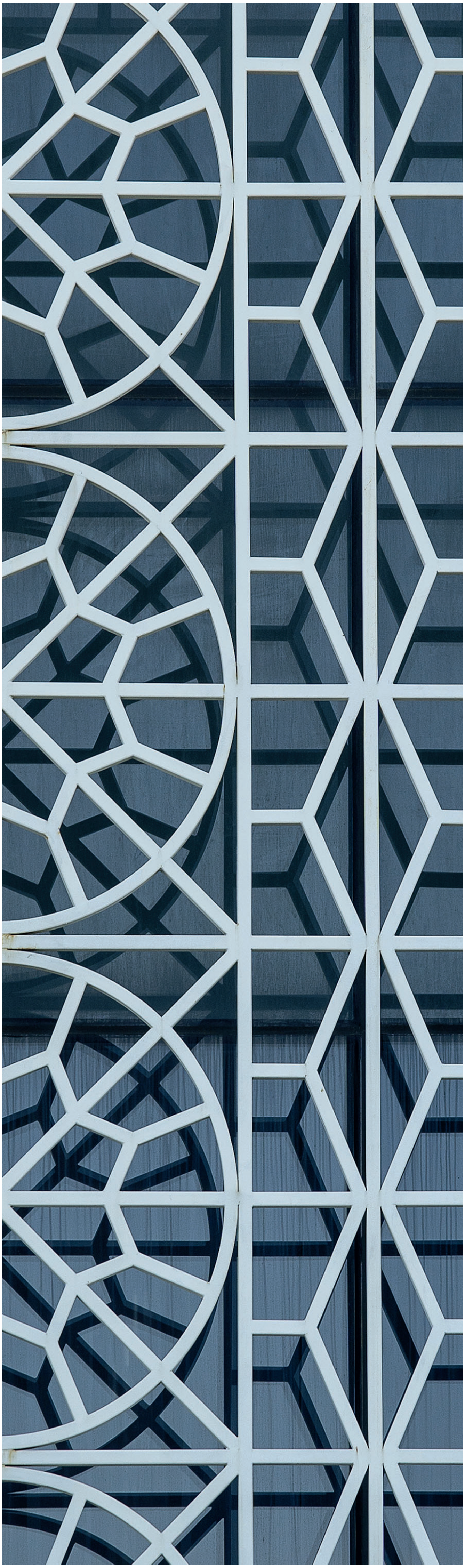

CHARTERED INSTITUTE FOR SECURITIES & INVESTMENT

ESA Business School

Level 3 Certificate in Islamic Finance

Islamic Finance Qualification (IFQ)

Edition 10, February 2022

This learning manual relates to syllabus version 10.0 and will cover examinations from 1 June 2022 to 31 December 2026

APPROVED WORKBOOK

Welcome to the Chartered Institute for Securities & Investment's Islamic Finance Qualification study material.

This workbook has been written to prepare you for the Chartered Institute for Securities & Investment's Islamic Finance Qualification examination.

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Candidates should be aware that the laws mentioned in this workbook may not always apply to Scotland.

A learning map, which contains the full syllabus, appears at the end of this manual. The syllabus can also be viewed on cisi.org and is also available by contacting the Customer Support Centre on +44 20 7645 0777. Please note that the examination is based upon the syllabus.

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Learning manual version: 10.6 (February 2026)

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Foreword by Shariah Scholar Mufti Muhammad Nurullah Shikder

Islamic finance continues to grow at a high rate, with an increasing number of people interested in this area of innovative finance. Some people see this as an excellent opportunity to diversify their business into this area of finance, whereas others are looking to do business in accordance with Islamic law because of their religious convictions. Whatever the motive may be, the fundamental rules and principles relating to Islamic finance apply to all. As such, all market participants, particularly the new entrants, need to have solid and accurate knowledge of Islamic financial products and services, and of the Shariah principles that govern them. In this regard, this latest edition of the Islamic Finance Qualification manual provides an excellent platform at an introductory level, which should allow the reader to grasp the fundamentals of Islamic banking and finance.

This manual will provide a stepping stone for those who are interested in Islamic finance to familiarise themselves with the basic concepts and structures that are generally used by Islamic banks and financial institutions, and to enhance their understanding.

(Mufti) Muhammad Nurullah Shikder
Managing Director
Alhuda Shariah Advisory Services Limited

Foreword

The IFQ represents a positive step towards the global recognition of Islamic finance and the role it has to play in global finance, and the Chartered Institute for Securities & Investment (CISI) would like to thank all of the contributors to the workbook and to the IFQ examination.

The IFQ continues to underpin the development of the Islamic finance profession and the content of this edition is fully Shariah-compliant, having been reviewed by Mufti Muhammad Nurullah Shikder. The IFQ official workbook ensures that candidates gain a comprehensive understanding of examination content, as well as being a valuable reference for practitioners.

Chartered Institute for Securities & Investment

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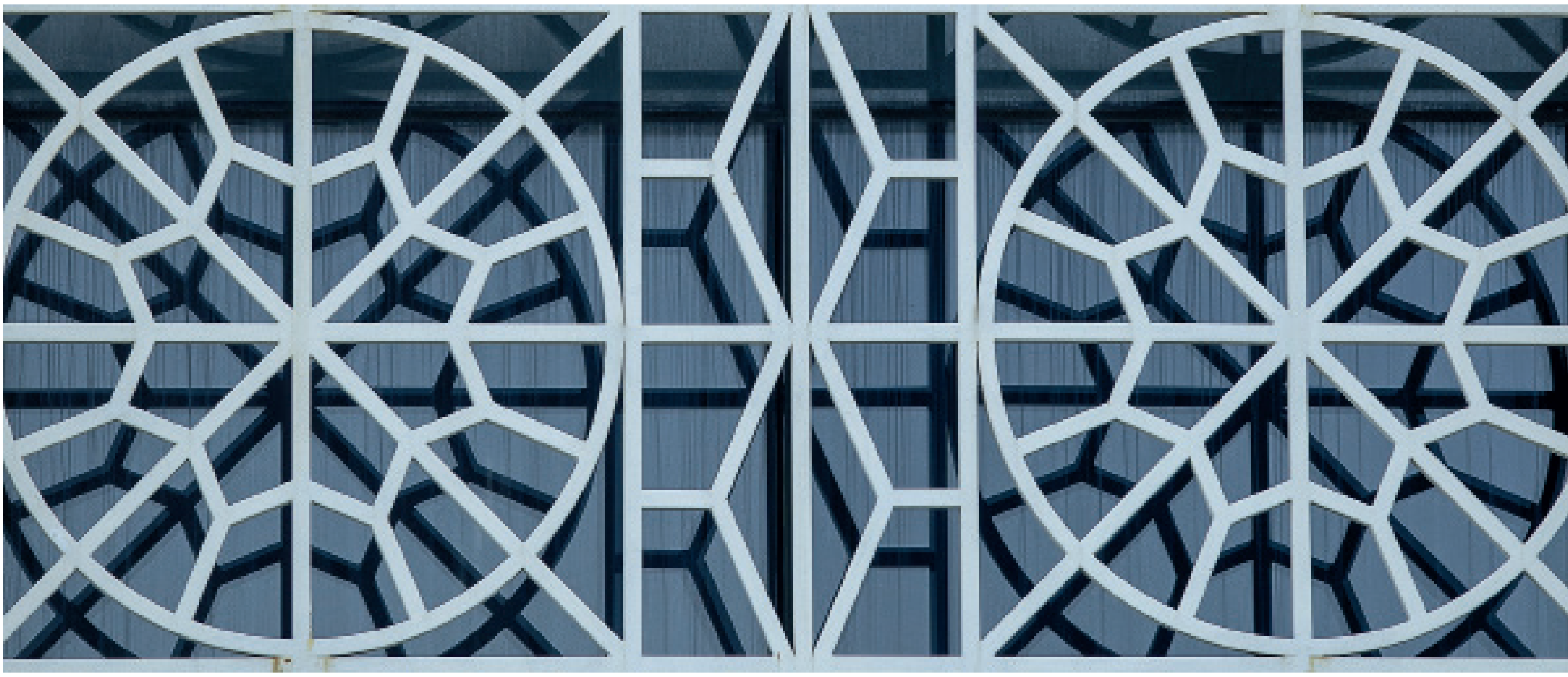
It is estimated that this manual will require approximately 130 hours of study time

Chapter One

The Basis of Islamic Banking and Finance

This syllabus area will provide approximately 2 of the 100 examination questions



1. Introduction

Islamic finance has been growing steadily at a compound annual growth rate of 10.8% per year since 2006. As of 2020, worldwide Shariah compliant assets stood at US$1.7 trillion[1]. As such, it has become an increasingly attractive sector within the financial industry.

To be able to understand Islamic finance, it is necessary to understand the underlying principles (outlined in this chapter) and recognise that **Shariah** governs all aspects of life.

The term 'conventional bank' is used throughout this workbook, reflecting the fact that, within the Islamic financial industry, a conventional bank is understood to be a bank that is not based on Islamic principles.

It is important to bear in mind that the workbook does not advocate any particular stream of the Islamic jurisprudence. The views on Islamic instruments presented throughout this workbook represent a generally accepted view of the financial instruments in the marketplace.

2. Islamic Banking and Finance: Conceptual Framework

Learning Objective

1.1.1 Understand the ethical underpinning of Islamic finance: Islamic moral guidance governing property and wealth given through the Quran and Sunnah; to make charitable distributions: Zakat (obligatory) and Sadaqah (voluntary); the role of trade and investment in wealth creation; prohibition of Riba, gambling and Gharar

---

Islamic commercial and financial ethics stem from the principles and rules of the Islamic faith and Shariah. Therefore, Islamic finance has a strong ethical underpinning as it is imbued with the concepts of efficiency (avoiding waste and resource misallocation), fairness (equitable distribution and non-monopolisation) and Ihsan (pursuing perfection and giving more than is due) which is clearly stated in some verses of the **Quran**:

Allah commands justice (fairness), and (the pursuit of) virtue. (Surat Al Nahl, 16:90)

2.1 Islamic Commercial Ethics

Islamic commercial and financial ethics are based on five main principles:

1. **The Principle of Stewardship of Humanity on Earth**

The Quran designates human beings as Allah's stewards in the created world.

I will create a steward on earth. (Surat Al Baqara, 2:30)

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1 https://www.thebanker.com/Markets/Top-Islamic-Financial-Institutions-2020

This verse affirms that man is responsible for developing the earth and the implementation of Allah's (SWT) directives. SWT stands for Subhanahu wa Ta'ala, which has the meaning of 'Blessed be His name'. It is placed after the name of Allah as a sign of reverence. Although private ownership is permitted, any personal wealth or property should be regarded by the individual as entrusted property from Allah (SWT). Ownership of assets is a means to provide a decent life for the owner, his family and society as a whole and not an end in itself. Fairness, justice and transparency in economic transactions are important characteristics and, in addition, the public and environmental good should be considered equally when using wealth or property in order to achieve fairness and perfection relating to society and nature.

2. **Integrity**

Integrity is valued highly and should govern all acts.

3. **Sincerity**

A person must always act with sincerity and should be fair and just.

4. **Piety**

Piety implies that people have to be devout both in private and in public and that the values, norms and rules of Shariah will be implemented in all circumstances.

5. **Righteousness and Perfection at Work**

A person must have the ability to perform his duties, but should not just confine himself to performing his occupational and professional duties. All people should strive to reach righteousness and perfection in all their religious, social and economic obligations.

2.2 Charitable Distribution

Zakat, one of the five pillars of Islam, is mandatory almsgiving and is levied on anyone who has in excess of a minimum level of wealth (Nisab). For the calculation of Zakat, see chapter 4.

The Quran also encourages Muslims to make voluntary charitable donations (Sadaqaat), the amount of which is dependent on the goodwill of the donor. Individuals are encouraged to prioritise the distribution of their charity as follows:

> *They ask you about what they should spend (in charity), say, 'whatever you spend on good (let it be first) on your parents, and (then) your close relatives, the orphans, the poor and the traveller and, whatever good you do, surely Allah knows'*. (Surat Al Baqara, Verse 215)

2.3 Wealth Creation

One of the major objectives of Shariah is the preservation of wealth. Preservation of wealth requires avoiding waste or improper use, but also entails the creation of wealth via appropriate means. Wealth creation is, therefore, in principle, an objective of Islamic economics, provided that it is directly linked to economic activity and production (see chapter 3).

Making money purely from money (ie, lending on interest), gambling and deceptive uncertainty are prohibited for Shariah-compliant investors. This does not mean, however, that wealth creation as such is prohibited. On the contrary, investments in trade and enterprises with a view to making a fair and acceptable level of profit are encouraged.

The challenge in Islamic finance is how to apply the basic principles of Shariah in such a way that individuals and organisations are able to finance their needs without violating the underlying principles.

2.4 Enterprise and Asset Bias

As a result of the adherence to Shariah principles and its associated precepts, the modes of financing that can be applied differ from **conventional banks**. Conventional banking is largely based on lending and borrowing against interest, a practice that is prohibited in Islamic finance due to the prohibition of **Riba** (see chapter 3). In addition, within Shariah, deceptive uncertainty (**Gharar** – see chapter 3) is prohibited, which results in a situation where many derivative-type transactions that are common in conventional finance cannot be applied.

The Islamic ban on interest does not mean that capital is costless in the Islamic system. Islam recognises capital as a factor of production. However, Islam regards finance as a means to undertake business activities: trade and production.

The value of time is acknowledged in relation to economic value and wealth creation. Wealth and returns cannot be generated by pure lending and can only be created by means of real economic transactions. Legitimate transactions either involve ownership of goods and services, or represent an ownership stake in an enterprise. Both Riba and Gharar are forbidden as they decouple financial activities from the underlying real transactions, thus potentially creating an imbalance in the economy resulting in instabilities and crises.

3. Islamic Fundamentals

Learning Objective

1.1.2 Understand the role and purposes of Shariah

3.1 Shariah and its Role

Shariah is a comprehensive system of values, norms and rules governing all aspects of life. In Arabic, the word Shariah refers to a path, or to a water spring in which water is abundant and easily accessible. In early Islamic literature, Shariah refers to guidance and instructions concerning all Islamic teachings. In late Islamic literature, however, the meaning changed and mostly referred to rulings related to practical matters excluding matters of belief (**Aqidah**).

Fiqh literally means ‘deep understanding’ and is often defined as jurisprudence. It represents the interpretations of Shariah scholars. **Fiqh al Muamalat**, ie, Fiqh related to worldly transactions, has developed over time from the Quran and the **Sunnah**, as well as the secondary sources (see section 3.2).

3.1.1 Morality of Shariah

Although Shariah is often referred to as Islamic law, scholars clearly stipulate that it is a code of both moral and civil behaviour, simultaneously governing matters relating to this life and the hereafter.[2]

The relationship between the ethical and legal dimensions of Shariah is clear as Shariah rulings are categorised into two classes:

1. Religious verdicts (ahkam al-diyanah) – rulings on matters between a person and Allah (SWT).
2. Judicial verdicts (ahkam al-qadha) – rulings concerning actions before a judge or human court.

However, despite the best efforts of a human judge, a court ruling cannot overrule a divine ruling. It is acknowledged that the world we live in is imperfect and that a human judge may not be in full possession of all relevant information. The moral dimension makes up for these imperfections which distinguishes Shariah from worldly legal systems.

Example

Although the Quran clearly forbids Israf (extravagant spending), a sale contract through which extravagant spending is conducted is legally valid. The contract is, however, not Shariah compliant.

The sale of grapes for the purpose of making wine, or the sale of weapons for the purpose of killing innocents, is prohibited. The underlying sale contract is legally valid since the use of the asset is not stated in the contract. The contract is, however, not Shariah compliant.

In either of these cases, a court is unlikely to invalidate the sale contract. It is the moral obligation of the seller not to conduct the sale if they have reason to believe the goods are intended to be used in a non-compliant manner.

3.1.2 Individual versus Collective Responsibility

Shariah balances the responsibilities of the individual versus those of society. In this respect, the following two categories of obligation are identified:

1. Individual obligations (Fardh 'ayn): to be fulfilled by each individual irrespective of other members of the society. The paying of Zakat is an example of an individual obligation.
2. Collective obligations (Fardh Kifayah): to be fulfilled individually or collectively. In the event they are not fulfilled, this will be the responsibility of every individual. For example, saving a drowning person is an obligation on all those nearby, but once some individuals start to rescue the person, there is no longer any obligation on the others unless called for by the rescuers. However, if no one volunteers to rescue the drowning person, each of them becomes accountable, both legally and morally. The same applies to, for example, taking care of orphans, the elderly and other philanthropic non-profit activities.

Collective obligations also include building institutions vital for society, such as schools, hospitals, various markets and industries. Usually, governments are responsible for such institutions, but if the government fails to perform these responsibilities, every member of society becomes accountable until those institutions are established.

2 Al Zarqa, M Al Madkhal Al Fiqhi, Vol. 1, pp. 67-69, 277-280

3.2 The Sources of Shariah

Learning Objective

1.1.3 Know the sources of Shariah: primary sources (Quran and Sunnah) and secondary sources (Ijma' Qiyas, Ijtihad)

There are a number of sources of Shariah, which can be roughly divided into primary and secondary, each of which is described further in this section.

3.2.1 Primary Sources

There are two primary sources of Shariah: the Quran and the Sunnah.

The Quran (Book of Allah (SWT))

The Quran contains the word of Allah (SWT) as it was dictated to the Prophet Muhammad (PBUH) by the angel Gabriel and communicated by him to others. In respect of the Quran, the Prophet Muhammad (PBUH) is an intermediary communicating the word of Allah (SWT) to man.

The Quran is the primary reference for all Muslims and should be consulted before any of the other sources.

The Sunnah (Words, Acts and (Tacit) Approvals of the Prophet)

During the life of the Prophet Muhammad (PBUH), the Muslims sought his clarification and guidance on various parts of the Quran and observed his behaviour so they could follow what Allah (SWT) had described to him to be the model of a proper Islamic life.

Each of the sayings, words, acts and (tacit) approvals of the Prophet Muhammad (PBUH) is represented by a **Hadith** which together form the Sunnah.

- The sayings of the Prophet Muhammad (PBUH) were used to outline the laws and provide moral guidance. For example, the principle of Al-Kharaju bi-dhaman states that the right to the revenue of an operation is linked to the responsibility to take on the possible loss of the same operation.
- The acts of the Prophet Muhammad (PBUH) refer to actions of the Prophet Muhammad (PBUH) that are used as a reference and followed. For example, the way of praying or the manner of performing the pilgrimage (Hajj).
- Tacit approval is the absence of a reaction of the Prophet Muhammad (PBUH) to an action carried out by one of his companions in his presence or to an action he was aware of. The lack of reaction is considered to be an approval, since the Prophet Muhammad (PBUH) was under an obligation to correct any undesirable action.

3.2.2 Secondary Sources

Secondary sources are those that are referred to in the event that the Quran and Sunnah do not provide a direct answer to the issue at hand. There are three secondary sources: **Ijma'** (consensus), **Qiyas** (analogy) and **Ijtihad** (interpretation), which are applied in this order.

Collective Interpretation

Ijma' (Consensus)

Ijma' literally means 'agreement on a matter' or consensus, and is the consensus of the Mujtahidin (independent jurists) from the **Ummah** (the Muslim community) of the Prophet Muhammad (PBUH), concerning a specific issue. Ijma' is of the utmost importance as the rulings adopted are integrated within Shariah and are considered to be a third source of Islamic law. The process of Ijma' allows for contemporary issues to be addressed in light of the principles, values and rules of the Quran and the Sunnah.

Example

Jurists have reached a consensus (Ijma') on the prohibition of forward sales, whereby the good sold is a debt obligation on the seller and the price is a debt obligation on the purchaser, each of which is to be delivered at a certain point of time in the future.[3]

Example

Jurists have reached a consensus (Ijma') that philanthropic activities, other than Zakat, are collective obligation of the society (Fardh Kifayah).[4]

Qiyas (Analogy)

Qiyas (analogy) is one of the main interpretation techniques used by Islamic scholars and refers to the assignment of an existing legal rule to a new scenario. Qiyas is applied when there is no legal rule found in the Quran or Sunnah but there is a previous ruling for a similar case. Literally, Qiyas means measuring or estimating one situation in relation to another. It is technically defined as '*the application of the legal rule of an existing case found in the texts of the Quran, the Sunnah, or Ijma' to a new case whose legal rule is not found in these sources*'. This transposition is made on the basis of the similarity of the attribute called the 'illah' (underlying rationale) of both legal rules.

Example

The prohibition of Khamr (grape wine) is laid down in the Quran. The Arabic word 'Khamr' means cover or veil. From this, it has been deduced by jurists that the underlying rationale (illah) for the prohibition of wine is intoxication, as this is against the objective of Shariah to preserve the intellect. Accordingly, scholars would look at other substances that intoxicate and extend the prohibition to include these.

3 Bidayah al-Mujtahid, Ibn Rushd, Vol. i, p. 480.
4 Al Istithkar, Ibn Abdul-Barr, Vol. 15, p. 358.

Ijtihad (Scholarly Interpretation)

Following the death of the Prophet Muhammad (PBUH), and with the expansion of Islam, religious leaders at the time were confronted with requests for guidance on new issues. Their recourse was first to the Quran to determine a course of action. If they were unable to find a solution to their problem in the Quran, they would turn to the Sunnah. Once it is established that an issue is not dealt with within the Quran, Sunnah or Ijma', scholars come to their own judgement on the basis of an exhaustive examination of textual evidence (Ijtihad).

There are two kinds of Ijtihad: individual Ijtihad interpretations performed by individual scholars and collective Ijtihad.

Individual Interpretation

Islamic scholars may refer to other Shariah sources to resolve an issue. In doing so, they might take into consideration public welfare (Istislah), common plight (Umoom Balwa) and/or the traditions (Urf) of the geographical location. They may also base their decision upon consideration of Shariah objectives and ultimate wisdom (**Istihsan**).

Collective Interpretation

Collective interpretation occurs when a group of scholars interpret a specific issue together.

3.2.3 Schools of Jurisprudence

The scholars involved in Ijtihad follow the methodology of one of the five Islamic schools of jurisprudence. There are four Sunni schools of jurisprudence (**Hanbali**, Maliki, Shafi'i and Hanafi) and one Shi'a (Ja'afari). All schools use the Quran and the Sunnah as the primary sources of their legal opinions (**Fatwa**/plural Fatawa) but differ in their interpretation of the texts. The Sunni schools can be classified along a continuum, with the Hanbali school mainly promoting a literal reading of the sacred texts on the one hand and the Hanafi school primarily supporting logical reasoning on the other side of the spectrum. In between lie the Maliki school, which gives particular importance to the tradition of Medina, and the Shafi'i school, which is an important influence as its founder ordered the practice of Ijtihad.

- **Hanbali** – the Hanbali school originates from Damascus and is currently largely associated with Saudi Arabia. The Hanbali school is particularly influential in the Arabian Gulf region.
- **Maliki** – the Maliki school originates from Medina. This school ruled heavily in favour of the practice (Sunnah) of the local community of Medina because the town was the territory of the Prophet (PBUH) and, as such, the traditions of the town are directly in line with the Quranic message.
- **Shafi'i** – the founder of the school, Al Shafi'i, was the first to standardise the activity of Ijtihad. In a book defining **Usul al-Fiqh** (Principles of Islamic Jurisprudence), he advocates the use of the sources of Islamic law in the following hierarchical order: the Quran, the Sunnah, Ijma' (consensus) and Qiyas (analogy). Al Shafi'i also mentioned the possible use of Istihsan (juristic preference). Its approach to Islamic jurisprudence has become a standard reference and is used by all the schools.
- **Hanafi** – the Hanafi school was created in Kufa in Iraq. It is distinctively renowned for using Ra'y, which is the logical deduction of scholars (using primary and secondary sources), comparatively more than the other schools. The Hanafi school has a strong influence on many modern practices in Islamic finance.
- **Ja'afari** – the Ja'afari school also originated in Iraq and, although it is a Shi'a school, it has many similarities with the **Hanafi** school.

3.2.4 Bodies of Interpretation

Learning Objective

1.1.4 Know the authorities that are able to interpret the Quran and Sunnah and their role: the scholars within the schools of jurisprudence; the Islamic Fiqh Academy; the Shariah supervisory boards of regulatory or industry institutions

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The examination (Ijtihad) of the text of the Quran and the Sunnah can be performed by individual scholars of requisite competence, Islamic financial institutions, Shariah supervisory boards (SSBs) of regulatory bodies and the Islamic Fiqh Academy.

Shariah Supervisory Board (SSB)

Islamic Financial Institutions use the services of their SSB to ensure their practices are in line with Shariah. Part of the task of the SSB is to issue informed legal opinions allowing institutions to provide financial services in a Shariah-compliant way. The SSB, which often generally includes three or more Shariah scholars, adheres to the following process when determining whether a financial instrument is Shariah compliant or not:

- reviewing the product concept description created by the product development team
- reviewing the market conditions identified by the product development team
- reviewing the product development team's views on the Islamic principles on which the transactions will be based, and
- reviewing the product development team's proposals and issuing the proper legal opinions (Fatawa).

The resulting opinion of the scholars is then reviewed by the product development team and can be followed by a discussion between the scholars and the product development team to finalise the product.

The need for a constant dialogue between the product development team and the scholars throughout this process should be stressed.

In the majority of countries where Shariah-compliant financial services are offered, each institution has its own SSB making individual decisions for the institution. In some countries, however, such as Malaysia and Sudan, Shariah compliance is centralised in the central bank.

Centralised Shariah Supervisory Boards

Originally pioneered by the Malaysian Central Bank (Bank Negara Malaysia), other central banks, such as those in Dubai, Oman, Nigeria and Pakistan, have more recently established a centralised SSB within the central bank or financial regulator. The central SSB is responsible for the approval of all Shariah-compliant financial transaction types in the country. The responsibility of the SSB of the individual financial institutions is to ensure the transactions undertaken by the institution are compliant with these rules. Any amendments requested by individual institutions must be presented to the central SSB for ratification.

In addition to a centralised SSB, Bank Negara Malaysia also maintains a register of approved scholars. Scholars cannot be a member of more than one board per type of financial institution. As a result, a scholar could, for example, be a member of the SSB of a retail and an investment bank, but not of two retail banks.

The Islamic Fiqh Academy

The Islamic Fiqh Academy was created in Jeddah, Saudi Arabia, following a decision of the Organisation for Islamic Cooperation, founded in 1981. The Academy includes members from most Islamic countries which are represented by scholars and knowledgeable people in many scientific, economic and social domains. The Academy meets periodically to debate contemporary matters relating to Islam and issues resolutions (jurisprudence) which originate from the Islamic tradition and Islamic thinking. [Note 1]

Chapter Notes

Note 1: This explanation is based on the translation of the Arabic website of the Islamic Fiqh Academy (www.fiqhacademy.org.sa).

End of Chapter Questions

1. Name the five main principles of Islamic and commercial ethics.
   Answer reference: Section 2.1

2. In relation to the creation of wealth, what is one of the challenges within Islamic finance?
   Answer reference: Section 2.3

3. What is the relationship between Shariah and Fiqh?
   Answer reference: Section 3.1

4. What are the two classes of Shariah rulings?
   Answer reference: Section 3.1.1

5. What are the primary reference sources of Shariah used by all Muslims?
   Answer reference: Section 3.2.1

6. What is the definition of Sunnah?
   Answer reference: Section 3.2.1

7. What are the three secondary sources of Shariah?
   Answer reference: Section 3.2.2

8. What are the two forms of Ijtihad and how do they differ?
   Answer reference: Section 3.2.2

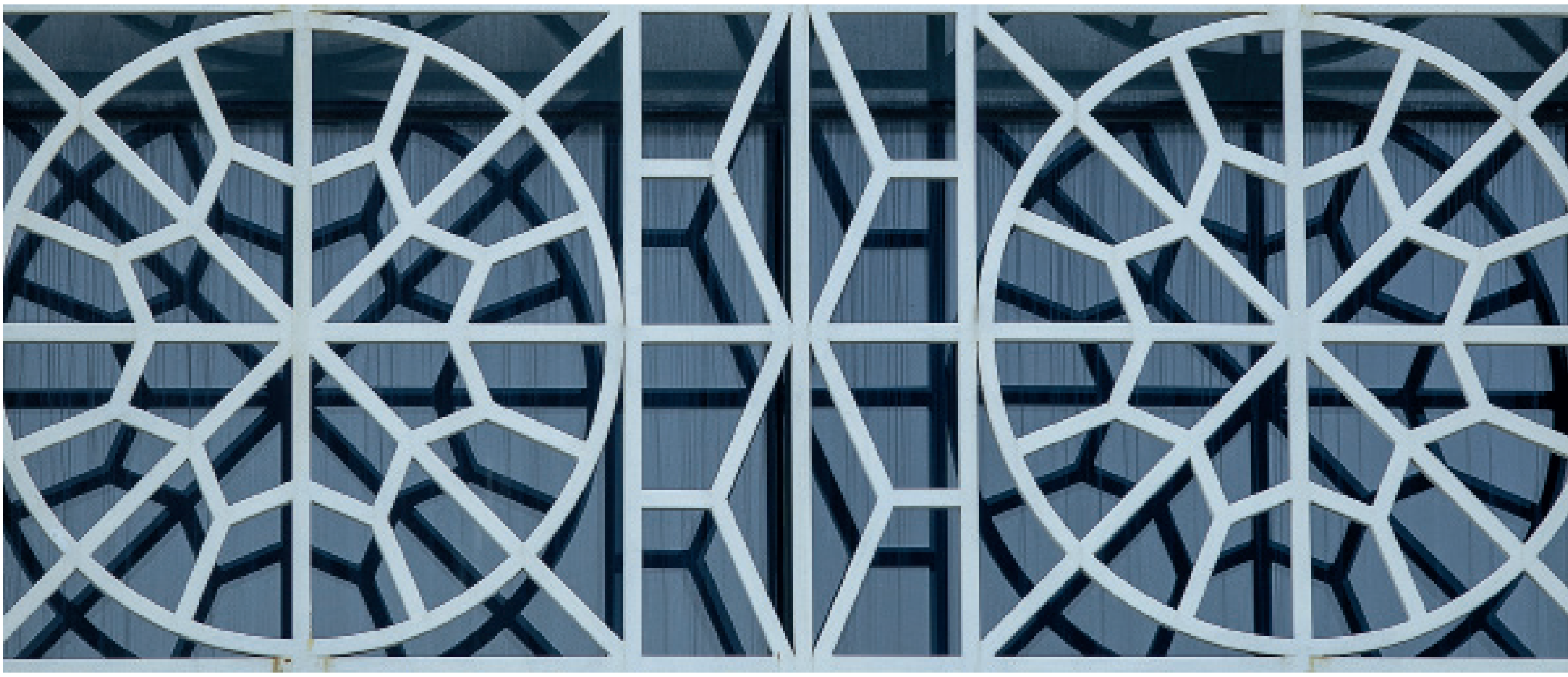
9. How would a jurist apply Qiyas?
   Answer reference: Section 3.2.2

10. Name the three bodies engaged in the interpretation of Shariah.
    Answer reference: Section 3.2.4

Chapter Two

An Introduction to Islamic Banking and Finance

This syllabus area will provide approximately 3 of the 100 examination questions



1. The History of Islamic Finance

Learning Objective

2.1.1 Know the development of Islamic finance and banking: the beginnings of Islamic banking; Islamic banking in the Gulf Cooperation Council (GCC), Africa and the Middle East countries; Islamic banking in Southeast and South Asia and Australasia; Islamic banking in Europe and the Americas

The history of Islamic finance is long and varied and its current development is subject to constant and rapid change. It is important for candidates to understand historic and current developments, so that they have a better idea of the background.

1.1 The Early History of Islamic Finance

Islamic finance dates back to the 7th century CE and the beginning of Islam, when the Prophet Muhammad (PBUH) approved the usage of one of the main contracts of Islamic finance – the Mudaraba, a participation type contract (covered in chapter 5) – and his companions continued its practice after he departed. From the 7th century onwards, Islamic merchants traded over long distances and the means of financing their trades and investments in line with Shariah were introduced. By the 11th century, many of the commercial practices used by Islamic merchants had been adopted across Southern Europe, Asia and the Middle East.

The concepts and practices of Islamic finance were revived in the 1960s.

1.2 The Contemporary History of Islamic Finance

The contemporary history of Islamic finance can be divided into three stages: a founding period, that took place during the 1960s; a formative period, which began with the creation of the Islamic Development Bank (IsDB) in 1975 and ended in 1990; and a development period, which began in 1990.

The timeline can be depicted as follows:

Founding Period 1963–1975	**Formative Period 1975–1990**	**Development Period 1990–Now**
1963 Mit Ghamr, Egypt, based on profit sharing and concepts of mutual credit union	Formation of IsDB and commercial banks First attempts to turn conventional finance into an Islamic format, some new product development	Regulation and standardisation Islamic windows Increasing sophistication

1.2.1 The Founding Period (1963–75)

Contemporary Islamic finance emerged in the 1960s with the creation in Egypt of the Mit Ghamr Saving Project in 1963. Set up by Dr Ahmad el Najjar, its aim was to assist the people of the region of Mit Ghamr with the financing of the development of their land in line with Islamic finance principles. All finance was free of Riba and based on profit sharing.

Around the same time, the Muslim Pilgrims' Saving Corporation in Malaysia offered to manage Muslim pilgrims' savings according to Islamic rules. This programme was specifically developed to assist people in their efforts to save money so as to be able to fulfil one of the important elements of Islam – to go on pilgrimage (Hajj).

1.2.2 The Formative Period (1975–90)

The second landmark in the history of Islamic finance was the inauguration of the IsDB in 1975. The IsDB is a multilateral bank with the objective of fostering the economic development and social progress of member countries and Muslim communities, using techniques that respect the principles of Shariah. This event was particularly important because it gave institutional recognition to the developing Islamic finance industry. A few months after the inauguration of the IsDB, the Dubai Islamic Bank, the first modern Islamic commercial bank, opened its doors, followed by the Kuwait Finance House, the Faisal Islamic Bank of Sudan and the Faisal Islamic Bank of Egypt. The Jordan Islamic Bank was incorporated in 1978 and, a year later, was followed by the Bahrain Islamic Bank. As it was only regarded of being of interest to a minority of customers, the development of Islamic finance during this period was still slow.

Initially, the focus of the banks was on providing an alternative to conventional commercial banking functions in a Shariah-compliant manner, and services were predominantly retail and trade finance-oriented. Since the 1980s, Islamic banks have expanded into countries with a Muslim minority. Simultaneously, Iran, Sudan and Pakistan sought to impose Islamic banking solutions, while Malaysia made significant progress in establishing a dual-banking system.

1.2.3 The Development Period (1990 onwards)

The development period began in 1990 with the incorporation of the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI). The establishment of AAOIFI was a clear statement that Islamic finance was becoming an integral part of the finance industry and this was reinforced further with the incorporation of the Islamic Financial Services Board (IFSB) in 2003. Both AAOIFI and the IFSB are detailed further in section 2. The result of the establishment of these two institutions was that Islamic finance started to offer a credible alternative to conventional finance. In addition to the regulatory frameworks provided by AAOIFI and the IFSB, Citibank, one of the largest full service conventional banks in the world, launched its Islamic finance operations under the name Citi-Islamic in Bahrain in 1996 and was the first conventional financial institution to offer Islamic financial services. More recently, some Western countries, such as the UK, have amended their regulation to facilitate the offering of Islamic financial services within the framework of their financial regulations.

Since the 1990s, Islamic finance has become increasingly sophisticated and Islamic financial products have developed to match almost every demand from capital markets, consumer banking and wealth management. During this period, the number of Islamic banks has expanded significantly around the world.

1.3 The Geographical Development of Islamic Finance

The Islamic financial industry has grown, irrespective of any government support. Initially mainly limited to Middle Eastern countries, it expanded into Asia in the 1980s and into Europe from around 2002. Bahrain, Malaysia and the UK have played important roles in their respective regional Islamic finance markets and the developments in each of these jurisdictions have been beneficial to the global development of the industry.

1.3.1 The Countries of the Gulf Cooperation Council (GCC), Middle East and Africa

Bahrain was the first country of the Gulf Cooperation Council (GCC) to develop a comprehensive approach to Islamic banking and finance and is considered as one of the key players in the field. It was among the first countries to recognise the importance of the industry and contribute to its growth. AAOIFI is based in Bahrain and the Central Bank of Bahrain (CBB) is playing an active role in the development of the Islamic financial industry. The CBB has established the necessary supervisory and regulatory framework to promote the growth of the sector. The CBB has, for example, implemented the IFSB standards for regulations, requires Islamic financial institutions under its supervision to adhere to AAOIFI standards and has designed an Islamic paper (Sukuk) issuance programme to provide a liquidity instrument for the Islamic financial institutions in Bahrain.

The Kingdom of Saudi Arabia started a process to formalise a robust regulatory structure for Islamic banking and finance in 2000 which has since encouraged the rapid adoption of Islamic banking and insurance in the Kingdom. As the largest market in the GCC, robust growth is projected for institutions based in Saudi Arabia.

All GCC countries now formally support Islamic banking and investment. More recently, Dubai formed the Dubai International Financial Centre (DIFC), Qatar formed the Qatar Financial Centre (QFC) and Kuwait has begun to examine how it may offer more robust financial services in the region. Although these centres aim to service their domestic economies, they are well positioned to service Iraq, Iran, the Indian subcontinent, and East Africa.

All the GCC countries are applying a dual-banking system in which Islamic and conventional financial institutions are operating side by side.

In Lebanon, Islamic banks and financial institutions have been authorised by the Central Bank (Banque du Liban) since February 2004 and are governed under the same legal and regulatory provisions as non-Islamic banks. An additional provision is included in the law which requires the banks to appoint a consultative body, consisting of three experts in Islamic law and banking and financial operations. This body is appointed for a renewable three-year period. Jordan has made it mandatory for Islamic banks in its jurisdiction to follow AAOIFI standards for accounting and reporting.

Islamic banks have been incorporated in Sudan for many years and also, more recently, in Syria, where banking supervisors have made AAOIFI standards mandatory.

Throughout the African countries, and currently in South Africa particularly, Islamic finance is gaining traction. In other countries, Islamic financial services are slowly being introduced.

1.3.2 South and Southeast Asia and Australasia

Bank Islam Malaysia Berhad (BIMB) was incorporated in Malaysia in 1983 as part of a national strategy to establish a dual-banking system. The primary driver for this strategy was that Muslims were disproportionately not using the formal financial system and required a viable alternative. Currently, Malaysia has one of the most developed Shariah-compliant financial systems in the world and is committed to the international development of Islamic finance. The IFSB is based in Malaysia and is considered to be one of the main hubs of Islamic finance. The Malaysian Islamic banking sector is regulated by the Malaysian Central Bank and Bank Negara Malaysia under a dual-supervision regime.

Pakistan originally had limited success in converting its financial infrastructure to be Shariah compliant and introduced a dual-banking system in 2004. Since the introduction of dual regulation, the Pakistani Islamic banking sector has rapidly expanded.

Singapore, Hong Kong, Indonesia and Australia are all making progress on the introduction of Islamic finance. Australia mainly focuses on managing funds containing Asian-based investments and Indonesia issued its first government **Sukuk** in 2009. In each of these countries, the Islamic banking and finance industry is regulated using the same framework as that in place for conventional banks.

1.3.3 Europe and the Americas

The US and the UK have been exploring the way to regulate domestic and cross-border Islamic financial services since the mid-1990s.

In 2002, the Financial Services Authority (FSA – the UK regulator at the time) and the Bank of England (BoE) adopted a series of measures to encourage the development of Islamic finance. Since then, several Islamic banks have been licensed to operate in the UK under the supervision of the UK regulator and, in 2014, the UK was the first country outside the Muslim world to issue a government Sukuk. The importance of London as an international financial hub is likely to lead to more institutions seeking authorisation and other European countries are exploring the possibilities of the Islamic financial industry.

In the US, the Office of the Comptroller of the Currency (OCC) has issued a series of public and private interpretive letters on the subject, and the Federal Deposit Insurance Corporation (FDIC) and various other agencies at state level have created a flexible framework to allow limited Islamic banking activities to take place onshore (notably in New York, Michigan and Illinois). In addition, US banks are allowed to engage in Islamic financial services activities offshore (for example, Citibank operates an Islamic subsidiary in Bahrain). The Federal Reserve Bank has initiated a study group to research the opportunities associated with Islamic finance and its implementation in the US, and the Securities and Exchange Commission (SEC) is regulating a growing number of Islamic mutual funds aimed at US domestic investors. In addition, Freddie Mac and Fannie Mae, the US government-sponsored mortgage securitisation companies have supported the development of Islamic alternatives to conventional mortgages since 2002.

1.4 The Future of the Islamic Finance Industry

Learning Objective

2.1.2 Know the constraints and challenges on the development of the Islamic banking and finance industry

1.4.1 The Interaction of Shariah with Local Law and Regulation

In some countries, local regulations do not permit the use of financial instruments that conform perfectly to each requirement of Shariah. Therefore, some concessions may have to be made in order to meet local regulatory requirements, for example, capital protection for retail customers. Shariah scholars approve financial instruments containing concessions in the event there is no other choice, since these products enable the Islamic finance industry to develop and may be used to advocate gradual change in local regulations in order to accommodate Shariah requirements. After all, something less than perfect is better than nothing at all. In addition, once the instrument is accepted, efforts can be made to improve them. In Muslim countries, these differences are less likely to be encountered.

1.4.2 The Constraints of Islamic Banking

Even though some of its instruments have been applied for centuries, the contemporary Islamic financial services industry is relatively young and is still developing new Shariah-compliant ways to provide a balanced, full offering of financial products and services. The ways in which Shariah-compliant products are structured vary by region, within regions, and by school of jurisprudence. This workbook attempts to follow the mainstream view on the various structures based primarily on the Fiqh Academy of the Organisation of Islamic Cooperation, the international body officially representing Muslim nations worldwide, as well as the Shariah Council of AAOIFI. It needs to be taken into consideration that this generally might be more conservative than what is advocated by some regional Shariah bodies. This workbook does not make a judgement on the various schools of jurisprudence, or attempt to include different views, as this would be outside its scope.

2. The Structure and Scope of the Islamic Finance Industry

2.1 The Functions of Islamic Banks

Learning Objective

2.1.3 Know the main functions of Islamic banks

From an economic perspective, the functions of an Islamic bank are similar to those of the conventional financial industry and include the following:

- **Investment and investment management** – Islamic banks invest funds that have been placed or deposited with them (ie, their own capital funds and funds in their customers' investment accounts) through investment mechanisms that are consistent with Shariah.
- **Generic banking services** – Islamic banks offer a variety of financial services similar to conventional banks, including current accounts, fund transfers, credit cards, consumer goods finance, home finance and small- to medium-sized business facilities, through Shariah-compliant arrangements. It is important to note that not all of these are offered uniformly by all institutions.

In addition to these generic functions, Islamic banks carry out direct social services since they have an explicit responsibility for the development of their staff and their local communities. They also carry out indirect social services via the charities to which they have donated Zakat or other gifts.

Besides commercial banks, the Islamic finance industry also encompasses investment banks, investment funds, **Takaful** (insurance) companies and multilateral and development banks, such as the IsDB.

2.2 The Operating Structures of Islamic Banks

Learning Objective

2.1.4 Know the operating structures and organisational forms adopted by the Islamic financial services industry: the window model; branches; subsidiaries; fully-fledged banks

Islamic financial services are offered via different structures, depending on whether or not the institution also offers conventional financial services. Institutions that provide conventional, as well as Islamic financial services, have three main organisational structures available to them.

Although in some countries, such as Iran and Sudan, the financial system is fully Shariah compliant, in the majority of countries, Shariah-compliant and conventional banks exist side by side.

In some countries such as Qatar, Kuwait and Lebanon, for example, it is not allowed for conventional banks to offer both Islamic and conventional financial services. In these countries, Islamic financial services can only be offered by fully fledged Islamic banks. In most countries, however, conventional banks are also allowed to offer Islamic financial services, but segregation of these services from the conventional financial services offering must be in place in order to ensure Shariah compliance.

Contrary to some other countries, Malaysia has made the choice to be an early introducer of new products and services, and to enhance their Shariah compliance over time or replace them with new, more favourable options as they develop. Although not all schools of jurisprudence agree with some of the instruments available in Malaysia (namely, **Bai al 'inah**), they are considered to be Shariah compliant by Shariah scholars in Malaysia who, in principle, follow the Shafi'i school of jurisprudence, which is predominant in Malaysia. The approach has made it possible for the Malaysian market to display significant growth and become one of the largest markets in the Islamic financial industry. It must be noted, however, that Bank Negara Malaysia, the central bank of Malaysia, issued a circular in December 2012 that strongly restricted Bai al 'inah transactions, aligning them closer to the principles of Shariah as considered by the majority of schools of jurisprudence.

There are four main organisational forms in which Islamic financial services can be offered and these are outlined below.

Islamic Financial Services Offerings by Conventional Banks

When conventional banks offer Islamic financial services, this is typically done using one of the following organisational models:

- **The Windows Model** – in this model, a conventional bank offers Islamic financial services via the same delivery channels it uses for its conventional financial services. For example, Lloyds in the UK offers Islamic financial products via the same branch network it uses to offer other financial services.
- **Branches** – contrary to the windows model, the Islamic financial services offered by a conventional bank are not distributed via the same channel, but instead via dedicated branches. For example, Standard Chartered Bank provides Islamic financial services in Pakistan via a dedicated branch network under the name Standard Chartered Saadiq. Similarly, HSBC offers Islamic financial services via the Amanah branch network in Malaysia.
- **Subsidiaries** – a subsidiary is a separate legal entity owned by a conventional bank or some other financial institution (a parent), which is set up specifically to provide Islamic financial services. The subsidiary can either have its own dedicated service delivery channels or utilise the parent's service delivery channels which also offer conventional financial services. Being a separate legal entity, the subsidiary usually formulates and manages its own policies on Islamic financial services, but within the parent's overall business strategies, eg, Citi-Islamic (a subsidiary of Citi) and Badr al-Islami (a subsidiary of Mashreqbank).

It is important to bear in mind that, in each of these structures, the operations and accounting of the Islamic financial services offering are segregated from the conventional part of the bank, and although the services are offered by a conventional bank, the offering is generally managed separately. Disregarding the operating model, Islamic financial services are subject to the review and controls of a SSB. BNP Paribas, for example, which operates a windows model, has an Islamic banking unit which manages its Islamic financial services offering.

Fully-Fledged Islamic Banks

Unlike any of the above, fully-fledged Islamic banks are stand-alone institutions and do not form part of conventional financial institutions. These banks are set up solely to provide Islamic financial services offered through their own service delivery channels. As they have fully independent management and operating structures, they draw up their own business strategies and policies. Most Islamic banks fall into this category. The following are among the largest Islamic banks (by total assets):

- Al Rajhi Bank
- Kuwait Finance House
- Dubai Islamic Bank
- Abu Dhabi Islamic Bank
- Qatar Islamic Bank
- Maybank Islamic.

2.3 The Regulators

Learning Objective

2.1.5 Know the bodies overseeing and/or supporting Islamic banking and finance: the regulators (central banks or other authorities); the standard-setters (AAOIFI and IFSB); other institutions supporting the development of Islamic finance and banking (IIFM, CIBAFI, IIRA, IILM, and IsDB Group)

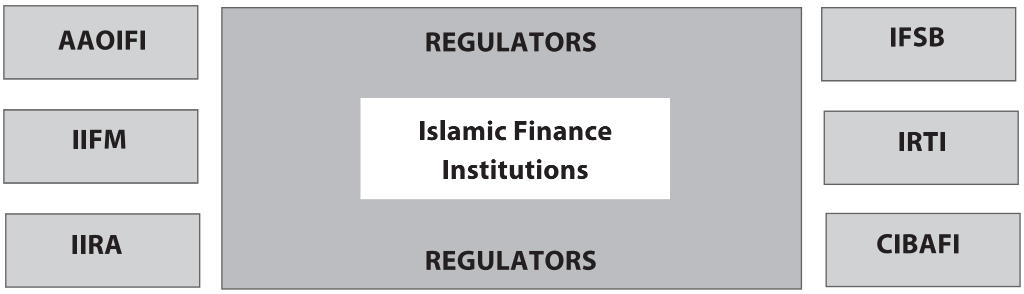


Figure 1: Islamic banking infrastructure

Islamic financial institutions are, like other financial institutions, authorised and supervised by the regulatory authority in their country of incorporation. In addition, two standard-setting bodies have been established: the AAOIFI and the IFSB. Their main aim is to ensure the integrity and stability of the Islamic financial industry within the global financial system and to protect the interests of the stakeholders (especially the customers) of financial institutions. These and other supporting institutions are detailed in the remainder of this chapter.

2.3.1 The Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI)

AAOIFI, whose headquarters are in Bahrain, is an autonomous body established in 1990 by Islamic banks, and is responsible for the formulation and issuance of accounting, auditing, ethics, governance and Shariah standards for the international Islamic banking and finance industry. The standards have been developed to encourage the harmonisation of Islamic banking and finance practices, and to ensure transparency and uniformity of financial reporting by Islamic banks and financial institutions.

AAOIFI's role is similar to that of the International Accounting Standards Board (IASB) of which it is a member. AAOIFI's accounting standards build heavily on the International Financial Reporting Standards (IFRS) and are designed to provide best practice on how to handle financial reporting issues specific to Islamic institutions.

Although the standards are international, they are not mandatory in every country. The standards are mandatory for Islamic financial institutions in countries such as Bahrain, Jordan, Syria and Sudan but are only used as guidance in, for example, Saudi Arabia.

AAOIFI has issued standards for the following:

- **Shariah Standards** – these standards identify contractual issues with different instruments, such as trading in currencies, how to deal with a default in payment by a debtor, guarantees, **Murabaha** to the purchase orderer and any of the other instruments detailed in chapter 5. AAOIFI Shariah Standard No. 11, for example, deals with the requirements of **Istisn'a** (project finance) and Parallel Istisn'a.
- **Accounting Standards** – the accounting standards use the IFRS as a basis and provide additional standards that cater for the specific accounting requirements associated with Islamic financial instruments. Financial Accounting Standard (FAS) No. 9, for example, sets out the accounting rules for the treatments related to the determination of the Zakat base, and how it needs to be accounted for in the financial statements of the Islamic financial institution.
- **Auditing Standards** – these standards outline guidance on the objectives and general principles governing the audit of financial statements of Islamic financial institutions. Auditing Standard for Islamic Financial Institutions No. 2, for example, provides an overview of the elements that need to be contained in the auditor's report.
- **Governance Standards** – these standards outline the additional governance required for Islamic financial institutions. Governance Standard for Islamic Financial Institutions No. 2, for example, outlines the requirements for Shariah review.
- **Ethics Standards** – the ethics standards defined by AAOIFI are applicable to internal accountants and internal auditors of Islamic financial institutions and deal with, for example, integrity, sincerity, trustworthiness and objectivity.

2.3.2 The Islamic Financial Services Board (IFSB)

The IFSB, headquartered in Malaysia, is an international standard-setting organisation founded by central banks of member countries in 2003. The IFSB aims to promote and enhance the soundness and stability of the Islamic financial services industry by issuing global prudential standards and guiding principles for the industry, broadly defined to include banking, capital markets and insurance sectors.

The IFSB also conducts research and coordinates initiatives on industry-related issues, as well as organising roundtables, seminars and conferences for regulators and industry stakeholders.

The IFSB standards are based mainly on the identification, management and disclosure of risks relevant to Islamic products and operations. The role of the IFSB is comparable with that of the Bank for International Settlements (BIS) with whom it cooperates closely. Members of the IFSB include the Organisation of the Islamic Cooperation (OIC), member state central banks, multilateral banking regulators and a diverse group of central banks from non-OIC countries, including China and Singapore.

IFSB standards are currently optional. However, there is an expectation that, as the Islamic financial industry becomes more mainstream, IFSB standards will be adopted by member countries and other jurisdictions to provide a stable and regulated environment.

The IFSB has, for example, issued the following standards:

- **IFSB-7** – Capital Adequacy Requirements for Sukuk, Securitisations and Real Estate Investment
- **IFSB-8** – Guiding Principles on Governance for Takaful (Islamic Insurance) Undertakings.

In addition, the IFSB issues technical notes, such as:

- **TN-1** – technical note on issues in strengthening liquidity management of institutions offering Islamic financial services: the development of Islamic money markets and other documents such as the IFSB-IRTI-IsDB Islamic Finance and Global Stability Report.

2.3.3 Supporting Institutions

The international Islamic banking and finance industry is also supported by several other institutions.

International Islamic Financial Market (IIFM)

The IIFM is the global standard-setting body for the Islamic capital and money market segment of the Islamic financial services industry. Its primary focus is the standardisation of Islamic products, documentation and related processes. The IIFM has issued a master agreement for treasury placement, which provides a standard for interbank Commodity Murabaha and has issued a standard for hedging under the name ISDA/IIFM Tahawutt Master Agreement, which includes a master agreement to use for profit rate swaps. The IIFM works closely together with the International Swaps and Derivatives Association (ISDA). The ISDA is a global trade association and develops and maintains industry-standard conventional documentation and the IIFM's role is comparable to that of the ISDA.

Islamic International Rating Agency (IIRA)

The IIRA is an Islamic rating agency, playing a role similar to Moody's, S&P and Fitch Ratings. The difference with the conventional rating agencies is that the IIRA focuses specifically on the Islamic financial services industry. The IIRA issues ratings based on an independent assessment and opinion on the likelihood of timely payment of financial obligations by sovereigns, corporates, banks and financial institutions; and securities issued by governments, corporates, banks and financial institutions. The assessment process includes an independent opinion on the level of compliance with Shariah principles.

Other Supporting Institutions

In addition to the above, there are other institutions supporting the Islamic financial services industry which include:

- The General Council for Islamic Banks and Financial Institutions (CIBAFI), whose mission is to promote Islamic financial institutions and disseminate rules and concepts related to Islamic finance. The CIBAFI, an industry group, is also responsible for providing information relating to Islamic finance institutions and strengthening cooperation among Islamic finance players. The CIBAFI is comparable to the British Bankers Association (BBA) in the UK.
- The International Islamic Liquidity Management Corporation (IILM) is an international institution established by central banks, monetary authorities and multilateral organisations. Its objective is to create and issue short-term Shariah-compliant financial instruments to facilitate effective cross-border Islamic liquidity management.
- The Islamic Development Bank (IsDB) is a multilateral bank with the objective of fostering the economic development and social progress of member countries and Muslim communities using techniques that respect the principles of Shariah. One of the important members of the IsDB Group is the Islamic Research and Training Institute (IRTI), a specialised entity with a mission to promote Islamic research and training in Islamic finance and economics. The IRTI has a comparable role to, for example, the World Bank Institute (WBI).

2.3.4 Conventional Institutions

The following table shows the institutions described in the above sections and their conventional counterparts:

Islamic Financial Industry Body	Conventional Financial Industry Body
AAOIFI Accounting and Auditing Organisation for Islamic Financial Institutions	**IASB** International Accounting Standards Board
IFSB Islamic Financial Services Board	**BIS** Bank for International Settlements
IIFM International Islamic Financial Market	**ISDA** International Swaps and Derivatives Association
IIRA Islamic International Rating Agency	Credit rating agencies such as Moody's, S&P and Fitch Ratings
CIBAFI General Council for Islamic Banks and Financial Institutions	**BBA** British Bankers Association (UK) and other comparable bodies
IRTI Islamic Research and Training Institute	**WBI** World Bank Institute

2.4 Other Components of the Islamic Finance Industry

Learning Objective

2.1.6 Know other components of the Islamic finance industry: the Shariah-compliant equity markets; the market for Sukuk (Islamic capital market instrument); Islamic investment funds; Islamic insurance companies – Takaful; the Waqf properties (Islamic charitable trust); Zakat funds (funds constituted of charitable obligatory tax); Islamic microfinance; purification of non-permissible income (Haram)

2.4.1 The Equity and Capital Markets

Islamic equity markets allow individual and institutional investors to buy and sell shares in Shariah-compliant companies. As with the conventional equity market, the Islamic equity market encompasses both listed and private equity. Like any other instruments, equity investments have to be Shariah compliant, which means that the activities and financial ratios of the company, as well as the inherent structure and documentation in connection with the equity investment, need to be compliant with Shariah.

The establishment of a modern limited liability company and the buying and selling of its shares was accepted as permissible in Resolution No. 63/1/7, 7th Session of the Islamic Fiqh Academy, in Jeddah, in May 1992. During the same session, a resolution to permit Shariah-compliant investment funds was also accepted.

Islamic capital markets have a similar function to conventional capital markets and provide short-term and long-term liquidity on an interbank basis. Contrary to conventional capital markets, Islamic capital markets solely use Shariah-compliant instruments, such as Sukuk (covered in detail in chapter 7).

2.4.2 Islamic Investment Funds

The market for Islamic asset management (see chapter 6) has grown significantly over the years and there are currently close to 700 funds listed in the major databases, with estimated funds under management of around US$70 billion. The type of funds offered are varied and include fixed-income funds, lease funds, commodity funds, real estate funds, private and public equity funds, equity tracker funds, exchange-traded funds and hedge funds. The operations of these funds are fairly similar to those of a conventional fund, save for the fact that the fund structure, the underlying documentation, and all investments made by the fund, need to be Shariah compliant.

2.4.3 Takaful

Takaful (covered in detail in chapter 8) is Shariah-compliant insurance and works on a mutual or cooperative basis.

In Takaful, the participants jointly contribute funds (known as Tabarru) to a pool for the purpose of providing mutual indemnity and protection to the participants exposed to defined risk(s) under the Takaful policy. The pool is typically managed by an independent third party, the Takaful operator, on behalf of all participants against unexpected loss or damages which are covered under the terms of the insurance within the agreed period and terms of the policy.

2.4.4 Waqf and Zakat

Waqf and **Zakat** are both associated with benevolent giving but have different forms and imperatives: Zakat is obligatory whereas Waqf is recommended. Waqf represents charitable giving in a form comparable with a charitable trust. Waqf properties are those preserved for certain philanthropic purposes which cannot be overridden. They make up a considerable proportion of the societal wealth in all Muslim populations. Islamic institutions and financial markets are becoming increasingly sophisticated about the management of Waqf funds.

Zakat is a mandatory religious duty paid by Muslims according to Shariah that can be donated to any one of the nominated recipients at the discretion of the donor. As detailed in chapter 4, Islamic financial institutions can pay this on behalf of their shareholders or leave the responsibility for the payment of Zakat to the shareholders. In the event that the Zakat payment is delegated to the shareholders, the institution remains responsible for informing them of the amount of Zakat per share.

2.4.5 Islamic Microfinance

By its nature, Islamic finance is very suitable for microfinancing-type projects. The investments are typically in a tangible business venue and have a high level of social responsibility attached to them.

There are a wide range of structures in Islamic finance that lend themselves to microfinance initiatives, with joint venture contracts, such as **Musharaka** and **Mudaraba**, potentially the most suitable. Microfinanciers tend to have a very close relationship with their clients, which makes a joint venture ultimately viable. The microfinance institution (MFI) will not only supply money, but also expertise related to the setting up and successful running of a company. It is highly likely that the client will initially only put in expertise, while the MFI contributes in cash and will take its profit share as agreed in Mudaraba. However, from experience with conventional microfinance, it appears that the entrepreneurs are likely to want to obtain full ownership over their business, which could become a feature of the contract.

Looking at a $100 investment using a Mudaraba agreement, a suggested structure could be as follows:

- The bank invests $100 and receives 40% of the profit for their input of both capital and expertise.
- 20% of the profit is held by the bank in a reserve account, which can be used as a buffer for unforeseen circumstances or for the client to purchase units in the partnership from the bank with its share of the profit.
- 40% of the profit is paid directly to the entrepreneur.

The advantage of this is that it provides a form of security to the entrepreneur and encourages savings to be built up. The entrepreneur should, however, be free to use other funds (eg, excess profits) to repurchase units.

In the Middle East and Asia, entrepreneurial funding on this scale is often granted on an informal basis by small groups of friends, neighbours and family. The intensive nature of microfinance, in combination with the fact that clients typically are not deemed creditworthy and the subsequent additional capital charge, does not necessarily make microfinance a viable business proposition to large banks. On the other hand, it should be recognised that the peer pressure on financiers, as well as their motivation, is extremely high, and the default rates are negligible, which makes it an attractive proposition, despite small ticket sizes.

2.4.6 Crowd Funding and Peer-to-Peer (P2P) Lending

Crowdfunding is a way in which individuals, charities and businesses (including start-ups) can raise money from the public to support a project, campaign or person. It usually takes place via websites that allow businesses or individuals to raise money, and investors to provide that money. The business or individual often explains their project in a pitch to attract loans or investment from as many people as possible[1].

Similarly, peer-to-peer (P2P) lending provides alternative investment opportunities for individuals to lend directly to other people or businesses without using a bank. It operates on a 'many to many' lending model through internet-based lending platforms who arrange and manage the loans[2].

Although originally started with interest-bearing loans, there are a growing number of Shariah compliant crowdfunding and peer-to-peer financing platforms available.

2.4.7 Purification of Non-permissible (Haram) Income

Globalisation and the interrelationship between Islamic and conventional financial institutions means that, for a number of reasons, a Shariah-compliant investor or financial institution may receive non-permissible (Haram) (prohibited) income, eg, when investing in large multinational companies, when the financial institution levies penalty interest charges or when a transaction that was deemed compliant has been processed incorrectly. Any transaction subject to non-permissible income is not automatically null and void. Instead, the financial institution will need to assess the amount of income attributable to the non-permissible activity and purify this income by donating it to charity. The charity and the size of the donation is usually approved by the SSB.

2.4.8 The Impact of Technology in Islamic Finance

Learning Objective

2.1.7 Know the impact of FinTech in Islamic finance

Islamic finance institutions, as with conventional counterparts, are highly reliant on technology, and embracing change is critical to the survival of most of the Institutions. The introduction of FinTech, particularly disruptive technologies and processes in the finance sector by the use of blockchain, artificial intelligence (AI) and cryptocurrencies, presents Islamic finance with new challenges, but also new opportunities within the sector.

1 https://www.fca.org.uk/consumers/crowdfunding
2 https://www.gov.uk/guidance/peer-to-peer-lending

With the rapid growth and uptake of emerging technologies in the global financial sector, Islamic finance is embracing some of these new technologies. Governments are even encouraging hubs to be set up around the main global Islamic finance centres in order to focus on developing FinTech specialising in Islamic finance.

The scholars, in principle, have no real issue with most of the new developments, but they do have concerns as to how emerging technologies are being applied or used, ie, ensuring that new technology is applied and used in a Shariah-compliant manner. Some areas of technology are relatively clear (for example, the use of blockchain in smart contracts) and relatively straightforward to understand and implement, but scholars have differing views as to their usage and their level of Shariah compliance with other technologies, such as cryptocurrencies (eg, Bitcoin).

In the coming years, the use of these emerging technologies within the financial sector will become the norm and the Islamic finance sector will have implemented and embedded a number of these technologies within the operations of its institutions and products (depending on the jurisdiction of implementation and its own scholars' interpretation). The use of these new technologies will vary, but it is inevitable that technological change will have an impact on Islamic finance, in areas ranging from operations, payments, transactions and customer communication to the introduction of new products.

End of Chapter Questions

1. Outside of the Muslim world, what was the first country to issue a government Sukuk and when did this occur?
   Answer reference: Section 1.3.3

2. Name the four methods by which Islamic financial services can be offered.
   Answer reference: Section 2.2

3. When conventional banks offer Islamic financial services, what is the key difference between the windows model and branches?
   Answer reference: Section 2.2

4. What is the main aim of the two bodies engaged in regulating the Islamic finance industry?
   Answer reference: Section 2.3

5. Which body issues Shariah standards?
   Answer reference: Section 2.3.1

6. What is the primary focus of the IIFM?
   Answer reference: Section 2.3.3

7. How do Islamic capital markets differ from conventional capital markets?
   Answer reference: Section 2.4.1

8. What is the role of the Takaful operator?
   Answer reference: Section 2.4.3

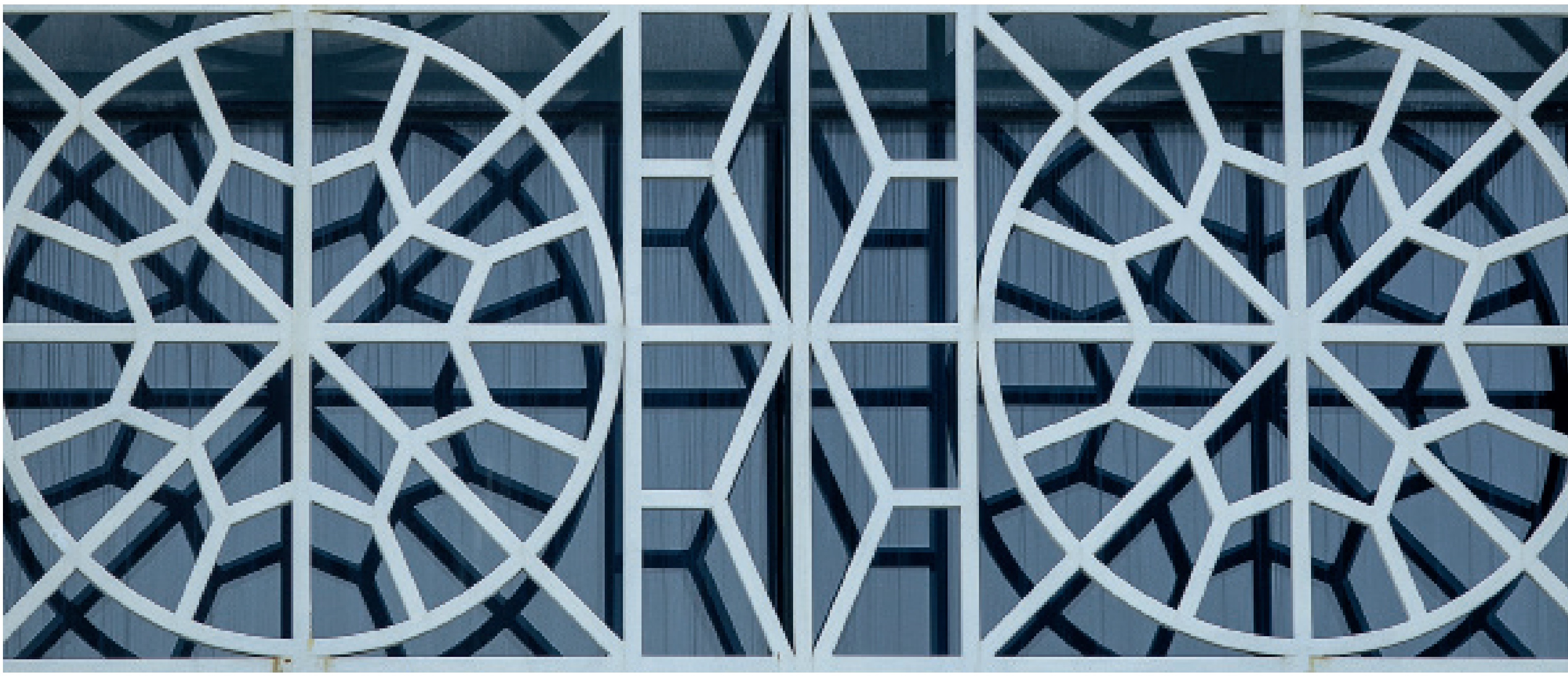
9. How do Waqf and Zakat differ?
   Answer reference: Section 2.4.4

10. How is non-permissible income purified?
    Answer reference: Section 2.4.7

Chapter Three

Islamic Principles of Exchange

This syllabus area will provide approximately 13 of the 100 examination questions



1. Introduction

The Islamic principles of exchange are crucial to an understanding of Islamic finance, as they form the basis of all Islamic finance transactions. Fiqh al Muamalat is a comprehensive body of principles and rules, designed to promote harmonious relations between contracting parties and the avoidance of the kinds of problems in contracting that can result in a falling-out of the contracting parties, leading to costly litigation and other misfortunes. Transactions in Islamic finance which do not comply with these principles and rules of contracting are not Shariah compliant and, apart from the fact that they transgress moral principles, may have negative consequences, such as non-enforceability of contracts or non-recognition of any resultant income.

Section 2 of this chapter introduces Islamic teachings relating to business and, in particular, certain prohibitions which, if not observed, impair the legitimacy as well as the enforceability of contracts. Section 3 provides an introduction to the major principles of Islamic contracting and sections 4 and 5 cover the major prohibitions in Islamic finance, namely Riba and Gharar. Section 6 is concerned with detailed rules of exchange and section 7 offers some concluding remarks.

2. Islamic Teachings Relating to Business

Learning Objective

3.1.1 Know the ethical precepts relating to Islamic business

2.1 Values to be Observed by Market Participants

Chapter 1 introduced the five main principles on which Islamic commercial and financial ethics are based. The Islamic ethical principles consist of a set of rules that should be respected by every Muslim and every institution claiming to be Shariah compliant. Hence, the objectives of Islamic financial services must be in line with the teachings of the Quran and Sunnah. The Prophet Muhammad (PBUH) emphasises the importance of ethical behaviour in commercial and financial dealing by identifying some ethical guidelines that a Muslim must follow:

- Do not lie to sell your products (principles of honesty and sincerity).
- Honour your pledges and trustee obligations.
- Do not deceive or defraud others.
- Do not offer or solicit bribes.
- Do not boast about your products.
- Do not sell products that have a negative influence on the society (principle of stewardship).
- Uphold justice in all your dealings and transactions with both friends and enemies. This implies that all customers must be treated fairly, for example, when imposing charges and fixing profit-sharing ratios (principle of sincerity).
- Do not value your trade higher than your Lord (SWT) or allow it to distract you from the call to prayer.

The above mentioned ethical behaviours apply to individuals as well as to institutions, commercial or otherwise.

2.2 Islamic Teachings Relating to Business

Learning Objective

3.1.2 Know the Islamic teachings relating to business

Based on the principles and foundation laid down by Shariah, the Islamic teachings relating to business are primarily structured by ten rules:

1. **Avoidance of Riba** – Riba is often translated by the term 'interest', but its literal meaning is 'excess'. In Shariah, it is defined as '*any excess compensation without due consideration*' and is banned. Any business agreement which includes an element of Riba is invalid from the Shariah point of view, even if the parties agree on the terms of the contract. To be lawful, any profit or benefit should be linked to the performance of a real asset and to its associated risk. The concept is explained in detail later in this section.
2. **Avoidance of Gharar** – the prohibition of Gharar is also a major tenet of Shariah. The term 'Gharar' means danger or hazard; it is related to the concept of harmful uncertainty or ambiguity. In a commercial transaction, Gharar normally relates to deceptive uncertainty, ignorance and lack of transparency that inadvertently lead to deceit, as well as outright fraud. An agreement that includes a significant element of Gharar is invalid from the Shariah point of view, irrespective of whether the parties agree upon such a contract or not. Gharar is explained in detail later in this section.
3. **Honesty and Fair Trade** – trade manipulation and malpractices (hoarding, using illegal markets, profiteering, cheating, taking advantage of a person in distress, manipulating numbers) are prohibited. The Quran stresses the importance of fairness in business: '*And, O my people, give full measure and weight justly, and defraud not people of their things, and act not corruptly in the land making mischief. What remains with Allah (SWT) is better for you, if you are believers*' (Surat Hud, 11:85).
4. **Disclosure and Transparency** – it is the duty of the seller to disclose all known faults in his goods to the buyer. The Prophet (PBUH) states: '*It is illegitimate for a Muslim to sell to his brother something with a defect without disclosing it to him.*' He also states: '*The parties of a sale have the right to cancel unless they depart each other; so if they tell the truth and disclose, their trade will be blessed. If they lie and conceal, the blessing of their deal will be lost.*'
5. **Avoid Misrepresentation** – a Muslim businessman should not make false declarations concerning their goods.
6. **Do Not Sell Over and Above the Sale of Another Person (Bai Alal Bai)** – a person cannot interfere in a transaction that has been concluded. When person X has sold goods to another (Y), a third party (Z) cannot interfere and try to reverse the trade by offering their own goods at a better price or by undermining the goods already sold by X. Bargaining is permitted in Islam, but all offers should be made before the deal is closed. The Prophet (PBUH) said: '*A person should not enter into a transaction when his brother is already concluding the transaction.*'
7. **Non-permissible (Haram) Items** – a Muslim can only trade goods and services which have been declared permissible (**Halal**) (lawful). Non-permissible (unlawful) items, such as wine and pork, are banned from any transaction. See chapter 6 for more detail on non-permissible items.
8. **Hoarding** – the Quran condemns hoarding and excessive affection for material wealth, particularly where it is not applied to helping the poor and supporting the needy. '*And those who hoard gold and silver and do not spend it for the cause of Allah (SWT) give them tidings of a painful punishment*' (Surat Taubah, 9:34).

9. **Sale of Goods and Services in the Open Market** – goods and services should be sold in the open market and parties – buyer and seller – must be aware of the state of the market before any transaction is concluded. Buyer and seller should not take advantage of each other's ignorance of the conditions and prices prevailing in the market. The Prophet (PBUH) said: '*Do not go out to meet the merchant in the way and enter into business transaction with him, and whoever meets him and buys from him when the owner of (merchandise) comes into the market he has the option (to cancel the transaction null and void if he finds that he has been paid less than the market price).*'
10. **Avoid Taking Advantage of a Seller's Helplessness (Bai' al-Mudtar)**: Islam judges that it is unacceptable to take advantage of the hardship of an individual who is forced, under duress or false pretences, to sell an item. Instead of purchasing this item and taking undue advantage of the seller's helplessness, the buyer should offer to help them.

The above rules prove that Islam links business and wealth creation to social values. The prohibition of interest (Riba), speculation (Gharar), non-permissible (Haram) items and hoarding can be related to the principle of stewardship, while honesty and fair trade, full disclosure, misrepresentation, Bai Alal Bai and the sale of goods and assets in the open market are based on the principles of integrity and sincerity. As for Bai Al-Mudtar, it is indirectly linked to the Islamic obligation to distribute obligatory charity and encourage voluntary charitable giving.

3. Principles of Islamic Contracting

Learning Objective

3.1.3 Understand the general principles governing contracts in Islamic law

There are a large number of principles governing contracts in Islamic finance. The most important ones are detailed in this section.[1]

3.1 Freedom of Contracting

In accordance with the principle of permissibility, all economic activities are permissible unless otherwise stated by Shariah. This results in the situation that the set of acceptable activities in daily and economic life ('aadat) is unlimited, although there are a limited number of prohibited activities.

It is, therefore, unnecessary to obtain proof that a particular transaction is acceptable; instead, special proof is required to establish that a transaction is not permissible. In the event two parties have contradicting opinions (one asserts a transaction is permissible and the other asserts it is not), the burden of proof is on the party asserting impermissibility, since permissibility is the default state.

1 Further detail on the most important principles governing contracting are available in Al Madkhal Al Fiqhi, by Sh. Mustafa Zarqa. A list of the most important 100 maxims of Shariah of the Majalla can be found at: www.iium.edu.my/deed/lawbase/al_majalle

3.1.1 Permissible Transaction Types

The principle of permissibility means that permissible transactions are not limited to those that are stated in classical texts of Fiqh, thus leaving room to create, innovate or design new instruments and arrangements as needed, as long as they avoid the incorporation of any prohibited elements. Although there are no special rituals associated with contracts, a fundamental component of all transactions is that they need to be undertaken by mutual consent, ie, all parties need to be in agreement. Consent is derived from the intention of the contract and can be expressed through words, deeds or any other means. This is emphasised in the Quran and Sunnah:

O you who believe, do not usurp your wealth among yourselves unjustly but as trade by your mutual consent. (Surat Al Nissa, 4: 29)

3.2 Actions are Judged by Objectives

All actions are judged by the objectives of the parties involved, not just their words. For example, if a person says, '*this item is yours for 10 dinars*', and the other accepts, this is considered to be a sales contract, despite the fact that the word 'sale' is not specifically mentioned. Equally, if a person was to say, '*this is a gift to you for 10 dinars*', the objective is to sell something for 10 dinars, even though the word 'gift' is included. In both cases, the substance of the transaction is that of a sale.

Example

A creditor asks a debtor to provide a guarantor (Kafeel). The debtor agrees on the condition that the creditor shall no longer pursue them for the debt, but the guarantor. The substance of this condition is a transfer of debt (Hawala) instead of a guarantee (Kafala) since, effectively, the debt has been transferred from the debtor to the guarantor despite the lack of the word 'transfer' in the arrangement.

In a Mudaraba transaction, the investor (Rab al Mal), as the principal, provides capital to the manager (Mudarib) as their agent to undertake a specific business activity. The two parties share the profits in accordance with a pre-agreed profit ratio and losses are born by the investor as the capital provider. The business manager is not responsible for any losses unless they are guilty of negligence. In the event that the investor stipulates that the agent needs to guarantee the capital, they will have to repay the capital under any circumstance and the transaction will need to be classified as a loan instead of a Mudaraba.

In an agency agreement (Wakala), the principal appoints another person as their agent (Wakil) to undertake a particular activity on his behalf. If, for example, the Wakil is appointed to purchase a specific asset and they buy the asset with the intention to keep it for themselves, the Wakil, and not the principal, is the owner of the asset. If the asset is subsequently damaged or stolen, it is the agent's responsibility. However, if the agent intended to buy the asset for the principal, and it is subsequently damaged or stolen without negligence or malpractice on the side of the agent, the agent is not responsible for the damage. To avoid disputes, the agent has to indicate at the time of purchase (by any means) whether the good is purchased for the principal or for themselves.

3.3 Do No Harm

As a general rule, causing harm to people, property, and the environment in general is prohibited.

3.4 Flexibility in the Case of Hardship

Although it is prohibited to use Islam as an excuse to dishonour contracts or to reject or deny obligations, Shariah provides the flexibility to avoid hardship.

Allah wants ease for you rather than hardship. (Surat Al Baqara, 2:185)

3

This principle can be applied to Islamic financial services in several ways. When converting a conventional (ie, interest-based) bank into an Islamic bank, a gradual approach could be taken since interest-based assets and liabilities cannot be repaid or called in immediately without incurring significant penalty charges. Instead, the transactions will be converted at maturity. The interest collected during the period can be used for non-profit activities or charitable donations.

Equally, when a debtor is in hardship and has difficulties paying, the creditor should assist the debtor in any way he can, and charging additional penalties is not permitted. A solvent debtor, however, has the obligation to pay.

3.5 Incorporation of Custom and Convention

Custom (‘urf) plays an important role in the execution of a contract or transaction. Any accepted custom is implicitly included in the transaction, even if it is not specifically mentioned.

Example

An item on the shelf in a shop in Malaysia has a price tag of 10. This is understood to mean 10 Malaysian Ringgit since that is the commonly accepted currency. A price tag of 10 in Afghanistan, on the contrary, cannot be assumed to be Afghani since, in Afghanistan, it is customary to pay either in Afghani or in US Dollars.

If it is commonly expected that the delivery of a purchased good is the responsibility of the seller, the buyer has the right to claim for compensation if the seller refuses to do so, even if this was not explicitly stated at the time of purchase.

If it is common practice for borrowers to regularly pay an additional amount of money to a lender in addition to the principal, this is equivalent to an explicit stipulation of interest and thus becomes Riba.

In other words, custom or common practice is considered to be equivalent to explicit stipulation of a term.

3.6 Liability Justifies Return

The benefit, yield, or return on an asset is rightfully owned by those who bear the physical risk of damage and loss.

This principle imposes a certain degree of symmetry and balance between rights and obligations. Liability cannot be separated from benefits or, in other words, risk cannot be separated from return. One cannot (or should not) bear the risk associated with an asset without being entitled to its benefits. Separating the two, therefore, is not acceptable.

4. Major Prohibitions: Riba

Learning Objective

3.2.1 Know the nature of Riba

3.2.2 Know the rationale for the prohibition of Riba

3.2.3 Understand the different types of Riba

As highlighted in section 3 of this chapter, the Principle of Permissibility implies that economic activities are acceptable unless otherwise stated by Shariah. This section focuses on the major prohibitions.

4.1 Nature of Riba

One of the most important rules of Islamic finance is the prohibition of Riba which is absolute and unqualified. The lexical meaning of the word Riba is excess, and is most commonly interpreted to mean interest in which case any addition over and above the loan amount is Riba. The prohibition of Riba is not unique to Islam but is common across Judaism and Christianity as well. Other faiths, such as Buddhism and Hinduism, as well as many philosophers (such as Aristotle), also have a negative disposition against **usury**.

One of the major underlying issues is that usury disassociates finance from the real economy and decouples debt creation from wealth creation. The divergence between debt and wealth allows debt to grow at a higher pace than wealth, resulting in what is often referred to as an 'inverted debt pyramid' – the situation in which increasing amounts of debt need to be serviced by a shrinking base of wealth and income. The income required to pay the debt does not grow at the same rate as the debt and thus the system becomes unsustainable. A correction must take place to balance income with the cost of debt servicing. These corrections most commonly take place via recessions during which excessive debt is written off. As a result, debt levels are restored to acceptable levels relative to real wealth and income.

In Islam, finance and real economic activity cannot be disconnected, and wealth creation and debt creation must take place simultaneously and at the same pace. As a consequence, Islamic financial instruments need to be associated with the exchange of goods and services. With the exception of non-profit, interest-free loans, all modes of Islamic finance must involve an aspect of ownership of an asset or service.

4.1.1 Riba versus Trade

A loan involves the exchange of two items identical in quality and nature but with a potentially unequal value or quantity. For example, money now for money in the future. A sale, on the contrary, is an exchange of two items that are different in quality and nature, eg, money for food. The defining feature of a loan, therefore, is the quality of the two sides of the exchange. In the event the quality is identical, then the transaction is characterised as a loan; in the event that they differ, then the transaction is characterised as a trade.

The difference between a loan and a trade is illustrated in figure 1.

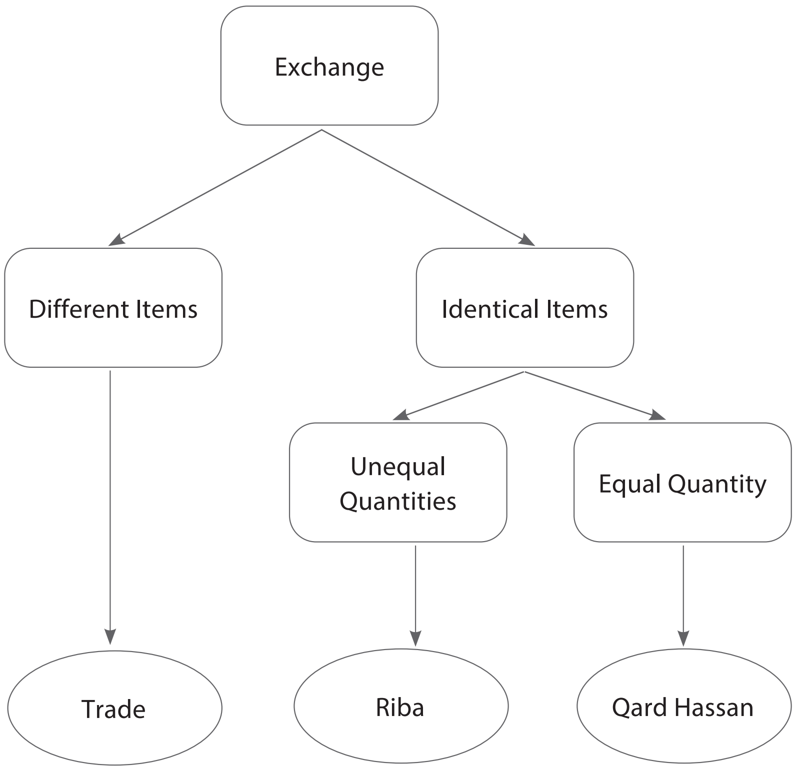


Figure 1: Loan versus trade

In other words, an exchange transaction is a:

- trade when the underlying items are of a different nature or quality, or
- a loan when the underlying items are identical in quality and nature. By nature, a loan is extended for a period of time since, as the parties exchange the same asset, there is no value in exchanging at the same time. Riba is associated with a loan where the borrower pays more than he has received (either goods or money). **Qard Hassan** (benevolent loan) is associated with a loan where the borrower repays the exact same value (either goods or money).

4.1.2 Trade and Wealth Creation

Trade fosters economic growth and encourages specialisation which is essential for wealth creation. Different people have different tastes, abilities, gifts, skills and experience. By allowing all participants to focus on their speciality, they can provide high quality goods or services which they can sell to others. With the income generated by their sales, they can purchase other goods and services. Specialisation enables each person to produce better quality and larger quantities of their product or service. However, the economy and individuals only benefit in the form of increasing wealth and prosperity if there is a market to trade the products and services.

A loan contract, on the contrary, involves the exchange of identical items and does not directly provide an incentive for specialisation and does not create wealth. In the event that the main activity of the community revolves around lending, borrowers are more likely to on-lend the funds rather than using the loan for the production of valuable goods or services, thus resulting in a lack of production and leading to a collapse of the economy. Although it is possible for some members of a community to live off interest income, a whole community cannot live off mutual indebtedness.

4.1.3 Sale with a Deferred Price Payment

One of the most important instruments of Islamic finance is sale with a deferred payment (Murabaha). It meets the requirements of a person who needs to obtain specific goods or services, with payment deferred to a future date. The deferred price is typically higher than the current price, reflecting time value. Shariah recognises time value in a sale and charging a higher price for deferred payment is permitted, as long as the price is determined at the time of sale.

There are similarities between the mark-up on a sale and interest on a loan in that both represent a premium for time value. However, Riba is prohibited due to the fact that it allows the debt to grow on its own, thus leading to the destruction of wealth. A sale with a deferred price, on the contrary, integrates debt creation with wealth creation. The debt cannot grow on its own, but is capped by real wealth-creating activities. Trade, with or without financing, is beneficial to all parties.

4.1.4 Types of Riba

There are three types of Riba:

1. **Simple interest** – applies to any loan of any type including money. Scholars are in agreement that any stipulated addition on a loan, whether a loan of money or goods, is Riba. Sometimes, also referred to as loan-Riba.
2. **Compound interest** – compound interest is interest on unpaid interest and occurs when a loan is extended beyond its original maturity date without any repayment. For example, a borrower has a loan of $1,000 at interest of 5% for one year. At maturity, he does not pay the debt of $1,050, but agrees with the lender to reschedule the payment for one year at an additional 5%. Effectively, the lender is lending the borrower a loan of $1,050 at 5% to pay off his previous debt. The result is a new payment at maturity of $1,050 + 5% = $1,102.50. Simple interest thus leads to compound interest. Compound interest is sometimes also referred to as debt-Riba.
3. **Sale-based Riba** – this type of Riba is associated with what are known as the **Ribawi commodities** (gold, silver, wheat, barley, dates and salt). In this case, both sides of an exchange are similar, but not identical. For example, gold and silver are similar since both can be considered to be a form of money, but they are not identical. This equally applies to, for example, the dollar and the euro. In brief, if the two sides of an exchange are similar, ie, neither identical nor sufficiently different, and the assets are of a certain type, their exchange will be subject to restrictions.

Ribawi commodities are explicitly stated in the following Hadith:

Gold for gold, silver for silver, wheat for wheat, barley for barley, dates for dates, salt for salt, hand in hand, like for like, in equal amounts. If these species differ, then sell as you like, as long as it is from hand to hand.

The essence of the statement '*if these species differ, then sell as you like*' is that a sale is an exchange contract in which the commodity on each side is different, while Riba involves the exchange of two identical or similar items.

The rules implied by the Hadith are summarised in the table below where each cell represents the requirements for exchange of the commodities in the row and column. For example, exchanging gold for silver requires that both are exchanged immediately or from hand to hand, although the quantity may differ. Exchanging gold for gold requires the two sides to be both spot and equal.

	Gold	Silver	Wheat	Barley	Dates	Salt
Gold	Δ =	Δ	√	√	√	√
Silver	Δ	Δ =	√	√	√	√
Wheat	√	√	Δ =	Δ	Δ	Δ
Barley	√	√	Δ	Δ =	Δ	Δ
Dates	√	√	Δ	Δ	Δ =	Δ
Salt	√	√	Δ	Δ	Δ	Δ =

Δ Both sides must be spot or from hand-to-hand.

= Both sides must be equal in quantity.

√ Exchange is not subject to any restrictions beyond the general rules of trade.

Source: R. Al-Masri: Al Jame' fi Usoul Al Riba, 1999, p. 94

Ribawi commodities can be grouped in two main groups, each with specific restrictions associated with them:

1. Gold and silver (money).
2. Wheat, barley, dates, and salt (staple food).

Between the two groups, there are no specific restrictions other than the general rules of exchange.

It is clear from the table that, as the commodity on each side of the exchange becomes more similar, the restrictions become stronger. Diagonal elements in the table, for example, are associated with transactions in which the same commodity is exchanged and are subject to maximum restrictions.

Three main levels of restrictions can be distinguished:

1. Same commodity on both sides of the transaction – both sides of the exchange must be immediate (spot) and equal.
2. Different commodities from the same group – the exchange needs to be immediate (spot), but does not have to be equal.
3. Commodities from different groups – minimum restrictions apply as mentioned in the Hadith 'if these species differ, then sell as you like'.

These types of interest are referred to under the following Arabic names:

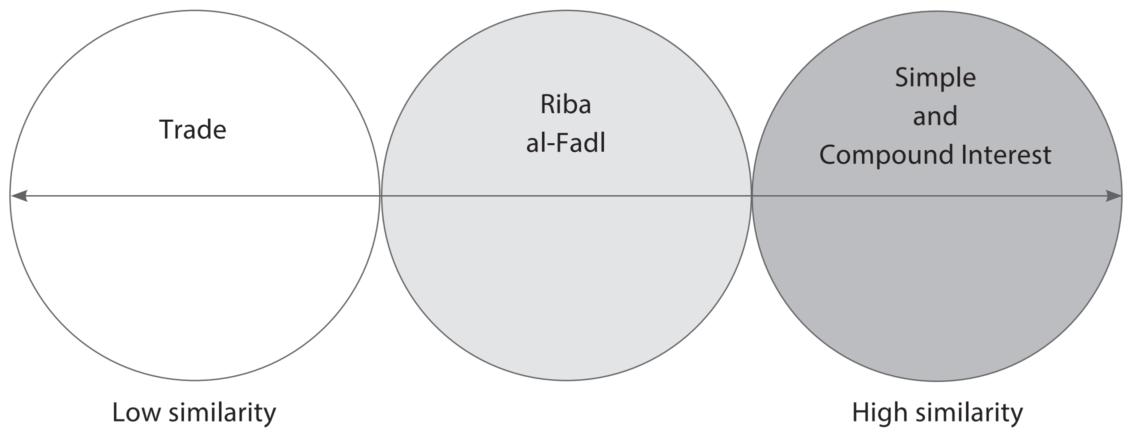
- Simple interest – **Riba al-Naseeyah**.
- Compound Interest – Riba al-Naseeyah/Riba al-Jahiliyyah.
- Sale-based Interest – **Riba al-Fadl**.

Scholars generally agree that Riba al-Fadl is a preventative measure against simple interest. The six commodities mentioned in the Hadith were, at the time of the Prophet (PBUH), considered to be necessities of strategic value and are fungible. In combination, these features ensure the Ribawi commodities are likely to be borrowed and lent and exposed to simple and compound interest.

Example

The sale of one ounce of 21 carat gold versus deferred delivery of two ounces of 18 carat gold, for example, is technically not a loan, as the two sides are not identical. However, the exchange involves a non-permitted financing element on the same commodity.

The degree of similarity is represented in the following figure:



From the figure above, it follows that:

- Transactions involving identical commodities are subject to the restrictions of single interest or loan-Riba.
- If the commodities are different, the exchange is considered to be a trade and not subject to Riba.

In between these extremes, where the commodities are not identical, but similar, the transaction is subject to the restrictions of Riba al-Fadl, which are less limiting than simple interest or loan-riba transactions.

The minimal restrictions associated with trade clearly show the emphasis on trade and wealth creation as one of the major objectives of Islamic economics.

5. Major Prohibitions: Gharar

Learning Objective

3.3.1 Understand the nature of Gharar

3.3.2 Know the rationale for the prohibition of Gharar

3.3.3 Understand the different types of Gharar

5.1 Nature of Gharar

The lexical meaning of the word Gharar is risk, ie, being exposed to harm or damage, but also implies deception and delusion (Al-Dharir, pp. 50-54). Classical scholars define Gharar as follows:

- Gharar is the risk in which existence and non-existence are equally likely (Al-Kasani).
- Gharar is the indecisiveness between two states, one of which is in line with the objective, the other is against it (Al-Dusuqi).
- Gharar involves two possibilities, the most likely of which is the most feared (undesired) (Al-Dusuqi).
- Gharar is the indecisiveness between two states: safety and damage (Ibn Taymiah).

In other words, Gharar is uncertainty that involves risk, ie, possibility of failure, damage or loss in which the likelihood of loss or failure is substantial. Consequently, a risk with a small or insignificant probability of uncertainty is not considered to be Gharar, cannot be avoided in practice and is often described as 'minor Gharar'. Gharar mainly applies to sale transactions (Uqood al-Muawadat). Gharar is, however, permitted in charitable transactions due to the fact that there is no loss associated with giving donating funds to charity.

Example

Classical examples of Gharar include:

- Sale by means of pebbles (Bai al-Hasat) – sale transaction in which the price is determined up front, but the good sold is determined by throwing a pebble on a collection of various goods of different qualities and values after the price has been agreed. The item that touches the pebble becomes the subject of sale. There is a risk of loss to one party for the benefit of the other, since the final object of sale may be of higher or lower value than the pre-agreed price.
- Sale of a lost camel for an agreed price. The price is discounted to reflect that the camel is lost and may not be found again. If the buyer finds the camel safe and intact, they benefit; otherwise, they lose the amount paid.

In a commercial transaction, Gharar may, for example, result from omissions or lack of clear descriptions in the contract. Ambiguities or anomalies can inadvertently lead to deceit as well as outright fraud. Any agreement subject to a significant element of Gharar is invalid from a Shariah point of view, regardless of whether the parties have agreed the contract.

In the context of modern-day finance, examples of Gharar include:

- buying a house for which the price will be determined in the future
- selling a lost or stolen car
- selling an existing car but without revealing the full specifications, or
- selling equity at a fixed price for an undisclosed company.

Gharar can be avoided, however, if the affected party has the right to cancel the sale in the event the outcome is not in his favour. Gharar does not apply where the asset sold is one of many items of the same kind and value, such as mass-produced goods.

5.2 Types of Gharar

5.2.1 Gambling (Qimar)

The most obvious form of Gharar is gambling (**Qimar**), which involves profiting from luck or destruction (harming the other party), and is not associated with productive skill or useful work. It destroys responsibility and morale and may cultivate hatred and enmity among parties. Gambling involves 'eating wealth for nothing' (akl-ul mal bil batel), ie, taking the wealth of another party for no useful consideration.

Gambling is characterised as a transaction in which each party is either a winner or a loser (Al-Dharir, p. 621) such as, for example, a lottery. Trading financial derivatives is an example of Qimar in modern finance since they result in the profit of one party to the loss of the other. A gamble does not benefit both parties in the same way and has a highly uncertain outcome. One party gains at the expense of another.

An easy way to verify whether or not a transaction is considered to be gambling is to assess whether the outcome of the transaction is known in advance. If, in the absence of uncertainty, one of the parties would not enter into the transaction, it does not serve the objectives of both parties, and one party would gain at the expense of the other. Conversely, a trade benefits all parties, even when the outcome is uncertain.

A trade can easily be distinguished from a gamble or a bet by considering whether the uncertainty has an impact on whether it will be executed. In other words, one of the parties will:

- still execute a trade whether there is uncertainty or not, or
- not execute a gamble if the outcome is certain.

5.2.2 Major and Minor Gharar

Not all Gharar is gambling, however, since, in some cases, it might be possible for both parties to gain, even though there is Gharar involved.

Example

Sharecropping (Muzara'aah) – in this transaction type, a farmer agrees to farm the land of a landowner in return for a pre-defined percentage of the crops. The farmer usually bears the cost of farming. If the size of crop is sufficiently large, the farmer will be able to recover his costs and generate a profit after having given the landowner his share. In this case, both the landowner and the farmer profit. However, in the event the crop is inadvertently small, the farmer may not be able to recover their costs.

Sale of fruit yet to be harvested – at the time of the Prophet (PBUH), it used to be common to purchase fruit ahead of the harvest season in order to obtain a better price and to ensure purchasers could obtain the amount of fruit required. However, it frequently occurred that the harvest did not yield the expected crop and so the buyer would lose (part of) his purchase price. In order to avoid disputes, the Prophet (PBUH) instructed that fruit could not be purchased before it starts to ripen.

When a transaction has the possibility of resulting in either a win-win or a win-lose, it is subject to two kinds of Gharar:

1. **Excessive or Major Gharar (Gharar Katheer)** – transactions in which the win-lose outcome is either significant or the dominant outcome. This type of Gharar is forbidden since it leads to obtaining wealth for nothing and may be harmful to society.
2. **Minor Gharar (Gharar Yaseer)** – transactions in which the mutual gain (win-win) outcome is the dominant outcome of the transaction, while the win-lose outcome is negligible or insignificant. In other words, the objective of the two parties is to achieve mutual gain, rather than creating wealth at the expense of the other. This type of Gharar is permissible and the transactions are acceptable.

In an **Arboon** transaction, the buyer makes a non-refundable down payment against the purchase price of a specific asset. The buyer retains the right to cancel the purchase within a specified period, but will lose their down payment in the event they decide to cancel. If the buyer continues with the purchase, they only pay the difference between the original purchase price and the amount of the down payment. The Arboon transaction, therefore, has two possible outcomes: win-win if the purchase is concluded, and win-lose if the purchase is cancelled by the buyer.

Some scholars question the validity of the Arboon sale due to the possibility of the win-lose outcome. However, the general agreement among scholars is that the win-lose outcome is permissible as long as it is not a significant possibility and the parties are better off to conclude rather than to cancel the trade. The OIC Fiqh Academy ruled that Arboon sale is permitted.

The following table summarises the types of Gharar and how they compare with gambling.

Type	Outcomes	Condition	Shariah Position
Gambling	win-lose, lose-win	no mutual gain	unacceptable
Major Gharar	win-win, win-lose	win-win is not dominant; win-lose is significant	unacceptable
Minor Gharar	win-win, win-lose	win-win is dominant; win-lose is insignificant	acceptable

Every transaction that has the possibility of a win-lose outcome is subject to an element of Gharar. However, Gharar only becomes major, and thus not permitted, if the win-lose outcome is significant. In the case of gambling, the only outcome is win-lose and it is therefore, by nature, the dominant outcome and one of the most obvious forms of forbidden Gharar.

6. Rules of Exchange

Learning Objective

3.4.1 Understand the concept of profit and liability

3.4.2 Know the rationale for being liable for a good or service

In addition to the rules concerning Riba and Gharar, Shariah provides a set of detailed rules related to trade and exchange. These rules aim to clearly draw the line between legitimate trade and illegitimate Riba or Gharar. While Shariah rules are clear on Riba and Gharar, there are grey areas between Riba and trade that need to be carefully considered in a transaction.

6.1 No Profit without Liability

The Prophet (PBUH) forbade making a profit without being liable for it (narrated by, among others, Ahmad, Tirmithi, Nasa'ie). In this context, profit means the difference between the purchase price of a good or service and its sale price, and liability (**dhaman**) refers to the responsibility for physical risks associated with the good or service. To understand how and when a person becomes liable for the asset or service, it is important to understand the concept of possession (qabdh).

Possession depends on the type of asset. For example, when purchasing something from a shop, it is physically handed over from the seller to the buyer. Social media accounts are owned via a user ID and password, and possession of a house is taken by obtaining the keys.

No matter how possession is obtained, it involves the ability to utilise the good or service. Once the buyer has taken possession, they become liable for it.

Example

Ahmed purchases a laptop from a computer store on Monday, at 2:00pm, for $1,500. The sales representative asks Ahmed to come to pick up the laptop the next morning at 10:00am. During this period, from 2:00pm Monday till 10:00am Tuesday, Ahmed is unable to utilise the laptop he purchased since he does not yet have it in his possession.

After Tuesday 10:00am Ahmed becomes liable for the laptop, irrespective of whether he has picked it up or not. Therefore, if the laptop is damaged after that time, without negligence or wrongdoing of the store, then he is responsible for it. Before that, however, the store is responsible.

In the event Ahmed receives an offer to sell the laptop before 10:00 am on Tuesday for $2,000, he cannot accept the offer due to the fact that he does not possess it yet. If he accepts the offer, he is making profit without being liable for the underlying good.

The rationale for possession is that if an asset can be purchased and sold at a profit without taking responsibility for the risk, the seller is making money without being liable for any real good or service which, in substance, is Riba. As a consequence, it is prohibited to pay for something and then sell it at a profit without taking responsibility (possession) for the underlying good or service.

Settlement

Settlement involves the seller receiving the money and the buyer receiving the goods or service. Until the transaction is settled, the seller remains liable for the asset; once the transaction is settled the liability moves over to the buyer.

In financial markets there is usually a two-day gap between the time a contract is executed and the settlement. From a Shariah point of view, this means that an investor who purchases an asset at a certain price at time 'T' must not sell that asset for a higher price (ie, to make profit) before the settlement date. If he sells prior to this time, any profits will be illegitimate because the investor has not taken possession of the asset.

Real-Time Gross Settlement (RTGS)

Real-time gross settlement (RTGS) is a system that performs settlement in real time, ie, at the same time of execution of the trade. Due to the fact that there is no gap between the time of contracting and the time of settlement, assets purchased through this system can be sold for a profit at any time after the trade is executed.

Currency Exchange

As outlined in section 4.1.4, trading gold for silver requires both sides of the transaction to be exchanged immediately. From the perspective of Shariah, spot is taken to mean instant possession and thus trading currencies on delayed settlement systems (eg, T+2) is a violation of the requirements. However, given the limited availability of alternatives, and the fact that businesses have a need for foreign currency this violation is forgiven based on the maxim 'flexibility in case of hardship'.

However, as technology improves, and given the increasing availability of RTGS in currency transactions, Islamic banks and businesses should, where possible, perform their currency transactions through RTGS. Not only is RTGS Shariah compliant, it is less risky and offers investors better protection.

6.2 Do Not Sell What You Do Not Have

Learning Objective

3.4.3 Understand the concept of selling what you have

3.4.4 Know the rationale prohibiting the sale of what you do not have

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The concept 'what you do not have' refers to the combination of ownership or authority, possession and control. In order to be able to sell an asset, the seller needs to either own the asset or be authorised to sell it, and be in control of it (ie, be able to deliver it). An agent who acts on behalf of the owner to sell an asset is able to do so since he is authorised to do so by the owner, and is in control of the asset. 'What you do not have', therefore, can be distilled into the following:

1. The seller has the legal ability to sell, ie, they own the good, or has permission of the owner to sell on their behalf.
2. The seller has the physical ability to deliver the good, ie, they have it in their possession.
3. The seller can control the asset.

A sale is valid when point 1 (ownership or authority) is fulfilled in combination with either one of the other two (possession or control). Solely having the asset in possession and having control over it is, however, not sufficient.

Example

The following are examples of invalid sales:

1. Sale of a car by the owner, but the car has been stolen from them – the seller legally owns the asset but is not able to deliver the car since it has been stolen.
2. Sale of a stolen watch by the thief – the seller does not legally own the asset, but is able to deliver it.
3. Selling an asset without authorisation – if an agent is in the possession of an asset and has control of it, but is not authorised to sell the asset by the owner, they are physically able to deliver, but is legally not entitled to sell the asset.

It should be emphasised that the ability to deliver should be judged not on the basis of subjective expectations, but on the basis of objective indicators showing the actual ability of the seller to deliver.

Example

On the basis that not all travellers show up for a flight they have booked, airlines tend to sell more tickets than they have seats on a flight. As a result, they are selling something they do not own since they are no longer able to deliver the service.

There are a variety of ways to avoid the violation of this rule, such as keeping passengers wait-listed until a seat becomes available.

6.2.1 Financial Derivatives

The global financial crisis of 2007–08 showed how deviating the financial sector from its role in serving the real economy can be harmful to society. Many financial instruments have a claim on assets but are not connected to these assets.

Example

Credit default swaps (CDSs) are insurance contracts against loans or debts. However, the buyer of a CDS on debts of a specific entity does not need to have any relation to or interest in that entity. In this case, the buyer of the CDS is not insuring anything, but is simply betting that the underlying asset will default, and they will, therefore, be able to collect in compensation more than what they paid in premiums.

A short sale is a sale in which the seller sells shares they do not own for a delayed delivery date in the expectation that the price will drop. Short sales can either be covered (the investor borrows the shares against a fee) or naked (the investor does not own or borrow the shares). At maturity, these contracts are typically settled in cash.

Derivatives contracts are detached from the **underlying assets** and are simply side bets on these assets. Derivatives are not permitted in Shariah.

6.2.2 Islamic Instruments

Within Islam, selling what one does not have is generally not permitted. This rule does, however, not apply to two transaction types: **Salam** and **Istisn'a**.

A Salam transaction is a sale contract in which the full price is paid in advance, while the delivery of the good is delayed to a predetermined date in the future. Salam transactions are typically applied to agriculture. The good does not have to be available at the time of contracting, but this does not imply the seller is selling something he does not own for two reasons:

1. The seller receives the full price upfront, which is a required condition for the Salam contract. The price helps the seller to be able to deliver the future goods. By receiving the full price upfront, the seller actually has the means to deliver the goods.
2. Since the future goods is a debt obligation on the seller, the terms of the contract must give the seller sufficient room to be able to arrange for the delivery at maturity. For example, the delivery date must be set so that the seller has enough time to manage delivering the goods.

The specifications of the goods must be sufficiently flexible so that the seller is able to obtain the goods from alternative sources and not be restricted to a particular source.

A very short horizon for delivery or very restrictive specifications of the goods will make it highly risky for the seller to meet his obligations, and thus make the transaction very close to the domain of 'selling what one does not have'.

The Istisn'a transaction is a production contract in which the seller agrees to produce or manufacture the desired asset to be delivered to the buyer at the agreed date. The producer contributes material and labour to produce the agreed product. Similar to Salam, the producer does not have the goods at the time of contracting. Unlike Salam, however, the full price is not necessarily paid in advance, but based on a payment schedule that is agreed between parties. The payment could be fully in advance, gradually over the production period, include a balloon payment at the end, or any other schedule agreed between parties.

Another important difference between Salam and Istisn'a is that, in Salam, the seller does not need to be the producer of the goods sold. Contractually, therefore, the seller in a Salam transaction is not required to put in any work or effort to produce the goods; they can simply buy it at maturity from the market and deliver it to the buyer.

In contrast, in Istisn'a, the seller needs to undertake the work to produce the agreed product. This means the producer must have the skill and expertise required.

6.3 No Debt for Debt

Learning Objective

3.4.5 Understand the concept of debt for debt

3.4.6 Know the rationale prohibiting the sale of debt for debt

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The exchange of a debt for a debt is prohibited. One of the main forms of debt for debt exchange is to purchase a good in such a way that both the price and the good are debt obligations, and both the payment and the delivery of the good are deferred to particular date(s) in the future.

Debt for debt relates to the exchange of an existing debt with a new debt, eg, by combining two debts into one and issuing a new debt to increase an existing debt. The rationale for this restriction relates to the link between finance and real economic activity. Debt for debt exchange creates debt obligations without real transactions, ie, without possession of any tangible object at the time of contracting. The restriction only applies to debt-creating transactions and not, for example, to Istisn'a transactions, where the responsibility of the producer is not strictly a debt obligation, but a conditional obligation. If the producer is unable to produce the asset for reasons beyond his control without committing negligence or wrongdoing, they are exempt from this obligation and the contract is dissolved. If the buyer has paid any down payment, however, the producer is indebted only for this amount and he must repay it to the buyer. In Salam, the seller is indebted to deliver the agreed goods and the obligation cannot be dissolved by an inability to deliver, even if this inability does not arise from negligence or wrongdoing. The obligation of the seller in Salam, therefore, is stronger than that of the producer in Istisn'a.

One instrument that was famous in Madinah is called 'sale in the way of the people of Medina'. This is similar to a modern day supply contract in which a buyer agrees regular delivery of specified goods over a given period with a seller such as, for example, a butcher, baker or greengrocer. Both the payment and the delivery of the goods are deferred. This is not considered to be a form of debt for debt for the following reasons:

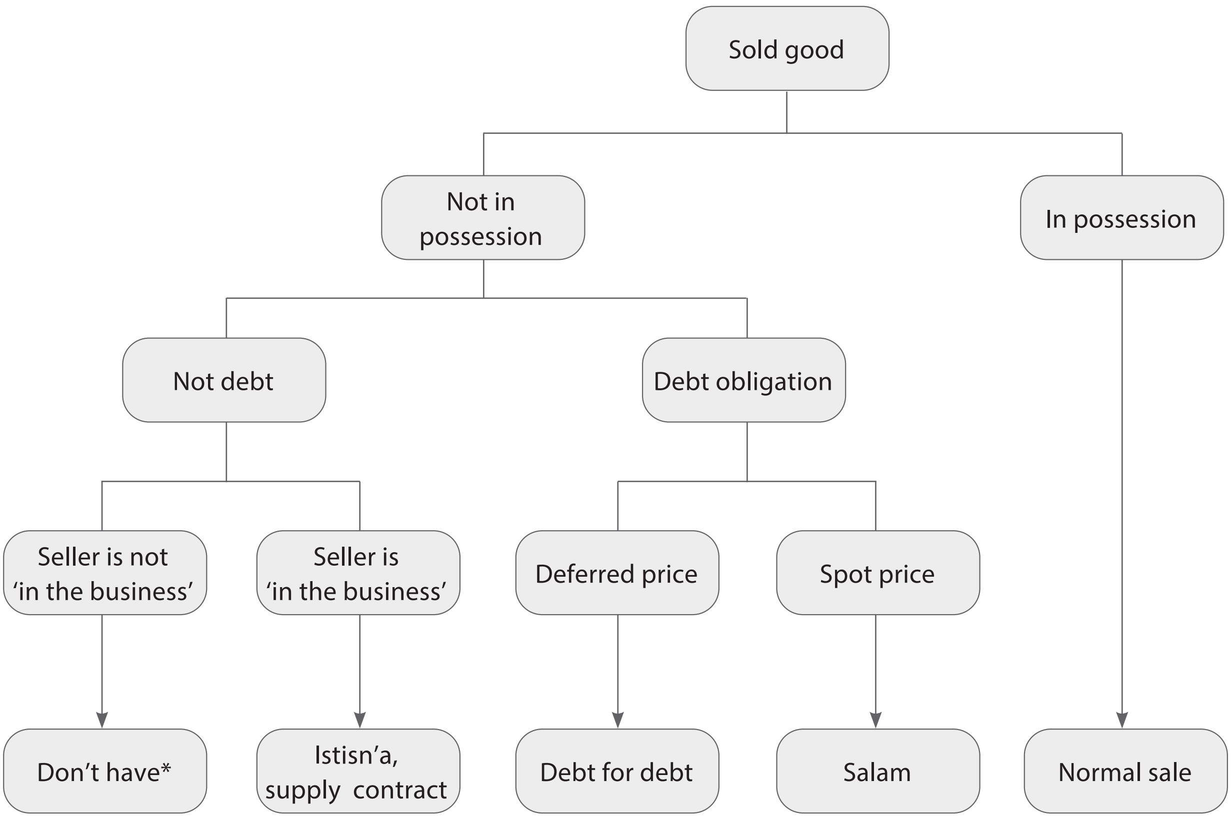
1. The seller in a 'Medina's sale' is the dedicated seller who is in the business of providing this type of goods and is, therefore, able to supply the goods on regular basis. Hence, the goods sold through this arrangement are not strictly debt; they are effectively or constructively available.
2. If the seller is unable to deliver for reasons beyond their control (eg, if they die), the contract is automatically dissolved and obligations are exempted (unless the buyer made a down payment, in which case the down payment will be a debt to be repaid).

This is consistent with the principles governing Istisn'a and is in harmony with business operations that meet the real needs of businesses and individuals.

Supply contracts do not fall within the range of debt for debt since they are associated with the business the supplier is in and their obligations are conditional, not a fixed debt.

6.3.1 Islamic Instruments – an Overview

The diagram below provides a simple overview of Islamic instruments and how they differ from unacceptable arrangements discussed above:



* See section 6.2 for the explanation of 'don't have'.

6.4 Two Sales in One

Learning Objective

3.4.7 Understand the concept of two sales in one

3.4.8 Know the rationale prohibiting two sales in one

The Prophet (PBUH) forbade combining two sales in one sale. While scholars provide a diversity of interpretations of the Hadith, they generally agree that combining contradictory or inconsistent contracts together is unacceptable. This Hadith is a cornerstone for financial engineering in Islamic finance.

Combining this restriction with the principle of permissibility, it can be concluded that innovation and creativity in Islamic finance should be directed towards fruitful and value-adding arrangements. Combining two or more contracts, therefore, is restricted only to situations where combining the two contracts does not add value. However, if the contracts are in agreement, the combination may bring in value that could not have been achieved by treating the contracts separately. The latter combination of contracts is not permitted.

Istisn'a can be viewed as a combination of Salam and leasing of labour. The producer sells his services (which is the use of his skills), but also undertakes to contribute material for the produced good, which is similar to Salam. However, the final outcome of the combination is different and results in a new contract with unique properties that are not shared with its constituents.

Combining multiple contracts into one is allowed under the principle of necessity (Darurah) and has the potential to effectively create an infinite number of financial contracts. The combination of contracts needs to add value and should not violate Shariah.

6.4.1 Controversial Contract Combinations – Bai al-Inah

Example

Bai al-Inah is an arrangement in which two legitimate sales contracts are used to arrive at an illegitimate outcome involving Riba. The structure is as follows:

1. 'A' buys a mobile phone for immediate delivery from 'B' for a deferred price of $1,000 to be paid in six months.
2. Now that 'A' owns and possesses the mobile phone, he sells it back to 'B' for a cash price of $950.

The final outcome of these two steps combined is that 'A' obtains $950 cash from 'B' and has to pay 'B' $1000 in six months. So, the result is simply a loan with a stipulated addition from 'B' to 'A', which is Riba.

The majority of scholars forbid the combination of contradictory contracts such as Bai al-inah because it is Riba in substance. Imam Al-Shafi'i however argues that people are free to trade as they wish (the principle of freedom of contracting). Therefore, unless the two parties explicitly state that their objective is to exchange money now for more money in the future, people cannot be prohibited from contracting as they want. Imam Al-Shafi'i nonetheless clearly states that if the two parties had the intention to reach this outcome, even without explicitly stating it, the transaction is questionable on moral grounds.

However, in court, the judge cannot invalidate the transaction because there is no explicit evidence that the two parties planned to reach that outcome. The majority of scholars concede that the objectives and practice of the two parties clearly indicate that the transaction aims to provide a loan with interest (the principles of actions are judged by their objectives, and custom and convention govern transactions).

As discussed in chapter 1, there are two dimensions through which Shariah judges actions:

1. Moral dimension.
2. Judicial dimension.

While Imam Al-Shafi'i emphasises the explicit stipulation of the two contracts in order to invalidate the transaction in court, he does point out that, morally, the parties should not pursue this objective.

There are many reasons why 'inah is inconsistent with principles and objectives of Shariah:

1. It is clear that the asset adds no value to the buyer and is used only to legitimise the loan. If the good was of value to the buyer, they would still be interested in buying it if they had the money available. To buy a good of no value whatsoever is considered to be misuse of wealth (Israf).
2. By intending to sell the good for a price below the purchase price, the buyer is not acting as a rational investor who seeks to create wealth and generate positive returns. This also falls under misuse of wealth (Israf).
3. Transparency is one of the ethics of business activities in Islam, but 'inah creates a situation in which the two parties cannot be transparent in stating their objective of the arrangement, which is to obtain a loan with a stipulated addition.
4. Since the good used in 'inah is redundant, it can be used over and over again in other transactions without limitation. Consequently, huge amounts of debt can be created by using a single good. This allows for the creation of an inverted-debt pyramid with the value of the good at its base, while the layers of debt on top are created by a potentially unlimited number of 'inah transactions.

6.4.2 Controversial Contract Combinations – Tawarruq

Tawarruq is a sale transaction in which A buys an asset from B and sells it to a third party C. As long as C is independent of B, and the two transactions are completely separate, Tawarruq is considered permissible, although many scholars consider it as undesirable (Makrouh).

If B is involved in the second sales transaction, eg, as an agent for A to sell the goods to C, the transaction becomes what is known as organised Tawarruq. Most scholars consider organised Tawarruq unacceptable given the explicit role of seller B in providing funds to buyer A, thereby making the two transactions structured and arranged explicitly to create a financing arrangement. The OIC Fiqh Academy ruled that, while Tawarruq is permitted, organised Tawarruq is not.

Reverse Tawarruq is another variety of this product family. In this structure, B provides funds to A as an agent to buy and sell goods on behalf of B. A, therefore, purchases the goods against spot payment from the broker on behalf of B. Next, A will buy the same goods for a deferred higher price. Subsequently, A will sell the goods to a third party, C, for cash. Once the transaction is finalised, A has a deferred obligation to B to repay an amount of money higher than the amount he originally received. The OIC Fiqh Academy ruled that reverse Tawarruq, like organised Tawarruq, is not acceptable.

6.4.3 Controversial Contract Combinations – Bai al-Wafa

In a Bai al-Wafa arrangement, A sells a good to B for a cash price, with A having the right to cancel the sale, return the money and receive the asset back. The right to cancel (**khiyar al-shart**) is a legitimate option in a sale transaction which gives the holder the right to unwind the sale transaction and return to the position prior to executing the transaction. It is a means to protect the party from unseen or unknown circumstances that might negatively affect their position.

The right to cancel can, however, also be used in a manner that creates an illegitimate outcome, in this case a loan with interest. The two parties agree that A will lend B an amount of money equal to the cash price of the good. The interest on the loan will be benefits derived from utilising the good during the loan period. If the good is a leased asset, the interest will be rent payments. The OIC Fiqh Academy has ruled that Bai al-wafa is a loan with interest in substance, and is therefore unacceptable.

6.5 Challenges for Product Innovation

Islamic banks operate in an environment dominated by interest-based lending. The Islamic financial industry is less than 2% of the global financial industry. Many clients of Islamic banks have a preference for Shariah-complaint financial services but still look for products that are comparable to conventional, interest-based products. Islamic banks may, therefore, find themselves in a position where they need to be more pragmatic, at least for a transitory period. While ‘inah have widely been applied in Malaysia, the central bank, Bank Negara Malaysia, has decided to restrict the application of ‘inah in order to encourage the industry to move to the next stage in their evolution towards realising the full objective of Islamic finance.

For the Islamic finance industry to achieve the objectives of Islamic economics, it needs to keep the rate of innovation relatively high in order to be able to not only compete with its conventional counterparts, but also to be able to be a step ahead and offer genuine Islamic products that serve the needs of its clients while satisfying the objectives of Shariah.

7. Concluding Remarks

The principles of Islamic finance represent a coherent system of financial activities that aim to create wealth and achieve prosperity for the community. While there is a diversity of interpretations of Shariah rules, these interpretations tend to share common understandings that ultimately serve the objectives of Shariah and meet the needs of parties with respect to justice, transparency and mutual gain.

The preceding discussions aim not only to clarify Shariah rules of exchange and contracting, but also to understand the rationale behind them and understand how to apply them in contemporary markets.

End of Chapter Questions

1. List the values to be observed by market participants.
   Answer reference: Section 2.1

2. Name seven of the ten rules relating to commerce.
   Answer reference: Section 2.2

3. What is the key difference between a loan and a trade?
   Answer reference: Section 4.1.1

4. Which type of Riba is associated with Ribawi commodities?
   Answer reference: Section 4.1.4

5. Within Riba, what are the three main levels of restrictions?
   Answer reference: Section 4.1.4

6. Define the nature of Gharar.
   Answer reference: Section 5.1

7. When does Gharar become major Gharar?
   Answer reference: Section 5.2.2

8. Why are derivatives contracts not permitted in Shariah?
   Answer reference: Section 6.2.1

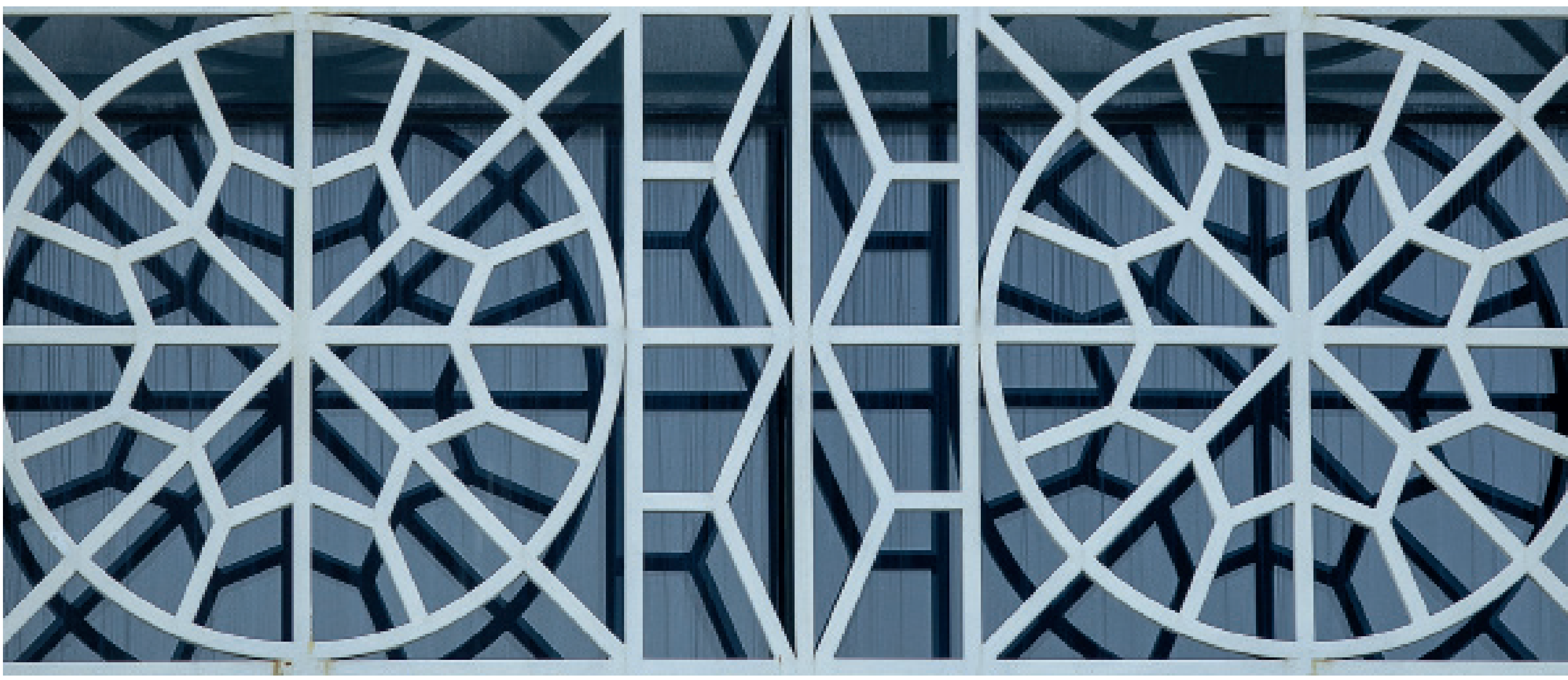
9. What is the key difference between Salam and Istisn'a?
   Answer reference: Section 6.2.2

10. Name the three controversial contract combinations.
    Answer reference: Sections 6.4.1–6.4.3

Chapter Four

Basic Contracts and their Treatment

This syllabus area will provide approximately 15 of the 100 examination questions



1. Introduction

This chapter outlines the main types of contract: contracts of exchange, with particular reference to sale contracts; contracts for the transfer of **Usufruct** (the right to use an asset), ie, lease contracts; partnership contracts; and contracts providing security, such as guarantees and mortgages; and, finally, foreign exchange contracts.

The types of contract described in this chapter are sometimes referred to as the 'nominate contracts' and form the very basis of Islamic finance.

2. Contracts

Fiqh al Muamalat, Islamic commercial law, includes a key section that deals with contracts. The law of contract is at the core of any commercial legal system and this applies in the same way to Islamic commercial law. In Shariah, principles and rules of valid contracts help parties to conduct their business so that it meets the requirements of Shariah. Three generic types of undertaking exist between two parties, each of which is briefly described below. The first is the actual contract and the other two are preliminaries to a contract, and these have generally been deemed binding on the party giving the undertaking, particularly in the context of modern Islamic banking and finance.

- The **Aqd**' (the contract).
- The **Wa'd** (unilateral promise).
- The **Muwaada** (bilateral promise).

2.1 Contract (Aqd')

Learning Objective

4.1.1 Understand the fundamentals of Aqd' (contract): contracting parties; subject matter; consideration; offer and acceptance

2.1.1 Definition

An Aqd' or contract is a transaction that is executed between two or more parties for mutual benefit and with mutual consent. Aqd' covers all types of contracts and is valid if it meets the following criteria:

- There must be at least two independent eligible parties.
- There must be offer and acceptance relating to both price and asset.
- Acceptance should match the offer.
- There must be a material effect (ie, transfer of ownership) following exchange of asset and consideration (payment or fee).

For example, A offers to sell their car to B for US$15,000. B accepts the offer to purchase the car for US$15,000. The contract is concluded and is valid because:

- there are two independent eligible parties (A and B)
- A has offered his car for sale and B has accepted the offer
- the acceptance from B matches the offer from A
- ownership of the car is transferred from A to B and, simultaneously (or as agreed), B pays US$15,000 to A.

If B wants to buy A's car, but only wants to pay US$10,000, they have made a counteroffer. There is no agreement and hence no contract.

Types of Aqd'

- Compensatory contracts where one person sells something to someone else for a price or other compensation (consideration).
- Non-compensatory contracts where one person gives something to someone else without any compensation, eg, in a will, a gift or as a donation.

2.1.2 Components and Conditions Influencing Contracts

The main components in relation to a valid contract are similar to other legal jurisdictions and can be summarised as follows:

- Contracting parties need to be mature and sane. Maturity implies that the parties need to be adults, although contracts concluded by minors are acceptable if their parents or legal guardians have provided consent. Sanity is related to mental soundness at the time of transaction. In the event that one of the parties is either temporarily or permanently insane, the contract is not valid.
- Subject – the subject of the transaction (assets, goods, skills) needs to be legitimate in the law of the jurisdiction as well as in Shariah (ie, the subject must be permissible). In addition, the subject must exist and be in control or possession of the seller. The subject must be defined in sufficient detail.
- Offer and acceptance – offer and acceptance need to match (see above) and need to be connected. Acceptance needs to be absolute and unqualified, and cannot be given after the offer has been withdrawn.

Conditions that Affect Contracts

- A sale with a condition which is a requirement of the contract of sale is lawful, and the condition is valid. For example, X will not give Y the keys of the car sold, but rather retain them as collateral (**Rahn**) until Y has paid X the full agreed purchase price for the car. This condition does not prejudice the sale; it only declares what is required by the contract and affirms the seller's rights.
- A sale with a condition in support of a requirement of the contract is acceptable and the condition is valid. For example, to sell an item on the condition that the buyer gives a pledge in connection with payment, or that they give some form of security (collateral) is lawful, and the condition is valid. However, conditions must be reasonable. For example, for A to buy a car from B on the condition that B will employ his son in their firm, is invalid due to the fact that the condition is unreasonable. Reasonable conditions are those which do not go against the contract. For instance, A tells B to deliver the goods within a month and this is considered a reasonable period.

- A sale with a condition which is generally accepted, by use and custom in a market and is a well-known condition is acceptable, and the condition is valid. For example, a sale of a house with a condition that the locks are replaced is valid if it is common practice to do so. The compliance of the seller with this condition is in this case necessary. For example, A buys a refrigerator from B with the condition that B undertakes its service for two years free of charge. The condition being recognised as a part of the transaction is valid and the sale is lawful under Shariah.
- A sale with a condition, which is not for the benefit of one of the contracting parties, is lawful, but the contract is voidable. For example, X sells his car to Y with a condition that Y must not sell it to another person for a period of at least six months.

2.2 Shariah Options of Sale

Learning Objective

4.1.2 Understand Shariah options of sale

In addition to the components outlined in section 2.1, with regard to the counterparties, subject matter, consideration, and offer and acceptance, there are five options of sale as formalised in classical Fiqh:

1. **Buyer's option to rescind** – time limited, seller has similar option, but ceases before execution of contract. For example, a 'cooling-down' period when buying a large asset.
2. **Option of inspection** – right to see or appoint a qualified person to inspect the object being sold for any form of defect.
3. **Option of defect** – right to return if defective.
4. **Option of quality** – right to receive the quality of goods as specified.
5. **Option of price** – right to a fair price within the market range.

2.3 Classification of Contracts

2.3.1 Introduction

This section contains further detail of contract characteristics influencing validity and the effect of the contract. In addition, the distinction between unilateral and bilateral contracts is explored as well as the types of unilateral and bilateral contract.

2.3.2 Validity and Effect of the Contract

Learning Objective

4.1.3 Understand the classification of, and conditions applied to, contracts with respect to their effect: valid (Sahih) contracts; voidable (Fasid) contracts; invalid (Batil) contracts

A classification of contracts with respect to their effect could divide them into:

- **Valid (Sahih)** – a valid contract is a contract for which the components and conditions of Shariah as set out above are met. The effect of such a contract is the immediate transfer of ownership of the subject matter to the buyer, and the transfer of the price (or consideration) to the seller. Valid contracts could be either:
  - **Enforceable (Nafiz)** – an enforceable contract is a contract that has been entered into by parties which have the ability and the authority to enter into the contract. For example, a contract between two sane and mature individuals, where all the components and conditions that have been detailed above are fulfilled, is enforceable.
  - **Unenforceable until authorised (Mawqoof)** – a contract that is unenforceable until authorised is a contract where a person has the ability to enter into a contract, but it exceeds their authority; for example, if an agent exceeds the authority accorded to them by their principal. Such a contract is unenforceable until authorised by the principal.
- **Voidable (Fasid)** – voidable contract is a contract that is sound in its essence (the spirit of the contract) but unlawful in its conditions. The contract is concluded, but some of its components are invalid from a Shariah perspective, eg, in the event an item has been sold for an uncertain price. A voidable contract can become valid if the component or condition which has led to its voidability is removed. In the above-mentioned example, this would be achieved by agreeing the price. If delivery has been made under a voidable contract and the subject matter is destroyed in the hands of the buyer, the buyer must compensate the seller. However, when a voidable sale has been annulled, the buyer can keep the item sold until the seller returns the money.
- **Invalid (Batil)** – an invalid contract is not good in its essence or components. This kind of contract cannot confer any legal or beneficial consequences. In the event the buyer has received the goods prior to having paid for them, and they are destroyed without any fault on the part of the buyer, the buyer is not under an obligation to compensate the seller. Strictly speaking, an invalid contract is not a contract at all, as it fails to meet the requirements for being recognised as a contract.

2.3.3 Unilateral and Bilateral Contracts

Learning Objective

4.1.4 Know the types of contract with respect to their underlying purpose: unilateral and bilateral

Unilateral Contracts

Unilateral contracts are usually without due consideration (which can be interpreted as free). Uncertainty or risk is permissible since the contract is free and without consideration.

Unilateral contracts include the following:

- **A gift (Hiba)** – a gift can be revoked prior to its actual transfer. A gift does not imply a transfer in property.
- **Borrowing and obtaining benefit of a tangible asset without consideration (Ia'ra)** – the borrowing of the tangible asset is economically similar to a free lease where usage (usufruct) of a specific object or asset (eg, car, house) is transferred to a recipient for free for a specified period.
- **A benevolent loan (Qard)** – typically a loan of money, usually given to assist the receiver, for example, to pay for study costs. The recipient is obliged to return the full amount at the end of the contract. The recipient may voluntarily (at their absolute discretion) return more than the principal, but this cannot be stipulated in the contract. At present some scholars allow lending institutions to charge administrative fees on the money lent. However, the extra money charged may not be benchmarked against interest rates or the cost of capital.
- **A will (Wassiyyat)** – the last will and testament in which the deceased bestows assets on a beneficiary.
- **An endowment (Waqf)** – a trust, generally set up for charitable purposes.

Bilateral Contracts

Bilateral contracts are contracts between two or more parties and they have a cost and benefits associated with them. These contracts are subject to strict rules, including the components outlined above. Bilateral contracts may be classified as:

- contracts of exchange (Muawadat)
- contracts of partnership (**Shirkah**)
- contracts of security (Damanat)
- contracts rewarding the specific work done or agency contracts (**Wakala**, Juala)
- contracts of safe custody (Wadia).

Bilateral contracts may be subject to Riba (interest), Gharar (uncertainty), **Maysir** (speculation) or the lack of knowledge (**Jahala**), which are not permissible in Shariah and need to be avoided. Bilateral contracts must include precise specifications and an understanding of the underlying goods or services which are the subject of the contract. In addition, bilateral contracts need to meet all other contract conditions outlined in section 2.1.2.

2.4 Wa'd (Promise)

Learning Objective

4.1.5 Understand the concept of Wa'd (promise) and Ah'd (undertaking), the difference between the two concepts and the conditions which make a commercial promise binding

Ah'd is a covenant, pledge or undertaking to perform certain tasks and to be held accountable for these tasks. Ah'd is considered binding, and breach of it could be subject to penalties or a claim, particularly in the event that the counterparty relies on the covenant. Penalties will only be awarded in the event that a party who has relied on the covenant has suffered a loss.

Wa'd means promise, and refers to a promise by one party to do, or not to do, something in the future. The promisor is the party making the promise, and the promisee is the party receiving the promise from the promisor. For example, A (the promisor) promises to sell their car to B (the promisee) at any time within the next three months for 25,000 dinars. This is a unilateral promise or Wa'd. The primary difference between a promise and a contract is that a promise is one-sided (unilateral) and does not bind anyone but the promissor. A contract, on the other hand, is bilateral and binds both sides. The binding nature and enforceability of a promise have been subject to debate among scholars.

The Islamic Fiqh Academy ruled that a promise in commercial dealings is binding, subject to the following conditions:

- It should be one-sided.
- The promise must have caused the promisee to incur some liabilities for the promisee to seek enforcement on the promisor.
- If the promise is to purchase something, the actual sale must take place at the appointed time by the exchange of offer and acceptance. A mere promise itself should not be taken as a concluded sale.
- If the promisor backs out of their promise, the court may force them either to purchase the asset or service, or to pay actual damages to the seller (promisee). Actual damages typically consist of the cost incurred in relation to the anticipated execution of the promise, but do not include opportunity cost (eg, the loss of mark-up or profit). For example, A (the promisor) promises to buy B's (the promisee's) car within the next month for 25,000 dinars (which cost B 22,000 dinars). B has the car cleaned and serviced in anticipation of the sale at a cost of 100 dinars. If A subsequently withdraws their promise, the court may force A to buy the car or pay damages to B equivalent to the price of the cleaning and servicing (ie, 100 dinars). Thus, if B can now only sell the car for, say, 20,000 dinars, they may not claim any damages from A for the opportunity loss of 5,000 dinars. In addition, the promisor is not bound to make good any loss where the lack of performance is for reasons beyond his control. For example, in the case where A (the promisor) promises to sell a horse to B (the promisee), and the horse dies prior to the date of the sale, A does not have to pay damages to B as long as the death of the horse is not caused by A's negligence. However, if the death of the horse is caused by A's negligence, A must make good the loss to the promisee.

It should be noted that the exercise of a unilateral undertaking by either of the parties does not lead to an automatic transfer of ownership. A contract of sale will have to be executed after the exercise of the unilateral undertaking to effect the transfer of ownership.

2.5 Bilateral Promise (Muwaada)

Learning Objective

4.1.6 Know the nature of a Muwaada (bilateral promise) agreement

A bilateral promise consists of two unilateral promises or undertakings extended by two parties on the same asset or service. For example, A provides a unilateral promise to B that he will purchase B's house for US$250,000 any time within the next 12 months. Similarly, B gives a unilateral promise to A that they will sell their house to A for US$250,000 at any time within the next 12 months. While most scholars agree on the binding nature of a unilateral promise in commercial transactions, as discussed above, they reject the acceptability of two identical unilateral promises as illustrated in the above example. Such a combination amounts to a forward contract (a contract concluded at a future date for a current price), which is generally not allowed.

3. Contracts of Exchange

4

Learning Objective

4.2.1 Understand the elements and conditions of a contract of exchange

The sale contract or contract of exchange is the most basic form of contract in Islamic law. These contracts involve the exchange or the transfer of ownership of specific objects or goods from one person to another, either by exchanging:

- one good for another (barter trading), such as my watch for your bracelet or a quantity of my potatoes for your bread, or
- one good for money (sale), such as the sale of a book in a bookshop, or the purchase of your car for £10,000, or
- money for money (**Sarf**), which represents the exchange of an amount in one currency for an equivalent amount in another currency; a foreign exchange transaction where both countervalues must be exchanged on spot.

Permissibility: Allah (SWT) has said in the Quran:

But Allah has permitted trade. (Surat Al-Baqara, 2:275)

The Prophet (PBUH) said:

A sale must be by mutual consent.

Exchange contracts dealing with barter trading or currency exchange could be subject to Riba al-Fadl. The latter exists in different types of currency exchanges, such as:

- the exchange of two homogeneous goods in unequal amounts and for future delivery, or
- the exchange of two heterogeneous goods for future delivery (ie, without taking immediate possession of the two exchanged goods), albeit in unequal amounts, which is permissible when the exchanged goods are different.

3.1 Components and Conditions of a Sale Contract

Contracts of exchange are subject to all the components and conditions mentioned in section 2 (contracting parties, subject matter, consideration, and offer and acceptance), as well as rules regarding price.

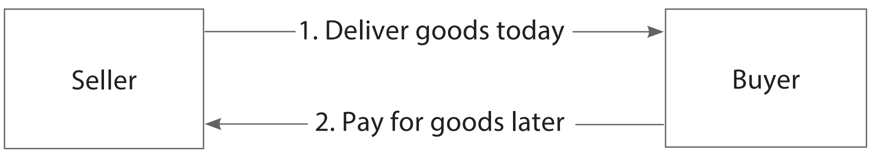
For a sale to be valid, the primary condition to be fulfilled before the sale contract is concluded is that the total price and currency has to be specified and agreed. If the price is uncertain, the sale is void. If, for example, the price is stated as 50 dinars for payment within one month and 55 dinars for payment after two months, the price is uncertain. The sale is, therefore, void, unless either one of the alternatives is agreed upon by the parties at the time of sale.

3.2 Exchange Contracts

Exchange contracts include a variety of contracts that differ from each other in terms of legal requirements, rights, obligations and liabilities, but all have a common obligation: the contract results in the transfer of ownership of the underlying object from one party to another. The theoretical underpinning of each of these contracts is detailed in this section. Chapters 5–8 contain their application in practice.

3.2.1 Cost Plus Sale (Murabaha)

Murabaha comes from the Arabic word for profit and simply means a 'profit-disclosed sale'. It is a trade transaction in which a good is exchanged for money. The payment may be deferred to a later date, in which case it is also known as a deferred payment sale or an instalment credit sale. In its most basic form, this transaction involves the seller and buyer of a good as can be seen in the figure below:



The price of the goods, the mark-up, the delivery date and payment date are all specified in detail. The sale of the goods is immediate, against future payment. In the context of trading, the advantage to the buyer is that they can use the goods to generate a profit in their business and subsequently use the profit to repay the original seller.

The underlying asset can vary, and can include raw materials and goods for resale.

3.2.2 Foreign Exchange (Sarf)

A foreign exchange transaction is related to the sale of gold, silver and currency, in which one currency is sold in exchange for another currency; it is generally referred to as a currency exchange contract. In this contract, both countervalues must be exchanged on spot.

3.2.3 Short-Term Production Finance (Salam)

Salam may be defined simply as a contract executed with spot payment, in full, for the purchase of assets which have commodity-like characteristics, such as base metals, eg, copper and zinc, and grain, promised for future delivery. In contrast to a credit sale Murabaha, under which goods are delivered and payment is deferred at a price higher than the spot price, in Salam, the agreed price is paid fully in advance, while delivery of goods is deferred. The Salam seller is, in all circumstances, required to deliver the assets to the specified type, quality and quantity. The Salam buyer expects that his future sale price will be higher than the price he pays; thus, the financier or Salam buyer takes a price risk on the asset. In a Salam transaction, the goods purchased must be freely available in the market. The goods, which are the object of a Salam sale, must be of a specified quality and quantity without ambiguity. Although one might envisage that the goods will be from a specific farm or producer, the Salam contract specifies the quantity, the quality, the date and the place of delivery.

For example, a shop might specify that it wants to buy Medjool dates, packed in boxes of 12, and of Grade A quality, with 100 boxes to be delivered on 9 October 2020 to the shop at Beirut airport departure lounge. Another example is a builder specifying slate roofing tiles of a particular size and colour, with 5,000 to be delivered to a designated construction site on 14 November 2019. The Salam contract cannot be used for either spot delivery or cross sales.

Salam might be called 'future delivery pre-financing' and has been applied, most notably, in the agricultural sector, since before the life of the Prophet (Peace be Upon Him (PBUH)), when it was a documented business method in the Hadith. Salam has been expanded in commerce to meet the needs of trade financiers. It has further expanded into project finance by means of the Istisn'a contract. Salam is one of the commercial contracts to which the rules related to the existence of the asset and 'do not sell what you do not have' do not apply.

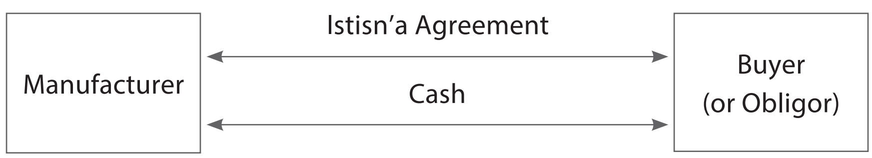
In a Salam, at the time of contracting:

1. the asset does not need to exist, but the specifications as to the type and quantity must exist, and
2. the seller does not need to have ownership of the asset. A condition governing Salam contracts, perhaps to restrict these concessions and drive them towards processing (agriculture, construction or manufacture), is that the minimum Salam period, in the view of many scholars, is ideally not less than 30 days.

3.2.4 Long-Term Production Finance (Istisn'a)

Similar to Salam, Istisn'a, or long-term production finance, is a transaction in which an asset is transacted before it comes into existence. The asset needs to be manufactured, constructed or sold. Gharar is avoided by specifying the asset in detail. Among the contract types of Islamic law, it is by far the most flexible in terms of payment and delivery as it leaves an open field for negotiation. The asset is to be built according to the buyer's specification and to be delivered on a specified date at a fixed price.

Payment may be made in a lump sum in advance, or progressively in accordance with the progress made. The delivery schedule and purchase price are agreed at the outset and take into account aspects such as material, labour, profit margin and other project costs. Settlement takes place under the Istisn'a on delivery of the completed goods upon meeting the specifications – equipment, plant or project.



3.2.5 Down Payment (Arboon)

In an Arboon, the buyer makes a non-refundable down payment against the purchase price following a sales contract. The buyer enters into a contractual obligation to confirm the purchase but loses the down payment if they do not conclude the purchase. However, if they continue with the purchase, the buyer only pays the difference between the agreed price and the down payment they have already made.

3.2.6 Contract in which the Price will be Agreed between Parties (Musawama)

The Musawama contract is similar to a Murabaha contract in that it is a contract for the sale of an asset. Contrary to the Murabaha contract however, the price is negotiated and the buyer does not know the seller's price or the amount of profit they are making. This type of transaction applies, for instance, when purchasing an asset at a market stall, or in shops in the majority of GCC and Asian countries. For example, X wants to sell a carpet which has cost them 1,000 dinars. Y is interested in buying it and X offers to sell it to them for 1,500 dinars. Y considers the offer and finds it too much, but makes a counteroffer of 1,300 dinars. After further negotiations, X and Y agree on 1,350 dinars and X makes a profit of 350 dinars.

3.3 Problematic Sales Contracts

Learning Objective

4.2.2 Know the problematic sales contracts

3.3.1 Twin Sales (Bai al-Inah)

Back-to-back sales of the same object between the same contracting parties, switching roles in each sale and the second sale being contingent upon the first are not permitted. Scholars and commentators have explained that twin sales apply to a transaction in which the same asset is sold between the same counterparties for a different price.

For example, X sells a car to Y for £25,000 today. Simultaneously, Y agrees that once they own the car, they will sell it back to X against a deferred payment of £26,000 payable in two months' time. Effectively, Y has extended a loan of £25,000 to X for two months against a mark-up of £1,000. Twin sales are akin to loans with interest and are thus prohibited.

3.3.2 Twin Contracts (Bai'atayn fi Bai'ah)

A twin contract is the combination of two contracts into one where one of the contracts is conditional upon the other. The Holy Prophet (PBUH) has disallowed the combination of two contracts in one in the same manner as he has disallowed twin sales. Examples of this can be:

- A agrees to sell goods at a discounted price to B conditional on B selling his house to A, and
- combining a contract of loan with a contract of sale.

4. Contracts Allowing the Transfer of the Usufruct

The main form of a contract allowing the transfer of the usufruct (usage of the asset) is the leasing contract (Ijara).

The **Ijara** contract is a bilateral contract in which the usage (usufruct) of an asset is transferred to another party for consideration (eg, money). Ijara is the Arabic word for providing goods or services for temporary use against a wage. Literally, one sells 'usage', or 'Usufruct' as it is commonly called in this context, for a period of time, but the asset ownership remains with the lessor. Ijara is similar to a conventional lease where a lessor buys an asset and subsequently leases it to a lessee against a specific income rental schedule. The duration and the specification of the lease contract are specified in advance. The Ijara contract has specifications that, in some cases, are different from a conventional lease. The following are some of the specifications of an Ijara contract:

1. The use of the leased asset must be both specified in the contract and Shariah compliant.
2. The lessor remains the owner of the asset during the Ijara contract.
3. The lessor is responsible for the major maintenance and ownership-related insurance of the underlying asset for the duration of the lease (in practice the lessor nominates the lessee as his agent for all maintenance issues).
4. The lessor is held liable for any damage incurred accidentally, unless it has been proven to be incurred due to the negligence of the lessee; the lessor, in this case, could annul the lease contract on application to a court of law.
5. The lessee is held liable for maintaining the asset in good shape so that it can continue to be leased.
6. The leased asset should be held in trust in the hands of the lessee. Subleases are permissible with the consent of the lessor or if similar usage could be expected.
7. The asset or service must have value. Certain consumables, such as money, food and fuel, may not be leased.
8. Some forms of lease that are permissible include arrangements that are similar to 'time sharing', whereby a specific space is leased at a specific time of the year to a seasonal tenant.

As a rule, it is best to think of an Islamic lease as more like an operating lease, but redemption features may be structured to make it similar to a financial lease.

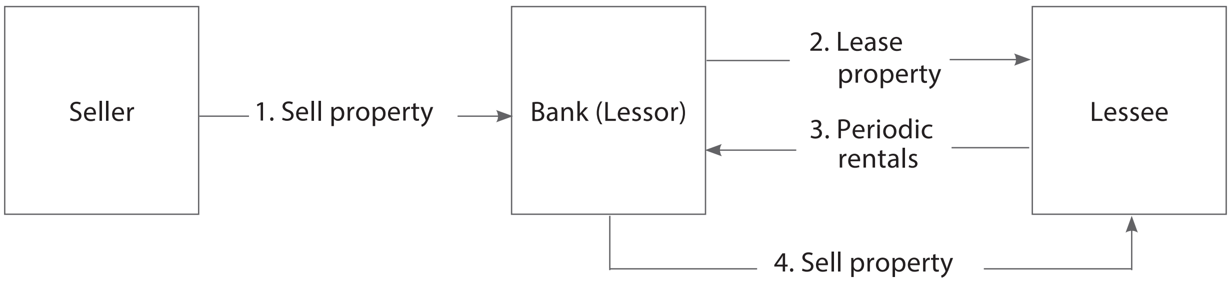
The rental may either be fixed for the life of the lease or adjusted periodically. Rent may commence only when the property has been delivered or made available to the lessee at a specific time and place agreed by the lessee. In many transactions, the bank will appoint the lessee to act as its agent to purchase assets. The traditional Islamic concept requires the lessor to pay for the ownership costs and the lessee to maintain the asset in good order. However, as a practical matter, the lessee usually agrees to insure and maintain the property in commercial deals on behalf of the lessor through a service agency agreement that specifies duties, values and performance. In retail leases, the lessor customarily pays the costs of ownership. In a typical true lease, the bank (the lessor) and the client (the lessee) will agree to the terms and conditions of the lease, specifying the object, when it will be available to rent and the rent.

In the event of a total loss, the lease is automatically terminated and the lessor has no rental claim from the lessee. The lessor's only recourse is to claim any insurance proceeds for which it is eligible. There is no Shariah objection to structuring a lease agreement with additional security such as guarantees, mortgages, **liens** on receivables or hypothecation of cash accounts.

Two main types of lease exist:

- Ijara – operating lease. In this case, the asset falls back to the lessor at the end of the lease period
- Ijara wa Iqtina/Ijara Muntahia Bittamleek – finance lease. In this case, the lessee provides a promise to purchase the asset at the end of the lease period.

The process of an Ijara structure is shown below, although the example in this case is an Ijara wa Iqtina structure:



Prior to entering into the lease transaction, the purchaser, willing to finance the purchase of a Shariah-compliant asset, negotiates the specifications of the asset with the asset seller. The purchaser contacts the lessor regarding the financing of the asset based on Ijara.

1. The lessor purchases the asset from the seller and appoints the lessee as its agent to buy the asset from the seller.
2. The seller delivers the goods as directed
3. The lessor leases the asset to the purchaser.
4. At maturity, if the contract between the lessee and lessor is an Ijara wa Iqtina contract, the ownership of the asset is transferred to the lessee according to specific terms and conditions as agreed.

5. Partnership Contracts

Partnership contracts can be divided into passive partnerships (Mudaraba) and joint ventures (Musharaka).

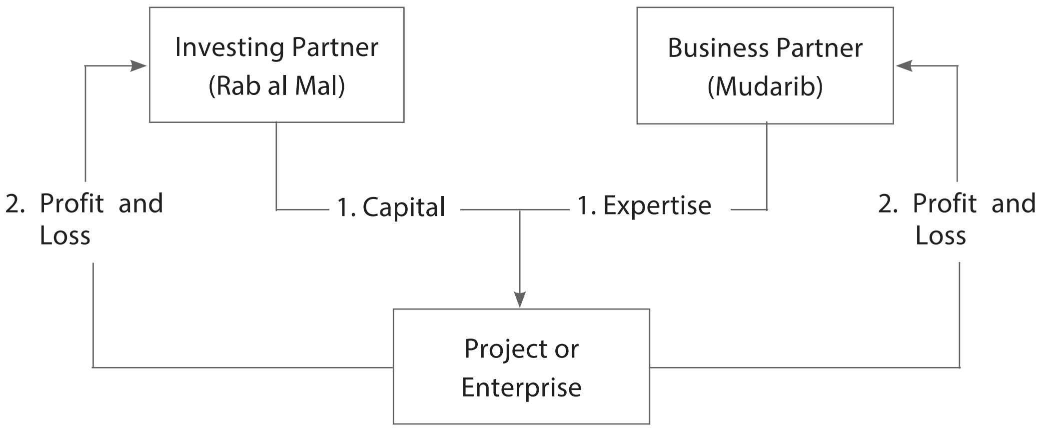
5.1 Passive Partnership (Mudaraba)

The Mudaraba contract is a partnership contract. Mudaraba is the technical term for a 'managed partnership' (a partnership between work – a manager or entrepreneur, and capital – one or more investors). Islamic banks apply the definition from a Quranic verse in which case it means 'walking and travelling the earth' and believe that this is what the **Mudarib** should do to seek profitable opportunities. The method was well known prior to the advent of the message of the Prophet Muhammad (PBUH).

A good example of Mudaraba is the Prophet Muhammad's (PBUH) partnership with his first wife Khadijah prior to their marriage. In this relationship, she provided capital with profit sharing for him as the manager. The Mudarib, as such, generally does not invest capital, but provides (or invests) skill and effort. In the event that the Mudarib is a co-investor, the structure is typically known as a bilateral Mudaraba.

The two forms of Mudaraba are **Mudaraba al Muqayyada**, or 'Restricted Mudaraba'; and **Mudaraba al Mutlaqa**, or 'Unrestricted Mudaraba'. The former is for a specific business or place and is contractually limited by time and place, partner and deal type. In the latter, the manager is free to invest the funds, as long as the investments and the investment process are Shariah compliant.

The Mudaraba contract can be depicted as follows:



Once the contract has been agreed between the partners, the process can be broken down into the following main components:

1. **Inputs**
   - **Capital** – the investor, also known as Rab al Mal, provides capital to the project or company. Generally, an investor will not provide any capital unless a clearly defined business plan is presented to him. In this structure, the investor pays up 100% of the capital.
   - **Skill and expertise** – the Mudarib or business manager's contribution to the partnership is his skill and expertise in the chosen industry or area.
2. **Profit and Loss**
   - Any profits accrued are shared between the partners according to the ratio agreed in the contract. Any losses are distributed in accordance with the proportion of capital provided. Due to the fact that the Rab al Mal provides all capital, all losses are solely attributable to him. The only exception to this is when the business manager has been negligent, in which case he becomes liable for the total loss.

The Mudaraba contract can usually be terminated at any time by either of the parties giving a reasonable notice.

5.2 Joint Venture (Musharaka)

Musharaka (or Shirkah) literally means 'sharing'. The Musharaka contracts are similar to the Mudaraba contracts with the difference that, in this case, all partners provide capital as well as skills and expertise to the project. Profits are shared as agreed in the contract and losses are distributed in accordance with the proportion of capital provided.

6. Security Contracts

Learning Objective

4.3.1 Know the nature of the security contracts: Hawala; Kafala; Rahn

Security contracts consist of the following types:

6.1 Transfer (Hawala) Contract

Hawala is the transfer of an amount from one person (X – the transferor) to another (Z – the transferee). The transfer is typically conducted via a trusted intermediary or agent who may charge an administration fee but this fee cannot be proportionate to the amount transferred. For example, X, who is based in England, transfers £200 to the account of Y, who is based in Belgium. X instructs the bank to effect this transfer and the bank charges an administration fee of £20. This administration fee is allowed as long as it does not vary in accordance with the amount transferred.

The basic Shariah conditions are the absence of delay (Nasi'a) and the absence of excess (Tafadul), according to Ibn Rushd, with the objective being to avoid Riba and Gharar.

6.2 Guarantee (Kafala)

Kafala refers to the addition of a third-party guarantee to an existing obligation with respect to an action or a project. This contract makes the third party liable, alongside the original debtor (jointly and severally), if this was stipulated by the guarantor in the security contract. This means that the debtor and the guarantor are both liable for the full amount of the debt; for example, if one of the parties declares bankruptcy, the other will be responsible for the whole debt. Generally, scholars are of the opinion that the guarantor cannot charge a fee for providing a guarantee per se. However, out of necessity, many scholars have allowed guarantors to charge administration fees as long as they are not proportionate to the duration of the guarantee period or the amount of the contract.

Example

Kafala Contract X has borrowed US$3,000 from Z to buy a car. X enters a Kafala Contract with Y (the guarantor) under which Y agrees to repay Z the US$3,000 if X is unable to pay him. Both Y and X are now responsible for ensuring Z receives his US$3,000. Y could charge X an administration fee for issuing a letter of guarantee on his behalf.

6.3 Collateral (Rahn)

Rahn is a contract in which a creditor/seller prefers to mitigate the risk of default by the debtor/buyer by taking collateral in the form of a mortgage or pledge against an asset belonging to the debtor (registered pledge) or by taking physical possession of the pledged asset itself (possessory pledge). The payment of the claim could be taken from the value of the collateralised asset, which may be sold for this purpose, if the debtor does not meet the contractual terms of payment. Any surplus proceeds in excess of the outstanding debt realised from the sale of the pledged asset must be returned to the debtor.

A pledge of collateral has the advantage that the owner of the collateralised asset may continue to benefit from it, providing that he has the creditor's consent, while at the same time using it as collateral to enhance his creditworthiness. For example, the owner of a car may continue to use it while providing it as security for a benevolent loan or for deferred payment under a sale contract. Should the pledged asset become damaged or destroyed while in the creditor's possession without any negligence or fault of the creditor, the creditor will not be held liable as the pledged asset is held by him on trust.

7. The Rules Regarding Foreign Exchange Transactions (Sarf)

Learning Objective

4.4.1 Know the issues associated with the debate regarding Sarf (the purchase and sale of currencies)

7.1 Introduction

At the time when the Fiqh al Muamalat was originally developed, money consisted of coins made of gold, silver and copper, the value of which was related to their weight and the quality. At the time, there was no paper money and the coins of one country were easily accepted in other countries since their value was based on weight and the type of metal. Such transactions were subject to the rules of Sarf (exchange of currency). With the introduction of paper money and coins, whose value no longer relates to the quantity and quality of metal used to create them, Shariah jurists have had to interpret the original principles of Fiqh al Muamalat to determine the permissibility of foreign exchange transactions or transactions in which an amount in one currency is exchanged for an amount in another currency. Most companies operate in a global economy and have, from time to time, requirements for different currencies. The rules of Sarf also apply to exchanging different denominations of the same currency (eg, exchanging a £50 note for two £20 notes and one note of £10).

7.2 Foreign Currency Dealings in Islamic Commercial Jurisprudence

Although different opinions exist, the majority of scholars treat currency dealing in a similar way as buying gold and silver (ie, the ‘foreign currencies’ that existed at the time the Fiqh al Muamalat was originally developed). These general Shariah rulings related to dealing in currencies have been incorporated in AAOIFI’s Shariah standards and can be summarised as follows:

- It is permissible to trade in currencies under the following Shariah conditions:
    - both parties must take immediate possession (actual or constructive) of the countervalues
    - the countervalues of the same currency must be of equal amount
    - the contract shall not contain any conditional option or deferment clause regarding the delivery of one or both countervalues
    - the dealing in currencies shall not aim to establish a monopoly position
    - currency transactions shall not be carried out on the forward or futures market.

  For example, X is going on holiday to Paris and wants to have some euros before they depart. X can go to their bank or an exchange company and exchange an amount of euros for the equivalent amount in cash in their own currency. Alternatively, if they have an account with the bank, X can request their bank to deduct the countervalue from their account.
- The majority of Shariah jurists regard dealing in conventional forward currency contracts as impermissible, mainly because deferring two exchanged currencies is in violation of the spot requirement in currency trading. So, currency dealings cannot be done as forward sale contracts and, consequently, must be done as spot transactions.
- It is permissible to hedge against foreign currency exposures by recourse to the following:
    - to execute back-to-back interest-free loans using different currencies without receiving or giving any extra benefit, providing that these two loans are not contractually connected to each other (commonly known as an exchange of deposits)
    - where the exposure is in respect of an account payable, to sell goods on credit, eg, using a Murabaha transaction in which the currency is not the seller’s own currency
    - where the exposure is in respect of an account receivable, to buy an asset or goods on credit, eg. using a Reverse Murabaha transaction, in which the future payment is in a currency which is not the buyer’s own currency. Thus, forward currency transactions for hedging purposes can be synthesised in a way considered by some Shariah jurists to be permissible (subject to certain conditions) by entering into either a Murabaha or a Reverse Murabaha transaction. The applicable rules are designed to avoid currency dealings being used as a disguised form of Riba.

7.3 Sale of Foreign Currencies: Rules Regarding Possession of the Subject Matter

Learning Objective

4.4.2 Know AAOIFI's Shariah standards on the sale of currencies

A common type of foreign currency transaction is the spot sale or purchase of a foreign currency by a bank to or from a client. In order to prevent interest, such transactions must comply with a number of rules regarding possession of the currency. In accordance with AAOIFI's Standard of Foreign Currency Dealings, a contract concluded for the spot sale of an amount of currency (ie, a Sarf contract) is permissible in the following circumstances:

- At the closing of the transaction, both parties take possession of the full amount of the countervalue in the respective currencies; taking partial possession is not sufficient.
- Possession may be either physical or constructive:
    - Physical possession takes place by means of simultaneous delivery by hand, ie, cash-for-cash.
    - Constructive possession is deemed to have taken place once the parties have taken possession of the currency and can transact (Tasaruf) in it at will. Constructive possession can take the following forms:
        1. Debit and credit of a bank account:
            a. purchase or sale of a cash amount of one currency against a payment from or to an account in a different currency (eg, transfer £100 into a US$-based bank account. The bank account will be credited with the countervalue in US$)
            b. when the institution debits, by the order of the customer, a sum of money to the latter's account and credits it to another account in a different currency, either with the same or another institution, for the benefit of the customer or any other payee. A delay in making the transfer is allowed by the institution, consistent with the practice whereby a payee may obtain actual receipt according to prevailing business practice in the markets. However, the payee is not entitled to dispose of the currency during the transfer period.
        2. Receipt of a cheque constitutes constructive possession, providing that the balance payable is available in the account of the issuer in the currency of the cheque and the bank has blocked the associated amount for payment.
        3. The receipt of a credit card slip by a merchant, signed by the credit card holder (the buyer), is constructive possession of the amount of currency, providing that the card-issuing institution pays the amount without deferment (ie, within two working days) to the merchant on presentation of the credit card slip.

7.4 Agency for the Trading of Currencies

Foreign exchange contracts can be executed using an agent who has the authorisation to take possession of and deliver the countervalue. In addition, an agent can be appointed to sell currencies without authorising him to take possession of the amount sold, providing that the principal, or someone on their behalf, takes possession of the currency at the closing of the transaction.

It is permissible to authorise taking possession of the countervalues after the execution of a contract of currency exchange, providing that such possession is completed by the authorised agents at the closing of the transaction.

7.5 Use of Modern Means of Communication for Currency Trading

Foreign exchange contracts can be concluded face to face and also using modern communication means such as telephone, fax and email. As with contracts of exchange in general, an offer transmitted by one of the prescribed means of communication remains binding on the offeror, but can be time limited. The contract is not completed until acceptance by the offeree within the prescribed period, and taking possession (either actual or constructive) of the countervalues, by both parties, has taken place.

7.6 Bilateral Promise to Purchase and Sell Currencies

A bilateral promise to purchase and sell an amount of foreign currency constitutes a conventional forward transaction and is prohibited if the promise is binding, even for the purpose of hedging against currency risk. However, a unilateral promise (a promise from one party) is permissible even if it is binding on the promisor.

The parallel purchase and sale of currencies is not permissible as it incorporates one of the following invalidating factors:

- There is no delivery and receipt of the two currencies bought and sold and, thus, the contract amounts to a deferred sale of currency.
- It makes one contract of currency exchange conditional on another. Guarantees for the protection of currency risk are not permitted between the partners in Musharaka or Mudaraba. However, it is permissible for a third party to volunteer to act as a guarantor for that purpose, providing that this guarantee is not stated in the contract.

7.7 Exchange of Currencies in the Form of Currency Denominated Debts

Settling amounts owed in different currencies between two parties and netting (where one party pays the difference between the amount they owe and that which they are due from another party) are permissible as long as all the criteria mentioned above are met.

This covers the following cases:

- Discharge of two debts when one party owes an amount to another party denominated in one currency and the other party owes an amount to the first party denominated in a different currency, at an agreed exchange rate (set-off).
- A creditor receiving payment of a debt due to them in a currency different from that in which the debt was incurred, providing that the settlement is effected as a spot transaction at the spot exchange rate on the day of settlement.

7.8 Combination of a Currency Exchange and a Transfer of Money

It is permissible to execute a financial transfer of money (remittances) in a currency different from that presented by the applicant for the transfer. It is also permissible for the institution to charge a fee for the transfer.

7.9 Forms of Dealing in Currencies via Institutions

It is not permitted for the customer of an institution to enter into currency trading for an amount of money exceeding the amount of money they own, using credit facilities granted by the institution which handles the currency trading. In addition, it is not permitted for an institution to lend the customer a sum of money on the condition that currency dealing must be effected with that institution and not with any other.

8. Accounting Treatment

Learning Objective

4.5.1 Understand the conceptual framework of International Financial Reporting Standards (IFRS): the aims of IFRS; the objectives of financial statements; the qualitative characteristics required from financial statements; the general principles governing decision making and presentation of financial data; the fundamental accounting assumptions underpinning financial statements

International accounting regulation applies to all types of industry including finance. Depending on the country of operation of an Islamic bank, it also applies to Islamic financial institutions. As these rules are designed with conventional financial institutions in mind, they cannot always easily be applied to the operations of Islamic financial institutions. In order to overcome these challenges, AAOIFI developed a set of accounting rules and regulations for Islamic financial institutions, including guidance for Shariah audit and ethics.

8.1 Introduction

The International Financial Reporting Standards (IFRS) are designed to facilitate transparent, consistent and comparable information dissemination to interested parties. The absence of transparency and comparability of financial statements has a negative effect on the efficiency of financial markets, hinders the development of corporate governance best practices and leaves a void in terms of accounting standards' benchmarks.

The need for an international accounting reference has been emphasised in order to:

- facilitate the comparison of financial information across different accounting periods and jurisdictions

- provide financial information readily understood by users of global financial markets with reasonable knowledge of business and economic events
- contribute to the development of financial markets by using a financial language which emphasises the principle of transparency of financial statements, thereby enhancing the information quality.

The objectives of the IFRS are mainly to:

- ensure efficient functioning of the financial markets
- protect investors and provide an added layer of security for all stakeholders, and
- preserve confidence in the financial markets.

In addition to setting objectives of general purpose reports, the conceptual framework also sets the:

- qualitative characteristics
- general principles, and
- basic assumptions.

8.1.1 Qualitative Characteristics

In order to determine usefulness, financial information must be characterised by both relevance and faithful representation. Usefulness is also enhanced through comparability, verifiability, understandability and timeliness.

- **Relevance** – information in financial statements is relevant when it influences the economic decisions of users. Such influence is determined by the predictive value and/or confirmatory value (feedback value) of information. Materiality is a component of relevance. Information is material if its omission or misstatement could influence the economic decisions of users.
- **Faithful representation** – information should be presented in a way that reflects its substance rather than its legal form. This representation should hold three characteristics: complete, neutral and accurate. Although completeness cannot possibly be achieved, the reported information should at least cover all material economic events. At the same time, this representation should be free of bias (ie, neutral) and accurate (ie, free of error).
- **Comparability** – in order to facilitate the users' decision-making process, information should be able to identify the similarities and differences between peer group entities and between different periods of the same entity. Users should, therefore, be able to compare the financial statements of an entity over time so as to be able to identify trends in its financial position and performance. In addition, users must be able to compare the financial statements of different entities within the same economic activity. Comparability does not, however, mean uniformity, and users can still compare between entities who have adopted alternative standards options, as long as those entities disclose the effect of such selection.
- **Verifiability** – information is verifiable if different, knowledgeable and independent accountants reach a similar result when processing the same economic events. This result could be perfectly identical if those different accountants used the same alternative standard options.
- **Understandability** – information should be presented in a way that is readily understandable by users who have a reasonable knowledge of business and economic activities and accounting, and who are able to analyse this information diligently.
- **Timeliness** – this means that information should be available for the users within the time period in which it is most likely to have an impact on their decisions.

8.1.2 General Principles

The process of selecting the appropriate accounting rule to be applied is governed by the following accounting fundamental principles:

- **Prudence (conservatism)** – financial statements should be prepared prudently, eg, items on the income statement and balance sheet should be assessed conservatively. This principle raises the issues of impairment and fair value evaluation.
- **Substance over form** – transactions and other events should be accounted for and presented in accordance with their substance and financial reality, and not merely their legal form.
- **Cost/benefit analysis** – when selecting the appropriate accounting standard, a trade-off needs to be made, taking into account the cost of applying the standard and the benefits of it.
- **Consistency** – accounting policies should be consistent, from one financial period to another, in order to facilitate comparability.
- **Accrual** – the accrual basis of accounting means that revenues are recognised when they are earned and expenses are recognised when they are incurred, regardless of when the cash transaction occurred, ie, irrespective of receiving or paying money.
- **Matching** – this means that expenses are recognised in the period where their related revenues are recognised. This matching could be done directly (such as cost of goods sold) or indirectly (such as depreciation of assets).

8.1.3 Basic Assumptions

There are three fundamental accounting assumptions that apply to businesses which are not explicitly stated in the financial statements of an entity:

- **Going concern** – the enterprise is considered to be a going concern, meaning that it is expected to continue to operate for the foreseeable future. It is assumed that there is neither the intention nor the necessity of liquidation nor of curtailing significantly the scale of operations.
- **The accounting unit concept** – business transactions or events can be measured and expressed in terms of monetary units which are stable and dependable.
- **The periodicity concept** – this assumes that, for reporting purposes, the organisation's life cycle can be divided into discrete accounting periods. The periods are of equal length and are used to measure the financial progress of the business.

8.2 AAOIFI Standards

Learning Objective

4.5.2 Understand the need for Islamic accounting standards

4.5.3 Know the role and responsibilities of AAOIFI

4.5.4 Understand the conceptual framework of AAOIFI financial accounting statements: the qualitative characteristics of accounting information

8.2.1 Introduction

The modern Islamic banking and finance industry has shown significant growth since the early 1990s, and this has increased the diversification in the inputs and outputs. In combination with the introduction of different financial instruments, such as Murabaha and Mudaraba, this has resulted in the need for additional accounting standards. As the IFRS does not cater for these new developments, the need for a new standard-setting body arose, which eventually resulted in the establishment of AAOIFI. This body has been actively involved in developing Shariah, accounting and governance standards, in conformance with the trend followed by transnational bodies, such as the International Accounting Standard Board (IASB), the International Organisation of Securities Commissions (IOSCO) and the Bank for International Settlements (BIS).

In addition to providing regulations in the aspects of accounting, Shariah and audit and governance, the standards have contributed to the growth of the Islamic banking industry by increasing investor confidence and dispelling any concerns relating to issues caused by unfamiliarity with the industry, such as terrorist financing and money laundering.

8.2.2 The Benefits of Sound Conceptual Principles

In today's global economy, where institutions operate across national boundaries, the ability to use a consistent set of accounting standards for all purposes has the potential to achieve economies of scale and to generate considerable cost savings. This reduces not only the costs of preparing financial statements, but also the costs of auditing and the costs incurred by financial analysts and rating agencies in assessing Islamic financial institutions. The effect of this may be that less risk has to be factored in, which, in turn, may lead to a reduction in the cost of capital.

The Islamic banking industry has recognised that these benefits apply equally to them and established AAOIFI to devise a set of Islamic financial accounting standards. In a number of non-Muslim jurisdictions, the accounting processes of Islamic financial institutions are governed by the IFRS, the country's regulations, local Generally Accepted Accounting Principles (GAAP) and company law. The IFRS and local GAAP are not geared to include Shariah requirements and do not fully capture the nature of the financial transactions of Islamic institutions. AAOIFI standards address this shortfall by complementing the IFRS with its own standards to cater for the distinctive nature of Islamic financial institutions. Solely applying the IFRS may result in a situation where Islamic financial instruments are reported in a similar way to conventional financial instruments.

8.2.3 Background to AAOIFI

In 1992, AAOIFI began with the development of a core set of accounting and Shariah and, more recently, auditing and governance standards for Islamic financial institutions. AAOIFI works closely with the IASB, the BIS and other relevant parties. AAOIFI is actively engaging with central banks, banking supervisors and relevant professional bodies in order to raise awareness of the benefits of adopting AAOIFI standards as the benchmark standards for Islamic financial institutions in their jurisdiction. Regulators and supervisors in a number of countries, such as Bahrain, Syria and Sudan, have made AAOIFI standards mandatory for Islamic banks, while others, such as those in Saudi Arabia, are specifying AAOIFI standards as guidelines. Qatar has issued accounting standards based on both AAOIFI standards and the IFRS, and the DIFC in the United Arab Emirates has also prescribed AAOIFI reporting for specific categories of Islamic firms. In Lebanon, Islamic financial institutions are not required to implement AAOIFI standards but need to follow unique circulars issued by regulators and supervisors that are based on both AAOIFI standards and Lebanese laws and regulations.

8.2.4 AAOIFI's Approach

Conventional IFRS accounting standards are applied by AAOIFI in two ways:

1. The basis for its conceptual framework and standards. AAOIFI uses both IFRS and Shariah requirements to set the standards.
2. The default accounting rule reference. In the absence of an AAOIFI standard, institutions have the obligation to apply the IFRS unless otherwise stated by the institution's jurisdiction/country.

In line with IASB, AAOIFI's conceptual framework provides a guideline for general practice and setting standards, and includes the same components as IASB's conceptual framework – objectives, purposes of the standards and the general purpose reports. In addition, the framework of AAOIFI covers:

- qualitative characteristics
- basic assumptions, and
- measuring concepts.

It is important to note that there is disagreement among scholars regarding AAOIFI's approach in setting standards, as some state that standards should solely be derived from Shariah principles and there should not be any dependence on the IFRS. It is essential to understand that the Financial Accounting Standards (FAS) apply the basic principles of financial accounting, as appropriate, to Islamic financial transactions and Islamic banks. These concepts or basic principles are, while strongly rooted in internationally accepted accounting standards, consistent with the broader view of Islamic principles – a view which does not require that a concept always needs to be derived from Shariah. Islamic thought accommodates for principles not specifically stated in Shariah as long as they are beneficial or unharmful to society and do not violate any precept of Shariah.

8.2.5 Qualitative Characteristics of Accounting Information

AAOIFI specifies that accounting information should possess the following characteristics:

- **Relevance** – the information should be relevant to the decision-making process of all users of financial statements. This characteristic requires that the information meets the following three criteria:
  - **Predictive value** – the user can use the information to make predictive statements regarding the financial situation of the entity.
  - **Feedback value** – the user can use the information to verify the accuracy of their previous predictions.
  - **Timeliness** – the information should be reported in due time in order to provide the user with up-to-date information that supports the decision-making process.
- **Reliability** – reliable information tends to increase the confidence in the financial statements. To be reliable, six sub-characteristics should be fulfilled:
  - **Faithfulness of representation** – information should reflect what it purports to represent, ie, the information should reflect reality.
  - **Neutrality** – accounting information should be presented without bias and without providing preferential information to some users at the expense of others.
  - **Substance and form** – contrary to the IFRS, which states substance over form, AAOIFI's view is that substance should be no different than form; Shariah rejects any conditions, covenants or clauses that cause the substance or economic reality of the transaction to differ from its legal form.
  - **Completeness** – information should be complete and given appropriate attention to cost/benefit. For example, significant information should not be omitted on the basis of cost.
  - **Verifiability** – any accountant should be able to reach the same results when processing the same data and using the same accounting convention or methodology.
  - **Consistency** – in order to enhance comparability over time, there should be consistency in adopting accounting standards over the years, and any change should be disclosed along with its effect.
- **Comparability** – as with financial reporting under the IFRS, comparability is an important qualitative characteristic under AAOIFI standards. Comparable financial information allows users to identify similarities and differences in an entity's performance in relation to its own previous results and to those of its peers.
- **Understandability** – accounting information should be readily understandable by the users in order for it to be useful for the decision-making process.
- **Prudence** – caution should be exercised when making estimates. This principle caters for uncertainties that might arise in order not to overestimate the assets and revenues nor underestimate expenses and liabilities.

Similarly to the IFRS, when analysing a new financial situation, the FAS stresses two important factors when selecting the appropriate accounting policies: materiality and cost/benefit analysis.

8.2.6 Basic Assumptions

AAOIFI has defined a series of basic assumptions that are applicable in all financial statements of banks following the standards, without the need for continuously disclosing them.

- **The accounting unit concept** – Islamic jurisprudence recognises the limited liability company, which allows an Islamic bank to be treated as a separate accounting unit from its owners. In other words, an Islamic bank can be a separate entity from its owners in terms of assets and liabilities. The Council of the Islamic Fiqh Academy has declared: '*there is no objection in Shariah to setting up a company whose liability is limited to its capital for that is known to the company clientele and such awareness on their part precludes deception*' (Resolution 130 (14/4)-C).
- **The going concern concept** – like the IASB, AAOIFI recognises the concept of the going concern. This concept means that a business will continue to operate for the foreseeable future and there is no intention to liquidate it or to reduce its scale of activities drastically, with the exception of companies accounted for as not being a going concern. Unless there is evidence to the contrary, financial accounting assumes the entity is a going concern and, in preparing the entity's financial statements, there is no intention or necessity to liquidate the entity. This concept is of importance for the accounting measurement method. Due to the entity being conceived as a continuous stream of activities, the measurement method enables the assessment of the real value of its assets without waiting for liquidation in the market.
- **The periodicity concept** – this concept assumes that, for reporting purposes, the organisation's life cycle can be divided into discrete accounting periods. The periods are of equal length and are used to measure the financial progress of the business. This concept is persistent within GAAP and is also accepted by AAOIFI.
- **The stability of the purchasing power of the monetary unit** – AAOIFI assumes stability of the purchasing power of the monetary unit. The IFRS, and similar accounting principles, also assume the stability of the monetary unit, with the exception of inflation accounting standards, such as the standard on financial reporting in hyperinflationary economies. AAOIFI has not issued a standard to cater for this effect and there has been no call for such a standard in countries where Islamic banks operate.
- **Accrual Accounting** – similar to IFRS, accrual basis accounting is one of the basic principles of AAOIFI standards, which means that revenue should be recognised when realised, and costs should be recognised when incurred. There are three conditions for the realisation of revenue:

  1. The institution has earned the right to receive the revenue.
  2. There is an obligation on the part of the other party to remit the revenue.
  3. The amount of revenue should be known and collectible with a high degree of certainty.

  These conditions indicate the preference for accrual accounting rather than cash accounting. Revenue recognition on the basis of accrual accounting meets the Islamic requirement to determine the real financial performance of an entity. In addition, expenses are recognised either because the expense relates directly to the earning of revenues or because it relates to the period when the expense is incurred. This results in the matching principle which, from the Islamic perspective, results in fairness and justice simultaneously to the shareholders and other stakeholders because it allocates expenses to their related revenues.

8.3 Zakat

Learning Objective

4.5.5 Know the methods of calculating Zakat and the accounting treatment

8.3.1 Calculation

Persons possessing more than a specified minimum level of wealth (known as Nisab), usually over a period of one year, have to pay Zakat, an obligatory charitable tax. The Zakat rate is determined by using 2.5% for a lunar calendar year and 2.5775% for a solar calendar year. Two methods can be used for the calculation of the Zakat base:

1. The net asset method.
2. The net invested method.

Net Asset Method

The Zakat base is determinable by:

+ Assets subject to Zakat (including cash, cash equivalent, net receivables, trading assets, financing assets)
– Liabilities to be paid during the year ended on the date of the financial statements.
– Equity of investment account holders
– Minority interests
– Equity owned by governments
– Equity owned by endowment funds
– Equity owned by charities
– Equity of non-profit organisations, excluding those owned by individuals.

The following conditions apply:

- Financing assets should be included net of provisions and funds used to acquire fixed assets related to these financing assets.
- Assets acquired for trading are measured at their cash equivalent value on the date Zakat is due.
- Consideration should be given to the Nisab (the Zakat base) specific to some assets (agricultural products and livestock).

Example

Zakatable Assets	In millions (US$)
Cash and cash equivalents	1,000
(+) Net receivables (Murabaha, Salam)	1,170
(+) Mudaraba financing	250
(+) Istisn'a financing	150
(+) Musharaka financing	160
(+) Assets for trading (marketable securities, inventory, real estates and other assets)	400
Total Assets	**3,130**
Customer current accounts	100
Due to banks and financial institutions (due to be paid during the next financial period)	300
Other liabilities (due to be paid during the next financial period)	90
Equity of investment account holders	2,000
Minority interests	40
Government and endowment funds equities	10
Total liabilities (due to be paid during the next financial period)	**2,540**
Zakat base = 3,130 – 2,540	**590**
Zakat due to be paid for the period – lunar calendar year = 590 x 2.5%	14.75
Zakat due to be paid for the period – solar calendar year = 590 x 2.5775%	15.21

Net Invested Funds Method

The Zakat base is determined by:

\+ Paid-up capital
\+ Reserves
\+ Provisions not deducted from assets
\+ Retained earnings
\+ Net income
\+ Liabilities not due to be paid during the year
– (Net fixed assets + investments not acquired for trading + accumulated losses).

Example

Zakatable Assets	In millions (US$)
Owners' equity	340
(+) Difference between cash equivalent value and book value of asset for trading	50
(+) Payables (not due to be paid during the next financial period)	600
(+) Provision for investment risk	10
(–) Government and endowment funds equities	10
(–) Investments (not for trading)	50
(–) Other assets for rents	250
(–) Net fixed assets	100
=	590
Zakat due to be paid for the period – lunar calendar year = 590 x 2.5%	14.75
Zakat due to be paid for the period – solar calendar year = 590 x 2.5775%	15.21

8.3.2 Accounting Treatment of Zakat

Cases in which an Islamic bank is obliged to pay Zakat

When an Islamic bank is obliged to pay Zakat, the Zakat shall be treated as a non-operating expense of the Islamic bank and included in the determination of net income in the income statement.

The bank is obliged to pay Zakat when:

- the law requires the Islamic bank to satisfy the Zakat obligation
- the Islamic bank is required by its charter or by-laws to satisfy the Zakat obligation, or
- the general assembly of shareholders has passed a resolution requiring the Islamic bank to satisfy the Zakat obligation.

Unpaid Zakat is treated as a liability and presented in the liabilities section in the financial statements of Islamic banks.

Cases in which the Islamic bank is not obliged to pay Zakat

- When shareholders ask an Islamic bank to act as agent in meeting the Zakat obligation relating to their investment in the Islamic bank from their share of distributable profits, Zakat is deducted from the shareholders' share of distributable profits.
- When shareholders ask an Islamic bank to act as agent in meeting their Zakat obligation, and the Islamic bank agrees to do so, even if there are insufficient distributable profits to meet the shareholders' obligations, the amount paid by the Islamic bank is recorded as a receivable due from these shareholders.

Zakat due from an Islamic bank, as well as amounts of Zakat received from other sources of funds, are presented in the statements of sources and uses of funds in the Zakat and charity funds.

8.4 Form and Substance

Learning Objective

4.5.6 Understand the relationship between form and substance of contracts

The terms 'form' and 'substance' are typically used when referring to financial statements and how they reflect the transaction – form refers to the legal form of the transactions and events while substance refers to the financial reality of the transaction. In Western financial accounting, the practice of substance over form generally prevails. This means that, if a transaction looks and behaves like a loan with interest (substance), even though it has a different legal guise (form), it should be reported as a loan with interest. From a Shariah perspective, both form and substance are important to observe, but occasionally, necessity and societal circumstances may warrant prioritising one over the other.

The general position of AAOIFI is that substance is important but is not always overriding.

9. Concluding Remarks

The role of Islamic (or Shariah-compliant) contracts (nominate contracts) in Islamic finance cannot be overemphasised. The various financial instruments and structures used in Islamic finance all have their basis in these contracts. Combinations of them are used to create the structures needed for major project financing and for Islamic **securitisations** (Sukuk issuances). This raises issues regarding the legal enforceability of these contracts in various jurisdictions.

In principle, an Islamic contract that meets the requirements for validity discussed in section 2 of this chapter should be more readily enforceable as a contract in a common law jurisdiction, such as the UK and most of the US, than in civil law jurisdictions which may impose statutory conditions that may not be met. Hence, it is common practice in major international Islamic financing transactions to stipulate that the law of one of the former jurisdictions (eg, UK law or New York law) will be the governing law for the transaction. However, problems regarding the enforceability of security contracts (see section 6 of this chapter), such as obtaining possession of collateral among others, may still remain.

End of Chapter Questions

1. What is Aq'd?
   Answer reference: Section 2.1.1

2. List the conditions that affect contracts.
   Answer reference: Section 2.1.2

3. What are the five Shariah options of sale?
   Answer reference: Section 2.2

4. Describe the validity classifications 'enforceable' and 'unenforceable'.
   Answer reference: Section 2.3.2

5. What is the key difference between bilateral and unilateral contracts?
   Answer reference: Section 2.3.3

6. Describe the Salam transaction and how it differs from Murabaha.
   Answer reference: Section 3.2.3

7. How is an Islamic lease best described?
   Answer reference: Section 4

8. Describe the difference between restricted and unrestricted Mudaraba.
   Answer reference: section 5.1

9. Describe the difference between Kafala and Rahn.
   Answer reference: sections 6.1 and 6.2

10. What are the main objectives of the IFRS?
    Answer reference: Section 8.1

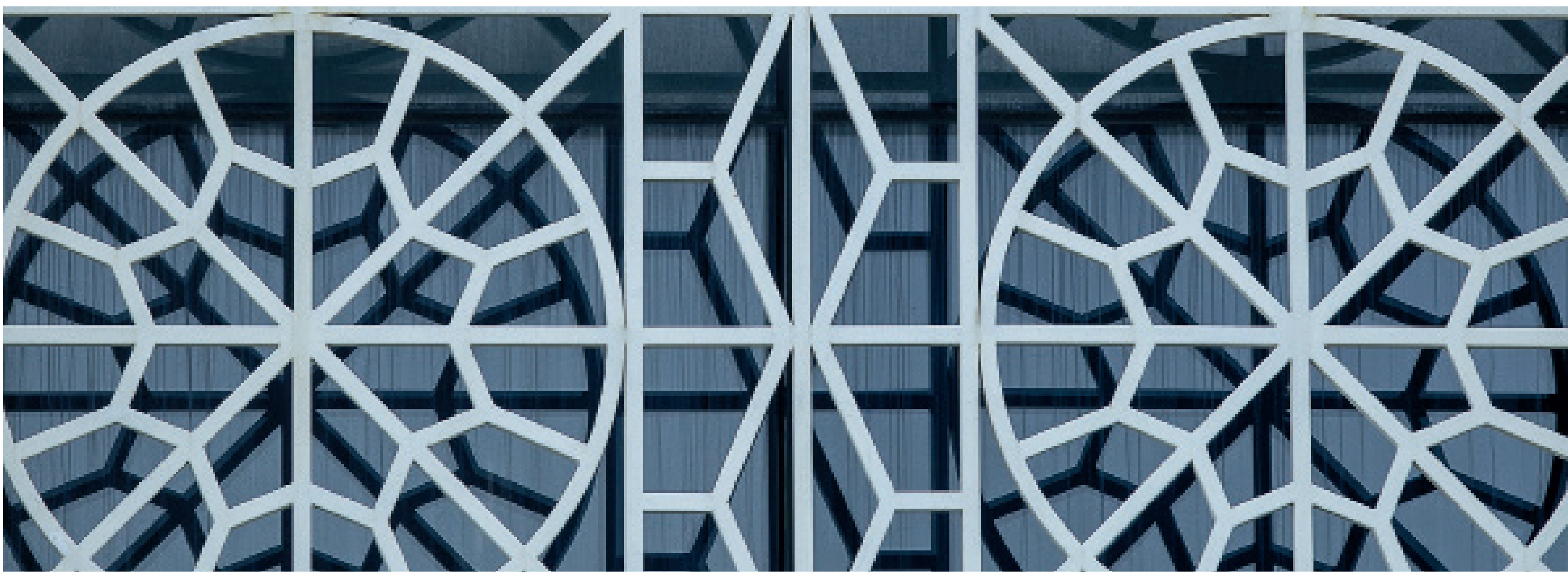
11. What is the meaning of accrual accounting?
    Answer reference: Section 8.1.2

12. List AAOIFI's basic assumptions.
    Answer reference: Section 8.2.6

Chapter Five

Financial Contracts and Techniques Applied by Islamic Banks

This syllabus area will provide approximately 25 of the 100 examination questions



1. Introduction

The ban on Riba (explained in chapter 3) results in a situation where earnings and wealth creation must be linked directly to an economic activity, such as investment, leasing and sales. Under Islam, money cannot generate money; instead, it is a means to support business activities. In conventional finance, money can be used to generate more money, by charging interest on loans or speculation. Islamic finance acknowledges time value of money within the context of economic activities that create wealth, such as trade and production.

This chapter builds further on the theoretical basis for the different transaction types and shows how they are used by Islamic financial institutions. The chapter begins with an overview of where funds come from (individuals and institutions depositing and investing money) and how they are applied or utilised (in profit sharing and project financing enterprises). Current developments that are likely to lead to the expansion of the Islamic banking industry are included towards the end of this chapter, but the emphasis here is to explain the practical mechanics and Shariah basis of these activities. Specific examples are provided throughout the text.

2. Types of Contract

Learning Objective

5.1.1 Know the differences between the different types of contracts: debt-based contracts; equity-based contracts; other types of contracts

As outlined throughout this chapter, contracts within Islamic finance can be divided into two main categories: debt-based and equity-based. Debt-based contracts result in a debt being repaid, such as Murabaha and Salam transactions. Equity-based contracts are those that are based on an underlying asset or enterprise, such as Musharaka, Mudaraba and Ijara. Other types of contracts that occur in Islamic financial services are those that are not specifically based on debt or equity and are, for example, Wa’d (promise) or Arboon (down payment).

3. Sources of Funds

3.1 Islamic Financial Intermediation

Learning Objective

5.2.1 Understand the distinction between a conventional bank and an Islamic bank: the relationship between the bank and its clients; the sources of funds; the use of funds

In conventional banking, the bank acts as a financial intermediary, accepting deposits from clients and granting loans to others at a higher interest rate than paid to the depositors. The bank generates profits from commissions, as well as a process known as 'maturity transformation', in which short-term, low-interest deposits are used to lend for longer terms at higher rates. The difference between interest rates paid to depositors and the interest charged to borrowers is known as the 'spread'. From a Shariah perspective, the transformation of deposits into loans does not justify the spread, as this constitutes a pure return on money, ie, Riba, which is prohibited.

In Islam, a return on capital is justified only when the capital has taken the form of a real (non-monetary) asset, Usufruct, or service. The fact that the bank has to manage liquidity and credit risk does not constitute a Shariah-acceptable justification for such a return. In reality, however, businesses and consumers who borrow money use the funds in real economic activities. Therefore, the banks' profits are indirectly linked to business economic activities. On the other hand, when a bank lends money to another bank, who on-lends to yet another bank and so on, there is no underlying economic activity and, eventually, there will be no profits. From an Islamic finance point of view, profits must be linked directly with economic activity, thus keeping debt under control and directing money capital to the most productive uses.

The financial intermediary role of an Islamic financial institution extends to include the responsibility for identifying projects in which it can invest the customer's funds. The contract between the customers and the bank is a type of partnership (Mudaraba) contract in which the bank is the Mudarib (business manager) and its customers are the Rab al Mal (investors). As a Mudarib or business manager, the Islamic bank's prospective income is tied to the underlying transaction and takes the form of a share of the profit or loss rather than a spread. The profit margin is structured into the transaction.

More significantly, the Arbab al Mal (plural; singular: Rab al Mal) or 'investment depositors' are not lenders or creditors; they are investors. Unlike the structures underlying a conventional current account, this relationship entitles the depositors to a share of profits as defined in the Mudaraba agreement and potentially exposes them to a loss of capital. No matter how much the bank mitigates the risks to which they are exposed by careful selection of investments, investors' capital (or investment accounts in an Islamic bank) are ultimately at risk, even if the bank itself remains solvent. This means that an Islamic deposit account has equity-like characteristics. Figure 1 illustrates the comparison between the conventional bank and the Islamic bank intermediary functions. The depositors, or more accurately the named investors, agree to a management agreement (a Mudaraba contract) with the bank (the Mudarib) who then uses the funds for Shariah-compliant investments.

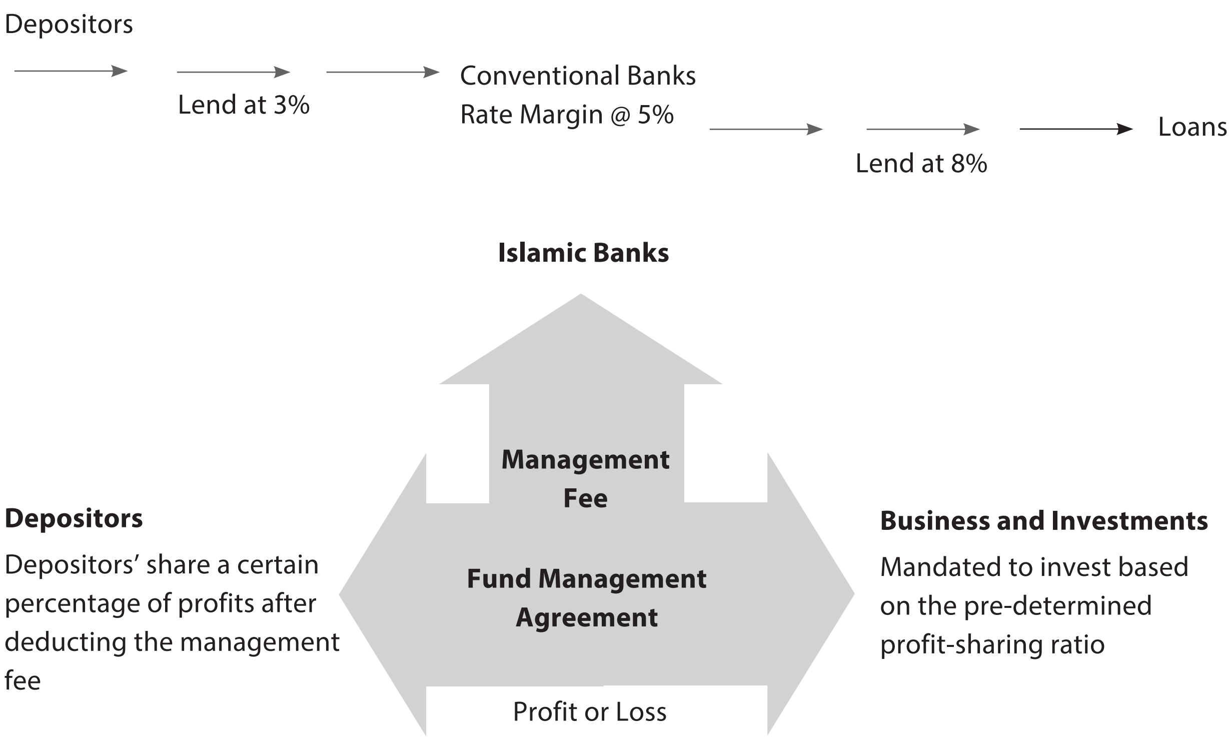


Figure 1: Conventional versus Islamic financial intermediation

Source: M. Ikram Thowfeek (diagram amended)

The following diagram illustrates the process of how the profit-sharing investment accounts are compensated for in an Islamic bank:

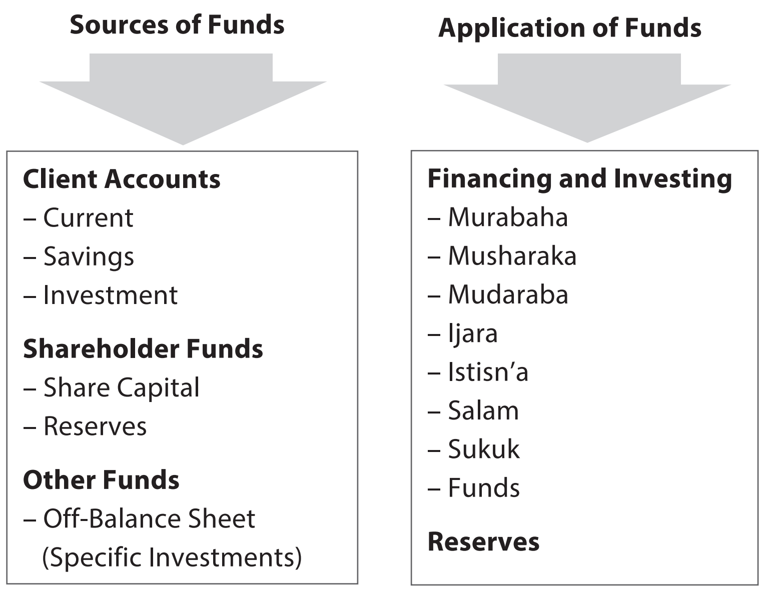


Figure 2: Islamic banking – Source: M. Ikram Thowfeek

Islamic banks offer current accounts allowing customers to deposit funds with the bank. These accounts cannot earn any profits.

In the case of investment accounts, the bank acts as a manager (Mudarib) on behalf of depositors. When the bank contributes its own capital (shareholders' money) to the investments, the bank becomes a partner (active partner or Sharik) in the transaction and is no longer just the Mudarib. Hence, the bank only acts as a Mudarib in respect of investors' money.

Bank and depositors agree on the share of profits for each party. Losses are attributed in accordance with the capital provided.

Example

Bank A has three investment account holders who have deposited the following amounts:

X = £2,500 (25%)
Y = £4,000 (40%)
Z = £3,500 (35%)

Depositors share 75% of the profits and the bank receives 25%. The bank does not contribute any capital. In the event the bank makes a profit of £3,000, this will be distributed as follows:

1. The bank receives 25% of the profit = £750
2. Depositors share 75% of the profit = £2,250
   a. Depositor X: £562.50, representing 25% of the 75% of the profit.
   b. Depositor Y: £900.00, representing 40% of the 75% of the profit.
   c. Depositor Z: £787.50, representing 35% of the 75% of the profit.

In the event the bank incurs a loss of £1,000, this will be distributed as follows:

1. The bank does not incur any loss since it has not contributed any capital.
2. Depositors, as the contributors of capital, bear the total loss as follows:
   a. Depositor X: £250.
   b. Depositor Y: £400.
   c. Depositor Z: £350.

The bank may apply different profit-sharing ratios to different accounts, depending on the risks and periods of time (tenors or terms), as long as the differential is disclosed. The differential may be related to the amount of funds invested or the mix of funds. For example, an account in which a larger proportion is held in cash is more liquid and has a lower level of risk. The level of cash held in the account could differ per term (eg, short-, medium- or long-term accounts could vary in the proportion of cash held).

It is to be noted that Islamic banks are subject to provisions on their profits which affect the final amount of the distributed returns or profits to investment account holders and shareholders. (See chapter 9 for more detail on profit reserves.)

The regulatory treatment of investment accounts (discussed further in chapter 9) is, in many countries, similar to that of conventional client accounts and ignores the equity nature of these accounts.

3.2 Current Accounts

Learning Objective

5.2.2 Understand the operation of current accounts in Islamic banking

Like any other instrument, an Islamic current account has to operate under Shariah principles. These are notable with respect to the application of funds, overdraft facilities, credit card usage and interest either paid on an overdraft or paid in favour of the client from a deposit.

In a current account, the bank must obtain the permission of the account holder to apply the money to its operations. The bank effectively borrows the money from the client and is obligated to return the funds on demand or as agreed. The bank bears the risk of the funds and is, therefore, entitled to the associated returns. No returns are paid on current accounts.

The bank may provide a safekeeping service for valuables or documents, including cash. In this case, the bank is solely responsible for the safekeeping of the items and will put in place appropriate security measures. The bank does not guarantee the items.

Typically, an Islamic current account does not include any kind of overdraft facility which is subject to a predetermined charge, since this would result in Riba. As a consequence, banks will not be able to process any transaction for an amount in excess of the account balance.

Example

Conventional banks can offer current accounts via Islamic windows. To guarantee Shariah compliance of the operations, the conventional bank should:

- **ensure segregation of funds** – Shariah-compliant deposits may not be mingled with the general funds of the bank and applied to the traditional interest-based lending of the bank. Rather, these deposits are to be segregated with separate accounts and must be applied solely to Shariah-compliant transactions.
- **submit the relevant information regarding these accounts to a properly constituted Shariah board** – a conventional bank offering Islamic accounts should submit the relevant information regarding these accounts to a properly constituted Shariah board, whether engaged by the bank or provided by a third-party Shariah adviser (the role of the SSB is described in chapter 9).

4. Uses of Funds

Learning Objective

5.2.3 Understand how funds are used by Islamic banks

Islamic banking is closely aligned with the concept of merchant banking – the concept of conventional money-lending does not apply in the same way. There are three prospective applications of funds within an Islamic bank. Foremost among these, and most favoured by Islamic banks, are the deferred contracts of exchange which are known as fixed-income-type instruments in conventional finance. Their equivalents in Islamic finance are:

- Murabaha or cost plus profit exchange contract
- Ijara or lease
- Salam or forward sale purchase, and
- Istisn'a or project finance.

Islamic banks and their regulators prefer these methods due to their predictable returns and relatively simple implementation (ie, they do not require significant monitoring of the counterparty's operations to ensure that the bank receives the returns to which it is contractually entitled). Many Islamic theorists, on the other hand, prefer the profit-sharing equity methods of Islamic commerce, namely Musharaka and Mudaraba. Musharaka originally meant 'general partnership', but is generally interpreted as any permitted business combination ranging from unlimited liability general partnerships to limited liability companies, corporations and most forms of special purpose vehicles (SPVs). Beyond the risk operations of an Islamic bank, there are the service-type instruments which include, but are not restricted to, currency-related services, and agency services.

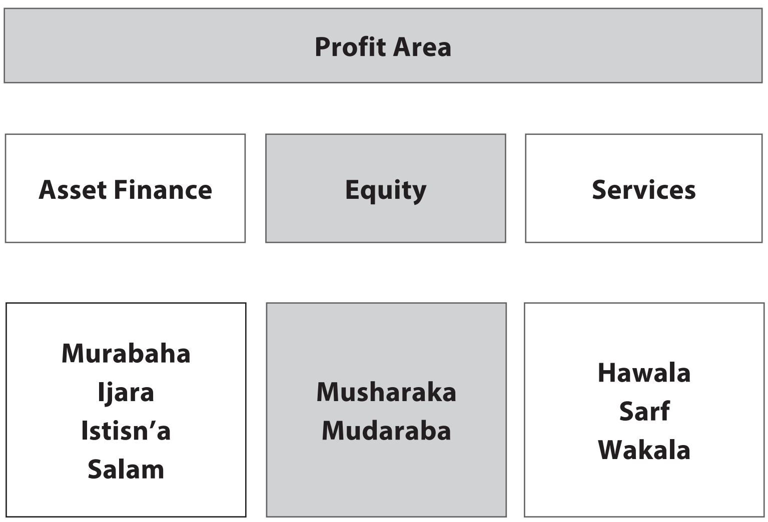


Figure 3: Islamic techniques which are ideal for business risks

5. Predictable Return versus Profit-Loss Sharing Modes of Finance

Learning Objective

5.2.4 Understand the Islamic banking model and the challenges it faces

Broadly speaking, the Islamic financial model is based on the following transaction types:

- Fixed-income (or mark-up) based.
- Profit and loss sharing.

This is contrary to conventional instruments, which are typically based on fixed or variable interest. The differences in structure are due to the differences between Shariah principles and modern Western banking practices. The principles of Islamic jurisprudence, as they relate to finance, are well-defined, although applying the principles to contemporary banking has raised several challenges.

Firstly, Shariah requires the investor or financier to focus on asset or commercial risk in order to earn a reward. Although the credit rating of the asset or business opportunity must be taken into account, the starting point is not credit as such, but the actual assets or operations underlying the investment. The instruments that fit closely to conventional finance are the fixed-income tools of Murabaha and Ijara which produce the predictable, relatively secure results with which bankers and their regulators are comfortable. However, these are subject to limitations in their application.

Secondly, the Islamic instruments that are considered ideal for business risks are the profit- and loss-sharing instruments which are an equity-type instrument. Only relatively recently have profit- and loss-sharing instruments been implemented in a way that mitigates risks and provides comfort to banking regulators and credit-driven management (see Figure 3).

There are strong arguments in favour of each of the types of financial instruments mentioned above but, in the end, the bank's decision regarding the most suitable offering will mainly evolve around whether or not they meet the business requirements of their clients, are suitable for the risk controls in place at a bank, and how they are affected by the Basel III capital adequacy rules. In addition, the choice of instruments offered depends on the objectives of the financial institution and the nature of their business. Generally speaking, commercial banks tend to prefer fixed-income type instruments, like Murabaha and Ijarah, whereas others, such as venture-capital and equity-driven institutions, tend to be more inclined to use equity-based instruments (Mudaraba and Musharaka). However, institutions hardly ever use only one type of instrument, since diversity of products is needed to support the different requirements of clients.

The pricing of fixed-income type instruments, for example, is driven by the creditworthiness of the client, and can be less attractive to small or starting businesses.

6. Wakala (Agency Contract)

Learning Objective

5.3.1 Know the nature of the Wakala (agency) contract

5.3.2 Be able to apply the Wakala contract

Wakala is an agency contract and is widely applied by Islamic banks and their clients. The concept ranges from brokerage services in permissible activities to fund management (as an alternative to Mudaraba) and underwriting management in Islamic insurance to serving as the agent (Wakil) – buyer or seller – on behalf of a contractor (usually a bank) in several transactions. In principle, an agency contract is permissible with respect to all activities that are permitted to be discharged by the principal.

There are two types of agency contracts:

- **Disclosed agency** – in this contract type, the agent discloses their role as agent to others. All documentation in connection with the subject matter or service undertaken is produced in the name of the principal. This is considered to be the preferred contract type.
- **Undisclosed agency** – in this contract type, the agent does not disclose that they are acting on behalf of another party and, to all intents and purposes, they are acting as principal in dealing with third parties. For example, if A appoints B as their agent, and B buys a car from C for 10,000 dinars on credit and does not disclose to C that they are acting as an agent for A, C can then only claim their money from B. However, if B discloses that they are acting on behalf of A then C shall claim their money directly from A and, therefore, shall bypass B. Applying this rule of agency to Islamic banks leads to the following situation. A bank appoints an agent, X, to procure specific goods on its behalf from a supplier. Acting as the bank's agent, X buys the goods, but does not disclose the name of the bank for which they have bought them. In this case, the suppliers cannot claim payment from the bank; they must make their claim to X.

Furthermore, it is important to note that the agent has a fiduciary responsibility and hence acts as trustee in holding the assets of the principal or in executing the service. Accordingly, an agent cannot be held liable for any loss or damage pertaining to the assets, or for any liability arising from the performance of the agency contract, unless such loss, damage or liability was caused by the agent's negligence, misconduct or breach of the terms of the agency agreement. Similarly, the principal is responsible for all costs and expenses incurred by the agent in performing the work agreed under the contract and must, therefore, reimburse the agent accordingly.

Wakala contracts can be used in combination with a wide range of Shariah-compliant transactions.

7. Mudaraba – Shariah Standards

7.1 Application of the Mudaraba Contract

Learning Objective

5.4.1 Be able to apply the Mudaraba contract to deposits

7.1.1 Application of the Mudaraba Contract to Deposits

Islamic banks usually use Mudaraba contracts with clients who deposit their money using, what is generally known as, an investment account. In an investment account, the funds are placed with the bank with the expectation of a return. The bank uses these funds in its capacity as Mudarib, and provides an anticipated, though not guaranteed, return. This is comparable with savings accounts in conventional banks, where the bank lends out depositors' money with a view to generating a higher return than the deposit rate. Islamic banks invest clients' money on their behalf.

International banking typically defines saving accounts as deposit accounts with capital protection. Deposit guarantees are provided by a third party and are generally limited to a maximum amount. In non-Muslim countries, this deposit guarantee is usually also applied to Mudaraba deposits, since the economic reality of the transaction is deemed to be the same as conventional savings accounts. The deposit guarantee is normally defined as a national insurance scheme. In Islamic banking, deposit insurance could, for example, be implemented through Takaful or Islamic cooperative insurance.

The Process

- The client places their money in an Islamic bank account. In this case, the clients are considered as Investment Account Holders (IAHs) and are the Arbab al Mal.
- The Islamic bank, as Mudarib, invests the IHAs money in Shariah-compliant businesses.
- The IAHs can choose between Unrestricted Investment Accounts (UIAs) and Restricted Investment Accounts (RIAs) – these are covered further in section 7.4 of this chapter.
- In an attempt to increase the Islamic bank's responsibility in its investment selections, Shariah scholars usually advise the Islamic bank to invest part of its capital together with the IAHs' money in the Mudaraba activity. Islamic banks can also be capital providers (Rab al Mal) in Mudaraba activities. The risk can be reduced by reviewing a feasibility study or business plan drawn up by the Mudarib and by obtaining collateral or a third party's guarantee. Collateral and third-party guarantees can only be enforced in the event of gross negligence or breach of contract by the managing partner (Mudarib). The two primary parties in a Mudaraba are the managing partner, or Mudarib, and the investor, or Rab al Mal (literally 'owner of the capital'). The Mudarib is a fiduciary and does not share in losses unless the Mudarib is also a co-investor (in a bilateral Mudaraba). The Mudarib's investment of skill and effort is subject to the opportunity loss of both their time and effort. As managing partner of the investment or business activity, the Mudarib alone is empowered to make business decisions. The Mudarib may earn a wage under the investment agreement for performing specific tasks. Typically, the Mudarib expects to recover their expenses from the ordinary proceeds of the Mudaraba.

7.2 Returns in a Mudaraba Contract

Learning Objective

5.4.2 Understand the roles of, and the returns received by, the Rab al Mal and Mudarib under a Mudaraba contract

The Rab al Mal (the investor) is the sole party obligated to contribute capital (Ras al Mal). As a financial investor, the Rab al Mal has an absolute right to information and to monitor investment activities. In a typical Mudaraba, the Rab al Mal has the same rights and obligations as a limited partner, a member of a limited liability company or an investor in a mutual fund company. The investor's rights are normally negotiated in advance and defined in the investment management agreement.

In modern Islamic banking, the profit is typically allocated from the business's gross operating profit or loss (before deduction of general overhead expenses), rather than the net operating profit or loss. This is because the Mudarib does not need to be an individual, but can be a firm or a company in which case the company as a whole acts as the Mudarib. Accordingly, expenses of the company, including overhead and rent, are not borne by the investor or Rab al Mal.

The termination of a Mudaraba is executed according to the agreement between the two parties. The parties may agree to terminate the contract while the underlying business is still ongoing. In this case, net asset value (NAV) may be pursued as a means to determine the profitability of the business and the share of each party. The transaction can be exited either by the investor (Rab al Mal) selling his share to a third party or by the Mudarib voluntarily buying the investor's share in the business. As a result of its flexibility, the concept of Mudaraba has become a key organising principle of Islamic banking and asset management.

7.3 Two-Tier Mudaraba Structure

Learning Objective

5.4.3 Be able to apply the two-tier Mudaraba contract

Islamic banking may be structured in the form of a two-tier Mudaraba whereby the bank collects funds from depositors on a Mudaraba basis and then invests these funds by forming a Mudaraba between the bank and a client who requires the funds. In order to understand the two-tier Mudaraba structure, it is important to first consider how the Mudaraba can be applied with the Islamic bank in the role of the investor.

7.3.1 Application of the Mudaraba in Financing

In addition to the application of a Mudaraba transaction to deposit-taking activities, it can equally be applied when providing financing. In this case, its application is similar to a direct investment. In this case, the Islamic bank fulfils the role of the Rab al Mal, which occurs when the bank invests in other investments as depicted in Figure 4 below.

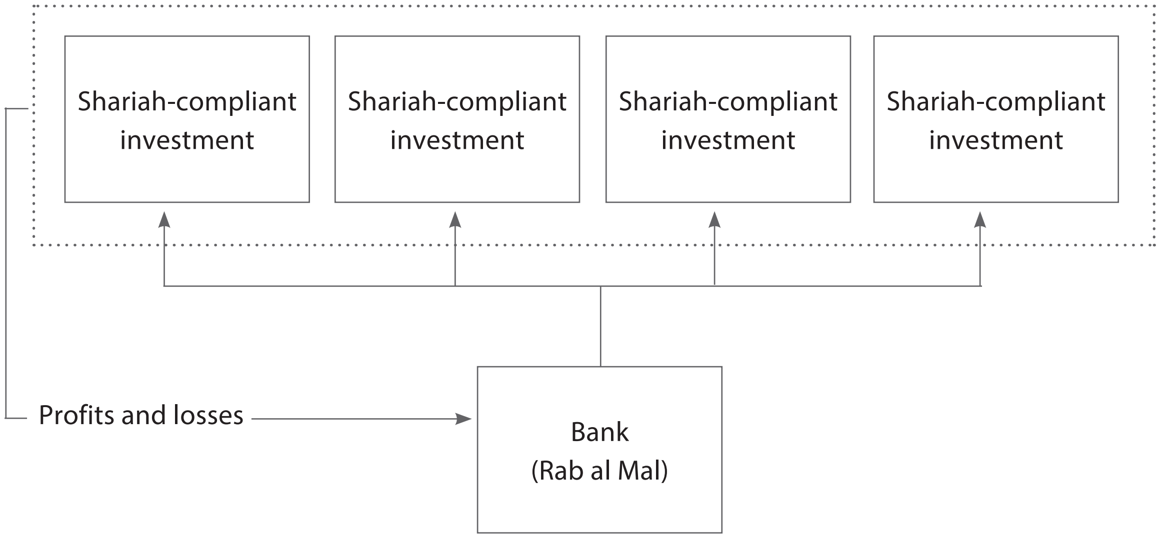


Figure 4: Mudaraba contract

1. Client and Islamic bank enter into a Mudaraba agreement. The latter acts as Rab al Mal (an investor who provides the capital). The client acts as a Mudarib (an entrepreneur who gives their expertise to the project).
2. The project's profits (if any) are distributed among the two Mudaraba parties (Rab al Mal and Mudarib).
3. Profits are distributed according to a predefined ratio agreed between the two parties in the Mudaraba agreement. In case of any loss, material losses are borne by the Rab al Mal only.

Example

An engineer embarks on a project to construct a bridge and needs a partner to provide all the capital for the project. The engineer approaches a bank with a business plan including a feasibility study and a cash flow statement. The bank assesses the plan and the feasibility of the project and enters into a profit-sharing agreement (Mudaraba) with the engineer.	The engineer (the Mudarib) negotiates the terms of the contract with the bank: the amount the bank will invest in the project and the profit sharing ratio between the engineer and the bank. The Mudarib contributes expertise and management of the project. The bank contributes all the capital (either in a bullet payment or in tranches depending upon the nature and requirements of the project). The bank issues investment deposit certificates/Mudaraba certificates to customers contributing capital.	Periodically, the Mudarib and the bank assess the project's performance. If the project performs according to plan, the bank will recover its capital and profits. Profits are shared between the bank and the Mudarib according to the pre-agreed ratio. Profits can be distributed periodically as long as the bank's capital is assured. If the project makes a loss, the bank bears the loss. Only if the engineer (the Mudarib) has been negligent will he be held liable for the loss of capital.

The application of Mudaraba finance requires a different set of skills and expertise from the bank in comparison with conventional debt financing.

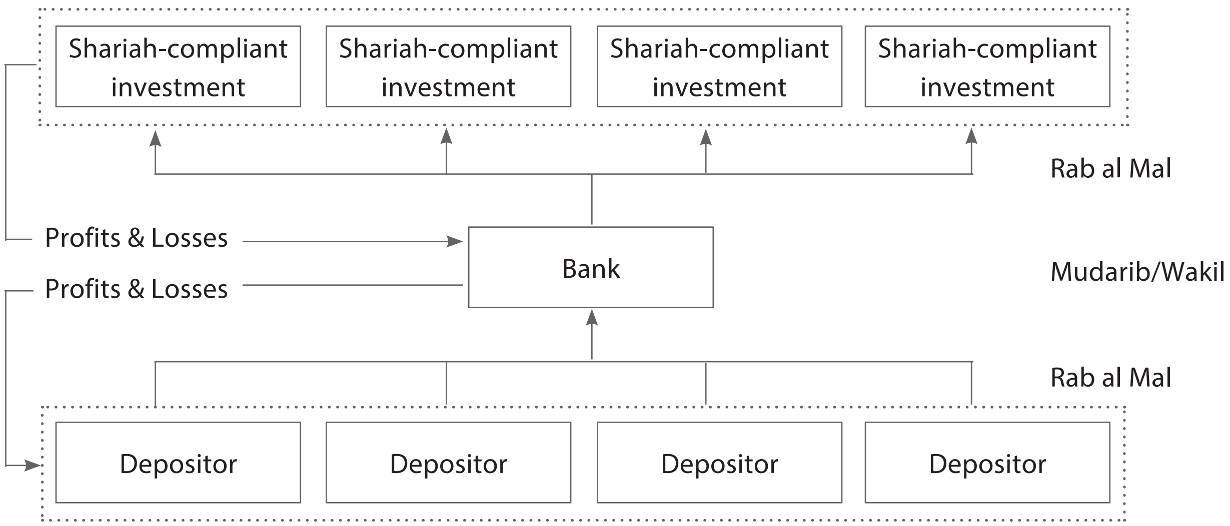


Figure 5: Two-tier Mudaraba structure

Example

Two-Tier Mudaraba

First Mudaraba Contract

Investors deposit US$200,000 with Islamic Bank under a Mudaraba contract for a period of 12 months and a profit allocation set out in the agreement as 80% to the investors (Arbab al Mal) and 20% to Islamic Bank (as Mudarib). The investors receive Mudaraba Certificates (investment deposit certificates) in exchange for their deposits.

Second Mudaraba Contract

Islamic Bank (as Rab al Mal) invests the US$200,000 in Islamic Enterprises (the Mudarib) to build a new factory. Islamic Enterprises contributes its expertise in managing the project, but no capital. Islamic Enterprises is responsible for the day-to-day management of the project and will receive a share of the profit of the development. Islamic Enterprises' Mudarib share is based on a percentage of the profit and agreed to be 20%. At the end of the Mudaraba, when the factory is completed, it is sold at a pre-agreed amount of US$220,000. Islamic Bank recovers its US$200,000 capital and the US$20,000 profit is returned as follows:

- US$4,000 (20%) to Islamic Enterprises, (as Mudarib).
- US$16,000 (80%) to Islamic Bank (the Rab al Mal).

Under the first Mudaraba contract, the US$16,000 profit is distributed between Islamic Bank (as Mudarib) and the depositors (as investors) as follows:

- US$12,800 to the investors (80%).
- US$3,200 to Islamic Bank as Mudarib (20%).

If the factory is sold at a lower amount than expected, the loss is passed on to the depositors.

The Mudaraba contract is frequently applied to the syndication of large Islamic transactions involving multiple banks and investors. The Islamic bank has a strong incentive to perform well because, even though it does not bear the loss, it will still incur expenses of its own, such as overheads and rental.

7.4 Restricted and Unrestricted Investment Accounts

Learning Objective

5.4.4 Understand the nature of restricted and unrestricted investment accounts

The two forms of investment accounts in Islamic banks are restricted and unrestricted investment accounts. A restricted investment account is contractually limited by one or more restrictions, such as term to maturity, geographical location, transaction type and partner. The restrictions are agreed between the parties. In an unrestricted investment account, the manager has the flexibility to invest the funds within a wide range of activities the bank is involved in, as long as the investments and the investment process are Shariah compliant.

7.4.1 Restricted Investment Account Holders (RIAHs)

Restricted investment accounts are a type of collective investment scheme (CIS) in which:

- the asset allocation is restricted as set out in the contract, and
- there is no secondary market, but investors may be able to withdraw their funds (including undistributed profits but less any losses) before maturity on account basis as unearned income, with the agreement of the bank.

In many Islamic banks, the restricted investment account is not implemented through a separate legal entity such as an investment company or trust but operates under a Mudaraba or Wakala contract, with the bank as Mudarib or Wakil (agent). In other Islamic banks, restricted investment accounts are structured as dedicated investment funds which are held **off-balance sheet**.

During a financial period, the bank is entitled to a percentage share of the investment income (the Mudarib's share) for investment management but does not share in losses, with the exception of losses associated with the capital it has contributed itself.

7.4.2 Unrestricted Investment Account Holders (UIAHs)

Unrestricted investment accounts differ from restricted investment accounts, both from a Shariah perspective and in terms of their economic function. In a UIAH managed by the bank, the client does not specify how their funds must be invested or the way in which the investment needs to be taken into account, as long as the investments are Shariah compliant. Instead, the bank takes on the responsibility to manage these funds to the best of their ability and the profits are shared between client and bank in accordance with the contract underlying the transaction. These accounts are subject to complex governance issues.

The asset allocation of a UIAH is not restricted by contract and the bank can place the funds in any Shariah-compliant investment at its discretion, subject to its fiduciary duty, ie, its relationship of trust, to the IAH. This typically includes mingling the UIAH funds with other funds at the bank's disposal, such as the bank's shareholders' funds and the funds of current account holders. The mingling of funds raises issues of possible conflicts of interest between the shareholders and the UIAH, with regard to the choice and riskiness of investments and the allocation of the income from those investments. In principle, the latter is specified by contract, but because of a lack of transparency in financial reporting and the use of special-purpose reserves, the management, in fact, has considerable discretion in making this allocation.

Shareholders typically have a higher risk tolerance than the UIAHs, who are likely to be more defensive. The economic function of UIAHs is to provide a Shariah-compliant substitute for conventional (interest-bearing) deposit accounts. Conventional deposit accounts are capital guaranteed and enjoy a specified (fixed or floating) rate of return.

Within the guidelines of Shariah, an investment made on the basis of a Mudaraba or Wakala cannot be capital-certain. The Rab al Mal is exposed to losses, unless they are due to misconduct and negligence on the part of the Mudarib. Due to the profit sharing and loss bearing characteristics of the Mudaraba and Wakala, the rate of return cannot be specified in advance in the same way as an interest payment.

The challenge faced by the Islamic financial industry and regulators is to reconcile the Shariah basis of unrestricted investment accounts with their economic function of providing a Shariah-compliant substitute for conventional deposit accounts.

This issue has been addressed differently in different countries. In some countries (eg, Jordan, Malaysia and Qatar), the industry and its supervisor have taken the view that Islamic banks are under some kind of an obligation to maintain the capital of UIAHs intact and also to pay the account holders a steady rate of return, similar to that paid on conventional deposits. In Malaysia, the central bank (Bank Negara) considers explicitly that, since UIAs are marketed as a substitute for conventional deposit accounts, banks have a constructive obligation by law to maintain the account holder's capital and to pay them a steady rate of return on their investment.

In Jordan and Qatar, the position is less explicit and, instead of a constructive obligation in law, there is a commercial obligation of sound banking practice while for prudential matters, such as capital adequacy, UIAs are treated in effect as conventional deposits.

In other countries, such as Bahrain and other GCC states, the view is that there is no obligation to maintain the capital of the UIAHs intact or to pay a return as long as the assets in which their funds are invested have been impaired in the normal course of business. Guaranteeing capital and paying of a return are considered to be commercial matters associated with the fact that managing IAH funds is an important source of income for the banks. However, the banking supervisor does consider a failure to maintain the capital of unrestricted IAHs intact or to pay them returns as bad banking practices and, therefore, to be avoided. Supervisors fear that such failures may lead to a run on the bank, with subsequent systemic risk implications. This is typically addressed by enhanced regulations and audits.

In some countries, such as Saudi Arabia, the Islamic banks in general do not offer UIAs. Banks wishing to offer a deposit-like investment product do so in the form of investment funds, where investors clearly and explicitly bear the risk of the investment.

In order to obtain a banking licence in the UK, and to be permitted to take deposits, the regulator requires the facility is capital certain. Firms offering UIAs who wish those to be treated as deposits under the UK regulator's definition, have to guarantee the capital. However, the customer has the right to waive this protection after any loss event has occurred on a voluntary basis. The choice is left to the customer as to whether or not to opt out of statutory protection and to accept the loss on the UIA, in order to keep the account Shariah compliant. Firms offering UIAs who do not wish them to be treated as deposits are not required to offer guarantees on these products. From a corporate governance point of view, the position of UIAHs in the UK is, therefore, highly ambiguous. The only corporate governance issues raised by conventional deposits concern the depositors' rights as creditors in case of default by the bank (eg, a right to appoint an administrator to manage an insolvent bank on behalf of its creditors). The situation of UIAHs in the UK is similar. Elsewhere, however, UIAHs are not creditors and do not have such rights. In fact, the only right they have is that of withdrawing their funds, subject to any contractual restrictions on their so doing (eg, a notice period and loss of any accrued and undistributed profits).

From the standpoint of transparency, UIAHs are generally in a worse position than RIAHs, since they are generally uninformed of the asset allocation applied to their funds and the allocation of profits between them and the bank's shareholders is generally not transparent and may be manipulated by the management. Thus, as well as having no control rights, they are not well served in terms of either information rights or cash flow rights. However, increased competition in the market is likely to change this situation.

8. Musharaka – Shariah Standards

8.1 The Parties to a Musharaka Contract: Provision of Capital and Management by both Bank and Customer

Learning Objective

5.5.1 Be able to apply the partnership contract of Musharaka

Musharaka transactions generally take either one of two forms: **Shirkat al Milk** or **Shirkat al Aqd**. Shirkat al Milk (or ownership-partnership) is a partnership in which the partners have shared ownership over a property, but none of them manages the property to generate a return or profit. This form of partnership may be established without a specific contract. The primary limitation of the partnership is that its object, the underlying property, is not divided or unitised.

Shirkat al Aqd (or contractual partnership) is a partnership by mutually agreed contract in which one or more of the partners manages the property on behalf of others to generate returns. This is derived from the principle in Shariah that contractual partnership implies a contract of agency. Musharaka typically refers to Shirkat al Aqd. Although capital contributions may be in kind or in the form of services provided, they are typically cash and valued at an agreed par value. The primary basis for the valuation of contributed capital is mutual agreement between the contracting parties.

Shirkat al Aqd comes in two forms: the permanent, or continuous, Musharaka, and the diminishing Musharaka contracts.

8.1.1 Permanent or Continuous Musharaka

In this contract, each partner to the Musharaka contract retains their share in the capital until the end of the project. Any partner can, however, sell their shares in the Musharaka capital to other partners or to a third party. This contract is used by Islamic banks when investing in a specific project. Similar to the Mudaraba, the profit ratio is pre-agreed in the contract and losses are distributed in proportion to the capital provided. When applying Mudaraba or Musharaka, Islamic banks require a feasibility study and/or cash flow statement for the project as part of the investment decision-making process.

With all methods of Musharaka, the capital is quantified and specific. As with Mudaraba, Musharaka profits must be shared in the same proportion as set down in the contract. Losses are borne by partners according to their share in the capital. The profit cannot be structured to give a guaranteed rate or yield to one party.

Example

X and Y are partners in a Musharaka, with X contributing 80% of the capital and Y contributing the remaining 20%. The agreement specifies that they will share profits in a ratio of 70% to X and 30% to Y, to reward Y for the work he undertakes for the project. Losses are borne by X and Y according to their initial contribution of capital (80/20).

The process of a Musharaka structure is defined as follows:

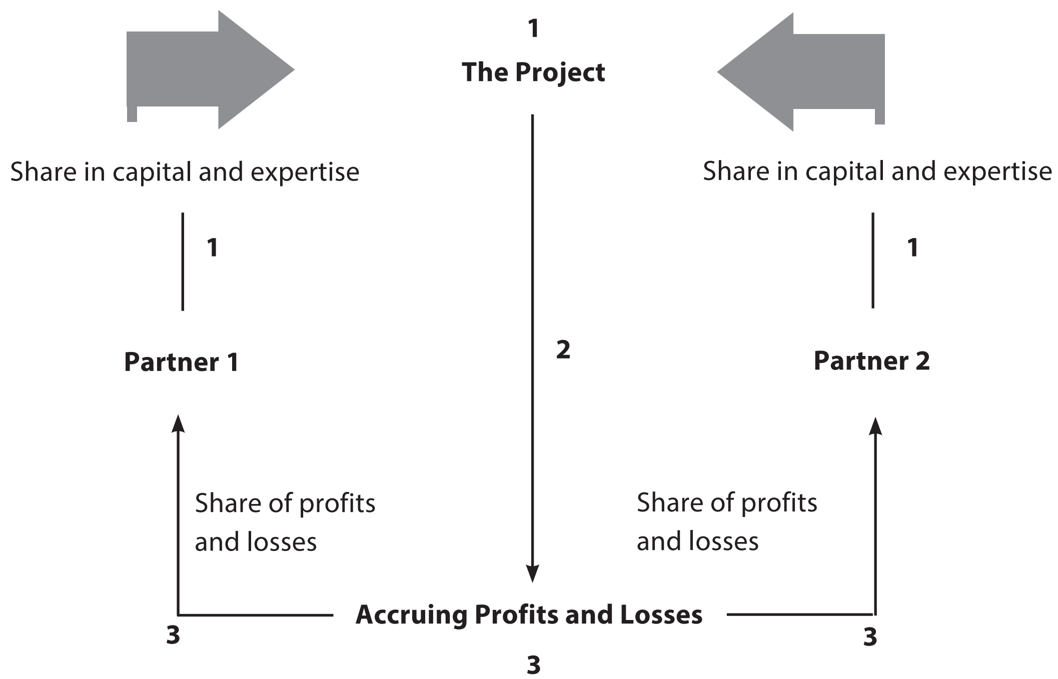


Figure 6: Musharaka contract

1. Two or more partners intend to undertake a Shariah-compliant project (eg, to build a manufacturing plant on land owned by the client) on a Musharaka basis and enter into a Musharaka agreement. All parties provide capital to the project (the client, for example, provides the land and expertise in building the manufacturing plant and the bank provides the finances) and have the right to participate in the project management and operation.
2. The project's profits (if any) are distributed among the partners. Profits are distributed according to a predefined ratio agreed between the two parties in the Musharaka agreement.
3. Losses (if any) are born by partners according to their contribution to capital.

A general principle of partnership under Shariah is that partners have the right of pre-emption, unless the property is tightly defined or there is mutual agreement. This means that, if one party wants to sell his share, they will first need to be offered to the other partners. This stipulation may be removed by mutual contract agreement, making Musharaka a more practical proposition for the banking environment.

In theory, every partner may participate in the operating management of the enterprise. Within a Musharaka, the partners may appoint a deputy to operate the partnership or perform specific functions of the business. As with the modern corporation, the members of a Musharaka may elect one or more of themselves or a third party, a non-member, to manage the Musharaka.

Some banks practise Musharaka in a manner similar to Mudaraba and severely reduce the bank's risk and operational liability profile. Part of this process of mitigation relates to the process of termination. For this, the Islamic bank calculates the valuation for interim withdrawal or profit distribution/loss allocation and advises clients in what is termed 'constructive liquidation', ie, the enterprise is not terminated, rather a member withdraws or sells their position. This is a form of NAV determination which seeks to define the price a willing buyer would pay for the assets of the enterprise.

5

Also, similar to the modern corporation, a Musharaka may not be subject to a specific time frame. As a rule, a Musharaka may not be dissolved without the knowledge of all of its members. Most Islamic scholars agree that the formal process of notification fulfils this obligation.

Example

Investors place deposits with Islamic Bank, for which it issues them notes of participation, to fund a Musharaka partnership with Islamic Enterprises to buy a property which is to be rented out. Under the Musharaka contract with Islamic Enterprises, Islamic Bank provides capital of US$400,000 and Islamic Enterprises contributes US$100,000. Hence, Islamic Bank provides 80% of the capital and Islamic Enterprises 20%. This joint venture buys the property and successfully rents it out. The rental income is shared between Islamic Bank and Islamic Enterprises in a ratio of 60% to Islamic Bank and 40% to Islamic Enterprises. If the property is not rented, the project is not losing cash but is losing an opportunity return. If the partners decide to sell the property, and the selling price is below US$500,000, then if the selling price is, say, US$400,000 (loss of US$100,000) the loss is shared 80%:20%; Islamic Bank receives US$320,000 and Islamic Enterprises receives US$80,000.

8.1.2 Diminishing Musharaka (Musharaka Muntahiya Bittamleek)

Learning Objective

5.5.2 Be able to apply the Diminishing Musharaka contract

Diminishing Musharaka (also called declining balance partnership, or Musharaka Mutanaqisa) has been a popular tool for banks, with particular success in the property sector. This method is also useful for pre-export finance and working capital. The Diminishing Musharaka is a special form of a Musharaka transaction, in which it is agreed at the outset that one of the partners will, over time, purchase units in the Musharaka venture from one of the other partners at a pre-agreed unit price. At the start of the agreement, the project is divided into a number of equal units. The purchase can take place gradually over time at a fixed or increasing number of units per period.

For example, the bank and the client jointly invest in a property that generates rental revenue. The bank purchases 90% of the property, while the client purchases 10%. In addition, the client promises to gradually purchase the bank's share in the property, eg, 30% per year. Once the client has purchased all the shares, they will be the sole owner. The client promises to purchase the share of the bank at fair value or at a price agreed at the time of purchase.

The parties jointly own the property or the venture. However, if one partner purchases the share of another partner, and then immediately resells it to the same partner at a profit, this is considered to be a form of Inah that is not acceptable in Shariah.

A Diminishing Musharaka may consist of layered contracts and can include binding promises. For instance, in the case of property, the declining balance partnership is based on a property contract in which the majority partner is the financier, and the beneficiary of the finance, the client, is the manager of the property.

In the event a client fails to keep up payments on a mortgage under a Diminishing Musharaka, the bank is technically not in a position to repossess since it owns (part of) the house. However, the bank may modify the client lease, evict the client or adjust the ownership share to reflect the client's past due payments.

For example, X wants to buy a house for their family and enters a Diminishing Musharaka contract with Islamic Bank. Under the agreement, the Islamic Bank buys 80% of the units in the property and the client 20%. The client promises to purchase shares in the house from the bank over a period of 25 years. The client rents the part of the property they do not own from the bank. After ten years, X stops making payments to the bank. Generally, the bank has the following options:

- amend the rental agreement
- evict the client, sell the property and share any profits with the client, or
- adjust the ownership share to reflect the client's past due payments.

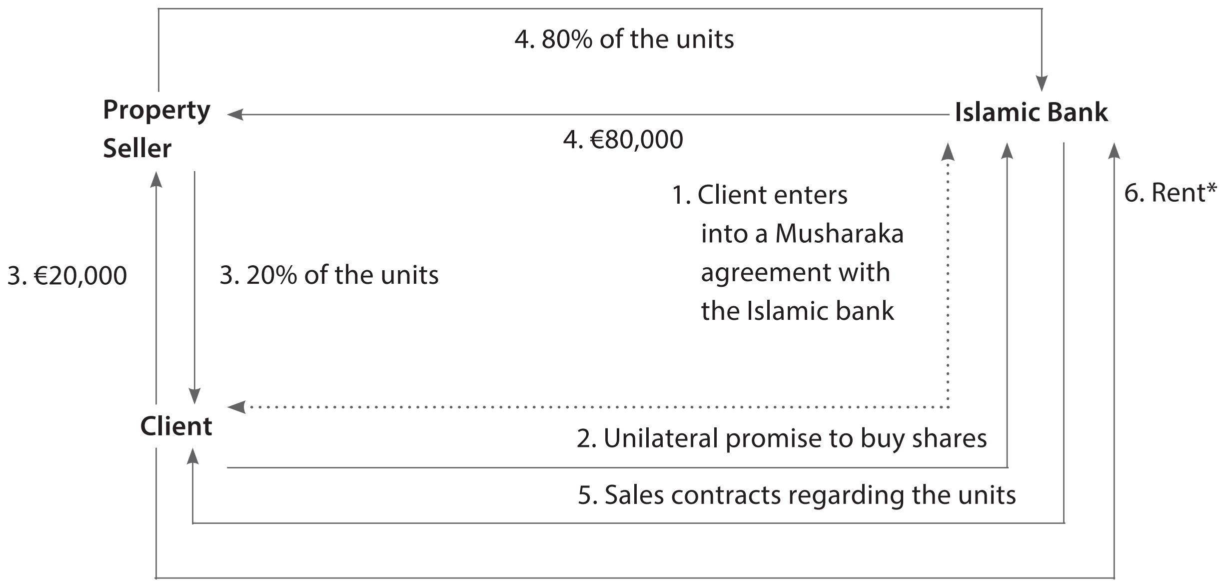


Figure 7: Example of a Diminishing Musharaka contract for a mortgage contract

Source: Schoon, N. 2016, Modern Islamic Finance, London: Wiley

* Rent needs to be adjusted after each acquisition of shares.

Client identifies the property and makes an offer of 100,000 which is accepted by the seller.

1. Client enters into a Musharaka agreement with the Islamic bank in which the following is agreed:
   - the share of the house the client will initially purchase (in this example 20%)
   - the share of the house the bank will initially purchase (in this example 80%)
   - the division of the property into equal units, and
   - the length of the rental period.
2. Client provides unilateral purchase undertaking to buy the bank's share as agreed.
3. Client transfers 20% of the sale price to the seller of the property and receives 20% of the units.
4. Bank transfers 80% of the sale price to the seller of the property and receives 80% of the units.
5. Sales contract is drawn up between the bank and the client governing the sale of the remaining units which are not currently owned by the client. The transfer of the ownership of the remaining units can take place gradually over time, at the end of the rental period or as and when it suits the client (which could be done by a purchase at the end of the Musharaka agreement).
6. Client pays pre-agreed rental payments to the bank. Rental payments can include a component towards the ownership of the remaining units of the property.

At the end of the contract, the client has full ownership of the property.

Example

A builder enters into a project to renovate a block of flats and approaches the bank for capital. Based on a business plan or equivalent documentation the bank enters into an equity participation agreement with the client. The bank may issue notes of participation to investors.	The builder and the bank negotiate the term of the Musharaka contract: the amount of capital each will invest in the project, the profit-sharing ratio between the parties, the responsibilities of the builder and the bank for managing the project.	On conclusion of the project, the builder and the bank assess the profits. In a continuing Musharaka, the builder and the bank share the rental income from the flats in accordance with the agreed proportions – which may differ from the ratio of capital contributions. Losses are shared by the builder and the bank according to their capital contributions. In a diminishing Musharaka, the builder will buy out the bank's share in the property over a period.

9. Murabaha – Shariah Standards

9.1 Murabaha: The Instalment Deferred Sale Contract

Learning Objective

5.6.1 Be able to apply the Murabaha contract

Most Islamic financial institutions base their banking operations on Murabaha as their method of financing activities. Murabaha refers to a particular kind of sale transaction in which a seller sells an asset to a buyer, at cost, plus a profit mark-up. Cost price and mark-up are known to both buyer and seller. As an example, X, the seller, agrees with Y, the buyer, that Y will buy 100 kilograms of apples from X for £120, where the cost of the apples to X was £100 and X has added £20 profit. This example makes clear that when using Murabaha, the seller discloses to the buyer the actual cost incurred in buying the asset and the profit added.

Figure 8: Murabaha

The payment in a Murabaha transaction may be at spot or at a later date agreed upon by the parties. Murabaha does not necessarily imply the concept of deferred payment although, when Murabaha transactions are used as a method of financing, payment is typically deferred. Murabaha can be used as the method of finance only when a client purchases the goods with a deferred payment. For example, if Y needs to purchase apples as an ingredient to make apple pies in their bakery, but lacks the necessary funds to do so, the bank can purchase the apples from the supplier on the basis of spot payment and then sell them to Y on a deferred payment basis.

The bank does not typically choose to be a principal and instead appoints an agent. The agent could be the ultimate buyer or a third party. The process of a Murabaha structure is defined in Figure 9.

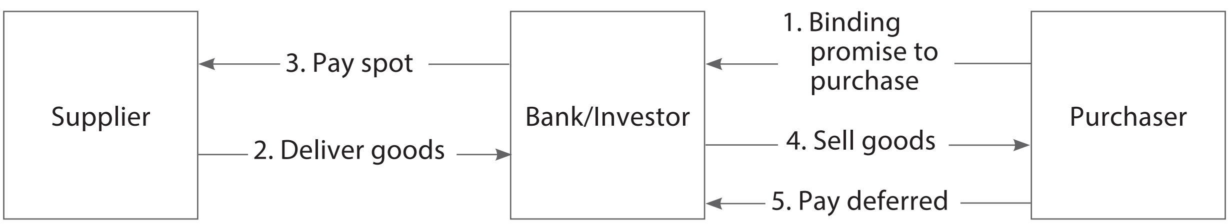


Figure 9: Murabaha contract

Prior to the start of the contract, the buyer of the goods defines their requirements and negotiates the specifications and characteristics of the goods with the seller in advance. Goods should be permissible in Shariah.

1. The buyer promises to buy the goods from the Islamic bank. The promise could be binding or not depending on the agreement between the two parties. In practice, the promise is deemed binding which is reflected in AAOIFI's standards. The Islamic bank may ask the customer to provide a down payment in the form of earnest money (**Hamish Jeddiyah**). This payment shows the buyer's good faith in the transaction. Upon signing the Murabaha, the down payment becomes part of the agreed price and thus reflects on the total price.
2. The Islamic bank enters into a sales contract with the seller and buys the goods as agreed between the buyer and the seller (pre-step 1). Islamic banks can either buy the goods directly (as principal) or appoint an agent to buy the goods.
3. The seller transfers the ownership of the goods to the Islamic bank, who becomes the owner of the goods, and, therefore, bears ownership-related risks. Due to the ownership transfer, the Islamic bank is eligible to earn profits.
4. The Islamic bank enters into a deferred-payment sale agreement with the ultimate buyer and sells the goods to the buyer at a higher, deferred price (price with a mark-up).
5. The buyer pays the Islamic bank the agreed amount on the specified future date.

When used by a bank, the typical Murabaha agreement is a purchase and sale agreement between the bank and its client. If the bank is unable or unwilling to buy the goods for reasons such as legal restrictions or insufficient knowledge about the goods to be purchased, the bank may execute an agency agreement appointing the client as its agent to buy the goods. According to AAOIFI, this should be limited to situations where the Islamic bank is unable to undertake the transaction directly or through an independent agent with the seller. When the client acts as an agent, the technical ownership of the goods resides with the bank. The agency agreement typically incorporates inspection of the goods by the agent of the bank and a waiver of inspection for the purchase and sales agreement between the bank and the buyer. The bank may seek appropriate security for the payment in the form of a guarantee, lien, charge or mortgage.

In the event that a Murabaha is structured as a deferred sale contract, the transaction date and the payment date must clearly be defined. Collateral in the form of a registered lien, charge or mortgage is permissible and the sold goods or property may be reclaimed in the event of foreclosure or other form of legal seizure. In the event of late payment, the seller may not claim a late payment fee or penalty charge, although the actual cost associated with the recovery of the payment can be charged. If a bank decides to charge a penalty, the bank may not benefit from it and any amount over and above the actual cost incurred to recover the funds must be donated to charity.

Various risk mitigants are used against the risk of such losses, in the form of Hamish Jeddiyah (earnest money) retained in part or entirely to cover any loss, or Arboon (a non-returnable down payment). In the context of Murabaha, Hamish Jeddiyah applies after providing the promise to purchase but before the parties enter into the actual Murabaha contract. Arboon is a non-refundable deposit, which is provided by the purchaser after the Murabaha contract is signed.

The most common form of risk mitigation is the unilateral promise to purchase the goods from the bank. In many jurisdictions, including the UK and the US, the promise to purchase is sufficient to pursue a collection judgment against the client (ie, the courts will allow the bank to collect the payment) if the client refuses to accept delivery when the goods meet the contractual specifications.

An alternative technique to hedge the risks facing the bank is for the bank to buy the goods from the seller with the right to cancel the sale within a certain period, for example, 24 hours. The bank then notifies their client that the goods are available for purchase for a shorter period, eg, 12 hours. If the client completes the purchase, the Murabaha transaction is concluded. Otherwise, the bank has the right to cancel the purchase transaction with the seller and thus hedge the risk of reselling the goods.

9.2 Murabaha Export Financing

Learning Objective

5.6.2 Understand the use of Murabaha in export finance

When a supplier is not in a position to provide deferred payment conditions to a buyer, the buyer can involve a bank and undertake a Murabaha contract as a financing agreement. In this case, the following steps occur:

1. The buyer approaches the bank for the financing of specific goods.
2. The bank buys the goods from the supplier and pays them spot.
3. The bank sells the goods to the buyer against deferred payment as agreed.
4. The bank instructs the seller to deliver the goods to the buyer.

In a similar way, Murabaha transactions can be used to provide pre-export or import finance. After completing the Murabaha steps outlined above, the bank instructs the buyer (the client) to act as its agent to sell the goods onwards in the market. This has the benefit of providing working capital finance to the client. Alternatively, the client may provide financing to the end buyer if the final sale is on credit basis. This is particularly helpful if the end buyer is not a customer of the bank. In order to collect the payment, the client may appoint the bank as its agent to collect the receivable against a fee payable to the bank.

9.3 Differences between Murabaha and a Loan

Learning Objective

5.6.3 Know the differences between a Murabaha sale and a loan of money

Many bankers and their regulators are comfortable in taking the view that Murabaha is a synthesised loan or form of debt. There are, however, a number of major differences between a Murabaha sale and the loan of money:

1. The banker in a Murabaha must have some form of actual ownership of the underlying goods or services, registered or not, constructive or physical.
2. In Murabaha, the finance and sale transaction are fully integrated, since the financing is related to a real transaction. In a loan, there is no contractual link between the financing and the real transaction. Hence, finance and economic activities may diverge.
3. The payment date for a Murabaha transaction may be extended, but this may not result in an increase in the mark-up or a penalty fee. Any increase or penalty violates the basic rule of Riba.
4. If the payment is late, no form of penalty may be charged for the profit of the creditor.
5. Most Islamic scholars do not like net sales, sales discounts or early payment discounts when these are structured into the contract. Scholars find it acceptable if the financier (ie, the bank) elects on its own to give discounts at its absolute discretion and shall not be contractually pre-agreed.

As a rule, the same object cannot be sold back to the original seller, or associates which the seller has control over, at a different price. This is a twin sale and mimics loans involving interest, which is forbidden.

Example

Islamic Enterprises produces copper tubing. Islamic Enterprises specifies the quality of the copper it wishes to buy and obtains a quotation from Vendor (the seller of the copper) which is valid for two months. As a customer, Islamic Enterprises enters into a Murabaha arrangement with Islamic Bank (the buyer), promising to buy the copper for the cost of the ingots, plus an agreed-upon mark-up. Islamic Bank agrees to buy the copper from Vendor and pays Vendor US$1,000 for each copper ingot. Islamic Bank bears the costs of the secure delivery of the ingots to Islamic Enterprises. Islamic Enterprises buys the copper ingots from Islamic Bank at a price of US$1,100 for each ingot. Islamic Enterprises notifies Islamic Bank that it has taken delivery of the copper in the capacity of the bank's legal representative. Islamic Bank and Islamic Enterprises sign the Murabaha sale contract, which requires payment to the bank one month after delivery of the ingots. This one-month period is the period of financing under the contract and, during this period, Islamic Enterprises lodges tubing of equivalent value with the bank as collateral.

9.4 Commodity Murabaha And Tawarruq

Learning Objective

5.6.4 Understand the operation of Tawarruq and Commodity Murabaha

9.4.1 Commodity Murabaha

The Commodity Murabaha is the instrument most commonly used by Islamic financial institutions to provide short-term interbank liquidity or, in the case of retail finance, unsecured personal loans. A Commodity Murabaha is, like the basic Murabaha transaction, a deferred payment sale or instalment credit sale and uses a commodity, usually a base metal, as the underlying asset for the transaction. Unlike basic Murabaha, however, when the commodity is sold to the buyer, the buyer immediately liquidates it (ie, sells it for spot cash).

The objective of this transaction, therefore, is not to facilitate the ownership of the client of the underlying commodity. Rather, it is to replicate a conventional money market transaction or unsecured loan. The banks do not typically hold the underlying commodity nor is the client interested in owning it. The metals are purchased and sold solely to obtain cash now against a higher payment in the future, using techniques that are compliant, in form at least, with Shariah principles.

Because Commodity Murabaha does not finance real ownership of goods and services, but rather replicates a conventional loan, it has been subjected to criticisms at various levels and on many occasions. The transaction is considered to be a compromise to meet urgent needs that could not otherwise be met. As outlined in chapter 3, flexibility in case of necessities or surmounting difficulties is embedded within Shariah. Many Islamic banks are actively seeking alternatives to Commodity Murabaha to reduce the costs of the transactions, whilst at the same time satisfying the objectives of Islamic finance.

As Commodity Murabaha transactions are fixed-rate, they are typically for a relatively short term. The Commodity Murabaha is executed using a commodity as the underlying asset, which has to be non-perishable, freely available and uniquely identifiable. Any commodities that were originally used as a means of exchange or money – ie, gold, silver, barley, dates, wheat and salt – are not acceptable. The majority of Commodity Murabaha transactions use London Metal Exchange (LME) base metals as an asset since they meet all criteria for a commodity and are easily identifiable via warrants. (An LME warrant is a certificate for a specific metric tonnage of an approved brand of metal stored in an LME approved warehouse. The warrant is a bearer document and signifies ownership of the underlying metal to the holder.)

In comparison to conventional deposits, Commodity Murabaha transactions attract an additional cost associated with the purchase and sale of the warrants, which can be dependent on volume and contract size. For longer-dated contracts, this is not necessarily an issue, as the additional cost is spread over a longer period. It does, however, significantly increase the price of shorter-dated deposits.

Figure 10 describes the transaction where an Islamic bank wants to provide a deposit to its counterparty to generate a return. The process flow is as follows:

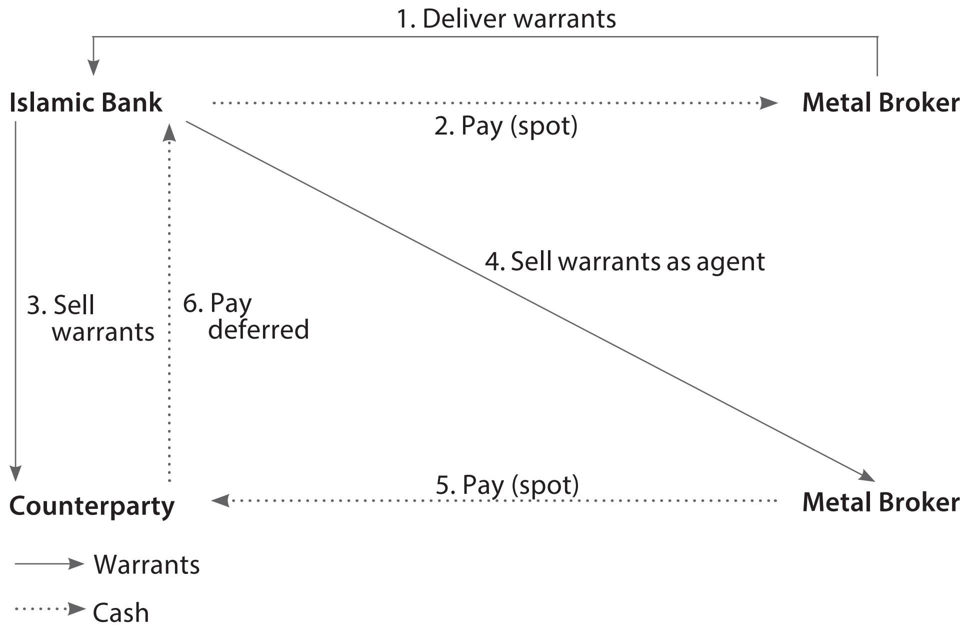


Figure 10: Commodity Murabaha

Source: Schoon, N. 2016, Modern Islamic Finance, London: Wiley

The individual steps are defined below, using an example of a Commodity Murabaha to deposit £1 million with its counterparty:

1. The Islamic bank buys warrants from a metal broker. The ownership of the warrants transfers from the metal broker to the Islamic bank. The Islamic bank purchases warrants for the value of the deposit, £1 million.
2. The Islamic bank pays spot. The bank initiates payment of £1 million to the metal broker spot in return for the warrants.
3. The Islamic bank sells warrants to the counterparty. The Islamic bank sells the warrants to its counterparty on a deferred payment basis and agrees that the counterparty will pay for the warrants in three months' time for an amount of £1.05 million.
4. The counterparty requests the Islamic bank to sell warrants on its behalf. The Islamic bank is requested to act as an agent, on behalf of the counterparty, to sell the warrants at spot. The Islamic bank sells the warrants at the spot price of £1 million to a metal broker.
5. Payment from end buyer to counterparty. The metal broker (end buyer) pays the counterparty spot in return for the warrants. In this example, the metal broker pays £1 million to the counterparty (using the Islamic bank as an agent to facilitate payment). At this point during the transaction, the counterparty is in the possession of £1 million and does not have to pay the Islamic bank until three months later, when they will have to pay £1.05 million to the Islamic bank.
6. Payment from counterparty to Islamic bank. This payment takes place at a pre-agreed time in the future and consists of the principal of the original purchase (£1 million) plus a pre-agreed mark-up (£0.05 million).

The net result of the above movements of warrants and cash is that the counterparty now holds an amount of money against an offsetting payment to the Islamic bank, for a pre-agreed principal, plus a mark-up at a pre-agreed future date, thus creating a synthetic deposit. It is important to note that each of the steps has to take place in the correct sequence and that the ownership of the warrants will have to transfer from one party to the next before the next action can take place.

In steps 1–3, the Islamic bank buys the warrants as a principal and subsequently sells them to the client on a deferred payment basis. The client now owns the warrants and can sell them, which is often done by requesting the Islamic bank to act as an agent on his behalf to sell the warrants in the spot market. The Islamic bank arranges for the sale to a metal broker resulting in a synthetic interbank deposit placed by the Islamic bank with the client.

Example

Commodity Murabaha to place a deposit. An Islamic bank wants to place a deposit with XYZ Bank, a conventional bank, of £1 million for a period of six months using a Commodity Murabaha. Islamic Bank and XYZ Bank have a Master Murabaha agreement in place. The trade takes place on 16 March 2014, for value date 16 March, and maturity date 18 September 2014. The following steps are taken on different dates:

1. Trade Date – 16 March 2016:
   The Islamic bank purchases £1 million worth of aluminium alloy from the metal trader.

2. Trade Date – 16 March 2016:
   The Islamic bank receives warrants from the metal trader.

3. Trade Date – 16 March 2016:
   The Islamic bank offers to sell £1 million of aluminium alloy to XYZ Bank for a deferred payment on 18 September 2016 of £1.05 million.

4. Trade Date – 16 March 2016:
   XYZ Bank accepts the offer.

5. Trade Date – 16 March 2016:
   The Islamic bank transfers ownership of the warrants to XYZ Bank (which is now the owner of the warrants).

6. Trade Date – 16 March 2016:
   XYZ Bank sells the warrants by requesting the Islamic bank to act as its agent and sell the warrants on a spot basis for £1 million with the money to be received on 18 March 2016.

7. Trade Date – 16 March 2016:
   The Islamic bank sells £1 million of aluminium alloy to the metal trader on behalf of XYZ Bank, with the payment to be made to XYZ Bank.

8. Value Date – 18 March 2016:
   The Islamic bank pays £1 million to the metal trader.

9. Value Date – 18 March 2016:
   The metal trader pays £1 million to XYZ Bank.

At this point in time, XYZ Bank has received £1 million against a deferred obligation of £1.05 million to the Islamic bank which has created a synthetic interbank placement.

10. Maturity Date – 18 September 2016:
    XYZ Bank pays £1.05 million to the Islamic bank.

There are variations in the market on the above structure.

9.4.2 Tawarruq

Tawarruq is a transaction in which a person purchases a good on a deferred-payment basis, then sells it to a third party to obtain cash. Accordingly, Commodity Murabaha discussed above is essentially a Tawarruq transaction. The Tawarruq has, however, some Shariah issues associated with it. The main Shariah issue with Tawarruq transactions relates to the fact that the intention behind the purchase of the commodity is not to own and use the commodity. Instead, the commodity is sold instantaneously in order to obtain the required funds. Historically, although the minority of the schools of Islamic jurisprudence have rejected the Tawarruq for that reason, the majority have approved it only subject to certain conditions, such as an auditable ownership transfer of the commodity and separation of the purchase and sale arrangements.

Organised Tawarruq is a Tawarruq transaction in which the bank acts as an agent to the client to sell the commodity for cash, collect the cash and deposit it in the client's account. The two major Fiqh academies of the Islamic world, the OIC Fiqh Academy (resolution No. 179 in 2009) and the Muslim World League Fiqh Academy (in 2003 and 2007), both rejected organised Tawarruq because it results in Riba.

The two Fiqh Academies also rejected Reverse Tawarruq, a transaction type in which the bank is the party seeking financing. In this transaction, the bank collects cash from the investor as an agent to buy commodities on their behalf. Then the bank purchases these commodities from the investor on a deferred-payment basis. Reverse Tawarruq is used to imitate saving deposits to investors and replicates a loan with interest.

AAOIFI Standard (No. 30 in 2006) stipulates that '*the client should not sell the commodity except by himself or through an agent other than the institution, and should duly observe the other stipulations*'.

The standard allows the bank (the institution) to act as an agent only if the regulations do not permit the client or a third party to sell the commodity.

The standard further stipulates that:

> '*monetisation is not a mode of investment or financing. It has been permitted when there is a need for it, subject to specific terms and conditions. Therefore, the institutions should not use monetisation as a means of mobilising liquidity for their operations, instead, it should exert effort for fund mobilisation through other modes, such as Mudaraba, investment proxy, Sukuk, investments funds and the like. The institution should resort to monetisation only when it faces the danger of a liquidity shortage that could interrupt the flow of its operations and cause losses for its clients*'.

Although Tawarruq may not be a perfect instrument and has serious Shariah issues associated with it, it does serve a purpose when value added tax (VAT – a tax on purchases in many countries), stamp duty (a UK tax on the purchase of shares and property) or other taxation rules pose limitations on Islamic finance and Tawarruq is more often than not the only feasible transaction type available.

The Tawarruq transaction can graphically be depicted in the same way as the Commodity Murabaha in Figure 10.

Example

Bank A wishes to place $1,000,000 with another bank, applying a Commodity Murabaha for a period of three months. As commodity prices are in US$, Bank A and B have decided to use US$ LIBOR as a benchmark for the mark-up. Taking into consideration risk factors, such as creditworthiness, liquidity risk, commodity price risk, US$ three-month LIBOR of 2.15%, and a brokerage cost for buying and selling the underlying commodity of 25bp, Banks A and B agree on a mark-up of US$22,500.

10. Ijara and Ijara Muntahia Bitamleek – Shariah Standards

Learning Objective

5.7.1 Be able to apply the Ijara contract

In an Ijara transaction, the bank will buy the asset from the seller or manufacturer and take possession; the bank will then become the lessor and lease the asset to the client (the lessee). A sale and leaseback transaction, in which the owner sells the asset and then leases it back, is also permissible in Shariah. The sale and the lease should not be conditional on each other.

Shariah permits the assignment of a lease, providing that due consideration is paid for passing the title, or sufficient elements of the asset's ownership are transferred, and all rights and obligations of the lease are assumed by the new lessor. The assignment or sale of rent only is not permitted. This has important implications for securitising leased assets.[1] The certificate representing the securitised asset must be attached to asset ownership and include proportionate rights and obligations. The certificate represents an undivided part of an identified asset or pool of assets.

Leases have a wide range of applications and can, for example, be used for the lease of individual equipment to companies, or for cars to individuals.

1 Pooling of financial assets which offer an income stream, eg, rental income/mortgages and repackaging them as tranches of securities which generate cash flows with different risk profiles.

10.1 Ijara Wa Iqtina

Learning Objective

5.7.2 Understand the redemption of a lease through Ijara wa Iqtina/Ijara Muntahia Bitamleek

Most Ijara transactions have a formal redemption feature where the lessee will take possession of the asset at the end of the lease. This type of transaction takes two forms:

- Ijara Muntahia Bitamleek – lease ending in ownership, or
- Ijara wa Iqtina – lease with acquisition.

The general view is that these represent a synthesised version of a financing lease. The transfer of ownership is typically arranged via a unilateral promise of transfer. The promise can be provided by the lessor or the lessee and tends to be at a pre-negotiated price. The promise is not a contract by itself and hence the property does not transfer automatically to the customer. A sale and purchase agreement must be signed to formally transfer the property ownership to the customer.

The purchase price for the asset may be market value, at a discounted or fixed price. Ideally, the lease itself is not contingent on any promise to sell or buy, but they may be executed at maturity. Leases may be terminated early by mutual consent. The lessor may not force the lessee to buy the asset and the lessee may not oblige the lessor to sell at a discounted price. Similar to the Ijara or operating lease, periodic modification or repricing is allowed during the lifetime of the lease transaction.

Example

Islamic Bank buys cement mixers from Islamic Enterprises (the vendor). Islamic Bank then enters a 12-month lease for the cement mixers with the customer (and lessee) for use in their property construction business. The customer pays a monthly rent to Islamic Bank for the use of the mixers. Under a standard operating Ijara, title to the cement mixers remains with Islamic Bank. Under an Ijara wa Iqtina, title to the mixers passes to the client at the end of the contract by means of a separate purchase and sale contract.

10.2 Ijara Mawsoofa Bil Thimma

Learning Objective

5.7.3 Understand the use of Ijara Mawsoofa Bil Thimma (forward lease)

Leasing is often applied in project finance. In this case, the application of leasing is usually a combination of construction finance (Istisn'a) followed by an Ijara wa Iqtina that buys out the completed project, either in tranches or as a whole on completion. When agreed in advance with the initial construction transaction, it is known as **Ijara Mawsoofa Bil Thimma** (forward lease). Shariah scholars permit leases to be executed for a future date and may be pre-paid in advance, thereby providing working capital for construction. Pre-rentals are payable by the lessee on the understanding that the equipment will be leased once completed. If the plant is not manufactured or acquired according to the specifications laid down in the agreement to lease by a certain date, such pre-rentals will be repayable by the lessor.

In the event of late payment, the late instalment may be recovered as long as there is no penalty (see Murabaha section previously). In addition, the lease may be terminated or renegotiated with the lessee if there is a history of late payments or other problems such as evidence of poor treatment of the leased item.

Pricing a Lease

The price of a lease transaction is made up of the following components:

Component	Finance Lease	Operating Lease
Term, repayment profile and payment in advance or in arrears	✓	✓
Deduction or inclusion of servicing fees	✓	✓
Fees and commissions payable	✓	✓
Cost of funds	✓	✓
Counterparty credit risk	✓	✓
Value of the underlying asset	✓	✓
Country and other risks	✓	✓
Residual value risk		✓
Residual value realisation		✓

11. Salam and Parallel Salam – Shariah Standards

Learning Objective

5.8.1 Be able to apply the Salam contract

When applied in the financial markets, the Salam contract effectively provides a means of placing short-term funds. Banks and investors can make a return by paying funds in full to a trader for future delivery of commodities, knowing there will be a third-party buyer and a supply coming into the market. The buyer may secure the transaction with a mortgage, guarantee or letter of credit. The financier in a Salam transaction often appoints the trader as agent to sell the goods to a third party at a higher price on a cash or deferred basis. Payment to the Salam seller is made as a lump sum in advance. The delivery schedule and purchase price are agreed at the outset and take into account aspects such as material, labour, profit margin and costs. Settlement under the Salam is delivery of the goods.

Salam is a useful tool for pre-export and working capital finance. In this case, the beneficiary is the supplier as opposed to the buyer, although it is conceivable that in a bank-managed deal, the bank as buyer is providing purchase finance to the end buyer on the other side of a deal. Like Murabaha debts, Salam deliveries may be secured.

Most Salam transactions take between three and 12 months. The investor in a Salam transaction seeks to profit from the end sale of a purchased commodity, often securing a LIBOR mark-up over the investor's funds. Repayment at maturity is through the delivery (and on-sale) of commodities. Salam transactions may be syndicated in bilateral, international or domestic syndications.

The pricing of the investor's profit in a Salam transaction is comparable to similar conventional trade finance facilities. The pricing may only be determined on a case-by-case basis, in line with tenor (term), credit quality of supplier and strength of security. Salam transactions are accounted for as pre-payments.

11.1 Salam Documentation

Learning Objective

5.8.2 Understand the documentation associated with a Salam contract

Salam documentation is similar to conventional trade purchase and sales documents and includes a sales agreement for deferred delivery of goods (the Salam). There may be a master agreement for renewing facilities or multiple shipments. When the buyer is not a direct consumer of the goods, the Salam is exited through a parallel sales contract. Otherwise, a letter of credit, purchase order or open account documentation suffices to establish delivery of goods as paid for and ordered under the documents. An agency agreement is included in the event the bank relies upon a third party to execute the purchase and on-sale of goods. In addition, there may be various contract notes supporting the different obligations. Syndicated purchases include an investment management agreement. Security documents, including guarantees, mortgages, receivables and cash, are all acceptable, depending upon the terms of the Salam.

As a general rule, it is not permissible to sell something one does not have. This rule, however, does not apply to Salam and Istisn'a transactions. Salam transactions involve a future sale of a specific asset for a pre-agreed quality and quantity against full payment at spot. The contract is binding and the seller needs to deliver. In the event the seller has not been able to produce the asset by the delivery date, they are obliged to procure the goods from the market and deliver them to the buyer. Therefore, assets subject to a Salam transaction need to be freely available in the market.

The process of a Salam structure is defined as follows:

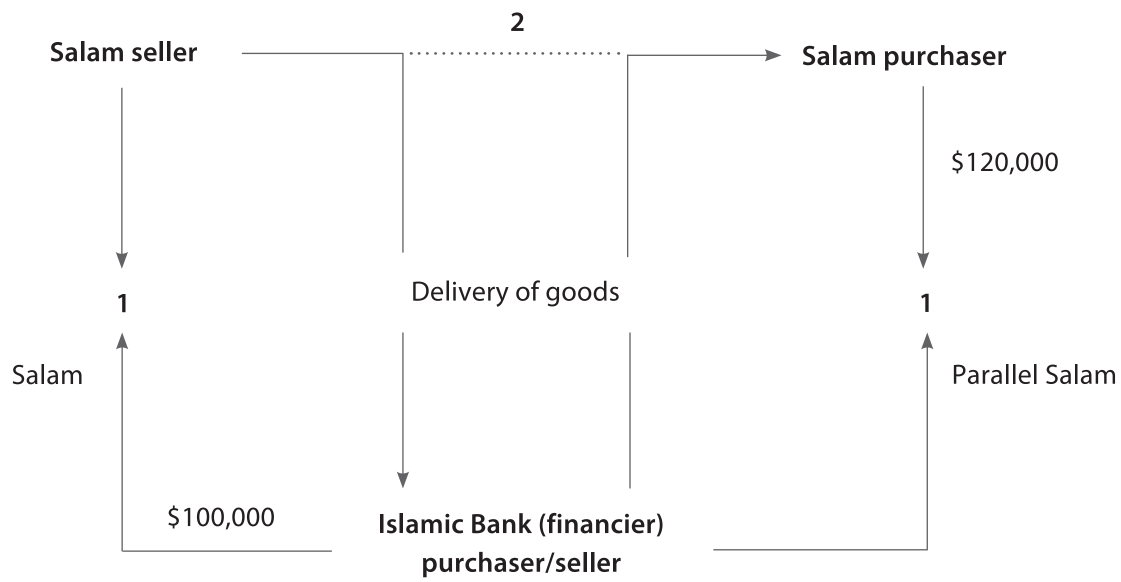


Figure 11: Salam contract

1. An Islamic bank (financier) enters into a Salam contract as the purchaser and pays US$100,000 to the seller for delivery of the assets in one month. The Islamic bank may appoint an agent to enter into the contract with the Salam seller. The agent, typically, also acts as the agent to sell the goods (in this case at US$120,000) to the ultimate buyer in the parallel Salam contract.
2. Goods are delivered to the Islamic bank under the Salam agreement. The Islamic bank delivers the goods to the Salam purchaser under the Parallel Salam agreement. Since the bank makes a payment for the assets in advance, they will often require some form of security from the trader, which may be in the form of a requirement for the Salam seller to secure an ultimate buyer for the goods, effectively resulting in a Parallel Salam, or exit for the bank's initial purchase.

11.2 Parallel Salam

Learning Objective

5.8.3 Understand the use of Parallel Salam in managing bank assets acquired under a Salam contract

Similar to the binding promise to purchase in a Murabaha contract, the **Parallel Salam** has evolved as a tool for Islamic banks with the following purposes:

- manage cash, and
- arrange exits or hedge positions (exposures to price risk).

As a consequence of the purchase, the bank ends up owning the goods and is subject to a level and type of risk that is unacceptable from a regulatory point of view. To mitigate the risk, most regulators require the bank to enter into a parallel sales agreement. This is usually an outright purchase of the goods by a customer of the original seller or structured at a future date. The supplier usually acts as agent for the bank to arrange the onward sale and collecting payment in favour of the bank. The parallel sale can be secured by a promissory note, a letter of credit or another Salam agreement. The ultimate buyer needs to be an independent third party and the two Salam contracts must be separate and independent from each other.

The structuring of a Parallel Salam transaction results in the unwinding of the original transaction in such a way that it transforms the Salam transaction into a financing tool (see Figure 12).

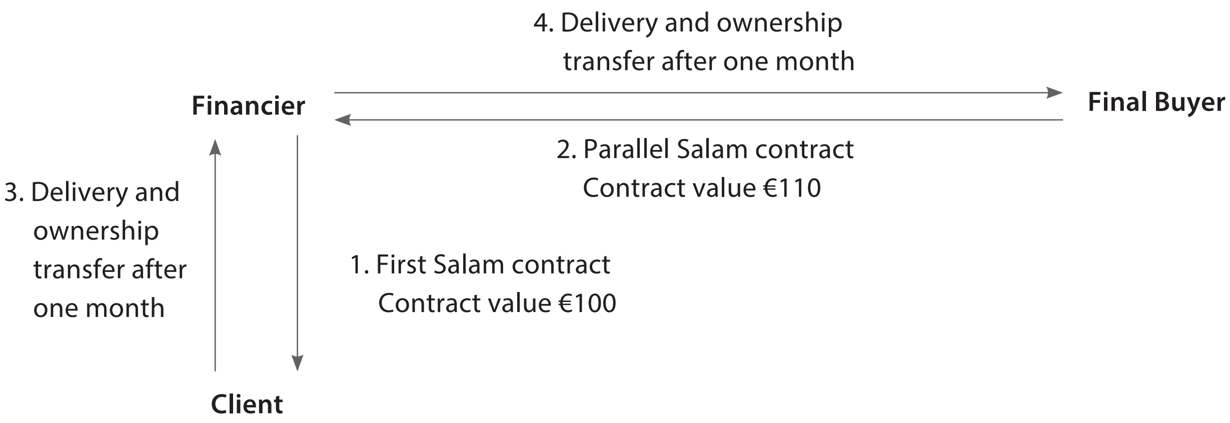


Figure 12: Parallel Salam contract

12. Istisn'a And Parallel Istisn'a – Shariah Standards

12.1 The Nature of Istisn'a

Learning Objective

5.9.1 Be able to apply the Istisn'a contract

Istisn'a is commonly used for project or pre-export finance in which the bank acts as an intermediary between the producer (construction firm or manufacturer) and the ultimate customer (the obligor).

The obligor is often appointed by the bank as an agent to manage the relationship with the manufacturer on their behalf under a Wakala (agency) agreement. The obligor cannot be the manufacturer or have a stake of 30% or more in the ownership of the manufacturer. The exit or off-take agreement may be in the form of a back-to-back Istisn'a (parallel Istisn'a – see section 12.2), or in the form of transfer of ownership of the asset upon full payment.

Under the Istisn'a agreement, the buyer enters into an Istisn'a agreement with the manufacturer. For large assets, the buyer usually requires financing, in which case, the bank will enter into the agreement with the manufacturer appointing the buyer (obligor) as the Islamic bank's agent (under an agency agreement). The buyer receives the funds to pay the manufacturer as per the agreement. Although payment is usually made on an instalment basis according to the work progression, it may also be a lump sum in advance. When the asset is completed, the ownership will be transferred to the bank. The bank can then sell the asset to the client, or lease it to the client for an agreed period of time.

12.2 Parallel Istisn’a

Learning Objective

5.9.2 Understand the reasons for Parallel Istisn’a contracts

A Parallel Istisn’a is usually applied either because the bank is unable to manufacture the asset or is unwilling to hold the asset after completion. Therefore, the bank enters into two mutually independent Istisn’a contracts with the same product specifications. The difference in price between the two contracts is the spread or margin earned by the bank. Neither contract is dependent. Thus, if the manufacturer fails to deliver according to specification, the bank is still required to deliver the asset (see Figure 14).

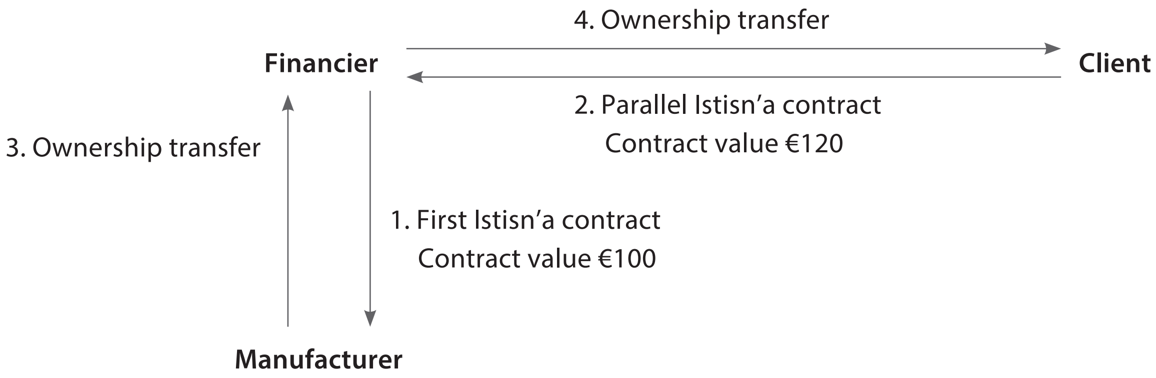


Figure 14: Parallel Istisn’a contract

Example

Islamic Enterprises provides equipment for hospitals and requires funding for the manufacturing of 100 hospital beds. The Islamic bank pays the bed manufacturer to produce the beds and adds a profit margin to the purchase price to determine the price the beds will be sold for to Islamic Enterprises. The Islamic bank agrees to produce and deliver the beds on 1 June 2016. The Islamic bank enters into an Istisn’a contract with the bed manufacturer for 100 beds according to the specification of Islamic Enterprises with a delivery date of 1 June 2016. On 1 June 2016, the bed manufacturer delivers 100 beds to Islamic Enterprises and checks the delivery to ensure it matches the specification.

12.3 Salam Versus Istisn’a

Learning Objective

5.9.3 Understand the differences between Istisn’a and Salam contracts

Istisn’a is considered to be a variant of Salam used for the financing of manufacturing or construction. There is no debt in the form of a conventional loan since the obligation is for the delivery of manufactured goods, not for money.

The differences between Istisn'a and Salam contracts can be summarised as follows:

Salam	Istisn'a
Deliverables have commodity-type characteristics and must be fungible like base metals or grain.	Deliverables are manufactured goods or constructed property subject to detailed specification.
The contract may not be cancelled.	The contract may be cancelled unilaterally before work starts.
The full price must be paid in advance.	The price may be paid in advance, in instalments according to progress, post delivery, in instalments without reference to progress or at delivery. Payment schedules are agreed in the contract.
No penalty for late delivery. However, in the event the seller fails to produce the commodity, they will need to source it in the open market and deliver to the buyer.	Progress payments may be deferred and may attract pre-agreed penalties for the late delivery of the contracted assets. To be valid, all specifications, delivery options, payment conditions and pricing must be agreed in the Istisn'a contract. Typically, the financier subcontracts the manufacture or construction of the object. However, they remain responsible for the product warranties, even if they are able to assign or otherwise cover this risk.
Delivery is on a specific date.	Delivery date does not need to be specific, but should fall within a pre-agreed time frame.

13. Off-Balance Sheet Financing (Letters of Credit)

Learning Objective

5.10.1 Know the use of letters of credit and guarantees in Islamic finance contracts

13.1 Letters of Credit and Guarantees

A letter of credit is a document from a bank guaranteeing that a seller will receive payment in full as long as certain delivery conditions have been met. In the event that the buyer is unable to make payment on the purchase, the bank will cover the outstanding amount. Letters of credit are typically used in import/export transactions. Within the context of Islamic finance, letters of credit are commonly used in Murabaha and Salam transactions, either as a form of guarantee, or as a means of assuring that payments will be processed in accordance with customary documentary procedures. Islamic scholars generally consider that the payment of a fee for a guarantee is prohibited. Extending a fee on a promise to pay to a loan is deemed to equate to Riba. A letter of credit, on the other hand, is a customary instrument of international trade, allowing two parties to conduct a sale with a trusted intermediary who assures that the terms of documents are complied with prior to payment taking place. On this basis, letters of credit and other documentary assurances between distant or unfamiliar parties are permitted in a trading transaction.

Recently Islamic banks have started to bundle the letter of credit and processing services into either the Murabaha price or enter into a Musharaka agreement with the client. In the latter case, the costs of providing a letter of credit is incorporated in the profit share together with the bank's capital contribution. The characteristics of a letter of credit can be provided via a Wa'd (promise) under which the Islamic bank buys the asset and then sells it to their client by means of a Murabaha transaction. In this case, the Islamic bank's promise is viewed as binding to the seller and will be honoured as long as the documents are presented correctly. The Islamic bank will not charge for its promise, but will charge administrative costs and adjust the Murabaha profit to incorporate their expected costs and profits relating to the letter of credit.

Guarantees, Kafala or Dhamana, are permitted and both the debt and the delivery of goods can be guaranteed. A guarantee cannot apply to business performance and may not be used to assure the returns or profits on a Musharaka, as this will turn the investment into a loan. A third-party guarantee can be attached to a Mudaraba for certain activities, but not from the manager or Mudarib. Generally, Islamic law does not permit a fee to be charged for guarantees, although some scholars permit this as long as the guarantee is associated with true services such as the preparation of a feasibility study and credit risk analysis.

14. Application of Wa'd

Learning Objective

5.11.1 Be able to apply the concept of Wa'd (promise) and the concept of Ah'd (undertaking), and the conditions which make a commercial promise binding

Although highly controversial, the Wa'd is often used to provide a level of security to both parties regarding a future event. It is most commonly used in the following structures:

1. **Ijara wa Iqtina/Ijara Muntahia Bittamleek (finance leases)** – in a finance lease, the lessee provides a promise to purchase the asset from the lessor at the end of the lease period. This promise to purchase is binding (see chapter 3) and is given at the start of the lease period. The promise cannot be a condition for the lessor to enter into the lease transaction.
2. **Forward foreign exchange contracts** – in a forward foreign exchange contract, one party promises to purchase or sell a specific amount of one currency against a specific amount in a different currency. Some scholars disagree on the permissibility of a forward foreign exchange contract, as they are often equated to speculation. However, there are circumstances in which there is a defined, non-speculative, requirement for an exchange of currency at a future date. For example, an import/export business that pays bills and receives funds in other currencies cannot necessarily take the risk of exchange-rate fluctuations on its payments and receivables.

3. **Profit rate swaps** – profit rate swaps are often structured as one long-dated, fixed-rate, Commodity Murabaha transaction in combination with a series of sequential short-dated, reverse, Commodity Murabaha or Musawama transactions, for which the maturity date of the final transaction matches the maturity of the Murabaha transaction. Beyond the current short-dated transaction, one party will promise the other to enter into the other transactions at an agreed interval, until the end-date of the long-dated Commodity Murabaha.

Ah'd, or covenant, can be part of any transaction and, for example, provide additional security to the contract.

15. Other Contracts

15.1 Arboon

Learning Objective

5.12.1 Know how Arboon is used to synthesise option behaviour

Arboon is a down payment on a sales contract in which the buyer has neither paid the full price nor taken possession of the goods. Thus, it is not like Salam, in which full payment is made for goods to be delivered in future. Although it is often used to replicate a conventional call option giving the holder the right, but not the obligation, to buy a fixed quantity of an underlying asset on or before a specified date in the future, it is not an option in the conventional sense for the following reasons:

- The Arboon cannot be traded or sold to a third party.
- It is typically exercised on a specific date rather than at will.
- The seller of the Arboon has to have the underlying asset in their possession or else they are 'shorting prior to exercising' which is a condition that will result in a void contract.
- At the time of exercise, the buyer only pays the difference between the price and the down payment.

Nonetheless, it is used by many parties to synthesise option behaviour. If the buyer decides not to take the goods by the stipulated time, the down payment may be kept by the seller. This form of down payment formally constitutes a part of the purchase price and, thus, is not refundable. Arboon is becoming a common tool of modern Islamic banking.

16. Summary of Certain Islamic Contracts

Note that the term commodity, as used in this chapter, refers to the raw materials used by industry, which are traded on specialist markets such as the London Metal Exchange, eg, aluminium and copper.

Instrument	Mudaraba	Musharaka	Murabaha	Salam	Istisn'a	Ijara
Equivalent contract.	(Direct) equity investment	Direct equity investment	Deferred/ instalment payment sale	Short-term production finance and agricultural forward (non-tradeable)	Long-term project finance	Finance and operational leases
Type of contract	Profit and loss sharing partnership (investment financing). Material loss is borne by one capital provider to the Mudaraba unless negligence is proven	Profit and loss sharing partnership (joint venture). Partners have unlimited liability	Sale at cost + profit mark-up	Contract for the production or manufacturing of a good in which the full payment is at spot against delivery of goods at a future date. Buyer is exposed to the asset in the event the client is unable to deliver the goods or the goods do not meet the specification of the Salam contract	Contract for the production or manufacturing of a good in which the payment is made progressively during the project against delivery of goods at a future date	Leasing in which the lessee pays rental to the lessor. Lessor may have exposure to the residual value of the asset in operational lease
Parties to the contract	Rab al Mal (investor/ capital owner/ bank). Mudarib (business manager). Mudarib is a silent partner	The business partners, both called Musharik (investor and business manager whether both are active, or one is a sleeping partner)	The principal (seller of goods). The end user (buyer of the goods)	Salam seller (the producer of the goods) receives money in advance. Salam purchaser (the financier) receives the goods at maturity.	The purchaser pays progressively according to a predefined schedule. The manufacturer or contractor manufactures or builds the asset and progressively receives money from the investor	The lessor (owner of the leased asset). The lessee (beneficiary of the leased asset)

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Instrument	Mudaraba	Musharaka	Murabaha	Salam	Istisn'a	Ijara
Type of business in practice	1. Mudarib, who has a business activity, approaches investors to provide capital 2. Investors (Arbab Al Mal – plural of Rab al Mal) approach a Mudarib to invest their funds in Shariah-compliant projects. Can be used to deposit funds with an Islamic bank	All partners provide capital as well as (business-related) expertise. In practice one of the partners could provide a contribution in kind (eg, land) which is valued as a capital investment. Another partner provides cash. Both partners invest in a Shariah-compliant project	A buyer requires goods but lacks cash. He then approaches a bank and expresses his wish to buy from the bank at a pre-agreed price once the bank acquires the title/ ownership and possession of the goods 1. The bank buys goods at spot from a seller (First Sale: spot payment and immediate delivery of the asset) 2. The bank sells the same goods to the end buyer for the principal amount plus a fixed mark-up payable at a later date. (Contract can be used for working capital finance.)	Salam purchaser advances money to the Salam seller to purchase an asset that does not exist at the time of contract. The latter delivers the commodities (goods) at maturity to the Salam purchaser. (Contract can be used in agriculture finance or short-term project finance.)	Investors approach a manufacturer to manufacture an asset which does not exist at time of contract. Detailed specifications of the object to be manufactured or constructed must be stated. (Contract is typically used in project finance.)	The lessor (the owner of the leased asset) leases a Shariah-compliant asset to the lessee (the beneficiary of the leased asset). The lessee pays a periodic rent to the lessor

Instrument	Mudaraba	Musharaka	Murabaha	Salam	Istisn'a	Ijara
How are profits shared between the partners?	Profits are shared between the Mudarib and the Rab al Mal according to a percentage agreed in the Mudaraba agreement	Profits are shared between the partners according to a percentage agreed in the Musharaka agreement	Not applicable as there is no partnership between the contracting parties: mark-up/ profit goes to the bank (seller)	Investor's profit usually based on the term of the contract, credit quality of the Salam seller. It is usually benchmarked to LIBOR. There is no partnership between the contracting parties	Investor's profit agreed at outset covering material, labour, profit margin and project costs. There is no partnership between the contracting parties	Lessee pays rent to lessor. Rent is either fixed for life of project or adjusted periodically. There is no partnership between the contracting parties
In the event of a loss, which party bears the loss?	Losses are distributed in proportion to the capital provided. Rab al Mal as sole provider of capital bears all loss, unless the Mudarib has been negligent	Losses are distributed in proportion to the capital provided	In theory, there should not be any loss unless the user becomes insolvent (ie, unable to pay the instalments, in which case the securities held by the bank may be enforced) A penalty for late payment is not allowed	In theory, there should not be any loss unless the Salam seller is unable to deliver, in which case the they should buy the goods from the market. One of the criteria of Salam is that the asset is commonly available in the market to make the delivery possible at any time	In theory, there should not be any loss unless the manufacturer is unable to complete the work. Actual damages or loss are borne by the purchaser, unless the manufacturer is negligent	Borne by the lessor unless due to negligence of the lessee. In the event of total loss of the asset, the lessor has no further recourse to rental payments from the lessee, but has recourse to any insurance payments

Instrument	Mudaraba	Musharaka	Murabaha	Salam	Istisn'a	Ijara
What happens at maturity of the project?	Termination of the Mudaraba – Rab al Mal is entitled to receive his investment. Profit (if any) is distributed among Mudarib and Rab al Mal according to the contract. Loss (if any) is borne by Rab al Mal	Termination of the Musharaka – Partners are entitled to receive their investments. Profit (if any) is distributed among partners according to a predefined ratio. Loss (if any) is borne by partners according to their proportionate share in the capital	End user pays all the Murabaha instalments to the merchant bank (seller)	Salam seller delivers the commodities to the Salam buyer	Manufacturer delivers the manufactured goods to the purchaser	Asset reverts to lessor in case of Ijara (operating lease) or ownership transfers to the lessee in case of Ijara wa Iqtina (finance lease).
Timing of sale and payment	Rab al Mal pays spot	According to the interest of the partnership (spot or deferred)	Delivery of the asset is immediate, payment is usually deferred	Full payment is immediate, delivery of the asset is deferred	Payment can be lump sum in advance, progressive payments, at delivery or by instalments post-delivery. Delivery of the asset is deferred. Penalties, agreed in advance for late delivery, can be charged	Not applicable
Forms	Restricted. Unrestricted	Shirkat al Milk. Shirkat al Aqd	Murabaha to the purchase orderer. Commodity Murabaha. Murabaha account	–	–	–

Instrument	Mudaraba	Musharaka	Murabaha	Salam	Istisn'a	Ijara
Variants.	Two-tier Mudaraba.	Diminishing Musharaka.	–	Parallel Salam.	Parallel Istisn'a.	Ijara wa Iqtina.
Contracts used for liquidity management	–	–	Commodity Murabaha, a fixed-income-type transaction which includes some minimal exposure of the Islamic bank to the asset during the period when the Islamic bank holds the asset	–	–	–

End of Chapter Questions

1. How does Islamic financial intermediation differ from conventional intermediation?
   Answer reference: Section 3.1

2. What are the two types of Wakala and how do they differ?
   Answer reference: Section 6

3. Describe the process of Mudaraba applied to deposits.
   Answer reference: Section 7.1.1

4. In a Mudaraba contract, what is the incentive for the Islamic bank to perform well?
   Answer reference: Section 7.3.1

5. What is the difference between restricted and unrestricted investment accounts?
   Answer reference: Section 7.4

6. What is a Diminishing Musharaka?
   Answer reference: Section 8.1.2

7. Describe the difference between ijara wa iqtina and Ijara mawsoofa bil thimma.
   Answer reference: Section 10

8. What are the differences between Murabaha and a loan?
   Answer reference: Section 9.3

9. What is the purpose of Parallel Salam?
   Answer reference: Section 11.2

10. What are the differences between Salam and Istisn'a?
    Answer reference: Section 12.3

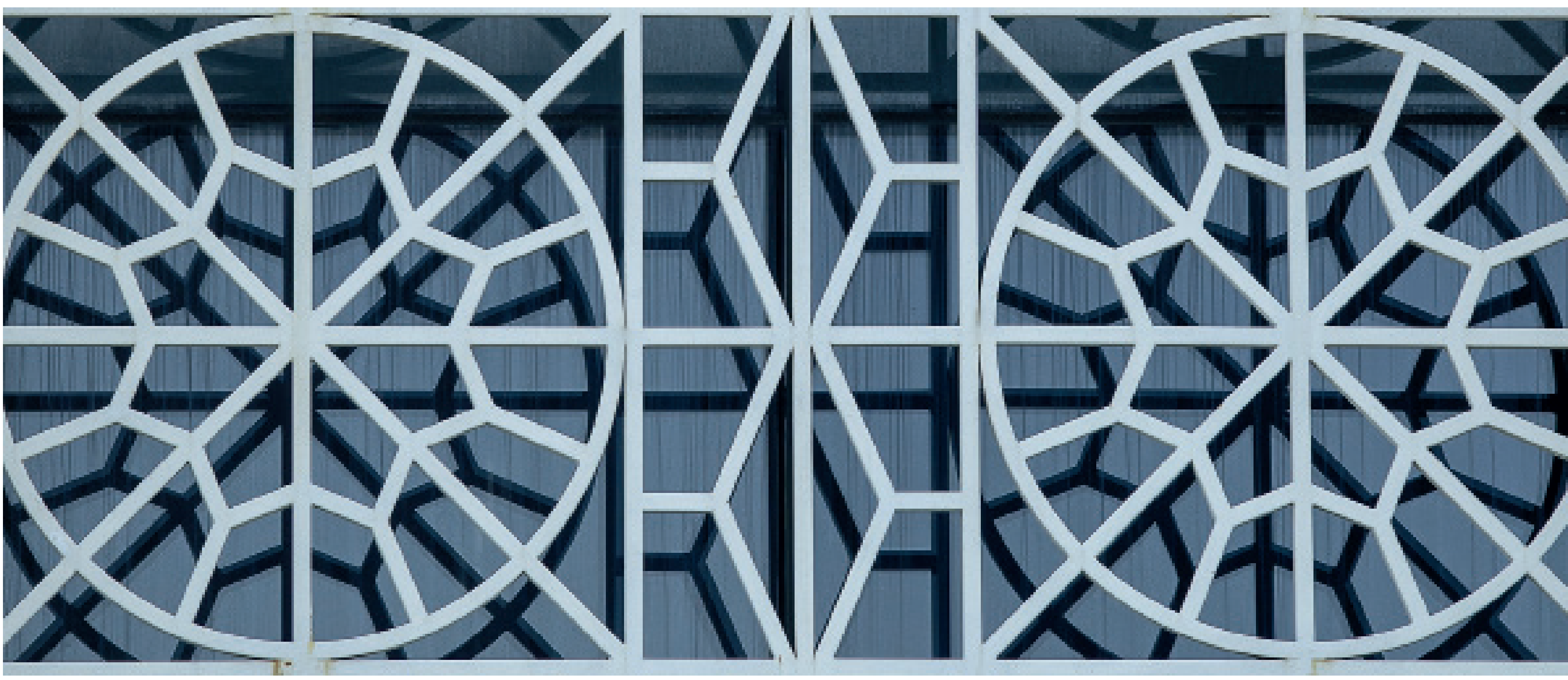
11. List how wa'd can be used in forward foreign exchange contracts.
    Answer reference: Section 14

12. Why is Arboon not an option in the conventional sense?
    Answer reference: Section 15.1

Chapter Six

Islamic Asset Management

This syllabus area will provide approximately 12 of the 100 examination questions



1. Islamic Banking and Sustainable Investing

Learning Objective

6.1.1 Know the similarities and differences between Islamic finance and Socially Responsible Investing (SRI)

6.1.2 Understand the similarities between the UN Sustainable Development Goals (SDGs) and Islamic Finance

There is a growing trend among investors to demand more socially responsible investments that provide more than just a rate of return. Common themes are the avoidance of investments in companies that produce or sell harmful products or services, such as alcohol, gambling and tobacco. Instead of a passive strategy, investors prefer an active strategy. This involves, in addition to abstaining from investing in harmful products, investing in companies engaged in social justice, environmental sustainability and alternative energy/clean technology efforts. However, in the wider context of Maqasid of Shariah, these ought to be included.

The underlying principles of socially responsible investing (SRI), as well as environmental, social, and governance (ESG) investing, are largely similar to the ethical principles underpinning Islamic financial services. However, Shariah-compliant investments do not necessarily meet all SRI and ESG criteria. The Shariah industry screens (see section 3 of this chapter) typically do not include social and environmental components.

One possible source, to derive ethical principles from, are the UN Sustainable Development Goals (SDGs). The SDGs consist of 17 distinct items which include poverty alleviation, quality education, gender equality, clean water, sustainable cities and communities, climate action, and environmental issues. These goals have been adopted by all UN member states and provide a shared blueprint for peace and prosperity. These goals are inherent in the principles underlying Shariah. Climate change, reduction of pollution, clean water and energy, for example, are covered under the 'stewardship on earth' principle. Poverty reduction, equality, and zero hunger are covered in the Sunnah and the Quran. Islamic financial institutions are, therefore, in a prime position to ensure the implementation of SDG in their local communities.

2. Asset Management[1]

Learning Objective

6.2.1 Understand the principles of Islamic investing

Within Islam, investing in enterprises and assets is encouraged not only because of the wealth increase for the individual investor, but also because it advances the economy and, at the same time, allows others to increase their wealth. This, in turn, results in better wealth distribution.

Conventional and Islamic investors have common objectives such as capital preservation, yield maximisation and ensuring a balance between liquidity and profitability, in addition to which Islamic investors also look for Shariah compliance. Not every investor has the time to manage their investments actively and, like conventional investors, Islamic investors often turn to fund or asset management solutions.

Like conventional investment managers, Islamic investment managers can invest in a wide range of Islamic and conventional products and asset classes, including shares and other securities. The main difference between conventional and Islamic investment managers is that the latter must ensure that his individual investments, as well as his fund, remain compliant with Shariah. In addition, Islamic fund managers cannot use derivatives, pay or receive interest or apply stock lending techniques.

Fund structures are typically similar to conventional structures although, again, Shariah compliance is a key factor. An SSB, which is typically made up of three to five members, is involved from the start of the fund. The SSB is not responsible for any operational and strategic decisions the fund manager makes as long as the fund continues to be Shariah compliant. The SSB is, however, involved in the definition of the framework the fund operates in and defines issues such as which industries are deemed compliant.

The remainder of this chapter outlines the AAOIFI Shariah standards for the selection of Shariah-compliant investments and presents a view on how Islamic asset management can successfully be applied in practice.

1 This chapter is based on Schoon, N (2016) Modern Islamic Finance London: Wiley & Sons; and Schoon, N (2011) Islamic Asset Management: an asset class on its own? Edinburgh: Edinburgh University Press

3. Selection of Shariah-Compliant Investments

Learning Objective

6.3.1 Know the components of the industry screen

6.3.2 Know the components of the financial screen

6.3.3 Be able to apply the industry and financial screens

6.3.4 Understand what happens when an investment becomes non-compliant

When investing in a company, there are two basic screening processes that need to be applied prior to deciding whether or not a stock should be allowed to be part of the investment universe. Within Shariah, a number of business activities are deemed to be non-permissible (Haram), in which one should not invest.

3.1 Industry Screen

The first selection when deciding whether to accept a share in the investment universe is often referred to as the 'industry screen' or 'qualitative screening'. Although it is preferable to allow only fully Shariah-compliant assets in the universe, increasing globalisation, diversification and market demand does not always make this possible. As a result, a particular share or business can be a Shariah-compliant investment opportunity, even when an insignificant amount of its turnover is deemed to be Haram. Although the definition of 'insignificant' varies between SSBs, it is generally accepted to be 5% or less of total turnover. The industry screen is meant to eliminate any non-permissible businesses from the investment universe and excludes the following business activities:

- **Conventional banking and insurance** – conventional banking and insurance is associated with interest and is, therefore, not permissible.
- **Alcohol** – the prohibition of alcohol extends to distilling, marketing and sale and includes working in the industry. There are limited circumstances, however, in which alcohol is permitted, such as, for example, medicinal use. Permissibility needs to be assessed on a case-by-case basis.
- **Pork-related products and non-compliant food production** – non-compliant food production covers everything which is not prepared in a halal way and covers, among others, meat which is not slaughtered in an acceptable fashion.
- **Gambling** – this covers casinos, betting shops, bingo halls and online betting.
- **Tobacco** – as with alcohol, this includes the production, marketing and sales of tobacco and associated products.
- **Adult entertainment** – any activity associated with adult entertainment including escort services, brothels and movies with explicit sexual content.
- **Weapons, arms and defence manufacturing**.

These industries or sectors should not form part of the portfolio of any Islamic investor.

3.2 Financial Screen

In addition to the industry screen, companies that use too much leverage are also excluded from the investment universe. Although the exact financial ratios can vary between SSBs, the generally accepted financial ratios are as follows[2]:

- Conventional debt/market capitalisation < 30%.
- Interest bearing deposits/market capitalisation < 30%.
- (Total interest + income from non-compliant activities)/income < 5%.

3.3 Application of the Industry and Financial Screen

Although not all scholars agree on this, the general approach is that any income from non-permissible activities should be purified via the dividend payments. This is a pragmatic approach to allow Islamic funds to be set up and operate within the Shariah framework. The Shariah-compliant indices that have been developed over time may use more lenient or more stringent criteria. Dow Jones, for instance, uses the following for the Dow Jones Islamic Market Index (DJIM):

- **Industry Screen** – exclude alcohol, tobacco, pork and pork-related products, financial services, defence/weapons and entertainment.
- **Financial Screen** – the financial screens are all taken over market capitalisation and apply a 24-month rolling average to enable a smoother picture, and any firm should meet the following criteria:
    - Total debt/trailing 24-month average market capitalisation < 33%
    - (Cash + interest-bearing securities)/trailing 24-month average market capitalisation < 33%
    - Accounts receivable/24-month average market capitalisation < 33%

On the other hand, the FTSE Shariah Global Equities Index Series (GEIS) applies the following rules:

- Debt/total assets < 33.33%
- (Cash + interest bearing securities)/total assets < 33.33%
- (Cash + accounts receivable)/total assets < 50%
- Total interest and non-compliant activities should not exceed 5% of total revenue.

The exact screening criteria applied to an individual fund or index strongly depends on the framework of the fund or index and the opinion of Shariah scholars.

3.4 Non-Compliance

No matter how thorough the screening, a situation could occur where an investment becomes (temporarily) non-compliant. It is the responsibility of the fund manager to report this to the SSB, together with his recommendation on how to proceed. If the stock is deemed to be temporarily non-compliant, the SSB could allow the stock to remain part of the investment universe. All income from the stock in that period will need to be purified for as long as the non-compliance occurs.

Some SSBs, however, do not allow any period of non-compliance and a share that becomes non-~~compliant will need to be sold~~ within a given number of days, whether it is expected to get back to

2 AAOIFI Shariah Standard No. 21

being compliant or not. However, once a share is compliant again, it can be added to the fund, although the fund manager will probably incorporate the fact that a share was non-compliant and the likelihood of this occurring again in his decision-making.

If permanent non-compliance occurs, divestment will always be required. However, within the framework of the fund, and in order to protect investors' interests, the SSB is likely to allow this to be a phased process.

4. The Definition of a Fund

Learning Objective

6.4.1 Know the definition of a fund

6.4.2 Know the definition of an Islamic fund

6.4.3 Understand the difference between a conventional and Islamic fund

The Oxford Dictionary of Finance and Banking[3] provides the following definition for the term 'fund':

1. *A resource managed on behalf of a client by a financial institution.*
2. *A separate pool of monetary and other resources used to support designated activities.*

From the perspective of asset management, a fund combines both of these definitions into one. It is a separate pool of resources managed on behalf of one or more clients. From an investor's point of view, an investment in a fund is typically a financial investment made with the expectation of a monetary gain.

The Oxford Dictionary of Finance and Banking defines a financial investment as:

> *'The purchase of assets, such as securities, works of art, bank and building-society deposits, etc., with a primary view to their financial return, either as income or capital gain. This form of financial investment represents a means of saving. The level of financial investment in an economy will be related to such factors as the rate of interest, the extent to which investments are likely to prove profitable, and the general climate of business confidence'.*

For the purpose of this chapter, an investment in a fund is defined as the purchase of assets (the fund units) with a view to generate monetary return, typically with a medium- to long-term time horizon.

From an investor's perspective, there are many advantages to investing in funds. Due to the longer investment horizon and increased risk levels, the return on investment tends to be higher than the return on a deposit account. Different types of funds cater for different risk appetites and, as a result, different levels of potential profit or loss. However, even the types of funds with the lowest risk profiles, such as enhanced cash funds, tend to provide the potential for a higher return than deposit accounts, which is mainly due to a combination of a longer time horizon and the possibility to invest in a more diversified asset.

3 Oxford Dictionary of Finance and Banking (1997), Second Edition, Oxford: Oxford University Press

Diversification is an important tool for an investor since it reduces volatility, spreads risks and smooths returns. This can be achieved by actively managing a portfolio of direct investments. However, this would require the investor to spend significant amounts of time monitoring the portfolio and to have a broad knowledge base of the market. In addition, the investor is likely to incur significant transaction costs which have a much lesser impact on larger investment amounts. For the majority of individual investors, this is not a feasible option because of monetary and/or time constraints. Investing in one or more funds offers a viable alternative. On the one hand, the required investment amounts are typically lower which makes funds accessible to a larger audience. On the other hand, the fund manager has large amounts of assets under management, which allows for larger diversification opportunities and lower transaction costs, and has access to large-scale resources to analyse investment opportunities and monitor current investments. As a result, investing in funds gives the investor access to the benefits of large-scale investments against relatively small invested amounts.

4.1 Shariah-Compliant Fund

Within Islam, investing in enterprises and assets is encouraged not just because of the wealth increase for the individual investor, but also because it advances the economy and, at the same time, allows others to increase their wealth. This, in turn, results in better wealth distribution.

Conventional and Islamic investors have common objectives such as capital preservation, yield maximisation and ensuring a balance between liquidity and profitability in addition to which Islamic investors also look for Shariah compliance. The fund manager of a Shariah-compliant fund assumes full responsibility for the Shariah compliance of the investments. In the event of direct investments, initial and ongoing monitoring of Shariah compliance, which is the responsibility of the individual investor, is difficult to ensure and is time-consuming, resulting in uncertainty as well as additional cost.

Similar to conventional investment managers, Islamic investment managers can invest in a wide range of Islamic and conventional products and asset classes including shares and other securities. The main difference between conventional and Islamic investment managers is that the latter will have to ensure that their individual investments, as well as his fund, remain compliant with Shariah. In addition, Islamic fund managers cannot use derivatives, pay or receive interest or apply stock lending techniques.

AAOIFI defines a fund as follows:

> *'Funds are investment vehicles, which are financially independent of the institutions that establish them. Funds take the form of equal participating shares/units, which represent the shareholders'/ unitholders' share of the assets, and entitlements to profits or losses. The funds are managed on the basis of either a Mudaraba or Wakala contract'*. (AAOIFI Financial Accounting Standard 14, appendix B).

It is clear that, besides the way a Shariah-compliant fund is managed, the definition of a fund does not vary significantly from the general definition of funds as outlined previously. From an investor perspective, there is equally hardly any difference in their objectives.

The same standard further specifies that:

> *'Investment funds are permissible by Shari'a. Because funds are a form of collective investment that continue throughout their term, the rights and duties of participants are defined and restricted by the common interest, since they relate to third parties' rights. Hence, in case the fund is managed on the basis of agency the shareholders/unitholders waive their right to management, redemption*

or liquidation except in accordance with the limitations and conditions set out in the statutes and by-laws'. (AAOIFI Financial Accounting Standard 14, appendix B).

5. Islamic Fund Management Structures

Learning Objective

6.5.1 Understand the Mudaraba fund management structure

6.5.2 Understand the Wakala fund management structure

The general fund management structure can be depicted graphically as follows:

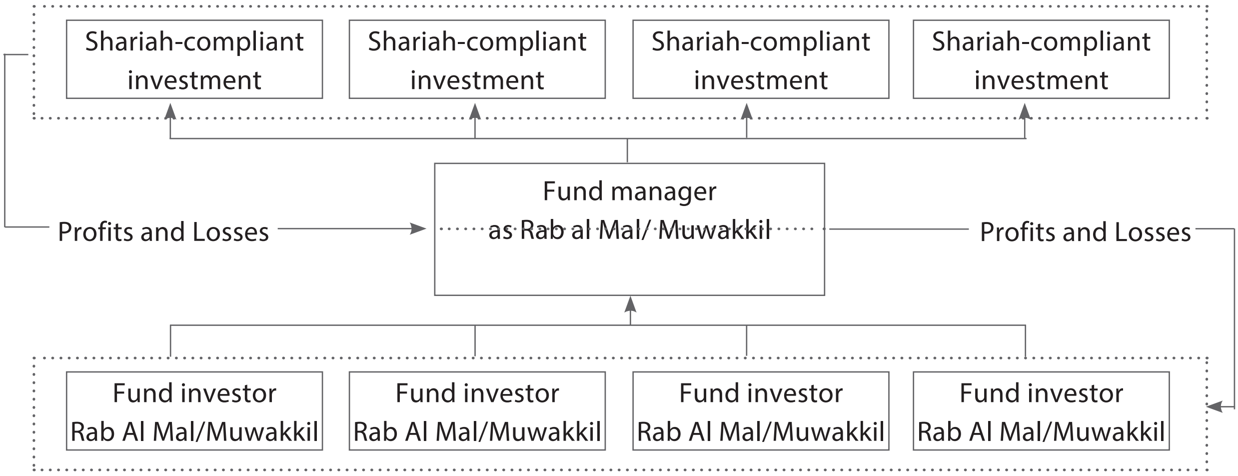


Figure 1: Islamic Asset Management Structure

The fund investors are generally known as the Rab al Mal or the providers of capital. The relationship between the investors and the fund is based on a Mudaraba or Wakala contract, in which the fund manager is either the Mudarib or business manager – who provides investment knowledge, expertise and experience – or, in the case that the fund management contract is based on a Wakala contract, the Wakil or agent. When it comes to the investment process however, the fund manager takes on the role of the capital provider on behalf of the fund unit holders.

Fund management can be undertaken under either a Mudaraba or a Wakala transaction.

1. **Mudaraba** – in this instance, the fund investors are the Rab al Mal and the fund manager acts as the business manager bringing in investment expertise. When making investments, the fund manager acts as the Rab al Mal investing the funds in a range of Shariah-compliant investments. The Mudaraba contract can usually be terminated at any time by either of the parties giving reasonable notice. Typically, conditions governing termination are included in the contract so that any damage to the business or project is eliminated in the event that the investor would like to take their equity out of the venture. Mudaraba contracts are particularly suited to fund management since two distinct roles can be defined in the process – that of the investor and that of the fund manager. The fund manager typically does not invest any money in the funds they manage. They are paid a a pre-agreed percentage of the profits of the fund.

2. **Wakala** – in this instance, the fund investors are the Rab al Mal and the fund manager acts as an agent on their behalf investing the funds in Shariah-compliant investments. The agent or Wakil is entitled to a fee for their services. In addition, any profit made by them over and above a pre-agreed anticipated profit rate can be granted to them as an incentive. Within the context of Shariah-compliant fund management, the Wakala agreement can be used for the purpose of managing the fund, but also as a liquidity instrument within the range of products available to the fund manager.

6. Types of Funds

Learning Objective

6.6.1 Know the characteristics of fixed-income funds

6.6.2 Know the characteristics of lease funds

6.6.3 Know the characteristics of commodity funds

6.6.4 Know the characteristics of real estate funds

6.6.5 Know the characteristics of equity funds

6.6.6 Know the characteristics of exchange-traded funds

6.6.7 Know the characteristics of hedge funds

Generally, the types of funds offered are very similar to the ones offered in the conventional world. Fund structures are typically similar to conventional structures, although Shariah compliance is a key factor. An SSB is involved from the start of the fund and is not responsible for any operational and strategic decisions the fund manager makes – it is solely concerned with Shariah compliance.

6.1 Fixed-Income Funds

Outperformance in a fund is typically generated by investments with longer maturities, such as Sukuk and Ijara. Wakala and commodity Murabaha transactions provide the necessary liquidity. The exact asset allocation will depend on the framework of the fund and its objectives. As a broad rule of thumb, the underlying investments of fixed-income funds can be categorised into the following types:

1. Cash.
2. Wakala.
3. Commodity Murabaha.
4. Collective schemes.
5. Sukuk.
6. Ijara.

The majority of the outperformance of an income-producing fund will be generated by investments in instruments with longer maturities, such as Sukuk and potentially large Ijara positions. The necessary liquidity in the fund will be generated from the short-term instruments, like Wakala and Commodity Murabaha transactions. The exact allocation of the different instruments in the fund will depend on the framework of the fund and its objectives and also on the availability of instruments in the primary and secondary markets and economic circumstances. As a broad rule of thumb, fixed-income funds can be divided into the following types:

- **Deposit funds** – typically invest in deposit-type instruments that have an average maturity of 60 days, with a maximum of one year per individual asset. Investors can generally redeem on a daily basis providing them with a high level of liquidity. A deposit fund typically invests in the most conservative assets, such as cash, Wakala and Commodity Murabaha. Contrary to liquidity funds, deposit funds do not invest in any non-cash-type instruments.
- **Liquidity funds** – typically invest in deposit-type instruments with a small portion (likely up to 20%) of the funds invested in short-dated Sukuk. The average maturity of the assets is 60 days, with a maximum of two years per individual asset. Investors can generally redeem on a daily basis.
- **Money market funds** – typically invest in a diversified mix of cash, Wakala, Commodity Murabaha, Sukuk and Ijara. The proportion of funds invested in Sukuk and Ijara is likely to be up to 50% of the total holdings. The average maturity of the underlying assets is around one to two years, with a maximum maturity of ten years for an individual instrument. Although redemption is daily, the settlement period is typically three to four working days.
- **Enhanced cash funds** – typically invest in a diversified mix of cash, Wakala, and Commodity Murabaha and, in addition, allocate a large proportion (50–80%) to Sukuk and Ijara. The average maturity of the underlying assets is one to five years, with a maximum of ten years for an individual instrument. Redemption takes place daily, with an average settlement period of three to four working days.
- **High-yield funds** – typically invest in a diversified mix of cash, Wakala, and Commodity Murabaha and, in addition, allocate a large proportion (typically up to 80%) to Sukuk and Ijara. The average maturity of the underlying assets is one to five years, with a maximum of ten years for an individual instrument. In addition, unhedged currency exposure can be part of the investment strategy. Redemption takes place daily, with an average settlement period of three to four working days.

Comparative Risk, Return and Liquidity

The following chart provides an indication how these funds can be compared given their risk, expected return and level of liquidity. It goes without saying that a higher risk is not necessarily accompanied by a higher return. After all, the value of investments can go up as well as down. However, funds with a lower level of liquidity typically do have higher returns associated with them due to the fact that the money can be invested for a longer period.

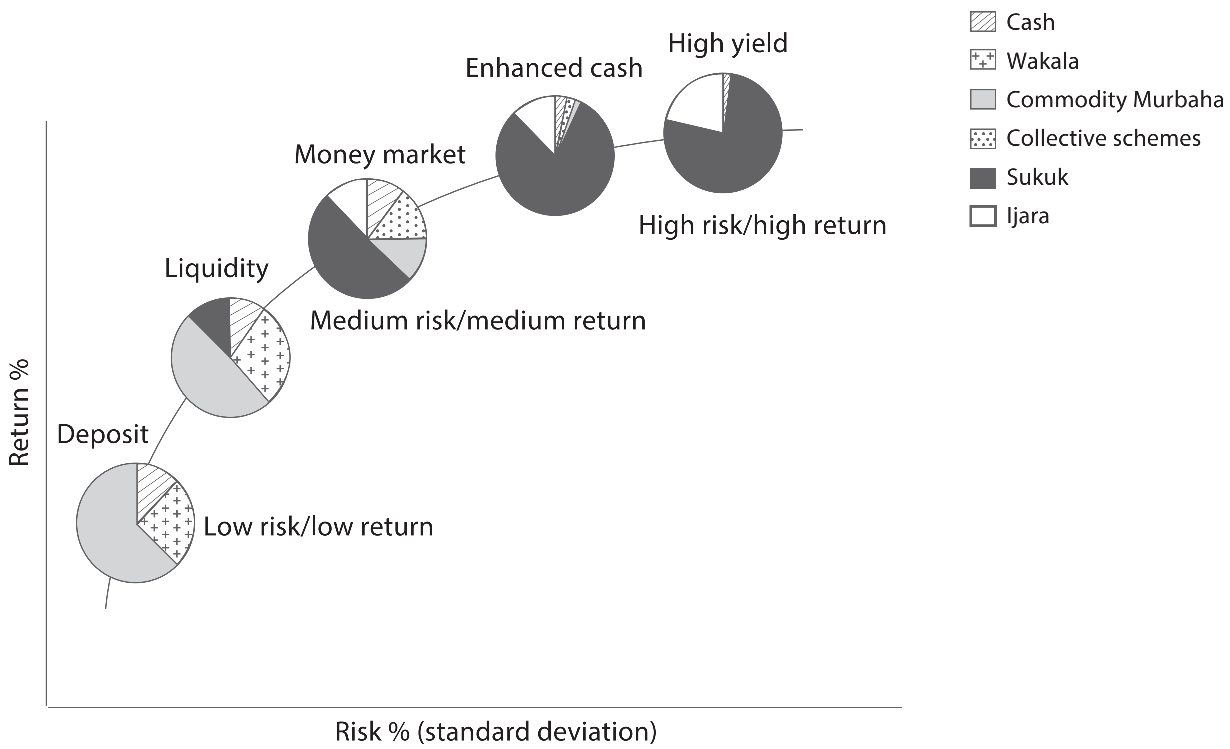


Figure 2 – Comparative risk return and liquidity

Source: Schoon, N , 2011, Islamic asset management

6.2 Lease Funds

Lease-based funds are generally considered to be slightly higher risk and potentially provide a higher return than fixed-income funds. The higher risk is mainly associated with the potentially less diversified portfolio and the ownership risk on the underlying asset. The advantages of a lease fund are:

- the fund owns the asset
- the lessee, ie, the user of the asset – relies on the availability of the asset for his operations and is, hence, less likely to default on the rental payments, and
- finance leases do not take residual risk on the asset and, since the periodic payment includes a principal payment as well as a rental contribution, the cash streams are predictable over the duration of the investment.

In addition to leases, the fund typically holds around 10–20% of its funds in relatively short-term liquid instruments such as cash, Commodity Murabaha and Wakala in order to meet its liquidity requirements.

The structure of a lease fund can, for example, be depicted as follows:

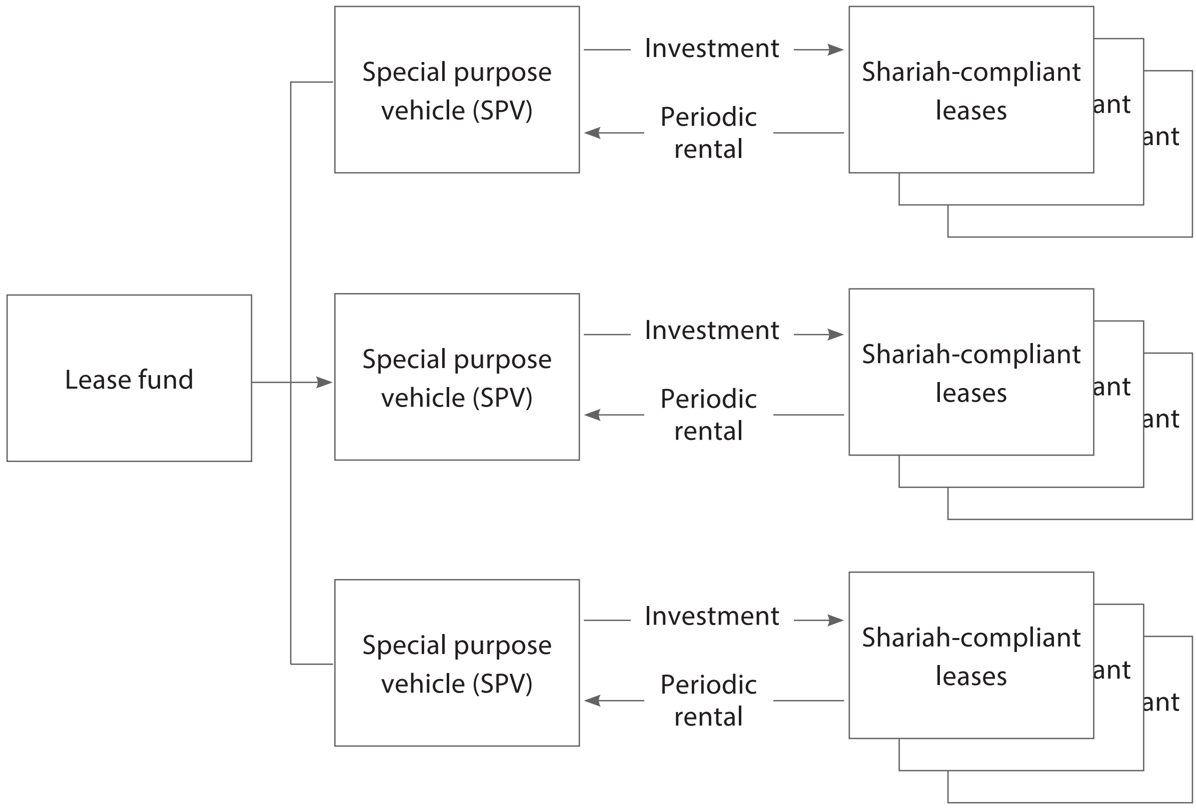


Figure 3: Lease Fund Structure

Source: Schoon, N , 2011, Islamic asset management

Investors' funds are invested in one or more special purpose vehicles (SPVs). The SPV owns the leases on behalf of the investors, which has the advantage that the underlying assets are retained by the SPV. This may prevent any potential tax and ownership transfer issues that might occur depending on the jurisdiction of the lessor.

The SPV, in its role of lessor, purchases the assets and leases them to the lessee. The SPV manages the receipt of periodic rental payments from the lessee and manages any other functions a lessor has. The SPV makes periodic payments to the fund manager as agreed and reinvests the proceeds in any asset category, depending on its requirements.

6.3 Commodity Funds

In a commodity fund, the fund manager uses the investments in the fund to purchase commodities with the intention to sell them at a profit. In order for an investment to be eligible, it needs to fulfil a number of criteria associated with a valid sales contract.

- **Ownership** – the commodity must be owned by the seller at the time of sale. Short-selling is not permitted.
- **Forward selling** – forward sales are not permitted unless the transaction is associated with short- or long-term production finance (Salam or Istisn'a).
- **Acceptability** – the commodity has to be lawful or halal and cannot, for instance, be alcohol, pork or any other commodity prohibited in Shariah.
- **Possession** – the seller must have physical or constructive possession of the commodity, which implies that the ownership risk is with the seller.
- **Price** – the price at which the commodity is sold needs to be certain and unconditional.

The risk of investing in a commodity fund is higher due to the price volatility of the underlying commodities. Shariah-compliant commodity funds typically invest in base metals, precious metals and oil- and gas-related commodities.

6.4 Real Estate Funds

Real estate funds can invest in commercial and residential real estate and generate a yield from rental income and increase in value. Rental income is generally reinvested in the fund or used to repay any mortgage financing. The use of any property needs to be Shariah compliant and its use will need to be monitored for ongoing compliance. Commercial properties that are leased to conventional financial institutions or any other unlawful industries cannot be included in the fund and any income associated with the non-compliant use must be donated to charity. In the event a property becomes non-compliant, it must be disposed of in an organised manner. Generally, a reasonable period of time is allowed for the disposal process in line with market conditions so as not to disadvantage the investors.

6.5 Equity Funds

Equity funds occur in the following main variations:

- **Private Equity** – funds investing in non-public companies either via direct investment or by obtaining shares. Investment in private equity is particularly suited to Shariah due to the partnership and profit- and loss-sharing principles underlying the transaction. The performance of funds investing in private equity is, however, difficult to determine as a private enterprise does not have a market value since the shares are not tradeable and the enterprises are typically relatively small.
- **Listed Equity** – funds can either be actively managed, through investment in listed companies via share purchases in the open market, or passively managed, in which case they track the performance of an assigned index. All major index providers have also introduced Shariah-compliant indices, such as the Dow Jones Islamic Market Index (DJIM) and the FTSE Shariah Global Equity Index Series. Besides the fact that these indices contain only those equities that are Shariah compliant, they are similar to other equity indices.

All equity needs to meet both the industry and financial screening criteria.

Individual Islamic indices may apply different screening criteria depending on the requirements defined by their SSB.

Examples

The **Dow Jones Islamic Market Index (DJIM)** applies the AAOIFI industry screen and three financial screens to exclude companies which have:

- Total debt/trailing 24-month average market capitalisation < 33%.
- (Cash + interest-bearing securities)/trailing 24-month average market capitalisation < 33%.
- Accounts receivable/trailing 24-month average market capitalisation < 33%.

  The trailing 24-month average market capitalisation is applied to reduce volatility.

The **FTSE Shariah Global Equity Index Series** applies the AAOIFI industry screen and adopts the following financial screens:

- Debt/total assets < 33.33%.
- (Cash + interest-bearing securities)/total assets < 33.33%.
- (Cash + accounts receivable)/total assets < 50%.
- Total interest and non-compliant activities should not exceed 5% of total revenue.

The **MSCI Islamic Index Series** applies the AAOIFI industry screen and also specifically excludes hotels, cinema and music from its investment universe and applies the following financial screen:

- Total debt /total assets < 33.33%.
- (Total cash + interest bearing securities)/total assets < 33.33%.
- (Total cash + accounts receivable)/total assets < 33.33%.

6.6 Exchange-Traded Funds (ETFs)

Islamic exchange-traded funds (ETFs) are securities that track the performance of an Islamic index or basket of commodities in the same way as an index fund does. However, the ETFs can be traded on an exchange in the same way as securities. The price of ETFs changes during the day as a result of units being bought and sold. The fund is not required to keep liquid instruments, since the investor can liquidate their holdings by selling them in the open market.

A physical or conventional ETF invests in stocks with the aim to replicate the performance of an index. Provided the underlying investments are Shariah compliant, this type of ETF is suitable for Shariah investors.

A synthetic ETF has the same aim (replication of the performance of an index), but achieve this by investing in derivatives and swaps to achieve the result. Due to their use of derivatives, synthetic ETFs are not suitable for Shariah investors. However, synthetic ETFs that are constructed using different types of instruments, such as swaps, can be.

6.7 Hedge Funds

Due to the prohibition on short-selling, hedge funds are still contentious. Some scholars have permitted the use of structures, including Salam, Arboon, and Wa'd, to overcome the prohibition of short-selling, although these are not generally accepted. Some Shariah-compliant single-manager equity hedge funds are available in the markets that make advance payments against forward asset purchases through the utilisation of the Salam contract.

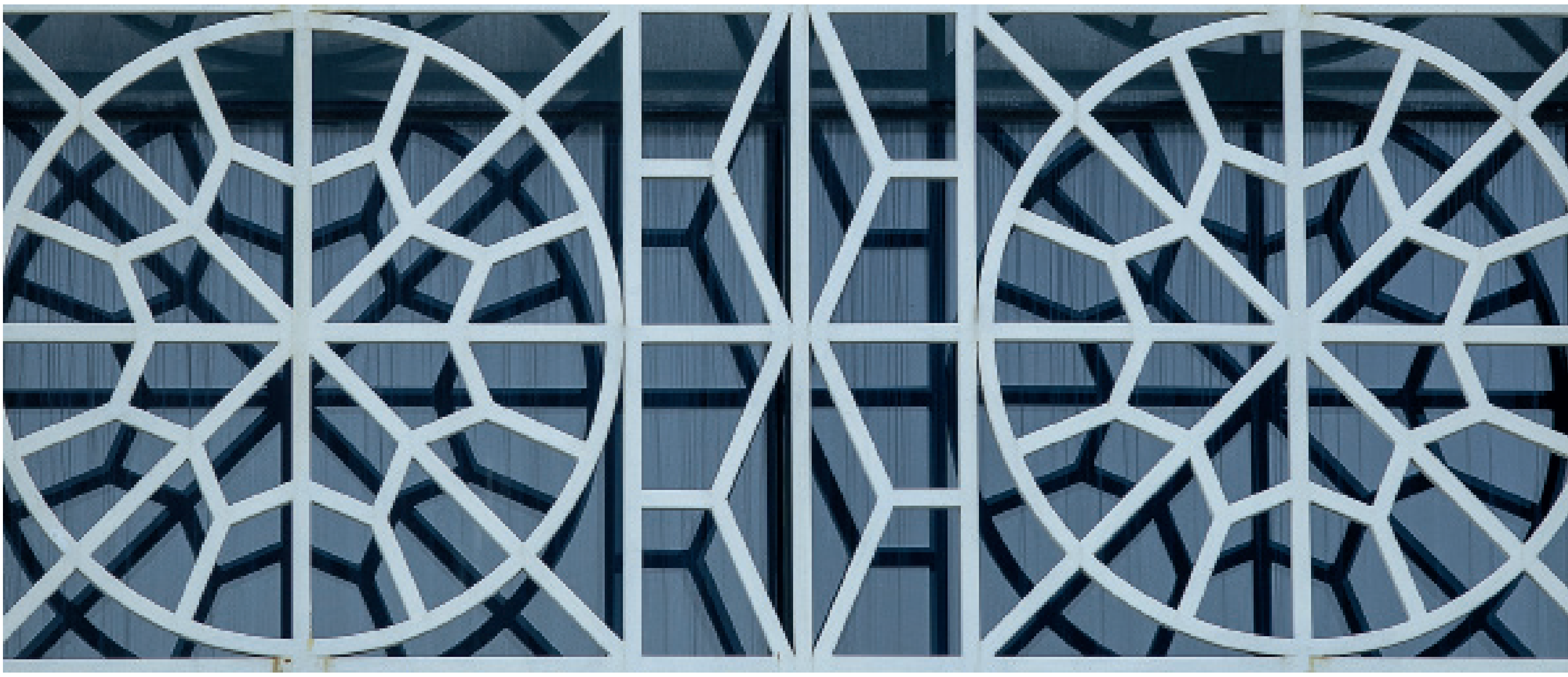
7. Concluding Remarks

Similar to conventional financial services, Shariah-compliant fund management provides diversification in investments. A range of different fund types is available with different levels of risk. The main difference between conventional and Shariah-compliant fund management is that all transactions and operations of an Islamic fund must comply with Shariah.

Chapter Seven

Sukuk Market

This syllabus area will provide approximately 11 of the 100 examination questions



The emergence of Sukuk has been one of the most significant developments in the Islamic capital markets in recent years, and can be traced back to a February 1988 decision of the Fiqh Academy of the OIC ruling '*... any collection of assets can be represented in a written note or bond; and that this bond or note can be sold at a market price provided that the composition of the group of assets, represented by the security, consists of a majority of physical assets and financial rights, with only a minority being cash and interpersonal debts*'.

Shortly thereafter, in 1990, the first Sukuk was issued with the following characteristics:

- Issuer – Shell MDS of Malaysia.
- Issue amount – RM125 million (equivalent to approximately US$30 million).
- Underlying transaction type – **Bai' Bithaman Ajil** (deferred payment sale).

The first sovereign Sukuk was issued by the Government of Bahrain for an amount of US$100 million, based on an Ijara structure. This was followed by the first global Sukuk (US$600 million Sukuk al Ijara) issued by the Malaysian government and the first Sukuk issued outside an Islamic country (Saxony-Anhalt, Germany, US$123 million Sukuk al-Ijara). In 2006, the first fund investing solely in Sukuk was launched; in 2012, France modified its legislation to accommodate Sukuk issuance and, in 2014, the UK issued a sovereign Sukuk issue of GBP 200 million. As of September 2016, US$37 billion was issued out of the Middle East and North Africa (MENA) region, US$12 billion in Asia, US$7 billion in Europe and US$500 million in both Africa and the US[1].

Sukuk has bond-like characteristics, and is an instrument that generates predicable income (yield) until maturity. At maturity, the capital is repaid.

The first part of this chapter details the differences between conventional bonds and Sukuk, and emphasises the importance of assets in the issuing process. The second part outlines the issuing process, and the third part explains some of the most commonly used structures.

1. Definition, Management and Characteristics of Sukuk

1.1 Conventional Debt Securities and Sukuk

Learning Objective

7.1.1 Know the differences between conventional securities and Sukuk

7.1.2 Understand the difference between asset-backed and asset-based Sukuk

1.1.1 Conventional Debt Securities

Debt securities or bonds are tradable financial instruments issued by a company or corporation to borrow a significant amount of money. Bonds are long-term loans allowing the holder to receive interest before the distribution of profits to shareholders. Bonds can be redeemed at the due date or upon liquidation,

1 International Islamic Financial Market (2017) Sukuk Report - 6th edition.

and have priority for repayment over shareholders in the event a company becomes insolvent. They can be sold and bought in both the primary and secondary markets and have the following characteristics:

1. The borrowing entity is either a government or a corporate.
2. Funds are borrowed for a defined period of time.
3. They pay a fixed or variable interest rate.

Redemption is generally at the due date or upon liquidation, with bondholders having priority over shareholders in the event of insolvency. Bonds may be secured or structured to have priority over other classes of debt.

The trading and pricing mechanism for conventional debt securities is based on the buyer's and seller's view of expected movements in interest rates.

Debt securities are important tools to achieve a balanced portfolio or to assure income. Prior to the advent of Sukuk, there were no true Islamic investment securities meeting the same need.

1.1.2 Islamic Securities – Sukuk

Case Study – Saxony-Anhalt Private Funding

In 2004, the German federal state of Saxony-Anhalt decided to raise €100 million from the international debt markets to meet its funding requirements. The local government decided to reach out to Islamic investors from the GCC and issued a Sukuk to comply with the Shariah rulings in relation to:

1. Riba – the coupon should not represent an interest rate, but a return on the asset.
2. Liability justifies return/reward is linked to risk – the coupons and capital redemption should be linked to the performance of the underlying assets.
3. Tradability – Sukuk should be tradable on a secondary market.

A US$123 million Sukuk al-Ijara was issued in July 2004.

AAOIFI defines Sukuk as follows:

'Certificates of equal value representing undivided shares in ownership of tangible assets, Usufructs and services or (in the ownership of) the assets of particular projects or special investment activity'. (

Source: AAOIFI, 2004:298

This definition clearly establishes the link between the instrument and ownership of assets. Although not the same, Sukuk, as a financial instrument, is often compared to conventional bonds.

Case Study – Saxony-Anhalt Sukuk (1)

In order to be able to issue the Sukuk, the arranger of the Saxony-Anhalt Sukuk required an asset with the following characteristics:

1. Tradable – the asset can be sold to raise the required funds.
2. Useable – the asset can generate a regular stream of income to pay the periodic return.
3. Redeemable – at the end of the period, the asset can be sold back to the issuer.

The underlying structure is a sale and leaseback of real estate owned by the state. The assets were sold to the SPV for the amount of €100 million and leased back to the state of Saxony-Anhalt. The Sukuk holders are paid a periodic return on the basis of the rental received. At maturity, the real estate is bought back by the state, and the proceeds of this are used to repay the initial capital investment of the Sukuk holders.

The Essential Role of Assets

From a Shariah-compliance perspective, the asset is essential, and pricing in the primary and secondary market should be based on the buyer's and seller's views of the value of the underlying asset. The profit levels should be calculated according to the performance of the underlying assets or projects. In practice, however, the primary role of the asset is to act as a security and pricing is based on creditworthiness, market conditions and benchmark rates.

Income received by the Sukuk holder is legitimate, since it is linked to a proportionate share of the underlying asset owned by them.

The security of the capital of the Sukuk holder depends on the contractual agreement as well as whether or not the Sukuk is secured. In a secured Sukuk, the capital is collateralised by the underlying asset. A secured Sukuk is secured by an existing asset. In addition, the asset that is constructed with the Sukuk proceeds may be used as additional collateral. In an unsecured Sukuk, on the contrary, the asset cannot be considered to be collateral, resulting in lower levels of security for the Sukuk holder.

Asset-based versus Asset-backed Sukuk

The terms 'asset-based' and 'asset-backed' refer to whether the Sukuk is secured (asset-backed) or unsecured (asset-based).

Asset-backed Sukuk involve a true sale (transfer of ownership) of the underlying asset from the originator to a SPV. The SPV will hold the asset in trust on behalf of the Sukuk holders. Sukuk holders, as the owners of the asset, are exposed to the risks and potential losses associated with ownership. In the event of bankruptcy of the obligor, the Sukuk holders have recourse to the asset and will be repaid from the proceeds of the sale.

Asset-based Sukuk are unsecured and typically only provide beneficial ownership of the asset to the SVP. A beneficial owner is defined as: '*a legal term where specific property rights ('use and title') in equity belong to a person even though legal title of the property belongs to another person*' (Black's Law Dictionary (2nd Pocket ed. 2001 pg. 508).

The legal owner, in this case, retains the ownership of the asset.

Case Study – Saxony-Anhalt Sukuk (2)

The state of Saxony-Anhalt sells the beneficial ownership of the buildings to the SPV and pays a rental to the SPV for the continued use of the assets until maturity of the Sukuk.

In the event of bankruptcy, the assets in an asset-based Sukuk revert back to the obligor (legal owner) and the claim of the Sukuk holders will rank *pari passu* with other unsecured debtors.

1.1.3 Differences Between Sukuk and Conventional Debt Securities

The differences between Sukuk and conventional debt securities are summarised in the following table:

Sukuk	Conventional Debt Securities
Sukuk represent a share of the ownership of the underlying asset used by the company issuing the securities. Sukuk holders are exposed to appreciation or depreciation of the asset.	Debt securities are a negotiable or tradable liability or loan. Debt holders do not bear losses as a result of the performance of the borrower company since there is no direct link between the securities and the company's assets.
The income of the Sukuk holders is linked to the performance of the underlying asset.	The income of the investors is linked to interest rates and creditworthiness of the borrower.
Sukuk holders have the right to profits but may bear losses if the underlying asset underperforms.	Bondholders are not exposed to losses unless the issuer declares bankruptcy.
Sukuk holders bear various ownership costs that are paid out of their share of the profits.	Bondholders are not liable for any costs associated with ownership of an asset.
The term to maturity of the Sukuk corresponds with the completion of the project or activity financed.	The term to maturity of a conventional debt security is not necessarily linked to an underlying project.
The capital of Sukuk holders is at risk of a loss in the value of the asset.	The capital of debt securities holders is guaranteed to be repaid at maturity except for in the instance of bankruptcy.

The differences between Sukuk and conventional debt securities have an impact on the tasks and responsibilities of the Sukuk manager. The Sukuk manager represents the Sukuk investors and works on their behalf. They may be dismissed by the Sukuk holders which results from the fact that, as owners, Sukuk holders are entitled to decide who is most qualified to manage their property or project.

2. Structuring Sukuk Transactions

2.1 The Basic Sukuk Issuance Process

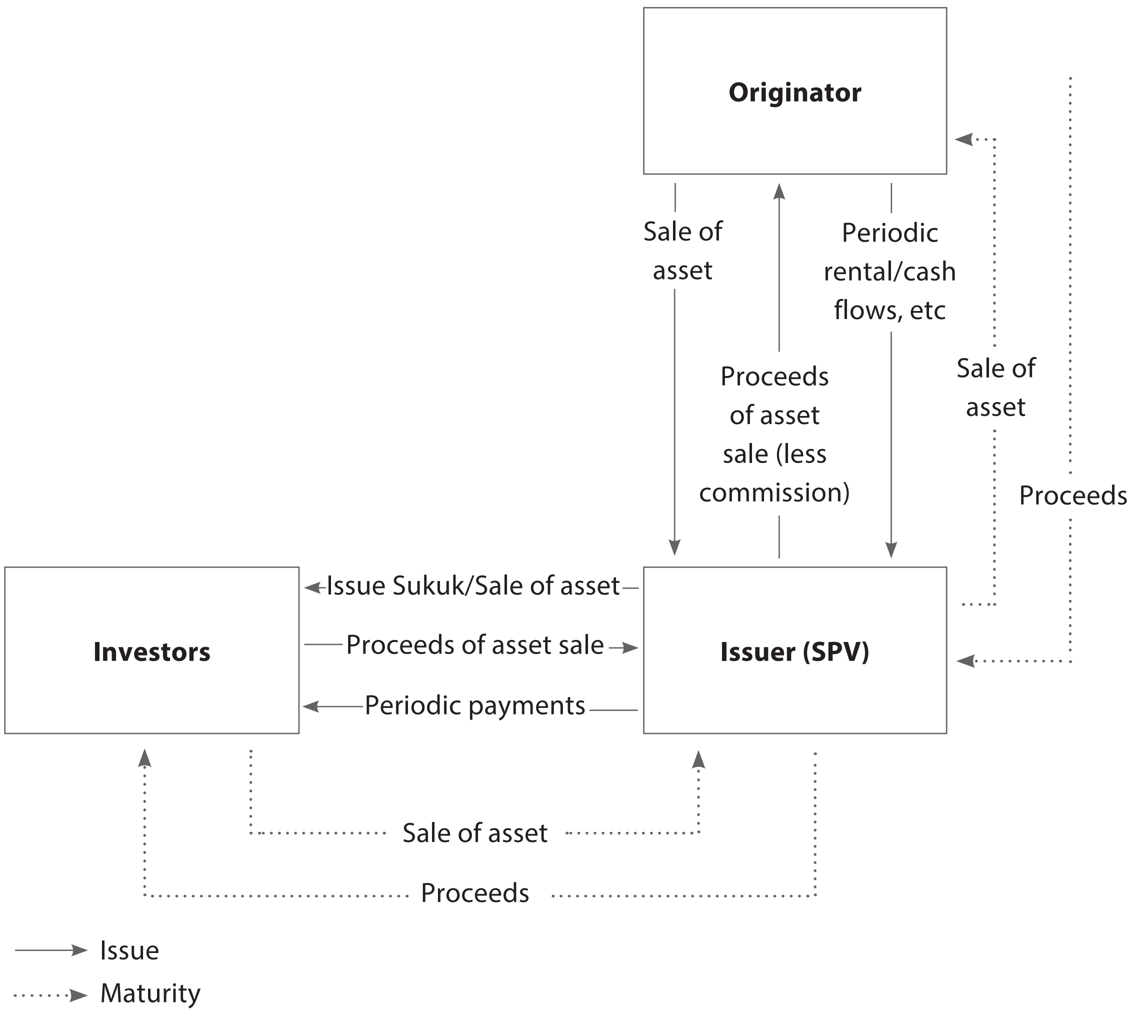
Learning Objective

7.2.1 Understand the basic processes and applications involved in the issuance of Sukuk in different jurisdictions

The usual format for issuing Sukuk is as follows:

- Set-up of the general framework and organisational structure. All legal, procedural and organisational issues need to be incorporated in the subscription prospectus.
- Creation of a SPV as a tool for asset acquisition.
- Underwriting the subscription. A commitment should be made to regulate the subscription process for any unsold Sukuk. This commitment is made by the party who undertakes to underwrite the issue to buy all the unsubscribed Sukuk; usually, this is the Islamic bank.

Figure 1: A Sukuk Structure



Source: Schoon, N (2016) Modern Islamic Finance London: Wiley

Similar to conventional bonds, the purpose of a Sukuk is to mobilise funds from multiple investors to a company which requires funds for a project. The parties involved in a Sukuk are:

1. **Originator/obligor** – a company or government seeking funds to undertake a project. The obligor will approach a bank to organise the issuance process.
2. **Arranger** – the bank that sets up the structure and establishes a SPV that will issue the Sukuk and manage the process on the behalf of the investors. The arranger is typically responsible for the prospectus, the underwriting of the issue and promotion and marketing.
3. **Issuer** – the SPV, that issues the Sukuk to the investors (the subscribers), collects their funds, manages the issue and distributes profits. The SPV has the following characteristics:
    - It is bankruptcy remote – in the event of bankruptcy of the obligor, any trade creditors cannot stake a claim on the assets held in the SPV or otherwise interfere with the rights of the Sukuk holders with respect to the underlying asset.
    - It is domiciled in a tax-efficient jurisdiction such as the Cayman Islands, Luxembourg, Jersey, Bahrain or Labuan.
    - It acts as a trustee – the SPV often acts as a trustee on behalf of the investors.
4. **The assets/project** – the underlying assets, Usufruct, or services will be owned by the investors until maturity.
5. **Investors** – Sukuk holders receive Sukuk certificates from the SPV in return for their funds.
6. **Manager** – the investors are represented by the manager who manages the investment of their funds in accordance with the terms of the Sukuk documentation. This manager can be an Islamic bank.
7. **Underwriter** – party committed to buy all unsubscribed Sukuk.

Case Study – Saxony-Anhalt Sukuk (3)

Obligor – State of Saxony-Anhalt

Arranger – Citi Islamic Investment Group

Issuer – Stichting Sachsen-Anhalt Trust, Luxembourg

Asset – state-owned administrative buildings

Investors – varied across type and geographic jurisdiction and included investors from the US, the UK, Saudi Arabia, Bahrain, Malaysia, Japan, Hong Kong and Germany.

Pricing – 100bp (1%) over six-month EURIBOR

Tenure – five years

2.2 Calculating Sukuk Return

Sukuk periodically pays a target rate of return which, in the documentation, may be referred to as the expected return. Unlike a conventional bond's coupon, there is no obligation to pay the expected return. Pricing should be based on the expected return on the asset but is, in practice, typically driven by elements such as the creditworthiness of the obligor, market conditions, interest rate environment and other benchmark offerings.

3. The Different Types of Sukuk

By definition, Sukuk are subject to fluctuating profits, possible losses and uncertainty of repayment of the capital. Investors desire stable income and capital preservation. Sukuk structures are designed to cater for these opposing interests.

3.1 AAOIFI Classification of Sukuk

AAOIFI's Shariah standard No 17 identifies 13 different Sukuk structures, each with a specific purpose and asset type:

1. **Sukuk al Ijara (certificates of ownership in leased assets)**.
    - Purpose – securitisation of existing tangible leased assets.
    - Asset owned – securitised assets.
2. **Sukuk Ijara Mawsoofa Bil Thimma (certificates of ownership in described future leased assets**).
    - Purpose – mobilisation of funds to meet the acquisition cost of tangible to-be-leased assets.
    - Asset owned – described future leased assets.
3. **Sukuk Manfaa Ijara (certificates of ownership in the usufruct of leased assets)**.
    - Purpose – securitisation of the Usufruct of existing leased assets.
    - Asset owned – the usufruct of the leased assets.
4. **Sukuk Manfaa Ijara Mawsoofa Bil Thimma (certificates of ownership in the Usufruct of described future leased assets)**.
    - Purpose – securitisation of the Usufruct of assets to be acquired and leased.
    - Asset owned – the Usufruct of the assets to be acquired and leased.
5. **Sukuk Milkiyat al-Khadamat (certificates of ownership of services of a specified party)**.
    - Purpose – pre-sale of the cost of services and their expected benefits.
    - Asset owned – the services.
6. **Sukuk al Salam (certificates of ownership of future goods or commodities)**.
    - Purpose – pre-sale of future goods or commodities.
    - Asset owned – goods or commodities to be delivered at a future date.
7. **Sukuk al Istisn'a (certificates of ownership of future manufactured or constructed assets)**.
    - Purpose – mobilisation of funds to cover the cost of construction and manufacturing of specific assets.
    - Asset owned – manufactured or constructed assets to be delivered at a future date.
8. **Sukuk al Murabaha (certificates of ownership of goods to be sold under Murabaha)**.
    - Purpose – mobilisation of funds required for the acquisition cost of goods to be sold under a Murabaha.
    - Asset owned – goods to be sold under Murabaha.
9. **Sukuk al Musharaka (certificates of partnership in a venture)**.
    - Purpose – sale of capital participation in a partnership.
    - Asset owned – shares of the venture.
10. **Sukuk al Mudaraba (certificates of ownership in a Mudaraba operation)**.
    - Purpose – mobilisation of funds from capital providers for a Mudaraba transaction.
    - Asset owned – project or activities managed under the Mudaraba.
11. **Sukuk al Wakala (certificates of ownership of goods entrusted to an agent)**.
    - Purpose – mobilisation of funds for the acquisition of certain goods that are entrusted to an agent.
    - Asset owned – the goods entrusted to the Wakil (agent).

12. **Sukuk al Muzara' (certificates of ownership of a share of a crop)**.
    - Purpose – mobilisation of funds for the cultivation of land.
    - Asset owned – share of crops to be produced.
13. **Sukuk al Musaqa' (certificates of ownership of a share of a crop or a share of ownership of land and its trees)**.
    - Purpose – mobilisation of funds for the planting or irrigation and maintenance of fruit bearing trees.
    - Asset owned – share of the crops of fruit-bearing trees, or the land and its trees.

Although the AAOIFI standards cover multiple structures, in practice, only a few are used. The majority of Sukuk instruments are based on lease transactions or business partnerships with predictable income streams.

4. The Main Types of Sukuk

The focus of this section is on those types of Sukuk that are most commonly used in practice:

- Sukuk al Ijara.
- Sukuk al Wakala.
- Sukuk al Musharaka.

It will also cover those used to a lesser extent:

- Sukuk al Murabaha.
- Sukuk al Istisn'a.
- Sukuk al Salam.
- Sukuk al Mudaraba.

The distinction between these different types is based on the type of contract that underpins the structure or that is used to generate the Sukuk holder's income.

4.1 Sukuk al Ijara

Learning Objective

7.2.2 Be able to apply Sukuk al Ijara

Sukuk al Ijara is the most popular type of Sukuk. The structure is relatively simple and, due to the underlying transaction type (Ijara), has regular payments throughout the life of the arrangement. In addition, it provides flexibility to tailor the payment profile and method of calculation to generate a profit.

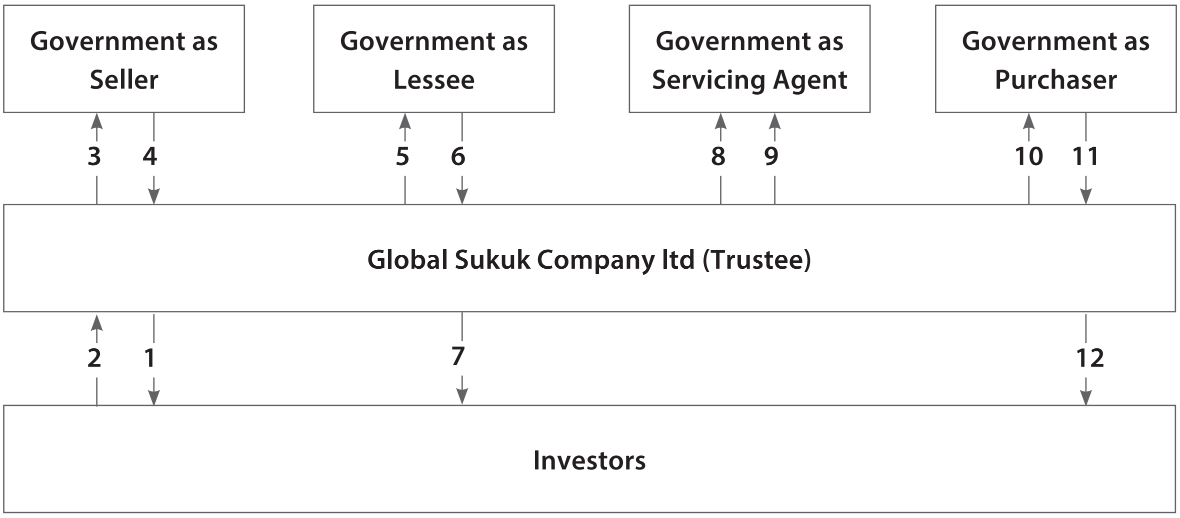
The structure of the Sukuk al Ijara follows the rules of the underlying Ijara transaction and is typically a sale and leaseback transaction. The Sukuk certificates constitute shares in a leasing project (usually equipment or real estate), providing holders with the right to receive rental fees and the ability to dispose of the properties without affecting the lessee's rights. Ijara Sukuk are tradable, since the seller will also sell their proportionate share in the assets and can be listed on an exchange.

Case Study – Dubai Department of Finance (DOF)

The Dubai DOF Sukuk was issued in November 2009 as the first dual-currency Sukuk. The structure was composed of two tranches, one of US$1.25 billion and one of 2.5 billion Arab Emirates Dirham. Investors received twice yearly returns of 6.396% calculated on the face value of their holding.

The US$ tranche detailed below was redeemed on 3 November 2014.

The Dubai DOF Sukuk issue was structured as follows:



- **Phase A**
  1. Dubai DOF Sukuk ltd issues Sukuk in order to
  2. raise funds.

- **Phase B**
  3. Dubai DOF Sukuk ltd uses the proceeds of the certificates to
  4. purchase, from the government of Dubai, a portfolio of assets including airport infrastructure, storm water drainage systems, an Emirates operation tunnel, a crisis centre and a car park.

- **Phase C**
  5. Dubai DOF Sukuk ltd leases the acquired assets to the government of Dubai.
  6. The government (as lessee) makes periodic rental payments equal to the distribution amount payable for the corresponding period.
  7. Dubai DOF Sukuk ltd uses those imbursements to pay its due to the certificate holders on each periodic distribution date.
  8. Dubai DOF Sukuk ltd appoints the government as its servicing agent to carry out certain of its obligations under the lease agreement, namely the obligation to undertake any major maintenance, insurance and payment of taxes in connection with the lease assets.
  9. Dubai DOF Sukuk ltd reimburses the government for any expenses incurred while undertaking these duties.

- **Phase D**
  10. On the scheduled dissolution date, Dubai DOF Sukuk ltd requires the government to purchase all of its rights, title, interest, benefits and entitlements in the assets portfolio.
  11. The exercise price is paid by the government.
  12. The final dissolution amount is payable by Dubai DOF Sukuk ltd to the certificates' holders.

Main Contracts Used

- **Phase A**
  Trust deed – the trust assets, in respect of each series, comprise Dubai DOF Sukuk ltd's rights, title, interest and benefits in the relevant lease assets; its rights, title, interest and benefits, present and future, in the transaction documents; and any amounts standing to the credit of the relevant transaction account.

  According to the trust deed, Dubai DOF Sukuk ltd will, in relation to each series:

  1. hold the relevant trust assets on trust for the certificate holders as tenants in common pro rata according to the face value of the trust certificates held by each of them, and
  2. act as trustee in respect of the relevant trust assets, distribute the income from the relevant trust assets and perform its duties in accordance with the provisions of the trust deed.

- **Phase B**
  Purchase agreement – according to this agreement, the government will sell Dubai DOF Sukuk ltd and Dubai DOF Sukuk ltd will buy from the government rights, interest, title and benefits to certain assets described in each supplemental purchase agreement, free and clear of any encumbrance or other rights of third parties.

- **Phase C**
  Lease agreement – under the terms of the lease agreement, Dubai DOF Sukuk ltd will lease to the government, and the government will lease from Dubai DOF Sukuk ltd, certain assets identified in supplemental lease agreements. The government agrees to use the relevant lease assets at its own risk. Accordingly, it shall bear the risk of loss or damage to the relevant lease assets or arising from the usage or the operation of the said assets. In addition, Dubai DOF Sukuk ltd will not be liable (and the government will waive any claim or right, howsoever arising, to the contrary) for any indirect, consequential or other losses, howsoever arising, in connection with the government use or operation of the relevant lease assets.

  Under the lease agreement, the government will also agree to be responsible, at its own cost and expense, for the performance of all ordinary maintenance and repair required for the lease assets. Dubai DOF Sukuk ltd will be responsible for:

  a. the performance of all major maintenance and structural repair
  b. the payment of any proprietorship or other relevant taxes, and
  c. insuring the leased assets.

  The rental amounts (less any servicing agency expenses incurred by the government in relation to the relevant lease assets for the relevant period), payable under each lease agreement, will equal the periodic distribution amounts payable on the periodic distribution dates for the relevant series.

  Service agency agreement – Dubai DOF Sukuk ltd and the government enter into a service agency agreement according to which the government is appointed servicing agent to manage the lease assets portfolio.

- **Phase D**
  Purchase undertaking – the government enters into a purchase undertaking in favour of Dubai DOF Sukuk ltd pursuant to which the government undertakes irrevocably to purchase all of Dubai DOF Sukuk ltd's rights, interest, title benefits and entitlements in the lease assets on the relevant maturity date or any earlier dissolution date.

Sale undertaking – Dubai DOF Sukuk ltd, as trustee for the certificate holders, enters into a sale undertaking in favour of the government. According to this agreement, the government may, by exercising its right under the sale undertaking and serving notice on Dubai DOF Sukuk ltd no later than 45 days prior to the relevant dissolution date, oblige Dubai DOF Sukuk ltd to sell all of its rights, benefits and entitlements in and to the lease assets of the relevant series on the relevant dissolution date at the exercise price.

Finally, the government will be entitled under a substitution undertaking to substitute new assets for existing lease assets, at its own cost.

4.2 Sukuk al Musharaka

Learning Objective

7.2.3 Be able to apply Sukuk al Musharaka

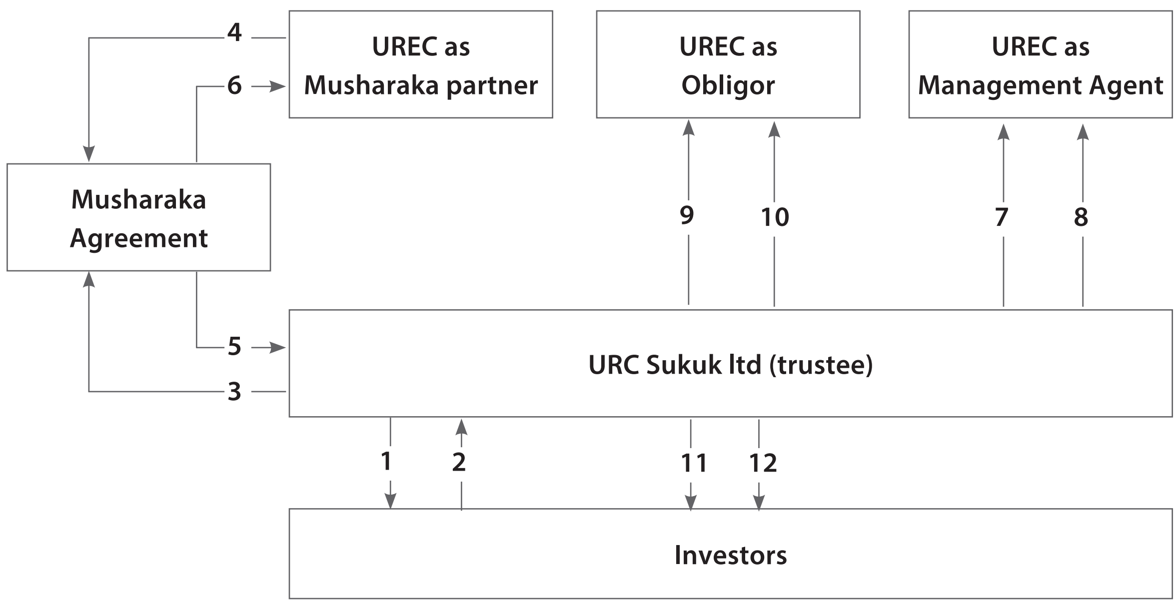
The funds raised via a Sukuk al Musharaka are invested in a new project, the development of an existing project or to finance a business activity. Unlike Sukuk al Murabaha and Sukuk al Ijara which generate a steady flow of income, the partners of Sukuk al Musharaka share in the profits and losses of the enterprise. Hence, the revenues may fluctuate and repayment of the capital cannot be guaranteed.

This level of risk does not meet the requirements of all investors and arrangers may attempt to design a structure that could smooth the income of the investors and guarantee capital. Shariah compliance may, however, be an issue with this.

Case Study – United Real Estate Company (URC) Sukuk ltd

In 2007, the Kuwaiti United Real Estate Company (UREC) issued a US$100 million Sukuk al Musharaka with a five-year maturity.

The URC Sukuk ltd issue was structured as follows:



- **Phase A**
  1. URC Sukuk ltd issues Sukuk in order to
  2. raise funds.

- **Phase B**
  3. URC Sukuk ltd is based on a Musharaka agreement which contributes US$100 million raised from the market to the capital of the Musharaka.
  4. UREC participates in kind with rights, benefits, interest to use certain real estate and properties that have a market value of US$30 million.
  5. The partners agree that the URC Sukuk ltd will receive 90% of the profit of the Musharaka.
  6. UREC receives 10% of the profit of the Musharaka.
  7. UREC is appointed as manager of the Musharaka.
  8. UREC receives management fees for performing their task.
  9. UREC is nominated obligor.
  10. As such, they agree to a purchase and sale undertaking that binds them to buy back units of the Musharaka at the request of the trustee.

Main Contracts Used

- **Phase A**

  Declaration of trust – the issuer will hold certain assets, primarily consisting of all of its rights, title and interest in the Musharaka entered into with the UREC as a partner and the rights under the transaction documents and the transaction account and all proceeds of the foregoing.

  On the 13th day of each March, June, September and December commencing on the first periodic distribution date, the issuer will pay a periodic distribution amount to the certificate holders calculated on the basis of:

  - LIBOR plus 1.50% pa, on the outstanding principal amount of the certificates as at the beginning of the relevant return accumulation period on an actual/360 basis, plus
  - in respect of each periodic distribution date, an amortisation payment of:
    - US$20 million, being 20% of the initial principal amount of the certificates, plus
    - any additional costs.

- **Phase B**

  Musharaka agreement – according to the Musharaka agreement, the Musharaka partners agree to enter into an unincorporated joint venture (the Musharaka). The Musharaka will commence on the date of the Musharaka agreement and will terminate and dissolve on the date at maturity.

  Upon its creation, the capital of the Musharaka is US$130 million. The issuer contributes US$100 million and UREC makes a contribution, in kind, of no less than US$30 million. UREC's contribution consists of the vesting into the Musharaka of all UREC's rights, benefits and interests to use certain real estate and properties that have a market value of US$30 million.

  Each Musharaka partner is entitled to share in the profits of the Musharaka with 90% of all net cash profit to be distributed to the issuer and 10% to UREC. If the issuer's profit share is in excess of the periodic distribution amount, the surplus distributable profit is paid to the management agent as incentive fees for acting as manager under the management agreement. The Musharaka partners will also bear the losses of the Musharaka. It will be borne by the partners, in proportion to the units held by each one in the Musharaka.

Purchase undertaking – under the purchase undertaking, UREC (as obligor) undertakes irrevocably to purchase one unit from the issuer when the latter exercises its option. UREC will purchase this unit at the relevant exercise price to be determined on the relevant exercise date.

Sale undertaking – pursuant to the terms of the sale undertaking, the obligor may oblige the issuer to sell its units. The issuer will sell those units to the obligor at the relevant exercise price determined on the relevant exercise date.

Management agreement – according to the management agreement reached between the Musharaka partners and the managing agent, the managing agent shall be appointed as manager of the Musharaka.

The managing agent is authorised to carry out all necessary action on behalf of the Musharaka to achieve the Musharaka's objectives. In consideration for acting as managing agent, the managing agent is entitled to incentive fees to be paid out of any surplus distributable profit after payment and/or settlement in full of any amounts owing under the certificates.

- **Phase C**
  The Sukuk holders receive the:

  11. periodic distribution amount, and
  12. the dissolution amount.

4.2.1 Profit Distribution Challenges

There is often a contradiction between the prospectus and the terms and conditions of the Musharaka transaction. From the information incorporated in the transaction, it is often easily inferred that the Sukuk will provide a foreseeable income. The Musharaka agreement itself, however, states that profits may fluctuate and that investors' capital is at risk. This is resolved within the purchase undertaking, the sales undertaking and the management agreement.

Example – Profit Distribution in Sukuk al Musharaka

Assume the periodic payment calculated using the methodology of the prospectus is equal to US$1,748,219. Three different scenarios can be considered.

Profit distribution – Scenario 1

The Musharaka makes a profit of US$1,942,466. According to the Musharaka agreement, US$194,247 (10%) is paid to UREC and US$1,748,219 (90%) to URC Sukuk ltd. The share of the trustee is equivalent to the sum due to the Sukuk holders and the amount is transferred to their accounts.

Profit distribution – Scenario 2

The Musharaka makes a profit of US$2,500,000. According to the Musharaka agreement, US$250,000 (10%) is paid to UREC and US$2,250,000 (90%) to URC Sukuk ltd. The trustee is obliged to transfer only US$1,748,219 to Sukuk holders. This sum is transferred to their accounts and the balance (US$501,781) is transferred to the management agent in accordance with the management agreement.

Profit distribution – Scenario 3

The Musharaka makes a profit of US$1,300,000. According to the Musharaka agreement, US$130,000 (10%) is paid to UREC and US$1,170,000 (90%) to URC Sukuk ltd. The trustee is obliged to transfer US$1,748,219 to Sukuk holders. Hence, there is a deficit of US$578,219. According to the purchase undertaking, URC Sukuk ltd asks UREC to buy some of its units to cover the shortfall and transfers the whole amount to the Sukuk holders.

From the scenarios in the example, it is clear that the risk to investors is minimised by the purchase undertaking, which specifies that: '*UREC will purchase (the) unit at the relevant exercise price on the relevant exercise date*' and the sales undertaking states that '*the issuer will sell (the) units to the obligor at the relevant exercise price*'.

The meaning attached to the expression 'relevant exercise price' depends on the time during the transaction the purchase undertaking is invoked.

- At the time of periodic distribution of profits, the US$ amount is equal to the periodic distribution.
- At the time of maturity, the US$ amount is equal to the dissolution distribution amount.

As a result, Sukuk holders have the certainty that they will receive the expected return on their investment and are highly likely to recover their whole capital at maturity.

4.3 Sukuk al Wakala

Learning Objective

7.2.4 Be able to apply Sukuk al Wakala

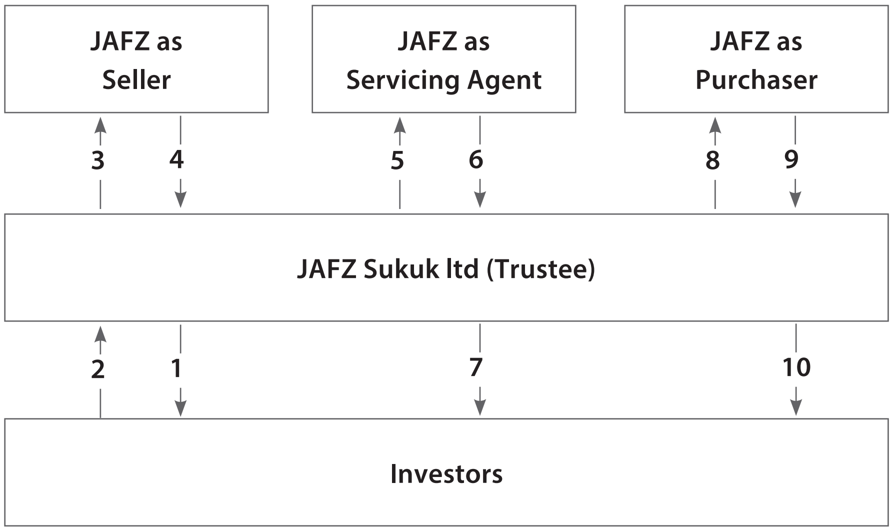
This type of Sukuk is structured on the basis of a Wakala transaction, an arrangement whereby one party entrusts another party to act on its behalf. The agent (Wakil) uses its expertise to select and manage investments on behalf of the investor to ensure that the portfolio will generate the expected profit rate agreed by the principal.

Case Study – Jebal Ali Free Zone (JAFZ)

In 2012, JAFZ[2] issued trust certificates to the value of US$650 million. The funds were used by the SPV (JAFZ Sukuk ltd) to buy a Wakala portfolio from JAFZ with a maturity date of 19 June 2019. Until maturity, Sukuk holders will receive twice-yearly periodic payments on the 19 June and December of US$35 for every US$1,000 invested.

2 Jabal Ali Free Zone (JAFZ) is a major industrial and commercial development in Dubai and one of the largest operating free zones in the GCC. In 2012, it included approximately 55 square kilometres and hosted approximately 6,700 companies from over 100 different countries (with approximately 125 Fortune 500 and large multinational companies as tenants). JAFZ was established as a free zone establishment on 5 March 2006 with a mandate to realise the maximum commercial value from operational and commercial activities within the free zone. Its activities consist of leasing, commercial and administrative services.

The JAFZ Wakala Sukuk issue is structured as follows:



- **Phase A**
  1. JAFZ Sukuk ltd issues Sukuk in order to
  2. raise funds.

- **Phase B**
  3. JAFZ Sukuk ltd uses the proceeds of the certificates
  4. to purchase from JAFZ a portfolio of identified income generating real estate assets, consisting of plots of land and, in cases where JAFZ owns the building, the attached buildings.

- **Phase C**
  5. JAFZ Sukuk ltd appoints JAFZ as the servicing agent to manage the Wakala portfolio.
  6. Prior to each periodic distribution date, JAFZ, as servicing agent, pays to the trustee an amount reflecting the returns generated by the Wakala portfolio during the relevant Wakala distribution period.
  7. The funds are intended to be sufficient to fund the amounts payable to the certificate holders.
  8. On the scheduled dissolution date, JAFZ Sukuk ltd has the right to require JAFZ to purchase all of its rights, title, interests, benefits and entitlements in the Wakala portfolio.
  9. The exercise price payable by JAFZ, together with any Wakala portfolio revenues then held by the JAFZ as a servicing agent and payable to JAFZ Sukuk ltd under the Service Agency Agreement, are intended to:
  10. fund the final dissolution amount payable by JAFZ Sukuk ltd to the certificates holders.

Main Contracts Used

- **Phase A**
  Declaration of trust – the trust assets include all of the:

  1. trustee's rights, title, interests and benefits, present and future in the assets constituting the Wakala Portfolio
  2. trustee's rights, title, interests and benefits, present and future in the transaction documents
  3. monies standing to the credit of the transaction account
  4. proceeds of the foregoing.

According to the declaration of trust, the trustee will:

a. hold the trust assets on trust absolutely for the certificate holders pro rata on an undivided basis according to the face amount of the certificates held by each of them, and
b. act as trustee in respect of the trust assets, distribute the income from the trust assets and perform its duties in accordance with the provisions of the declaration of trust.

Investment agency deed – this agreement appoints Dubai Islamic Bank as investment agent to enter into facility finance documents on the behalf of the participants and JAFZ.

- **Phase B**
  Sale and purchase agreement – according to this agreement, JAFZ sells and the investment agent purchases a portfolio consisting of real estate assets which are leased to third parties and generates an income stream for onward distribution to investors.

- **Phase C**
  Service agency agreement – the investment agent and JAFZ enter into a service agency agreement according to which JAFZ is appointed servicing agent to manage the Wakala portfolio.

- **Phase D**
  Purchase undertaking – JAFZ enters into a purchase undertaking in favour of the investment agent pursuant to which JAFZ will irrevocably undertake to purchase from the investment agent all or part of the Wakala assets upon the occurrence of certain designated events.

  Sale undertaking – the investment agent enters into a sale undertaking in favour of JAFZ pursuant to which the investment agent will irrevocably undertake to purchase from JAFZ all or part of the Wakala assets upon JAFZ exercising its rights.

4.3.1 Equalisation of the Periodic Distribution Amounts

Even though the income from the Wakala portfolio is variable, the periodic distribution to JAFZ Sukuk is structured as regular income by means of the Wakala reserve collection amount. This is similar to the Musharaka reserve profit account and is used to smooth the income of the investors by accumulating the surplus of profit and compensating any possible loss.

4.4 Other Sukuk Structures

Learning Objective

7.2.5 Understand the structure of the following: Sukuk al Murabaha; Sukuk al Istisn'a; Sukuk al Salam; Sukuk al Mudaraba

7.2.6 Understand how Green Sukuk is emerging to help tackle environmental and climate change concerns

4.4.1 Sukuk al Murabaha

Sukuk al Murabaha are based on a Murabaha transaction in which an asset is sold against a deferred payment and are typically used to finance the purchase of commodities. The SPV uses the proceeds of the Sukuk to acquire specific Shariah-compliant commodities from a third party at the request of the obligor. Delivery of the commodities and the payment of the purchase price are immediate. The SPV then sells the commodities to the obligor on the basis of Murabaha, in which delivery of the commodities is immediate and payment is deferred.

4.4.2 Sukuk al Istisn'a

Sukuk al Istisn'a is generally applied to the financing of larger-scale projects, such as infrastructure, and is similar to conventional project finance contracts. Sukuk al Istisn'a typically consists of the following:

- Istisn'a agreement to secure the financing of the manufacturing of the assets. Payments to the construction company are typically made in instalments in accordance with pre-agreed milestones, and
- leasing agreements including a forward lease and a finance lease ensure investors receive regular payments according to a defined schedule. The forward lease is incorporated to enable payment to investors prior to the completion of the asset.

Although the Sukuk is tradable, the prevailing view is that the certificates cannot be traded prior to the completion of the asset. All funds are raised at the start of the project. Given that payment to the construction company is phased, a significant number of funds may be idle until further payments are made. Unless the Sukuk manager identifies other yielding assets, these funds may potentially not generate any returns.

4.4.3 Sukuk al Salam

Sukuk al Salam is comparable with a zero coupon bond, with the investor paying the funds up front and receiving the return once the goods bought under Salam are delivered and sold at the end of the contract period. Interim delivery of goods, and thus interim payments to investors, are permissible. The certificates cannot be traded on the secondary market and the structure is subject to all conditions associated with a Salam contract.

Sukuk al Salam is, typically, applied as a short-term liquidity management instrument by central banks including, but not restricted to, the Central Bank of Bahrain, the Central Bank of Yemen and the Central Bank of Gambia.

4.4.4 Sukuk al Mudaraba

In a Sukuk al Mudaraba, the underlying transaction type is Mudaraba, in which only one of the partners, the special purpose vehicle (SPV) acting on behalf of the Sukuk holders, provides the capital and acts as the Rab al Mal. The SPV invests in a project or company governed by a Mudaraba agreement, and the investment of the SPV is divided into equal units and sold to the Sukuk holders. At the end of the period, the investment is liquidated in any Shariah-compliant manner and investors get their principal plus or minus net returns.

4.4.5 Green Sukuk

With growing climate and environmental concerns, the demand for green or environmental investment opportunities is increasing. Over recent years, a number of green Sukuk have been introduced to meet the demand. The underlying principles of Shariah are closely aligned with environmental and climate change, and a green Sukuk can be issued under any structure.

5. Sukuk Rule Changes 2008

Learning Objective

7.3.1 Understand the Sukuk regulations

The incorporation of profit-smoothing structures, such as the Wakala reserve account and the purchase undertaking in the Sukuk al Musharaka, negate all risks and are not considered to be Shariah compliant. In February 2008, AAOIFI issued the following restrictions to the Sukuk regulations:

- **Purchase undertaking** – an issuer's purchase undertaking constitutes an integral part of the Sukuk structure. It guarantees that the Sukuk holders will recover their initial investment at the maturity of the certificates. The price that will be used for the purchase undertaking can be pre-agreed at the beginning of the transaction only in the case of Sukuk al Ijara which is based on a sale and lease-back transaction. In any other Sukuk structure, a purchase undertaking is permitted, but the price cannot be agreed in advance. At maturity, the market price of the underlying asset or partnership needs to be used.
- **Sukuk manager guarantee** – the Sukuk manager, acting as an agent of Sukuk holders, cannot provide a guarantee to compensate the shortfall of any income to the Sukuk holder.
- **Reserves** – the Sukuk manager may build up reserves out of the profit or rentals generated by the Sukuk to cover any potential future shortfall. However, amounts will have to be assigned to specific reserves before distributing the profit to the Sukuk holders.

The Musharaka Profit Reserve Account

The main result of the new regulations was the creation of the Musharaka profit reserve account which is used as a buffer to smooth the income of the investors. This is how the prospectus of JAFZ Sukuk ltd (page 2) describes this account:

'If the profit payable to the Trustee is greater than the relevant Periodic Distribution Amount, any surplus profit distributable to the Trustee over the Periodic Distribution Amount will be recorded by the Managing Partner in the Musharaka Accounts as a credit to the line item entitled ''Musharaka Profit Reserve Amount''.

Any amount standing to the credit of the Musharaka Profit Reserve Amount column in the Musharaka Accounts on the Musharaka End Date will, subject to the terms of the Musharaka Agreement, be paid to the Company as an incentive fee for acting as Managing Partner … If (the) profit is less than the relevant Periodic Distribution Amount or if for any other reason the funds available in the Transaction Account on the Periodic Distribution Date are not sufficient to enable the Trustee to pay the relevant Periodic Distribution Amount due on the relevant date, in full for any reason, the Managing Partner will deduct such shortfall from the Musharaka Profit Reserve Amount.

If the amounts standing to the credit of the Musharaka Profit Reserve Amount are insufficient, the Managing Partner shall meet the shortfall through the provision of Shari'a compliant financing and in the event this is not possible it will provide an interest free loan to the Trustee which shall be repayable solely from profits of the Musharaka'.

6. Capital Market Considerations Relating to Sukuk

Learning Objective

7.4.1 Understand the capital market considerations relating to Sukuk: rating the issue; distribution; tradability and non-tradability

The following are the two critical issues to consider when issuing a Sukuk:

- Should the issue be rated?
- How should it be distributed?

6.1 Rating the Issue

In Malaysia, rating an issue is mandatory and issuers typically seek the rating of one of the domestic agencies. Issuers outside Malaysia do not always chose to rate the issue, partly due to a lack of domestic and regional specialised rating agencies, and partly because the alternative, ie, the use of international rating agencies, has a high cost associated with it.

International rating agencies (Standard & Poor's, Moody's and Fitch Ratings) have been active in Sukuk rating since 2002. When rating a Sukuk, the rating agencies consider whether the issue can have a rating better than its country of domicile and whether Shariah, the civil code or the national rules, can hinder the securities issuance process and ratings, including, for example:

- Enforceability of the asset under the relevant laws.
- Presence of a trust law.
- Interpretations of Shariah.

When rating an individual issue, a rating agency analyses the same five factors in determining an obligor's capacity to make scheduled or promised payments:

- **Cash** – does the issuer have cash balances, reserves or standby access that will assure timely payment in the event of a cyclical or unexpected interruption of cash flow?
- **Cash flow** – what is the nature, history and consistency of the issuer's cash flow? What coverage does this provide for future obligations?
- **History** – what is the originator, asset class and underlying obligor payment history? What is their business history? Does the prior history of each component (the originator, asset class and obligor) meet a standard that gives a reasonable prediction of future payment?
- **Security** – is the underlying sufficient to secure repayment in the event of servicer (party collecting monthly payments), issuer or originator-related problems including default? Or must additional security including extra assets, reserve funds or guarantees be added to arrive at an attractive rating?
- **Servicing** – will the originator service collections related to the underlying? Is the originator sufficiently skilled and competent to do this? If the originator fails, has a back-up servicer known to the investing community been identified and contracted to step in and replace the original servicer without harm to the investors?

Shariah compliance is not considered as a criteria since rating agencies consider that Shariah compliance does not impact the ability of the issuer to make payments.

6.2 Distribution

Popular listing platforms for cross-border Sukuk include Luxembourg, London, Dubai, Bahrain and Labuan. Each has its own tax regime designed to facilitate global investors. Although Sukuk investors are mainly institutional investors, there is increasing distribution to retail investors through direct sales, Sukuk funds, mixed or balanced funds, and listings on public exchanges.

For a number of reasons, the Sukuk market has mainly been a market of primary issues:

- Relatively small number of eligible issuers.
- No programme issues, such as Freddy Mac or Fanny Mae. Hence, there is no standard delivery platform into a market for specific investment types with defined characteristics.
- Pressure on Islamic banks to reduce commodity Murabaha transactions resulting in Islamic banks buying and holding Sukuk.

The lack of programme issues may soon be addressed by Islamic banks as they have to start considering securitising many of their existing and future assets to meet Basel capital adequacy standards.

6.3 Tradability

Generally, Sukuk are tradable both in a primary and secondary market. They are listed on national and international exchanges and the units can be bought and sold publicly as well as privately. However, Sukuk al Murabaha and Sukuk al Salam cannot be traded freely for money as this violates the rules of debt trading.

7. Concluding Remarks

The Sukuk market is growing rapidly for many reasons, one of them being the increased sophistication of global Islamic banks and their clients. Further growth is likely to be fuelled by the Basel capital adequacy requirements which encourage the reconstruction of risks into investment securities which have greater prospects of monetisation. In light of the relatively short history of Sukuk, the diversity of issuances and the quality of instruments is impressive and will no doubt lead to programmes by high-quality issuers.

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End of Chapter Questions

1. What are the differences between conventional debt securities and Sukuk?
   Answer reference: Section 1.1.3

2. What is the second phase in the Sukuk issuance process?
   Answer reference: Section 2.1

3. In a Sukuk, who is the arranger and what are their responsibilities?
   Answer reference: Section 2.1

4. Which type of Sukuk is based on a Murabaha transaction in which an asset is sold against deferred payment and when is it typically used?
   Answer reference: Section 4.4.1

5. To which type of conventional bond can a Sukuk al Salam be compared?
   Answer reference: Section 4.4.3

6. Describe the Musharaka profit reserve account.
   Answer reference: Section 5

7. List the Sukuk rule changes of 2008.
   Answer reference Section 5

8. List the rating factors.
   Answer reference: Section 6.1

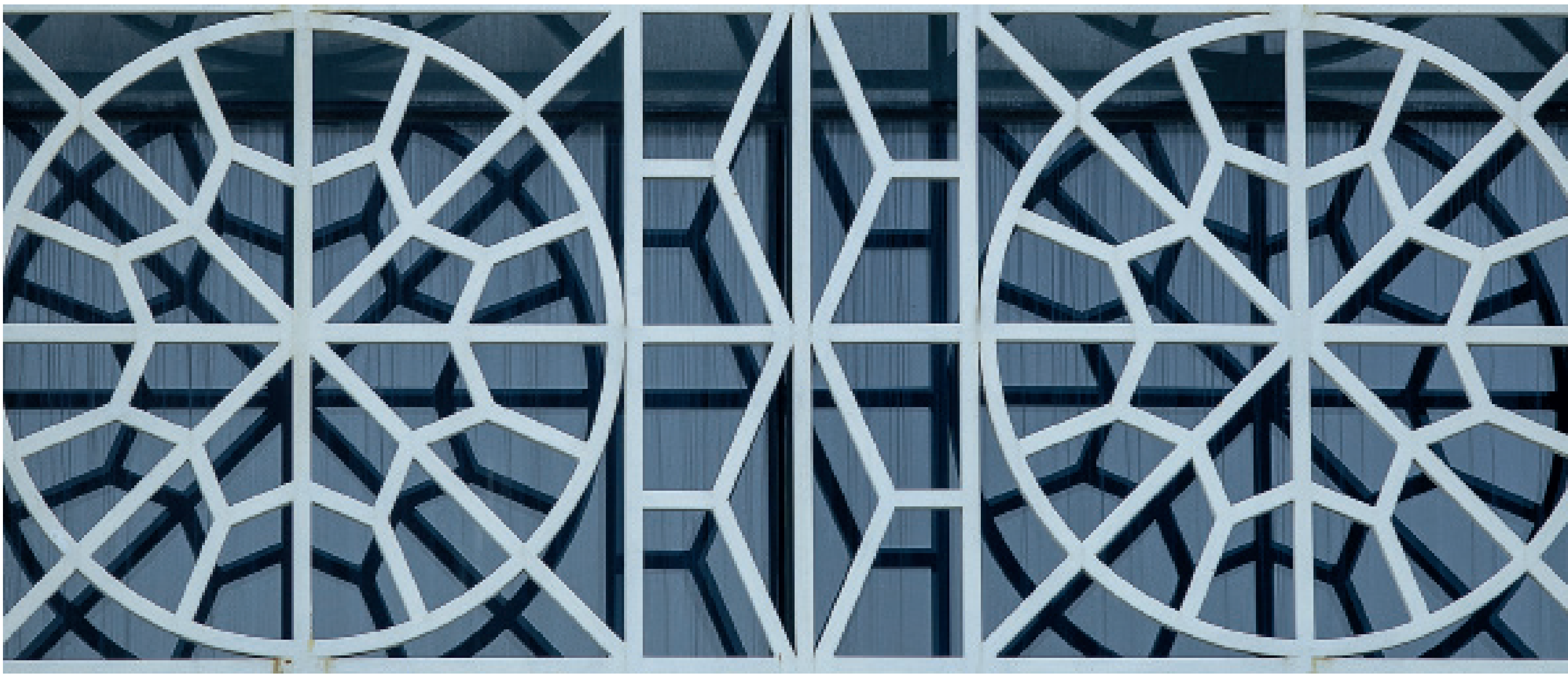
9. Why do rating agencies not consider Shariah compliance?
   Answer reference: Section 6.1

10. List the reasons why the Sukuk market has mainly seen primary issues.
    Answer reference: Section 6.2

Chapter Eight

Islamic Insurance – Takaful

This syllabus area will provide approximately 9 of the 100 examination questions



Students should understand the main similarities and main differences between conventional insurance and Islamic co-operative insurance (Takaful), with particular reference to mutual or co-operative insurance (both conventional and Islamic) and to the legality of Takaful in Fiqh al Muamalat, and how the latter differentiates Islamic from conventional mutual insurance. There is no intention to deal at length with Fiqh relating to Takaful. It is assumed that students will initially have some awareness of the insurance industry.

1. Introduction

Learning Objective

8.1.1 Understand the position of Islam regarding insurance

8.1.2 Understand the origins of Takaful: the characteristics of mutual insurance; the nature of conventional mutual insurance; the nature of a Takaful undertaking and the need to avoid Gharar through Tabarru' (donation) and Riba through the use of non-interest bearing assets; the structure of Takaful undertakings: non-profit and commercial

1.1 Why Islamic Insurance?

Position of Islam Regarding Insurance

Islam permits the taking of measures to reduce risks. This is illustrated by the Hadith in which the Prophet (PBUH) advises a Muslim to have faith in Allah (SWT) and tie up his camel, rather than relying just on his faith in Allah (SWT) to prevent the animal from wandering off. However, Islam does not permit contracts for the buying or selling of indemnities or guarantees. This is because such contracts contain elements of speculation (Maysir) and uncertainty (Gharar) which are forbidden.

In a conventional insurance contract with a proprietary (not a mutual) insurance company, the insurer takes money (the premium) from the insured in the hope of making a commercial profit. The company anticipates that the claims made by the insured for the period covered by the insurance will be less than the amount of the premium. This is Maysir. Also, the insured pays for an uncertain benefit, which may be nil if there is no claim or may greatly exceed the amount of the premium. This is Gharar. In order to avoid Maysir and Gharar, Islamic insurance takes the form of co-operative or mutual insurance – Takaful, which is the Arabic word for solidarity or mutuality.

Origins of Islamic Insurance

Forms of mutual insurance arrangements existed in the early years of Islam and, indeed, the origins of conventional insurance are to be found in mutual insurance (risk pooling) arrangements. Muslim jurists acknowledge that the basis of shared responsibility in the system of **Aquila**, as practised between Muslims of Mecca and Medina, laid the foundation of Islamic mutual insurance. In the case of Aquila, as approved by the Prophet Muhammad (PBUH), if a person was killed by another from a different tribe, this made the members of the killer's tribe liable to pay blood money to the heirs of the dead person. The operation of Aquila provided the funds necessary to pay the blood money.

Although practised before, Islamic insurance gained greater popularity in the early second century of the Islamic era (roughly the 9th century AD in the Christian calendar) when Muslim Arabs expanding trade into Asia mutually agreed to contribute to a fund to cover anyone in the group who incurred mishaps or robberies during the numerous sea voyages.

Characteristics of Mutual Insurance

In mutual insurance, the insured (or policyholders) co-operate to create a risk pool for a defined category of their risks and contribute to a mutual underwriting fund from which benefits are payable to indemnify them in the case of losses arising from such risks. The underwriting fund belongs to the policyholders. There is thus no buying or selling of indemnities (legal exemptions from liabilities for damages) as the owners and the insured are the same, ie, the policyholders, and any surpluses or deficits on underwriting are not commercial profits or losses but are attributable to the policyholders. In contrast to the profit-making objective of underwriting in commercial or proprietary insurance, the objective of mutual underwriting is that the expected value of underwriting surpluses should be zero (with surpluses and deficits averaging out over time), except to the extent that surpluses are sought for the purpose of building up reserves in the underwriting fund.

1.2 Comparing Conventional Mutual Insurance and Islamic Insurance

1.2.1 Conventional Mutuals

In the conventional insurance sector, many insurance undertakings are mutuals, in which the capital of the undertaking is owned by the policyholders who are, therefore, both the owners and the insured. In recent years, however, there has been a tendency for mutual insurance companies, including some of the largest, to demutualise by converting themselves into proprietary insurance companies (limited companies with capital owned by shareholders) and making public issues of shares. The reasons for this are twofold: (a) the need for access to new capital in an industry in which size and the resultant economies of scale are crucial when competing in global markets; and (b) the effects of regulation in recent decades on the need for capital in order to meet capital adequacy and solvency requirements. For these reasons, it is hard to imagine a new insurance undertaking starting today as a mutual, as many did in previous centuries before the introduction of regulatory capital requirements, subsequently building up reserves (policyholders' equity) that are now adequate to meet current requirements.

1.2.2 How Takaful Undertakings Differ

Introduction

Islamic Takaful undertakings differ in three main ways from conventional mutual undertakings: they are, of course, subject to the rules of Islamic commercial jurisprudence (see section 7 of this chapter) and, therefore, operate on a different legal basis, and they have a different structure.

Juristic Basis: Avoidance of Gharar (by the use of Tabarru') and of Riba

Avoidance of Gharar

There is an important difference of a legal nature between conventional mutual insurance and Takaful, which explains why the development of Islamic insurance is quite recent. Islamic scholars considered that, in conventional mutuals, while the contractual basis related to premiums and benefits in a mutual undertaking are free from Maysir (as there is no speculative profit objective), they are not free from Gharar. This is due to the element of uncertainty of the benefits still being present (the insured pays premiums to cover for an event that may or may not occur in future and, if it occurs, it is uncertain to what degree). It was necessary to replace this contract with another which avoided this problem. The solution took some time to find, but was eventually achieved by applying the concept of Iltizam bi al-Tabarru' (a commitment to a donation) as developed by the Maliki school of Fiqh al Muamalat (Islamic commercial jurisprudence).

In Takaful, the contributions of the insured to the Takaful underwriting fund as insurance premiums are made with the intention of donation. Hence, a payment of a benefit made to an insured in the case of that insured's loss contains an element of intentional donation from the other insured. Although Gharar still exists, it is permissible, on the basis that Gharar only affects contracts of exchange and not **Tabarru'** (gratuitous contract).

Avoidance of Riba

All insurance undertakings invest liquid funds in income-producing assets, the income from which increases the amounts available to meet claims and conventional insurance undertakings may borrow funds on an interest-bearing basis. In contrast, Islamic insurance undertakings avoid what is non-permissible (including, but not restricted to, Riba) by investing liquid funds only in non-interest-bearing assets and by not borrowing on an interest-bearing basis.

Structure (Overview)

Takaful undertakings do not generally have a pure mutual form. Instead, various hybrid, two-tier forms are found in which the management of the undertaking is provided by a limited company with share capital: a Takaful operator. The Takaful (underwriting or risk) funds are owned by the Takaful participants (policyholders), as in a conventional mutual, but are managed by the Takaful operator. This relationship is governed by different contracts as described in section 3 of this chapter. The Takaful operator is also responsible for managing the investments of the Takaful (underwriting) funds and, in the case of life or family Takaful (see below), the investment funds. If an underwriting deficit occurs during a period in which the amount of the reserves in an underwriting fund are exceeded, the capital of the Takaful operator stands behind that of the underwriting fund.

The deficit is covered in one, or a combination, of the following three ways:

1. Through any permissible finance arrangement.
2. Through an interest-free loan from any party, including the Takaful operator at the expense of the fund against future profit.
3. Through further contributions by the policyholders, if agreed upon at the time of signing the contract.

The mechanisms for achieving this are discussed in section 3 of this chapter.

Currently, Takaful is offered through the following business forms:

- **Non-profit**, whereby, regardless of the formal legal structure, the business is run on a purely mutual or co-operative basis for the participants in the Takaful scheme. The board runs the business on behalf of all participants and there is no separate entity managing the business. There is thus no two-tier structure. Some Islamic insurance undertakings are government-owned (eg, the National Company for Co-operative Insurance in Saudi Arabia) and operate on a non-profit basis.
- **Commercial**, whereby a commercial entity (Takaful operator) is entrusted with managing the Takaful fund. Depending on the specific rules in each jurisdiction, the fund may be embedded within the operator (as life funds commonly are in conventional insurers) with a clear separation between shareholders' and participants' funds, or the fund may be set up as a company separate from the operator. In some countries, a Takaful scheme may be offered through the window of a conventional insurer. In family (life) Takaful, the participant's contribution is typically divided into two portions, one forming part of the Takaful pool to cover mortality risk, and the other, in effect, constituting a personal investment account (as a sub-account of the investment fund). The Takaful operator will usually provide an interest-free loan to cover any deficiency in the Takaful fund. The loan has to be repaid from any future surpluses of the Takaful fund.

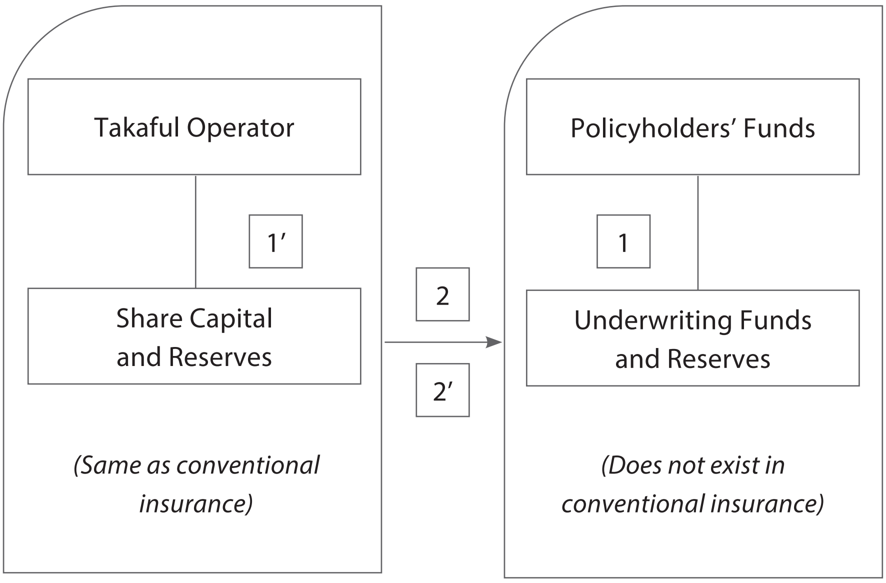


Figure 1: Simplified illustrative capital structure of a general (non-life) Takaful undertaking

1 – In the case of a separate company, underwriting funds are vested in a separate company.

1' – Takaful operator is a limited liability company which has its own share capital and reserves.

2 – Takaful operator provides management and underwriting.

2' – Takaful operator provides interest-free loans in case of an underwriting deficit.

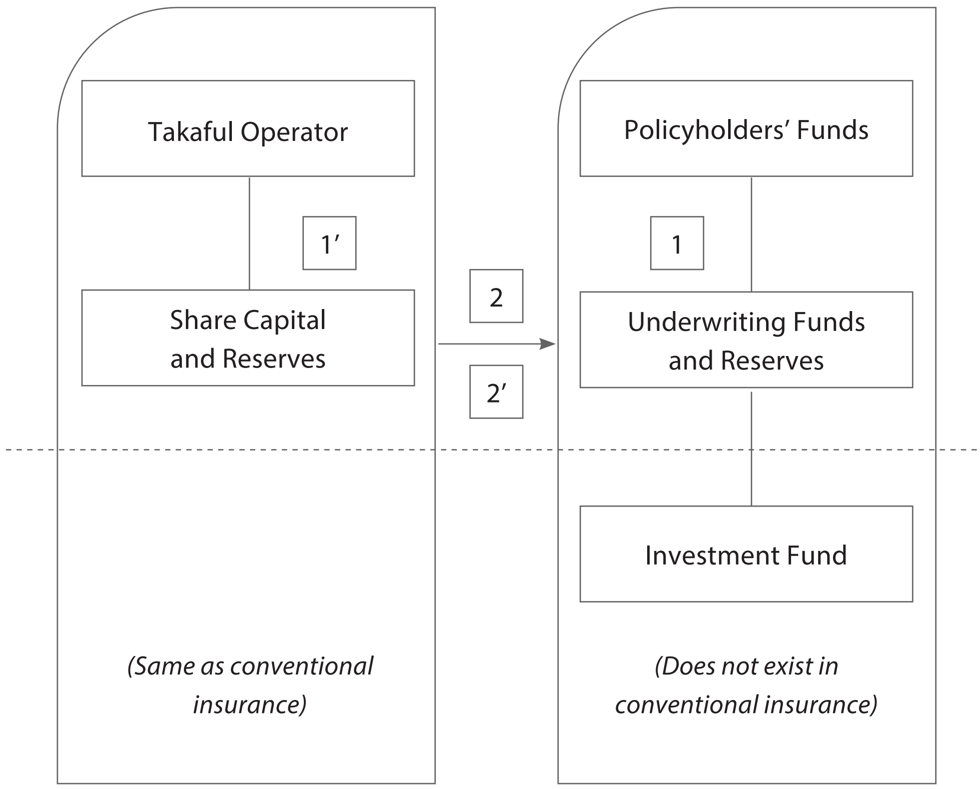


Figure 2: Simplified illustrative capital structure of a life (family) Takaful undertaking

1 – In the case of a separate company, underwriting funds are vested in a separate company.
1′ – Takaful operator is a limited liability company which has its own share capital and reserves.
2 – Takaful operator provides investment and underwriting.
2′ – Takaful operator provides interest-free loans in case of an underwriting deficit.

Policyholders’ funds = underwriting funds + investment funds.

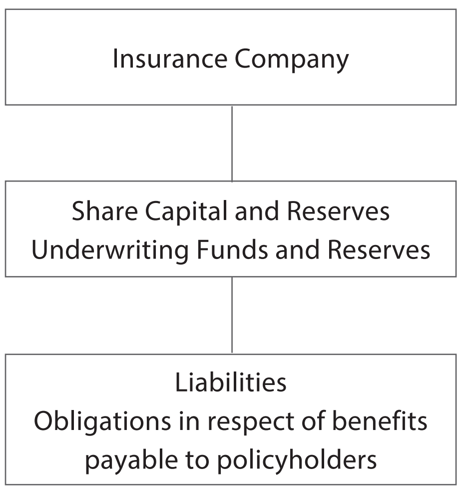


Figure 3: Illustrative capital structure of a proprietary undertaking

The Takaful operator provides capital backup, if needed, to the underwriting funds by means of a Qard Hassan (interest-free) loan, which is repaid out of subsequent underwriting surpluses. The management contracts for underwriting and investment management may be Wakala contracts or Mudaraba contracts (see section 3.2).

The structures of Takaful undertakings shown in Figures 1 and 2 may be compared to those of conventional mutual and conventional proprietary insurance companies as follows.

Conventional Mutual Insurance Company

The left-hand sides of Figures 1 and 2, representing the Takaful operator's capital and reserves, do not exist in the case of a conventional mutual company, as the company's capital belongs to its policyholders.

Conventional Proprietary Insurance Company

The right hand sides of Figures 1 and 2, representing the policyholders' capital and reserves, do not exist in the case of a conventional proprietary company. The underwriting funds and reserves are part of the shareholders' reserves. So far as the investment funds in a life company are concerned, they also belong to the shareholders but the company has obligations towards the policyholders in respect of benefits payable to the latter which are represented by liabilities in the balance sheet. This includes the case where some life policyholders have policies with benefits containing a participation (profit-sharing) element, such as with-profit endowment life policies but, in this case, the profit-sharing element of the benefit does not become a liability until the amount of profit payable to the policyholders (known as bonuses) has been determined (see Figure 3).

1.2.3 Comparison Between Takaful and Conventional Insurance (Proprietary and Mutual)

Learning Objective

8.2.1 Understand the differences between conventional proprietary insurance, conventional mutual insurance and Takaful

The set-up of Takaful is similar to conventional mutual insurance companies, in that the company is owned entirely by the policyholders, although, in mutual insurance, such ownership may be restricted to a certain class of policyholders. The management of Takaful, however, is similar to proprietary insurance, where the proprietary company shares in the profit generated from the investment operations.

The following table provides a comparison between conventional proprietary insurance, conventional mutual insurance and Takaful for general insurance. A similar comparison may be made between conventional insurance and Takaful for life insurance. In the latter case, in both conventional mutuals and Takaful, investment profits belong to the policyholders, except that, in Takaful, the operator may share in these profits through a Mudarib share for fund management. There are also some products (such as whole life cover and defined benefit pensions) which Takaful does not offer, as they are not Shariah compliant.

	Conventional Insurance (Proprietary)	Conventional Insurance (Mutual)	Takaful
Contract.	A policy in the form of an exchange contract (sale and purchase) between the insured (policyholder) and the insurance company, the subject matter of which is an indemnity provided by the insurer to the insured.	A policy in the form of a risk-sharing indemnity contract between the individual insured and the pool of insureds as represented by the co-operative insurance company.	A risk-sharing indemnity based on a combination of Tabarru' (donation) and Dhamman (indemnity) contracts between the individual insured and the pool of insureds (policyholders) as represented by the Takaful, and agency (Wakala) and/ or profit-sharing (Mudaraba) contracts between the insureds and the Takaful operator.
Responsibility of policyholders/ participants.	Policyholders to pay a premium to the insurer.	Policyholders pay contributions to the pool in the form of premiums paid to the co-operative insurance company. Any underwriting surplus belongs to the policyholders who are also liable for any deficit. Annual surpluses are normally retained in underwriting reserves, out of which any annual deficits are met.	Participants make contributions to the scheme. Any underwriting surplus belongs to the policy holders who are also liable for any deficit. Practices regarding disposal of annual underwriting surpluses or deficits vary. In some Takaful, the Takaful operator shares in the underwriting surplus.

8

	Conventional Insurance (Proprietary)	Conventional Insurance (Mutual)	Takaful
Liability of the insurer/ operator.	Insurer is liable to pay claims according to the policy, using the underwriting fund and, if necessary, shareholders' funds.	Pool is liable to pay claims according to the policy using the underwriting fund.	Takaful operator acts as the administrator of the scheme and pays the Takaful benefits from the Takaful (underwriting) fund. In the event of deficiency in the Takaful fund, the Takaful operator is expected to provide an interest-free loan to the Takaful fund to cover the deficiency.
Access to capital.	Access to share capital and debt with possible use of subordinated debt.	No access to share capital, but access to debt with possible use of subordinated debt.	Access to share capital by Takaful operator but not to debt, except interest-free loan from operator to underwriting fund.
Investment of fund.	There is no restriction apart from those imposed for prudential reasons.	There is no restriction apart from those imposed for prudential reasons.	Assets of the Takaful funds are invested in Shariah-compliant instruments.

2. Types of Takaful Undertaking

Learning Objective

8.2.2 Know the two types of Takaful: general; life

2.1 Introduction

In insurance, a distinction is generally made between life and non-life (general and accident) insurance. The distinction is important because life insurance typically includes savings products (eg, endowment policies and pension plans), rather than pure life (ie, whole life) policies. The performance of a life insurance undertaking depends not just on the quality of the underwriting but also on the investment performance. In non-life insurance, investment performance is less critical (see, however, the comments on long-term risks in section 5).

2.2 General Takaful and Life (or Family) Takaful

Islamic insurance can cover almost all of the risks covered by conventional insurance, so long as the subject matter associated with such a risk is permitted by Shariah and a distinction similar to that above can be made between general Takaful and life (or family) Takaful.

One important exception concerns whole life policies, in which the benefit is paid only on the death of the insured. This is considered to be un-Islamic because it contains the elements of Maysir and Gharar. In place of these, Islamic life insurance offers endowment-type policies, which are essentially savings plans with a maturity date incorporating a specified benefit in case of the death of the insured before that date. This type of policy, commonly referred to as 'family Takaful', may also incorporate features such as pension plans, savings plans for the education of children, and health insurance (although the latter has the risk characteristics of general insurance). As Takaful undertakings do not invest in interest-bearing assets, the ability to make appropriate investments is particularly important in family Takaful.

2.3 Pioneering Islamic Insurance Undertakings

Some of the pioneering Islamic insurance undertakings are listed below. Islamic banks have played an important role in the foundations of the early Takaful undertakings, partly because of their own requirements to insure assets. Although their Shariah boards typically allowed these banks to use conventional insurance out of necessity, as the industry evolved, Takaful started to emerge.

1. The Sudanese Islamic Insurance Co., which was the very first Islamic insurance company and founded in 1399 AH/1979 in Khartoum by the Faisal Islamic Bank of Sudan.
2. The National Company for Cooperative Insurance, founded in Riyadh, Kingdom of Saudi Arabia, in 1401 AH/1981 by a Royal decree and is a 100% government-owned company.
3. Takaful Malaysis Sdn Brhd, founded in Malaysia in 1984.
4. The Arab Islamic Insurance Co. (AIIC), which was established in 1399 AH/1979 in Dubai by the Dubai Islamic Bank.
5. The Islamic Company for Insurance and Reinsurance, founded in1405AH/1985 in Bahrain.

6. The International Islamic Insurance Company, founded in 1412AH/1992 in Bahrain. The Bahrain Islamic Bank had an important role in its foundation and in the investment of its funds.
7. Islamic Insurance ltd, founded in 1416AH/1995 in Jordan by the Jordan Islamic Bank.

3. Structure of Takaful Undertakings

Learning Objective

8.3.1 Understand the structure of Takaful: separation of participants' funds from those of the Takaful operator; the role of Qard Hassan (interest free loan)

3.1 Introduction

As noted in section 1.2.2, Takaful undertakings normally have a two-tier structure, consisting of (a) a fund or funds that belong to the policyholders and (b) a limited company with share capital (the Takaful operator) which undertakes the management of the undertaking, including its underwriting and investment activities. The funds that belong to the policyholders consist of an underwriting fund and, in the case of life or family Takaful, an investment fund (as discussed below).

In countries where mutual or co-operative forms of companies (with no share capital) are recognised by law, the policyholders' funds are vested in such a company, which is separate from, but linked contractually to, the Takaful operator company. In countries where the law does not permit the incorporation of companies without share capital, the policyholders' funds cannot be vested in a separate legal entity, but are treated as funds under management of the Takaful operator (rather like the investment accounts of an Islamic bank). However, in both cases, it should be clear that the policyholders' funds are not part of the Takaful operator's shareholders' funds (see Figures 1 and 2 in section 1.2.2).

Takaful involves two functions:

- underwriting (insurance services), such as the preparation of the insurance policy; collection of contributions (premiums; assessments of claims; and the distribution of compensations, and
- offering investment services by way of managing the investment funds on either a Mudaraba basis or investment Wakala basis.

3.2 The Two-Tier Structure and its Mechanisms

Learning Objective

8.3.2 Understand the three models for underwriting and managing the investments of the Takaful fund: Wakala; Mudaraba; the combined model

One important reason (indeed, the only economic, as opposed to legal, reason) for the two-tier structure of Takaful undertakings is the need for the underwriting fund to have capital backing, in case an underwriting deficit occurs that exceeds the amount of reserves in the fund and may result in the insolvency of the fund. This capital backing is, in principle, provided by the Takaful operator, a limited company with share capital. The mechanism by which the limited company may provide capital backing to the underwriting fund is by making an interest-free (Qard Hassan) loan facility available to the underwriting fund, which can be drawn down to cover the amount of the deficit. The loan must be repaid out of subsequent underwriting surpluses. Thus, the Takaful operator is not directly exposed to underwriting risk, as this is not compliant with Shariah. Note that the loan does not remove the deficit, as it does not increase the net assets of the underwriting fund, but it is intended to enable the fund to meet its current obligations. Such a loan might also be needed for a fund that is not in deficit, but which lacks enough liquid assets to meet current liabilities.

As a Qard Hassan loan is juristically a benevolent loan, the Takaful operator cannot be contractually obliged to make it. Instead, the obligation needs to be imposed by regulation with legal backing. The situations in which such a loan is needed are attributable, at least to some extent, to the management policies and actions of the Takaful operator, which thus has some responsibility for them.

This raises the question of the remuneration of the capital of the limited company. The limited company will be required by the regulatory authority to have enough capital and reserves to provide the Qard Hassan loan facility. If drawn down, the loan itself is not remunerated, nor can any charge be made for the facility as such. The Takaful operator, however, receives a fee for its work as Takaful operator, which includes underwriting and managing the investments of the underwriting fund and, in the case of life Takaful, the policyholders' investment fund. Although other models have been advocated, this work is typically performed on one of three legal bases or models:

1. Wakala Model (a Wakala contract between the limited company and the policyholders)

In this model, the principal-agent relationship is used for both underwriting and investment activities (It is important to understand what is meant by the principal-agent relationship here. The principal is the party paying for services and the agent is the party providing the services). In underwriting, the Takaful operator acts as an agent on behalf of the participants to run the Takaful fund.

All risks are borne by the fund and any operating surplus belongs exclusively to the participants (policyholders). The Takaful operator does not share directly in either the underwriting risk borne by the fund or any surplus/deficit of the fund. Instead, the operator receives a set fee called a Wakala fee for managing the operation on the participants' behalf, which is usually a percentage of contributions paid. However, the operator's remuneration generally includes a performance fee, from the generated profit, as an incentive to manage the Takaful fund effectively. The investment of the Takaful fund is also based on a Wakala contract, whereby the operator charges the participants a fee in exchange for services rendered and this fee may also have a performance-related component.

2. Mudaraba Model (a Mudaraba contract between the limited company and the policyholders)

In this model, the Takaful operator acts as a Mudarib (entrepreneur) and the participants as Rab al Mal (capital provider). The contract specifies how the investment profit and/or surplus from the Takaful operation are to be shared between the Takaful operator and the participants. Losses are borne solely by the participants as the providers of capital (unless the operator is guilty of misconduct or negligence) but, in case of a loss, the Mudarib is not entitled to receive any compensation for its efforts. In this model, the underwriting fee takes the form of a specified percentage of any underwriting surplus and the fee for investment management is a specified percentage of any investment profits. However, as explained below, it may be considered permissible for the Mudarib to share in the investment income only, which leads to a third model.

3. Combined Model (combination of Wakala and Mudaraba contracts)

In this model, the Wakala contract is adopted for underwriting activities, while the Mudaraba contract is employed for the investment management of the Takaful fund. In addition to a fixed fee as Wakil for underwriting, the insurance operator as Mudarib for investment management receives a specified percentage of the investment income, including income earned on investments financed by the underwriting fund. This approach, which is favoured by some international organisations and financial sector regulators (eg, the Central Bank of Bahrain), is widely adopted by Takaful undertakings in practice.

Some Islamic scholars object to the second mechanism mentioned above (the pure Mudaraba model) for the following main reasons:

- A pure Muduraba model implies that the Mudarib operates purely for the sake of making a profit, which is only possible from investment returns.
- A pure Muduraba model would expose the Takaful operator to a greater risk as it will only obtain a return if, and only if, the investments it has made generates a profit.

An underwriting surplus in a mutual insurance undertaking is not the same as a profit, since in a mutual insurance the expected value of the underwriting surplus is zero (as surpluses and deficits should average out over time), except to the extent that there is an intention to build up reserves in the underwriting fund. Any underwriting surplus should be considered as belonging to the policyholders, with the possible exception of a specified percentage of the income from investments financed by the underwriting fund, as in mechanism three.

The second mechanism (pure Mudaraba model) could motivate the Takaful operator to aim for substantial underwriting surpluses in order to receive a larger remuneration, which is not consistent with the interests of the policyholders or with the concept of mutual insurance. Moreover, as Mudarib, the limited company will share in underwriting surpluses, but not in deficits. In contrast, the third mechanism (combined model) motivates the Takaful operator to seek investment profits, but not excessive underwriting surpluses.

3.3 Fiqh Contracts used in Takaful – Summary

Learning Objective

8.3.3 Know the Islamic financial contracts used in Takaful

As indicated above, the main contracts of Fiqh al Muamalat used in Islamic insurance are those of guarantee or indemnity between the insured and the mutual underwriting pool, Iltizam bi al-Tabarru' (donation) as the basis on which the contributions are paid by the policyholders, and Wakala and/or Mudaraba as the basis on which the Takaful operator undertakes management of underwriting and investment on behalf of the policyholders.

Example

X, Y and Z each decide to take out a family Takaful policy with Islamic Insurance (II) to provide protection for their families against them dying or suffering a short- or long-term disability, which will result in expenses such as funeral costs or hospital bills. Each pays an annual contribution of £5,000. The latter contribution is divided into two portions which make up the policyholders' underwriting (mortality and sickness risk) fund and investment fund, respectively. The mortality and sickness benefits are specified in the contract. The investment fund is similar to a savings plan with a maturity of ten years. II is an independent company. II's share capital and reserves (shareholders' funds) are maintained separately from the policyholders' funds (underwriting and investment). II manages the policyholders' underwriting fund on a Wakala basis and the policyholders' investment fund on a Mudaraba basis. In the investment fund, the policyholders act as Arbab al Mal and the Takaful operator as Mudarib. According to the Mudaraba agreement, the profit-sharing ratio between the Mudarib (Takaful operator) and the Rab al Mal (policyholders) is respectively 20% : 80%. II, as Wakil (agent) for the underwriting fund, invests the fund's money in Shariah-compliant investments.

During a fiscal year, the underwriting fund generates £10 million. II's fees are calculated as 5% of the profit (£0.5 million). The remaining surplus (£9.5 million) belongs to the policyholders and is retained in the underwriting fund to provide policyholders' equity for solvency purposes. In the investment fund, II as Mudarib (entrepreneur), invests the fund's money in Shariah-compliant investments. During a fiscal year the investment fund generates £20 million. II's Mudarib share of the profit is calculated as 20% (£4 million). The remaining surplus (£16 million) belongs to the policyholders and would normally be reinvested in the investment fund. In case of the death of X before the maturity of the investment policy, II as Wakil of the policyholders' funds will pay X's heirs the specified death benefit. At the end of the Takaful agreement, the investment fund will pay back the investors' capital in the investment fund, ie, the total amount invested plus any reinvested income or profits less any losses. Y and Z (as Arbab al Mal) thus receive the money they invested in the investment fund plus any reinvested income or profits, less any losses.

4. Underwriting Surplus and Technical Provisions

Learning Objective

8.3.4 Understand the rules on distribution of underwriting surpluses in Takaful: the definition of an underwriting surplus; the nature and allocation of technical provisions; the rules for distributing underwriting surpluses

4.1 Definitions

The underwriting surplus for a period is defined as:

- contributions received or receivable for the period, plus
- income from investments generated by the underwriting fund, less
  - claims arising during the period (paid or payable), net of reinsurance (see below)
  - underwriting expenses, including the underwriting fee payable to the Takaful operator, plus or minus
  - changes in technical provisions.

The technical provisions, being estimates of future claims payable in respect of insured events that have already happened (or the consequences of such events that are covered by the policy) are liabilities and not part of capital. Amounts set aside out of premium income in a period for retention in technical provisions are not part of the underwriting surplus for the period, while amounts released from technical provisions are included in the underwriting surplus.

4.2 Application to Takaful

In Takaful, as in mutual insurance undertakings, underwriting surpluses belong to the policyholders. Therefore, if a surplus for a period is not required to build up reserves or to repay an interest-free loan from the Takaful operator, it may be redistributed to the policyholders. There are various rules that may be applied for making such distributions:

- Distribution in proportion to the contributions paid by each policyholder for the period, without reference to any claims that the policyholder has made.
- Distribution in proportion to the premium contributions paid by each policyholder for the period, but taking account of whether the policyholder has had a claim paid, in one of the following ways:
  - Policyholders who have had a claim paid during the period receive no distribution.
  - In calculating the proportionate shares to be distributed, policyholders who have had a claim paid during the period receive half of what they would have received if they have had no claim paid.
  - Policyholders who have had a claim paid during the period receive their proportionate share of the surplus after deducting the amount of any claims paid to them during the period. If the amount of the claim(s) paid to a policyholder is equal to or greater than his share of the surplus, the amount distributed to him is nil.

In some Takaful undertakings, there is a rule according to which only a specified percentage of the surplus is distributed to the policyholders, the remainder being retained in reserves.

5. Insurance Industry Considerations

Learning Objective

8.4.1 Understand the risks associated with Takaful claims and their mitigation: the nature of technical provisions for general Takaful; implications of the size of the risk pool; the nature of the underwriting and investment fund in life Takaful; internal risk pooling arrangements

5.1 General Takaful (Non-Life)

An important feature of general and accident insurance is the maintenance of adequate technical provisions. This is particularly the case with so-called 'long-tailed' risks with which claims may be made many years after the period in which the insured event occurred. A notorious example of this is claims under employers' liability policies, such as those for cases of industrial diseases suffered by former employees. In insurance undertakings with substantial technical provisions, the investment returns earned on the funds retained can make a significant contribution to the underwriting fund.

In contrast, risks such as those covered by motor or fire policies tend to be 'short-tailed', as the vast majority of claims are made within a relatively short period after the insured event has occurred, and hence there is not the same need for substantial technical provisions.

Amounts required for technical provisions are calculated by actuaries on the basis of statistical tables and claims' histories for each category of risk and, in some cases, the category of policyholder. The use of reinsurance (as discussed in section 6 of this chapter) reduces the amount needed in technical provisions by transferring part of the risk to the reinsurer. Reinsurance allows pooling of risks between different insurance undertakings.

The larger a risk pool, the more the law of large numbers applies to the total amount of claims being made for a period, which is averaged out over a greater number of policyholders, thereby providing a smoother overall claims history with less likelihood of a substantial underwriting deficit. With smaller risk pools (ie, fewer policyholders), there is a greater risk of a substantial deficit occurring before adequate reserves have been built up. This is the main reason why economies of scale are important in the insurance industry. Similar to conventional insurance, Takaful faces market, liquidity and credit risk. In addition, it is subject to Shariah risk, or the non-compliance with Shariah and conflict of opinions.

5.2 Life or Family Takaful

In life Takaful, the function of the underwriting fund is to meet the requirements to pay death benefits in cases where the policyholder dies before the policy matures. Statistical tables compiled by actuaries, known as mortality tables, are used to calculate the premiums taking account of the age, sex and other personal characteristics (eg, occupation, smoker or non-smoker) of the policyholder. On this basis, taking account of the amount of the specified death benefit, the premiums paid by a policyholder are divided between the underwriting fund and the investment fund.

The investment fund is subdivided into personal investment accounts, one for each policyholder. The balance on a policyholder's account consists of the parts of the policyholder's premium contributions that were credited to the investment fund, plus the proportionate share of the investment returns earned on the assets of the fund.

Takaful Pensions

Takaful pension plans are of the defined contribution type and not the defined benefit type. In other words, the amount of the pension payable on the maturity of the policy is not a specified amount but depends on the balance on the policyholder's account and the available returns on the assets in which this balance can be invested.

5.3 Internal Risk-Pooling Arrangements

Within an insurance undertaking, there may be a number of different risk pools and underwriting funds for different categories of risk, eg, fire, motor, marine. In a given period, one fund may have an underwriting surplus, while another has a deficit. If surpluses are allowed to offset deficits by means of an internal risk-pooling (ie, Takaful) arrangement, the risk of insolvency is substantially reduced, especially for an insurance undertaking of modest size. On the other hand, if one fund is regularly in deficit, this implies that the premiums (or, in case of Takaful, contributions) being paid by policyholders for that category of risk are too low. In such a case, to continue relying on surpluses arising from other funds to maintain solvency, rather than increasing the premiums for the category of risk covered by the fund that is in deficit, will amount to the policyholders covered by the latter being unfairly subsidised by other policyholders. To avoid such unfairness, Takaful undertakings typically have rules setting out what is permissible for internal risk pooling.

6. Reinsurance and Retakaful

Learning Objective

8.4.2 Understand how Retakaful operates: the funding of Retakaful; the place of Retakaful; resorting to reinsurance in the absence of viable Retakaful options

Reinsurance is a form of insurance in which the policyholders are insurance undertakers which use reinsurance to reduce excessive concentrations of risks. They pay a proportion of their premiums receivable to the reinsurer in return for the cover of a proportion of their risks in a specified category if these exceed prudent underwriting limits. An insurance undertaking which transfers some of its risks and its premium income to a reinsurer is known as a **cedant**. There are two basic forms of reinsurance: proportionate and stop-loss. In proportionate reinsurance, the cedant shares the risks with the reinsurer according to agreed proportions. In stop-loss, the reinsurer meets any claims above an agreed limit. The reinsurance industry sector is dominated by a small number of very large international reinsurance undertakings operating on conventional principles. There are only a few reinsurance undertakings operating on Islamic insurance principles (**Retakaful**), and these are considerably smaller and operate only in national or regional markets. However, reinsurance is important in the Takaful sector because of the relatively small size and limited capital of many Takaful undertakings.

Consequently, some Islamic scholars consider it to be permissible for Takaful operators to reinsure with conventional reinsurers under the principle of need or necessity. However, this is controversial and it is likely that steps will be taken in the future to extend the coverage offered by the Retakaful industry sector. Any use of conventional reinsurance is subject to Shariah board approval on a case-by-case basis.

7. Shariah Governance and Compliance

Learning Objective

8.4.3 Know the responsibility of the Takaful operator for Shariah compliance

As with other Islamic financial institutions, the operations of Takaful undertakings are governed by Shariah rules of Islamic commercial jurisprudence (Fiqh al Muamalat). In some countries, such as Malaysia and Sudan, there is a central Shariah authority which issues applicable interpretations of Shariah, ie, Fatawa (the plural of Fatwa), with which Islamic financial institutions must comply. In Malaysia, the Shariah parameters are issued by the Central Bank and are binding. The responsibility for Shariah compliance lies with the board of directors and the management of the Islamic financial institution, which needs to put in place an appropriate internal organisation to ensure Shariah compliance, which will normally include at least one part-time independent Shariah adviser. The internal audit function may be organised so as to provide an internal check of Shariah compliance and the external auditors may also include Shariah compliance in the scope of their examination and report. In the case of a Takaful undertaking, the management is that of the Takaful operator. In the majority of countries, there is no central Shariah authority and each Islamic financial institution has its own SSB which issues the applicable Fatawa. In this case, the SSB is a key part of the governance structure of all Islamic financial institutions, including Takaful undertakings.

8. Concluding Remarks

Managing risk is deemed to be appropriate behaviour, but is only permitted on a mutual basis in which the insured cover each others losses for defined adverse events. Pensions, health, and other insurance is permitted, however life insurance is not.

End of Chapter Questions

1. Where does insurance fit within Islam?
   Answer reference: Section 1.1

2. How do Islamic Takaful undertakings differ from conventional mutual insurance undertakings?
   Answer reference: Sections 1.2.1–1.2.2

3. How does conventional proprietary insurance compare with Islamic insurance?
   Answer reference: Section 1.2.3

4. Describe the Takaful two-tier structure.
   Answer reference: Section 3.2

5. What are three models used to remunerate the Takaful operator for its work as an operator?
   Answer reference: Section 3.2

6. As far as policyholders are concerned, what is the disadvantage of the pure Mudaraba model as a mechanism to remunerate the Takaful operator?
   Answer reference: Section 3.2

7. What is a technical provision?
   Answer reference: Section 4.1

8. Outline how the investment fund in family Takaful is structured.
   Answer reference: Section 5.2

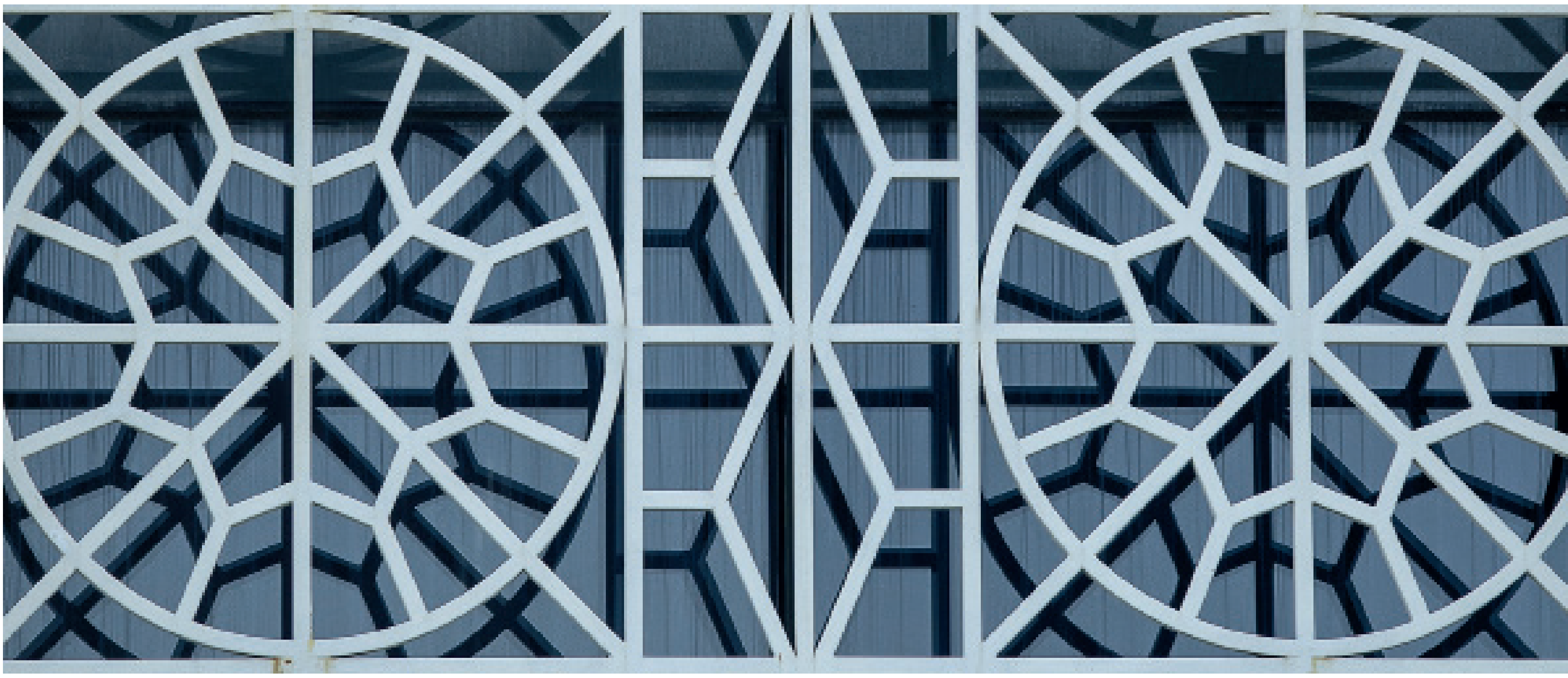
9. What is Retakaful and how does it work?
   Answer reference: Section 6

10. In a Takaful undertaking, who is responsible for Shariah compliance?
    Answer reference: Section 7

Chapter Nine

Islamic Corporate Governance

This syllabus area will provide approximately 10 of the 100 examination questions



1. Corporate Governance

Learning Objective

9.1.1 Know the origin and nature of corporate governance

9.1.2 Understand how corporate governance principles are incorporated in Shariah

9.1.3 Know the corporate governance mechanisms available to stakeholders to exercise their rights

Corporate governance is a set of organisational arrangements designed to align, as much as possible, the actions of the management of a corporation with the interests of its stakeholders.

In this context, the following terms are relevant:

Arrangement
- Units within the organisation referred to as 'organs of governance', such as boards of directors and their committees.
- Procedures, such as annual general meetings and external audits.

Stakeholders
- Anyone with certain rights with respect to the corporation, in particular property rights and rights to information.
- Rights of stakeholders may be established by law, the legal article of incorporation or codes of corporate governance.

Corporation
- Includes both private sector firms and public sector bodies having a corporate form as legal entities.

Corporate governance started to gain importance during the early decades of the 20th century. The increasing size of corporations required additional capital and companies started to issue shares. Subsequently, control and ownership of the corporation were increasingly separated with share capital widely held and the company managed by professional managers. Corporate governance enables shareholders to safeguard their interests given that the management might pursue their own interests at the expense of those of the shareholders. Although in the UK and the US stakeholders are typically restricted to shareholders, other EU states have a wider view on stakeholders and include, for example, employees, government, suppliers, unions and anyone else with an interest in the workings of the corporation.

The OECD Principles of Corporate Governance (June 1999) define corporate governance as involving: '*a set of relationships between a company's management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined...*'. The Basel Committee for Banking Supervision (BCBS) '*Enhancing Corporate Governance for Banking Organisations*' (September 1999, revised version February 2006) defined corporate governance as follows: '*Stakeholders include employees, customers, suppliers and the community. Due to the unique role of banks in national and local economies and financial systems, supervisors and governments are also stakeholders [of banks]...*'.

These broad definitions raise various issues, such as:

- Which individuals or groups have rights as stakeholders?
- What rights do the various groups of stakeholders have?
- How are such rights enforced and safeguarded?

Broadly speaking, stakeholder rights may consist of rights to control; rights to information; and rights to cash flows, profits and other benefits. For example, rights of shareholders are a matter for company law and a company's own statutes. Ordinary shareholders with voting rights have all three of these types of rights (control, information and cash flows) to some extent, while non-voting ordinary shareholders do not have control rights but rely on the voting shareholders to protect their interests.

Islamic financial institutions are based on the foundations of Islamic religious ethics. For this reason, their sound governance from a Shariah perspective is crucial to their proper functioning. Shariah states that Allah's (SWT) rights, if breached by mankind, may be forgiven by Him. However, people's rights, financially or otherwise, if infringed, cannot be forgiven, save by people themselves, and Allah (SWT) may not interfere at all. Similarly, the management of an Islamic bank is regarded as a seller of its management services, and the shareholders/stakeholders buy those services by paying the price in the form of salaries. Shariah wants to ensure that the consideration of this transaction (ie, the salary paid to management) and the subject matter of this transaction (ie, the services provided in managing the institution) are well defined and meet the agreed specifications. Hence, corporate governance requirements in Islamic finance are not only necessary following the segregation of ownership and management, but are also dictated by Shariah.

Corporate governance, in its broadest sense, applies well beyond stakeholders' rights to control, information, cash flow and other benefits. It governs how the corporation handles its relationships with its wider sphere of customers, employees, suppliers and the community, as well as shareholders and its regulator. From an Islamic perspective, the modern concept of corporate governance reflects the principles and foundations laid down by Shariah. As such, a corporation which works to a high standard of corporate governance will arrange its activities and operations in ways which, for example:

- are not harmful to mankind and/or the environment – and the corporation may well take steps to make its actions beneficial
- deal fairly and properly with customers: products are suitable for their needs; staff interactions with clients are courteous and efficient
- compete properly with its rivals: hoarding and monopoly are out, and any manipulation to corner the market is rejected
- ensure personal and confidential information on the corporation's customers and staff are held securely and not open to abuse
- ensure staff are treated fairly and, in turn, staff respect the corporation and act professionally in their dealings with the corporation and its customers, and
- are transparent – the customer's ignorance of the market cannot be deliberately exploited or abused. A failure to operate to high standards can lead to a slow decline in the effectiveness and profitability of a corporation and, at worst, can lead to significant adverse media coverage which brings rapid decline.

Similar to other organisations, Islamic financial institutions operate in an open system and are required to align their internal and external processes to avoid conflicts among various stakeholders. In this context, stakeholders include shareholders, depositors, boards of directors, senior management, internal auditors, external auditors, employees, systems, information technology (IT), SSBs, associations, central banks, central and national Shariah boards and governments.

The underlying principles of Islamic finance have a strong basis in social responsibility. As such, they are closely aligned to corporate social responsibility (CSR). CSR is a voluntary code of practice, in which companies make a conscious effort to work in ways that benefit society.

1.1 Mechanisms

Corporate governance depends on a number of mechanisms, whereby stakeholders may exercise their rights. Most of these mechanisms are required by national company law but some are set out in voluntary codes. Generally, two types of board structure are recognised, one-tier (or unitary) and two-tier. The main difference between these two types of organisations is that a two-tier organisation does not only have an executive board, but also an additional organ of governance in the supervisory board. The most important corporate governance mechanisms are set out below.

1. Board structure.

<table>
<tr><th>Unitary Board</th><th>Two-tier Board</th></tr>
<tr><td>CEO may also be chairman of the board, although codes of corporate governance generally (but not in the US) consider this to be bad practice as it concentrates too much power in the hands of one individual.</td><td>Supervisory board is independent from executive board.</td></tr>
<tr><td>Board comprises of executive and non-executive directors.</td><td>Supervisory board is composed entirely of non-executive directors. The CEO is in attendance but has no vote.

The executive board is composed of the top management and chaired by the CEO.

Stakeholder interests, such as workers' councils, may be represented on the supervisory board.</td></tr>
<tr><td>Board committees are part of the unitary board.</td><td>Board committees are part of the supervisory board.</td></tr>
<tr><td colspan="2">Board committees:
• Audit committee to which both external and internal auditors report with particular responsibility for the appointment of the external auditors.
• Nominations committee which has the responsibility of nominating candidates for membership of the board of directors.
• Remuneration committee with the responsibility for approving the remuneration of board members and, in principle, ensuring this is not excessive.</td></tr>
</table>

2. Directors – non-executive directors must be independent and grey directors need to be avoided. Grey directors are directors who are supposed to be independent but whose independence is compromised by an indirect relationship with the corporation or its senior management.
3. Annual report – serves to discharge the responsibility of the executive board.
4. Independent external auditors – independent review and verification of the annual report.
5. General meeting of shareholders – provides a medium for shareholders to question management and to appoint and remove directors and external auditors.
6. Insolvency procedures – in case the corporation is unable to pay its creditors, certain rights of governance pass to creditors' representatives in order to minimise their losses.

In general, these mechanisms are intended to protect the interests of shareholders and, in the case of insolvency procedures, those of lenders and creditors.

2. Corporate Governance in Financial Institutions

Learning Objective

9.1.4 Understand the reasons why banks face special corporate governance challenges

There are a number of reasons why banks are considered to be a special case in relation to corporate governance, which can be summarised as follows:

- A wider definition of 'stakeholders' (eg, BCBS definition).
- The issue of 'systemic risk'.
- Regulation and compliance issues.
- Depositors need for protection.
- The need for strong internal control and risk management.
- Issues of transparency and information asymmetry.
- Issues of related party transactions (and 'grey directors') which are particularly sensitive for banks.

As such, banks are required to have a two-tier board.

In the case of banks, the BCBS defines stakeholders as more than just shareholders and creditors, including, but not restricted to, employees, customers, suppliers and the community, supervisors, and governments. The BCBS cites '*the unique role of banks in national and local economies and financial systems*' as one of the main reasons for this but also considers systemic risk resulting from the contagious nature of financial distress which may be transmitted from one bank to other banks within the system. The health of the whole economic system can be threatened by widescale bank failures. The soundness of banks is, therefore, a matter of public interest, which is one reason why banking is a regulated industry. Various guarantee schemes exist for the protection of depositors. However, from a corporate governance point of view, the very existence of such schemes gives rise to a concern that insured deposits entail an element of moral hazard, namely that management may be induced to take risks with the depositors' money (eg, credit risks in lending) that it would not take in the absence of such insurance, as such risks would jeopardise the solvency of the bank.

Some specific corporate governance considerations applicable to banks are mentioned in Pillars 2 and 3 of the Basel Capital Accord (BCA). Pillar 2 is concerned with the process followed by banking supervisors in their supervisory review of banks, and the need for them to pay particular attention to the quality of risk management. Pillar 3 deals with market reporting and transparency, drawing attention to the potential disciplining role of the market.

There is a considerable lack of transparency in relation to off-balance sheet positions which may expose banks to risks which are far from obvious. In addition, it should be noted that banks are particularly vulnerable to the negative effects of related party transactions, in particular, because of the danger of credit being given on a 'non-arm's length basis' (ie, credit given on unduly favourable terms or without proper prudence) to related parties. Loans made on this basis have frequently led to banking crises and failures in different global markets.

Grey directors are problematic with banks. Independent directors who are not truly independent, and promote the making of unsound loans for their own private benefit, cause the bank to suffer losses, which, if the loans are not repaid, may result in insolvency.

Shariah governance is characterised by similar terms to those found in corporate governance, such as transparency, justice, fairness, disclosure and accountability. These terms are an integral part of the Quran and the Prophet's (PBUH) tradition (Sunnah) and, in turn, Islamic jurisprudence.

In addition to the corporate governance requirements outlined above, Islamic financial institutions are required to have an additional organ of governance in the form of a SSB. Of particular interest, from a corporate governance perspective, are investment account holders (IAHs), for which there is no alternative in conventional financial institutions.

3. Shariah Supervisory Board

Learning Objective

9.2.1 Understand the position, remit and characteristics of the Shariah Supervisory Board

9.2.2 Know the roles of the Shariah Supervisory Board: advisory; approval; audit

9.2.3 Understand the operational issues surrounding the Shariah Supervisory Board: membership; governance; delegated responsibility; reporting; other duties

The SSB is an independent body in the governance structure of an Islamic financial institution and reports directly to shareholders as the owners of the organisation. Conventional financial institutions offering Shariah-compliant financial services either have their own SSB, or may use the services of a Shariah advisory company. Either way, the governance issues are the same for both types of organisations.

It is important to note that the role of the SSB is restricted to ensure conformity with Shariah rules and regulations, and does not extend to an executive or managerial role. As such, the SSB ensures all transactions and operations are Shariah compliant, but does not have any input in the commercial aspect of the institution.

The purpose of the SSB is twofold:

1. Financial institutions need to ensure that the products and services they offer are genuinely Shariah compliant and are in line with the institutions' standards, principles and shareholders' requirements.
2. Investors' and clients' need to be able to ensure their investments are in line with Shariah. Ultimate responsibility for Shariah compliance remains with senior management of the organisation.

Shariah governance is defined in the IFSB Shariah Governance Standard number 10, issued in December 2009, as a set of institutional and organisational arrangements through which an Islamic Financial Institutions ensures effective independent oversight of Shariah compliance over the following structures and processes:

- Issuing Shariah resolutions.
- Dissemination of information on Shariah resolutions to management.
- Shariah compliance review and audit.

Any decisions must be communicated throughout the organisation in a clear and transparent way and are binding on the organisation.

The SSB reports to the shareholders and may be present at the annual general meeting (AGM) to read the Shariah report. Compliance with Shariah principles is included in audit and compliance functions.

3.1 Role of the SSB[1]

Five main criteria are generally identified when considering the role of the SSB:

1. **Independence** – independence of the SSB and its members is a fundamental requirement to function effectively. The SSB and its members must be independent from the management of the bank.
2. **Confidentiality** – due to the nature of the SSB members' work and duties, they are exposed to a great amount of proprietary information which dictates a detailed confidentiality requirement.
3. **Competence** – due to the multifaceted nature of the SSB members' role, they are required to have specialist knowledge and expertise in Fiqh al Muamalat (Islamic law of contracts) as well as have an understanding and knowledge of modern financial and banking practices and products.
4. **Consistence** – the SSB needs to remain consistent in its decisions, guidelines and advice in order to build up and maintain consumer confidence.
5. **Disclosure** – disclosure and transparency are a vital part of the SSB roles and functions. By disclosing procedures, decisions, Fatawa and structural details, the SSB encourages and promotes confidence not only for shareholders but also the industry and the wider public.

The role of the SSB can be divided into three main areas: advisory, approval and the audit role.

3.1.1 The Advisory Role

Islamic financial Institutions turn to a Shariah scholar for clarifications or opinions on specific or general Shariah principles. In line with industry best practice and AAOIFI recommendations, this is often an in-house Shariah specialist with in-depth knowledge of Shariah teachings. Having an in-house specialist enhances the knowledge available within the institution, and can improve the effectiveness of the SSB due to the fact that issues can, in the first instance, be referred to the in-house specialist.

1 This section is adapted from Schoon, N (2016) Modern Islamic Finance, London: Wiley & Sons

3.1.2 The Approval Role

The generic SSB approval process spans several steps:

1. Reviews of the initial structures and concepts to ensure they are in line with Shariah.
2. Approval of the legal documentation. This process can extend to several revisions depending on the transaction and the legal and SSB requirements.
3. Final approval for specific transactions where the structures are highly individual in nature and for more complex structures, eg, syndications.

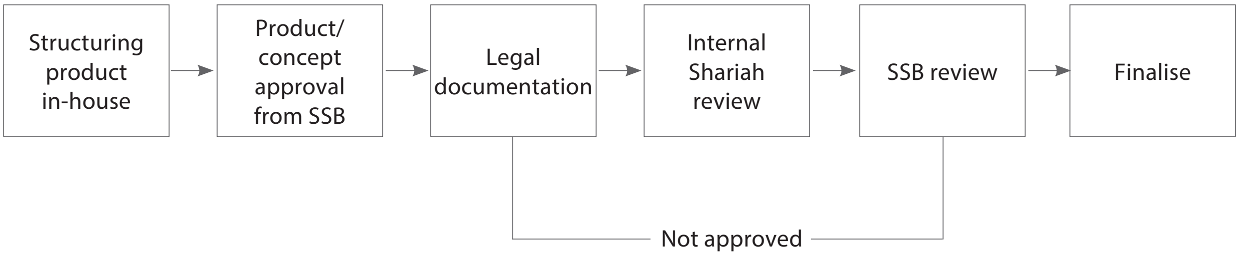


Figure 1: Shariah approval process for a new product or structure

Amendments to existing products follow a similar, albeit shorter path.

3.1.3 The Audit Role

It is the responsibility of the SSB to ensure ongoing compliance by verifying that all transactions and operations of the Islamic financial institution have indeed complied with the SSB guidelines and associated Fatawa. Although the audit process varies from institution to institution, it is generally done on the basis of a departmental audit. The regularity of the audit varies depending on the size of the institution and the number of transactions. Part of the SSB audit and control function may be the calculation of Zakat obligations. Depending on the institution and local regulations, Zakat contributions are either made by the institution or are delegated to shareholders. Either way, the SSB provides the Zakat obligations on a per share basis.

3.2 SSB Membership

SSB members are typically Shariah scholars with extensive knowledge of Islamic jurisprudence. In addition, knowledge of finance, banking, law, and economics is important to ensure they are able to provide balanced advice and assistance to the financial institution. A well-balanced SSB has diversity among its members in the schools of Islamic jurisprudence as well as other professional and academic backgrounds. Typically, an SSB has a minimum of three Shariah scholars, although larger institutions tend to have larger boards to accommodate for the diversity and complexity of the banking requirements. SSB members are nominated by the CEO and board of directors and presented to the general meeting of shareholders for appointment. Any dismissal of a SSB member follows the same process. The engagement period of SSB members may vary as agreed between the financial institution and the SSB members or could be limited by supervisory authority regulations. Regulations such as a limited period (eg, three years) with a limited number of renewals are in place to ensure the objectivity of scholars and to avoid conflicts of interest. Contracts may typically be signed for a full engagement period or on an annual renewable basis.

3.3 Governance and Reporting

Responsibilities and activities of SSB are governed by the terms of reference (TOR) or SSB charter. The TOR stipulates all the functions and responsibilities of SSB members including the number of meetings, appointment of the chairman and responsibility for the Shariah audit. The chairman and members of the SSB consider the primary and secondary sources of Shariah as well as the different schools of Islamic jurisprudence in their decision-making process. Based on their deliberations, the SSB establishes the Shariah principle for their ruling, applying the most suitable and practical Shariah reference without affecting the authenticity. The SSB needs to issue its ruling in a clear written document, signed by the members. This document will be disclosed to the general public if required. At a minimum, the SSB rulings will be made available to customers of the institution.

Annualy, the SSB submits a report to shareholders which includes the following information:

1. Description of the scope of work completed.
2. Opinion on the Shariah compliance of the financial transactions and operations.
3. Any major observations.
4. Zakat statement (if required).
5. Donations to charity resulting from non-compliant earnings.

Members are paid a fee as specified in their contract for attending meetings as well as travel and accommodation expenses (if applicable). The level of remuneration tends to be market conform, but there are variations between institutions.

In addition to SSB reports, the SSB and the board of directors interact regularly to discuss issues of mutual interest. Depending on local regulations SSB performance may need to be assessed by an external governance committee, consisting of some members of the board of directors.

3.4 Shariah Executive Committee and Internal Shariah Expert

The SSB typically meets on a quarterly basis which may not be sufficient to cater for the challenges the institution faces on a day-to-day basis. For this purpose, the institution may appoint an internal Shariah expert or Shariah executive committee. The internal expert or executive committee will act as the first point of contact and is more easily available to the institution. A Shariah executive committee can issue Shariah rulings within the already approved SSB product programmes and Shariah guidelines.

The presence of a Shariah executive committee or internal expert will alleviate the demands on the SSB outside its normal meeting times. However, the SSB will still need to be available when required and must be fully aware of and in agreement with any Shariah-related decisions.

In the event an SSB resolution is obtained prior to the meeting by means of a circulation of documentation, there must be the full agreement of either all, or an agreed majority of, the members for it to be effective.

3.5 Other Duties and Guidance

Additional rules and regulations for SSBs are incorporated in the regulatory frameworks provided by AAOIFI, IFSB and central banks to ensure better practice of SSB.

One of the main concerns is related to intellectual independence and objectivity. SSB members need to avoid conflicts of interest with the business objectives of the Islamic Financial Institutions and ensure prudent rulings and solutions for the Islamic Financial Institutions.

Generally, there are hardly any restrictions on the number of boards a Shariah scholar can be a member of. In Malaysia and Oman, however, the regulator places restrictions on the number of board memberships. In these countries, scholars are only permitted to be a member of one board of each type of institution (bank, asset manager or Takaful) to ensure they can dedicate sufficient time to fulfil their obligations, as well as to avoid any conflict of interest, thus enabling them to better serve the purposes of all institutions concerned.

As part of their role, SSB members may be requested to provide training to staff members and other stakeholders including clients. These events may be held in public venues and include conferences. However, the SSB should not be involved in marketing since this may have an adverse effect on the image of the SSB members and the financial institution.

4. Internal Shariah Audit

Learning Objective

9.3.1 Know the Shariah audit regulations

AAOIFI governance standard No. 3, issued in January 2000, outlines the requirements for the internal Shariah audit. The internal Shariah audit is a non-executive function and is an integral part of the audit function within the institution. Similar to the conventional audit function, the internal Shariah audit department operates on the basis of a clear set of processes and procedures clarifying its objectives, authorities, and responsibilities. The manual has to be prepared in compliance with Shariah rules and regulations set by the SSB and approved by the board of directors. The AAOIFI requirements can be summarised as follows:

1. **Independence and objectivity** – the internal Shariah audit unit needs to have the right level of authority within the organisation to allow it to undertake its responsibilities independently and without being hindered. Auditors need to have direct contact with all levels of staff in the organisation and have access to all documents and reports they require.
2. **Professional competency** – Shariah auditors are required to commit to the ethical and moral covenant of the external accountant and auditor for Islamic Financial Institutions issued by AAOIFI, and maintain discipline, knowledge and the necessary skills to complete the internal Shariah audit, knowledge of the principles and rulings of Islamic Shariah in general; and financial transactions jurisprudence especially. Professional conservatism and care should be taken in conducting the Shariah audit function and ensuring the adequacy of the followed procedures.

3. **Audit plan** – the audit needs to be planned in such a way that it can be executed effectively and efficiently. The plan should be developed adequately to include the full understanding of the Islamic Financial Institutions operations with regard to products, size of operations, locations, branches and divisions, and should cover all activities and products.
4. **Audit steps** – the audit plan needs to follow the following consecutive steps:
   a. Establish the objective of the audit and the scope of work.
   b. Determine the necessary resources required to complete the audit.
   c. Define a work plan and share it with appropriate parties.
   d. Collect information related to the audited activity.
   e. Obtain the rulings, guidelines and instructions of the SBB, and the result of the audit of the previous year.
   f. Contact all relevant individuals.
   g. Determine the method and date to report the results.
5. **Audit** – the auditor collects, analyses, explains and documents the information evidencing the audit findings. This includes documents, inquiries, analysis and discussions with management and staff.
6. **Reporting** – the responsible auditor and (if required their manager) discusses the results, observations and recommendations with the related department heads. A final written report will be provided to the SSB, management and the audit committee.
7. **Follow-up** – although it is the responsibility of management to implement the recommended actions and to remedy the findings, a follow-up will be required to verify all required actions have been taken.

Shariah audit procedures must be in place detailing the work, structure of the audits, and roles and responsibilities. Procedures include checklists to ensure all relevant activities have been undertaken.

5. Governance Standards

Learning Objective

9.3.2 Know the governance standards

There are a number of standards associated with the SSB and Shariah audit. Although these standards are devised by internationally recognised regulatory authorities in Islamic financial services, they are not binding in every jurisdiction.

Governance Standard	Clause	Definition
AAOIFI Standard (1) – Shariah Supervisory Board	2	Rulings and decisions of the SSB are binding on the institution.
	14	The responsibility of the SSB within the annual report is to stipulate that '*our responsibility is restricted to disclose an independent opinion*'.
	21	If a violation to the SSB rulings and decisions is incurred by management, then this violation should be exhibited in the paragraph disclosing the independent opinion.
AAOIFI Standard (2) – Internal Shariah Audit	4	Confirm that the operations of the Islamic Financial Institution do not contravene Shariah.
	5	The SSB is responsible for establishing and disclosing an independent opinion, but the responsibility of application is borne by management.
AAOIFI Standard (3) – Internal Shariah Audit	2	The objective of the internal Shariah audit is to examine the extent of compliance with Shariah and SSB rulings by the institution.
	4	The internal Shariah auditor has no executive authority or responsibility towards the reviewed transactions.
	17	The scope of work is to examine and evaluate the efficiency and effectiveness of the internal Shariah audit system.
	19	Data should provide a valid base to arrive at the final results and recommendations.
	21	Disputes between the internal Shariah audit and management are referred to the SSB.
	22	Confirm the execution of the SSB recommendations; and management is responsible for addressing any non-compliance issues.
AAOIFI Standard (29) – Guidance for Shariah rulings	6/1	The institution is bound to abide by the SSB rulings if it is a 'mandatory' ruling, and if the ruling entails permissibilities, the institution is entitled not to abide. If the institution's management violates the SSB rulings, the violation is advised to the general assembly of shareholders.

6. Shariah Compliance and Investment Account Holders

The IFSB's approach to the corporate governance issues outlined above has been to focus on the governance aspects of Shariah compliance and the rights of IAHs. The following subsections are broadly consistent with the approaches taken by the IFSB but are not intended to be followed in detail.

The IFSB's draft *Guiding Principles of Corporate Governance* emphasises the status of the SSB as a key organ of governance in an Islamic bank. The draft refers to the need for co-ordination between the SSB, the audit committee and another committee whose establishment is recommended, the governance committee, with particular regard to issues of Shariah compliance.

The SSB has a key governance role whether it has the function of issuing Fatawa for application to the bank's operations and supervising their subsequent application or that of supervising the application in the bank of Fatawa issued by a central Shariah authority. Nevertheless, the ultimate responsibility for Shariah compliance falls on the bank's board of directors.

6.1 Rights of IAHs

Learning Objective

9.4.1 Understand the distinction between information rights, control rights and cash flow rights for restricted investment account holders and unrestricted investment account holders

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These rights may be classified as information rights, cash flow rights and control rights. Information rights concern transparency and relate to matters of asset allocation, fund performance, use of reserves and profit allocation. Cash flow rights concern the right to the profit earned from the investment of their funds, subject to the deduction of the bank's share as Mudarib. Control rights are a more controversial matter given the contemporary interpretation of the Mudaraba contract, and are discussed further below.

6.1.1 Information Rights – Restricted Investment Account Holders (RIAHs)

RIAHs should receive similar information on fund performance to that received by members of a conventional Collective Investment Scheme (CIS) in well-developed markets.

These include:

- Income statement (statement of total return).
- Cash flow statement.
- Portfolio statement.
- Balance sheet.
- Summary of material portfolio or asset allocation changes.

- Notes.
- Distribution table showing differences between profits and distributions and 'equalisations' of the latter.

6.1.2 Information Rights – Unrestricted Investment Account Holders (UIAHs)

Since UIAH funds are typically mingled with other funds under the control of the banks, it is not practicable to provide all the same information as with RIAHs. Moreover, there are other issues of transparency that are of particular relevance to UIAHs. In particular, in order to be able to maintain the UIAHs' capital intact, and to pay them a steady rate of return, Islamic banks have developed certain practices involving the use of reserves such as a profit equalisation reserve (PER) and an Investment Risk Reserve (IRR).

6.1.3 Profit Equalisation Reserve (PER)

The PER is built up by appropriations from income earned on investments of UIAH funds prior to the profit allocation between the bank as Mudarib and the IAH as Rab al Mal. It, thus, comprises a shareholders' portion and an IAHs portion. Amounts may be released from this reserve to increase the profit payout to IAHs in years when the income earned on IAHs investments is low, without any corresponding reduction in the dividend payout to shareholders.

Example

The annual report of an Islamic bank X shows a net profit of US$1,000,000 to be distributed among shareholders and investment account holders. The shareholders' share of the profit is valued at US$250,000 while the IAHs share in the profit is valued at US$750,000. In order to smooth the profit distributed and compete with other banks in the market when profits are low during the coming years, the bank decides to retain 5% of the net profit (US$50,000) in the PER.

6.1.4 Investment Risk Reserve (IRR)

The IRR is built up by appropriations from the share of profit allocated to the IAH after deduction of the bank's Mudarib share. Amounts may be released from this reserve to reduce the amount of any loss attributable to the UIAH funds. (In principle, the same mechanisms may be used in connection with RIAHs, but this is rare as there are not the same pressures to maintain capital intact and to pay a steady rate of return. Moreover, the situation is more transparent as there is little or no mingling of funds.)

Example

The annual report of an Islamic bank X shows a net profit of US$1,000,000 to be distributed among shareholders and IAHs. The shareholders' share of the profit is valued at US$250,000 while the IAHs' share in the profit is valued at US$750,000.

In order to cushion against future potential losses, the bank decides to retain 4% of the IAHs' net profits (US$30,000) in the investment risk reserve.

PER and IRR differ from conventional revenue reserves.

PER and IRR are introduced to reduce displaced commercial risk. This type of risk is related to the common practice among Islamic banks to 'smooth' the financial returns to IAHs by varying the percentage of profit taken as the Mudarib share. The use of these reserves (PER and IRR) has similarities with the use of conventional revenue reserves (eg, retained profits as maintained by both conventional and Islamic banks) to smooth dividend payouts to shareholders. There are, however, some important differences.

On the one hand:

- Financial reports make a clear distinction between profits attributable to ordinary shareholders and amounts paid or payable to them as dividends.
- Ordinary shareholders have the right in AGMs to vote for or against the dividend proposed by the board of directors and their use of revenue reserves.
- Amounts held in conventional revenue reserves belong to the ordinary shareholders and, all other things being equal, are reflected in the value of their shares.

On the other hand:

- Financial reports may not make a clear distinction between profits attributable to UIAHs and their profit payout. There is a tendency to confuse the two.
- IAHs have no right to vote for or against the use of reserves decided by the board of directors in making the profit payout to them. At best, their investment contract may place some limits on the amounts the board may appropriate to these reserves (see under cash flow rights below).
- Amounts held in the IAHs' portion of the PER and in the IRR do not belong to the IAHs. When an IAH receives the balance of their investment, in accordance with the investment contract, they get no share of the balance of these reserves. For these reasons, it is important that IAHs be clearly informed about the investment of their funds by the bank, including:
  - asset allocation and changes in this, making clear the risk characteristics of the asset classes
  - the extent and nature of mingling, and the allocation of IAHs and other funds to different investments
  - allocation of profit between IAHs and shareholders, including the composition of profit attributable to IAHs before deducting the bank's Mudarib share, the calculation of the latter and the use of the reserves (PER and IRR) making clear the distinction between the profit earned and the profit distributed.

The use of PER and IRR by the management staff of Islamic banks thus raises some very important corporate governance issues with regard to the information rights, cash flow rights and control rights of UIAHs. The position taken on these issues by the IFSB in its *Guiding Principles of Corporate Governance* is outlined below, with particular reference to control rights.

Cash Flow Rights – RIAHs

In general, cash flow rights for RIAHs are not problematic. They are entitled to the profit from the investment of their funds, subject to the deduction of the bank's Mudarib share. Issues regarding the use of reserves for the purpose of smoothing their profit payout, thus limiting their cash flow rights, may arise, but this is not normal for RIAHs.

Cash Flow Rights – UIAHs

Cash flow rights for UIAHs are normally limited by management's right to withhold part of their share of profit in order to build up reserves (PER and IRR) for the purpose of smoothing their profit payout. Unlike ordinary shareholders, UIAHs have no control rights allowing them to challenge management's use of these reserves if they believe that they are not being used to the advantage of the UIAH (see under control rights below).

Control Rights – RIAHs

As with conventional CIS, the issue of control rights does not arise in connection with RIAHs. This is provided that the bank, as Mudarib, acts in accordance with the investment contract. In other words, the issue is one of investor protection rather than one of corporate governance. The corporate governance issue is that of information rights, as set out above.

Control Rights – UIAHs

The issue of control rights for UIAHs arises insofar as their capital is exposed to losses, ie, they have the status of residual claimants without the legal protection afforded to creditors. The contemporary interpretation of Shariah jurisprudence concerning the Mudaraba contract is that the Rab al Mal should not interfere in management. In fact, shareholders do not have the right to interfere in management, but they do have the right, if they can form a majority of votes, to change the board of directors, to overturn dividend decisions and to approve the appointment of external auditors and various other important control rights. All of these rights are denied to UIAHs.

On the other hand, it is doubtful whether most UIAHs would wish to play an active role in exercising control rights. Moreover, in spite of the potential for conflicts of interests, their interests largely coincide with those of ordinary shareholders. Rather than rights to attend and vote at general meetings, it seems more practicable to propose that they receive some representation in the bank's governance structure. This may be achieved by the establishment of a committee of the board of directors with a specific responsibility to provide oversight on behalf of the UIAH.

The composition of such a committee might be as follows:

- At least three members, including:
  - a member of the audit committee who, as such, should be an independent non-executive director
  - a Shariah scholar from the bank's SSB, and
  - a further independent non-executive director (selected on the basis of his or her experience and ability to contribute to the process).

In the execution of its functions, the committee is empowered to:

- oversee and monitor the implementation of the bank's governance policy framework by working together with the senior management, the audit committee and the SSB, and
- provide the board of directors with reports and recommendations based on its findings in the exercise of its functions.

The IFSB's Guiding Principles suggest the title 'Governance Committee' for such a committee. It is also proposed that the governance committee should be accorded special attention by the supervisory authority, with the selection of an independent non-executive director who is to sit on that committee requiring the supervisor's specific approval.

6.2 IAH and Shareholders

Learning Objective

9.4.2 Understand the distinction between the rights of shareholders and investment account holders

Funds of UIAHs are mingled with the funds of the shareholders and invested in the bank's day-to-day operations. The UIAHs share in the profits as well as the losses and they run the risk of losing their capital. Similarly, shareholders invest their funds in the bank, share in the profit and run the risk of losing their capital. Unlike shareholders, however, UIAHs cannot sell their holdings, although they can, of course, take the funds out of their account and deposit them with another bank.

6.3 UIAHs and RIAHs

Learning Objective

9.4.3 Understand the distinction between the rights of restricted investment account holders and unrestricted investment account holders

In the place of depositors, who provide funds to a conventional bank in accordance with a debt contract and are hence entitled to interest on those funds at either a fixed or a floating rate, Islamic banks receive funds from IAHs who place their funds on the basis of a Mudaraba profit-sharing and loss-bearing contract, in which they are the Rab al Mal (investors) and the bank is the Mudarib (investment manager). The Mudaraba contract is described in section 5 of chapter 5. A Mudaraba contract may be of two major types: restricted or unrestricted.

IAHs have no governance rights under existing interpretations of Mudaraba in which the Rab al Mal is expected to be an entirely passive investor. The main corporate governance issues arising from this state of affairs concern the IAHs' rights to information about the riskiness and performance of the assets in which their funds are invested and to some form of oversight of this performance. This has different implications for RIAHs and UIAHs.

RIAHs are provided with information on riskiness when they invest as the asset allocation is known to them, but this is not the case with UIAHs.

7. Corporate Governance Implications for Islamic Insurance (Takaful)

Learning Objective

9.5.1 Understand the corporate governance issues facing the Takaful industry

7.1 Introduction: Nature and Structure of Takaful

Takaful is a form of cooperative or mutual insurance that is Shariah compliant. Its characteristics are described in detail in chapter 8 of this workbook. Takaful undertakings normally have a two-tier structure: a mutual tier and a limited company. The mutual tier, which belongs to the policyholders, comprises a fund or funds which underwrite the insured risks (underwriting funds) and, in the case of life or family Takaful, represent the savings of policyholders (investment funds). The limited company (Takaful operator) provides underwriting and investment management services to the policyholders in return for a fee under either a Wakala (agency) or a Mudaraba contract or a combination of both (Wakala for underwriting and Mudaraba for investment management). Like conventional mutual insurers, Takaful undertakings include both life (or family) and non-life (or general) insurance.

7.2 Corporate Governance Issues in Takaful

The corporate governance issues that arise in Takaful undertakings are, in some respects, similar to those in Islamic banks:

- Shariah governance is a key issue.
- Policyholders' rights (in place of IAHs' rights) are another major issue, with possible conflicts of interest between policyholders and shareholders.
- However, the issues of systemic risk that affect Islamic banks do not have the same relevance for Takaful undertakings. A distinction needs to be made between non-life and life policyholders:
  - The value of a life policyholder's investment depends on management performance in asset management, while non-life policyholders have much less concern for asset management, but are greatly affected by underwriting performance.
  - Life policyholders are not free to switch their policy to another Takaful undertaking as non-life policyholders may do. Hence, life policyholders have a greater need for governance rights, both to information on the performance of their investments and to some form of control or oversight, such as that which could be provided by a governance committee.

7.2.1 Forms of Contract

The form of contract used for the management of underwriting (Mudaraba or Wakala) is also relevant, especially for non-life policyholders. In principle, by virtue of the mutuality of underwriting in a Takaful, any underwriting surplus or deficit is attributable to the policyholders, not the shareholders. The Takaful operator may opt to distribute part or all of a surplus to policyholders in line with the terms and conditions. If the Takaful operator performs the underwriting services under a Mudaraba contract, the operator as Mudarib will nevertheless be entitled to a percentage share of any underwriting surplus, without bearing any share of an underwriting deficit. This may result in a conflict of interest between the Takaful operator (ie, the shareholders) and the policyholders with regard to a desirable underwriting policy.

The policyholders do not seek a short-term underwriting surplus, once sufficient reserves have been built up in the underwriting fund to meet an occasional deficit. By contrast, the operator has a motive to seek underwriting surpluses. For this reason, sound governance principles suggest that a Wakala contract is preferable to a Mudaraba contract for underwriting. On the other hand, a Mudaraba contract may be suitable for investment management, providing that policyholders' governance rights are recognised and respected.

7.2.2 Legal Structure

A further issue relates to the legal structure of the Takaful undertaking, ie, as to whether the underwriting and investment funds are legal entities separate from the Takaful operator or are funds set up by the operator under a Mudaraba or Wakala contract (as IAH funds are set up under a Mudaraba contract by an Islamic bank). In some countries, the legal system does not permit the setting up of companies with a mutual or co-operative structure and no share capital. In that case the underwriting and investment funds cannot be separate legal entities. However, where this is possible, the use of separate legal entities as vehicles for these funds seems preferable from a corporate governance point of view, as it is likely to afford more protection for policyholders.

8. Concluding Remarks

The principals underlying Shariah are closely related to the principals incorporated in good corporate governance. Shariah-compliant financial institutions have an additional body of governance in the Sharia'a supervisory board, but follow the same governance principles and structures.

End of Chapter Questions

1. What are the mechanisms of corporate governance?
   Answer reference: Section 1.1

2. Why are banks considered to be a special case for corporate governance?
   Answer reference: Section 2

3. What is the purpose of the SSB?
   Answer reference: Section 3

4. Define the criteria of the SSB.
   Answer reference: Section 3.1

5. Describe the approval role of the SSB.
   Answer reference: Section 3.1.2

6. List the AAOIFI requirements for the internal Shariah audit.
   Answer reference: Section 4

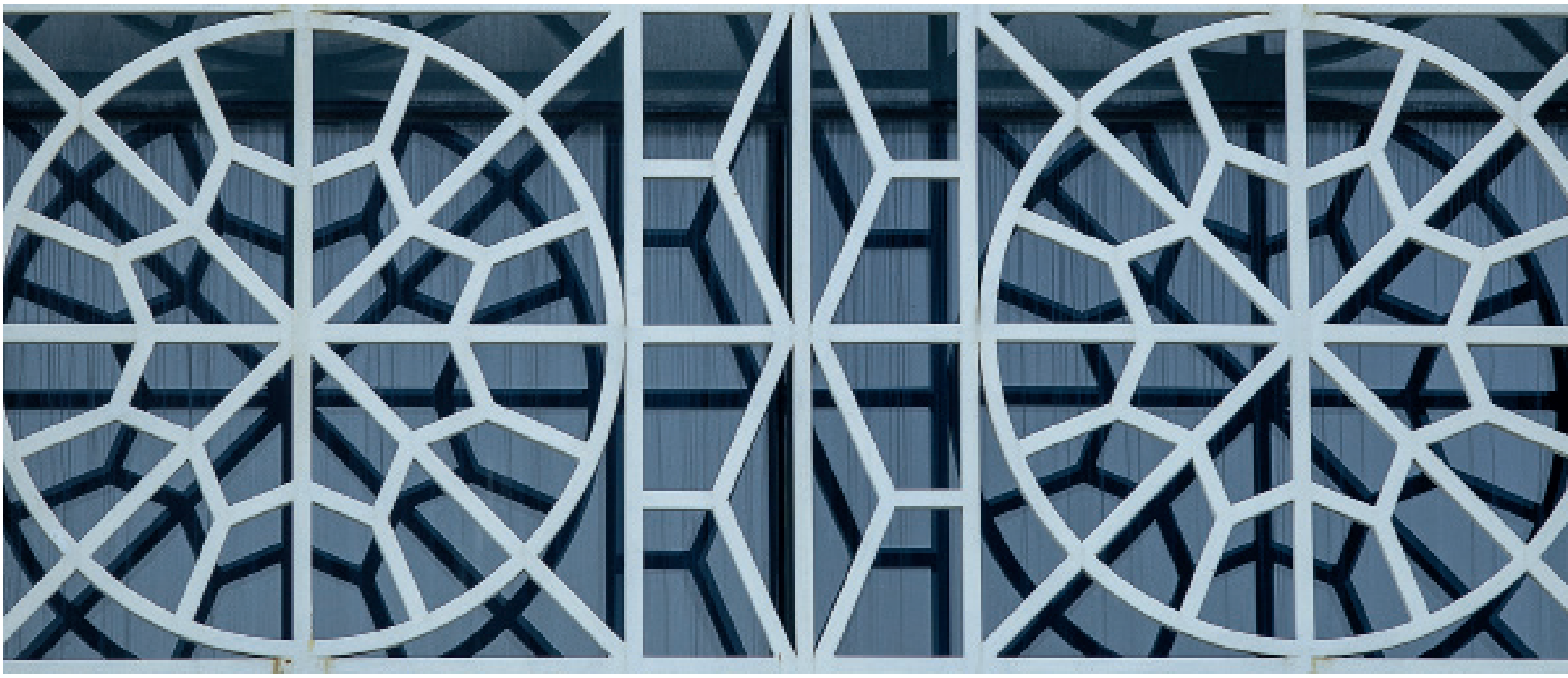
7. Describe the different rights of investment account holders.
   Answer reference: Section 6.1

8. Who benefits from the PER?
   Answer reference: Section 6.1.3

9. How is the IRR built up?
   Answer reference: Section 6.1.4

10. Compare and contrast the rights of shareholders and investment account holders.
    Answer reference: Section 6.2

Glossary



There is no standardised system for translating Arabic terms/words into English.

This text uses one spelling of Arabic words, but there are others. For example, this book uses Shariah but readers may well find spellings such as Sharia and Syariah in other texts; these are equally valid. The examination will use the spellings given in this glossary.

Ah'd (Undertaking)

Ah'd is a covenant, pledge or undertaking to perform certain tasks and to be held accountable for these tasks.

Amanah (Trust)

Refers to deposits in trust. A person can hold a property in trust for another, sometimes by express contract and, sometimes, by implication of a contract. Current accounts may be regarded as Amanah (trust).

Aqd'/A'qd (Contract)

Contract, a bilateral obligation meriting financial consideration.

Aqidah (ideology)

Islamic creed.

Aquila (Shared Rresponsibility)

Shared responsibility; the foundation of Islamic mutual insurance.

Arboon/Arbun/Arboun/Urbun/Urboon (Down payment)

Down payment; a non-refundable deposit paid by a buyer retaining a right to confirm or cancel a sales contract.

Bai al 'inah (Sale and repurchase)

A contract which involves the sale and repurchase of assets between the same buyer and seller. A seller will sell the asset to a buyer on a cash basis. The seller will later buy back the same asset on a deferred payment basis where the price is higher than the cash price. This contract is rejected by most Islamic scholars.

Bai bi Thamin al Ajil/Bai' Bithaman Ajil (BBA) (Deferred sales contract)

A deferred sales contract typically used for financing. When securitised in Malaysia, it is call a BBA bond. In the Malaysian regulatory scheme, this is a long-term contract, with Murabaha being a short-term contract.

Batil (Invalid)

Invalid (contract).

Cedant

An insurance undertaking that transfers some of its risks and its premium income to a reinsurer.

Conventional bank

Used throughout this workbook, and throughout the industry, to identify banks that are not based on Islamic principles.

Dhaman/Daman (Guarantee)

A guarantee or security.

Fasid (Voidable)

Voidable (contract).

Fatwa (pl. Fatawa) (Decree)

A legal pronouncement in Islam provided by an Islamic legal jurist.

Fiqh (Jurisprudence)

The science of Islamic jurisprudence or Islamic law.

Fiqh al Muamalat (Commercial jurisprudence)

Islamic commercial jurisprudence or the rules of transacting in a Shariah-compliant manner.

Gharar (Unnecessary uncertainty)

Any element of uncertainty in any business or contract which is otherwise preventable or avoidable.

Hadith (pl. Ahadith) (Words and sayings of the prophet)

Words of the Prophet (PBUH), traditions. The narrative record of the sayings, actions and tacit approval of the Prophet Muhammad (PBUH).

Halal (Permissible)

Anything (lawful) permitted by Shariah. One of the five major Shariah categorisations of human acts.

Hamish Jeddiyah/Gedyyah (Earnest money)

Security deposit, 'earnest money'. An amount of money paid by the purchaser when giving an order, upon the request of the seller to make sure that the order giver is serious in his order of the asset. However, if the promise is binding and the purchase order declines to purchase the asset, the actual loss incurred to the seller is made good from this amount.

Hanafi

One of the Islamic schools of jurisprudence.

Hanbali

One of the Islamic schools of jurisprudence.

Haram (Prohibited)

Anything (unlawful) prohibited by Shariah. One of the five major Shariah categorisations of human acts.

Hawala/Hawalah (Transfer)

Literally, it means transfer. Legally, it is an agreement by which a debtor is freed from a debt by another person accepting to receive a transfer of the obligation, or the transfer of a claim of a debt by shifting the responsibility from one person to another – contract of assignment of debt. It also refers to the document by which the transfer takes place.

Hiba/Hibah (Gift)

Gift.

Ijara/Ijarah (Lease)

Leasing. Sale of a definite Usufruct of any non-monetary asset in exchange for definite reward.

Ijara Mawsoofa Bil Thimma (Financial lease)

A lease agreed upon, perhaps even with a deposit, for delivery and use of an asset in the future.

Ijma/Ijma' (Consensus)

Consensus of all or a majority of the leading qualified jurists on a certain Shariah matter in a certain age.

Ijtihad (Interpretation)

This refers to an endeavour (literally, toil) of a qualified jurist to derive or formulate a rule of law to determine the true application of Shariah in a matter on which the Holy Quran and the Sunnah are not explicit, and when a previous precedent for the issue at hand has not been set.

Illah (Underlying rationale)

Underlying rationale.

Istihsan (Judicial preference)

Judicial preference for one legal analogy over another, usually to give preference for the public welfare.

Istisn'a (Production finance)

This is a contractual agreement for manufacturing goods and commodities, allowing any combination of cash payment in advance, progressive payments over time, future payment and future delivery. A manufacturer or builder agrees to produce or build a well-described good or building at a given price on a given date in the future. The price can be paid in instalments, step by step as agreed between the parties. Istisn'a can be used for providing the facility for financing the manufacture or construction of houses, plants, projects and building of bridges, roads and highways.

Jahala or Jahl (Ignorance)

Ignorance, lack of knowledge; indefiniteness in a contract, sometimes leading to Gharar.

Kafala

The addition of a third-party guarantee to an existing obligation with respect to an action or a project.

Khiyar al-shart (Optional right to cancel)

An option in a sale contract concluded at the time of signing the agreement, giving one of the two parties to the contract a right to cancel the sale within a stipulated time.

Lien

A charge, claim, hypothecation or mortgage pledging an asset to a creditor.

Manfa'a/Manfaa (Usufruct)

Usufruct or benefit derived from an asset.

Mawqoof (Unenforceable until authorised)

This is an unenforceable-until-authorised contract, where a person has the ability to enter into the contract but exceeds his authority; for example, where an agent exceeds the authority accorded to him by his principal. Such a contract is unenforceable until authorised by the principal.

Maysir (Speculation)

Speculation. Maysir is one of the fundamental prohibitions in Islamic finance and is one of the reasons that led to the design of a specific business model for Islamic insurance.

Mudaraba/Mudarabah/Mudharabah (Trust Financing)

This is an agreement made between two parties, one of whom usually provides 100% of the capital for a project and has no control over the management of the project; another party, known as a Mudarib, manages the project using their entrepreneurial skills. Profits arising from the project are distributed according to a predetermined ratio, and financial losses are borne by the provider of capital.

Mudaraba al Muqayyada (Restricted partnership)

Restricted Mudaraba – applies when the agreement relates to a specific business or place and it is contractually limited by time, place, partner and deal type.

Mudaraba al Mutlaqa (Unrestricted partnership)

Unrestricted Mudaraba – where the Mudarib is free to act within traditional Shariah parameters.

Mudarib (Business manager)

Mudarib manager in a Mudaraba contract. The Mudarib does not invest capital, but provides skill and effort.

Murabaha (Cost Plus Financing)

This is a contract sale between the bank and its client for the sale of goods at a price which includes a profit margin agreed by both parties. As a financing technique, it involves the purchase of goods by the bank as requested by its client. The goods are sold to the client with an agreed mark-up.

Musharaka/Musharakah (Partnership)

This Islamic financing technique involves two or more parties who both provide capital towards the financing of a project or business. Both parties share profits on a pre-agreed ratio but losses are shared on the basis of contributed capital. Management of the project may be carried out by both the parties or by just one party. This is a very flexible arrangement where the sharing of the profits and management can be negotiated and pre-agreed by all parties.

Musharaka Muntahiya Bittamleek/ Diminishing Musharaka or Musharaka Mutanaqisa (Partnership)

A form of partnership whereby one partner buys out the shares or units of the other according to a specific schedule.

Muwaada (Combination of unilateral promises)

Two unilateral promises extended by two parties on the same subject matter.

Off-balance sheet

An item not recognised for accounting purposes as being on the balance sheet.

Parallel Salam

A contract taken out to offset the delivery obligations of the Salam contract.

Qard (Loan)

The literal meaning is 'to cut'. It is so called because the property is really cut off when it is lent to the borrower. Legally, Qard means to lend anything having value so that the borrower could avail himself of the same for his benefit with the condition that the same or similar amount of that thing will be paid back on demand or at the agreed time. Qard is meant to be benevolent, or non-commercial.

Qard Hassan (Loan without interset)

A form of loan identified in the Quran as a means of charity or helping others in need; an interest-free loan.

Qimar (Speculation)

Speculation.

Qiyas (Analogy)

Literally, this means measure, example, comparison or analogy. Technically, it means a derivation of a rule on the analogy of an existing law if the basis (Illah) of the two is the same. In the order of priority, it is the fourth tool of Islamic law.

Quran

Text of God, the primary source of Islamic jurisprudence. The Book of Divine Revelation that was delivered to humankind by the Prophet Muhammed (PBUH).

Rab al Mal (Investor)

The party providing the capital – the investor.

Rahn (Pledge)

Pledge/mortgage.

Ras al Mal (Capital)

Capital.

Retakaful

Where a Takaful operator mitigates part of the risk associated with its Takaful funds by transferring part of the risk to another Takaful or a Retakaful operator.

Riba (Interest)

An excess of, or increase in, interest. Technically, it means an increase over the principal in a loan transaction.

Riba al-Fadl (Riba al-Quran/Riba al-Jahiliyyah) (Interest based on unequal exchange)

An exchange of similar commodities, defined as money or certain foods, in unequal amounts. Its prohibition is meant to close the door to Riba in lending.

Riba al-Naseeyah/Riba Al-Nasiah (Riba Al-Quran and Riba Al-Jahiliyyah) (Predetermined interest on a loan)

Riba Al-Nasiah or Riba of delay is due to an exchange of money today for more at a later date. Interest, in all modern banking transactions, qualifies as Riba Al-Nasiah.

Ribawi (Containing interest)

Susceptible or containing Riba.

Ribawi commodities

Gold, silver, wheat, barley, dates, salt; anything which is used as money.

Sahih (Valid)

Valid (contract).

Salam (Short-term production finance)

A contract for the purchase of a commodity for deferred delivery in exchange for immediate payment in full according to specified conditions.

Sarf (Exchange)

Literally, this means exchange. The rules of sarf restrict the methods of exchanging and depositing money in order to prevent Riba. These rules are based on the Hadith.

Securitisation

The conversion of assets into financial instruments, which may be sold in a manner that cuts the asset off from the seller, making it truly the property of the buyer of the financial instrument.

Shariah (Islamic law)

Islamic canon law derived from primary sources, the Quran and the Hadith practice, and traditions of the Prophet Muhammed (PBUH).

Shirkah (Partnership)

An alternative term for Musharakah. A partnership or company.

Shirkat al Aqd (Contractual partnership)

Partnership by mutual agreed contract.

Shirkat al Milk (Property owner partnership)

Partnership of two or more owners of a property held in common.

Sukuk (Investment certificates)

This is a document or certificate evidencing an undivided pro rata ownership of an underlying asset. Usually referred to as an Islamic bond.

Sunnah/Sunna (Customs)

Custom, habit or way of life. Technically, it refers to the utterances of the Prophet Muhammad (PBUH) other than the Holy Quran known as Hadith, or his personal acts, or sayings of others, tacitly approved by the Prophet (PBUH).

Tabarru' (Donation)

A donation/gift the purpose of which is not commercial. Any benefit that is given by a person to another without getting anything in exchange is called Tabarru'. The concept of Tabarru' has been applied within Takaful (Islamic insurance) schemes.

Takaful (Mutual insurance)

A Shariah-compliant system of mutual protection, insurance, in which the participants donate part or all of their contributions to a common fund. These may be used to pay claims for damages suffered by any of the participants. The company's role is restricted to managing the insurance operations and investing the insurance contributions.

Tawarruq (Credit sale)

A form of reverse Murabaha which is tolerated as it involves three sales contracts and three independent parties, frequently used to deliver money to a person wishing to avoid borrowing at interest. Considered objectionable by most Muslim scholars.

Tenor

The term of the contract.

Ummah (Nation of Islamic states)

The collective nation of Islamic states. The Islamic universal community.

Underlying asset

An asset which is the object of a contract, a specific Sukuk issuance, derivative, or guarantee.

Usufruct

The right to enjoy the benefit of property which is vested in another person.

Usury

Excessive interest.

Usul al-fiqh (Principles of Islamic jurisprudence)

Principles of Islamic jurisprudence.

Wa'd (Promise)

Promise by one party regarding future actions.

Wadia/Wadiah (Safe custody)

Safe custody, trust, deposits.

Wakala/Wakalah (Agency agreement)

A contract of agency in which one person appoints someone else to perform a certain task on their behalf, usually against a certain fee.

Wakil/Wakeel (Agent)

Agent, representative for commercial purposes with a capacity similar to a power of attorney.

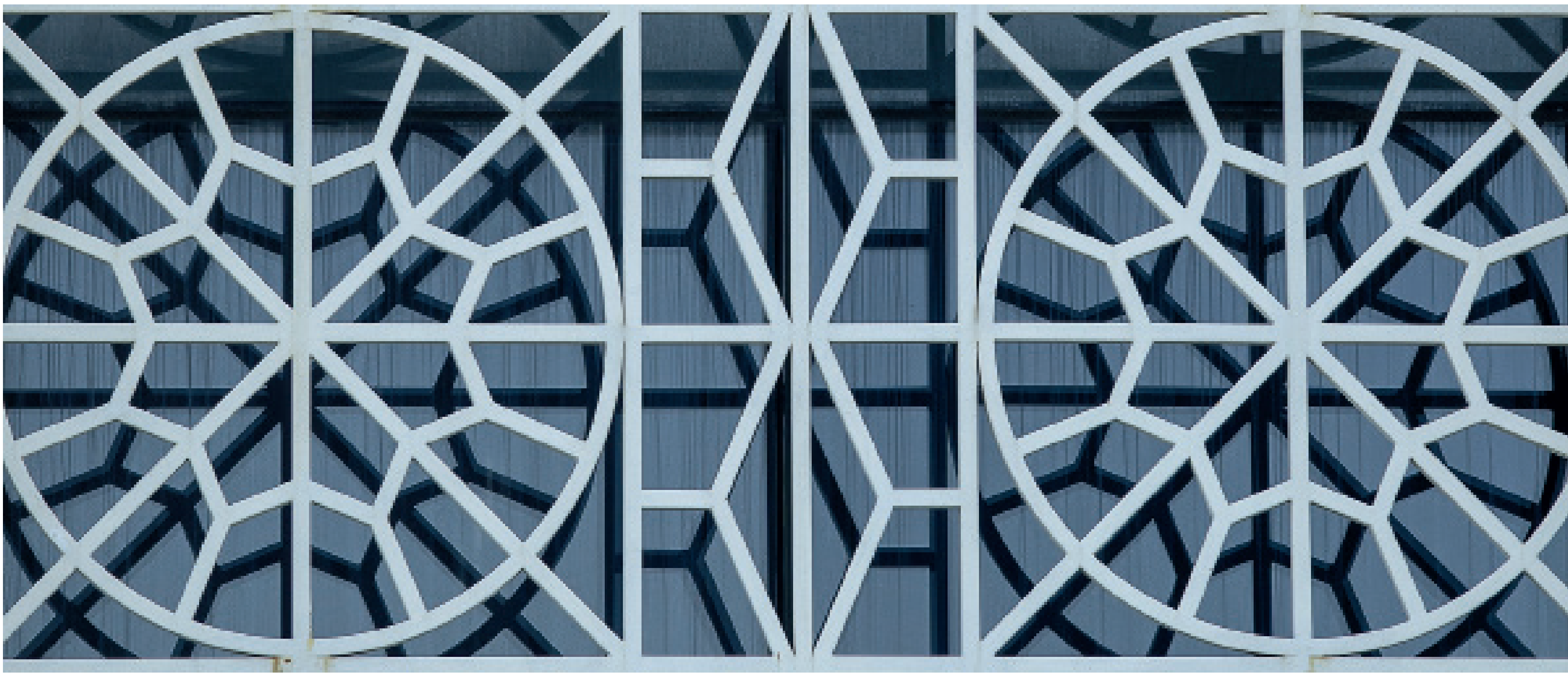
Waqf (pl. Awqaf) (Charitable trust)

Investments or properties which are charitable grants with limited or infinite life, which may be used to support specific beneficiaries designated by the grantor.

Zakat/Zakah (Mandatory almsgiving)

A religious obligation of almsgiving on a Muslim to pay 2.5% of certain kinds of their wealth annually to one of the eight categories of needy Muslims. Literally, it means blessing, purification, increase, or cultivation of good deeds. In Shariah, it is an obligation to pay Zakat on wealth above a specified minimum for defined beneficiaries, as noted in the Quran.

List of Arabic Terms

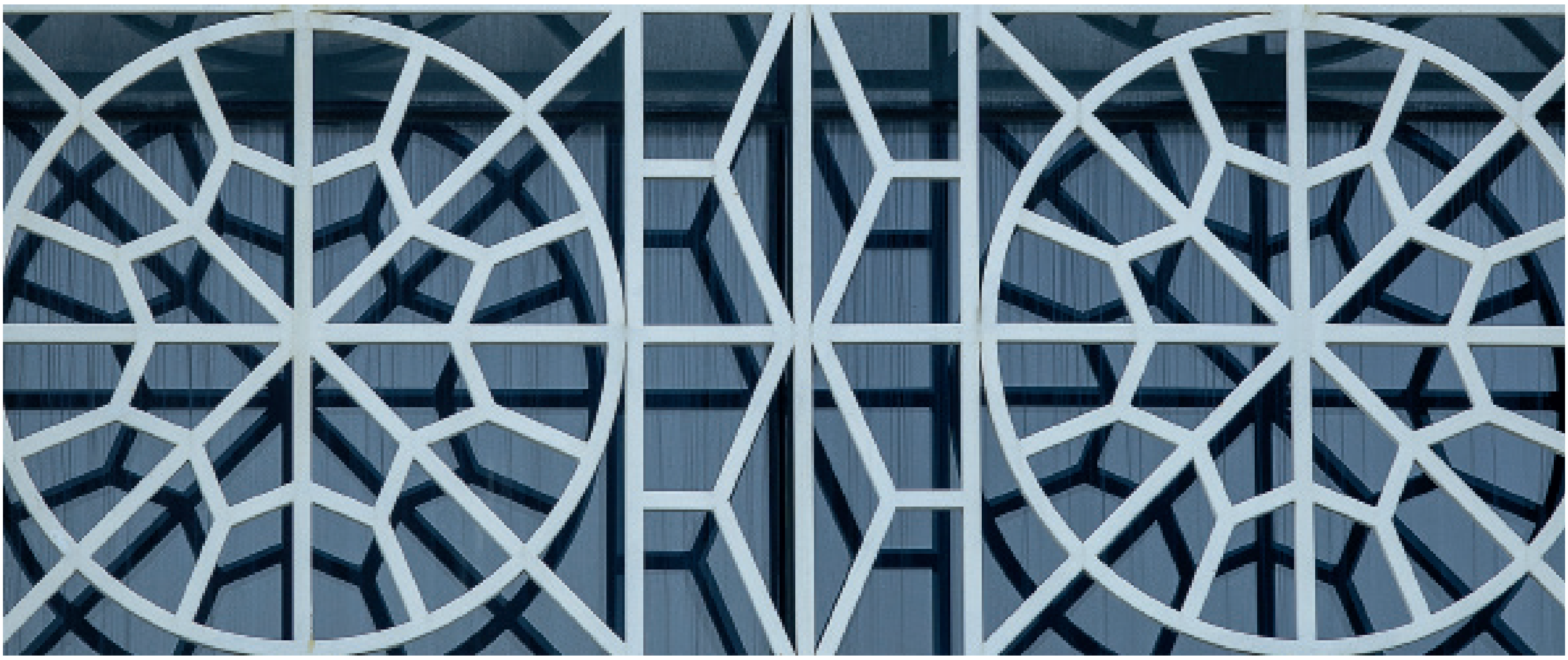


The following terms used in the workbook need to be known for the examination. Where pronunciation might not be evident, written guidance is given in the right hand column – although listening to Arabic speakers is strongly recommended.

Ah'd	
Akhlaq	
Amanah	
A'qd/Aqd'	A'kd
Aqidah	
Arboon	A'r boon
Fatwa (Fatawa, plural)	
Fiqh	
Fiqh al Muamalat	Fikh al Mu a'a malat
Gharar	
Hadith (Ahadith, plural)	Ha deeth (Aha deeth, plural)
Halal	
Haram	
Hawala	
Ijara	
Ijara Mawsoofa Bil Thimma	
Ijara Muntahia Bitamleek/Ijara wa Iqtina	I ja ra Mun ta hi a Bi tam leek/I ja ra wa Iq ti na
Ijma'	
Ijtihad	
Istisn'a	Is tis n'a
Kafala	
Maysir	
Muamalat	Mu a'a malat
Mudaraba/Mudarib	Mu da ra ba/Mu da rib
Murabaha	Mu ra ba ha
Musharaka/Musharik	Mu sha ra ka/Mu sha rik
Parallel Salam	

Qard	Kard
Qard Hassan	Kard Ha ss an
Qimar	
Qiyas	
Quran	Kor an
Rab al Mal (Arbab al Mal, plural)	Rab al Mal (Ar bab al Mal, plural)
Rahn	
Retakaful	Re Ta ka ful
Riba	Ri ba
Riba al-Fadl	Ri ba al-Fadl
Riba al-Naseeyah	Ri ba al - Na see ya h
Sadaqah (Sadaqaat, plural)	Sa da ka (Sa da kat, plural)
Salam	
Sarf	
Shariah	Sha ri a'a
Sukuk	Su kook
Sunnah	Su nn ah
Tabarru'	Ta ba rro
Takaful	Ta ka ful
Tawarruq	Ta wa rruk
Wa'd	
Wadia	
Wakala	Wa ka la
Wakil	Wa keel
Waqf	
Zakat	Za kat

Multiple Choice Questions



1. Where Arboon is used in a sales contract, what happens to the down payment if the buyer decides not to take the goods by the stipulated time?

   A. It must be returned in full to the buyer
   B. It may be retained in full by the seller
   C. It will be split equally between the buyer and the seller
   D. It should be forwarded to an independent third party

2. Combining two contracts into one is permitted as long as the contracts are:

   A. conflicting
   B. signed simultaneously
   C. between the same parties
   D. increased in value by the combination

3. When a client fails to keep up payments on a mortgage under a Diminishing Musharaka, the bank may:

   A. evict the client and keep the profits from the sale of the property
   B. sublet the property to generate additional income
   C. amend the rental agreement
   D. charge a penalty interest

4. The IFSB's main purpose is to promote:

   A. best accounting practices
   B. standardisation of transactions
   C. Islamic capital markets
   D. soundness and stability of the industry

5. In a Wakala agreement, the agent can be either disclosed or undisclosed. In an undisclosed Wakala agreement, the agent:

   A. acts in his own best interest
   B. does not have fiduciary duties
   C. can be held liable for any loss or damages to the assets
   D. does not reveal he acts on behalf of a third party

6. In a Mudaraba agreement, the Mudarib is entitled to a pre-agreed share of the profit but does not share in the losses. Profits are typically allocated from:

   A. gross operating profit or loss
   B. net operating profit or loss
   C. net earnings
   D. retained earnings

7. The main difference between a trade and a loan are that a trade is related to:

   A. equal quantities of a good
   B. equal qualities of a good
   C. identical items
   D. different items

8. Which of the following is not part of the industry screen?

   A. Gambling
   B. Adult entertainment
   C. Music and films
   D. Alcohol

9. Salam is a contract with:

   A. spot payment in full and deferred delivery
   B. spot delivery and deferred payment in full
   C. spot payment in full and spot delivery
   D. deferred payment in full and deferred delivery

10. Arboon transactions in modern Islamic finance can:

    A. not be sold
    B. be sold to the bank
    C. be sold to a party approved by the bank
    D. be sold to any party

11. In a Diminishing Musharaka transaction, the purchasing party pays:

    A. less rent as they buy more units
    B. the same rent until the end of the contract
    C. more rent as they buy more units
    D. no rent

12. Ijtihad, one of the secondary sources of Shariah, is associated with interpretation and is best described as:

    A. scholarly
    B. pragmatic
    C. contemporary
    D. analogical

13. A Wa'd or promise can be used in a finance lease transaction as a promise to purchase the asset:

    A. from the lessor at the beginning of the lease period
    B. then sell it to the lessor, and lease it back
    C. from the lessor at the end of the lease period
    D. from the lessee at the end of the lease period

14. Equity funds can invest in:

    A. private equity only
    B. listed equity only
    C. private and listed equity
    D. index funds only

15. The originator in a Sukuk is best described as the:

    A. person seeking to raise funds
    B. investor
    C. manager of the SPV
    D. creditor

16. When a conventional financial institution operates a branch model for the offering of Islamic financial services, which of the following needs to be segregated:

    A. operations and accounts only
    B. operations, accounts and distribution channel
    C. accounts and distribution channel only
    D. operations and distribution channel only

17. Under which of the following types of transaction are letters of credit most likely to be used?

    A. Ijara
    B. Salam
    C. Parallel Istisn'a
    D. Diminishing Musharaka

18. Which of the following is not a condition for the realisation of revenue under the accrual accounting method?

    A. The institution has earned the right to receive the revenue
    B. There is an obligation on the other party to remit the revenue
    C. The amount of revenue is known
    D. There is no certainty about the collectability of the revenue

19. Which of the following meets the industry and financial screens?

    A. A tobacco firm with conventional debt/market capitalisation of 29%
    B. A children's movie production company with interest bearing deposits/market capitalisation of 32%
    C. An illicit drugs trader with debt/market capitalisation of 28%
    D. A woollen mill with interest bearing deposits/market capitalisation of 22%

20. Which of the following is not a characteristic of an exchange-traded fund (ETF)?

    A. It tracks an equity index
    B. The price is stable throughout the day
    C. It is not required to keep liquid instruments
    D. It can be bought and sold

21. The assets in a real estate fund can be both commercial and residential. Any income from non-compliant use of the asset needs to be:

    A. given to charity
    B. declared to investors and paid out immediately as dividend
    C. reinvested in Shariah-compliant assets
    D. used to purchase social housing

22. Mudaraba and Musharaka transactions are equity-type transactions in which:

    A. profits and losses are shared according to a pre-agreed ratio
    B. profits are shared according to a pre-agreed ratio, losses proportionate to capital
    C. profits are shared proportionate to capital, losses according to a pre-agreed ratio
    D. profits and losses are shared proportionate to capital

23. Which of the following is not a Ribawi commodity?

    A. Sugar
    B. Salt
    C. Dates
    D. Barley

24. Person X wishes to buy an asset from Person Y, with the finance provided by Islamic Bank XYZ under an Ijara wa Iqtina contract. Who will act as lessee under this arrangement?

    A. X only
    B. XYZ only
    C. X and XYZ jointly
    D. Y and XYZ jointly

25. Which of the following needs to be met by the commodity in a commodity fund?
    A. The commodity may be sold forward
    B. Any commodity is acceptable
    C. The seller must have constructive possession
    D. The price may be determined after the purchase

26. When a financial institution provides a guarantee, it may:
    A. charge a fee as a percentage of the guarantee amount
    B. charge an administration fee not related to the amount
    C. charge its own cost to the client
    D. never charge a fee

27. When investing in a company, the investor needs to make an initial selection on the basis of:
    A. the industry screen
    B. the financial screen
    C. either the industry or the financial screen
    D. both the industry and the financial screen

28. Fahad is expanding his car dealership and wishes to issue a Sukuk. He approaches a bank which advises him to enter into a Sukuk al-Ijara, using the premises he owns as the asset. In this scenario, which of the following is correct?
    A. The special purpose vehicle is the lessee and the Sukuk holders are the lessor
    B. The special purpose vehicle is the lessor and the Sukuk holders are the lessee
    C. Fahad is the lessee and the special purpose vehicle is the lessor
    D. Fahad is the lessee and the Sukuk holders are the lessor

29. There are a number of rules that specifically apply to the role of business in society which are intended to ensure that:
    A. business and wealth creation are linked to social values
    B. Muslims do not engage in wealth creation
    C. all trades are undertaken in a fair and transparent way
    D. trades are free from Riba and Gharar

30. Exchange contracts are subject to what can be termed 'rules of exchange'. Which of the following is an example of rules of exchange?
    A. Do not sell what you do not own
    B. Overbooking or overselling is permissible
    C. Purchase and sale of debt
    D. No profit without liability

31. The principle of freedom of contracting implies that:

   A. every type of transaction is permissible as long as agreed between parties
   B. all economic activities are permissible unless otherwise stated by Shariah
   C. transactions are restricted to Ribawi commodities
   D. contracts are impermissible unless otherwise stated

32. In order to earn a return, Islamic banks need to focus on:

   A. asset and commercial risk
   B. credit and obligor risk
   C. displaced commercial risk
   D. product development risk

33. One of the key differences between a conventional bond and a Sukuk is that:

   A. a conventional bond exposes the holder to asset level risks
   B. a conventional bond has a fixed maturity date
   C. a Sukuk grants the holder undivided beneficial interest in the underlying asset
   D. a Sukuk will not result in the holder incurring a loss

34. Which of the following is true regarding charitable distributions?

   A. Zakat is voluntary
   B. Sadaqat is voluntary
   C. Both Sadaqat and Zakat are voluntary
   D. Neither Sadaqat nor Zakat are voluntary

35. When rating a Sukuk, a rating agency will not consider:

   A. Shariah compliance
   B. cash flow
   C. the underlying asset
   D. the history of the originator and asset

36. Sukuk certificates are defined as:

   A. a financial right
   B. a right to a fixed income
   C. an ownership share in the asset
   D. no right to the asset

37. Which of the following is not one of the roles of the SSB?

   A. Advisory
   B. Risk
   C. Approval
   D. Audit

38. 'Going concern' is an accounting term best described as the concept that:
    A. a business will continue to operate for the foreseeable future
    B. there is no hyperinflation in the foreseeable future
    C. the company is divided into equal units
    D. the economy will continue to grow at the current rate

39. In a Sukuk al Musharaka, the special purpose vehicle (SPV) is the:
    A. Musharik
    B. Rab al Mal
    C. obligor
    D. profit and loss sharing partner

40. An Islamic bank is not obliged to pay Zakat when:
    A. the bank appoints shareholders to pay Zakat
    B. the bank is based in a jurisdiction where Zakat is not recognised
    C. the bank is based in a jurisdiction with a solar calendar
    D. the bank has a legal exemption

41. X and Y are partners in a Musharaka contract with X contributing capital of $800,000 and Y contributing capital of $200,000. The agreement states that 70% of profits will go to X and 30% to Y. If losses of $50,000 are incurred, how much of this (if any) must be borne by Y:
    A. none
    B. $10,000
    C. $15,000
    D. $25,000

42. The rationale underlying the prohibition on the sale of a debt for a debt is that:
    A. it is unfair on one of the parties
    B. it is a supply contract
    C. the transaction creates interest
    D. there is no link between economic activity and finance

43. When applied to investment accounts, the Mudaraba transaction is deemed similar to a conventional savings account and under the regulatory regime which, generally, is:
    A. not subject to deposit guarantees
    B. subject to deposit guarantees for principal and expected return
    C. subject to deposit guarantees for principal only
    D. subject to deposit guarantees for expected returns only

44. In a lease fund, the fund acts as the:

A. special purpose vehicle
B. lessor
C. lessee
D. investor

45. A bilateral promise is best described as:

A. two unilateral promises by two different parties on the same asset
B. two unilateral promises by two different parties on two different assets
C. one unilateral promise by one party and a promise to purchase
D. two bilateral promises by one party on the same asset

46. Which of the following type of conventional life policy bears the closest resemblance to a family Takaful?

A. level term
B. endowment
C. whole of life
D. decreasing term

47. In a current account, the bank may apply the funds:

A. in any way it sees fits
B. only to pre-agreed investments
C. only to pre-agreed risk levels
D. in any way it sees fit, but only if allowed to do so by the client

48. Which of the following is not an AAOIFI requirement for SSB in relation to the internal Shariah audit?

A. Independence
B. Objectivity
C. Audit
D. Personal competency

49. Within a Sukuk structure, guarantees are:

A. typically not allowed
B. allowed if provided by a third party
C. allowed if provided by the Sukuk manager
D. incorporated as standard

50. Under the Mudaraba contract, who is normally liable for material losses which arise other than through negligence or contractual breach?
    A. the Rab al Mal only
    B. the Mudarib only
    C. both the Rab al Mal and the Mudarib in equal shares
    D. both the Rab al Mal and the Mudarib according to the profit distribution ratio

51. Fahad offers to pay £5,000 for Ali's car and Ali says he is willing to sell his car for £7,500. This is a:
    A. contract
    B. promise
    C. Murabaha agreement
    D. counteroffer

52. In a permanent Musharaka:
    A. one partner holds all the shares to the end
    B. each partner retains their share to the end
    C. one partner sells all shares over time to the other
    D. both partners sell their shares to a third party

53. In an Istisn'a transaction:
    A. the asset has commodity-type characteristics
    B. the contract may not be cancelled
    C. there is no penalty for late delivery
    D. the delivery date should fall within a pre-agreed time frame

54. Internal risk pooling occurs when a pool that has a deficit is:
    A. temporarily covered by a surplus from another pool
    B. permanently covered by a surplus from another pool
    C. temporarily covered by an interest-free loan
    D. permanently covered by an interest-free loan

55. The Islamic Fiqh Academy has defined a number of rules which have to be met for a promise to be binding. Which of the following is not part of these rules?
    A. The promise has to be bilateral
    B. The promise must incur some liabilities
    C. In a promise to purchase, the actual sale still needs to take place
    D. Only actual damages can be awarded

56. In accordance with the AAOIFI Sukuk rules of 2008, a purchase undertaking is:

A. never allowed
B. allowed at original purchase price
C. allowed at market value
D. allowed at any price agreed between parties

57. The concept of selling what you do not have refers to a sale in which the seller:

A. does not own the asset
B. is not authorised to sell the asset
C. owns or is authorised to sell and controls the asset
D. sells a stolen asset

58. In a Mudaraba transaction, profits are typically allocated from:

A. net profit
B. gross operating profit
C. net operating profit
D. profit after tax

59. AAOIFI accounting standards are based on the:

A. IFSB
B. IFRS
C. ACCA
D. IAS

60. Roads'R'Us is starting a major infrastructure project in Sharjah and is considering issuing a Sukuk to fund this project. Which of the following is most appropriate?

A. Istisn'a Sukuk
B. Ijara Sukuk
C. Musharaka Sukuk
D. Mudaraba Sukuk

61. A Murabaha contract is:

A. an instalment credit sale with profit mark-up
B. an Islamic bond
C. a profit and loss sharing partnership contract
D. a sale/purchase with profit mark-up

62. Gharar is best defined as which of the following?
    A. Gambling
    B. Risk with a small probability of risk
    C. Uncertainty involving risk
    D. Sale by means of pebbles

63. Stop-loss reinsurance is a reinsurance contract in which the reinsurer takes:
    A. an agreed proportion of the loss
    B. a proportion of the loss to be determined when the loss occurs
    C. any claims up to an agreed limit
    D. any claims above an agreed limit

64. When accepting funds under an unrestricted investment account agreement, Shariah scholars typically prefer for the bank to:
    A. keep its own funds separate
    B. invest with the clients exactly the same amount
    C. invest with the clients some of its own capital
    D. invest with the clients an amount higher than the client

65. After paying back loans and making provision for reserves, what is the maximum proportion of the remaining underwriting surplus of a Takaful fund which can be redistributed to policyholders:
    A. 75%
    B. 80%
    C. 90%
    D. 100%

66. Shariah standards are issued by:
    A. the statutory regulator
    B. AAOIFI
    C. Banks
    D. IIRA

67. Which of the following is true regarding cash flow and control rights for unrestricted investment account holders? The account holders have:
    A. limited cash flow rights, limited control rights
    B. full cash flow rights, limited control rights
    C. limited cash flow rights, full control rights
    D. full cash flow rights, full control rights

68. A fund is best defined as a:

A. collection of investments managed by an individual
B. resource managed on behalf of a client by a financial institution
C. purchase of units to generate monetary return
D. financial investment as a means of saving

69. One of the main differences between Takaful and conventional mutual insurance is that in Takaful:

A. the insured from a risk pool for a defined category of risk
B. benefits are payable from the underwriting fund
C. the expected value of the underwriting surplus should be zero
D. policyholders' funds are vested in a separate commercial entity

70. The profit equalisation reserve is built up of appropriations from:

A. income prior to profit allocation between bank and IAH
B. income after profit allocation between bank and IAH
C. profit share allocated to IAH before tax
D. profit share allocated to IAH after tax

71. Restricted investment accounts:

A. have no secondary market
B. do not allow for the investor to withdraw their funds prior to maturity
C. are a separate legal entity
D. have no restrictions on asset allocation

72. Which of the following is not a type of Riba?

A. Riba al Naseeyah
B. Riba al Gharar
C. Riba al Jahliyyah
D. Riba al Fall

73. Fixed-income funds are known for typically having:

A. low risk and high liquidity
B. medium risk and low liquidity
C. medium risk and high liquidity
D. high risk and low liquidity

74. One of the main differences between Takaful and proprietary insurance is that any deficiencies in the Takaful fund will normally be addressed by:

    A. a one-off levy on all policyholders
    B. a scaling down of future claims payments
    C. an interest-free loan from the Takaful operator
    D. an appropriate reduction in the level of Zakat

75. In a Salam transaction, the:

    A. asset has commodity-type characteristics
    B. contract may be cancelled unilaterally
    C. price may be paid in advance
    D. delivery date should fall within a pre-agreed time frame

76. Under the two-tier Mudaraba contract, what does the bank normally do with the money it collects from clients?

    A. Provides safekeeping for the funds
    B. Invests it with another client requiring funds
    C. Returns it to the clients on a staggered basis
    D. Returns it to the clients as a short-term loan

77. AAOIFI has to date not developed inflation accounting principles due to the fact that:

    A. this is not Sharia compliant
    B. Islamic banks do not operate in hyperinflation countries
    C. Murabaha transactions are immune to inflation
    D. there is no interest in Islamic financial transactions

78. Which of the following is not a criteria generally associated with the role of the SSB?

    A. Dependence
    B. Confidentiality
    C. Competence
    D. Disclosure

79. Major Gharar is a transaction in which the dominant outcome is:

    A. win-win
    B. win-lose
    C. lose-lose
    D. mutual liability

80. In a Shariah-compliant fund, the fund manager acts as the:

A. Rab al Mal
B. Mudarib
C. Mudarib or the Rab al Mal
D. Musharik

81. What are two types of reinsurance?

A. Adequate and stop-risk
B. Proportionate and stop-loss
C. Disproportionate and stop-risk
D. Adequate and stop-loss

82. Which of the following is not a characteristic of an SPV?

A. Bankruptcy remoteness
B. Domiciled in tax efficient jurisdiction
C. Acts as guarantor
D. Acts as trustee

83. Banks are considered a special case in relation to corporate governance due to:

A. narrower definition of stakeholders
B. absence of regulation and compliance
C. presence of systemic risk
D. information symmetry

84. Which of the following is not a principle of Islamic contracting?

A. Limitation in contracting
B. Judging actions by objectives
C. Liability justifies return
D. Incorporation of custom and convention

85. The issue of corporate governance was identified as a result of the fact that:

A. corporations became larger
B. shareholders became more aware of their rights
C. control and ownership of corporations was increasingly separated
D. senior management refused to share information

86. John has designed his dream house and is now looking to appoint a builder. Unfortunately, he does not have the funds available to pay for the building works and he is discussing his options for financing with the bank. Which of the following transaction types is best suited to his requirement?

    A. Commodity Murabaha
    B. Mudaraba
    C. Salam
    D. Istisn'a

87. Which of the following is not a part of a Sukuk?

    A. Undertaker
    B. Arranger
    C. Investor
    D. Obligor

88. The Takaful model in which all risks are borne by the fund and any operating surplus belong exclusively to the participants is known as a:

    A. pure Wakala model
    B. pure Murabaha model
    C. combined model
    D. pure Musharaka model

89. The asset allocation on an unrestricted investment account is determined by:

    A. the bank and the investor
    B. the investor
    C. the bank
    D. the Shariah Supervisory Board

90. Amounts from the investment risk reserve may be released in which of the following events?

    A. Increase profit pay-out to IAH
    B. Increase dividend pay-out to shareholders
    C. Reduce the amount of loss attributable to IAH
    D. Reduce the amount of loss attributable to shareholders

91. Which of the following is not a Shariah option of sale?

    A. Seller's option to rescind
    B. Option of defect
    C. Option of quality
    D. Option of price

92. Which of the following is not a main contract of Fiqh al Muamalat used in Islamic insurance?

A. Dhaman
B. Tabarru
C. Murabaha
D. Wakala

93. Unrestricted investment accounts:

A. have a guaranteed return
B. are higher risk than restricted investment accounts
C. may be co-mingled with other funds at the bank's disposal
D. have no restriction on asset allocation

94. Fund management is typically either undertaken on the basis of:

A. Musharaka
B. Murabaha
C. Mudaraba
D. Musawama

95. The Wa'd is often used:

A. to provide a level of security
B. instead of a Wakala
C. to guarantee performance
D. to ensure Shariah compliance

96. Which of the following is true in relation to gambling?

A. It is a type of major Gharar
B. It is a type of minor Gharar
C. It is not a type of Gharar
D. It is a type of Qimar

97. Corporations that work to a high standard of corporate governance will ensure their activities:

A. are environmentally friendly
B. are culturally sensitive
C. are inflexible
D. deal with customers fairly

98. Islamic financial institutions have an intermediary function in which the relationship with the client is based on a Mudaraba transaction. The return to the depositors is based on the institution's:

    A. overall profit
    B. profit after Mudarib share
    C. profit after provisions
    D. profit before Mudarib share

99. Banks are regarded as a special case when it comes to corporate governance because of their strong need for:

    A. risk management
    B. external control
    C. executive management
    D. audit

100. There are two different types of contract – compensatory or bilateral contracts and non-compensatory or unilateral contracts. Which of the following is a non-compensatory contract?

    A. Murabaha
    B. Mudaraba
    C. Qard
    D. Ijara

Answers to Multiple Choice Questions

1. Answer: B Chapter 5, Section 15.1

If the buyer decides not to take the goods by the stipulated time, the down payment may be kept by the seller.

2. Answer: D Chapter 3, Section 6.4

Combining two or more contracts, therefore, is restricted only if these contracts are contradictory or in conflict with each other and the combination does not add value. However, if the contracts are in agreement, the combination may very well bring in value that could not have been achieved by treating the contracts separately.

3. Answer: C Chapter 5, Section 8.1.2

When a client fails to keep up payments on a mortgage under a Diminishing Musharaka, the bank typically has the following options:

- Amend the rental agreement.
- Evict the client, sell the property and share any profits with the client.
- Adjust the ownership share to reflect the client's past due payments.

4. Answer: D Chapter 2, Section 2.3.2

The IFSB is an international standard-setting organisation with a mission to promote and enhance the soundness and stability of the Islamic financial services industry, by issuing global prudential standards and guiding principles for the industry, broadly defined to include banking, capital markets and insurance sectors.

5. Answer: D Chapter 5, Section 6

In an undisclosed agency agreement, the agent does not disclose that he acts on behalf of another party and is, to all intents and purposes, acting as a principal in dealing with third parties. Agents have a fiduciary duty and act as trustees in holding the assets of the principal in executing the service. They are not liable for any loss or damage to the asset unless this is caused by the agent's negligence.

6. Answer: A Chapter 5, Section 7.2

The Mudarib is entitled to a pre-agreed share of any profit, but does not share in losses (unless the Mudarib has been negligent). In modern Islamic banking, the profit is typically allocated from the business's gross operating profit or loss (before deduction of general overhead expenses) rather than the net operating profit or loss. This is because, although he does not participate in the expenses of the investments, he must incur certain expenses in his capacity as Mudarib, such as overhead expenses, and premises rental.

7. Answer: D Chapter 3, Section 4.1.1

A trade is when the underlying items are of a different nature or quality, while a loan is when the underlying items are identical in quality and nature.

8. Answer: C Chapter 6, Section 3.1

The industry screen excludes the following business activities:

- Conventional banking and insurance.
- Alcohol.
- Pork-related products and non-compliant food production.
- Gambling.
- Tobacco.
- Adult entertainment.
- Weapons, arms and defence manufacturing.

9. Answer: A Chapter 4, Section 3.2.3

Salam may be defined simply as a contract executed with spot payment in full for the future delivery of assets which have commodity-like characteristics.

10. Answer: A Chapter 5, Section 15.1

Although it is often used as an option (ie, a conventional covered call option giving the holder the right, but not the obligation, to buy a fixed quantity of an underlying asset on or before the maturity date), an Arboon cannot be traded or sold to a third party.

11. Answer: A Chapter 5, Section 8.1.2

As the purchasing party owns more units, he owns a larger proportion of the asset and thus pays lower rent to the other party.

12. Answer: A Chapter 1, Section 3.2.1

First recourse is to the Quran to determine a course of action. If they were unable to find a solution to their problem in the Quran, they would turn to the Sunnah. When the indications in the Ahadith were insufficient to deal with the problem fully and the problem was not confirmed by Ijma' or Qiyas, an exhaustive scholarly examination of the textual evidences (Ijtihad) was used to resolve the question.

13. Answer: C Chapter 5, Section 14

In a finance lease transaction, the promise is given by the lessee to purchase the asset from the lessor at the end of the lease period.

14. Answer: C Chapter 6, Section 6.5

Equity funds can invest in both private and listed equity as long as it meets the industry and the financial screen.

15. Answer: A Chapter 7, Section 2.1

The originator or obligor is the person or entity seeking to raise funds.

16. **Answer: B** **Chapter 2, Section 2.2**

Islamic financial services can be offered by conventional financial institutions using a windows, branch, or subsidiary model. In all cases, operations and accounts need to be segregated. In a windows model, the same distribution channels are used for both conventional and Islamic financial services. In a branch model, the services are offered via a separate distribution channel. A subsidiary is a separate legal entity.

17. **Answer: B** **Chapter 5, Section 13.1**

Recently, Islamic banks have started to bundle the letter of credit and processing services into Musharaka agreements with the client.

18. **Answer: D** **Chapter 4, Section 8.2.6**

There are three conditions for the realisation of revenue:

1. The institution has earned the right to receive the revenue.
2. There is an obligation on the part of the other party to remit the revenue.
3. The amount of revenue should be known and collectible with a degree of certainty.

19. **Answer: D** **Chapter 6, Section 3.2**

Only the woollen mill meets the industry screen and the financial screen.

20. **Answer: B** **Chapter 6, Section 6.6**

Islamic exchange-traded funds are securities that track the performance of an Islamic index or basket of commodities in the same way as an index fund does. However, the ETFs can be traded on an exchange in the same way as securities. The price of ETFs changes during the day as a result of units being bought and sold. The fund is not required to keep liquid instruments since the investor can liquidate his holdings by selling them in the open market.

21. **Answer: A** **Chapter 6, Section 6.4**

Any income associated with the non-compliant use must be donated to charity.

22. **Answer: B** **Chapter 4, Section 5**

In Mudaraba and Musharaka transactions, profits are shared in accordance with a pre-agreed ratio and losses are distributed in proportion to the capital provided.

23. **Answer: A** **Chapter 3, Section 4.1.4**

Ribawi commodities are gold, silver, wheat, barley, dates and salt.

24. **Answer: A** **Chapter 5, Section 10.1**

In an Ijara transaction, the bank will become the lessor and lease the asset to the client (the lessee).

25. Answer: C Chapter 6, Section 6.3

The commodity needs to fulfil the following criteria:

- Must be owned by the seller at the time of sale.
- Forward sales are not permitted.
- Commodity has to be lawful.
- Seller must have physical or constructive possession.
- The price needs to be certain and unconditional.

26. Answer: B Chapter 4, Section 6.2

Although a charging a fee to act as a third-party guarantor is not allowed, Shariah scholars are of the opinion that on the basis of the principle of necessity, financial institutions may charge an administration fee as long as it is not proportionate to the amount guaranteed.

27. Answer: D Chapter 6, Section 3

Firms that use too much leverage must be excluded from the investment universe in addition to meeting the industry screen.

28. Answer: C Chapter 7, Section 4.2 and 2.1

The structure of the Sukuk al Ijara follows the rules of the underlying Ijara transaction. The Sukuk certificates constitute shares in a leasing project.

29. Answer: A Chapter 3, Section 2.2

The rules prove that Islam links business and wealth creation to social values.

30. Answer: D Chapter 3, Section 6

Rules of exchange are:

1. No profit without liabilities.
2. Do not sell what you do not have, which includes a prohibition on overbooking and overselling.
3. No debt for debt.
4. Restrictions on combining two contracts into one.

31. Answer: B Chapter 3, Section 3.1

In accordance with the principle of permissibility, all economic activities are permissible unless otherwise stated by Shariah.

32. Answer: A Chapter 5, Section 5

Shariah rules require the investor or financier to focus on asset or commercial risk in order to earn a reward.

33. Answer: C Chapter 7, Section 1.1.3

Sukuk represents a share of the ownership of the underlying asset used by the company issuing the securities. Sukuk holders are exposed to appreciation or depreciation of the asset.

34. Answer: B Chapter 1, Section 2.2

Zakat, one of the five pillars of Islam, is mandatory almsgiving and is levied on anyone who has in excess of a minimum level of wealth (Nisab). The Quran also encourages Muslims to make voluntary charitable donations (Sadaqat), the amount of which is dependent on the goodwill of the donor. Individuals are encouraged to prioritise the distribution of their charity.

35. Answer: A Chapter 7, Section 6

When rating a Sukuk, a rating agency considers the same matters as for a comparable conventional issue. Shariah compliance is typically not considered.

36. Answer: C Chapter 7, Section 1.1.2

AAOIFI defines Sukuk as certificates of equal value representing undivided shares in ownership of tangible assets, Usufructs and services or (in the ownership of) the assets of a particular projects or special investment activities.

37. Answer: B Chapter 9, Section 3.1

The roles of the SSB are advisory, approval, and audit.

38. Answer: A Chapter 4, Section 8.1.3

Going concern means that a business will continue to operate for the foreseeable future and there is no intention to liquidate it or to drastically reduce its scale of activities.

39. Answer: A Chapter 7, Sections 4.3 and 2.1

In a Musharaka Sukuk, the SPV acts as a Musharik on behalf of the Sukuk investors.

40. Answer: A Chapter 4, Section 8.3.2

Cases in which the Islamic bank is not obliged to pay Zakat are:

- When shareholders ask the Islamic bank to act as agent in meeting the Zakat obligation relating to their investment in the Islamic bank from their share of distributable profits, Zakat is deducted from the shareholders' share of distributable profits.
- When shareholders ask the Islamic bank to act as agent in meeting their Zakat obligation and the Islamic bank agrees to do so, even if there are insufficient distributable profits to meet the shareholders' obligations, the amount paid by the Islamic bank is recorded as a receivable due from these shareholders.

41. Answer: B Chapter 5, Section 8.1.1

Losses are borne by the investors in proportion to the capital provided. Y provides 20% of the capital and is therefore subject to 20% of the loss.

42. Answer: D Chapter 3, Section 6.3

The exchange of a debt for a debt is prohibited. The rationale for this restriction relates to the link between finance and real economic activity. Debt for debt exchange creates debt obligations without real transactions, ie, without possession of any tangible object at the time of contracting.

43. Answer: C Chapter 5, Section 7.1.1

International banking typically defines savings accounts as deposit accounts with capital protection. In non-Muslim countries, this deposit guarantee is usually also applied to Mudaraba deposits since the economic reality of the transaction is deemed to be the same as conventional savings accounts. The deposit guarantee is normally defined as a national insurance scheme. In Islamic banking, deposit insurance could, for example, be implemented through Takaful or Islamic cooperative insurance.

44. Answer: B Chapter 6, Section 6.2

In a lease fund, the fund owns the asset and acts as the lessor.

45. Answer: A Chapter 4, Section 2.5

A bilateral promise consists of two unilateral promises or undertakings extended by two parties on the same asset or service.

46. Answer: B Chapter 8, Section 2.2

Islamic life insurance offers endowment-type policies.

47. Answer: D Chapter 5, Section 3.2

In a current account, the bank must obtain the permission of the account holder to apply the money to its operations.

48. Answer: D Chapter 9, Section 4

The AAOIFI requirements can be summarised as:

1. Independence and objectivity.
2. Professional competency.
3. Audit plan.
4. Audit steps.
5. Audit.
6. Reporting.
7. Follow-up.

49. Answer: A Chapter 7, Section 5

Financial guarantees are not typically allowed in Sukuk. This means that the investment is not normally guaranteed for investors.

50. Answer: A Chapter 5, Section 7.3.1

Profits are distributed according to a predefined ratio agreed between the two parties in the Mudaraba agreement. In case of any loss, material losses are born by the Rab al Mal only.

51. Answer: D Chapter 4, Section 2.1.1

Acceptance must match the offer. If the counterpart offers a higher price, he has made a counteroffer.

52. Answer: B Chapter 5, Section 8.1.1

In permanent Musharaka, each partner to the Musharaka contract retains their share in the capital until the end of the project.

53. Answer: D Chapter 5, Section 12.3

In an Istisn'a transaction:

- Deliverables are manufactured goods or constructed property subject to detailed specification.
- The contract may be cancelled unilaterally before work starts.
- The price may be paid in advance, in instalments according to progress, post-delivery, in instalments without reference to progress or at delivery. Payment schedules are agreed in the contract.
- Progress payments may be deferred and may attract pre-agreed penalties for the late delivery of the contracted assets. To be valid, all specifications, delivery options, payment conditions and pricing must be agreed in the Istisn'a contract. Typically, the financier subcontracts the manufacture or construction of the object. However, they remain responsible for the product warranties, even if they are able to assign or otherwise cover this risk.
- The delivery date does not need to be specific, but should fall within a pre-agreed time frame.

54. Answer: A Chapter 8, Section 5.3

In a given period, one fund may have an underwriting surplus, while another has a deficit. If surpluses are allowed to offset deficits by means of an internal risk-pooling arrangement, the risk of insolvency is substantially reduced, especially for an insurance undertaking of modest size.

55. Answer: A Chapter 4, Section 2.4

Contrary to a contract, a promise has to be unilateral.

56. Answer: C Chapter 7, Section 5

Purchase undertakings are allowed as long as the price is determined on the basis of the current market value. Only in case of Ijara can the purchase undertaking be at a pre-agreed price.

57. Answer: C Chapter 3, Section 6.2

The concept 'what you do not have' refers to the combination of ownership or authority, possession and control. In order to be able to sell an asset, the seller needs to either own the asset or be authorised to sell it, and be in control of it (ie, be able to deliver it). An agent who acts on behalf of the owner to sell an asset is able to do so since they are authorised to do so by the owner, and is in control of the asset. What you do not have, therefore, can be distilled into the following:

1. The seller has the legal ability to sell, ie, they own the good, or has permission of the owner to sell on his behalf.
2. The seller has the physical ability to deliver the good, ie, they have it in their possession.
3. The seller can control the asset.

A sale is valid when point 1 (ownership or authority) is fulfilled in combination with either one of the other two (possession or control). Solely having the asset in possession and having control over it is, however, not sufficient.

58. Answer: B Chapter 5, Section 7.2

In modern Islamic banking, the profit is typically allocated from the business's gross operating profit or loss.

59. Answer: B Chapter 4, Section 8.2.4

AAOIFI standards are based on IFRS and GAAP.

60. Answer: A Chapter 7, Section 4.4.2

Sukuk al Istisn'a is generally applied to the financing of larger-scale projects.

61. Answer: D Chapter 4, Section 3.2.1

A Murabaha is a cost plus sale in which the price of the goods, the mark-up, the delivery date and payment date are all specified in detail. The sale of the good is immediate, against future payment.

62. Answer: C Chapter 3, Section 5.1

Gharar is uncertainty that involves risk, ie, the possibility of failure, damage or loss in which the likelihood of loss or failure is substantial.

63. Answer: D Chapter 8, Section 6

In stop-loss, the reinsurer meets any claims above an agreed limit.

64. Answer: C Chapter 5, Section 7.1.1

In an attempt to increase the Islamic bank's responsibility in its investment selections, Shariah scholars usually advise the Islamic bank to invest part of its capital together with the Investment Account Holders' money in the Mudaraba activity.

65. **Answer: D** **Chapter 8, Section 4.2**

In Takaful, as in mutual insurance undertakings, underwriting surpluses belong to the policyholders.

66. **Answer: B** **Chapter 2, Section 2.3.1**

AAOIFI has issued standards for the following:

- Shariah.
- Accounting.
- Auditing.
- Governance.
- Ethics.

67. **Answer: A** **Chapter 9, Section 6.1.4**

UIAH cash flow rights are normally limited by management's right to withhold part of the profit to build up PER and IRR. The Rab al Mal (UIAH) should not interfere with management and has no control rights.

68. **Answer: B** **Chapter 6, Section 4**

A fund is defined as:

1. A resource managed on behalf of a client by a financial institution.
2. A separate pool of monetary and other resources used to support designated activities.

69. **Answer: D** **Chapter 8, Section 1.2.2**

In Takaful, the policyholders' funds including the underwriting funds and reserves are, where possible, vested in a separate commercial entity.

70. **Answer: A** **Chapter 9, Section 6.1.3**

The PER is built up by appropriations from income earned on investments of UIAH funds after the profit allocation between the bank as Midrib and the IAH as Rab al Mal.

71. **Answer: A** **Chapter 5, Section 7.4.1**

Restricted investment accounts are a type of CIS in which the asset allocation is restricted as set out in the contract. There is no secondary market but investors may be able to withdraw their funds prior to maturity.

72. **Answer: B** **Chapter 3, Section 4.1.4**

The types of interest are referred to under the following Arabic names:

- Simple interest – Riba al Naseeyah.
- Compound Interest – Riba al Naseeyah/Riba Al Jahiliyyah.
- Sale-based Interest – Riba Al Fadl.

73. Answer: A Chapter 6, Section 6.1

Comparatively fixed-income funds are low risk and low return and offer a high level of liquidity.

74. Answer: C Chapter 8, Section 1.2.2

The Takaful operator provides capital back-up, if needed, to the underwriting funds by means of a Qard Hassan (interest-free loan).

75. Answer: A Chapter 5, Section 12.3

In a Salam transaction:

- Deliverables have commodity-type characteristics and must be fungible like base metals or grain.
- The contract may not be cancelled.
- The full price must be paid in advance.
- There is no penalty for late delivery. However, in the event the seller fails to produce the commodity, he will need to source it in the open market and deliver to the buyer.
- Delivery is on a specific date.

76. Answer: B Chapter 5, Section 7.3.1

Under the two-tier Mudaraba contract, a bank normally invests money it collects from clients with one or more other banks.

77. Answer: B Chapter 4, Section 8.2.6

AAOIFI assumes stability of the purchasing power of the monetary unit but has not developed inflation accounting standards due to the fact that there has been no call for such a standard in the countries where Islamic banks operate.

78. Answer: A Chapter 9, Section 3.1

The five main criteria are independence, confidentiality, competence, consistency and disclosure.

79. Answer: B Chapter 3, Section 5.2.2

Excessive or major Gharar (Gharar Katheer) – transactions in which the win-lose outcome is either significant or the dominant outcome. This type of Gharar is forbidden since it leads to obtaining wealth for nothing and may be harmful to society.

80. Answer: C Chapter 6, Section 5

Depending on which side of the investment the fund manager is on, he acts either as the Rab al Mal or the Mudarib.

81. Answer: B Chapter 8, Section 6

There are two basic forms of reinsurance: proportionate and stop-loss.

82. Answer: C Chapter 7, Section 2.1

The SPV is bankruptcy remote, domiciled in a tax-efficient jurisdiction and acts as a trustee.

83. Answer: C Chapter 9, Section 2

Banks are considered to be a special case of corporate governance due to:

- A wider definition of 'stakeholders' (cf, BCBS definition).
- The issue of 'systemic risk'.
- Regulation and compliance issues.
- Depositors need for protection.
- The need for strong internal control and risk management.
- Issues of transparency and information asymmetry.
- Issues of related party transactions (and 'grey directors') which are particularly sensitive for banks.

84. Answer: A Chapter 3, Section 3

The principles of contract are:

- Freedom of contracting.
- Actions are judged by objectives.
- Do no harm.
- Flexibility in the case of hardship.
- Incorporation of custom and convention.
- Liability justifies return.

85. Answer: C Chapter 9, Section 1

The issue of corporate governance was first identified in relation to private sector corporations since, by the early decades of the 20th century, the control of corporations was increasingly separated from the ownership of the corporations.

86. Answer: D Chapter 5, Section 12

Istisn'a transactions are typically most suited to project-finance-type transactions such as construction.

87. Answer: A Chapter 7, Section 2.1

The parties to a Sukuk are originator/obligor, arranger, assets/project, investors and manager. Other associated parties, such as SPV, vendor and underwriter, may be involved.

88. Answer: A Chapter 8, Section 3.2

In a pure Wakala model, all risks are borne by the fund and any operating surplus belongs exclusively to the participants.

89. Answer: C Chapter 5, Section 7.4.2

The asset allocation of a UIAH is not restricted by contract and the bank can place the funds in any Shariah-compliant investment at its discretion, subject to its fiduciary duty.

90. Answer: C Chapter 9, Section 6.1.3

Amounts from the IRR may be released to reduce the amount of any loss attributable to the UIAH funds.

91. Answer: A Chapter 4, Section 2.2

The Shariah options of sale are:

1. Buyer's option to rescind – time limited, seller has similar option, but ceases before execution of contract. For example, a 'cooling-down' period when buying a large asset.
2. Option of inspection – right to see or appoint a qualified person to inspect the object being sold for any form of defect.
3. Option of defect – right to return if defective.
4. Option of quality – right to receive the quality of goods as specified.
5. Option of price – right to a fair price within the market range.

92. Answer: C Chapter 8, Section 3.3

The main contracts of Fiqh al Muamalat used in Islamic insurance are those of Dhaman (guarantee or indemnity) between the insured and the mutual underwriting pool, Tabarru' (donation) as the basis on which the premiums are paid by the policyholders and Wakala and/or Mudaraba as the basis on which the TO undertakes management of underwriting and investment on behalf of the policyholders.

93. Answer: C Chapter 5, Section 7.4.2

The funds of an unrestricted account holder can be mingled with other funds at the bank's disposal and invested as the bank sees fit. They are profit- and loss-sharing and cannot attract a guaranteed return under Shariah. They may attract a higher risk than restricted investment accounts, but this is not necessarily the case.

94. Answer: C Chapter 6, Section 5

Fund management can be undertaken either on a Mudaraba or Wakala basis.

95. Answer: A Chapter 5, Section 14

Although highly controversial, the Wa'd is often used to provide a level of security to both parties regarding a future event.

96. Answer: A Chapter 3, Section 5.2.1

Gambling (Qimar) is a type of major Gharar since it is a transition in which each party is either a winner or a loser.

97. Answer: D Chapter 9, Section 1

Corporations which work to a high standard of corporate governance will, among other things, ensure their activities are arranged in such a way that they deal fairly and properly with customers; products are suitable for the customers' needs and staff interactions with clients are courteous and efficient.

98. **Answer: B** **Chapter 5, Section 3.1**

Depositors receive a share of the profit after deducting the management fee (Mudarib share).

99. **Answer: A** **Chapter 9, Section 2**

The need for strong internal control and risk management is a reason why banks are a special case as regards corporate governance.

100. **Answer: C** **Chapter 4, Section 2.3.3**

Qard is a benevolent loan and, although the receiving party has the obligation to repay the principal, there is no compensation for the lender.

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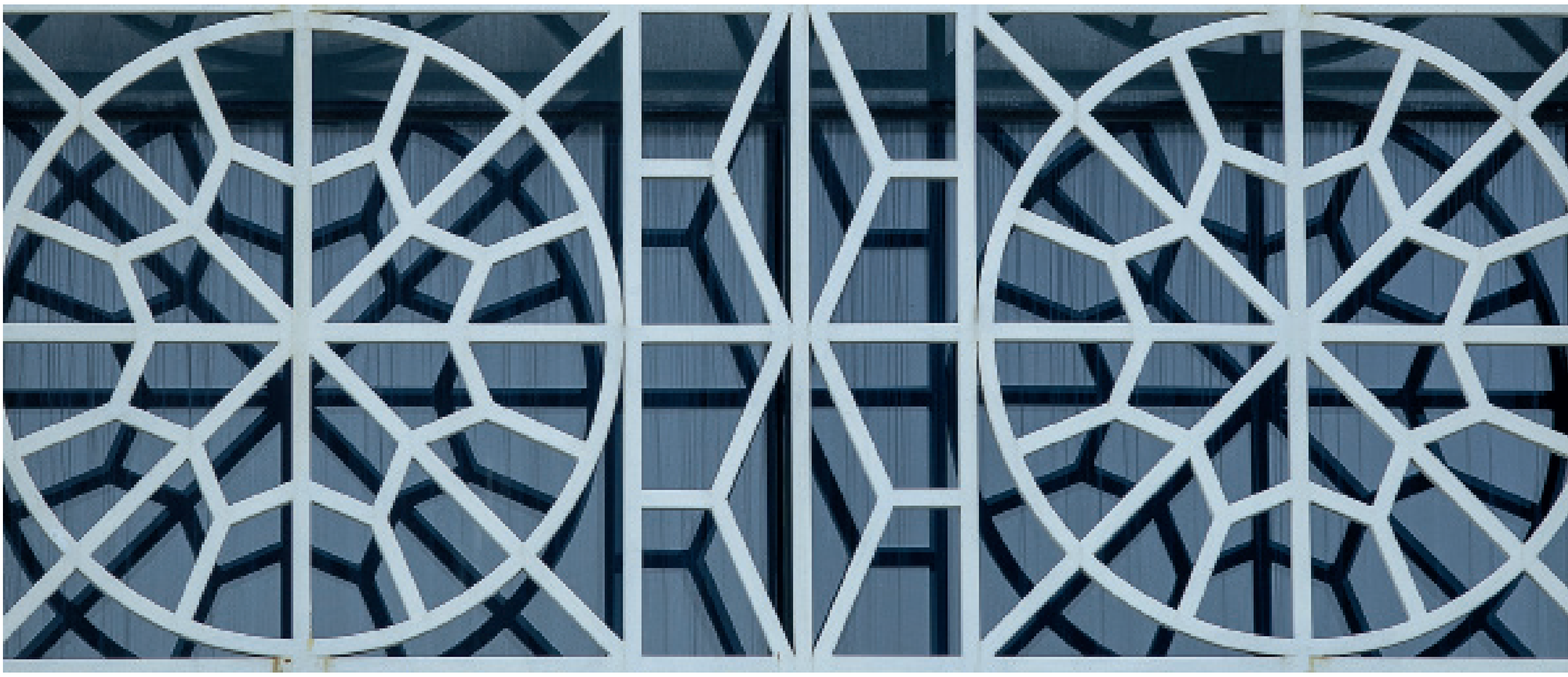

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https://us.spindices.com/index-family/shariah/dow-jones-islamic-market

Dubai International Financial Centre
www.difc.ae

Failaka's iFunds Review
www.failaka.com

Fitch Ratings
www.fitchratings.com

IBF Net
www.iiibf.com

Islamic Development Bank
www.isdb.org

Islamic Finance
www.islamicfinance.de

Islamic Finance Information Services
www.globalcapital.com/emerging-markets/islamic-finance

Islamic Financial Services Board
www.ifsb.org

Islamic Finance News
www.islamicfinancenews.com

Journal of Islamic Banking and Finance
www.jibfnet.com

LMC Liquidity Management Centre
www.lmcbahrain.com

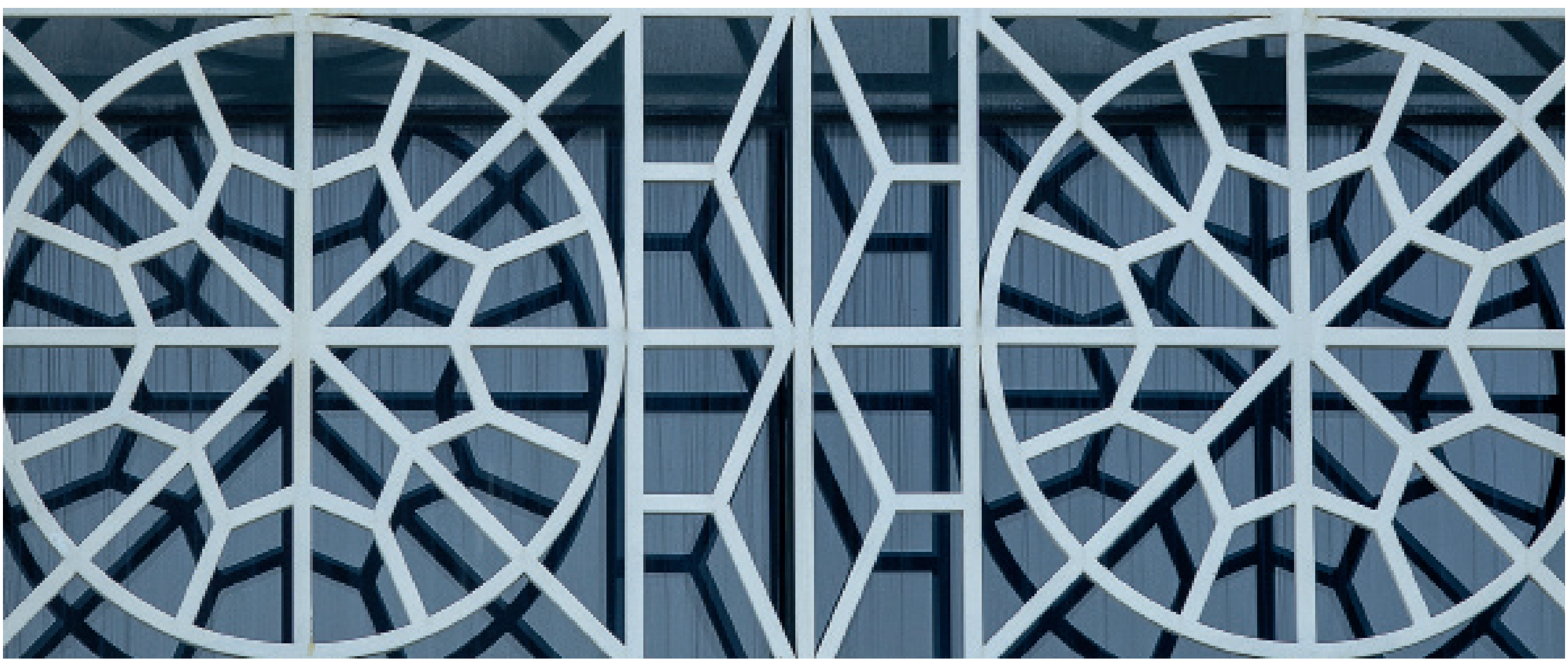
Moody's Investors Service
www.moodys.com

Qatar Financial Centre Authority
www.qfc.qa/en/Pages/default.aspx

Reuters UK
www.reuters.com

Standard & Poor's
www.standardandpoors.com

Syllabus Learning Map



Syllabus Unit/ Element		Chapter/ Section

Element 1	**The Basis of Islamic Banking and Finance**	**Chapter 1**
	On completion, the candidate should:	
1.1.1	Understand the ethical underpinning of Islamic finance: • Islamic moral guidance governing property and wealth given through the Quran and Sunnah • to make charitable distributions: Zakat (obligatory) and Sadaqah (voluntary) • the role of trade and investment in wealth creation • prohibition of Riba, gambling and Gharar	2
1.1.2	Understand the role and the purposes of Shariah	3
1.1.3	Know the sources of the Shariah: • primary sources (Quran & Sunnah) • secondary sources (Ijma', Qiyas, Ijtihad)	3.2
1.1.4	Know the authorities that are able to interpret the Quran and Sunnah and their role: • the scholars within the schools of jurisprudence • the Islamic Fiqh Academy • the Shariah supervisory boards of regulatory and industry institutions	3.2.4

Element 2	**An Introduction to Islamic Banking and Finance**	**Chapter 2**
	On completion, the candidate should:	
2.1.1	Know the development of Islamic finance and banking: • the beginnings of Islamic banking • Islamic banking in the GCC, Africa and the Middle East countries • Islamic banking in Southeast and South Asia and Australasia • Islamic banking in Europe and the Americas	1
2.1.2	Know the constraints and challenges on the development of the Islamic banking and finance industry	1.4
2.1.3	Know the main functions of Islamic banks	2.1
2.1.4	Know the operating structures and organisational forms adopted by the Islamic financial services industry: • the window model • branches • subsidiaries • fully fledged banks	2.2
2.1.5	Know the bodies overseeing and/or supporting Islamic banking and finance: • the regulators (central banks or other authorities) • the standard-setters (AAOIFI and IFSB) • other institutions supporting the development of Islamic finance and banking (IIFM, CIBAFI, IIRA, IILM and IsDB Group)	2.3

Syllabus Unit/ Element		Chapter/ Section
2.1.6	Know other components of the Islamic finance industry: • the Shariah-compliant equity markets • the market for Sukuk (Islamic capital market instrument) • Islamic investment funds • the Islamic insurance companies – Takaful • the Waqf properties (Islamic charitable trust) • the Zakat funds (funds constituted of charitable obligatory tax) • Islamic microfinance • purification of non-permissible income (Haram)	2.4
2.1.7	Know the impact of fintech in Islamic finance	2.4.7

Element 3	**Islamic Principles of Exchange**	**Chapter 3**
3.1	**Islamic Principles Relating to Business** On completion, the candidate should:	
3.1.1	Know the ethical precepts relating to Islamic business	2
3.1.2	Know the Islamic teachings relating to business	2.2
3.1.3	Understand the general principles governing contracts in Islamic law	3
3.2	**Riba** On completion, the candidate should:	
3.2.1	Know the nature of Riba	4
3.2.2	Know the rationale for the prohibition of Riba	4
3.2.3	Understand the different types of Riba	4
3.3	**Gharar** On completion, the candidate should:	
3.3.1	Understand the nature of Gharar	5
3.3.2	Know the rationale for the prohibition of Gharar	5
3.3.3	Understand the different types of Gharar	5
3.4	**Rules of Exchange** On completion, the candidate should:	
3.4.1	Understand the concept of profit and liability	6
3.4.2	Know the rationale for being liable for a good or service	6
3.4.3	Understand the concept of selling what you have	6.2
3.4.4	Know the rationale prohibiting the sale of what you do not have	6.2
3.4.5	Understand the concept of debt for debt	6.3
3.4.6	Know the rationale prohibiting the sale of debt for debt	6.3
3.4.7	Understand the concept of two sales in one	6.4
3.4.8	Know the rationale prohibiting two sales in one	6.4

Syllabus Unit/ Element		**Chapter/ Section**
Element 4	**Basic Contracts and their Treatments**	**Chapter 4**
4.1	**Contract** On completion, the candidate should:	
4.1.1	Understand the fundamentals of Aqd' (contract): • contracting parties • subject matter • consideration • offer and acceptance	2.1
4.1.2	Understand Shariah options of sale	2.2
4.1.3	Understand the classification of, and conditions applied to, contracts with respect to their effect: • valid (Sahih) contracts • voidable (Fasid) contracts • invalid (Batil) contracts	2.3.2
4.1.4	Know the types of contracts with respect to their underlying purpose: • unilateral • bilateral	2.3.3
4.1.5	Understand the concept of Wa'd (promise) and Ah'd (undertaking), the difference between the two concepts and the conditions which make a commercial promise binding	2.4
4.1.6	Know the nature of a Muwaada (bilateral promise) agreement	2.5
4.2	**Contracts of Exchange** On completion, the candidate should:	
4.2.1	Understand the elements and conditions of a contract of exchange	3
4.2.2	Know the problematic sales contracts	3.3
4.3	**Security Contracts** On completion, the candidate should:	
4.3.1	Know the nature of the security contracts: • Hawala • Kafala • Rahn	6
4.4	**Foreign Exchange** On completion, the candidate should:	
4.4.1	Know the issues associated with the debate regarding Sarf (the purchase and sale of currencies)	7
4.4.2	Know AAOIFI's Shariah standards on the sale of currencies	7.3

Syllabus Unit/ Element		Chapter/ Section
4.5	**Accounting Treatment** On completion, the candidate should:	
4.5.1	Understand the conceptual framework of International Financial Reporting Standards (IFRS): • the aims of IFRS • the objectives of financial statements • the qualitative characteristics required from financial statements • the general principles governing decision making and presentation of financial data • the fundamental accounting assumptions underpinning financial statements	8
4.5.2	Understand the need for Islamic accounting standards	8.2
4.5.3	Know the role and responsibilities of AAOIFI	8.2
4.5.4	Understand the conceptual framework of AAOIFI financial accounting statements: • the qualitative characteristics of accounting information	8.2
4.5.5	Know the methods of calculating Zakat and the accounting treatment	8.3
4.5.6	Understand the relationship between form and substance of contracts	8.4

Element 5	**Financial Contracts and Techniques Applied by Islamic Banks**	**Chapter 5**
5.1	**Types of Contracts** On completion, the candidate should:	
5.1.1	Know the differences between the different types of contracts: • debt-based contracts • equity-based contracts • other types of contracts	2
5.2	**Funds in Islamic Banking** On completion, the candidate should:	
5.2.1	Understand the distinction between a conventional bank and an Islamic bank: • the relationship between the bank and its clients • the sources of funds • the use of funds	3.1
5.2.2	Understand the operation of current accounts in Islamic banking	3.2
5.2.3	Understand how funds are used by Islamic banks	4
5.2.4	Understand the Islamic banking model and the challenges it faces	5
5.3	**Wakala** On completion, the candidate should:	
5.3.1	Know the nature of the Wakala (agency contract)	6
5.3.2	Be able to apply the Wakala contract	6
5.4	**Mudaraba** On completion, the candidate should:	
5.4.1	Be able to apply the Mudaraba contract to deposits	7.1
5.4.2	Understand the roles of, and the returns received by, the Rab al Mal and Mudarib under a Mudaraba contract	7.2

Syllabus Unit/ Element		Chapter/ Section
5.4.3	Be able to apply the two-tier Mudaraba contract	7.3
5.4.4	Understand the nature of restricted and unrestricted investment accounts	7.4
5.5	**Musharaka** On completion, the candidate should:	
5.5.1	Be able to apply the partnership contract of Musharaka	8.1
5.5.2	Be able to apply the Diminishing Musharaka contract	8.1.2
5.6	**Murabaha** On completion, the candidate should:	
5.6.1	Be able to apply the Murabaha contract	9.1
5.6.2	Understand the use of Murabaha in export finance	9.2
5.6.3	Know the differences between a Murabaha sale and a loan of money	9.3
5.6.4	Understand the operation of Tawarruq and Commodity Murabaha	9.4
5.7	**Ijara** On completion, the candidate should:	
5.7.1	Be able to apply the Ijara contract	10
5.7.2	Understand the redemption of a lease through Ijara wa Iqtina/Ijara Muntahia Bitamleek	10.1
5.7.3	Understand the use of Ijara Mawsoofa Bil Thimma (forward lease)	10.2
5.8	**Salam** On completion, the candidate should:	
5.8.1	Be able to apply the Salam contract	11
5.8.2	Understand the documentation associated with a Salam contract	11.1
5.8.3	Understand the use of Parallel Salam in managing bank assets acquired under a Salam contract	11.2
5.9	**Istisn’a** On completion, the candidate should:	
5.9.1	Be able to apply the Istisn'a contract	12.1
5.9.2	Understand the reasons for Parallel Istisn’a contracts	12.2
5.9.3	Understand the differences between Istisn’a and Salam contracts	12.3
5.10	**Letters of Credit** On completion, the candidate should:	
5.10.1	Know the use of letters of credit and guarantees in Islamic finance contracts	13
5.11	**Wa’d and Ah’d** On completion, the candidate should:	
5.11.1	Be able to apply the concept of Wa’d (promise) and the concept of Ah’d, (undertaking) and the conditions which make a commercial promise binding	14
5.12	**Arboon** On completion, the candidate should:	
5.12.1	Know how Arboon is used to synthesise option behaviour	15.1

Syllabus Unit/ Element		Chapter/ Section
Element 6	**Islamic Asset Management and Socially Responsible Investing (SRI)**	**Chapter 6**
6.1	**Comparison of Conventional and Islamic Financing** On completion, the candidate should:	
6.1.1	Know the similarities and differences between Islamic finance and Socially Responsible Investing (SRI)	1
6.1.2	Understand the similarities between the UN Sustainable Development Goals (SDGs) and Islamic Finance	1
6.2	**Islamic Investing** On completion, the candidate should:	
6.2.1	Understand the principles of Islamic investing	2
6.3	**Selecting Shariah-Compliant Investments** On completion, the candidate should:	
6.3.1	Know the components of the industry screen	3
6.3.2	Know the components of the financial screen	3
6.3.3	Be able to apply the industry and financial screens	3
6.3.4	Understand what happens when an investment becomes non-compliant	3
6.4	**Funds** On completion, the candidate should:	
6.4.1	Know the definition of a fund	4
6.4.2	Know the definition of an Islamic fund	4
6.4.3	Understand the difference between a conventional and Islamic fund	4
6.5	**Fund Management** On completion, the candidate should:	
6.5.1	Understand the Mudaraba fund management structure	5
6.5.2	Understand the Wakala fund management structure	5
6.6	**Types of Fund** On completion, the candidate should:	
6.6.1	Know the characteristics of fixed-income funds	6
6.6.2	Know the characteristics of lease funds	6
6.6.3	Know the characteristics of commodity funds	6
6.6.4	Know the characteristics of real estate funds	6
6.6.5	Know the characteristics of equity funds	6
6.6.6	Know the characteristics of exchange-traded funds	6
6.6.7	Know the characteristics of hedge funds	6

Element 7	**Sukuk Market**	**Chapter 7**
7.1	**Characteristics of Sukuk** On completion, the candidate should:	
7.1.1	Know the differences between conventional securities and Sukuk	1

Syllabus Unit/ Element		Chapter/ Section
7.1.2	Understand the difference between asset-backed and asset-based Sukuk	1
7.2	**Structuring Sukuk** On completion, the candidate should:	
7.2.1	Understand the basic processes and applications involved in the issuance of Sukuk in different jurisdictions	2.1
7.2.2	Be able to apply Sukuk al Ijara	4.1
7.2.3	Be able to apply Sukuk al Musharaka	4.2
7.2.4	Be able to apply Sukuk al Wakala	4.3
7.2.5	Understand the structure of the following: • Sukuk al Murabaha • Sukuk al Istisn'a • Sukuk al Salam • Sukuk al Mudaraba	4.4
7.2.6	Understand how Green Sukuk is emerging to help tackle environmental and climate change concerns	4.4
7.3	**Sukuk Regulations** On completion, the candidate should:	
7.3.1	Understand the Sukuk regulations	5
7.4	**Capital Market Considerations** On completion, the candidate should:	
7.4.1	Understand the capital market considerations relating to Sukuk: • rating the issue • distribution • tradability and non-tradability	6

Element 8	Islamic Insurance – Takaful	Chapter 8
8.1	**History of Takaful** On completion, the candidate should:	
8.1.1	Understand the position of Islam regarding insurance	1
8.1.2	Understand the origins of Takaful: • the characteristics of mutual insurance • the nature of conventional mutual insurance • the nature of a Takaful undertaking and the need to avoid Gharar through Tabarru' (donation) and Riba through the use of non-interest-bearing assets • the structure of Takaful undertakings: non-profit and commercial	1
8.2	**Types of Takaful** On completion, the candidate should:	
8.2.1	Understand the differences between conventional proprietary insurance, conventional mutual insurance and Takaful	1.2.3
8.2.2	Know the two types of Takaful: • general • life	2

Syllabus Unit/ Element		Chapter/ Section
8.3	**Structure of Takaful** On completion, the candidate should:	
8.3.1	Understand the structure of Takaful: • separation of participants' funds from those of the Takaful operator • the role of Qard Hassan (interest-free loan)	3
8.3.2	Understand the three models for underwriting and managing the investments of the Takaful fund: • Wakala • Mudaraba • the combined model	3.2
8.3.3	Know the Islamic financial contracts used in Takaful	3.3
8.3.4	Understand the rules on distribution of underwriting surpluses in Takaful: • the definition of an underwriting surplus • the nature and allocation of technical provisions • the rules for distributing underwriting surpluses	4
8.4	**Takaful Industry Considerations** On completion, the candidate should:	
8.4.1	Understand the risks associated with Takaful claims and their mitigation: • the nature of technical provisions for general Takaful • implications of the size of the risk pool • the nature of the underwriting and investment fund in life Takaful • internal risk pooling arrangements	5
8.4.2	Understand how Retakaful operates: • the funding of Retakaful • the place of Retakaful • resorting to reinsurance in the absence of viable Retakaful options	6
8.4.3	Know the responsibility of the Takaful operator for Shariah compliance	7

Element 9	Islamic Corporate Governance	Chapter 9
9.1	**Corporate Governance** On completion, the candidate should:	
9.1.1	Know the origins and nature of corporate governance	1
9.1.2	Understand how corporate governance principles are incorporated in Shariah	1
9.1.3	Know the corporate governance mechanisms available to stakeholders to exercise their rights	1
9.1.4	Understand the reasons why banks face special corporate governance challenges	2

Syllabus Unit/ Element		Chapter/ Section
9.2	**Shariah Supervisory Board** On completion, the candidate should:	
9.2.1	Understand the position, remit and characteristics of the Shariah Supervisory Board	3
9.2.2	Know the roles of the Shariah Supervisory Board: • advisory • approval • audit	3
9.2.3	Understand the operational issues surrounding the Shariah Supervisory Board: • membership • governance • delegated responsibility • reporting • other duties	3
9.3	**Corporate Governance Regulations and Standards** On completion, the candidate should:	
9.3.1	Know the Shariah audit regulations	4
9.3.2	Know the governance standards	5
9.4	**Investment Account Holders** On completion, the candidate should:	
9.4.1	Understand the distinction between information rights, control rights and cash flow rights for restricted investment account holders and unrestricted investment account holders	6.1
9.4.2	Understand the distinction between the rights of shareholders and investment account holders	6.2
9.4.3	Understand the distinction between the rights of restricted investment account holders and unrestricted investment account holders	6.3
9.5	**Corporate Governance in Takaful** On completion, the candidate should:	
9.5.1	Understand the corporate governance issues facing the Takaful industry	7

Examination Specification

Each examination paper is constructed from a specification that determines the weightings that will be given to each element. The specification is given below.

It is important to note that the numbers quoted may vary slightly from examination to examination as there is some flexibility to ensure that each examination has a consistent level of difficulty. However, the number of questions tested in each element should not change by more than plus or minus two.

Candidates should note that in Elements 5 and 7 more than one question may be set on certain learning objectives to test that candidates have fully grasped the nature and use of the contracts.

Element Number	Element	Questions
1	The Basis of Islamic Banking and Finance	2
2	An Introduction to Islamic Banking and Finance	3
3	Islamic Principles of Exchange	13
4	Basic Contracts and Their Treatment	15
5	Financial Contracts and Techniques Applied by Islamic Banks	25
6	Islamic Asset Management	12
7	Sukuk Market	11
8	Islamic Insurance – Takaful	9
9	Islamic Corporate Governance	10
Total		**100**

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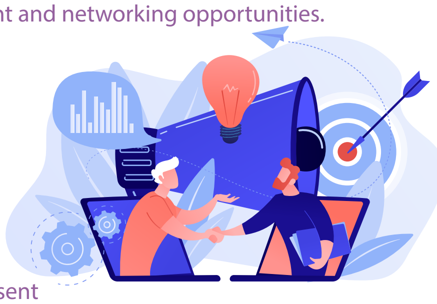

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