULATION

In order for providing the contextual background as per requirements for any study of this kind in this section attempts are made to examine the theories of financial regulation with particular reference to its theoretical frameworks, categories and key objectives.

4.1 An Overview of Financial Regulation

In general, regulations are specific standards or instructions concerning what can or cannot be done by individuals or groups. In other words, they are particular rules that oversee the activities of persons or private sector enterprise. However, the term 'regulation' has been defined as action that 'command and control' the individual decisions of firms, in an effort to prevent private decision-making that fail to take adequate account of the 'public interest'.[206] In practice, regulation is a tool of government supervision that is often required from a public goods and services perspective where excessive market power exists. Whenever the provision of a certain service remains a monopoly and is considered an essential public good, it would continue to be regulated by the government or an independent commission, to prevent abuse of market position and power. Regulation therefore, has been diversely

206 Brown, B. 1992. "Regulation", P. Newman, M. Milgate, and J. Eatwell (eds.) *The New Palgrave Dictionary of Money and Finance*, vol.1, New York: Stockton Press. pp. 294–96.

categorised ‘good’ or ‘bad’ depending on the existing convention in development thinking at the time.[207]

Regulations, which are made under the authority of an act, are simply one way of implementing regulatory policy.[208] They are also implemented through statutes and administrative policy and enforcement activities keeping in view of accomplishing necessary public ends such as improved education and training, consumer protection and high standards of environmental quality, health and safety in the most efficient manner.[209] The financial sector may traditionally include banks, mutual funds, intermediation firms, insurance companies, lending institutions and other financial intermediaries.

Regulation is often enforced by government, either directly or through an appointed regulator. However, some industries and professions impose rules on their members through self-regulation. Regulation is often introduced to tackle market failure. Regulation, even though when introduced for sound economic reasons can generate more costs than benefits. Regulated firms or individuals may face substantial compliance costs. Firms may allocate substantial resources to regulatory arbitrage, which would leave consumers no better off. Regulation may lead to moral hazard if people believe that the government is keeping an eye on the behaviour of the regulated business and so do less monitoring of their own.[210]

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207 Kirkpatrick, Colin. 2001. *Regulatory Impact Assessment in Developing Countries: Research Issues*, Centre on Regulation and Competition working paper series, Manchester. p.2.

208 Regulation may be defined as “a state imposed limitation on the discretion that may be exercised by individuals or organisations, which is supported by the threat of a sanction”.

209 British Columbia Regulatory Reform Office, “BC Deregulation and Regulatory Reform Initiative: Mandate and Approach”, Regulatory Reform Office website, available at: http://www.deregulation.gov.bc.ca/minreport.htm (accessed January 27, 2007).

210 Research Tools, *Economics A-Z,* Economist website, available at: http://www.economist.com/research/Economics/alphabetic.cfm?TERM=REGULATION#REGULATION (accessed January 27, 2007).

The regulation of the financial system can be viewed as a significant tool of public control over the economy. The accumulation of capital and the distribution of financial resources are considered as an indispensable feature in the process of the economic development of a nation. The special role of financial intermediation and of the intermediator justifies the existence of a broader system of controls with respect to other forms of economic activity. Numerous theoretical motivations have been developed based on the existence of particular forms of market failure in the financial sector.[211]

4.2 Theoretical Frameworks for Regulation

In a mixed market economy, like that of Australia, why does the government regulate the behaviour of firms and individuals? What factors influence the number and extent of regulations and what stimulates individual regulations? The answers to these questions come from theories, of how institutions, businesses, and individuals behave; and from analyses and observations.

Broadly speaking, there are three Schools of thought on the existence of regulation in a mixed market economy.[212]

The first and most optimistic explanation is that regulation arises as a response to some market failure, and that it is carried out in "the public interest". This thought is based on an

211 Goodhart, C., P. Hartmann, D. Llewellyn, L. Rojas-Suarez and S. Weisbrod. 1998. *Financial Regulation: Why, How and Where Now?* London: Routledge.

212 Theory is model or framework (made up of a body of principles) to explain phenomena. The word 'theory' derives from the Greek word 'theorein', which means 'to look at'.

assumption that unregulated markets experience frequent failures and that governments regulate to counteract those failures and to make the markets safer and more competent.

The second is one variation of the public choice theory and proposes that the regulated industries capture the regulators and are able to turn the regulatory progression to the benefit of the regulated. Under this model, stricter regulations are in the interest of the active players in the market because the regulations limit access to the marketplace and facilitate the existing operators to earn monopoly rents.

The third theory is a second variation of public choice under which the government regulations exist to give politicians and bureaucrats the opportunity to create artificial scarcities and then extract the rents from such scarcities through bribes, campaign contributions, and employment opportunities for friends and family members.[213]

More importantly, in the public interest approach, protections of people in the face of market failures are of paramount importance. In the other two approaches peoples' needs are not significant in any way. Rather, in those two approaches players of financial markets in fact require regulation with the aim of making conditions for better productivity. The key dissimilarity between the capture theory and the special interest approach is their competitive behaviour between interest groups. In the capture theory only a single group exercises power over a particular group. On the other hand, the special interest approach gives importance on

213 Simeon Djankov, Rafael La Porta, Florencio Lopez-de-Silanes and Andrei Shleifer. 2001. "The Regulation of Entry", vol. 1, No.17, *Quarterly Journal of Economics*. pp.1-2.

the existence of a minimum restricted competition for agency control among special interests.[214]

Before examining each of these theories in more detail, it is imperative to recall the distinction between normative and positive legal theory. While normative legal theory tells us *what the law ought to be,* positive legal theory seeks to explain *what the law is* and *why it is that way,* and *how laws affect the world.* Or more simply: normative legal theories are about values whereas positive legal theories are about facts. In the case of regulation, normative theory asks *when the government should* intervene in private markets. Positive analysis, in contrast, examines *what is*. Positive theories try to envisage *when* regulation will take place, and help elucidate *why we see* various types of regulations in some industries and not others.

Given the above explanation, now it is pertinent to delve into the theories of financial regulation on a case by case basis as below.

4.2.1 The Public Interest Theory of Regulation

The perception of why we see regulation has developed over time the public interest theory of regulation (or what is referred to as "Normative Analysis as a Positive Theory" by Viscusi, Vernon, and Harrington)[215] recognised that markets are very much capable at distributing

214 See Richard A. Posner. 1974. "Theories of Economic Regulation", *The Bell Journal of Economics and Management Science,* vol. 5, No. 2, autumn.
215 See K. Viscusi, Vernon, J., and Harrington Jc. J. 1995. *Economics of Regulation and Antitrust*, 2nd edn., Cambridge, MA: The MIT Press.

inadequate resources to their best uses.[216] It is based on a normative concept that government intervention may be appropriate in cases when markets "fail" to allocate resources efficiently and as such they are unable to regulate themselves.[217] It is a form of *normative analysis* because it justifies the existence of regulation through claims that regulatory responses to specific situations give rise to improvements to social welfare. The theory holds that governments in the hunt for serving the public interest will regulate to correct those "market failures".[218] The notion of market failure derives from the theory of a "perfectly competitive market",[219] which was focused on the need for government intervention when markets diverge from these "perfect market" conditions.[220] Pioneered by Bator [221] and Samuelson,[222] the market failure model centres on questions of externalities (third party effects) and the ability to set efficient prices for goods and services.

The following four main causes of market failure have been identified by the economists.

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216 Gustave de Molinari. l977. *The Production of Security* (Huston McCulloch trans.), New York: The Centre for Libertarian Studies. p. 3.

217 The term "fail" here is not designed for meaning an economic failure, or a breakdown in market relations.

218 "Market failure" is a claim that the market is failing to create maximum efficiency. The term is used for situations when it is suggested that non-market institutions (such as fire fighting) would be more efficient and wealth-producing than their private alternatives.

219 A competitive market is something else for economists than what we usually find in the real world. We tend to define a competitive market as a market with at least several suppliers, which bring down the prices and allows the consumer some choice. However, a perfectly competitive market is where agents in the market (buyers and sellers) are price takers. In reality, no such thing as a true perfectly competitive market exists. The economists' 'Perfect Market' notion is about what would be perhaps the ideal conditions for capitalist market places to function. The assumption underlying the perfectly competitive markets 'Perfectly Competitive Markets' model as follows: a) there are no transaction costs incurred when buying in one market and selling in another; that is, prices are identical; b) freedom of entry and exit for the market players; c) identical products are being sold for identical prices; and d) the participants in the market must have access to perfect information. For example, the buyers in a market must know exactly what is for sale, where and at what price.

220 See Arthur Cecil Pigou. 1912. *Wealth and Welfare*, London: Macmillan.

221 See Francis Bator. 1958. "The Anatomy of Market Failure". *Quarterly Journal of Economics*, vol.72, August. pp.351-379.

222 See Samuelson Paul. 1954. "The Pure Theory of Public Expenditure". *Review of Economics and Statistics*, vol.36, November. pp.387-89.

4.2.1.1 Abuse of Market Power

The abuse of market power can occur whenever a single buyer or seller can exercise significant authority over prices or productivity. The presence of monopoly power in a market gives a firm the ability to control prices. In such a situation, without some form of intervention, prices would be higher and quantity produced lower than in a competitive market.

4.2.1.2 Externalities

Externalities occur when one party's actions impose uncompensated costs or benefits on another party. If those actions affect another party's welfare enough that they would be willing to pay to alter them, resources are not allocated the way they would be if all costs and benefits were "internalised" in the market place.[223]

4.2.1.3 Public Goods

Public goods are universal resources where it is not possible to exclude users. They have a propensity of being overused or undersupplied.[224] A public good as economists term the model, is any from whose enjoyment non-contributors cannot be excluded. The theory of public goods is of interest to liberals for two reasons: first, because a great many things we care about (for instance, highways, education, law enforcement, fire protection and national defence) are broadly thought to be public goods, or to have public-good features; and second,

223 In economic terms, air and sea pollution are cases of market failure due to externalities (market agents do not pay the full costs of their actions). While most environmentalists propose to solve such problems through government regulations.
224 Public goods are goods that would not be provided in a pure free-market system. This is because they display two particular characteristics: 1. Non-rivalry - consumption by one person does not reduce the amount available for others. 2. Non-excludability - once the good is provided it is impossible to stop people consuming it even if they have not paid.

because a great number of economists are convinced that such public goods cannot be supplied on the free market.[225]

4.2.1.4 Asymmetric Information

When market participants have incomplete information, markets may not allocate resources efficiently. However, some would argue that adequate information is a must and recent empirical analysis shows that it is not even optimal for an efficient market.

When one of the above failures occurs, a normative approach might argue that governments should intervene to correct it (by tackling through antitrust policy, internalising externalities, regulating monopolists, or providing information, for example). Using this normative analysis as a positive theory implies that we would see regulations passed to serve the public interest by addressing apparent or real market failures.

Many regulations do not stand for market failures, such as natural monopoly or externalities. The key critique of market failure analysis is that it does not identify the presence of transactions costs, or government failures. Transactions costs are indispensable funds of transport, establishment, and maintaining chattels rights. Externalities subsist since the transactions costs of resolving them are too high. Determining a market failure is not in itself an excuse for government action, as government action is also not faultless.[226]

225 See Roderick T. Long. 1994. "Funding Public Goods: Six Solutions", *Formulations*, autumn issue, Free Nation Foundation.
226 See Michael Hantke-Domas. 2003. "The Public Interest Theory of Regulation: Non-Existence or Misinterpretation?" *European Journal of Law and Economics*, Springer Netherlands, March, vol.15, No. 2, pp. 165-194.

As a positive theory, it assumes that regulation will pass when it ought to since the net social gains are greater than without regulation, but it does not tell us how or why people, in their role as government officials, businessmen and consumers, etc., will generate the sought-after outcome.[227] More significantly the public interest theory does not perform a good job of predicting when we will see regulation.

These market failures, together with the common need for regular public disclosure schemes by business firms, make regulation essential if the public interest is to be protected. Keeping these problems in view regulation is needed for protect of public from the negative impacts of such market failures and other detrimental business activities.

The public interest theory of regulation has instinctive appeal as the basis for realising the goals of regulation, although according to the most favourable interpretation it is ambiguous. It highlights absolutely the essence of regulation rather than how it develops and or upholds established solution to regulatory problems. As Bruce Mitnick's extensive study of regulation places it, "there remains no accepted definition of the phrase ['public interest']; much less an accepted operational definition offering indicators that we may use to determine empirically whether something is in the public interest".[228]

227 See William R. Smith. 2000. "Will Marketers Survive the "Information Age?" *The Graziadio Business Report,* issue 2, Spring.
228 Mitnick, B. M. 1980. *The Political Economy of Regulation: Creating, Designing, and Removing Regulatory Forms.* New York: Columbia University Press. p.259.

4.2.2 The Capture Theory of Regulation

The public interest theory of financial regulation was first challenged methodically in the early Seventies when it was suggested by researchers that the individual government regulatory bodies did not work for the public interest in any way, they worked for private interests instead. Some scholars even argued that each individual government organisation was "captured" by the foremost organised interest in the industry over which a particular agency functioned. [229]

This analysis rests on the perception that the governments that mainly involved in the regulation of a particular business are the companies in that very business. As a consequence of this strictly focused interest direction among economic players, it is believed that each regulatory body has been secluded and in effect taken over by a single influential interest alliance representing the very industry under regulation. Moreover, it is assumed that influential interests in one industry usually do not intervene the regulating activities in other industries.

This kind of analysis implies that there is little or even no competition over control of public policy among economic interests. Within each industry a single company or industry association dominates, and each industry minds its own business being careful not to interfere with other industries and their particular public agencies. General public are considered to be mostly out from the processes of economic regulation. Hence, this exclusion is thought to be derived from two things: 1) the issues and processes involved are complicated and 2) the impact of regulation on any individual inhabitant is relatively light

229 George, Stigler. 1971. "The Theory of Economic Regulation", *Bell Journal of Economics*, No.2. pp.3-21.

compared to the impact on the businesses under regulation. In short, regulation exists not because the public need it, but because the regulated industry wants it!

4.2.3 The Economic Theory of Regulation

The economic theory of regulation was introduced by Stigler in 1971 and later developed by Peltzman, James Buchanan and Gordon Tullock, which has a great impact on thoughts on theories of financial regulation.[230] With various minor differences in analysis this form of theory bears variety of names such as economic theory, special interest theory, private interest theory, public choice theory and perhaps lots more.[231] As a positive theory it is believed that regulators i.e. the politicians are maximisers of services and utilities. Even though the utilities are not precisely indicated they would seem to mean securing and maintaining political power.[232] To implement this they have to obtain votes and wealth or income to be provided by groups positively affected by regulatory decisions.

This move towards regulation is compatible with 'public choice theory' which lays emphasis on the degree with which governmental behaviour is understood by envisaging all players as realistic individual maximisers of their own interests. The study is directed to the competing preferences of the individuals concerned – how they become known to regulatory objectives in order to promote their own objectives. As a result private interests are provided rather than the public interest. Public choice brings together political and economic problems.

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230 See B. Brown, *supra* note 202.

231 Sanderson, Allen R. 2001. "Wealth of notions", *University of Chicago Magazine*, Chicago: The University of Chicago Alumni Association, December, vol. 94, No. 2.

232 Majone, Giandomenico. 1996. "Public Policy and Administration: Ideas, Interests and Institutions", Goodin, Robert E. and Hans-Dieter Klingemann (eds.), *A New Handbook of Political Science*, Oxford: Oxford University Press. pp. 610-27.

4.3 Categories of Regulation

Generally, regulation falls into two key categories: 1) social regulations, and 2) economic regulations.

4.3.1 The Social Regulation

The social regulations are intended to deal with issues related to health, safety, and the environment. They are concerned with the conditions under which goods and services are produced and the impact of these goods on the public welfare.[233] The Environmental Protection Authority, National Occupational Health and Safety Commission, Food Standards Australia New Zealand, and the Australian Transport Safety Bureau are examples of agencies that oversee social regulations. Their activities are normally limited to a particular issue, but they also have the authority to regulate across industry boundaries. For example, the National Occupational Health and Safety Commission regulate worker safety across industries.

4.3.2 Economic Regulation

Economic regulations are usually industry-specific. They are common for natural monopolies; situations where economies of scale exist with production by one firm.[234] Australian Securities and Investments Commission, the US Federal Communications Commission, and the Federal Energy Regulatory Commission are examples of agencies that fall into the economic regulation category. They regulate a broad base of activities in

233 See William Boyes and Melvin Michael. 2003. *Fundamentals of Economics*, 2nd edn., Houghton Mifflin Co., available online at: http://college.hmco.com/economics/boyes/fundamentals/2e/instructors/protected/toc/ch07/section170.html (accessed July 22, 2007).
234 *Ibid.*

particular industries using economic controls such as price ceilings or floors, quantity restrictions, and service parameters.[235]

In fact, there are various categories of regulation. The above mentioned economic and social regulations are but two instances. Regulation of quality, service, right to use, performance, and pricing, are all component of the broad authorisation of regulators in most countries. In different sectors such as financial market regulation, price regulation is immaterial, but ensuring consumer protection against deceptive activities is crucial. Therefore, regulation forms are regularly dictated by the services that are regulated.

4.4 The Objectives of Financial Regulation

The objectives of public sector regulation may be the easiest to sort out. Nonetheless, while a legitimate case can be made for regulating credit institutions, the rationale for regulating investment firms is considered by some commentators to be much less transparent. However, the following three main regulatory objectives should be relevant in any institution that provides financial services.

4.4.1 Financial Stability

A first objective of financial regulation is to strengthen the stability of the financial system as a whole. Financial stability is a pure 'public good' in that it will not be produced by the operation of market forces. It translates into control over the financial exchanges, clearing

235 Herring, R. and R., Litan. 1995. *Financial Regulation in the Global Economy*, Washington, DC: The Brookings Institution.

houses and securities settlement systems. Its primary objective also includes stability of all business enterprises and entrepreneurial activities as well as risk based capital ratios, limits to portfolio investments and the regulation of off-balance activities.[236]

4.4.2 Consumer Protection

A second objective of financial regulation is transparency in the market and in intermediaries and consumer protection. This theme is related to the more common objective of equity in the distribution of the available funds. However, this is closely related to the objective of financial stability and may extend beyond. Confidence in the market in general lies at the core of both financial stability and consumer protection.

4.4.3 Competition Promotion

A third objective of financial regulation is the protection and promotion of competition in the financial intermediation sector. This relates to the free provision of services and the promotion of competition as well as to limiting potential destabilising excesses generated by competition itself.

A number of principles directly drawn from the objectives mentioned above may be identified in the pursuit of a better regulatory arrangement. They can be summed up as under:

236 Di Giorgio, Giorgio, Di Noia, Carmine and Piatti, Laura. 2000. *Financial Market Regulation: The Case of Italy and a Proposal for the Euro Area,* The Wharton Financial Institutions Centre working paper series, Roam. pp.6-7.

First, proximity to the markets and financial intermediation sectors. It implies that regulators should always be aware of the introduction of new products and services and the creation of new risks, in order to appraise and achieve the essential information in time. Regulation should come first than markets.

Second, incorporated markets entail integrated regulation. Recent financial defaults and market failure clearly specify that constant supervision, exchange of information and managing crises cannot be efficiently conducted on an individual or merely Co-operative basis.

Third, to circumvent competitive distortion, the principle of 'same business, same risks, same regulations' must apply.[237]

Fourth principle is related to regulatory and supervisory balance. The regulator needs to strike a delicate balance between regulation that supports the reputation and, thereby, attracts business; and regulation that is so strict as to drive business out.

Fifth, globalisation and financial business consolidation have need of new tools for supervision. Where such developments are of paramount importance to lead to regime shifts and new operational structures, regulators need to make sure that they got a supervisory system ready that can deal with the inescapable mistakes that financial institutions will make as they learn how to operate in the new regime.

237 *Ibid.*

These key principles have to co-exist if a chosen regime is to accomplish its mission sensibly. This is particularly important in periods of structural change, especially today, when markets are integrated and the risk of systemic loss shadows their stability, regulators and regulated have to work together for the common objectives.

4.5 Concluding Remarks

The theories of financial regulation have shed new light on when we can expect to examine regulation, and what will be its structure. These theories have proven very positive in elucidating regulatory activity. They also let us know that, irrespective of ethics and objectives, politicians have the same motivations as other people to make best use of their own well-being. Therefore, small, structured interest groups can affect the political motivation to obtain specific benefits while distributing costs to large unstructured populace. However, these theories have come across many problems for which it has been unable to provide solutions. For example, Stigler's theory did not explain the events of cross-subsidisation where the economic benefits of regulation develop from the intended group to other groups of producers and consumers.[238] Another major problem of these theories is that they are unable to explain regulation. For instance, Majone (1996) concludes that "positive and normative theories of regulation should be viewed as complementary rather than mutually exclusive".[239]

238 *Ibid.* pp.32-34.
239 *Ibid.* p.34.

CHAPTER 5

HISTORICAL EVOLUTION OF FINANCIAL PRODUCTS

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5.1 Evolution of Conventional Financial Products

The present chapter of this research is mainly motivated by the need to place our current age of financial revolution in historical perspective. Financial products and instruments are devised by investment bankers roughly overnight, which are then analysed, valued, traded, saved, and hedged themselves – sometimes to be replaced by new financial instruments, and at other times become part of the permanent toolkit of financial engineers and investors.[240] This evolution process of finance through 4,000 years of history to the dawn of writing is in fact built on three key foundations although there are quite a number of other important principles of modern and historical finance. They are: (1) the intertemporal transfer of value through time or time value of money,[241] (2) the ability to contract on future chance outcomes, and (3) the ability to trade contractual claims to a third party or the negotiability of claims.[242]

240 See William N. Goetzmann and K. Geert, Rouwenhorst. 2005. "Introduction to Financial Innovation in History", *The Origins of Value: The Financial Innovations that Created Modern Capital Markets*, Goetzmann, William. N. and Rouwenhorst, K. Geert (eds.), USA: Oxford University Press. p.3.

241 Money is a good that acts as a medium of exchange in transactions. Classically it is said that money acts as a *unit of account*, a *store of value*, and a *medium of exchange*. Most authors find that the first two are nonessential properties that follow from the third. In fact, other goods are often better than money at being intertemporal stores of value, since most monies degrade in value over time through inflation or the overthrow of governments.

242 See William N.G. and K. Geert, R., *supra* note 236.

5.1.1 The Concept of Time Value of Money

The simplest financial arrangement is an intertemporal value transfer – in other words a loan. In a loan contract say 'A' lends something to 'B' with the promise that 'B' will repay it to 'A' in future. In this example, 'B' who is a borrower comes to the arrangement without any money suddenly has wealth. On the contrary, 'A' who being a lender takes current wealth, places it in the contractual equivalent of a time machine, and transfers it to a future date, when he might better use it. For doing so 'A' is typically compensated with interest that makes him better off than in the present.

If we look into the origin of written loan contracts with interest we find that it was first attested in Babylonia that are more than 3,000 years old. From Babylonia the concept of loans spread out all over the Near East by the third millennium. Thus, the roots of finance can be traced back to the roots of civilisation itself.[243] Nevertheless, the usury laws in the Roman Catholic Church frowned upon the taking of interest during the thirteenth through eighteenth centuries in Europe – the period of greatest dynamism and invention in finance.[244] According to French theologian William of Auxerre (d.1231 C.E.), who recognised the fundamental role played by the time in financial contracting and used it to justify this ban on interest for centuries: "The usurer acts contrary to natural law, for he 'sells time' which is common to all creature".[245]

243 Mieroop, Marc Van De. 2005. "The Invention of Interest: Sumerian Loans", *The Origins of Value: The Financial Innovations that Created Modern Capital Markets,* Goetzmann, William. N. and Rouwenhorst, K. Geert (eds.), USA: Oxford University Press. p.17.

244 Islamic precepts against usury, prohibiting any interest at all, may have been a reaction against the heavy burden imposed on those who had the misfortune to need a loan.

245 John, H. Munro. 2003. "The Medieval Origins of the Financial Revolution: Usury, Rentes, and Negotiability", *The International History Review 25,* No. 3, September. pp.505-562.

5.1.2 Contingent Claims

The second key foundation of finance is the ability to contract on future chance outcomes. This, coupled with inter-temporal wealth transfer, is largely responsible throughout financial evolution for creative innovation. Contingent claims are nothing more than bets, in which first parties pay the second parties depending upon the outcome of some event. Life insurance is the classic example where the insurer pays the beneficiary when the insured party dies. Once the contractual framework for life insurance is established, however, there is now limit to the range of things that can be contracted upon.

Like loan documents, the earliest written contingent contracts are Mesopotamian cuneiform records; however, some of the most exciting developments in contingent contracting took place in Holland in the 17^{th} century with the creation option contracts on shares-puts and calls that allow speculators and hedgers to buy or sell stocks at a pre-specified if they went up or down.

Contingent claims tools not only allow society to address immediate, foreseeable risks, but they also allow society to deal with the "meta-uncertainty" of an evolving future. What worries one generation about the future may not be what concerns the next. The principle of contingent claims is flexible enough to adapt to these changing concerns. As new risks appear, new insurance contracts are written to allow counterparties to limit and define their exposal. A modern example of this is Fannie Mae, the mortgage insurance agency in the United States of America.

5.1.3 Negotiability of Claims

Negotiability is the defining characteristic of a capital market which allows investors to transfer financial claims. Loans and contingent claims are certainly visible without a secondary market, but the ability to trade contractual claims to a third party dramatically enhances the power of financial technology. For example, 'A' has loaned 'B' AUD 1,000 and will not get it back for a year. However, 'A' suddenly needs the cash. 'A' could, of course, become a borrower itself. Another possibility is for 'A' to sell the loan contract to 'C'. In effect, to tell 'B' the borrower, to repay the money to someone else.

The true negotiability first developed in China and enriched its most dramatic expression in the 11th century in the form of paper money. Indeed, the Chinese not only invented paper money, but also fiat money that is negotiable because the government says so.[246] Paper money in China was an experiment that lasted approximately for 400 years. Ironically, it disappeared in the 15th century, just as financial markets were developing in Western Europe.[247]

There are many other factors that make financial innovation possible; however, intertemporal transfer, contingent claims, and negotiability are considered as the fundamental principles of conventional financial products.

246 In a fiat money system, money is not backed by a physical commodity (i.e. gold). Instead, the only thing that gives the money value is its relative scarcity and the faith placed in it by the people that use it.

247 Experience had shown that carrying large quantities of gold, silver, or other metals proved inconvenient and risked loss or theft. The first use of paper money occurred in China more than 1,000 years ago. By the late 18th and early 19th centuries paper money and banknotes had spread to other parts of the world. See for more elaboration, *Encyclopaedia Britannica*, available at: http://www.britannica.com/eb/article-247595/money#845906.hook

5.2 Evolution of Islamic Financial Products

Islamic financial management were set out by the Prophet Muhammad (PBUH) in his Farewell Sermon, wherein he pinpointed the ideal system at which Muslims should aim. Nevertheless, in modern age, in the late 19th Century, the Ottomans introduced Western-style banking to the Muslim world to finance their expenditures.[248] While a minority Islamic legal scholars permitted modern banking practices, the majority found those practices to be violations of Islamic prohibitions against *riba*, interpreted any interest charge on loans. This antipathy continued through the European colonial period, which lasted into the mid-20th Century. Islamic revival played a central role in the intellectual and social foundations of independence movements of the mid-20th Century.[249] To many intellectual founders of the movement, political independence was to be supplemented with economic independence, through the definition of an Islamic economic system.

Early writings on what came to be known as "Islamic Economics" focused on macroeconomic developmental issues. By the 1970s, theoretical discussions of Islamic economics had given rise to practical discussions of Islamic finance, which turned juristic in nature: how can Muslims replace conventional financial practices with Islamic alternatives.[250] Mid-Century literature suggested a profit-and-loss sharing silent partnership alternative to interest-based lending. The Arabic name of this contract is *Mudaraba*, which is

248 See Mahmoud El-Gamal. 2006. "Overview of Islamic Finance". U.S. Department of the Treasury, Office of International Affairs, *Occasional Paper Series*, No.4. August, available online at: http://www.treasury.gov/offices/international-affairs/occasional-paper-series/ (accessed July 20, 2007).
249 *Ibid.*
250 *Ibid.*

akin to the medieval European Commenda contract, and the Jewish *Heter Iska*, designed similarly to avoid usurious lending in Jewish and early Catholic Law.[251]

This partnership-based focus survives in some Islamic financial practices (e.g., as a substitute for interest-bearing bank deposits). However, with the help of Islamic jurists and lawyers Islamic financial practitioners were soon able to provide close analogues to almost all financial products, including various debt-instruments and fixed-income investment vehicles. In the following section we shall summarise some of the most widely used Islamic financial products.

5.3 Islamic Financial Products: The State of the Art

There are many financial products used within the industry collectively known as Islamic finance. Specifics vary across countries and sectors. In prevailing section, emphasis has been given mostly to some of the basic and central modes financing that are most popular in Islamic finance today. When significant differences exist between implementations of a particular Islamic financial product in different regions or sectors, those differences are highlighted briefly.

251 On *Mudaraba*/Commenda, see Abraham L. Udovitch. 1970. *Partnership and Profit in Medieval Islam*. Princeton, N.J: Princeton University Press. On the *Iska* contract, see J. Stern. 1982. "Ribit: A Halachic Anthology", *Journal of Halacha and Contemporary Society*, 46, Sample *Iska* forms are available online at: http://www.jlaw.com/Forms/iska_d.html, (accessed July 21, 2007).

5.3.1 Consumer and Business Loan: Islamic Alternatives

The Shari`ah alternative understanding of forbidden *riba* or interest suggests that Islamic finance has to be "asset-based", in the sense that one cannot collect or pay interest on rented money, as one does in conventional banking.[252] Therefore, the easiest transactions to Islamise were secured lending operations, e.g., to finance the purchase of real estate, vehicles, business equipment, etc. Three main tools are utilised for this type of retail financing.

5.3.1.1 Buy-Sell-Back Arrangements as *Murabaha*

Under this transaction, the bank obtains a promise that its customer will purchase the property on credit at an agreed-upon mark-up (an alternative to interest), then proceeds to buy the property and subsequently sell it to the customer. Depending on the jurisdiction and the object of financing, this may or may not impose additional sales taxes, license fees, etc. In the U.K., a recent regulatory ruling allowed Islamic financiers (HSBC) to practice double-sale financing without being subject to double-duty taxation. The mark-up in *Murabaha* financing is benchmarked conventional interest rates.

5.3.1.2 Lease-to-Purchase or Diminishing Partnership as *'Ijara* or *Musharaka Mutanaqisa*

A typical structure requires the bank to create a special purpose vehicle (SPV) to purchase and hold title to the financed property. The SPV then leases the property to the customer, who makes monthly payments that are part-rent and part-principal. Rents are calculated

252 As Islamic finance provided to finance investment is asset-based, i.e. it is used to acquire real assets; it is much less likely to lead to debt crises. Such type of asset-based finance, directly contributes to the ability of the economy to meet its internal and external financial obligations. See for details, Mabid Ali Al-Jarhi, n.d. "Islamic Finance: An Efficient & Equitable Option", The Islamic Research and Training Institute working paper, available online at: http://www.wfdd.org.uk/articles_talks/mabid.pdf.

based on market interest rates, allowing monthly payments to follow a conventional amortisation table. The Shari`ah justification of this practice is that principal parts of monthly payments increase the customer's ownership in the property, and allow him to pay less rent (on the part ostensibly owned by the bank through the SPV) over time, thus replicating a conventional amortisation table.[253] Again, in the UK, at the request of the United Bank of Kuwait (UBK), the Office of the Comptroller of the Currency examined the typical structure of Islamic lease-to-own (*'Ijara*) transactions, and reasoned as follows:

> "Today, banks structure leases so that they are equivalent to lending secured by private property ...a lease that has the economic attributes of a loan is within the business of banking...Here it is clear that UBK's net lease is functionally equivalent to a financing transaction in which the Branch occupies the position of a secured lender…".[254]

An added advantage to lease financing is that Islamic jurists allow the SPV to issue certificates securitising the lease (ostensibly, the certificates represent ownership of the underlying asset, and thus allow their holders to collect rent). In recent years, this has given rise to a booming securitisation industry in Islamic Finance. In the U.S., both Fannie Mae and Freddie Mac have purchased and guaranteed *'Ijara*-based mortgages, subject to their note requirements (which required overcoming some legal and juristic hurdles). Those Islamic home finance-backed securities are currently being marketed as fixed-income investment alternatives for Muslims.

253 See Section 9.1 of this study for more information on such an amortisation table (Table 2).
254 See Lariba Bank website, available at: http://www.lariba.com/knowledge-center/articles/pdf/LARIBA%202002%20-%20Western%20Regulatory%20Concerns.pdf, (accessed July 22, 2007).

5.3.1.3 Consumer Finance through a Three-Party Contract Known as *Tawarruq*

This is a practice that IBs used with more sophisticated business customers for a number of years, but only recently have introduced for consumer financing. For example, a customer wants to borrow AUD 1000 using a Shari`ah compliant mechanism. Islamic jurists in the Gulf Cooperation Council (GCC), relying on an opinion within the Hanbali School of jurisprudence, which is dominant in that region, allow the bank to buy USD1,000-worth of commodities (e.g., wheat), and sell them to the customer on credit at a mark-up (equal to the interest rate they would have charged on a loan, perhaps plus compensation for the transaction costs associated with multiple sales). The customer may then turn around and sell the commodity to a third party (often times the same party that sold it to the bank), collecting the desired cash immediately, with a deferred debt equal to principal plus interest. In 2004, at least one other bank in a GCC country announced a new *Tawarruq* facility. Since this type of financing can easily replace lending for any purpose (consumer loans, unsecured loans, etc.), it has allowed a number of conventional banks to announce that they will "Islamise" all of their operations. The most significant such announcement was that made by Saudi Arabia's National Commercial Bank, stating that it planned to Islamise all of its lending practices in near future.[255]

255 The National Commercial Bank (NCB), headquartered in Jeddah, Saudi Arabia was the first bank established in Saudi Arabia in 1953, which is now considered the largest bank in terms of capital; both in Saudi Arabia and in the Middle East. It has now total 248 branches out of which 161 branches are dedicated exclusively to Islamic Banking services. See for details on NCB at: http://www.infosys.com/finacle/casestudies_ncbjeddah.asp, retrieved Aug 7, 2007.

5.3.2 Investment Vehicle: Islamic Alternative

For investment in corporate equity, it was easy to see why Islamic investors should shy away from companies that produced products that are forbidden to Muslims (e.g., beer, pork products, etc.), as well as some others that Islamic jurists decided to forbid (e.g., weapons producers, cutting-edge genetic research, etc.). The issue of interest was much more difficult. Most companies either have excess liquidity - in which case they earn interest, or use leverage - in which case they pay interest. Islamic jurists decided to invoke the rule of necessity (the universe of equity securities to choose from would be too small if they exclude all companies that either pay or receive interest).[256] They decided to impose three financial screens: (i) exclude companies for which accounts receivables constituted a major share of their assets; (ii) exclude companies that had too much debt; and (iii) exclude companies that received too much interest. After experimentation with different cut-off marks for financial ratios, the set of rules selected by the Dow Jones Islamic indices became globally accepted: (i) exclude companies whose receivables accounted for more than 45% of assets; and (ii) exclude companies whose debt to moving average of market capitalisation exceed 33%. Many add a third rule related to the first: (iii) exclude companies whose interest income exceeds 5% (or, for some, 10%) of total income.[257]

Dow Jones, and later Financial Times, launched their Islamic indices in the late 1990s, and continue to add various other Islamic indices paralleling their other conventional indices, with the smaller universe of equity securities. Mutual fund companies either mimic their

256 See Mahmoud El-Gamal, *supra* note 244.
257 *Ibid.*

screening rules, or obtain licenses from one of the indices, which they use as a benchmark.[258] These types of mutual funds are generally named 'Islamic' or 'Shari`ah compliant'. While sales of mutual funds in general have done well in Saudi Arabia and GCC markets, Islamic mutual funds seem to have only a limited marketing advantage over conventional ones. In one study done by National Commercial Bank in Saudi Arabia, investors indicated that all other things equal, they would prefer an 'Islamic' fund to a conventional one. However, if other things are not equal, they would prefer a conventional fund with better returns, or offered by a more reputable provider, to ones that are 'Islamic' but inferior along those dimensions. As a result, the total funds under supervision by Islamic mutual funds have - to date - fallen significantly short of initial expectations.

On the other hand, growing unanimity over the general screens used by Islamic mutual funds has enabled Islamic private equity and investment banking boutiques to thrive. Those institutions typically collect investor funds in GCC countries (investors from Saudi Arabia, Kuwait, and U.A.E being primary sources of funds). Through local subsidiaries or partners in the West (U.S.A. and U.K. being primary destinations for investment funds), collected funds are used to acquire real estate and small companies that pass the above mentioned screens, or whose debt can be restructured to pass them (oftentimes through lease-based leveraged buy-outs, a popular Western mergers and acquisitions tool of the 1980s and 1990s). There are 134

258 In order to provide a benchmark for equity prices for investment two indices were launched in 1999 by Islamic financial institutions: the Dow Jones Islamic Market (DJIM) Index in Bahrain and the Financial Times Stock Exchange Global Islamic Index Series (GIIS). Although these indices have since been published worldwide, Islamic indices remain in their infancy and play a limited role in Islamic financial markets. For more exposition on this see Mohammed El Qorchi, *supra* note 197.

registered equity funds, six hybrid funds, six *Sukuk* funds, two *Takaful* funds (insurance), five leasing funds and eight real estate funds worldwide.[259]

5.3.3 Corporate and Government Bonds: Islamic Alternatives

In its early stages of development in the 1980s and 90s, a number of bond alternatives were tried with very limited success. Some were based on PLS (e.g., in Sudan and Pakistan), while others guaranteed the principal but did not guarantee a fixed rate of return (e.g., in Malaysia). Once the securitisation of leases became fully understood, a significant number of corporate and government bonds were structured as lease-backed securities (under the Arabic name *Sukuk al-'Ijara*).[260] In 2004, the largest issuance was made by the Department of Civil Aviation of the United Arab Emirates for USD750 million. The second largest was by the Bahrain Monetary Agency for USD250 million. The latter was led by Citigroup, with heavy involvement of the Norton Rose law firm to structure the deal. A third interesting government issuance was by the German Federal State of Saxony Anhalt for €100 million, which is heavily marketed in the Arab countries of the GCC as the first Western government issued Islamic bond. The two largest corporate Islamic bond issuances in the first half of 2004 were those of the National Central Cooling Company (U.A.E.) for USD100 million and HANCO Rent-A-Car in Saudi Arabia for USD26.13 million.[261]

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259 As of February 2006. See for details *Failaka Islamic Fund Reports 2006*, available online at: www.failaka.com

260 Arabic precursor of cheques, meaning certificates of debt or bond. For more details on *Sukuk* See Ayman H. Abdel-Khaleq and Christopher F. Richardson. n.d. "New Horizons in Islamic Securities: Emerging Trends in Sukuk Offerings", *Convergence: New Directions in Islamic Finance?* The Arab Financial Forum, Harvard University, available online at: http://www.divinity.cam.ac.uk/cip/documents/Report_islamic_financeAFF.pdf

261 The product used by HANCO Rent-A-Car was named the 'Caravan *Sukuk'* and structured on an *'Ijara* basis, ran for three years with a variable rate of return paid to investors on a monthly basis, which was forecast to be 6% per annum. This *Sukuk* was followed closely by a similar offering, designated 'Tabreed', on behalf of the National Central Cooling Company using a combination of *'Ijara* and *'Istisna`a.* See Rodney Wilson. n.d. "Overview of the Sukuk Market", working paper, Institute for Middle Eastern and Islamic Studies, University of Durham.

Corporate bond issuances in the early part of 2006 totalled USD10.2 billion, the most notable being the Dubai Ports issuance of the largest *Sukuk* to date, a 2 year convertible USD3.5 billion bond (PLS).[262] In 2005, an estimated USD11.4 billion in corporate *Sukuk*s were issued, up from USD5.5 billion and USD 4.6 billion in 2004 and 2003 respectively. Sovereign issuances in 2006 total USD 2.7 billion thus far, up from USD 706 million in 2005, USD 1.5 million in 2004 and USD 1.2 million in 2003.[263] An additional USD 6.7 billion in sovereigns is slated to be issued for the remainder of 2006.[264]

A number of those issuances were made by SPVs, which buy some properties from the respective governments or corporations using bond-sale proceeds, and then lease the properties back, passing principal and interest back to bond-holders in the form of rent. A number of different U.S. and European investment banks[265] are involved in the securitisation process (e.g., Citigroup for the Bahraini and German state bonds, Credit Suisse First Boston for the UAE cooling company, and Barclays Bank with the Dubai Islamic Bank for the Dubai Ports Co.).

Lease-backed bonds are long-term securities, for which underlying physical assets allow secondary markets to exist. Shorter-term (Treasury bill-like) bonds are also issued on

262 Managed by Dubai Islamic Bank and Barclays Bank. Details about the *Sukuk* structure, and thus about potential risk-structure differences from conventional bonds, are not available.
263 Sovereigns include government-owned institutions, utilities, etc.
264 See ISI Emerging Markets' Islamic Finance Information Service (IFIS) Data 2006. The Data is available online at www.securities.com/ifis.
265 The term 'investment bank' was invented in the United States in early the 20th century and is now broadly used in other countries, including Australia. It is a term that is generally explanatory of the specific intermediary functions such banks carry out, rather than a particular designation given by the relevant authority. Although referred to as 'banks', historically they have not held banking licences nor been permitted to provide commercial banking activities such as taking deposits from or lending money to retail customers. In Australia they have also been referred to as merchant banks, although the American term is now more widespread. See Michael Evans. 2004. "Investment Bankers Have Reason for Joy", *The Sydney Morning Herald,* Sydney, 13 December.

occasion by governments of countries with significant Islamic banking operations (e.g., Bahrain). Those are typically based on forward sales of some commodities, using the Arabic name *Salam,* and adhering to the classical juristic ruling that price must be paid in full at the inception of a *Salam* sale. By utilising what is called a "parallel *Salam*", the bond issuer can match a forward-purchase with a purchase-sale for the same commodities and the same delivery date, but initiated at different times. Thus, corn deliverable in six months can be sold forward today for USD 1 million, and then bought forward in three months (using a separate contract with a different counterparty) for USD 1.01 million. While residual credit, commodity and delivery risks may exist in this structure, issuers typically guarantee the contract so that the bond buyers would - in our example - be guaranteed 1% in 3 months. Since the underlying assets for this type of bond are debts, Islamic jurists ruled that they cannot be traded on secondary markets (except at face value, which defeats the purpose).[266] Thus, they were originally envisioned as vehicles primarily for IBs to hold to maturity. Recently, however, Bahrain has introduced some innovative repo (repurchase) facilities, to allow IBs to use those bills more effectively for liquidity management.

5.3.4 Insurance: Islamic Alternative

The vast majority of Islamic jurists declared the use of, and investment in, insurance companies to be impermissible under Islamic jurisprudence. This prohibition is based on two considerations: the first consideration is that 'safety' or 'insurance' is not itself viewed as an

266 The general rule regarding Bai` Salam as has been mentioned in Islamic jurisprudence that the buyer of Salam will benefit from the prospect of paying a lower price than the expected future price. See for example, Muwaffaq Ad-Din Abu Muhammad `Abdullah b. Qudamah. 1983. *Al-Mughni wa Sharh al-Kabir*, Beirut: Dar al-Kitab al-`Arabi, vol.6. p.384.

object of sale in classical Islamic jurisprudence. Thus, Islamic jurists argued, the insured-insurer relationship is viewed to be one akin to gambling, wherein the insured as buyer pays periodic premiums as price, but may or may not receive the object of sale (compensation in case of loss), depending on chance. The second consideration that prompted Islamic jurists to forbid insurance is the fact that insurance companies tend to concentrate their assets in interest-based instruments such as government bonds and mortgage-backed securities.[267]

The alternative they proposed is marketed under the Arabic name *Takaful,* which has recently begun making inroads in Islamic countries, after years of slow growth.[268] The main idea behind *Takaful* is similar to mutual insurance, wherein there is no commutative financial contract that allows one to interpret premium payments as prices and insurance claim fulfilment as an object of sale. Rather, policy holders are viewed as contributors to a pool of money, which they agree voluntarily to share in cases of loss to any of them. Early *Takaful* companies were in fact structured as stock insurance companies, but the language of 'voluntary contribution' to insurance claimants was used to argue that the contract was not a commutative one. Inroads have recently been made by Bank Al-Jazira of Saudi Arabia by modifying its insurance to better approximate Western-style mutual insurance, and the model appears to be boosting its underwriting success. Regardless of structure, both types of *Takaful* companies do not invest in conventional government bonds and fixed income securities. However, as seen elsewhere in this section, Islamised analogues of those securities have become increasingly available in recent years, further contributing to the industry's

267 See Misbah Kamal, "Perspectives on Takaful Convergence: A Preliminary Approach", *Convergence,* London: The Arab Financial Forum, available online at: www.divinity.cam.ac.uk/cip/documents/Report_islamic_financeAFF.pdf

268 The first *Takaful* company was established in Sudan in 1979 under the name 'Islamic Insurance Company Limited'. The ground for the emergence of Islamic insurance companies were prepared by the various writings of Muslim scholars and commentators establishing the *Shari`ah* framework for insurance.

growth. Despite the industry's growth, it has not yet reached a critical size that would support the equivalent of re-insurance, or 're-*Takaful*', companies to emerge. Consequently, Islamic jurists have invoked the rule of necessity to allow *Takaful* companies to sell their risks to conventional re-insurance companies, with the provision that they should work to develop a re-*Takaful* company as soon as possible.

5.3.5 Bank Deposit and Fixed Income Security: Islamic Alternatives

In the Islamic world, IBs can only accept fiduciary deposits, for which they cannot pay interest, since interest would be considered *riba* once the principal is guaranteed. On the other hand, they are allowed to accept 'investment account' funds, which they may invest on behalf of the account holders, and share profits and losses thereof. This clearly gives rise to a moral hazard problem, and a regulatory issue regarding protection of investment account holders who are neither protected as creditors (first claimants), nor as stock-holders with representation on boards of directors. Attempts by significant juristic bodies to justify interest-bearing bank deposits have been strongly rejected by most Islamic jurists, especially the ones to whom IB customers look for guidance. [269]

In the U.S. a number of conventional banks are offering Islamic financing products, and working towards offering FDIC-insured[270] variable-interest (tied to rate of return on portfolio of Islamic housing finance, auto-financing, etc.) NOW, money market, and other types of

269 For a summary of this debate and its juristic grounds, see Mahmoud El-Gamal, *supra* note 63.
270 The Federal Deposit Insurance Corporation. The FDIC provides deposit insurance which currently guarantees checking and savings deposits in member banks up to $100,000 per depositor. See on Wikipedia webpsge at: http://en.wikipedia.org/wiki/Federal_Deposit_Insurance_Corporation

bank accounts. Interpretation of such services as 'deposits' is controversial, and their appeal to target customers is uncertain. In particular, and in analogy to the limited appeal of Islamic mutual funds, it may be the case that potential IB customers who are sufficiently sophisticated to accept deposit insurance will also be sufficiently sophisticated to seek the best combinations of returns and offering institution-size. On the other hand, the novelty of 'Islamic banking' availability may prove to be sufficiently attractive for a group of Muslims who have so-far shied away from depositing their funds in savings or money market accounts, as well as others who have such accounts but prefer to buy the 'Islamic' brand-name.[271]

In the meantime, as we have shown, market-based fixed-income alternatives have been available for quite some time based on securitisation. Thus, Islamic finance customers can buy Islamic home finance -based securities, or invest directly in pools of securitised fixed-return Islamic financial products.

In this regard, while securitised *Murabaha* (cost-plus credit sale receivable) portfolios are deemed non-tradable except on face value, Islamic legal scholars have allowed trading mixed portfolios of sale-based and lease-based receivables, provided that the latter constitute at least 51%. If the market for Islamic-finance assets continues to grow, the ability to offer all types of fixed-income instruments, including bank savings accounts, should become more common in the West. It may take time for Middle-Eastern and Asian customers to accept this notion,

271 For instance, a small market exists for "*Halal* (permissible) meat", analogous to Kosher products, based on specific slaughter and processing procedures. Those products appeal to customers who otherwise would only consume vegetarian products, as well as others who would buy regular meat products but prefer to buy "*Halal*" meat.

given the vigour with which they have constantly argued against interest-based transactions as the forbidden *riba*.

5.4 Concluding Remarks

Islamic finance is an industry which in many ways tries to produce successive approximations of Western financial practices. However, this industry is here to stay due to continued existence of customers who value Islamic jurist approval of its modes of operation and tradable financial products. Its absolute size has already reached levels that require monitoring the sector, and ensuring the development of appropriate prudential regulations therein as well as harmonious development within the international financial system.

Islamic finance has likely to be succeeded in integrating some part of the global Muslim population in the formal international financial system. In the process, Islamic jurists were forced to analyse classical Islamic jurisprudence in light of contemporary legal, regulatory, economic and financial systems. This gave rise to a continuing process of growth in Islamic jurisprudence, which ultimately may further produce an efficient integration of Muslims who had previously shunned the conventional financial sector. Moreover, recall that the primary market for Islamic finance is in developing countries - which may have formally borrowed modern legal, regulatory, and financial standards from advanced countries, but fall significantly short of those standards in practice. In this regard, one may recall that provisions in laws of contracts under classical Islamic jurisprudence were, in essence, prudential regulations of that time. To the extent that those provisions are respected in

Islamic financial practice (which is not necessarily the case), Islamic finance may in fact be a catalyst for improving financial practices in those countries. For instance, the focus on secured rather than unsecured lending coupled with proper marking-to-market of asset values, can improve collateralisation practices that have been non-existent or poorly implemented in some majority Muslim countries, leading to catastrophic bad loan volumes that threaten their banking systems.

On the other hand, one cannot but conclude that the modus operandi of Islamic finance, including the evolving opinions of its professional Islamic jurists, is a prolonged reinvention of the financial wheel. One needs only to observe the evolution of standards from original practices of *Murabaha*, to more advanced *Murabaha* with agency provisions to notice how competition and better understanding of banking practices brings Islamic financial practice closer to its conventional counterpart. However, the industry's state of the art has relied on its captive market of pious Muslims, who may abandon it if full convergence is obtained. Moreover, just as some manufacturers may delay the introduction of their latest products to smooth demand over time, IFSPs prefer to introduce 'innovations' (better approximations of conventional financial practice) gradually, to extract the most rents, and gently prepare their customers. This implies that some level of inefficiency is intrinsic to this industry, taking the forms of transactions costs, additional legal costs, and fees for Islamic jurists. Moreover, the industry by its very nature has a longer lag in 'chasing past returns'.[272] However, due to

272 For instance, Islamic REITs are currently very popular (June 2004), when REITs were in fact a very good investment in 2001-2. Similarly, a number of new "Islamic Hedge Funds" are beginning to reach the market now, again years after the optimal performance of conventional hedge funds. This chasing of past returns has proved taxing in the past. For instance, the Dow Jones Islamic Index (DJII) debt ratio screen was originally set for debt to assets. In the middle of the tech bubble in the late 1990s, jurists changed the 33% cut off for debts to assets into one for debts to market capitalisation (just as market capitalisation was soaring).That allowed DJII-licensed mutual funds to make spectacular returns for a very short period of time, by being NASDAQ heavy. Once technology sector stocks crashed, many of the stocks had to be excluded from the DJII universe because their market capitalisations had fallen too low (i.e. they bought high and sold low), disallowing investors to benefit from the partial recovery that ensued.

catering to captive customers, the industry has been able to survive and continue its growth despite this continued inefficiency.

With time, competition is likely to reduce inefficiency in the industry. To attain higher levels of efficiency, Islamic jurists will have to continue their process of understanding modern financial practices, and developing an Islamic jurisprudence that is appropriate for today's legal, regulatory, and financial realities. In this regard, while some developments facilitate Islamic finance (e.g., the English elimination of double duty taxation on some IFSPs' financial structures involving double-sale for financing purposes), one should not encourage regulatory adjustments to accommodate Islamic financial practices. Islamic finance has shown its ability to adapt to existing regulatory frameworks (e.g., recent attempts to develop FDIC-insured Islamic money market accounts, CDs,[273] and NOWs in the U.S.).[274]

The above mentioned adaptation and alike eventually change the very Islamic jurisprudence upon which the industry is built. Toward that end, regulators' primary concern should continue to be protection of consumers of financial services, as well as safety, stability, and fairness of the overall financial system. To the extent that current Islamic jurisprudence has not yet reached a level of maturity that allows it to co-exist harmoniously within the best legal and regulatory standards, it would be unwise to push market participants toward standardising their financial and religious-legal standards at this time. Premature standardisation of the current inefficient practices may become tantamount to irreversible codification of what can be considered an anachronistic financial model.

273 Certificate of Deposits.
274 NOWs stands for negotiable order of withdrawal (accounts). They are interest-bearing savings accounts against which depositors are permitted to write checks.

CHAPTER 6

ISLAMIC FINANCIAL PRACTICE IN THE AUSTRALIAN LEGAL CONTEXT

CHAPTER 6

ISLAMIC FINANCE PRACTICE IN THE AUSTRALIAN LEGAL CONTEXT

6.1 The Regulatory Regime for Islamic Finance in Australia

An appropriate legal and regulatory framework is a basic requirement for establishing and operating sound financial institutions and markets. Like the Common law and Civil law systems the Shari`ah, as was mentioned earlier in this study, offers its own framework for the implementation of commercial and financial contracts and transactions. Nevertheless, commercial, banking and company laws appropriate for the implementation of Islamic banking and financial contracts do not exist in many countries. For example, in most countries, the Islamic banking and financial contracts are treated as buying and selling properties and hence are taxed twice. In some countries like the UK and Singapore, double stamp duty on some Islamic home finance schemes [275]has been abolished so as to provide tax neutrality.[276] Conventional financial laws also narrow the scope of activities of IFIs within conventional limits. In the absence of Islamic banking laws, the enforcement of agreements in courts may require extra efforts and costs. Therefore, banking and company laws in several countries require suitable modifications to provide a level playing field for IBs.[277] Furthermore, international acceptance of Islamic financial contracts requires them to be

275 Throughout this study the term 'Islamic home financing scheme', 'Islamic mortgage', 'Islamic home finance/financing', and 'Islamic housing finance' have been used interchangeably to refer to the IFSPs' home purchase plans under the products permissible in the *Shari`ah.*

276 IRTI and IFSP working paper. n.d. "Islamic Financial Services Industry Development: Ten-year Framework", available online at: http://www.sbp.org.pk/ibd/2006/Ten_Year_Master_plan.pdf.

277 Ahmad, Abu Umar Faruq. 2004. "Islamic Banking in Bangladesh: Legal and Regulatory Issues". Paper presented in the 6th Harvard University Forum on Islamic Finance, Cambridge.

Shari`ah compatible as well as acceptable under the major legal regimes such as Common law and Civil law systems.

The IFIs by their nature are subject to the same regulatory infrastructure which applies to conventional financial institutions taking into consideration of the characteristics of IBs, and also of the review of their compliance with Islamic principles.[278] The regulatory framework for Islamic banking and finance is necessary for the benefit of the banks' account holders (such as investment accounts, current accounts etc.), shareholders, other stakeholders and the community at large. The regulatory regime and the public have an interest to ensure an efficient banking system and averting systemic risk leading to bankruptcy. Likewise, IBs and IFSPs have an interest in ensuring not only that the bank is financially sound but also that their internal financial involvement is strictly in accordance with the Shari`ah. The reason lies behind all these is that a sound financial system is a key factor in achieving economic and political stability as well as sustainable growth in both developed and underdeveloped economies. On the contrary, the weak financial systems are bound to break down in periods of economic distress, causing severe distress in other economies and heavily damaging otherwise healthy financial systems. Given this, the authoritative legal and regulatory bodies in any country are needed in order to enhance the stability of the key elements of the financial system. Some of the elements of structural regulation would include the establishment of measures of capital adequacy and of the riskiness of portfolios, setting

278 Clode, Michael. 2002. "Regulatory Issues in Islamic Finance", Simon Archer and Rifaat, A. A. Karim (eds.), *Islamic Finance - Innovation and Growth,* London: Euromoney Books and AAOIFI. p.67.

deposit insurance schemes and the enforcement of regulatory standards for disclosure of information.[279]

In the light of the above, like conventional financing, Islamic finance industry needs to be supported by a strong regulatory and supervisory framework. This is to ensure that the operations of the IFIs are sound and not a source of susceptibility to the banking system. Apart from a common legal and regulatory framework to a large extent, the IFIs in most jurisdictions should be governed by the same regulatory framework that is applied to operations of conventional finance reinforced by the Islamic legal framework and the Islamic accounting standards. However, as the regulatory framework of conventional finance is premised on an interest-based debtor-creditor relationship, the regulatory framework for conventional finance is built to assess and mitigate risks arising from loan-based financial transactions. Islamic finance is different in term of its underlying philosophy on the prohibition of interest. This in turn shapes the nature of the financial transactions that has its own risk characteristics. The specific risks associated in operations of Islamic finance therefore needs to be identified, to ensure its prudential regulation is adequately addressed. This is to ensure the greater transparencies and disclosure as well as a strong legal and judiciary system, reinforced by the strong Shari`ah governance for IFIs.

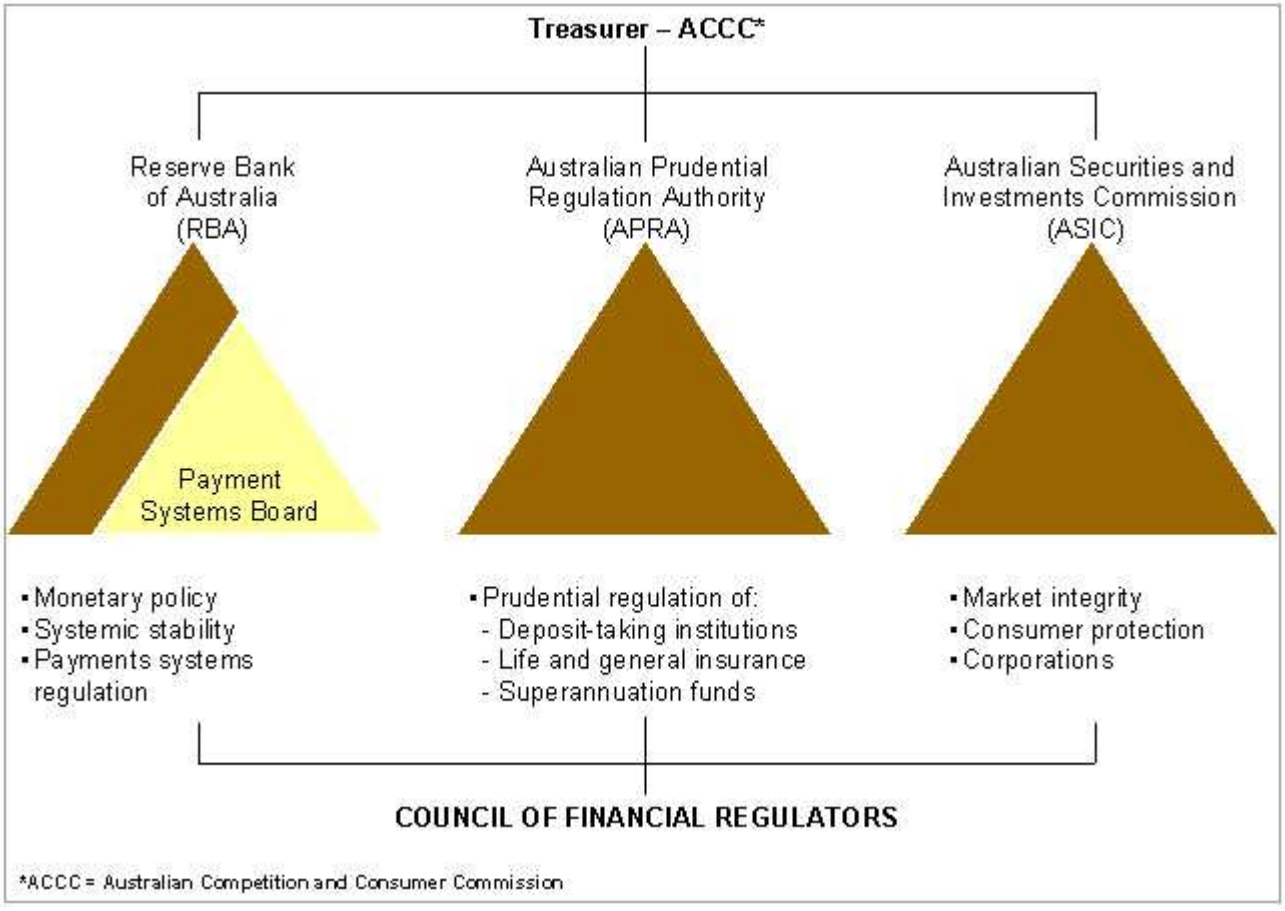
The legal and regulatory framework of the financial sector[280] in Australia covers banks, non-banks deposit-taking institutions, investment banks, collective investment managers,

279 David, Q. Rendon. 2000. "The Formal Regulatory Approach to Banking Regulation", *Badell & Grau Legal Consultant*, available online at: http://www.badellgrau.com/legalbanking.html (accessed July 19, 2007).

280 The financial sector of Australia includes: banks, permanent building societies, credit unions, life or general insurance companies, general government enterprises, superannuation schemes, corporations. These are registered under the *Financial Corporations Act 1974* (including Finance Companies and General Financiers).

securities and futures exchanges, clearing houses, securities and futures dealers and brokers, and insurance and superannuation entities.[281] There is no formal legal and regulatory framework or infrastructure in existence in Australia for guiding and supervising the functions of IBs and other IFIs operate in line with the precepts of Islamic legal system. Australia's financial sector regulatory framework reflects a considered approach by government to prudential supervision and is based upon the international standards put forward by the Basel Committee of the Bank for International Settlements (Figure 1).

Figure 1: Australia's Financial Regulatory Framework



Source: *KPMG 1998 Financial Institutions Performance Survey*; AXISS Australia

281 Australian Government - The Treasury, "Financial Sector Supervision", available on the Treasury website at: http://www.treasury.gov.au/documents/178/HTML/docshell.asp?URL=ch7.asp (accessed January 21, 2006).

The regulatory framework as is mentioned in Figure 1 is based around three central agencies: the Reserve Bank of Australia (RBA);[282] the Australian Prudential Regulation Authority (APRA);[283] and the Australian Securities and Investments Commission (ASIC).[284] The co-ordinating body for these agencies is the Council of Financial Regulators.[285] It contributes to the efficiency and effectiveness of financial regulation by providing a high level forum for co-operation and collaboration among its members.[286] However, the Department of Fair Trading administer the Consumer Credit Code in relation to the conduct of the credit facilities. In relation to bank mergers and/or expansion applications; ASIC regulates company takeovers under the Corporations Act. The Australian Competition and Consumer Commission (ACCC) also enjoys the right to play a role in the competition issues relating to the merger.[287]

The Government's legislative framework provides scope for self-regulation by the main securities and derivatives markets - the Australian Stock Exchange Limited (ASX)[288] and the

282 The RBA is responsible for the objectives of monetary policy, overall financial system stability, and the regulation of the payments system. Also, payments system policy is carried out by the Payments System Board (PSB) within the RBA.
283 The APRA is responsible for the prudential supervision of deposit-taking institutions, life and general insurance companies, and superannuation funds. Prudential regulation administered by the APRA is applied where financial risks cannot be satisfactorily managed in the market, and where concerns about financial security are utmost.
284 The ASIC is responsible for corporate regulation, market integrity, disclosure and other consumer protection issues.
285 Australian Bankers' Association Fact Sheets: "A Strong Banking System", available online at: http://www.bankers.asn.au/Default.aspx?ArticleID=587 (accessed December 10, 2005).
286 See "The Council of Financial Regulators", available on Australian Prudential Regulation Authority website at: http://www.apra.gov.au/Policy/The-Council-of-Financial-Regulators.cfm (accessed March 12, 2006).
287 Currently, merger of Australia's main in-country banks is prohibited, by the so-called "Four Pillars" ban. The industry has been lobbying against this restriction, and meanwhile global competitors like HSBC and GE have moved in, including with offers of sub prime loans. See for details, *The Asian Banker Journal*, November 15, 2004, available on Journal's website at: https://www.theasianbanker.com/A556C5/homepage.nsf (accessed May 27.2006).
288 The Australian Stock Exchange Limited (ASX) was formed in 1987 through the amalgamation of six independent stock exchanges that formerly operated in the State capital cities. It was originally a mutual organisation of stockbrokers, which become a listed company in 1996 through passing legislation by the Australian Parliament. It operates Australia's primary national stock exchange for equities, derivatives and fixed interest securities. For more elaboration See "ASX Overview and Structure", available on ASX website at: http://www.asx.com.au/shareholder/l3/asxoverview_as3.shtm

Sydney Futures Exchange (SFE)[289] subject to oversight by ASIC. These exchanges have Memoranda of Understanding with ASIC which elaborate on their respective roles as set out in the Corporations Law.

Although under subsection 9(3) of the *Banking Act 1959* an authority to carry on all kinds of banking business in Australia was granted by the APRA to the Muslim Community Credit Union Limited (MCCU) in December 1999, subsequently its license was withdrawn in August 2002 when it became apparent that its funds were not enough to sustain operations.[290] Once the APRA granted authorisation to MCCU to carry on banking business the ability to bring scale and order to the field of Islamic housing finance was achieved. On a more positive note, the similarities between Australia's new community banks (which have emerged largely due to the closure of traditional branches in smaller towns and funded and operated by local townspeople) and community-based Islamic co-operative financial institutions are making it easier for IBs to make an inroad to the Australian housing industry.[291]

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289 The SFE listed on the Australian Stock Exchange on 16 April 2002. It offers the financial market community trading products for investment and risk management, disseminates real-time and historical trading market data and provides centralised clearing, settlement and depository services for both derivative and cash products. On 25 July 2006 the SFE Corporation Limited merged with the Australian Stock Exchange Limited making the combined entity the ninth largest listed exchange in the world. The merged company operates under the name "Australian Securities Exchange". See SFE Corporation Limited website at: http://www.sfe.com.au/homepage/index.htm

290 Under paragraph 9(4) (a) of the of the *Banking Act 1959*, the APRA imposed on the MCCU the condition of maintaining a minimum ratio of capital to risk-weighted assets of 15% at all times among other conditions.

291 Halabi, Abdel Karim. 2000. "Islamic Banking and Australia's New Community Banks - Surprisingly Similar", *Journal of Banking + Financial Services (B+FS),* February.

6.1.1 The Development of Legal Framework of Islamic Finance

The legal framework and regulatory standards are important elements in the development and growth of the Islamic financial services industry. The development of an Islamic financial system that is able to contribute towards stability and balanced global growth needs for its development to be achieved in the context of a rigorous and robust legal, regulatory and supervisory regime. This is reinforced by effective supervision, strong Shari`ah framework and an efficient judiciary system that promotes confidence and soundness in the Islamic financial system.

Although Islamic finance is different from conventional finance in terms of its mission, objectives and practice, operations of IFIs in Australia is still subject to basically the same laws and regulations as their conventional peers and apply the same Western interest-based framework for regulatory and supervisory activities. A uniform regulatory and legal framework supportive of an Islamic financial system has not yet been developed in this country. This is indeed essential as the absence of such a supportive framework obstructs Islamic finance in its effective and smooth functioning in accordance with Islamic principles. Thus, in order to support the operational soundness, Islamic banking and finance should be equipped with a proper set of regulatory and supervisory instruments that fit its operational activities, and are different from the conventional ones.

It is true that a few set of regulations have been developed and foundations for regulatory instruments have been laid by the Australian banking regulatory authorities in this regard, but it did not make any substantial steps towards developing effective services and operation of

Islamic finance that comply the tenets of the Shari`ah. The regulations which have been developed at this stage to facilitate IFSPs' practices in Australia in line with the principles of the Shari`ah without violating the laws of the land are mentioned as under:

I. Exemption of Double Stamp Duty

In order to be treated Islamic home financing similar to conventional home loans with regards to the payments of stamp duty the Victorian Legislative Assembly and Legislative Council have recently approved the amendments to Victoria's *Duties Act 2000* on 7th and 14th October 2004. In the above example, the amendments would exempt the second transfer of title from stamp duty, thereby placing the Islamic alternative on an equal footing with a conventional mortgage. The amendments also introduce other stamp-duty exemptions to make a range of different Islamic financial products practical. The purpose of the Victorian Parliament in enacting this legislation is clear. In the words of the amendment:

> "(It) ensures that persons who enter into Islamic financial arrangements are treated on an equal footing with people who enter into conventional mortgages". [292]

The amendment which came into operation on October 19, 2004 after the day it received Royal Assent, is a major breakthrough for Muslim customers of IFSPs of Australia as it will help to make the mortgage market fairer and more accessible to the Muslim community in Australia. According to MCCA's the then General Manager Dr Abdul Rahim Ghause:

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292 *Ibid.* MCCA Newsletter, November-December 2004. p.1. See also, "State Taxation Acts (Amendment) Bill", which reads: "[17]. Inserts new sections 57A to 57F into the *Duties Act 2000* concerning alternative property finance arrangements for housing purchases such as Shariah or Islamic Law compliant transactions". Available online at: http://www.parliament.vic.gov.au/sarc/2004alerts/04alt8body.htm (accessed June 11, 2006).

> "The amendment will not only enable Muslims to practice their religious beliefs but also make the market more competitive, allow greater innovation in products by financial institutions and attract investments from international institutions".[293]

MCCA has also approached other states to seek exemption from double stamp duty. In New South Wales, Office of State Revenue, NSW Treasury is looking into the matter seriously and it is expected that positive responses be achieved sometimes this year.[294]

One of the key requirements of Islamic finance is that a financial institution must justify its profit under an Islamic loan agreement by sharing risk with the customer in the underlying property in some cases, this could be the land that is the subject of the finance or it may be the beneficial interest in that land. At some point, the financial institution must therefore, take ownership of the property. In all States of Australia including Victoria the transfer of property will be subject to the imposition of a tax known as transfer duty. In a typical Islamic finance, ownership of the property will move at least twice; first to the financial institution and then to the customer which results in multiple payments of transfer duty. This makes the cost of Shari`ah compliant housing finance expensive and in some cases, commercially unviable. On the contrary, in conventional mortgage a customer pays a single amount of transfer duty in such a transaction.

At first blush, this might seem to be a relatively insignificant development, of interest only to a religious minority in Victoria. But it is more than that. It may represent the embryonic

293 *Ibid. MCCA Newsletter*, November-December 2004. pp.2-3.
294 *Ibid*. p.1.

stages of an Islamic financial sector in Australia. Therefore, the exemption of double stamp duty is of vital importance for two main reasons. Firstly, the obstacles of committed Muslims' access to Shari`ah compliant finance are minimised. In the absence of this exemption, the previous law of paying multiple transfer duty had an adverse effect in a sense that Muslims having strong religious beliefs had limited recourses to Islamic system of housing finance. Secondly, this is the first piece of legislation recognising the Islamic finance industry in Australia a global industry with USD 200 billion in assets.[295]

II. Exemption of the Use of the Word 'Interest'

The use of the word 'interest' is a product of the Australian regulatory regime under the Uniform Consumer Credit Code (UCCC). As such, the IFIs in Australia are legally bound to mention it in several contracts documents of housing finance in order to inform the customers that this is mandatory under Australian law. In order to reflect the Shari`ah compliant transactions in which interest is not present, MCCA has been working with the UCCC management committee to enact a Federal legislation to exempt from having to use the word 'interest' in all Shari`ah compliant products. It is progressing very well and the legislation is in the final stages of being enacted to law. This legislative change will facilitate Muslims in Australia for increasing adherence to their religious beliefs as well as practices with conformity of interest free Islamic financial system.[296]

Having developed the necessary legal structures, there are still a number of hurdles which need to be overcome for the market to fully develop. They are summarised as under:

295 See Archer, Simon; Ahmed, Rifaat and A. Karim, *supra* note 19.
296 Ghouse, Abdul Rahim. 2004. MCCA's letter circulated on September 27.

(a) Under current regulations on lease agreements, the product has to be 100% risk weighted whereas a conventional mortgage has a risk weighting of only 50% and;

(b) Unlike a conventional mortgage, the proposed product under Australian law would require two sets of solicitors as there are two conveyances. IFSPs however, are seeking an exemption from the requirements to have a second set of solicitors.

The obstacles hindering growth in this sector are surmountable. Double stamp duty was one such obstacle that has recently been overcome in State of Victoria. Double stamp duty was payable due to the fact that the Shari`ah compliant structures involve a double conveyance (one at the time of the purchase from the current vendor and another one when the property is transferred to the customer when the finance has been repaid). Historically, this has made the Shari`ah compliant home financing prohibitively expensive, but the law has recently been amended in some States other than Victoria to reflect the reality of the scheme and only a single stamp duty charge is now payable.

6.2 Legal and Regulatory Challenges of Islamic Finance in Australia

Despite the remarkable growth and development of IBs and IFIs in the globe over the last few decades, their expansion in Australia has been slow and steady. Several factors are hampering the Australian expansion of IBs. These include *inter alia* the lack of understanding and standards on Islamic finance products, the absence of a standard rate of return in IFIs and the difficulty of classifying risk sharing funds placed in these institutions.

However, these challenges are needed to be tackled in order to set the future path on sound footing.

The embargo on receiving and paying *riba* under the Shari`ah resulted in some remarkable challenges and impediments. The Australian banking system is primarily based, as in most countries on a Western banking tradition, which is founded on the receipt and payment of interest and this applies to the regulatory system as well.

There are also quite a lot more subtle impediments to many of the more common products and instruments used by the Shari`ah compliant financial services providers. More may become perceptible as the Islamic finance industry grows in Australia.

A brief discussion on these issues and challenges is specified as under.

6.2.1 Legal and Regulatory Issues

Since Islamic finance is still in state of infancy in Australia, it has been facing a number of problems and challenges, which can be identified as operational problems. The present section of the study demonstrates some of the issues and challenges that come with introducing Islamic finance into Australian financial market in the following sections.

6.2.1.1 Problem of Operating as a Bank

A major regulatory problem faced by IFSPs in Australia is getting approval from the APRA for an Islamic Financial Institution (IFI) to operate as a full fledged bank normally would in taking deposits. Like many countries, Australian law generally does not permit taking deposits without having a license from the appropriate authority. In order to carry on banking business, a financial institution has to obtain license from the APRA under the section 66 of the *Banking Act 1959*.[297] These licences are not easy to get and have to have detailed examinations by the regulator of the proposed financial institution, with the typical application period taking up to 18 months.[298]

6.2.1.2 Regulatory Change

The absence of a regulatory and legal framework to support Islamic banking system is a major drawback in the proper implementation of Islamic financial practices in Australia. The main problems in this regard seem to be a result of two separate pieces of legislation. For housing loans, there is the double stamp duty problem. In Victoria, at least, this problem has been dealt with though it has not yet been dealt with in other jurisdictions as it has been mentioned earlier in this study.

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297 Under section 66 of the *Banking Act 1959* (the 'Act'), a person cannot use or assume a restricted word or expression in connection with their financial business without the consent of APRA. That means, by virtue of section 66 of the *Banking Act*, a person (whether an individual, a body corporate or a body politic) must not use the expressions *bank, banker, banking, credit union, credit society* and *credit co-operative* in relation to a financial business carried on by the person except as permitted by section 66 of the Banking Act; or a consent in force under section 66 of the Banking Act. See "Banking Act 1959 Consent to Use Restricted Expressions", available on APRA website at: http://www.apra.gov.au/Legislation/Banking-Act-1959-CONSENT-TO-USE-RESTRICTED-EXPRESSIONS.cfm

298 It was previously mentioned in this study that the APRA had granted the Muslim Community Credit Union Limited (MCCU) permission in December 1999 to carry on banking business. However, its license was withdrawn in August 2002 when it became apparent that its funds were not enough to sustain operations. The reason was that the APRA under paragraph 9(4) (a) of the 'Act', imposed on the MCCU among other conditions the condition of maintaining a minimum ratio of capital to risk-weighted assets of 15% at all times.

Although the Shari`ah compliant home financing already exist, various legal hurdles make them relatively expensive. Therefore, regulatory changes would make it easier and cheaper for Muslims in Australia to get financial products that do not conflict with their beliefs. This would in turn help to make home-ownership more accessible and affordable for Australia's most significant religious minority. It may also help foster competition in the market.

6.2.1.3 The Incompatibility of the Basel Accords

The apparent incompatibility of the current Basel I and Basel II accords with Islamic finance are also issues in Australian regulation. The Australian prudential regulations that are essentially administered by the APRA follow the current Basel I standards, and are in the process of changing over to the Basel II standards.[299] Since neither of these makes provision for Shari`ah compliance internationally this has not yet been addressed in Australia. Also, there have been no applications to the regulator to confront the issue as of yet.[300]

6.2.1.4 Mortgage Lending Law

The conventional business of mortgage lending is highly efficient and strictly regulated in Australia. Part and parcel of the formality in mortgage lending is a very strong culture of discloser and consumer protection codified by the Federal Government and various States and Territories. It is enforced by several law enforcement as well as consumer protection

299 Basel II, also called The New Accord (correct full name is the International Convergence of Capital Measurement and Capital Standards - A Revised Framework) is the second Basel Accord and represents recommendations by bank supervisors and central bankers from the 13 countries making up the Basel Committee on Banking Supervision to revise the international standards for measuring the adequacy of a bank's capital. It was created to promote greater consistency in the way banks and banking regulators approach risk management across national borders.

300 "Islamic Banking - A Way Forward?", *Risk Management in Australia*, APRA website, available at: http://ozrisk.net/2006/08/17/islamic-banking-a-way-forward/#more-38 (accessed December 30, 2006).

agencies. Therefore, layered over the real estate process is a specific flow of paper and documentation that is designed to present to consumers the cost of lending, the terms of lending, and the overall timeliness of communication as well as quality.

6.2.1.5 The Cost Prohibitiveness of Islamic Home Financing

In the simplest of many possible examples of a typical Islamic financial arrangement, the financier would buy the property and resell it to the customer at a profit on a deferred payment basis over a fixed period. This requires legal title in the property to be transferred twice: once to the financier, and subsequently to the customer which means there is double stamp duty to pay. Indeed, it is a major obstacle in Islamic housing finance, because in Islam, the payment or receipt of interest is strictly forbidden. Islamic housing finance relies on the involvement of a financier who buys the property, and then sells it on to the buyer and collects instalment payments (similar to traditional mortgage payments) for the repayment of the capital. Instead of charging interest, the financier often sells the property for the same price but then charges additional profit/rent on it for a specified period of time. Stamp duty is therefore charged twice - as the ownership of the property transfers twice - first to the financier, and then to the ultimate buyer. This has necessarily been reflected in the price of the Islamic housing finance. Re-financing also presents a problem because the old lender has to sell the property to the new lender and thus incur another charge of stamp duty.

If overseas experience is any guide, recent legislative amendments to Victoria's *Duties Act 2000* is considered a very small step in a potentially lucrative direction, whereas, in Western countries, Islamic financial markets are growing at astonishing rates. Britain passed

legislation facilitating Islamic consumer finance in 2001, before which its Islamic financial sector was, in effect, non-existent. Yet market researchers Datamonitor recently projected that in the UK alone, the Islamic consumer finance industry would be worth GBP 4.6 billion (USD12 billion) by 2006. By generating various Islamic banking products, major multinational banks such as Deutsche Bank, Citibank and especially HSBC have been beneficiaries of this boom.[301] Meanwhile, in the United States, Freddie Mac has developed secondary markets for Islamic home finances.[302]

6.2.1.6 Exclusion from Lender of Last Resort Function

A related impediment is that IFSPs in Australia are, by their unique character excluded from the lender of last resort function. The Reserve Bank of Australia being the central Bank of the country by tradition stands behind the conventional banking and financial system to offer liquidity, lending to banks if the system is short of funds. IFSPs in Australia may not be able to get advantage of this because of the interest payments due on loans which are outlawed by the Shari`ah.

6.2.1.7 Absence of Interest-free Pension Funds

Australia's pension funds are known as Superannuation funds which are the mandatory provident funds for individual pensions. Australian law currently mandates that at least 9

301 Aly, Waleed. 2004. "The Muslim dollar: Australian financial sector - take note", *ON LINE Opinion*, 21 December 2004, available online at: http://www.onlineopinion.com.au/view.asp?article=2872 (accessed January 20, 2007).

302 Some Islamic legal scholars object to the term 'Islamic mortgage', arguing that the concept of a 'mortgage' brings to mind a conventional mortgage and its inherent unfairness to defaulting borrowers. The government of UK has, as a consequence, referred to 'home purchase plans' when referring to some types of Islamic mortgages. See for details, Tariq Hameed. 2007. "Does the Diminishing Musharakah reflect the spirit of Sharia?" *Mortgage Finance Gazzette*, January, available online at: http://www.mfgonline.co.uk/mortgages/17015/113/Mortgages_&_housing_/Does_the_Diminishing_Musharakah_reflect_the_spirit_of_Sharia?.htm (accessed August 24, 2007).

percent of every employee's wages or salaries are paid into a pension fund which, in most cases, cannot be accessed until the person retires at the age of 65.[303] The problem at the moment is quite simple i.e. none of the superannuation funds currently being offered to the public are Shari`ah compliant.[304] The pension funds are typically invested in broad index-type products and include interest receipts. This means that devout Muslims need to either try to calculate how much of the returns to their superannuation funds are due to Islamically unlawful activities and then give that amount to charitable causes or try to manage their superannuation by themselves. The first option is difficult, if not impossible, and the second is expensive and time-consuming.

6.2.1.8 Absence of Islamic Insurance

Islamic Insurance is, in effect, non-existent in Australian financial market. Although there have been several attempts to establish Islamic Insurance funds, notably during the 1990s, these do not seem to have succeeded for regulatory constraints they had faced.

6.2.2 Australian Legal Concern

Under the Consumer Credit Code (the Code), credit is advanced if there is a charge for the credit, whether or not that charge is in the form of interest. Where the Shari`ah compliant

303 Andrew. 2007. "Opportunities Down Under: Islamic Finance in Australia", *Risk Management in Australia*, available online at: www.ozrisk.net.

304 Nevertheless, an amendment to the Financial Services Reform Bill (FSRB) requiring superannuation funds and funds managers to disclose their policy on ethical investment has been passed by the Australian Parliament in 28 August, 2001. The amendment will require all financial services product disclosure statements to outline "the extent, if any, to which labour standards, environmental, social or ethical considerations are taken into account in the selection, retention or realisation of the investment". The legislation is not fully *Shari`ah*-compliant though it creates an imperative for the investment community to get up to speed on socially responsible investment. See for this amendment, Ethical Investment Association of Australia (EIA), "FSRB Enforces Ethical Transparency", Media Release, 28 August 2001, available online at: http://www.asria.org/pro/news&events/FSRBdisclosureLeg.htm (accessed January 21, 2007).

methods of finance do invoke the Code, complications in complying with the Code can arise from the lending structure used. MCCA has lobbied the Victorian Government for a serious consideration of how to maintain consumer protection like the Code without hindering the development of the Shari`ah compliant lending. In 2003, MCCA had over AUD 20 million committed to home lending arrangements. It also reported having hundreds of potential borrowers waiting for Shari`ah compliant finance so they could purchase a home. The Code assumes that most credit will be advanced in return for an annual percentage rate of interest. Where consumer credit involves profit in the form of interest but this profit cannot bear an 'interest' label, thus compliance problems arise.[305]

The options for dealing with such an issue include amending large parts of the Code to accommodate quasi-interest charges, issuing an exemption from all or most of the Code for Shari`ah compliant lending, introducing a separate regulatory scheme for Shari`ah compliant lending or relying on non-specific consumer protection such as the *Fair Trading Act*.

The existence of Shari`ah compliant lending to finance home purchase, along with the potential for growth in this market, leads to questions about the Code's capacity to continue to regulate all consumer credit. Although the Code was designed to accommodate product flexibility and to apply to all consumer credit, the diversification and sophistication of the market since the Code's inception mean that emerging products and trends challenge its effectiveness. Sometimes, the challenge is a new product such as Shari`ah compliant loans; at

305 See *The Report of the Consumer Credit Review: Part B, Four Areas of Focus*. 2006. Melbourne: Consumer Affairs Victoria. p.160, available online at: http://www.consumer.vic.gov.au/CA256902000FE154/Lookup/CAV_Credit_Review_Documents/$file/credit_review_3_partb.pdf

other times, the challenge arises from the development of new or the redevelopment of existing products, such as the recent trend to use promissory notes in small amount lending, the renewed activity in reverse mortgages and the seeming rise in resort to consumer leases.

If Shari`ah compliant loans were to be treated differently from other lending, difficult judgements would need to be made, for example: 1) what is the definition of a Shari`ah compliant loan? 2) What other religions practised in Australia have special lending requirements? 3) What happens when non-Muslims want Shari`ah compliant loans?

For the time being, there is no prospect of Shari`ah compliant lending being exempted from the Code. The question will then arise: could departure from the universality of the Code be warranted on other grounds? For example, where full compliance with the Code inhibits the provision of low cost loans to vulnerable and disadvantaged consumers?[306]

6.2.3 Islamic Legal Concerns

Apart from the above mentioned legal, regulatory and other related concerns, there are some operational problems and issues confronting Islamic finance in Australia. Like other countries where Muslims are minorities namely, the USA, UK, France and Germany,[307] several leading Islamic legal scholars were also involved in different aspects of the development of Islamic housing contract in Australia. This was applied mainly by the

306 *Ibid.*

307 As in the year 2003, more than one third of the world's Muslims are living as minorities in non-Muslim countries. For example, the UK's Muslim population is: 2.0%, while their number in the USA is 1.9%, in France7.1%, and in Germany 4.4% respectively. See for details, Karen J. Sparks (ed.). 2003. *Encyclopedia Britannica Book of the Year 2003*, London: Encyclopedia Britannica, Inc.

Muslim Community Co-operative (Australia) Ltd. as the pioneer IFI in developing Islamic financial products in conformity with the Australian legal environment. All were in agreement with the style and philosophy of the relevant countries' consumer disclosures and protections in cases where the Islamic legal scholars were acquiescent to advising consumers of the purpose of the law and avoiding a controversy over matters that are non-contractual.[308] Scholars of the Shari`ah, however, have a number of issues, which are significant to them when determining whether or not a contract complies with the rules of the Shari`ah:

I. Single Contract – No Amalgamation

In accordance with the Australian Law of contract, it is possible to combine contracts.[309] As far as the Islamic law is concerned, the majority of scholars do not allow the combining of more than one contract into single contract. For instance, a contract of sale and lease may not be combined into a single contract.[310]

II. A Promise is not Equal to Contract

Although most Australians courts will find a promise to be contract [311] the Islamic legal scholars distinguish between the two.[312] The result is that an Islamic financial relationship

308 For instance, the *Shari`ah* scholars committee of Islamic banks and financial institutions often opine only on Islamic portion of deal, and ignore other pieces of deal.

309 For example, a Hire Purchase contract combines a basic lease contract with an option-to-purchase contract.

310 The operative principle in this matter is that the *Shari`ah* prohibits the commingling of two separate transactions under a single contract. Rather, it should be in two separate transactions. That in the first place there is a sale of assets to be purchased by the lessor. This is governed by the *Shari`ah* rules of sale/purchase at a fair market value. Once the ownership title is validly passed on to the lessee a lease transaction can then be executed separately through a lease agreement.

311 In Ward v Byham [49] a promise to make a child happy was accepted as sufficient consideration in contract formation. For more information on this See http://www.murdoch.edu.au/elaw/issues/v1n3/clarke13.html

312 A promise by one party, without some form of consideration being extended by the other party, does not result in a contract or other enforceable obligation, regardless of the sincerity of the promise. Although each party must extend consideration to the other in order to form a contract, the value of the consideration need not be equal.

may be entered into Australia with a greater legal attachment than if it were entered into a purely Islamic environment.

III. Form and Asset Orientation

Although the Islamic legal scholars are very much concerned with the substance of a contract, their initial point of evaluation is the form. This has, in part, to do with the categorisation of commercial contracts in Islamic legal analysis. Since the distinguishing substantial matter in the Shari`ah is the existence and sale of a non-monetary asset the convergence between form and substance is that for a profit, financial transaction must involve an asset, not money.

IV. Property Taxes and Assessments

The Shari`ah rules require that the owner of property pay property taxes. In the case of leased property, the cost to the owner may be recovered in the rent, even as a form of supplemental or additional rent. In an Australian consumer transaction the borrower or lease-to-own tenant is normally responsible for paying taxes.[313] There is no regulatory barrier to structuring payments as mandated by the Shari`ah.

313 The Australian Taxation Office defines leasing as 'ownership implied'. This means the finance company (lessor) has ownership of the financed item under a lease until the residual is paid. As the finance company has ownership, the tax invoice from the supplier will be in its name. Therefore, the lessee cannot claim any GST credits on the purchase price of the item. See Keith Harvey and George Kolliou. 2003. "GST Treatment of Lease, Hire Purchase and Chattel Mortgage Facilities", *Taxation in Australia*, issue 37, No.10 May. pp.544-546.

V. Casualty Insurance

As with taxes and assessments, Islamic law requires that the owner of property pay the cost of casualty insurance. Flood, hazard and liability insurance have the same treatment in the Shari`ah and Australian regulations. On the face of it, such insurance, in the absence of *Takaful* is contrary to Islamic rules. But, neither securitisation, nor investment will occur without some form of protection of the property from various disasters, natural or man-made. The Shari`ah experts have permitted conventional insurance in this circumstance on the basis of *darurah* or necessity.

VI. Statutory Interest

In Australian conventional banks accounts as well as in certain pre-paid expenses must accrue interest. Typically, it accrues at a very low rate. The ruling of Islamic legal scholars is that consumer must donate this to charity with no personal benefit. Therefore, the consumer is may not count the donation as either *zakah* or *sadaqaat.*[314]

VII. The Use of the Term 'Interest'

State and Federal Commonwealth government agencies in Australia require home finance/mortgage to provide their customers with various standard disclosures and representations. These mandatory disclosures utilise standard lending terminology - such as 'interest', 'lender' and 'borrower' - that do not correspond to the nature of the Shari`ah compliant financial instruments and products. Furthermore, the government has yet to

314 The root meaning of Arabic term *Zakah* comes from *Z-K-W*, meaning 'growth' and 'development', while the root meaning of *Sadaqaat* comes from the root S-D-Q, meaning truth and power. Although both of these terms are interchangeably used in the Qur'an to mean the compulsory charity the *Sadaqah* (singular of *Sadaqaat*) is also used in some places for voluntary charity. *Zakah* is exclusively meant for compulsory charity, which is a fixed share of income or property that every Muslim must pay as tax or charity, for the welfare of the needy. See for instance Al-Qur'an, 2:215, 3:134, 7:156, and 9: 60.

approve modifications to these disclosures to adapt them to these products and other transactions in which interest is not present.

VIII. Mortgages

There is no objection in the Shari`ah to the granting of a housing finance or deed of trust to secure a creditor or investor in their rights. Clearly, the language of such documents must flow with the underlying Shari`ah compliant agreements and procedures.

IX. Late Payments

The penalty in late payment is forbidden in the Shari`ah as it is identical to the forbidden *riba*. But, the Islamic legal scholars have permitted that lenders and lessors may charge a flat fee commensurate with their costs of collection. There may not be any compounding of the fee: it is assessable one time per instance of delaying.[315]

X. Rent

The payment of money for the use of real or personal property is permissible. The rate or basis for the rent should be freely negotiated in a manner that is transparent to both lessor and lessee.

In fact, the above and many other considerations have been addressed by different quarters and a great number of Muslim Australians now enjoy an Islamically permissible contract

315 Most scholars have ruled that, to serve as a deterrent to such as may wilfully delay payments, the financer may get the buyer to agree, at the time of the contract, to make a pre-specified donation to an agreed charity in case of late payment of monthly instalments. These scholars, however, caution that this device should be used to the minimum extent and only in cases where *Musharaka* or *Mudaraba* are not practicable for one reason or another.

whereby they occupy or acquire their homes. If the best conclusions are drawn from a number of experiments, then the numbers of Muslims benefiting from Islamic home acquisition programs will increase in an exponential manner to the tens, if not hundreds of thousands.

6.2.4 Other Related Issues

Aside from the above mentioned legal and regulatory issues there are some other related problems that hinder smooth functioning and potential growth of Islamic finance industry in Australia. Some of these issues may be discussed under the following headings.

6.2.4.1 Lack of Understanding on Islamic Finance

The first challenge is that many people - Muslims and non-Muslims alike do not understand what Islamic finance exactly is. Although the underlying principle is clear to many is that Islamic law does not allow to make money out of money and thus capital should accumulate from buying and selling and possession of real assets, there does not appear to be a unified definition of an Islamic financial product. The key concern is that the respective Shari`ah Supervisory Board (SSB) of the IB or IFI that in fact defines what is and is not Islamic financial product and it interprets transactions differently. This leads to an ambiguity about what is, and what is not Islamic product and good enough to conduct businesses, which in turn can complicate risk appraisal for both the bank and its customers. This ambiguity so far

prevents standardisation and makes it difficult for regulators justifiably they would like to know precisely what it is they are authorising.[316]

6.2.4.2 Risk Analysis and Balance Sheet Management

The second problem for IFIs in Australian financial market is the risk analysis and balance sheet management. Like in any country, the challenge in formulating the risk management infrastructure in IFIs lies in having an accurate assessment of the various risk variants underlying the alternative modes of finance to provide for their effective quantification and management. On the asset side, the IFIs enter into different financing modes that have varying risk characteristics, ranging from the low risk sales and lease-based modes to the higher risk Equity-based modes of finance. Each of these modes of finance have a distinct intrinsic characteristic dictated by its underlying Shari`ah principle, and thus entail different risk profiles. An Equity-based finance may for example involve higher risks and therefore attract higher capital requirement. Likewise, the liability structure of IBs is characterised by two distinct categories of deposits: 1) demand deposits which are not subject to risks associated with banking business and for which the principal is guaranteed, and 2) investment deposits which involves risks and hence, is eligible to share the profits earned from the banking business.[317]

316 Ainley, Michael. 1997. "Under a Veil of Regulation", *The Banker*, October 1. p.1.

317 See Zeti A. Aziz. 2006. "Towards Evolving Islamic Finance as an Integral Component of the International Financial System", opening speech at 5th Annual Islamic Finance Summit, 24 January, London, available online at: http://www.bnm.gov.my/files/publication/qb/2006/Q1/p6.pdf.

6.2.4.3 Absence of a Standard Rate of Return

A further regulatory challenge arises from the liability structure of IFIs is the determination of a standard rate of return for account holders. Unlike conventional finance practice where returns are pre-determined, profit-sharing depositors of IFIs know their returns at the maturity of the deposits. These returns are subject to the earnings of the assets that are shared between the IFIs and the profit-sharing depositors. In the event of loss, the depositor as the capital provider will bear the losses. As the deposits in Islamic finance practice for the most part are in the form of profit-sharing deposits, it places a higher degree of fiduciary risk on the management to ensure the funds are utilised in the most efficient manner. [318]

6.2.4.4 Difficulty in Classifying Risk Sharing Funds

Another complexity is how to classify risk sharing funds placed with IFSPs as the classification of these funds has implications for IBs' capital requirements. If these funds are capital certain they would be defined as bank deposits under Australian banking regulation. On the contrary, if they are defined as investments in a collective investment scheme they are not bank deposits.[319] On levels of adequate capital the Basel Committee on Banking Supervision (BCBS) envisages that all internationally active banks should be subject to the minimum capital requirements, and the Basle Standards have gained general recognition throughout the globe, including Australia. However, a number of key regulatory issues pertaining to liquidity requirements remain unresolved, especially whether they should apply to all on-balance sheet funds; and how liquidity should be managed for funds which are held

318 See The Securities Commission. 2007. "Cross-sectoral Regulatory Approach to Supervision", *Malaysian ICM*, vol.2, No.2, Malaysian Islamic Capital Market Quarterly Bulletin.

319 See Tarek, S. Zaher and M. Kabir Hassan. 2001. "A Comparative Literature Survey of Islamic Finance and Banking", *Financial Markets, Institutions & Instruments*, vol.10, No.4. pp.155-199.

off-balance sheet. Yet, the basic issue as for any bank whether Islamic or conventional is how easily and quickly, and at what discount, assets can be turned into cash.

6.2.4.5 Problem of Accounting Standard

A subtle problem that conventional interest-based financial institutions have with IFSPs is the question of how to account for them. In most of the world, IAS 39 may be applied as it is called AASB 139[320] in Australia.[321] The problem with Islamic finance is that it does not operate in the same way the arrangements will actually work if these standards are used, as most of the world's banks do. The risk sharing nature of many of the arrangements (*Musharaka* for example) means that they are possibly of the nature of a joint venture, but the precise balance of the risks and control transferred really matters. The definition of a joint venture in the standard[322] makes it plain that there must be an element, not only of joint ownership, but also joint control. If there is no real control over the use of the asset by the bank, then is it a financial instrument, merely entitling them to a flow of revenue (say the rental income) or is it an equity ownership of the asset as they are entitled to a proportion of

320 AASB 139 (issued July 2004) included a free choice option to designate financial instruments at fair value through profit or loss. Under AASB 2005-4 the ability to designate financial assets and financial liabilities is restricted. See "Regulation Impact Statement", *AASB 2005-4 Amendments to Australian Accounting Standards*, available online at: http://www.aasb.com.au/public_docs/ES_RIS/RIS_AASB_2005-4.pdf (accessed March 19, 2006).

321 The Australian Accounting Standards Board (AASB) is implementing the Financial Reporting Council's (FRC) strategic directives to adopt International Financial Reporting Standards [the Standards and Interpretations of the International Accounting Standards Board (IASB)] for application to reporting periods beginning on or after 1 January 2005 and to harmonise the requirements applicable to general purpose financial reports of public sector entities and those applicable to Government Finance Statistics. *Ibid.*

322 See International Accounting Standards (IAS) 31, "Financial Reporting of Investments in Joint Ventures", para 3, which says: "a contractual arrangement whereby two or more parties undertake an economic activity that is subject to joint control".

the unpaid, residual value? During the life of a *Musharaka* arrangement when does ownership and equity control really pass?[323]

6.2.4.6 International Prospective

Another related problem is disregarding the potential for the sale of Australian-sourced financial products overseas. Australia offers very stable political, regulatory and judicial systems. Returns on investments in Australia have, over the long terms favoured by Islamic investors, been very high and much of the investment in Australia is in Shari`ah compliant products such as land, mining and agriculture. The first company to issue products to investors globally is likely to encounter some regulatory hurdles, but they are also likely to tap into a deep and growing well of capital.[324]

323 See Lydia Troshina. 2004. "Accounting Methods and International Accounting Standards", IMF Committee on Balance of Payments Statistics and OECD Workshop on International Investment Statistics. See also, Andrew. 2007. "Islamic Finance - Accounting Standards", *Risk Management in Australia*, available online at: www.ozrisk.net.
324 See Andrew, *supra* note 299.

CHAPTER 7

COMPLIANCE REQUIREMENTS FOR ISLAMIC FINANCE IN AUSTRALIA

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Compliance requirements for Islamic financial sector in Australia are not different from those applicable to the conventional financial sector. Given this, Islamic finance in Australia is subject to comply with the same requirements set by the regulatory and supervisory regime for the conventional banking and finance industry. In this context, the Australian regulatory regime regulates those Islamic institutions that conduct banking and financial activities in parallel with the conventional financial institutions. While it is an absolute that fair and strict regulation is the prime objective of the regime, it is also an objective shared by all the institutions licensed by the relevant authority, including the IFIs themselves. However, due to the explicit and distinctive features of Islamic financial products and services its operations entail unique risks that require adjustments in the capital adequacy ratios, more disclosures and transparency, and other modifications of prudential and supervision norms. These are discussed under the following main headings.

7.1 Prudential Standard Requirements of Islamic Finance

The fundamental role of the regulators is 'prudential' - making sure that banks and other financial institutions are run in a prudent manner. Confidence is instilled by creating the true protections and imposing strict supervision. A number of monitoring mechanisms - prudential ratios, accounting, auditing and disclosure rules - are available and have far

reaching implications. Besides, prudential regulation and effective supervision boosts the efficiency of financial institutions. It also promotes freedom of markets by protecting the rights of users of the financial services especially depositors. It ensures a level playing field and equal competitive opportunity to the market participants through the applications of best practices and offering support to financial institutions at times of need. Due to its relative infancy and the special nature of its liabilities and assets, credible and more supportive supervision and regulation of IBs and IFIs is needed.[325]

Islamic financial services in Australia apply the same prudential regulatory standards to be complied with by their conventional counterparts. For instance, the instruments used by Australian IFSPs (such as hire purchase and sale and leaseback) are exactly the same, and come under the same Australian laws and regulations.[326] The reason is that generally as firms in which financial institutions take stakes, greater transparency, along with strengthened corporate governance, are necessary. With regard to fulfilling the prudential standard requirements the following key areas are important for the development of the Islamic financial market in Australia.

7.1.1 Effective Legal, Regulatory and Supervisory Framework

To achieve the common goal of ensuring stability of any financial system an effective legal, regulatory and supervisory function is an indispensable and vital component of the financial infrastructure of that system. For the Islamic financial system, this infrastructure also needs to be consistent with the requirements of the Shari`ah principles which provide assurance that

325 Warde, Ibrahim. 2000. *Islamic Finance in the Global Economy*, Edinburgh University Press. p.196.
326 Newsome, Brad. 2006. "Islamic Principles Right on the money", *The Age*, 2 December, available online at: http://aap.newscentre.com.au/ahri/061202/library/human_resources/14335782.html

the strategic direction, the formulation of policies and the conduct of financial transactions are in compliance with the Shari`ah principles. The legal framework should also deal with supervisory issues, including the relevant regulatory agencies involved in the supervision of IFSPs. The relevant agencies should have clear responsibilities and objectives to ensure effective financial supervision.

While the conventional financial system is guided by the Basel core principles which delineates the minimum requirements for the supervisory regime, these principles need to be reviewed from the perspective of Islamic finance, taking into account the unique characteristics and risks involved in products and services of IFSPs.[327] A fundamental issue is the setting of prudent and appropriate minimum capital adequacy requirements for IBs. Such requirements need to reflect the risks that the banks undertake. The framework devised would need to incorporate fundamental Islamic concepts. Islamic banking operations therefore need to be governed by its own standards and best practices in parallel with the international best practice. While certain products in Islamic finance by their nature may not attract capital, the IFIs need to have a more rigorous risk management systems in managing the funds placed under this arrangement. In this regard, the risk management standard needs to specifically address this concern.

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327 See Governor of Bank Negara Malaysia's Speech. 2004. The 3rd Annual Islamic Finance Summit, "Ensuring Stability in the Islamic Financial System". London: 13 January, available on BNM website at: http://www.bnm.gov.my/index.php?ch=9&pg=15&ac=145&print=1 (accessed August 23, 2007.

7.1.2 Improved Corporate Governance

Good Corporate Governance contributes towards maintaining market confidence and reinforcing transparency. It also upholds fairness and justice with respect to all stakeholders of the Co-operative types of Islamic financial institutions like MCCA and ICFAL among IFSPs in Australia. Justice, it is said, should not only be done but also be seen to be done and, accordingly, an element of the development of corporate governance is an ever-increasing demand for transparency.[328] With the increasing emphasis on self-regulation under the Basel guidelines, corporate governance is becoming even more important in the overall regulatory framework for banks and financial institutions, including IFSPs. For corporate governance to work whether in Islamic finance or conventional, good corporate practices need to be inculcated and embedded in all aspects of the operations and at all levels within the organisation. Islamic corporate governance serves through its underlying principles of economic well-being of the community, justice, accountabilities and equitable distribution of income. Therefore, while the virtues of Islam always advocate good corporate governance, the challenge lies in its application.

7.1.3 Effective Risk Management System

In general, operation of Islamic banking and finance is characterised by a high degree of financial risks. In the absence of guaranteed returns on deposits, IFIs undertake risky operations in order to be able to make comparable returns to their customers. A successful risk management system is fundamental to decision-making efforts. The risk management

328 See Michael Clode, *supra* note 274.

system in Islamic institutions need to be able to address the distinguishing features of Islamic financing practice involving financial contracts and products which may lead to other risks in addition to credit risk. The sophistication of the respective risks in the Islamic financial products needs to be fully investigated and measured to provide for their effective evaluation and management.

The requirement to manage the risks in Islamic financial services becomes more significant because of the unique peculiarities in the contracts. Basel II has, to a certain degree, incorporated some aspects in the identification of risks, in particular the credit, market and operational risks that can be absorbed by the IBs in terms of its product offering. One of the considerations that need to be addressed in assessing the risks associated with the IB is with regard to the capital charge on its investment accounts. Basel II does not address this unique feature in its framework. Assets that are funded by monies in the investment account may not require the capital charge for the purpose of capital adequacy measurement except in the case of misconduct and negligence. Similarly, if the Islamic banking institutions were to be more engaged in the profit-sharing arrangement in its balance-sheets, it will require the IB to have a more rigorous risk management assessment and monitoring mechanism. While risk mitigation is desirable in Islamic finance, further improvements need to be made to the existing risk management framework.[329]

329 Khan, Tariqullah and Ahmad, Habib. 2001. "Risk Management: An Analysis of Issues in Islamic Financial Industry", *Islamic Research and Training Institute Occasional Paper No.5*, Jeddah: Islamic Development Bank.

7.1.4 Development of a Dynamic Islamic Financial System

The Shari`ah which is an essential tool towards developing a dynamic Islamic financial industry should always be viewed as an enabler to innovation and creativity, rather than a constraint. Efforts, therefore, need to be enhanced to fully appreciate and maximise the true potential and wisdom. The collaboration among the Islamic legal scholars, practitioners, researchers and regulators to undertake in-depth studies and research to create new products will provide the fundamental foundation towards the development of a dynamic Islamic financial system.

7.1.5 Development of Comprehensive Legal Framework

An all-inclusive legal infrastructure is an important pre-condition to sustain the continued growth of Islamic banking and finance, which needs to cover both effective regulatory and substantive laws to resolve disputes relating to Islamic financial transactions. To address this, efforts are needed to develop a sufficient number of competent lawyers that are equipped with sound knowledge and expertise in both the Shari`ah and civil laws to deal with such matters.

7.1.6 Development of Vibrant Islamic Financial Markets

The need of the time in the Islamic financial services in Australia is to steer the development of an Islamic financial system which would essentially include the key components comprising the capital market to provide an alternative source of financing, as well as to

create broader and more diverse Islamic financial instruments for investors. The equity and bond markets will provide a more balanced allocation of financial and economic resources. This would result in a more efficient distribution of risks within the system, thus creating stability in the system. The equity and bond markets would also provide an avenue for raising long-term capital. With a wider spectrum of instruments in the market, fund managers would be able to manage their portfolios better and spread their risk according to their desired risk tolerance, thereby contributing toward greater stability.

In addition to the requirements mentioned above, to ensure an equal opportunity, a number of support facilities need to be provided to IFIs in compliance with the the Shari`ah including:

i. Liquidity support such as lender of last resort facility;
ii. Neutrality of capital requirements to be accorded to assets of IFSPs as compared to their conventional peers;
iii. Return on deposits held with central banks;
iv. Appropriate treatment of investment accounts for mandatory reserves and capital requirements;
v. Investment opportunities in sovereign financial issuances;
vi. Proper understanding of the Islamic banking services and their equal treatment with conventional products;
vii. A clearer understanding of the Shari`ah governance structures and facilitating them further;
viii. Extension of safety-net systems such as deposit protection;

ix. Ensuring a supportive legal system, and

x. Ensuring tax-neutrality for Islamic financial contracts.

7.2 Compliance with Core Principles

The unique characteristics of Islamic financial services industry require the development of a legislative and supervisory infrastructure that adequately addresses its compliance requirements. The most important of these requirements are existence of a SSB; a management that is committed to Islamic financial concepts; safeguarding of investors' fund from negligence, trespass, and fraud; and compliance with standards of the AAOIFI.[330]

At the heart of the development and growth of the Islamic financial services industry is the compliance with Islamic core principles. The development of an Islamic financial system that is able to contribute towards stability and balanced global growth needs for its development to be achieved in the context of a rigorous and robust legal, regulatory and supervisory regime. This is reinforced by effective supervision, strong Shari`ah framework and an efficient judiciary system that promotes confidence and soundness in the Islamic financial system.

330 The most significant Islamic financial institutions have their own *Shari`ah* Supervisory/Advisory/Boards or Councils comprised of one or more Islamic scholars that have particular expertise in economic, legal and financial transactions. These *Shari`ah* Boards/Councils often examine in detail both the structure of a proposed transaction or financial product and the documentation giving effect to that transaction or product. There may have variations in interpretation and implementation from one *Shari`ah* Board to another, with a multiplicity of views on a specific issue. Nevertheless, Islamic legal scholars in this period strive to achieve a consensus on difficult and original issues, such as those involved in the development of new financial instruments and products.

There is a need to have an independent SSB for any IB and IFI, and that SSB should consist of highly qualified scholars having considerable experience with knowledge of modern financial transactions. The SSB will serve as the central point for Shari`ah matters in relation to Islamic products, instruments and services. The SSB's role is to approve and authorise all Islamic products and services currently practised, as well as any new products developed by the bank and financial institution. It is important that the SSB introduces a culture of self-regulation within the IB and IFI to foster a strong sense of commitment to the Shari`ah values which could be achieved in various ways. For example, this could be realised through a code of ethics adopted by the individual bank and self-certification by the practitioners of the principles of the Shari`ah.[331]

The IFIs in Australia, as mentioned earlier in this study, to a large extent are governed by the same regulatory framework that is applied to conventional banking and financing operations reinforced by the compliance to the Shari`ah framework. The strict adherence to the Shari`ah is of paramount importance for such institutions in order to serve as a check and balance to ensure that the management and operations of the IFIs do not deviate from the Islamic principles in the formulation of their policies. Therefore, the financial reporting by an IFI is required to provide the necessary disclosure to report on the conformity of its operations with the Shari`ah principles. These will promote the foundations for building public confidence and assurance that the Islamic financial products and services are Shari`ah compliant.

331 Khan, Iqbal A. 2000. "Developing the Country Framework for Islamic Finance", *Proceedings of the 3rd Harvard University Forum on Islamic Finance*, Cambridge: Centre for Middle Eastern Studies, Harvard University. p.161.

7.3 Transparency and Disclosure Requirements

Transparency and disclosure is essential particularly in a rapidly changing environment. While the comprehensive and timely availability of financial information will increase market discipline, the disclosure of information needs to be complemented with the ability of the market players to analyse, and appropriately interpret the information.

Closely related to disclosure requirements is the need to strengthen the framework for consumer protection to provide an avenue for redress due to lack of transparency. This is more relevant to Islamic finance where Islamic financial transactions are not merely based on the lender and borrower relationship as is the case in conventional banking. The move towards the adoption of the supervised market approach requires continuous efforts to enhance product disclosures. Enhanced financial disclosure needs to be complemented by customer education and awareness programs to elevate the level of financial literacy of consumers and businesses to be able to make informed financial decisions and inculcate market discipline amongst financial players. Enhanced awareness on the manner in which Islamic financial transactions are being conducted and Islamic financial contracts are being executed will not only strengthen the role of market discipline in driving IFIs towards ensuring Shari`ah compliance in the operations, but also contribute towards improving operational efficiency, strengthening risk management infrastructures and instituting sound and dynamic risk management practices.[332]

332 See Governor of Bank Negara Malaysia. 2004. Speech at the IFSB Interactive Session on "The Future Prospects of the Islamic Financial Services Industry", Bali: 31 March, available on BNM website at: http://www.bnm.gov.my/index.php?ch=9&pg=15&ac=148

To further enhance transparency proper accounting standards need to be in place to reflect the true and fair value of banking operations that would lead to greater accountability and responsibility on the part of the banking institution. It is to be ensured in IBs and IFIs that accounts are not only drawn in accordance with the international accounting standards but are also in line with Islamic principles. This is to enable the investors and supervisors to obtain the true and fair assessment of the Islamic institution's financial condition and the profitability of the business. The standards issued by the AAOIFI including those were issued on the role of the Shari`ah committee as well as the code of ethics that should govern the accountants and auditors of IFIs, have contributed towards improved quality of financial statements and reporting methodology of IFIs.

7.4 Consumer Credit Code of Islamic Finance

The Consumer Credit Code governs all consumers transactions taking place in Australia including those are carried out by IFSPs. The Code not only introduces standardisation, it also presents credit information in a clear and easy to understand format. Credit providers such as banks, building societies, credit unions, finance companies and businesses, must tell the customers what their rights and obligations are in any credit arrangement. They are required by law to truthfully disclose all relevant information about consumers' arrangement irrespective of the users of conventional or Islamic financial services in a

written contract, including interest rates, fees, commissions and other information which in the past was often hidden.[333]

While the aim is to prevent many of the credit problems faced by consumers, the Code recognises that it is still important to protect consumers if they get into trouble. The Code requires that every consumer be given a written notice disclosing the terms and conditions of a credit agreement. Credit providers are required to be careful not to make contracts with consumers who would find it difficult to meet their repayments. A court can also order changes to a contract if it is considered unjust.[334]

Under the UCCC, the use of the word 'interest' is a product of the Australian regulatory regime. As such, the IFIs in Australia are legally obliged to mention this word in several contract documents of housing finance in order to inform the customers that this is mandatory under Australian law. However, in order to reflect the Shari`ah compliant transactions in which interest is not present MCCA – the pioneer of IFSPs in Australia has been working with the UCCC management committee to enact a Federal legislation to exempt from having to use the word 'interest' in all Shari`ah compliant products. A letter circulated by MCCA on September 27, 2004 in response to the Islamic Information and Support Centre of Australia (IISCA)'s letter comments the following in this regard.[335]

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333 The Consumer Credit Code website, "How the Code will Benefit You ?", available online at: http://www.creditcode.gov.au/display.asp?file=/content/consumer.htm

334 See the Queensland Government, Department of Tourism, Fair Trading and Wine Industry Development. 2007. "Payday Lenders", available on Office of Fair Trading website at: http://www.fairtrading.qld.gov.au/oft/oftweb.nsf/Web+Pages/5AC30F969DE98B154A25708A00160A4D?OpenDocument

335 See Islamic Information and Support Centre of Australia. 2004. "Response to IISCA", available on IISCA website at: http://www.iisca.org/press/release.jsp?id=5#Newsletter, 12 December.

> "We have applied to the Uniform Consumer Credit Code (UCCC) Management Committee for exemption from using the word interest in all Shariah compliant products. It is progressing very well".

The products used by Australian IFSPs comply with the financial regulation of the country. According to Kingsley Dawood David, MCCA's Senior Manager, business and compliance:

> "In its suite of four Shariah certified home financing products, MCCA has two products which originate for securitisation through two of the largest non-bank RMBS issuers in Australia based on the Ijara method of asset financing. Both these home financing products carry structural elements that are comparative to conventional home mortgages namely, the use of a registered first mortgage as collateral, mandatory compliance with Australian credit and fair trading laws, industry standard credit assessment and credit management, and mortgage market driven pricing".[336]

7.5 Concluding Remarks

From regulatory point of view the significant foundation is to accept that the fundamental principles of interest-based conventional financial markets regulation apply with equal

336 David, K. Dawud. 2007. "Islamic Mortgages in Australia", *Islamic Finance News,* vol. 4, issue 1, 5 January. See also, "A Question of Time", available online at: http://www.mcca.com.au/docs/A%20Question%20of%20Time.pdf . Currently, there are at least 40 securitisation programs funding in excess of AU$126 billion in the RMBS – the Australian Residential Mortgage-Backed Securities market, where one out of every six home mortgages in Australia is funded through the issuance of RMBS.

force to Islamic financial markets. The key philosophies that distinguish conventional from Islamic financial markets may suggest that the regulatory building blocks for regulating Islamic finance need to be different from those used for conventional regulation, but in fact it is not indifferent from regulatory perspectives. The principles that strengthen conventional markets regulation are mainly designed to ensure that financial firms are able to deliver upon their promises - promises to cover policy holders' losses; or to repay investors or depositors upon particular terms agreed at the time of contract formation.

> Given the perspective, like other regulators, Australian regulatory authorities would like to be satisfied that Islamic financial markets have appropriate compliance and enforcement powers and practices; that the conventional and IFSPs are both in good standing with relevant international standard setters; and that they are committed to appropriate levels of information sharing and cooperation. If all of these hurdles can be overcome, obviously they can take comfort that differences of detail in regulatory approach will not prejudice consumers of the Shari`ah compliant products.

CHAPTER 8

CRITICAL ANALYSIS OF FINANCIAL INSTRUMENTS USED BY THE ISLAMIC FINANCIAL SERVICES PROVIDERS IN AUSTRALIA

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8.1 Australian Islamic Financial Services Providers: An Overview

The leading IFIs that conducting their functions in Australia are as follows:[337]

I. Muslim Community Co-operative (Australia) Limited,

II. Islamic Co-operative Finance Australia Limited,

III. Iskan Finance Pty Limited.

8.1.1 Muslim Community Co-operative (Australia) Limited

MCCA is a non-bank financier based on unique system that recognises and meets the community's religious needs. It also spouses a philosophy of providing finance on a fairer and more equitable basis, which in the long-term should be better for society at large. Based in two major cities of Australia, Melbourne and Sydney, MCCA serves the diverse needs of all consumers and was recently honoured with the 2006 Australian Business Award for Small and Medium Enterprises (SMEs) in the categories of *Enterprise* and *Community Contribution* for community service and community reinvestment. [338] Its membership is open to all, whether Muslims or non-Muslims. Anyone who is interested in alternatives to interest-based finance is encouraged to become a member.

337 See for more elucidation, Abu Umar Faruq Ahmad and Abu Bakr Rafique Ahmad. 2007. "Islamic Micro and Medium Sized Enterprises (MMEs) Finance: The Case Study of Australia", *1st International Conference on Inclusive Islamic Financial Sector Development Proceedings*, Brunei. pp.816-844.

338 The *Enterprise* category acknowledges business that have shown the "initiative and willingness to undertake bold new ventures", while *Community Contribution* recognises "those who demonstrate examples of policies or projects that positively impact on the community and generate outcomes that have a long time benefit". See "Newratings", *Australian Business Awards*, available online at: http://www.newratings.com/analyst_news/article_1422447.html (accessed January 9, 2007). See also, MCCA Newsletter, January 2007.

MCCA is considered "the largest provider of specialised financial services in Australia that comply with both conventional credit laws and Islamic requirements".[339] Established in February 1989 with ten members and a starting capital of AUD 22,300, MCCA's members stand now over 7,000 in Victoria and New South Wales.[340] According to updated information provided by MCCA in its official webpage:

> "We have since become the largest and most widely recognised Australian provider of Islamic finance and investment services with 6,900+ member shareholders and more than $240 Million in financial accommodations currently managed".[341]

Currently, MCCA originates AUD 100 million a year in Islamic home finance and manages a finance book of Islamic home finance and equipment assets in excess of AUD 250 million. As a corporate, that is majority owned by Australian Muslims, "MCCA is now the most recognised and trusted brand within the Islamic finance market in Australia".[342]

In addition to its consumer finance offerings, it co-developed Australia's first and only Islamic public offer ASX listed equities investment product, the Crescent Ethical managed discretionary account service.[343]

MCCA's principal managed funds are of the following types: *'Ijara, Murabaha, 'Ijara Muntahia Bittamleek* (IMB), *Tamleek, 'Ijara wa Iqtina, Qard Hasan* and *Mudaraba*.[344]

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339 MCCA Media Release, accessed on November 16, 2006 from: http://www.mcca.com.au/UserFiles/061116%20MCCA%20ABA%20Press%20Release.pdf
340 *Ibid.*
341 See Muslim Community Co-operative (Australia) Ltd website, accessed October 01, 2007 at: http://www.mcca.com.au/page.php?id=housing&product_id=8
342 See K. Dawud David, *supra* note 332.
343 *Ibid.*

Among these products MCC's fund under the '*Ijara* mode is provided for residential house financing only and for property construction. While financing under *Murabaha* is managed for both residential and commercial purposes. MCCA's IMB, a relatively new product which was initially named as Sale to Lease (S2L) is now used for residential and commercial financing. On the other hand MCCA's *Tamleek* is used for funding residential properties only. The *Murabaha* and *'Ijara wa 'Iqtina* products are used for motor vehicles and other commodity financing. The Qard Hasan (interest free loan) is made from the pooled donations of the members and is generally granted to those who are facing an emergency personal crisis. *Mudaraba* is used for joint partnership investment in MCCA, while the *Musharaka* product is used for equity investment in MCCA and Crescent Ethical MDA Services.[345] The *Musharaka* was initially used by MCCA for home financing under the product name Shared Equity Rental (SER).[346] To the author's knowledge it is not in use any more by MCCA for home financing.

In fact MCCA's Shared Equity Rental (SER) Scheme under *Musharaka* looks akin to the model announced by the Australian Prime Ministerial Taskforce on home ownership in June 2003, in which the homeowner and a bank or other mortgage lender would co-own a home. Under the proposal, the financier would own about 30% of the home's value – reducing the amount of the homebuyer's mortgage and making it easier for people to buy a home.[347] In

344 See MCCA website, *supra* note 337.
345 See MCCA website, *supra* note 337.
346 This product was applied as a Diminishing Partnership (DP). In home financing under DP the customer forms a partnership with the financial institution for the purchase of a property. The financial institution rents out their part of the property to the customer and receives compensation in the form of rent, which is based on a mutually agreed fair market value. Any amount paid above the rental value increases the share of the customer in the property and reduces the share of the financial institution.
347 Prime Minister John Howard said that he was particularly concerned about young home buyers struggling to afford properties in Melbourne and Sydney. However, some commentators have criticised the proposal, saying that a real danger is negative equity where the house is sold for less that the amount outstanding.

keeping with the Islamic principle that the financier and the buyer should share the risk and reward of the venture, MCCA takes an equity stake in the property and buyer pays monthly rent with a capital repayment component – eventually to assume full ownership.

So far as the activities and purposes of MCCA are concerned, the following summary given by Peter Moody of the Australian Taxation Office is worthy of mention.

> "a. A place for the advancement of the principles of the Muslim faith, and the evolution of a 'community' that overlooks its members and shareholders. MCCA funds can be, and are used to help those in need within the community. Donations are received and applied for this purpose. A separate fund has been created for this end, and is known as the Qard Hasan Fund.
>
> b. To operate as a housing co-operative that assists with the purchase of mainly residential properties for and on behalf of its shareholders. The purchase of other asset classes is undertaken in a similar fashion, mostly the purchase of motor vehicles, computers, and some limited business finance. The purpose of the provision of this facility is solely centered around the Muslim doctrine that forbids the payment of interest. MCCA charges an upfront 'administrative' charge for their involvement, but thereafter, the loan is interest free. This conforms to all the requirements of their religion, and such transactions are held to be Halal, which means that they are 'allowable' under Muslim doctrine. Repayments under these types of transactions are known as repayments of Murabaha.
>
> c. To accept funds and issue shares in the co-operative from time to time, and to distribute the trading surplus of the co-operative back to the members in the form of dividends".[348]

348 See Hamdi, A. Abdul. 1999. "Islamic Banking System", available online at: http://www.mail-archive.com/indoz-net@cc.utas.edu.au/msg01221.html

However, MCCA itself underscores its core purpose in its official website as follows:

> "to provide goods and services to members in accordance with Islamic law and the principles of co-operation".

It also stipulates that its vision is:

> "to be the leading provider of specialised financial and wealth management services catering to the needs of Australian Muslims".[349]

8.1.2 Islamic Co-operative Finance Australia Limited

Islamic Co-operative Finance Australia Limited (ICFAL) was officially endorsed and registered by the Registry of Co-operatives, Department of Fair Trading, the Government of the State of New South Wales, in May 1998 under the *Co-operatives Act 1992* (NSW), sections 8, 9 and 10 to function as co-operative within the state of New South Wales.[350]

The primary objectives of ICFAL are:

> "A. To provide methods of investment & finance opportunities for its members in line with Islamic principles (Halal): Equity Profit & Loss sharing concept, which is fair, simple and straightforward,
>
> B. Facilitate earning Halal income,
> C. Facilitate ownership of property (home, vehicle & other approved tangible assets),
>
> D. Facilitate performing social & religious obligations for Muslim members i.e., Zakah & Hajj and,

349 See MCCA website, *supra* note 337.
350 See Islamic Co-operative Finance Australia Limited website, available online at: http://www.icfal.com.au/about_us.html

E. Establish feasible joint venture or partnership deals with members & similar organisations".[351]

At present, ICFAL provides the following products and services for its members.

A. Housing finance under *Murabaha, Musharaka* and *'Ijara wa 'Iqtina* financing schemes. It follows almost all the terms and conditions and procedures followed by MCCA for its house financing scheme.

B. Vehicle finance under *Murabaha* and *'Ijara wa 'Iqtina* modes of finance.

C. Buying consumer's durables for customers and reselling to them under the *Murabaha* mode of finance.

D. Small business finance under *Musharaka* and *Murabaha* financing schemes.

E. Hajj Fund under the *Mudaraba* mode of investment. Under this scheme a customer wishing to perform Hajj deposits money by installments to this fund over a specified period to be able to bear Hajj related expenses when the fund is matured. The accrued dividend is distributed among the participating members for the whole period of investment.

F. Children Education Fund under the *Mudaraba* mode of investment. Under this arrangement ICFAL provides financial facilities to cover the education expenses of the participating members' children during the later stage of high School and tertiary education. To meet eligibility criteria of an active membership provision a child under the age of 18 years pays at least 10% of the joining fee of AUD 100 plus10% of 5 shares (each share is valued at AUD 100) and agrees to pay the remaining portion by equal installments during the first financial year. The maturity period of this fund package to be purchased must be at least 5 years.

351 *Ibid.* See also, Islamic Co-operative Finance Australia Limited, ICFAL at a Glance, (an undated brochure.)

G. *Zakah* Fund. Under this scheme ICFAL acts on behalf of each member, if requested to calculate, collect and distribute *Zakah* to the poor and other deserving needy people as outlined in the Islamic Shari`ah.[352]

H. Qard Hasan (Benevolent Fund).

As regards the membership requirements, any person residing in the State of New South Wales may be eligible to become a general member of ICFAL by paying a one-off membership fee of AUD 100 and an active member of ICFAL by purchasing a minimum of 5 shares valued at AUD 100 each. An active member is entitled to receive finance from ICFAL's under the schemes mentioned above subject to the down payment of 20% of the total price of the house, commodity or other products under purchase.[353]

8.1.3 Iskan Finance Pty Limited

Iskan Finance, as stated on its official website, is an Australian business established in 2001 by a group of Australian and Non-Australian Muslims with the core objective to pioneer, create and promote the most competitive Shari`ah compliant home facilitation programme possible for the Islamic community in Australia.[354]In 2002, Iskan Finance commenced business with its *Murabaha* Facilitation Programme and building on the success of this core home financing product, has developed its *'Ijara wa 'Iqtina* ("Lease to Purchase") facility. Both the *Murabaha* Facilitation Programme and the *'Ijara wa 'Iqtina* facility has been modeled on *fatwa*s [355] issued by various Islamic scholars and on opinions that Iskan has

352 See ICFAL website, see also *supra* note 347.
353 *Ibid.*
354 See Iskan Finance Pty Ltd. website, available at: http://www.iskan.com.au/home.htm
355 *Fatwas* are legal statements in Islam, issued by a scholar of Islamic laws, on a specific issue. They are asked for by judges or individuals, and are needed in cases where an issue of Islamic law and jurisprudence is undecided or uncertain. Lawsuits can be settled on the basis of a fatwa.

sought from Al Azhar University in Egypt. At the same time, Iskan Finance has worked hard to ensure that the financing will have longevity and consistency of delivery by engineering both its funding products to comply with the Australian UCCC. In 2005 Iskan introduced a new product under the name "Tayseer-Ijara" for residential and commercial customers which replaced its previous product *'Ijara wa 'Iqtina.* In 2006, it introduced another product called ultiMATE Home Finance package offering a wider range for its customers. The reason given for this modification as it claimed was "to cater for the specific needs for our community".[356]

At a practical level, Iskan Finance has established links with a number of third party providers to service its customers. For instance, the custodian of Iskan's mortgages is Perpetual Trustee Australia Limited; mortgage insurance is provided by G. E. Mortgage Insurance Services; and the Programme Manager is RESIMAC Limited. Iskan has contracted with Advance Investment Securities Australia Pty Ltd to manage distribution of its facilities and strategic alliances have now been forged around Australia to service a growing customer base.[357]

Iskan Finance believes its *Murabaha* Facilitation Programme and its *'Ijara wa 'Iqtina* offer a sound foundation for a growing suite of financing products that are planned to service the Australian Muslim Community. Iskan's *Murabaha* Facilitation Programme is designed to offer a 'better alternative' for Australian Muslims who are seeking the security, stability and financial independence of home ownership. It is a contract of sale between Iskan and its customer that establishes a fixed *Murabaha* price including a profit mark-up, secured by a mortgage. Under Iskan's *Murabaha* Property Facility programme, following settlement, Iskan's customer is the sole owner of the property and enjoys the full benefit of any capital gain in the property.[358]

356 See Iskan Finance Pty Ltd. website, *supra* note 351.
357 *Ibid*.
358 *Ibid.*

Iskan's *'Ijara wa 'Iqtina* financing model as it mentions on its website is designed to be a 'better alternative' for Australian Muslims who are seeking the security, stability and financial independence of home ownership. The model is based on the concept of 'leasing to purchase' a home. Iskan's customer agrees to lease the property and pay rent, either fortnightly or monthly. Rent is reset at twelve monthly intervals and each rental payment made increases the customers' equity, ultimately retiring Iskan's equity. Iskan customers have the option to retire the facility in part or full on yearly anniversary dates when the rental payments are reset.[359]

The *'Ijara* facility is secured by a mortgage on the property. Under this scheme, Iskan customers are required to pay deposit of at least 5% toward the purchase price of the home and Iskan provides the balance. However, as Iskan customers do not need to open a savings account with Iskan, there is no lengthy waiting time to qualify. The *'Ijara* facility does not require the customer to enter into any partnership with Iskan and the customer enjoys the full benefit of any capital gain in the property. Like Iskan's *Murabaha* Property Facility, applying for an *'Ijara* facility is also simple. Most of the requirements of this programme are stated on its website.[360]

8.2 Instruments used by Australian Islamic Financial Services Providers: A Critical Analysis

As discussed earlier in this study, the products and instruments used by IFSPs in Australia fall basically under the following two categories: i) Equity based financial instruments; and ii) Non-equity based (Debt-based) financial instruments. In this section attempts are made to critically analyse these products and instruments from the perspective of the Shari`ah compliance in IFSPs.

359 *Ibid.*
360 *Ibid.*

8.2.1 Equity-based Financial Instruments

There is perceptible consensus among classical and contemporary Islamic legal scholars that Equity-based products and instruments used by Islamic financial services providers signify the most desirable type of financing investment and business because of their ability to bind reward-sharing to risk-sharing between the two transacting parties.[361]

The *Musharaka* and *Mudaraba* among the equity based contracts together form the Islamic substitutes to conventional methods of venture capital and private equity financing. These contracts are highly practical and successful. The practicality of these modes is not assumed simply on the basis of ideology or belief. Contemporary Islamic finance provides plenty of empirical evidence confirming the viability of these modes of finance.[362] The methodology and spirit of equity based financing modes in Islamic finance is such that their successful implementation does not require anything more than a genuine business-based relationship between the bank and its customer.

The key Equity-based financial product used by Australian IFSPs is *Musharaka.* This model is used by MCCA and ICFAL mainly for house financing under the name Shared Equity and Rental (SER).[363] This is essentially a *Musharaka Mutanaqisa* (Diminishing Partnership or

361 Adam, Nathif J. 2005. *Khaleej Times*, 2 August issue.

362 See Mahmoud El-Gamal and Hulusi Inanoglu. 2003. "Islamic Banking in Turkey (1990-2000): Boon or Bane for the Turkish Financial Sector?" *Proceedings of the 5th Harvard University Forum on Islamic Finance*. Cambridge: Centre for Middle Eastern Studies, Harvard University.

363 Under SER agreement for house financing MCCA for example, join a prospective home purchaser with equity. The total cost of purchase is shared. The property is registered in the name of the customer as well as MCCA. The rent of the property is determined in the light of the rent rates announced by the Australian Real Estate Institute periodically. To these

DP)[364] structure which has generally been used by other IFIs in the Muslim and Non-Muslim world. In subsequent sub-sections the mechanism and rules of *Musharaka Mutanaqisa* as well as criticisms of this instrument are discussed.

8.2.1.1 Rules of *Musharaka Mutanaqisa* Contract

The *Musharaka Mutanaqisa* (DP) practised by the IBs and IFSPs today is a relatively recent development on the classical *Musharaka* contract which is a PLS mode of finance available for project and business ventures. It is a partnership agreement whereby the customer and the financier share the cost of both the capital and the management of a project while the profits are distributed between them according to pre-determined ratios, usually but not necessarily based on their equity participation. Losses must be shared in proportion to the respective capital contributions.[365]

In fact *Musharaka* involves a financial institution obtaining an equity share in an asset or business as opposed to providing a conventional loan. Some basic rules of *Musharaka* are discussed below:

1. Profits are shared as per the agreement of the partners whereas losses are shared on a pro-rata basis in the investment.

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rate is added the average growth rate of rents over the last 15 years. The value of the property remains fixed throughout the period, with the customer having the option to purchase MCCA share at the original purchase price. Till then the customer pays MCCA rent in proportion to the latter's share in the property.

364 Musharaka Mutanaqisa or DM in short, Diminishing Partnership or DP, Shared Equity and Rental or SER and Diminishing Shared Ownership have been used interchangeably throughout this study to refer to the same product practisd by the IBs and IFIs in different parts of the globe using different nomenclature.

365 See M. Raquibuz Zaman and H. Movassaghi. 2001. "Islamic Banking: A Performance Analysis", *The Journal of Global Business,* vol. 12, No. 22, Spring. pp.31-38.

2. Contribution to the *Musharaka* fund can be via liquid assets or illiquid assets. Once the assets are in the fund they are pooled for the benefit of all partners.
3. Silent partners must take a share of profits in direct proportion to their initial investment.[366]

Musharaka Mutanaqisa, otherwise known as Diminishing *Musharaka* (DM) or Diminishing Partnership (DP) is a hybrid financing technique involving both *'Ijara* and *Musharaka* elements. In the DP the financier and the customer participate either in the joint ownership of an asset or in a joint commercial enterprise. It has been used mostly in house financing. The share of the financier is further divided into a number of units and it is understood that the customer will purchase these units one by one periodically, until he becomes the sole owner of the property, or the commercial enterprise, as the case may be.[367]

A DP is entered into by means of a number of different transactions. The first step that the customer takes in a home purchase is to bring in the financier as a co-owner of a home. This partnership is established by the use of a co-ownership agreement rather than conventional loan documentation. The rights and responsibilities of both parties while they own the home together are spelled out in this agreement. The customer and the financier are co-owners who own specific shares in the home. A customer finds a home that is priced to sell, for example, at AUD 300,000. The customer can place 5%-20% (AUD15,000-60,000) into the transaction, while the financier provides the remaining 95%-80% (AUD 285,000-240,000). The customer is 5%-20% owner; the financier is 95%-80% owner.

366 "Islamic Finance Explained", 1st Ethical website, available at: http://www.1stethical.com/Finance.pdf, (accessed March 2, 2007).
367 Usmani, M. Taqi. 2002. *An Introduction to Islamic Finance*, Hague; New York: Kluwer Law International.

Although both co-owners would have the right to occupy the property in this transaction, the financier gives the customer the exclusive enjoyment and use of the whole property. After purchasing the property jointly, the customer uses the house as his residence. The customer's monthly payment amount consists of two elements. The first portion is the 'Rent Payment' for exclusive use of the financier's share of the property.[368] The remaining portion is 'Acquisition Payment' which allows the customer to acquire an increasing share of ownership in the home. Together, these two amounts make up a predictable monthly amount. As the customer makes payments to acquire a further share in the property financier's ownership share decreases. The rent payable to the financier is also reduced to that extent. This arrangement allows the financier to claim rent according to his proportion of ownership in the property and at the same time allows him periodical returns of a part of his principal through purchases of the shares of ownership in the home.

In order to achieve full home ownership over time, the customer commits to buy the financier's share of the property over a period of say 15, 20 or 30 years. In the first example above, the financier obtains a share of the home of between 95% and 80% depending on the share allocation. The customer acquires the financier's 95% or 80% share at the original price through a series of monthly acquisition payments. At any time, the customer also has

368 It may be argued that the IB purchases the property in its own name, and rents it to the customer at a monthly cost that includes principle plus a fixed rental rate. These rental rates are compatible with an interest rate benchmark. In addition, purchaser is required (i) to pay a non-refundable "membership" fee, and (ii) to purchase shares of IFSPs up to 5% -10% of the value of the property. Thus, the eventual cost to the purchaser of the property seems to be greater than a conventional loan. Nevertheless, according to the Shariah, the rent in an *Ijara* transaction can be set at any value agreed between the buyer and seller. There is no particular reason why a house financed by this method should be any more or less expensive than a house financed by a conventional mortgage. Also, Shari`ah scholars have permitted IFSPs to refer to any interest rate benchmark for determining rent provided that the benchmark is well known to everyone so that no dispute over the amount of rent can arise in the future.

the option to reschedule and expedite his acquisition of the financier's remaining share in the property at a faster pace than the predetermined acquisition payments or even buy out the property entirely. There are no additional fees or penalties associated with this option. For instance, if the customer decides to move out of the property before the end of the financing period he can do so by first acquiring the financier's remaining ownership share and then selling the property in the market.[369] The second step normally takes place immediately after the first step during a single settlement, allowing the customer to use the proceeds of the sale to pay the amount owed to the financier for its remaining share. Naturally, because the customer fully owns the property at the point it is sold in the market, the customer will retain the full gain or loss resulting from this sale.

The above mentioned DP model of Islamic finance enables home financing that honours the principles of the Shari`ah while benefiting from the best of what is available in the modern financial marketplace.

From an Islamic legal perspective the contract of DP is composed of the following transactions:

1. Creating co-ownership in the property.
2. Renting the financier's share to the customer.
3. Promise from the customer to purchase financier's shares.

369 In the event of non-payment of rent from the customer, the bank has to take into consideration the reason for the non-payment. If the customer has a valid excuse for non-payment, the financier has to show leniency so that the customer does not feel over-burdened, and the customer should be given more time to make the payment. In theory, if the bank charges any extra amount as compensation for the late payment that would be tantamount to charging forbidden interest. However, if there is no genuine reason for the late payment, the bank can ask the customer to make a payment to a charity as penalty (*Ibid. An Introduction to Islamic Finance*. p.172). This prohibition of charging late fees makes it even more important for the IFSPs to carefully evaluate each application before entering into an agreement.

4. Actual purchase of the shares at scheduled intervals.
5. Adjustment of the rental in proportion to the financier's decreasing share in the property.[370]

Looking into each part of the DP model in a greater detail one finds that the first step which creates a co-ownership in the property can come into existence in different ways, including joint purchase by the parties. This has been expressly allowed by all Schools of Islamic law. Therefore, no objection can be raised against creating this co- ownership.[371]

Relating to the financier leasing his share in the house to his customer and charging rent there has also been no difference of opinion among the scholars of the Shari`ah in the permissibility of leasing one's undivided share in a property to one's partner.[372] However, the jurists have difference of opinions if the undivided share is leased out to a third party. Abu Hanifa and Zufar are of the view that the undivided share cannot be leased out to a third party, while Malik, Al-Shafi`i, Abu Yusuf and Muhammad opined that the undivided share can be leased out to any person.[373]

The third step in the aforesaid transaction in which the customer purchases different units of the undivided share of the financier is also allowed according to all the Islamic Schools. If the undivided share relates to both land and building, the sale of both is also allowed. Similarly, if the undivided share of the building is intended to be sold to the partner, it is also

370 See M. Taqi Usmani, *supra* note 364.
371 *Ibid.*
372 *Ibid.*
373 See Yusuf Talal De Lorenzo (ed.). 1997. *A Compendium of Legal Opinions on the Operations of Islamic Banks: Murabaha, Mudharabah and Musharaka,* London: International Institute of Islamic Banking and Insurance. pp.45-50.

allowed unanimously by all jurists. However, there is a difference of opinion if it is sold to a third party.[374]

Although each one of the transactions mentioned above is allowed per se, the question arises whether this transaction may be combined in a single arrangement. The answer is that if all these transactions are combined by making each one of them a condition to the other, then this is not allowed in the Shari`ah, because it is a well settled rule in the Islamic legal system that one transaction cannot be made a pre-condition for another.[375] However, the proposed scheme suggests that instead of making two transactions conditional to each other, there should be uniteral promise from the customer, firstly, to take out a lease on the financier's share and pay the agreed rent, and secondly, to purchase units of the financier's share of the house at different stages. This leads us to the fourth issue, which is the enforceability of such a promise.

It is generally believed that a uniteral promise to do something creates only a moral obligation on the promisor which cannot be enforced through the courts of law. However, there are a number of jurists who opine that uniteral promises are enforceable, and the courts of law can compel the promisor to fulfil his promise, especially, in the context of commercial activities. A short discussion of this juristic view is given below:

Some Maliki and Hanafi jurists are of the opinion that uniteral promises can be enforced through the courts of law in cases of need. The Hanafi jurists have adopted this view with

374 See M. Taqi Usmani, *supra* note 364.
375 *Ibid.*

regard to a particular sale called *Bai`-bi al- Wafa.*[376] This is a special arrangement for the sale of a house whereby the buyer promises to the seller that whenever the seller gives him back the price of the house, he will resell the house to him. This arrangement was in vogue in Central Asia. The Hanafi view is that if the resale of the house to the original seller is made a condition for the initial sale, it is not allowed. However, if the first sale is effected without any condition, but after effecting the sale, the buyer promises to resell the house whenever the seller offers him the same price, this promise is acceptable and it creates not only a moral obligation, but also a right enforceable by the original seller. The Muslim jurists allowing this arrangement have based their view on the principle that "a promise can be made enforceable at the time of need".[377] Even if the promise has been made before effecting the first sale, so long as it is not made a condition of the sale, it is also allowed by certain Hanafi jurists. [378]

Conversely, if the sale is without any condition, but one of the two parties promises to do something separately, then the sale cannot be held to be contingent or conditional upon fulfillment of the promise made. It will take effect irrespective of whether or not the promisor fulfils his promise. Even if the promisor reneges on his promise, the sale will remain effective. The most the promise does is to create a right which the promisee can enforce through legal action. If the promisor is unable to fulfil the promise, the promisee can claim damages for loss suffered owing to the default.

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376 In a DP, a unilateral promise is permissible if the clause for returning the house is not instituted before-hand. But if the said clause is the essence of the contract the agreement becomes void. The *Bai`-bi al-wafa* contract is similar to the conventional repo (i.e. an agreement in which one party sells a security to another party and agrees to buy it back on a specified date for a specified price) with the difference that in case of the *Bai`-bi al-wafa*, the repurchase price is the same as the initial sale price. In a repo the repurchase price is set higher than the initial price, which renders the transaction *riba*-based borrowing. See for details, Mohammed Obaidullah. 2005. *Islamic Financial Services*, Jeddah: Islamic Economics Research Centre. pp.52-53.

377 See Saba Habachy. 1962. "Property, Right, and Contract in Muslim Law", *Columbia Law Review*, vol. 62, No. 3, March, pp. 460.

378 See M. Taqi Usmani, *supra* note 364.

This makes it clear that a separate and independent promise to purchase does not render the original contract conditional or contingent. Therefore, it can be enforced.

The following steps are involved in a DP contract for home financing:

Step1. The vendor sells the property directly to the IFSP in whose the legal title to the property is vested. The IFSP pays the full purchase price of the property to the vendor.

Step 2. The IFSP and the customer enter into a partnership agreement to co-own the property. The IFSP and the customer agree at the start that their respective shares in the property shall be pro-rata in proportion to their contributions towards the purchase price paid to the vendor.

Step 3. Both parties also agree that during the course of their partnership, which has an agreed date of termination, the customer will purchase the IFSP's share in the property in instalments and for the price that the IFSP had paid for such share on the initial date of acquisition. As the customers increase their share in the property, the IFSP's share correspondingly decreases by the same amount.

Step 4. Parallel to the DP agreement, the IFSP grants to the customer a lease in respect of its share in the property. The lease is effective for as long as the IFSP has a share in the property.

Step 5. As security for the customer's obligations to make payments of rent under the lease and acquire the IFSP's share in the property at a fixed price under the DP Agreement, the customer charges by way of security in favour of the IFSP, its interests in the property under the Lease and the DP agreement.[379]

On the basis of the above steps to be followed, Diminishing *Musharaka* (DM) may be used for home financing so long as the following conditions are fulfilled:

1. The agreement of joint purchase, leasing and selling different units of the financier's share should not be tied up together in one single contract. However, the joint purchase and the contract of lease may be joined in one document whereby the financier agrees to lease his share, after joint purchase, to the customer. This is permitted because *'Ijara* can be effected for a future date.
2. The customer may sign a unilateral promise to purchase different units of the financier's share periodically and the financier may undertake that when the customer purchases a unit of his share, the rent for the remaining units will be reduced accordingly.
3. The purchase of each unit must be effected by the exchange of an offer and acceptance at that particular date.

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379 Hameed, Tariq. 2007. "Does the Diminishing Musharakah Reflect the Spirit of Sharia?" *Mortgage Finance Gazette*, January, available online at: http://www.mfgonline.co.uk/ccstory/17015/113/Does_the_Diminishing_Musharakah_reflect_the_spirit_of_Sharia?.htm, (accessed March 4, 2007).

It is preferable that units be priced according to the market value of the house prevalent on the date of purchase of that unit. However, it is permissible to agree a particular price in the promise of purchase signed by the customer.[380]

8.2.1.2 Critique of *Musharaka Mutanaqisa* Contract

Various forms of partnership contract including *Musharaka* which are considered to be PLS modes of financing which may be contrasted with Debt-based forms of financing (to be discussed later in this chapter). It was viewed by some scholars that PLS modes of financing are more ideal from an Islamic point of view.[381] On this basis, it is viewed by some that most Islamic financing practices that are Debt-based, such as credit sales and leases, are mere re-labelling of the interest forbidden in the Shari`ah.

However, some contemporary scholars do not agree with this view. They argue that if the IBs and IFIs carefully abide by the rules of the Shari`ah, there is no reason to think that Debt-based financing such as credit sales and leases are any "less Islamic" than Equity-based partnership modes of financing like *Mudaraba* and *Musharaka*.[382]

Although the *Musharaka* mode of financing is believed to be the cardinal of Islamic finance, it has never been popular among the majority of IFSPs in Australia. IFSPs have advanced

380 The Institute of Islamic Banking and Insurance. n.d. "What do Different Islamic Schools of Thought Say?", available on Islamic mortgages website at: http://www.islamicmortgages.co.uk/index.php?id=88 (accessed October 02, 2007.)

381 For instance Justice M. Taqi Usmani in his judgment gave in the Shariah Appellate Bench of the Supreme Court of Pakistan stated that Musharaka is not only the principles of Islamic jurisprudence, but also the basic philosophy of an Islamic economy. See "The Text of the Historic Judgment on Interest given by the Supreme Court of Pakistan", *Albalagh E-Journal*, available at: http://www.albalagh.net/Islamic_economics/*riba*_judgement.shtml. See also, Tariqullah Khan. n.d. "Redeemable Islamic Financial Instruments and Capital Participation in Enterprises", Islamic Research and Training Institute Research Paper, No.29.

382 See Mahmoud A. El-Gamal. 2000. *A Basic Guide to Contemporary Islamic Banking and Finance*, Houston: Rice University. p.23.

various reasons for not employing this mode of financing, which can be summed up as following:

1. Secretiveness and lack of adequate transparency on the part of the managing partners with regard to the performance of projects.
2. The high cost of following up and monitoring projects.
3. Unfair treatment in taxation. While profit made from such contracts is taxed, interest on the other hand is treated as a cost item and is not taxed. Such discrimination can prove negative and can limit the growth of Equity-based financing contracts.[383]

While the above reasons may be justified to an extent, a close consideration of the circumstances involved reveals deliberate avoidance of these modes by IFSPs in favour of relatively less riskier modes of finance such as *Murabaha* and *'Ijara* which offer predetermined rates of return.

A DM in which a customer pays 'Rent plus Acquisition Payments' periodically does indeed resemble a conventional mortgage schedule. The Rental Payment corresponds to 'Interest Payment' in a conventional mortgage while the Acquisition Payment corresponds to the 'Principal Payment' in a conventional mortgage.[384] In reality the DM differs from a mortgage loan by the nature of the transaction, in particular the relationship between the parties involved. In a loan transaction, the lender advances funds to the borrower in exchange for a future repayment of the funds plus interest. This amounts to an exchange of cash for a greater

383 See Humayon A. Dar and John R. Presley. 2000. "Lack of Profit and Loss Sharing in Islamic Banking: Management and Control Imbalances", *International Journal of Islamic Financial Services*, vol. 2, No.2, July-September.
384 Usmani, M. Taqi. 2006. *Islamic Finance - Musharaka & Mudaraba*, Karachi: Darul Uloom. Available online at: http://www.darululoomkhi.edu.pk/fiqh/islamicfinance/musharakah.html

amount of cash in the future and is prohibited in the Shari`ah.[385] On the other hand, the relationship between the financier and the customer in the DM is that of co-owners in a property and not that of lender-borrower. The initial financing provided by the financier is applied to acquire a share in the property and not to provide a loan. The customer's monthly Acquisition and Rental Payments are applied, respectively, to acquire the financier's share in the property and for the customer's exclusive use of the whole property. These payments do not constitute a repayment of a loan with interest. This transaction does not involve an exchange of cash for a greater amount of future cash, which would give rise to interest.[386]

Notwithstanding the fact that a DM differs fundamentally from a loan, it is designed to provide benefits to customers that are equivalent to what is offered by a conventional mortgage, but in a manner that complies with the tenets of the Shari`ah. The concept allows customers to acquire their homes at their own pace through pre-determined monthly payments and ensures the integrity of the transaction by respecting the rights and obligations of the two parties in the agreement. An essential difference between the Shari`ah compliant modes of financing and loans that incorporate interest is that the financier is not permitted to profit from financial distress.[387] No interest may be charged on late payments except that expenses incurred in the collection of such payments may be charged to the customer.[388]

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385 See for example, Shahnaz Naughton and Tony Naughton. 2000. "Religion, Ethics and Stock Trading: The Case of an Islamic Equities Market", *Journal of Business Ethics*, vol. 23, No. 2, January. pp.145-159.
386 See Abu Umar Faruq Ahmad and M. Kabir Hassan. 2007. "Regulation and Performance of Islamic Banking in Bangladesh", *Thunderbird International Business Review*, vol.49. No. 2. p.262.

387 Haneef, M. Rafe. 2005. "Recent Trends and Innovations in Islamic Debt Securities: Prospects for Islamic PLS Securities", S. Nazim Ali (ed.), *Islamic Finance: Current Legal and Regulatory Issues*, Cambridge: Islamic Finance Project Islamic Legal Studies Program, Harvard University. pp.40-42.
388 *Ibid.*

Another important issue related to the DM form of contract is the purchase of shares by a home-buying customer. Here, the price and timing of share purchases is usually fixed at the outset of the contract. According to MCCA's DM contract, the price of share purchases is related to the market value of the underlying property at the time of the purchase, and such purchases are not forced upon the customer contractually. It is to be mentioned here that the Shari`ah standards of the Bahrain-based AAOIFI prohibit the purchase of shares in a DP at a price that is fixed in advance. This is on the basis that partners in a contractual investment (in this case, a rental property) must share any losses on their investments in proportion to their capital contribution. If one partner forces another to buy his shares at a predetermined price, he may effectively be able to protect himself against loss, thus breaking the principle of loss sharing that must apply if an Islamic partnership is to be valid.[389]

The DP contract practised by some of IFSPs, mainly MCCA, protects them from capital loss on their share of the partnership by various means and to varying degrees under Australian law. In the event of property market decline Muslims who default under such contracts may therefore find themselves required to guarantee IFSPs' original capital contribution to the property purchase. If property prices fall significantly, the position of negative equity could become widespread. This would no doubt be an unexpected surprise for many customers, given the language of "risk sharing" that typically accompanies Islamic home finance products. Given the above, it is believed that any Shari`ah compliant financing scheme in

389 The AAOIFI clearly recognises the risk that a *Shari`ah*-compliant partnership contract can be transformed into a *riba* contract by means of pre-agreed share transactions. It says: "It is permissible for one of the partners to give a binding promise that entitles the other partner to acquire, on the basis of a sale contract, his equity share gradually, according to the market value or a price agreed at the time of acquisition. However, it is not permitted to stipulate that the equity share be acquired at their original or face value, as this would constitute a guarantee of the value of the equity shares of one partner (the institution) by the other partner, which is prohibited by Shari`a". See Accounting and Auditing Organization for Islamic Financial Institutions, *AAOIFI Shari`ah Standards 2003 - 2004*, section 5. "Diminishing Musharakah". p. 214.

which the financing organisation stipulates conditions to protect itself from a negative return on capital is equivalent to an interest-bearing loan.[390]

8.2.1.3 IFSPs' Home Financing on *Musharaka Mutanaqisa*: How it Works in Practice?

In classical Islamic finance, *Musharaka* is used to describe those joint business enterprises in which the partners share the profit or loss of the venture.[391] Unlike an interest-based product, there is no guaranteed rate of return on the investment, as income is based on the profit earned by the joint venture, and may possibly result in loss. In modern Islamic finance, *Musharaka* structures have been used in various joint ventures in connection with the acquisition and development of real estate, private equity funds and project finance.[392]

Mainly based on the principles of the *Musharaka* mode of finance, IFSPs of Australia have been practising the DP mode of finance for house financing. This model has been tried and tested over many years in Canada by the Islamic Co-operative Housing Corporation Limited,[393] and has been introduced into Australia by MCCA. Under this mode, the financial institution and customer jointly purchase the house. The ownership of the house is split between the financier and the customer; and it is agreed that the customer will purchase the financier's share in the house gradually, thus increasing his own share until all the financier's shares of are purchased by him so as to make him the sole owner of the asset after a specified

390 Al Haddad, Haytham and El Diwany, Tarek. 2006. *The Islamic Mortgage: Paradigm Shift or Trojan Horse?* Available online at: http://www.islamicawakening.com/viewarticle.php?articleID=1291, (accessed March 02, 2007).
391 Siddiqi, M. Nejatullah. 1985. *Partnership and Profit-Sharing in Islamic Law*, Leicester: The Islamic Foundation. pp.22-23.
392 King & Spalding International LLP. 2005. "Demystifying Islamic Finance", *London Newsletter,* January, at: http://www.kslaw.com/library/pdf/Lon_Jan05.pdf (accessed on February 10, 2005).
393 El Diwary, Tarek. 2003. "The Great Mortgage Caper?" available on Islamic Finance website at: http://www.islamic-finance.com/item122_f.htm

period. But during the financing period, the financier's share is leased to the customer who pays rent for using the financier's share in the asset. Here, a prequalification period is required in which each customer purchases shares in the house financing institution in order to gain the right to apply for house financing at a later time. Funds raised by the institution in this manner are used to finance other customers who have completed their prequalification periods. When the customer has qualified for house financing, person 'A' (the house financing institution) buys the house in its name from person 'B' (the seller of the house). Person 'C' (the customer) then becomes a partner of person 'A' in a nominal partnership vehicle which is deemed to own the property.[394] For this purpose, person 'C' transfers the value of his prequalification shares in the institution to the partnership vehicle, and the relative size of person A's and Person C's contributions determine the ratio of their shares in the partnership. Person 'C' now lives in the house and pays rent to 'A'. The rent is then distributed among the shareholders of the house, which of course include person 'C' himself. Over time, person 'C' buys person A's shares in the house and eventually comes to own all of them. At this stage he is the full nominal owner of the house and therefore pays the entire rental on the property to himself. The final formal step is then taken of transferring title in the property to the customer, following of a special final payment between person 'A' and Person 'C'.

The most common implementation of the DP scheme is one in which the rental levels and the purchase price of each share is fixed at the outset of the contract (rather than being related to market values at each point in the future). Models in which the purchase price of the shares has to be made at a price reflecting the property's market value at the time of purchase have

394 'Nominal' because the name of this partnership vehicle does not appear on the property's title deeds.

not been well received by potential customers. This is presumably because customers know that house prices tend to rise over time and, therefore, it is not in their interest to pay a price that reflects the market value of the property each time they want to increase their holding of shares. The disadvantage of such fixing is that the people who invest in the institution's shares are often those who are doing so in order to save the deposit for their own house. If the institution's property assets are sold off piece by piece at prices that were agreed several years previously, then given that property prices tend to rise, those assets will tend to be sold at below market value. This of course is a rather poor commercial deal from the point of view of the scheme, and in turn for the savers whose money has financed it. The fairest deal is for each sale of shares to take place as close to market value as can be achieved with cost efficiency. To this end, the MCCA product attempts to some degree to share gains or losses in the capital value of the house among the partners (in a pre-agreed ratio) when the nominal partnership comes to an end. This is the special final payment referred to above.

8.2.2 Non-Equity (Debt-based) Financial Instruments

IFSPs in Australia have been developing various instruments of financing which they claim to be in conformity with the Islamic tenets of equity and fairness, and also seem to stand the test of day to day business, the commercial needs of the modern world and the sophisticated tools of scientific analysis. Australian IFSPs have identified and developed a relatively broad range of business and banking contracts. These include among others *Murabaha*,[395] *'Ijara,*[396]

395 *Murabaha* was initially introduced by almost all Australian IFSPs namely MCCA, Iskan and ICFAL, but it is now only practised by the Iskan and MCCA.
396 This product is now used by MCCA and Iskan.

'Ijara Muntahia Bittamleek,[397] *Tayseer 'Ijara* Home Finance,[398] *'Ijara wa 'Iqtina* (Hire Purchase)[399], *Tamleek,*[400] *Qard Hasan*[401] and *Mudaraba.*[402]

8.2.2.1 Rules Relating to *Murabaha* Contracts

The most common Islamic financing structure used by IFSPs in Australia, like elsewhere in the Islamic finance industry is *Murabaha.*[403] *Murabaha* refers to the sale of a commodity at a price that includes a predetermined profit known to both the buyer and the seller.

The difference between a conventional sale and a *Murabaha* sale is that in the latter, the seller's cost price is made known to the buyer. Under the *Murabaha* mode of financing, the bank purchases goods on behalf of the buyer and then sells them to the buyer at an agreed mark up. The Shari`ah allows in this case a justifiable profit in addition to the real cost incurred. In order to be Shari`ah compliant some conditions are imposed on *Murabaha* such as the prohibition of interest, rebate on early payment and penalty for default.[404] Financing for unspecified purposes and overheads are not permissible under *Murabaha*.

How Does Murabaha Work in Practice?

397 A product introduced by MCCA. The mechanism of *'Ijarah Muntahia Bittamleek* is similar to *'Ijara wa Iqtina* and *Tayseer Ijara*. It was initially named by MCCA as Sale to Lease (S2L) and it is now used to finance for residential and commercial purposes.

398 Previously known as *'Ijara wa Iqtina* ("Lease to Purchase"), the *Tayseer Ijara* Home Finance is now practised by Iskan Finance for its residential and commercial customers.

399 This product is practised by MCCA for motor vehicle and other consumer goods financing.

400 This relatively new product introduced by MCCA for house financing.

401 *Qard Hassan* is used by ICFAL and MCCA to provide interest free loans to extremely needy customers.

402 Currently the *Mudaraba* product is only used by MCCA for investment.

403 The full technical name of this contract should be: *Bai` al-Murabaha lil-amir b-il-shira'* (a credit sale with mark-up to one who ordered the initial purchase). See Mahmoud A. El-Gamal, "Limits and Dangers of Shari`a Arbitrage", Houston: Rice University, Department of Economics working paper.

404 To provide a deterrent to undesirable practice of defaulting, some Islamic legal scholars have agreed that an Islamic bank could only penalise habitual and the recurring defaulters. In this case, the additional amount so charged should be the percentage of profit distributed by the bank to its depositors equivalent to the period of default. Furthermore, an Islamic bank is not allowed to take such penalty amount into its profit but can use this purely for specific charitable purposes. See Sohail Zubairi. 2004. "Islamic Finance: Different characteristics of money and commodities", *The Gulf News*, 17 March.

The IB or IFI, at the request of its customer, procures the specified goods from a third party against payment. Immediately upon the transfer of ownership of the goods, the bank sells these goods to the customer at cost plus an agreed fixed profit margin. The customer then takes physical possession of the goods and undertakes to pay the price to the bank either in instalments or in a lump sum, at an agreed later date. Examples are not lacking where customers of the bank and the seller of the goods are sister concerns. In other examples, customers of IBs or IFIs purchase the commodities themselves as agents of the bank and then repurchase the same commodity from the bank for a cost plus profit to be paid at a mutually agreed later date.

Example of Murabaha

Although the *Murabaha* structure looks very similar to conventional interest-based financing the following examples illustrate the difference between a conventional banking transaction and an Islamic banking transaction under a *Murabaha* contract.

Example 1: Transaction made by a conventional bank

In order to purchase a car for AUD 20,000 'A' requests a loan from the Bank for AUD 20,000. The Bank may agree to give a two year loan provided 'A' pays, say AUD 100.00 per month in addition to the principal amount he borrowed from the Bank. In other words, the Bank is charging AUD 100.00 each month for providing the AUD 20,000. This is a lending transaction. In this scenario of conventional financing the Bank charges money for making the loan, which is interest.

Example 2: Transaction made by an Islamic bank

Considering the above scenario, suppose 'A' requests funding through an IB based on a *Murabaha* mode of financing. In this case the Bank will appoint 'A' its agent. 'A' will purchase the car on behalf of the Bank for AUD 20,000.00. The IB then sells this car to 'A' for a total price of AUD 22,400. Even though the end result in both cases is the same, i.e. AUD 22,400, the approach is totally different. In the latter case the buyer knows the price at which the seller obtained the object to be financed, and agrees to pay a premium over that initial price. Furthermore, in the IB's transaction the bank must own the car at the time 'A' buys it from it with the specified profit margin.[405]

The above definition and examples of a *Murabaha* contract represent a situation where the seller, in this case a bank, owns some assets and declares its purchase price as well as its selling price, which contains a declared fixed profit to be paid later. The combination of a deferment of price with an agreed profit margin allows the sale arrangement to be used for finance. Although the *Murabaha* contract was originally conducted on the basis of spot or advance payment, the deferred payment has been adopted in order to assist customers in achieving desired growth in their business.[406]

405 This premium is the combination of the price of the object plus the profit margin agreed upon by the bank as the seller and the customer as the buyer. This is not tantamount to *riba* or interest. Because in Shari`ah the term riba refers to the premium that the borrower must pay to the lender along with the principal amount, as a condition for the loan or for an extension in its maturity. Unlike a loan transaction of conventional bank basically *Murabaha* is an exchange transaction where a buyer purchases items from a seller at a specified profit margin payable to the seller. In a *Murabaha* sale it is assumed that the seller will divulge his costs accurately so that a profit-margin can be agreed on. It is a trust sale since the buyer must trust that the seller is disclosing his costs correctly. The profit margin agreed on may be a percentage of the cost or a fixed amount. If a trader is acting on behalf of another party when buying goods, *Murabaha* may be used to specify payment for the services of locating, transporting and delivery of the goods by the trader.

406 See Wahbah al-Zuhayli. 2003. *Financial Transactions in Islamic Jurisprudence*, (Translation of *Al-Fiqh Al-Islami wa Adillatuhu*), vol.1, Beirut: Dar al-Fikr al-Muasir. pp.119-120.

The fine-tuning of *Murabaha* to suit to operational needs of modern financial transactions has necessitated the incorporation of certain conditions to the contract. Unless a secure demand exists, the purchase of assets by the financier could be a risky enterprise. As the business of IBs goes, predominantly, the orderer is bound to purchase the asset provided it meets the full specifications mentioned in the order.[407] Meeting the full specifications of the orderer exposes the bank to certain levels of unwanted risks. At the time of taking ownership of the acquired assets, the orderer may go on interpreting its specifications. This will delay the acquisition of the asset by the orderer, prolong the active ownership of the asset by the bank and increase the bank's storage costs and other liabilities, thus, exposing the bank to unwanted risks. To avoid such risks, the bank appoints the customer to act as an agent on its behalf. The customer selects the asset of its choice, purchases it from the seller on behalf of the bank for the bank to sell it to him (the customer). As a second step, the ownership is transferred to the customer. In most cases, the asset does not remain in the ownership of the bank for any meaningful period. Thus, for creating the initial debt, mark-up based financing is as risk-free as interest-based financing.[408]

8.2.2.2 Risk Management in *Murabaha*: *IICG versus Symphony Gems* [2002]

The case of Islamic Investment Company of the Gulf (Bahamas) Ltd v Symphony Gems N.V. and others was heard in the English High Court in February 2002 before Tomlinson J. This case is a landmark decision and is important to those involved in Islamic financing

407 Islamic jurisprudence has held that the customer is bound to compensate the bank for any out of pocket expenses the latter incurs as a result of the refusal of the customer to purchase the goods.
408 See Michael J.T. McMillen. 2001. *Islamic Shari`ah-Compliant Project Finance: Collateral Security and Financing Structure Case Studies*, 24 Fordham Int'l L.J. 1184.

transactions, especially as it is the first case to be brought before the English High Court concerning a *Murabaha* Financing Agreement governed by English law. As *Murabaha* transactions are an extremely popular means of financing a wide variety of assets and goods, the case is particularly important. Islamic Investment Company of the Gulf (IICG) won the case.[409]

The Facts

The *Murabaha* documentation

In January 2000 the claimant, IICG, entered into a *Murabaha* Financing Agreement with the first defendant, Symphony Gems N.V. ("Symphony Gems"). The *Murabaha* Agreement was a relatively standard long form *Murabaha* Agreement governed by English law. It envisaged that IICG would provide a revolving purchase and sale facility to enable Symphony Gems to purchase certain supplies (in this case precious stones and gems). The purchase of the supplies would be in accordance with the Shari`ah. The obligations of Symphony Gems under the *Murabaha* Agreement were guaranteed by two personal guarantors.

The *Murabaha* Agreement clearly identified the structure of the *Murabaha* transaction whereby Symphony Gems, as purchaser, would identify precious gems or stones which IICG would purchase and immediately call on to Symphony Gems for an agreed profit. This was documented by the requirement that, if Symphony Gems wished to use the facility, it should

409 See Umar F. Moghul, Esq & Arshad A. Ahmed, Esq. 2003. "Contractual Forms in Islamic Finance Law and Islamic Inv. Co. of the Gulf (Bahamas) Ltd. V. Symphony Gems N.V. & Ors.: A First Impression of Islamic Finance", *Fordham International Law Journal*, vol. 27; part 1. pp.150-194, available online at: www.ahmedmoghul.com/Fordham_Jan_04_Article.pdf. See also, UNCTAD. 2006. *Islamic Finance and Structured Commodity Finance Techniques: Where the Twin Can Meet*. Study prepared by the UNCTAD Secretariat, January. Available at: http://www.unctad.org/Templates/Download.asp?docid=7050□=1&intItemID=2094 (accessed March 19, 2007).

issue an Offer document to IICG identifying the gems and the supplier and specifying the relevant contractual details. This Offer could be accepted by IICG and, if accepted, a Purchase Agreement was entered into between Symphony Gems and IICG which documented IICG's purchase of the gems or stones and their subsequent sale to Symphony Gems. The documentation contained a definition of the "Cost Price", namely the price payable by IICG to the supplier of the gems, and a definition of "Sale Price", namely the price payable by Symphony Gems to IICG by instalments. The difference between the Cost Price and the Sale Price included an agreed margin to represent IICG's profit on the transaction.

The *Murabaha* Agreement contained detailed provisions relating to the passing of title and various conditions precedent that Symphony Gems had to satisfy prior to utilising the facility. The terms stated that Symphony Gems accepted sole responsibility for selecting each proposed supplier and the gems themselves. The *Murabaha* Agreement was governed by and construed in accordance with English law and Symphony Gems submitted to the exclusive jurisdiction of the English Courts.

The facts of the case

In February 2000, Symphony Gems identified a Hong Kong company called Precious (Hong Kong) Ltd ("Precious"), which was to supply a very large quantity of rough diamonds. Under a Purchase Agreement entered into between IICG and Symphony Gems under the *Murabaha* Agreement, IICG paid Precious for the diamonds and, accordingly, Symphony Gems was obliged to pay the Sale Price in specific deferred instalments on specific dates. It was

asserted by the defendants that Precious is a reputable diamond broker and had paid amounts to a diamond sight holder to acquire diamonds but this sight holder did not honour the commitment to Precious and, in turn, Precious could not honour its commitment to IICG. It was alleged that the diamond sight holder did not honour its commitment to Precious because of an ongoing family dispute between one of the guarantors, being the third defendant, and his two brothers. Those two brothers controlled the sight holder to whom Precious had paid the money to acquire goods under the *Murabaha*. Symphony Gems failed to repay amounts to IICG which enforced certain security and sought to reclaim the balance of unpaid amounts in the High Court.

The nature of the proceedings

IICG obtained Freezing Orders and commenced proceedings against the defendants. IICG instituted proceedings for "Summary Judgment" (i.e. a judgment on the basis that neither Symphony Gems nor the guarantors had any arguable defence). In order for a defendant to successfully defend an application for Summary Judgment, the defendant only needs to convince the judge that there is an arguable defence. If there is an arguable defence, it is not necessary to establish the argument would succeed if argued in detail.

A number of arguments were put forward by Symphony Gems and the guarantors, but none succeeded.

1. The defence that the *Murabaha* Agreement constituted a purchase and on-sale

One interesting argument put forward by Symphony Gems was that the *Murabaha* Agreement was in reality a purchase and sale agreement and IICG's claim to recover the Sale Price should fail because no goods had been delivered by IICG to Symphony Gems. This argument failed. Mr Justice Tomlinson held that, if there had been no delivery of goods from Precious to IICG and therefore from IICG to Symphony Gems, that could only arise because Symphony Gems had not made the necessary arrangements. As the *Murabaha* Agreement provided that Symphony Gems should pay instalments of the Sale Price whether or not IICG was in breach of any of its obligations under any Purchase Agreement, including failure to deliver, Symphony Gems had no arguable defence.

2. The illegality defence

Symphony Gems also raised an argument on the grounds of illegality. In particular, Symphony Gems sought to argue that IICG would perform some part of the *Murabaha* Agreement in Saudi Arabia and the *Murabaha* Agreement would be objectionable under the Shari`ah. Symphony Gems sought to argue that IICG was a company based in Saudi Arabia and that the *Murabaha* Agreement sought to dress up a finance agreement as a sale of goods to flout Shari`ah prohibitions and was therefore illegal. The Judge noted, however, that IICG was in fact a Bahamian entity, that the contract was entered into in India and that no part of the performance of the contract was to be effected in Saudi Arabia. This argument failed.

Evidence of the Shari`ah

The Court heard evidence on the Shari`ah from two Islamic legal scholars concerning the nature of a *Murabaha* Agreement. Evidence was adduced on the prerequisite conditions of a

Murabaha Agreement and it was alleged that IICG should be responsible for any defects or loss of the goods. However, it is crucial to the decision in the case that Tomlinson J. noted that the *Murabaha* Agreement was governed by English law, and not by the Shari`ah. Accordingly, he reviewed the *Murabaha* Agreement from the English law point of view and gave his judgment based on his interpretation of that agreement. As the *Murabaha* Agreement was fully enforceable in accordance with English law and there were no arguable defences to IICG's claim for payment of the instalments, judgment was granted to IICG.

Concluding comments

Of particular importance is the fact that, had the English court ruled against IICG, it may have resulted in IBs reconsidering the way they do business under a *Murabaha* Agreement. Each case will, of course, depend on its own facts. The case clearly confirms that the English courts will enforce a suitably drafted *Murabaha* Agreement governed by English law.

8.2.2.3 Critique of *Murabaha* Contract

Although *Murabaha* is a common instrument in Islamic Banking, its mark-up feature has frequently been criticised. Critics argue that the mark-up added to the original cost of the good is equal to or even higher than the amount of interest, which a borrower would pay in conventional banking practice. Therefore, it is often stated that "mark-up" is just another designation for interest and is consequently not in line with the Shari`ah principles.[410]

410 Henry, C.M. 1999. "Guest Editor's Introduction", *Thunderbird International Business Review*, vol. 41, nos. 4 and 5, July-October. pp.357-368.

Criticisms of *Murabaha* or Mark-up Trade Finance stem from the role of the seller and the practical execution of the transactions. PLS, which is arguably a central tenet of Islamic finance theory, does not seem to feature in the *Murabaha* mode of finance. Of course, the criticism that *Murabaha* does not correspond to the original spirit of Islam is a criticism that can just as easily be directed toward the entire practice of contemporary Islamic finance.[411] Besides this criticism, it is claimed that the mark-up element is *gharar* on the basis that it is *haram* for the bank to sell a good, which is not at hand. Also, in *Murabaha* the customers accept the offer of the bank, in which they bind themselves to purchase the goods before the bank has approached the supplier. Moreover, the customers' deposits are not repaid in case of default of the customers, which may not be in accordance with the Shari`ah that prohibits contractual penalties. In addition, the mark-up represents a fixed profit for the bank that is obtained by the bank without further effort or risk taking, which should ideally not occur in Islamic banking.

From an operational point of view, the very essence of the *Murabaha* contract states, among other things, that the seller be exposed to the risks normally associated with ownership such as the risk of loss, damage, and deterioration of the goods prior to delivery. The seller must also accept the buyer's right to return the goods and cancel the sale if the goods are damaged, do not meet the buyer's preferences, or involve a mistake in pricing.[412]

411 See Umar F. Moghul, Esq & Arshad A. Ahmed, Esq, *supra* note 402.
412 See Ina Burghardt and Carolin Fub. 2004. *Islamic Banking Credit Products in Germany and in the United Kingdom*, working paper series No.12, October, European Business School, International University Schloß Reichartshausen. p.15.

In engaging in *Murabaha* transactions as sellers, IBs do not share in the profits and losses of their customers. Rather they assume the typical role of conventional banks. In some cases, the risks normally associated with ownership are transferred contractually to the buyer. In other instances, the seller does in fact bear such risks from the time of purchase until the time of delivery, leading some to argue that the bank takes a risk, until the customer fulfils his original promise to purchase the commodity, which justifies the profit.

The counterargument is that the seller does not *really* own the goods, never truly has physical or even constructive possession of the goods, and owns the items for only moments, as both sales are concluded at the same closing. Effectively, the bank as seller does not bear the risks of ownership. The rights of the customer as buyer, such as the right to inspect the goods and the right to rescind the sale, are typically nullified or shifted so they become beneficial to the seller rather than to the buyer. Some classical jurists held that such reallocations could take place if buyers were to affirmatively waive their rights. However, affirmative waivers do not occur as often as constructive waivers in modern Islamic finance. Moreover, according to many *Murabaha* contracts, the buyer is responsible for compliance with all applicable laws and regulations, including those relating to the import of goods.[413]

In short, the seller-bank has now effectively avoided many, if not all, of the risks and responsibilities that classical jurisprudence expects it to bear. The risk that the buyer may refuse to buy is avoided by means of an advance payment, "promissory note" security, third-party guaranty, and/or contract terms.

413 *Ibid.*

Some IBs use these measures well in advance of purchasing the item and deposit assets and collateral to be held until they have been fully paid. Typically, for example, the advance payment amount would be sufficient to cover any loss that may occur from a refusal by the buyer. Alternatively, the bank may contractually be afforded the right, if the customer refuses delivery, to sell the goods at the prevailing price in the market and if such sale price is insufficient, to demand from the customer the balance of what is due to the bank, including the profit margin. It is argued, thus, that like charging interest by a conventional bank an IB earns a predetermined return on capital by practicing the modern *Murabaha* mode of financing.

As mentioned in this study previously, penalties and fees for late payments were prohibited traditionally but are now allowed in a somewhat conspicuous fashion as part of modern *Murabaha* transactions. Some contemporary jurists have observed that the penalty imposed is actually calculated by means of a bank doing nothing more than examining its normal rates of return. This is not dissimilar to conventional banks' seeking to recover the opportunity cost of their capital.[414]

8.2.2.4 IFSPs' Home, Motor Vehicle and Consumer Goods Financing on *Murabaha*

In accordance with modern Islamic legal financial theory, in a *Bai` Murabaha* mode of finance, rather than advance the money to the party seeking financing, the bank buys the goods from a third party and sells those goods on to them for a pre agreed price which

414 See Sohail Zubairi. 2006. "Reducing Default Risk in Murabaha Deals", *Gulf News*, available online at: http://archive.gulfnews.com/articles/06/01/04/10009345.html

includes a profit margin agreed to by both parties, on a deferred payment basis.[415] The buying and selling price, other costs and the profit margin must be clearly stated at the time of the sale agreement. The bank is compensated for the time value of its money in the form of the profit margin. This is a fixed-income loan for the purchase of a real asset (such as home or a motor vehicle), with a fixed rate of interest determined by the profit margin. The bank is not compensated for the time value of money outside of the contracted term (i.e. the bank cannot charge additional interest on late payments). However the asset remains in the ownership of the bank until the loan is paid in full.[416]

Given the above definition of modern *Murabaha*, IFSPs of Australia apply the procedures as mentioned below to finance home, motor vehicle and consumer goods.

A. Home Financing under Murabaha: How it Works in Practice?

The *Bai` Murabaha* mode of financing was first applied widely in Australia at the retail level by MCCA. The following outline illustrates IFSPs' application of this technique to mortgages:

- The Customer identifies a property and agrees all terms of the purchase with the IFSP. The Customer requests the IFSP to purchase the property and then sell it to the Customer at the cost price plus a declared mark-up.

415 See Warren Edwardes, *supra* note 386.

416 For exposition of time value of money concept in Islamic finance see Abu Umar Faruq Ahmad and M. Kabir Hassan. 2006. "The Time Value of Money Concept in Islamic Finance", *American Journal of Islamic Social Sciences*, vol. 23, No.1. pp.66-89.

- The IFSP purchases the property directly from the vendor and immediately sells it to the Customer with a fixed mark-up-profit (this is calculated on the property value, length of finance, payment terms and amount of deposit).
- The Customer repays the IFSP the initial price and the agreed mark-up (the customer's first instalment payment to the IFSP in is made on the date of completion and is usually a minimum of 5%-10% of the purchase price).

For example, person 'A' (the IFSP) buys the house for AUD 400,000 from person 'B' (the vendor) and immediately sells it on to person 'C' (the customer and prospective homeowner) at a price of say AUD 450,000 to be paid in equal instalments over say 15 years. Person 'C' must initiate the process by promising person 'A' in writing that if person 'A' buys the house from person 'B', then person 'C' will immediately buy the house from person 'A'.

Islamic legal scholars who approve this transaction say that it is trading (buying and selling of houses), not lending at interest, and it is therefore *halal* i.e. Islamically lawful. Others point out that if banks are traders of houses then their stock in trade should be a portfolio of houses, just like every other property dealer, whereas in fact the stock in trade of a bank is money. No doubt the suspicion among some sections of the Muslim community is only increased when they see that the cash flows paid by the customer to the bank are usually fixed from the outset of the transaction, just like the interest based alternatives. Viewed from the bank's perspective, as soon as the bank transfers AUD 400,000 to person 'B', the agreement with person 'C' automatically comes into effect requiring person 'C' to repay AUD 450,000 to the bank at a later date. The transaction is therefore one of transferring

money to person 'B' on condition that person 'C' repays a larger amount at a later date. The upshot is money now for more money later with the house in between, so to speak. Many bankers admit in private that this is an interest-bearing transaction, and indeed standard banking practice is to enter an interest-bearing loan on the asset side of the bank's balance sheet. There have been exceptions to this rule, for example with the Shared Appreciation Mortgage issued by the Royal Bank of Scotland some years ago. Here, the bank's return was a share of the increase in the price of the property being financed.[417] However, even in this case, the bank refused to share *falls* in the price of the property over time, and therefore fixed its minimum return on funds loaned at 0%.

B. ***Motor Vehicle Finance under Murabaha: How it Works in Practice?***

IFSPs use this product to replace conventional inter-bank deposits. It involves the sale and subsequent re-purchase of a commodity. It is structured in such a way that it is essentially similar to a loan granted by the seller to the buyer. The difference in the sale and re-purchase price earns the seller a return which is broadly equivalent to interest. The following outlines the steps involved:

Step 1: The customer identifies the motor vehicle he wishes to purchase and agrees the purchase price with the seller of the car in the normal way.

Step 2: The customer approaches the IFSP for assistance.

Step 3: IFSP buys the car and immediately sells it to the customer at a higher price.

Step 4: The higher price is calculated depending on the value of the car and the number of years allowed for repayment.

417 See Tarek El Diwary, *supra* note 387.

Step 5: When purchased, the car is registered in the customer's name and the sale between himself and the IFSP is recorded in the *Murabaha* contract.

C. *Consumer Goods Finance under Murabaha: How it Works in Practice?*

The IFSP, at the request of the customer, purchases the consumer goods from a third party. Immediately upon the transfer of ownership of the goods, the IFSP sells these goods to the customer at cost plus an agreed fixed profit margin. The customer then takes physical possession of the goods and undertakes to pay the price to the IFSP either in instalments or in a lump sum, at an agreed later date.

Consumer goods finance under *Murabaha* works in the same way as motor vehicle finance. It follows the same steps mentioned below:

- The customer identifies the goods he wishes to buy and agrees the purchase price with the seller of the goods in the normal way.
- The customer seeks the IFSP's assistance and completes the specific application form.
- The IFSP buys the property and immediately sells it to the customer at a higher price.
- The higher price is calculated depending on the value of the consumer goods and the number of years allowed for payment.
- When purchased, the sale of the goods between the customer and the IFSP is recorded in the *Murabaha* contract.

The following simple example can be given to illustrate on how IFSP conduct their consumer goods finance in practice under a *Murabaha* contract:

If the customer wants a personal computer the IFSP buys that computer for, say, AUD 1000 and sells it to the customer for a price of AUD 1100, payable at some point in the future. The customer obtains immediate use of a computer worth AUD 1000, and has an obligation to pay AUD 1100 in, say, two years time. The extra AUD 100 that the customer pays is clearly, in Islamic finance terms, the profit obtained in the process of buying and selling.

8.2.2.5 Rules of the *'Ijara wa 'Iqtina* Contract

'Ijara wa 'Iqtina is fast becoming the most popular method of property finance used by IBs and IFSPs elsewhere in the world. It is a similar arrangement to that of the *'Ijara* or lease contract which refers to an agreement to lease to a customer an asset specified by the customer for an agreed period against specified instalments of lease rental. An *'Ijara* contract commences with a promise to lease that is binding on the part of the potential lessee prior to entering the *'Ijara* contract. *'Ijara wa 'Iqtina* is a form of *'Ijara* under which the customer is able to buy the item at the end of the contract.[418] *'Ijara wa 'Iqtina* is virtually identical to leasing and HP arrangements, with the main difference that *'Ijara wa 'Iqtina* cannot be used for financing consumer goods. Islamic legal scholars give permission to use it only for the products that will be used productively to generate returns.[419]

For the Malikis, *'Ijara* resembles a sale contract whereby the price and usufruct are exchanged and the contract should specify usufruct either by the duration or by its subject matter. The contract is invalid if the subject of *'Ijara* is used for the purposes which are

418 See Nik Nozrul Thani, M. R. M. Abdullah, and Megat H. Hassan. 2003. *Law and Practice of Islamic Banking and Finance*, Sweet & Maxwell. pp.48-49.
419 *Ibid.*

prohibited by the Shari`ah,[420] or the activity is a mandatory duty in nature.[421] Hanbalis have described *'Ijara* as being a contract where the subject matter is lawful and defined as a usufruct, for a specific period of time. To the Shafi`is, *'Ijara* is a contract where the subject matter is the determined, legitimate, assignable and lawful use of an object against a fixed consideration. On the other hand, the Hanafis describe *'Ijara* as a contract intended to give ownership of a determined and legitimate usufruct of a rented corporeal subject against consideration.[422]

All Schools of Islamic thought have agreed that *'Ijara* is a binding contract. However, they disagree about the reasons which could cause the cancellation of *'Ijara*. Malikis and Shafi`is opine that *'Ijara* is invalidated only by a material defect affecting the corporeal object leased or hired. Another situation which annuls the contract is when the purpose of the lease or hire has disappeared.[423] To the Hanafis, *'Ijara* is cancelled by any reasonable excuse that the lessee may invoke, while Hanbalis believe that *'Ijara* is cancelled if the rented object is destroyed or affected by a material defect.[424]

'Ijara wa 'Iqtina is one of the concepts of *'Ijara* or leasing agreement in which IFSP purchases and then leases an asset (for example a property) to their customers for a specified rental over a specified period of time.[425] IFSPs may have the right to adjust the rental charge

420 For example, renting premises to use as a night club, bar or other vice activity.
421 This is like hiring a mother to feed her own baby.
422 Phoenix Journal Review. 2006. "Islamic Banking Revisited: Back to Basics in Banking", *Contact*, vol.46, No.12, February 8, Manila. pp.6-7.
423 Such as when a person asked a butcher to slaughter cattle and before the slaughtering began the cattle died.
424 *Ibid.*
425 The *'Ijara* contract is of two types with respect to its subject-matter. The first type of which has as object the usufructs of things, such as leases of land, goods, or animals. The second type is which has as object work or services to be performed by a hiree, as in the hiring of employees, servants, or labourers. The hiring of persons skilled in crafts and

in line with changes in the cost of finance. This method can be used for Islamic housing finance. This usually entails the customer making capital payments in addition to the rental charge. The customers' ownership in the consumer durables or property increases and IFSP's ownership decreases by a similar amount with each payment. Once all payments have been made, ownership of the consumer durables or property passes to the customers.

'Ijara wa 'Iqtina is a more flexible scheme than *Murabaha* as it enables the customer to repay the mortgage early with one payment, or to make additional "overpayments" during the life of the mortgage, thus reducing the length of the mortgage.[426] One advantage of the *'Ijara wa 'Iqtina* over the *Murabaha* is that the *'Ijara wa 'Iqtina* avoids the problem of an excessively high implicit interest rate with an early sale. That is because IFSP's profit from this rent-to-purchase transaction comes from the rent it receives. Because repurchasing the house ends the obligation to pay rent, an early repurchase reduces the total implicit interest in the transaction.[427]

8.2.2.6 Critique of the *'Ijara wa 'Iqtina* Contract

The *'Ijara wa 'Iqtina* contract used by IFSPs in Australia has been criticised from both Islamic and Australian legal perspectives. From the Shari`ah point of view, it has been observed that rather than calculating the rent on the basis of average rent market, in such contracts rent is often pegged against measures such as RBA interest rate or the London

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manufactures is of this type. For example, giving cloth to a tailor and paying him to create a garment from the cloth is a hire contract.

426 Available online at: http://www.yasaar.org/pubs/20255%20Shariah%20Compliant%20Mortgages%20brochure1.pdf.

427 Knoll, Michael. 2004. "The Ancient Roots of Modern Financial Innovation: The Early History of Regulatory Arbitrage", *The Law School and the Wharton School*, University of Pennsylvania, working paper No.49, available online at: http://lsr.nellco.org/cgi/viewcontent.cgi?article=1053&context=upenn/wps (accessed February 24, 2007).

Interbank Offered Rate (LIBOR).[428] The rate of this rent is subject to change any time in the future and hence unpredictable. Given that, it is not known what the RBA or LIBOR interest rate will be for any period in subsequent months or years; home buyers whose rental payments depend upon that interest rate are in a position of ignorance as to what their future rental payments will be. Some Islamic legal scholars have argued that setting rental levels in line with market interest rates is not in itself unlawful in Islam on the basis that it is permitted for a Muslim shopkeeper to make the same percentage profit selling lemonade as the non-Muslim shopkeeper makes selling alcohol. However, the problem is not the link to the RBA interest rate or LIBOR. Rather, it arises from *gharar*. The reason is that the customer does not know what rental amount he must pay to the bank until the beginning of each new period even though he is contractually bound to rent the property for the subsequent period. If interest rates increase dramatically, then the rental payments will likewise increase and the customer may find himself locked into the payment of rentals that he cannot afford. Similarly, it is not justified to increase in rental payments due to the increase in interest rates because typically there is a fall in the value of land and property with the rise of interest rates.

If the home-buying customer later decides that he can no longer afford the rental, both the MCCA and Iskan contracts require that he must guarantee to repay the cash sum initially provided by these IFSPs to fund the purchase of the property. In those cases where the

428 The LIBOR is the most widely used benchmark or reference rate for short term interest rates. It is the rate of interest at which banks borrow funds from other banks, in marketable size, in the London interbank market. Given the absence of reference rates based on Islamic financial instruments, most Islamic legal scholars allow the use of RBA or LIBOR as a reference rate. However, most Islamic legal scholars object to variable or floating rates in the body of an on-going *`ijara*. See for example, M. Ali. Elgari. 1999. "Some Recurring *Shari`ah* Violations in Islamic Investment Agreements Used by International Banking Institutions", *Islamic Finance into the 21st Century: Proceedings of the 2nd Harvard University Forum on Islamic Finance*, Cambridge, Massachusetts: Center for Middle Eastern Studies, Harvard University. p.129

property has to be sold to achieve this, the possibility arises that, if property prices have fallen in the meantime, the sale proceeds may not be sufficient to repay the financed amount. In this case, by requiring the customer to make up any shortfall to IFSPs, the possibility of "negative equity" arises, a position in which the customer owes more to IFSPs than the property is worth.

From the Shari`ah perspectives, a customer can only rent a property if he does not own it. Yet if the legal reality is one of rental, a question arises as to why the customer must bear the risk of a fall in the property's price. Those who rent cars from hire companies are not expected to compensate the hire company for a fall in the value of the car during the period of the hire. On the other hand, if the customer bears the risk of a fall in property value precisely because they own the property, then it must be asked why the customer is expected to pay rental to IFSP.

In answer to this question some Islamic legal scholars have argued that, in a modern *'Ijara wa 'Iqtina* agreement, the bank or financial institution only buys the property and rents it to the customer because the customer has expressed a need for the property. It would be unfair, they argue, for the bank to suffer a loss if the customer does not proceed to purchase the property at the price agreed at the outset of the *'Ijara wa 'Iqtina*. Such arguments would be seen as invalid under the principles of the Shari`ah as the essence of an *'Ijara wa 'Iqtina* contract is to free the tenant from bearing responsibility for loss or damage to the property (unless it results from the tenant's misuse of the property). A compensation for loss of capital value is a condition that defeats the purpose of an *'Ijara wa 'Iqtina* contract, and this kind of

condition is not permitted in the Shari`ah.[429] Furthermore, Islamic home financing on an *'Ijara wa 'Iqtina* typically requires that the customer purchases the property from the IFSP at the end of the *'Ijara wa Iiqtina* term as a means of protecting the IFSP's original capital contribution. This transaction, involving a deferred delivery of both counter values (property and price), has been prohibited by the four main Islamic Schools of Islamic law. Al-Qurtubi mentions in this regard: "Delay from both sides is not permitted by consensus either in corporeal property or in liabilities as it amounts to a proscribed exchange of a debt for a debt".[430]

So, far the problems with the *'Ijara wa 'Iqtina* contract generally mean that in the case of home financing under the *'Ijara wa 'Iqtina* contract, the property remains in the ownership of the lender. A person who would normally be a mortgagee is, in fact, a tenant - an assured tenant, but the person who is acquiring the house through *'Ijara wa 'Iqtina* finance is not the owner of the house. The equivalent of the mortgage lender is the owner, which presents two serious technical and legal problems.

First, the occupant of the house is in a much weaker position in respect of disputes over arrears. Under the *'Ijara wa 'Iqtina*, the lender or owner of the property can evict the borrower a few months of arrears, whereas under a conventional mortgage arrangements the mortgagee has security of tenure. In those circumstances eviction is a matter for a court and a

429 See Haytham Al Haddad, and Tarek El Diwany, *supra* note 384.
430 Ibn Rushd.1996. *Bidayat al-Mujtahid wa Nihayat al-Muqtasid (The Distinguished Jurist's Primer),* English translation, Imran Ahsan Khan Nyazee, vol.2. p.154.

court order has to be obtained. The *'Ijara wa 'Iqtina* borrower is therefore in a much weaker position than the conventional mortgage borrower.

Second, another difficulty applies either when someone wants to pay off their obligations or to foreclose. Under a conventional mortgage, the mortgagee is protected in that the mortgage lender is obliged by law to secure the best possible price and to make available, if he sells the property, a full account of the transactions. Under an *'Ijara wa 'Iqtina* arrangement, however, the provider has no such obligation. From legal perspectives, it is not fair to unwittingly place people who undertake *'Ijara wa 'Iqtina* transactions for perfectly good reasons in a very weak legal position with respect to the providers of those products.

8.2.2.7 Motor Vehicle Financing under the *'Ijara wa 'Iqtina*: How it Works in Practice?

'Ijara Bi al-Bai` or 'Hire Purchase' (frequently abbreviated to HP) financing for motor vehicles is a conventional method of financing cars over a period of months, which benefits customers who want to pay for the goods in a cost effective manner and enjoy the flexibility of being able to settle the agreement early. More precisely, a traditional HP is a form of credit where the customer agrees to buy goods from the bank or financier and to pay for those goods in installments. The customer has the right to possess and use the goods from the time the contract is made. The seller i.e. bank or financier has a security interest in the goods until all amounts owing by the customer are paid. A rental or lease agreement may also be a HP contract where the customer hires the goods with an option to purchase.

The structure of the Islamic Hire Purchase looks very similar to the conventional one with one fundamental difference. Under a conventional HP agreement, the customer cannot unilaterally terminate the contract, and must meet all the payments before ownership of the asset is passed from the financial institution to the customer. However, under an Islamic Hire Purchase agreement, the Shari`ah allows the customer to terminate the contract at any time he wishes, and to acquire the asset at a pre-determined purchase price.

The HP product introduced by IFSPs, specifically MCCA and ICFAL for motor vehicle financing is not the same. A potential member of MCCA and ICFAL, having identified the new or old car approaches them to finance the purchase of the motor vehicle. The transaction structure is as follows:

1. MCCA and ICFAL first acquire the motor vehicle (new or used).
2. They subsequently (and simultaneously) sell it to the customer.
3. The sale of the motor vehicle is on a fixed price, computed based on the original cost of acquisition plus a fixed margin of profit.
4. The customer chooses to pay from as little as 5% of the amount to be financed as his initial deposit.
5. The term of payment is deferred and payment is on the basis of pre-agreed regular monthly instalments.

Computation of Monthly Instalments under the 'Ijara wa 'Iqtina

When a member chooses to purchase a car under the MCCA and ICFAL's Islamic Hire Purchase scheme for motor vehicle financing, he is actually paying the cash price of the goods and a profit margin on the amount financed. For example, a member buys a car at a cash price of AUD 40,000 with a down payment of AUD 4,000. He will obtain financing of AUD 36,000 with a repayment period of 60 months (five years). If the profit margin is at 5.50% per annum, the monthly instalment the customer will have to pay is calculated as follows:

Cost of car	AUD 40,000
Down payment	AUD 4,000
Financing amount	AUD 36,000
Margin of finance	90%
Repayment period	60 months/5years
Profit margin charged	5.50% p.a.

Profit margin for the repayment period of five (5) years at the profit margin of 5.50% per annum

= (AUD 36,000 x 5.50 x 5) / 100 = AUD 9,900

Amount payable = Total amount financed + Profit margin

= AUD 36,000 + AUD 9,900

= AUD 45,900

Monthly instalment = Amount payable / Repayment period

= AUD 45,900 / 60

= AUD 765

In the above scenario the member has to pay 60 instalments of AUD 765.

According to the above structure, Austrian Muslims and non-Muslims alike are allowed to get access to car financing without any discrimination. The structure allows Australian Muslims to purchase motor vehicles without violating Islamic prescriptions on borrowing money on which interest is charged. Further, this initiative is consistent with the well-established public policy of encouraging car ownership in order to facilitate mobility, convenience and independence.

The transaction structure of the conventional HP in relation to motor vehicle financing is as follows:

1. The customer pays a deposit agreed with the bank or financier.
2. The customer repays the balance as fixed monthly payments over an agreed number of months.
3. At the end of the period, and subject to all payments having been made, including the option to purchase fee, the vehicle is for the customer to keep, sell or trade-in for a new vehicle.
4. The bank or financier has a security interest in the car until all amounts owed by the customer are paid.

8.2.2.8 Rules and Forms of the *'Ijara Muntahia Bittamleek* Contract

I. Rules of the 'Ijara Muntahia Bittamleek Contract

In July 2004 MCCA launched a new product called Sale to Lease (S2L) which generated support as well as criticism from within the Muslim community because of its dealing with

conventional funders. Later MCCA renamed it *'Ijara Muntahia Bittamleek* or Lease Ending with Ownership.[431] Interestingly, MCCA renamed it again recently, choosing to call it *'Ijara,* most probably to avoid more criticism. However, MCCA's *'Ijara* structure (for merely S2L) is used by IBs and IFIs elsewhere in the world.[432] This is a form of leasing contract which includes a promise by the lessor to transfer the ownership in the leased property to a lessee at an agreed sale price, either at the end of the term of leasing period or in stages during the term of the contract.[433] What makes *'Ijara Muntahia Bittamleek* or a lease ending in ownership different from a conventional lease is that the lessor, or investor, and customer as lessee exchange letters that obligate customer to buy the property, while similarly obligating the investor to sell it to the customer.

Applying the above, upon customer's promise to lease from the IFSP, the IFSP purchases, in its own name, the property specified in the customer's promise and then the IFSP leases it to the customer. The IFSP calculates the total cost of the property on the basis of the original price plus a reasonable mark-up. Rental is installed over a period of time agreed between the IFSP and the customer. The rental is structured so that at the end of the lease period, the IFSP's purchasing cost and profit is recovered and it transfers ownership of the property to

431 The *'Ijara Muntahia Bittamleek* is also called Finance Lease or Capital Lease as this lease has to be capitalised.
432 These are variations on a theme of purchase and lease back transactions. Some Islamic banks use other nomenclatures for the similar theme. For example, Doha Islamic Bank names it *'Ijara Tamlikiyah* or Lease-to-own sale.
433 In essence, the subtle difference between *Ijara* and *'Ijara Muntahia Bittamleek* lies in the pre-existence of that promise whereby a lease concludes with the legal title passing to the lessee through either: (i) gift (transfer of legal title for no consideration); (ii) token consideration or other amount as specified in the lease; (iii) transfer prior to the end of a lease for a price equivalent to the remaining *Ijara* installments; or (iv) a gradual transfer of the legal title (sale) of the leased asset. See for details, Ros Aniza. M. Shariff and A. Rahim Abdul Rahman. n.d. "An Exploratory Study of *Ijara* Accounting Practices in Malaysian Financial Institutions", *International Journal of Islamic Financial Services*, vol. 5, No. 3.

the customer for a nominal sale price or as a gift by a separate sale or gift contract at the end of the lease period.

The following sequence illustrates IFSPs' application of *'Ijara Muntahia Bittamleek* or Lease Ending with Ownership technique to home financing:

- The customer identifies the property to be purchased and agrees the price with the vendor in line with a conventional mortgage.
- The IFSP purchases the property and enters into a future purchase agreement with the customer. The purchase price between the IFSP and the customer is the same price as the original purchase price.
- The customer simultaneously enters into a lease with the IFSP which details the customer's right to occupy the property during the tenure of financing.
- The customer pays the IFSP monthly payments, which are calculated so that part is applied towards the purchase of the property from the IFSP and part of it is rent.
- The payments are fixed every 12 months. Every year the rent and repayments are reassessed and are likely to vary.
- Customers may purchase the property from the IFSP at any time by paying the IFSP the balance of the purchase price.

II. Forms of 'Ijara Muntahia Bittamleek Contract

The *'Ijara Muntahia Bittamleek* contract has various forms as mentioned below:

1. *'Ijara Muntahia Bittamleek* through gift (transfer of legal title for no consideration)

The main features of *'Ijara Muntahia Bittamleek* through gift are as follows:

A. Legal title is transferred to the lessee for no consideration by entering into a gift contract in fulfilment of a prior promise upon the settlement of the last lease instalment.
B. Legal title is automatically transferred without the need to enter into a new contract as well as without any extra payment.

Nevertheless, there are differences of opinions among the scholars of the four Schools of Islamic Jurisprudence whether or not to make the gift conditional in the above form of *'Ijara Muntahia Bittamleek.* The Hanafi, Shafi`i, Hanbali, Zaidi and Immiya scholars opine that it is not valid to make the gift conditional. While the view of some Hanafi and Hanbali scholars' is that it is permissible to make the gift conditional upon something suitable or acceptable. In addition, it is also considered permissible to the lessor to promise to give the lessee the leased asset as a gift at the end of the period specified in the *'Ijara* contract after the settlement. The promise is considered to be binding, according to the opinion of the Malikis and those who agree with them. A gift contract must then be effected.[434]

2. *'Ijara Muntahia Bittamleek* through transfer of legal title (sale at the end of lease period for a token consideration)

The main features of the *'Ijara Muntahia Bittamleek* contract through transfer of legal title (sale at the end of lease period for a token consideration) include the following.

A. An executable *'Ijara* contract whereby the rent and *'Ijara* period are determined. If the *'Ijara* period expires, then the contract will be nullified.

434 See Phoenix Project Journal. 1999. "Islamic Banking is Here to Stay", *Contact*, vol.25, No.3. September 08. p.14. Available online at: http://www.phoenixsourcedistributors.com/021204.pdf

B. A promise to enter into a sale contract to be concluded at the end of the *'Ijara* period, if the lessee wishes so and has paid the agreed consideration. In this situation *'Ijara* is permitted as there is no limit to the consideration to be paid in a bargained sale.

C. The transfer of a legal title at the end of the period of *'Ijara* is based on the assumption that the lessor earns a rent higher than that which is paid for a similar asset such that in both cases, he will recover the cost of the asset through the *'Ijara* instalments.

D. If the title is not transferred and the lessee has fulfilled his obligations and has not caused damage to the leased asset, then the rent should be adjusted to reflect the fair rental amount and, for the purpose of justice, the difference between the two amounts should be refunded to the lessee.

3. *'Ijara Muntahia Bittamleek* through transfer of legal title (sale at the end of lease period for an amount specified in the lease)

The following are the main characteristics of the agreement of *'Ijara Muntahia Bittamleek* through transfer of legal title (sale at the end of lease period for an amount specified in the lease)**.**

A. It is also a contract that includes an *'Ijara* contract, a promise to enter into a sale contract.

B. The sale contract includes an amount for the sold asset to be paid by the lessee (buyer) after the expiry of the *'Ijara* period.

C. Upon the lessee's payment, the leased asset is sold and its title transferred to the lessee (buyer).

D. The sale contract will only be effective after the expiry of the *'Ijara* contract due to the consideration paid by the lessee to the lessor to own the leased asset.

4. *'Ijara Muntahia Bittamleek* through transfer of legal title (sale prior to end of lease term for a price equivalent to remaining *'Ijara* instalments)

The key features of this form of *'Ijara Muntahia Bittamleek* contract include.

A. The Shari`ah rules related to *'Ijara* are applicable to this contract.

B. Includes a promise made by the lessor that he will transfer the title of the leased asset to the lessee at any time during the *'Ijara* period for a price equivalent to the remaining instalment of *'Ijara.*

C. The juristic character of this form of *'Ijara* is that when the agreement becomes effective it is treated as an *'Ijara* contract and remains so until the legal title is transferred to the lessee.

D. This type of sale through transfer of title for a price that is equivalent to the remaining instalments should be executed by a sale contract to be concluded at the time of sale.

5. *'Ijara Muntahia Bittamleek* through gradual transfer of legal title of leased asset

This form of *'Ijara Muntahia Bittamleek* includes inter-alia.

A. A promise made by the lessor that he will gradually transfer the legal title of the leased asset to the lessee until the lessee has full legal title of the leased asset.

B. Determining the price of the leased asset which is to be divided over the period of the *'Ijara* contract so that the lessee is able to acquire a share of the leased asset for a

proportionate consideration of the total price until the full title of the asset is transferred to the lessee at the end of the *'Ijara* contract period.

C. The agreement should be a sale contract for each share sold to the lessee. In addition, the amount of the rent should decrease as the lessee acquires a greater share of the leased asset.

D. If the *'Ijara* contract is revoked (prior to the transfer of title), the title of the leased asset will be shared by both the lessor and lessee. This is fair to the lessee whose aim is to acquire the title of the leased asset through payment of rent in excess of fair rental amount.[435]

8.2.2.9 Home Financing under the *'Ijara Muntahia Bittamleek*: How it Works in Practice?

The steps of *'Ijara Muntahia Bittamleek* for IFSPs' home financing are as follows:

Step 1. The customer first applies for finance.

Step 2. The IFSP assesses the customer and give him a conditional approval.

Step 3. The customer finds a property and then approaches the IFSP again.

Step 4. The IFSP values the property and either approves or rejects.

435 See Meezan Bank website, available at: http://www.meezanbank.com/uploads/docs/IFMC_Presentations/Structuring%20of%20Shariah%20compliant%20IREITs_Awan.pdf.

Step 5. Upon approval the IFSP assigns him as an agent on behalf of the IFSP.

Step 6. Upon approval the agent enters into a contract of sale with the vendor through a real estate agent.

Step 7. The Agent fulfils the agency contract and signs a *Tamleek* contract according to the concept of *'Ijara Muntahia Bittamleek.* He pays agreed rental instalments that contain principle and profit. The profit rate is variable or fixed for one to five years as agreed.

Step 8. At settlement the IFSP will be the owner and permits the member to register his name on the title.

Step 9. Upon repayment of the total amount of money owed to the IFSP, the member re-assumes the rights from the IFSP through the last rental instalment, which make him the full owner of the property.

8.2.2.10 Critique of the*'Ijara Muntahia Bittamleek* Contract

The *'Ijara Muntahia Bittamleek* product for home financing has been criticised by its opponents in the following ways.

1. IFSPs are criticised more often than not, basing the lease rent in *'Ijara Muntahia Bittamleek* on fluctuating conventional benchmarks such as RBA interest rate or LIBOR. Why not fix the lease rent at the outset for the entire lease term? The objection raised against this practice is that, by making the rental payments equal to a rate of interest, the transaction may be rendered

akin to interest-based financing. By doing so, IFSPs are guaranteed a return whatever happens to the actual value of the property.

2. The future variation in RBA/LIBOR rate being unknown renders the rent thus tied up to it uncertain (i.e. an element of *gharar* is found in this product). This is not allowed under the Shari`ah since all consideration in a contract must be clearly known and understood to the parties entering into it. This means that the customer is unaware of the rental rates in the future and hence the total cost of the property (total rent paid plus the sale price) is not known to the buyer at the time of the contract. The Shari`ah requires that the price of goods must be known at the time of a sale contract.
3. It is claimed that *'Ijara Muntahia Bittamleek* boils down to a form of disguised security agreement since it transfers to the lessee all the risks associated with ownership. The long-term and non-cancellable nature of the financial lease adds to that problem. Even when the leased object is eventually rendered into a free gift or given at a nominal price, it does not address the issue that the residual value is predetermined and built into the lease payments which may prove to be unjust. The lessee loses the asset as well as the extra payments he may have made if he dies or is unable to continue the lease payments.
4. In some cases the lease commences on the very day the lessee receives the price irrespective of whether he has taken delivery of the asset. The lessee's liability for rent thus begins prior to taking delivery of the leased asset. This contravenes one of the requirements of *'Ijara* as it amounts to charging rent

on the money given to the customer, and it is tantamount to interest. If the supplier has delayed delivery after receiving the price, the lessee should not be liable for the rent of the period of delay.

5. Furthermore, when the lessee himself has been entrusted with the purchase of the leased asset, two separate relations come into play between the institution and the customer one after the other. In the first instance, the customer is an agent of the institution to purchase the asset on the latter's behalf. The lessor-lessee relationship has not yet come into operation at this stage. The second stage begins from the date when the customer takes delivery from the supplier. It is only then that the lessor-lessee relation begins within the context of *'Ijara*. During the first stage, the customer cannot be held liable for the obligations of a lessee as he only acts as a trustee and agent. It is only when he takes delivery of the assets that he acquires the role of the lessee.[436]
6. It has been pointed out that the obligatory manner of committing the lessee to acquire ownership of the leased asset at the end of the contract period is inconsistent with the requirements of Islamic law. Stipulation of such terms in the original lease not only amounts to combining two contracts in one, but can also lead to injustice. There is no objection to drawing a basic memorandum of understanding, or exchange of promises, between the parties that would help secure the desired purposes of the parties, provided it does not bind the lessee to acquire ownership. The lessor may also make a

436 Kamali, M. Hashim. 2005. "Shariah Issues of Islamic Leasing: Perspective of the Lessor", paper presented at the International Islamic Leasing Conference in Kuwait, April 24-25.

unilateral commitment to offer the lessee an option to buy the leased assets at the end.[437]

8.3 Concluding Remarks

While comparing the Equity-based and non-equity (Debt-based) financial instruments used by IFSPs in Australia it has been observed that Equity-based financial instruments have a strict risk, profit, and loss sharing rule, whereas the non-equity based financial instruments, namely *Murabaha, 'Ijara wa 'Iqtina* and *'Ijara Muntahia Bittamleek* can easily accommodate a hidden interest rate. Given this, among the non-equity financial instruments used by IFSPs, the *'Ijara* model of home financing is probably more Shari`ah compliant than that of the *Murabaha* model despite the questions raised against the *'Ijara wa 'Iqtina* and *'Ijara Muntahia Bittamleek*. It is important that the act of buying the property by the IFSP and then selling or leasing it to the customer constitutes two separate transactions but it is not permissible in the Shari`ah to combine two transactions into one.

In reality, IFSPs in Australia commonly use an accounting interest rate for book keeping these transactions. Some IFSPs attempt early in their operations to conduct *Mushraka Mutanaqisa* but eventually submit to using *Murabaha*, *'Ijara wa 'Iqtina* and *'Ijara Muntahia Bittamleek* as the main modes of operation. Those practices are commonly favoured due to the elimination of the risks of enterprise failure, moral hazard, and adverse selection.

437 *Ibid.*

Conceivably the common constructive criticism is that while IFSPs rely on the non-equity (Debt-based) modes of financing, they do not seem to be fulfilling realistically the conditions laid down by the Shari`ah for the permissibility of these modes. This criticism may or may not be right. However, what provides credibility to it is the secretiveness and lack of adequate transparency on the part of these financial institutions about their operations.

Another criticism is that certificates about their Islamic credentials are issued to them by their own internal Shari`ah boards. There may not be any doubts about the integrity of the members of these boards, who are highly qualified and well-respected Islamic legal scholars. Yet, they are employees or paid advisers of these institutions and there is a possibility of conflict of interests.

It is not possible to ascertain the legitimacy of most of these criticisms until a comprehensive survey of IFSPs has been undertaken. No such survey is feasible or meaningful unless there is assurance of transparency on the part of these IFSPs. However, those well-informed about the working of IFSPs feel that, while IFSPs do deserve a significant part of the blame for their weaknesses, the total blame does not necessarily rest on their shoulders.

Expectations may be too high, and there seems to be little appreciation of the various problems that these IFSPs face while operating in a predominantly interest-based financial environment without experienced know-how, shared institutions, and whole-hearted official support. A major reason for their shortcomings may be systemic, and it may not be possible for them to solve systemic problems in their individual capacities. Moreover, these

institutions are very small compared with the conventional mega-banks with which they have to compete, and do not have the resources to create a proper enabling environment.

CHAPTER 9

PRACTICE OF MODERN ISLAMIC FINANCE IN AUSTRALIA: COMPARATIVE ANALYSIS AND DIVERGENCE FROM THE SHARI`AH

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Islamic finance in Australia is a venue enabling both Muslims and non-Muslims to benefit from financing provided by IFSPs. However, it is aimed to cater for the needs of those who wish to avoid conducting their financial dealings on *riba*. Accordingly, IFSPs have introduced different Shari`ah compliant modes for home ownership, financing motor vehicles and consumer goods. While these modes of financing are operative, voices of discontent have begun to emerge from customers. Some products and instruments used by these finance houses have been widely criticised by different quarters branding them as non-Shari`ah compliant products. For instance, the Shari`ah legitimacy of MCCA's Sale to Lease (S2L) product for home financing was criticised by some quarters in the following words:

> "…It is not important that we call the usury/interest (riba) gain but the important thing is that it should be in its nature and in its truth a real halal gain…there should be an honest debate about the validity of this contract that the customer is entering into them and how this company should be directed in Islamic legislation if they accept to deal within its boundaries…That is, what is the benefit of MCCA?" [438]

438 See The Islamic Information and Support Centre of Australia website, "Response to MCCA Letter/Newsletter" (a translated version of the original Arabic response), 12 December 2004, available online at: http://www.iisca.org/press/release.jsp?id=5#Newsletter

Given the above and similar criticisms, an attempt has been made in this chapter to investigate whether or not they have diverged from the traditional Shari`ah. In this connection, comparisons are made where deemed necessary to give a real picture of current practices mainly in home, automobile and consumer goods financing using *Musharaka Mutanaqisa, 'Ijara Muntahia Bittamleek,* and *'Ijara wa 'Iqtina* structures. The products and services that are not in use by IFSPs along with their *'Ijara* schemes for consumer goods financing are excluded from this analysis.

9.1 IFSPs' *Musharaka Mutanaqisa* Home Financing and the Conventional Mortgage: A Comparative Analysis

A comparison of IFSPs' current practice of home financing with that of their conventional counterparts and on analysis of the operational differences between IFSPs' *Musharaka Mutanaqisa* mode of financing for housing and conventional housing finance are given in this section by use of a hypothetical example. For this purpose, the 'Shared Equity & Rental (S.E.R.)' model i.e. 'Diminishing *Musharaka*' or 'Diminishing Partnership' used by MCCA and ICFAL is chosen. The normal procedure for financing the purchase of a house today in conventional banking is to apply for a mortgage. If the price is AUD 400,000 for example, the bank may require a down payment equal to 10 percent of the apprised value. In case the apprised value and the purchase value are the same, the bank will require an AUD 40,000 down payment and lend the remaining AUD 360,000. The buyer will sign a mortgage contract that will require monthly payments over a period of years. Typically, home mortgages run for a period of 15, 20, or sometimes as much as 30 years. The bank, of course,

charges interest based on the amount of the unpaid principal, whose rate depends on prevailing market conditions and the term i.e. time period of the loan.

In the conventional system, if the bank agrees to give a 30-year mortgage for AUD 360,000 at an annual interest rate of 8 percent for example, the monthly payments will be AUD 2641.56. Each payment will consist of the interest due and partly the repayment of principal. Since the interest is figured on the basis of the remaining unpaid principal balance, the interest portion will decline over time while the principal portion increases. Over the 30-year period, the buyer will make 360 such payments, which add up to a total of AUD 950961.60 paid to the bank. This is more than two and a half times the AUD 360,000 borrowed, with AUD 590961.60 interest accruing to the bank.

If the buyer misses payments as scheduled a circumstance arisen for, the bank is entitled to foreclose and sell the house to recover the amount of principle and interest the bank still owes. The buyer may or may not recover any of its own investment. Since the bank's claim has priority over the buyer's, possibly it will not try very hard to get the best price. The bank is mainly concerned about recovering its own investment, not the buyer's. So, it may set the selling price low in order to liquidate the property quickly, leaving little or nothing for the buyer to recover.

Contrary to the conventional arrangement, MCCA and ICFAL use as one of their modes of finance *Musharaka Mutanaqisa* or 'Shared Equity & Rental'.[439] Just as with conventional banks, MCCA and ICFAL require some down payment in equity sharing, which is the buyer's initial equity share. It can be the same amount as in the conventional system, i.e. 10 percent, or AUD 40,000 in AUD 400,000. MCCA and ICFAL put up the remaining AUD 360,000. Now the buyer and the bank are co-owners. The buyer owns 10 percent of the house and MCCA and ICFAL own 90 percent of the house. There is no interest to be paid on MCCA and ICFAL's capital but if the buyer occupies the house, he will be required to pay rent to the owner. Of course, since the buyer is part owner, part of the rent comes back to him. At the outset, the bank will get 90 percent of the rental payments and the buyer will get 10 percent. But the buyer is also allowed to increase his ownership share at any time by making additional payments to the Islamic bank, in effect, buying out the bank's share in the house. As the buyer does so, his proportionate share increases while the Islamic bank's share decreases and the distribution of the rent payments will change accordingly.

Now, this arrangement can be compared with the conventional mortgage in the example given above. The big question, of course, is what is a fair amount for the monthly rent? It might be reasonable to assume that it is equal to the monthly payments the buyer would have made under the conventional mortgage arrangement, in this case, AUD 2641.56. At the outset, the buyer will receive 10 percent of that rent as their ownership share and MCCA and ICFAL will receive 90 percent. It might be assumed also that the buyer applies his share of

439 This is nothing new. It was common practice among the Dutch banks of the 13th century, a time when laws against usury were strictly enforced. It avoids usury by avoiding debt. For a detailed discussion see Thomas H. Greco. 1998. "How Does Halal Mortgage Compare With a Conventional Mortgage?" *Islamic Horizons*, London: September/October. p.50.

the rental payments to increasing his ownership share. Table 2 is an abridged amortisation table, which shows the respective returns to the buyer and MCCA and ICFAL.

Table 2

Amortisation schedule for a 30 year conventional mortgage at 8% interest; AUD 360,000 principal

Payment number	Monthly Payment	Interest	Principal	Balance after payment
1	$2641.56	$2640.00	$1.56	$359758.44
2	$2641.56	$2398.40	$243.16	$359515.28
3	$2641.56	$2396.76	$244.80	$359270.48
12	$2641.56	$2381.68	$259.88	$356992.52
…				
120	$2641.56	$992.93	$1648.63	$315807.36
…				
240	$2641.56	$583.20	$2058.36	$217715.92
…				
359	$2641.56	$34.80	$2606.76	$2612.36
360	$2641.56	$29.20	$2612.36	$0.00
Totals	$950,961.60	$590,961.60	$360,000.00	

Under this arrangement, the buyer will own 100 percent of the house after making the 360th payment, or in 29.16 years. The buyer will have paid total rent of AUD 924,073.2. The bank's total share will have been AUD 564,073.20. This is a saving of more than AUD 24,000 over the amount of interest paid on the conventional mortgage. In percentage terms, this is saving of a little over four and a half percent. This may not seem like much, but we shall see when comparing this approach with conventional mortgages carrying higher interest rates, that the savings can be significant.

A more important advantage derives from the risk sharing inherent in MCCA and ICFAL's DP or shared equity approach. Under this arrangement, *if the buyer is unable to make the scheduled principal payments, there is no foreclosure. The buyer simply does not add to his*

ownership share. If he is unable to pay the rent, however, he can be required to vacate the house, just as if he was renting from anybody else, but he would not lose his ownership equity. When the house is rented to someone else, the buyer will still receive his share of the rent, or if the house were to be sold, he would get his share of the proceeds based on the percentage of the equity which he owns. Of course, since the Islamic bank's claim does not take priority over the buyer's, it is in the best interests of both the parties – the buyer and the bank to try to get the highest price possible for the house.

In contrast to the conventional mortgage debt, the relationship in an Islamic mortgage between the buyer and MCCA and ICFAL is amicable rather than antagonistic, since their interests are common rather than opposed. The conventional mortgage, being exploitative, creates conflict, stress, and insecurity, while contributing to greater disparities of income and wealth. Shared equity financing, however, reduces conflict, stress and insecurity, and makes for a more harmonious and equitable society.

Table 3

MCCA's shared equity with rent equal to conventional 8%; 30 year monthly payment; owner's share applied to repurchase; no additional principal payments

Payment number	Monthly payment	Buyer's share	MCCA & ICFAL's share	Buyer's equity	Buyer's equity %	MCCA & ICFAL's equity	MCCA & ICFAL's equity %
				$40000.00	10%	$360000	90%
1	$2641.56	$240.16	$2377.40	$40264.16	10.07%	$359735.84	89.93%
2	$2641.56	$267.64	$2375.64	$40530.08	10.13%	$359469.92	89.87%
3	$2641.56	$267.64	$2373.92	$40797.72	10.20%	$359202.28	89.80%
…							
24	$2641.56	$307.32	$2334.24	$46845.36	11.71%	$353154.64	88.29%
…							
120	$2641.56	$578.16	$2063.40	$88123.76	22.03%	$311876.24	77.97%
…							
240	$2641.56	$1273.72	$1367.84	$194144.96	48.54%	$205855.04	51.46%
…							
359	$2641.56	$2610.08	$31.48	$397845.48	99.46%	$2154.52	0.54%
360	$2641.56	$2154.52	$14.24	$400,000.00	100.00%	$0.00	0.00%
Totals	$924,073.20	$360,000	$564,073.20				

To fully appreciate the advantages of MCCA and ICFAL's Shared Equity and Rental approach, one must examine the numbers pertaining to higher conventional mortgage interest rates. Table 4 shows the figures for conventional mortgages at 8%, 10%, and 12% interest rates, along with figures for comparable shared equity. It can be seen how seemingly small changes in the interest rate cause enormous increases in the amount of money the buyer must pay back. At 12% interest, for example, the buyer will repay AUD 1,333,080.00 on his AUD 360,000 loan over 30 years, giving the bank an interest income of AUD 973080.00. However, a shared equity scheme with the same monthly payment of AUD 3703.00 would give the buyers full ownership in 20.83 years. The total rent shares to the IB would be only AUD 565,292.56, saving the buyer over AUD 400,000.

Table 4

Conventional mortgage and MCCA and ICFAL's shared equity mortgage Summary

Conventional mortgage
Comparative figures of different interest rates
30 year conventional mortgage: AUD 360,000 principal; AUD 40,000 down payment

Interest rate	Monthly payment	Total payback	Total interest	Total principal
6%	$2158.38	$777017.48	$417017.48	$360,000.00
8%	$2641.56	$950958.89	$590958.89	$360,000.00
10%	$3159.24	$1137332.75	$777332.75	$360,000.00
12%	$3703.00	$1333081.93	$973081.93	$360,000.00

MCCA and ICFAL's shared equity AUD 360,000 initial MCCA and ICFAL's equity (90%); AUD 40,000 initial buyer's equity (10%)buyer's share of monthly rent applied to repurchase of MCCA and ICFAL's share

Total payment	Monthly rent	Total payout	MCCA & ICFAL's share of rent	Principal	Payment required to complete buyout	Years required to complete buyout
	$2158.40	$923517.40	$563517.4	$360,000.00	428	35.67
	$2641.56	$924073.20	$564073.20	$360,000.00	350	29.17
	$3159.24	$924669.19	$564669.16	$360,000.00	293	24.42
	$3703.00	$925292.56	$565292.56	$360,000.00	250	20.83
$3159.24	$2641.56	$670248.64	$310248.64	$360,000.00	213	17.75
$3703.00	$2641.56	$577927.32	$217927.32	$360,000.00	157	13.083

The figures in this table assume that the fair rent in each case is equal to the mortgage payment. That assumption, however, may be too far fetched. It might be assumed that in every case, the fair rent is equal to the mortgage payment at 8 percent, or AUD 2641.56. Under these circumstances, any amount paid over and above that figure would be directly applied to increasing the buyers' equity share rather than being split between them and MCCA and ICFAL. The lower part of the Mortgage Summary Table (Table 4) shows the figures for monthly payments equivalent to those at the 10 and 12 percent mortgage rates. With payments of AUD 3159.24, buyers will achieve complete ownership in 17.75 years. MCCA and ICFAL's share of total rents will be only AUD 310248.64. With payments of AUD 3703.00, buyers will achieve complete ownership in only 13.08 years, having paid MCCA and ICFAL rent shares of only AUD 217927.32, saving the buyers almost $756,000 or 77.6 percent over the conventional mortgage with the same monthly payment.

9.2 IFSPs' Home Financing on *'Ijara Muntahia Bittamleek* and Conventional Mortgage: A Comparative Analysis

Before delving into a comparison between IFSPs' home financing on *'Ijara Muntahia Bittamleek* and conventional mortgages it is necessary to investigate thoroughly some significant differences between a conventional lease and an Islamic *'Ijara* lease. Four main differences are discussed below:

I. Rental Payments Based on Interest

Where an asset is financed by way of floating-rate funds, the owner will usually pass the risk of rate fluctuations down to the lessee through the rentals payable by the lessee. This creates

a problem in the Islamic context where lease rentals cannot be expressed by reference to interest rates. This difficulty is, to a certain extent, surmountable. In leasing transactions the lessor is providing an asset, not funds, so the return is in the form of rent, rather than principal and interest. The lessor is, in effect, using its funds productively to invest in an asset and is accepting the associated risk. In an *'Ijara* lease the amount and timing of the lease payments should be agreed in advance, though the agreed schedule and amount of those payments need not be uniform. In some leases the problem has been overcome by referring to the rental payable under the lease at the date of signing, but subject to adjustments by reference to provisions in other documents. In another lease, the rent was adjusted by cross-reference to fluctuating rentals payable under a non-Islamic lease being signed at the same time and at the same rentals. Other transactions have included a rental adjustment letter linking rentals to LIBOR.

II. Default Interest

Conventional leases usually provide for default interest on late payment of amounts due, which is not possible in Islamic leases. In an *'Ijara* lease the same effect can be achieved in different ways, for example by providing for some form of discount formula, where an agreed rate of discount is applied for each day that payment is made prior to a backstop date. The backstop date is chosen to reflect a commercial period in which funds might be expected at the latest to be paid. However, if payment is made after the backstop date, then the lessor cannot recover any additional amount. In other leases we have seen late-payment fees replace the conventional default rate of interest.

III. Insurance and Maintenance

In contrast with most conventional leases, in an *'Ijara* lease the responsibility for maintaining and insuring the leased asset remains that of the lessor throughout. Therefore, the owner/lessor will agree in the lease to procure the maintenance and insurance of the asset. The conventional position of the lessor relieving itself of these burdens can be achieved within the *'Ijara* framework if the owner/lessor recovers the insurance costs by increasing the rental payments and if the lessor appoints the lessee or another third party as its agent to obtain the required insurance in return for a fee. Maintenance obligations can be dealt with in a similar way, where the lessor agrees in the lease to perform all maintenance and repair obligations but appoints the lessee or another third party to perform such obligations on behalf of the lessor in return for a fee. The extent to which maintenance responsibilities have been transferred is usually reflected in the lease payments due from the lessee.

IV. The Shari`ah Board Clearance

One distinct feature of the modern Islamic finance movement is the role of the Shari`ah board, which forms an integral part of an Islamic financing institution. The role of the Shari`ah board is to monitor the workings of the Islamic financing institution from a Shari`ah standpoint and to review every new transaction to make sure that it is Shari`ah compliant. These boards include some of the most respected contemporary scholars of the Shari`ah. Yet the Shari`ah is open to interpretation and the Shari`ah boards often have divergent views on the key Shari`ah issues. In this regard, there is no practical guide as to what constitutes an acceptable Islamic financial instrument, and the suggestions mentioned above, which are designed to achieve the same effect as conventional leases within an *'Ijara* framework, need

to be viewed in this light. A document or structure may be accepted by one Shari`ah board but rejected by another.

Given the above introductory analysis of Islamic and conventional leases, some of the key differences between home financing on *'Ijara Muntahia Bittamleek* and conventional mortgages are highlighted below:

1. As owner of the property, the IFSP faces risks associated with property ownership. This is a situation that does not exist under an interest bearing mortgage, where the conventional bank never actually owns the property.

2. In a conventional mortgage, the customer is the borrower. However, in an *'Ijara Muntahia Bittamleek* structure, the customer is the IFSP's tenant in the property. This different relationship between the IFSP and its customer presents the IFSP with different risks and requires different remedies to problems that might occur. It is crucial differences like these that allow Islamic legal scholars to approve a product and make IFSPs' Shari`ah compliant home finance an acceptable way for Muslims to finance the purchase of their homes.

9.3 IFSPs' Motor Vehicle Financing on *'Ijara wa 'Iqtina'* and Conventional Motor Vehicle Financing: A Comparative Analysis

The transaction structure of the conventional HP in relation to motor vehicle financing is as follows:

1. The customer pays a deposit agreed with the bank/financier.

2. The customer repays the balance as fixed monthly payments over an agreed number of months.

3. At the end of the period, and subject to all payments having been made including the option to purchase fee, the vehicle is for the customer to keep, sell or trade-in for a new vehicle.

4. The bank/financier has a security interest in the car until all amounts owing by the customer are paid.

Given the transaction structures followed by both the Islamic and conventional hire purchase system for motor vehicle financing in Australia, the following *similarities* are of worth mentioning:

1. Gaining ownership of the motor vehicle by the customer.
2. Deferred payment facility.
3. Pre-agreed regular monthly payments.
4. Finance is available on new and used vehicles.
5. Paying a deposit then paying off the balance over certain years.

However, there are some basic *differences* in the practices of Islamic and conventional HP for car finance which can be summed up as follows:

1. In the conventional HP for financing motor vehicles the car remains the property of the bank/financier until a significant proportion of the loan has been paid off,

whereas the ownership of the car is transferred to the customer from the very outset in the Islamic Hire Purchase for financing motor vehicle product used by MCCA and ICFAL.

2. In the conventional HP system the car is repossessed if the customer is unable to keep up with payments. In the Islamic Hire Purchase system used by MCCA and ICFAL the car is not repossessed in the same situation as the car becomes the property of the customer once the agreement is signed between the two parties.
3. The customer cannot sell the car until the finance is settled in the conventional HP finance system. In the case of the Islamic Hire Purchase practised by MCCA and ICFAL they may at their sole discretion approve a third party to take on the ownership of the car and the customers' financing obligation. The essential condition, however, is that the terms and conditions of the original agreement must remain the same.
4. The conventional bank/financier may charge a late payment fee that reflects the interest rate. MCCA and ICFAL charge such a fee only to discourage customers from making unnecessary late payments and to recover administrative expenses incurred for monitoring and following up on late payments and defaults arising due to late payments.
5. Under the conventional HP agreement, the customer cannot unilaterally terminate the contract, and must meet all the payments before ownership of the asset is passed from the financial institution to the customer. However, in the Islamic Hire Purchase agreement, the Shari`ah allows the customer to terminate the

contract at any time he wishes, and to acquire the asset at a pre-determined purchase price.

A thorough investigation of the common features of the Islamic Hire Purchase system shows that the product used by IFIs in Australia, namely MCCA and ICFAL for financing motor vehicles is not exactly the same as conventional HP. In principle, the Islamic HP or *'Ijara wa 'Iqtina* is a leasing contract whereby a financial institution purchases an asset upon the request of a customer who pays for the asset with periodic lease payments. The period of the lease and the amount of each instalment are mutually agreed upon by the parties, and the customer owns the asset at the end of the lease period.

As the name 'Hire Purchase' implies that this is a lease agreement combined with an undertaking by the customer to purchase the leased goods at any time during the term of the lease, at an agreed price. Islamic Hire Purchase therefore, resembles a conventional HP agreement with one fundamental difference. Under a conventional HP agreement, the customer cannot unilaterally terminate the contract, and must meet all the payments before ownership of the asset is passed from the financial institution to the customer. However, under the Islamic HP agreement the customer is allowed to terminate the contract at any time he wishes, and also permitted to acquire the asset at a pre-determined purchase price. Other important features of an Islamic Hire Purchase contract include.

1. At the expiry of the lease agreement, the title to the asset is transferred under a new contract to the lessee, provided the lessee has met all the terms and conditions of the original agreement.
2. A lessee can also exercise the option to acquire the leased asset prior to the expiry of the lease agreement, at a price to be mutually agreed between the lessee and lessor at the time of the execution of the lease. However, the purchase option price is usually determined by reference to either the fair market value of the asset as determined by experts at the time the purchase option is exercised, or an estimated residual value is agreed in advance, at the time the lease is signed.

Therefore, it is evident from the above analysis that the product used by MCCA and ICFAL for car finance is not a conventional HP in substance. A closer examination of this product shows that it is a modern *Murabaha* (cost plus profit) which is one of the most popular products being practised by IFSPs elsewhere in the world. This product is based on a mark-up, which is defined as the amount added to the cash price of goods to cover overhead charges/profit, etc. However, although the product used by these financial institutions is the *Murabaha* or mark-up there is a hot debate among the idealists and pragmatists on how far the *Murabaha* is Islamic. The following discussion is an examination of the issue through close scrutiny of the literature and practice of Islamic finance.

Before delving into the debate on whether *Murabaha* is Islamic and how far it is an Islamic financial technique if it is so, it is necessary to know whom we consider idealists and pragmatists in the Islamic finance industry. The idealists are those who attempt to look at the

key concepts of Islamic finance such as 'PLS', 'money', 'interest' and 'profit' from an ideal perspective. This means that the ideal form of each concept should be accepted as the valid one and any attempt to dilute the purity of the concepts should be opposed. On the contrary, the pragmatists are generally the practicing Islamic bankers and those who are involved in the Shari`ah Supervisory Boards of IBs and IFIs. The idealists argue that the modern *Murabaha* used by IBs is not Islamic as it resembles interest for *selling money at a profit*. This has led to the conclusion that if the Shari`ah accepts it as valid, it is left with no basis to reject interest.

On the other hand, the pragmatists say that *Murabaha* is one of the Shari`ah compliant products used by IFSPs. They admit that with regard to credit trade, there has been some differences of opinion among Muslim jurists on the Shari`ah position of the difference in cash and credit prices of a commodity. Apart from that according to most Islamic legal scholarship the credit price of a commodity can genuinely be more than its cash price provided that the price is settled before separation of the parties. This is tantamount to the acceptance of time value in the pricing of goods. Therefore, what is prohibited is any addition to the price once it is mutually agreed because of any delay in its payment. This is because the commodity, once sold, even on credit, belongs to the purchaser on a permanent basis and the seller has no right to re-price a commodity that he has sold and which does not belong to him. The pragmatists put the following arguments in support of their view regarding the permissibility of the *Murabaha* financial technique in the Shari`ah.

Islamic economics has the genuine provision of converting money into assets on the basis of which one can measure its utility. While it concedes the concept of time value of money to the extent of pricing in credit sales, it does not uphold generating rent to the capital as interest does in credits and advances leading to a rentier class in society.[440] As per rules of the Shari`ah, the aspect which matters is the conversion of AUD 1000, for example, into an asset in which case that AUD 1000 asset may be worth more or less in future leading to profit or loss. This conversion into assets is subject to well articulated rules governing PLS, trading and leasing. The concept of time value of money in the context of the Shari`ah is also established from the fact that the Shari`ah prohibits the mutual exchange of gold, silver or monetary values except when it is done simultaneously and at per value.[441]

This is because a person can benefit from the use of a currency which he has received while he has not given its counter value from which the other party could benefit. It further appears that time valuation is possible only in business and the trade of goods and not in the exchange of monetary values and loans or debts. Loaning is considered in the Shari`ah to be a virtuous act from which one cannot take any benefit. Therefore, no time value can be added to the principal of a loan or to a debt after it is created or to the liability of a purchaser offer it is stipulated.[442]

Given the above arguments placed by the proponents of *Murabaha,* there should be no confusion in this regard about interest vis-a-vis the concept of rent in HP or leasing. It might be argued, for example, that as per approved the Shari`ah principles, predetermined rent

440 See Abu Umar Faruq Ahmad and M. Kabir Hassan, *supra* note 409.
441 *Ibid.*
442 *Ibid.*

includes a time-value of money; therefore, a predetermined time value of money in loans/debts should also be permitted by analogy.[443] This argument does not have any substantive basis. The rent in HP or leasing is calculated on the basis of the capacity of the asset to give usufruct, which is in principle uncertain. Hence, it remains uncertain how much time-value of money is actually realised until the asset has completed its economic life. The lessor, as owner of the leased assets, is also the owner of risk and reward of that asset. Further, anything which cannot be used without consuming its corpus cannot be leased out like money, edibles, fuel, etc.

The above discussion leads to an important conclusion that while the time value of money is acceptable in respect of the pricing of assets and their usufruct, it is not acceptable with regard to any addition to the principal of loans or debts. The valuation of credit periods based on the value of goods or their usufruct is different from the conventional concepts of 'opportunity cost' or 'time value'. As such, mark-up in *Murabaha* is permissible provided the Shari`ah rules relating to trade or leasing are adhered to, but interest is prohibited due to being an increase over a loan or debt.[444]

Therefore, the argument that MCCA and ICFAL, like other IFSPs, sell money at a profit, which is tantamount to interest, is not correct. In fact what they practice is the attribution of their profits to the purchase of goods from the original owner/manufacturer at a lower price (seller's cost) and its resale to the consumer at a higher price. However, a closer examination

443 *Ibid.*
444 *Ibid.*

of and comparison between the original *Murabaha* conditions and the modern *Murabaha* contracts in use, shows up the inadequacy of this claim. This is summarised below:

1. In the Original *Murabaha* the profits gained by a seller were the profits actually realised from the 'sale' of goods. In the modern *Murabaha* the profit from the 'sale itself' goes to the original owner who may have bought the house 10 years ago for AUD 100,000 and is selling it today for say AUD 200,000 or to the manufacturer whose cost of producing the machine may have been AUD 100,000 and he is selling it for AUD 200,000.
2. In both cases, the owner of the house and the manufacturer, do not declare their own cost and the buyer is not relying on their honest disclosure in determining what he should pay for the item. Thus, although there is profit from the sale, there is no *Murabaha* contract between the original owner/manufacturer and the consumer/buyer or the original owner and the IFSP.
3. The buyer in a modern *Murabaha* already knows the purchase price of the item he wants to buy. Generally, modern *Murabaha* contracts provide that the buyer either act as the agent of the IFSP or assign the sale contract signed between him and the original owner to the IFSP, to enable it to buy the item from the original owner. In both cases, the buyer is the one who finds the goods, negotiates the purchase price, signs the sales agreement and then asks the IFSP to buy it from the original owner at the price negotiated by the buyer and confirmed as fair by an independently licensed appraiser.
4. If one removes the financing role played by the IFSP, can one honestly say that the additional amount the buyer agrees to pay the IFSP (on top of the profit he is already

paying the original owner), reflects the 'profit from the sale' (as required in the original *Murabaha*) of the house and not from 'financing the purchase' of the house? Without financing, the IFSP would have no role to play in the sale contract.

5. Those who make a living on profits gained from the purchase and sale of properties know that, in the real world, one does not buy a house for AUD 100,000 at 1:00 p.m. and sell it to a buyer with a mark-up of AUD 200,000 at 1:05 p.m. As it is implied that the settlement (purchase by the IFSP from the original owner and its resale to the buyer at a mark-up) generally takes place in the same meeting and on the same table, IFSPs do not take title to goods nor do assume the risk of loss for an extended period of time because they pass ownership of the property immediately to the actual buyer. No one in the real business world makes a 200% profit 'resulting from buying and selling goods' within 5 minutes. Yet IFSPs claim to do it all the time and mostly several times a day.
6. Although the IFSP would say that its profit is from the sale of goods at a mark-up, the real profit which an IFSP makes is the difference between the cost of funds it uses to finance the purchase and the mark-up at which it passes those funds to its customers. Thus while on paper it looks as though the profit on the transaction is AUD 100,000, its actual profit is 2 or 3 percentage points it has added on top of what it has to pay the supplier of funds and other fees for processing the financing.
7. In the original *Murabaha*, once the sale is concluded, the total amount, the seller's cost as well as his profit, becomes one single purchase price due and payable to the seller. It can be paid in cash at the time of sale or later. Except for the purpose of showing later that the seller was less than honest in disclosing his cost, the purchase

price is considered one integral price. A purchaser who has promised to pay the total *Murabaha* price one year after buying the item and informs the seller one week after the sale that he can afford to pay the whole price now (i.e. prepay), will still be liable to pay the total debt (i.e. seller's cost as well as his full profit). In the modern *Murabaha*, a buyer who wishes to prepay before maturity is not obligated to pay the unpaid portion of the mark-up (in the same way as in a conventional mortgage or debt financing.) Generally, a person only pays the remaining balance of the principal and not the interest. Some lenders may charge a prepayment penalty, but no one asks the full payment of interest regardless of pre-payment. If the IFSP's profit was from the 'sale of goods' and not from 'financing of the purchase of those goods', then it should not matter when the buyer pays. A prepayment should be in the same amount as the aggregate of all payments until the agreed maturity date.

8. Thus if there is no *Murabaha* contract between the original owner and the buyer and no such contract between the IFSP and the original owner, then we should examine whether there is *Murabaha* between the IFSP and the buyer. In this context, one can ask the question, what is it that the IFSP is selling that is generating profit from the sale? If the IFSP's real source of profit is from the financing, is the IFSP disclosing its own cost of funds (whether its own or obtained form others in the secondary market)? Is the IFSP really a seller as required in the *Murabaha* or a financier in the guise of a seller? If the profits are really generated from the sale then why are indexes such as LIBOR always used to determine the rate of return rather than indexes reflecting the profits resulting from the sale of homes or cars or their lease, etc?

These are some of the concerns and questions which are increasingly asked of the Islamic financial industry. However, one should not say that the use of *Murabaha* (mark-up sale) is un-Islamic. One explanation given is that at this stage of the formative development of Islamic finance, it is fine to give Muslim consumers an alternative which they can wholeheartedly accept as Islamic without doubt. Many comparable conventional products are viewed by the majority of Islamic legal scholars today as undesirable if not totally unlawful. This has created doubts about their authenticity. So long as one does not violate the rules of the Shari`ah, satisfying a consumer's heart is in itself a virtue and is recommended in Islam.

9.4 The Extent of IFSPs' Compliance with the Shari`ah in their Current Practice

The performance of IFSPs in Australia depends heavily on the extent to which the practice of these institutions adheres to Islamic legal principles and reflects well-established Islamic principles for financial transactions. Given this fundamental requirement, the underlying objective of this study as elucidated at the outset is to critically evaluate the extent to which the Islamic Shari`ah has been followed by IFSPs in Australia. So, in following sections, attempts are made to determine the extent of the Shari`ah compliance in the practices of IFSPs using different financial products and instruments.

9.4.1 Divergence From the Shari`ah in IFSPs' Practice of Debt-based Financial Products

The following divergences from the principles of the Shari`ah in IFSPs' use and practice of Debt-based financial products and instruments have so far been identified.

9.4.1.1 Islamic *'Ijara* Mortgages

As mentioned previously in this study, IFSPs of Australia under the *'Ijara wa 'Iqtina* and *'Ijara Muntahia Bittamleek* Islamic home finance contracts, purchase property selected by the customer, following a promise from the customer that he will live in that property and purchase it after an agreed period of time. In return, the customer pays monthly instalments to IFSPs, mainly composed of two payments. One portion of the instalment is considered to be a payment of the purchase price for the property, and another portion is counted as rent that the customer pays for living in the property in the meantime. The purchase price paid by the customer is equal to the purchase price initially paid by IFSPs for the property. Once the customer has paid all the purchase instalments plus the rental instalments, IFSPs will transfer the ownership of the property to the customer. IFSPs make their profits from the difference between the prices they pay for the property (including related transaction costs) and the amounts received in instalments from their customer.

This type of scheme, with some minor modifications, as discussed earlier, is practised in Australia by MCCA, ICFAL and Iskan. In principle, an *'Ijara* scheme can be structured in such a way as to be acceptable under the Shari`ah so long as certain conditions are met. However, the implementation of the scheme by IFSPs is highly problematic for the reasons elucidated below:

Firstly, the contract of *'Ijara wa 'Iqtina* and *'Ijara Muntahia Bittamleek* for Islamic housing finance is ambiguous in its nature. In fact it is not clear whether it is a lease contract, a purchase contract or a combination of the two. Based on an injunction in which the Prophet

Muhammad (PBUH) prohibited two transactions in one, some Islamic legal scholars forbid a transaction that combines both lease and purchase, although there are some who have allowed this type of transaction under certain strict conditions. However, there is a consensus among the scholars that the presence of a significant amount of ambiguity invalidates a contract. This consensus is based on a Prophetic Tradition which bans any sale that involves *gharar* or ambiguity.[445]

Some Islamic legal scholars, among them those who work in contemporary *Fiqh* Councils, hold the opinion that if rental and sale are mixed in such a way that one cannot distinguish at any point of time whether the customer is a tenant or a buyer, then such a contract is invalid according to Islamic jurisprudence.

When asked to clarify the nature of the *'Ijara* mortgages used by IFSPs in Australia, the relevant staff in these financial institutions frequently describe it as a 'lease ending in a purchase/ownership'. Yet if this really is the case, then the *'Ijara* mortgage should display the features of a lease throughout the entire time-span of the contract (often as much as 25 years) until it concludes with a purchase/ownership event. In other words, IFSPs will rent out the house for a period of time with the promise that it will sell to the customers/make them owners at the end of the tenancy. During the tenancy, IFSPs will remain the legal owners of the property. After the tenancy the customers will be the legal owners.

Although many scholars do not allow this type of combined contract, just for the sake of argument it may be assumed as valid according to the opinion of those scholars who accept

445 See Sunnahonline website, available at: http://www.*Sunnah*online.com/library/contemporary/0038.htm.

it. Upon examining the available *'Ijara* schemes used by IFSPs more closely, it is found that the theoretical structure outlined above does not exist in practice. The *'Ijara* contract as it stands is neither a lease nor a purchase. Rather, it is closer to a conventional loan where banks lend money to customers for property purchases, and require that customers must repay with a mark-up under the guise of 'rent'.

The following questions which illustrate the ambiguity of the contract may be considered in this regard:

1. Why does the tenant need to pay a large down payment? (Frequently an amount equal to 5%-10% of the price is required. A genuine tenant does of course make some kind of down payment; relevant to the period of the tenancy, but no credible tenancy agreement can bind the tenant to place such a large down payment.)

2. Who pays the insurance for the house? Are they IFSPs or the tenants? (Technically, the owner of an asset is the one who should pay for its insurance.)

3. What will happen if there is loss or damage to the property and the insurance company refuses to cover the losses incurred? Who will pay for this? (Once again, if IFSPs are the actual owners, and such a loss or damage occurred through no fault of the customers, then IFSPs cannot hold the customers responsible for damages.)

4. If the tenants decide to terminate the tenancy agreement, IFSPs will sell the property. If the price of the property has depreciated in the meantime (which means

IFSPs as the owners of the property suffer a loss), why are the customers bound to compensate that entire loss while being only tenants?

The point of all these questions is to address the central issue, namely, who are considered the actual owners (and thus liable for any damages or depreciation in value) for the duration of the lease? Are they IFSPs (in which case all of the above scenarios do not make sense), or are they the customers (in which case this contract is not a lease contract in the first place, but rather something else)?

IFSPs may give an answer to all or some of these questions supported by quotations from jurists of the past or present. Some of these answers may indeed prove to be acceptable when looked at in isolation but, when they are taken as a whole, such practices may invalidate the contracts.

To illustrate the author's point, IFSPs might state that, according to a particular School of Islamic Jurisprudence, the down-payment is not a part of the price of the property since it is not a purchase agreement. Rather, it is an assurance that the tenant is serious in renting the property for a given period of time (say up to 25 years). Such a condition is acceptable according to some jurists. Furthermore, IFSPs may state that the insurance is paid by the tenants based on a mutual agreement, and there is nothing wrong with such a condition, for in a *hadith* the Prophet Muhammad (PBUH) is related to have said: "Muslims shall be bound by

the conditions/stipulations which they make except the condition which prohibits the lawful or permits the unlawful".[446]

Meanwhile, IFSPs might claim that they are bound by the law of the land (Australian/English Law) to hold the title of the property, and will only pass it to the customers upon the final payment. However, the contractual agreements that are signed between IFSPs and their customers put all of the risks of ownership upon the customers, and these factors defeat the purpose of *'Ijara*, even if technically speaking IFSPs claim to follow the letter of English law as 'owner' of the property.

From the above arguments it has been observed that each of these, on its own, is widely considered to be valid. However, this should not lead one into the grave error of assuming that three valid matters when combined produce a valid outcome. An example of a plain *riba* transaction may be given within the following framework:

1. An interest-free loan (which is something recommended)

2. A gift (which is again, something recommended)

3. A promise.

If the above three transactions are taken individually, they will be considered entirely valid. However, if they are combined in a single contract, the result is pure *riba.* For instance, 'A'

446 Al-Tirmizi as quoted by Shaikh Jad al-Haq in *Al-Iqtisadul Islami*, July 1995. p.60. The direction contained in this hadīth is of a general nature and relates to all contracts, subject to the basic rule that no condition opposed to the *Shari`ah* is valid.

says to 'B': "Grant me a loan which I will repay you" (a valid matter), and 'A' says to 'B': "I promise you (a second valid matter) a gift (a third valid matter) in addition to the repayment when it becomes due". If it is asked whether such a contract is valid or tantamount to *riba*, the answer would be that it is clear *riba* without any doubt, since 'B' who gave the money was promised that same amount back along with some profit.

Given the above, one should look at the end-to-end process here and evaluate it as one transaction. The critical question is "who is the real owner of the property during the whole process? Is it the customer while the IFSP is just financing the deal as it does in a normal conventional mortgage, or is it the IFSP?" Again, "if the owner is the IFSP, then can a real owner ignore his responsibility towards his own property? Why does the IFSP then avoid owning the property?"

Another example may be given to further illustrate the above argument. A financial transaction known as *Bai` al-`Inah* or sale and buy back agreement is strictly prohibited in the Shari`ah when taken as a whole, as it is seen as something similar to *riba* based financing. However, when broken down into individual parts and examined solely upon these parts, this transaction, appears to be valid. One of the means of practising *Bai` al-`Inah* is that the first party sells a product to the second party on a deferred payment. The second party then sells it back to the seller at a lesser price, but in cash. If this transaction is broken into sub transactions one can conclude that there are two acceptable sale transactions. It is allowed for a person to sell a product for a deferred payment, and it is also allowed to buy a product for cash. However, the ultimate aim of this transaction is to enact a pure *riba*

transaction in the guise of buying and selling. This is because the second party receives an amount of cash from the first party and is then required to pay back an amount of greater value at a later time. As for the product itself, since it changes hands twice, it returns to the initial 'seller'. Therefore, the product is used merely as a loop-hole to avoid the prohibition on *riba*.

Although Imam Al-Shafi`i permits this concept, it is his personal opinion and not based on interpretation of any authentic Islamic authority. On the contrary, other Schools that prohibit such a sale base their opinion on the consensus of the jurists on the authority of Islamic legal sources. As Ibn Qayyim prohibited *Bai` al-`Inah* quoting the following *hadith* that the Prophet Muhammad (PBUH) is reported to have said: "A time is certainty coming to mankind when they legalise *riba* under the name of *ba`i* (trade/sale)". But again, Imam Al-Shafi`i agrees with all other scholars that the aim of the transaction should not be to overcome a prohibited transaction. In other words, all scholars are in agreement that it is sinful for two parties to try to devise a scheme that appears to make permissible something that the Shari`ah declares impermissible. Moreover, there is hardly any satisfactory evidence which enables one to say that Shafi`i has expressly declared *Bai` al-`Inah* to be lawful. It should be pointed out that Shafi`i's method of determining the validity of any contract by formal evidence that they are legally concluded, and this cannot be cancelled on account of the intention of the parties. Although Shafi`i recognises that such intentions may be lawful, he deems the contract to remain valid unless the unlawful intention is expressed in the contract. As not every valid contract is a lawful contract, Shafi`i thus permits contracts

because their legal preconditions are fulfilled, but forbids the transacting act of the parties when it conflicts with Shari`ah principle.[447]

In conclusion, there is no significant difference between the *'Ijara* scheme outlined above and the conventional mortgage which is a pure *riba*-based loan. Under the *'Ijara* scheme, IFSPs perform what is essentially a money lending transaction, placing such conditions upon its customers that guarantee, for all practical purposes, that it will obtain the same amount of money in return plus a profit disguised as 'rent'. It might be true that many of the individual clauses and conditions of the contract are permissible (or, at best, subject to differences of opinion among the scholars), but when put together and examined as a whole, it is apparent that there is little that separates this contract from a simple mortgage. Of the many matters that clearly illustrate this is that the risks and rewards of ownership of the house are carried by the tenant, not IFSPs, regardless of who is the 'paper-owner' under Australian/English law.

As per Shari`ah rules for financial transactions, whenever an investment contract is structured in a way that one party is guaranteed a profit, something is simply not correct. Only in a *Riba*-based transaction will there be guaranteed profit. Any permissible transaction in the Shari`ah must have an element of risk involved, no matter how small that element is.

Given this basic principle, when looking at the above particular transaction, it is essential that IFSPs do not take advantage of customers by exploiting the financial power of the former

447 See Saiful A. Rosly and Mahmood M. Sanusi. n.d. "The Application of Bay' Al-'Inah and Bay' al-Dayn in Malaysian Islamic Bonds: An Islamic Analysis", *International Journal of Islamic Financial Services*, vol.1, No.2.

and the desperate need of the latter. If these IFSPs enact their transactions with this principle as an underlying moral framework, such contracts seem to disappear. Yet, the reality is far from this ideal. In light of this principle, a question will always arise: Do these IFSPs share with their customers the risk of loss, or are they stipulating all possible conditions to protect themselves against any loss? Additionally, do these IFSPs own the properties they are renting to people?

The simple answers to these questions in discussion would be that the current *'Ijara* schemes practised by IFSPs are almost identical to conventional mortgages. They appear to be a *hila* or trick designed to promote conventional interest-based practices using Islamic terminologies and nomenclatures.

Based on the above, MCCA's *'Ijara* (including *'Ijara wa 'Iqtina* and *'Ijara Muntahia Bittamleek*), ICFAL's hire purchase, and Iskan's *Tayseer-'Ijara* schemes for home, automobile, and consumer durable financing as implemented here in Australia apparently are not based on the Shari`ah principles of financial transactions. In fact, this practice is a deception rooted in *riba*. Until those in charge of these schemes prove that the above argument is invalid and give clear answers to the questions highlighted earlier, it is believed that such transactions are totally prohibited from the perspectives of the Shari`ah.

9.4.1.2 Financing on *Murabaha*

Murabaha is a straightforward sale agreement that seems to be very similar to many conventional interest based provisions. Upon examining *Murabaha* contracts prepared and

used by IFSPs in Australia, their pricing and outcomes have been found to be mostly similar to conventional products and instruments. It may be said in other words that *Murabaha* contracts practised by IFSPs are nothing but conventional interest-based financing that bear an Arabic appellation. The reason is that according to the Shari`ah compliant *Murabaha* sale, IFSPs should add a known fixed amount of profit to its cost price. They should make the amount of profit they are charging known to the customer. The cost plus the known profit amount is the price for which IFSPs should sell the article. All other additions to this profit such as penalties for late repayments, service charges etc. are deemed to be null and void and hence would not be permissible.

Instead of maintaining the transaction in the pure unmodified form the Shari`ah has set for *Murabaha* agreements, IFSPs give loans, charge interest on loans and pass them off as *Murabaha* contracts. The factors which render such transactions unlawful in the Shari`ah are as follows:

1. In case of motor vehicle financing under *Murabaha* agreements, for example, the customer does not purchase the vehicle from the IFSP. Rather, he arranges the deals directly with the suppliers of motor vehicles and takes his delivery from the suppliers through paying cheques on behalf of the IFSP as their agents. This itself is in accordance with the rules of financial transactions in the Shari`ah. But the problem is that the same agreements appoint the buyer of the vehicle as IFSP's agent to sell the vehicle to himself.

2. The sale agreements are entered into at a time when the IFSP does not own the vehicle. The vehicle has not yet been acquired by the IFSP. It sells the vehicle which it does

not own. This is called *Bai` al-Ma`dum* or Sale of something which does not exist. Such a deal is null and void in the Shari`ah. It is imperative for the IFSP to first buy the vehicle and then only the sale will be valid. The sale by the IFSP of vehicle that it does not own yet is not lawful and thus a clear divergence from the Shari`ah. The IFSP can rectify this incongruence by simply sending representative to purchase the vehicle in such cases. The customer can accompany IFSP's representative to the supplier/dealer. After the purchase has been concluded, it can assign the vehicle to the customer. In this case the customer will not deal directly with the supplier. However, to the author's knowledge, only ICFAL among other IFSPs in Australia ensures this process so that firstly buying and secondly selling the vehicle to its customer take place in practice as per the rules of the Shari`ah.

3. IFSPs' *Murabaha* agreements assert that motor vehicle suppliers act as their agents in selling the vehicles, but reality belies this contention. The suppliers/dealers sell their own property. In such a situation the question may arise as to how they can be the IFSPs' agents when they are selling items which are their own property. IFSPs have not yet procured the vehicles. Hence, it is now clear who the true sellers of the vehicles are. If IFSPs wish to be known as sellers, they should send their own people to the suppliers and purchase the vehicles absolutely. Simply saying that the suppliers are IFSPs' agents does not render them so.

4. IFSPs' agreements also stipulate that *"the Purchaser shall at his own cost procure and take delivery of the goods from the Seller"*. These additional costs as well as all related costs in *Murabaha* transactions have to be borne by IFSPs who act as the buyers of vehicles to resell them to their customers and hence be included into their cost structure. IFSPs are

allowed to reflect their total cost price which they will add to their desired profit made known to the buyers.

5. MCCA and Iskan stipulate an oppressive clause in their *Murabaha* agreements. It says:

> "If the Seller cancels the Agreement or enforces the Agreement and the Purchaser disputes such cancellation or enforcement, the Purchaser shall continue to pay to the Seller all amounts due in terms of this Agreement on the due dates of payment…". [448]

If the deal is cancelled, according to the Shari`ah compliant *Murabaha* the purchaser is under no obligation to pay the instalments. This is an oppressive and exploitative stipulation which allows the seller to usurp the purchaser's money.

6. IFSPs blatantly stipulate in their agreements, payment of *riba* on late payments made by purchasers. Actually they are not the purchasers in relation to IFSPs. The customers are debtors to whom IFSPs have made loans. The camouflaging tactic of describing the interest charges as 'penalties' do not alter the *riba* status of the charges. IFSPs have in vain endeavoured to make this unlawful *riba* lawful by presenting altruistic motives. Such altruism even if sincere does not legalise what the Shari`ah has made unlawful.

Keeping in view all of the above violations of the Shari`ah made by IFSPs in Australia in their practice, their deals are not valid *Murabaha* transactions and are thus unlawful.

448 See MCCA website, *supra* note 337.

CHAPTER 10

THE UK REGULATORY FRAMEWORK FOR ISLAMIC BANKING: APPROPRIATENESS FOR ADOPTION INTO AUSTRALIA

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The United Kingdom is regarded as the Hub of Islamic Financing in Europe. The UK has seen significant landmark activity recently with the creation of two stand-alone Islamic banks, the Islamic Bank of Britain Plc, and the European Islamic Investment Bank Plc, while major U.K. retail players such as HSBC and Lloyds TSB have been quick to focus on this retail market and broaden their product offering. Similarly, global investment banks such as Deutsche Bank and Credit Suisse have established their own Islamic finance desks, typically centred in London, to provide Islamic corporate and investment banking services to these markets. Indeed, at a recent conference on Islamic finance in London, the U.K. Chancellor of the Exchequer Gordon Brown announced the ambition of the British government to make Britain the gateway to Islamic finance and trade in following words:

> "The foundation for making Britain the gateway to Islamic trade is to make Britain the global centre for Islamic finance".[449]

It is worth mentioning that the UK is the largest European trader with Muslim and Arab world and its trade with Arab world has grown 60% in the last six years.[450] Structuring on the UK's strong relations with the Muslim world, the UK has begun to focus on developing a full

449 Speech by the then Chancellor of the Exchequer, Gordon Brown MP, at the Islamic Finance and Trade Conference, London, 13 June, 2006.

450 See The London Islamic Financial Services Summit. 2007. "Opportunities and Challenges for Market Participants", availavle on City & Financial Conferences wevsite at: http://www.cityandfinancial.com/conferences/?id=145&sector=4

range of the Shari`ah compliant products both to enable UK and other Western companies to access the vast liquidity that exists in the Gulf States.

While on the retail side, an increasing number of UK banks are beginning to offer Islamic banking services to both borrowers and savers on the wholesale side, British banks have taken a leading role in developing the Shari`ah compliant *Sukuk* bond market, which is estimated to be worth £24 billion globally from almost nothing five years ago.[451]

The Chancellor of the Exchequer further remarked:

> "Today British banks are pioneering Islamic banking - London now has more banks supplying services under Islamic principles than any other Western financial centre". [452]

The UK Treasury plans to introduce the framework to support the issuance of *Sukuk* in London next year via parliamentary legislation. The Treasury also examine the treatment of other financial products, such as derivatives, to ensure that there is a level playing field for Islamic finance. Other areas of huge potential for the UK are Islamic equity funds, the Shari`ah compliant hedge funds and the use of Islamic finance within project finance.[453]

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451 *Ibid.*
452 See Gordon Brown, *supra* note 442.
453 See Pre-Budget Report December 2006, available on the UK HM Treasury website at: www.hm-treasury.gov.uk/media/4/3/pbr06_completereport_1439.pdf -

10.1 The Legislative Framework for Islamic Finance in the UK

There are around 1.8 to 2 million Muslims permanently resident in the UK, making Muslims the largest religious minority in Britain (3% of the total population). It is therefore unsurprising that the UK is one of the first Western states to have a detailed tax and regulatory regime addressing Islamic finance products.[454] It is worthy of noting that the progress of Islamic finance witnessed by the UK is more sophisticated than many countries with a Muslim-majority population. Many such countries are, as a consequence, following the experience of the UK in this regard. Since one of the key objectives of this study is to suggest that the UK experience in Islamic banking and finance be adopted in Australia, it is necessary to discuss the UK regulatory and tax regime in which the extraordinary advancement of Islamic finance took place.

10.1.1 The Financial Services Authority: The UK's Single Statutory Authority

The UK's Financial Services Authority (FSA) has been vested with responsibility by Parliament under the *Financial Services and Markets Act 2000* (FSMA), to regulate the financial services and markets of the country.[455] It is accountable to Treasury Ministers and through them to Parliament. Its aim is to maintain efficient, orderly and clean financial markets and help retail consumers achieve a fair deal.

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454 The 2001 census found there were approximately 1.6 million Muslims in Britain. The figure may now be as high as 2 million. See EIWG/Research Analysts Islam Team. 2007. "Key Facts: DfID (Department for International Development) Aid to Muslim Countries", available on Foreign & Commonwealth Office website at: http://www.fco.gov.uk/servlet/Front?pagename=OpenMarket/Xcelerate/ShowPage&c=Page&cid=1134650559096 (accessed at August 1, 2007. See also, Humayun Ansari. 2002. "Muslims in Britain", *Minority Rights Group International*.

455 The FSA is an independent non-departmental public and quasi-judicial body that regulate the financial services industry in the United Kingdom. Its main office in based in Canary Wharf, London, with another office in Edinburgh. When acting as the competent authority for listing of shares on a stock exchange, it is referred to as the UK Listing Authority (UKLA), and maintains the Official List.

The FSA is directly responsible for the whole of the UK financial system as the *Bank of England Act 1998* now transfers the Bank's former banking supervision functions from the Bank of England to the FSA.[456] Given this responsibility, the FSA is the single UK statutory regulator who regulates the whole range of banking, insurance and investment products. It is also the UK competent authority (i.e. the Listing Authority) for the admission of securities to official listing on the Stock Exchange.

10.1.2 The Role of the Financial Services Authority as a Regulator

The FSA has the following four statutory objectives under the Act (FSMA 2000):

1. Market confidence: maintaining confidence in the financial system;
2. Public awareness: promoting public understanding of the financial system;
3. Consumer protection: securing the appropriate degree of protection for consumers/investors; and
4. Reduction of financial crime: reducing financial crime to the extent to which it is possible.

Within that framework of objectives, the legislation gives regulators a considerable degree of flexibility to adapt and amend regulations to meet the objectives.

456 Up till 1997, the UK's banking regulation had been the function of the Bank of England while other areas of financial services had been regulated by bodies such as: The Securities and Investment Board (for investment business) and the Department of Trade and Industry (for insurance). Section 21 of the *Bank of England Act 1998* effectively transferred banking supervision to the Financial Services Authority (then known as the Securities and Investments Board). See Marianne Ojo. 2005. "The External Auditor's Role in Bank Regulation and Supervision: Helping the Regulator Avoid Regulatory Capture", unpublished paper, Munich Personal RePEc Archive.

The Financial Services and Markets Act 2001 brings in eleven principles for the handling of business, which set out at a high level firm and its management is expected to conduct itself. In terms of minimum criteria, the FSA has to be satisfied that institutions have adequate capital, liquidity and control over large exposures; that Banks of whatever origin must be prudently run and that their management are fit and proper for the task. Satisfactory risk management, a realistic business plan, and adequate systems and controls need to be clearly demonstrated. The FSA must be satisfied also that each institution is subject to effective consolidated supervision - i.e. that one supervisory authority takes prime responsibility for supervising the bank or banking group as a whole.

10.1.3 Conditions for Authorisation of Islamic Banks

Historically the regulatory view of IBs in the UK was that, while Islamic Banking is a perfectly acceptable mode of financing, an IB did not fit within the UK definition of a bank. It did not take deposits within the definition of banking legislation. Banks seek to provide capital certainty for their depositors, primarily through investment in fixed rate instruments, which are highly liquid and may provide cover for day-to-day losses arising from banking business, whereas Islamic Banking is based on the concept of PLS between the customer and the bank. Of course, the PLS has no guaranteed return. However, in order to be authorised under the FSA's requirements in the UK, new applicants whether they are IBs or conventional banks must meet five 'threshold conditions' for authorisation as an institution

entitled to take deposits in the country. Schedule 6 to the FSMA and *COND* which set out the *threshold conditions* in full, are as follows:[457]

> "(1) *Threshold Condition* 1: Legal status. This sets out a number of conditions for legal form. A *credit union* by definition will comply.
>
> (2) *Threshold Condition* 2: Location of offices. A regulated *UK credit union* must have its head office and registered office in the *UK*. This requirement is aimed at ensuring that *firms* are organised in a way that can be effectively supervised.
>
> (3) *Threshold Condition* 3: *Close links.* This condition requires the *FSA* to be satisfied that it can effectively supervise a *firm,* taking into account the structure of the *group* to which it belongs or the other *firms* to which it has *close links.* This will have little relevance to *credit unions* because of the way they are constituted.
>
> (4) *Threshold Condition* 4*:* Adequate resources. The adequate resources condition has a wide meaning. The *FSA* will interpret the term 'adequate' as meaning sufficient in terms of quantity, quality and availability, and 'resources' as including all financial resources, non-financial resources and means of managing its resources; for example, capital, provisions against liabilities, liquidity and human resources. … The *FSA* will consider whether a *credit union* is ready, willing and organised to comply with these requirements when assessing if it has adequate resources for the purposes of this *threshold condition.*
>
> (5) *Threshold Condition* 5*:* Suitability. Essentially, this condition requires the *FSA* to be satisfied that a *credit union* is 'fit and proper' to be *authorised* and permitted to carry on the relevant activities. It will therefore have regard to all relevant matters. These will include whether there are any indications that the *firm* will not be able to meet its debts as they fall

457 COND contains guidance on the threshold conditions. Threshold conditions are the FSA's basic requirements against which an application for authorisation will be measured. See for details, *FSA's consultation paper 107*, available on FSA website at: http://www.fsa.gov.uk/pubs/cp/cp107.pdf

due and whether the *firm* has taken reasonable steps to identify and measure any risks of regulatory concern". [458]

Some of the conditions mentioned above, such as the legal status of a bank, its location etc., are entirely straightforward. No bank should have difficulty meeting them. The two key conditions are that a bank must have adequate resources and must have reasonable systems and controls to manage the type of business it wishes to undertake in a reasonably sound and prudent way. That will include systems to guard against money laundering.

In the context of the UK's increasingly integrated financial services industry, in which distinctions between banks, building societies, investment intermediaries, insurance companies and so on, have become increasingly blurred, the argument is made for moving away from a fragmented supervisory and regulatory structure (in which banks were separately regulated), to a centralised form of regulatory control under the FSA.

The major development in the realm of Islamic finance in the UK has been the opening of the Islamic Bank of Britain Plc under the FSMA. This Act authorised the first purely IB in Europe, the Islamic Bank of Britain Plc, to offer the Shari`ah compliant financial products. The Islamic Bank of Britain Plc has started a sister bank - the European Islamic Investment Bank (which incorporated on January 11, 2005 to become Europe's first Islamic investment

458 Financial Services Authority (FSA). 2001. "Draft Rules", *Credit Unions Specialist Sourcebook*, August. pp.44-46.

bank), along with the Bahrain-based Islamic Joint Venture Partnerships and has approached the FSA for a license.[459]

10.2 The UK's Tax Proposals for Shari`ah Compliant Products on Islamic Financial Services Providers and their Users

Under the Shari`ah the receipt and payment of interest is expressly forbidden and in order to ensure that this criterion is not breached, financing arrangements are often structured in such a way that they do not result in the payment of *riba*. This can, obviously, lead to difficulties, with payments often being regarded for taxation purposes as a distribution as opposed to interest.

In many countries, tax rules are geared towards dealing with the non-Islamic form of banking. However, there is a new trend to incorporate legal rules which deal with the taxation of Islamic finance in the tax codes of both Muslim and non-Muslim countries. Due to the increasing importance of IBs in modern economic life, it is important that clear and equitable rules ought to be formulated to deal with Islamic finance.

Over the last few years, tax law has been amended in the UK. The objective of these amendments was mentioned in the 'Regulatory Impact Assessment for the Shari`ah Compliant Financial Products' prepared by HMRC's directive:

459 See "Islamic Banking Shows Growing Global Trends", available on VIPLoan website at: http://www.viploan.co.uk/Banking-1086.shtmlowing shows growing global trends (accessed May 07, 2005).

"The objective is to ensure that Shari'a compliant financial products are taxed in a way that is neither more nor less advantageous than equivalent banking products without facing commercial disadvantage, and to enable customers to take up these products without encountering uncertainty or disadvantage over tax treatment …Shari'a compliant finance is an important part of life for this faith group and the UK is committed to removing discrimination and unfair impediments. Shari'a compliant financial products are available to both Muslims and non-Muslims, so all consumers should have the opportunity to take up these products without facing undue tax barriers. The tax proposals for Shari'a compliant products apply equally regardless of the faith of provider or customer". [460]

10.2.1 Taxation of Shari`ah Compliant Financial Products: Recent Developments

A revised proposal of the Budget Bill originally tabled in 2003 was presented in 2005 addressing tax issues specific to Islamic financial products. In this proposal, the UK relevant authority have confirmed their intention to place Shari`ah compliant financial products on an equivalent basis to other conventional financing products with a view to ensuring that taxpayers entering into such arrangements are not unduly disadvantaged. The new measures which have been announced by the Chancellor of the Exchequer in this regard are as follows:[461]

- "Corporation Tax, Income Tax and Capital Gains Tax rules are to be changed. This will allow the Islamic equivalents of loans and deposit accounts - based on Murabaha and Mudaraba contracts - to receive the same tax treatment as equivalent banking products.

460 "Regulatory Impact Assessment for Shari'a Compliant Financial Products", available online at: http://www.hmrc.gov.uk/ria/sharia.pdf (accessed September 8, 2007).
461 HM Treasury, "New Measures Increase Fairness for Muslim Banking Products", *Press Release*, available online at: http://www.hm-treasury.gov.uk/newsroom_and_speeches/press/2005/press_31_05.cfm

- The removal of multiple payments of Stamp Duty Land Tax (SDLT) will be made more accessible in Scotland and will cover a newly available Shari`ah compliant product, known as Diminishing Musharaka. This will help house-buyers who want to finance their purchase without taking an interest-bearing mortgage".

The new Tax proposals i.e. the *Finance Act 2005* (FA2005) as amended by the *Finance Act 2006* (FA2006) introduced some new tax laws which apply to certain types of transactions if certain tests are met. They apply to all transactions of that type, regardless of who carries them out, and regardless of whether or not it is intended to fall within the Shari`ah. The above proposals also included important changes to remove the tax impediments to Shari`ah compliant Islamic finance products. The first Bill Proposal remedied a problem with the way in which stamp duty affected Shari`ah compliant home financing. The second Proposal extends the benefits of that change and alters the rules for income tax, corporation tax and capital gains tax to remove impediments to Shari`ah compliant saving and loan products.

The following is a summary of recent developments in UK corporate tax laws.

1. The FA2005 introduced new measures (known as "alternative finance arrangements") to tax the return on both *Mudaraba* based accounts and *Murabaha* based borrowing and lending transactions in the same way as interest on loans. This applies to tax relief for the borrower, taxation on the lender and the exemptions from withholding tax, as they apply to interest.

2. The 2006 Budget extends the range of Shari`ah based products to be included in the alternative finance arrangements. It includes both *Wakalah* (agency)[462] arrangements and *Musharaka Mutanaqisa* finance arrangements.
3. The 2006 Budget also proposed new legislation to incorporate *'Ijara wa 'Iqtina*-based financing arrangements into the HP legislation to allow capital allowances to be claimed by the customer.[463]
4. In March 2007 the Chancellor of the Exchequer announced in his budget that *Sukuk*[464] were to be given equivalent tax treatment to traditional interest-bearing bonds with the intention that London should eventually compete with Dubai and Kuala Lumpur in the development of new Shari`ah compliant financial instruments.[465]

The 'Regulatory Impact Assessment for Shari'a Compliant Financial Products' remarks regarding the developments made by the Government in its tax treatment for Islamic finance:

> "The primary policy objective is to remove an existing inequality that derives from the inapplicability of existing legislation to the taxation of Shari'a compliant financial products, and to offer genuine choice to consumers wishing to take up these products. The

462 The *Wakalah* is the delegating of a duty to another party for specific purposes and under specific conditions. Under this concept, the bank acts as customer's agent in completing a particular financial transaction against the payment of a certain amount of fee for the services it provides.

463 See Tony Urwin, Richard Iferenta, Theamhock Chew, Abdel H. Atalla, and Mohamed Nabih. 2006. "How Islamic financing instruments have developed?" *International Tax Review,* supplement - Financial Services - July.

464 The Arabic word *Sukuk* is the plural of Sakk, which is similar to the European root 'cheque', but in fact, it is an asset-backed, trust certificate or bond or securities showing evidence of ownership of an asset or its usufruct. The Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) - the regulatory and accounting standards body for Islamic finance – defines Sukuk as being: *"Certificates of equal value representing after closing subscription, receipt of the value of the certificates and putting it to use as planned, common title to shares and rights in tangible assets, usufructs and services, or equity of a given project or equity of a special investment activity".*

465 Macfarlane, Benjamin. 2007. "United Kingdom: London: The New Souk For Sukuk", *Banking and Financial*, available online at: http://www.mondaq.com/article.asp?articleid=47714, (accessed August 01, 2007).

Exchequer effect in the short term is expected to be minimal, but potentially positive in the long-term if more institutions offer such products, if the existing product range is expanded, and if the customer base continues to expand". [466]

10.2.2 The Key Concepts in the New Tax Proposals

There are some key concepts in the tax proposals of 2005 and 2006, with some new expressions describing "alternative finance arrangements" which give rise to two types of commercial return: "Alternative Finance Return" and "Profit Share Return". These are precisely designated in the statute. The legislation only operates where one of the parties to the contract is a financial institution as defined. If neither party is a financial institution, these rules do not apply even if one meets all the other tests. The definition of financial institution has five categories.[467]

1. A bank, as defined by the *Income and Corporation Taxes Act 1988* s.840A.

2. A building society, as defined by the *Building Societies Act 1986*.

3. A person licensed under Part 3, *Consumer Credit Act 1974*, to carry on consumer credit business or consumer hire business.

4. A person authorised outside of the UK to receive deposits from the public. UK taxpayers may find themselves engaging in Islamic finance transactions with foreign

466 See "Regulatory Impact Assessment for Shari'a Compliant Financial Products", *supra* note 453.
467 See Mohammed Amin. 2006. *UK Taxation of Islamic Finance – Where Are They Now?* 20 November, available online at: http://pwc.blogs.com/mohammed_amin/2006/11/uk_taxation_of_.html (accessed July 21, 2007)

IFIs. Unless the foreign institution falls within this definition, the new tax law will not apply.

5. A wholly owned subsidiary of a bank or building society also counts as a financial institution. The legislation is very precise: the subsidiary has to be wholly owned. If there is even one share of that subsidiary owned outside the banking group that subsidiary will not count as a financial institution.

As a further qualification, the new tax treatment only applies to a commercial return which equates, in substance, to the return on an investment of money at interest. As it is designed to mirror the tax treatment of conventional finance, it is limited to transactions, which are providing finance economically equivalent to debt, and does not apply to something which is economically in the nature of equity participation.

If all of the definitions of the tax law are met, then the customer's expense is treated, for all tax purposes, in exactly the same way that interest would be treated. The law is very careful to avoid saying that the item is interest. At the same time, the financial institution is treated exactly as if it were paying or receiving interest.

In the case of foreign investors, the activities of the financial institution, either as an agent or as a borrower, will not cause the foreign investor to have a UK taxable presence.

10.2.3 Application of the New Tax Proposals to Islamic Finance

Since 2003, the UK government has introduced a number of measures equalising the tax treatment of Islamic housing finance with a view to creating a level playing field for financial institutions and customers. In 2007, secondary legislation bringing certain categories of Islamic housing finance into regulation will come into effect. Alternative Finance Return, when legislated in FA 2005, only applied to contracts which followed the *Murabaha*. In FA 2006, it was extended to *Musharaka Mutanaqisa* in the legislation. Profit Share Return when legislated in FA 2005 only applied to a *Mudaraba* contract with a deposit and payments on that deposit deriving from the profits of a commercial venture. In FA 2006 it was extended to a *Wakalah* contract with an agency arrangement. It is worthy of noting that the relevant tax law never uses terms such as *Mudaraba* or *Wakalah.* It only uses the definitions of the transactions as set out in the tax legislation.[468]

I. Direct Tax Implications: Murabaha

The precision of the law can be illustrated by looking in more detail at the rules governing *Murabaha* set out in FA 2005. The law refers to two parties, the first party and the second party. Using the same language; say that the second party is a customer who wants some goods, either for use in its own business or to sell them immediately to raise cash. The first party sells those goods to the second party. For the new rules to apply, one or both parties must be a financial institution. If the second party is a financial institution, and the first party is not, then the first party has to sell these goods immediately on purchase. If the first party has owned these goods for certain period of time, the contract falls outside this new tax law.

468 *Ibid.*

Conversely, if the first party is a financial institution, it does not have to sell immediately; it can also have owned the goods for certain period of time. However, in the case of a non-immediate sale, the law then requires that the first party must have bought the goods for the purposes of sale under a contract within these definitions.

II. Direct Tax Implications: Musharaka Mutanaqisa

Again, the relevant provision in the FA 2006 is very precise. The financial institution can share in any losses on the asset. If the bank were unable to share in any losses on the asset, then this contract would probably fail to be Shari`ah compliant and nobody would ever use it.

However, FA 2006 states that the bank cannot participate in increases in the value of the asset. This could become a problem. While there are some DM contracts that are based upon the original purchase price, there is also a move by some organisations to have a contract which allows the financial institution to participate in the growth of the asset. This is regarded by them as perhaps being slightly better from a Shari`ah perspective. Unfortunately, such a contract does not satisfy these new tax rules.

One can do a sale and lease back. The law doesn't say that the asset has to be bought from a third party, it could be sold by the eventual owner to the bank with the eventual owner then paying rent and gradually buying back the property. That is economically equivalent to remortgaging a property one already owns.

Islamic home purchase plans became a regulated activity on 6 April 2007 pursuant to the FSMA 2000 (Regulated Activities) (Amendment) (No.2) Order SI 2006 No 2383. This will have a marked effect on the way such business is conducted and marketed to residential customers.[469]

III. VAT Implications: Murabaha

The UK has not changed VAT law to fit in with the Alternative Finance Arrangements legislation, because it is constrained by the European Union treaties, in particular the Sixth Directive that sets out how VAT is intended to operate throughout the EU.[470]

There are discussions underway at EU level to see if the Sixth Directive can be modified for Islamic finance. Pending any change, one looks at a *Murabaha* contract for VAT purposes and analyses it in the same way as one would have prior to FA 2005.

The first party starts by buying some goods. If those goods are in the UK and they are goods of a type subject to VAT; that gives rise to input VAT for them, which they may or may not be able to recover. The sale from the first party to the second party again is a taxable sale, with VAT that the second party may or may not be able to recover.

The application of VAT may not always be undesirable. For example, if the second party is a fully-taxable person, then they can recover the VAT. Conversely, if the first party is a bank buying these goods for the express purpose of reselling them, then it should be able to

469 See Tariq Hameed, *supra* note 298.
470 See Mohammed Amin, *supra* note 460.

recover the VAT on the cost of the goods. Furthermore, the taxable activity that the bank is now carrying on might help it to recover some of the VAT on its other overheads.

IV. VAT Implications: Other Shari`ah Compliant Products and Services

When considering the application of VAT to Islamic finance, it is important in the first instance to analyse all aspects of the service or product, and consider the VAT treatment under the current rules. In some cases, the analysis will be relatively straightforward. For example, as regards an operating current account, the fees and charges for a conventional account and a Shari`ah compliant account are the same. As a result, those fees and charges will have the same VAT exempt treatment.

The real challenge arises from the need to structure more complex Islamic financial services and products to be both Shari`ah compliant and VAT neutral. For products and services such as savings accounts, loans, HP transactions, insurance and bonds, the products have to be structured for Shari`ah compliant purposes as commodity transactions to avoid interest being charged. As VAT is a transactional tax, the VAT treatment of such products may not necessarily be the same as that applied to conventional products without careful structuring and, possibly, negotiations with HM Revenue & Customs.

A corresponding, but equally important, issue facing institutions offering Shari`ah compliant products is VAT compliance. The nature and structure of the transactions can complicate the institution's partial exemption methodology that can be applied to determine the proportion of its overhead VAT that should be recoverable.

Furthermore, the importance of trading commodities in Islamic finance transactions raises particular concerns. First, as the commodity transactions tend to be quite high in value, an error in VAT accounting can result in severe consequences. Second, the rules for commodities are very complex and require careful management. The nature, location and trading process can all have an impact on the VAT treatment.

A final point is the issue of interest, both default and statutory. At a basic level, an Islamic finance institution would not want to be faced with default interest charges. Conversely, they would not want to be paid statutory interest (which, in practice, would likely be donated to charity). As a result, it is incumbent on such businesses to be very prudent with their VAT accounting, to avoid being levied with default interest.

With Shari`ah compliant products coming onto the market every day, the VAT treatment cannot be taken for granted. The development of new products will present intriguing challenges to VAT practitioners and legislators alike. In response, HM Revenue and Customs and HM Treasury in the UK have formed an Islamic finance working group, which held its first meeting in 2005. Furthermore, the European Commission is in the process of reviewing the EU legislation that governs the VAT treatment for the finance and insurance sector, and will be considering the Shari`ah compliant products in the course of their evaluation.

V. Tax Treatment of Takaful [471]

The Treasury is in the process of drafting laws which will govern the tax treatment of *Sukuk* issuance and *Takaful* products. In fact, the Chancellor of Exchequer will include enabling legislation for *Takaful* product in his next Finance Bill.

Mr Balls MP, the then Economic Secretary to the Treasury (now Secretary of State for Children, Schools and Families), emphasises:

> "… Alongside this statement on *Sukuk,* HMRC (Her majesty's Revenue and Customs) will be publishing guidance on how *Musharaka Mutanaqisa* or Diminishing *Musharaka* products will be treated for Capital Gains (tax) and Capital Allowances. This will provide certainty of interpretation. Similarly, HMRC plans to clarify uncertainty in the market over the tax treatment of *Takaful* products by publishing guidance on how these products will be taxed within the current rules". [472]

VI. Tax Treatment of Sukuk

Under the proposals laid out in the March 2007 Budget, *Sukuk* will in the future, be taxed in the same way as conventional bond transactions and it will therefore be possible to issue, hold and trade such *Sukuk* in the UK on that basis. And if companies that issue *Sukuk* meet the necessary conditions, they will also be able to qualify for the special tax regime that applies to securitisation companies. Before this proposed change, there was much uncertainty

471 The basic concept of *Takaful* is that of shared responsibilities, solidarity and mutual cooperation, which in turn provides for mutual financial security and assistance to safeguard participants against a defined risk. In modern time the term is used as insurance which complies with the *Shari`ah* and is based on co-operative principles.

472 HM Treasury, speech by Mr. Ed Balls MP to the Euromoney Conference on Islamic Finance, 30 January 2007.

as to how capital gains tax, income tax and capital allowances would apply to Islamic Bonds.[473]

As outlined by the Chancellor of Exchequer, income payments will be treated as if they were interest payments, so that the issuer will get a deduction in computing the tax liability. In addition, there are provisions which equate *Sukuk* to traditional debt securities for other tax purposes such as the 'qualifying corporate bond' regime and the tax treatment of discounts. By treating *Sukuk* in the same way as corporate securitisations, a level playing field is being created, which will facilitate the issuance and trading of *Sukuk* in the UK. This will widen the choice of products for all investors, including those businesses which want to diversify their investor base and tap into the immense pool of Islamic funds in the Middle East.[474]

10.2.4 Stamp Duty Land Tax

The changes in FA 2005 and 2006 were needed to give certainty of treatment for income tax and corporation tax purposes. However, transaction taxes can also have a greater impact on Islamic finance than on conventional finance. One example is SDLT, where a specific relief was therefore legislated in 2003 when SDLT itself came in.

Without special relief there would be two SDLT charges: one when the financial institution buys the property and another when the eventual owner buys the property from the financial institution. There could also be SDLT on the lease to occupy the property. Conversely, with a

473 Meanwhile, the *Finance Act 2007* saw HMRC expand the range of bonds eligible for the status to include *Sukuk*. The move means *Sukuk* will, in principle, be a qualifying investment for investment savings accounts and child trust funds, subject to satisfactory listing requirements and, for ISAs, meeting the five year requirement. See *Financial Times*. 2007. issue 27 August, available on Financial Times website at:
http://funds.ft.com/funds/morenews.do;jsessionid=6C4B2B8957739C993106DE92E739FBE0

474 See Benjamin Macfarlane, *supra* note 458.

conventional mortgage, SDLT only gets paid once when the property is first acquired under the mortgage. There is no further SDLT when the mortgage is repaid/redeemed.

This relief from SDLT was originally only available where the person renting or buying the property was an individual. In FA 2006, the relief was widened because it was recognised that Muslims not only wanted to use this approach for the acquisition of personal residential property but also to acquire property for their businesses in a Shari`ah compliant way and such a business might well be conducted by a company. Now this relief is available for any person who is renting and buying, whether an individual, a partnership, or a company.

The definition of a financial institution for this SDLT relief is narrower than for the alternative finance arrangements in FA 2005. The Consumer Credit Act license qualification is absent in the SDLT legislation. Perhaps more importantly, the foreign authorised deposit taker qualification is also absent. This difference may not arise from deliberate policy, but simply from the SDLT legislation being older than the FA 2005 rules. However, unless the law is changed, a foreign institution that does not qualify as a bank under UK tax law cannot carry out Islamic home finance transactions in the UK without a double SDLT charge.[475]

Conversely, to illustrate the differences in the legislation, the SDLT rules permit the financial institution to participate in an increase in the value of the property, because there is no express prohibition, unlike the FA 2006 rules dealing with DM.

475 See Mohammed Amin, *supra* note 460.

Customers of DM products who were individuals have benefited from the 'level-playing field' legislation since 2005. Sections 71A of The FA 2003 (as amended) exempted steps 2 and 4 (mentioned earlier) of a DM from incurring a SDLT liability although the financier will invariably require the customer to pay SDLT in respect of Step 1. Pursuant to s. 168 of the FA 2006, such exemptions were extended to customers who are 'persons' and thus applicable to incorporated companies and partnership since 20 July 2006.[476]

10.3 The Objectives of the UK's Financial Regulations and Their Application to Islamic Banking

10.3.1 The Aims and Objectives of the UK's Financial Regulations

The aim of the UK Treasury is to enable the Islamic finance market to develop and flourish; to help the industry go 'from strength to strength' and to cement London as one of the global centres for Islamic finance and trade. London is already the preferred legal jurisdiction for Islamic finance transactions, with freedom to contract under English law complementing Islamic law. While it is not located in the Islamic world itself, London hopes to become a centre for Islamic Finance by taking advantage of its status as perhaps the most global financial centre in the world. In particular, Prime Minister Gordon Brown announced, while still Chancellor of the Exchequer, his intention to make London a hub for Islamic Finance.[477] With regards to the key objectives of the UK's financial regulations, it is worthy of noting that under the UK's existing regulatory environment many individual Muslims are able to

476 See Tariq Hameed, *supra* note 298.
477 See Alexander G. Leventhal. n.d. "Hubs of Islamic Finance", Alexander G. Leventhal (ed.), *Convergence: New Directions in Islamic Finance?* Arab Financial Forum, Harvard University.

choose from a range of Shari`ah compliant financial products, all of which must meet the following three key objectives.[478]

1. The products and firms involved must meet the basic European Union (EU) Directive requirements that are set in place to protect consumers and investors.
2. Those involved - whether as shareholders or customers - must understand what exactly is being offered.[479]
3. Those providing the services must be wholly professional and competent in what they do. There can be no benefit to anyone (and certainly neither to devout Muslims nor to regulators) from the slightest suggestion that the probity and competence with which Shari`ah compliant products are provided are in any way less than those of conventional financial products.

10.3.2 The Relationship between the Objectives of the UK's Financial Regulations and Islamic Banking Structures

The powers given to a bank within the EU are so considerable that, inevitably, regulators need to spend a good deal of time and effort with an applicant bank, trying to establish whether indeed it has the capital, the systems and the competence to run the bank successfully. Most importantly, the regulator needs to spend considerably more time with a prospective bank testing out these strengths than it would have to do with a financial organisation that was set on providing a much more limited range of financial services.

478 Foot, Michael. 2003. "The Future of Islamic Banking in Europe", speech delivered at the 2nd International Islamic Finance Conference, Dubai, 22 September, available online at: http://www.fsa.gov.uk/Pages/Library/Communication/Speeches/2003/sp150.shtml (accessed at July 21, 2007).

479 There will only be long-term damage to the cause if unrealistic expectations are created of what can be achieved.

Many Shari`ah compliant financial products are provided within the EU by companies that are not banks. This is mirrored in the conventional sector where many banks offer residential or commercial mortgages while many mortgage lenders have never been and have no interest in being a bank. Unlike the pre-1998 period, the FSA being single regulator is now responsible for the regulation of the whole range of banking, insurance and investment products in the UK. Therefore, the FSA is able to help address Muslim aspirations across the whole range of financial services.[480]

10.3.3 Islamic Banking under the Current UK Regulatory System

As discussed earlier in this section, the FSA operates under a single piece of legislation that applies to all sectors, the FSMA 2000. The FSA's policy towards IBs, and indeed any new or innovative financial services company, can be summed up simply as 'no obstacles, no special favours'. The FSA is keen to promote a level playing field between conventional and IFSPs. One thing the FSA is clear about is that it is a financial, not a religious, regulator.[481] As the 'Regulatory Impact Assessment for Shari`ah Compliant Financial Products' prepared upon HMRC's directive, remarks:

> "Legislation was not tied to the Qur'an or the Islamic faith, but used intrinsic features of the underlying contracts under UK law to define the transactions to which the rules apply".[482]

480 See Michael.Foot, *supra* note 471.
481 Financial Services Authority (FSA), the U.K. n.d. "Islamic Banking in the UK", available on the FSA website at: http://www.fsa.gov.uk/pages/About/Media/notes/bn016.shtml, (accessed July 21, 2006).
482 See "Regulatory Impact Assessment for Shari'a Compliant Financial Products", *supra* note 453.

The Islamic Bank of Britain Plc and other financial institutions in the UK are now offering Islamic financial products that are economically equivalent to conventional banking products but do not involve interest or speculative returns. The first Shari`ah compliant home finance product in the UK was offered in 1997. Before legislation in 2003 to remove the double payment of SDLT on such products, however, the size of the market was limited and there were no other providers.[483]

In recent years there have been a number of prominent developments in the UK Islamic finance market, and there is now considerable interest in developing and marketing a wide range of products. Shari`ah compliant current accounts, savings accounts, and house purchase facilities are now available. All deposit takers must be authorised and regulated by the FSA. However, one of the most important issues for the FSA is that of Islamic deposits. The UK legal definition of a deposit is:

> "a sum of money paid on terms under which it will be repaid either on demand or in circumstances agreed by the parties".

In other words, money placed on deposit must be capital certain. For a simple non-interest bearing account there is no problem. The bank safeguards the customer's money and returns it when the terms of the account require it to do so. However with a savings account there is a potential conflict between UK law, which requires capital certainty, and the Shari`ah, which requires the customer to accept the risk of a loss in order to have the possibility of a return.[484]

483 *Ibid.*
484 *Ibid.*

The IBs resolve this problem by offering full repayment of the investment but informing the customer how much should be repayable to comply with the risk-sharing formulation. This allows customers to choose not to accept full repayment if their religious convictions dictate otherwise.

There are currently two broad types of Shari`ah compliant home purchase arrangements available in the UK: *Murabaha* and *'Ijara*. On 31 October 2004, the FSA assumed responsibility for the regulation of mortgages, including mortgage backed equity release products and *Murabaha*. However, neither home reversion plans nor *'Ijara* products fall within the framework of financial services set out by the FSMA and therefore, do not fall within the scope of FSA regulation. However, the Government recently consulted on whether *'Ijara* products should be included in the legislation to bring home reversion products into FSA regulation and the majority of respondents agreed that they should. Legislation to bring Home Reversion schemes into the scope of FSA regulation will be brought forward as soon as Parliamentary time allows.[485]

10.4 The Attitude of the UK Courts Towards the Shari`ah

Upon investigating the ways in which the Shari`ah compliant financial products and institutions have been received in the UK, it has been suggested that the focus has been roundly on issues of compliance rather than value. For one commentator, the main question for UK regulators is whether the proposed business conforms to the requirements of existing

485 *Ibid.*

law, and in particular whether it offers adequate protection to investors. There are a lot of other issues too which impact upon the reception of IFIs in the UK. Not least are those banking risks which must be guarded against, particularly in the light of Basel II. Such risks include credit, market and operational risk, credit concentration risk and liquidity risk and the question is the ability of the Shari`ah compliant products to protect against these. Further questions surround transparency, or the lack of it, whilst there is uncertainty surrounding accepted accounting practices. Meanwhile, the Islamic traditions of running equalisation accounts and rewarding investors for their participation pose a host of searching questions of their own.

The following case is perhaps representative of the attitude of the UK courts towards the Shari`ah. A decision of the English Court of Appeal illustrates the difficulties parties may face in having their agreements construed in accordance with the Shari`ah.

10.4.1 *Shamil Bank of Bahrain EC V Beximco Pharmaceuticals Limited and Others [2004]*

In the matter of Shamil Bank of Bahrain EC v Beximco Pharmaceutical Limited and others, a number of Bangladeshi companies and their directors (in their capacity as guarantors) challenged the court's finding that they owed large sums of money to the Shamil Bank of Bahrain. The monies had been advanced to the companies under the *Murabaha* agreement. The agreement contained the following choice of law provision: "Subject to the principles of the Glorious Shari'a, this Agreement shall be governed by and construed in accordance with the laws of England". Because the only legal difficulties with the contract were those under Islamic law, the London High Court looked to the complex set of issues surrounding the

questions of whether the principles of the Shari`ah had in fact been violated and whether the court should address that question at all. Since no court had previously addressed these issues, the English Court had occasion to break new ground in dealing with them.

The companies had argued that the agreements were only valid and enforceable insofar as they were in accordance with the principles of both English law and the Shari`ah. They argued that the agreement was invalid under the principles of the Shari`ah as it was, in fact, disguised loans at interest. This meant that it was unlawful agreement to pay *riba* and, as such, unenforceable. However, this argument was rejected by the judge at first instance, who concluded that he was not concerned with the Shari`ah at all.

The judge, referring to the rules of international law, concluded that parties are free to choose which law will govern their agreements. However, such choice of law must refer to the law of a country rather than a non-national system of law or legal system which applies to other aspects of life, such as the Shari`ah. It seemed unlikely that the agreement had intended the English courts to adjudicate on the nature or application of such controversial religious principles. The judge was of the opinion that the reference to the contracts being "subject to the principles of the Glorious Shari'a" was merely notification of the fact that the Bank was conducting itself according to the Shari`ah in the opinion of its own religious board.

Before the appeal court, the companies accepted that international law precluded the choice of the Shari`ah. However, they argued that it was not inconsistent with international law for a codified system of rules to be incorporated into English law and this was the essence of what

the court was being asked to do here. Also, it was not unreasonable for the English court to be asked to consider and apply the Shari`ah, given the expert evidence that had been put before it and the fact that the aspects of the Shari`ah involved were not controversial.

The appeal court ruled that the aspects of the Shari`ah involved could not be held to have been incorporated into English law in this case. The companies had not identified the specific 'black letter' provisions that were to be incorporated into the contract and thus the reference to "the principles of Shari'a" stood unqualified as a reference to the body of the Shari`ah generally. As such the principles of the Shari`ah were repugnant to the choice of English law as the law of the contract and were, in effect, meaningless. The court adopted the view of the judge at first instance that the words were simply intended to reflect the Islamic religious principles under which the Bank held itself out as doing business.

The English Court made it unmistakably clear that it would generally uphold agreements in which religious Islamic parties are participants so long as the agreements can be reconciled with English law. Furthermore, English courts will not take the place of the Shari`ah boards by reviewing a contract's consistency with Islamic law. The judgment takes care to secure substantial legal certainty for financial institutions. It thus shifts and reduces the particularities of Islamic finance to the preparation of the contract and the internal review of the relevant materials. This ultimately makes dependable legal advice necessary.[486]

486 For summaries and comments on this court case, see Adam Greaves. n.d. *Governing Law Clauses in Morababa and Ijarah Agreements: The Court of Appeal's Decision in Shamil Bank of Bahrain Ec v Beximco Pharmaceuticals Limited and Others (2004)*, available online at: http:// www.steptoe.com/assets/ attachments/19.pdf, (accessed March 18, 2007); Brewer Consulting, *Choice of Law Clauses (2004),* available online at : http://www.brewerconsulting.co.uk/cases/CJ0449RR.htm, (accessed March 18, 2007); Lovells (International Law Firm), *Shariah Law in the English Courts (2004),* available online at: http://www.yasaar.org/pubs/ (accessed March 18, 2007).

10.5 The Relevance of the UK Approach to the Australian Experience in Islamic Banking

As has been discussed earlier in this study, Islamic finance in Australia has been growing rapidly since it was first introduced in 1989 with MCCA. Since then, a number of IFSPs have come into existence in the Australian financial services market during the past decade and some international financial institutions are also considering the introduction of Islamic banking branches and subsidiaries.[487] There is no formal legal and regulatory framework or infrastructure in existence in Australia for guiding and supervising the functions of IBs and other IFIs operate in line with the precepts of the Shari`ah.

The legal and regulatory framework of the financial sector in Australia, unlike the UK, consists of a multiplicity of bodies, such as (1) RBA; (2) the APRA; and (3) the ASIC. Under subsection 9(3) of the *Banking Act 1959* an authority to carry on all kinds of banking business in Australia was granted by the APRA to the then MCCU in December 1999. Australia's new community banks (which have emerged largely due to the closure of traditional branches in smaller towns and are funded and operated by local townspeople), and community-based Islamic co-operative financial institutions were registered and given licenses to carry on Co-operative businesses under the *Co-operatives Act 1992*.

Unlike the FSA in the UK, a uniform regulatory and legal framework supportive of an Islamic financial system has not yet been developed in Australia, which resulted in obstructing Islamic finance in its effective and smooth functioning in accordance with

487 These are HSBC and CitiBank. See "Datamonitor Report", September 2004, *Australian Mortgages 2004*, available online at:
http://www.datamonitor.com/~ee1532b3e34d4986932858d8d0acf4ac~/Products/Free/Report/DMFS1726/010DMFS1726.

Islamic principles. Thus, in order to support the operational soundness, Islamic banking and finance should be equipped with a proper set of regulatory and supervisory instruments that fit its operational activities. On this matter the UK model would represent best practice for Australia. While new regulations have been developed and foundations for regulatory instruments have been laid by the Australian banking regulatory authorities in this regard, it still has a long way to go compared to the UK.[488]

According to a report published in the VIP News, the authorities from the Canadian and Kenyan central banks visited the FSA and met with representatives of the local banks who have taken the step of starting Islamic banking operations like the Islamic Bank of Britain Plc, ABC International Banks, Lloyds TSB and HSBC Amanah. These two central banks are planning to adopt the UK model for enabling investors to start Islamic banking practices in their own countries. They will also issue licenses in their countries for stand alone IBs. Both banks will then approach the market through private placements to raise further equity funding.[489] Given the success of Islamic banking and finance practice under the existing legal and regulatory environment in the UK, and its growing global trends, it is most important that consideration be given to the adoption of the UK model of regulatory framework for Islamic banking and finance into Australia. In this regard, the Australian regulatory regime must develop regulations so as to make Islamic finance a viable alternative system of financing for Muslims in Australia.

488 For detailed discussion on the application of the UK move towards Islamic Banking to Australian experience see Abu Umar Faruq Ahmad and M. Kabir Hassan. 2006. "The Adoption of the UK Finance Bill Proposals on Islamic Finance into Islamic Banking in Australia", *Review of Islamic Economics,* Leicester U.K. vol. 10, No.1, 2006. pp. 41-57.
489 See VIPLoan website, *supra* note 452.

What then is the position of the Shari`ah in the UK, and what lessons does it offer for Australia? In other words,

1. has the UK remedied the problem of divergence of Islamic Finance from the traditional Shari`ah?
2. to what extent has Islamic Banking adapted itself to the UK Financial System?
3. how will the UK Financial Services Bill Proposals on Islamic Finance fare when examined in reference to the Australian Banking and Finance Regulation? and
4. is the new UK model appropriate for adoption into Australia?

1. In relation to the issue whether the UK has solved the problem of divergence of Islamic finance from the traditional Shari`ah it is noteworthy that like elsewhere in the world the sole responsibility of solving this sort of problem lies directly with the respective Shari`ah Boards/Councils of the IBs and IFSPs. The following comments made by Michael Foot, the Managing Director of the FSA, regarding the issue are worthy of mention.[490]

> "We will no doubt continue to play that role in respect of shari'a compliant products too (and in some cases our rules will leave us no choice). However, I think it is also true to say that we shall be looking for help from experts wherever we can find them. And I should also add – though it is probably unnecessary for me to say this – we shall have neither the ability nor the desire to monitor a bank's actual

490 See Michael Foot, *supra* note 471.

shari'a compliance. That has to be something for the shari'a board and for the institution itself".

Generally, it is under the jurisdictions of the Shari`ah Boards/Councils of respective IBs or IFSPs to monitor their functions from the Shari`ah perspectives and to evaluate every new transaction to make sure that it is Shari`ah compliant. Yet the laws of and regulations of the Shari`ah are open to interpretation and the Shari`ah Boards/Councils often have divergent views on the key Shari`ah issues. In this regard, there is no practical guide as to what constitutes an acceptable Islamic financial instrument. A document or structure may be accepted by one Shari`ah Board/Council but rejected by others.

2. Regarding the issue of the extent to which Islamic Banking practice has adapted itself to integrate with the core Financial System of the UK, even if the regulator did not exist or did not require the conditions to be met to function as IBs, they would in any case be necessary for the commercial success of the operation. So, it is of paramount importance for Islamic banking and finance to adapt itself to the mainstream of the core Financial System of the UK for its own interest. It is helpful that many of the financial products commonly used in the UK - for example, current accounts and savings products, such as investment funds or unit trusts, or borrowing through leasing or HP products - already have some, at least, of the characteristics consistent with precepts of the Shari`ah.

3. The above discussion of the UK Financial Services Bill Proposals on Islamic Finance and the existing Australian Banking and Finance Regulation in this section has demonstrated that for example, the way the Australian Shari`ah compliant housing finance product is structured means that stamp duty would be levied twice on a single property purchase. This additional levy would obviously make the product uncompetitive. It is therefore suggested that the government should consider making changes to the stamp duty legislation to recognise this problem and facilitate the levying of a single charge on what in effect is a single purchase.

4. In line with the legislation in the UK which has given ethical funds a significant market advantage, an amendment to the Financial Services Reform Bill (FSRB) requiring superannuation funds and fund managers to disclose their policy on ethical investment has been passed by the Australian Parliament in 28 August, 2001. The amendment will require all financial services product disclosure statements to outline "the extent, if any, to which labour standards, environmental, social or ethical considerations are taken into account in the selection, retention or realisation of the investment".[491] The legislation creates an imperative for the investment community to get up to speed on socially responsible investment.

It may be argued that since the Australian Muslim community avail themselves of existing conventional interest-bearing products, they are unlikely to switch to the new Shari`ah compliant products offered by IFSPs of Australia. However, if the Shari`ah compliant

491 See Ethical Investment Association of Australia (EIA), *supra* note 300.

products are properly structured and competitively priced it is expected that many people will switch to Islamic financial services. Certainly, new buyers will seriously explore these facilities. As the range and scope of these products builds up, the saving and borrowing patterns of Australian Muslims are likely to change. And as the volume of financing builds up, the underlying ethical base of Islamic financial products will begin to make its mark on the market. At that point, it is reasonable to expect that many non-Muslims will also be attracted to these products. In time, these products may provide a valuable bridge between different communities and interest groups in Australia.

Furthermore, it is expected that if a better and more precise understanding of Islamic financial products is made and the Muslim community of Australia are encouraged to develop a more consistent - and desirably more standardised - specification of the products they wish to introduce, then ways of fitting them into the Australian legal and regulatory framework on a par with its more traditional financial products can surely be found.

CHAPTER 11

SUMMARY, FINDINGS AND RECOMMENDATIONS

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11.1 Summary and Findings of the Study

The objectives of this research project were two fold. The first aim was to analytically study the extent to which IFSPs of Australia differ from the traditional Shari`ah in their current practices of Islamic legal financial system by their use of different financial products and techniques. While the second purpose of this study was to create awareness and transparency about the various products and instruments used by IFSPs of Australia. However, it did not attempt to evaluate the economic efficiency and profitability or otherwise, of IFSPs in Australia. In line with its objectives the investigations were carried out through conducting the following.

At the outset, a methodological approach to introduction of the sources of the Shari`ah, main Schools of Islamic Jurisprudence and the application of the Shari`ah principles of financial transactions to Islamic finance was developed. Then, theories of financial regulations and historical evolution of financial products were elucidated aiming at providing the contextual background required for the research. The study also investigated the practice and compliance requirements of Islamic finance in the Australian legal context. Following that, it attempted to critically examine the extent of divergence of Australian IFSPs from the strict Shari`ah compliance in their current use of different financial products and instruments.

Finally, the study proposes to adopt a new Bill Proposal on Islamic Finance following the UK model in a move to establish an Islamic Bank which would contribute to growing Muslim community in Australia to find a truly viable alternative for banking and finance based on religious and ethical considerations.

Given the above, the review and findings of the study that aimed at examining law and practice of modern Islamic finance in Australia have been summarised as under:

- The Shari`ah comprises the set of laws by which a Muslim society is controlled and governed, and it provides the means to find the way out of conflicts among the members of society. There is no disagreement among Islamic legal scholars that the Qur'an is the basis of the Shari`ah and the *Sunnah* is complementary source to the Qur'an. The *Sunnah* makes possible to understand the contents of the Qur'an, but it may not be interpreted or applied in any way which is not in agreement with the Qur'an. With regard to the *'Ijma`* - the third source of the Shari`ah, these are the rules developed due to debate and subsequent consensus among Islamic legal scholars and the community as a whole. When these three key sources of the Shari`ah fail to provide befitting guidance, they are supplemented by a method in which the jurist can draw analogies with the first three sources and that is known as *Qiyas*. The rest of the methods of the Shari`ah for developing judgments that have been categorised as supplementary sources, each of them allows increased use of judgment by the jurist. These latter sources allow for the development of the Shari`ah in more moderate jurisdictions, but are rejected in more conservative jurisdictions.

- Consistent with Muslims' belief, the process of ruling based on the Qur'an and the *Sunnah* led them to discussion then to difference of opinion, academic debate, and ultimately to proper methodical thoughts. This development concluded in the achievement of four great jurists of Islamic law lived in the 8th and 9th centuries. The excellence of juristic skill, adherence to the *Sunnah*, and religious zeal which are attributed to these rationalise their position as the eponymous founders of the four major Schools of Islamic law - the Hanafi, Maliki, Shafi`i, and Hanbali. This, by a continuing process throughout the 10th century, came to be the focus of allegiance to a majority of Sunni Muslims. They recognised each other and acknowledged a number of minor Sunni Schools, and, sometimes, to the Shi`i School, which gradually evolved in parallel with that of the Sunnis for the most part.

- Islamic financial system is based on keeping in view of certain social objectives for the benefit of society as a whole embodied with enhancing economic and social equality and justice for the good of society. This is so much so that many scholars of the Shari`ah have treated Islamic legal maxims for financial transactions as a branch of the Shari`ah objectives literature. Their wordings are occasionally taken from the Qur'an and Prophetic *Ahadith* but are more often taken the work of leading jurists that have subsequently been refined by other scholars throughout the ages.

- The components of Islamic finance are develops based on the prohibition of interest in addition to the emphasis on equitable contracts, the linking of finance to productivity, the desirability of profit sharing, and the prohibition of gambling. With regards to Islamic modes of financing they are either Equity-based or Debt-based financing. These revolve around the

following core products and instruments derived from Islamic commercial law: 1. *Musharaka* (PLS); 2. *Mudaraba* (investment partnership); 3. *Bai` Murabaha* (purchase and resale); 4. *Bai` Salam* (purchase with deferred delivery of goods); 5. *Istisna`a* (pre-delivery financing); 6. *'Ijara* (Islamic leasing) and; 7. *Qard Hasan* (interest-free loan). The application of these Islamic financial products is in the early stages, just as the development of a true Islamic economy is in its infancy. The transactions described in this study, and others, are efforts to lay the critical base and explore the use of a variety of Islamic techniques within a framework that must acknowledge the critical security, cultural, religious and legal concerns of both conventional and IFSPs' customers. And new products are being developed as more and more conventional financial institutions move into Islamic banking, which is an accelerating trend.

◘ There are a few theories that attempt to elucidate the existence and structures of regulation, including: 1. the 'competition for regulation theory' that suggests that there exists a market for regulation, in which consumers and producers compete; 2. 'capture theory' that proposes that producers capture regulatory agencies and control them in their own interests; 3. 'the public interest theory' which argues that regulation is an attempt to correct for market failures, such as monopoly, externalities and lack of information. On the other hand, regulation has some important dimensions. First, regulation is a cost; second, regulation has a time element; and third, regulation should not prevent the effective working of the market force.

- The international financial backdrop is persistently being changed with the rapid pace of globalisation, financial liberalisation and the advancement in technology. This has resulted in increased competition and the creation of new financial products and services. Given this reality, a phenomenal growth has been observed in Islamic financial products over the last two decades. Modern Islamic financial products and services are developed using two different approaches. The first approach is by identifying existing conventional products and services that are generally acceptable to Islam; and through modifying and removing any prohibited elements so that they are able to comply with the Shari`ah principles. The second approach involves the application of the various Shari`ah principles to facilitate the origination and innovation of new products and services. The study investigated in this connection how these contracts came to the age and what the major innovations in Islamic financial products and services being witnessed in historical evolution.

- There is no legal and regulatory framework in existence in Australia for guiding and supervising the functions of IFSPs to operate in line with the precepts of Islamic legal system. But the fact is that like their conventional counterparts the regulation of IFSPs is most effective where there is already a sound regulatory framework in place that provides for adequate reporting, monitoring of capital adequacy, risk management controls and customer disclosure. Given this, it is the regulatory authority which will address the issue of financial soundness. The IFIs in Australia were established in an environment where conventional financial services providers are already in the market. The crucial challenge in this regard is that IFSPs' customers must enjoy similar, although not necessarily the same, protection as customers of conventional financial institutions. At the same time, it is expected that

regulatory authorities would ensure there is a level playing field, so that neither IFSPs nor conventional financial institutions are disadvantaged. In Australia where Muslims are minorities and full fledged IBs are absent, regulators have nevertheless been expected to approve and monitor Islamic financial products, including those offered by Islamic managed funds.

- From a regulatory perspective the significant foundation is to accept that the fundamental principles of conventional financial markets regulation apply with equal force to Islamic financial markets. The key philosophies that distinguish conventional from Islamic financial markets may suggest that the regulatory building blocks for regulating Islamic finance need to be different from those used for conventional regulation, but in fact it is not indifferent from regulatory perspectives. The principles that strengthen conventional markets regulation are mainly designed to ensure that financial firms are able to deliver upon their promises - promises to cover policy holders' losses; or to repay investors or depositors upon particular terms agreed at the time of contract formation. Like other regulators, Australian regulatory authorities would like to be satisfied that Islamic financial markets have appropriate compliance and enforcement powers and practices; that the conventional and IFSPs are both in good standing with relevant international standard setters; and that they are committed to appropriate levels of information sharing and cooperation. If all of these hurdles can be overcome, obviously they can take comfort that differences of detail in regulatory approach will not prejudice consumers of the Shari`ah compliant products.

◘ Islamic finance in Australia is still in its early stages. Because of the character of most of Australian immigrants, lots of incoming Muslims here have naturally been more worried with how to support their families than with developing financial institutions. However, quite a few small financial enterprises have started; with at least three in operation at present namely the Muslim Community Co-operative (Australia) Limited, known as MCCA, Islamic Co-operative Finance Australia Limited (ICFAL) and Iskan Finance. MCCA and ICFAL are currently limited to providing facilities with their shareholders and are not allowed to accept normal bank deposits as like in many countries, Australian law normally does not permit taking deposits without an appropriate license. While Iskan works with a number of other providers and offers mortgage and leasing facilities.

Products and instruments IFSPs in Australia use to provide facilities to their shareholders and customers apparently look different because they use different Arabic nomenclatures, are limited to *Musharaka, Mudaraba, Qard Hasan, Murabaha, 'Ijara* and the combination of *Murabaha* and *'Ijara.* However, IFSPs in Australia are supposed to promote *Mudaraba* and *Musharaka* transactions which are based on the concept of PLS since there is no better example of the Shari`ah compliant financing than PLS finance. Given that these financial institutions are Co-operatives, both MCCA and ICFAL are supposed to share their customers' risks as risk sharing is the essence and spirit of Islamic finance. Nevertheless, in practice these institutions invest only a tiny portion of their portfolio in PLS transactions and a very big margin of their assets consist of *Murabaha* and *'Ijara* modes of finance, which in the view of some Islamic legal scholars carry interest veiled in Islamic costume.

- While comparing the different products practised by both IFSPs and conventional financial services providers in Australia it was found that inherently, the features of the Conventional HP loan and MCCA's *'Ijara wa 'Iqtina* and *'Ijara Muntahia Bittamleek,* the ICFAL's HP, and Iskan's *Tayseer-'Ijara* schemes for home, automobile, and consumer durable financing, for example, are quite similar. However, the differences between the two are: Firstly, IFSPs' above mentioned HP financing under different names is supposed to follow the Shari`ah principles as well as the spirit of the Hire-Purchase Act, while conventional HP follows only the Hire-Purchase Act. Secondly, the financing for IFSPs is sourced from *halal* funds whilst the conventional HP has no limitation of its sources of funds. Thirdly, there are two agreements involved under IFSPs namely the Leasing Agreement; and the Purchasing Agreement. Fourthly, under IFSPs, customers have to sign the Letter of Acceptance to signify the offer and acceptance of transactions whereas conventional HP does not have such agreements.

It was also found in comparison analysis between conventional mortgage and the SER systems practised mainly by MCCA and ICFAL among IFSPs that the relationship between the buyers and MCCA and ICFAL is amicable rather than antagonistic, where interests are harmonious rather than conflicting. The conventional mortgage being exploitative creates conflict, stress, and insecurity, while contributing to greater disparities of income and wealth. The SER financing, however, reduces conflict, stress and insecurity, and makes for a more harmonious and equitable society.

The following comparative analysis of IFSPs' *Murabaha* mode of financing with interest-based conventional financing being carried out in this study is worthy of mentioning as it led to investigate the extent of IFSPs' divergence from the traditional Shari`ah while practicing this mode:

i) The *Murabaha* contract needs a bank purchases commodity required by an end-user and then the bank sells the article to the end-user at a price that is calculated using an agreed profit margin over the costs incurred by the bank. In the event of default by the end-user, the financier only has recourse to the items financed and no further mark-up or penalty may be applied to the sum outstanding with passage of time as in the case of amounts borrowed from conventional banks on interest.

ii) As in the case with conventional bank, no money is loaned to the customer in the event of a *Murabaha* transaction. Rather, the bank purchases the goods itself, based on the requirement of the customer. This ensures that financing is always asset-based.

iii) In a *Murabaha* transaction the bank assumes the risk by purchasing the commodity before it sells it at a mark-up. This mark up is considered as the reward of the risk it assumes. On the other hand, interest-bearing loans given by the conventional banks assume no risks whatsoever.

iv) In conventional financing the bank gives loans to its customers without ever being concerned how the money is being put to use, while in Islamic financing the bank cannot be unconcerned about the purposes for which the objects being sold is to be put to use.

Keeping in view of the above comparative analysis upon examining the *Murabaha* contracts practised by IFSPs in Australia it was found that their financing (pricing, outcomes etc.) was mostly similar to conventional products and instruments for not fulfilling the following key conditions:

1) As per *Murabaha* sale, the bank or financial institution should add a known fixed amount of profit to its cost price which has to be known to the customer. The cost plus the known profit amount is the price for which the bank sells the object. All other additions to this profit such as penalties for late repayments, service charges etc. are deemed to be null and void and hence would not be permissible.

2) To be in consonance with the principles of Islamic finance, *Murabaha* transactions may be undertaken only where the customer of a financial institution, wants to purchase an object. This type of transaction cannot be effected in cases where the customer wants to get funds for a purpose other than purchasing an object.

3) In a *Murabaha* agreement it is appropriate for the sale of a commodity for a deferred price, but this implies a trading transaction that takes some time to effect. The critical condition is that to make *Murabaha* a valid transaction it is necessary that the article is really

purchased by the financial institution and it comes into the ownership and possession (physical or constructive) of the financial institution, who assumes ownership responsibilities until the good is resold. Hence, the risks associated with ownership are borne by the financial institution, justifying the mark-up. If the buying and reselling come into effect on the spot then there is no real risk for the financial institution and the transaction becomes a legal fiction, which is certainly in conflict with the spirit of the Shari`ah.

- It was also found from the investigations of the degree of the divergence of Australian IFSPs from the Shari`ah in their practice and services that from IFSPs' contracts of *'Ijara wa 'Iqtina* and *'Ijara Muntahia Bittamleek* for Islamic housing finance it was not clear whether it was a lease contract, a purchase contract or a combination of the two. Nevertheless, when all of the above three transactions (i.e. *'Ijara, 'Ijara wa 'Iqtina* and *'Ijara Muntahia Bittamleek*) were taken individually, they were considered entirely valid. But the presence of a significant amount of ambiguity invalidated the contracts in accordance with the tenets of the Shari`ah. This is why the Islamic legal scholars hold the opinion that if rental and sale are mixed in such a way that one cannot distinguish at any point of time whether the customer is a tenant or a buyer, then such a contract is Islamically invalid.

11.2 Recommendations for the Study

This study makes the following suggestions and recommendations for consideration by regulatory authorities for Islamic banking and finance in Australia:

1. There is a strong desire and growing demand among and from Muslims for a fully fledged Islamic bank to function in line with the tenets of the Shari`ah. It is thus recommended that a fully fledged Islamic bank along with the Shari`ah complaint Superannuation and investment funds be established for nearly 350,000 Muslims living in Australia. The author believes the Australian government should take necessary steps to enable these growing opportunities to be pursued in this country. In this connection, following the UK model steps be taken to introduce legislation in the Australian Parliament for strengthening this country's Islamic financial market system. Such move to enact legislation by the lawmakers would contribute to the Muslim community in Australia finding a truly viable alternative for banking and finance based on religious and ethical considerations.

2. The study recommends IFSPs' conventional counterparts like NAB, CBA, ANZ etc. to introduce the Shari`ah compliant banking services side by side with conventional banking facilities being offered to prospective customers, since other global banking institutes such as HSBC, Citibank, Standard Chattered Bank have already entered these markets in a significant manner through their trans-national banking subsidiaries.

3. Recognising the problem that some financing instruments practised by IFSPs closely resemble interest-bearing instruments, it is suggested that more PLS instruments should be developed and used by these financial institutions. This is because PLS financing being a basis for equal distribution of wealth in the society is unanimously considered by the scholars of the Shari`ah as one of the most authentic forms of the Shari`ah approved financing and thus a real alternative for the conventional interest-based financing schemes. There is another legitimate reason to justify the importance of this proposition. Taylor and Evans concluded when comparing the traditional Western banking system with the Islamic banking system that both systems prohibit usury and permit any return from partnership provided that the partner making the investment genuinely shares the risk. According to these writers:

> "the closeness of the two systems (*conventional and Islamic financial systems*) is great and there is some evidence of common origins. Contemporary Western thought, however, has apparently removed itself far from its own tradition - hence the gap between Western and Islamic banking systems". [492]

4. Notwithstanding the fact that in practice using *Musharaka* as a mode of financing by IFSPs is difficult in the current conventional financial setup of Australia as IFSPs' investments under PLS are not regulated by the APRA. Under such adverse situations contemporary Muslim scholars have permitted the use of other non-Equity-based products such as *Murabaha* and *'Ijara* as modes of financing. Islamic finance in Australia has currently introduced at least 5 basic Shari`ah compliant instruments which can be extended to

492 Taylor. T. and Evans. J.1987. "Islamic Banking and the Prohibition of Usury in Western Economic Thought". *National Westminster Quarterly Review*, November. p.26.

a wide, varied, and variegated menu of financial instruments. To this end, more creative techniques need to be undertaken to suit the financial needs of individuals and groups to facilitate their contribution in community development in particular and the economic development of Australia at large. Besides, this would facilitate IFSPs to provide greater security, liquidity, and diversity to meet the demand of investors in the Muslim community.

5. Currently all of IFSPs in Australia are providing investment facilities rather than retail banking services that are insufficient to meet the growing demands of Muslim community. In order to attract more customers, the providing of both forms of banking to the communities' religious needs and economic development of the country, it is suggested that Islamic investment and retail banking facilities be integrated.

6. The study recommends that the regulators in Australia introduce measures necessary to equalise the revenue duties liabilities of Islamic alternatives for interest-based mortgages with a view to creating a level playing field for financial institutions and customers. Given the differing treatment of similar financial products under the different State regulatory systems, it is suggested that the government consider making changes to facilitate the levying of a single charge on what in effect is a single purchase.

7. The co-operative nature of financial institutions among IFSPs, namely MCCA and ICFAL may merge with each other for their future growth and development through attracting more capital and providing investment facilities. This will help expand Islamic

finance that Australia's vibrant Muslim community could use comfortably as it would meet their religious as well as financial and market requirements.

8. This study also suggests that a strenuous effort be made to educate people before establishing fully fledged IBs to provide Shari`ah compliant retail banking products and services, given the high level of ignorance of the underlying philosophy and nature of Islamic banking and finance among the general populace and those associated with the industry. For example, it is not known to many people that one of the great successes and growth of Islamic banking lies in "its value-orientated ethos that enables it to draw finances from both Muslims and non-Muslims alike".[493] Also, since the Shari`ah contracts that are now used and advertised by IFSPs in Australia appear to be traditional mortgage contracts where the borrower takes the risk and the lender gets a fixed rate of return it is suggested that Muslim customers should be fully informed about the institutions with whom they enter into business relationships.

11.3 Suggestions for Further Research

The volume of research on Islamic banking and financial systems has considerably amplified over the past two decades. However, there are still many significant issues remain to be critically examined. In relation to the theory and practice of Islamic finance in Australia from legal and regulatory perspectives, which is the topic of the author's research, there is scope of more work to be undertaken. The author's research was somehow limited to theoretical and technical analysis. It should be followed by empirical studies and tests. Within a few years,

493 See for more information regarding this, "Status of Islamic Banking", available on Islamic Banking website at: http://www.islamic-banking.com/ibanking/statusib.php (accessed July 12, 2007).

sufficient volume of data on the Islamic banking and financial systems of Australia is expected t be available, to make such studies practicable.

Apart from the topic of this dissertation, there are other issues for further studies into Islamic finance in Australia. An interesting area of future study relates to exploring the potential for launching Shari`ah compliant banking services by IFSPs' conventional counterparts like NAB, ANZ, Westpac, CBA, St George Bank etc. side by side with the conventional banking facilities they offer for the prospective customers since other leading global banking institutes such as HSBC Amanah, Citibank, Standard Chattered Bank, Deutsche Bank and UBS of Switzerland have already entered the markets to offer Islamic financing facilities in a significant manner through their trans-national banking subsidiaries.

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GLOSSARY OF ARABIC TERMS

Ahl al-bayt: Literally, it means 'people of the house'. Technically, it refers to the household of the Prophet Muhammad (PBUH). The Sunni Muslims inclusively refer it to Prophet's family, his wives, children and companions. The Shi`as however have a restrictive view of its meaning as they only refer it to Prophet's daughter Fatima, his cousin Ali and their two sons Hasan and Husain and the nine *imam*s from the ancestors of Husain.

Al- 'Ashbah Wa 'al-Naza'ir [fi Furu` al-Shafi`iyya]: Literally, it means 'Similarities in the Branches of the Law Within the Shafi`i School'. It is an important manual for Shafi`i Islamic jurisprudence written by Jalal al-Din al-Suyuti al-Suyuti.

Al-Bai` Thumma al-'Ijar: Literally, it means 'buying then leasing'. Technically, it is a leasing contract which includes a promise by it as lessor to transfer the ownership in the leased property to its customer as a lessee by stages during the term of the contract.

Al-Hidayah: Literally, it means 'The Guidance'. It is an important manual for Hanafi Islamic jurisprudence written by Burhan al-Din 'Ali al-Marghinani, which presents the corpus of Hanafi law in its approved and preferred form and forges an organic link with the other schools of law.

Al-Istibsar [fima Khtulifa fihi min al-akhbar]: Literally, it means 'Reflection Upon the Disputed Traditions'. It is the fourth and last of the major works of Shiite Islamic School of thought compiled by Shaikh al-Taifah Muhammad al-Tusi (d.1068 C.E.).

***Al-Kafi [fi furu` al-Hanafiyyah]*:** Literally, it means 'That Which is Sufficient'. Prepared by Hanafi jurist Hakim Marwazi it is the condensed version of six major works of Muhammad bin Hasan al-Shaibani who recorded Abu Hanifa's opinions, decisions and writings. The six works are: 1) *Al-Jam`i al-Kabir* 2) *Al-Jam`i al- Saghir* 3) *Kitab al-'Asl* or *Al-Mabsut* 4) *Al-Ziyadah* 5) *Al-Siyar Al-Kabir* and 6) *Al-Siyar Al-Saghir.*

Al-Kafi [fi 'Ilm al-Din]: Literally it means 'The Sufficient in the Knowledge of Religion'. It is believed by to be a collection of the traditions taught by the Prophet Muhammad (PBUH) and the *Imam*s and handed down to the Muslim Community by the disciples of the *Imam*s.

Al-Mabsut: Literally, it means 'The Expanded (Reference Book)'. It is an important work of encyclopaedic size extending to thirty volumes written by famous Hanafi scholar Shams al-Din al-Sarakhsi (d.1090 C.E.), which ranks among the master legal books of mankind.

Al-Mudawwanah: Literally, it means 'The Enactment'. It is a collection of questions that people used to ask Imam Malik and the answers he gave to them. One of his famous disciples Sahnun was known to have listed most of them. *Mudawwanah* has been regarded as the foundation of *Fiqh* among the followers of Maliki School. It treated more than thirty thousand legal issues.

Al-Mukhtasar: Literally, it means 'The Concise Summary of Law'. It is an important manual for Maliki Islamic jurisprudence written by Khalil b. Isahq (b.1365 C.E.).

Al-Musnad: Literally, it means 'That Which is Ascribed To (something)'. It is a great collection of Prophetic *ahadith* compiled by Abu `Abdullah, Ahmad b. Muhammad b. Hanbal Al-Shaibani, known as Ibn Hanbal.

Al-Muwatta': Literally, it means 'The Well Trodden Path'. It is an early collection of some 2,000 traditions attributed to the Prophet Muhammad (PBUH) that compiled and edited by Imam Malik b. Anas. It is a code of law based on the legal practices that were operating in Medina. It covers various areas ranging from prescribed rituals of prayer and fasting to the correct conduct of business relations.

Al-Qur'an: Literally, it means 'Reading', or 'Recitation'. Technically, it refers to the messages revealed to Prophet Muhammad (PBUH) from Allah through angel Gabriel for a period of 23 years. The Qur'an has one text, one language (Arabic), and one dialect. In fact, no translation of the Qur'an can compare in beauty and style with the original Arabic.

Al-Risalah: Literally, it means 'The Message'. It is Imam Al-Shafi`i's first book written on the principles of Islamic jurisprudence. Its English translation is *Treatise on the Foundations of Islamic Jurisprudence* translated with an introduction, notes, and appendices by Majid Khadduri (Cambridge: The Islamic Texts Society, 1987).

***Al-al- Imamiyyah al-Ithna `Ashariyyah:*** Literally, it means 'The Twelver Imami Shiites'. Most Shi`i schools including Ja`fari school of jurisprudence is the name of the jurisprudence of the Shi`a Twelvers who follows these 12 *imam*s: 1. Ali b. Abu Talib (600–661), 2. Hasan b. Ali (625-669), 3. Husain b. Ali (626-680), 4. Ali b. Husain (658–713), 5. Muhammad b. Ali (676-743), 6. Jafar b. Muhammad (703-765), 7. Musa b. Jafar (745–799), 8. Ali b. Musa (765–818), 9. Muhammad b. Ali (810–835), 10. Ali b. Muhamad (827–868), 11. Hasan b. Ali (846-874), 12. Muhammad b. Hasan (868-?). The Twelver Shi`as believe that the twelfth *imam* Muhammad b. Hasan was born in 868 and has been hidden by Allah (referred to as *occultation*) to later emerge to fulfil his mission.

***`Aqilah:*** The paternal relatives who used to pay the blood money in ancient pre-Islamic Arabia. The origin of present day *Takaful* is often traced back to the blood money of this *`aqilah* as an early form of a collective or mutual insurance system.

`Aql: Literally, it means 'intellect', 'wisdom' or 'reason'. Technically, it is referred to: 1) a source of knowledge and as such is the antithesis of *naql* or tradition; 2) a quality that leads to praiseworthy conduct; 3) a part of the soul by which it 'thinks' or 'knows' and as such is the antithesis of perception. The protection of the *'aql* is one of the five essential elements of Islamic law and is to be protected by *maslaha* or public interest.

***Ayah*:** Literally, it means 'sign'. Technically it refers to the shortest division of the Qur'anic text, i.e. a phrase or sentence.

***Bai`*:** Literally it means 'sale and purchase transaction'. It also means 'the simple exchange or barter of commodities'. Technically, it refers to a contract of exchange mutually agreed upon between the two or more parties concerned for a given quantity of a commodity or service. The delivery of the commodity or service on the part of either party may be immediate (cash on spot) or deferred. The term has been used in this study as a prefix in referring to different types of sales as follows:

Bai` al-`Inah: Literally, it means 'a loan in the form of a sale'. Technically, it refers to the instant sale and buy-back of an asset for a higher price than that for which the seller originally sold it.

***Bai` al-Ma`dum*:** Literally, it means 'buying and selling of the non-existent or unseen goods'. Technically, it refers to buying and selling of the object, which does not exist or is not sensorally perceived, by contractual parties or alternatively, where the object of the contract is present but hidden from view.

Bai`-bi al-Wafa: Literally, it means a 'sale and purchase of honour'. Technically, it is referred to a sale that takes place when a commodity is sold on the condition that the seller is allowed to redeem the commodity upon paying its price; and the buyer agrees to honour the condition. For example, the purchaser of an immovable property undertakes that whenever the seller will give him the price he will resell the house to him.

Bai` Murabaha: Literally it means 'buying and selling on mutually agreed profit'. Technically, it refers to a financial instrument which is linked to the sale of goods at a price comprising the purchase price plus a margin of profit agreed upon by banks and their customers.

Bai` Salam: Literally, it means 'advance or prepaid sale and purchase'. Technically, it is a sale contract to supply a specific commodity at a future date in return for an advanced price paid in full on the spot. This product is offered by the Islamic financial institutions mostly to facilitate the trading activities of farmers and generally for the production of raw materials and fungible goods.

***Bidayat al-Mujtahid [Wa Nihayat al-Muqtasid]*:** Literally, it means 'The Distinguished Jurist's Premier'. It is an authoritative manual of Maliki School of Islamic law compiled by Ibn Rushd al-Andalusi, popularly known as Averroes in the West (d. 595 A.H./1198 C.E.). It provides exhaustive information on Islamic legal issues and is considered to be a book on *khilaf,* a discipline that records and analyses the differences among Muslim jurists.

***Darar*:** Literally, it means 'harm', or 'damage'. In Islamic legal contractual term, the principle of *la darar* conveys the ideas that no one shall be harmed and that there will be no abuse of rights in a contractual relationship.

Darurah: Literally, it means 'necessity' or 'emergency'. Technically, it refrs to a condition in which aspects of the Shari`ah may be suspended in order to safeguard a life; it also may refer to a supplementary principle in the methodology of Islamic jurisprudence.

Daruriyaat: Plural of *daruriyah.* It literally means 'necessities'. Technically, it refers to all activities and things that are essential to the preservation of the five foundations of good individual and social life according to Islam: religion, life, posterity, reason, and property.

Din: Etymologically it connotes a state of 'indebtedness', 'judgment' or 'retribution'. The idea of debt came to signify judgment on the one hand, and on the other, the obligations to be fulfilled on the other. Technically, it refers to a system of belief in an Omnipotent, Omniscient, and Omnipresent Creator whose absolute authority should not only be recognised but be acknowledged as well.

Fatwa: Literally, it means 'opinion', 'ruling', 'explanation'. Technically, it refers to an authoritative answer to a problematic legal case in the Shari`ah. Scholars who give these opinions need to provide the evidence from Islamic sources to support them. Often it is not uncommon for scholars to come to different conclusions regarding the same issue.

Fiqh: Literally, it means 'knowledge', 'understanding' or 'comprehension'. Technically, it refers to practical rules of the Shari`ah derived from the detailed evidence in the textual sources. The term has been used throughout this study to mean Islamic jurisprudence.

Fiqh al-Mu`amalat: Literally, it means professional knowledge in civil transactions. Technically, it refers to Islamic commercial jurisprudence, rules of transacting business or the law of human interaction which constitutes an important branch of law dealing with issues related to all kinds of financial transactions.

Gharar: Literally, it means 'ambiguity', 'deception', or 'risk'. Technically, it refers to a transaction in which the object of contract is not determined for the contracting parties and thus the contract involves an element of risk and uncertainty. All such transactions are regarded null and void in Islam.

Haajiyaat: Plural of *hajiyah,* which literally means 'needs'. Technically, it is conveniences that comprise all activities and things that are not vital to the preservation of the five foundations of good individual and social life according to Islam: religion, life, posterity, reason, and property but rather, are needed to relieve or remove impediments and difficulties in life.

Hadith: Literally, it means 'anecdote' or 'narrative'. Technically, it refers to the reports of Prophet Muhammad's (PBUH) sayings (specific pronouncements), actions or tacit approval of other people's actions. These are the real explanation, interpretation, and the living example of the Prophet for teachings of the Qur'an.

Hajj: Literally, it meanins 'to continuously strive to reach one's goal'. Technically, it is the annual pilgrimage to the House of Allah at Makkah once-in-a-lifetime for a Muslim who has reached the age of puberty and has the physical and financial ability to undertake this journey. It is one of the five pillars of Islam.

Halal: Literally it means 'permissible', 'lawful', 'legitimate', or 'allowed'. Technically it refers to things or actions that are fully compliant with the Shari`ah.

Hanafi: The first of the four orthodox Sunni schools of Islamic law named for its founder, the Imam Abu Hanifa in Kufa, Iraq (d. 150 A.H. /767 C.E.). The Hanafi School appeals to analogical reasoning known as *Qiyas* and a quest for the better. It is generally tolerant and the largest doctrine within Islam. It is followed by the majority of the Muslim population Of Turkey, Albania, the Balkans, Central Asia, Afghanistan, Pakistan, China, India and Iraq.

Hanbali: The fourth orthodox School of Islamic law within Sunni Islam named after its founder Imam Ahmad b. Hanbal (d. 241A.H./855 C.E.). It derives its decrees from the Qur'an and the Sunnah, which it places above all forms of consensus, opinion or inference. The Hanbali School is officially recognised as authoritative in Saudi Arabia and areas within the Persian Gulf.

Haram: Literally, it means 'forbidden', 'prohibited', but also 'taboo', 'holy', 'sacred', 'sacrosanct'. Technically it refers to all that are prohibited in the Shari`ah.

Hashiyah [`ala Mukhtasar al-Khalil]: It is a glossary on the commentary of *Mukhtasar al-Khalil* - the most authoritative work in the Maliki School, which has been compiled by Muhammad Al Kharshi.

Hilah/Hila: Its plural is *hiyal,* which literally means 'legal trickery'. In modern Islamic banking and finance implication it is referred to producing a usurious loan from otherwise permissible contracts.

***`Ibadaat:*** A plural of *`ibadah,* which literally means 'worship', 'submission' and 'devotion'. Technically it refers to acts of worship that Allah has commanded.

***`Ibadi:*** A distinct sect of Islam which is neither Sunni nor Shiite. It takes its name from the Abdullah b. Ibad al-Tamimi, who became the leader of the group in Basra around 685 C.E. *Ibadis* are relatively few in number in comparison to the Sunnis and the Shi`as, and for many centuries have been living largely in isolated areas, mainly in Oman, East Africa, Algeria, Libya and Tunisia. This sect developed out of the seventh-century Islamic sect known as the *Khawarij*. Modern *Ibadi*s, however, tend to minimise their Kharijite origins.

Idah al- Masalik `ala Qawa`id al-Imam Abi `Abd Allah Malik [al-Silsilah al-turathiyah]: A summary of Maliki School of Islamic jurisprudence written and compiled by Ahmad b. Yahya al Wansharisi (d. 914 C.E.).

'Ijara: Literally, it means 'to give something on rent'. Technically, it refers to possession of a usufruct for a consideration. In modern day Islamic banking implication it is an exchange transaction in which a known benefit arising from a specified asset is made available in return for a payment, but where ownership of the asset itself is not transferred. The terms of *'Ijara* are often flexible enough to be applied to the hiring of an employee by an employer in return for a rent which is actually a fixed wage.

***'Ijara bi al-Bai`:*** An Islamic banking product used for hire or lease to be followed by sales contract. There are two contracts to be undertaken in *'Ijara* one is *'Ijara* or hire contract while the other is *Bai`* or Sale contract.

'Ijara Muntahia Bittamleek: Literally, it means 'leasing ending into ownership' or 'lease to own'. Technically, it refers to a form of leasing contract which includes a promise by the lessor to transfer the ownership in the leased property to a lessee by purchasing it from the lessor at an agreed sale price at the end of the term of an agreed *'Ijara* period or alternatively, by stages during the term of the contract.

'Ijara wa 'Iqtina: Literally, it means 'leasing and acquisition'. Technically, it is a form of leasing contract similar to that of *'Ijara Muntahia Bittamleek.* These products have been used by the IBs in a variety of cross-border applications for an increasing range of asset classes including ships, aircraft, telecommunications equipment and power station turbines.

'Ijma': Literally, it means 'consensus', which is, 'agreeing upon a matter by a specified group of people'. Technically, it refers to the unanimity of all the leading qualified jurists and Islamic legal scholars of one era on a single Shari`ah ruling, after the period of Prophet Muhammad (PBUH). If any ruling based on Qur'an, Sunnah or Qiyas is not absolute, and then *'Ijma'* will render such ruling absolute and binding.

Ijtihad: Literally, it means 'to strive' or 'to exert to the utmost'. Technically, it is an endeavour of a qualified jurist to derive or formulate a rule of law to determine the true ruling of the divine law in a matter on which the revelation is not explicit or certain, on the basis of the text or evidence found in the Qur'an and the *Sunnah*.

Imam: Literally, it means 'leader'. Technically, it refers to a person who leads congregational prayers or the community in matters related to every aspects of Islam. According to Sunni views, an *Imam* is not infallible as the Muslims believe. *Imam* is responsible for his mistakes to all the members of the community and above all he is responsible to Allah.

Islam: Its iteral meaning is 'submission' ('*aslama*), 'peace' (*silm)*, 'greeting one another with peace' (*salam*). Technically, it refers to the way of life which teaches that all faiths have, in essence, one common message: the existence of a Supreme Being, the One God, whose sovereignty is to be acknowledged in the pledge to obey His commands, conveyed through His prophets sent at various times and in many places throughout history.

'Istihsan: Literally, it means 'to deem something preferable', or 'to approve', or 'to beautify some thing'. In Islamic law, it refers to the judicial preference for one legal analogy over another, usually in view of the public welfare. In other words, it is a doctrine that allows exception to strict legal reasoning, or guiding choice among possible legal outcomes, when considerations of human welfare so entail.

'Istishab: Literally, it means 'presumption of continuity' or 'permanence'. Technically, it refers to a subsidiary legal tool of Islamic jurisprudence associated with the Shafi`i School of thought.

Istislah: Literally, it means 'public interest' or 'social welfare'. In Islamic legal terminology it is a supplementary tool of juristic interpretation, associated with the Maliki School of jurisprudence.

***Istisna`a:*** Literally, it is derived from the root word *s-n-`a*, which means 'to manufacture' or 'to develop'. It is basically a sales contract (a variation of the *Murabaha*) originally used by IFSPs to finance the sale of unripe fruit and other foodstuffs. In terms of present day applications, it has been used for the advance funding of major industrial projects or construction of houses, plant, projects, and the building of bridges, roads and highways. IFSPs fund the manufacturer during the construction of the asset, acquire title to that asset on completion and either immediately pass title to the developer on agreed deferred payment terms or, alternatively, lease the asset to the developer under an '*Ijara wa Iqtina* contract.

***Ja`afari:*** The Ja`afari Islamic Jurisprudential School named after its founder, the sixth Imam Ja`afar al-Sadiq (d. 148 A.H./765 C.E.). It is also, called the Twelver School.

Kafalah: Literally, it means 'responsibility', 'amenability or suretyship'. Technically, it refers to a pledge given to a creditor that a third party becomes surety for the payment of debt on behalf of the debtor.

Khiyar al-'Ayb: Literally it means 'an option for defect'. Technically it refers to an option to rescind a sales contract if a defect is discovered in the object of sale.

Kitab al-Umm: Its literal meaning is 'The Book of Essentials'. It is one of the main treaties of Shafi`i School of Islamic Jurisprudence that contains much material transmitted from its founder Imam Muhammad b. Idris Al-Shafi`i edited by al-Rabi b. Sulayman al-Muradi. It represents the early tradition of the Shafi`i legal school. Another edited and summarised version of *Kitab al-Umm* is done by Husain Abdul-Hameed.

Madhhab: Literally, it is derived from the root *'dh-h-b',* which means: 'to go' or 'to take as a way'. Technically, it refers to a scholar's choice in regard to a number of interpretive possibilities in deriving the rule of Allah from the primary texts of the Qur'an and the *Sunnah* on a particular question. The plural of the word is *madhahib* i.e. four Sunni mainstream Schools of law, named after their founders, developed and codified by the end of the tenth century. They developed a School of their own.

Madinah: Also known as Medina and *Madinatun-Nabi* (City of the Prophet) it is a city situated north of Makkah. It was formerly known as *Yathrib*. The people of Madinah welcomed the persecuted Muslim immigrant from Makkah and accepted Prophet Muhammad (PBUH) as their leader.

***Makkah*:** Previously known as Mecca it is now a city in Saudi Arabia - an important religious centre that houses the *Ka`abah*. At the time of Prophet Muhammad's (PBUH) birth, Makkah had become an important caravan city on the trade route from Yemen to Syria as well as a religious shrine.

Mal: Literally it means 'anything is capable of being owned' or 'whatever a person may acquire or possess'. Technically it refers to people's property or wealth. The protection of *mal* is one of the five essentials of Islamic law which is to be protected by public interest.

Maliki: One of the four Schools of Islamic jurisprudence in *Sunni* Islam based upon the techniques for law and jurisprudence developed by Malik b. Anas (d.179 A.H./795 C.E.). The basic foundations of Maliki school are: the Qur'an, the *Sunnah,* consensus ('*Ijma`*), analogy (*Qiyas*), the practice of the people of Medina (*`Amal 'ahlil-Madinah*), a statement of a companion (*Qawlus-sahabi*), public interests *(Masalih Mursalah)*, blocking of the means (*Saddudh-dhara'i`i*), and custom (*`Urf*).

Maslaha: Literally, it means 'benefit' or 'interest'. In the terminology of Islamic Jurisprudence, it is often perceived as overriding public interest. It is used synonymously with *Istislah.*

***Man La-Yahdurhu al-Faqih*:** An important manual of Shi`i School of Islamic Jurisprudence written by Ibn-Babawayh.

Maysir: Literally, it is derived from *y-s-r* in Arabic meaning 'ease'. It is an ancient Arabian game of chance played with arrows without heads and feathering, for stakes of slaughtered and quartered camels. In modern day application it came to be identified with all kinds of gambling and games of chance. It is One of three fundamental prohibitions in Islamic finance (the other two being *riba* and *gharar).*

Minhaj al-Talibin: Its literal meaning is 'The Way of the Seekers'. Written down by Muhyi al-Din Abu Zkariyya Yahya b. Sharaf al-Nawawi (d. 676 A.H./1277 C.E.), it is regarded as the standard text of Islamic Law, especially by the Shafi`i School of Law. Its English translation from French is done by E. C. Howard.

***Mu`amalaat:*** It is a plural of *mu`amalah.* Literally it means 'transactions', or 'interactions'. Technically, it refers to commercial transactions, civil transactions, social affairs, human relationship or interactions. In Islamic law, all such acts are permissible unless there is evidence to the contrary.

Mudaraba: Literally, it is derived from *d-r-b*, which means endeavouring and journeying on earth. Basically it means an agreement between two parties according to which one party provides the capital for the other to work with on the condition that the profit is to be shared between them according to a pre-agreed ratio. In the case of Islamic Financial Services Providers (IFSPs), under the *Mudaraba* the customers purchase shares with IFSPs, and IFSPs become totally responsible in the management and investment of the funds in Islamically

lawful business ventures. Profits/dividends gained are distributed accordingly, based on a pre-agreed profit sharing ratio.

Mudarib: The entrepreneur who provides the entrepreneurship and management expertise in the *Mudaraba* form of partnership agreement between the capital provider and the entrepreneur. In the case of *Mudaraba Sukuk* the issuer of these certificates is the *Mudarib*.

Mujtahidun: A plural of *mujtahid.* Literally it means one who strives or exerts. Technically it refers to a jurist competent enough to deduce precise inferences regarding the commandments from the Qur'an and the *Sunnah* of the Prophet by the process of *Ijtihad*.

Murabaha: Literally, it means a sale on mutually agreed profit. Technically it refers to a contract of sale and purchase transaction for the financing of an asset whereby the cost and profit margin (mark-up) are made known and agreed by all parties involved. The settlement for the purchase can be settled either on a deferred lump sum basis or on an instalment basis, and is will be specified in the agreement.

Musharaka: Literally, it means 'partnership' or 'sharing'. Technically, it refers to a relationship established under a contract by the mutual consent of the parties for sharing of profits and losses in joint business. In the case of Islamic Financial Services Providers IFSPs and the customers jointly enter financing a project with individual equity participation where the former as partners, participate in the running of the project. Once the project is disposed off, the latter ends the partnership by returning the former's equity plus the profit derived from the project, based on the agreed sharing ratio. The loss, if any, is borne by both parties strictly in proportion to respective capital contributions.

Musharaka Mutanaqisa: Literally, it means 'diminishing partnership'. Technically, it refers to a joint venture in which sharing of one joint venturer diminishes over time with performance by the other joint venturer. In the case of IFSPs it is an agreement that requires IFSPs to purchase and hold title to the financed property. IFSPs then lease the property to the customers, who make monthly payments that are part-rent and part-principal. The parts of monthly payments increase the customers' ownership in the property, and allow them to pay less rent over time.

***Nafs*:** Literally, it means 'self' or 'psyche'. Etymologically, it is 'breath', and thus common to virtually all archaic psychologies where the act of breathing was connected with life, animating otherwise lifeless object.

Nasl: Literally it means 'human kinship', 'ancestry 'or 'progeny'. The protection of progeny is one of the five *daruriyyat* or essentials of Islamic law and is to be protected by *Maslaha* or public interest.

Qard Hasan: The literal meaning of *Qard* is 'to cut', and *Hasan* means 'beautiful', 'good', 'benevolent'. Technically, it is an interest-free small loan granted by IBs to needy such as small farmers, small producers, needy consumers, etc. as a help, charity or advance for a

certain time. The repayment of the loan is obligatory. Usually, banks levy a service charge to cover their expenses.

Qimar: Literally, it is derived from the word *qamar* (i.e. moon), that which increases at times and decreases at other times. Technically, it is similar to *Maysir* or gambling. It has been given the name *Qimar* due to the possibility that each one of the gamblers may lose his wealth to his counterpart and it is also possible that one may gain from the wealth of the other.

Qiyas: Literally, it means 'measure', 'example', 'comparison' or 'analogy'. Technically it refers to a derivation of the law on the analogy of an existing law if the basis (*`illah*) of the two is the same.

Ra'y: Literally, it means 'opinion' or 'reasoning'. Technically, it refers to human reasoning or rationale, and hence, the rationalists are called as *Ahl al-ra'y*. The scholars of this group in Islam think that legal interpretations of the Shari`ah should have a basis in reason, should take into account the best interests of the people, and should be backed by discernable wisdom. Thus, in many cases, reason would be accorded legalistic preference when such reasoning conflicted with the evidence of certain categories of *Hadith*.

Riba: Its literal meaning is 'to grow' and 'to increase'. Technically, it refers to the amount that a lender receives from a borrower at a fixed rate in excess of the principal in a loan transaction or in exchange for a commodity accrued to the owner (lender) without giving an equivalent counter-value in return to him.

Sadaqaat: A plural of *Sadaqah,* which literally means, 'donations' or 'charity'. Technically, it is referred to religiously inspired voluntary alms giving or discretionary charitable donation, not necessarily monetary in nature.

***Shafi`i:*** The third Sunni School of Islamic jurisprudence based upon the theories of the Islamic theologian Imam Abu Abdullah Muhammad b. Idris al-Shafi`i (d. 204 A.H./820 C.E.). According to this School the principal sources of legal authority are the Qur'an and the *Sunnah.* Of less authority are the *'Ijma`* and *'Ijitihad* (thought of scholars) exercised through *Qiyas.* It has a large following in Egypt, Indonesia, Malaysia, the Philippines, Brunei, Singapore, Thailand, Sri Lanka, the Maldives, and among the Kurdish people.

***Shari`ah:*** Etymologically it is derived from the root *sh-r-`a,* which means 'to introduce' or 'prescribe'. Conceptually it refers to a set of rules, regulations, teachings and values governing the lives of Muslims. The Shari`ah embraces worship, morals and conduct. It also embraces the political, social and economic and other spheres. As a means of regulating society, The Shari`ah attempts to secure the rights of all human beings and by doing so, enjoins upon them certain responsibilities geared towards protecting these rights.

***Shi`a:*** Literally, it refers to a 'group or supportive party of people'. The commonly-known term is shortened from the historical '*Shi`at* Ali', or 'the party of Ali'. The Muslims believe that following the Prophet Muhammad's (PBUH) death, leadership should have stayed

within the Prophet's own family, among those specifically appointed by him, or among *Imam*s appointed by Allah Himself. They also believe that the *Imam*s are sinless by nature, and that their authority is infallible as it comes directly from Allah. Significant populations of Muslims can be found in Iran and Iraq, and large minority communities in Yemen, Bahrain, Syria, and Lebanon.

Sukuk: A plural of *Sakk*, which is similar to the European root 'cheque', but in fact, it is an asset-backed, trust certificate or bond or securities showing evidence of ownership of an asset or its usufruct. The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) - the regulatory and accounting standards body for Islamic finance – defines *Sukuk* as being: *'Certificates of equal value representing after closing subscription, receipt of the value of the certificates and putting it to use as planned, common title to shares and rights in tangible assets, usufructs and services, or equity of a given project or equity of a special investment activity'*.

Sukuk al-'Ijara: These types of *Sukuk* are title deeds of equal shares in a leasing project, usually equipment or real estate which provide their holders the right to own shares, receive rental fees and dispose of their *Sukuk* in a manner that does not have an effect on the right of the lessee. The *Sukuk al-'Ijara* instruments have been used in a variety of cross-border applications for an increasing range of asset classes including ships, aircraft, telecommunications equipment and power station turbines.

Sunnah: Literally, it means 'custom', 'habit', 'practice', 'a way', 'a rule', 'a precedent'; 'a manner of life', or 'trodden path'. Technically, it refers to whatever the Prophet Muhammad (PBUH) said or did to be way of life for his followers. In other words, it is the way of life prescribed as normative in Islam, based on the teachings and practices of Prophet Muhammad (PBUH).

Sunni*:* Literally, it is derived from the word *Sunnah*, which means 'habitual practice', and refers to the sayings and actions of the Prophet Muhammad (PBUH). Thus, *Sunni* means 'one who follows the traditions of the Prophet'. Sunni are also referred to as *Ahl as-Sunnah Wal-Jama`ah* people of the example (of Muhammad [PBUH] and the community) which implies that they are the majority, or *Ahl as-Sunnah* for short. Unlike Shi`a*,* Sunnis believe that Prophet Muhammad's (PBUH) successor did not have to be a member of his family, but could be chosen by the consensus of designated community leaders, and the first four caliphs were chosen by this process.

***Surah*:** Literally, it means 'row' or 'fence'. Technically, it refers to the passage-wise division of the Qur'anic text, i.e. a chapter or part, set apart from the preceding and following text. The total number of these chapters in the Qur'an is 114.

***Tahdhib al-Ahkam [fi sharh al-muqni`a*]:** Literally, it means 'The Refinement of the Laws (as Discussed) in Terms of the Explanation of *the Sufficiency'*. It is an important manual for Shi`i School of Islamic Jurisprudence compiled by Shaikh al-Taifah Muhammad al-Tusi.

Tahsiniyaat: A plural of *tahsiniyah,* which literally means 'refinements', or 'flourishes'. Technically, it refers to supplementary benefits which involve the refinement and perfection

of ethics and the enhancement of life. The least important of the three categories of rights protected by *Maslaha* or public interest.

Takaful: Literally, it means 'guaranteeing each other', or 'mutual responsibility'. In Islamic finance it is seen as an alternative to conventional interest based insurance, wherein there is no commutative financial contract that allows one to interpret premium payments as prices and insurance claim fulfilment as an object of sale. Rather, policy holders are viewed as contributors to a pool of money, which they agree voluntarily to share in cases of loss to any of them.

Tamleek 'Ijara: Literally, it means 'ownership through leasing'. It is a product which looks similar to *'Ijara Muntahia Bittamleek* (see above) previously practised by MCCA for property finance, which it renamed as *Tamleek.*

***Tawarruq**:* Literally, it is derived from the word *'wariq'* that means 'silver'. Technically, it refers to buying goods with a delayed payment and then selling it to other than the seller [from whom one bought the goods] in order to obtain cash money. It is so named because the one who buys the product is only buying it for the sake of *dirham*s (originally, silver coins). The Islamic legal scholars differed concerning the ruling on this transaction whether it is permissible under the Shari`ah.

Ta'wil: Etymologically, the word the root word '*a-w-l',* which is derived from *'ta'wil'* means 'to return, to revert,'. It implies going back to the original meaning of a word to see what its meanings and connotations are. Technically, it has three meanings: 1) to understand a word in the Qur'an or the *Hadith* in light of one of its connotations, despite the fact that this connotation is not the primary intent of the word, 2) to explain the inner and concealed meanings of the text of the Qur'an or the *Hadith*, and 3) the actuality of an event.

Tayseer 'Ijara: Literally, it means 'ease leasing'. It is a product looks akin to *'Ijara Muntahia Bittamleek* (lease ending with ownership) currently practised by Iskan for property finance. See for details, *'Ijara Muntahia Bittamleek.*

**`*Urf:*** Literally, it means 'custom' or 'tradition'. Technically, it refers to a general or local model of behaviour, social understanding, or mode of expression that is generally accepted by the population and does not contract a definitive rule of the Shari`ah.

Usul al Fiqh: '*Usul* is plural of '*Asl,* which literally means 'proof', 'root', 'origin' and 'source'. Technically the word *'usul* denotes rules or principles on which a branch of knowledge may be founded and thus *'Usul al-Fiqh* are the rules governing the science of *Fiqh* or the principles of Islamic jurisprudence.

Wahi: Literally, it means 'revelation' or 'inspiration'. In technical Qur'anic terms, it refers to: 1) guidance in natural intuition [28:7]; 2) guidance in natural instinct [16:68]; 3) guidance by signs [19:11]; guidance from evil [6:112]; guidance from Allah [8:12].

Wakalah: An agency contract, in which one person appoints someone else to perform a certain task on their behalf, usually against a fixed fee.

***Wasa'il Al-Shi`a:*** The most widely used manual among the Shi`a School of Islamic Jurisprudence compiled by Hurr al-`Amili.

Zahiri: Literally, it means 'literalist' or 'one who goes for the outward meanings of things only'. It is a School of thought in Islamic Jurisprudence named after its founder Dawud b. Ali al-Isbahani al-Baghdadi (d. 270 A.H./883 C.E.), better known as al-Zahiri. It is so named because literalism was the central idea around which the *Zahiri* School was built. The two original sources of the Shari`ah - the Qur'an and the Sunnah were the same, but the method of *Ijtihad* used in determining what this School meant was different.

Zahir al-Riwayah: Literally, it means 'Apparent Narration' or 'Clear View'. It is a collection of treaties refers to the most authentic transmission of the views and opinions of Imam Abu Hanifa and his disciples - Abu Yusuf and Muhammad b. al-Hasan, also Zufar and Hsan b. Ziyad written down by Muhammad b. Hasan al-Shaybani.

Zaidi: It is a Shi`i School of thought named after the Imam Zaid b. Ali (698 – 740 C.E.). The followers of this School do not believe in the infallibility of the *Imam*s. In matters of law and jurisprudence, they follow the Prophet's companion Zaid b. Ali's teachings which are documented in his book *Al Majmu` al Fiqh*. They are believed to be closest to the Sunni Hanafi and Shafi`i Schools of thought with elements of the Shiite Ja`afari School.

***Zakah*:** Literally, it means 'purification', or 'growth'. Technically, it refers to a fixed proportion levied on property such as gold, silver, merchandise and income producing animals, as well as farming land and then distributed among the rightful beneficiaries. It is paid on the net balance after a Muslim has spent on basic necessities, family expenses, due credits, donations and taxes.