

Islamic Finance, another form of financial engineering

Mahmood al-Sheahabi

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بسم الله الرحمن الرحيم

الحمد لله رب العالمين والصلاة والسلام على سيدنا محمد وعلى آله وصحبه ومن سار
على هديه وعلى جميع الأنبياء والرسل إلى قيام يوم الدين

In the name of Allah the beneficent, the merciful.

Praise be to Allah, lord of universe and his blessings upon his messenger Mohammed, his family, his companions, his followers and all prophets and messengers of Allah until the judgment day.

Preface

The main drive behind my decision to write this book has been my feeling that it is my religious duty to spread the knowledge I have gained through my practical experience. I believe I was rather fortunate in my professional life to acquire a broad exposure in Islamic finance.

In my position as the relationship officer for Islamic institutions first at Chemical Bank / Chase Manhattan Bank and later on with Asian Capital Partners of Hong Kong, I worked very closely with leading Islamic institutions and participated directly in developing innovative and ground breaking solutions for the Islamic Market. I hope by sharing my experience with my colleagues in the industry it will lead to a better understanding of Islamic finance, insha' Allah. I am convinced that only through sharing of information and transparency the industry could achieve the standardization and uniformity required for future development.

Finally, it is only fair to mention that this book is a product of many years of hard work and by many people in the industry. As such I do not claim that all ideas and solutions are solely mine!

M. al-Sheahabi

Basic Principles

Source of Legislation

Sharia is the Islamic legal framework derived from the five Islamic legislative sources, and these are:

- a) The Qur'an (Moslems' holy book).
- b) Sunna (prophet's preaching and practice).
- c) Ijtihad (the opinion of Islamic jurists on a particular issue).
- d) Ijma (the consensus of the Islamic community on a particular issue).
- e) Qiyas or analogy (the application of accepted principles by analogy to new cases), not a source relied upon by all schools.

The rational behind forbidding Riba (usury)

Koranic verse, 275 Cow:

"Those who swallow down Riba cannot arise except one whom shaitan (satin) was prostrated by (his) touch does arise. That is because they say, trading is only like usury and Allah has allowed trading and forbidden usury".

النص القرآني: "الذين يأكلون الربا لا يقومون إلا كما يقوم الذي يتخبطه الشيطان من المس ذلك بأنهم قالوا إنما البيع مثل الربا وأحل الله البيع وحرم الربا"

This verse clearly states that God does not want Moslems to take usury as a way of earning their living, instead the faithful must engage in trade. So, God who certainly knows what is best for us has ordered us not to deal in usury (Riba) and that we should engage in commerce.

Skeptical views

It is not a secret that many Moslems have doubts about Islamic banking despite their belief that it must be the right way because Allah (God) has ordered us not to engage in usury, however when they compare the results with conventional banking they cannot see the difference. In fact they might find conventional banking sometimes to be less complicated and the overall benefit being far greater than dealing with Islamic banks.

In the Koranic verse the capitalists said that trading is like usury, they meant that in commerce you make profit as the case is in lending money. Obviously they did not want to realize that in commerce you create value and you risk your capital and you can make a profit or incur a loss, while in pure lending your claim to your capital and profit is fixed regardless whether the borrower has made profit or not.

Today, the situation tends to be slightly different, as generally the consumers, not the capitalists are the ones making the argument that there is no difference because the results are same. The response to this

is that it is important to realize that form and methodology are also of paramount importance in Islam. I could say it is the most important factor in any Islamic business dealing, take for instance, halal meat! The only difference with non-halal meat is the way in which the animal is slaughtered. The same is generally true in a marriage; unless a special process is followed the marriage could be viewed illegal and children could be considered illegitimate, thus would be deprived from their rights under the law. Some could argue that in Islam the intent is the most important issue for any behavior. Yes, it is true, but no one knows about our intentions except God, even sometimes a person himself is doubtful if his intent is for the sake of God, or the sake of something else.

So form and methodology are the most crucial part of any business dealing in Islam. The other general criticism of Islamic finance is that Islamic banks do not have their own benchmark rate for determining return and almost all of the Islamic institutions use Libor (London Interbank Borrowing Rate) as the reference rate. The simple answer here is that there is nothing wrong in the Sharia (Islamic Legislation) that prohibits the use of Libor as a benchmark rate. In my view, this is exactly like the case with liquor, which if for some reason was transformed into vinegar then it would be permissible to consume it. Besides this is not the fault of Islamic institutions, as it is almost a universal issue because the world economy is interlinked and that the most efficient market has been the London interbank market. Even if the Islamic institutions were to establish their own benchmark, it would still be compared to Libor as the case with interest rates on domestic currencies. So the Islamic market has little choice here.

Good Riba

Although Riba is clearly forbidden by Allah as it is explicitly stated in the Holy Book "Koran" and as per the above verse, The prophet, peace be upon him (PBUH), has made certain exceptions. For instance, he has stated that there is no Riba between the master and his slave, the father and his son and in some cases between the husband and his wife.

حيث قال (ص): " ليس بين السيد وعبد ربا وبين الوالد وولده ربا وبين الزوج وزوجته ربا".

He (PBUH) has also mentioned that it is acceptable to charge Riba to non-Moslems but has forbidden to give Riba to non-Moslems.

حيث قال (ص): " لا نعطيهم بل نأخذ منهم الدرهم بألف ".

I guess the main reason being is to encourage non-Moslems to embrace Islam in order to enjoy the financial benefits i.e. interest free loans (Qard Al Hassan) or charity loans. So because of this you see certain groups of Moslems place their funds with non-Moslem institutions as Riba in this situation is halal (lawful), although there are certain conditions most important of which is that this does not lead to weakening of Islamic economies and/or strengthening non-Moslem communities on the account of Moslem societies. Therefore some scholars will demand that in these situations where a Moslem earns Riba from dealing with non-Moslems that a portion of the interest be donated to charity.

This concept is now-frequently used by Islamic institutions to discourage delinquencies. In the past Islamic banks found themselves trapped with corporate borrowers who for genuine business reason had to reschedule their debt. This was clearly the case during the Asian crises. Islamic institutions were not willing to reschedule because they could not accept delay charge on extending their debts to new maturities.

In summary, these exceptions by the prophet (PBUH) are simply ways to go around Riba provided that there is strong socio-economic reasons and most importantly not causing any harm to Moslem community. As such state owned institutions are permitted to pay Riba to the citizens of the same country applying the concept of father and children. We can see this exception is also applied by Islamic institutions with their subsidiary companies as a way to reduce taxable income.

The Discipline

The book will focus on market segments and the appropriate solution necessary for each situation. The products offered in the Islamic market cover a wide range of banking products and can be segmented into the following categories:

- Cash Management.
- Money Market Products.
- Hedging Techniques.
- Interest Rate Arbitrage.
- Trade Finance Products.
- Project Finance.
- Risk Participation.
- Acquisition Finance.
- Asset Securitization.
- Trading in Shares.
- Trading in Currencies.
- Trading in Debt.

The distinctive feature of Islamic finance is that it is asset based financing and centers around the passage of title through the Islamic financier. Except for the Ijara and Mosharaka contracts the general characteristics of other contracts are that they are all fixed rate instruments, thus do not allow repricing.

The objective here is to provide the reader with practical examples of how Islamic instruments are applied to resolve problematic situations. It is important to realize that these solutions have been approved by different Sharia Boards and scholars, representing the different school of thoughts in Islam. However, we will not make any reference to any Sharia Board or scholar who has approved these situations nor we will mention any institution, which has applied these solutions. The primary reason is that we do not have their permission and also because a solution that might be acceptable to one institution might not be with another. The important thing to realize here is that our goal is to help the reader understand how Islamic deals are structured and everybody is free to take the necessary Sharia opinion on these applications.

Section One

Cash Management Solutions

By Cash Management we mean very short-term cash positions starting from overnight positions to generally less than one-week maturity.

Islamic banks maintain current accounts with their correspondent banks in various countries. These accounts are used to settle their obligations in different currencies. Occasionally these accounts could be overdrawn as expected funds from other parties are not received on time, or from time to time they could have huge excess balances because either that the Islamic bank cannot place these funds in the normal course of its daily operations, or that an unexpected deposit is received into the account. So, Islamic banks need to manage these daily fluctuations in their current accounts. Since Islamic banks cannot accept paying or receiving interest, they have to find innovative solutions to handle these unexpected deficits and surpluses on daily basis.

Obviously, the treasury departments at Islamic banks try very hard to manage the payments and receipts in a manner that the net settlement is very minimal but it is not possible to maintain a balanced cash position at all times therefore they revert to the following solutions:

Debit and Credit products

The Islamic bank enters into an arrangement with its correspondent bank that for every dollar of overdraft it will maintain a credit balance slightly higher than the overdraft amount. This usually takes the form of a fixed ratio of debit and credit products, for instance for every dollar of overdraft the Islamic bank has to place a dollar and twenty cents (i.e. a ratio of 1:1.2). Obviously this settlement has to take place within a short period of time normally within 30 days, but not exceeding 90 days. Otherwise interest rate fluctuations could make it an economic to the correspondent bank.

Points Systems

The points systems is for those institutions which usually maintain credit balances. This means that Islamic banks will have an arrangement with their correspondents to accrue points for credit balances against which the Islamic bank would borrow interest free loans at different dates. You could have a situation where the Islamic banks has left \$100 Million for 5 days, it could borrow for instance; \$100 Million for 4 days in interest free loans, or it could borrow \$50 Million for 8 days and so on.

You note that in both situations the debit/credit products and the points system the Islamic bank has to keep a margin over its borrowings to compensate the correspondent bank and the ratio is not one to one. This is because the correspondent bank treats the transactions as deposits and loans, therefore it has to have its own mark-up.

The Chase Solution

At Chase Manhattan Bank we developed the first cash management program for the Islamic market whereby Islamic investors could invest with tenors from overnight to 360 days. The investor would buy a pro-rata interest in a pool of leased assets, and could sell back his participation at any time provided he gave one-day notice. So this program worked exactly like an open ended fund and was the closest alternative to an inter-bank instrument. The program was very successful, as the Islamic bank had the option to invest through this Sharia compliant cash management or to lend those balances (Interest free) to Chase who would invest them through the conventional overnight scheme and accrue the points (Earnings) for the account of the Islamic bank who would borrow interest free loans against the accumulated credit/points.

Section Two

Money Market Transactions

The Morabaha Contract

Islamic banks have succeeded in creating products comparable to conventional bank deposits. Morabaha contract has provided the solution to offering guaranteed investments with predetermined returns. Morabaha simply means selling at a profit. It has been widely used by Islamic banks to invest short-term liquidity. The concept is to buy a commodity or an asset for cash and to sell it immediately on credit. Obviously the transaction is pre-arranged, as the Islamic bank would only accept to buy the commodity if it is assured that there is another credible buyer willing to purchase the commodity at a pre-agreed price, which basically reflects the interest rate prevailing during the period between the spot payment by the Islamic bank and deferred payment by the ultimate buyer. Usually these transactions are arranged by one party who would act as a principal (either the supplier or the ultimate buyer of the commodity) or as a broker/arranger identifying either the supplier or the ultimate buyer for the commodity. It is essential in the Morabaha to have three independent parties i.e. the supplier, the Islamic bank, and the ultimate buyer.

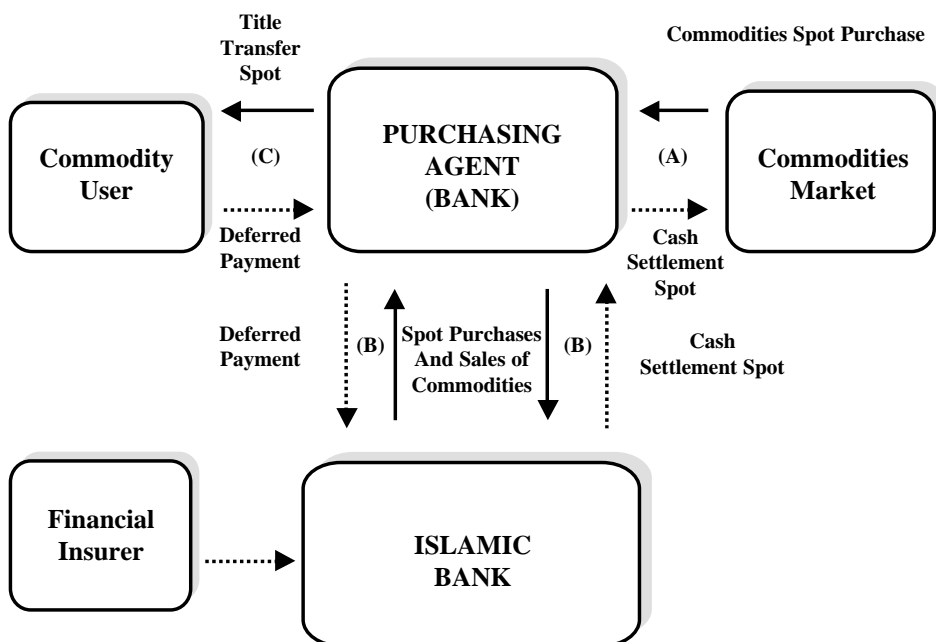
The Tawarroq Contract

Tawarroq works exactly the opposite to Morabaha. This solution was developed as way to raise financing. In fact the word (Tawarroq) means creating money or raising funds. So it is a tool to borrow money. The concept here is to purchase a commodity on credit from one party and immediately selling it to another for cash usually at a discount. This resembles exactly a 'Wadheea' or Hateeta sale which means sale at discount, so the words "Wadheea" and "Hateeta" are the opposite to the word Morabaha. This contract also requires three independent parties, otherwise it will be considered Bei Al Eana (single party financing i.e. buying and selling back to the same party). Again it is pre-arranged by the bank and mostly invested in commodities. This contract is now widely used by Islamic banks to raise financing at pre-determined cost.

So in short the Morabaha contract is an instrument to invest liquidity while Tawarroq contract is a solution to raise necessary short-term financing.

ISLAMIC BANK FUNDED MORABAHA PURCHASE

Risk Profile: Payment risk of the USER guaranteed by investment graded financial insurer.



- A) Purchasing Agent buys spot selected commodity from market place for cash in the name and on behalf of the Islamic Bank under the terms of a "Master" commodity investment agreement signed with the Bank as Purchasing Agent.
- B) The Master Agreement allows the Purchasing Agent to sell for deferred payment the same commodity to a third party User at pre-set conditions. The Islamic Bank is effectively investing in a "synthetic" commodity repo.(Repurchase Agreement)
- C) Purchasing Agent sells the commodity to the User under 30 to 90 days payment terms. The Purchasing Agent or another third-party eligible guarantor issues a demand guarantee to Islamic Investor to insure the deferred payment of the User.

Section Three

Hedging Techniques

Islamic banks are restricted in accessing the forward foreign exchange market to hedge against currency exposure and price fluctuations. The rationale being that there is an embedded interest rate component in the forward price of the foreign exchange contract. Because of this obstacle the market has turned to indirect means to mitigate such risks. Let's examine the following cases:

Case I, Mitigating Currency Exposure

A Dollar based Islamic investor has a property in UK, which he intends to sell after 5 years and he wants to hedge himself against the currency risk. The investor here will revert to the commodities market to create a mitigating currency exposure to protect his investment. Therefore, he would buy, from a commodity trader platinum spot delivery against deferred payment in sterling pound. So he receives the commodity spot, which in turn he would sell to another party also spot delivery against deferred payment in Dollars. So, at maturity the Islamic investor has to pay sterling pound to the commodity trader, which basically represent the value of the property and he would receive Dollars from the other party.

Case II, Mitigating Country Exposure

The Islamic bank has an on going exposure in Indian Rupees because of daily remittances. On the other hand a foreign bank operating in India wants to reduce its sovereign risk to India. So, the foreign bank would arrange for the Islamic bank through a commodity trader, to buy platinum on spot and pay Dollars to the broker and in turn the Islamic bank would sell the platinum on spot to the foreign bank against Indian Rupees. So the net result is that the Islamic bank receives Indian Rupees in its account in India and pays Dollars outside India.

Case III, Mitigating Price Volatility

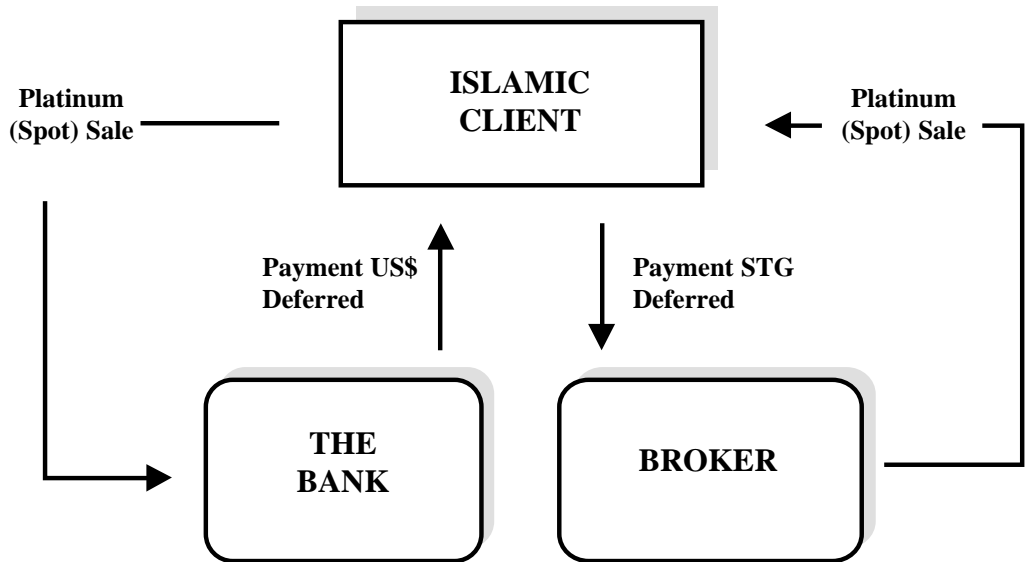
The Islamic bank buys oil against future delivery so value is prepaid by the Islamic investor, i.e. utilizing a Bie Salam mode of finance. The Islamic bank does not want to be exposed to price volatility, so he would sell the oil for a fixed price against deferred payment. However, the problem here is that from Sharia point view, it is not permissible to have both legs of the transaction deferred; one leg of the transaction must be spot. The other issue also is the concept that you cannot sell what you do not own, as the oil will be in the possession of Islamic bank only on the delivery date. Therefore, the solution here is to enter into a promissory contract to purchase, which would have to be replaced on the delivery date with a sale contract; the promise can be mandatory so the right of both parties are protected. It is effectively a conditional promise that if the Islamic bank was able to deliver the specific quantity of oil on the agreed date, the commodity trader would pay the pre-determined price for it. In fact it resembles the (Joa'la Contract) Reward Contract, which allows a contractual obligation on objects that do not exist and are not under the control of the party, which is exactly the case here, as the oil does not exist until it is extracted and delivered, besides it is not under the buyers control. The Joa'la contract has been based on the Koranic verse when prophet Joseph (PBUH) declared "We are missing the kings goblet whoever brings it back will have a camel's load, I can vouch for it".

النص القرآني: " قالوا نفقد صواع الملك ولمن جاء به حمل بعير وأنا به زعيم "

Case IV, Forward Price Agreement

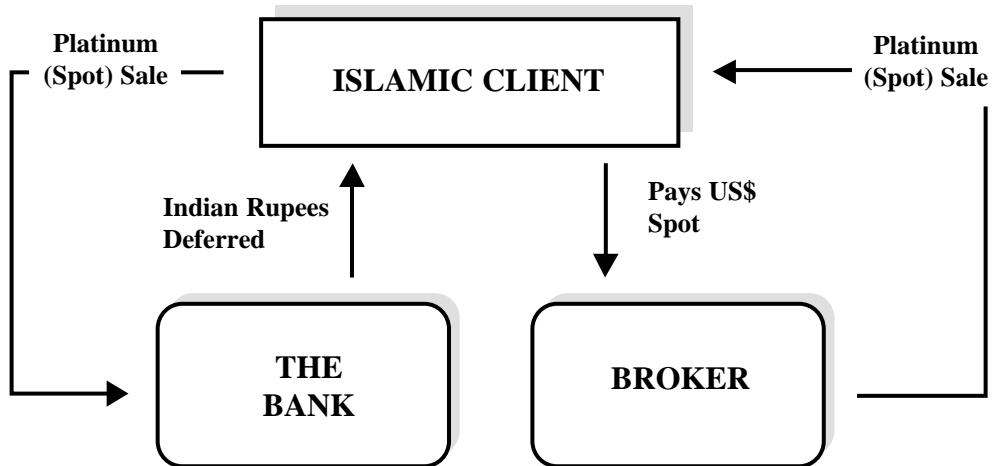
A commodity importer is concerned about price fluctuation needs to lock-in a forward price, he can use what is referred to Bei Al Urboon to lock-in a future price. At maturity the client can take delivery of the commodity, or he can sell it to another party should the spot price be advantageous to him. Some scholars approve this only on the basis of the premium being part of the sale price. Others view this is an insurance premium similar to a normal insurance against accidents on automobiles, as the issuer merely buys protection against future and unexpected loss. It can be viewed as building barriers to protect against storms or floods that might damage your property.

HEDGING TECHNIQUES – Case I (Long Term Hedging)



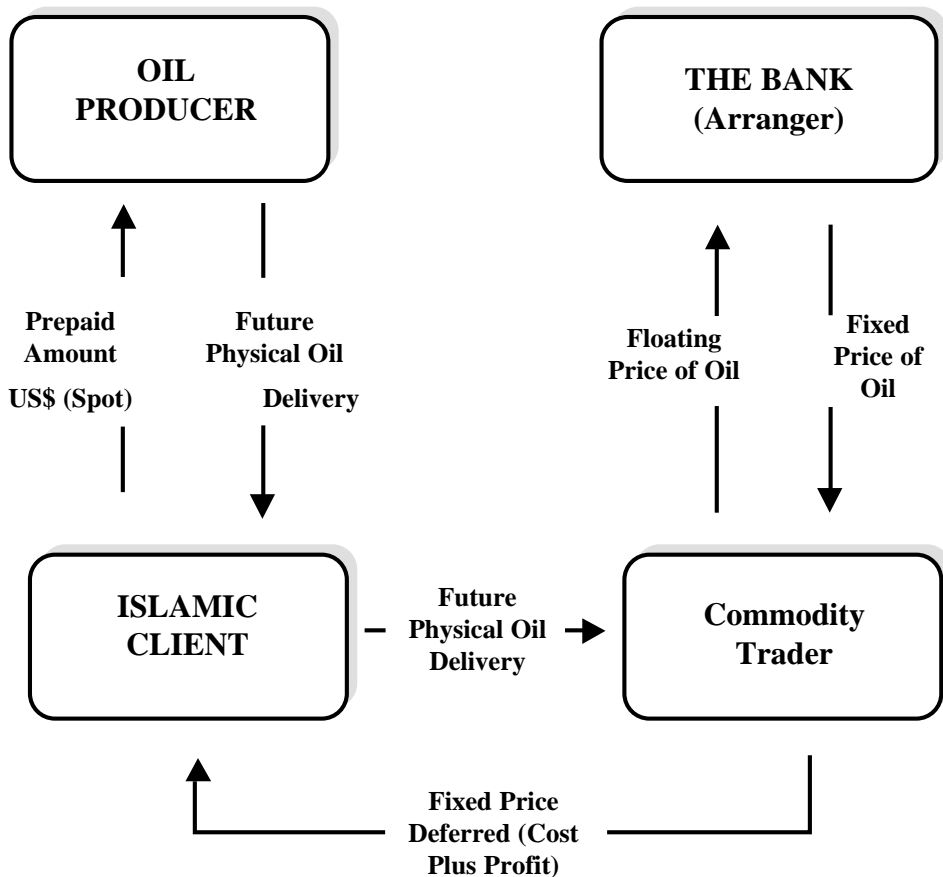
- The Islamic client has a property in UK which he intends to sell after five years. He wishes to hedge himself against the currency risk.
- The Islamic Client buys platinum from a broker (which can be a separate legal entity within the Bank network) against deferred payment in STG.
- The Islamic Client sells platinum to the Bank against deferred US\$ payment.

HEDGING TECHNIQUES – Case II (Short Term Hedging)



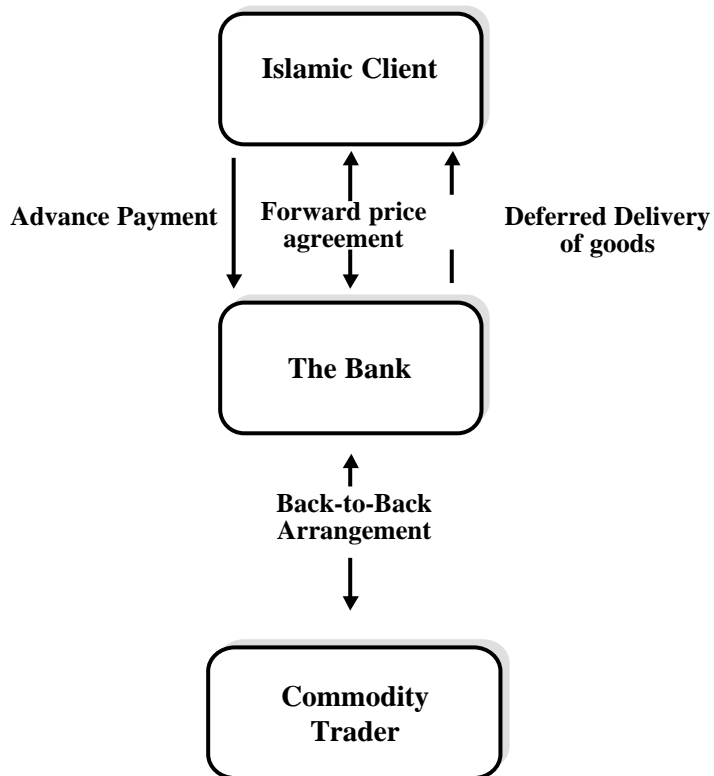
- The Islamic Client has an exposure in Indian Rupees because of the remittances to India that he wants to hedge. On the other hand, the Bank also wants to reduce its sovereign risk to India.
- The Islamic Client determines its average monthly needs of Indian rupees. He buys platinum and pays US\$ to the Broker on spot (the Broker can be a separate legal entity within the Bank network).
- The Islamic Client sells the platinum to the Bank against deferred payment in Indian Rupees.

HEDGING TECHNIQUES – Case III (Mitigating Price Volatility in Oil Financing)



- The Oil Producer sells oil to the Islamic investor in advance, against future delivery of oil. Value is prepaid by the Islamic investor (i.e. using a Bie Al Salaam mode of finance).
- The Islamic investor immediately sells the oil spot to the Commodity Trader against deferred payment (the Commodity Trader will enter into oil swap with the Bank), so commodity price risk is mitigated and value will be paid at maturity. Effectively, the Islamic investor created a loan, with no market risk except for the delivery risk by Oil Producer, which the Islamic Client is willing to accept. Again the Commodity Trader can be a separate legal entity within the Bank network.

Hedging Techniques – Case IV (Using Bie Salam to a Secure Forward Price)



- A commodity importer in Asia is concerned about price fluctuation needs to lock-in a forward price.
- The advance payment (Urboon) allows the importer to lock-in a forward price.
- At maturity the client takes delivery of the commodity.

The Forward Foreign Exchange Market

As mentioned earlier that Islamic banks are restricted from accessing the forward foreign exchange market directly because of the embedded interest component in the forward price and also because that both sides of the transactions are deferred. Regarding interest rate element, the fact is that all Islamic contracts which have future values are measured against interest rates. The clear example is the difference between the cash price and the deferred price. The Morabaha contract, which accounts for almost 80% of all contracts in Islamic finance, is entirely based on interest rates, the value for Salam and Istisna' contracts also determined in reference to interest rates. In fact, the Ijara contract being the most desirable financing instrument, is merely because it allows the financier to reprice his rentals in line with the interest rate cycle. So almost all Islamic contracts are priced based on interest rates and as I explained earlier in the introduction there is no escape from this. Therefore this argument does stand as to why should we make an exception in this respect for the forward exchange contracts.

Concerning the issue that both legs of the transaction are deferred, as the condition of the trade is that either the price or the commodity has to be exchanged on spot, or as it referred to in Arabic that either "Althamman (the value)" or "Almothamman (the object being valued)" must be delivered as the case in deferred Morabaha whereby the commodity is delivered spot and the price is deferred. The opposite is true in a Salam contract as value or the price is delivered in advance and the commodity is deferred. First of all technically speaking in a forward foreign exchange you do not have the above classification i.e. the value and the object being valued, or Thaman and Mothamman because both currencies are values. In fact most Islamic scholars do not recognize currency notes as commodities. They view them as measurement of values unlike in the western world, where they are considered as commodities. So, technically speaking we have in this case counter values, besides looking at a forward currency contract no one can determine exactly which currency is considered to be the value/price and which is being regarded as the object being valued. We have a very relevant example in a Joa'la contract where both legs of the transactions are deferred and the contract will be fulfilled only if the object is delivered.

In other words, the reward in Joa'la will be paid only if the object is delivered. This is the case in a forward foreign exchange contract as both parties have to simultaneously pay each other. The delivery of one currency is contingent on the receipt of the other. More importantly, the intention here is to hedge a currency exposure that the Islamic investor has already created. It is only prudent banking to protect your asset and limit your cost. As illustrated, this can be achieved through the commodities market but why go through all this unnecessary complications while there is a more efficient and straight forward way. The ban by the prophet (PBUH) not to trade deferred with deferred does not mean one should not protect his investment. In fact, the real essence of his ban is to avoid uncertainty. The prophet (PBUH) mentioned that "If types are different you may trade as you wish". He has also mentioned "Whoever wishes to give credit, he should do so in a specified measure and in a specified weight and in specified date".

So, the message here is clarity and specificity in contracts beyond any doubt and uncertainty, which will be the case in the forward foreign exchange contract.

In fact, if we carefully examine the (Mandatory promise to purchase) under a letter of credit we can argue that the effect here is also "trading deferred with deferred" because the mandatory promise from legal point of view is a contractual obligation by the importer to purchase the goods that he is ordering the bank to purchase on his behalf. The goods are clearly identified and the value is predetermined and the client has no alternative but to purchase the goods when delivered to him, otherwise the bank would sell the goods and claim compensation from the client. What simply happens at delivery is that a Morabaha contract will be signed but this is just cosmetic and it does not change the fact that goods

were pre-sold and the value for the Morabaha was predetermined, as it is not logical at all for any merchant to leave the price of the Morabaha undetermined until the delivery date. No one would accept such a risk.

Incidentally, the price of the Morabaha is definitely determined in reference to the prevailing inter-bank interest rates. The concept of mandatory promise was recently approved by scholars as a protection for the banks and to discourage clients from denying their obligation. So it is a new concept that has the same legal effect as a sale contract. Some scholars in fact view the mandatory promise as a deferred sale agreement. From legal point of view, it makes no difference if the client and the bank signed the Morabaha contract on delivery date or not as it will not improve the bank's legal position over the mandatory promise, not even an iota.

On the contrary it is acceptable in an Istisna contract to exchange deferred with deferred. For instance two parties can agree to exchange a car that is to be manufactured against refrigerators or washing machines which are also to be manufactured some time in the future, provided that both parties have clear understanding beyond any uncertainty of the descriptions of the products to be exchanged. This kind of exchange is acceptable and not considered to be exchanging deferred with deferred because it is not a requirement to have the values of the Istisna' contract exchanged on spot basis and therefore can be deferred. In making comparison between this kind of exchange and the forward foreign exchange contract any sensible person would conclude that the uncertainty in this deferred Istisna' is far greater than a forward foreign exchange contract.

Section Four

Interest Rate Arbitrage

1- Islamic Swaps

Some Islamic institutions use the concept of Qard alHassan (Charity Loan) to exchange deposits among themselves and also with conventional banks. These deposits are simultaneously exchanged and are in different currencies. The essence behind this is to take advantage of interest rate differential between the two currencies. The two parties agree on the counter value amounts taking into account the interest rate and the period of the deposits. The net effect would be to convert interest income into a foreign exchange income.

To achieve this, usually the spot foreign exchange (FX) rate is adjusted to reflect the interest rate differential.

2- Parallel Purchase and Sale of Currencies

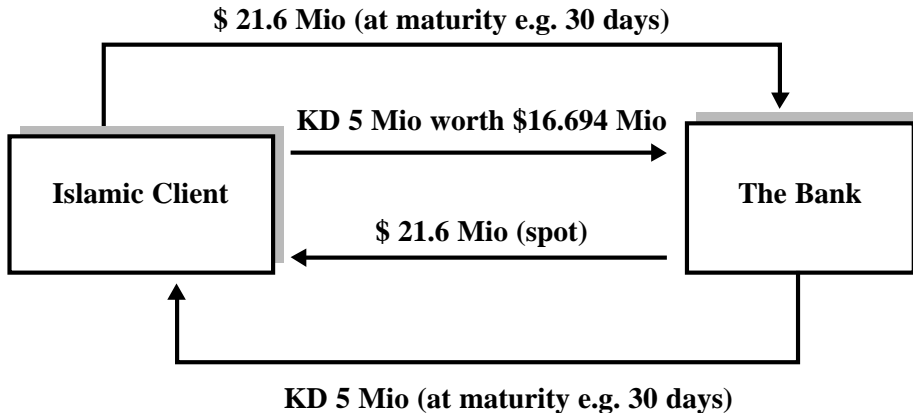
Other institutions have developed a slightly different structure to convert interest income into foreign exchange income. In this situation, the Islamic bank would enter into a spot foreign exchange with a conventional bank. For instance, it would sell Riyals spot against Dollars to the conventional bank and remits the Riyal to the account of the conventional bank on the value date. But it will not directly receive the counter value in Dollars and it will request the conventional bank to credit the Dollars to its account with the conventional bank, under what is referred to a "Blocked Account" which is obviously a non-interest bearing account. So the net result at spot value is that the conventional bank has received Riyals and created a non-interest bearing deposit on its books for the Islamic bank.

At the same moment a forward foreign exchange contract will be executed, whereby the Islamic bank would sell forward the Dollars back to the conventional bank against Riyals. Thus effectively reversing the original transaction with a key difference being that the forward FX rate is adjusted to reflect the interest income earned indirectly on the Riyals by the conventional bank. So, again the net result here is to convert interest income into foreign exchange income. The Islamic bank is permitted to sell the Dollars immediately, because his account will be credited on spot with Dollars so, he is selling what he owns in his account though technically has no right to withdraw such amount until the maturity date.

3- The Straight Forward Islamic Swap

Certain schools look at this in a more straightforward way. Their view is that it is acceptable to lend in a currency and be repaid in another. For instance, you can lend Dollars and get repaid in Riyals. Under this scenario it will be acceptable to charge interest by inflating the future value of the currency with which the loan will be repaid. Obviously all this has to be fixed and agreed upon on the date of the contract. So the borrower would know exactly from day one how much he will have to pay in Riyals. This group bases its Fatwa on the prophet's (PBUH) permission, which states, "If types of goods are different, you may trade as you wish". In fact, this can be classified as a Morabaha with deferred payment. Besides what might be seen to be as profit could turn into a loss because no one can be assured of the future value of the currency. The lender takes a currency risk as well as the credit risk on the borrower, so he is not certain about the results whether he can make profit or incur a loss.

Exchange of Deposits Agreement (Islamic Swaps)



Calculations:

$$\text{KD } 5\text{Mio} / 0.2995 = \$16.694 \text{ Mio}$$

$$\text{KD } 5 \text{ Mio} \times 0.07375 \times (30/365) = \text{KD}30.308\text{k} \text{ (1/8 skim on Kibor)}$$

$$\text{KD}30.308\text{k} / 0.2995 = \$ 101.196\text{k}$$

$$\$101.196\text{k} = 5.625\text{X} \text{ (30/365)} \times \text{Principal}$$

$$\text{Principal} = \$21.588 \text{ Mio (effective exchange rate is } 0.23160)$$

$$\text{Loan portion of principals exchanged} = \$16.694 \text{ Mio} - \$21.588 \text{ Mio} = \$4.894 \text{ Mio}$$

$$\text{Skims} = \$ 3933.2 \text{ (spread of } 0.98\% \text{ on the loan portion)}$$

- The above example assumes \$/kD 0.29950 spot rate, 2% interest rate differential in favor of the KD (i.e. Libor 5.5% & Kibor 7.5%), and 1/8 spread on the deposit and loan sides, so kibar will be applied on the deposit is 7.375% and the libor for the dollar is 5.625%.
- Value spot, the Islamic client wants to swap the KDs for US\$ and on a rate that will give it more principal to earn the interest rate differential. The Bank advances more dollars to the Islamic client thus, the Fx rate is adjusted to be 0.2316.

Section Five

Trade Finance

1- The Morabaha Contract

Trade is the cornerstone of Islamic finance, as Allah the almighty has allowed trading and banned usury. Trading which is referred to here is engaging in buying and selling of all kind of permissible commodities and assets while risking your efforts and capital and not like the case with usury where the financier wants to be assured of his capital and profits regardless of what happens to the actual transaction being financed. Therefore in Islam the conventional sale contracts are divided into three categories:

- Morabaha sale: means selling the object being financed at a profit.
- Tawliyah sale: means selling the object being financed at cost i.e. no profit no loss.
- Wadheea or Hateeta sale: means selling the object being financed at discount or at loss.

These are the three scenarios that can occur in any genuine trade. But because people's motive in any commercial transaction is to make profit, the market's emphasis has been on Morabaha transactions and Islamic banks are not different, after all they represent shareholders whose aim is to make exceptional returns. To further secure this aspect, Islamic banks managed to get the scholars approve the concept of mandatory promise to purchase (MPP). There are two main reasons for this, the first is to go around the issue of selling deferred against deferred, the second is that they cannot sell before owning the object being financed.

The process in a Morabaha deal is that the client/importer will furnish a specific and detailed request of the goods he wants to buy/import, the bank would accept to purchase the goods from the supplier/exporter on the condition that the client will on the delivery of the goods will buy the same at cost plus the mark-up for the bank. As the bank cannot sign a sale contract before it has the goods in its possession, the client must sign a mandatory promise to purchase, which for all practical and legal purposes have the same effect as the sale contract. On delivery date a sale contract will be signed. It is important to note here that the bank does not take any price risk (market risk).

Refinancing of Morabaha Contract

The biggest problem facing Islamic banks is that most of the contracts except in limited cases such as Ijara (Lease contract) are fixed rate debt instruments. So, once a Morabaha price is determined there is no way to change the price because the title (ownership) of the object has been transferred and the bank will hold a debt instrument. So if the client could not pay on time there is no way for the bank to get compensated [Yet some still argue that there is no time value for money]. Some have proposed that in this situation to reschedule the debt in a different currency, but it has not been approved because the opposing view argues that the benefit was drawn from rescheduling and that the rescheduling must be in same currency. One could argue that the difference between the cash price and the deferred price is also because the buyer is unable to pay cash. However, they have allowed that at the time of payment and before any default occurs the object could be priced in a different currency based on the exchange rate on the date of settlement. In fact, this could be one solution for rescheduling. For instance, the

client has a Dollar obligation that he cannot pay, he could inform the bank that he could instead pay the amount in Riyals, but on installment basis. So the bank can enter into a new and deferred payment foreign exchange by simply selling him Dollars, which the client would use to repay his debt on time and against the dollars the bank would buy Riyals that the client would pay on deferred basis. The bank can include its cost of refinancing into the foreign exchange rate. This supports the view that lending in a currency and being repaid in another is an acceptable way to charge interest as was explained earlier.

If the above was not an acceptable solution then another way is perhaps through the Tawarroq, a contract that was designed to allow raising funds. In this situation the Islamic bank would arrange to sell the client a new commodity on a deferred payment basis and at the same time would find a buyer that will be willing to pay cash for the same commodity and in this way the client would receive new money in his account with which the Islamic bank can settle the debt from the previous Morabaha. The new Morabaha price could be deferred and on installments to make it possible for the client to honor the payments due to the bank. This process should be acceptable because it involves a new transaction and could be repeated as frequently as required.

Mosharaka Motanakesah in Morabaha

Mosharaka Motanakesah means diminishing partnership/ownership. Some Islamic banks have reverted to the Mosharaka concept as a way to avoid a deadlock in a default situation. This means that the bank and the client agree to form a temporary un-incorporated partnership in a Morabaha transaction. The two parties agree to jointly buy a commodity for a fixed price from the supplier based on an agreed ratio (i.e. 90% for the bank and 10% for the client). The bank agrees to sell its share (90%) in the commodity on a gradual basis, based on a pre-determined formula, which takes into account a defined schedule of purchases by the client. This provides the bank the flexibility to adjust the pricing of the Morabaha based on actual market price (actual interest rates) on the date on which a sale takes place. So every time the client is able to purchase a portion a price is agreed upon and title relating to that portion is transferred or released. So the idea here is to continue owning a portion in the commodity until the bank is fully paid because only through maintaining the title the bank can adjust the overall price for the Morabaha particularly in a default scenario.

Some might argue that the client might need the title released to him in order to sell the commodity so that he can pay the bank. In this situation the bank could release up to 90-95% of the title and keep 5-10% to enable it to sell the last portion of 5-10% at a price that will compensate the bank for its loss if the client were to default. This way the bank will have a mechanism acceptable to Sharia that will justify the bank to get compensated, in the same way as other creditors namely conventional banks which are paid delay charges. There is nothing wrong from the Sharia point of view for the client to buy the last portion at a price that will be fair to the Islamic bank.

Alternatively, the title could be legally transferred to the client as agent for the bank, yet the bank has the legal right to determine the sale value of the commodity it owns through its agent. Besides the separation of legal ownership and beneficial ownership is also supported under English Law, as we will explain later in the book.

2- The Salam Contract

The Salam contract (supplier finance or a pre-delivery finance) is another important Islamic instrument to finance trade. This contract was developed initially to finance farmers to produce wheat and barley.

The incentive for the buyers of Salam, or as some group calls it Salaf i.e. credit sale was the high profit margins in buying the crops in advance, and also to secure a supply for their market.

This contract is hardly being used by Moslems to finance trade merely because of high market risk associated with this kind of trade. Under the Salam contract, the buyer has to pay the full value to the farmer/seller in advance and his options are very limited. In addition to taking the performance risk/delivery risk he is not allowed to hedge himself against price deterioration and in case of a default by the seller the buyer of Salam has no right to claim compensation for loss of investment or for the indirect damages that could be caused to him with his clients particularly in a situation where he has entered into a parallel Salam contract. This contract has remained undeveloped for over 1000 years now, unlike other contracts for instance the Morabaha contract where a new concept of mandatory promise has been attached to it to protect Islamic banks from a client who might negate on his non-mandatory promise to the bank because market developments may not be favorable to him at the time of delivery. So under Morabaha the bank will not finance unless the client agrees to buy the goods on the delivery date at cost plus the mark-up for the bank regardless of what happens to the actual market price for the goods. The bank is not concerned whether the client would make or lose money as such it is not taking market risk.

With these constrains in mind and at the request of an Oil Producer, we developed a solution that will eliminate the market risk in financing crude oil extraction through the Salam contract. The proposal was as follows:

- The buyer of the Salam will pay \$20 per barrel in advance for delivery in 90 days.
- The Oil Producer will guarantee a selling price of say \$21 per barrel at the date of delivery, so if the price was lower than \$21 the Oil Producer would provide additional quantity of crude to the buyer to make his minimum price of \$21.
- In return for this guarantee the buyer would forgo any price increase over \$21 to the Oil Producer.

The rationale for this was that the Oil Producer is taking market risk any way i.e. assuming the Oil Producer did not sell the same quantity on Salam basis, and kept the crude until the date of delivery, the Oil Producer could only sell the oil for what the market is on the delivery date, so the actual scenarios will be one of the following:

Scenario one: The market price will be exactly at \$21. In this case no one will compensate the other and everybody will be happy, the Oil Producer sold at \$21 three months before, and it received cash in advance and has definitely gained from investing the funds.

Scenario two: The market price is over \$21. The Oil Producer is happy because it will be the beneficiary of the upside and on the other hand the buyer of the Salam contract (Islamic Investor) will receive the minimum price, again no compensation is required.

Scenario three: The market price is much lower than \$21. Let's say it is \$16. In this situation the Oil Producer has to provide additional crude to make the difference, which is \$5 per barrel.

On the surface, it may look that the Oil Producer is losing \$5, but if you analyze the situation closely you will realize that from cash flow point of view the Oil Producer is benefiting much more than in the first two scenarios because had it not sold that quantity on Salam basis and waited until the delivery date it would have only received 16 Dollars, the actual market price, but instead it was able to get extra four Dollars in advance and for the whole period of the Salam. So it raised much more money and in advance.

The Oil Producer approved this proposal because it made economic sense from every angle. Besides and most importantly, the Oil Producer is taking market risk any way, therefore it was not taking any additional risk. This scheme was presented to different groups of scholars, and the responses were as follows:

- 1- The first group which had no association with any financial institutions directly or indirectly approved the above proposal based on the Hadith (prophet's preaching) by the prophet (PBUH) "all conditions agreed upon by Moslems are upheld, except a condition which allows what is prohibited or prohibits what is lawful".

حيث قال (ص): " المسلمون على شروطهم إلا شرطاً أحلّ حراماً أو حرم حلالاً "

- 2- The second group proposed that the seller (the Oil Producer) provides a unilateral promise that in case the buyer is not able to sell the commodity for a particular price, it will compensate the buyer; this promise should be separate from the Salam contract.

- 3- The third group proposed entirely a different approach as follows:

- The Salam contract to be based on the prevailing market price at the time of concluding the Salam contract less a percentage i.e. 10% discount for the one year contract and 20% discount for the two year contract. The financing for the Salam contracts to be through a fund which will issue participation certificates "The Salam Sukuk".
- The state which owns the Oil Producer to make an open offer to the Sukuk holders to buy their share at base value i.e. the nominal value before the discount with an option for the Sukuk holders to sell to state by accepting its offer or if they choose to sell at higher prices at delivery date.
- The offer by the state should be limited to a period of two weeks, a week before the delivery date and a week after the delivery date and if the Sukuk holders did not exercise their option within the two-week period, then they will be subjected to the actual market price.

- 4- The fourth group proposed two options as follows:

- Under an agency agreement the banks will appoint the Oil Producer as the sale agent to sell the crude on delivery date at no less than a minimum sale price (MSP) which will be agreed upon in advance, any excess over the MSP can be shared according to one of the following options:
 - a) The Oil Producer can take up to 99% of the excess over the MSP.
 - b) A maximum sale price to be determined and that any excess over the maximum sale price would be for the account of the oil producer.
- To mitigate against the fall in the price below the MSP, it is permissible to obtain a unilateral promise from an independent party to buy the specified quantity of the crude for a specified price and that such promise to be mandatory only on the third party.

5- The fifth group proposed the following solutions:

- The bank to purchase a specified quantity of crude at a nominal price or a price to be well below any expected decline in the price of the crude at the time of delivery, for instance \$6 per barrel. (This proposal was made when the average market price was \$25).
- The bank will appoint the Oil Producer to sell the crude at the time of delivery to any major international buyer. The agency agreement will stipulate that the Oil Producer will not sell the crude below a certain price for instance \$8.
- The bank will provide a separate mandatory and irrevocable promise that if the market price on delivery date was higher than the Salam purchase price plus the predetermined profit margin, the bank will grant the excess in value to the Oil Producer as gift and that the bank would forego its rights to the remaining quantity of crude in favor the Oil Producer.

Naturally the company opted for the first option as the most simple and practical approach. Option two which called for a separate unilateral promise was also acceptable. Option three was seen to be very complicated and unfair because it gave all the upside to Islamic investor and all the downside was for the Oil Producer. Option four would have been acceptable if it was not for the mandatory unilateral promise to be provided by a third party. Option five was not acceptable, because it was calling for off market rates; despite the fact it was cosmetic, it was against policy.

The interesting thing in all these proposals is the innovation in hedging the market risk. However, the writer's preference is option one as the simplest approach with a minimal sale price being incorporated and the excess over the MSP to be shared by a mutually agreed formula i.e. anywhere between 1-5% to be for the Islamic investor and the balance for the account of the Oil Producer. Obviously this sharing would depend on either the initial discount that the Islamic investor is willing to accept or the level of the MSP that he wants to guarantee. The higher these two factors are, the lower the sharing ratio would be. In another word, the lower the cost of financing will be to the Oil Producer its willingness to accept a much bigger share of upside for Islamic investor would be greater.

The challenge is to reach to the right equation here, which would be fair to both parties. If successful you could have a new Islamic instrument that will have the characteristic of a fixed income with an equity element. This would definitely be a positive development for Islamic instruments. It should not be so difficult to achieve; in fact Islamic banks can do this on their own without directly involving the seller of the Salam, through the parallel Salam contract. The Islamic banks can initiate their own direct Salam contracts acting as principals because the seller of the Salam does not need to be a producer of the commodity, so long it is assured that it can deliver the commodity on the delivery date. This should not cause too much problem because investors are not really interested in the commodity, they merely want their return protected. The Islamic banks could create a synthetic Salam, which is linked to the price of a commodity. Besides the seller of the Salam does need to own the commodity at the time of sale, as the key condition is that the commodity must not exist at the time of concluding the Salam contract.

This leads us to an important question which is that the buyer of the Salam cannot sell his contract to a third party before taking delivery of the goods. This prohibition contradicts the spirit of the Salam contract because the original seller of the Salam does not own the commodity in the first place as the commodity does not exist. If we apply the concept that you cannot sell what you don't own then on what basis we permit the original seller to sell what he does not own, besides the seller does not have to be the producer of the commodity.

On the other hand, we allow the buyer of the Salam to execute a parallel Salam contract. Again he does not have to own anything at the time of execution of the contract, so why not permit the buyer to sell direct participations in the original Salam contract in the same way as it is acceptable to original seller. One could argue that this might lead to unnecessary speculations as people might create Salam contracts just to raise financing. In fact, there is nothing stopping them now, even if this leads to speculation it will be just like any other speculation in other instruments namely real estate, equities or any other financial instruments. Some schools have permitted the sale of the Salam contract to other parties so long as the commodity is not food. This might have been the concern in the past but in today's market such speculations would not have any impact on prices of food because the market is so huge and open, prices generally reflect the actual demand/consumption. One could argue that conventional banks in taking deposits could cause speculations, as it will encourage them to finance speculative projects. This was the argument of the money center banks in the 80's during the LDC (less developed countries) crises, banks argued that they were swamped with cash deposits from Opec countries and they did not know what to do with it except to lend to Latin American countries. I believe, so long the Islamic institutions are properly regulated and adapt prudent banking standards, there is nothing to be feared from.

Penalty for default

Today the Salam contract does permit the buyers to ask for compensation in case the seller could not deliver and his right is limited to his principal amount. If we make an analogy with the Morabaha contract, we see that the Islamic bank has the right for compensation should the client refuse to honor his mandatory promise to purchase. The bank has the right to sell the goods at market prices and charge the loss if any to the client. I don't think that the Salam contract should be treated differently. In fact the buyer of the Salam should be more protected than under any other contract because he will advance the full amount, without having any recourse to the goods as the case is the Morabaha. Besides there is nothing in Sharia that prohibits the inclusion of a provision that basically permits the buyer of the Salam to have the right, in case of the failure by the seller to deliver, to buy the same product from the spot market and charge the loss if any to the seller. If this condition was agreed by the seller and was part of the contract why should Sharia prevent this? In fact the prophet (PBUH) has said: "All conditions agreed upon by Moslems are upheld except a condition which allows what is prohibited or prohibits what is lawful." By agreeing both parties on a penalty in case of default, they are not committing a crime under the Sharia. In fact, in Islam if you buy an animal the buyer has the right for compensation if the animal dies within three days, the buyer has the right to full value, yet death is beyond the control of any one. How come we let the seller of the Salam whether willingly or unwillingly to default without any penalty? He has no incentive to meet his obligation.

Exactly and in the same manner as we are forcing the ultimate buyer under Morabaha to honor his promise to purchase the goods as the scholars have ruled that a promise is now mandatory because the bank based on this promise will be buying the goods, we should use the same analogy also to make the seller of the Salam contract live to his promise to deliver the produce or else be willing to compensate the buyer based on market prices, should he decide to obtain the goods from the market. Therefore, we can also devise here a mandatory promise to sell, or be forced to pay compensation based on market valuation as the buyer may have contracted with another party to sell him the goods.

Section Six

Project Finance and the Istisna' Contract

In the conventional market, project finance means those projects where the primary source of repayment is from the cash flow of the project being financed. So risks are very high in project finance deals as also the returns to the bank. Additionally project finance mainly refers to industrial projects such as construction of petrochemical projects and oil refineries, etc. In the Islamic market project finance means all projects whether industrial or commercial that require construction or manufacturing. So, it has a much broader definition in Islamic finance and it would also include real estate construction, ship building and aircraft manufacturing. Besides, it is not a requirement under Islamic finance that the primary source of repayment should be generated from the same project.

The most suitable Islamic contract for project finance is the Istisna' Contract, which means Commissioned Construction or Manufacturing. The majority of scholars consider Istisna' a form of Salam or Salaf contract. However, it is much more flexible than the Salam contract; for instance, the value under Istisna' could be paid in advance, deferred or made on installment basis.

Istisna' contract can be used for the construction phase and can be refinanced by an Ijara contract for the post completion period. However, a key issue must be taken into consideration here is that it must be determined beforehand for whose account the Istisna' is. Is it for the account of the project sponsor or for account of the financier? If it is for account of the sponsor, then when the project is completed the title to the project is automatically transferred to the project sponsor and the recourse of the financier (the Islamic bank) would be limited to a debt obligation against the project sponsor. So, if the intention is to lease the project to the project sponsor, the title has to be released to the Islamic bank first, so that it can legally lease it to the project sponsor. Otherwise, the financier has to construct the project for its own account and then lease it to project sponsor.

The other issue of concern is that Istisna' is a fixed rate instrument, i.e. does not have the feature of the Ijara contract, thus cannot be re-priced periodically in accordance with interest rate movements. Since project finance deals take an average between 2-3 years to complete, it is not possible to mark to market the exposure in the same manner as the commercial banks can do, as they are permitted to capitalize interest every 90-180 days based on current market rates.

This could cause problems particularly if the project is being co-financed by commercial banks, which usually is the case as these deals require huge financing and are beyond the capacity of Islamic banks. On the other hand, Islamic banks generally would not be encouraged to take on these projects on their own, as they generally lack the technical expertise to evaluate these complex transactions. In fact, most of the conventional banks in the Arab world take comfort in having major international banks participate with them in these projects.

One way to overcome this problem is to divide the project into phases and each time a phase is complete it would be handed over to the project sponsor who would make a small upfront payment as advance rental relating to the phase that has been completed. This way it will be possible to re-price the Istisna value to reflect the debt service, in line with market rates. This method was approved by one of the most conservative scholars who actually provided his Fatwa (Sharia ruling) based on the following steps:

- The project sponsor to sign a release letter for the portion already completed in favor of a special purpose vehicle (SPV).

- The SPV in its capacity as the owner of the project to enter into a construction contract with the project sponsor to complete the project.
- The SPV will sign a Memorandum of Understanding with a promise (Mowa'ada) to lease the project to the project sponsor.
- The project sponsor to sign a Mowa'ada to lease the project after it is completed and should specify the period of the lease. There is no objection to take a portion as rental but the lease contract to be signed only when the project is complete.
- It is acceptable to lease part of the project before the entire project is complete provided that portion being leased can be of use.
- After the construction is complete and the handing over of the project by the project sponsor in its capacity as the contractor the lease agreement can be signed.
- The lease could be for a period of 6 months, which could be renewed. The lease rentals can be reviewed and pre-determined every 6 months.
- The SPV will undertake to give the whole project as a gift at the end of the lease agreement provided that the project sponsor had met its obligation under the lease.
- The amount being received during the construction period should be considered on the account and when the lease agreement is signed these amounts will be considered as part of the lease rental.
- In determining the lease rentals the total cost of the project and the appropriate profit will be taken into account. The method of payment should be clearly stated in the Memorandum of Understanding (MOU).
- The insuring party is the owner (the SPV) and not the sponsor and cost of the insurance to be added to the total cost of the project.
- No reference to loan or interest to be made in the MOU or the agreement. No objection to use mathematical formulas in determining the profits/rental income if they are not based on loans or interest.

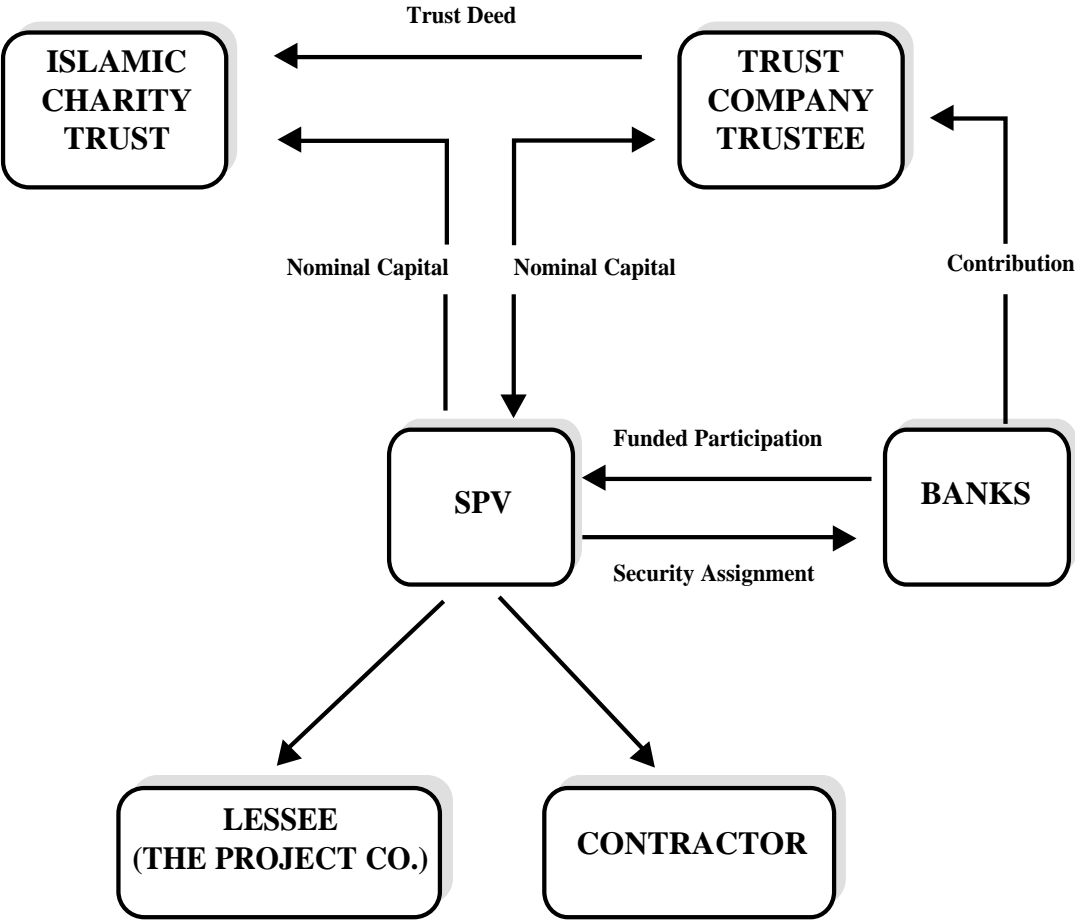
The last condition was a deal breaker for the sponsor because it was not possible to agree on a benchmark to determine profits/rental income, other than the Libor index. The Sharia Scholars need to be realistic and realize that industrial projects are not like other common assets that are easily leased to whoever is willing to pay more. Besides sponsors of such projects are not willing to allow Islamic institutions to participate as Mosharaka partners (Equity participants) without taking equity risk.

The above scenario was for a project that was entirely financed Islamically as both conventional and Islamic banks agreed to finance the project through the Istisna' financing. However there are situations where you have a mix of both Islamic and conventional financing. In this situation the need arises for a complex inter-creditor agreement to maintain the pari-passu treatment between all parties.

In such situations Islamic institutions need to agree to give up their rights to the assets they legally own and that all assets must be pooled for the benefit of all creditors.

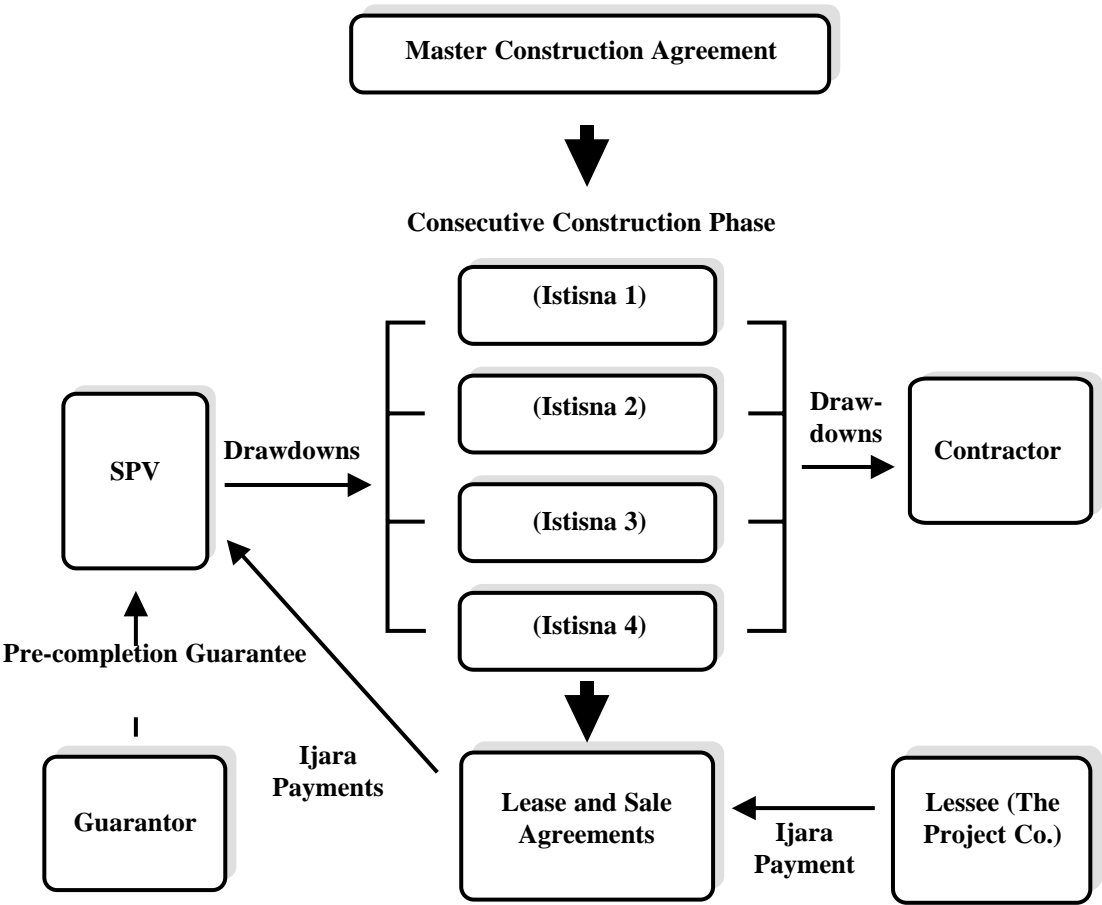
The situation gets more complex if the project is supported by export credit agencies (ECA), technically the Islamic banks will have no rights to the assets in case of default because the ECA would rank ahead of them in enforcing actions. So Islamic banks' role here would be limited to being financier, as they will have no recourse to the assets.

LEGAL STRUCTURE



FINANCING STRUCTURE

Mosharaka Construction payment



Mosharaka in Istisna' with refinancing in Ijara Motenakesah

Mosharaka in the Istisna' is the most suitable method to go around the mark to market issue/repricing as it works like an open ended fund which is evaluated on a daily basis to reflect market value based on work in progress. It also resolves the issue of down payment usually provided by the project sponsor. This is particularly the case in aircraft and ship finance. Moreover this structure should give great comfort to the Islamic bank as the project sponsor is also contributing in the project.

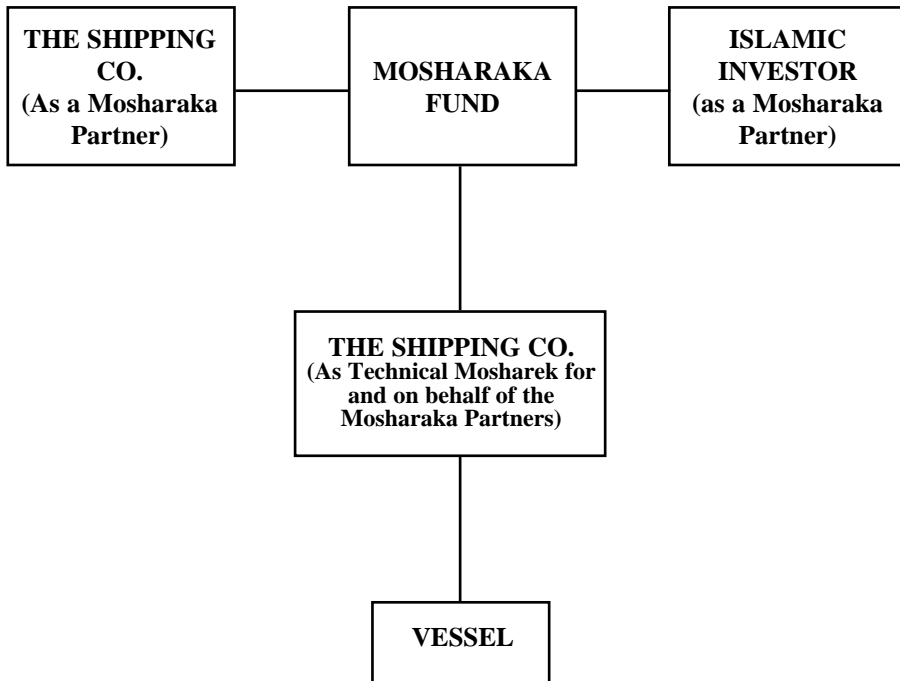
A Mosharaka or a diminishing un-incorporated partnership here is a form of a joint venture agreement where two parties undertake to jointly finance a project. Let us examine a real case, which we structured for a regional shipping company.

- 1- A regional shipping company which had already advanced about 30% of the value to the shipbuilding company entered into a Mosharaka agreement with the Islamic bank to complete building a vessel for their joint own account, the Islamic bank agreed to take 70% interest in the vessel. This was obviously executed through a master Mosharaka agreement which included a parallel Istisna' and an Ijara agreement.
- 2- The shipping company was selected as the "Technical Mosharek" as well and was authorized to continue negotiation with the shipbuilding company.
- 3- The Islamic bank provided a (Mowa'ada) promise to lease the vessel to the shipping company upon delivery.
- 4- The Islamic bank also agreed that the vessel be registered in the name of the shipping company because the company did not want to lose the subsidy it was receiving from its government. As a result of this, the shipping company was the legal owner of the vessel and also a lessee of an interest in the vessel. On the other hand, the Islamic bank was not the legal owner yet was the lessor of an interest in the vessel. This concept was acceptable under Sharia and was also applicable under the concept of the "Trust", under English law. It is possible for an object to be owned and registered in the name of one person (the legal owner) as trustee for and on behalf of another person (the beneficial owner). The shipping company in this case acts in two capacities, as one of the Mosharaka partners and the other as the Technical Mosharek. Anything that the technical Mosharek does under the Mosharaka master agreement is done as trustee for and on behalf of the Mosharaka partners. In other words the Technical Mosharek will be the legal owner of the vessel upon its delivery and the Mosharaka partners will be the beneficial owners of the vessels.
- 5- Under the Ijara agreement the Islamic bank (as one of the Mosharaka partners) will lease its beneficial ownership in the vessel to the shipping company (as the other Mosharaka partner). Accordingly, the shipping company will be both the legal owner and also a lessee of the Islamic bank's interest in the vessel. On the other hand the Islamic bank will not be the legal owner of the vessel yet will be the lessor of its beneficial interest in the vessel.
- 6- To give comfort to the Islamic bank it was granted a mortgage over the vessel upon delivery, assignment of the insurance relating to the vessel, an assignment of shipping contract (during pre-delivery stage) and an assignment of the refund guarantee in relation to shipbuilding contract. So, the Islamic bank got exactly the same security package as a conventional bank would get in these situations.

- 7- The structure also distanced the Islamic bank from environmental liability as UK legislation confines liability to the "Registered" owner.
- 8- The lease agreement was also subject to Mosharaka Motenakesah, as the shipping company was given the right every 6 months to make an offer to buy a portion of the Islamic bank's interest in the vessel.

This innovation can be applied to any project finance transaction as it provides the maximum flexibility and security to Islamic investors yet it could easily be securitized because of the Mosharaka aspect in the transaction. Participants will be owning interest in the Istisna' contract which is a real contract that will increase in value because of the work in progress. It is like someone building a house and selling it while partly constructed and not completely finished, certainly no one would expect the owner to sell the house without giving any consideration to the work already executed, otherwise he could be considered as Safeeh (fool) under the Sharia.

Mosharaka in Ship Building



You will see from the above diagram that the Shipping Co. acts in two capacities; as one of the Mosharaka Partners and also as the Technical Mosharek. Anything which the Technical Mosharek does under the Mosharaka Master Agreement is done as trustee for and on behalf of the Mosharaka Partners. In other words, the Technical Mosharek will be the legal owner of the Vessel. Under the Ijara Agreement, the Islamic investor (as one of the Mosharaka partners) will lease its beneficial ownership in the Vessel to the Shipping Co. (as the other Mosharaka partner). Accordingly, the Shipping Co. will be both the legal owner of the Vessel and also a lessee of the Islamic investor's interest in the Vessel. Furthermore, the Islamic investor will not be the legal owner of the Vessel but still will be the lessor of its beneficial interest in the vessel.

Mosharaka / Lease Structure for Expansion Project

This proposal was submitted for an expansion of a petrochemical plant, on the basis of combining conventional and Islamic finance:

Definition

a) Mosharaka

The Mosharaka in its broadly known definition is the Islamic equivalent of joint venture agreement, where partners contribute capital and share the profit and loss equally. However, the substance of the Mosharaka contract which is being proposed here is quite different, as it is only for two years and the profit element is already determined, i.e. Libor plus a credit spread. Though there is no reference to the loss sharing, it is implicit that should the project fail, the Islamic Party as well as the Project Company as Mosharek, will share the loss on a pro-rata basis. This could be clearly documented. In fact, this is in line with the merits of a project finance.

b) Lease/Ijara

It is almost identical to a conventional contract for a finance/full payment lease with no residual risk. However, from Sharia point of view, there is no distinction between finance and operating, as all contracts are viewed to be operating leases.

Key Features

- 1) The Mosharaka/lease structure has been proposed to give the Project Company the maximum flexibility in carrying out the expansion financing in the same way, as it will do with the conventional lenders.
- 2) The Mosharaka Contract permits the Project Company to execute all Engineering, procurement and construction (EPC) agreements directly in its name, without any interruption / involvement by the Islamic Party.
- 3) The minimum participation by the Project Company in the Mosharaka is 10%.
- 4) Mark-up, because the project does not provide value until the production phase, Islamically, it is not acceptable to receive cash returns before completion. However, such returns could be either accrued and later paid as an advance Ijara payment, or if need be, could be capitalized as part of the overall cost upon the effective date of the lease contract.
- 5) Pooling concept / subrogation rights, in case the ECAs are lenders as well is feasible, so long as a pro-rata sharing mechanism is in place. The only minor issue we might need to tackle is that proceeds on assets owned by Islamic Party are not to be used to pay for interest to the conventional lenders. In any case, in a default situation conventional lenders usually apply recoveries toward principal amounts outstanding and not as interest income.
- 6) It is not clear if the promise to sell / transfer of title is mandatory or not. Generally speaking during the construction period, the Islamic Party would effectively capitalize the interest. The Islamic Investor has reservations on giving a mandatory promise to sell, as then it could be regarded as a deferred sale agreement, thus would not qualify as a "Lease Structure", which means we would not be able to refinance and also have a variable rate instrument i.e. no re-pricing clause.

The key structural features, which make this proposal the optimum Islamic financing solution, are as follows:

- **Maximize Project Co. Control**

Under this structure, the Project Co. maintains the maximum amount of control over the asset and the overall financing structure with minimal interference from the Islamic party. Specially, under this proposal, the Project Co. acts as agent and owner of the asset on behalf of the Mosharaka Fund. All arrangements under the Mosharaka Fund are implemented by the Project Co. as manager of the Fund and all permits and authorizations are in the name of the Project Co. Furthermore, the Islamic Institutions are not party to the EPC contract during construction, and the Project Co. is the direct contract counter-party with the EPC contractor. The Project Co. as the technical Mosharek is free to consult with the contractor without the advice of the Islamic Party. Finally, the Project Co. will be entitled to depreciate the asset on its financial statements.

- **Use of a Floating Rate Rather Than Fixed Rate Instrument**

The Project Co.'s requirement to issue floating rate debt using Islamic financing makes this proposal the only viable Islamic structure. Similar to most Islamic financings in project finance, the Islamic Party's Istisna'a contracts would be issued as fixed rate debt.

- **Maximize The Project Co. Flexibility**

The current proposal is particularly advantageous to the Project Co. in that it permits refinancing of the same agreement without a need to sign a new contract or seek additional Sharia Board approvals. Unlike post completion Islamic Istisna'a structures, under the proposed Ijara structure, repayment deferrals could be possible under the same terms available to the commercial lenders. Under previous Islamic Bank Istisna'a contracts, this would not have been possible.

- **Minimal Advance Ijara Payment**

Under Islamic financing principals, Islamic financial institutions are not permitted to receive cash returns payments during the construction period. Accordingly, unlike conventional lenders who will be entitled to commitment fees and capitalized interest prior to completion, Islamic lenders are being offered an Ijara payment post completion in lieu of cash returns and fees during construction in order to equalize the return among all lenders. Whereas the Ijara payment could be paid in full at completion and still meet the requirements of Sharia Boards, it has been proposed to divide the Ijara payment into (i) a 15% "Advance Ijara Payment" paid at completion, and (ii) the balance of the Ijara payment allocated evenly over the remaining scheduled Mosharaka payments. The Advance Ijara Payment is thus being proposed at a level to minimize the impact on the Project Co.'s cash flow immediately after completion.

- **Other favorable Features**

Relative to other Project Co. financing sources, namely from commercial banks, the proposed Islamic structure offers the same features on similar terms without any penalty to the Project Co. As such, the proposed Islamic structure is designed to be equally attractive to the Project Co. relative to commercial funding sources. At the same time, by seeking new funding sources, Islamic funding increase the

potential market capacity available to the Project Co. and would reduce the overall amount required from commercial financing institutions.

The key potential concerns to the Project Co. and Partners from the use of the Mosharaka Islamic structure revolve largely around the inconsistent or unclear application of Sharia principles with respect to Islamic finance.

- **Risk: Islamic Institutions having title to certain assets**

The comfort here is that legally, all documents would be in the name of the Project Company, acting as agent for its own account and on behalf of the Islamic bank. Such ownership might be challenged in courts in case of dispute. In such a scenario, the Project Company would have the same problem with the conventional lenders (who would have a mortgage) should they wish to go after the assets. Furthermore, we should be able to mitigate this through an inter-creditor agreement, which would stipulate the rights of all parties through an appointed security agent who would represent all lenders (conventional and Islamics) through a voting majority.

- **Risk: The Project Co. as Manager of the Mosharaka Fund**

Generally, under Sharia principles, power of attorney or agency (The Project Co. as Manager of the Mosharaka Fund, in this instance) is revocable at will by the grantor of the agency. However, some scholars take the view that an agency in the context of a Mosharaka Fund is not revocable at will once the capital is utilized for its intended purpose. However, it is worth noting that the Local Regulations would uphold the proposed management structure in an unincorporated joint venture such as the proposed Mosharaka Fund. The documentation has been structured in a way as to protect against the removal of the Manager by providing a vote of 75% of the holders of the Mosharaka is required in order to remove the Manager if they are grossly negligent in the performance of their duties. Since the Project Co. will always hold a minimum of 30% of the Mosharaka Fund, they would always be able to block such a removal.

- **Risk: Increase Complexity of the Inter-creditor Agreement**

Since the Project Co., as Manager of the Mosharaka Fund will own the asset on behalf of the Fund, the Islamic intuitions may, following an Event of Default and subsequent foreclosure of the project, be in a slightly better position than other lenders as they would be able to claim an ownership interest in the asset being financed. Commercial lenders, to ensure that they are not unnecessarily disadvantaged, will wish to ensure that any foreclosure process is controlled through the Inter-creditor Agreement.

Accounting

The Project Company's minimum participation of 10% would be classified as shareholders funds. On the remaining portion (90%), it would be classified as Mosharaka Financing, and will receive the same treatment as a normal liability similar to the loans from the other banks. It is more of a P&L issue, as it may require certain adjustments so that the return being received by the Project Company on its participation should not be classified as dividend. Given the fact that the Mosharaka is only for two years and that return is only accrued and not paid in cash and that the return is Libor based, the Project Company should receive a favorable accounting treatment. The simplest approach would be to consider it as a down payment, similar to down payments on Aircraft financing or possibly as Equity in Investment.

Equity Distortion

The ratio of the 30% equity and 70% debt, would not be distorted at all, the Islamic Party does not require more than 10% participation by the project company which is more favorable.

Tax

The Project Company should be able to claim the normal depreciation, as it will have the risks and rewards of the assets, (Economic Title). It should be able to report the entire asset as fixed assets on its book. This view is based on legal title being with the Islamic Party. However, as we know, legal title would be in the name of the Project Company under the Mosharaka.

Zakat

The Project Company could have the best of both worlds, as from the Sharia, they do not own the asset, therefore, the 2.5% Zakat is not applicable. So for Zakat, the project Company can prepare another set of accounts, in fact many local corporates are turning to Islamic finance because of this! This does not mean that the Project Company will be violating the Zakat's law, as the Islamic banks would be paying for it, because they would be reporting it as an asset on their books and under Sharia, there is no double payment for Zakat. This is during the construction period but after completion and when the Ijara contract is effective the Islamic bank would pay Zakat only on the rental income. In any case. The project company would not be liable for Zakat because capital assets, plants and machinery are exempt and also because it is holding title on behalf of the Islamic party.

Documentation

- 2) The Mosharaka contract would cover the Project Company's agreement to construct the facilities, and to act as agent on behalf of itself and other Islamic lenders in carrying out the project and executing all necessary EPC contracts. General clauses for this type of transaction would be incorporated in the document.
- 3) The lease contract would not be very different from a conventional lease, with the possibility of requiring a side letter to document the methodology of the re-pricing (Libor Fixing and the reference rate).
- 4) To document the promise to sell, we may require to have effectively "a Bill of sale" that would be executed at the end of the lease contract transferring the title to the Project Company. Since legal title is already with the project Company, we may need to have a release letter from the Islamic bank instead.

Execution

The Islamic Bank to act as the lead Bank / Agent which would execute the above agreements with the Project Company, and the security agent (if any) and the inter-creditor agreement for and on behalf of Islamic participants. The Islamic Bank would enter into sub-participation agreements with other Islamic banks participating in the financing.

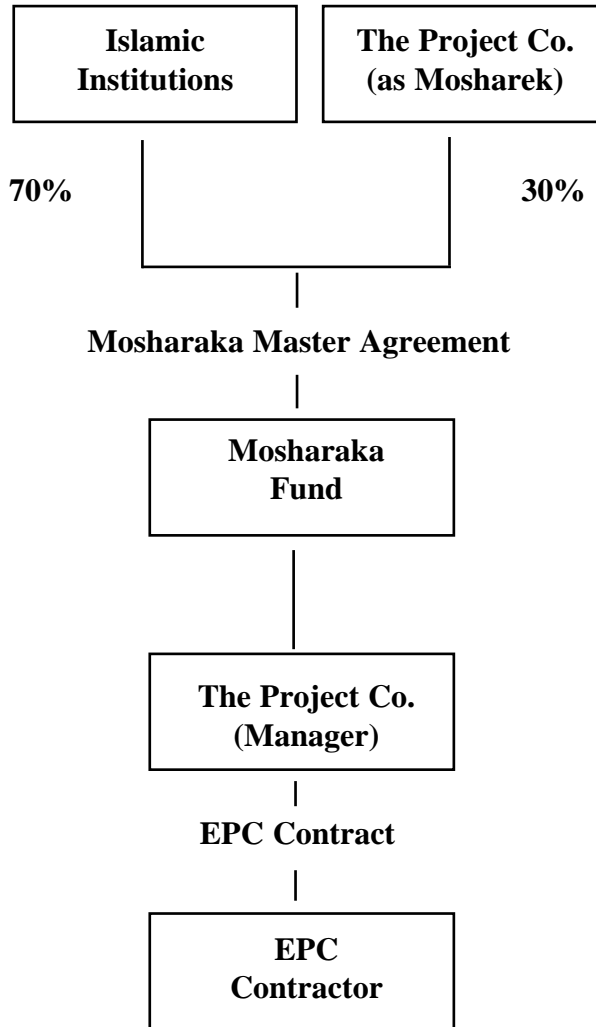
Summary

The above, is a breakthrough in its proposed structure as an Islamic deal structure. The Project Company would be getting at least the same deal if not a better one for the following reasons:

- 1) A variable rate instrument, with the flexibility to have all lenders pari-passu in terms of yield and the security package.
- 2) Less demand on the Project Company's cash flow during the first two years, as the Islamic Party would not want to receive cash returns.
- 3) Same accounting and tax treatment as the conventional lenders.
- 4) The Project Company not providing any additional security to the Islamic banks, as the relationship between all lenders would be governed by an inter-creditor agreement subject to English law, which would supersede any implicit or explicit understanding under the Sharia.

THE EXPANSION PROJECT

I. Pre-Completion

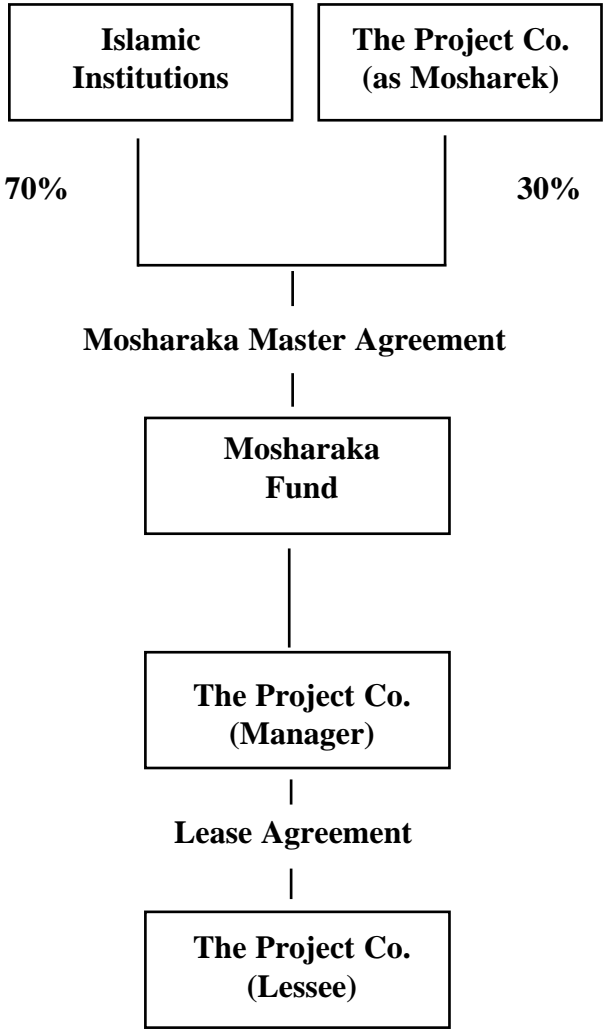


The Project Co., on behalf of the Mosharaka fund, manages and is a party to the EPC Contract.

Title over the assets passes to the Project Co. under the EPC contract.

THE EXPANSION PROJECT

II. Post-Completion



The Project Co., on behalf of the Mosharaka Fund, owns and manages the assets which are, in turn, leased to the Project Co under the Lease Agreement.

Section Seven

Silent Risk Participation

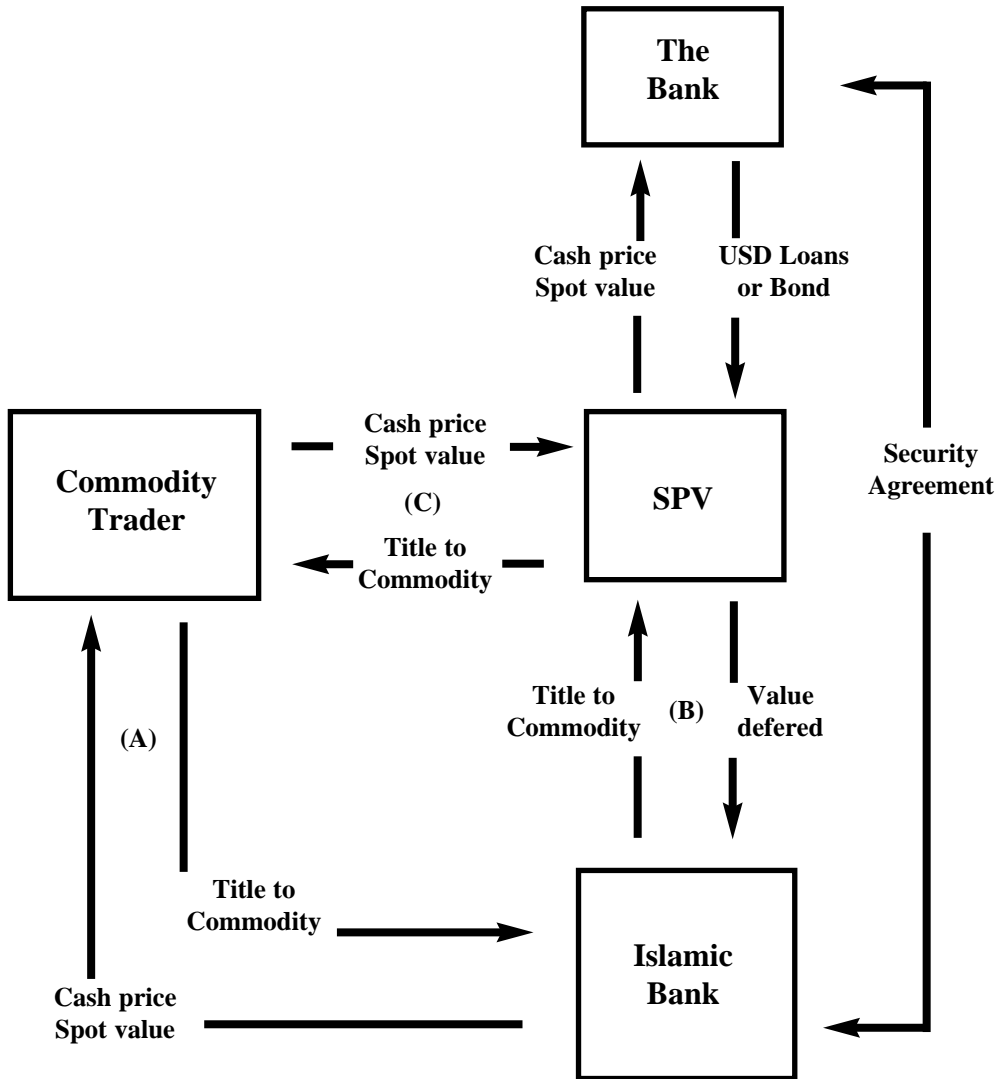
Some Islamic banks revert to indirect risk participations in conventional loans or securities as a way to enhance returns over the returns provided in the commodity market. Apparently there are certain views that support accepting credit risks in conventional instruments. Perhaps their argument is that it is like extending credit facilities on Islamic principles to institutions which are not classified as Islamic in their business dealings. For instance, there is nothing wrong in providing a Morabaha financing to General Motors. In this approach they segregate the credit risk from the actual business activity. It is viewed as accepting a guarantee of a conventional bank to support an Islamic transaction.

A conventional bank that wants to reduce its credit exposure to a client without the knowledge of the client, usually in the conventional market sells such risk on silent basis through un-funded participations, so the party which is buying the risk will take the full credit risk against a fee without the need to fund the transaction. It is referred to as silent risk participation or un-funded risk participation. However un-funded risk participations are not suitable for Islamic banks because first they cannot provide guarantees as they cannot charge for them and second is that Islamic banks are cash rich and are desperate for a way to park their huge liquid positions, so the solution is as follows:

- To create a special purpose vehicle (SPV) through which a transaction will be channeled.
- The Islamic bank will buy a commodity for cash i.e. on spot basis usually from a commodity trader.
- The Islamic bank sells the commodity to the SPV on deferred basis.
- The SPV will sell for cash the commodity it bought on deferred basis to same commodity trader, which sold the commodity to the Islamic bank.
- The SPV will receive value spot for the commodity and transfers the title of the commodity back to the commodity trader.
- The SPV will use the proceeds to buy the loan or the security, which the conventional bank wants to sell to the Islamic bank indirectly.
- The Islamic bank would undertake to keep funding the SPV during the period of risk participation which could be until the actual expiry of the instrument or as might be agreed for a specified period of time.
- The conventional bank through a security agreement would undertake to administer the SPV and ensure that the SPV would not engage in any other activity, which might have an adverse effect on its obligation toward the Islamic bank. This undertaking is viewed by the Islamic bank as an implicit guarantee which would allow it to classify the risk on its balance sheet as exposure being guaranteed by the conventional bank, but this might not be the case in the event of a default by the obligor under the loan or the security. The Islamic bank would not be covered by the conventional bank, after all the whole idea is to sell the credit risk of the obligor for which the Islamic bank receives a much higher return than on its commodity investment.

- The conventional bank obviously will also act as agent for the Islamic bank and the SPV to execute their transactions.
- The Morabaha transaction is rolled over periodically to coincide with the rollover cycle (interest rate cycle) of the instrument being funded.
- The obligation of the SPV to pay the deferred payment to the Islamic bank is explicitly conditional upon the obligors' performance under the loan or the security.

SILENT RISK PARTICIPATION



Section Eight

Acquisition finance

Islamic institutions have been active in corporate acquisitions in the western world, primarily in the US market. They generally target real estate and industrial companies, and avoid service based companies such as banks and insurance companies. Most of the target companies have significant amounts of bank financing, the big challenge for the Islamic investor is to convert the conventional finance into Islamically acceptable funding. However the main problem is that commercial banks in the western world are not permitted to engage in trading activities or taking title to real property.

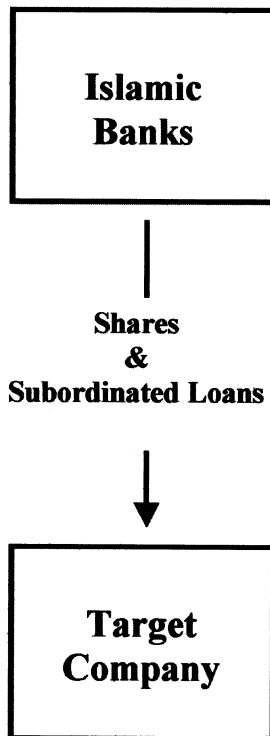
The first option for the Islamic investor is to finance the acquisition entirely with equity but this may not be economical, as it will attract huge tax liability, which could make the return on the investment unattractive. The second option is to arrange for a mix of equity and conventional financing from the same investors who are providing the equity. This way they will keep an efficient tax structure because the investors can charge the target company interest based on the concept of father and son. So every equity investor must also have his pro-rata share of the debt. This might not be enough, as the target company will still have ongoing needs for banking facilities. Offshore financing from Islamic institutions might attract withholding tax liability on loans. Therefore the best alternative would be in applying a similar concept as the silent risk participation but in a reverse manner and by creating a bankruptcy remote single or special purpose vehicle (SPV) to act as an intermediary between domestic US banks and the target company. The process would be as follows:

- 1- An offshore "Trust" will be set-up and the trust will establish a US based SPV.
- 2- The SPV will buy the assets of the target company and will lease them back to the target company.
- 3- To finance the purchase by the SPV, it will obtain conventional finance from US banks.
- 4- The US banks will take a mortgage on the assets being leased to the target company and will have security interest in the lease.
- 5- The US banks will make conventional short-term credit facilities to the SPV.
- 6- The SPV, pursuant to a master agency agreement will provide short-term facilities, such as Morabaha, Tawarroq, Istisna or Bei Salam to support the working capital requirement for the target company. The SPV can rely on the commodity market to raise short term general purpose financing. The SPV will source the commodity in the spot market and will sell it on deferred payment to the target company, which in turn, sells the commodity on spot basis and receives cash, this can continue as an evergreen line of credit.
- 7- The US banks will have security interest and the necessary assignments in all transactions and contracts between the SPV and the target company. So, in case of default/bankruptcy the SPV would be collapsed effectively and the banks would have direct recourse to the target company as secured lenders.
- 8- The Islamic investors control the SPV through a Trustee. Any law firm would be more than willing to set-up a trust for a fee and occasionally, they use charitable trusts in order to make it immune from legal action, who would want to go after a charitable organization. It is like giving birth to a

child and giving it up for adoption to foster parents who are usually paid to bring up the child. As the case in adoption, the title to the SPV will be relinquished here also. The Islamic investor relinquishes any legal title to the SPV thus the Islamic investor maintains no ownership interest in the SPV. So as far as they are concerned it is a separate legal entity.

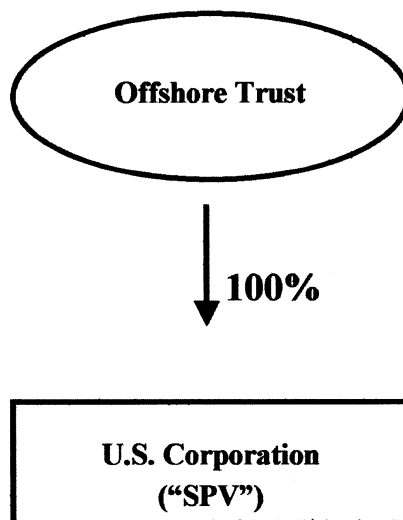
It is worth mentioning that the government of the United States when it decides to block or freeze any asset it will not just look at who owns the asset but also who controls it.

Acquisition of Target Company



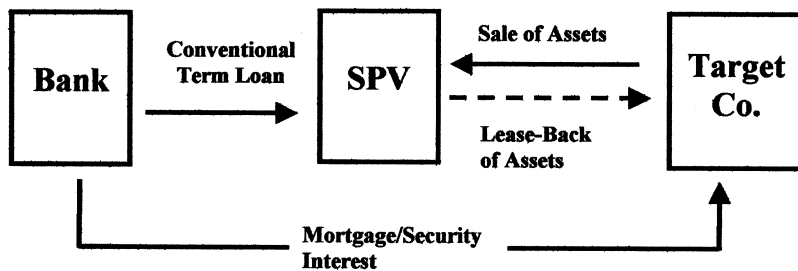
Acquisition of the Target Company by Islamic banks

SPV Formed to Purchase Assets of Target Co.



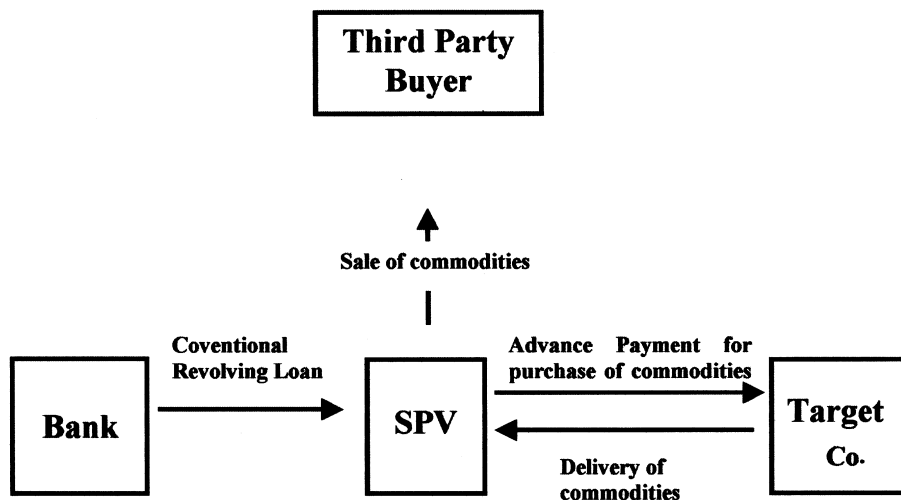
A “special purpose company” (“SPV”) structure is formed to purchase assets of the Target Co. and lease them back to the Target Co simultaneously with sale of Target Co. to Islamic Banks. The Islamic Banks will have no ownership interest in the SPV financing structure.

“Ijara” Lease Contract



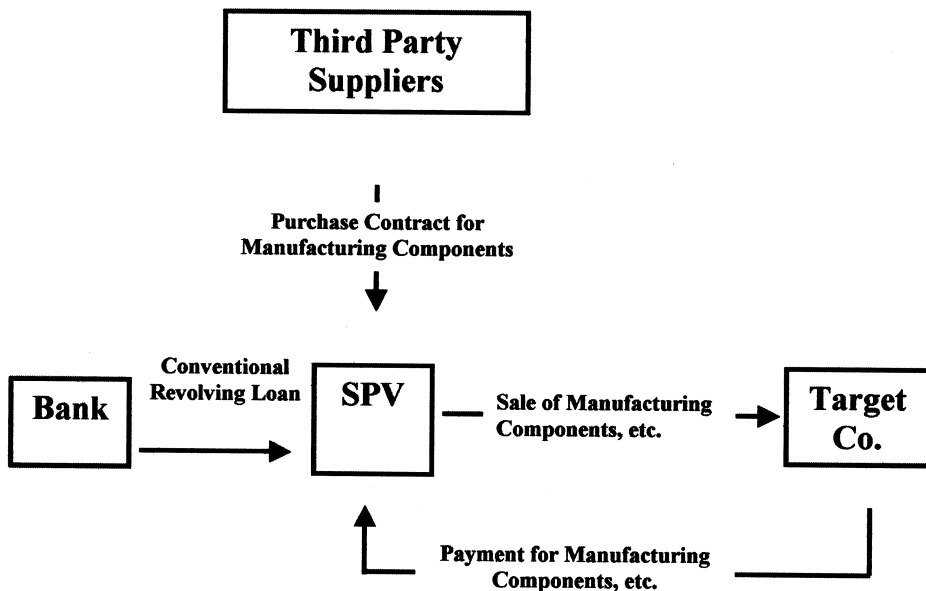
Bank makes conventional loan to SPV; SPV purchases assets of Target Co., Target Co. leases the assets. Bank takes mortgage lien on, and/or security interests in, assets and collateral assignment of Target Co's obligations under the lease.

“Bei Salam” Advance purchase of commodities and Resale to Third Party Buyer



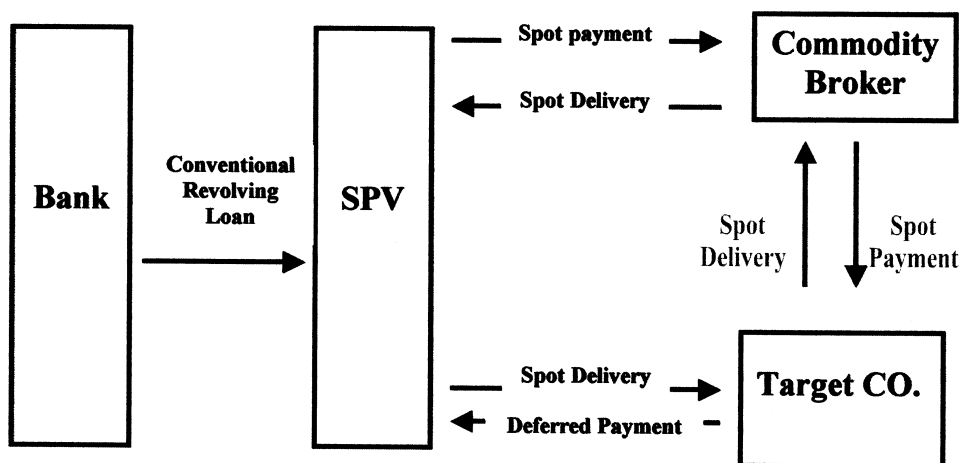
Bank makes conventional revolving loan to SPV, SPV makes advance payment to Target Co. for future delivery of commodities; Target Co delivers commodities; SPV resells commodities to third party buyer at cost plus profit.

“Bei Istisna” Financing of Purchase Contract



Bank makes conventional loan to SPV; SPV enters into a purchase agreement with the supplier; SPV resells or leases purchased goods to Target Co

“Tawarroq Finance” Commodity Based Revolving Credit Facility



Bank makes short-term loans to SPV; SPV enters into spot commodity purchase transaction with commodity broker; SPV resells commodities to Target Co, delivery immediate but payment deferred; Target Co resells commodities to commodity broker for immediate delivery and payment, Target Co pays SPV on deferred payment.

Section Nine

Securitization

Securitization is a concept that was developed by US banks to convert an illiquid and long-term loan into a security in order to broaden the placement of the exposure to non-bank organizations such as pension funds, insurance companies and private investors. In recent years this concept has been used by the corporate world to raise financing on a primary basis. Therefore asset securitization has been used to leverage the balance sheet and has become an asset class on its own and a form of secured borrowing. The process is rather simple. It basically requires to set-up a trust/SPV which would issue shares (either by way of private placement or listed securities) and uses the proceeds to buy certain assets. Such assets could be either real tangible assets or financial claims such as receivables. So, it is one form of assets backed securities. This concept has been appealing to the Islamic market because on one hand Islamic finance is supposed to be asset backed financing and on the other the Islamic market lacks tradable securities equivalent to the debt securities in the conventional market. Therefore, great time and effort have been devoted to develop this aspect of the market.

The general guidelines for Islamic tradable security are:

- 1- The security must represent ownership interest in the asset being financed.
- 2- The level of debt instrument should not exceed 49%.
- 3- The security must not be guaranteed by the underwriter. Similarly the participants (the holders of the security) should not guarantee each other.
- 4- Market making to be on best effort basis and subject to prevailing market prices.
- 5- It is acceptable for the underwriters to make a general offer to buy back the security but must be subject to mutual agreement and market conditions.
- 6- It is permissible for the underwriters to buy back the security for the nominal value to protect the client from capital loss provided that this has not been a pre-condition or announced at the time of subscription.
- 7- If the market price is higher than nominal value then the underwriter should buy at market prices.
- 8- It is acceptable for an independent third party to guarantee the issue but such guarantee must be under a separate agreement.
- 9- The participant must all share in the risks and rewards equally according to their pro-rata interest in the underlying asset.
- 10- Expenses arising from owning the asset, such as insurance, maintenance cost and taxes should be borne by the participants/owners.

Types of securities:

Though Islamic securities are equity based instruments, technically speaking they can be classified in two main categories; equity linked securities and Libor linked securities:

The equity linked securities

1- Modharaba Sukuk:

The word Sukuk means deeds or title deeds. It has been widely used as reference to Islamic bonds or securities. So, going forward we will use this word. On the other hand the word Modharaba means speculation or trading but its true meaning here is arbitrage.

Modharaba is a contract between two parties, one who has money but no expertise (the investor) and another who has the expertise, but no money (the arbitrageur or Modhareb). The Modhareb will receive an agreed percentage of the profit and will get nothing if he did not make profit and all losses are for the account of the investor, except in case of negligence or mismanagement. At the outset the two parties agree on the general guidelines and after that, the investor will not get involved in the management. The Modhareb is considered as Ameen (trustee). Therefore he cannot guarantee the investment, even if he is to volunteer his guarantee it will not be acceptable. However there is a minority view, which says that his guarantee might be acceptable only after the signing of the contract and when the funds are invested. The Modhareb may be requested to provide an independent third party to guarantee him against negligence and mismanagement.

The Modharaba contract resembles exactly the discretionary fund management agreement except that it is entirely performance based. In fact, certain major institutions would only give money to conventional portfolio manager based on similar arrangements. The rationale for this is that the Modhareb is a partner with his effort and the investor is with his capital. So, if he did not make profit he should earn nothing otherwise the principal amount of the investment would gradually diminish if he is to be paid regardless of his performance. One could argue that this could be a recipe for disaster, as the Modhareb might be forced to show profits in order to earn his living or in today's market his bonus from his employer (if he is managing the account within the institution which is acting as Modhareb). It is understandable not to be paid if he loses money but if he managed to break even he should earn a minimum fixed amount. This is only fair considering the nature of the markets. Today in a declining market it is an achievement to preserve capital or to lose less than the market's general decline. Besides the spirit of Islamic finance is to risk your capital and for this specific reason Riba/usury has been banned. Some might propose that the solution to this is to have an agency agreement where the agent is paid a fixed fee to administer and manage the investment through an investment committee. However the agent here will have no incentive to earn more if he is only paid a fixed fee, in any case it will not be considered as a Modharaba contract. In fact such arrangement is more like the Jo'ala contract, which is based on reward against services provided, perhaps a combination of a Modharaba and Jo'ala would be ideal to resolve this issue.

The Modharaba Sukuk could be issued through a trust/special purpose vehicle (SPV) on the basis of equal units and must be registered in the name of the participant of common interest in the capital of the SPV. Trading in the Sukuk is not permitted until the funds are invested and that the levels of cash and debt instruments are not exceeding 49% of principal investment. The funds can be invested in all permissible activities such as trading in shares, commodities, industrial investments, leasing etc.

The Modhareb who is also acting as an underwriter for the issue is permitted to buy back the Sukuk at

market prices based on mutual agreement and such offer must be for all investors without any discrimination. This in fact is similar to the situations where Islamic banks accept investment deposits as part of their general funding on the basis Modharaba investments. Islamic banks subject to a notice would repay the principal deposit back plus any accrued earnings. If we to assume that Modharaba deposits were fully invested which must be the case, then technically the Islamic bank is buying back the investment at least at nominal value.

The Modhareb/underwriter is also permitted to buy back the Sukuk at the higher value of either the nominal price or the market price to protect the client from losing a portion of his capital provided that this was not a pre-condition at the time of the issue and was not announced to the investors prior to their subscription. This could lead to preferential treatment and could cause suspicion by investors. In a volatile market some investors might be successful in getting their principal investments back while others might not, because by such time the Modhareb may have stopped buying at nominal value or refuse to buy at any price.

To resolve this issue certain institutions arrange for a third party guarantee from a member within their group to guarantee the principal amount of the investment. Perhaps a much easier way to protect the principal is to have a two-tier structure of equity and debt. The SPV could be funded with a nominal capital and the entire funding required for the Modhareb would be provided in the form of interest free loan. The Sukuk holders will be the owners of the nominal equity and also the providers of the loan and each participation will have a pro-rata share in both the equity and the loan. The Sukuk holders will still receive all their income in the form of dividends from the SPV. This would allow for capital protection without the need for third party guarantee, which very seldom will be without a cost and most of the time it is a member of the group relating to the issuer, which will provide the guarantee, so it is an in-house affair. On the other hand, the Modhareb/the underwriter would still have the flexibility to protect the client from any capital loss or to adjust the net amount payable based on the market value of the clients ownership in the SPV, which would effectively be the net asset value of the SPV.

2- Mosharaka Sukuk:

The Mosharaka Sukuk are very similar to the Modharaba Sukuk the difference here is that the underwriter/issuer will also participate with his own money in the Sukuk and will manage the fund through an investment committee. Under this concept, it should be easier for the issuer who is also a partner (Mosharek) to commit to market making and buy back the Sukuk from the participants based on mutual agreement and market prices. If the Sukuk are not either listed or the return is not predetermined based on a recognized index, then it would be critical to agree on an independent process for valuation of the Sukuk, an independent trustee would be critical in this situation.

Certain private institutions in Gulf region have reverted to this scheme to raise general purpose funding. The Sukuk holders in this case will have general interests in all capital assets of the company and will be entitled to the same earnings (dividends) as the other shareholders less a management fee. So the Sukuk are effectively direct investments in the company but have no voting rights in how the company is managed. It is not clear if the Sukuk holders will have the same treatment as the ordinary shareholders in case of a bankruptcy. Under this arrangement the company which is a closed entity (unlisted) has effectively issued shares to public, yet it is not subject to the regulatory guidelines and reporting requirement as a publicly listed company. On the other hand, the company has indirectly engaged in banking activities without being subject to reserve requirement as the commercial banks. Besides it is not fair from every aspect that the investors get less returns than the ordinary shareholders

because they will have to pay management while they have no say in how the company is run. This certainly requires an independent trustee to represent these helpless and captive investors. In the conventional market, at least the preferred shareholders have certain advantages over the common shareholders. The market should be very concerned about these kinds of arrangements particularly in light of lack of transparency.

The Libor linked securities

By libor linked securities we mean those transactions that are priced in reference to Libor, they are either fixed or floating rate instruments. Under these instruments the investor knows exactly the expected return and the index on which the rate of return will be based upon, as it will be determined in advance, unlike the Modharaba or Mosharaka contracts. Under this category we have basically three types of Sukuks.

Ijara Sukuks

The word Ijara means leasing, hiring or employment. Technically you can lease tangibles such as equipment and lease services by hiring or employing an individual. In this regard we quote a verse from the holy book, when prophet Shu'aib (PBUH) offered prophet Moses (PBUH) one of his daughters in marriage.

Stories 25, 26 and 27

"One of the girls said my father hire him, the best man you can hire is someone who is strong, trustworthy (faithful)" he (Shu'aib) said " I want to marry you to one of these daughters of mine, provided you hire yourself out to me for eight seasons (years) if you should complete ten, then that will be your affair, I do not want to be hard on you, you will find me an honorable man if God so wishes" he (Moses) said " That is up to you and me, whichever term I may serve out, there will be no injustice done to me. God is a trustee for anything we say".

النص القرآني: " قالت إحداهما يأبى استئجره إن خير من استئجرت القوي الأمين. قال. إني أريد أن أنكحك إحدى ابنتي هاتين على أن تأجرني ثماني حجج فإن أتممت عشراً فمن عندك وما أريد أن أشق عليك ستجدني إن شاء الله من الصالحين. قال ذلك بيني وبينك أيما الأجلين قضيت فلا عدوان عليّ والله على ما نقول وكيل."

So Moses married the daughter and served for 10 years.

The Ijara contract is the most flexible contract, as it allows the Islamic investor to retain direct ownership in the asset being leased throughout the life of the contract, and at the same time permits re-pricing based on market conditions. Therefore it has become the most desirable method of financing for long term projects. The principal financial benefit for the investor is the savings on tax (Zakat), as Zakat is paid on the rental income unlike other contracts, which will have to be based on the principal amount plus obviously the return earned.

There are basically two types of lease contracts, one is operating lease and the other is financial lease, or what is referred to "Ijara Wa Tamleek" which equates to a conditional sale agreement. Title to the asset will be transferred either through a promise to sell or as a gift at the end of the lease agreement and must be documented separately, however practically Islamic banks usually entertain full payment

leases. Their objective is obviously not to own the asset. The Sukuk here will represent ownership interest in the underlying asset and are tradable in the same manner as any stock or shares are traded and the Sukuk can be fixed rate or floating rate instruments.

Salam Sukuk

It is acceptable to issue Sukuk for participations in a Salam contract but the Sukuk cannot be traded because the Salam obligation (The seller's obligation) is considered as debt and should not be traded. Perhaps one way to tackle this, is to trade them in a different currency based on the Hadith "If types are of different kinds then trade/sell as you wish". Also applying the analogy of trading in currencies on spot basis! Currencies or bank notes are legally debt obligations of the countries that issue them. So since it is acceptable to buy and sell currencies on cash basis it should also be acceptable to buy and sell Salam contracts on cash basis.

Going back many years when the Salam financing was used initially, we note that this method was used to finance farmers who needed money to grow crops. The farmers would offer huge discounts to merchants to buy their future produce on Salam basis. So the farmer when he used to sell his crop forward, he could not commit to buyback the crop, because he was not in the business of buying and selling commodities. He would commit to grow the crop and if he failed he would repay back the debt, or if he realized that he could not meet his obligations prior to the delivery date for reasons beyond his control, such as natural disasters or dry season, or what can be considered act of God, at that point both parties would come to terms or what is referred to in Sharia "Mosalaha". In these situations the buyer of the Salam would be happy if he could recover his principal, as the seller of the Salam would be in distress and his recourse could be to the state or what is referred to in Islam "Dar Al mal" the Treasury House as he would qualify for bail or charity according to this Koranic verse, Repentance (66).

"Charity is (meant) only for poor, the needy, those working at (collecting and distributing) it, those (possible converts) whose hearts are being reconciled (to yours), for freeing captives and debtors and in (striving along) God's way and for the wayfarer as a duty imposed by God. God is aware, wise".

النص القرآني: " إِنَّمَا الصَّدَقَاتُ لِلْفُقَرَاءِ وَالْمَسْكِينِ وَالْعَامِلِينَ عَلَيْهَا وَالْمُؤَلَّفَةِ قُلُوبِهِمْ وَفِي الرِّقَابِ وَالْغَارِمِينَ وَفِي سَبِيلِ اللَّهِ وَابْنِ السَّبِيلِ فَرِيضَةً مِّنَ اللَّهِ وَاللَّهُ عَلِيمٌ حَكِيمٌ ".

If Dar Al mal was not in a position to rescue such debtor, then he would be considered as a stressed debtor and this verse would apply to him "And if (the debtor) is in straitness, then let there be postponement until (he is in) ease and that you remit (it) as alms is better for you, if you know", Cow (280).

النص القرآني: " وَإِن كَانَ ذُو عُسْرَةٍ فَنَظِرَةٌ إِلَىٰ مَيْسَرَةٍ وَأَن تَصَدَّقُوا خَيْرٌ لَّكُمْ إِن كُنتُمْ تَعْلَمُونَ ".

These situations are understandable and people generally would come to terms one way or the other. So, those times the seller of a Salam contract was relatively a simple farmer who was generally a person who was looking for liquidity and to earn some money to pay for his living expenses ahead of time. His options were very limited and certainly was not in a position to buyback the crop as his motive was only to deliver. In today's market, the sellers of the Salam contracts are very sophisticated and have many options to ensure delivery, including buying the necessary insurance policy to protect them. Moreover, they are traders and their business is to buy and sell commodities and on a daily basis they might be selling Salam contracts on one side and buying on the other. They are in the market and they know what is happening minute by minute. For instance, they might sell a contract today at a price and might buy it back the following day at a different price.

On the other hand the buyer of a Salam contract might find himself forced to liquidate/sell his contract because he might be facing liquidity crunch, the market might be moving against him, prices might be falling, or his expectation that, the seller might not be able to deliver or perhaps he might have a much better opportunity to reinvest his money or it might be politically incorrect to continue investing his money in the same way. All these are genuine reasons for a buyer of a Salam to want to liquidate his position prior to delivery date.

The answer from the scholars is that he can enter into a parallel Salam contract with another party. First of all this contradicts the Hadith "Do not sell what do not own" in case of the first seller he suppose to be the supplier or the grower of the commodity, so it is his business to sell such a product. Besides I do not think this is a genuine solution, because he will have to keep investing in the same commodity and will have to continue to deal with the seller of the Salam, moreover this might cause unnecessary complications with the new buyer. Why not sell the contract back to the original seller who might be very happy to buy the contract back given the circumstance? We had situations during the early days of Islam when certain groups who did not wish to embrace the new religion and decided to leave Madinah city but had debts against Moslems, they requested to be paid before they leave the city while those debts had not been due yet. The prophet (PBUH) said "Dha'wa taajjal" means if you want early settlement, then you have to give discount. This is an important precedent that undue debts can be settled directly with the debtor and at a discount. The argument is that trading in debt could lead to Riba, if we take this approach then all these dealings by Islamic banks could be considered as Riba, because Islamic banks are nothing but financial intermediaries and have no interest or desire in owning real assets or commodities, they merely use them as a bridge to reach to a halal profit. If you were to analyze the financial statements of all Islamic institutions you will find that they are all sensitive to interest rate fluctuations and very seldom you see them being sensitive to any commodity price risk or real property. In fact, if we analyze their assets we will find that the majority of investments are in Morabaha contracts, which are considered debts. Therefore someone could argue Islamic banks' shares do not qualify as tradable instruments.

The real argument against trading in debts has been that the debtor must have the right to any discount offered by the holder of the note and that the buyer of the note the new creditor should not claim more than what he has paid. For instance if the note is for \$100 and it matures in 6 months and the holder sold it for \$90, then the new holder should not claim more than \$90 and should pass the discount to the debtor. Well, this might happen between families and close friends and for small amounts but certainly it is not sensible to expect this treatment on a large scale and within the financial industry where players are professionals and financially able as opposed to the old farmers who were helpless and were exploited by the capitalists, as were the pearl divers not long ago in the Gulf region.

The principal reason that forced the farmer to sell on Salam basis was lack of liquidity. The other fact we have to take into account here is that the issuer of the Sukuk notes today are Islamic institutions, who are basically selling silent participations in the Salam contract. These banks initially fund the transaction from their own funds or in some cases they might underwrite the transactions, which means if they fail to sell to public then they will have to fund it from their own money. So, by undertaking to make market or to buyback these participations they will not be buying on behalf of the seller of the Salam. In fact, no corporate or institution would accept such an arrangement, not even in the conventional market. These banks merely buying back their own assets from the same clients who initially bought the note but the original contract remains in tact, the bank merely replaces its own funding with new funds sourced directly from public. In fact, this process happens on a daily basis within Islamic banks but behind the scene.

On a daily basis, Islamic banks receive new deposits classified as investment deposits, which are, invested primarily in Morabaha transactions. The depositor has the right to withdraw the deposit subject to a notice usually 48 hours, so when the bank is repaying this deposit, it is effectively buying back the deposit at a price. The bank can fund this withdrawal from new deposits being sourced from another party (the replacement deposit) or will source funds internally to replace this shortfall but certainly the bank will not break any of its contracts with other clients in order to pay this deposit i.e. in case of a Salam contract to sell back the debt to original seller of the Salam or in case of a Morabaha contract to buyback the debt. Nothing like this happens, besides it is inconceivable for the banks to be able to match fund their assets and liabilities. So, technically there is never a buyback of debt; the bank merely replace one source of funding with another. All this happens routinely and behind the closed doors. The only difference under securitization is that it becomes transparent and people view it as selling back of debt. This is not the case. It would have been the case provided the participants were a party to the original contract and the sale was with the seller of the Salam, i.e. the supplier. In fact, under securitization there will be transparency and pricing would be more fair, because it would be open to everybody who wants either to sell or buy. The issuer/the underwriters would offer a bid and offer price in these notes on a daily basis.

The best mechanism is to establish a Mosharaka fund that will invest in the Salam contracts, and a bank or group of banks can act as underwriters and market makers in these notes. The issuer to be a special purpose vehicle (SPV) that will own the Salam contracts and it will issue Sukuk to raise the necessary financing. The underwriting group should always maintain a portion of the Sukuk in their own name as the technical Mosharek and as comfort to rest of the investors. It also would be more acceptable from Sharia point of view for the partner (Shareek) to make offers from time to time to buy participations from other partners (Shoraka) in the company.

Additional comfort could be from a two-tier structure in capitalizing the SPV. For instance, mixing a form of nominal equity that will be used to fund certain real assets for the SPV and the bulk of the financing to be in the form of interest free loans by the investors. So, apart from the equity on its balance sheet the SPV will have basically two items. On the asset side, the Salam contract which is classified as debt and on the liability side the interest free loan which is also a debt. This would effectively negate the impact of the Sukuk debt on its balance sheet and net amount will represent tangible equity which will be traded. The interest free loan will be traded always at face value and it will be linked to equity shares of the SPV, which will also be priced to reflect the value of the interest free loan in the SPV. The investor in the SPV will receive dividends at all times. This structure will provide automatic capital protection to the investor without having to issue a separate guarantee or undertaking. It also is a perfect structure to withdraw capital without the need to go through a liquidation process of the SPV.

Istisna' Sukuk

Again here the Istisna contract can be securitized but the Sukuk cannot be traded because it is considered as a debt obligation of the manufacturer/contractor, so the general ruling that debt cannot be traded applies. Our argument here also is the same as for the Salam contract. In making markets in the Sukuk under Istisna or Salam, we are merely replacing one source of funding with another and that in same way as the Mostasne' (the buyer of the Istisna contract) was permitted to sell participations in the Istisna contract, the holder of the Sukuk should also be permitted to sell his interest to anyone else at a mutually agreed price.

Our argument here is much more solid under the case of the Istisna' because in case of default by AlSanea (the manufacturer) the Mostasnea may have the right to the product being manufactured since the items being manufactured are for the Mostasnea's account and legally he has the title to whatever items have been produced, be it in a finished form or semi finished. The simple example here, is in case of constructing a building, the Mostasnea will have the right to replace the contractor (Al-Sanea) and complete the construction. So title to work in progress belongs to the Mostasnea unless otherwise stipulated in the contract such as for instance in shipbuilding contracts, where the Mostasnea will have recourse only to a financial guarantee in case of a default.

The solution that has been recommended by some scholars for the Istisna Sukuk to qualify as tradable instrument is to have Al Sanea (The manufacturer/ the seller of the Istisna) issue the Sukuk on the basis of his real property and capital assets provided that the value of these assets are more than 51% of the value of Istisna contract. This would effectively mean buying direct participations in the business of the Al Sanea, who in this case, is not just securing financing (working capital) but also selling his real property. Therefore on the delivery date the Mostasnea (the buyer of the contract) has to also take partial delivery of the fixed assets because they are also part of the contract value/ the Sukuk.

The other problem is that Al Sanea/ the manufacturer has to be the issuer of the Sukuk and for his own account, which technically means under Sharia that the Istisna is for the account of Al Sanea and not for the account of the Mostasnea (the buyer). This would mean that in case of default the buyer would have no right to the work in progress or the finished products on the delivery date. The holders of the Sukuk in this case would be merely holding debt obligations. Again this might not be the perfect solution under Sharia, to have a tradable Istisna instrument because of lack of title to the underlying assets.

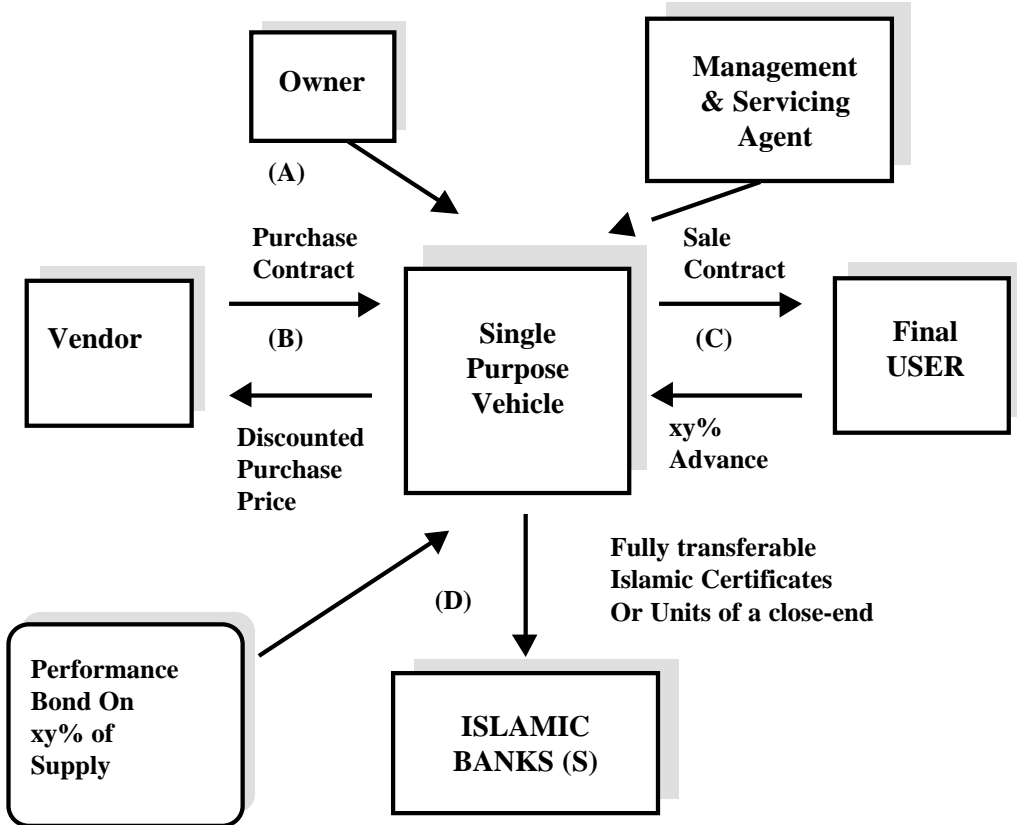
It is worth mentioning here that in calculating the Zakat amount (The Religious Tax) the scholars have ruled that capital assets such as buildings, machinery, plant and equipment are to be excluded because these are not part of the trading portfolio and that Zakat to be paid only on income generated from these assets and other tradable assets such as commodities. For instance, in a lease contract Zakat is only paid on rental income, and the asset being leased is not considered part of the trading portfolio. However, for the purpose of trading in securities such capital assets are considered tradable assets and must represent at least 51% of the pool, otherwise the security will not be eligible for trading. Is this not a contradictory classification?

The solution could be in creating a Mosharaka scheme in the Istisna' contract, whereby the manufacturer would act as the technical Mosharek and the fund will issue Sukuk. To overcome the issue relating to the level of the real assets, the Sukuk could be issued in tranches as the Istisna' contract allows for the value to be paid on stages. Therefore it would be possible to manage the value of the work in progress to reflect real added value representing tangible assets (property). Additionally this structure would make it possible to allocate the value of the intangibles to the technical Mosharek himself and his share of the Sukuk would be blocked from trading and would be settled on the delivery date of the finished products when everybody will be paid.

This mechanism would also allow to account for the down payments usually required from the account party. Islamic banks can act as underwriters and market makers in the issue and can make their fees from managing the entire transaction. On the delivery date and assuming that the assets qualify for a lease, then the Istisna' Sukuk could be refinanced with Ijara Sukuk otherwise Morabaha refinancing or cash settlement by the ultimate buyer.

PRE-DELIVERY ISLAMIC FINANCING

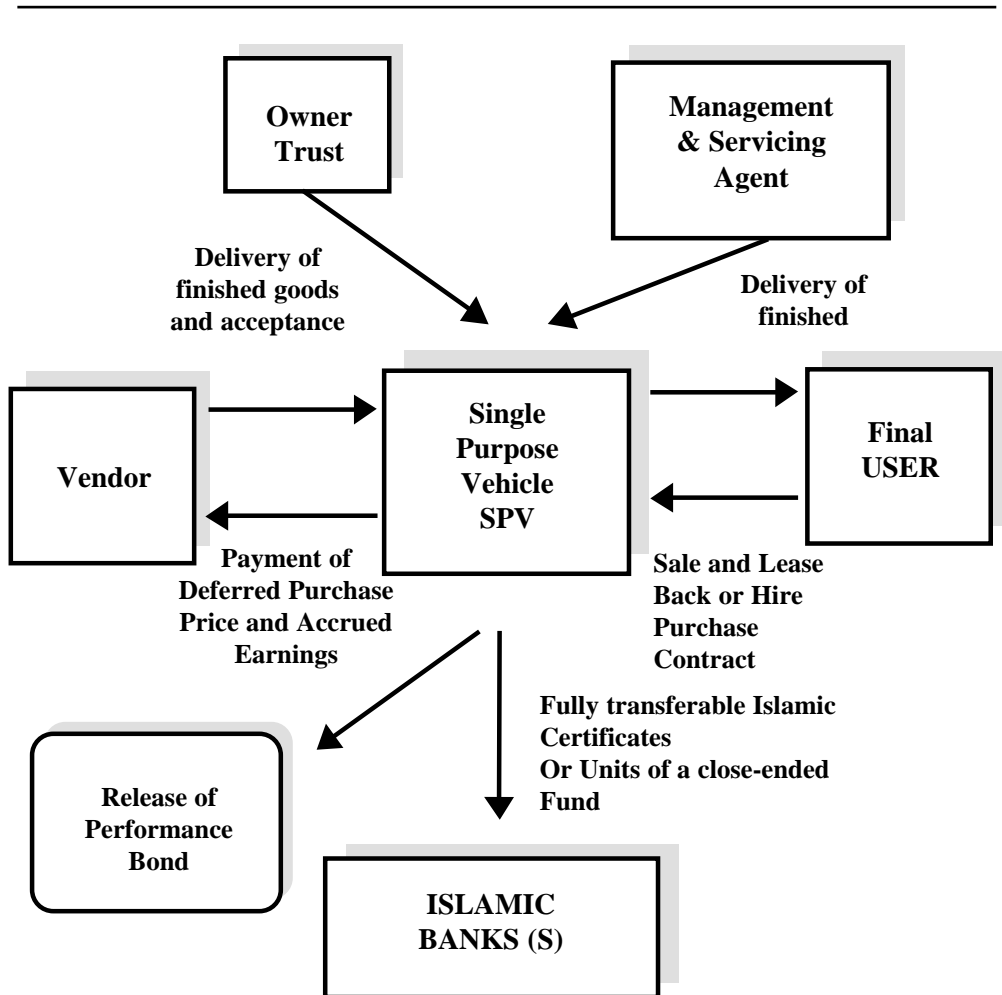
Risk Profile: Partially enhanced performance risk on the Vendor and asset-secured risk on the User



- a) The Purchase Contract may provide for installment payments occurring to a pre-set schedule setting milestone dates at different stages of completion of the supplied goods. Ownership of the work in process passes from Vendor to SPV at the time of payment of each milestone.
- b) SPV may pay to Vendor at the outset the discounted Purchase Price less a xy% over collateral (the Deferred Portion of the Purchase Price) to equal the advance payment received by the SPV under the back-to-back Sale contract.
- c) User under the Sale Contract pays at the outset a xy% Advance Payment to SPV while balance is due at final delivery of the goods, or of part of them. The Advance Payment is invested in an Islamically acceptable short term instrument (i.e. a “Murabaha” investment. A first charge on the investment account is given to the Islamic Bank(s) and a second charge to the User or any of its affiliates. Ownership of goods passes only after delivery and acceptance.
- d) Islamic Bank(s) fund SPV either through underwriting SPV’s issued Islamic certificates of ownership of the pool of assets or units of a close-ended fund, which would invest in the pool of goods purchased by SPV.

POST-DELIVERY RE-FINANCING THROUGH SALE AND LEASE BACK OR HIRE PURCHASE CONTRACT

Risk Profile: Asset-secured, medium term lease or hire purchase based financing to the Final User



- Upon delivery of the finished goods and acceptance by SPV and the User, the Vendor would receive payment from SPV of the xy% Advance Payment plus contractual profit. Also, there would be formal release of the surety bond.
- The Sale Contract would be automatically re-financed by a pre-signed sale and lease back or hire purchase arrangement at pre-agreed terms entered between SPV and the User.
- The SPV would continue to be financed by Islamic Investor(s) either through (new) Islamic Certificates each representing a percentage ownership in the pool of goods owned by SPV or units of a close-ended fund specifically set up to invest in SPV.

Section Ten

Trading in Shares

Trading in ordinary shares for the purpose of capital gains is a permissible activity under Sharia, provided that the core business of the issuer is lawful (halal). So any qualified person can trade in these instruments in the same manner as he or she trades in permissible commodities. However, as in most cases corporations rely on conventional finance to support their operations, the trader (investor) must adhere to certain cleansing procedure to negate the impact of conventional finance on the value of shares. This is based on a general concept in the Sharia', that lawful (halal) income being co-mingled with unlawful (haram) income does not make the entire income unlawful. Therefore the investor has to purify such income by determining the unlawful income and its positive impact on the value of the shares and donate the amount to charity. The general guidelines for investing in such shares are:

- Total borrowing should not exceed one third (33%) of total assets, certain institutions have permitted total borrowings to be up to 50% of total assets.
- Interest income should not exceed 5% of total income and some Sharia boards have allowed up to 10%.
- Income from unlawful operations such as selling of pork, liquor not to exceed 1% of total income.

The moderate view is that because the income, which was attributed to the borrowing, was the result of such borrowing and the effort of the company, therefore only 50% of the attribution to be paid to charity. This means that the company would not lose its sweat equity. The most extreme view by certain Islamic institutions is not to invest at all in companies where their charters permit them to borrow conventionally, but these institutions will not have a problem in providing credit facilities to such companies.

Trading in shares of Islamic banks

We wonder if we apply the above test to the equities of Islamic banks, obviously the listed ones, what would be the results? We understand that the bulk of their activities are commodity based Morabaha transactions, which are considered to be debt instruments. Perhaps for this reason we don't see many Islamic institutions listed, as significant portion of their assets can be classified as debt instruments; therefore, the shares would not qualify to be traded.

Section Eleven

Trading in currencies

Trading of currencies is restricted to spot dealing. Forward trading of different currencies against each other or against gold or silver is prohibited. Banknotes are considered as measurement of values in the same way as gold and silver use to be and can be exchanged only on cash basis. The argument is that forward trading in currencies would lead to usury, because the forward price reflects the interest rate. As we have demonstrated earlier, on this basis then we have to ban almost everything, as all Islamic transactions are based on the conventional interest. Most apparently the difference between the cash price and the deferred price is nothing but the interest rate variable between the spot and the deferred date. I am afraid this is not a solid argument in today's world. In fact the principal reason for favoring Ijara contract over all other contracts is because it allows re-pricing in line with interest rate cycle.

The other argument is that dealing in currencies on forward basis will lead to speculation, which has been the main cause of economic crises in many countries. This is not entirely true because speculation occur mostly in the spot market and primary because of leveraged/margin trading. Besides economic crises occur mainly because of excessive foreign currency borrowings by the nation as a whole. If we agree with this argument then the impact of trading in equities has lead to many economic crises in many countries. We have experienced many financial crises in the Gulf region in the last two decades such as the Souk almanakh crises in Kuwait, all of which were related to speculation either in shares or real estate and were not related to currency trading, yet no one has banned trading in shares or real estate. People will speculate in anything and everything if they can see an opportunity to make profit. In fact, one of the meanings of Modharaba is speculation in goods and commodities.

Moreover, as we explained, this ban has not stopped investors from accessing the forward foreign exchange market either for genuine hedging or speculative motives. To achieve these objectives, investors have used synthetic commodity transactions and account to account trading, where spot positions are carried forward by settling contracts through current accounts, which the speculator will maintain with his bank, or by rolling over positions on overnight basis. The primary beneficiaries of these transactions have been commodity traders. Islamic investors have been carrying unnecessary extra cost because they are banned from accessing the market directly and as a result their balance sheet have been inflated with synthetic exposure, as opposed to forward foreign exchange contracts which are off-balance sheet products.

The scholars have been very courageous in recommending innovative solutions such as the mandatory promise under the letter of credit and the purification process for unlawful income, while we have not been very creative in tackling this issue. To treat currency notes as gold and silver coins is not fair. Currency notes derive their value from the party who issues them while gold and silver coins have their own intrinsic values, which are universally accepted. On the contrary currency notes are not acceptable universally, except few, which are recognized as reserve currencies.

Currency notes really represent the equity of the country, which issues them, thus the holder of a currency note effectively owns equity in the issuer, which undertakes to substitute the holder of the notes with the equivalent in goods or services. So in a way they are like common shares in any corporation except that corporations pay dividends to the shareholders. Trading in shares has been accepted because they represent a common interest in the assets of the corporation, while in fact they are nothing but debts against the issuer. At no time the holder of a common share will have a direct right

to real property not even at the time of liquidation. In such situation, the assets of the company will be sold and shareholders will be compensated in cash if they are lucky.

On the other hand the holder of currency notes practically has the right to be compensated in real property as at anytime he can exchange the note with goods or services from the country, which had issued the note, so in this respect they are more Islamic compared to common shares. The argument has been that this was prohibited by the prophet (PBUH). I am not convinced because the prophet (PBUH) has also said: " If types are different then sell as you wish". Furthermore the Hadith #2182 from AlBokhari (may God bless him) also supports the above:

quote "Abdul Rahman Ben Abu-Bakra said that his father (may God bless them all) mentioned that the prophet (PBUH) banned trading silver with silver and gold with gold except on equal basis and ordered us to sell gold with silver as we wished and silver with gold as we wished" unquote.

نص الحديث: ٢١٨٢ - حدثنا عمران بن ميسرة: حدثنا عباد بن العوام: أخبرنا يحيى بن أبي إسحاق: حدثنا عبدالرحمن بن أبي بكر عن أبيه رضي الله عنه قال: نهى النبي (ص) عن الفضة بالفضة، والذهب بالذهب إلا سواءً بسواء، وأمرنا أن نبتاع الذهب بالفضة كيف شئنا، والفضة في الذهب كيف شئنا. [راجع: ٢١٧٥].

Some quote this Hadith from other sources, which are not as recognized as the AlBokhari with two words added at the end, and these are "hand in hand". "يداً بيد"

These last two words contradict the whole concept of "If types are different". If this is to mean, if types are different they must also be exchanged immediately, then the treatment will be same as exchanging gold with gold and silver with silver. As such there is no point in making any exception, as everything is treated similarly whether they are same kinds or different kinds, they must be exchanged "hand in hand". Besides it is not conceivable that he (PBUH) would make an exception and yet order us to handle them in the same way. If the understanding is to treat different kinds similarly i.e. "hand in hand", then the Morabaha with deferred payment as well as Salam and Istisna are all unlawful, because they are not "hand in hand". Therefore the words "hand in hand" were meant for the six specific types which are gold, silver, dates, wheat, barley and salt and on the basis that the same types being exchanged with each other.

It is strange, we have a Hadith from Bokhari, who is considered to be the prime book of reference for the Hadith by the majority of Moslems and which does not mention these last two words "hand in hand" yet people choose to ignore it and take another Hadith which makes people's life very difficult. This is contrary to what the prophet (PBUH) had said: "Make things easy and don't make them difficult". i.e. Gold for Gold and Silver for Silver.

حيث قال (ص): "يسروا ولا تعسروا".

We know if we just look at the holy book we realize that Riba is unlawful but the prophet (PBUH) made exceptions as we explained.

Based on above it is clear that if the types or kinds are different then trade as you wish, for this reason, certain groups permit lending in one currency and taking repayment in other. In this way the lender can get compensated for his money, as we have seen earlier in exchange of deposits. The lender will take the currency risk, which might wipe out his expected gains if he decided not to hedge himself immediately. However this is his option. I really do not see how buying a forward contract will lead to Riba (usury), assuming an importer of cars from Japan has an obligation to pay Yen in 3 months' time enters into a forward contract to buy Yen and sell Dinars. The price will be fixed and both amounts

will be determined for settlement in three months. On the due date the bank will charge the importer with the Dinars and pays the Yen to the Japanese exporter.

What really happened here is that the importer locked the price for his exposure in Yen because he is a car dealer and cannot and should not take risks in the currency market. His option was to leave the exposure naked, uncovered, the price of Yen could be lower and he will be a happy person. But the price of Yen could also be much higher and in this case he would not forgive himself. So why take such a risk and live with the uncertainty? Some might argue that he sold what he did not own. First of all, this restriction, as many scholars have confirmed, is relating to dealing in food, yet we see under the Salam contract, which was designed initially for foodstuff, the seller also sells what he does not own. In fact one of the key objectives for the Salam is to lock in a price for both parties of the contract. Another might argue that it is "Bie AlKalea Bel Kalea" in another word the exchange of delayed counter value for another delayed counter value. Yes, on the surface it may look like this, but the fact is this does not fit here because the importer had already created the exposure in Yen under a separate contract, which he technically owns. So, he is selling what he is going to own with great certainty. There is no doubt about this. He has committed himself to pay, so the ownership of the exposure is real and it would reflect on him either positively or negatively. People sometimes are willing to pay a fee for owning such exposure, so what he has done is merely to neutralize the effect of the currency fluctuation by locking the price. We saw earlier under the parallel purchase & sale of currencies, The Islamic bank sold on spot basis the deposit before its due date.

Why not treat the forward contract as a Joa'la contract, because the payment of the counter values are linked and conditional upon each other. If one party failed to deliver, the other has the right not to deliver as well or recall his money back. It is true that both payments usually are payable on the same day, there are ways to ensure that payment orders have been received before releasing the counter value. In certain occasions the contract can have split value dates i.e. one currency being paid a day or two earlier. So in a way it is like a Joa'la, the reward is paid if the object is delivered. The object can also be monetary. For instance, if someone lost his wallet, he can give to the one who finds it a financial reward.

It is like taking a vaccine against an uncertain virus. In fact, the Sharia encourages people to be prudent and cautious. We should also look at this from the point of view of the less fortunate countries where importers have to queue for foreign currency allocations. Importers in those countries cannot risk waiting until the settlement day to buy the currency from the spot market. The most efficient way to ensure access to foreign currency is through the forward market.

The least could be said about this transaction is that the importer has a debt obligation in yen to his bank, which is due in 90 days. He knows for sure that he cannot pay in Yen so he agrees with his bank to pay instead in local currency. Both parties agree to switch the debt into the local currency on price determined on the same day and in one session. Similarly, the bank agrees with the foreign bank to switch/transfer its Yen obligation into Dollars, both parties agree at same time and in one session on the price and the Dollar counter value. This process truly reflects the real meaning of "Hand in Hand" that is to conclude the deal before departing each other and with certainty.

This is similar to the situation whereby one party (a creditor) has a debt obligation against another party (a debtor). The creditor buys from the debtor a commodity on Salam basis i.e. future delivery against the settlement of the debt, if the debtor agrees then the deal is lawful. The debt amount will be considered as the advance payment for the Salam contract. The above is also supported by Ibn Omar, the son of the second Khalifa (may God bless them all) who mentioned that (at Bakeea in Madinah) we were selling camels against Dirhams and would take Dinars instead and the opposite, we asked the

prophet (PBUH) who responded: "No problem provided it is taken at same day price before departing each other and something between them". This is a clear authority to switch obligations from one currency to another at same day price and before the buyer and seller depart each other.

It is exactly the case here the parties agree to switch the obligation at same day price and in one session. The justification for this as the scholars indicated is that a debt obligation is considered as value received by the debtor. Therefore, the debt can be regarded as value received for the Salam contract.

We quote below what Ibn Qayyem (may God bless him) has said about currencies:

quote "The Dirhams and the Dinars are values for sales and the value is the measure by which value of property will be known, therefore it must be fixed and precise and should not increase or decrease because if the value was to increase and decrease like commodities, we cannot consider it a value to determine with it sales, but all as commodities and people's needs for a value to determine with it sales is a very important public need and this is not possible except with a price by which value is known and this will not be except with a value with which things are priced (valuated) and will remain constant on one (same) condition and it will not itself be valuated with another thing, then otherwise it becomes a commodity that will rise and fall thus people's dealings will be spoiled and delinquency will occur and damage will be huge" unquote.

نص كلام ابن القيم رحمه الله كما ورد في كتاب بحوث في الاقتصاد الإسلامي
للشيخ الفاضل عبدالله بن سليمان المنيع: " فإن الدراهم والدنانير أثمان المبيعات
والثمن هو المعيار الذي به يُعرف تقويم الأموال فيجب أن يكون محدوداً
مضبوطاً لا يرتفع ولا ينخفض، إذ لو كان الثمن يرتفع وينخفض كالسلع لم يكن
لنا ثمن نعتبر به المبيعات بل الجميع سلعاً. وحاجة الناس إلى ثمن يعتبرون به
المبيعات حاجة ضرورية عامة وذلك لا يمكن إلا بسعر تعرف به القيمة، وذلك لا
يكون إلا بثمن تقوم به الأشياء ويستمر على حالة واحدة ولا يقوم هو بغيره. إذ
يعتبر سلعة ترتفع وتنخفض فتفسد معاملات الناس ويقع الخلاف ويشتد الضرر".

Ibn Qayyem, a famous and very respected scholar, defines value (currency) to be fixed and precise and should not be subject to rise and fall, otherwise it will be considered as commodity. This must be the case of a currency within each economy because volatility of any currency within its own boundaries will lead to economic disasters as we have experienced in many countries and no one will question this understanding. However, the interesting point in Ibn Qayyem's definition is, once the value is subject to increase or decrease and/or is valuated by another thing, then it is a commodity. This is exactly the case when comparing a local currency against a foreign currency. As we all know currencies are valuated against each other on a daily basis and are subject to fall or rise on a daily basis. Besides each currency is generally accepted as value within its own economic boundary, for instance, if you go to any city in the United States you see that they will only accept US Dollars. Similarly in most cities in Europe the accepted value is Euros. Therefore based on the definition by Ibn Qayyem is that all foreign currencies must be regarded as commodities because those foreign currencies are falling and/or rising against the local currency on a daily basis. Foreign currencies are not considered as values as far as the local economy is concerned and should be treated as commodities in line with the understanding of Ibn Qayyem. If we to accept this, then buying and selling of foreign currencies should be subject to same guidelines as any commodity. This concept if applied will allow traders to pay in advance a portion or the entire counter value if they wished to secure the foreign currency at a future date or at least it would allow them to enter into a mandatory promise to purchase the foreign currency at a later date, in the same manner as bank gets a mandatory promise to purchase from its clients under a letter of credit. It is worth mentioning that some scholars regard this mandatory promise as deferred sale agreement.

Section Twelve

Trading in Debts

Trading of debt is very restricted under the Sharia because it could lead to Riba (usury). However there are ways through which a creditor can trade his debt without violating Sharia guidelines. The definition of debt here obviously excludes those conventional debt instruments that carry interest rates and all debts that an Islamic investor is banned from participation in the first place. Some of these solutions are:

- 1- The creditor sells his debt to the debtor directly against a discount for early settlement. This was practiced during the prophet's time (PBUH) when he allowed certain people who were leaving Madinah to offer discounts in order to get paid early. He (PBUH) said "Dhaoo wa Taajjallo" plural or "Dha' wa Tajjal" singular.

حيث قال (ص): "ضعوا وتعجلوا أو ضع وتعجل"

- 2- Here the debtor has no cash to settle, but he could offer a commodity or a property. The creditor sells his debt to the debtor against purchasing a merchandize from him, the merchandize can be delivered on spot or on deferred basis.
- 3- The creditor buys a property spot delivery from a third party; the creditor endorses the debt to this third party as settlement for his purchase.
- 4- The creditor buys a real property i.e. a car or a building for future delivery, the creditor will endorse the debt to the seller. Here you have a deferred delivery with deferred payment, it is acceptable because it does not involve commodities that are subject to Salam contract.
- 5- The creditor buys from the debtor a commodity for future delivery such as grain, dates, barley, or oil that has not been extracted yet. If the debtor agreed, then the amount of debt will be switched to represent the payment of the Salam amount. This cannot be permitted with a third party because it will not be possible to receive full or partial value in advance, which is a key condition under the Salam contract.

We wonder if the debt is a bearer instrument such as a post dated check, would it be acceptable to trade it with a third party? Logic says yes, because a bearer check is as good as receiving value, provided obviously the credit risk is acceptable.

These are some of the solutions for trading in debts. However in practice, investors want a practical solution to take advantage from these situations, the most efficient way is to use the LME (London Metal Exchange) market.

Example:

- 1- A creditor who has a note for \$100 due in 6 months time willing to sell the note for \$90.
- 2- An investor who is interested in acquiring the note would buy a commodity i.e. Aluminium on spot basis from a commodity trader for \$90.

- 3- The investor sells the Aluminium spot for \$100 to the holder of the note and receives the note.
- 4- The creditor will have title to the Aluminium and sells it back on spot basis to the commodity trader for \$90.

Obviously all the above steps are pre-agreed and pre-arranged through the commodity trader as the case is with other commodity based transactions. Commodity traders without any doubt have been the biggest beneficiaries of Islamic finance.

Applying this logic, it should also be permissible to buy a dollar note at discount by paying for it in a different currency. The seller could immediately sell the foreign currency in the market and recover at spot the dollar value for his note.

This will lead to a question about zero coupon bonds. Applying the above analogy (Qiyas) it should be acceptable to buy zero coupon bonds in the same manner as other non-interest bearing instruments such as currency notes, bills of exchange and promissory notes. However, the key conditions are that these bonds are not to be purchased on primary basis and the value must be paid in a different currency. This obviously relates to bonds issued by foreign governments. However, citizens of a country are permitted to buy bonds issued by their local government in the same currency in which the bonds are issued whether they are zero coupon or interests bearing bonds. This view is supported by certain sects and scholars representing different sects. They base their view on the concept of father and children. It is the privilege of governments to be generous with their citizens. Incidentally in the Arab world, it is referred to the King or the Amir or the Sheikh or the Leader or the President as the father of the nation. So the father can be kind to his children by paying them interest (Riba).

Section Thirteen

Required Innovation

Islamic banks have been criticized for their limited contribution in the local economies and in some cases have been accused of recycling funds out of Islamic societies. Although this is partly true it is not entirely the fault of Islamic banks, who argue and rightly so, that alternatives in the domestic markets are scarce and risks in regional markets have been very high. In our view this is partly due to lack of innovation and daring solutions on the part of Sharia scholars and on the other hand, the limited support that Islamic banks have received from Islamic governments. Below are some alternatives to make Islamic banking much more effective in supporting local economies.

Innovation by Sharia Scholars

There has been very little substantive change since the first two centuries of Islam when much of the development of financial instruments had taken place, unfortunately we have been captive to the past views. In fact if some of the old scholars were to come alive again, they might change their views about Islamic finance because of the drastic changes that had taken place in the world economy. God forbid Riba primarily because of the welfare of the Moslem nation and the whole concept behind trade in Islam is to create added value in the Islamic economy. God has taught us to make a balance between the advantages and the disadvantages. This is clearly stated in the holy book (Koran) "They will ask you about liquor and gambling, say: In each of them there lies serious vice as well as some benefits for mankind, yet their vice is greater than their benefits (usefulness)", 219 Cow.

النص القرآني: "يسئلونك عن الخمر والميسر قل فيهما إثم كبير ومنافع للناس وإثمهما أكبر من نفعهما"

So we have to weigh things and take the overriding result as the deciding factor, being captive to old views is not what Islam is about. The prophet (PBUH) made certain exceptions when he declared that there is no Riba between the father and his son, the master and his slave, the man and his wife and in charging Riba to a non-Moslem (but not paying to him).

It is amazing to see the scholars allowing Islamic investors to invest in companies that deal in Riba while devising a purification method for the un-lawful income. Some scholars have recommended that the maximum conventional borrowing not to exceed 33% of the balance sheet and some have been more generous and have permitted up to 50%. This could effectively mean that they are encouraging Riba, granted that they will have to donate the unlawful income to charity, i.e. for good cause. Someone could argue that if this is the case, then I will gamble and pay a portion of my income to charity. While on the other hand, still today they would not allow trading in Salam contracts which are Islamically structured because they are considered as debt and trading in debt could lead to Riba. As we explained earlier, if we scrutinize all financial instruments including the equities, we will find them all being nothing but debts because at the end of the day none of these instruments would give recourse to the real property.

Moreover we have demonstrated that almost all instruments are Libor based products particularly the Ijara contracts, by insisting that price re-determination or interest rate fixing must not be part of the

lease agreement and should be handled in a side letter, is not going to change the fact that we all know what is happening and most importantly God knows what we are doing. Our problems are much bigger than interest rates, the entire Islamic economies are interlinked with the western economies and all our savings and wealth are sensitive to interest rates and some other things, which are more important!

We have to also recognize that the average Islamic investor has very little appetite for risk. This is clearly evident from the huge amounts of funds being invested in commodity transactions which bring very little benefit to Islamic economies. In fact if we to weigh things scientifically we will discover that the impact is quite negative on Islamic societies. It is mind boggling to see Islamic countries begging for foreign investments yet the people of same countries have billions of Dollars invested outside their countries. It is not all because of political risk, some of it is to do with the fact we have not been successful in creating proper venues for these funds in the domestic markets. This is exactly the case with Islamic institutions, in spite of the fact that Islamic economies are mostly commodity based economies none of the Islamic countries has been successful in creating domestic commodity markets to absorb the huge liquidity in the Islamic banking.

This could be partly due to lack of domestic investors but most importantly it is a question of devising the right mechanism, we must keep in mind what the market wants. The providers of funds want a secured income without being subject to too much risk, particularly market risks. On the other hand the users of funds want an instrument that pre-determines their cost, easy to understand, straight forward, transparent and based on market rates i.e. does not call for off-market rates even if it is cosmetic. In short the users want similar products as provided by conventional banks. I believe these criteria can be achieved with little innovation and flexibility of the Salam contract as below:

- 1- The contract to be based on market prices with a minimum return to the investor in case prices fall below a certain minimum price, which would include principal plus the expected return. This way the investor can switch back the market risk to the supplier, who should not mind because he is in the risk already.
- 2- The contract to stipulate that any rise in the price of the commodity above that minimum price or the majority of the upside will be for the account of the supplier the seller of the Salam. The profit sharing here will depend on the level of the minimum return required, i.e. the lower the minimum return the higher the profit sharing can be in the upside. This will obviously depend on calculated benefits and mutual agreement of both parties.
- 3- The Salam contract must be based on real market rates and not on fictitious prices.
- 4- The managers of the issue to undertake market making in the Salam Sukuk not on the basis of trading in debts but on the basis of trading in equity in the Salam contract. The principal reason is that delivery is assured here, specially if you are dealing with state owned companies. Besides as you come closer to the delivery date, the price of the Sukuk would reflect the accrued earnings in the contract. Most importantly in buying and selling these contracts, the traders are buying and selling among themselves and not selling back to the supplier, so the debt obligation from the supplier remains in tact.

The concept of guaranteed return is practiced all over the Islamic countries on a daily basis. Governments have price control for essential commodities, they sell the commodity to the traders (investors) at a fixed price and also they determine the price at which the traders can sell the commodity. So, both buying and selling prices are fixed and known by all parties and before entering into the contract. For instance in Bahrain the government (the supplier) sells meat at a fixed price to

the butchers on the condition that they sell to public at a predetermined fixed price. So, the trader is guaranteed the profit he can make on the transaction without taking any price risk.

The above concept could also be applied to the Istisna' contract. In this way huge funds could be mobilized to finance oil/petrochemical projects and other commodity based operations, such as the production of aluminium and agricultural products i.e. rubber and cotton. We can bring back substantial amounts to participate in the development of Islamic economies. It would only require a courageous decision by the Sharia boards, certainly if we keep in our mind the welfare of the Islamic societies, we will find the benefits outweigh any shortcomings.

It is not conceivable to allow the use of Mohalel (the intermediary that would legitimize the transaction) as in the case of risk participation and acquisition finance whether knowingly or unknowingly and yet here being very rigid without giving real consideration to the welfare of the society. The use of SPV's in the case of acquisition finance or other transaction has no purpose other than making the transaction lawful. In spite of the fact that Islamic investors have no ownership interest in the SPV, it is clear that it is a pass through vehicle and its sole purpose is to make the transaction lawful. I recall when Citibank decided to establish an Islamic bank, a big debate took place about whether it is acceptable to capitalize the bank, with unlawful money and things like that. I believe Citibank was forced to establish the bank with a clean money, which was sourced from what is perceived to be lawful income generated from Islamically structured transactions.

The question here, is it acceptable to borrow in an unlawful way to finance lawful transactions? This is what the SPV does under acquisition finance. It borrows conventionally and extends facilities on Islamic basis to the target company. The SPV does not deal with any other party except with the target company, which supposedly is an Islamic operation. On the other hand the reverse of this situation is also true under silent risk participation. Should we understand that the scholars are not aware of this? Or they are aware but keep a blind eye? Or perhaps they are told half of the story! Or Perhaps they weighed the benefits to Islamic society and found them to be greater than the disadvantages, while the holy book clearly states that we must relinquish what remains of Riba "O you who believe, be careful of Allah and relinquish what remains from usury if you are believers".

النص القرآني: " يَا أَيُّهَا الَّذِينَ آمَنُوا اتَّقُوا اللَّهَ وَذَرُوا مَا بَقِيَ مِنَ الرِّبَا إِن كُنتُمْ مُؤْمِنِينَ "

Are we relinquishing what remains of usury in this fashion or in fact encouraging it through devising a mechanism of purification so that people continue to invest in companies that deal in Riba, and also through creating an entity to transact in Riba so that it can provide us with lawful financing? Which options of these are most acceptable under Sharia?

It is important to mention that purification of money was approved by the scholars for people who were not adhering to the Sharia rules in earning their money and wished to abide. Therefore purification was a way to repent and start clean again and certainly not to encourage them to continue earning their money unlawfully so that they can donate a portion of it to charity. Otherwise a thief could have the same argument, while we know that stealing is a much less crime than engaging or encouraging Riba, because God said: "If you do not do so (relinquish Riba) then be prepared to face war declared by God and his messenger. The punishment for stealing is known, but a war declared by God and his messenger is beyond any imagination."

As a Moslem if I am to choose between these situations, I would certainly opt for the above Salam structure as opposed to financing or investing in a company that deals directly in unlawful activities or indirectly through Mohalel. This is simply because of the above verse and also because the benefits to the Islamic societies in having the Salam and Istisna Sukuk traded with minimum guaranteed returns

are much greater than the other three situations, despite the purification of the unlawful income. At least under the proposed Salam and Istisna structures you keep the funds within Islamic societies. This in itself should be enough justification for the Sharia scholars not just to approve the structure but also to promote the concept throughout the Islamic countries.

Inter-bank Dealings

Islamic banks require an effective mechanism similar to the inter-bank dealings that will allow them to support each other on short-term basis. Islamic banks have been using what is called an exchange of deposit agreement, i.e. exchanging interest free loans but this generally requires simultaneous exchange of deposit and it is not really an effective solution for very short-term borrowings, such as overnight money. Below are several ideas that will allow Islamic banks a greater flexibility.

a. Securitization of Lease Contracts

In a similar option that was adapted by Chase in mid nineties, it is possible to securitize lease contracts and sell them in units, Ijara Sukuk. The issuing bank would offer on a daily basis prices of bid and offer in these instruments. The Sukuk will trade exactly like any equity instrument, and can be guaranteed by the issuing bank, so that the buyer can classify them as a bank risk and not as asset risk. Each Islamic bank needs to have its own branded Ijara Sukuk, so that an investor can, if he wishes, have a portfolio mix. In this fashion the Islamic banks can reciprocate with each other. The return will basically represent the accrued rental income, which will be reflected in the net asset value and the daily price. The Sukuk should be listed on the stock exchange; this will encourage market making and secondary trading.

b. Issuing of Treasury Stocks

Islamic banks (including the privately held) should be allowed to allocate a portion of their capital to be traded as treasury stocks. This will enable the investors to own a direct interest in the bank itself. Besides it will provide greater flexibility for the Islamic banks to raise short-term equity, as it does not need to be based on a specific transaction. This will complement the Ijara Sukuk. Again the issuer will have to list these shares and make a bid and offer price on a daily basis. The return here will reflect the increase in the net asset value on a daily basis for the entire operation.

c. Central Treasury/ Islamic Clearing House

Islamic banks lack what is referred to a discount window or direct support from central banks. Islamic banks will have excess and deficits in liquidity on a daily basis. By establishing a central treasury or Islamic clearing house, it will be a great value to the market and would complement the above two alternatives in facilitating indirect dealings. Some Islamic banks may not prefer to deal directly with each other, this option will allow them to do that without losing their pride. The mechanism will be as follows:

- 1- A separate legal entity to be established and to be owned collectively and on equal basis by all Islamic banks.

- 2- The central bank or IDB (as the parent for all Islamic institutions) to manage this company and it should have the golden share, or a veto right. IDB would be more appropriate as it would encourage cross border participations by all Islamic institutions in the OIC countries.
- 3- The company will manage the excess liquidity that Islamic bank will have, specially overnight funds.
- 4- The company will make short-term interest free loans to its shareholders on a daily basis; it will be the squaring point between all Islamic banks.
- 5- The company's daily shortfall or surplus will be squared with central bank or IDB so it will have technically a lender of last resort.
- 6- The company will keep separate accounts for each bank participant and will give credit (points) for each deposit it receives and charge points for the loans it makes to each member, at the end of each quarter it will settle the surpluses or deficits with each member, through either borrowing interest free loans or placing with the company interest free deposits.
- 7- Each member will be assigned a limit on the maximum amount that it can borrow and for specified periods.
- 8- This company in time can act as market maker in short-term inter-bank instruments and other Sukuk or treasury stocks that are listed on the stock market and as an independent entity it can facilitate business dealings of Islamic banks in general by serving as a legitimate counter party in holding title or acting as trustee.
- 9- To maintain profitability the company can charge fees for executing transactions with or on behalf of Islamic banks. In fact it may be allowed even to charge and receive interest with its shareholders based on the concept of father and children.

So, effectively it can act as the clearing house and the settlement bank for all Islamic institutions and it can provide netting arrangement as well.

Underwriting commitments/guarantees

The Sharia boards need to review their stand on commitments or guarantees extended by Islamic banks. Their view that guarantees should be free is not practical because Islamic banks must allocate capital for any commitment they issue. The minimum cost for Islamic banks would be the cost of primary capital, which is somewhere between 8-12% of amount of the guarantee depending on the nature of the commitment. Therefore Islamic banks must be allowed to recoup their cost at least. Here we are not talking about guarantees issued to support the poor and the needy, on the contrary, these commitments are extended for commercial projects. Today, Islamic banks are at a disadvantage and are losing business to conventional banks because they are not in a position to charge for guarantees. Holders of plastic cards whether they are charge cards, credit cards, Tejara or Ijara cards are technically and practically guaranteed by the issuing bank which is charging directly or indirectly for its guarantee. The scholars need to be consistent in their views.

Section Fourteen

Conclusion

The progress has been very slow, during the last two decades there have been so much emphases on Islamic finance but very little has been achieved. The vast majority of Moslems still prefer to deal with conventional banks, besides due to the September 11th disaster Islamic banking has lost much of its glow globally and this will continue, unless serious steps are taken, among which are:

1- Transparency and Public Trust

Transparency is a scare commodity with Islamic banks. Primarily because they are generally scared that, if they become open about their business, the public might view it to be nothing but semantics. Islam is a very transparent religion and its institutions must also be transparent. After all Islamic banks are primarily fiduciary institutions, therefore they owe it to the public to be forthcoming. This is partly due to the fact that most of the Islamic institutions are closed companies, and assume many different and contradictory functions, i.e. they are commercial banks, investment banks and fund management companies at the same time. There is no regulation today that calls for segregation of these functions. Often these activities are carried out by a very small group of people, who are acting on behalf of clients and the shareholders at the same time. There is no mechanism currently in place, which ensures that there will be no switching of profits and losses between these two beneficiaries; profits could be overstated in order to attract more investors or losses could be understated so that investors are not scared away! Obviously employees' loyalty is to their employers (shareholders).

In the Western world, there is a clear segregation of these functions, while in Islamic banking everything is co-mingled. Some might argue that this is the nature of Islamic banking and that we have to trust the shareholders, the management and the Sharia Boards because they are good Moslems. First of all we have already witnessed mismanagement in few Islamic institutions. Besides, as we have demonstrated in this book, some Sharia Boards have no clue about what really happens inside these institutions. However it is not entirely their responsibility to monitor the activities of Islamic banks. Most importantly nobody is considered as good or bad Moslem unless he is proven one way or the other. Our prophet (PBUH) has taught us not to trust anyone with our money unless we actually put the person to the test. On the other hand, Allah has ordered us not to leave things to peoples' conscious as he clearly demanded that we must document debts and must have two witnesses so that the debtor does not even think not to honor his obligation and it is the duty of the debtor to document the debts which in this case, is the Islamic bank. Therefore Islamic banks need to be subjected to more rigorous inspection by independent parties representing investors "Trustees" and this party should not be compensated directly or indirectly by the banks. Otherwise the exercise will not be of much value. They should be elected and paid by investors. Additionally, it is time to segregate the funds management activities under separate legal entities and these entities and their staff should be subjected to Trust Laws and Regulations. This is very crucial because the bank may undertake certain activities for its own account, which might lead to its bankruptcy. In this situation, fiduciary assets, which are currently reported as off-balance sheet accounts would also be at risk. There is no guarantee that under the companies' law these fiduciary accounts will not be pooled as part of the bank's assets. The question here is, if these funds would be subject to bankruptcy procedures, they must be part of the balance sheet of these institutions and if they are not, then all these assets must be outside the accounts of these institutions and under a separate legal structure. Islamic banks should not have it both ways.

2- Scale and Status

The industry is fragmented. We have too many small institutions, most of which are nothing but specialized funds. They are more like mutual funds as opposed to being investment banking operations. Except for a very limited number, the majority lacks the size and scale to make any real contribution. More over many of these are merely vehicles to transfer capital out of the region. Their only positive contribution to the economy is in job creation. Perhaps for this reason local authorities are lenient and accommodating these funds gathering operations. We could be experiencing the same phenomenon as we did with the Offshore Banking Units (OBUs) in early eighties. Where are they today? Most of them have disappeared. Very few have survived and these are the ones that had the support of regional governments. But the privately owned ones have either been liquidated, dormant or are in serious financial difficulties. Therefore it is necessary to look at the long-term impact, and should not just focus on short-term gains. New criteria should be devised for Islamic banks. If these institutions cannot meet these criteria, then they must merge, or be de-classified to trading companies, or collective schemes, but certainly not as banks. The most important criteria should be that any Islamic institution, which wants to solicit deposits or funds directly from the public, it must turn itself into a public company and should not be entirely controlled by a selective group. A true Islamic bank which believes in Islamic financing and wishes to raise funds on the basis of profit/loss sharing concept must not object to being a public company, unless the motive of the shareholders is to enrich themselves on account of Islamic investors. This motive can be clearly tested by making a comparison between the return the shareholders are allocating for themselves and the return the poor depositors are getting on the Modharaba deposits, which are co-mingled with the shareholders funds. The investors assume equity risk but receive money market returns if they are lucky.

3- Innovation not Imitation

The way to go forward is by innovation, being captive to the old views is not what Islam is about. Ijtihad is an important source of Islamic legislation. Therefore Sharia scholars have huge responsibility here to face the realities of the current financial needs of the Islamic societies. The principal reason behind the prophet's (PBUH) exceptions in accepting Riba is to set a precedent for the Islamic nation to take into account the welfare of Islamic societies. Sticking to the form is not just enough in Islam, as substance is also important. We have demonstrated in this book that while the structure is Islamic the underlying transaction is unlawful. The real essence behind Islamic banking is to create real economic value in Islamic societies. This will not be accomplished if we continue to encourage capital flight because the structure is Islamic. To achieve this objective the scholars must be flexible and courageous in providing their opinions.

والحمد لله رب العالمين الصلاة والسلام على سيدنا محمد وعلى آله وصحبه ومن سار على هديه وعلى جميع الأنبياء
والرسل إلى قيام يوم الدين والسلام عليكم ورحمة الله وبركاته.

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