3

Two Major Prohibitions: *Riba* and *Gharar*

We have shown in Chapter 2 that Islamic finance is a prohibition-driven industry. In this regard, the instigating factor for prohibition-based contract invalidation can almost always be attributed to the two factors labeled *riba* and *gharar*. We have also shown in Chapter 1 that mainstream contemporary scholars of economic analysis of the law consider such prohibitions of mutually agreeable financial transactions paternalistic and conducive to efficiency losses. The form-oriented nature of Islamic finance has done little to counter this claim for Islamic prohibitions.

Participants in the industry, especially ones who are not themselves devout Muslims, operationally respect Muslims' religious observance and devise financial solutions that avoid various prohibitions according to juristic opinion. This attitude has contributed further to the form-above-substance approach in Islamic finance: Lawyers and bankers are loath to challenge jurists' solutions as merely inefficient replications of what they had deemed forbidden transactions. To provide proper understanding of Islamic finance as practiced today, this chapter covers the economic substance that we believe was intended by the prohibitions. In later chapters we shall compare the economic substance of prohibitions and premodern nominate contract conditions in greater detail, comparing the form-oriented approach of contemporary Islamic finance to the substance-oriented classical jurisprudence.

Paternalism of Prohibitions

In the process of highlighting economic substance of prohibitions of *riba* and *gharar* in this chapter, we need to address two charges against prohibitions: paternalism and efficiency reduction. The paternalism charge is freely admitted, since devout Muslims – and indeed most religious people – do not shy away from a paternalistic image of God. In this regard, Islamic jurists and legal theorists have maintained that God never forbids anything that is good. When God forbids

something that contains some good, legal theorists argued, it must be because of the potential for greater hidden harm.[1] For instance, the second of three Qur'anic stages of gradual prohibition of wine and gambling state explicitly: "They ask you about wine and gambling, say: 'Therein is great sin and some benefit, and their sin is greater than their benefit' " [2:219].

Human irrationality in the face of addictive activities such as drinking and gambling appears to be at the heart of this prohibition. This is suggested by the conjunction of wine and gambling in the cited verse as well as the final stage of categorical Qur'anic prohibition of addictive drinking and gambling activities: "O people of faith: Wine, gambling, dedication of stones, and divination with arrows are abominable works of the devil. Thus, avoid such activities so that you may prosper" [5:90].

More generally, one may consider four types of activities based on *net* benefit or harm: (1) beneficial ones that are apparently beneficial, (2) beneficial ones that are not clearly beneficial, (3) harmful ones that are apparently harmful, and (4) harmful ones that are not apparently harmful. No injunctions or prohibitions are needed for the first and third types of activities, whereas injunctions to perform the first type of acts, and prohibitions against the fourth, are necessary. In this regard, the verse [2:219] clearly explained that drinking and gambling belong to the fourth category: Humans may be lured by the apparent benefits and thus lose sight of the greater harm.

This is easily explained in the context of drinking, which may not be harmful in small measure, but can be extremely dangerous because of human irrationality in the face of addictive and intoxicating substances. The intoxication effect was highlighted in the first stage of prohibition of wine: "O people of faith, do not approach prayers while you are intoxicated" [4:43], wherein gambling was not mentioned. The addictiveness effect and resulting tendency to create acrimonious and irresponsible behavior were highlighted by conjoining wine and gambling in the two subsequent stages of prohibition in [2:219] and [5:90].

Bounded Rationality and Paternalism

In the case of wine and gambling, the Qur'anic solution was complete avoidance thereof, since those activities are not essential. In contrast, transfers of credit and risk are at the heart of finance, without which an economic system cannot function. The Islamic legal solution in this case was to impose restrictions on the means of transferring credit and risk, through prohibitions of *riba* and *gharar*. In this chapter I shall argue that – in finance – the forbidden *riba* is essentially "trading in credit," and the forbidden *gharar* is "trading in risk," as unbundled commodities.

In other words, Islamic jurisprudence uses those two prohibitions to allow only for the appropriate measure of permissibility of transferring credit and risk to achieve economic ends. As many observers and practitioners in financial markets will testify, trading in credit and risk (perfected through derivative securities) is as dangerous as twirling a two-edged sword. Although those vehicles can be used judiciously to reduce risk and enhance welfare, they can easily entice otherwise cautious individuals to engage in ruinous gambling behavior. While financial regulators seek to limit the scope of credit and risk trading to prevent systemic failures, Islamic jurisprudence introduces injunctions that aim also to protect individuals from their own greed and myopia.

What to Forbid? Balancing Benefits and Risks

The objective of balancing economic freedom (allowing more contracts to enable more economic activities) with risk of abuse (if too much freedom is allowed) is made clear by the fact that some contracts that contain *riba* and/or *gharar* are permitted in the canonical and juristic texts. This is the case with prepaid forward sales (*salam*), which contain significant *gharar* (unnecessary risk and uncertainty), since the object of sale typically does not exist at contract time. However, this *gharar* is deemed minor relative to the potential gains from financing agricultural and other activities through *salam*. Thus, this benefit consideration overruled the contract's invalidity based on *gharar*, as would be dictated by analogical reasoning alone. Similarly, credit sales can easily be used as vehicles for *riba*, as shown in the previous chapter (e.g., through same-item sale-repurchase, either as ʿ*ina* or *tawarruq*). In both of those examples, the benefits from allowing production of nonexistent goods through *salam*, and consumption of goods against claims to future income through credit sales, respectively, outweigh the potential dangers of abuse. Hence the contracts were permitted despite the corrupting factors.

The discussion in Chapter 2 of various juristic opinions on ʿ*ina* (same-item sale-repurchase) is illustrative of juristic cost-benefit analysis. Obviously, one cannot forbid all spot sales or credit sales, since that would lead to economic ruin. On the one hand, jurists unanimously forbid same-item sale-repurchase if the second sale is stipulated in the first.[2] On the other hand, if the two transactions are executed under separate contracts, some jurists forbade the practice to prevent abuse (the Maliki juristic rule of preventing means of circumventing the law, known as *sadd al-dharaʾiʿ*), whereas others (e.g., Al-Shafiʿi, who restricted juristic reasoning to analogy) felt compelled to deem the practice valid. Of course, in Islamic finance, jurists may be asked to validate each contract separately, without explaining the entire financial structure for which they will be used.

This example is indeed central for understanding our subsequent discussion of contemporary Islamic jurisprudence and finance. By definition, almost all novel

financial transactions, and variations thereof that were considered by jurists on Islamic banks' Shariʿa boards, are sufficiently complex to generate multiple juristic opinions based on analogy, prevention of abuse, benefit analysis, and the like. Variations in opinions allow Islamic financial providers to exercise price discrimination by segmenting the market according to degree of conservatism, thereby extracting greater Shariʿa arbitrage rents from more conservative customers.

3.1 The Prohibition of *Riba*

The three-letter past-tense root of the term *riba* is the Arabic verb *raba*, meaning to increase.[3] Therefore, jurists defined the forbidden *riba* generally as "trading two goods of the same kind in different quantities, where the increase is not a proper compensation."[4] Naturally, the lexical meaning of the term (which covers increase of all types) is not the object of prohibition. Thus, numerous jurists have analyzed the juristic meaning of the forbidden *riba* over the centuries. While most contemporary jurists have denied any uncertainty about the juristic definition of forbidden *riba*, studies such as the two in Rida (1986) clearly show that premodern and contemporary jurists have expanded the definition of the forbidden *riba* considerably beyond its original domain.[5]

In this regard, the distinction between legitimate compensations and forbidden *riba* is the most fundamental distinguishing feature of Islamic finance, as a prohibition-driven industry. However, the distinction – as defined by contemporary jurists – is exploited mostly by adopting premodern forms rather than mechanisms that ensure fairness of contract pricing. In this regard, understanding the canonical prohibition of *riba*, and contemporary interpretations thereof, is central to understanding the industry as it exists today, as well as any likely alternative "Islamic" structure. We thus turn now to the task of providing an economic analysis of the canonical texts on *riba* and the classical juristic analyses thereof. We begin by considering the canon.

Canonical Texts on Riba

There are two main types of *riba* recognized by all scholars, with Shafiʿi scholars providing a further refinement of the second type. The first type is called *riba al-nasiʾa*.[6] The worst form of this *riba*, known as *riba al-jahiliyya* (practiced in pre-Islamic Arabia), was strictly forbidden in the Qurʾan, to the point that Imam Malik is reported to have described its prohibition as the severest one in Islam.[7]

The first mention of *riba* in the Qurʾan was in Makka, and it discouraged collection thereof, without explicitly prohibiting it: "That which you lend to increase in the property of others will not increase with God; but that which

you give out in charity, seeking God's pleasure, it will surely multiply" [30:39]. The first verses regarding *riba* that were revealed in Madina only forbade pre-Islamic *riba* of Arabia, whereby interest was charged at the maturity of debts from interest-free loans or credit sales, and compounded at later maturity dates. Thus, the principal due on the debtor was described in the Qur'an as "*riba* doubled and multiplied" [3:130].[8] Among the very last Qur'anic verses to be revealed, the verses [2:275–9] ordered Muslims to abandon all remaining *riba* (presumably of the same form defined in [3:130]), otherwise to expect a war from God and His Messenger.

Main Juristic Taxonomies of Riba

Most jurists have expanded the strict Qur'anic prohibition of pre-Islamic *riba* to cover all forms of interest-bearing loans, subsumed under the term *riba al-nasi'a*. They provided three explanations of the rationale for this prohibition: (1) one might potentially exploit poor debtors who need to borrow money or commodities, (2) trading money may lead to fluctuations in currency values and monetary uncertainty, (3) trading foodstuffs for larger amounts of future foodstuffs would lead to shortages in spot markets for those foodstuffs (presumably because many traders would withhold the goods in the hope of getting more in the future!).[9]

None of those explanations seems particularly convincing. After all, a usurer can equally easily exploit a needy debtor by selling him a property of market value $100, say, for a deferred price of $1,000, without violating the rules of *riba* as envisioned by jurists. The second explanation seems equally weak on economic grounds. Relative prices of commodities may fluctuate based on supply and demand changes, regardless of the possibility of extending interest-based credit.

Finally, the logic of the argument on foodstuffs is clearly defective: Traders prefer deferment only as long as the terms of trade exceed their time preference and vice versa – indeed, that is how implicit interest rates would be determined in equilibrium, based on market participants' rates of time preference. Moreover, if credit trading in foodstuffs could cause the problems of which classical jurists spoke, those same problems would result from selling deferred claims on foodstuffs for an immediate monetary price, or selling foodstuffs for deferred monetary prices, both of which are allowed by jurists with implicit compensation for time value. In fact, jurists of all major schools, declaring that "time has a share in the price," recognized the legitimacy of seeking compensation for time value in credit and *salam* sales, including where the objects of sale are foodstuffs.[10]

The second category of *riba* recognized by jurists is called *riba al-fadl* (the *riba* of increase, also called *riba al-Sunna*). It prohibits trading goods of the same genus and kind in different quantities, based on a valid Prophetic tradition: "Gold for gold, silver for silver, wheat for wheat, barley for barley, dates for dates, and salt

for salt, like for like, hand to hand, and any increase is *riba*."[11] Non-Zahiri jurists agreed that those six commodities were given only as examples. Hanafi jurists extended the prohibition to all fungible goods measured by weight or volume, whereas Shafiʿi and Maliki jurists restricted it to monetary commodities (gold and silver) and storable foodstuffs.

In our discussion of currency exchanges (*sarf*), we shall discuss Prophetic traditions that dealt exclusively with spot- and deferred-price trading of gold for gold, silver for silver, and gold for silver. Those traditions explicitly forbade a standard trick used by Medici bankers to circumvent the early Catholic Church's prohibition of interest, by subsuming interest rates in exchange rates.[12]

Riba Is Not the Same as Interest

There are reports that some prominent early companions of the Prophet, including the brilliant jurist ʿAbdullah ibn ʿAbbas, did not recognize the strict prohibition of *riba* that does not involve a time factor. He, Usama ibn Zayd ibn Arqam, Ibn Jubair, and others ruled that the only type of definitively forbidden *riba* is that which contains a time factor (*riba al-nasiʾa*), even citing a Prophetic tradition to that effect: "There is no *riba* except with deferment."[13] Later reports by Jabir suggest that this tradition referred to trading different goods, such as gold for silver or wheat for barley, and that Ibn ʿAbbas reversed his opinion and joined the majority opinion of prohibition of *riba al-fadl*.[14]

Jurists listed two reasons for the prohibition of *riba al-fadl*, which does not include a time factor: (1) spot trading of the same commodity for different quantities can be easily combined with credit sales to bring about the same effect as deferment *riba* (hence *riba al-fadl* is forbidden to prevent circumvention of the law – *saddan lil-dharaʾiʿ*), and (2) such trading includes excessive *gharar* (avoidable risk and uncertainty), since neither party knows whether the trade is beneficial or harmful to them.[15] Ibn Rushd based his central analysis of *riba*, on which we shall elaborate below, on the latter explanation of the prohibition (uncertainty regarding equity in exchange).

The inclusion of *riba al-fadl* under the general heading of forbidden *riba* is very important for understanding the economic substance of the prohibitions. However, most contemporary jurists and scholars of Islamic finance wish to exclude discussions of this topic, precisely to continue the mistaken one-to-one rhetorical association of "*riba*" with "interest." In fact, equivalence of the two terms is far from appropriate.

First, even the most conservative contemporary jurists do not consider all forms of what economists and regulators call interest to be forbidden *riba*. A simple examination of *riba*-free Islamic financial methods such as mark-up credit sales (*murabaha*) and lease (*ijara*) financing shows that those modes of financing are

not "interest-free." Indeed, truth-in-lending regulations in the United States force Islamic and conventional financiers to report the implicit interest rates they charge their customers in such financing arrangements. Thus, the practice of Islamic finance itself illustrates the fact that some forms of interest (e.g., in credit sales and leases) should not be considered forbidden *riba*.

Conversely, the prohibition of *riba al-fadl* illustrates definitively that there are forms of forbidden *riba* (illegitimate increase in exchange) that do not include interest. Indeed, as some Hanafi jurists have noted, the six-commodities Prophetic tradition cited in the previous section stipulated two conditions: "hand to hand" and "in equal amounts." Thus, if one traded an ounce of gold today for a deferred price of one ounce of gold next year, the transaction would still be deemed *riba*, despite the zero interest rate, because of violation of the "hand-to-hand" restriction. Those Hanafi jurists reasoned as follows: An ounce of gold today is clearly worth more than an ounce of gold in one year (recognizing the time value of money). Thus, one would never trade an ounce of gold today for an ounce of gold next year, unless one is getting something else in return (which is not disclosed in the sales contract). Whatever that extra benefit may be, they argued, it constitutes *riba*. Our subsequent analysis of the prohibition of *riba* – in terms of ensuring economic efficiency and equity in exchange – would simply explain the prohibition at zero interest based on the same general principle, applied to any other interest rate: How do we know that zero percent is the fair rate in exchanging gold today for gold in one year?

Economic Substance of the Prohibition of Riba

In his seminal work on comparative jurisprudence, the Maliki jurist, judge, and philosopher Ibn Rushd (also known as Averroës, d. 595 A.H./1198 C.E.) adopted the Hanafi generalization of rules of *riba* (based on the six-commodities tradition) to all fungible commodities, based on the following economic analysis:

> It is thus apparent from the law that what is targeted by the prohibition of *riba* is the excessive inequity it entails. In this regard, equity in certain transactions is achieved through equality. Since the attainment of equality in exchange of items of different kinds is difficult, we use their values in monetary terms. Thus, equity may be ensured through proportionality of value for goods that are not measured by weight and volume. Thus, the ratio of exchanged quantities will be determined by the ratio of the values of the different types of goods traded. For example, if a person sells a horse in exchange for clothes ... if the value of the horse is fifty, the value of the clothes should be fifty. [If the value of each piece of clothing is five], then the horse should be exchanged for 10 pieces of clothing.
>
> As for [fungible] goods measured by volume or weight, equity requires equality, since they are relatively homogenous, and thus have similar benefits. Since it is not necessary for a

person owning one of those goods to exchange it for goods of the same type, justice in this case is achieved by equating volume or weight, since the benefits are very similar.[16]

Thus, Ibn Rushd articulated the conditions for efficiency in exchange: that the ratio of traded quantities should be determined by the ratio of prices, and the latter should be equal to the ratio of [marginal] utilities.[17] This restriction was never made part of the rules of *riba*, since monitoring market prices of all goods would be a very tedious task. Thus, the prohibition is imposed only for equality in exchanging fungible goods, with the understanding – as suggested by Ibn Rushd – that if significant quality differences existed, one would avoid directly exchanging low-quality goods for high-quality ones of the same kind in barter.

A number of Prophetic traditions clearly support the notion of equity through equality when trading fungibles and illustrate the alternative of avoiding direct barter in cases of different good qualities. In this regard, Bilal and Abu Hurayrah narrated that a man employed in Khaybar brought the Prophet some high-quality dates. The Prophet inquired if all Khaybar dates were similar to that kind, and the man told him that they traded two or three volumes of lower-quality dates for one volume of higher-quality ones. The Prophet told him – angrily – never to do that again, but to sell lower-quality dates and use their proceeds to buy the higher-quality ones.[18]

Equity and Efficiency through Marking to Market

Selling the first type of dates (at the highest available market price), and buying the other type (for the lowest available market price), ensures that exchange takes place at the ratio dictated by market prices. Naturally, traders would trade only at that ratio if they valued the marginal units differently. Allowing for diminishing marginal utilities, whereby the buyer of each type of dates will value successive marginal units less, trading eventually halts by equating the ratio of marginal utilities to the ratio of market prices. Hence (Pareto) efficiency in exchange is attained, as dictated by contemporary neoclassical economic theory. Thus, the injunction against this type of *riba al-fadl* can be readily seen as a mechanism that precommits those who observe the prohibition to collection of information about market conditions, and marking terms of trade to market prices. This protects individuals against engaging in disadvantageous trades and enhances overall exchange efficiency. In this regard, notice that trading at any ratio that deviates from that of market prices will – by necessity – be disadvantageous to one party. Hence, justice and efficiency both dictate following this mark-to-market approach to establishing trading ratios.

Extending this logic to exchange over time (through credit sales, leases, or other transactions) is not difficult. In the context of credit sales and lease-to-purchase fi-

nancing, the substantive prohibition of *riba* – aiming to ensure equity in exchange – dictates that credit in such transactions must be extended at the appropriate interest rate. In this regard, conventional finance has played a very important role for contemporary Islamic finance, by determining the market interest rates for various borrowers, based on creditworthiness and security of the posted collateral.

Here, benchmarking the implicit interest rate in Islamic credit sales and lease-to-purchase transactions to conventional interest rates is quite appropriate. Indeed, if, for instance, the market interest rate for a particular borrower and particular collateral was 6 percent, but customer and financier agreed on a credit sale at 10 percent implied interest, one would object that this clearly violates the spirit of Islamic prohibition of *riba*, even if it uses a sale-based ruse to stay clear of the ancient forbidden form. In this regard, Al-Misri (2004) has argued that Islamic banks are well advised to abandon characterizing their mark-up in credit sales as "profit," and list it instead as "interest," since the former is potentially unlimited whereas the latter is capped by various contemporary anti-usury laws that protect those in need of credit against predatory lenders.

Islamic Finance: Form and Substance Revisited

Why, then, would we need an Islamic finance? Why would we go through the trouble of forcing an Islamic bank to buy a property first and then sell it to the customer on credit if the actual objective can be achieved more directly, through a secured lending transaction? Those questions must be answered in two steps: The first step is recognition that individuals engage in myopically excessive borrowing behavior if left to their own devices. Adherence to religious law can serve as an effective precommitment mechanism to ensure that individuals do not abuse the availability of credit to their own detriment.

The second step is recognition that adherence to religion has been historically ensured through adherence to forms, equally in the areas of ritual and transactions. In this regard, classical jurists developed contract forms and conditions thereof in a manner that encapsulated the spirit of the law to the best of their ability. When contemporary jurists attempt to help Muslims adhere to the spirit of the law, they feel safest working within the formal and informal methodologies of Islamic jurisprudence. We have seen in earlier chapters that Islamic jurisprudence is in fact a common-law system (if dressed in the garb of canon law), with emphasis on precedent and analogy. The resulting contemporary process of adapting classical contract forms to modern needs necessarily produces interim inefficiency.

This inefficiency would be tolerable only if we ensure that the spirit of the Law that gave rise to adopted forms is protected. Otherwise, it would be shameful merely to copy or adapt inefficient historical forms and squander the substance of Islamic law. Ideally, contemporary jurists would develop a modern jurisprudence

that embodies the substance of premodern laws within the context of contemporary legal and regulatory frameworks. This ideal may be approachable in the long term but seems impossible in the short term. In this regard, earlier jurists had the luxury of seeking efficiency by adopting Roman or other legal forms. However, later jurists have to work under the heavy burden of sacred history, including unreasonable admiration of the presumed timeless wisdom of their predecessors. Thus, practical Islamic solutions for the short to medium term may abandon premodern forms only gradually.

Multiple Paternalistic Parties

Earlier in this chapter, we discussed the paternalistic nature of prohibitions in general. We now turn to the prohibition of *riba* in particular, which aims substantively to protect individuals from getting excessively indebted, as well as paying or receiving unfair compensations for receipt or extension of credit. Naturally, one might argue that secular regulators also strive (paternalistically, one might add) to prevent individuals from borrowing excessive amounts, or falling prey to unfair predatory lending. However, regulators care primarily about the general health of the financial system – their concern about financial health of specific individuals being secondary at best. Thus, regulators may allow certain types of transactions that are hazardous to a few individuals, based on the tradeoff between that particular group's well-being (which is not their primary mandate) and overall systemic well-being (e.g., economic growth).

A second group of economic agents who aim to prevent excessive indebtedness are bankers, who use debt payments relative to income and other criteria for credit extension. However, bankers and loan officers work primarily for financial corporations that care little about systemic or individual financial health and care mostly about their own profitability. Thus, they would generally allow large numbers of customers to borrow excessively if the expected rate of repayment remains sufficiently high to ensure profitability.

Human Time Inconsistency and Precommitment Solutions

Thus, restrictions imposed by regulators and financial professionals require supplementary protections for individuals against their own irrational behavior – a function that can be fulfilled by religious law. In this regard, it is well documented in psychological and behavioral economic research that humans exhibit fundamental forms of irrationality in time preference, against which precommitment mechanisms (including those based on religion) can protect them. For instance, most individuals would prefer \$100 today over \$105 in one year, but prefer \$105 in twenty years over \$100 in nineteen. Those and other "time preference anoma-

lies" suggest that individuals will be "dynamically inconsistent" in their saving, spending, and borrowing behavior.[19]

The conclusion of this research is that individuals tend to discount the immediate future (e.g., one year from now) much more severely than they discount over a similar period later in the future (e.g., between nineteenth and twentieth years). Thus, in the previous example, an interest rate of 5 percent looks low for the current year, but sufficiently high for an arbitrary year further in the future. An individual exhibiting this type of time preference will choose to borrow $100 today, planning (genuinely) to save in the future and pay off his loan. However, once the future arrives, present consumption is again valued substantially more than future consumption, and the individual borrows even more, under the illusion that he will later save enough to pay off both loans. The debt cycle never ends. Some of those individuals may experience sufficiently fast growth in their incomes, so that they can eventually pay off their debts without increasing their saving rates. However, many other debtors may get buried under a debt cycle and eventually have to declare personal bankruptcy, which has become a mini-epidemic in some Western societies.

Good Loans and Bad

Why, one may wonder, would banks extend those bad loans that lead to bankruptcies? The answer is that loans are very rarely bad at their inception. When economic conditions are favorable, many borrowers experience income growth, and banks have an incentive to continue lending to them, since the number of defaults and bankruptcies will be too small to affect their profits. Sometimes, for example, in Asia during the 1990s, borrowed funds are invested in real estate and other fast-appreciating assets, making loans that are secured by those overpriced assets seem less risky than they are in reality. As economic conditions worsen, and asset market bubbles burst, too many of those loans may turn bad simultaneously, threatening the financial system. Hence, regulators impose restrictions to ensure that banks' operations do not threaten the system, albeit in a reactive manner that often fails to protect against later banking crises. In contrast, religious law aims to protect each and every individual by ensuring that they do not borrow excessively.

For instance, consider a Muslim customer who wishes to finance a home purchase through lease financing. If the housing market in question happens to be experiencing a speculative bubble, that fact should become clear to the customer by comparing the "rent" he would have to pay his Islamic bank (which is benchmarked to mortgage market interest rates) to the actual market rent of the property. If mortgage payments are excessively high relative to rent, that is generally

an indication that the customer is about to borrow an excessive amount of money relative to the long-term value of the property serving as collateral. Thus, marking the interest rate to market lease rates should prevent the individual from engaging in excessive borrowing to purchase that property. In the process, the customer is also assured that the implicit interest rate he pays is marked to the market-determined time value of the property serving as security for the debt.

If such considerations are ignored, the Islamic bank in this example would merely allow the customer to become "house-poor" or bankrupt, but do it "Islamically" through partial adherence to classical contract forms. That would be shameful abuse of religion and finance. Consequently, although we have accepted the necessary inefficient Islamic financial adherence to classical contract forms, it is equally if not more important to ensure adherence to the substance of Islamic law, which premodern jurists attempted to enshrine in those classical forms.

Digression on Loans in Islamic Jurisprudence

We have thus seen that the classical prohibition of *riba* in finance refers to the unbundled sale of credit, wherein it is difficult to mark the interest rate to market. In this regard, the simplest form of an unbundled credit sale is an interest-bearing loan. Indeed, if loans were viewed as commutative financial contracts (i.e., if repayment of the loan were viewed as compensation for the lent amount), then even interest-free lending would have been deemed forbidden *riba*. Al-Qarafi argued in *Al-Furuq* (a legal-theory book dedicated to explaining juristic distinctions) that lending is exempted from the rules of *riba* because of its charitable nature. Religiously, one who extends a loan does not seek repayment as the compensation, but rather seeks to give the time value of lent money, or usufruct of lent property, in charity.[20]

Thus, the Prophet's companions and early jurists said that they preferred to lend a coin, have it repaid, and lend it again, rather than to give it away in charity. Goodly loans have direct charity built in, as a needy debtor would be absolved if he cannot pay. On the other hand, a needy borrower retains dignity relative to recipients of explicit charity, through the possibility of repaying the principal. Even in case of repayment, the lender gains religious credit through sacrificing the time value of his property, and proving his willingness to sacrifice the property itself if necessary. Hence, Islamic jurisprudence excluded lending from the arena of finance, to retain its goodly charitable nature. This is possible since all the financial ends that can be served through commercial lending can be equally if not better served through other forms of commutative contracts (such as sales, leases, and the like).

3.2 The Prohibition of *Gharar*

We have explained prohibitions in terms of boundedly rational human behavior, in particular with regard to highly addictive behavior such as drinking and gambling. In particular, we have argued that the prohibition of *riba* may very well be based on the potentially addictive nature of borrowing and living beyond one's means. In this section we deal with the prohibition of *gharar*, which was characterized by prominent jurists in light of its similarity to gambling. In this regard, the late Professor Mustafa Al-Zarqa defined the forbidden *bay*ʿ *al-gharar* as "the sale of probable items whose existence or characteristics are not certain, the risky nature of which makes the transaction akin to gambling."[21]

Numerous historical examples of forbidden *gharar* sales are enumerated in classical jurisprudence books.[22] Generally speaking, *gharar* encompasses some forms of incomplete information and/or deception, as well as risk and uncertainty intrinsic to the objects of contract. Since complete contract language is impossible, some measure of risk and uncertainty is always present in contracts. Thus, jurists distinguished between major or excessive *gharar*, which invalidates contracts, and minor *gharar*, which is tolerated as a necessary evil. In his seminal paper summarizing classical opinions on *gharar* and applying them to contemporary transactions, Professor Al-Darir listed four conditions for *gharar* to invalidate a contract.[23]

First, *gharar* must be excessive to invalidate a contract. Thus, minor uncertainty about an object of sale (e.g., if its weight is known only up to the nearest ounce) does not affect the contract. Second, the potentially affected contract must be a commutative financial contract (e.g., sales). Thus, giving a gift that is randomly determined (e.g., the catch of a diver) is valid, whereas selling the same item would be deemed invalid based on *gharar*.[24] This condition is extensively used in designing *takaful* (cooperative insurance) as an alternative to commercial insurance solutions. *Takaful* companies, stockholder and mutually owned, use noncommutativity structures of voluntary contribution (*tabarru*ʿ) and agency (*wakala*), respectively, to resolve the *gharar* problem on the basis of which most contemporary jurists forbade commercial insurance. We shall discuss those structures in greater detail in Chapter 8.

Third, for *gharar* to invalidate a contract, it must affect the principal components thereof (e.g., the price or object of sale). Thus, the sale of a pregnant cow was deemed valid, even though the status of the calf may not be known. Indeed, the price of a pregnant cow would be higher than the price of the same cow if it were not pregnant. However, the sale of its unborn calf by itself is not valid based on *gharar*. In the first case, the primary object of sale is the cow itself, whereas in the latter case the object of sale is the unborn calf, which may be still-born.

Finally, if the commutative contract containing excessive *gharar* meets a need that cannot be met otherwise, the contract would not be deemed invalid based on that *gharar*. A canonical example is *salam* (prepaid forward sale), wherein the object of sale does not exist at contract inception, giving rise to excessive *gharar*. However, since that contract allows financing of agricultural and industrial activities that cannot be financed otherwise, it is allowed despite that *gharar*. Similarly, while contemporary jurists forbade commercial insurance based on excessive *gharar* and availability of noncommutative (*takaful*) alternatives, they currently allow *takaful* companies to deal with conventional reinsurance companies, since re-*takaful* alternatives are not yet available.

Definition of Gharar

The distinction between major and minor *gharar*, as well as considerations in the fourth criterion for *gharar* to invalidate contracts, suggests a strong cost-benefit analysis as the foundation for prohibition. Indeed, a number of classical jurists explicitly highlighted this central cost-benefit analysis:

> [The Prophet's] prohibition of *gharar* sales (*bayʿ al-gharar*) render such sales defective. The meaning of "*gharar* sale," and God knows best, is any sale in which *gharar* is the major component. This is the type of sale justifiably characterized as a *gharar* sale, and it is unanimously forbidden. However, minor *gharar* would not render a sales contract defective, since no contract can be entirely free of *gharar*. Consequently, scholars differ in opinion regarding which contracts are thus rendered defective, based on their assessment of the extent of *gharar* in the contract. Thus, each scholar would invalidate a contract if he deems its *gharar* component substantial, and would otherwise declare the contract valid if the *gharar* is deemed minor.[25]

> Scholars said that the criterion for invalidity of a contract based on *gharar*, or validity despite the existence of *gharar*, is this: If necessity dictates allowing *gharar*, which thus cannot be avoided without incurring an excessive cost, or if *gharar* is trivial, the sale is deemed valid, otherwise it is deemed invalid. . . . Thus, differences in opinion among scholars are based on this general principle, where some of them render a particular form of *gharar* minor and inconsequential, while others render the same form substantial and consequential, and God knows best.[26]

> In this regard, the corrupting factor in *gharar* is the fact that it leads to dispute, hatred, and devouring others' wealth wrongfully. However, it is known that this corrupting factor would be overruled if it is opposed by a greater benefit.[27]

Perhaps the best literal and juristic translation for "*bayʿ al-gharar*" is "trading in risk."[28] In this regard, the *Encyclopedia of Islamic Jurisprudence* also lists cheating (*tadlis*) and fraud (*ghubn*) as special cases of *gharar*.[29] Thus, *gharar* incorporates

uncertainty regarding future events and qualities of goods, and it may be the result of one-sided or two-sided and intentional or unintentional incompleteness of information.

The factor that is common in all those categories is significant (possibly unquantifiable) risk and uncertainty. The possibility of unanticipated loss to at least one party may be a form of gambling or may lead to ex post disputation between contracting parties. The prohibition of *bayʿ al-gharar* (the sale of *gharar*) may thus be seen as a prohibition of the unbundled and unnecessary sale of risk. Of course, the most extreme form of unbundled sale of risk is gambling: paying a predetermined price for some unproductive game of chance (e.g., spinning a roulette wheel and winning a larger sum of money if the ball falls on black). Various forms of *gharar* are assessed based on proximity to this extreme form.

Economic Substance of Prohibition

The most significant developments in finance over the past three decades have been in the area of separating various financial credit and risk components for accurate pricing. This was accomplished through advances in securitization and development of financial derivatives. We admitted earlier that finance (Islamic or otherwise) is about allocation of credit or risk. Moreover, we have argued that the two main prohibitions in Islamic jurisprudence, those of *riba* and *gharar*, are best characterized as trading in unbundled credit and trading in unbundled risk, respectively. For the case of *riba*, we argued that disallowing unbundled trading of credit can protect individuals who are vulnerable to excessive borrowing from falling into debt cycles and ensured marking interest rates to market. Similarly, it can be seen that the prohibition of trading unbundled risk aims to protect individuals from exposure to excessive financial risk or payment of mispriced premia to eliminate existing risks.[30]

Bounded Rationality in the Face of Risk

Starting with the early experiments by Allais in 1953, behavioral economists and psychologists have documented a number of basic patterns in human behavior under risk and uncertainty. Kahneman and Tversky (1979) summarized the most important patterns under four headings, the most important being (1) the excessive weight humans place on events considered certain, relative to ones that are highly probable, (2) the overweighting of losses compared to gains, and (3) risk-loving behavior over losses. A recent literature has emerged in finance, using those documented idiosyncrasies of human behavior under risk to provide explanations for a host of otherwise puzzling human and market behaviors.[31]

The above-mentioned idiosyncrasies drive individuals to take too much risk, and then to pay too much for insurance. For instance, when one buys a computer at a retail store in the United States, the computer commonly comes with only a one-year manufacturer's limited warranty. At the check-out, just before one pays for the computer, the sales clerk offers the buyer an extended warranty. This insurance sales tactic is used to capitalize on individuals' loss aversion. If the insurance was offered bundled with the computer (e.g., if it sold for $1,000 without warranty, and for $1,200 with extended warranty), buyers will tend to view safety as an attribute of a computer they do not yet own, and would thus be unwilling to pay a high price for the embedded insurance. In contrast, once the buyer is ready to pay for the computer, thus considering it his property, loss aversion will drive him to pay more for insurance than he would have otherwise.

Some experimental evidence suggests that financial professionals are no less susceptible to those documented human idiosyncrasies in decision making under risk and uncertainty.[32] Most humans seem to exhibit loss aversion or asymmetric assessment of small gains versus small losses. This loss aversion produces willingness to pay too much for insurance, once the new "reference point" – with respect to which "prospects" are evaluated – makes one think of more events in terms of loss. In addition, since humans also tend to exhibit risk-loving behavior over losses and risk-averse behavior over gains, they treat the same prospect differently, depending on how it is presented to them. Those human idiosyncrasies in decision making under risk and uncertainty lead to dynamically inconsistent behavior. Precommitment, through prohibition of selling the unbundled insurance, helps to protect consumers against that dynamic inconsistency.

Insurance and Derivatives

If we accept the definition of forbidden *bayʿ al-gharar* as trading in risk, we can readily understand contemporary jurists' prohibition of conventional insurance and derivatives trading. Those topics will be discussed in much greater detail in Chapter 8. Thus, our coverage in this chapter only briefly links juristic analysis of the prohibition of *gharar* to our economic understanding of its legal substance. In this regard, we have noted in Chapter 2 that jurists argued that "safety" or "insurance" itself does not qualify as the object of sale. Hence, the object of sale in that contract would have to be defined as a contingent claim, akin to an option: The insured party has a legal right to receive compensation for damages in the event of loss stipulated in the insurance contract.

Based on this interpretation, jurists have forbidden commercial insurance dateing back to the late nineteenth century C.E., when the prominent Hanafi jurist Ibn ʿAbidin, whose work and opinions were central to the Ottoman *Majalla*,

forbade maritime insurance on similar grounds. Likewise, jurists forbade naked options (calls and puts), which give their holders a legal right (respectively, to buy or sell the underlying assets). In this regard, the legal right to exercise the option was also viewed to be ineligible as object of sale. Thus, in both insurance and options, the price (insurance premium or option price) is certain, but its compensation (insurance payment or profit from exercising option) is uncertain, and hence the trade is forbidden based on *gharar*.

Notice that, in both instances, it is the sale of an unbundled contingency claim or legal right that jurists have forbidden. Jurists have not forbidden the inclusion of warranty in sale, whether the warranty is provided by the manufacturer or the retail seller. This bundled sale of insurance was allowed, just as the bundled sale of credit was (e.g., by allowing a manufacturer or dealer to sell cars with deferred payments, whereas financially equivalent loans are considered forbidden unbundled sales of credit). Likewise, jurists have not forbidden the sale of bundled options. Indeed, juristic analyses of sales contracts include lengthy discussions of permissible options in sales, an area in which the highly respected Hanbali jurists Ibn Taymiyya and his student Ibn Qayyim were particularly liberal.

3.3 Bundled vs. Unbundled Credit and Risk

We have thus argued that the two major prohibitions in Islamic jurisprudence of financial transactions, those against *riba* and *gharar*, are in fact prohibition of trading in unbundled credit and unbundled risk, respectively. We have further argued that the paternalistic nature of those prohibitions is understandable, in light of human idiosyncrasies that would lead to dynamically inconsistent behavior, much like wine drinking can lead to dynamically inconsistent behavior for most humans. Unlike the consumption of intoxicating beverages, which is not necessary for life, transfer of credit and risk is fundamental to the functioning of financial systems and economies. Hence, classical jurisprudence evolved methods of bundled trading in credit and risk while maintaining the prohibition of unbundled trading thereof.

That being said, one must recognize that classical contract forms – specific means of bundling credit and/or risk with other economic activities – can be used as apparently legitimate means toward illegitimate ends. This is obviously the case in *tawarruq*, for instance, where the stated purpose is to extend credit and provide liquidity to some customer. Economic activities camouflaging the underlying sale of credit (two spot sales and one credit sale of some commodity) do little to protect individuals from borrowing or lending excessively, for the wrong reasons, or at the wrong interest rate.

In the case of legitimate credit sales or lease-to-purchase financing secured by real estate, vehicles, equipment, and the like, marking-to-market rental value of the financed instrument can help individuals and lenders determine whether or not the implicit loan is justifiable. In contrast, the "rental" value on commodities used in *tawarruq* is precisely the rental value on money: that is, market interest rates that are not linked to the object of sale in any meaningful way. In other words, the "bundling of credit" in this transaction serves no economic purpose. It is a mere legal stratagem or ruse (*hila*) to legalize otherwise forbidden interest-based lending. That is why jurists of most schools have forbidden this transaction, which takes the form of multiple valid sales but does not serve the desired substance of Islamic law.

In later chapters we shall see that some classical nominate contract-based solutions to the prohibitions of *riba* and *gharar* seem to serve the form and substance of classical jurisprudence, while others clearly do not. In cases where current practice in Islamic finance serves legal form alone, and ignores substance, we have seen the credibility of the industry erode (e.g., in scholarly and public attacks on the contemporary practice of *murabaha* financing as merely inefficient lending).[33] This in turn led to the development of better alternatives (e.g., increased use of lease-based financing, including in *sukuk* issuances, in which marking-to-market rent is more straightforward). By attempting to analyze forms and economic substance of classical jurisprudence simultaneously, we hope to make it easier for industry participants to develop instruments that serve the latter. In the longer term, that emphasis on the economic substance of transactions may eventually rid Islamic finance of outdated and inefficient modes of operation. Thus, the Islamic brand name of the industry may be redefined in terms of consumer protection and social development, rather than contract mechanics.

4
Sale-Based Islamic Finance

As noted in earlier chapters, nominate contracts in classical Islamic jurisprudence play a very prominent role in contemporary Islamic finance. This prominence is in large part a function of the common-law nature of Islamic jurisprudence. Contemporary jurists are generally reluctant to declare that a contemporary financial practice is permissible under Islamic law, even though the default rule in transactions is permissibility. Thus, jurists seek precedents in classical jurisprudence to justify proposed contemporary practices.

To illustrate, consider the Chapter 1 example of conventional mortgage loan transaction and the Islamic version based on *murabaha* financing. Background credit checks, and other financial considerations to determine whether or not credit should be extended to a particular customer, are identical in both settings. Indeed, the mark-up charged to a customer under the Islamic model can be determined based on the customer's credit rating and benchmarked to interest rates on potential conventional loans to the customer. The main difference between conventional and Islamic financing procedures is thus inherent in the contracts used.

In the case of conventional mortgage lending, the bank collects principal plus interest on debt documented as a loan. In contrast, the *murabaha* model of Islamic finance is predicated on the permissibility of charging a credit price that is higher than the spot price of a property. Thus, the Islamic bank collects principal plus interest on debt documented as a credit price. As noted previously, the price mark-up can mimic conventional interest rates, and indeed the amortization table for a *murabaha* financing facility may be identical to the corresponding table for a mortgage loan. However, the *murabaha* financing return on capital is characterized rhetorically as profit or price mark-up in a sales transaction rather than interest on a loan.

One problem in applying the credit sale *murabaha* model directly to mortgage financing is that the bank does not own the property it finances. In fact, most

banks in the West are prevented from owning real estate or trading it. Thus, the Islamic model requires that the bank must first purchase the property (possibly through a special-purpose vehicle) and then sell it (or lease it then sell it, in *ijara* financing) to the customer. This imposes a number of additional transaction costs, including legal fees and sales taxes.

Some of those costs may be reduced by lobbying regulators. For instance, the Financial Services Authority (FSA) recently made *murabaha* financing, for example, as practiced in the United Kingdom by HSBC, more affordable by eliminating double-duty taxation when the two sales are executed to facilitate financing.[1] Other costs can be reduced by allowing the customer to act as the bank's agent, thus buying the property on the bank's behalf and then selling it to himself. Those and other steps allow the Islamic model progressively to approximate the conventional model's procedures and costs.

Islamic finance as practiced today serves a primary goal of replicating conventional financial products and services, as efficiently as possible, utilizing classical contract forms (such as sales and leases). Toward the end of enhancing efficiency in Islamic finance, bankers and lawyers venturing in the field need to understand some of the basic features of classical nominate contracts, which are used to mimic conventional financial products and services. However, one can hope that as the industry matures, its practitioners will look beyond mimicking contemporary financial practices utilizing those classical contract forms. As we review the main classical contract forms, we should reflect on our Chapter 3 analysis of the main prohibitions in Islamic financial jurisprudence, their economic merit, and the way classical nominate contracts implemented the principles enshrined in the jurisprudence. This can help in our quest for a thoroughly contemporary Islamic financial model that retains the substance of classical jurisprudence, rather than falling into superficial adherence to classical contract forms while possibly violating the substance of Islamic law.

4.1 Basic Rules for Sales

Sale is the ultimate permissible contract, as indicated by the Qur'anic verse asserting that God has permitted trade and forbidden *riba* [2:275]. Sales generally are characterized by classical jurists as exchanges of owned properties, including services and some property rights for non-Hanafi jurists. A sales contract requires offer and acceptance, with a meeting of minds for buyer and seller. For Hanafis and Malikis, a sale is concluded and binding on both parties on the expression of offer and acceptance. On the other hand, Shafiʿis and Hanbalis ruled that buyer and seller retain the option to rescind the sales contract as long as they have not parted from the contract session. This is called the "contract session option"

(*khiyar al-majlis*), which is based on an authentic Prophetic tradition: "The two parties to a sale have the option [to rescind it] as long as they have not parted, and one of them may give the other the option for a longer period."[2]

A number of restrictions on objects of sale were put in place, in part to ensure that sales contracts are not used as ruses for *riba*, and in part to protect the interests of contracting parties. With the exception of prepaid forward sales (*salam*) and commissions to manufacture (*istisna*ʿ), to be discussed separately in later chapters, objects of sale must exist at the time of the contract. Moreover, for a sale to be executed, objects of sale must be owned by the seller, in his possession, and deliverable to the buyer. This set of conditions is central to the practice of Islamic financial institutions, wherein the financial institution must own a property in order later to sell or lease it to its customer. As noted above, this requirement results in additional legal costs for the extra sale and establishment of SPVs, as well as potential additional sales taxes, licensing fees, and the like. Interestingly, although the Shafiʿis and Hanbalis listed the seller's ownership of an object of sale as a condition of conclusion of the sale contract, Hanafis and Malikis deemed it only a condition of execution of the sale. Thus, the latter two groups of scholars deemed sales by an "uncommissioned agent" (known in Arabic as *bay*ʿ *al-fuduli*) concluded but suspended pending the [ultimate] seller's approval.[3]

*The Underused Uncommissioned Agent (Bay*ʿ *al-Fuduli) Structure*

In this regard, while most areas of Islamic finance tend to be dominated by the Hanafi and Hanbali schools of jurisprudence,[4] there is ample evidence that opinions from other schools of jurisprudence have been accepted in the industry. For instance, in the classical *murabaha* practice, wherein the bank buys a property and then sells it on credit to customer, jurists and banks have accepted a Maliki opinion of the jurist Ibn Shubruma – to allow the bank first to obtain a binding promise by its customer that he will buy the property after the bank buys it. It appears that developments along the "uncommissioned agent" opinions of the Hanafis and Malikis can greatly reduce the transaction costs in *murabaha* financing, by approximating conventional procedures more accurately.

Thus, the bank may act as an uncommissioned agent for the seller, selling his property to the customer on credit. At this stage the customer will owe the seller that property's price plus mark-up as determined by market interest rates, if the seller were to accept it. The seller may accept to provide financing to the customer directly, in which case the bank would be entitled only to its agency commission. On the other hand, if the seller demands receiving the price in cash, the bank – as agent – may conclude the sale by paying him the cash price he demanded, while collecting from the customer the credit price he agreed to pay. Thus, the bank

would act as a traditional financial intermediary, with the associated lower costs, rather than trading in property.

Although this alternative structure based on uncommissioned agent trading (*bay*ʿ *al-fuduli*) may not necessarily be acceptable to all jurists, it appears to have been used in Islamic finance in the GCC. For instance, *fatwa* #62 for Dalla Al-Baraka and *fatawa* #17 and #24 for Kuwait Finance House all permitted the uncommissioned agent structure, arguing that ex post acceptance of the Islamic bank (that the customer bought on its behalf) is equivalent to ex ante agency authorization.[5]

Trust Sales: Murabaha, Tawliya, Waḍiʿa

The most common type of sale in Islamic jurisprudence is negotiated-price sale *bay*ʿ *al-musawama*), wherein the two parties agree on a price at which they are both willing to conclude the transaction. However, there are three other types of sale, wherein the two parties agree on a profit or loss margin, and the buyer relies on the seller's truthful revelation of his cost. In *murabaha* the two parties agree to trade at a price equal to the cost plus mark-up or profit, in *tawliya* they trade at cost, and in *waḍi*ʿ*a* they agree to trade at a marked-down price.[6]

In *murabaha* and *tawliya*, jurists ruled that the seller must be the owner, otherwise it is impossible for the seller to disclose the cost at which he obtained the property. The most common method of financing by Islamic financial institutions is "*murabaha* to order." It is based on a concatenation of two opinions, one by Al-Shafiʿi that permitted a potential buyer to tell a seller "buy this property, and I will buy it from you at x percent mark-up," and an opinion of the Maliki jurist Ibn Shubruma that allows the potential buyer's promise to be made binding. In the first conference of Islamic banks in Dubai (1979), participants concluded that "this type of promise is legally binding on both parties based on the Maliki ruling, and religiously binding on both parties for all other schools." This ruling was reiterated in 1983, at the second conference of Islamic banks in Kuwait, reasoning that "this [*murabaha*] sale is valid as long as the bank is exposed to the risk of destruction of the good prior to delivering it to the buyer, as well as the obligation to accept return of the good if a concealed defect is found therein."

Led by the Pakistani jurist and retired Justice M. Taqi Usmani, jurists who are involved in Islamic finance have allowed the rate of return in *murabaha* to be benchmarked to conventional interest rates. In this regard, the rate of return earned by the bank was justified by two risks: (1) the risk of ownership between the two sales, and (2) the risk that the property may be returned to the bank (as seller) if a defect is found therein. We must note, however, that the risk of ownership can be made minimal by restricting the time period between the two sales

to minutes, if not seconds. Moreover, although jurists insist that any cost of insurance of the property during that period must be borne by the Islamic financial institution, the bank may negotiate a mark-up that compensates it for that cost. Similarly, the cost of insuring against the risk of having to accept the return of defective merchandise can be transferred easily back to the original seller or forward to the buyer. Thus, the only material risks to which the bank is exposed are credit risk and interest rate risk, which conventional banks specialize in managing. Indeed, many of the transaction costs associated with Islamic finance arise precisely for the purpose of eliminating all other (e.g., commercial) risks, which banks are not particularly well equipped to manage.

Currency Exchange (Sarf)

The well-known Prophetic tradition on *riba*, discussed in Chapter 3, listed six commodities that should be traded hand-to-hand and in equal quantities. In a variation on this Prophetic tradition that applied exclusively to monetary commodities, ʿUmar ibn Al-Khattab said, "Do not sell gold for gold or silver for silver except in equal quantities. Moreover, do not trade gold for silver with one of them deferred. Even if your trading partner asks you to wait until he can fetch the money from his house, do not accept the deferment. I fear that you will fall in *riba*."[7] Thus, *murabaha* financing cannot be applied to trading gold for silver with deferment for equal or different quantities.

Of course, gold and silver represented the bimetallic monies of the time, and thus trading gold for gold, silver for silver, or gold for silver were all grouped together under the title "currency exchange," or *sarf*. In those trades the aforementioned Prophetic tradition requires the exchange to be hand-to-hand (i.e., without deferment), and if the two compensations are of the same genus, then they must be equal in weight. No conditions or options are allowed in this contract, which is deemed binding at its conclusion.

The earliest jurists reasoned by analogy that currency exchange contracts may not be used to settle existing debts (e.g., settling a debt for gold with payment in silver). However, later jurists reasoned by juristic approbation that clearing a debt in one currency with payment in another currency is permissible if both parties consent to it, regardless of when and how the debt was initiated, and in some cases, the exchange would be enforced without need for mutual consent.[8]

Contemporary jurists have allowed regular currency-trading transactions, in which a payment in one currency is made in one country, and receipt of another currency is made in a different country, possibly at a later time. This practice was characterized as an instantaneous currency exchange contract in the first country, followed by an interest-free loan to be repaid at the later date in the other

country.[9] Of course, the underlying assumption is that exchange will be carried out at the spot exchange rate of the initiation date, to avoid suspicion of *riba*. On the other hand, those familiar with the evolution of modern banking in Europe will recognize bills of exchange along those lines (known by the Arabic name *suftaja*) as the classical forms through which Medici bankers managed to embed interest rates in exchange rates, to circumvent the classical Catholic prohibition of "usury."[10]

Metals and Tawarruq

Another interesting development in Islamic finance is that some precious metals (e.g., platinum) were exempted from rules of currency exchange. For instance, the Rajhi Investment Company's Shariʿa board reasoned as follows in its *fatwa* #101:

> Platinum is a precious metal that does not inherit the legal status rulings of gold and silver, even though some people call it "the white gold." Thus, mutual receipt during contract session is not required for platinum, and it may be sold with deferment in exchange for currency.
>
> In general, platinum is subject to legal status rulings for metals other than gold and silver. Thus, if the company [Al-Rajhi] wishes to deal in this metal when it is not present [in the seller's possession], it may only buy it through *salam* [prepaid forward contract], subject to all the conditions of that contract. Moreover, the company must receive the metal prior to reselling it.[11]

Thus, although the classical rules of currency exchange very strictly ensured that an interest-bearing loan cannot be manufactured out of trade, recent developments in jurisprudence have allowed trade-based financing to replicate loans. This is especially prevalent today through the *tawarruq* contract that is increasingly practiced in GCC countries. Thus, if a customer wishes to borrow $10,000 and pay 5 percent interest, and the bank wishes to lend him the money at that rate, the bank needs only to buy $10,000 worth of platinum from a dealer, sell to the customer on a credit basis for $10,500 to be paid later, and then sell the platinum on behalf of the customer back to the dealer, thus generating the desired result. Needless to say, all interest-based financial transactions (including loans and bonds) can be (and are in fact) generated through such trade cycles, which involve a credit component through either credit sales or prepaid forward sales.

In the context of *tawarruq* as practiced by Islamic banks, it is noteworthy that most classical jurists deemed it impermissible for one entity to execute a sale as agent for both trading parties, with the exceptions of judges, plenipotentiaries, and parents.[12] This restriction was intended to ensure that sales contracts are legitimate, and that they are perceived by all parties to be beneficial to them. One particularly troublesome practice that would be voided by this restriction applies

to banks engaging in "trade" for the purpose of *tawarruq* financing, whereby the bank acts as an agent for its customer and the merchant – buying commodities from the merchant, selling to the customer on credit, and then selling back to the merchant for the amount of cash desired by the customer.

4.2 Same-Item Sale-Repurchase (*'Ina*)

Most recent developments in Islamic finance involve the utilization of a commodity or property as one degree of separation to recharacterize an interest-bearing loan in the form of trade. Thus, we have just described the most common form of *tawarruq* financing that has become increasingly popular in Saudi Arabia, UAE, and other GCC countries in recent years. This practice was common in earlier decades for larger corporate customers of Islamic banks and financial institutions. For those larger customers, the bank did not need to provide agency services for all sales. Indeed, larger customers were capable of borrowing through a simple *murabaha* transaction for platinum, and they had the necessary recourses to sell the platinum on the spot market to obtain desired liquidity. This was particularly advantageous to bankers who operated in countries wherein *tawarruq* was unacceptable, whereas *murabaha* was.

As noted briefly in previous chapters, most Islamic bond (*sukuk*) structures developed in recent years also involve the sale and repurchase of some property or commodity. Thus, short-term bill-like instruments are manufactured through prepayment (*salam*) sale of commodities, and long-term bondlike instruments are manufactured through sale of a property, followed by leasing back the same property, and possibly buying it back at lease end. In this section we shall review classical and contemporary juristic rulings on same-property sale-repurchase and their implications for Islamic finance.

Same-Item Trading in 'Ina and Tawarruq

The classical *bayʿ al-ʿina* (same-item sale-repurchase to circumvent the prohibition of interest-based lending) was discussed extensively in the classical juristic literature.[13] Discussion centered mostly around Prophetic traditions, the authenticity of which were accepted by some jurists but not others. In the simplest form of *ʿina* sale to produce interest-based debt, the "borrower" sells some property to the "lender" and receives its cash price. Then, the "lender" turns back and sells the same property to the "borrower" on credit, at a higher price equal to the "principal," or cash price, plus interest. Classical jurists also recognized that a third party may be introduced as an intermediary, whereby A (dealer) sells to B (bank) in cash, B sells to C (customer/borrower) on credit, and C sells to A

in cash. Of course, if jurists were to forbid same-item repurchase through one intermediary, more degrees of separation – for example, trading parties D and E – may be added.

Abu Hanifa had generally ruled that the validity of sales is determined by contract language. However, he ruled that same-item sale-repurchase without an intermediary third party is defective, based on a tradition of Zayd ibn Arqam.[14] He also reasoned that if someone sells a property on credit, and then the buyer sells it back to him for cash, the second sale would not be valid. He based that ruling on the view that the deferred price in the first sale would not have been received, and thus the second sale (which is contingent on the first) could not be definitively concluded. Of course, the latter objection can be circumvented formally in Islamic banking by asking the customer first to sell any property to the bank for cash, and then turn around and buy it back on credit.

The two closest associates of Abu Hanifa differed in opinion regarding this contract. Thus, the judge Abu Yusuf ruled that the contract is valid and not reprehensible, whereas Muhammad Al-Shaybani found it extremely reprehensible, as an obvious stratagem invented to circumvent the prohibition of *riba*. Similarly, Shafiʿi and Zahiri jurists ruled that the contract is valid, since it satisfies the cornerstones and language of valid sales, and since Al-Shafiʿi himself did not accept the tradition of Zayd as authentic. However, they reasoned, it is reprehensible since the intent to legitimize *riba* through sales is clear, although their legal theory did not allow them to invalidate a contract based on such analysis of intent.[15]

Interestingly, Maliki and Hanbali jurists ruled that same-item sale-repurchase without a third-party intermediary is forbidden, by invoking the rule of preventing means of legitimizing illegitimate ends (*sadd al-dharaʾiʿ*). However, if a third-party intermediary is present (as in the case of *tawarruq*), most Malikis and some Hanbalis reasoned that the contract is merely reprehensible. Since the use of *tawarruq* has been spreading quite rapidly in the GCC region (especially Saudi Arabia and UAE) based on its permissibility among some Hanbali jurists, it seems appropriate to review some of the more recent classical and contemporary juristic opinions regarding this contract.

Hanbali Denunciation of Organized Tawarruq

Ibn Qayyim Al-Jawziyya, a prominent Hanbali jurist and star student of Ibn Taymiyya, said the following regarding Ibn Taymiyya's attitude toward *tawarruq*:

> and our teacher (God bless his soul) forbade *tawarruq*. He was challenged on that opinion repeatedly in my presence, but never licensed it [even under special circumstances]. He said: "The precise economic substance for which *riba* was forbidden is present in this contract, and transaction costs are increased through purchase and sale at a loss of some commodity. Shariʿa would not forbid a smaller harm and permit a greater one!"[16]

Similarly, Al-Baʿli reported in his selection of juristic rulings of Ibn Taymiyya that the latter had forbidden *tawarruq*.[17] More recently, two very prominent juristic councils, both housed in Saudi Arabia, tackled the issue of *tawarruq*. The more prominent Fiqh Academy of the Organization of Islamic Conference, in Jeddah, Saudi Arabia, forbade *tawarruq*. The second and generally less prestigious Fiqh Academy of the Muslim World League, in Makka, Saudi Arabia, issued two rulings on the transaction. The first opinion was issued in the fifteenth session of the academy in October 1998. It permitted the contract subject to the condition that the customer does not sell the commodity to its original seller, to avoid direct evidence of *ʿina* as a legal stratagem to circumvent the prohibition of *riba*. In the seventeenth session of the academy, held in December 2003, they tackled the issue of "*tawarruq* as practiced by Islamic banks today" and forbade it. They based their decision on the following characterization and reasoning:

After listening to presented papers on the subject, and discussions thereof, the Academy recognizes that some banks practice *tawarruq* in the following manner:

The bank routinely sells a commodity (other than gold or silver) in global markets or otherwise to the customer on credit, wherein the bank is bound – by virtue of a contract condition or convention – to sell the commodity to another buyer for cash, which the bank delivers to the customer.

After study and deliberation, the Academy ruled as follows:

First, *tawarruq* as described above is not permissible for the following reasons:

1. The seller's obligation to act as the buyer's agent to sell the commodity to another buyer, or making similar arrangements, makes the dealing akin to the forbidden *ʿina*, whether that obligation is spelled out as an explicit contract condition, or determined by custom.
2. In many cases, this type of transaction would result in nonsatisfaction of receipt conditions that are required for validity of the dealing.
3. The reality of this transaction is extension of monetary financing to the party characterized as a *tawarruq* customer, and the buying and selling operations of the bank are most often just meant for appearances, but in reality aim to provide the bank an increase in compensation for the financing it provided.

Some banks have attempted to address those concerns of the Muslim World League Fiqh Academy by ensuring that all trasanctions are bona fide sales and purchases, with corresponding transfer of commodity risks. Towards that end, many banks in Saudi Arabia have begun to emphasize that all commodities used for *tawarruq* are bought and sold in domestic markets, with real merchants delivering the goods or reassigning their ownership as dictated by trade. However, it would appear that this increased emphasis on forms misses the argument made by Ibn Taymiyya as reported by Ibn Qayyim: that the difference between what is

permitted and what is forbidden cannot possibly be determined by the amount of transaction costs involved (with higher transaction costs favored!).

Returning to our analysis of *riba* in Chapter 3, it appears that the true demarcation should be determined by "marking to market." We explained the canonical prohibition of trading dates for dates in different quantities by arguing that when dates are sold for money, one seeks the highest bid, and when one uses the money to buy dates, one seeks the lowest offer. This enhances efficiency in markets (especially if added transaction costs are negligible) and ensures equity in exchange. Similarly, if financing is replaced by bona fide trade, as both Fiqh Academies have agreed, then the financing charge in *murabaha* financing (whether or not the customer plans to sell the commodity for cash) will be determined by the difference between actual cash and credit prices in the marketplace.

In contrast, a *tawarruq* transaction is usually structured by banks to equate financing charges to market interest rates on loans to similar borrowers, regardless of the actual underlying commodity. It is thus possible to understand the Fiqh Academies' opinions in terms of rejection of robbing the trading components of Islamic finance of all economic significance, thus squandering the potential efficiency-enhancing provisions built into Islamic jurisprudence. The distinction based on marking to market is more significant in Islamic transactions structured through leases, where a market lease rate may be computable and useful for comparison to the interest rate being charged on similar financial products.

Custody Sale (Bayʿ Al-ʿuhda) and Sukuk Al-ijara

We have described the recent lease-backed Islamic bonds briefly in the introduction, and we shall discuss them in much greater detail in Chapter 6. The structure quite simply proceeds as follows. The entity that desires to issue bonds (be it a sovereign government, a corporation, etc.) creates an SPV that sells certificates (*sukuk*) for the amount of the bond issuance. The SPV uses the proceeds to buy some property (typically, land, buildings, machines, etc.) from the issuer and proceeds to lease the property back to the seller. The issuer pays rent, which is passed through the SPV to certificate holders. At lease end, the issuer typically buys the property back from the SPV (although in at least one structure that we shall discuss in detail, the property will be given back as a gift from the SPV to original seller).

We have noted in Chapter 1 that there are two elements of same-item sale-repurchase in this structure: (1) the property and its usufruct are sold to the SPV, and then the usufruct is purchased back through the lease, and (2) the property itself (and all of its remaining usufruct) is purchased back at lease end. This raises the issue of *ʿina*, which would deem the contract forbidden. However,

same-item sale-repurchase has been approved in lieu of debt by some schools of jurisprudence. That sale form is called fulfillment sale (*bay' al-wafa'*), wherein a property is sold on condition that once the seller returns the price, the buyer must return the property. Shafi'i jurists call this trade *bay' al-'uhda* (custody sale), and the Hanbalis call it *bay' al-amana* (trust or faithfulness sale).

Maliki and Hanbali jurists, as well as early Hanafi and Shafi'i jurists, ruled that such sales are defective, since they were viewed as legal stratagems to reach illegitimate ends (forbidden *riba*) through legitimate sale means. In this regard, they forbade the practice by characterizing the apparent sale as a loan of the price, with usufruct of the property being the profit or interest collected on the loan. Interestingly, this ruling is reinforced in *sukuk* structures, wherein the usufruct is further monetized through leasing the property back to the seller. However, some later jurists have allowed the contract based on convention, thus paving the road for its contemporary utilization.[18]

In general, Islamic jurisprudence does not forbid the same property being sold back to its original seller, provided that the two sales are not stipulated in the original contract. Otherwise, a sales contract that requires the buyer to sell the property back is not a sale at all, since the buyer never in fact obtains ownership rights, which include the right not to sell the property, and certainly the right not to sell it to any given individual or entity (e.g., the original seller). However, the precedent of fulfillment sale mentioned in this section opened the door for the possibility of constructing the *sukuk* structures that have become popular in recent years, which we discuss in Chapter 6.

Now, we may return once more to the issue of "marking to market," which we argued to be at the heart of the prohibition of *riba*. Many Islamic finance practitioners have hailed the ability of countries and corporations to engage in secured lending through sale-lease-back-repurchase certificates, which may – in theory, if not in practice – allow them to borrow at lower rates. Indeed, because of the recent preponderance of those issuances, Standard and Poor's has developed a rating methodology for such lease-backed bonds (discussed in Chapter 6), and the country of Bahrain has progressively used that tool to refinance substantial amounts of its conventional debt at lower interest rates. Invariably, however, the interest rates on those secured bonds are benchmarked to interest rates for conventional bonds with similar credit ratings. We must thus turn to this issue of benchmarking Islamic financing rates to conventional interest rates.

4.3 Cost of Funds: Interest-Rate Benchmarks

Contemporary jurists have simultaneously lamented benchmarking implicit interest rates in Islamic sale- and lease-based financing to conventional interest rates

(such as the London Interbank Offer Rate [LIBOR]) and argued that such benchmarking by itself would not deem the financing un-Islamic. A favorite argument of contemporary jurists' has been drawing an analogy to two lines of business, one legitimate and the other illegitimate. Just the fact that the legitimate business (say, a carpenter's shop) may demand the same profit rate as the illegitimate one (say, a brewery, which earns a 6 percent profit rate), they argued, does not render the legitimate business illegitimate. Other analogies that one hears at Islamic conferences compare the price of *halal* chicken (chicken slaughtered according to Islamic standards) to the prices of chicken processed otherwise, again arguing that numerical equality of prices does not imply similar legal status of the priced properties.

Needless to say, those analogies are patently fallacious: The object of sale in Islamic finance does not differ from the object of sale in conventional finance the way carpentry differs from brewing, or even the way *halal* or kosher chicken differ from regularly slaughtered chicken. When an Islamic financial provider structures an "alternative" to conventional finance (say, a conventional mortgage) through double-sale *murabaha* financing facility, the ingredients of the financial transaction are the same as those for conventional mortgage (cost of funds, credit risk, collateral property risk, etc.), and the output is the same (a debt on the customer equal to the sum of money he needed to purchase the property plus finance charges exceeding the bank's cost of funds).

In this regard, whether a double-sale procedure is followed, or a simpler single sale takes place via an uncommissioned agent (*bayʿ al-fuduli*), as suggested earlier in the chapter, the financial provider still converts funds now into funds in the future and compares his future cost of funds (the interest rate he has to pay to fund providers, whether they are depositors, *sukuk* holders, etc.) to the rate of return that he collects. It is in this spirit that we have argued that the "*murabaha*" disclosure rules – when applied to finance – dictate that the Islamic financier should report his cost of funds and interest-rate mark-up to its customers.

Opportunity Cost for Conventional Fund Providers

It is not surprising that LIBOR is the benchmark of choice for Islamic bankers and financiers. That interbank rate represents the opportunity cost for bankers who are operating or were trained in the United Kingdom, as most Islamic bankers have been. If the bank is left with idle funds, LIBOR represents the rate of return it can obtain by lending those funds to other banks. Hence, other borrowers/finance customers must pay the bank a rate of return equal to LIBOR plus a mark-up commensurate with the level of credit risk to which the bank is exposed by lending to them, rather than lending to other banks. Thus, LIBOR has been

the appropriate benchmark for London bankers to use, and the historical precedent for the majority of Islamic bankers who started their careers in U.K.-based conventional banking.

In contrast, the Islamic financial customer has no access to funds at LIBOR, and any familiarity he may have with interbank rates would merely result from his education and level of familiarity with various financial publications. Bankers will naturally demand at least LIBOR plus the appropriate spread, and competition will naturally drive implicit interest rates on Islamic financing closer to that benchmark rate (as Shariʿa-arbitrage rents vanish). However, bankers do their customers a disservice by limiting the process of Islamic financing to explicit benchmarking of interest rates to LIBOR or any other market rate, and implicitly to rates that competitors would charge (as dictated by truth-in-lending provisions in various Western countries).

Indeed, the customer should also consider his own opportunity cost to involvement in a financing contract with any particular financial services provider. In this regard, the asset-based nature of Islamic finance, if taken seriously, can provide the customer with another economic comparison to determine whether or not he should engage in any particular financial transaction. Within the context of our mortgage example, an appropriate Islamic model (whether it is a buy-sell-back *murabaha* transaction, or a buy-lease-back *ijara* transaction, etc.) should do more than merely camouflage a conventional mortgage loan through sales, leases, and the like. It should provide the customer with appropriate tools for determining whether or not the purchase of a particular property at a particular price and financing that purchase at a particular interest rate constitute a good investment or financial decision. Islamic financial providers should be equally interested in looking beyond the quality of collateral and borrower in terms of the credit risk associated with an Islamized mortgage loan.

This may be done by disentangling the benefits from owning a property and benchmarking each component to the appropriate market variable. Thus, capital gains on the property (at the appropriate level of leverage) should be compared to capital gains that could be made on other investments. Rental rates (value of usufruct) of similar properties should be compared to interest paid on the borrowed sum, after factoring in tax advantages of deducting mortgage interest for income tax purposes, where applicable.

Financially wise customers make such comparisons in conventional as well as Islamic financial transactions. One difference between conventional bankers and Islamic bankers should be increased involvement of the banker in the real transaction being undertaken by the customer, even if – in the end – it is only a financial transaction for the bank, which should be benchmarked to the bank's opportunity cost as measured by LIBOR or other interest rates. An Islamic banker would thus

use additional benchmarks (which every customer should use, but often many would not without the help of a financial advisor) to decide whether or not the financial transaction is advantageous to the customer.

The explicit mechanics of a real transaction (the bank having actually to get involved in buying and selling the property, or leasing it, etc., even if at arm's length through special purpose vehicles, or ex post through uncommissioned agency) force Islamic financial providers to take their customers through this cold unemotional financial calculus. Although efficiency would dictate performing those calculations only within the context of counterfactual financial scenarios (thus avoiding unnecessary transaction costs), the sad reality is that Islamic finance in the short-to-medium term will likely remain captive to premodern procedures, where the actual trading, leasing, and the like is required. The use of additional benchmarks, as discussed in this section, would – at least – allow the spirit of Islamic jurisprudence to be served through adherence to those premodern forms as adopted by Islamic financial providers.

Viability of Islamic Benchmark Alternatives

In recent years a number of jurists and Islamic bankers have called for the development of "Islamic benchmarks," while maintaining that benchmarking rates of return in sale- and lease-based Islamic financing to conventional interest rates is legitimate. The reason suggested by those Islamic finance practitioners is that *murabaha* financing with a profit rate benchmarked to market interest rates looks suspiciously similar to a conventional loan. Those proponents of an Islamic benchmark have also expressed the ambitious goal of eventually developing an entire Islamic yield curve, to be used for benchmarking rates of return in Islamic finance facilities of varying maturities. The recent growth in Islamic bonds (*sukuk*) issues was thus hailed as a positive step in the direction of developing that Islamic yield curve, which presumably can easily emerge once that market develops sufficient depth and liquidity.

In fact, however, this search for Islamic benchmarks and yield curves is misguided, for a number of good reasons. First, Islamic financial practitioners' discomfort with benchmarking to conventional interest rates seems to be based on continuing misconceptions such as that Islamic finance is "interest free" or that Islamic jurisprudence does not recognize the time value of money. As we have seen in Chapter 3, those views – which were foundational for the Islamic economics literature that predated Islamic finance – are fundamentally flawed. Indeed, Islamic jurisprudence does recognize the time value of money, which is precisely why a seller may charge a higher price for a credit sale than he would for a cash sale of the same property.

In this regard, one must note that the juristic argument that "time value is recognized in sales but not in debts or loans" is at best insufficient, and at worst disingenuous. If the claim is based on the need for pricing time value for each transaction separately (based on credit rating, quality of collateral, etc.), then there is a valid argument to be made (in conventional as well as Islamic finance). However, the mere claim is insufficient in this case, since the manner in which appropriate interest rates are determined in sales, leases, and the like remains unspecified. On the other hand, if interest rates in Islamic finance (including the pure time-value components thereof) are benchmarked to conventional interest rates, it would appear that the general claim is vacuous and disingenuous, since it serves only to create arbitrage opportunities, from which jurists stand to be primary beneficiaries.

Divergence of Rhetoric from Reality

With regard to "interest rate" (or the equivalent Arabic "*si ʿr al-faʾida*"), we have to recognize that although the term may have initially applied only to interest on loans, modern usage applies it to any compensation for time value. In fact, an Islamic financial provider in the United States is required by "truth-in-lending" regulation Z to report the implicit "interest rate" in lease or double-sale financing. The sooner Islamic finance providers can disabuse their customers of those lingering misconceptions about time value and permissibility of charging interest in certain types of transactions, the higher will be the industry's credibility with regulators and customers alike.

A closely related reason why Islamic finance practitioners feel uncomfortable about using conventional interest rates as benchmarks is the Shariʿa arbitrage nature of Islamic finance, as illustrated in Chapter 1. In fact, Islamic finance has been, and continues to be, fully dependent on conventional finance for its existence and the nature of its products, as well as its rates of return. If Islamic financial providers continue to market their industry based on the rhetoric that conventional finance is generally forbidden and exploitative, then benchmarking to conventional interest rates will continue to be an embarrassment, prompting skeptical customers to ask: "What is the difference between Islamic and conventional finance?" In contrast, if Islamic financial providers were to focus on the substance of Islamic jurisprudence instead of its forms, they can explain to customers that some – but not all – forms of debt are harmful, and some – but not all – forms of interest are harmful.

Indeed, industry rhetoric needs to change so that a double-sale (*tawarruq* style) at 100 percent interest is recognized as usurious predatory lending rather than legitimate trading. Islamic financial providers need to explain to customers that the purpose of following nominate forms of classical Islamic jurisprudence is to

impose discipline and ensure that we select from the wide range of conventional financial products only the ones that are advantageous to particular individuals based on their specific circumstances. Then the fact that credit selected through that methodology costs the same as credit selected through different (conventional) screens would no longer be a source of concern or embarrassment for the industry.

Finally, one of the potential advantages of asset-based Islamic financing is that it can be provided at rates that deviate substantially from a time-value benchmark plus credit-risk premium. For instance, a country or corporation with a poor credit rating may be able to obtain financing at implicit interest rates substantially below those dictated by its credit rating if it genuinely collateralizes its debt with real assets, for example, through the currently popular sale-lease-back *sukuk* structures. At least theoretically, lease-backed *sukuk* with different underlying assets should have different implicit interest rates, depending on the quality of collateral, its depreciation rates, market rent, and the like. Moreover, as we shall argue in Chapter 10, lease *sukuk* built on bona fide sale of government assets can help in restarting stalled privatization programs in various Islamic countries.

Disadvantages of "Islamic Benchmarks"

It is true that if implicit rates in Islamic finance were indeed to vary according to the qualities of underlying assets, then the "Islamic-debt" market would never develop sufficient depth and liquidity to generate a uniform benchmark that can be used to determine implicit rates for other Islamic financial transactions. On the other hand, if – as has indeed been the case – the issued *sukuk* are backed by the full faith and credit of issuing governments and corporations, and thus resulting implicit interest rates are determined solely by the issuing entity's credit rating and a conventional benchmark (typically LIBOR), then referring later to those implicit interest rates is at best cosmetic, and at worst misleading. It would be cosmetic if we first strip the implicit interest rate of its credit-risk premium, essentially to reproduce LIBOR under another name, prior to adding the appropriate credit-risk premium for another Islamic debt instrument. To the extent that reproduction of the underlying measure of time value may be erroneous, benchmarking to such rates may lead to erroneous pricing of other Islamic financial instruments.

Consequently, the development of an "Islamic benchmark" is (1) unnecessary, since there is no reason to be embarrassed about using conventional benchmarks, (2) impractical, since sufficient depth and liquidity of homogeneous Islamic financial assets is unlikely, and (3) superfluous or dangerous, since the only logical or practical approach to developing such an Islamic benchmark would be to try to recover the underlying conventional benchmark, which may be done erroneously.

It would be more advantageous for industry practitioners to explain to customers that the products they offer must meet all conventional product requirements, in addition to Islamic considerations that essentially provide further protection to those customers. Then, if Islamic financial products are more expensive than their conventional counterparts (which they are, almost always), bankers can explain that this additional cost is compensation for the service being provided through adherence to those prudential requirements of Islamic jurisprudence, in analogy to higher fees charged by full-service brokers who provide investment advice to their customers.

Other Conventional Benchmarks

While we are discussing the subject of interest-rate benchmarks, it is worthwhile noting that the use of LIBOR as a benchmark, while reasonable for many bank-type financial instruments, seems less appropriate for sovereign bonds. Benchmarking to LIBOR reflects the industry's dependence on London-based banks, and domination – even after the industry's centers of gravity moved from London, Geneva, and Luxembourg to Kuala Lumpur, Bahrain, and Dubai – by bankers who are based, or used to be based, in London. In this regard, no reasonable person would disagree that LIBOR is perhaps the best measure of an English bank's opportunity cost of funds, and hence benchmarking to that rate makes perfect sense for Islamic financial instruments that are similar to bank loans.

In contrast, many of the countries that continue to issue "Islamic debt" (mainly Bahrain, Qatar, Malaysia, Pakistan, and others likely to join the sovereign *sukuk* movement in part to retire their conventional debt, as in the case of Bahrain), would like to be viewed as "emerging markets." Indeed, Malaysia and Turkey – which is currently contemplating issuing *sukuk* – have been on the radar screens of emerging market debt traders for a number of years. In that market the benchmark most commonly used is the yield on U.S. Treasury bonds – with emerging market bond yield spreads (e.g., on indices such as JP Morgan's EMBI+) over U.S. Treasury yields now serving as the most common measures of global economic risk. Migrating sovereign *sukuk* benchmarking from LIBOR to Treasury yields would be a sign of maturity in the sector, signaling graduation of those *sukuk* from a market-niche curiosity generated by bankers and lawyers.

5

Derivative-Like Sales: *Salam*, *Istisna'*, and *'Urbun*

As we indicated in the previous chapter, existence of some property as the object of sale is generally a condition for contract validity. However, there are two notable exceptions that allow sales of nonexistent objects. The first is an ancient contract that predates Islam, called *salam* in the Hijaz area of western Arabia, wherein the Prophet lived, and *salaf* in Iraq, both terms meaning "prepayment." This contract was primarily used for financing agricultural production and was legalized by the Prophetic traditions cited below. A similar contract, called *istisna'*, meaning "commission to manufacture," was legalized in later centuries, likewise to assist financing of nonagricultural (e.g., manufacturing) production.

In recent years Islamic financial practitioners have adapted the classical forms of *salam* and *istisna'* and combined them with other transactions to generate approximations of conventional financial transactions, including interest-bearing loans, interest-bearing bills and bonds, build-operate-transfer and build-operate-own infrastructure and other project financing, etc. We start this chapter by reviewing the classical rules on *salam* and *istisna'* and the innovative uses of those contracts that have been approved in recent years (not entirely without controversy) by various juristic bodies.

5.1 Prepaid Forward Sale (*Salam*)

All six major compilers of Prophetic tradition narrated on the authority of Ibn 'Abbas that when the Prophet migrated to Madina (formerly known as the city of Yathrib), he found its inhabitants engaging in one-to-three-year forward sales of fruits, with prices being prepaid at contract inception (which gives *salam* = "prepayment sale" its name). He then narrated that the Prophet said, "Whosoever engages in a *salam* contract, let him specify a volume or weight for the object of sale, and a definitive term of deferment." Thus, jurists of all schools considered the forward sale of fungible commodities (measured by weight, volume, length/size,

or number of homogeneous units), with full prepayment of the price, to be a valid contract. As in all forward and futures contracts, jurists stipulated that the object of sale should be specified in genus, type, and quality, as well as quantity, however measured. In this regard, they agreed that the *salam* contract constituted an exception to the general prohibition of sale of nonexistent properties, as well as the prohibition of sale of properties that are not in the seller's possession at the time of sale.[1]

Classical jurists recognized the economic need for this contract primarily to allow farmers access to capital (price of *salam*), with which they can buy seeds, fertilizer, and other materials to grow their crops. However, they also recognized that the contract includes an element of speculation, since the *salam* seller benefits if the spot price at delivery time is lower, and the buyer benefits if it is higher. They also recognized that *salam* includes price discounting for time, that is, an element of interest, since the prepaid salam price will be generally lower than the expected spot price at time of delivery. This recognition prompted classical jurists to stipulate numerous conditions on *salam* contracts, to minimize elements of *gharar* and eliminate elements of *riba* therein.

In their efforts to avoid the abuse of *salam* contracts to synthesize *riba*-like transactions, classical jurists imposed strict conditions on delivery and settlement options for the *salam*-short (seller).[2] On the other hand, it is clear – as we shall argue later – that conditions on immediate or near-immediate delivery of the price, which distinguish *salam* contracts from contemporary forwards, are rendered immaterial if the *salam*-long can simultaneously obtain a credit line (e.g., through *tawarruq* or *murabaha*) for the present value of the desired forward price. Hence, we shall focus on the delivery restrictions, which are generally observed today and which have given rise to legal stratagems such as parallel *salam*.

Revocation and Settlement of Long Position

If the *salam*-long wishes to take part in a *salam* contract for purely financial purposes, without intent of taking delivery of the *salam* object, he can theoretically attempt to achieve his goal in one of two simple ways: (1) settle the position with the *salam*-short in cash or some other commodity (based on spot prices on the delivery date, or some other formula), or (2) sell the *salam*-long position to a third party, which is tantamount to selling the *salam* object prior to receiving it. In their efforts to restrict *salam* contracts to genuinely needed economic activities, such as the original financing of agricultural production, premodern jurists generally forbade both avenues. However, as we shall see in the next two sections, contemporary jurists have utilized some minority opinions, as well as the permissibility of debt transfers for *salam* objects, to synthesize purely monetary financial transactions from the *salam* contract.

A third way to settle a *salam* financially would be to revoke the contract shortly before delivery, whereby the *salam*-long may accept a different price from the one he paid (reflecting the difference between the prepaid price and spot price at time of revocation, known by the Arabic name *iqala*). However, although revocation of *salam* sales is permissible, jurists did not allow settlement in cash either directly or through revocation. In that context, classical jurists, starting with Abu Hanifa and his associates Abu Yusuf and Al-Shaybani, relied on a Prophetic tradition: "Whosoever engages in a *salam* contract, let him not take any replacement for the contract's specified price or object."[3] This Prophetic tradition disallows the long from accepting a replacement for the object of *salam* (e.g., financial equivalent at spot price) or from revoking the contract and receiving a replacement for the price refund reflecting that financial equivalent at spot price. In other words, this canonical text appears directly to address the remaining ways in which financial engineers might try to convert the *salam* contract into a purely financial tool.

However, a minority opinion in the Maliki school allowed sale of the object of *salam* prior to its receipt, provided that the object was not foodstuffs. In this regard, if the object is sold to the original *salam*-short, they allowed the sale subject to the condition that the price does not exceed the initial prepaid price. Indeed, in that case, one could characterize the second sale as a partial revocation of the original sale (which is generally not accepted in the Maliki school, but accepted in other schools),[4] together with an exoneration of the *salam*-short's remaining liability.[5] Moreover, the Malikis permitted sale of the *salam* object prior to its receipt to a third party at any price, provided that the price is paid in a different genus, and the *salam* object was not a foodstuff. Those opinions also meant that Malikis allowed settling the long position with the *salam*-short for an equal or smaller amount.[6]

Parallel Salam

Since the Maliki school of jurisprudence does not have a significant following in the areas where Islamic finance has witnessed its greatest growth, selling *salam* objects to third parties was not the first method contemplated to utilize *salam* as a pure financial tool. However, bankers and jurists found another juristic opening for such utilization based on characterization of the *salam*-short position as debt for the fungible *salam* object. Once it is characterized as debt for fungibles, the short position may thus be forwarded to a third party, possibly within the context of mutual debt clearance (*maqassa*). The most practical procedure devised along those lines by Islamic bankers came to be known as "parallel *salam*."

This structure has allowed banks to use *salam* contracts to synthesize debts with fixed or variable interest rates as follows: Party A wishes to borrow $1,000,000 for

three months at LIBOR + 200 basis points, and party B is willing to lend him at that rate. Party A may take a short position to sell platinum, deliverable in six months to party B at a specified location, collecting the prepaid *salam* price of $1,000,000. Three months later, the two parties may engage in a second and opposite *salam* contract, usually through a third-party intermediary to ensure separation from the initial contract (as we have described in the case of *tawarruq*), for delivery of the same amount of platinum at the same location, with the prepaid price being $\$1{,}000{,}000 \times (1+\text{LIBOR}+0.02)$. Then both parties have liabilities toward one another for delivery of the same amount of platinum at the same location, and the two liabilities may be canceled against one another according to the rules of debt clearance (*maqassa*).

There are two main contemporary *fatawa* that pertain to this practice of parallel *salam*.[7] Notice the wording of requests for *fatwa* in the two cases. The questioner in the first *fatwa* asked directly about the permissibility of using this particular financial transaction (parallel *salam*) essentially as an institutionalized method for conventional banking practice. In this case, jurists ruled that, in fact, while the practice was permissible on an individual basis in their opinion, it is not permissible to turn it into a business mode. However, that prohibition was promptly diluted by the following appeal to considerations of competitiveness tantamount to necessity. Cleverly, the posers of the second *fatwa* question omitted asking about making the practice a business mode. Also, the jurists in that second *fatwa* conveniently did not go out of their way to rule on the issue of systematic use, about which they were not asked.[8]

The first *fatwa* that we quote on parallel *salam* was the second *fatwa* of the second Dalla Al-Baraka Symposium:

Question:

Is it permissible to sell the object of *salam* prior to its receipt?

If that is not allowed, is it permissible for the *salam*-long to take a *salam*-short position in the same genus, based on his long position, but without linking the two contracts for what he is eligible to receive and what he is responsible to deliver?

Is it permissible for the *salam*-long to make this a systematic trade?

Answer:

1. It is not permissible to sell the object of *salam* prior to its receipt.
2. However, it is permissible for the *salam*-long to take a *salam*-short position of the same genus, without tying the first *salam*-long position by virtue of the first contract to the *salam*-short liability of the second contract.
3. It is not permissible to use this type of transaction [which was allowed in the second paragraph of the answer] as a systematic mode of business. This is due to the fact

> that *salam* was permitted as an exception to general legal rules, based on the needs of producers that can be met through *salam* in individual cases, without turning the latter into a systematic trade. On the other hand, if economic conditions in some Islamic countries, and major benefit considerations, dictate using this methodology as a systematic business mode in special cases, to minimize the effect of existing injustice, then it may be permitted based on that major benefit, as determined by *fatwa* and Shariʿa supervisory boards.

The general prohibition of using this structure to synthesize interest-based debt instruments in paragraph (3) was diluted substantially in the last sentence of that paragraph. A second *fatwa* by the Shariʿa Board of Al-Rajhi Investment Corporation (*fatwa* #41) indirectly appealed to that window of opportunity by invoking the need for Islamic banks to be competitive with their conventional counterparts in extending credit and being compensated accordingly. In the text of that Rajhi *fatwa*, given below, the questioners tried to be less specific about their intent, but the Shariʿa board in fact addressed the issue of synthesizing conventional bank loans in this manner, by appealing to the aforementioned need:

Question:
Please inform us of the religious legal opinion regarding the Corporation's purchase of commodities (such as crude oil, various metals, etc.) through *salam* contracts, with the price being paid immediately, and delivery scheduled for a future date, knowing that the Corporation may sell that commodity through a *salam* contract, by receiving the price at the time of the [second] sale, with delivery scheduled for a future date.

Answer:
The main characteristic of the *salam* contract is that its object is a fungible liability measured by volume, weight, size, or numbers of homogeneous commodities, including agricultural products such as grains, oils, and milk, industrial products such as iron, cement, automobiles, and airplanes, and raw or semiprocessed materials such as crude and refined petroleum.

It is permissible for the *salam*-long (buyer) after the inception of the contract and prior to the delivery date to act as a *salam*-short (seller) for a similar commodity, with similar conditions to the existing contract, or with different conditions. As described, the *salam* contract is a highly efficient tool to meet the needs of an Islamic bank, recognizing that the main task of a bank is to extend credit, and its revenues rely primarily on the compensation it receives for time value.
. . .

Since dealings in credit markets of advanced countries require facing severe and critical competition, and since those countries provide a great deal of flexibility for competition, but put impediments for other tools of investment, this tool [*salam* contract] is considered a vital and important one to allow safe access to markets with flexible and wide competition, while providing protection against customary risks in those markets, such as political and inflation risks.

The Rajhi Shariʿa board then proceeded to list five examples of using *salam* contracts to finance trading in a variety of commodities, in most cases emphasizing the real transaction aspect of *salam*. The Shariʿa board also listed the generally accepted Hanbali position to be permission of pawning or use of mortgaged collateral (*rahn*) and guaranty (*kafala*) in lieu of liability for the *salam* objects.

Those provisions allow Islamic financiers to use *salam* contracts to synthesize interest-based debt. In fact, applications of *salam*, for example, by the government of Bahrain in issuing short-term bonds known as *sukuk al-salam*, cut more corners in settling the first *salam* for cash, as we shall see in Chapter 6. Those short-term debt instruments (similar to treasury bills) pay a declared interest rates, and they are backed by the full faith and credit of the issuing government. While those *salam*-based *sukuk* represented debt, and therefore were initially nontradable and meant to be held to maturity, repurchase facilities were recently announced to enhance liquidity management of Islamic banks that are the primary buyers of those instruments. Details on how this repurchase facility worked are not readily available, but it is clear how one could be constructed through the parallel *salam* vehicle described earlier.

Conventional and Synthesized Forwards

Classical jurists of all schools of jurisprudence forbade conventional forward contracts, wherein both price payment and delivery of sale object are stipulated as future liabilities.[9] The primary reason they gave for the prohibition is *gharar*, citing in particular ignorance about the state of the object of sale at the specified future date. Thus, they argued, the price to be paid in the future is known, but the future quality of the specified object of sale is unknown, which is a source of ignorance and uncertainty conducive to disputation. Recently Malaysian jurists, led by Dr. M. Hashim Kamali, have argued that legal and institutional advances, especially in organized futures exchanges, eliminate all excessive *gharar* from futures contracts by specifying in standardized contracts the characteristics of objects of sale, as well as compensation formulas for various delivery options given to the futures-short.[10] Consequently, they have allowed trading in Islamic futures, where the only Islamic constraints pertain to, for example, the objects of sale or margin trading rules.

In contrast, most jurists outside Malaysia remain opposed to forward and futures trading.[11] Some refer to the insistence of classical jurists of all schools that the price of *salam* must be paid in full at contract inception. Classical jurists argued that prepayment of the price (which gives *salam* its name) is the essence of permissibility of the contract, to give farmers access to capital with which to buy necessary inputs and sustain themselves until harvest. In addition, when the

price of *salam* is also fungible (e.g., monetary), those classical jurists argued that deferment of the price, while the object of *salam* is obviously deferred, would classify the transaction in an explicitly forbidden category of exchanging one deferred liability for another (called *bayʿ al-kaliʾi bi-l-kaliʾ*).[12] However, Malaysian and some other jurists questioned the authenticity of traditions forbidding this type of trade, many of them citing Al-Shafiʿi's report that scholars of tradition considered its chain of narration weak. Nevertheless, most scholars continue to reject forward and futures trading, and many of them continue to quote that tradition as proof – especially those influenced by the Hanbali preference of traditions with weak chains of narration over any reasoning by analogy.

Thus, most jurists and Islamic finance practitioners outside of Malaysia ruled that deferment of the price alone (in credit or installment sale) is permissible, as is deferment of the object of sale alone (in *salam* sale), but deferment of both (conventional forward sale) is not permissible. This collection of rulings creates another Shariʿa arbitrage opportunity for synthesizing forbidden conventional forward contracts from the *salam* and credit sale contracts that jurists permitted.

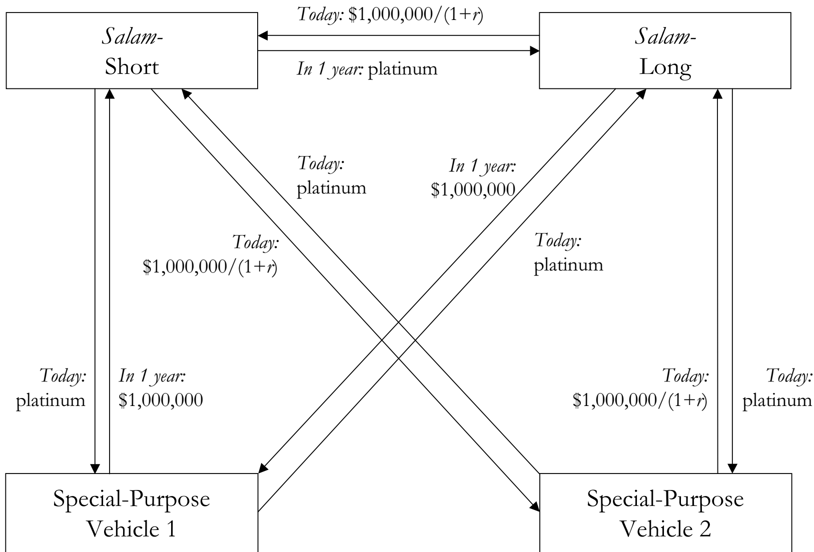

Fig. 5.1. Forward Synthesized from *Salam* and Credit Sales

Figure 5.1 illustrates one possible structure for synthesizing a forward contract from *salam* and a credit facility for its price (characterized variously as *murabaha*, *tawarruq*, etc., depending on banker and jurist preferences). The combination allows the *salam*-long to prepay the present value of the desired forward price.

For instance, if the desired contract was to pay \$1,000,000 in one year for some amount of platinum, one could always convert it into a *salam* contract by paying \$1,000,000/(1+r) at contract inception, where r is the appropriate interest rate. In this regard, the *salam*-short may extend a credit facility to the *salam*-long, perhaps using *tawarruq* with the same platinum serving as the underlying commodity, whereby the *salam*-long will obtain \$1,000,000/(1+r) today (with which to pay the *salam* price), for which he would have to pay the deferred price of \$1,000,000 in one year (at the time he originally desired to make that forward price payment).

The detailed procedure can be implemented as follows, utilizing two special-purpose vehicles, to ensure that no two parties ever engage in more than one trade of platinum with each other – thus minimizing concerns based on the prohibition of ʿ*ina* sales:

1. *Salam*-short sells platinum to SPV1 on credit, for \$1,000,000 payable in one year. This is a standard credit sale transaction.
2. SPV1 sells platinum to *Salam*-long on credit, for \$1,000,000 payable in one year. This is also a standard credit sale transaction.
3. *Salam*-long sells platinum to SPV2, for a cash price of \$1,000,000/(1+r). This is a standard spot sale.
4. SPV2 sells platinum to *Salam*-short for a price of \$1,000,000/(1+r). This is also a standard spot sale.
   The net result of steps 1–4 is a *tawarruq* facility whereby *Salam*-long receives \$1,000,000/(1+r) today (through SPV1) and owes *Salam*-short \$1,000,000 in one year (through SPV2). Finally,
5. *Salam*-long uses the \$1,000,000/(1+r) as a prepaid *salam* price, which he pays to *Salam*-short.

   As a result of this *salam* contract, *Salam*-short owes *Salam*-long platinum deliverable in one year. In the meantime, *Salam*-long owes *Salam*-short \$1,000,000 to be paid in one year. This is the forward contract we wished to synthesize.

This structure ensures that each entity does one and only one transaction with each other entity, hence avoiding any problems with same-item sale-repurchase (ʿ*ina*). This separation also allows the long and short to gain approval from Shariʿa boards for all components separately, thus avoiding potential prejudice against synthesizing a forward position. Depending on the Shariʿa board or boards of the short and long, transaction costs can be further reduced, according to the *tawarruq* conditions imposed by those boards, which determine transactions costs

of that component of our structure. In Chapter 10 we shall discuss the use of similar synthetic forwards to synthesize options, short positions, and the like.

It might appear that this proposed structure merely replicates classical forms of Islamic financial transactions, while adding no contribution to substance. Of course, based on the track record of Islamic finance, that would be the most likely utilization for this and similar contrived structures. In fact, however, the same "marking to market" logic utilized in Chapter 4 can ensure that the suggested structure – at least as a counterfactual that is not in fact implemented – adds substance. In this regard, arbitrage pricing of forwards, as taught in all finance textbooks, will force forward participants who contemplate using the *salam* contract to engage in a beneficial calculation. The arbitrage pricing logic for forwards proceeds as follows:

- Consider two portfolios: (1) a long forward contract plus the present value of the specified forward price (discounted at the riskless interest rate r), and (2) a long position for goods to be delivered at the same future date specified in the forward contract.
- Notice that the second portfolio is precisely the liability on *Salam*-short toward *Salam*-long after full payment of the *salam* price at contract inception.
- Obviously, one can invest the present value of the forward price at the riskless rate (e.g., in treasury bills), thus converting the first portfolio into the second. In other words, if there are no other risks, the two portfolios must have equal values at delivery time.
- Since no risk is being taken between contract inception and delivery time, and since the two portfolios are equal in value at delivery time, they must also be equal in value at contract inception time. In other words, the *salam* price will be correct if and only if it is equal to the present value of the forward price: A higher *salam* price would unjustly favor the seller and vice versa.

Consequently, as we argued in the case of property purchase financing, the calculus imposed by our structure forces the parties through a "marking to market" exercise, which in turn ensures that trading will not take place at unfair prices. Needless to say, performing the calculations to ensure proper pricing does not require actually engaging in multiple inefficient trades. This structure may be used merely as a legal fiction to ensure proper pricing, without actually realizing the efficiency losses associated with multiple trades and corresponding transaction costs.

5.2 Commission to Manufacture (*Istisnaʿ*)

Classical jurists approved another contract to purchase some item that is generally not owned by the seller at contract time, and that may never have existed prior to the contract. Under this contract, generally known as *istisnaʿ* or commission to manufacture, the buyer (known as *mustasniʿ* or commissioner to manufacture) pays the price either in one or multiple installments, and a liability is established on the worker/seller (known as *saniʿ* or manufacturer) to deliver the object of sale as described in the contract at some future date.

Thus, *istisnaʿ* shared with *salam* the function of financing the production of nonexistent items, which are established as liabilities on the sellers. However, *istisnaʿ* differed from *salam* in a few main respects: First, jurists did not require price in *istisnaʿ* to be fully paid at contract inception, to facilitate the financing of multistage manufacturing or construction projects, wherein the buyer may pay for each phase separately. Second, the term of deferment in *salam* is prespecified, and the seller must therefore acquire the object of sale at the specified delivery time on the spot market if he fails to produce it – prompting jurists to list a *salam* condition of general availability of the object of sale at delivery time. In contrast, the object of *istisnaʿ* may never come into existence except by virtue of the *istisnaʿ* contract. Hence, the term of deferment in *istisnaʿ* need not be fixed at the inception of the contract.

Third, although the object of a *salam* sale is fungible (e.g., metals or grains), the object of an *istisnaʿ* sale is typically nonfungible (e.g., a freeway or building). Fourth, *salam* contracts are binding on both parties and thus may be voided only by mutual consent. In contrast, *istisnaʿ* contracts were deemed nonbinding on either party by early classical jurists. However, later jurists made the contract binding on both parties, and that opinion was codified in the Hanafi *Majalla* and adopted in the AAOIFI standard.[13] That standard also chose a minority opinion that requires the term of deferment in *istisnaʿ* to be specified, provided that a mutually agreeable term is selected, allowing sufficient time for the necessary work to be done.

Some classical jurists debated whether the object of an *istisnaʿ* contract is the object to be manufactured or the manufacturer's labor/effort. If the contract is merely the sale of an object to be delivered in the future, it would be no different from *salam*. Conversely, if the contract was merely over the manufacturer's labor, it would be an employment or hire contract, as discussed under the rules of *ijara* contracts in Chapter 6. Either characterization by itself would deem the contract impermissible based on analogy, since sales of nonexistent properties are generally forbidden (*salam* being an exception), and hiring contracts require that the employer must provide raw materials.[14]

Jurists of the various schools finally reached a compromise characterization of the contract, stipulating that the object of *istisnaʿ* is the sold object, but that the contract requires the one commissioned to manufacture that object of sale to exert effort in its production. Moreover, contemporary jurists stipulated that if the contract did not require the commissioned party in *istisnaʿ* to do the work himself, he may subcontract the work to another through a second *istisnaʿ* contract. This practice of the commissioned agent engaging in a second *istisnaʿ* contract came to be known as parallel *istisnaʿ*. In parallel *istisnaʿ* there is no direct liability on the final worker toward the initial commissioner/buyer, thus keeping the two contracts separate.[15]

The *istisnaʿ* contract is most commonly used in conjunction with a lease (*ijara*) contract, thus giving rise to a BOT (build, operate, transfer) structure for financing infrastructure development and similar large projects. The Islamic Development Bank has been particularly active in utilizing this contract for financing infrastructure projects in various member countries. Because of the specific nature of this contract, it has not easily lent itself to pure financial applications, thus remaining a tool for real project financing. On the other hand, some advances in securitization have expanded its uses in synthesizing Islamic *sukuk*, as discussed in Chapter 6. In general, project finance structures based on *istisnaʿ* differ very little from their conventional counterparts.

5.3 Down-Payment Sale (*ʿUrbun*)

In its classical manifestation, *ʿurbun* was a down payment from a potential buyer to a potential seller toward the purchase of a particular property.[16] If the buyer decided to complete the sale, the *ʿurbun* counted toward the total price. Otherwise, if the buyer did not execute the sale, he forfeited the down payment, which was thus considered a gift to the seller. Naturally, contemporary jurists and Islamic financial practitioners contemplated the similarity of this arrangement to a call option, which is likewise binding on the seller but not on the buyer. Indeed, some classical Hanbali jurists had even contemplated that the option period should be fixed (making the transaction somewhat similar to an American call option), otherwise the seller may have to wait indefinitely for the potential buyer to decide whether or not to exercise his right.[17]

Classical jurists differed over the legal status of this contract, most of them forbidding it based on a Prophetic tradition (which referred to the transaction under the name *bayʿ al-ʿurban*). Although that tradition was deemed nonauthoritative, because of missing links in its chain of narration, most classical jurists still deemed the contract forbidden, because of *gharar*, since the seller does not know whether or not the buyer will conclude the sale. Moreover, they argued, the potential seller

gives the potential buyer in this contract an option (in contemporary parlance: a call option), but if the buyer proceeds to exercise that option, the down payment counts toward the price, and the seller would thus not have been compensated for the option.[18]

This argument is particularly interesting, since classical jurists (and most contemporary ones) forbid the sale of naked options (because of *gharar*, according to the same logic as before), and since most of them do not consider mere legal rights (e.g., to exercise an option) to be valid objects of sale. However, those same classical jurists clearly felt that an embedded option (as in the case of *ʿurbun*) should be properly compensated. It is in this regard that they ruled that the seller is compensated only if the buyer did not exercise his right, and even that may not be sufficient compensation for the time he had to wait, during which he was not able to sell the property and benefit from its price.

In contrast to the majority of jurists of his time, Ahmad ibn Hanbal deemed the practice of down-payment sales permissible. He relied on a Prophetic tradition: "The Messenger of God was asked about down-payment sale (*al-ʿurban*), and permitted it."[19] Interestingly, scholars of tradition consider this also a tradition with a weak chain of narration. However, this narration was further supported by another weak narration that ʿUmar ibn Al-Khattab allowed down payment toward the purchase of a jailhouse. Moreover, classical Hanbali and contemporary jurists of most schools argued that down-payment sales had become very common and provided some compensation to the seller for waiting, in case the buyer decides not to execute the sale. Moreover, contemporary jurists argued, there are weak Prophetic traditions that provide support either for permission or for prohibition. Hence, the Fiqh Academy of the Organization of Islamic Conference (the most prestigious international juristic body) ruled at its eighth session in Brunei in 1993 that down-payment sales are permissible.

ʿUrbun as Call Option

Most analysts of the differences between the down-payment sale (*ʿurbun*) and contemporary call options concluded that the latter cannot be synthesized from the former.[20] On the other hand, a number of institutions have been in fact using call options under the name *ʿurbun*, ignoring some of the finer legal differences between the two contracts. For instance, if a seller wishes to write (sell) a call option to a potential buyer, giving him the right to buy within the specified time window at a strike price of \$100, and sell that call option to the potential buyer for $\$c$, one may call $\$c$ a "down payment" and inflate the agreed-upon price in the down-payment sale to $\$100+c$. Thus, if the option holder decides not to exercise the option, he would have paid the premium $\$c$, and if he does exercise