WESTERN SYDNEY UNIVERSITY

FATWA SHOPPING AS MODERNISING ISLAMIC FINANCE LAW

By

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In the Name of Allah, the Most Beneficent, the Most Merciful

DEDICATION

This thesis is dedicated to my *qurrota 'ayun*: my beloved wife drg. Nisa Rahmania, my children: Ahmad Mufti Jalaluddin Awwal; Ahmad Alfathir Jamaludin Tsani, and Alya Khaira Tsalitsa. My children, I have created a path for you to follow someday. Thank you all for your love and support.

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STATEMENT OF AUTHENTICITY

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

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

March, 2019

[redacted]

Yudi Ahmad Faisal

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GLOSSARY OF ARABIC TERMS

Al-Bay	: Sale contract
Alkharaj bi al Dhaman	: Profits related to risks or liabilities
Ayn	: Specific unique property
Bay al-Urbun	: Down Payment Sale
Dayn	: Debt
Dhimmah	: Legal capacity
Fatwa	: An Islamic legal verdict issued by Muslim jurists on a specific issue
Fiqh	: Islamic jurisprudence
Gharar	: Excessive and Unnecessary risks, uncertainty, deception
Halal	: Lawful
Hillah	: Legal stratagem
Ijarah Wa Iqtina	: Lease to purchase
Ijma	: Consensus among Muslim scholars on a particular case
Ijtihad	: Individual intellectual effort and wider independent reasoning
Ikhtilaf	: Divergence of opinions
Kafalah	: Suretyship or guarantee
Khiyar al-Shart	: Stipulated Option
Madhab	: Islamic school of thought, plural: madhahib
Mafsadah	: Adverse consequences
Maslahah	: Public Interests
Maysir	: Speculation, gambling
Mudharabah	: Type of profit and loss sharing contract
Mufti	: Muslim jurist
Muqayyadah	: Restricted mandate
Murabahah	: Cost plus profit sale
Musawama	: Type of sale contract
Musharakah	: Type of profit and loss sharing contract
Musharakah Mutanaqisah	: Diminishing Partnership
Mutlaqoh	: Unrestricted mandate
Qard al-Hasan	: Benevolent loan
Qiyas	: Analogical reasoning
Rabbul Mal	: Capital Provider
Riba	: Usury, interest, unlawful gains
Salam	: Forward sale
Sukuk	: Islamic version of bonds or securitisations
Tahawwut	: Hedging
Takaful	: Islamic insurance

Talfiq	: Selection
Tawarruq	: Reverse murabahah
Ta'widh	: Compensation
Uqud Mu'awadah	: Commutative contract
Uqud Tabarru	: Donative contracts
Wa'ad	: Unilateral promise
Wakalah	: Agency contract
Waqf	: Endowment or trust fund
Zakat	: Mandatory almsgiving fund

ABREVIATIONS AND ACRONYMS

AAOIFI	: Accounting and Auditing Organization for Islamic Financial Institutions
ADIs	: Authorised Deposit Taking Institutions
APRA	: Australian Prudential Regulation Authority
ASIC	: Australian Securities and Investment Commission
ATO	: Australian Taxation Office
BCBS	: Basel Committee on Banking Supervision
BI	: Bank of Indonesia
BIS	: Bank of International Settlements
CSA	: Credit Support Annexes
DCR	: Displaced Commercial Risk
DFT	: Designated Future Transactions
DSN-MUI	: National Shariah Council (*Dewan Syariah Nasional*) of Indonesian Ulama Council
ICC	: Indonesia Civil Code (*Kitab Undang-Undang Hukum Perdata*)
ICFAL	: Islamic Cooperative Finance Australia Limited
IDB	: Islamic Development Bank
IFIs	: Islamic Financial Institutions
IFSB	: Islamic Financial Services Boards
IIFM	: International Islamic Financial Markets based in Bahrain
IMF	: International Monetary Fund
IOSCO	: International Organization of Securities Commissions
IRR	: Investment Risk Reserve
ISDA	: International Swap and Derivatives Association
JFX	: Jakarta Future Exchange
KPS	: *Komite Perbankan Syariah* [Sharia Banking Committee]
LIBOR	: London Interbank Offered Rate
LLC	: Limited Liability Corporation
MCCA	: Muslim Communities Cooperative of Australia
Non-IDIs	: Non-Authorised Deposit Taking Institutions
OIC	: Organisation of Islamic Cooperation
OJK	: *Otoritas Jasa Keuangan* [Indonesian Financial Services Authority)
OTC	: Over-the-Counter Derivatives
PER	: Profit Equalization Reserve
RBA	: Reserve Bank of Australia
RIA	: Relevant Index Amount
RWA	: Risk Weighted Asset
SAC	: Shariah Advisory Council of Bank Negara Malaysia
SSBs	: Shariah Supervisory Boards

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ABSTRACT

The thesis examines the evolving role of Islamic financial instruments in the modernisation of Islamic financial practices. Crucial to this process of modernisation is the proper appreciation of the impact and importance of selective Sharia opinions termed *fatwa* shopping in this thesis. *Fatwa* shopping involves selecting, reviewing, and combining Islamic juristic rulings in the form of *fatwas* (the plural of *fatwa* in English and it is also referred to as *fatawa* in Arabic*)*. Using this approach, medieval Islamic rules and contracts are utilised on a functional basis and as a means of developing modern functional equivalents.

The thesis argues that *fatwa* shopping continues the classical tradition of doctrinal selections (*talfiq*) made by Muslim jurists to find an interpretation that best fits the circumstances. The application of this approach finds expression in the views of Muslim scholars and Islamic Financial Institutions (IFIs) and their Sharia Supervisory Boards (SSBs) reviewing and selecting various Islamic juristic rulings from different schools of Islamic jurisprudence to certify modern Islamic financial products and services. This approach recognises that medieval Islamic commercial contracts have significant problems in terms of feasibility and practicality in modern banking transactions. The thesis takes a middle path between legitimacy and practicality by allowing the development of Islamic financial instruments that obey Islamic juristic rulings but also take into account economic and financial considerations.

Since financial institutions including IFIs are crucial to economic development and invariably involve risks to the economy, institutions, and consumers, regulation plays an important role in ensuring financial stability and risk management. Thus, it is important to contextualise the position of Islamic finance within the global financial system. Islamic financial institutions cannot be separated from the general regulatory framework and the management of risk. A key justification for the regulation of banking and financial institutions is to mitigate and prevent risks that may jeopardise the industry and the whole economy. This is reflected in both the public interest and economic theories of regulation. The government has a central role in risk regulation to protect the public from adverse consequences of banking and financial transactions through regulations that are primarily concerned with specifics risk in the financial industry. In the case of IFIs, it is not only government that has a central role in the development of financial products and the regulation of risks in Islamic finance. SSBs, as non-governmental bodies, provides substantive determinations as to whether a particular financial activity or instrument is Sharia compliant. Unlike conventional products, the character of Islamic financial products relies on Sharia compliance.

One of the main challenges for Sharia compliance is whether *fatwas* can accommodate modern risk management instruments. Risk management instruments are pivotal to managing and hedging risks. These include various forms of derivatives as well as insurance and limited liability corporations. As modern derivatives and insurance are considered essential to deliver benefits to the financial industry and the economy as a whole, modern Islamic finance should be able to adapt to this economic and risk management environment. Despite disagreements

Muslims scholars on whether modern instruments comply with Islamic law, the method of selective Sharia rules or *fatwa* shopping provides a mechanism for deriving modern *fatwas* on which to base Sharia compliant equivalents on derivatives, insurance, and limited liability corporations.

In order to assess how IFIs actually operate in a financial system, the thesis examines Islamic finance in two jurisdictions: Indonesia and Australia. These two jurisdictions are selected as providing a comparison of a system that makes little or no accommodation for a very small Islamic finance industry (Australia) and Indonesia where *fatwas* are recognised in the local banking system; the validity of Islamic financial instruments depends not only on satisfying conventional regulatory requirements but also on SSBs certification of Sharia compliance. The legitimacy of local Islamic financial products and services operates through a non-state agency, Sharia Advisory Boards – Indonesian *Ulama* Council. They set their own juristic rules. The *fatwas* produced by that body play an important role in harmonizing Sharia opinions in the Indonesian financial system. Local banking acts direct Indonesian regulators to adopt *fatwas* as a national benchmark. In addition, *fatwas* of that governing body allow the adoption of various juristic rules from different Islamic schools in defining local *fatwas* on Islamic finance. In contrast, in Australia there is decentralised Sharia regulation so that local IFIs develop their own Sharia justifications for products and services offered to the markets. Local regulators have no concerns on Sharia compliance aspects of those local IFIs.

The thesis concludes that that selective Sharia rules or *fatwa* shopping has contributed to the modern development of Islamic finance. The method has been successful in harmonizing legitimacy and practicality of Islamic financial transactions with the needs of a modern financial system.

CHAPTER 1: INTRODUCTION

1.1 Thesis Overview

This thesis explores the growing practice in the modern Islamic finance industry to review, select, and combine rulings emanating from the various interpretations of Islamic law. The purpose of this is to provide legitimacy for the structuring of Islamic financial instruments for use in the market place. This is referred to in the thesis as *fatwa* shopping. Islamic finance itself refers to the means by which financial institutions and corporations conduct financial transactions in accordance with the principles of Sharia, or Islamic law.[1] The terms Sharia and Islamic law are used interchangeably. Sharia compliance is the foundation for banks providing Islamic products and services. Since the receipt and payment of interest is religiously prohibited (*haram*).[2] Islamic banks avoid this by adopting particular forms of Islamic contracts and arrangements, i.e. *Musharakah*, *Mudharabah,*[3] and other mechanisms. These Islamic contracts are structured to produce a sharing and collaborative mechanism in the provision of

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[1] This law is derived from the primary sources namely the Qur'an and the practices and saying of the Prophet Mohammad (*Hadits*) and from the secondary sources of Islamic law: *Ijma* (consensus among *ulama* or Moslem scholars) and *qiyas* (analogical reasoning). Shariah encompasses all daily activities pertaining to the relationship between man and God, man and man, and man with its environments including animals. The great part of Shariah is found in the corpus of *fiqh* which often referred in the Western legal tradition as the science of Islamic law or jurisprudence, see H. Patrick Glenn, *Legal Traditions of the World*, Fourth Edition (Oxford University Press, 2010) 184-236.

[2] Discussion about whether interest is prohibited and reflects *riba* in the Quranic text has been massively debated in the contemporary discussion of Islamic economic and banking system. Mahmoud El Gamal, *Islamic Finance, Law, Economics, and Practice* (Cambridge University Press, 2006) observes the controversy of so called "Islamic" financial products. Meanwhile, Abdullah Saeed, Islamic Banking and Interest (Brill, 1999) and Abdul Kadir Thomas (eds), *Interest in Islamic Economics: Understanding Riba* (Routledge, 2006) observe the questions of *riba* and the challenges facing of this term in the contemporary Islamic Banking and Finance industry.

[3] This thesis uses *Bahasa Indonesia* for transliteration. *Musharakah* is a contract between two parties whereby both parties contribute agreed proportion of capital in running a business. The profit is to be distributed according to the agreement meanwhile the loss is to be borne in proportion to capital contribution, see Muhammad Taqi Usmani, 'The Concept of *Musharakah* and Its Application as an Islamic Mode of Financing' (1999) 14(3) *Arab Law Quarterly*, 210. Meanwhile *Mudharabah* is a contract between two parties, one is a capital owner (*shahibul maal*) contributes money, and the other is an agent-manager (*mudharib*) contributes times and managerial skills. These two parties agree to commence a business venture. The profit will be shared between the two based on the profit ratio decided at the beginning of the contract and the loss will be borne by the capital owner, in Zamir Iqbal and Abbas Mirakhor, *An Introduction to Islamic Finance: Theory and* Practice (John Wiley & Sons (Asia), Pte Ltd, 2007) 110.

finance.[4] Those contracts generate distinctive financial contractual arrangements, and affect the nature of risks, legal, governance, capital and liquidity requirements governing Islamic financial services.[5]

Fatwa shopping is one of the most controversial issues in modern Islamic finance but surprisingly has not yet attracted much attention by Islamic finance scholars.[6] Research in Islamic finance has disproportionately focused on agency theory in the Sharia certification process whereby *fatwa* shopping involves conflict of interests between *fatwa* seekers including bankers and finance institutions and Muslim jurists who issue *fatwas* on a particular product and service.[7] The thesis aims to fill this vacuum by critically appraising a classical method in Islamic jurisprudence that is often used to select, review, and combine various Sharia opinions to justify a desired outcome in a particular case called *talfiq*, and examining the relationship between this traditional methodology in Islamic law and modern practices of *fatwa* shopping in contemporary Islamic finance.

[4] Nicholas D. Ray, *Arab Islamic Banking and the Renewal of Islamic Law* (Graham & Trotman, 1995) and Mervyn K. Lewis and Latifa M. Algoud, *Islamic Banking* (Edward Elgar, 2001) 29.

[5] Mervyn K. Lewis and Latifa M. Algaoud, *Islamic banking* (Edward Elgar, 2001) 39-60, and Habib Ahmed, *Product Development in Islamic Banking* (Edinburgh Univ. Press, 2010) observed that Islamic contracts, its development and application in the Islamic banking industry. The nature of Islamic banking risks and its implications of the risk assessment method is discussed in Simon Archer and Rifat Ahmed Abdel Karim (eds), *Islamic Finance: the regulatory challenge* (John Wiley and Son, 2007) and Hennie van Greuning and Zamir Iqbal, *Risk Analysis for Islamic Banks* (the World Bank, 2008). Meanwhile, the governance structure of Islamic banks is explored in Zulkifli Hasan, *Shari'ah Governance in Islamic Banks* (Edinburgh University Press Ltd, 2012), and Zafar Iqbal and Mervyn K. Lewis, *An Islamic Perspective on Governance* (Edward Elgar, 2009).

[6] Various sources have identified the issue of *fatwa* shopping under the discussion of the Islamicity issues of Islamic finance transactions, see, eg, Barry Rider, 'Corporate Governance for Institutions offering Islamic Financial Services' in Craid R. Nethercott, et al (eds), Islamic Finance: Law and Practice (Oxford University Press, 2012) 172; Malik, M. Shaukat, Malik Ali, and Mustafa Waqas, 'Controversies that Make Islamic Banking Controversial: An Analysis of Issues and Challenges' (2011) 2(1) *American Journal of Social and Management Sciences* 41; Ahmed, above n 5; Wafik Grais and Matteo Pellegrini, 'Corporate Governance and Shariah Compliance in Institutions Offering Islamic Financial Services', (2006) 4045 *World Bank Policy Research Working Paper* 1, 9; Volker Nienhaus, 'Human Resources Management of Islamic Bank: Responses to Conceptual and Technical Challenges' in Simon Archer and Rifat Ahmed Abdul Karim, Islamic Finance: The Regulatory Challenge (John Wiley and Sons, 2007) 395; Mahmoud El-Gamal, 'Contemporary Islamic Law and Finance: the Tradeoff between Brand-Name Distinctiveness and Convergence' (2008) 1(6) *Berkeley Journal of Middle Eastern and Islamic Law* 195, 199; M. Fahim Khan, 'Setting Standards for Shariah Application in the Islamic Financial Industry' (2007) 49(3) *Thunderbird International Business Review* 285, 286; and Saad Azmata, Michael Skully, Kym Brown, 'The Shariah compliance challenge in Islamic bond markets' (2014) 28 *Pacific-Basin Finance Journal* 47.

[7] For the first discussion on this issue, see Grais and Pellegrini, above n 6, 9, Nienhaus in Archer and Karim, above n 6, and El Gamal, above n 6, 199.

The practice of *fatwa* shopping is closely related to risk management and regulatory demands in modern Islamic finance. Conventional counterparts have well-developed risk management processes as well as instruments that identify, measure, and manage various risk exposures. In contrast, Islamic banking and finance struggles to reconcile risk management demands by business entities both nationally and globally with the seemingly rigid stances of some Sharia scholars in the issue of Islamic legal edicts (*fatwas*). These restrictive approaches have effectively resulted in the proscription in the usage of financial instruments designed for risk management purposes even if utilised for legitimate commercial reasons.

The development of Islamic finance puts in sharp focus the elaboration and implementation of corporate strategies not only for the competitiveness of enterprises seeking to operate within the confines of the economic doctrine of the Sharia, but also for their survival in the international market place. It has been widely acknowledged that the Islamic finance may not be sustainable in the long term without a proper risk regulation and management framework that can effectively deal with the complex risks that exist in today's globalised economy.[8] A particular challenge for the Islamic financial industry is financial stability.[9]

This thesis first, examines the nature, causes, and consequences of *fatwa* shopping in the fields of Islamic banking, Islamic hedging and derivatives, Islamic insurance (*takaful*), and in relation to limited liability in Islamic law. Secondly, it examines how the practice of *fatwa* shopping contributes to the modern development of medieval Islamic juristic rules and provides a mechanism for the development of modern Islamic products and services which meet the needs of modern financial industry. Through the process of selection and adaptation,

[8] See, Muhamad Umer Chapra, and Tariqullah Khan, "Regulation and Supervision of Islamic Banks" (2000) 3 *Islamic Development Bank Review*, Islamic Research and Training Institute, and Moody's, "Derivatives in Islamic Finance: Examining the Role of Innovation in the Industry" (Moody's Global Corporate Finance, 2010).
[9] Habib Ahmed, Mehmet Asutay and Rodney Wilson, *Islamic Banking and Financial Crisis: Reputation, Stability, and Risks* (Edinburg University Press, 2014) 1.

those traditional contracts can be re-engineered to accommodate modern financial transactions. And thirdly, the thesis suggests regulatory mechanisms that can be employed in Islamic finance to deal with the issue of conflicts in Sharia interpretations that are often claimed to inhibit standardisation and Sharia harmonisation in the industry.

The methodology used throughout this thesis is based on doctrinal legal research. It adopts a positivist perspective in evaluating relevant laws and regulations. This approach views law and its inherent methodology as a self-contained system not requiring a separate research methodology.[10] Using doctrinal legal research, the thesis analyses and evaluates the meaning and effectiveness of legal doctrine particularly Islamic law and how it has been developed and applied in modern financial transactions. The next section starts by providing a background to Islamic finance.

1.2 Development of Islamic Finance

Modern Islamic finance grew rapidly during the second-half of the 20th century.[11] In 1956, the *Tabung Haji*, a state-sponsored pilgrimage fund was established providing Malaysian Muslims a savings scheme free from interest (*riba*) for pilgrims to save for the purpose of performing *hajj* (pilgrimage) to Mecca.[12] This type of fund management became a popular method of collecting and managing the funds for depositors and investing those funds in

10 Terry Hutchinson and Nigel Duncan, 'Defining and Describing What We Do: Doctrinal Legal Research' (2012) 17 *Deakin Law Review* 83, see also See Richard Schwartz, 'Internal and External Method in the Study of Law' (1992) 11(3) *Law and Philosophy* 179, 185.

11 Frederic L. Pryor, "The Islamic Economic System" (1985) 9 *Journal of Comparative Economics* 197, 197, Thomas B. Pepinsky, "Development, Social Change, and Islamic Finance in Contemporary Indonesia" (2013) 41 *World Development* 157, 158, and Shofwan Al Banna and Bhakti Eko Nugroho, "Indonesia's Islamic Economy Project and the Islamic Scholars" (2013) 17 *Procedia Environmental Sciences* 957, 958, Imtiaz A. Pervez, "Islamic Finance" (1990) 5(4) *Arab Law Quarterly*, 259, for critical views on Islamic finance, see Muhammad Anwar, "Islamicity of Banking and Modes of Islamic Banking" (2003) 18(1) *Arab Law Quarterly*, 62.

12 For an interesting review on Islamization of economy in Malaysia, see Patricia Sloane-White, "Working in the Islamic Economy: Sharia-ization and the Malaysian Workplace" (2011) 26(2) *Journal of Social Issues in Southeast Asia* 304.

accordance to Sharia principles.[13] In the 1960s, El Naggar established the *Mith Ghamr* project in a village of Egypt. This was the first experience of Islamic banking based on the profit sharing model.[14] In the Middle East since the 1970s with the rapid increases in oil revenue and wealth, there was growing interest in financial investment based on religious tenets.[15] This led to the establishment of some banking institutions dedicated to serve the needs of Muslim community based on Islamic law. In 1974, the first modern Islamic bank, the Dubai Islamic Bank, was established in the United Arab Emirates. This was followed by the establishment of the Islamic Development Bank in 1975.[16] In the 1980s and 1990s, Islamic finance continued to grow in its traditional markets in the Middle East and South East Asia. This stage witnessed the involvement of Western banks to establish Islamic windows, branches, subsidiaries, and joint ventures to access lower cost Islamic finance. In the late 1990s, there was also growing number of Arab-based Islamic banks opening branches, subsidiaries, and joint ventures overseas in Malaysia, London, and some European countries. In the 2000s, there were two significant Islamic finance developments. The first was the expansion of Islamic finance in European countries, Africa, East Asia, and Americas.[17] Second was the introduction of financial and governance infrastructure for Islamic Financial Institutions (IFIs). These included the establishment of Accounting Auditing Organization for Islamic financial institutions (AAOIFI), the Islamic Financial Services Boards (IFSB), and International Islamic Financial Markets (IIFM). In the area of risk management, there were also a growing number of over-the-counter (OTC) Islamic derivatives to mitigate the risks of IFIs with the involvement of

[13] Ibid.
[14] Lena Rethel, "Whose Legitimacy? Islamic Finance and the Global Financial Order" (2011) 18(1) *Review of International Political Economy* 75.
[15] Ibrahim Warde, *Islamic Finance in the Global Economy* (Edinburgh University Press, 2001).
[16] Rethel, above n 13, 82.
[17] Alfred Kammer, et al, "Islamic Finance: Opportunities, Challenges, and Policy Options" (2017) 15(5) *IMF Staff Discussion Note*, 11.

International Swaps and Derivatives Associations (ISDA). These are discussed in chapters 2, 5, and 6.

Today, Islamic finance continues to grow with opportunities of becoming a player in international finance. It has been described as the industry that is “too big to be ignored”.[18] At the end of 2017, Islamic financial assets globally were worth at US $2.44 trillion.[19] These assets are predicted to continue to grow to US$3.4 trillion by the end of 2018 and available in 76 different countries.[20] This rapid growth has raised concerns by international financial authorities and organizations such as International Monetary Fund (IMF), World Bank, the Basel Committee on Banking Supervision (BCBS), and International Swap and Derivatives Associations (ISDA). Their concern is to ensure that Islamic financial institutions are financially stable, have sound products and have an effective service base providing a level playing field for the Islamic banking industry regionally and globally.[21] The thesis addresses these concerns particularly in relation to the needs for derivatives instruments in the Islamic financial industry. This is discussed in chapters 5 and 6. Central to the thesis is the importance of *fatwas* in establishing standard requirements for modern Islamic financial transactions which is examined in the next section.

[18] Maher Hassan and Jemma Dridi, ‘the effects of the Global Crisis on Islamic and Conventional Banks: A comparative Study’ (2010) 10 (201) *International Monetary Fund Working Paper.*
[19] Thomson Reuters, “Islamic Finance Development Report 2018: Building Momentum” [20/01/2019] https://repository.salaamgateway.com/images/iep/galleries/documents/20181125124744259232831.pdf.
[20] Ernst and Young, *World Islamic Banking Competitiveness Report 2013-2014* (Report, Ernst and Young, 2014).
[21] Archer and Karim, n 6, 2.

1.3 *Fatwa* as a Driving Force of the Development of Islamic Law

The development of Islamic law is greatly influenced by the roles of Muslim jurists (*mufti*) in *fatwa* (*fatawa* is a plural form of *fatwa*)[22] issuance for the changing needs of Muslim societies. A *fatwa* is an Islamic legal verdict issued by a qualified Shariah jurist or a *mufti*. A *fatwa* consists of a question (*su'al, istifta*) addressed to a *mufti*, together with an answer (*jawab*) provided by that *mufti*.[23] The *fatwa* was instrumental in bringing legal change and the development of Islamic law.[24] According to Schacht, the founders of Islamic legal schools (*madhahib*) in Sunni tradition were actively engaged in *ifta*, an activity of giving *fatwa*.[25] Islamic law reflects social and economic conditions and has grown with developments of state and society,[26] where *fatwas* played its role as a social and legal instrument.[27]

From the beginning, a *fatwa* was essentially private with no official sanction for those who abandoned it. The authority of a *fatwa* was based on the reputation of a Muslim legal scholar whose opinions were voluntarily followed by a laymen with no official sanction.[28] Following the final establishment of major Islamic legal schools (*madhahib*) in Sunni traditions, Islamic governments started to appoint prominent Muslim scholars as official *muftis* to provide general public opinions on religious issues.[29] Howeer, these official *muftis* had no monopoly of giving *fatwas*, and the private practice of *ifta* (a giving *fatwa*) by un-official scholars has never stopped.[30]

[22] *Fatawa* is a plural form of *fatwa*. see Wael B. Hallaq, 'From *Fatwa* to Furu: Growth and Change in Islamic Substantive Law' (1994) 1(1) *Islamic Law and Society* 29, 31.
[23] Hallaq, above n.22.
[24] Joseph Schacht, *Introduction to Islamic Law* (Oxford: Clarendon Press, 1964) 75.
[25] Ibid.
[26] Ibid.
[27] Hallaq, above n. 22, 31.
[28] Schacht, above n.24, 74.
[29] Ibid.
[30] Ibid.

In modern Islamic legal tradition, *fatwa* has become an accelerating factor in the growth and change in modern Islamic financial law. Hallaq suggested that any inquiry into the historical evolution and later development of Islamic legal doctrine must take account of the *mufti*(s) and their *fatwas*.[31] As will be discussed thoroughly in this thesis, modern Islamic financial transactions are derived from various *fatwas* either from individual *mufti* or organisations such as the International Islamic Fiqh Academy of the Organization of Islamic Cooperation (OIC) and Sharia Advisory Boards of Indonesian Ulama Council.

1.4 *Fatwa* as the Source of Islamic Legitimacy

Modern Islamic finance institutions derive their Islamic legitimacy from various *fatwa(s)*[32] issued by Muslim jurists or scholars.[33] In issuing those *fatwas*, these scholars seek various juristic opinions from similar or different Islamic legal schools (*madhahib*) to structure Islamic financial transactions for use in the market place. These scholars may operate as members of a Sharia Board or Sharia Committee in Islamic Financial Institutions (IFIs). At the macro level, scholars are employed by government bodies such as Central banks (as the peak regulator) to issue a *fatwa* for *Shariah* standards in Islamic products and services in a particular jurisdiction.[34] At the micro level, scholars are hired by individual banks but may have different

[31] Ibid, 65.
[32] *Fatawa* is a plural form of *fatwa*. A *fatwa* declaration is an Islamic legal verdict issued by a qualified Shariah scholars or mufti. A *fatwa* consists of a question (*su'al, istifta*) addressed to a mufti, together with an answer (*jawab*) provided by that mufti, see Wael B. Hallaq, 'From *Fatwa* to Furu: Growth and Change in Islamic Substantive Law' (1994) 1(1) *Islamic Law and Society* 29, 31.
[33] These scholars are assumed to have hybrid knowledge in Islamic law and a more technical knowledge of finance and economics. The main role of these scholars is to apply *ijtihad* that is interpretations of the Qur'an and the prophetic traditions of Muhammad (*hadits*) as the main sources of Islamic law. To a larger extent, these scholars rely on the interpretations and legal traditions of the four schools of law namely Maliki, Hanbali, Hanafi, and Shafii school of law (*madhahib*).
[34] In Indonesia, *Undang-Undang Nomor 21 Tahun 2008 Tentang Perbankan Syariah* [Law No 21 of 2008 on Islamic banking] [author's trans] requires the central bank to adopt the *fatwa* of the National Shariah Council (DSN) – the *Ulama* Council of Indonesia (MUI), see Tim Lindsey, 'Monopolising Islam: The Indonesian Ulama Council and State Regulation of the Islamic Economy (2012) 48(2) *Bulletin of Indonesian Economic Studies* 253. Meanwhile in Malaysia, the *Islamic Banking*

functions. In Indonesia and Malaysia, the main function of these scholars is to harmonize the banking products with the centralized *fatwas* in their respective countries as well as to supervise the implementation of those *fatwas* in financial products and services. In other countries such as in Singapore, United Kingdom, and Kuwait, these scholars have authority or independent decisions to issue a *fatwa* on Islamic products and services.[35]

Choosing and selecting Sharia opinions as a system of governance for Muslims activities including economic and financial matters has existed since the classical era of Islamic history, "in many times and places, merchants could choose the *madhab* [Islamic legal school] they wished to govern their transactions".[36] The process of choosing and changing religious guidance through *fatwas* is a result of rational debate and critical analysis within Islamic law resulting from changes to the business and social environment. Thus, a *fatwa* can be seen as a bridge to fill the gap between the ideal and the real.[37] However, the character of a *fatwa* largely depends on particular juristic opinions adopted by Muslim jurists in creating that *fatwa*. Thus, character of *fatwa* may vary from static and restrictive to flexible and practical. This is discussed further in various themes related to the thesis particularly in chapter 2, 5, 7, and 8.

Islamic legal tradition has provided legal diversity as a source of richness rather than difficulty.[38] This diversity can occur in the absence of a dominant Islamic law authority or institutional hierarchy.[39] As a result, the different interpretations among diverse Islamic schools

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Act 1983 and the *Central Bank of Malaysia Act 2009* established the Shariah Advisory Council (SAC) as the highest authority for reference in Islamic banking and finance matters.

[35] See, Rusni Hasan, et al., 'A Comparative Analysis of Shari'ah Governance in Islamic Banking Institutions Across Jurisdictions' (Research Paper No 50, International Shari'ah Research Academy for Islamic Finance (ISRA), 2013).

[36] Nicholas H.D. Foster, 'Islamic Perspectives on the Law of Business Organisations I: An Overview of the Classical Shariah and a Brief Comparison of the Shariah Regimes with Western-Style Law' (2010) 11 *European Business Organization Law Review* 3, 27.

[37] See Bryan S. Turner and Berna Zengin Arshan, 'Sharia and Legal Pluralism in the West' (2011) 14(2) *European Journal of Social Theory* 139.

[38] Ihsan Yilmaz, 'Inter-Madhab Surfing, Neo-Ijtihad, and Faith-based Movement Leaders' in Peri Bearman, Rudolph Peters and Frank E. Vogel (ed), *The Islamic School of Law: Evolution, Devolution, and Progress* (Harvard University Press, 2005) 195.

[39] Adam Possamai, Bryan S Turner, Joshua Roose, Selda Dagistanli and Malcolm Voyce, 'Defining the conversation about Shari'a: Representations in Australian newspapers', (2013) 61 *Current Sociology* 626.

of thought (*madhahib*) are inevitable. This situation has prompted the practice of "picking up" the most favourable Islamic legal verdicts (*fatwas*). Since, there is no requirement that a restrictive single *fatwa* to be followed. This leaves the individual free to seek guidance from various *fatwa*s from different *madhahib*. From this perspective, a growing practice of what the thesis calls *fatwa* shopping can be seen as an expression of legal pluralism whereby a party openly searches for a particular religious opinion that will satisfy the unique requirements of that individual.[40]

Fatwa shopping is seen as a major issue by Islamic finance scholars. In the absence of the centralised *fatwa* institution that harmonises doctrinal views on Islamic products and services, financial institutions might seek a series of opinions to gain Sharia compliance.[41] Financial institutions may approach a number of Muslim jurists or scholars (simultaneously or consecutively) within the same or from different Islamic legal schools (*madhahib*) to provide religious opinions on financial contracts, products, and services.[42] This procedure enables these institutions to receive a preferred *fatwa* based on their financial objectives.[43] Furthermore, the thesis argues that the practice occurs due to the weak governance arrangements of the Shariah Supervisory Board (SSB) at the institutional level. As argued by Wafiq and Pellegrini, the practice is a result of conflict of interests in the process of Sharia supervision due to a dual relationship of the Sharia Supervisory Board's (SSB) position as the employee and as the supervisor or assessor.[44] Nienhaus[45] and El-Gamal[46] agree adding that its implications may weaken the process of supervision and undermine a sound Sharia pronouncement on Islamic

[40] Bryan S. Turner, 'Legal Pluralism, State Sovereignty, and Citizenship', (2011*)* 7(4) *Democracy and Security* 317, 324.
[41] Rider, 'Corporate Governance for Institutions offering Islamic Financial Services' in Nethercott, et al (eds), above n 6, 172.
[42] See Shaukat, Ali, and Waqas, above n 6.
[43] The product proposal usually comes after banking practitioners, who have conventional financial training and expectations, build a product structure which tends to mimic a conventional financial product or a traditional practice that has been engineered by bankers and lawyers to fit into the conventional banking model. see Habib Ahmed, above n 5.
[44] Grais and Matteo Pellegrini, above n 6, 9.
[45] Nienhaus in Archer and Karim, above n 6, 395.
[46] El Gamal, above n 6, 199.

products and services. It has also been argued that *fatwa* shopping works against Sharia harmonisation in the industry.[47] Differences in Sharia rules result in differences in reporting standards, financial auditing, and accounting treatment.[48] This situation may jeopardize market discipline, as the market is unable to judge efficient players based on transparent and standard disclosures.[49] Furthermore, this practice may increase *Shariah* risk and reputational risk that may reduce market trust.[50] It has also been seen as creating moral hazard between the bank and its Sharia Board since they are involved in a transactional relationship in issuing *Shariah* certification.[51]

In contrast to the existing literature that views *fatwa* shopping as a major problem in Islamic finance, the thesis argues that such a practice is part of the evolutionary process for the modernisation of Islamic finance. It provides a mechanism for reviewing and modernising traditional Islamic commercial contracts to accommodate the needs of modern banking and financial transactions.[52] *Fatwa* shopping reflects legal diversity in Islamic legal tradition which promotes the development of modern Islamic finance enabling Islamic banks and financial institutions to remain competitive with products that meet the needs of consumers, business and global finance. It is one of the common methods used by modern scholars in deriving a Sharia compliant product.[53]

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47 See Malik, Shaukat, Ali, and Waqas, above n 6, 14.
48 Hennie Van Greuning and Z. Iqbal, *Risk Analysis for Islamic Banks* (2008, the World Bank) 176.
49 Khan and Fahim, above n 6, 286.
50 When the external stakeholders such as the investors or customers loss their confidence in Islamic banks due to the inconsistency in the work of Shariah supervisory boards when their decisions contradict each other. Shaukat, et al, above n 6, p.14. See also, Abdul Karim Aldohni, *the Legal and Regulatory Aspects of Islamic Banking: A Comparative Look at the United Kingdom and Malaysia*, (Routledge, 2011) 107.
51 Azmata, Skully, and Brown, above n 6.
52 Razeen Sappideen, 'The modernisation of Islamic Finance', forthcoming.
53 See, Frank E. Vogel and Samuel L. Hayes, III, *Islamic Law and Finance: Religion, Risk, and* Return (Kluwer Law International, 1998) 36, Walid Hegazy, "Fatwas and the Fate of Islamic Finance: A Critique of the Practice of Fatwa in Contemporary Islamic Financial Markets" in S. Nazim Ali (ed), *Islamic Finance: Current Legal and Regulatory Issues* (Islamic Finance Project, Islamic Legal Studies Program, Harvard Law School, 2005) 133-152, Habib Ahmed, above n 5, 47, and Barry Rider, 'Corporate Governance for Institutions offering Islamic Financial Services' in Craid R. Nethercott, et al (eds), above n 6, 172.

1.5 Scope of Research

The primary focus of this thesis is *fatwa* shopping in modern Islamic financial transactions, and how this can successfully balance orthodoxy and efficiency. The efficiency and the need to accommodate modern financial instruments has led to the development of financial instruments bear little resemblance to classical Islamic contracts. The discussion of this thesis is limited to the discourse of Sunni Islamic schools of thought, namely the Hanafi, Maliki, Shafii, and Hanbali schools. Some cases in this thesis have been derived from the case of Indonesia and Malaysia. This research is relevant to jurisdictions offering Islamic finance and services.

1.6 Structure

The thesis consists of ten substantive chapters and a concluding chapter. A summary of each of the chapters follows.

1.6.1 Modernisation of Islamic Financial Transactions

Chapter 2 examines the nature and development of *fatwa* shopping as a method of modernising Islamic finance. This chapter views *fatwa* shopping as an inevitable and legitimate method of developing modern versions of medieval Islamic contractual forms. *Fatwa* shopping is viewed as a source of richness rather than difficulties and a continuation of the classical method of selective Sharia rules known as *talfiq*. This method allows the adoption of a particular interpretation that best fits the circumstances, regardless of whether or not this interpretation come from the scholar's own legal school.

1.6.2 Regulatory Theory

Chapter 3 explains how banking and finance regulation exists for preventing and mitigating financial risks. It discusses banking and finance regulations particularly in relation to risk management. Three different theories of regulation are elaborated to show that banking and finance including Islamic finance and banking is subject to regulatory concerns. One of the justifications for regulation of banking and finance is to mitigate and prevent risks that may jeopardise the industry and the whole economy. As part of the global financial regulatory regime, Islamic financial industry needs to harmonise between Sharia compliant and risk management aspects preventing risks in the industry.

1.6.3 Hedging and Derivatives

Chapter 4 examines the nature, types, and functions of risks and risk taking in the financial industry and discusses contractual agreements to manage and control risk exposures including derivatives instruments such as options, forwards, futures, and swaps contracts.

1.6.4 Derivatives and Islamic Law

Chapter 5 discusses the need for derivatives in Islamic finance. It also examines key objections to derivatives in Islamic finance. Although derivatives instruments are new to Islamic financial law, the thesis examines the possibilities for Sharia compliant derivatives such as the development of so-called Islamic hedging through derivatives-like instruments. It also discusses Sharia compliant derivatives such as Islamic profit rate swaps. These contracts perform a similar economic function to that of conventional interest rate swaps. Interest rate swaps are the basic form of swaps in conventional derivatives that are widely used in derivatives markets. In a modern global regulatory regime, Sharia compliant derivatives need to be consistent with mainstream derivative instruments. This is discussed in chapter 6.

1.6.5 Legal Frameworks for Sharia Compliant Hedging Derivatives

Chapter 6 examines Islamic derivatives particularly the documentation of Sharia compliant hedging transactions called the ISDA/IIFM *Tahawwut* (Hedging) Master Agreement. The discussion focuses on the type of derivatives and hedging transactions that are accommodated in the Master Agreement as well as how it operates. The development of these instruments illustrates how different Islamic juristic rules can be used to develop effective Islamic derivative products which meet the needs of the economy and the financial market as well as Sharia compliance.

1.6.6 Islamic Insurance (*Takaful*)

Chapter 7 discusses how selective Sharia rules (Chapter 2) have been applied in creating Islamic insurance (known as *takaful* in Islamic finance terminology). *Takaful* is imperative as another risk management vehicle in Islamic finance along with derivatives. This chapter reviews and evaluates the Islamic juristic rules that have been utilised to form an Islamic insurance scheme for protection against risks. This scheme has distinctive characteristics compared to its conventional counterparts combining elements of a cooperative and commercial-based insurance with some modifications to conform to Islamic principles.

1.6.7 Limited Liability in Islamic Law

Chapter 8 deals with another pivotal concept in the area of risk management namely the limited liability corporation which is accepted by most of Islamic financial institutions (IFIs). Medieval Islamic juristic rules do not recognise a corporation as a legal entity, 'artificial person'. A modern financial industry is virtually impossible without the corporation as a juristic entity. This chapter critically analyses various Islamic juristic rules on the legitimacy of the corporation. The limited liability corporation is central to development of modern contracts which enable expansion of business and industry as the risks to the capital owners are limited to their capital contribution to the corporation.

1.6.8 Islamic Finance in Indonesia

The focus of Chapter 9 is the regulation of Islamic finance in Indonesia. It is an important illustration of how the regulatory framework has been adapted to formally recognised the important of the Sharia Advisory Boards – Indonesian Ulama Council (DSN-MUI). These bodies, through *fatwas*, play an important role in harmonizing Sharia opinions for local financial institutions. Indonesia regulators are required to adopt their *fatwas* as national benchmarks.

This chapter argues that the *fatwas* of the DSN-MUI are consistent with the global trend of financial *fatwas* allowing the adoption of various juristic rules in defining local Islamic financial forms.

1.6.9 Islamic Finance in Australia

In contrast to the position in Indonesia, in Australia there is no recognition in the regulatory framework of special needs for Islamic compliant products. Chapter 10 provides a general discussion of the regulation of IFIs in Australia. It examines the decentralised Sharia approach where local IFIs develop their own Sharia justifications for products and services offered to the markets. Unlike Indonesia, local regulators in Australia are not concerned with Sharia compliance aspects of those institutions. This creates issues for the industry which will be addressed in this chapter. The chapter also examines how local IFIs adopt the most common Islamic products such as *murabahah*-based financing (the term is referred differently in some jurisdictions). This product is considered as a product of the legalistic approach in Islamic finance (chapter 2).

1.6.10 Conclusion

Chapter 11 concludes that selective Sharia rules or *fatwa* shopping has contributed to the modern development of Islamic finance. The method has been successful in harmonizing legitimacy and practicality of Islamic financial transactions with the needs of a modern financial system and discusses the way forward for future developments in Islamic finance.

The chapter following, chapter 2, examines the nature and development of *fatwa* shopping as a method of modernising Islamic finance.

CHAPTER 2: MODERNISATION OF ISLAMIC FINANCIAL TRANSACTIONS

2.1 Introduction

A key issue for Islamic finance is how to modernise disparate sets of Islamic contracts created by medieval Muslim scholars. This is not a simple task considering that these contracts have fallen into disuse in most Muslim countries,[1] where Islamic rules on financial transactions have been mostly displaced by European law.[2] Modern financial instruments and concepts such as risk management techniques including derivatives, legal personality and corporate limited liability, and insurance, bear no resemblance to medieval Islamic financial transactions.[3] The reason for the focus on modernising medieval financial transactions is because there were accepted as the embodiment of financial transactions which complied with the fundamental principles and precepts of Islamic law.

With this in mind, the pivotal question is how an emerging "Islamic" methodology can adapt Islamic financial instruments to meet modern expectations. The three basic options are: first, one could adopt juristic rules of one particular school of Islamic legal thought (*madhab*). This approach limits the acceptable rules that might be derived from a single school and is restrictive in nature. Second, some fusion of the jurisprudence from the four schools could be undertaken. This provides a solution where there are no criteria on how different juristic rules can be stitched together pragmatically and when the legitimacy of combining juristic rules of the four schools is a matter for debate. This chapter argues that this approach could be

[1] Haider Ala Hamoudi, 'Present at the Resurrection: Islamic Finance and Islamic Law' (2011) *Legal Studies Research Paper Series*, 1109.
[2] Ibid 1109.
[3] These modern concepts have been a focus of this thesis where Islamic finance replicate existing those concepts as closely as possible in legal and economic substance through adjustments of various Islamic medieval juristic rules so as to enable them to comply with Islamic prohibitions in a formal manner.

defensible as a means of meeting the modern needs of Islamic finance. The third possible approach is to adopt a new methodology so that the original sacred texts can be reinterpreted in a way that provides scope for modernising financial instruments – a process referred to as the reopening the gates of *ijtihad* (individual intellectual effort and wider independent reasoning).[4]

It is argued that the most appropriate methodology is the second option. That is, current Islamic financial rules are selected from all four schools on a functional basis, that is, favouring rules that operate best under modern circumstances. This model is often called the pragmatic approach. It utilises a legalistic tool in Islamic jurisprudence termed as *talfiq* (amalgamation of various Sharia rules). It provides a mechanism for reviewing and modernising traditional Islamic commercial contracts to accommodate the need for modern banking and financial transactions.[5]

This chapter proceeds as follows. It begins by examining the source of Islamic rules for Islamic finance particularly the importance of *fatwas* (Islamic legal verdicts) in legitimizing Islamic financial products and services. It then highlights the approaches to modernising Islamic finance to determine the most appropriate method for the development of modern financial contracts and instruments. This is followed by a discussion of the legitimacy of legalistic and selective juristic rules and how this would apply in practice.

[4] Hamoudi, above n 1, 1114-1115.
[5] Razeen Sappideen, 'The modernisation of Islamic Finance', forthcoming.

2.2 Sources of Islamic Finance Law

In theory, the term Islamic finance refers to financial products or services which are based on, or comply with, either the primary or secondary sources of Islamic law. The primary sources are often called revealed sources of Islamic law derived from the Qur'an (the Holy Book) and the Sunnah (traditions based on the hadith, sayings and actions of the Prophet Muhammad, peace be upon him). The secondary sources are the non-revealed sources developed by Muslim jurists after the revelation of the primary ones including *ijma* (consensus on a point of law), *qiyas* (a sub-*ijtihad* species of strict analogical reasoning), and other authoritative sources.[6] In supporting a legal proposition in Islamic law, Muslim jurists in Sunni traditions should be based on either a verse of the primary sources or an interpretation by Muslim jurists on those primary sources.

The Qur'an provides general principles, the Sunnah then operates in a similar fashion to case law, consistent with the Quranic principles. In other words, the Sunna embodies the application of the Qur'an to concrete disputes and hypothetical questions that arose during the prophet's life. If the resolution of a new case cannot be found in the Qur'an and the Sunnah, then scholars will endeasvour to find a Sharia rule by interpreting those primary sources.[7] For instance, in the case of the prohibition of *riba* which is found literally in the Qur'an,[8] there is no dispute on this prohibition among the four major Islamic legal schools (*madhahib*). However, the Qur'an does not clearly define what is *riba*. Classical Muslim jurists then turned to the Sunnah to understand what *riba* was. Although the translation of *riba* in the modern

[6] These sources have been developed by Muslim scholars through a certain methodology called *Ijtihad* as the "maximum effort expended by the jurist to master and apply the principles and rules of *usul al-fiqh* (legal theories) for the purpose of discovering God's law", see Wael B. Hallaq, 'Was the Gate of Ijtihad Closed?' (1984) 16(1) *International Journal of Middle East Studies*.
[7] See David M. Eisenberg, "Sources and Principles of Islamic Law" in Craig R. Nethercott and David M. Eisenberg, *Islamic Finance: law and Practice* (Oxford University Press, 2012) 15-53.
[8] Qur'an, 2: 272-80.

Quranic translation is often referred to as "interest", classical jurist did not draw on such a conclusion.[9] As will be seen below there are various opinions on what qualifies as 'interest'. In modern terminology, interest has many forms ranging from simple interest to compound interest. It is the percentage that a borrower of money must pay to the lender in return for the use of money. In its simplest form, interest is paid on the principal only and for compound interest, it is paid on both the principal and the previously accumulated interest.[10] One of the leading Sunna texts reported in various compilations including Bukhari, Muslim, Tirmidhi, and Ibn Maja is as follows:

> "Gold for gold, silver for silver, wheat for wheat, barley for barley, dates for dates, salt for salt, like for like, hand to hand, and whoever increases it or demands more is engaged in *riba*, both the one who takes it, and the one gives it".[11]

This hadith deals with the prohibition of trade in classical currencies. The application to modern interest-based banking requires an interpretative process as money today is no longer based on any sort of gold standard and in the case of digital currency not based on physical notes and coins.

There are different views on whether the modern banking interest is part of the *riba*. Some argue that interest is not inherently evil and that the term *riba* does not include modern bank interest.[12] For example, Sheikh-al-Azhar Muhammad Sayyid Tantawi issued a *fatwa* when he was the *Mufti* (an official expounder of Islamic law) of Egypt that permits Muslim to access interest-based banks.[13] Mohammad Hatta, one of the founding fathers of Indonesia and

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[9] Haider Ala Hamoudi and Mark Cammack, *Islamic Law in Modern Courts* (Wolters Kluwer, 2018) 480.
[10] Black's Law Dictionary, (9th Edition, West, 2009) 886.
[11] Hamoudi and Cammack, above n 9, 480.
[12] Alexandre Ceiro, "The Social Construction of Sharia: Bank Interest, Home Purchase, and Islamic Norms in the West" (2004) 44(3) *Die Welt des Islams* 351, 352.
[13] The essence of his fatwa is that the bank's depositors should be viewed as passive investors and banks should be viewed as their investment agents. Focusing on the liabilities side of the bank's interest, he viewed that bank's depositors are

a leading economist, argued that bank interest was not identical with *riba* as long as it is used for productivity not for consumptive purposes.[14] The predominant opinion is that banking interest is part of the *riba*. The divergence of opinion does not occur in the fundamental principles of Sharia,[15] but rather in its application to individual cases.[16] This is why some commentators argue that Islamic law has not been received as ready-made rules for implementation.[17] The interpretation of its sources can take the form of a *fatwa* and is in essence an interpretative process.[18] This can lead to different opinions among Sharia scholars.[19]

Since modern financial transactions such as payment of interest do not resemble any classical Islamic contracts, prohibition would not be found in the primary or secondary sources of Islamic law.[20] It is the role of contemporary Muslim jurists and scholars to determine the permissibility of these transactions and any alternatives. The mechanism for Islamic certification of Sharia compliance is through *fatwas* (Islamic legal verdicts). These *fatwas* are developed through a process of selection, interpretation, adaptation, and modification of various Sharia opinions developed by the four prominent Islamic jurisprudence schools (*madhahib*) in Sunni traditions (Hanafi, Maliki, Shaffi, and Hanbali).

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entitled to receive a profit as a percentage of their capital, see Mahmoud A. El-Gamal, 'Interest and the Paradox of Contemporary Islamic Law and Finance' (2003) 27(1) (6) *Fordham International Law Journal* 108, 109-110.

[14] See, eg, Muhammad Hatta, *Beberapa Fasal Ekonomi, Djalan ke Ekonomi dan Bank* (Dinas Penerbitan Balai Pustaka, 1958), 170-187; and Dawam Rahardjo, 'Questions of Islamic Banking in Indonesia' in Mohamed Ariff (eds), *Islam and the Economic Development of Southeast Asia. Islamic Banking in Southeast Asia* (Institute of Southeast Asian Studies 137, 138.

[15] For example, there is no dispute on faith issues, i.e. the unity of Allah, the prophecy of Muhammad, and the authenticity of the Qur'an. There is also no major divergence on how the five pillars of Islam, such as the five daily prayers, fasting, and pilgrimage, are performed.

[16] Ahmed Alkhamees, *A Critique of Creative Sharia Compliance in the Islamic Finance Industry* (Brill, 2017), 96.

[17] Bernard Weiss, 'Interpretation in Islamic Law: The Theory of Ijtihad' (1978) 26(2) *The American Journal of Comparative Law* 199.

[18] Mohd. Daud Bakar, 'The Sharia Supervisory Board and Issues of Sharia rulings and Their Harmonization in Islamic Banking and Finance' in Simon Archer and Rifaat Ahmed Abdel Karim (ed), *Islamic Finance: Innovation and Growth* (Euromoney Books and AAOIFI, 2002) 83.

[19] Ibid.

[20] For instance, a *murabaha* (cost plus profit) financing in Islamic bank does not reflect an original *murabahah* found in classical Islamic commercial law (*fiqh muamalat*). This product is structured by combining several arrangements such as *waa'd* (promise) and *wakalah* (agency contract). This will be further discussed somewhere in this chapter.

The next section illustrates the application of the prohibition of *riba* from an ideal into the current Islamic financial industry.

2.3 From Ideal to Pragmatic: The Road to a Modern Financial System

2.3.1 The Ideal

Modern Islamic finance is more than just a rule that bank interest is unlawful in Islamic law. In the period from the 1950s to the 1960s, Islamic finance was envisaged as part of an ideological project referred to as "Islamic economics". This was meant to be distinct from the dominant paradigms of Marxism and Capitalism.[21] During this period, Islamic finance was directed to securing social justice and economic opportunity for those in need, while simultaneously adhering to Islamic legal and moral principles.[22] Islamic finance was then designed to alleviate the economic hardship of Muslims.[23] It was believed that Islam encompasses not only religious ritual, but also social and economic aspects. Thus, Islam was seen as having its own economic system whilst rejecting Western economic systems notably interest-based financial institutions in Muslim countries.[24]

This view was adopted by Mit Ghamr in Egypt. This local rural saving bank was established in the 1960s creating a profit and loss sharing mechanism to replace interest-based banking system.[25] The institution provided financing to the poorest of potential borrowers not

21 Hamoudi and Cammack, above n 9, 478.
22 See, eg, Walid S. Hegazy, 'Contemporary Islamic Finance: From Socioeconomic Idealism to Pure Legalism' (2007) 7(2) *Chicago Journal of International Law* 581, 583; Abdullah Saeed, 'Islamic Banking and Finance in Search of a Pragmatic Model' in Victoria Hooker and A. Saikal, *Islamic Perspectives on the New Millennium* (Singapore: ISEAS, 2004) 113-129.
23 The Muslim Brotherhood Movements and Ahmad Al-Najjar in Egypt are a starting point to discuss this model, see Hegazy, above n 64, 583, see also Delwin A. Roy, "Islamic Banking" (1991) 27(3) *Middle Eastern Studies* 427.
24 Hegazy, above n 22, 583.
25 Ann Elizabeth Mayer, 'Islamic Banking and Credit Policies in the Sadat Era: The Social Origins of Islamic Banking in Egypt' (1985) 1(1) *Arab Law Quarterly* 32.

served by existing institutions.[26] This local savings bank utilised non-usurious financial products, and implemented profit and loss sharing arrangements in its intermediary role.[27] The founder believed that these equity based partnerships could help to rebuild Muslim societies, not only by financing large projects, but also by promoting entrepreneurship and strengthening small businesses.[28] Thus, it could promote social justice, alleviate poverty, develop the local economy, and provide equal access to credit.[29]

This earliest model relied on Islamic finance to alleviate poverty in Muslim societies. This is contrary to the current practice where the legitimacy of Islamic finance is derived among others from the *fatwa* certification of an authority employed to determine what is prohibited and what is permissible. This is argued in later sections of this chapter and subject to analysis in Chapters 10 and 11. For the idealist, the legitimacy relies on the ability of Islamic finance to protect the broader Muslim polity or the Muslim poor, rather than maximising profits of the investors and shareholders.[30]

In this period, Islamic finance was imagined as a *riba* free (an interest free) model which relied on the mechanism of profit and loss sharing. This mechanism was built on a type of Islamic-based partnership contracts known as *Musharakah* and *Mudharabah*.[31] These contracts create a sharing and collaborative mechanism between what Western financial systems would

[26] Mayer, above n 25, 38.
[27] Rania Kamla and Rana Alsoufi, "Critical Muslim Intellectuals' Discourse and the Issue of Interest (*riba*): Implications for Islamic Accounting and Banking" (2015) 39 *Accounting Forum* 140, 141.
[28] See for instance, Hegazy, above n 22, 585.
[29] M. N. Siddiqui, 'Islamic Banking: True Modes of Financing' (2001) *New Horizon* 15.
[30] He further argues that Sharia compliant commutative structures and mutual cooperatives might support economic development within Muslim communities, see Hamoudi, above n 1, 1120.
[31] *Musharakah* is a contract between two parties whereby both parties contribute agreed proportion of capital in running a business. The profit is to be distributed according to the agreement meanwhile the loss is to be borne in proportion to capital contribution, see Muhammad Taqi Usmani, 'The Concept of *Musharakah* and Its Application as an Islamic Mode of Financing' (1999) 14(3) *Arab Law Quarterly*, 210. Meanwhile *Mudharabah* is a contract between two parties, one is a capital owner (*shahibul maal*) contributes money, and the other is an agent-manager (*mudharib*) contributes times and managerial skills. These two parties agree to commence a business venture. The profit will be shared between the two based on the profit ratio decided at the beginning of the contract and the loss will be borne by the capital owner, in Zamir Iqbal and Abbas Mirakhor, *An Introduction to Islamic Finance: Theory and Practice* (John Wiley and Sons (Asia) Pty Ltd, 2007) 110.

regards as borrowers and lenders.[32] Under a *mudharabah* for instance, a bank is composed of two silent partnerships, first, the bank is financier vis-à-vis those who need capital, who are the working partners. Second, the depositors are the financiers vis-à-vis the bank, which is the working partner. As such, profits flow from the borrowers to the bank, and then to the depositors.[33]

According to the advocates of the idealist approach, the profit sharing mechanism promotes brotherhood whereby a financial institution and its clients share profits or losses in some form of solidarity.[34] This contrasted with the ordinary interest-based finance, where, the capital owners or shareholders earn their money at the expense of labour, irrespective of the amount of money actually earned by labour in its productive activities.[35] A well-known advocate of the idealist approach is Iraqi Shi'i Scholar Muhammad Baqir al-Sadr. He argued that interest taking is not efficient because the financier has no interest in whether or not the venture in which they invest is in fact profitable. The financier is guaranteed a profit either way. The same is not true in a two tiered silent partnership, where the financier only makes a profit if the venture is profitable.[36]

Nowadays Islamic finance has moved away from the ideal of sharing, solidarity, and partnership because of its impracticality and inefficiency. The problems include the issue of higher risk and transactional costs, moral hazards, incentive issues,[37] and the difficulty of

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32 Nicholas D. Ray, *Arab Islamic Banking and the Renewal of Islamic Law* (Graham & Trotman, 1995) and Mervyn K. Lewis and Latifa M. Algoud, *Islamic Banking* (Edward Elgar, 2001) 29.

33 Hamoudi and Cammack, above n 9, 484.

34 These advocates include Egyptian Islamist Sayyid Qutb and Pakistani Abul A'la al-Maududi, see Hamoudi and Cammack, above 9, 484.

35 The influence of Marxist thought on Islamic economics in its origin is perhaps obvious given that given these references to owners of capital and providers of labor and the exploitation of the latter by the former, see Hamoudi and Cammack, above 9, 484.

36 This idea has dominated literatures of Islamic finance where profit and loss sharing has been perceived as the ideal model of Islamic finance, see Hamoudi and Cammack, above n 9, 484, see also Ibrahim Warde, *Islamic Finance in the Global Economy* (Edinburg University Press, 2nd edition, 2014) 146.

37 More discussion on this issue, see Mervyn K Lewis, Mohamed Ariff, and Shamsher Mohamad (ed), *Risk and Regulation of Islamic Banking* (Edward Elgar Publishing, 2014) 28.

competing with conventional financial institutions. In this environment, Islamic financial institutions (IFIs) strive to maintain a level of confidence in its operation. Additional issues arise such as the use of a profit benchmark to interest-based system (this will be discussed in paragraph 5.4.2 of Chapter 5), and displaced commercial risk where Islamic banks are under pressure to pay its investors-depositors a rate of return higher than what should be payable under the "actual" terms of the investment contract. This can occur when a bank underperforms and is unable to generate adequate profits for distribution to the account holders.[38] Nowadays, the profit sharing mechanism is only a minor part of Islamic financial industry.[39]

As Islamic finance has not been successful in operating on the basis of profit and loss sharing principles as advocated by the idealist approach, Islamic finance has been then dominated by the pragmatist as explained below.

2.3.2 Pragmatism in Islamic Finance

Islamic finance has been under pressure to develop equivalents to modern financial instruments. This pragmatic approach not only purifies, but also replicates existing conventional financial practices through adjustments to various medieval Islamic juristic rules.[40] This approach considers the various ways of creating modern Islamic products and services in sometimes unorthodox and liberal ways.[41] This approach recognises problems of

[38] Hennie van Greuning and Zamir Iqbal, *Risk Analysis for Islamic* Banks (World Bank Publications, 2008) 176
[39] Warde, above n 36.
[40] Hegazy, above n 22, 602.
[41] Alexandre Ceiro, 'The Social Construction of Sharia: Bank Interest, Home Purchase, and Islamic Norms in the West' (2004) 44(3) *Die Welt des Islams* 351-375, 352.

feasibility and practicality in the reliance on profit and loss sharing arrangements and seeks to balance practicalities with traditional Islamic principles.[42]

The pragmatic approach has been successful in recasting the conventional financial transactions into Islamic forms through various legalistic tools derived from Islamic jurisprudence.[43] It mimics and replicates most conventional financial products and services. This trend was inevitable because in most jurisdictions Islamic finance co-exists with its conventional counterparts. It also reflects the change in focus for Islamic financial institutions from poverty reduction to investor and bank profits.[44] In such an environment, efficiency, competitiveness, and profitability emerge as main contributing factors for the advance of Islamic financial institutions. This approach is a choice for economic and financial efficiency rather than social benefits of Islamic financial transactions.[45]

The next section discusses the application of the pragmatic approach through the selection of various Sharia rules in structuring and developing modern Islamic finance transactions. Under this method, various Sharia opinions in the form of *fatwas* have been a rich source to structure Sharia compliant financial products and services.

2.4 The Role of Selective Sharia Rules in Modern Islamic Finance

The pragmatic approach utilises various Sharia opinions in *fatwas* as a basis for structuring Islamic banking and finance products. These opinions are derived from four Islamic

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[42] Abdullah Saeed, 'Islamic Banking and Finance in Search of a Pragmatic Model' in Victoria Hooker and A. Saikal, *Islamic Perspectives on the New Millennium* (Singapore: ISEAS, 2004) 113-129.
[43] Hegazy, above n 22.
[44] Abdul Rahim Abdul Rahman, 'Islamic Banking and Finance: Between Ideals and Realities' (2007) 15(2) *International Islamic University Malaysia Journal of Economics and Management* 123, 127.
[45] Mahmoud El Gamal, *Islamic Finance, Law, Economics, and Practice* (Cambridge University Press, 2006).

legal schools (*madhahib*) in Sunni traditions. Thus, the vast compendia of norms and rules developed by medieval Muslim jurists are reviewed, selected, modified, and structured to enable modern financial transactions.

2.4.1 *Talfiq* (Selection of Sharia Opinions) and its Legitimacy

In Sunni traditions, selection and combination of various Sharia opinions is referred to as *talfiq*.[46] Where there is a conflict of opinions in deriving Sharia rules or conflicting *fatwas* given to a lay person (a *muqallid*). It is the absence of strong evidence favouring one over another, the jurists and the layperson can choose between legal opinions,[47] both inside and outside the particular school (*madhab*), that best fits their circumstances.[48] This method is viewed as a "pragmatic eclecticism".[49] This may also involve the adoption of "weak" and discredited opinions from the school, as well as opinions held by other schools enabling the harvesting of opinions from various schools.[50] This method could also lift seemingly "out of date" restrictions, [51] and create a new positive law from the "the virtual dispersal-cum-

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[46] See Ahmed Fekry Ibrahim, "Talfiq/Takhayyur" in the [Oxford] Encyclopedia of Islam and Law, Oxford Islamic Studies Online, [18/03/2018], <http://www.oxfordislamicstudies.com/article/opr/t349/e0082>. Some also refer to the term *takhayyur* as a moderate form of *talfiq*. According to Coulson, "The review of the mass of variant views which the method of takhayyur entailed had brought about a growing consciousness of the human and therefore fallible nature of the bulk of traditional Sharia doctrine; and the validity of the thesis that the juristic speculations of medieval scholars were binding upon modern generations naturally began to be questioned. Traditional principles now appeared in relation to certain problems as a formidable barrier to the further progress that modernism desired", see N. J. Coulson, *History of Islamic Law* (Edinburgh University Press, 2011) 201.
[47] Ibrahim, above n 46.
[48] See Albert Hourani, *Arabic Thoughts in the Liberal Age 1798-1939* (Cambridge University Press, 2003) 152-153.
[49] Ahmed Fekry Ibrahim, *Pragmatism in Islamic Law: A Social and Intellectual History* (Syracuse University Press, 2015).
[50] Wael B. Hallaq, *an Introduction to Islamic Law* (Cambridge University Press, 2009) 117.
[51] Birgit Krawietz, 'Cut and Paste in Legal Rules: Designing Islamic Norms with Talfiq' (2002) 42(1) *Die Welt des Islams, New Series* 3.

restructuring of Sharia law".[52] This alleviates the hardship suffered by a particular doctrine in a particular circumstance,[53] and provides a methodology as the basis for reform.[54]

Talfiq has been commonly utilised by four legal actors: consumers of the law, judges, juris-consultants and author jurists. Consumers of the law include subjects of the law, laypeople and jurists in their capacity as consumers of the law such as litigants and *fatwa*-seekers not only on ritual and moral matters but also for financial and economic matters. The other categories are judges (*qadis*), Muslim jurists (*mufti*), and author jurists (jurists who compile law books, creating, justifying, modifying, and codifying legal doctrine).[55] One would assume that, given the choice, rational legal authorities and subjects would attempt to engage in forum and doctrinal shopping to facilitate their transactions.[56] Some also argue that *talfiq* can be utilised by legislators to write codes that are more compatible with modernity.[57] According to Schacht, it was only the Modernists who abandoned the principle of abiding by the rules of one school when temporarily changing one's madhab (an Islamic legal school).[58] In the case of Islamic finance, *talfiq* might be used by Muslim scholars who are working closely with bankers and financial consultants in confirming the legitimacy of a particular modern financial product.

Although some classical Muslim scholars rejected *talfiq* in deriving Sharia rules,[59] other scholars supported it as legitimate.[60] There are some seventeenth and eighteenth centuries *fatwas* concerning its validity.[61] The 17th century Mufti known as Mar'i, he is said to have

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52 See Hallaq, above n 50, 117.
53 Coulson prefers to use the term *takhayyur* rather than *talfiq*, see Coulson, above n 46, 192.
54 Ibid.
55 Ibrahim, above n 46, 4.
56 Ibid.
57 Norman Anderson, *Law Reform in the Muslim World* (Athlone Press, 1976) 34-80.
58 Joseph Schacht, *An Introduction to Islamic Law* (Clarendon Press, 1964) 68.
59 Those who rejected including Ibn Khaldun arguing that criticized that some mufti satisfying the whims of their fatwa seekers (mustaftis), issued fatwas using the different schools for their arbitrary practice, which lacked any normative guidelines, see Lutz Wiederhold, 'Legal Doctrines in Conflict: The Relevance of Madhhab Boundaries to Legal Reasoning in the Light of an Unpublished Treatise on Taqlid and Ijtihad' (1996) 3 *Islamic Law and Society* 234, 252.
60 See, eg, Ibid; Ibrahim, above n 49, 83; and Wiederhold, above n 59, 247.
61 See for more discussion on this issue in Krawietz, above n 51, 13-15.

been one of the greatest Hanbali scholars in Egypt, issued a *fatwa* declaring "the permissibility of *talfiq* within *taqlid"* although not with the deliberate intention to look around for easy solutions which is sinful.[62] There is support for approaching a jurist from a different school for the purpose of obtaining a more advantageous view which is legitimize by consensus among Muslim scholars.[63] Promotion of common or public interest (*maslaha*) is also relevant in choosing the easier of two things.[64]

In recent times, *Talfiq* was also made permissible when state officials such as judges and legislators, used it to write modern codes.[65] It is also supported by the paradigm of *ikhtilaf* (different opinions among Muslim scholars).[66] Historically, the status of *talfiq* changed once the Mufti Mar'i issued a *fatwa* on the permissibility of the practice of *talfiq*.[67] This *fatwa* recognises that this method is easier and it is normal for people to follow what is easier for them as a practical social need,[68] and in the case of *muamalat* (commercial transactions) is necessary for the interest of people and their well-being.[69] More so where there are no clear texts in the Qur'an and the Sunnah of the Prophet Muhammad disapproving *talfiq*.[70] Changing *madhab* in contemporary Muslim society is seen as inevitable especially for a layperson not strictly adhering to a particular school of Islamic law.[71]

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62 Ibid 16.
63 Wiederhold, above n 59, 253.
64 Krawietz, above n 51, 19.
65 Anderson, above n 57.
66 Following this complaint, it is found in history that a decree was issued ordering muftis to be confirmed by the chief of judges of their madhab. Before this decree, a mufti only after having received formal permission to deliver a legal opinion from a senior representative of his own madhab, see for more discussion on this issue in Wiederhold, above n 59, 252.
67 Ibrahim, above n 49, 86.
68 Ibid 92.
69 Muhammad Tahir Mansoori, 'Is "Islamic Banking" Islamic? Analysis of Current Debate on Sharia Legitimacy of Islamic Banking and Finance' (2011) 50 (3-4) *Islamic Studies 383*, 406.
70 Ibid 407.
71 Nadirsyah Hosen, *Dari Hukum Makanan tanpa Label Halal Hingga Memilih Mazhab yang Cocok* (Noura Books, 2015) 47. While following a *madhab* is required, following a single *madhab* on every issue is not according to many scholars. The obligation of *taqlid* is to follow a school or an authority on a given issue or set of issues. Thus, for example, an individual is permitted to follow the Hanafi school in prayer and the Maliki school in rulings related to zakah (an obligatory almsgiving). This is not interdicted so long as one: (i) actually knows the rulings of the other school on the issue; (ii) does not

2.4.2 Legitimacy of Modern Islamic Finance

One of the pivotal questions for the method of selective Sharia rules in modern Islamic finance is the Islamicity or legitimacy. Some argue that modern Islamic finance has no legitimacy considering that its practice purports to justify modern financial products that bear no resemblance to what which existed at the time the Sharia rules were developed.[72] Some contemporary scholars argue that the raw materials of *talfiq* are the old Sharia rules that have limited use in the modern world.[73] It has been argued that *talfiq* is methodologically wrong because opinions and dicta of individual jurists are taken out of context and recombined according to the user's personal preferences so that an authority is sometimes used to support a conclusion unwarranted by the original author's position.[74] This is further supported by other scholars who argue that there is no legitimacy in modern financial institutions offering Sharia compliant products and services and no validity in the methodology deriving medieval Sharia rules,[75] the mechanism of selective Sharia opinions or "Sharia Arbitrage" makes the Islamic financial industry vulnerable to abuse by elite financiers to increase profit under Islamic brands.[76]

However, it can be argued that the legitimacy and authority in question in is in fact private. Most of the Islamic financial industry adopts privatization of Sharia, through "Sharia Supervisory Boards", or "Sharia Boards," whose review and approval must be obtained for any transaction. This is the case for Indonesia and Australia, see chapter 10 and 11. This private

systematically seek out dispensations (i.e. the easiest position), see Ibn `Abidin, *Radd al-Muhtar* (1:33) and Nabulsi, *Khulasa al-Tahqiq* (56).

72 Haider Ala Hamoudi, 'Jurisprudential Schizophrenia: On Form and Function in Islamic Finance' (2007) 7 *Chicago Journal of International Law* 605, 610.

73 Abdullahi Ahmed An-Na'im, *Toward Islamic Reformation: Civil, Liberties, Human Rights, and International Law* (Syracuse University Press, 1996) 33.

74 Ibid.

75 El-Gamal elaborated extensively on the issue of legitimacy in Islamic finance, see El Gamal, above n 45.

76 Ibid 190.

law model relies on non-state mechanisms and institutions. Thus, the legitimacy of Islamic finance in in fact private and more intimately tied to the logic of modern finance and international financial transactions. Chapter 5 will argue that Islamic finance, for instance, relies on risk management techniques developed by its Western counterparts. The so-called Sharia compliant derivatives are then developed to meet the modern needs of Islamic financial transactions.

As indicated above, Islamic finance has benefited from the application of conventional theories of economics and finance to Islamic finance such as risk management theories as will be discussed in Chapter 4. Although some argue that the application of these theories also create the trade-off between efficiency and legitimacy,[77] there are other normative considerations in Islamic law that might support forgoing efficiency gains for the sake of legitimacy. In some case that will be discussed in the following section, the current method of selective Sharia rules may balance legitimacy and efficiency concerns and ultimately lead Islamic finance from not only an ideological discipline but also a rational discipline influenced by the concept of economic efficiency.

2.5 The Legalistic Approach

The application of selective Sharia opinions in the financial and banking industry is described as follows. If there are two opposite views on a particular contract say scholar A's permissibility in one case and scholar B's prohibition on the same case, the A's view would be chosen.[78] This method enables institutions to combine various Sharia rules in structuring

[77] See El Gamal, above n 45, that extensively discusses this issue.
[78] Habib Ahmed, *Product Development in Islamic Banking* (Edinburgh Univ. Press, 2010), 48-49.

modern Islamic financial products, but also to alter medieval Islamic commercial contracts to meet modern needs.[79] Some commentators note that the method should be at the final stage of the intellectual effort whereby the solution in a particular *madhab* (school) is not able to provide the best possible solution in particular circumstances.[80] This is viewed as a legitimate practice as long as it is exercised through reputable Muslim jurists.[81]

One of the pivotal arrangements utilised in modern Islamic finance for credit facilities is *murabahah* (a cost plus profit sale). In its original version, *murabahah* is a sale contract where a seller discloses all information concerning the object of sale including its original cost, and both parties freely agree on a fixed profit to be added to that cost.[82] In Islamic banking practices, this original form of *murabahah* was an ineffective mechanism for the provision of credit facilities. Islamic bankers needed to combine this contract with other Sharia rules taken from different Islamic schools that bore no relation to the original rules of the *murabahah* itself. The adoption of different rules for the sake of the *murabahah*'s implementation in the banking practices has created different and opposing Sharia opinions. Ultimately, the banking industry has adopted Sharia opinions that support the modified version. The modified version is discussed in the following section.

The resurrection of the *murabahah* contract in modern Islamic finance has emerged as a result of the expansion of Islamic finance post profit and loss sharing to create a credit facility without violating the Islamic prohibition of interest.[83] During the 1970s, Islamic banking

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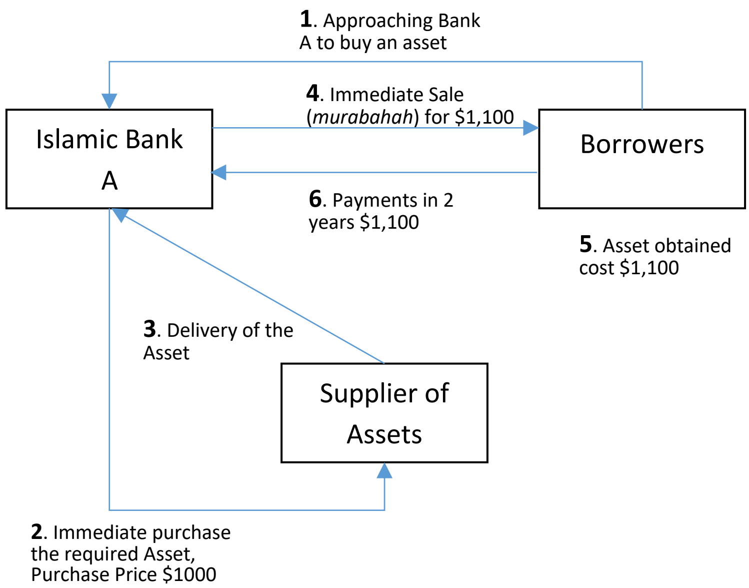
[79] Ghazala Ghalib, "An Analysis of Application of *Talfiq* in Modern Islamic Commercial Contracts" (2013) 10(2) *Policy Perspectives* 133.
[80] Mohd Hafiz Jamaludin and Ahmad Hidayat Buang, "An Analysis of the Views of the Supporters and Opponents in the Usage of Talfiq in Islamic Law" (2017) 25(3) *Jurnal Syariah* 363-394.
[81] Ghalib, above n 79.
[82] See, eg, Nicholas Dylan Ray, *Arab Islamic Banking and the Renewal of Islamic Law* (Graham and Trotman, 1995) 41; and Necmeddin Guney, "*Murabahah* financing revisited: The Contemporary Debate on its Use in Islamic Banks" (2015) 23 *Intellectual Discourse* 495-506, 497.
[83] Walid Hegazy, "Fatwas and the Fate of Islamic Finance: A Critique of the Practice of Fatwa in Contemporary Islamic Financial Markets" in S. Nazim Ali (ed), *Islamic Finance: Current Legal and Regulatory Issues* (Islamic Finance Project, Islamic Legal Studies Program, Harvard Law School, 2005), 147.

advocates searched for an appropriate medieval Islamic contract that may overcome the inefficiencies of profit and loss sharing mechanism as envisaged by the idealist.[84] They found *murabahah* could achieve its objective. Its permissibility has been confirmed by a *fatwa* of Al-Sanhuri, an Egyptian legal scholar who drafted the Egyptian Civil Code.[85] Furthermore, the introduction of *murabahah* may replicate and mimic conventional debt-based products. Debt-based products itself (asset-backed financing) are considered low risk and resemble familiar conventional fixed-interest rate products in their risk-return profile.[86]

In order to be applied in modern Islamic finance, the original *murabahah* contract needs adjustments. Islamic bankers through the approval of their Sharia Advisory introduce additional Sharia rules including a *wakalah* contract (agency) and *wa'ad* (a unilateral promise). The following diagrams explain these modifications.

[84] Ibid.
[85] Hegazy in Ali (ed), above n 83, 147-148.
[86] Ibid 168.

Figure 2.1. Original *Murabahah*.



Source: Author

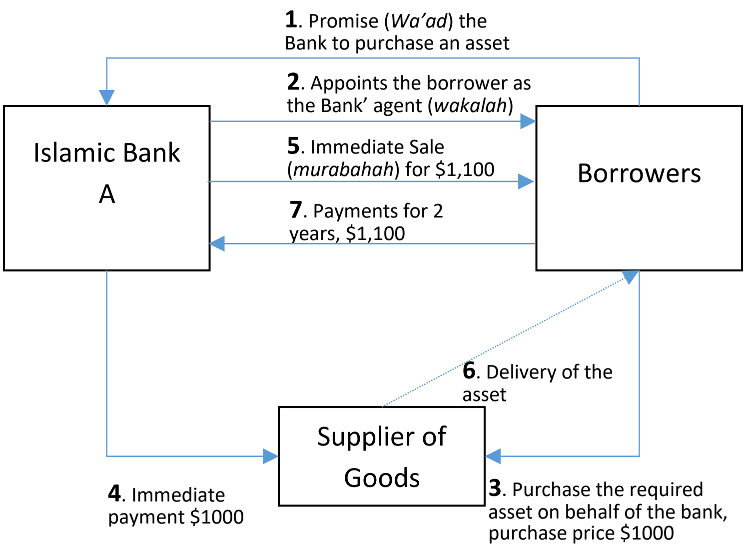
Two parties namely Islamic Bank A (Bank A) and a borrower enter into a contract wherein one of them, defined as the "Seller" (Bank A) in the above case, agrees to purchase an asset from a third party, defined as "Suppliers" in the above case, at a cost of $1000. The Seller (Bank A) then sells that asset to its borrower, referred to as "Purchaser" above, at a mark-up $100 agreed between them, presumably to compensate the Seller for the effort and risk involved in obtaining the asset from the Supplier. In other words, there are two purchase and sale agreements entered into as part of a *murabahah*. The first is sale from the Supplier to the Seller, and the second is a sale from the Seller to the Purchaser. The second sale is at the same price as the first, plus a mark-up in the Seller favor. In the above case, the second sale can take the form of a credit sale, wherein the Purchaser (the Borrower) agrees to pay the Seller (Bank

A) in future installments. Using this way, *murabahah* can be used to replicate an interest rate in all material legal and economic respects.[87]

The above example on the application of original *murabahah* involves some risks for Bank A. First, the bank would incur loss if the potential borrower (the Purchaser) does not honor the promise to purchase the asset from the bank. Second, the bank would add additional costs considering that the bank is obliged to find the requested asset before reselling it to the borrower (the Purchaser). Third, the bank would also incur loss if the asset was damaged before re-selling to the borrower. Hence, the original *murabahah* creates significant risks if it used as a method for modern Islamic financing.

To address the difficulties encountered by the original *murabahah* in practice, Islamic bankers started combining other Sharia rules. This is illustrated in the following diagram.

Figure 2.2. Modified *Murabahah* in Credit Facilities



Source: Author

[87] An extensive discussion on *murabahah* including its surrounding legal and *Shariah* issues, see Hamoudi and Cammack, above n 9, 485-511.

In the above example, this modified structure shifts the potential risks from Bank A to its borrowers. In the above example, a borrower (the Purchaser) desiring to buy an asset, approaches Bank A (the Seller), and promises (*wa'ad*) to buy the requested asset from Bank A. The bank then appoints the borrower to search for the required asset and appoints the borrower as the bank's agent through the application of *wakalah* (agency) contract. In these two arrangements (*wa'ad* and *wakalah*), Bank A shifts its transaction costs to the buyer. Bank A does not need to employ staff to locate the asset and buy it for the borrower. Furthermore, through the application of the *wa'ad* rule, the borrower is obliged to fulfil the promise (*wa'ad*) to buy the requested asset. Although there are some objections to this modified *murabahah* particularly on the arrangement that makes a promise (*wa'ad*) legally binding, Islamic banks have adopted the *fatwa* which treats the promise (*wa'ad*) as legally binding. This *fatwa* is pivotal because it will block the revocation of the potential buyer (the borrower) of their promise at any time before concluding the *murabaha* contract. This modified *murabahah* is used to replicate the mechanism of interest-based credit facilities, and transform the activities of Islamic banks to acting as an intermediary institution rather than as a seller of the asset.

The legitimacy of the modified *murabahah* depends upon whether the potential purchaser's promise is legally binding. The *fatwa* issued by Al-Zarqa declared that a promise (*wa'ad*) may be legally binding based on a popular view of the Maliki school. Other Muslim scholars reviewed the Islamic jurisprudence literature (*fiqh*) looking for a basis for the *fatwa*.[88] Support for the *fatwa* came from the first conference on Islamic banks held in Dubai in 1978 where a *fatwa* was issued allowing the use of the promise in the *murabahah*-based credit facilities and recognizing the promise as legally binding. In 1988, the OIC (Organisation of Islamic Cooperation) the International *Fiqh* Academy declared that the promise, though

[88] Hegazy in Ali (ed), above n 83, 147-148.

ethically binding on the promisor, is not legally binding on such promisor unless the promisee has incurred expenses (reliance) on the basis of such a promise resulting in the obligation of the promisor to fulfil the promise.[89]

Thus, the modified *murabahah* used for credit facilities was derived from two most important *fatwas*, one *fatwa* is on the permissibility of *murabahah*, while the other *fatwa* is on a binding nature of *wa'ad* (promise). The first *fatwa* which was based on a minority view in the Islamic jurisprudence (*fiqh*), allowed *the murabaha contract*, but placed restrictions on its practice. The second *fatwa* removed all such restrictions.[90] The third *fatwa* concened the application of *wakalah* (an agency contract) in the *murabahah*-financing. The combination of these instruments (*wa'ad, wakalah,* and *murabahah*) is common in jurisdictions offering Islamic financial products and services. For instance, the National Sharia Advisory Council of the Indonesian Ulama Council issued *fatwas* on the permissibility of *murabahah* and the binding nature of *wa'ad* to give a Sharia foundation of the practice of *murabahah* in Indonesia's Islamic banking industry.[91]

In modern Islamic finance, *murabahah* has been a mainstream product leading to the resurrection of another pivotal arrangement in modern Islamic finance, *tawarruq* (reverse or commodity *murabahah*). *Tawarruq* is examined extensively in Chapter 5. Briefly, a *tawarruq* contract is a continuation of the *murabahah*.[92] Traditionally, *tawarruq* refers a series of sale contracts whereby a purchaser buys an asset from a seller for a deferred payment and subsequently sells it to a third party for cash at a lower price for the purpose of obtaining cash.[93]

89 Ibid.
90 Ibid.
91 See Indonesian Ulama Council, *Himpunan Fatwa Keuangan Syariah Dewan Syariah Nasional MUI* (The *Fatwa* Collection on Sharia Finance) (Penerbit Erlangga, 2014).
92 Craig R. Nethercott, 'Murabaha and Tawarruq' in Craid R. Nethercott and Eisenberg (eds), *Islamic Finance: Law and Practice* (Oxford University Press, 2012), 200.
93 Ahmad A. Alkhamees, A Critique of Creative Sharia Compliance in the Islamic Finance (Brill, 2017) 69.

This practice has been widely adopted in South East Asian countries as a means of cash liquidity where a person buys a commodity, i.e. wheat on a deferred basis and then sells it on the spot market for a lower price to obtain cash. However, it should be clearly noted that such a practice occurs outside modern financial markets so that the seller has no role in the second sale.[94] Medieval Muslim scholars had different views on the legitimacy of such a trading.[95] However, in recent times, the traditional *tawarruq* is regarded as permissible by the majority of individual *fatwa* as well as collective fatwas such as those issued by fatwa bodies or Sharia Supervisory Boards (SSBs) of financial institutions in Middle Eastern Countries. The most referred *fatwa* on the permissibility of *tawarruq* comes from Saudi scholars.[96] The International Fiqh Academy based in Jeddah also issued a *fatwa* that the application of traditional *tawarruq* is not against the Sharia principles as long as there is no other solution and due to necessity (*dharurah*).[97]

The original *tawarruq* causes practical difficulties in financial markets. Bankers and Sharia scholars modify this contract creating what has been called the organized *tawarruq*.[98] Under this modified mechanism, the purchasing and selling of a particular asset has been organized previously by an arranger (commonly a financial institution such as bank) to facilitate cash payment to the client. This mechanism is contrasted with its traditional version where the seller has no role in the second sale. Under the modified version, the bank organizes the purchase of the asset on a deferred payment basis and sale by the purchaser for cash. The

94 Ibid.
95 For more discussion on these debates, see Habib Ahmed and Nourah Mohammad Aleshaikh, 'Debate on Tawarruq: Historical Discourse and Current Rulings' (2014) 28 *Arab Law Quarterly* 278.
96 For instance, in 1966, the early grand Mufti of Saudi Arabia, Shaikh Muhammad ibn Ibrahim issued a fatwa on the permissibility of classical tawarruq following the view of the Hanbali School. Later on in 1977, during the advent of the Islamic banking, the Saudi Arabia Council of Senior Scholars issued a fatwa that *tawarruq* trading of a commodity is lawful as long as it does not involve two sales in a sale (bay innah). This *bay al-innah* is considered a double sale whose ultimate and sole objective is to circumvent the prohibition of usury and achieve an interest-based loan, see Hegazy, above n, 596.
97 Ibid.
98 Zamir Iqbal and Abbas Mirakhor, *An Introduction to Islamic Finance: Theory and Practice* (Wiley, 2nd Edition, 2011) 86.

arranger, usually the bank, manages the sale agreement.[99] Although this mechanism deviated from its original form, there are some *fatwas* declaring the permissibility of such an organized *tawarruq*.[100] It indicates the need for modern Islamic finance to provide alternative financial instruments. This argument has also been extended to derivative markets. This will be discussed in detail in Chapter 5.

The above illustrations of how *murabahah* and *tawarruq* have been adapted by combining the rulings from various Sharia interpretations to structure Islamic financial instruments for use in the market place. This demonstrates that the modern method of Islamic finance that this chapter refers to as *fatwa* shopping in Chapter 1 is a prevailing practice in the industry.

2.6 Summary

Selective Sharia rules allow modernisation of Islamic finance. Under this approach, medieval Islamic contracts are utilised on a functional basis. This leads to the reinvigoration of fresh ideas to decide which of medieval juristic rules can be adapted for use in modern financial transactions. This chapter argues that this pluralist approach which allows the combination of Sharia rules in the form of *fatwas* is a legitimate method of adapting medieval Islamic

[99] The definition of the organized *tawarruq* is taken from the International Fiqh Academy of the Organization of Islamic Cooperation (OIC) based in Jeddah, Saudi Arabia, as follows: "[An arrangement] when a person (mustawriq) buys merchandise from a local or international market on a deferred price basis. The financier arranges the sale agreement either himself or through his agent. Simultaneously, the mustawriq and the financier execute the transactions, usually at a lower spot price. Reverse tawarruq: it is similar to organized tawarruq, but in this case, the mustawriq is the financial institution, and it acts as a client", see Ahmed and Aleshaikh, above n 93, 292.

[100] Asyraf Wajdi Dusuki, Mohammad Mahbubi Ali, and Yulizar D. Sanrego, 'The Application of Commodity Murabahah in Bursa Suq Al-Sila' Malaysia vis-à-vis Jakarta Future Exchange Sharia Indonesia: A Comparative Analysis' (2013) 49 *ISRA Research Paper*, 6.

contractual arrangements so as to meet the requirements of a modern financial industry. The various Sharia opinions need to be viewed as a source of richness rather than difficulties.

The legalistic approach reflects a continuation of the classical method called *talfiq*. This method is a form of doctrinal selections made by a Muslim jurist toward a particular interpretation that best fits the circumstances, regardless of whether or not this interpretation came from the scholar's own legal school. The application of the legalistic approach involves two steps. First, Sharia scholars review and select various opinions from different schools to derive a single conclusion that legitimates a particular financial product. Then, Islamic banks review and select a *fatwa* that would legitimise their financial products and services. Thus, the users of this method are Muslim jurists who may be members of Sharia Supervisory Boards as well as the subjects of the law itself namely Bankers, financial firms and consultants.

As shown in this chapter, medieval Islamic commercial contracts have significant problems in terms of feasibility and practicality. This method is an attempt to find a middle path between adaptation and rejection. By this approach, it is possible to have Islamic financial instruments that obey religious precepts and also meet economic and financial considerations to face modern challenges of the financial industry.

The disputes on the legitimacy of selective Sharia rules have been addressed in this chapter. This chapter locates legitimacy of modern Islamic finance in the private actors known as Sharia Supervisory Boards (SSB) that control Islamic finance. These actors provide substantive determinations as to whether a particular financial activity or instrument is Sharia complaint. They are thus responsible for determining Sharia compliance with regards to different types of financial instruments offered by various market participants.

Moreover, the legitimacy of modern Islamic finance could be also placed within the logic of modern financial theory particularly efficiency and practicality. Although Islamic finance can adapt to modern financial requirements, there are still normative considerations in Islamic jurisprudence that might support forgoing efficiency gains for the sake of legitimacy. This would mean that current Islamic finance remains an ideological discipline rather than a purely rational discipline dominated by concepts of conventional economic theories such as efficiency and risk management. The risk regulation and risk management theory particularly derivatives from a conventional perspective will be discussed in the next two chapters.

CHAPTER 3: THEORIES OF REGULATION

3.1 Introduction

Financial and banking regulations exist to protect the industry, customers, and the economy from risks or adverse consequences arising from the financial and banking activities. Regulation is directed towards managing and mitigating those risks. These risks include market, credit, operational, liquidity, and systemic risks.[1] This chapter discusses risks in the financial and banking industry. It then discusses the main theories on regulation including financial regulation.[2] Based on this section, this chapter argues that the combination of public interest and the economic theory of regulation is imperative in the current global financial industry to prevent those risks.

3.2 Risks in the Financial Industry

Risk, broadly defined, refers to uncertainty of future outcomes, positive or negative.[3] There are known and unknown risks as Rumsfeld observed.[4] In relation to known risks not all are easily capable of being measured. Some risks can be managed within the organization

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[1] Razeen Sappideen, "The Regulation of Credit, Market and Operational Risk Management under the Basel Accords" (2004) *Journal of Business Law* 59.

[2] Based on the Lecture notes distributed by Razeen Sappideen in his seminars on International banking and Finance Law, School of Law, Western Sydney University.

[3] See for instance Frank H. Knight, *Risk, Uncertainty, and Profit* (New York, 1921).

[4] He stated that "Reports that say that something has not happened are always interesting to me, because as we know, there are known knowns; there are things we know we know. We also know there are known unknowns; that is to say we know there are some things we do not know. But there are also unknown unknowns – the ones we don't know we don't know. And if one looks throughout the history of our country and other free countries, it is the latter category that tend to be the difficult ones", see "Defense.gov News Transcript: DoD News Briefing – Secretary Rumsfeld and Gen. Myers, United States Department of Defense (defense.gov)", [2/05/2018], http://archive.defense.gov/Transcripts/Transcript.aspx?TranscriptID=2636.

others could be transferred to other parties. Most of these risks cannot be easily quantified using quantitative models.[5]

Financial sectors pool and allocate various risks using a variety of instruments to reduce risks such as derivatives, hedging, diversification, and insurance. In order to be successful, firms must mitigate and manage risks and simultaneously take advantages of such risk exposures. Risk exposure is the extent to which a bank could be affected by certain factors that may have a negative impact on returns and the stability of that institution.[6]

One of the justifications for regulation of banking and finance institutions is to mitigate and prevent risks that may jeopardise the industry and the whole economy. The government has a central role in the risk regulation to protect the public and the economy from adverse consequences of banking and financial transactions. The Global Financial Crisis 2008 (the GFC) highlighted the importance of managing the financial risks. The global interconnectedness of financial institutions exposed financial institutions and economies to systemic risk (see paragraph 3.2.5 below).

3.2.1 Market Risks

Market risk is a risk of loss resulting from volatility of income or changes to market value resulting from movements in underlying market factors such as interest rates, foreign

[5] See John Evans and Amandha Ganegoda, "Measuring Operational Risk in Financial Institutions" (2008) 4 *The Finsia Journal of Applied Finance* 9.

[6] Joel Bessis, *Risk Management in Banking* (Wiley, 4th Edition, 2015) 2.

exchange rates, equity and commodity prices, or credit spreads.[7] Market risk consists of several risks including interest rate risks, commodity risks, foreign exchange risks, and equity risks.

Interest rate risk is the potential for losses due to movements in interest rates. This risk arises because bank assets (loans and bonds) usually have a significantly longer maturity than bank liabilities (deposits). If interest rates rise, the value of the longer-term assets will tend to fall more than the value of the shorter-term liabilities, reducing the bank's equity. In addition, if interest rates rise, the bank will be forced to pay higher interest rates on its deposits well before its longer-term loans mature and it is able to replace those loans with loans that earn higher interest rates.[8] Meanwhile, equity risk is the potential loss due to an adverse change in the price of stock. Stock, also referred to as shares or equity, represent an ownership interest in a company. Banks can purchase ownership stakes in other companies, exposing them to the risk of the changing value of these shares.[9]

Foreign exchange risk is the risk that the value of the bank's assets or liabilities changes due to currency exchange rate fluctuations. Banks buy and sell foreign exchange on behalf of their customers (who need foreign currency to pay for their international transactions or receive foreign currency and want to exchange it to their own currency) or for the banks' own accounts. In addition, commodity risk is the potential loss due to an adverse change in commodity prices. Commodities include agricultural commodities (e.g., wheat, corn, soybeans), industrial commodities (e.g., metals), and energy commodities (e.g., natural gas, crude oil). The value of these commodities may fluctuate significantly due to changes in demand and supply.[10]

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[7] Hennie Van Greuning and Sonja Brajovic Bratanovic, *Analyzing Banking Risk: A Framework for Assessing Corporate Governance and Risk Management* (World Bank, 3rd Edition, 2009) 223. This definition is in line with the definition given by the Basel Committee on Banking Supervision, *Minimum Capital Requirements for Market Risk* (BCBS, 2016) (10/04/2017) http://www.bis.org/bcbs/publ/d352.pdf, 5.
[8] Greuning and Bratanovic, above n 7.
[9] Ibid.
[10] Ibid.

3.2.2 Credit Risk

Credit risk is the potential loss to a bank where the bank's borrower or counterparty fails to repay (on time or not at all) its obligations, i.e. principal, interest, or other investment-related cash flows.[11] This risk adversely affects the bank's cash flow and liquidity.[12] Credit risk is also associated with counterparty risk[13], or default risk.[14] Credit risk is one of the chief risks in the banking system that can lead bank failures. It adversely affects cash flow and bank's liquidity. More than 70 percent of a banking balance sheet generally relates to this aspect of risk management.[15]

3.2.3 Operational Risks

Operational risks are concerned with the potential loss resulting from inadequate or failed internal processes, people, and systems or from external events.[16] For instance, in the GFC operational risk occurred in the form of a failure of due diligence in the process of issuing loans to the subprime borrowers.[17] Although operational risk is difficult to measure accurately, regulations require banks to take measures to deal with this type of risk.[18]

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11 See, eg, Greuning and Bratanovic, above n 7, 161-162; and Richard Apostolik, Christopher Donohue, and Peter Went, *Foundations of Banking Risk: An Overview of Banking, Banking Risks and Risk-Based Banking Regulation* (John Wiley & Sons, 2009) 18.
12 Greuning and Bratanovic, above n 7, 161-162.
13 Ibid.
14 Apostolik, Donohue, and Went, above n 11, 18.
15 Greuning and Bratanovic, above n 7, 161-162.
16 Rupak Chatterjee, *Practical Methods of Financial Engineering and Risk Management* (Springer, 2014), 295.
17 See John A. Allison, *Financial Crisis and the Free Market Cure: Why Pure Capitalism is the World Economy's Only Hope* (McGraw Hill, 2013) 37 on discussion on the Federal Deposit Insurance Corporation (FDIC) as one of the contributors of the financial crisis in the US.
18 Chatterjee, above n 16, 295.

3.2.4 Liquidity Risks

Liquidity risks occur where the bank may be unable to meet its obligations in a timely fashion. This may occur, for instance, when depositors deciding to withdraw their deposits. There is an inverse relationship between liquidity and liquidity risk, given that the higher the liquidity risk, the higher the probability of becoming illiquid, and therefore, the lower the liquidity.[19] This liquidity risk is related to Basel Accords that will be discussed in depth in Chapter 9.

3.2.5 Systemic Risks

Systemic risk is defined as "the probability that cumulative losses will occur from an event that ignites a series of successive losses along a chain of institutions or markets comprising a system".[20] According to Scott, systemic risks are related to connectedness of financial institutions, contagion, and correlation. Connectedness is that the failure of one bank will cause the failure of others through either on assets or liabilities side.[21] Contagion is an indiscriminate run by creditors of financial institutions that can render otherwise solvent institutions insolvent due to fire sale of assets that are necessary to fund withdrawals and the resulting decline in asset prices triggered by such sales. And correlation is the failure of multiple institutions resulting from the collapse of asset prices due to an exogenous event.[22] Systemic failure decreases capital availability, increases its cost, and may trigger "bank runs"

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[19] Kleopatra Nikolaou, "Liquidity (Risk) Concepts: Definitions and Interactions" (2009) *European Central Bank Working Paper Series* No. 1008, [04/07/2017] https://www.ecb.europa.eu/pub/pdf/scpwps/ecbwp1008.pdf?e87aba3a52137adea91048bf54801968, 15-16.

[20] George G. Kaufman, 'Bank Failures, Systemic Risk, and Bank Regulation' (1996) 16(1) *Cato Journal* 17, 20.

[21] Hal S. Scott, *Connectedness and Contagion: Protecting the Financial System from Panics* (The MIT Press, 2016) 1.

[22] Ibid.

in which the inability of one bank to meet depositors' withdrawal demands in turn causes other banks to fail.[23]

3.3 Regulation

There are various definitions on regulation.[24] Some scholars define regulation as an activity whereby the actions of individual or institutions are limited by the imposition of rules.[25] Others argues that it is implementation of legal instruments to achieve a broader policy objective including social and economics.[26] Viscusi, Harrington, and Vernon argue that regulation is "a state imposed limitation on the discretion that may be exercised by individuals or organizations, which is supported by threat of sanction".[27] From these definitions, it might be concluded that regulation contains some basic elements including rules, restrictions and guidance, legal instruments, the regulated and regulators, and objectives. However, the theory of regulation is not monolithic considering that there are three mainstream theories that define what is regulation below.

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[23] Ibid.
[24] See, eg, Barry M. Mitnic, *The Political Economy of Regulation* (University of Columbia Press, 1980) discussing and reviewing competing definition of regulation from theoretical perspectives; and Johan Den Hertog, "General Theories of Regulation", in B. Bouckaert and G. De Geest, *Encyclopaedia of Law and Economics* (Volume I: *The History and Methodology of Law and Economics*), (Edward Elgar, 2000).
[25] M. Moran, M 'Theories of Regulation and Changes in Regulation: The Case of Financial Markets', (1986) 34 *Political Studies* 185–201.
[26] Hertog, above n 24, 63.
[27] W. Kip Viscusi, Joseph E. Harrington, and John M. Vernon, *Economics of Regulation and Antitrust* (MIT Press, 20005).

3.4 Public Interest Theory

The public interest theory of regulation views that regulation as guided and created to satisfy the public interest.[28] There are two dimensions to this theory. First, regulation seeks the protection and benefit of the public at large. Second, regulation is a system of ideas, which seeks to remedy if not prevent market failure, with a view to maximizing social welfare.[29]

The second dimension of the public interest theory arises from the view that the regulation is designed to avoid market failures that could jeopardize public interests at large. This assumption may overcome the weaknesses of the first approach by defining what are the public interests. Pigou argues that the underlying proposition for regulation is based on a public demand for the correction of market inefficiencies and failures which affect the society at large rather than a particular interest group.[30] Den Hertog argues that the public interest theory leads to the best possible use of the scarce resource available for the public only when there is sufficient information and enforcement power to promote public interests.[31] Regulation could be designed to correct inefficient or inequitable market practices leading to economic and social problems. Consequently, regulations could be designed to require minimum wages and maximum rents accessibility to health care, guaranteeing income in the event of sickness, unemployment, disablement, old-age and so on.[32] This suggests that public interest theory is a subdivision of the economic theory of welfare.[33]

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28 See Arthur Cecil Pigou, *The Economics of Welfare* (Macmillan, 1932).
29 This if often called a welfare economic rationale for regulation, see Sophie Harnay and Laurence Scialom, 'The Influence of the Economic Approaches to Regulation on Banking Regulations: A Short History of Banking Regulation' (2016) 40 *Cambridge Journal of Economics* 401, 402.
30 Pigou, above n 28.
31 Hertog, above n 24, 225.
32 Richard A. Posner, "Theories of Economic Regulation', (1974) 5 (2) *Bell Journal of Economics* 335.
33 P. Aranson, 'Theories of Economic Regulation: From Clarity to Confusion' (1990) 6 *Journal of Law & Politics* 247, 249.

There is, however, the fundamental problem whether regulation genuinely reflects public interests at large. It has been pointed out that there are always private interests involved in regulation besides economic objectives particularly where political actors act on behalf of lobby groups, and political institutions.[34] It has also been observed that public interest often represents a compromise in achieving a balance between the conflicting interests of diverse groups in a society.[35] As economic agents, regulators may pursue their own interests, which may or may not be consistent with public interest. As a result, regulation is often designed to safeguard private interests, for instance, a paradigmatic change in the conception of the regulation instruments of the banking authorities.[36] Consequently, regulation often reflects a bias either for protection of the public interest or diverse groups within a society. There is always a risk of regulatory capture by privative interests. This is discussed in the following paragraph.

3.5 Captive Theory (Private Interest Theory)

Captive theory views regulation as a reflection of private interests. Regulation, although on the face of it designed to protect the public interest, may promote commercial interests.[37] Moreover, captive regulation is shaped by diverse private interests in a society such as political actors, private entities, or government or regulators. The regulatory process is depicted as a competitive process amongst pressure groups investing resources in political lobbying to obtain

[34] Paul Joskow and Rodger Noll "Regulation in Theory and Practice: An Overview." In G. Fromm (ed.), *Studies in Public Regulation*, (MIT Press Series on the Regulation of Economic Activity, Cambridge, MA, The MIT Press, 1981).
[35] A. J. Boudreau, 'Public Administration and the Public Interest' (1950) 16(3) *The Canadian Journal of Economics and Political Science* 371.
[36] For more discussions see, Harnay and Scialom, above n 29, 401.
[37] See Imad A. Moosa, *Good Regulation, Bad Regulation: The Anatomy of Financial Regulation* (Palgrave Macmillan, 2015) 9-13.

favorable action from the regulatory authorities.[38] Through regulation, politicians or political parties make their own demands to which private industries must respond.[39] This interest groups may be a key factor in determining regulatory outcomes.[40] Political interests pursue their own preferences rather than the public good.[41] Thus, small, well-organized groups are seen as more able to obtain rents through favorable regulation, as they can organize themselves less expensively than larger groups.[42] In this theory, the government controls representing public interests are more vulnerable to the demands of powerful political pressure groups than in capitalist economies.[43]

Private firms are also concerned with regulation. Thus, regulation may be influenced and designed for the purpose of safeguarding the benefit of those firms.[44] These firms seek regulations that can enhance their profitability and returns. For instance, regulation in the banking industry may serve the private interests of banks and to organize the distribution of rents between them. As the financial sector is especially well funded and organized, it is powerful enough to influence regulation.[45] In this context, a banking regulation may serve self-interest of the regulated banking entities rather than social welfare in general.[46]

Governments may also enact regulation to serve their interests. This especially occurs in banking and finance regulation. Historically, banking and finance institutions are engine of

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[38] Gary Becker, ‘A Theory of Competition among Pressure Groups for Political Influence’ (1983) 98(3) *The Quarterly Journal of Economics* 394.
[39] Fred S. Mcchesney, ‘Rent Extraction and Rent Creation in the Economic Theory of Regulation’ (1987) 16 *Journal of Legal Study* 102.
[40] Randall Kroszner and Philip Strahan, ‘Obstacles to Optimal Policy: The Interplay of Politics and Economics in Shaping Banking Supervision and Regulation Reforms’ (2000) University of Chicago, Graduate School of Business, 34.
[41] Ibid.
[42] See Harnay and Scialom, above n 171, 407.
[43] Gary Becker, ‘Pressure Groups and Political Behavior’ in Richard D. Coe and Charles K. Wilber (eds.), *Capitalism and Democracy: Schumpeter Revisited* (University of Notre Dame Press, 1985) 141.
[44] George J. Stigler, ‘The Theory of Economic Regulation’ (1971) 2(1) *Bell Journal of Economics and Management Science*, 3.
[45] Harnay and Scialom, above n 29, 407.
[46] Arnoud Boot and Anjan Thakor, ‘Self-Interested Bank Regulation’ (1993) 83(2) *American Economic Review* 206.

the economy. Through the regulations a state entity or the government may influence the national credit supply that matters for the stability of an economy. Regulations may facilitate government expenditures, channeling credit to politically attractive ends, maximizing welfare, and influencing the political actors and bureaucrats.[47] Banks may facilitate the government needs. For instance, the governments often use the bank to facilitate their programs and initiatives neglecting other sources of funding such as raising taxes and issuing sovereign bonds.[48] Governments then may regulate to benefit constituencies such a group of government supporters including political parties.

The captive theory of regulation suggests that economic and commercial purposes of diverse groups are protected or promoted through particular regulation. Commercial entities have an incentive to exercise control over institutions which affect their profitability. This could include the media, academia, and popular culture. For instance, it has been said that the finance industry has been captured by academia, since academic researchers have been providing the intellectual justification for giving this industry an incentive to pursue their financial objectives.[49] Some argue that there is a symbiotic relationship between finance professors and the financial industry. Based on empirical research, the industry may pursue their financial interest including lobbying government for regulations that produce avoid sub-optimal outcomes.[50]

There are fundamental criticisms of the capture theory of regulation. Posner argues that this theory does not tell why some interests are effectively represented in the political process and others not, or under what conditions interest groups succeed or fail in obtaining favourable

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47 Ibid.
48 See Xavier Freixas and Anthony M. Santomero, 'An Overall Perspective on Banking Regulation' (2002) Working Papers, Federal Reserve Bank of Philadelphia, 8.
49 J. D. Hanson, and G. D. Yosifon 'The Situation: An Introduction to the Situational Character, Critical Realism, Power Economics, and Deep Capture' (2004) 152 *Pennsylvania Law Review* 129.
50 Richard A. Posner, *A Failure of Capitalism, Cambridge* (Harvard University Press, 2009).

legislation. No reason is suggested as to why the regulated industry should be the only interest group able to influence an agency. Customers of the regulated firm have an obvious interest in the outcome of the regulatory process – why may they not be able to 'capture' the agency as effectively as the regulated firms. Posner thus argues that the capture theory of regulation is unsatisfactory.[51] It could be argued that this theory fails to acknowledge the similarity in interest between the public the regulated firms. For instance, the banks' interests in operating in a safe and sound-banking environment overlap with the public interests in achieving the same objective. The success of the banking system to mitigate their inherent risks, for instance, would also deliver the public interest in the whole economy. This weakness is further elaborated in the economic theory of regulation.

3.6 Economic Theory of Regulation

The economic theory of regulation argues that regulation is primarily for safeguarding and protection of the public at large or some large subclass of the public.[52] Stigler, for instance, challenged the idea that regulation is designed and operated primarily for the benefit of business, rather than solely to advance the overall public interest by correcting market failures.[53] Stigler argues that is instituted primarily for the protection and benefit of the public at large or some large subclass of the public. He observes that the political process sometimes defies rational explanation but comprehending acts of great moral virtue.[54] Even if the industry

51 For more discussion on the weaknesses of the capture theory of regulation, see Posner, above n 50, 342.
52 Stigler, above n 44, 3.
53 Ibid.
54 Ibid.

achieves some benefits from regulation, these benefits are obtained in a pure profit-maximizing form.[55]

Garry Becker focuses on competition between interest groups. Interest groups invest in influencing the political process to gain favorable legislation. The key to Becker's model is the relative pressure exerted by a group since the investment made by opposing groups will tend to have a counteracting effect on the effectiveness of resources devoted to gaining influence. This means that excessive resources will often be used to influence the political process, and the outcome will generally be inefficient.[56]

Posner argues that the Economic Theory of Regulation admits the possibility of 'capture' by interest groups other than the regulated firms; and it replaces the 'capture' metaphor, by the more neutral terminology of supply and demand. Posner accepts the economic regulation serves the private interests of politically effective groups. This is reasonable on the basis that the theory is committed to the strong assumptions of economic theory generally, notably that people seek to advance their self-interest and do so rationally. Economic theory insists that regulation can be explained as the outcome of the forces of demand and supply. Posner says that the theory rests on two assumptions. First, the coercive power of government can be used to give valuable benefits to a particular individual or groups, economic regulation – the expression of that power in the economic sphere – can be viewed as a product whose allocation is governed by laws of supply and demand. Second, the theory of cartels may help locate the demand and supply curves. The theory of cartels illuminates both the benefit and the cost side. This theory is based on the view the value of cartelization is greater, the less elastic the demand for the industry's product and the more-costly, or the slower, new entry into the

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55 Ibid 6.

56 Cento Veljanovski, 'Economic Approach to Regulation' in Robert Baldwin, Martin Cave, and Martin Lodge (ed), *the Oxford Handbook of Regulation* (the Oxford University Press, 2010).

industry. According to Posner, economic theory of regulation may be empirically analyzed using a body of data.[57]

3.7 Categories of Regulation

3.7.1 Social Regulation

Regulation may take several forms or categories including economic, social, and financial regulation.[58] Social regulation refers to social objectives that are embedded in a regulation, for examples, environmental protection, consumer protection, financial inclusion, redistribution of incomes, and prevention of crimes.[59] Based on the perspective of the private theory of regulation, social regulation confers general benefits to a large group at the expense of small and powerful groups.[60] Although social regulation produces few direct benefits but significant costs, private parties are beneficiaries of indirect effects of such regulation.[61] For example, indirect effects of social regulation, such as a competitive advantage gained, can be sufficiently large for private parties.[62]

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57 Posner, above n 50, 343.
58 See W. K. Viscusi, J. M. Vernon and J. E. Harrington, *Economics of Regulation and Antitrust* (MIT Press, 2005).
59 See He Wei Ping, *Banking Regulation in China: The Role of Public and Private Sectors* (Palgrave Macmillan, 2014) 32.
60 Florence Heffron and Neil McFeeley, *The Administrative Regulatory Process* (Longman, 1983) 149–151.
61 Ann P. Bartel and Lacy Thomas, 'Direct and Indirect Effects of Regulation: A New Look at OSHA's Impact' (1985) 28(1) *Journal of Law and Economics* 25.
62 Ann P. Bartel and Lacy Thomas, 'The Wage and Profit Effects of the Occupational Safety and Health Administration and the Environmental Protection Agency' (1987) 30(2) *Journal of Law and Economics* 57.

3.7.2 Economic Regulation

Economic regulation is divided into structural regulation and conduct regulation.[63] The former refers to market structure including rules and restrictions pertaining to conduct of the market. The latter refers to the behavior of economic actors particularly producers and consumers.[64] Economic regulation is designed to prevent a market imperfection resulting from an abuse of monopoly power, externalities, and exploitation of information asymmetry. Monopoly power restricts the number of firms that can operate in the market and hence determines prices and outputs.[65] Externalities are situations where there is a divergence between private and social cost or, in other words, where the prices used in exchange by individuals do not reflect general social costs or benefits.[66] Information asymmetry occurs where consumers and producers lack information about each other. Under such asymmetry, resources are misdirected from their most highly valued uses.

3.7.3 Financial and Banking Regulation

Financial regulation may be directed to safety-and-soundness (or solvency) regulation and/or compliance regulation. The former is designed to protect depositors from the losses arising from the insolvency of financial institutions while ensuring financial stability.[67] The predominant form of solvency regulation is capital regulation, whereby financial institutions must comply with liquidity and capital adequacy rules as required under the Basel Accords.[68]

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[63] J. Kay, and J. S. Vickers "Regulatory Reform: An Appraisal", in M. Giandomenico (ed.), *Deregulation or Re-regulation* (Pinter Publishers, 1990).
[64] Ibid.
[65] Stephen Breyer, *Regulation and Its Reform* (Harvard University Press, 1982) 15.
[66] Oliver James, 'Regulation Inside Government: Public Interest Justifications and Regulatory Failures' (2000) 78(2) *Public Administration* 330.
[67] Moosa, above n 37, 5.
[68] Ibid 5-6.

Regulation may require periodic reporting by banks and financial institutions, and the fair and non-discriminatory treatment of the customers and promoting competition within the market.[69] Compliance regulation refers to a firm's adherence to laws, regulations, guidelines and specifications relevant to its business. Violations of regulatory compliance often result in legal penalties, including fines.[70]

The justifications for banking regulation are predominantly similar to economic regulation. One dimension of the public interest theory of regulation is that markets for goods and services are imperfect. Thus, government intervention is needed to allocate resources efficiently. As argued in economic regulation, unregulated markets tend to create abuse of monopoly power, externalities, and exploitation of information asymmetry.[71] Regulation seeks to avoid or at least to mitigate the adverse outcomes of market imperfection.

In the context of banking regulation, there are, at least, four rationales for government intervention. First, regulation is needed to ensure fair and open competition. To achieve this objective, the regulator needs to maintain a level playing field among market participants. This includes applying uniform rules relating to capital adequacy and liquidity to financial institutions in line with the Basel Accords (see paragraph 3.8.1).[72]

Regulation is also needed to protect the interests of individual depositors in the banking industry. Information asymmetry may lead to a situation where banks are more knowledgeable about business risks than their depositors, who neither have access to relevant information about the operations of banks, nor, very often, the insight to understand the significance of any

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[69] Ibid.
[70] Ibid 6-7.
[71] See Pigou, above n 28, xviii.
[72] See Basel Committee on Banking Supervision (BCBS), "International Convergence of Capital Measurement and Capital Standards" (Basel: Bank for International Settlements, July 1988).

such information.[73] It has been long argued that this information asymmetry leads to adverse selection, where banks may choose and apply opportunistic information about loan customers and moral hazard, and where bank managers may engage in actions to divert economic resources for personal gain.[74] Thus, small and uninformed retail depositors may be incapable of looking after their own interests.[75] This lack of information among common depositors creates disadvantages and exposes their vulnerability. Retail customers do not make frequent repeat orders of contracts and do not have the capacity to acquire information, and the failure of contracts is costly to them.[76]As a result, information asymmetry is traditionally perceived as being more pervasive in retail than in wholesale markets.[77] Wholesale customers, including sovereign customers, corporate customers, and financial institutions, on the other hand, are normally sophisticated and professional.[78]

However, the global financial crisis 2008-2009 (GFC) showed that even sophisticated wholesale investors, perceived to be skilful and knowledgeable, also became vulnerable.[79] The complicated nature of new financial derivatives and products made it difficult for even sophisticated investors to assess financial information. These customers' exposure to adverse consequences of financial transactions was not covered by an effective deposit insurance scheme.[80] For this reason, the regulation is designed to protect not only individual depositors, but also wholesale customers.

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73 E. W. Bond and K. J. Crocker, 'Bank Capitalization, Deposit Insurance, and Risk Categorization' (1993) 60(3) *Journal of Risk and Insurance* 547.

74 Anthony J. Cataldo, *Information Asymmetry: A Unifying Concept for Financial and Managerial Accounting Theories* (JAI Press, 2003) 19.

75 Charles Goodhart, et al., *Financial Regulation: Why, How and Where Now?* (Routledge, 1998) 5.

76 Ibid 9.

77 David Llewellyn, 'Regulation of Retail Investment Services' (1995) 15(2) *Economic Affairs* 14.

78 BCBS, 'Core Principles for Effective Banking Supervision' (2006) Bank for International Settlements, 19–26.

79 Robert Pozen, 'Why We Need to Lower the FDIC Deposit Guarantee' (2009) *Harvard Business Review*, October 5.

80 Deposit insurance scheme will be discussed in the following section of this chapter.

Third, regulation is needed to ensure the smooth functioning of the credit supply. Most commonly, bank deposits constitute a primary source for credit. Any breakdown of the banking system will affect credit supply.[81] The provision of a payment system and effective credit circulation are essential to the functioning of a productive economy.[82] The role of banks is thus central to the functioning of a nation's monetary policy, and to assure a smooth-functioning payment system.[83]

Banks are highly leveraged institutions using debt to run their business and generate profits. Consequently, these debts are subject to strict regulations protecting the owner of these monies from loss.[84] These regulations are also directed to managing the adverse effects of banking risk exposures that may impact not only other banks, but also the broader economic sector and community generally.[85] In a globally connected banking and financial services market linked to international payments systems, losses can rapidly spread across countries resulting in what is known as systemic risk flowing from the contagion effect. Given the exposure of national economies and the international financial system generally, banks are treated as being "special" and as requiring more strategically tailored regulation compared to other types of businesses.[86] It is systemic risk associated with banking institutions that makes them special.[87]

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81 Jonathan R. Macey, Geoffrey P. Miller, and Richard S. Carnell, *Banking Law and Regulation* (Aspen Publishers, 3rd Edition, 2001) 63.
82 Catherine England, 'Are Banks Special?' (1991) *Spring CATO Review of Business & Government* 33.
83 Sappideen, above n 1, 5-6.
84 Ibid.
85 Risk exposure is the extent to which a bank could be affected by certain factors that may have a negative impact on returns and the stability of that institution, see Bessis, above n 6, 2.
86 Failures of banks and other financial institutions, especially in large numbers, can deprive society of capital and increase its cost. They are the most serious direct consequences of a systemic failure, Steven L. Schwarcz, 'Systemic Risk' (2008) 97 *The Gergetown Law Journal* 198.
87 E. Gerald Corrigan, 'The Banking-Commerce Controversy Revisited' (1991) 16 *Quarterly Review* (Federal Reserve Bank of New York), 3.

One essential goal of banking regulation is to prevent or mitigate crises that might cause the systemic collapse of banks, and even of the economy. Banks are interrelated through interbank markets where liquidity is transferred from banks with a surplus to banks with a deficit, and by payment systems, a system for clearing cheques and transmitting electronic payments.[88] Bank interaction through interbank markets and their dominance of payment systems creates the potential for widespread bank failure to cause severe economic disruption and even a banking panic.[89] Further, there is a fear of financial contagion spreading from one bank to another leading to the eventual collapse of the entire financial system.[90] Therefore, distress at some banks triggered by an initial default can potentially spread and force other events of default in other banks. Contagion due to interbank claims and obligations may also be reinforced by indirect contagion on the asset side of the balance sheet where banks are forced to write down the value of their assets.[91]

Financial risks have become increasingly complex and difficult to understand.[92] Preceding the GFC, hard-to-quantify dimensions of risk were largely neglected.[93] Banks did not appreciate their own levels of risk and counterparty risk. Those investing in complex products provided by banks also failed to understand their levels of risk.

In the event of a crisis, it is also in the public interest that banking regulatory measures restore market stability and market confidence. While the government may be prepared to act as lender of last resort in bad times, it is also important to implement applicable rules and

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[88] Franklin Allen, Elena Carletti, and Douglas Gale, 'Interbank Market Liquidity and Central Bank Intervention' (2009) 5 *Journal of Monetary Economics*, 640.
[89] Macey, Miller, and Carnell, *the Law of Banking Law and Financial Institutions* (Wolters Kluwer, 2017) 65.
[90] World Bank, 'Financing for Growth: Policy Choices in a Volatile World' (2001) World Bank, 75.
[91] Prasanna Gai and Sujit Kapadis, 'Contagion in Financial Networks' (2010) 466 Proceedings of the Royal Society, 2401–2402.
[92] Paul Hamalainen, 'Fallout from the Credit Squeeze and Northern Rock Crises: Incentives, Transparency and Implications for the Role of Market Discipline' in Franco Bruni and David Llewellyn (eds.), *The Failure of Northern Rock: A Multi-Dimensional Case Study* (The European Money and Finance Forum, 2009), 61.
[93] Patrick Honohan, "Risk Management and the Costs of the Banking Crisis," Institute for international integration Studies, TCD and CEPR, 2008, 9.

standards concerning bank exit policies. A robust exit policy could avoid credit and liquidity losses to depositors, avoid full insolvency triggers, and avoid contagion.[94] Rigorous bank exit measures provide certainty in the event of financial turmoil.[95]

The social objectives of banking regulation appear to be less obvious but are just as important. Social regulatory objectives include objectives such as increasing home ownership or channelling resources to particular sectors of the economy or population.[96] Bank credit can be directed, for example, to target disadvantaged sections of society or the economy.[97] Boosting economic development is an objective for banking regulation.[98] Other regulatory objectives include making funds available for small businesses, and for students to finance education-related spending.[99] These regulatory measures seek to redistribute income and stabilize the macro-economy. Particularly in developing economies, regulation plays a pivotal role in achieving developmental and social goals. Banks are regulated in a way designed to achieve those social objectives.[100] Finally, banking regulation also aims to combat financial crime including fraud and money laundering.[101] In summary, the public interest theory of regulation has two origins: economic and social. In this light, regulation is established largely in response to economic concerns and is created to solve economic problems.

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[94] Robert R. Bliss and George G. Kaufman, "U.S. Corporate and Bank Insolvency Regimes: An Economic Comparison and Evaluation," (2006) *Federal Reserve Bank of Chicago*, 3–5.
[95] Ibid.
[96] Australian Prudential and Regulatory Authority (APRA), 'Financial Regulation in the Twenty-First Century' (2000), [21/10/2017] http:// www.apra.gov.au/speeches/00_02.cfm.
[97] Ben S. Bernanke, 'Bank Regulation and Supervision-Balancing Benefits and Costs' (2006) Annual Convention of the American Bankers Association.
[98] Ibid.
[99] S. L. Harris and C. A. Pigott, 'Regulatory Reform in the Financial Services Industry: Where Have We Been? Where Do We Go?' (1997) 35 *OECD Financial Market Trends*, 67.
[100] Andrew Sheng, 'Bank Supervision Principles and Practice' (1990) 13 *World Bank Institute*.
[101] Ibid.

3.8 Risk Regulation Schemes

There are various types of regulations that are primarily concerned with a specific risk in the financial industry including among others systemic regulation and prudential regulation. The former is primarily concerned with the systemic risks. Meanwhile, the latter aims at providing a market confidence and level playing field for market participants. There are some important regulatory schemes directed to mitigate those risks including capital adequacy; deposit guarantee; and bailouts.

3.8.1 Capital Adequacy

Capital adequacy is one of the most important to any regulatory model. This is designed to mitigate credit risks, market risks, operational risks, liquidity risks, and systemic risks. This is based on the idea that risky assets require more capital while less risky assets require less. The Basel Committee on Banking Supervision (BCBS) of the Bank of International Settlement (BIS) introduced the capital adequacy standards regulation known as the Basel Accords in the 1980s. The Accords have been modified following financial failures and crises. Recently, the banking authorities around the world are implementing the changes to the Basel Accords III (known as a Basel IV) that is expected to be fully implemented in 2019. However, the discussions and debates on the new Basel Accords are ongoing.

3.8.2 Deposit Guarantee

Another important prudential regulation is deposit guarantee. The main objective of this scheme is to protect depositors' money and to reduce the fragility of the financial sector.[102] The principal objective is to contribute to the stability of the financial system and to protect less financially sophisticated depositors. Deposit insurance represents a financial safety net commonly used by governments to maintain depositors' confidence in the event of financial instability and thus to avoid bank runs. Although the issue arises as to whether government or private insurance mechanisms should be employed, most deposit insurance schemes around the world are government administered.[103] Historically, this regulation was firstly introduced in the United States following the Great Depression. In this era, thousands of banks were failing each year causing customers loss of their deposits. Thus, the US Federal Deposit Insurance Corporation (FDIC) was introduce in 1934. Accordingly, this deposit guarantee institution was perceived as the most important structural change in the banking history.[104] Currently, this type of scheme has been adopted by many countries. Diamond and Dybvig argue that this scheme is the only known effective measure to prevent bank runs.[105] They argue that with deposit guarantee, the banks no longer bear the downside risk of their positions since the deposit insurer bears that risk.[106] However, some argue that the existence of deposit guarantee creates an environment which provides incentive for banks to take on high risk/high return portfolios of assets. This is closely related to moral hazard problems.[107] In addition, the deposit insurance scheme is often directed towards systemic risks where the probability that the failure of a single

[102] George McKenzie and Manzoor Khalidi, "The EU Directive on Deposit Insurance: A Critical Evaluation" (1994) 32(2) *Journal of Common Market Studies* 171, 173.
[103] Ping, above n 59, 37.
[104] McKenzie and Khalidi, above n 103, 172.
[105] Douglas W. Diamond, and Philip H. Dybvig, 'Banking Theory, Deposit Insurance, and Bank Regulation' (1986) 59(1) *the Journal of Business* 55-68, 67.
[106] Ibid.
[107] McKenzie and Khalidi, above 103, 172.

bank will trigger a systemic collapse of the economy. This scheme may deter bank runs by alleviating the fear that banks will default on deposit accounts. This scheme can only be activated once a bank has declared defaults on its deposit payments.

3.8.3 Bailouts

The most controversial is government bailouts. Casey and Posner define a bailout as occurring:

> "When the government makes payments (including loans, loan guarantee, cash, and other types of consideration) to a liquidity-constrained private agent in order to enable that agent to pay its creditors and counterparties, when the agent is not entitled to those payments under a statutory scheme".[108]

The major rationale is the macroeconomic impact of failure and the systemic risk flowing from failure or large interconnected financial institutions. Private firms that utilised bailout are often perceived as being the 'too-big-to-fails", the failure of which would harm the whole economy.[109] There are objections to this policy on the grounds that it allows bailout of recipients that have no entitlement to a bailout, bailout encourages firms to engage in risky behaviour,[110] and that bailout transfers public money for the sake of private interests.

[108] Anthony J. Casey and Eric A. Posner, 'A Framework for Bailout Regulation' (2015) 91(2) *Notre Dame Law Review* 479, 481.
[109] Lev Ratnovski, 'Bank Liquidity Regulation and the Lender of Last Resort' (2009) 18 *Journal of Financial Intermediation* 541, 541.
[110] Ibid 482.

3.9 Summary

This chapter argues that the best approach is a combination of economic theory and public interest theories of regulation. It is the economic theory of regulation particularly banking and finance regulations that seek to balance diverse interests of regulated firms and entities, the regulators, and the public in general. In addition, from the viewpoint of economic rationale for banking regulation under public interest theory, there is a convergence of the interest of the public and some interests of the regulated banks. It is in the interest of banks to maintain a safe and stable banking regime that also confers benefits on the general public. On this view, banking regulation is not only captured under the private interest theory but also serves the economic objective stipulated by the public interest theory. However, it should be recognized that, regardless of the special attributes of banks, banks are exist to make profits and maximize returns for their investors. The corporate nature of banks in pursuing profit prevails over potential catastrophic consequences and regulatory penalties as a result of risk-taking. In part, it also justifies incumbent regulatory power to rein in banks and banking activities.

One of the justifications for regulation of banking and finance institutions is to mitigate and prevent risks that may jeopardise the industry and the whole economy. This is also related to public interest theory and economic theory of regulation. It is the government that has a central role in that risk regulation to protect the public from adverse consequences of banking and finance transactions through various types of regulations that are primarily concerned with a specific risk in the financial industry including among others capital adequacy policy. The next chapter begins the examination of how risk is managed through particular financial instruments, particularly hedging derivatives. It discusses how risk can be managed through a set of financial techniques designed to transfer risks.

CHAPTER 4: HEDGING AND DERIVATIVES

4.1 Introduction

In modern finance, derivatives are one of the pivotal hedging techniques to manage risks. They reduce potential risks that may occur in business activities of financial institutions. This discussion is important to the key arguments of the thesis since one of the key issues of Islamic finance is the lack of risk mitigation tools including hedging instruments that make Islamic finance more efficient to serve modern financial transactions.

This chapter discusses hedging and derivatives instruments from the perspective of conventional finance. It begins by exploring the nature of hedging including its purposes. It then moves to an examination of basic derivatives instruments such as options, forwards, futures, and swaps. This is followed by discussion of the trading system of derivatives including exchange traded, over-the-counter (OTC), and OTC cleared derivatives. It also considers some regulatory issues concerning derivatives.

4.2 Hedging and Its Economic Benefits

Hedging in its essence can be defined a method or means to manage risks in a business transaction. It is defined as a means of protecting against financial loss or other adverse circumstances .[1] It is also related to an investment activity that reduces the risk of adverse price

[1] Online Oxford Dictionary, 'Hedge' [06/12/2017] https://en.oxforddictionaries.com/definition/hedge.

movements in an asset[2] or a class of assets. Hedging is also used for some types of high risk activities to reduce risks that may impact on capital gains.[3]

Hedging performs a range of functions including risk mitigation, profit maximising, and arbitrage.[4] The focus of this section is the risk mitigation function of derivatives. Hedging is a risk management tool to avoid adverse movements of market prices in financial markets. Through hedging risks in financial markets can be distributed across a variety of innovative financial instruments such as derivatives. By mitigating those risks, financial markets may provide benefits through lowering the costs shouldered by other sectors on the economy. Hedging provides portfolio managers with a great deal of flexibility in investment choices.[5] Other forms of hedging activities including arbitrage enable hedgers or arbitrageurs not only to avoid risk but also to make a profit.[6] They act much like speculators.[7] There is also the advantage that hedgers may be able to avoid regulations and so maximise their profits.[8] This is because they function in private markets, are unregistered, and exempt from existing regulations.[9] Because of this hedging transactions are subject to surveillance and greater regulatory concerns due to its high risks in nature and potential negative impacts on financial industry.[10]

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[2] Investodia, 'Hedge' [06/12/2017] https://www.investopedia.com/terms/h/hedge.asp.
[3] The American Heritage Dictionary, 'Hedge Fund' (3rd Edition, 2011).
[4] Razeen Sappideen, 'The Regulation of Hedge Funds' (2016) 7 *Journal of Business Law 3.*
[5] Mark J. Powers et al, *Inside the Financial Futures Markets* (John Wiley and Sons, 1991).
[6] Ibid.
[7] Ibid.
[8] Henry Ordower, 'Demystifying Hedge Funds: A Design Primer' (2007) 7 *University of California Davis Business Law Journal* 323, 327.
[9] Particularly in securities, currencies, and derivatives markets, see W ulf A. Kaal and Dale A. Oesterle, 'The History of Hedge Fund Regulation in the United States' in *Handbook on Hedge Funds* (Oxford University Press, 2016).
[10] John Horsfield-Bradbury, 'Hedge Fund Self-Regulation in the US and the UK' (2008) Victor Brudney Prize in Corporate Governance 2008, [21/12/2017] http://www.law.harvard.edu/programs/corp_gov/papers/Brudney2008_Horsfield-Bradbury.pdf.

In contrast, the lack of hedging facilities or instruments for risk mitigation restricts opportunities for risk management and can lead to higher capital costs.[11] This is important in the later consideration of Islamic banks and opportunities for risk reduction, see chapter 5. This can result in financial markets becoming less efficient and jeopardising market participants in sustaining their business activities.

There are various instruments available for hedging activities in financial markets; the most important instruments are derivatives which are discussed in the following section.

4.3 Derivatives: Definition, Function, and Benefits

Derivatives are defined as contracts whose value is derived from the performance of underlying secondary sources or values.[12] These value of these financial instruments depends on financial assets that attached to it, such as bonds, equities, fixed-income instruments, shares, foreign currencies, commodities, etc.[13] Derivatives allow traders in the financial markets to purchase and sell a particular asset without the necessity of owing and trading in that asset. It also allow derivatives' participants to manage and hedge risks against adverse movements in the underlying asset's price.[14]

Legally, derivatives contain some basic features. First, it is the agreement or contract between two counterparties conferring rights and obligations on the parties.[15] Second, the

[11] Securities and Exchange Commission, 'Implications of the Growth of Hedge Funds' (2003) [8/12/2017] https://www.sec.gov/news/studies/hedgefunds0903.pdf.
[12] The definition of derivatives is varied across jurisdictions, see Timothy E. Lynch, 'Derivatives: A Twenty-First Century Understanding' (2011) 43 *Loyola University Chicago Law Journal*, 5.
[13] Black's Law Dictionary (8th Edition, 2004) 475, some argue that this definition may include nearly all financial instruments are derivatives such stocks and bonds, see Fischer Black and Myron Scholes, 'the Pricing of Options and Corporate Liabilities' (1973) 81(3) *The Journal of Political Economy* 637, 637.
[14] Satyajit Das, *Derivatives Products and Pricing* (John Wiley and Sons, 3rd Edition, 2006) 4.
[15] Lynch, above n, 12.

payment of derivatives relies on some unknown future events such that contracting parties have limited control over the outcome of the events.[16] Third, counterparties to these contracts take the opposite positions in relation to the underlying values. It means that one party expects the price of the underlying value to increase, while the other party expects a decrease.[17] Fourth, it is a form of zero-sum game, meaning that one trader's gain is another trader's loss.[18] Each type of derivatives functions in a particular way to mitigate a particular risk, as will be discussed below.

4.3.1 Options

Options give the contracting parties rights, but not obligations, to buy (call option) or sell (put option) a specified underlying asset at a predetermined price within a specified period of time.[19] To create options, a buyer pays a small payment (premium) in advance by way of a fee to a seller.[20] The amount of this premium depends on the level of risk for that option.[21] The premium is much smaller than the profit expected by the buyer.[22]

There are two methods of exercising an options, namely the American and European models. The former allows the timing of the exercising or execution before or on the expiration date of the option. The latter only permits exercise of the option on the expiration date.[23] The

[16] For further a limited control over the contingency in derivatives, See Lynch, above n 12, 18.
[17] Ibid.
[18] See, eg, Lynn A. Stout, 'Insurance or Gambling? Derivatives Trading in a World of Risk and Uncertainty' (1996) 14(1) *The Brookings Review* 38-41, 40; Timothy E. Lynch, 'Gambling by Another Name; the Challenge of Purely Speculative Derivatives' (2012) 17(1) *Stanford Journal of Law, Business, and Finance* 67.
[19] Alastair Hudson, *The Law on Financial Derivatives* (Sweet and Maxwell, 5th Edition, 2012) 1-56.
[20] Hudson, above n 19, 1-56.
[21] The Black-Scholes model is a common method to determine the price of options. This model enables transacting parties to quantify risk in determining the value of an option, for more discussion on this model, see Alan N. Rechtschaffen, *Capital Markets, Derivatives and the Law: Evolution after* Crisis (Oxford University Press, 2nd Edition, 2014) 204.
[22] Hudson, above n 19, 1-56.
[23] Most options being traded on exchanges are based on the American model, Hal S. Scott and Annan Gelpern, *International Finance: Transactions, Policy, and Regulation* (Foundation Press, 20th Edition, 2014) 922.

opportunity for early exercise of the option make the American option are more valuable than its European counterpart. While the American options can be treated similarly to the European ones just by deciding not to exercise until the expire date, the American model gives greater flexibility to respond to market movements prior to the expiration date. Consequently, American options are preferred.[24]

In terms of settlement mechanisms, both call options (rights to buy) and put options (rights to sell) can operate either physically settled options or as cash-settled options.[25] The former allows the buyer to call for delivery of the physical asset. While the latter allows the buyer of the option to receive a cash payment equivalent to the profit that would be made on the sale of those values.[26] In relation to trading options investors may take long or short positions. An investor (the buyer) has a long position where the investor has bought and owns those values. An investor (seller) has a short position where the investor owes those values, but does not actually own them yet.[27]

Options deliver economic benefits in the financial markets. Most importantly options increase liquidity. They provide investment opportunities in stock markets while financing long term projects. Investors can choose either to invest on a long-term or short term basis. The negotiable nature of options may attract more investments for projects. Investing in stock markets involves a high level of risk due to price fluctuations and the other influencing factors. Consequently, options give investors a method to mitigate the risk that the value of their investments may diminish. Options also give investors the opportunity to structure investment portfolios by choosing the most appropriate position of their portfolios.[28] Chapter 5 discusses

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[24] Muhammad al-Bashir Muhammad Al-Amine, *Risk Management in Islamic Finance: An Analysis of Derivatives Instruments in Commodity Markets* (Brill, 2008) 204.
[25] Hudson, above n 19, Ibid 1-58.
[26] Ibid 1-98.
[27] Rechtschaffen, above n 21, 198.
[28] See El-Gari, 'Towards an Islamic Stock Market' (1993) 1(1) *Islamic Economic Studies*, 12.

how far there are Islamic alternatives to options. Generally, options may provide efficiency in financial markets by allowing the parties to allocate risks. The next section will discuss forwards and futures.

4.3.2 Forwards and Futures

In forward contracts, both contracting parties agree to undertake a complete transaction at a future date for a specified price.[29] The main objective of this contract is to facilitate the sale and delivery of a commodity and to ensure that the commodity is available at the specified date in the future when it is needed by the purchaser of the forward.[30] In forwards, the price of the underlying asset or commodity may be subject to market fluctuations. The forwards contract can be sold to other parties at a lower or higher price than the original purchase price if buyer can find a counterparty willing to buy it.[31] An investor that agrees to buy an underlying value (such as bonds) has a long position, while the investor that agrees to sell that value has a short position.[32] The investor holding a long position will take the delivery of the asset and pay the seller of the asset the contract value, while the seller is obligated to deliver the asset.[33]

Forwards contracts are privately negotiated and arranged off-the exchanges.[34] Trading activities for these contracts operate outside formal exchanges and, in contrast to futures, without standard terms. Forwards' contracting parties privately negotiate the terms of the contracts such as duration, price, size, quality, and delivery location and time.[35] In forwards, a

[29] Hudson, above n 19, 1-92.
[30] Rechtschaffen, above n 21, 156.
[31] Ibid.
[32] Scott and Gelpern, above n 23.
[33] Ibid
[34] Rechtschaffen, above n 21, 156.
[35] J. Hull, *Options, Futures and other Derivatives* (Prentice Hall, 7th Edition, 2009).

seller must find the counterparty willing to enter into the contract for a similar asset or commodity.[36] This has been one of its major disadvantages because forwards may not be the most reliable and efficient instruments for hedging risks.[37] The reasons for this are explained below.

In contrast to forwards contracts, futures are essentially forwards contracts traded in an exchange with standardised terms.[38] Since futures are traded in an exchange, the trading system may remove disadvantages of forwards contracts. Since forwards contracts cannot be readily traded on a formal market platform this restricts ready conversion into cash (illiquidity). In forwards, there must simultaneously be a party who wants to sell a commodity on a forward basis and a party who wants to buy that commodity for future delivery, (double coincidence of wants). These limitations are mitigated by the trading system on organized exchanges.[39]

The problems arising out of counterparty risks, where a contracting party fails to conclude the forward contract, are removed by the margin system and the clearing-house acting as the counterparty in each transaction.[40] The margin system and clearing house will be discussed in next sections. There are additional measures to mitigate counterparty risks in futures markets. These are: the requirement that the investor provide a performance bond reflecting a "good faith" of margin deposit as collateral for the transaction; Futures are marked-to-market on a daily basis with an exchange of cash flow between member firms reflecting the net market movements of aggregated positions; futures exchanges recognise only exchange

[36] Rechtschaffen, above n 21, 156.
[37] Ibid.
[38] Ibid 157.
[39] This will be discussed in detail in the following section of this chapter.
[40] Sanjay Kevin, *Security Analysis and Portfolio Management* (Prentice-Hall, 2007) 240.

members as counterparties to individual transactions.[41] This would also be used to ensure solvency of the futures market members in trading activities of these futures.

Although futures address some of the deficiencies of forwards, not all problems have been resolved. For instance, the contracts are not sufficiently flexible to benefit from subsequent favourable price movements. In this situation, for instance, the price of the underlying asset in the market may decrease before the exercise date. Thus, market participants of futures markets may use put and call options or rights to buy and sell the underlying asset under the futures contracts within a defined period of time. If in a particular period the price of the asset is less than the exercise price of those futures contract, the buyer will purchase the underlying asset at the current price and sell it at the stipulated price in the option through exercising the put option. However, if at a particular time the price of the asset is greater than the exercise price of those futures, the buyer of the options will not exercise the option to buy the asset and let the options expire.[42]

4.3.3 Economic Benefits of Futures Markets

Risk shifting is the main reason for the development of futures markets. Hedgers use futures to mitigate risk exposures particularly price fluctuation in a commodity market. Futures contracts enable producers, processors, traders, and end users to look a price for their products. A processor, for instance, may opt to reduce the price risk involved in buying, storing and eventually using their raw materials. In a market economy, manufacturers run the risk of large

[41] Rechtschaffen, above n 21, 159.
[42] Anthony Saunders and Marcia Millon Cornett, *Financial Institutions Management: A Risk Management Approach* (McGraw Hill, 6th Edition, 2007) 308.

changes in the prices of the raw material or the final products between the time they buy their raw material and the time they sell their final products.

When the risk is transferred efficiently, futures market may enhance liquidity in a particular commodity market as a large group of traders ready to buy and sell that commodity. When a seller wants to sell futures contracts to protect the business, the seller need not wait for a long period of time for a buyer because futures markets enable a large number of traders and hedgers to transact quickly favouring their respective positions.

The other advantage is that the markets decide the appropriate price at a particular period of time. Futures contracts work in contrast to the fixed price system that often results in resource misallocation and high costs. Futures markets thus represent an equilibrium between the supply and the demand in a free market economy. Futures exchanges have been established to avoid losses due to price fluctuations. Moreover, commodities in futures markets need to be standardised and graded following market requirements. The quality of the commodities must also be standardised. This mechanism encourages producers to upgrade their production techniques.

Muslim economies, particularly in Middle Eastern countries, largely depend on oil production. It is clear that futures in crude oil may deliver advantages to mitigate the fluctuation of the oil price in global markets. Most Muslim countries have not taken advantage of futures to reduce the negative effect of oil price fluctuations and to profit from it. In these markets, as will be discussed in Chapter 5, derivatives instruments are considered as contrary to the spirit of Islamic finance. Chapter 5 argues that there are alternative positions possible for Islamic finance in delivering the economic effects of conventional derivatives.

4.3.4 Swaps

Another important derivatives product is swaps. Swaps are an agreement where buyer and seller exchange future cash flows for a period of time. One of the basic swaps is interest rate swaps also called "plain vanilla" swaps.[43] Under this contract, two parties are trading a fixed and variable interest rate. For instance, one company may have a bond that pays the London Interbank Offered Rate (LIBOR) which is a variable rate, while the other party holds a bond that provides a fixed payment of interest say 10 per cent. If the LIBOR rate over the period of the swap is higher than the 10 per cent, then the party agreeing to receive interest in accordance with LIBOR will receive more than the party entitled to receive the 10 per cent. Normally neither party will in fact pay the sums which it has agreed to pay over the period of the swap but instead will make a settlement on a net payment basis under which the party owing the greater amount on any day simply pays the difference between the two amounts due to the other.[44]

Swaps enable financial institutions or users to hedge against particular risks. For instance, an issuer (a bank) of a particular fixed-rate bond may reduce the risk of interest rate volatility by entering into the interest rate swap contract. The bank uses this bond to make floating rate loans to its customers. If rates decrease, the bank is at risk. By swapping its variable revenues for fixed rates, the bank hedges its exposure on its bonds.[45]

Similar to other derivatives instruments, swaps enable risks to be transferred to those who take on the risk. The following section will discuss general objectives of derivatives.

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[43] Frank Partnoy, 'Financial Derivatives and the Costs of Regulatory Arbitrage' (1997) 22 *Journal of Corporation Law* 211, 219.
[44] Hudson, above n 19, 1-96.
[45] Scott and Gelpern, above n 23, 962.

4.3.5 Objectives of Derivatives

1. Transferring Risks

Derivatives allow contracting parties to transfer specific risks that may occur in their business transactions. These risks include interest rate risks, currency risks, equity and commodity price risks, and credit risks. A party transfers these risks to other parties who are more willing or better suited to take or manage those risks. This mechanism frequently takes place without trading in the underlying asset or commodity that derivatives are based on.[46]

2. Managing and Hedging Risks

Derivatives are also designed to manage risk. Derivatives are commonly used to lock in uncertain future prices of an underlying asset without the need to purchase that asset. Contracting parties can invest in an underlying asset with a small upfront monetary commitment using borrowed funds enabling a party future control over an asset that has not yet been purchased.[47] In derivatives, a contracting party is not required to transfer funds until a contemplated performance or maturity date.[48]

Hedging is also one of the most common strategies of using derivatives. The unwanted risks of a particular transaction may be reduced or mitigated by entering into an offsetting derivatives transaction. Hedging contracts allow risks to be hedged one by one rather than

[46] This will be discussed in the following section of this chapter of this thesis.
[47] Rechtschaffen, above n 21, 153.
[48] Ibid.

relying solely on risk diversification allowing the banks to buy protection against the overall level of defaults.[49]

3. Maximising Profits and Zero Sum Game

The most controversial function of derivatives is speculation.[50] Speculators use derivatives to generate profits in financial markets.[51] In addition, derivatives also represent a zero-sum game.[52] It means that in derivatives contracts, such as futures and options, there are two contracting parties at opposing ends of the contract. If one party wins, the other will lose.[53] In addition, in exchange traded derivatives (discussed in the following section), there are a common rules namely margin trading that facilitates this speculation.[54]

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[49] The models used for this approach are, for instance, Value at Risk (VaR), Market Risk VaR. It is said that this collective hedging strategy is to be less costly than numerous individual hedging strategies, because it will capture economies of scale and diversification benefits, and avoid duplicative hedging costs that individual entities may incur, e.g. a mutual fund may own two stocks that have offsetting exposure to some risk, see John C. Hull, *Risk Mangement and Financial Institutions* (Wiley, 3rd Edition, 2012) 16.

[50] See Timothy E. Lynch, 'Gambling by Another Name; the Challenge of Purely Speculative Derivatives' (2012) 17(1) *Stanford Journal of Law, Business, and Finance* 67, 71.

[51] See Tony Norfield, 'Derivatives and Capitalist Markets: The Speculative Heart of Capital' (2012) 20(1) *Historical Materialism* 103-132, 103.

[52] See, eg, Lynn A. Stout, 'Insurance or Gambling? Derivatives Trading in a World of Risk and Uncertainty' (1996) 14(1) *The Brookings Review* 38-41, 40; Timothy E. Lynch, 'Gambling by Another Name; the Challenge of Purely Speculative Derivatives' (2012) 17(1) *Stanford Journal of Law, Business, and Finance* 67; and Thomas Lee Hazen, 'Rational Investments, Speculation, or Gambling: Derivatives Securities and Financial Futures and Their Effect on the Underlying Capital Markets' (1992) 86 *Northwestern University Law Review* 987, 1006.

[53] Ibid.

[54] See, eg, Daniel Ladley, Guanqing Liu, and James Rockey, 'Margin Trading: Hedonic Returns and Real Losses' (2016) Available at SSRN: https://ssrn.com/abstract=2762219; and Anne Jones Dorn, Daniel Dorn, and Paul Sengmueller, 'Trading as Gambling' (2015) 61(10) *Management Science* 2376-2393.

4. Arbitrage

Derivatives can also be used for arbitrage activities. There is on the one hand regulatory arbitrate, where derivatives are used to circumvent regulatory regimes (regulatory arbitrage) so the practice of using derivatives allows a position where a more favourable regulatory regime applies.[55] In its usual sense arbitrage refers to trading in derivatives which allows contracting parties to generate profit by exploiting the differences in identical or similar financial instruments in different markets. Some derivatives such as swaps trading allows contracting parties to take advantage of arbitrage opportunities among different financial markets. This arbitrage is based on the difference between swap spreads and interest rates available in other markets.[56]

4.4 Trading in Derivatives: Exchange Traded, OTC (Over-the-Counter), and OTC Cleared Derivatives

Derivatives are traded either in an exchange or over-the-counter (OTC).[57] Exchange traded derivatives are conducted in an exchange; contracting parties must be members of that exchange in order to trade in derivatives. This reduces counterparty risks where a party fails to conclude the derivative contract.[58] This type of trading requires standardised futures contracts. The exchange provides mechanisms to guarantee the interests of both parties where the contract

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55 Hudson, above n 19, 1-39.

56 See, eg, Frank Partnoy, 'Financial Derivatives and the Costs of Regulatory Arbitrage' (1997) 22 *Journal of Corporation Law* 211, 210 discussing on how the market manipulates the London Interbank Offered Rate (LIBOR) as a benchmark rate in the global interest rate swap market to take regulatory opportunities; and Philip Ashton and Brett Christophers, 'On Arbitration, Arbitrage and Arbitrariness in Financial Markets and their Governance: Unpacking LIBOR and the LIBOR Scandal' (2015) 44(2) *Economy and Society Volume* 188-217.

57 However, some classify derivatives into three groups: OTC derivatives; exchange traded derivatives; and debt obligations (hybrid securities or securitised derivatives), see Schuyler K. Henderson, *Henderson on Derivatives* (LexisNexis, 2nd Edition, 2010).

58 Rechtschaffen, above n 21, 152.

is dishonoured. First, the clearing-house is established and serves as its own counterparty to every trade. This house guarantees each contract. In other words, an individual trader does not need to evaluate the profile and integrity of their counterparty.[59] Those exchanges are, for instance, the Chicago Board of Trade (CBOT) and the Chicago Mercantile Exchange (CME) in United States, the Sydney Futures Exchange (SFE) in Australia, and Indonesian Futures Exchange in Jakarta.

In contrast, OTC derivatives are designed and negotiated individually between contracting parties.[60] This type of trading does not need an exchange. Some of basic derivatives instruments are in this category. These include swaps, options, and forwards. Swaps can be regarded as the first modern example of OTC financial derivatives.[61] These derivatives allow counterparties to negotiate specific contract terms and the parties to tailor contracts to individual needs.

A growing number of regulations directed to derivatives markets obscure the line between OTC and exchange-traded derivatives. These regulations force many standard forms of swaps to be cleared through the mechanism of an exchange called central counterparties (CCPs) akin to clearing-houses in exchange traded derivatives.[62] In addition, the use of standard documentation in the global swap transactions such as ISDA Documentation makes OTC derivatives contracts more standardised than customised.[63] In Chapter 6, the standardisation of OTC derivatives particularly one that was set up by ISDA will be examined along with its Sharia compliant alternatives.

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59 Ibid.
60 Ibid.
61 Christopher L. Culp, 'OTC-Cleared Derivatives: Benefits, Costs, and Implications of the "Dodd-Frank Wall Street Reform and Consumer Protection Act' (2010) 2 *Journal of Applied Finance* 103-129, 106.
62 Rechtschaffen, above n 21, 152.
63 ISDA Documentation will be discussed in Chapter 6 of this thesis.

4.4.1 The Trading System in Exchange-Traded Derivatives

In an exchange, a clearing house plays the role of an intermediary between the buyers and the sellers in derivative transactions. It simultaneously becomes the seller to the original buyer and the buyer to the original seller.[64] To allow this mechanism, the exchange requires its members to obtain margin rules, i.e. initial margin, maintenance margin or margin variation, and margin calls on every single derivatives transaction,[65] discussed in the next section.

4.4.2 Margin Rules in Derivatives Transactions

Exchange traded derivatives rely on margin rules in smoothing transactions. To illustrate this mechanism, assume that a trader wants to enter into a futures contract in an exchange market. After becoming a member of that exchange, the trader must maintain a certain amount of cash or collateral in the trader’s account to guarantee performance of the trader’s trading activities. The trader then deposits this amount with the clearing-house.[66] This amount (called the initial margin) is a small percentage of the current price of the futures contract, say 5 per cent.[67]

After the trader has signed into a trading platform, the trader holds a variation margin account. This margin is adjusted on a daily basis based on price movements in the underlying asset (this daily adjustment is called a “mark-to-market”) traded by the trader. This margin ensures that the trader’s account (variation margin) follows market movements. For instance,

[64] Rechtschaffen, above n 21, 188.
[65] For more discussion on the evolution of margin rules, see William G. Tomek, ‘Margins on Futures Contracts: Their Economic Roles and Regulation’ (1985) *American Enterprise Institute for Public Policy*, [21/07/2017] http://www.farmdoc.illinois.edu/irwin/archive/books/Futures-Regulatory/Futures-Regulatory_chapter3.pdf.
[66] Ibid 648.
[67] Scott and Anna Gelpern, above n 23, 930.

if the trader suffers a loss, this will be directly reflected in the trader's variation margin account; on the other hand, if the trader gains, the account will increase.

Lastly, the trader is also subject to a maintenance margin. This margin is required when the variation margin account falls below a specified level, the trader must inject more money into the account; otherwise the trader's position will be liquidated.[68] Thus, the trader has to maintain the minimum level of the maintenance margin. If this minimum margin call is insufficient to offset the decline in the contract's value, the broker or the dealer is obliged to pay the exchange any shortfall that must be paid by the trader.[69] The way that the dealer pays the shortfall is subject to regulations in respective jurisdictions.

From the perspective of risk management, the margin system allows exchanged-traded derivatives to protect their contracting parties. The risks of adverse movements of an underlying asset under the contract are adjusted directly in the parties' margin accounts. In addition, the margin system also signifies that futures contracts are highly leveraged financial instruments. This means that a trader is only required to provide at least 5 per cent of the contract's notional value to enter into in these derivatives transactions.

The above mechanisms allow huge profits or losses on a relatively minimal initial investment which encourages speculation.[70] It is less likely to be a problem if futures are used for hedging purposes. Losses on a position will be offset by gains on the underlying cash position being hedged, and vice versa. The amount of gains or losses are then taken from the clearing house and the winners receive the profits and losers have the amount of the equivalent loss debited from their margin account by the clearing house.[71] The combination of initial

[68] Ibid.
[69] Ibid.
[70] Sheila C. Bair, 'Lessons from the Barings Collapse' (1995) 64(1) *Fordham Law Review*, 1-10.
[71] Robert Tompkins, *Options Explained2* (Springer, 2016) 535.

margins and variation margins ensures that players in the market have sufficient funds to meet their obligations.[72]

The relevance of these derivatives to Islamic finance will be discussed in chapter 5. These types of trading mechanisms have not yet attracted major discussion by Muslim scholars. The discussion principally focuses on contractual functions of medieval Islamic contracts that may replicate the economic effects of conventional derivatives.

4.4.3 Trading System in OTC Derivatives: From Bilaterally Negotiated to Centralised Clearing

Financial crises in the last two decades has prompted OTC derivatives, particularly derivatives transactions that occur in banking and financial markets, to be shifted into central counterparties known as CCPs. This trend followed the G-20 summit in September 2009. There leaders made the commitment that all standardised OTC derivatives contracts, such as swaps, should be traded on exchanges or electronic platforms. These transactions should also be cleared through CCPs and reported to trade repositories in their respective jurisdictions. OTC derivatives that are not centrally cleared should be subject to higher capital requirements.[73] Jurisdictions that hosts OTC derivatives transactions should also establish rules of the game for trading mechanisms through CCPs.

[72] Lynn A. Stout, 'How Deregulating Derivatives Led to Disaster, and Why Regulating Them Can Prevent Another' (2009) available at http://ssrn.com/abstract=1432654>.

[73] See Point 13 of the G-20 Leaders Statement: The Pittsburgh Summit, (September, 2009) [21/10/2017] http://www.g20.utoronto.ca/2009/2009communique0925.html. In addition, capital requirement method developed by Basel highlighted in Chapter 3 and will be thoroughly discussed in Chapter 9. The principle of Basel capital requirement is that risky assets require more capital, while less risky assets require less capital.

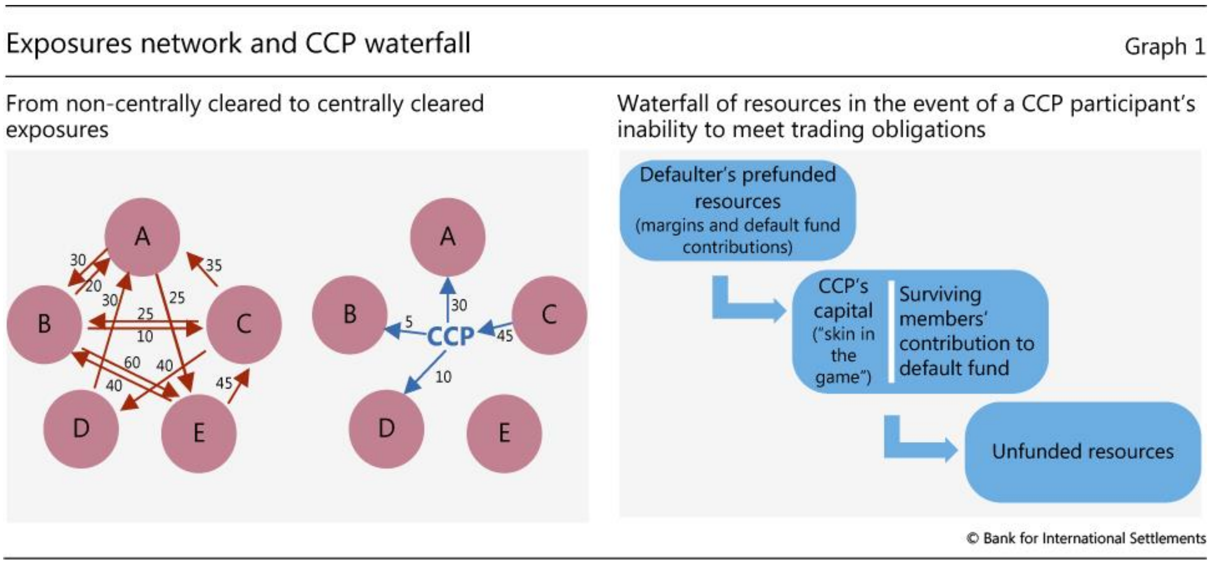
CCPs are organised in a similar fashion to futures exchanges. CCPs simultaneously act as a buyer to original sellers, and a seller to original buyers. To protect this trading mechanism, CCPs may require its members to submit to margin rules and default fund contributions (a fund to cover the losses of a clearing member in case that the initial margin is not enough to cover the losses).[74]

CCPs employ risk sharing arrangements in its trading activities. As shown in the following figure 3, each CCP member has responsibility to cover the risks that may occur in the OTC derivatives activities of other members. CCPs create three levels of defence against defaulting members. First, margin rules posted by clearing members provide risk protection against their positions. This margin rule is similar to the margin rule in futures exchanges. Second, defaults funds contributed by clearing members provide a second buffer after the margin is fully used. According to Basel, default funds also known as clearing deposits or guarantee fund contributions are clearing member's funded or unfunded contributions towards a CCP's mutualized loss sharing arrangements.[75] And third, the last level of defence is the CCP's own capital in a case that the defaults funds are not sufficient to cover the losses called "Skin-in-the game". If the final level of the CCP's capital proves to be insufficient, the CCP would default and the clearing members would need to mutualize the losses.[76] It means that all CCP members are responsible to cover losses resulting from derivatives transactions under the supervision of that particular CCP.

[74] Svetlana Borovkova, and HIcham Lalaoui El Mouttalibi 'Systemic Risk and Centralized Clearing of OTC Derivatives: A Network Approach' (2013), Available at SSRN: https://ssrn.com/abstract=2334251, 9.
[75] Basel Committee on Banking Supervision, 'Capital Requirements for Bank Exposures to Central Counterparties' (July 2012) Bank for International Settlements, 8.
[76] Cristiano Zazzara, "OTC Derivatives Clearing: Central Counterparties (CCPs) and Capital Requirements" (Harvard Symposium, Harvard University, 2016) 6.

The following figure shows the shift from non-centralised to a centralised trading system.

Figure 4.1. The Shift from Non-Centralised to a Centralised Trading System



Source: Bank for International Settlements.[77]

4.4.4 CCPs as Insurance for OTC Derivatives?

It is interesting to see how the global financial regulation is directed towards risk and loss sharing arrangements. As explained above, in the CCP's system, the clearing house acts as an insurance entity for OTC derivatives markets by controlling risks. As the members of the CCP are required to deposit a percentage of their notional amount, these default funds may cover their future losses. These funds are akin to a price or premium for protection against unknown risks in their future transactions.

[77] Dietrich Domanski, et al, 'Central Clearing: Trends and Current Issues' (December 2015) *BIS Quarterly Review*, 61.

Although the CCP is viewed as providing a self-controlled mechanism over systemic risk in the financial markets, a risk that may spread to the whole economy, it still raises some issues for concern. The first concern is whether the CCPs belong to a group of shareholders or its members. I If the CCP belongs to the members of CCP, then the members have a right to any benefits derived from the funds collected by the CCPs. In the case of default by any member, it is unclear whether the collected funds will be used to cover the default. If the losses are not covered by the collected funds, whether all members are responsible for the loss. This remains a question for the CCP system.

This last concern is also related to the possible risk transfer from the OTC derivatives members to the CCPs signifying collective coverage of a defaulting party creating the probability of individual risk taking of OTC derivatives participants.[78] The shift from bilateral OTC to central clearing may provide a protective mechanism where risks are pooled. However, this risk sharing mechanism may create costs in the form of distorted incentives. In other words, moral hazards may arise at various levels of the clearing either by the CCP itself or its members, i.e. CCP may engage in riskier investments if a bailout is assured, or members may become involved in riskier trade profiles and adverse selection.[79]

The July 2017 report by the Bank for International Settlements (BIS) and International Organization of Securities Commission (IOSCO) stated as follows:

> CCPs are expected to cover fully their current and potential future exposures to each participant with a high degree of confidence. All CCPs are also expected to maintain additional prefunded financial resources in an amount sufficient to cover a wide range of potential stress scenarios that should include, but not be limited to, the default of the one or two participants and their affiliates

[78] Ibid.
[79] Svetlana Borovkova, and HIcham Lalaoui El Mouttalibi "Systemic Risk and Centralized Clearing of OTC Derivatives: A Network Approach" (December 11, 2013). Available at SSRN: https://ssrn.com/abstract=2334251, 9.

that would potentially cause the largest aggregate credit exposure to the CCP in extreme but plausible market conditions.[80]

Thus, the CCPs are responsible to cover the future losses of its members. This means that CCPs become systemically important where their failure may create systemic effects in the financial industry making them as "too-big-to-fail" entities that may look to government for bailouts.[81] As a consequence, it has been argued that these entities should be not formed privately;[82] there should be a government role through a public-private partnership that may provide an incentive to discourage excessive risk taking in the OTC markets through various regulatory frameworks.[83]

Regulatory frameworks are imperative to guide CCPs in serving the public interest as part of economic regulation as stated in Chapter 3. Thus, several jurisdictions have established specific regulations for the central clearing mechanism. For instance, the first central clearing obligation in the EU came into effect on 21st June 2016.[84] Most countries have opted for mandatory clearing of interest rate derivatives, which makeup a large portion of the total outstanding derivatives transactions.[85] For instance, the Australian Securities and Investments Commission (ASIC) requires that certain OTC interest rate derivatives between larger financial institutions in major currencies are cleared through a CCP. However, Australian banks do not have to clear all their single-currency swaps.[86] In Indonesia, at the time of writing, has not yet

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80 Bank for International Settlements and International Organization of Securities Commissions, '*Resilience of Central Counterparties (CCPs): Further Guidance on the PFMI*' (July 2017) [15/10/2017] http://www.bis.org/cpmi/publ/d163.pdf, 24
81 Manmohan Singh, 'Making OTC Derivatives Safe - A Fresh Look' (March 2011) 11 (66) *IMF Working Papers* 1-22.
82 See Gordon C. Rausser, William Balson, and Reid B. Stevens, "Centralized Clearing for Over-the-Counter Derivatives" (September 18, 2009). Available at SSRN: https://ssrn.com/abstract=1475351.
83 Ibid.
84 Lucia Orszaghova, 'Central Counterparties: Recent Trends and Regulatory Responses' (2018) 1 *Financial Market Regulation* 26, 30.
85 Ibid 30.
86 Duke Cole and Daniel Ji, 'The Australian OTC Derivatives Market: Insight from New Trade Repository Data' (2018) *Reserve Bank of Australia Bulletin*, 13.

established any regulation of CCP. Bank Indonesia planned to establish this CCP for OTC derivatives transactions by the end of 2018.[87]

The growing number of OTC derivatives transactions has resulted in increasing regulation to govern these transactions including the establishment of CCPs. Most Muslim countries have no regulations on this. This is because derivatives transactions are almost absent in those countries due to the prohibition of most conventional derivatives under Islamic law. This interpretation has been refuted by modern Muslim scholars who argue that some types of derivatives-like features derived from medieval Islamic rules can be applied in Muslim economies. This is discussed in detail in Chapter 5. This means that most Muslim nations are left behind in developing regulatory frameworks for CCPs. Based on the author's review, up to 2018, Islamic perspective on CCPs has not been considered by the International Islamic Financial Services Board (IFSB), a non-government regulatory body for governance, supervision, and regulatory aspects of Islamic finance based in Kuala Lumpur or International Islamic Financial Markets (IIFM), a non-government regulatory specialising in creating standard documentation for Sharia compliant derivatives based in Bahrain. The CCP might attract interesting debates in Islamic finance discourses. On the one hand, CCPs might be regarded as gambling activities as this concept employs a margin system. On the other hand, this concept also involves risk sharing arrangements promoted by Islamic advocates as the true basis of Islamic finance as discussed in Chapter 2.

[87] Ayomi Amindoni, 'Indonesia to Establish Clearing House for Derivatives in 2018' (2016) the Jakarta Post, July 22.

4.5 Summary

This chapter has examined derivatives in financial markets. Derivatives contracts are contracts that derive its value from underlying assets. These instruments are inevitable in managing and hedging risks in a modern business economy. The basic features of derivatives such as options, forwards, futures, and swaps respectively deliver economic benefits if they are applied to mitigate the unknown future events.

The key distinctions of importance in this chapter are between options, forwards, futures, and swaps. As will be seen in chapters 5, 7, and 8, these distinctions are important in assessing financial instruments from the point of view of *Sharia* compliance transactions. As derivatives can deliver economic benefits for the economy, it is important to develop these types of contracts in modern Islamic finance. Amid the disagreements of derivatives instruments among Muslim scholars particularly on the view that derivatives involving a prohibited element particularly *gharar* (uncertainty) such as selling something that is not owned by the seller, modern Islamic finance reconstructs medieval Islamic rules arguing that derivatives may have its equivalent in the Sharia compliant industry. This will be examined in the next chapter.

CHAPTER 5: DERIVATIVES IN ISLAMIC LAW

5.1 Introduction

This chapter elaborates the argument in Chapter 2 that modern Islamic finance can find an appropriate balance between orthodoxy and efficiency. The logic of modern finance particularly risk management must be considered in structuring Islamic financial products and services.

This chapter examines seemingly rigid stances of some Sharia opinions that prohibit nearly all types of derivatives. Using the methodology described in chapter 2, this chapter provides alternative interpretations which would legitimise modern risk management instruments with derivatives-like features to be incorporated into Islamic finance.[1] First, this chapter discusses the importance of derivatives for a modern Islamic financial industry. Second, it provides an alternative Sharia view in response to some objections to derivative instruments by Islamic finance academics. Third, it examines the definition, scope, characteristics, and practices of Sharia compliant derivatives. Fourth, it discusses Sharia compliant derivatives-like features. This examination corresponds sequentially to the most common types of swaps namely interest rate swaps in conventional derivatives. This is followed by the summary.

[1] Well-known commentators in Islamic finance suggest that the current development of Islamic finance needs risk management tool such as derivatives, see, eg, M. Umer Chapra, and T. Khan, "Regulation and Supervision of Islamic Banks" (Policy Paper No 3, IRTI Islamic Development Bank, 2000); and Moody's, 'Derivatives in Islamic Finance: Examining the Role of Innovation in the Industry' (Report, Moody's, 2010).

5.2 The Need for Derivatives in Islamic Finance

Derivatives are a key part of modern financial risk management (Chapter 4). Derivatives allow financial institutions to mitigate and hedge various risks which occur in their business transactions. In order to develop Islamically acceptable derivatives, it is necessary to ensure that these instruments do not contravene Islamic juristic rules.[2]

Despite the need for modern risk management instruments particularly derivatives in the Islamic finance industry, the industry has been slow to develop Sharia compliant derivatives.[3] The reasons for this include the lack of research on efficient alternatives to Islamic alternatives on derivatives. It is complicated by the number of *fatwas* that prohibit conventional derivatives affecting risk management processes in Islamic finance and the lack of standardisation of Islamic contracts on derivatives.[4] The standardisation issue is not addressed in this chapter but is examined in chapter 6. The development of modern derivative instruments would permit IFIs to reduce and manage their risk exposures, improve their overall creditworthiness[5] make them more competitive as well as satisfying the needs of a modern economy, business, and customers.[6]

Another issue in developing Sharia complaint derivatives is whether these Islamic versions should simply duplicate existing non-Islamic derivatives instruments. Of course, there is diversity of scholarly opinions on those matters. They range from a total rejection of

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[2] See, eg, Muhammad Al-Bashir Muhammad Al-Amine, 'Risk and Derivatives in Islamic Finance: A Sharia Analysis' in K. Hunt-Ahmed, et al, *Contemporary Islamic Finance* (John Wiley and Sons, 2013) 331-352, 332; and Bashar H. Malkawi, 'Financial Derivatives Between Western Legal Tradition and Islamic Finance: A Comparative Approach' (2014) 15(1) *Journal of Banking Regulation*, 41-55.
[3] T. Khan and Habib Ahmed, *Risk Management: An Analysis of Issues in Islamic Financial Industry*, (Islamic Development Bank, Islamic Research and Training Institute, 2001) 164.
[4] Ibid, 164.
[5] Anouar Hassoune, 'Derivatives in Islamic Finance: Examining the Role of Innovation in the Industry' (Report, Moody's, April 2010).
[6] Ibid.

derivatives in some countries and limited implementation in others.[7] This has resulted in a cautious approach by the Islamic finance industry towards derivatives. However, contemporary Sharia rules provide an alternative interpretation to some seemingly rigid *fatwas* or Sharia opinions on derivatives. The following section examines those objections and alternative interpretations derived from various Islamic juristic rules that may bring alternative permissible derivatives under Islamic finance.

5.3 *Gharar* (Uncertainty) and Derivatives

The main objection to derivatives is that it may involve prohibited *gharar,* often translated as uncertainty. A *fatwa* prohibiting derivatives provides:

> "where the contract provides for the delivery of described and secured merchandise at some future date, and payment of its price on delivery. It also stipulates that it shall end with the actual delivery and receipt of the merchandise. This contract is not permissible because the deferment of the two elements of the exchange [delivery and payment]".[8]

This *fatwa* refers to futures contracts as one of the derivatives described in 4.3.2 of chapter 4. In futures, both the delivery of commodities and payment of money are postponed to a future date. The *fatwa* states that a sale can only be valid if either the money or the delivery is postponed but not both. For a sale to be valid, there must also be a transfer of ownership of the commodity sold. If the seller does not own the commodity, the seller cannot transfer ownership. It is argued that almost all Islamic legal schools (*madhahib*) in Sunni traditions agree that the

[7] Al-Amine in Hunt-Ahmed, et al, above n 2, 332.
[8] Organization of Islamic Countries (OIC), 'Resolution No 63/1/7' (2000).

sale of non-existent commodities or objects, and objects that may cease to exist, is not in conformity with Islamic law.[9]

But this is not a universal view as there are Islamic juristic rules indicating that the non-existence of subject matter does not necessarily invalidate the sale contract.[10] The rationale behind the prohibition of selling non-existent subject matter is the uncertainty regarding the qualitative and quantitative elements of the subject matter. If these uncertainties could be removed by a certain agreed mechanism, then it is possible to create such futures contracts under Islamic law.[11] Thus, the deferment of the two counter values (money and subject matter) should be allowed.[12] Some scholars argue that the opinion based on scholars unanimous agreement (*ijma*) on the prohibition of the sale of non-existent subject matter, is very weak.[13] This should not prevent Islamic futures contracts. Muslim scholars require that the deferment of counter values in sales contract be directed towards a real exchange not for speculative purposes.[14] Those scholars do not further elaborate on how the speculative nature of futures could be removed. There is the further difficulty to be considered, that is whether the margin system in futures exchanges may lead to speculative activities through the leverage system, whereby only a small percentage of cost for the notional transaction enables a participant to trade in that transaction to earn profit (paragraph 4.3.10 of chapter 4).

The thesis argues that futures contracts should not be categorised as a *gharar* (uncertainty) sale because the uncertainty has been removed by the trading and guarantee

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[9] Wahbah Al-Zuhayli, *Financial Transactions in Islamic Jurisprudence. Vol.1* (translated by Mahmoud A. El-Gamal, and revised by Muhammad S. Eissa) (Dar Al-Fikr, 2001), 75.
[10] M. Zahra and SM. Mahmor, 'The Validity of Contracts when the Goods are not Yet in Existence in Islamic La of Sale Goods' (2002) 17(4) *Arab Law Quarterly* 379-97, 397.
[11] Ibid.
[12] Monzer Kahf, 'Islam's Stance on Commodities and Futures Markets' [25/03/2017] http://www.Islamonline.net/servlet/satellite?cid=1119503544954&pagename=IslamOnline_English-Ask_Scholar52FFatwaE%2FPrintFatwaE.
[13] Ibid.
[14] Ibid.

mechanism of a standardised exchange market, i.e. through a clearing-house.[15] The clearing house mechanism has been extensively discussed in paragraph 4.4 of Chapter 4. This approach is based on public interest considerations (*maslahah*) in allowing futures transactions.[16] The public interest considerations have been discussed at paragraph 3.4 of chapter 3. Muslim scholars, in reviewing various *fatwas* that prohibit futures derivatives[17] found weaknesses in the evidential bases for these *fatwas*. This primarily because these Islamic legal verdicts fail to recognise the actual mechanics of derivatives trading and apply the rules of conventional sale to derivatives trading.[18] In other words, most *fatwas* fail to recognise the trading mechanism under exchange-traded derivatives whereby derivatives transactions are cleared by a particular clearing house. According to this view, the existence of clearing houses reduces significantly the failure to deliver the commodity under futures contracts. This supports the argument that futures should be allowed in Islamic finance as long as the underlying asset of these futures do not contradict Islamic principles. These principles will be separately discussed 5.3 of this chapter.

Moreover, futures contracts should not be classified under the hadith prohibiting sale of non-existent goods (*la tabi' ma laysa 'indak*). According to modern hadith commentators, the text of the hadith refers to a traditional sale whereby the existence of the good is essential. Where the goods are not in existence at the time of the transaction, the sale is invalid.[19] This hadith also refers to a sale of particular objects especially an object of sale that is difficult to find in a common market. However, if that object of sale is easily replaceable in the market,

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[15] See, eg, Mohammad Hashim Kamali, "Prospects for an Islamic Derivatives Market in Malaysia" (1999) 41(4/5) *Thunderbird International Business Review* 523-540, 532.
[16] Ibid.
[17] Mohammad Hashim Kamali, 'Islamic Commercial Law: An Analysis of Futures' (1996) 13 *the American Journal of Islamic Social Sciences* 197-225.
[18] Ibid, see also the article on options, and the prospect of derivatives in Islamic finance Mohammad Hashim Kamali, "Islamic Commercial Law: An Analysis of Options" (1997) 14 *the American Journal of Islamic Social Sciences* 17-39.
[19] Kamali, above n 15, 536.

then the seller can sell that object even if the seller does not possess the object of sale at the time of signing the sale contract.[20] It is argued that this hadith is not relevant to futures derivatives.

In futures contracts, sales and purchases of a commodity have been measured and standardised in its quality and quantity. The reason of the prohibition of sale of non-existence object is uncertainty of time of delivery, quality, and quantity of the object of sale. This reason is absent in futures contracts because in these contracts such requirements (time of delivery, quality and quantity) have been guaranteed by an exchange rule. Thus, this guarantee mechanism removes uncertainties leading to the absence of uncertainty in delivering the object of sale in futures-exchange traded derivatives.[21]

The common rationale that is often used in forbidding derivatives is that these transactions contain uncertainty (*gharar*) because of the absence of money and traded goods at the time of contract. This logic has been disputed by some scholars on the grounds that the mechanisms of modern derivatives are completely different from those traditional sale contracts. Thus, an analogy between traditional sales as equivalent to derivatives is invalid. The element of uncertainty (*gharar*) in derivatives transactions has been reduced by the mechanism of the clearing house, an intermediary institution between the seller and the buyer. This alternative interpretation supports the future development of Islamic derivatives. The next section addresses a further objection to derivatives, that is, it amounts to the sale of one debt for another debt.

[20] Ibid.
[21] Ibid 536-537.

5.4 Derivatives: Sale of One Debt for Another Debt

Another objection to futures derivatives is that they may involve a sale of one debt for another debt (*bai al kali bi al kali*) which is unlawful. For instance, party A signs a futures contract with party B to purchase a commodity from party B to be delivered in two months' time at an agreed price. As this is a futures contract, both the commodity and the price are to be delivered and paid for within two months. After one month, party A sells the commodity to Party C at a higher price with the commodity and the price to be paid and delivered in a month. In this transaction, party A has not yet received the commodity and it is indebted to party A. This example is often used to describe a sale of a debt for debt. The prohibition of such a sale comes from a *hadith* prohibiting sale of one debt for another debt.[22]

It can be argued that a sale of a debt for another debt is lawful provided that the sale is clear of *riba*, and there is not clear texts in the primary sources of Islamic law (the Qur'an and the Hadith) prohibiting it.[23] A further suggested condition is that such a future sale for a fixed period could be conducted with proper documentation as recorded in a Quranic verse that indicates a transaction involving future obligations for a fixed period of time needs to be in writing.[24] The verse could be applied to all types of transactions involving debts (*dayn*) as long as these sales are accurately recorded and documented.[25] Moreover, some scholars take the view that to facilitate the development of futures contracts under Islamic finance, the delay in payment is allowed until the subject matter is delivered,[26] as long as the subject matter is

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22 The *hadith* reported by Musa bin 'Ubayah bin Nashit al-Rabdhi reported from 'Abd Allah Ibn 'Umar, simply that "Prophet (peace be upon him) prohibited *bay' al-kali bi al-kali*" (sale one debt for another debt), see Mohammad Hashim Kamali, 'the Permissibility and Potential of Developing Islamic Derivatives as Financial Instruments' (1999) 2 IIUM *Journal of Economics and Management* 73-86, 83.

23 Kamali, above n 22.

24 "O you who believe! When you deal with each other in a transaction involving future obligations for a fixed period (*idha tadayantum bi-daynin ila ajalin musamman*) reduce it into writing. Let the scribe write faithfully as between the parties…" (Qur'an 2:282)", see Kamali, above n 22, 83.

25 Ibid.

26 Frank E. Vogel and Samuel L. Hayes, III, *Islamic Law and Finance: Religion, Risk, and* Return (Kluwer Law International, 1998) 114.

concrete goods (*ayn*) such as palm oil, a watch, horse, or house, and continuously available in the market.[27] These scholars are derived this opinion from the view that hadith preventing a sale of debt for another debt is weak (*dhaif*),[28] a type of hadith in which in its transmission has been found a defect such as in the credibility of its narrators.

Thus, the above alternative Sharia opinions support a transaction involving the sale of a debt for another debt. This may legitimise most important features of futures transactions whereby most traders in futures contracts exit the contracts before the expiry date. A further aspect of futures which have been argued to be Islamically objectionable is a sale before the seller takes possession.

5.5 Derivatives: Sale before Possession (*Qabd*)

Another objection to derivatives transactions is that they permit the sale of the subject matter before the seller takes possession. In futures contracts, transacting parties are allowed to re-sell the subject matter to third parties before they take possession. Almost all futures and options contracts are settled before maturity and physical delivery.[29] There is a *fatwa* that cited below prohibits such a transaction.

> The contract provides for the delivery of described and secured merchandise at some future date, and payment of its price on delivery. The contract, however, does not stipulate that it shall end with the actual delivery and receipt of the merchandise, and thus it may be terminated by

[27] Kamali, above n 22, 87.
[28] see also Muhammad al-Bashir Muhammad al-Amine, *Risk Management in Islamic Finance: an Analysis of Derivatives Instruments in Commodity Markets* (Brill, 2008), 21.
[29] See, eg, A. Khan, 'Commodity Exchange and Stock Exchange in Islamic Economy' (1988) 5(1) *the American Journal of Islamic Social Science* 91-114, 98; and Sami Al-Suwailem, 'Hedging in Islamic Finance' (Occasional Paper No 10, Islamic Research and Training Institute Islamic Development Bank, 2006) 43.

an opposite contract. This type of contract is the most prevalent in the commodity markets. It is not at all permissible, moreover, it is not permissible to sell a merchandise purchased under *salam* [deferred sale] (…) terms with advance payment unless the mechanise has already (been) received.[30]

This is supported by a *hadith* "He who buys foodstuff should not sell it until he has received it" which is also cited a prohibition of sale prior to taking possession.[31]

The *fatwa* and hadith referred to above have been disputed by some scholars. The *hadith* was linked to foodstuff, especially perishable goods, because of uncertainty over the delivery to the buyer of food that is not in the seller's possession. When there is no such uncertainty, such as in the sale of real property, the *qabd* (possession) is not a requirement.[32] In addition, it has been argued that the concept of possession (*qabd*) is a juristic concept that has various meanings such as "holding, retention, taking into custody, evacuation, measuring, separating, and even viewing".[33] Thus, the concept of possession should be viewed on the basis of prevailing practice.[34] Consequently, modern commercial transactions involving computerized and documented transactions should be considered as part of a current trading custom. Hence, the possession also occurs when a sale or an offsetting transaction is verified by the exchange and the contracting parties' accounts are properly documented.[35]

It is arguable that futures contracts can be categorised as a sale by description (*bay al-sifah*) which is permissible under Islamic law. Futures are similar to a sale by description on the basis that the sale of the asset (although not in possession at the time of signing contract)

30 Organization of Islamic Countries Fiqh Academy, '*Resolution 63/1/7'* (OIC Fiqh Academy, 2000).
31 Mohammad Hashim Kamali, 'Prospects for an Islamic Derivatives Market in Malaysia' (1999) 41(4/5) *Thunderbird International Business Review* 523-540, 538.
32 Ibid 358.
33 Ibid 359.
34 Ibid.
35 Ibid.

has detailed documentation relating to specification and time of delivery.[36] Consequently, the sale by description may validate certain aspects of futures contracts as Sharia compliant futures.[37] This view has been supported by *fatwas* in jurisdictions offering Islamic finance. For instance, the National Shariah Board of Indonesian Ulama Council (MUI) indicates that Islamic law recognises two distinct types of *qabd* (possession) namely *qabd haqiqi* (physical possession) and *qabd hukmi* (legal possession).[38] The former relates to a physical possession of a subject matter after a sale transaction takes place. The latter refers to a legal possession of a subject matter even though the subject matter is not physically held.[39] Both types of possession are allowed under Islamic law in a trading transaction.[40] This alternative view indicates a level of support for the sale of subject matter before the seller takes possession. A further objection to derivatives relates to the sale of rights discussed next.

5.6 Options and Selling of Rights

Another objection to derivatives, particularly options contracts, is that Islamic law does not permit the sale of rights. The Islamic *Fiqh* Academy of OIC, for instance, issued a *fatwa* stating that options contracts are illegal and their trading is prohibited. This is based on the view that options are new financial instruments that do not fall under the purview of any one of the nominated contracts in Islamic commercial law. Furthermore, the subject of matter of

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36 According to Al-Amine, Hanafi, Maliki, and Hanbali scholars accept this type of contract, Muhammad Al-Amine, 'Commodity Derivatives: An Islamic Analysis' In Muhammad Iqbal, & Tariqullah Khan (Ed.), *Financial Engineering and Islamic Contracts* (Palgrave Macmillan, 2005) 58-98.
37 Bashar H. Malkawi, 'Financial Derivatives Between Western Legal Tradition and Islamic Finance: A Comparative Approach' (2014) 15(1) Journal of Banking Regulation, 41-55.
38 Sharia Advisory Council (Dewan Syariah Nasional, DSN) – Indonesian Ulama Council (MUI), "*Fatwa Nomor 82/DSN-MUI/VIII/2011 on Perdagangan Komoditi berdasarkan Prinsip Syariah di Bursa Commodity* (Fatwa No.82/DSN-MUI/VIII/2011 on Commodity Exchanges based in Sharia Principles in Commodity Markets) (DSN MUI, 2011).
39 Ibid.
40 Ibid.

the options contracts are not subject matter that can be legally exchanged under Islamic law such as *mal* (wealth), *manfa'ah* (usufruct), and *haq mali* (right related to property).[41] Another objection is that options contracts may involve gambling (*maysir*). Gambling occurs when one party in an options contract, at the time of exercising the contract, gains from the contract, whilst the other must lose. This probability of gain or loss depends on an unknown future market price. In addition, in most options contracts, contracting parties have no intention of taking delivery, but use the contract to profit from price differentials.[42]

Conversely there is support for the view that options contracts may have their own Islamic version. It is argued that the concept of down payment (*bay al-urbun*) and a stipulated option (*khiyar al-shart*) may become Islamic alternatives to options contracts.[43] In these contracts, contracting parties are free to insert stipulations in contracts and to ask for a fee such as monetary compensation by one who grants an option to the other.[44] It is also argued that the concept of a stipulated option (*khiyar al-shart*) closely resembles options. This contract refers to an option in which a condition stipulated in the contract, whether to confirm the contract or to cancel it in a specified period.[45] There is support for this view as an Islamic alternative.[46] It also has the advantage that the stipulated option (*khiyar al-shart)* could be used as a tool of risk management in its own right meaning that the contract provides a right for either party, or both, or even to a third party, to confirm or to cancel the contract within a stipulated time period.[47]

[41] Al-Amine, above n 28, 36.
[42] Vogel and Hayes, above n 26, 164.
[43] Kamali, above n 15.
[44] Ibid 356-357.
[45] Al-Amine in Hunt-Ahmed, et al, above n 2, 339.
[46] Kamali, above n 15, 369-370.
[47] Al-Amine in Hunt-Ahmed, et al, above n 2, 339.

Other scholars argue that a down payment contract, (*bay al-urbun*) is the most relevant arrangement for options.[48] This contract allows one party to buy the right to purchase from the other party specified goods for a specified price on [or in some versions by] a certain date.[49] In this transaction, the buyer pays only a small part of the price of a commodity, on the understanding that the seller will retain this amount if the sale is not finally concluded due to withdrawal of the buyer.[50]

Although the alternative view has supported Sharia complaint instruments that resemble options, some disputes remain. The inherent leverage in options and their detachment from the reference asset(s) remains controversial.[51] Nonetheless, there is sufficient support for the argument that selling rights is not inconsistent with Islamic law.

5.7 Regulating Speculation in Hedging Activities

The previous discussion has been directed to the alternative Sharia opinions on derivatives, which leave open opportunities for structuring derivatives under Islamic finance. It has not, however addressed the issue of speculation as an inseparable part of derivatives transactions. This makes derivatives instruments completely different to traditional sales. In derivatives markets, a speculator does not intend to hold an asset other than for profit.[52] This has created adverse impacts for financial markets and separated the financial sector with real

48 Vogel and Hayes, above n 26, 156.
49 Ibid.
50 Al-Amine in Hunt-Ahmed, et al, above n 2, 341.
51 Juan Sole and Andreas Jobst, 'Operative Principles of Islamic Derivatives: Towards a Coherent Theory' (Working Paper, International Monetary Fund Working Paper, 2012) 14.
52 Joel Bessis, *Risk Management in Banking* (Wiley, 4th Edition, 2015), 73.

economic production.[53] Derivatives have been criticised as potentially corrupting,[54] and too remote from the underlying assets that are required in Islamic transactions.[55] Speculation is an inherent part of derivatives transactions.[56]

A distinction can be drawn between speculation and hedging. Most scholars consider that hedging for the purpose of risk mitigation is a valid in Islamic law.[57] But the issue is how to deal with speculative aspects of hedging. A limited level of speculation is not only needed but is necessary for the smooth functioning of any exchange.[58] Consequently, it may not be possible to eliminate speculation altogether in ordinary sales or in derivatives. However, if a limited level of speculation is necessary, the question then becomes how to draw the line between this limited scale of speculation and that which is excessive.[59]

One view is that speculation would be acceptable when it is part of some real activity and helps to shift risks from the vulnerable producers, who cannot afford to bear all the risk, to those who can afford to bear it.[60] A properly organized or regulated market may reduce speculation to an acceptable level. The existence of a clearing-house, for instance, may prevent market abuse and promote financial stability in derivatives markets.[61] In addition, the capital requirement for derivatives transactions is also another aspect that could be considered in derivatives markets. The International Swaps and Derivatives Association (ISDA) also

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[53] Edward LiPuma and Benjamin Lee, 'Financial Derivatives and the Rise of Circulation' (2005) 34(3) *Economy and Society* 404-427.
[54] Rodney Wilson, 'Islamic Financial Instruments' (1991) 6 *Arab Law Quarterly* 205-214, 209.
[55] Rodney Wilson, 'Global Islamic Capital Markets' (2007) *Islamic Finance News* 13-20, 14.
[56] Ibid. These opinions have been shared among advocates of Islamic finance, see Muhammad Akram Khan, 'Commodity Exchange and Stock Exchange in Islamic Economy' (1988) 5(1) *American Journal of Islamic Social Sciences* 92-114.
[57] A*l-Fatawah al-Iqtisadiyyah al-Sadirah an Nadwat al-Barakahli al-Iqtisad al-Islami by* Abd al-Sattar Abu Ghuddah in Al-Amine in Hunt-Ahmed, above n 2, 344.
[58] Ahmadal-Ashkar, 'Toward anI slamic Exchange in Transitional Stage' (1995) 3(1) *Islamic Economic Studies* 82–83.
[59] Mohammad Hashim Kamali, 'The Permissibility and Potential of Developing Islamic Derivatives as Financial Instruments' (1999) 7(2) *IIUM Journal of Economics & Management*, 77.
[60] Fahim Khan, '*Islamic Futures and Their Markets'* (Research Paper No 32, Islamic Research and Training Institute, Islamic Development Bank, 1996) 46.
[61] Australian Securities and Investment Commission, "Background to the OTC Derivatives Reform" [25/04/2017] http://asic.gov.au/regulatory-resources/markets/otc-derivatives-reform/background-to-the-otc-derivatives-reform/

launched its master agreements to ensure that OTC (over-the-counter) derivatives are documented properly. The discussion of this will be provided in Chapter 6. Standard documentation may increase market confidence and liquidity, since quotes can be made on standardised contractual assumptions.[62]

The next section discusses the meaning of Islamic derivatives, its characters, and restrictions in Islamic finance.

5.8 "Islamic" or "Sharia Compliant" Derivatives

Alternative Sharia views discussed in the previous sections provided a foundation for creating derivative-like features in Islamic finance. This section examines these "Islamic" or "Sharia compliant" derivatives, that is, instruments that are based on, or comply with, either the primary or secondary sources of Islamic law. As derivatives are modern transactions which bear little resemblance to any medieval Islamic juristic rules, their validity depends on *fatwas* issued by modern Muslim jurists or Sharia Supervisory Boards of respective IFIs who advocate Sharia compliant derivatives. These scholars whose opinions have also been relied on as foundations for Islamic derivatives have based their opinions on Islamic juristic rules particularly from Sunni traditions to legitimize Sharia compliant derivatives.

One of the important points in discussing derivatives in Islamic finance is that most scholars relate derivative activities to the Arabic term namely *tahawwut* (hedging). [63] This word literally means, among other things, 'care', 'precaution', or 'prudence'.[64] *Tahawwut* is thus

[62] Li Lin and Jay Surti, 'Capital Requirements for Over-the-Counter Derivatives Central Counterparties' (2013) IMF Working Paper WP/13/3.
[63] See Mohd Razif, N.F., et.al. 'Permissibility of Hedging in Islamic Finance' (2012) 12(2) *Middle-East Journal of Scientific Research*, 155-159.
[64] Craig R. Nethercott and David M. Eisenberg, *Islamic Finance: law and Practice* (Oxford University Press, 2012), 209-232.

related to hedging activities in Islamic finance which should not contravene prohibited Islamic law principles. One of the prohibited elements that has been addressed in the previous sections is *gharar* (uncertainty). It has been argued that *gharar* can be avoided under modern derivatives particularly in exchange-traded derivatives. Another prohibition that needs to be avoided in Islamic hedging activities is interest. Sharia compliant derivatives should not use interest as its underlying value. This will be discussed next.

In designing Sharia compliant derivatives, the underlying value or asset must be Sharia compliant. [65] Interest would not be allowed as an underlying value in this type of transaction due to the prohibition of *riba* (interest). Sharia compliant derivatives need to utilise commodities or assets that are classified as Sharia compliant such as oil, agricultural products, i.e. crude palm oil, or precious metals such as gold, and copper, etc.

The principle that the underlying economic activities of assets or values must be Sharia compliant is used in shares or stocks, which are commonly used as the underlying values of derivatives. Qualitative and quantitative Sharia screening is used to ensure Sharia compliance. Qualitative screening assesses whether the main business activities not contrary to Sharia principles. Some business activities are considered impermissible (*haram*). There are variations of these prohibited activities ranging from alcohol, tobacco, pork related products, financial services including interest-based conventional banks and insurance practices, gambling, casinos, music, hotels, cinemas, and adult entertainment, arms manufacturing, pornography, and so on.[66] It should be carefully noted that each jurisdiction has its own classification either

[65] Jan Smolarski, Michael Schapek, and Mohammad Iqbal Tahir, 'Permissibility and use of options for hedging purposes in Islamic Finance' (2016) 48 *Thunderbird International Business Review* 425–443.
[66] Each industry sets its own Sharia screening resulting the type of industry that is considered prohibited would vary. For detailed explanation on Sharia screening, see, eg, Ulrich Derigs and Shehab Marzban, 'Review and Analysis of Current Sharia Compliant Equity Screening Process' (2008) 1(4) *International Journal of Islamic and Middle Eastern Finance and Management* 285-303, 287; and Dawood Ashraf and Mohsin Khawaja, 'Does the Sharia Screening Process Matter? Evidence from Sharia Compliant Portfolios' (2016) 132 *Journal of Economic Behaviour & Organization* 77-92, 79.

to include all or some of those activities. A further screening is quantitative one that assesses whether sources of business income are permissible (*halal*).[67] Muslims jurists that sit on boards of Islamic financial institutions stated that as long as the non-*halal* income is less than one third or 33 per cent of the overall income, then the income could be categorized as Sharia compliant. This figure is common in Islamic finance markets. The figure 33 per cent referred to above is derived from the hadith: "the Prophet Muhammad (peace be upon him) advised Abu Bakr not to donate more than one-third of his wealth, and commented that one third is too much".[68] Although this hadith is not related to a financial screening of a business activity,[69] some scholars argue that since two thirds of sources of funds come from permissible sources, the one-third from impermissible sources is ignored.[70]

If after applying these two layers of Sharia screening, theoretically, Sharia compliant derivatives cannot be used by a company whose primary business activity is not permissible (*haram*). Although Islamic derivatives are derived from medieval Islamic commercial law contracts and thus deemed Sharia compliant, it does not necessarily mean that the hedging based on these contracts is Sharia compliant if the underlying assets of that hedging are considered non-halal.[71] In other words, the use of traditional Islamic commercial contracts to deliver returns from non-compliant investments are prohibited. The example of this principle will be separately discussed in the following sections particularly on Islamic profit rate swaps.

Another consideration relevant to Sharia compliance derivatives is where hedging is used exclusively for risk management purposes. This purpose is legitimate in Islamic law as it

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[67] Derigs and Marzban, above n 68.
[68] Ibid 292.
[69] Ibid.
[70] Mohamed Ali Elgari, 'Purification of Islamic Equity Funds: Methodology and Sharia Foundation' (Proceedings of the Fourth Harvard University Forum on Islamic Finance, Harvard University, 2000) 77-80.
[71] Yusuf Talal Delorenzo, 'The Total Returns Swap and the "Shariah Conversion Technology" Stratagem' [21/12/2017] https://uaelaws.files.wordpress.com/2012/06/delorenzo-copy.pdf.

provides an instrument to mitigate risks and harm based on modern financial needs and activities [72] and Islamic economic objectives.[73] There is support for this approach in some verses in the Qur'an[74] which promote the preventive steps in managing commercial transactions from unwanted risks.[75] This is also supported by a hadith saying that "In Islam, harm should neither be initiated nor reciprocated".[76] Muslim scholars derive from this hadith some principles related to managing future uncertainties. These include that harm must be eliminated or as much as possible and preventing harm takes priority over seeking benefit.[77] These principles provide a legal basis for hedging transactions in Islamic finance based on the public interest (*mashalah*).[78] Some jurists do not reject the concept of hedging but differ as to what Sharia compliant hedging mechanisms can be developed.[79] Generally, Muslim scholars agree on the permissibility of hedging activities as long as they are designed for risk management purposes and do not contravene Sharia principles.[80]

Some *fatwas* (Islamic legal verdicts) also support the permissibility of hedging for risk management purposes. Dallah Barakah Resolution No.2/28 in 2007 issued resolutions permitting managing risk through hedging (*tahawwut*) as long as it is in line with Sharia mechanisms, contract and instruments and as long as they do not involve matters that contravene Sharia principles.[81] The Accounting Auditing Organization of Islamic Finance

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72 Wan Zil Farlihah Wan Ibrahim, 'Hedging in Islamic Finance' (2016) 1(3) *Islamic Corporations for the Development of Private Sector Bulletin*, 13.
73 Sami Al-Suwailem, 'Hedging in Islamic Finance' (Occasional Paper No 10, Islamic Research and Training Institute Islamic Development Bank, *2006)*, 57.
74 Qur'an 2:195, 2:283-283, 12:47-49, see Noor Fahimah Mohd Razif, et al, 'Permissibility of Hedging in Islamic Finance' (2012) 12(2) *Middle-East Journal of Scientific Research* 155-159.
75 Ibid 156.
76 Asyraf Wadji Dusuki, 'Principle and Application of Risk Management and Hedging Instruments in Islamic Finance' [06/10/2017] http://www.iefpedia.com/english/wp-content/uploads/2012/07/Asyraf.pdf.
77 Ibid.
78 Derigs and Marzban, above n 68, 292.
79 Dusuki, above n 78.
80 Al-Amine in Hunt-Ahmed, et al, above n 2.
81 Mohamad Akram Laldin, 'Islamic Hedging Standards' (2017) IIFM Workshop on Islamic Hedging Standards 10th April, http://www.iifm.net/sites/default/files/Islamic%20Hedging%20Standards%20by%20Prof.%20Dr.%20Mohamad%20Akram%20Laldin.pdf.

Institutions (AAOIFI) in its Sharia Standard declares that hedging is permissible for institutions to hedge against the future devaluation of the currency with some Sharia requirements. In Malaysia, Sharia Advisory Councils of the Malaysian Securities Commission and the Central Bank of Malaysia issued a number of Sharia resolutions supporting hedging activities in Islamic finance. The Indonesian Ulama Council (MUI) issued a fatwa in 2015 on the permissibility of *tahawwut* (hedging).[82]

Furthermore, Sharia compliant derivatives restrict the use of derivatives for speculation and gambling.[83] As discussed in the previous section, the avoidance of speculation in hedging markets creates a dilemma because it is difficult to distinguish between hedging for prudent financial management and speculation. One way of avoiding speculation is through a well-regulated market that may reduce speculation to an acceptable level. As will be discussed in chapter 6, a standard documentation for a type of Islamic derivatives has been developed by the International Islamic Financial Markets (IIFM) and International Swaps and Derivatives Association (ISDA) providing a procedure for derivatives transactions within the spirit of Islamic principles.

This section sets out what can be considered the basic characteristics and scope of Sharia compliant derivatives.

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82 Yudi Ahmad Faisal, 'Islamic Derivatives in Indonesia: A Study on Indonesian Ulama Council (MUI)'s Fatwa on Tahawwut (Hedging)' (2016) 2(1) İslam Ekonomisi ve Finansı Dergisi 35-61.
83 Al-Amine in Hunt-Ahmed, et al, above n 2, 344.

Table 5.1. Sharia Restrictions for Derivatives Transactions

No	Sharia Restrictions for Hedging
1	Sharia compliant derivatives contracts are derived from various medieval Islamic juristic rules. These rules are selected, modified, and combined creating mechanisms, returns, and protection that are comparable to modern derivatives. In addition, Sharia compliant derivatives follow particular Sharia requirements and provisions developed by Muslim scholars who advocate the development of derivatives-like features in Islamic finance.
2	Sharia compliant derivatives use permissible underlying values or assets. Thus some types of assets or values cannot be used as their underlying values such as banking interest.
3	Underlying assets or values used for Sharia compliant derivatives must be evaluated using qualitative and quantitative screening.
4	Sharia compliant derivatives should be used only for risk management purposes
5	Sharia compliant derivatives should limit the use of speculation and gambling in its transactions

Source: Author

5.9 Time Value of Money in Sharia Compliant Derivatives Transactions

One of the rationales behind derivatives transactions is time value of money. It means the value of $1 today is greater than the value of $1 in the future because $1 can be put to productive use to generate profit over time. The value of $1 invested appreciates through the payment of interest,[84] and productive use to generate profits. The interest rate determines the cost of funds in the banking and non-banking sectors. The future value of money is adjusted for inflation as the value of money decreases due to increases in the prices of goods and services in the economy. The time value of money is central to hedging activities. Various hedging activities such as options, futures, and swaps are designed for the purpose of managing and mitigating unpredicted and adverse movements of the future value of money or underlying assets.

Sharia compliant derivatives can be designed to anticipate changes in the time value of money following Sharia rules. Islamic finance does not completely reject the time value, but modifies and imposes conditions as to comply with Islamic law. This is discussed in the next section.

5.9.1 Time Value of Money in Islamic Finance

There are two Sharia opinions concerning the time value of money. One view rejects the whole concept of the time value of money due to the prohibition of interest, *riba*. This prohibition includes the time value in interest-based loans as well as in a sale-based financing involving credit sale prices.[85] This view further argues that Islamic banks can also breach Sharia law in undertaking financing transactions notably sale-based financing such as *murabahah* (a cost plus sale on a deferred payment basis) (see paragraph 2.5 in Chapter 2).

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[84] Interest is a premium of using money and computed by multiplying capital value by the interest rate. Interest rate itself is a percent of premium paid on money at one date in terms of money to be in hand in a predetermined future time, in Irving Fisher, *the Theory of Interest: As Determined by Impatience to Spend Income and Opportunity to Invest it* (Augustus M. Kelley Publishers, Clifton, 1974) 13.

[85] Feisal Khan, *Islamic Banking in Pakistan: Sharia Compliant Finance and the Quest to Make Pakistan More* Islamic (Routledge, 2015) 74, another well-known Muslim jurist M. Taqi Usmani views "in Sharia there is no concept of time value of money", see M. Taqi Usmani, *An Introduction to Islamic Finance* (Brill, 2002) xvi.

Under *murabahah*, the spot price is lower than the forward price meaning that time has monetary effects that make the difference between spot and forward price. On the first view this is regarded as representing a rental for the use of money for a certain period and thus a form of interest, *riba*.[86] A different view is taken by other Muslim scholars that the profit under deferred payment sales in medieval Islamic juristic rules such as *murabahah* cannot be considered as time value of money. For them, the price difference between the present and the future value of that contract does not represent the pure time element (time value of money), but rather a recognition of changing forces of supply and demand.[87]

If time value of money is rejected, this has adverse consequences for Islamic finance. The absence of time value of money makes it difficult for Islamic banks to determine their margin rates particularly on its sale-based financing products. It is normal in Islamic banking practice for the spot price of a commodity to be less than the deferred credit price.[88] The difference between the spot price and the future price of a commodity is due to the logic that money has monetary effects.[89] Moreover, the absence of the time value of money on foreign exchange markets would also collapse forward exchange markets.[90] This creates an assumption that foreign exchange transactions should be carried out at spot market prices. A prohibition will eliminate speculative activity in the foreign exchange market and limit trading to the spot market to take advantage of differentials in bilateral or cross currency rates.

A further problem is that the absence of the time value of money on foreign exchange markets would also eliminate hedging markets. Hedging involves activities designed to protect

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[86] See, eg, Muhammad Anwar, 'Islamicity of Banking and Modes of Islamic Banking' (2003) 18(1) *Arab Law Quarterly* 62-80, 66; Mohammad Omar Farooq, 'Stipulation of Excess in Understanding and Misunderstanding Riba: The Al-Jassas Link' (2007) 21(4) *Arab Law Quarterly* 285-316, 314.
[87] Fahim Khan, 'Time Value of Money and Discounting in Islamic Perspective' (1991) 1(2) *Review of Islamic Economics* 35-45.
[88] Mahmoud El Gamal, *Islamic Finance, Law, Economics, and Practice* (Cambridge University Press, 2006), 12.
[89] Ibid.
[90] There is a strong argument in Islamic finance that money exchanges should be carried out on a spot cash basis.

against risks from receipts or payments in foreign currency and in the holding of assets in foreign currency whenever the devaluations or revaluations take place. The absence of hedging will transfer the risks from commodity trading and foreign investment directly to the groups involved in these activities. It then would limit activity in these areas since traders and investors will generally minimize risks and accordingly reduce the volume of their activities.[91] To avoid this, investors may resort to the conventional banking system.

The absence of the time value of money in commodity markets would also cause a collapse of Islamic hedging that relies heavily on commodity prices for its income stream. As discussed previously, most of the underlying assets of Islamic hedging (derivatives) are commodities such as oil, agricultural products, i.e. crude palm oil, or precious metals such as gold, copper, etc. Most Islamic derivatives instruments employ mechanisms that includes a series of sales and purchases of certain commodities based on the spot as well as credit price. This will be discussed separately in the following sections. If the price difference between the credit and spot price is considered as the prohibited time value of money, one should consider that there would be no Islamic hedging. This would place Islamic finance institutions at a serious disadvantage compared to its conventional counterparts.

The consequence is that the time value of money concept, is an inevitable aspect of Islamic finance but subject to certain conditions. Time value of money should be allowed as long as the money acts as capital combined with other resources to undertake a productive activity.[92] In other words, Islamic finance allows for $1 today to be worth more than $1 tomorrow as long this is the result of investing/bearing risk rather than lending. The key point of differentiation is that time by itself cannot create value, but investing and therefore bearing

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[91] M. Siddieq Noorzoy, 'Islamic Laws and Riba (Interest) and Their Economic Implications' (1982) 14(1) *International Journal of Middle East Studies* 3-17, 15.
[92] Zamir Iqbal and Abbas Mirakhor, *Introduction to Islamic Finance: Theory and Practice* (John Wiley and Sons, 2nd Edition, 2011) 10.

risk with associated profits (and losses) can create value. Furthermore, the Islamic conception on the time value of money has been derived from a long-standing conception of money as capital not as a commodity.[93] This means that money should not be recognised as an objective, but as a means to achieve or increase human welfare, if it is utilised in a legitimate manner.[94]

It is also permissible to compensate the time value in sales contracts. The time value applies only to tangible items which is why the spot (cash) price for a commodity is allowed to be lower than the future (deferred payment); these practices are referred to among others as a cost plus sale on deferred payment basis (*murabahah*),[95] see paragraph 2.5. This view is supported by the Hanafi school.[96] According to Said, the practice of *murabahah* in Islamic banks has clearly shown that "there is a value of time in *murabahah* based finance, which leads, albeit indirectly, to the acceptance of the time value of money".[97]

The acceptance of modified time value of money in Islamic finance does not necessarily allow its application to loan contracts. In the case of lending, increases (by way of interest) are prohibited as a means of providing material compensation for time.[98] If money is viewed solely as a medium of exchange, charging interest would distort this function since more would be returned in the future than was borrowed – i.e. the standard used in exchange would be violated. Thus, a shirt may cost you $10 if paid for on the spot or $11 if paid for next month but I may

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93 Abdul Azim Islahi, *Contributions of Muslim Scholars to Economic Thought and Analysis: (11-905 A.H.-632-1500 A.D.)* (Scientific Publishing Centre - King Abdulaziz University, 2005) 47.
94 This conception is closely related to a long-standing business vehicle in Muslim traditions particularly Islamic profit sharing contracts such as *mudharabah* and *musharakah*, see Chapter Islamic Partnership for further discussion on this issue
95 Muhammad Ayub, *Understanding Islamic Finance* (John Wiley and Sons, 2007) 404.
96 For instance, a great scholar of Hanafi namely Al-Sarakhsi (died 1090 CE.) stating unequivocally that "a thing is sold on credit for a larger sum than it would be sold for in cash", see Abraham L. Udovitch, *Partnership and Profit in Medieval Islam* (Princeton University Press, 1970) 78.
97 Abdullah Saeed, *Islamic banking and Interest: A Study of the Prohibition of Riba and Its Contemporary Interpretation* (Brill, 1996) 95.
98 Zamir Iqbal, and Abbas Mirakhor, Introduction to Islamic Finance: Theory and Practice (John Wiley and Sons, 2nd Edition, 2011), 10.

not lend you $10 to buy the shirt now on the condition that you pay me $11 next month.[99] The former is permitted but not the latter. Explanations vary from, it is knowable only to God[100] or that *riba* used to occur (*riba jahiliyyah*) at the time of the Prophet not because of its excessiveness (the interest rate is excessive), but a lack of stipulation and disclosure of a predetermined excess in the contract that might be the source of exploitation and vulnerability of the borrower.[101] This would mean that there would be no breach of Sharia principles where the banks state the rate of interest at the signing of the contract. This argument would also clarify the differences between trade and *riba* because in trade, it is clear that at the beginning of the contract, the profit rate is determined.

Based on the above explanations, the Islamic notion of the time value of money can be clearly understood by reviewing the distinction between loans, investment, and trading. In the case of loans, money cannot create money because it is an act of charity where the surplus funds are effectively being utilized to promote economic development and social wellbeing.[102] In relation to investment, the investor will be compensated for any profit and loss earned during that time and Islam fully recognizes this return on the investment as a result of an economic activity. In the case of trading, the difference between the cash price and credit price in sale transactions is acknowledged in Islamic law and thus permissible. In short, Islamic law recognizes time value of money considering that money is a medium of exchange, time facilitates completion of economic activity, and the owner of capital is to be compensated for

[99] Feisal Khan, *Islamic Banking in Pakistan: Sharia Compliant Finance and the Quest to Make Pakistan More* Islamic (Routledge, 2015) 75.
[100] Ibid.
[101] Mohammad Omar Farooq, 'Stipulation of Excess in Understanding and Misunderstanding Riba: The Al-Jassas Link' (2007) 21(4) *Arab Law Quarterly* 285-316, 314.
[102] Iqbal and Mirakhor above 100, 63.

any return resulting from economic activity. Lending should be a charitable act without any expectation of monetary benefit.[103]

5.10 Interest Rate Benchmarking

It is inevitable that Islamic financial institutions (IFIs) refer to an interest rate as a benchmark in determining prices (profit and margins) in IFIs' financial products and services. This is because IFIs have not yet provided a full-scale system for replacing an interest-based system in the financial markets.[104] An interest rate is an inseparable part of hedging activities in conventional markets. Consequently, Islamic finance cannot ignore this in managing their rate of returns to depositors and customers. This makes hedging an inseparable part Islamic financial activities. Some Muslim scholars take the view that benchmarking Islamic finance's rates of return to conventional interest rates is legitimate.[105] It is argued that the benchmark is just a number to determine a permissible market rate of return in Islamic products.[106] In practice, Islamic products are closely pegged to conventional interest rates. For instance, Islamic investments rates are attached to the conventional deposit rates.[107] Islamic asset based financing (*murabahah*)'s rate benchmarks interest rates as a determining factor to adjust with

[103] Ibid.
[104] Noorzoy, above n 93, 15.
[105] El-Gamal, above n 90, 78.
[106] Mohamed Ariff and Shamsher Mohamad, *Islamic Wealth Management: Theory and* Practice (Edward Elgar Publishing, 2017) 160.
[107] Beng Soon Chong and Ming-Hua Liu, 'Islamic Banking: Interest Free or Interest Based?' (2009) 17(1) *Pacific-Basin Finance Journal*, 125-144. There is recent empirical study showed that not all Islamic banks rigidly peg their investment rates to interest rates, see Raditya Sukmana and Mansor H. Ibrahim, "How Islamic Are Islamic Banks? A Non-Linear Assessment of Islamic Rate – Conventional Rate Relations" (2017) 64 *Economic Modelling* 443-448.

inflation, and to satisfy both depositors and the shareholders.[108] This is subject to compliance with Sharia requirements for a particular product.[109]

Benchmarking against the interest rate in Islamic finance has been the subject of debate and controversy and has led to the call for the creation of an "Islamic benchmark". In Pakistan, for instance, the majority of local Muslim scholars issued *fatwas* (Islamic legal verdicts) to prohibit the use of interest rates as a standard to determine prices in Islamic finance.[110] For some, an interest rate benchmark "allows usury (*riba*) through the back door".[111] It is seen as not advancing the "philosophy of Islamic economy having no impact on the system of distribution".[112] Other organizations such as the Fiqh Academy of the Organization of Islamic Cooperation (OIC) and Accounting Auditing Organization of Islamic Financial Institutions (AAOIFI) approve the creation of an Islamic benchmark as an alternative to the interest based rates to determine profit margins.[113]

The attempt to develop Islamic benchmarks may be misguided considering that Islamic finance recognizes the time value of money. This juristic position has several consequences:

> One must note that the juristic argument that "time value is recognized in sales but not in debts or loans" is at best insufficient, and at worst disingenuous. If the claim is based on the need for pricing time value for each transaction separately (based on credit rating, quality of collateral, etc.), then there is a valid argument to be made (in conventional as well as Islamic finance).

[108] Saeed, above n 99, 84.
[109] Taqi Usmani argues that "If a *murabahah*h transaction fulfills all the conditions … merely using the interest rate as a benchmark for determining the profit of *murabahah*h does not render the transaction as invalid, haram or prohibited, because the deal itself does not contain interest. The rate of interest has been used only as an indicator or as a benchmark", see Usmani, above n 87, 82.
[110] Shoaib A. Ghias, 'Juristic Disagreement: The Collective Fatwa Against Islamic Banking in Pakistan' in Karen Hunt-Ahmed (ed), *Contemporary Islamic Finance: Innovations, Applications, and Best Practices* (John Wiley and Sons, 2013) 103-120, 110.
[111] Ariff and Mohamad, above n 108, 160.
[112] Usmani, above n 87, 82.
[113] Majallah Fiqh Academy, IRTI, IDB, IDB OIC, Jeddah 18-19 Shawwal, 10-11 April 1993 Conference on Curriencies Issues, 8th Conference, Vol. 3, p.780 in Ariff and Mohamad, above 113.

> However, the mere claim is insufficient in this case, since the manner in which appropriate interest rates are determined in sales, leases, and the like remains unspecified. On the other hand, if interest rates in Islamic finance (including the pure time-value components thereof) are benchmarked to conventional interest rates, it would appear that the general claim is vacuous and disingenuous, since it serves only to create arbitrage opportunities, from which jurists stand to be primary beneficiaries.[114]

Benchmarking based on interest rates has consequences for Islamic finance. The interest rate risk has been inevitably attached to Islamic products and services. This is the risk that the value of underlying assets will change when the interest rate changes. To manage these risks, Islamic banks and other Islamic financial institutions along with their Sharia scholars, must develop instruments to hedge against those risks as will be discussed below.

5.11 Islamic Profit Rate Swaps

5.11.1 *Murabahah, Tawarruq,* and *Wa'ad*

Murabahah (cost plus profit sale contract) and *tawarruq* (reverse or commodity *murabahah*) are common contracts in modern Islamic banking and finance utilised as underlying contracts in derivative-like features.[115] *Murabahah* is a cost plus profit sale contract (paragraph 2.5 of Chapter 2). Under this contract, a seller purchases an asset from a supplier and resells it to the buyer at cost plus profit. Meanwhile, *tawarruq* involves a series of *murabahah* contracts involving a third party. Under this contract, a series of sale contracts are entered into whereby a buyer buys an asset from a seller for a deferred payment and

[114] El-Gamal, above n 90, 8.
[115] Ibrahim Warde, *Islamic Finance in the Global Economy* (Edinburgh University Press, 2000) 133.

subsequently sells it to a third party for cash at a lower price for the purpose of obtaining cash.[116]

Another important arrangement in structuring Islamic derivatives is promise (*wa'ad*). Under Islamic law, a mere promise (*wa'ad*), whether bilateral or unilateral, is legally unenforceable. This concept is the opposite of a contract (*aqd*) and is not a legally binding obligation that is generally understood to arise from the formal acts of offer (*ijab*) and acceptance (*qabul*).[117] In other words, a promise is simply a statement that one will do or refrain from something in the future. There is no expiration due for breaking it, although it is sinful to make a promise with the intentions of breaking it. Thus, wa'ad is substantively different from an oath (*yamin*).[118] All major schools in Sunni traditions argue that a promise made by a person to the other is religiously binding but not legally binding. This is because *wa'ad* is part of a voluntary contract (*aqd tabarru*').[119] Since the *wa'ad* is a mere promise, it does not have to satisfy the requirements of binding contracts (*aq'd*) under Islamic law.[120]

In order to be used in Islamic derivatives, the interpretation of *wa'ad* (promise) needs to be modernised allowing it to be enforceable before the courts. Although there are two different views on the enforceability of *wa'ad*,[121] the current practice takes the view that a promise is enforceable in the courts. This view has been strengthened by a *fatwa* in jurisdictions offering Islamic finance. For instance, the Indonesian Ulama Council (MUI), states that *wa'ad* is morally and legally binding.[122] The council argues that a promissory arrangement is

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[116] Paragraph 2.5 of Chapter 2.
[117] Nethercott and Eisenberg, above n 66, 226.
[118] Some argue that wa'ad is similar with a yamin, see Ibid 226.
[119] International Shariah Research Academy for Islamic Finance (ISRA), *Islamic Financial System: Principles and Operations* (ISRA, 2012) 288.
[120] The requirements of *aqd* under Shariah include possession or ownership of subject matter of the contract, contracting parties, ijab and qabul, Al-Amine, above n 28.
[121] Debates on this, see Islamic Banker, 'Islamic Contract Law' [30/04/2017] http://www.Islamicbanker.com/Islamic-contract-law.html.
[122] *Fatwa* Number 85/DSN-MUI/XII/2012 of Shariah Advisory Council (DSN) - Indonesian Ulama Council (MUI).

enforceable where the promisee suffers a cost for the promise. This is called *mulzim* (enforceable promise) whereby the promisee can be forced to honour promises. As part of the punishment for not honouring the promise, the Council allows the bank to execute compensation (*ta'widh*) on a defaulted promise. This opinion has been adopted by the local regulator (Bank of Indonesia) in the Islamic banking industry. This has legal consequence that an Islamic bank can require payment of compensation for failure to honour the promise in case of *murabahah* financing based on *wa'ad* (promise to buy the asset acquired by an Islamic bank).[123] The Council's view is similar to the International Fiqh Academy of Saudi Arabia's view that *wa'ad* is legally in a court of law.[124]

The view that *wa'ad* can be enforceable before the courts provides flexibility in structuring various Islamic products to accommodate modern derivatives. For instance, it is a common rule in the market that Islamic finance prohibits a forward contract for a currency transaction due to the issue of *riba*. To be Sharia compliant, a foreign exchange needs to be arranged on the spot basis. However, by using the concept of *wa'ad*, it is possible to create a currency transaction that mimics a foreign exchange forward whereby the parties mutually promise (*wa'ad*) to buy different currencies from each other at the exchange rate prevailing on such date with simultaneous delivery to occur sometime in the future.[125] This transaction is Islamically permissible since this arrangement is not legally binding and is not equivalent to enforcing a bilateral promise as a matter of law.[126] The Accounting Auditing Organisation for Islamic Financial Institutions (AAOIFI) takes this view stating that:

[123] *Bank Indonesia Regulation* No 18/2/PBI of 2016 Article 5(2).
[124] International Shariah Research Academy for Islamic Finance (ISRA), above n 468, 290.
[125] Al-Amine, above n 28, 103-109.
[126] Nethercott and Eisenberg, above n 66, 227.

> A bilateral promise to purchase and sell currencies is forbidden if the promise is binding, even for the purpose of hedging against currency devaluation risk. However, a promise from one party is permissible if the promise is binding.[127]

The prohibition continues in effect despite an acknowledgement that, in practice, Islamic financial institutions treat a bilateral promise as binding even if formally it is not.

The flexibility of *wa'ad* in structuring modern Islamic products has led to its adoption in the financial industry. Most Sharia compliant derivatives and ISDA and IIFM agreements employ *wa'ad* to structure Sharia compliant derivatives. This is further discussed in Chapter 6. In 2015, the Indonesian Ulama Council (MUI) issued a *fatwa* on *tahawwut* (hedging). All types of derivative-like features under the *fatwa* use the concept of *wa'ad*.[128] In addition, the adaptation of *wa'ad* as a primary component of the new standardised Islamic hedging documentation developed by ISDA and IIFM may create a global standard with *wa'ad* as the main component in structuring Sharia compliant derivatives.[129]

Three mainstream arrangements in modern Islamic finance namely *murabahah* (cost plus profit sale), *tawarruq* (reverse *murabahah*) and *wa'ad* (promise) have been pivotal in developing Sharia compliant hedging products including Islamic profit rate swaps.

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127 Accounting Auditing Organization of Islamic Financial Institutions (AAOIFI), 'Sharia Standard No 1 on Trading in Currencies (AAOIFI, 2000).

128 Currency Exchange based on *bay al sarf* has been approved by the Indonesian Ulama Council (MUI) on a *fatwa* number 28/DSN-MUI/III/2002 on *bay al-sharf*. The *fatwa* states that currency exchange is allowed on the spot basis in which the deal settlement is expected to be completed within 2 days after contract has been concluded. This *fatwa* also prohibits currency forward transactions, currency swap transactions, and currency option transaction. Later on the fatwa allows currency forward contracts. However, it needs to be preceded by *wa'ad* (unilateral promise) as will be discussed in detail in this chapter.

129 Nethercott and Eisenberg, above n 66, 229.

5.11.2 Islamic Profit Rate Swaps

The combination of the above *murabahah* (cost plus profit sale), *wa'ad* (promise), and *tawarruq* (reverse *murabahah*) can mimic swaps derivatives particularly interest rate swaps. This is done through a series of trades using the combination of these arrangements. Under the conventional interest rate swaps, the counterparties agree to exchange fixed and floating interest rates for a period of time by reference to a predetermined notional amount (see paragraph 4.3.4 of Chapter 4). Since, the interest is prohibited in Islamic finance and cannot use as the underlying value in Islamic derivatives (see paragraph 5.3), in Islamic swaps, the counterparties thus exchange profit rates derived from a series of trades in a Sharia compliant commodity such as crude palm oil. Thus, this transaction involves not only counterparties in the swap agreement, but also suppliers and traders in a commodity exchange where counterparties, for instance, Islamic Bank A and B can easily purchase and sell a preferred commodity.

Those three distinctive Islamic medieval arrangements (*wa'ad, murabahah,* and *tawarruq*) are used simultaneously in each period of trading. The *murabahah* is used to generate fixed profit payments from a series of trades between the banks, while a series of corresponding reverse *murabahah* (*tawarruq*) are used to generate floating profit payments.[130] The floating profit rate is commonly referred to London Interbank Offered Rate (LIBOR), as a global benchmark for interest rate (see paragraph 5.10). Similar to its conventional counterpart, the parties in Islamic profit rate swaps agree on the terms of the transactions (i.e. the trade dates, the fixed profit rate, the floating profit rate, the assets to be traded, and the notional cost price of the whole series of trading).

[130] See Kazi Hussain and Fahad Mehboob, 'Hedging Market Risk in Islamic Finance' (no date) [20/01/2018] available at http://www.worldcommercereview.com/publications/article_pdf/105, 22-24.

For example, Bank A has a fixed rate investment profile from its purchase of Islamic assets maturing in five years and paying quarterly. The management decides that it can get a better cash flow from a floating rate profit. In this case, the bank enters into an Islamic profit rate swaps agreement with Bank B in which Bank A receives a fixed profit rate and pays a floating profit rate. The Islamic swap is structured to match the maturity and cash flow of the fixed rate investment profile, and the two fixed-rate streams are netted. Bank A and Bank B then choose the preferred floating profit rate index which is usually benchmarked to LIBOR. Meanwhile, Bank B receives commodity market price plus floating profit rate over LIBOR. This floating profit rate is repeated quarterly until maturity. There is no actual payment is made, as the principal amount upon which total payments are based are merely notional.[131]

On each trade date, Bank A and Bank B undertake promises (*wa'ad*) to enter into two trading agreements based on *murabahah* with different profit rate types; the first has a fixed profit rate while the second has a floating profit rate. The first mechanism (fixed rate leg) includes the following steps:

(i) Bank B gives a *wa'ad* (promise) to purchase an amount of crude palm oil from Bank A;

(ii) Bank A sells the commodity to Bank B on *murabahah* basis at cost plus profit to be paid upon completion of subsequent transaction (floating rate portion).

Thus, the commodity *murabahah* transaction is executed. In this first mechanism, Bank B is considered as a fixed rate payer.

Simultaneously, the second mechanism (floating rate leg) is executed as follows:

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131 Ibid.

(i) Bank A gives a *wa'ad* (promise) to purchase the commodities from Bank B;

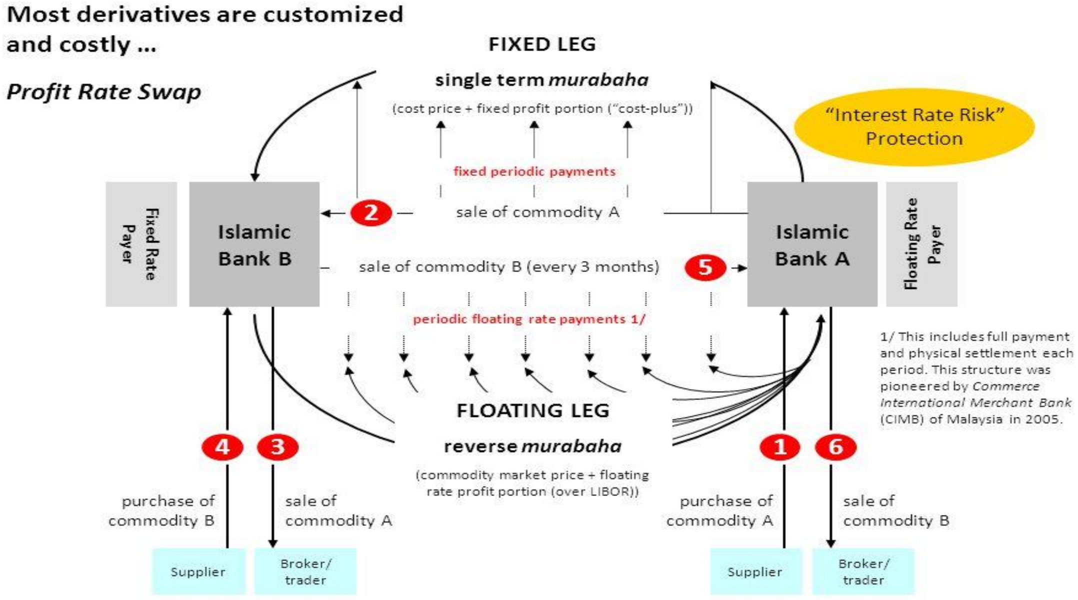
(ii) Bank B will sell the commodities to Bank A at cost plus profit based on the prevailing profit rate (agreed market price plus floating profit portion based on LIBOR).

Under this mechanism, Bank A is considered as a floating rate payer. In addition, it is important to note that in the above series of trades, both banks do not hold the commodities, since both of them utilise economic effects of the transactions not for holding the commodities. As a result, in each trade, each bank will purchase the commodities from suppliers and resells it to the traders or brokers at the same time. Thus, the commodities go back to the exchange in each transaction. Moreover, the whole series of trades will not go beyond the determined notional amount of the agreement.

The net result of these series of trades is that on each trade date the amount of commodities sold under each *murabahah* will be the same and the cost price will the same, and these will effectively be netted off by way of sales to a third party broker; only the profit element will differ, and, as in a conventional interest rate swap, the net beneficiary (of the difference between the fixed and floating rate) is dependent on whether the fixed or floating rate was higher.[132]

[132] See Hussain and Mehboob, above n 132, 22-24.

Figure 5.1. Islamic Profit Rate Swaps



Source: Jobs.[133]

Islamic profit rate swaps are part of the Sharia compliant OTC derivatives. The agreements between contracting parties are commonly drafted under a master agreement that records all transactions or trades. This master agreement as well the netting mechanism of Islamic profit rate swaps are discussed in chapter 6.

This preceding discussion indicates that in Islamic finance, as with Islamic law generally, there is a great deal of debate, respecting the permissible and the prohibited. As this chapter argues there is growing support for the legitimacy of derivatives in Islamic finance among contemporary Muslim scholars and market participants.

133 Andreas Jobst, 'Monetary Policy and Liquidity Management' (Seminar on Islamic Finance, Rome Italy November 11, 2009).

5.12 Summary

This chapter discussed the need of derivatives in Islamic finance and the use of these instruments for risk management purposes. This chapter has demonstrated that a total rejection of derivatives without genuine investigation is unwarranted. Despite the fact that almost all derivatives instruments are totally new to Islamic financial law, the possibility of admitting some of these instruments, or finding the suitable alternative for others, is feasible. Through selective juristic rules method, some Islamic juristic rules could be used to develop so-called Islamic hedging derivatives.

This chapter defined Islamic hedging derivatives as a type of hedging transaction following requirements of Islamic law. These requirements include: (i) that Sharia compliant derivatives shall be derived from Islamic contracts; (ii) Sharia compliant derivatives must utilise underlying asset that are classified as Sharia compliant; (iii) economic activities of those values or assets must be religiously permissible (*halal*). These assets are then evaluated through qualitative and quantitative screening. Based on these principles, for instance, it is prohibited to apply Islamic profit rate swaps to income or companies that are not deemed Sharia compliant; and (iv) Sharia compliant derivatives must be used for risk management purposes only so as to limit speculation and gambling. The chapter also discussed Islamic profit rate swaps through the combination of Islamic contracts creating an economic effect of conventional profit rate swaps. To be applied in practice, these Islamic profit rate swaps need to be drafted under a mainstream standardisation benchmark, a theme that will be discussed in the next chapter.

CHAPTER 6: LEGAL FRAMEWORKS FOR SHARIA COMPLIANT HEDGING DERIVATIVES

6.1 Introduction

Over-the-counter (OTC) derivatives have shifted to a standardised contract rather than a customised one (paragraph 4.4 of Chapter 4). At the global level, it is the International Swaps and Derivatives Association (ISDA) providing a master agreement for those types of derivatives. The ISDA version has become a benchmark for the documentation of Islamic OTC derivatives. International Islamic Financial Market (IIFM) based in Bahrain works with ISDA creating the ISDA/IIFM *Tahawwut* (Hedging) Master Agreement. This document provides legal frameworks for over-the-counter (OTC) Sharia compliant derivatives.[1] particularly Islamic profit rate swaps (paragraph 5.11.2 of Chapter 5). The *Tahawwut* agreement satisfies the need for standard documentation, the absence of which was one of the major issues behind the low demand for Islamic hedging.[2]

This chapter argues that a standard documentation for Islamic OTC derivatives is imperative for the global financial industry in order to tackle uncertainties in modern Islamic financial transactions as indicated in the previous chapter. This chapter begins with an examination of the ISDA/IIFM *Tahawwut* (Hedging) Master Agreement along with its close

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[1] Jonathan Lawrence, Anthony R.G. Nolan, Paul de Cordova, 'Sharia Compliant Master Agreement Introduced for Hedging Islamic Finance Transactions' (K&L Gates, 2010). In addition, the IIFM and ISDA recently introduced Credit Support Deed in March of 2017 to accommodate recent global initiatives on non-cleared derivatives particularly on collaterals and margin requirements as proposed by the Basel Committee on Banking Supervision (BCBS) and the International Organization of Securities Commissions (IOSCO).

[2] See, eg, ISDA, 'IIFM and ISDA Launch *Tahawwut* (Hedging) Master Agreement' (1 March 2010), available at http://www.isda.org/media/press/2010/press030110.html; and Saadiah Mohamad, Jaizah Othman, Rosmimah Roslin & Othmar M. Lehner, 'The use of Islamic hedging instruments as non-speculative risk management tools' (2014) 16(3) *Venture Capital*, 207-226, 222.

out netting system and its adoption for Islamic profit rate swaps. It then suggests the way forward for legal frameworks for Islamic derivatives. It then provides a concluding summary.

6.2 ISDA Master Agreement: A Global Market Benchmark

The 2002 ISDA Master Agreement was developed by the International Swaps and Derivatives Association (ISDA) – a non-government organization consisting of the largest derivatives dealers and professional advisors. This standard documentation has been a global benchmark for non-cleared OTC derivatives, and used in more than 90 per cent of the global financial derivatives markets.[3] ISDA documentation typically consists of three layers. These include:

(i) The master agreement that sets general rules applying to all derivative transactions agreed to by the counterparties;

(ii) The "confirmation" which documents each individual transaction; and

(iii) The "credit support" which provides for the collateralisation or the guarantee of payments to be made under specified transactions.[4]

The ISDA combines into a single contract all the multiple transactions under derivatives contracts between the counterparties. This enables various individual and unconnected transactions to be set off[5] one against one another.[6]

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[3] Hudson, Alastair, *The Law on Financial Derivatives* (Sweet and Maxwell, 5th Edition, 2012), 2-08.
[4] Ibid 2-01.
[5] The definition is explained in paragraph 6.3 of this chapter.
[6] Hudson, above n 3, 2-94.

The focus of this chapter is on two important features of the document. The first is that it provides the counterparties a termination mechanism in the event of defaults on one of the counterparties. This mechanism is closely related to insolvency law issues of derivative transactions. One of the important aspects of this mechanism is netting and close out netting, explained below. The second important feature is that the agreement organises the way in which the parties will govern their derivative transactions.[7] Most elements of netting and close out netting under the document are based on the law applying in the UK and New York.[8] Outside these jurisdictions, derivatives participants need to adjust to a specific governing laws set up in their dealings.

The reasons for the wider application of the ISDA documentation are that ISDA documentation may improve efficiency, reduce transaction costs especially in relation to termination mechanisms for a derivatives contract,[9] and diminish settlement risk.[10] It may also increase economic certainty particularly for close out netting in the event of defaults. This mechanism may provide protection for non-defaulting party.[11] It also provides greater certainty and market confidence that the terms and conditions of the document have been thoroughly tested and experienced in the global OTC derivative markets. For some commentators, the 2002 ISDA Master Agreement is the most remarkable standard form ever designed, covering an immense range of transactions; its terms and conditions handle huge transactional amounts traded on the global market.[12] But it is not without its critics who point to some deficiencies in ISDA documentation particularly in the master agreement itself and the Credit Support

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[7] Ibid 2-94.
[8] "The legal enforceability of the close-out netting provisions of the ISDA Master Agreement and their consequences for netting on financial statements", see ISDA, 'Effectiveness of Netting' [21/12/2017] http://www.isda.org/c_and_a/pdf/The-effectiveness-of-netting.pdf.
[9] Frank Artnoy and David Skeel, 'The Promise and Perils of Credit Derivatives' (Law School Paper No 125, University of Pennsylvania, 2006) 8.
[10] Alan N. Rechtschaffen, *Capital Markets, Derivatives and the Law: Evolution after Crisis* (Oxford University Press, 2nd Edition, 2014), 164.
[11] Ibid.
[12] Philip Wood, *Set-off and Netting, Derivatives, Clearing Systems* (Sweet&Maxwell, 2007) 217.

Annex.[13] ISDA has now proposed some amendments to address these issues.[14] In addition, the Basel Committee on Banking Supervision (BCBS) has also launched margin requirements to support the credit support annex, a type of collateral in derivatives transactions, of the 2002 ISDA Master Agreement.[15] This latest initiative is also included in the Credit Support of the ISDA (this credit support is beyond the scope of this chapter).

6.3 Netting and Close Out Netting under the ISDA Master Agreement

Close out netting is a particular important aspect of ISDA Master Agreement. It provides a credit enhancement to reduce counterparty risk, credit risk, or even systemic risks.[16] Netting is often referred to as the consolidation of multiple payments, transactions, or positions with the primary objective of creating a single value.[17] This process would determine the final amount owed by the party and amount based on that consolidation process. Netting may involve two parties and hence called a bilateral netting, or multi-parties called a multilateral netting. In the first scenario, all transactions between two parties in one currency are netted and only the net balance is transferred. Under the second scenario, all payments in one currency are netted and the payments from all companies taking part in the multilateral netting system are taken into account. The second type of netting often involves a third party commonly as a

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13 This is a mechanism to regulate collateral between contracting parties in derivative master agreement. Edmund Parker and Aaron McGarry, 'the ISDA Master Agreement and CSA: Close Out Weaknesses Exposed in the Banking Crisis and Suggestions for Change' (January 2009) *Butterworths Journal of International Banking and Financial Law* 16-19, 16.

14 See Marcus Jamson, 'Optional Amendment to ISDA Master Agreement' (24 October 2014) Mondaq Business Briefing, Business Collection [02/10/2017], see also comments on recent amendments on Guy Usher and Edward Miller, "Put Your Money Where your Mouth Is" – ISDA Publishes Long-Waited Amendments to Section 2(a)(iii)" [02/10/2017] http://www.mondaq.com/uk/x/334244/Commodities+Derivatives+Stock+Exchanges/Put+Your+Money+Where+Your+Mouth+Is+ISDA+Publishes+LongAwaited+Amendments+To+Section+2AIii.

15 Basel Committee on Banking Supervision (BCBS), 'Margin Requirements for Non-Centrally Cleared Derivatives' (Standard Documentation, Bank of International Settlements, March 2015).

16 Thomas F. Huertas, 'Negating Risk Through Netting' (1994) 4 *International Financial Law Review*, 3-4.

17 Investodia, 'Netting' [12/01/2018] https://www.investopedia.com/ask/answers/062515/what-difference-between-payment-netting-and-closeout-netting.asp?ad=dirN&qo=investopediaSiteSearch&qsrc=0&o=40186.

clearing house. This house handles all payments from multi-parties and calculates the netting amounts of those transactions. In addition, this type may also involve credit support annexes (CSA) as a mutual collateral against the default of a particular party in that multilateral transactions.[18]

Close out netting is often defined as a process involving termination of obligations under a contract whereby one of the contracting parties defaults in meeting their obligations.[19] This default triggers the termination of the contract and activates the immediate calculation of all transactions into a single value. Similar to the netting, this process determines the final amounts owed and the amount based on the consolidation process of multiple transactions and payments. This mechanism is an important process in the global financial markets notably OTC derivatives.[20] Under close out netting, the non-defaulting party has the ability to close-out or terminate all open financial positions in a contract upon the occurrence of specified events, including the commencement of insolvency proceedings. This is often tantamount to an early termination since it occurs prematurely to the scheduled termination dates of the relevant transactions. In addition, the parties then have the right to net all reciprocal obligations following from the close-out process on an aggregate basis. This involves combining the relevant positive and negative replacement values into a single net payable or receivable.[21] Thus, the close out netting commonly involves three steps: termination; valuation; and determination of the net balance.[22]

[18] Jon Gregory, *Counterparty Credit Risk: The New Challenge for Global Financial* Markets (Wiley, 2011) 46.
[19] David Mengle, 'The Importance of Close Out Netting' (2010) 1 *ISDA Research Notes*, [22/02/2018] https://www.isda.org/a/LPDDE/netting-isdaresearchnotes-1-2010.pdf.
[20] Ibid. Jeffrey Wern Loong Yow, 'The Enforceability of close out netting: A Malaysian Perspective' (2012) 6(6) *Law and Financial Markets Review* 399-409.
[21] Ibid.
[22] See, eg,David Mengle, above n. 19, 3; and Akhmad Affandi Mahfudz, '*Tahawwut* Master Agreement: Pertinent Issues and Legal Practices in Malaysia' (Conference Paper, International Islamic Financial Markets (IIFM) Specialized Sessions on Islamic Finance, 2007).

After the process of close-out netting, two possible scenarios may occur. If the single net amount is owed by the defaulting party, the collateral posted by the defaulting party can be applied to that single net amount. The remaining collateral must be returned to the insolvency administrator and the residual claims by the non-defaulting party are treated as unsecured claims. However, if the single net amount is owed by the non-defaulting party, the non-defaulting party may further set-off such amount with any amounts owed to it by the defaulting party under other financial contracts via cross-product netting arrangements if applicable under the relevant insolvency regime. The final amount arrived at will be paid by the non-defaulting party to the insolvency administrator.[23]

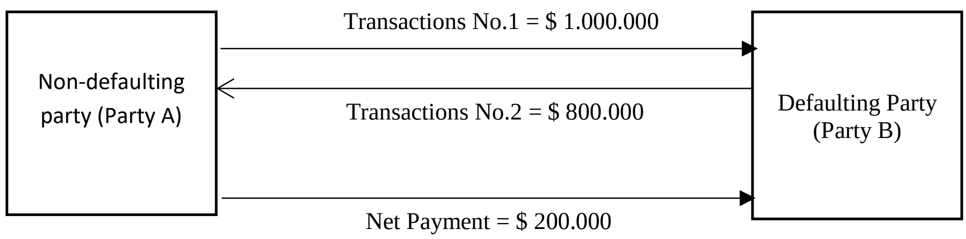
The fundamental premise of the 2002 ISDA Master Agreement in relation to close out netting is that all transactions entered into under such contract forms a single agreement between the contracting parties. This single agreement enables contracting parties to monitor and manage risk exposure based on the overall assessment of the transactions entered between the parties, considering the volume and frequency of derivatives transactions.[24] The "single agreement" concept under the ISDA enforces close out netting calculation. Close out netting enables for all transactions under the master agreement to be terminated on the occurrence of specific events stated in the agreement.[25]

As indicated previously, two possible scenarios may occur after the process of close out netting whether the net balance creates an asset or liabilities for contracting parties. A derivative contract may be either "in the money," that is, representing a present or future right to receive payment from the other counterparty (i.e., an asset), or "out of the money," that is, representing a present or future obligation to make payment to the other counterparty (i.e., a

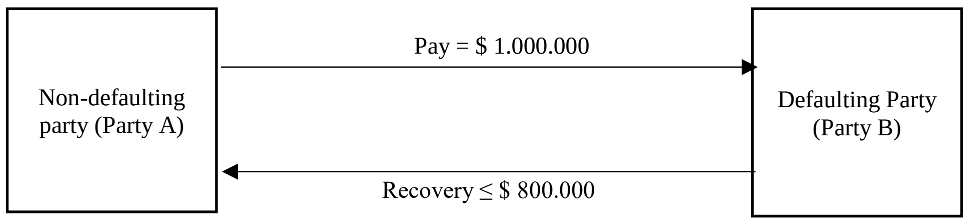
[23] See Yow, above n 19, 400.
[24] Ibid.
[25] Ibid.

liability). With certain derivative structures, it is also possible that at any given time neither party owes any payment to the other. Thus, the credit risk faced by a derivative counterparty is one that requires the simultaneous existence of two conditions in order for a loss to occur. These are that counterparty must be "in the money" when the derivatives are terminated; and that the other counterparty must be unable to satisfy the resulting payment obligation.[26] This is illustrated in the netting mechanism under the 2002 ISDA Master Agreement.

Figure 6.1. Close Out Netting Under Sec 6 of 2002 ISDA Master Agreement



If close-out netting is not enforceable, the above transaction is as follows:



Source: ISDA.[27]

The above figure shows that two parties, party A as a non-defaulting and party B as defaulting party, are engaged into two swaps transactions. For party A, transaction 1 has a negative replacement cost of US $1 million, while transaction 2 has a positive replacement cost

[26] Mark A. Guinn and William L. Harvey, 'Taking OTC Derivative Contracts as Collateral' (2002) 57(3) *the Business Lawyer* 1127-1156, 1138.

[27] International Swaps and Derivatives Association (ISDA), 'Netting and Offsetting: Reporting Derivatives under U.S. GAAP and Under IFRS' (2012), available at https://www.isda.org/a/veiDE/offsetting-under-us-gaap-and-ifrs-may-2012.pdf, 12.

of US$ 800 thousand. The figure shows that if the close out netting is enforceable, the party A is obliged to pay the net difference of US$ 200 thousand to party B. In other words, this transaction creates a liability of party A, and asset for party B. However, if the close out netting is not enforceable, the party A needs to pay US $ 1 million to party B, and also needs to wait the payment from the party B, possibly months or years, for whatever fraction of the US$ 800 thousand gross amount it bankrupts.[28] This unenforceable netting creates liability as well as an asset for party A and party B. However, there is uncertainty concerning on the ability of party B to recover debts from party A.

The mechanism of the Master Agreement could be adopted as a benchmark in developing standard documentation for the Sharia compliant derivatives. It provides most recognizable practices on how derivatives documentation should be drafted in modern derivatives markets. This will be a stepping stone for Sharia compliant documentation that is still in its infancy. The Islamic version which has adopted that documentation is discussed in the following section.

6.4 ISDA/IIFM *Tahawwut* (Hedging) Master Agreement

The IIFM and the ISDA introduced "the ISDA/IIFM *Tahawwut* Master Agreement" as an alternative for documenting Islamic derivatives particularly swaps transactions. It was the result of 24 drafts and a consultation process started from 2006.[29] It was completed in 2010.[30] The delays had been caused by differing views on Islamic aspects of the document including

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[28] See ISDA, above n 26, 11.

[29] Joel Clark, "Islamic *tahawwut* master agreement arrives at last" (01 Mar 2010) risk.net, available at https://www.risk.net/derivatives/structured-products/1593967/islamic-*tahawwut*-master-agreement-arrives-last. According to Irfan, the draft itself had been circulated to more than 100 Islamic finance institutions and conventional finance that has Islamic subsidiaries and windows, but only twenty-five took an active interest, the majority of these being conventional financial institutions, see Harris Irfan, *Heaven's Bankers: Inside the Hidden World of Islamic Finance* (London: Constable, 2014) 174.

[30] Clark, above n 28.

the use of Islamic contracts, settlement mechanism particularly netting and close out netting. Later on, major critics of the document mostly relate to these aspects. These will be discussed in the following section.[31]

Although the *Tahawwut* benchmarking the 2002 ISDA Master Agreement, the initiators stated that the document is different in substance to the ISDA version. The *Tahawwut* is to be strictly used for hedging actual risks, with no speculation (actual settlement of assets and payments). It is available only for permissible (*halal*) assets; and the charging of interest is prohibited. These restrictions reflect the limitations on Islamic hedging referred to in paragraph 5.3 of Chapter 5. In this way, the agreement provides a further stepping stone in product development and in allowing parties to financial transactions to protect themselves against market uncertainties and ensuring compliance with Sharia law.

6.5 The Structure of the *Tahawwut*

The *Tahawwut* agreement has special features compared to the 2002 ISDA Master Agreement. First, the *Tahawwut* divides transactions into "Transactions" and "Designated Future Transactions (DFT)".[32] The "Transactions" applies to any concluded transactions under the document based on *murabahah* (cost plus profit sale) contracts referring to actual or binding contracts that sets out the relevant terms and condition, referred to as the "Confirmation". As a binding contract, "Transactions" must state exact date of delivery of at least a portion of the agreed-upon subject of sale such as crude palm oil.[33] This commodity is an underlying asset

[31] Noor Suhaida Kasri and Siti Syafira Zainalabiddin, 'Breach of Wa'd and Its Compensation Payment: A Critical Analysis of Islamic Profit Rate Swap' (2016) 8(1) *ISRA International Journal of Islamic Finance* 191-195.
[32] Section 1 of the ISDA-IIFM *Tahawwut* Master Agreement.
[33] see J.T. McMillen, et al, 'The 2010 *Tahawwut* Master Agreement: Paving the Way for Shariah Compliant Hedging Products' (2010) [20/02/2017] http://ssrn.com/abstract=1670118, 10.

for implementation of the intended sale and purchase and creation of the payment obligation between contracting parties.

Meanwhile, “Designated Future Transactions” shorted as DFT refers to non-binding agreements or non-concluded transactions in the form of promise (*wa’ad*) to enter into a sale and purchase agreement to an uncertain future date subsequent to signing the agreement of *murabahah* (cost plus profit sale) contracts between contracting parties. Under DFT, the amount, time of delivery, and pricing of future sales and purchases of an underlying asset or commodity remain undecided. Unlike the “Transactions”, in DFT each party can cancel the agreement (promise) prior to become a binding contract. However, the DFT becomes binding when each party decides to execute it.[34]

The differentiation between two types of transactions under the *Tahawwut* affects the treatment of early termination under the document. The *Tahawwut* permits parties to enter into transactions that may be documented immediately (“Transactions”) as well as transactions due to occur in the future (“Designated Future Transactions”) so that parties are able to create cash flows similar to the cash flows created in conventional derivatives products.[35] Unlike the 2002 ISDA Master Agreement’s netting system allowing parties to aggregate the exposures between them and reduce them to a single payment, the *Tahawwut*, separates the netting mechanism into two types as will be discussed in paragraph 6.6.1 and 6.6.2 below.[36] Hence, there is no single net sum payable under the agreement. [37]

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[34] Ibid 9-10.

[35] Juan Sole and Andreas Jobst, ‘Operative Principles of Islamic Derivatives: Towards a Coherent Theory’ (Working Paper No 12(63), International Monetary Fund, 2012) 26.

[36] For detail explanation of these modifications, see Lynn Aziz, ‘ISDA/IIFM Launch *Tahawwut* Master Agreement’ (2010) [14/03/2018] https://islamicbanker.com/publications/islamic-hedging-agreement.

[37] Jonathan Lawrence, et al, ‘The New Islamic OTC Derivatives Contract’ (2010) 5 *Journal of International Banking and Financial Law* 305.

Second, the *Tahawwut* modifies some key provisions of the 2002 ISDA Master Agreement. It deletes several provisions related to receipt and payment of interest due to the issue of prohibited interest-based transactions. These include the provisions on the delay of payment due to illegality or force majeure event,[38] on the default of any payment or delivery obligation[39], and on the delay of payment of any unpaid amount or early termination amount.[40] There is disagreement in relation to these provisions and whether these amendments reflect Sharia principles.[41]

Third, all involved transactions either completed transactions or uncompleted transactions attached to the *tahawwut* need further Sharia approval from respective Sharia Supervisory Boards (SSBs). The *tahawwut* is the only agreement that is considered Sharia compliant. However, if there is any amendment or addition to the *Tahawwut* master agreement, contracting parties must first take all action required to satisfy themselves as to Sharia compliance. [42] The intention is that contracting parties are to ensure Sharia compliance for each transaction which precedes the agreement. The parties may make available approvals from their SSBs (e.g., based on a copy of the relevant *fatwa* or documentation of their own internal consideration) before entering into the agreement. Section 3(h) of the *Tahawwut* states:

> "insofar as [a party] wishes or is required for any reason to enter into transactions which are Shariah compliant it has made its own investigation into and satisfied itself as to the Sharia compliance of this Agreement (including the obtaining of a declaration, pronouncement,

[38] Section 6(e)(iv) of the ISDA-IIFM *Tahawwut* Master Agreement.
[39] Section 9(h)(i) of the ISDA-IIFM *Tahawwut* Master Agreement.
[40] Section 9(h)(ii) of the ISDA-IIFM *Tahawwut* Master Agreement.
[41] For instance, under Islamic law, the non-defaulting party is permitted to recover actual damages resulting from the default, including all fees, costs and expenses (other than interest and consequential damages) incurred as a result of such default. Frequently, cost recovery provisions (often capped at an amount determined on the basis of a default rate) are included in the documentation. However, this was not the approach applied in this master agreement. In Shari`ah-compliant *murabahah* and musawama transactions, obligations to pay interest are sometimes permitted in the documentation as an inducement to timely performance (although the non-defaulting party must donate the interest to charity, rather than retaining any interest amount). That also was not the approach taken in the *Tahawwut* Master Agreement", see McMillen, et al, above n 32.
[42] Ibid.

> opinion or other attestation of the Sharia adviser, board or panel relevant to it where required)".

Section 3(h) of the *Tahawwwut* is realistic enough that there would be different Sharia interpretations toward a particular transaction attached in the documentation. Strictly following a particular Islamic juristic view would not be feasible considering that the *Tahawwut* is intended to be applied in various jurisdictions with different Islamic juristic views. Moreover, the *Tahawwut* strictly places the legitimacy of Sharia into respective SSBs. This is clear when the section 1 (d) stating that the document is not intended to be governed by Islamic law before the courts, but rather by New York and English law as the governing law for the agreement. This means that determinations of unlawfulness or illegality are made without reference to Islamic law.

6.6 Terminated Transactions under the *Tahawwut*

In contrast to the 2002 ISDA Master Agreement's netting and close out netting calculation that consolidates all transactions into a single value (see above figure 6.1), the *Tahawwut* splits the calculation of terminated transactions into two separate methods as a reflection of two types of transactions under the document (paragraph 6.3). These include the calculation of terminated transactions under "Transactions" (concluded transactions) and "Designated Future Transactions" (non-concluded transactions).

6.6.1 Termination of "Transactions"

In the termination of "Transactions" (concluded transactions), the originally agreed payment price under *murabahah* contracts is accelerated and becomes payable immediately. All payments due from one counterparty to the other under concluded transactions are accelerated and set off against each other to determine a single close out amount. The economic effects of this calculation are similar to the 2002 ISDA Master Agreement's close out netting mechanism.[43]

6.6.2 Termination under "Designated Future Transactions" (DFT)

In non-concluded transactions, the calculation of terminated transactions refers to market quotations as in the 1992 ISDA Master Agreement.[44] Before explaining the termination method in DFT, the termination of the 1992 ISDA version is firstly explained. In the 1992 ISDA Master Agreement, the contracting parties must decide between "Market Quotation" or "Loss Method" as a method of calculating or measuring the value of the terminated transactions at the early termination date. In "Market Quotation", the value of terminated transactions would be set by obtaining the price quotations from market makers or leading dealers in the relevant derivatives. This quotation would be for the replacement cost of the particular terminated transactions. This is not available if fewer than three quotations are obtained, due to some reasons for instance because of unstable market conditions as in the case of global financial crisis, or because there were fewer dealers who deal in particular types of illiquid transactions, or if a market quotation would not (for some reasons) produce a commercially reasonable

[43] Sole and Jobst, above n 34, 26.
[44] Ibid.

result. In these situations, the “Loss Method” applies with respect to those terminated transactions. Under the Loss Method, the payment is measured by reference to what can be reasonably determined in good faith as the party’s total losses and gains in connection with the terminated transactions.[45] In practice, it may be difficult to find market advisors willing to price complex transactions realistically following a major default. As a result, the parties may opt for the “loss method” which gives a large amount of discretion to the determining party and introduces major subjectivity into the process.[46]

The difficulty to define the close out amount of the market quotation especially during the global financial crisis and the subjectivity of the loss method attracted the ISDA 2002 Master Agreement to change those methods with close out netting (see paragraph 6.3). This latest version has been introduced into the market place and gaining its recognition and popularity amongst market participants.[47]

While the 2002 ISDA Master Agreement has moving forward by introducing the “close out netting”, the *tahawwut* is moving backward by adopting the “Market Quotation” and “Loss Method” in the termination of non-concluded transactions (DFT). To apply these methods, there are three steps to be followed by market participants in terminating their DFTs. First, market reference is established on the basis of a replacement transaction. Thus, an index is calculated based on the Market Quotation or Loss Framework determining a replacement cost for the terminated transactions. This quotation may be referred to market dealers.[48] The index called “Relevant Index Amount” (RIA) is measured and calculated to determine the final price

[45] College of Law (England and Wales), *Commercial Contracts: Restrain of Trade* [no date].
[46] John Gregory, *The xVA Challenge: Counterparty and Credit Risk, Funding, Collateral, and Capital* (John Wiley and Sons, 3rd Edition, 2015) 54.
[47] Ibid.
[48] There is no explanation on this type of dealer in the case of Islamic hedging transactions whether it is referred to conventional derivative dealers or is there any dealer for Islamic hedging transactions called “Islamic dealers”, this for sure needs an additional research.

of assets for those transactions. Second and third are that the parties exercise *wa'ad* (promise), and enter into a *musawamah* sale contract using the index as a price reference of those assets. Unlike *murabahah* whereby the seller must disclose all relevant costs related to the price of a subject matter, the *musawamah* does not require such disclosure. Consequently, the use of *musawamah* is preferable in this model because the non-defaulting party has complete discretion in determining the loss. This consideration is similar under the conventional system as discussed previously.

6.6.3 Early Termination of DFTs

In the event of early termination date due to event of default, non-defaulting party makes the following calculation:

(i) Early termination amount = [close out amount + Unpaid amount owing to Non-Defaulting Party] + Unpaid amount owing to defaulting party

(ii) Relevant Index Amount = Aggregate of the Market Quotation (or Loss) for non-concluded transactions and concluded transactions

The close amount reflects netted accelerated payments of completed transactions (under *murabahah* contracts). Both amount either early termination and relevant index may be positive or negative. In a case that the index is positive, non-defaulting party is considered as "in the money" meaning that it can exercise promise (*wa'ad*) requiring defaulting party to enter into a sale-based *musawamah* and to purchase designated assets from non-defaulting party for the positive indexed value (market value of the assets plus relevant index value plus sale tax, etc.). However, if the relevant index value is negative, defaulting party is "in the money" meaning that it can exercise promise (*wa'ad*) requiring non-defaulting party to enter into a sale-based *musawamah* and to purchase designated assets from defaulting party for the positive indexed value (market value of the assets plus absolute value of relevant index value plus sales tax, etc.).[49]

The value of the Relevant Index is an amount determined by the relevant determining party (in the above case, the determining party may be non-defaulting or defaulting party) equal to the sum of either: the termination currency equivalent of the market quotations for each terminated non-concluded transaction for which a market quotation is determined; and secondly such determining party's Loss for each terminated non-concluded transaction for which a market quotation cannot be determined or would not provide a commercially reasonable result. This is a departure from the preference in the market for using the concept of close-out amount contained in the 2002 Agreement as market quotation with a fall-back to Loss was seen to be a more acceptable method of calculation to some Sharia scholars in the IIFM.[50] In addition, Loss is the determining party's losses and costs (or gain) in relation to the terminated non-concluded transactions. In contrast to the 1992 ISDA Master Agreement, due to Sharia requirements, Loss does not specifically refer to loss of bargain, cost of funding or losses or costs incurred as a result of terminating, liquidating, obtaining or re-establishing any hedge or related trading position. [51]

It is important to note that where the defaulting party fails to comply with its promise after a notice has been given (for instance, if it were insolvent). This party is discharged from its obligation to deliver the assets and is entitled, by way of liquidated damages, to payment of an amount equal to the value of the relevant index.[52] However, this last mechanism is not clear

[49] Tariq Zafar Rasheed, 'Introduction to the ISDA/IIFM Tahawwut Master Agreement' (Presentation, Berwin Leighton Paisner, 2015) 15, http://www.blplaw.com/media/download/Introduction_to_the_ISDA-IIFM_Master_Agreement.pdf.
[50] Allen and Overy, 'ISDA/IIFM *Tahawwut* Master Agreement' (2010), available at http://www.allenovery.com/publications/en-gb/Pages/ISDA-IIFM-*Tahawwut*-Master-Agreement.aspx.
[51] McMillen, et al, above n 32.
[52] Section 6(h)(ii) of the ISDA/IIFM *Tahawwut* Master Agreement.

particularly on how the penalty of failing to abide the non-binding *wa'ad* (promise) could be enforced, given that the obligation set forth in the undertaking is merely a non-binding promise rather than an enforceable agreement. It might be also difficult to enforce the liquidated damages right each party has for the other's refusal to comply with its *wa'ad* (promise).[53] However, in a summary, this mechanism crystallises an amount equal to the mark-to-market value of the concluded transactions in respect of which assets have not been fully delivered (DFT), giving the relevant party a liquidated damages claim for such amount. The end result therefore economically achieves a similar result to that which would apply under a conventional ISDA Master Agreement. The table below is summarised the differences between the 2002 ISDA Master Agreement and the ISDA/IIFM *Tahawwut* Master Agreement.

Table 6.1. Differences Between the 2002 Master Agreement and the ISDA/IIFM *Tahawwut*

	The 2002 ISDA Master Agreement	**The ISDA/IIFM *Tahawwut***
Purpose	1. Hedging and Swaps Derivatives 2. No limitation on type of assets 3. Interest is permissible	1. Hedging Actual Risks 2. Settlement of Actual Assets and Payments 3. Involving Halal Assets 4. Interest is Prohibited
Scope	Single Agreement Concept	Two types of agreements: 1. "Transactions" based on *murabahah* (cost plus profit sale) 2. "Designated Future Transactions" (DFT) based on *wa'ad* (promise)
Binding Nature	All transactions under the document are legally banding	All transaction under the "Transactions" are legally binding, whilst all transactions under the DFT are not legally binding. DFTs are promises to enter into future binding transactions. This means that each party can cancel prior to binding *murabahah* contracts.
Delivery of Goods and Assets	Uncertain date for delivery	Two types of delivery: 1. Under the concluded transactions (*murabahah* contract) = amount, timing, pricing and delivery are exact 2. Under the non-concluded transactions (promise or *wa'ad*) = amount, timing, pricing and delivery are deferred to uncertain future date

53 McMillen, et al, above n 32.

Early Termination	All remaining transactions are accelerated into one single amount	Two types of early termination: 1. Under "Transactions" = all remaining payments are accelerated following early termination 2. Under "DFTs", the early termination is determined by Relevant Index Amount which is Aggregate of the Market Quotation (or Loss)
Bilateral Netting (2 parties)	Single payment netted, net balance paid	No single payment considering two types of transactions: concluded ("Transactions") and non-concluded transactions ("DFT")
Multiparty netting	Usually clearing house calculates the net amount.	NA. Since the Tahawwut seems designed for bilateral agreements
Terminated Transactions	All transactions under the 2002 ISDA Master Agreement	All transactions including concluded and non-concluded transactions under the IIFM/ISDA *Tahawwut* Master Agreement
Default	Availability of Collateral under Credit Support Annex	The ISDA/IIFM *Wathiqah Hamish al Rahn al Naqdi* (Credit Support Deed for Cash Collateral (VM)).[54]
Non Defaulting Party	Option to close out or terminate. Steps to follow are: termination, valuation, and net balance	Option to close out or terminate. Steps to follow are: termination, valuation, and net balance
Governing Law	English and New York Law	English and New York Law excluded Sharia Law
Sharia Compliance	NA.	The ISDA/IIFM Tahawwut Master Agreement is considered Sharia compliant. However, the document of the transactions attached to the *Tahawwut* is subject to the approval of respective Sharia scholars

6.6.4 Issues of the *Tahawwut*

The first issue with the *Tahawwut* is the mechanism of close out netting particularly under the DFTs. One view is that close out netting under the Designated Future Transactions (DFT) breaches the principles of *wa'ad* (promise), particularly where there is a failure to perform the promise.[55] On this approach DFTs are not concluded transactions where

[54] International Islamic Financial Markets (IIFM), "IIFM And ISDA Publish Islamic Credit Support Deed For Variation Margin" [1/12/2018] http://www.iifm.net/news-updates/iifm-and-isda-2.
[55] Kasri, above n 30, 191-195.

counterparties have expressed an intention to enter into binding contracts (*musawama* sale contracts) because their terms are not yet fully determined and on their own, are not legally binding contracts. As the parties would not be legally bound to enter into the remaining asset trades, there would be no legal basis for close out for the party which is “in-the-money” to demand compensation for the replacement value of the swap transactions. However, the *Tahawwut* states that where a party fails or is unwilling to comply with its obligation to purchase the designated assets, the party who exercised the *wa'ad* is charged from its obligation to deliver the assets and is entitled, by way of liquidated damages, to payment of an amount equal to the value of the Relevant Index Amount (RIA) (Above), thus crystalizing an amount equal to the mark to market value of non-concluded transactions (DFT).[56] However, in Sharia, this mechanism modifies Islamic traditional contracts which are adapted for modern hedging transactions. Disagreements among Muslim jurists and scholars (*ikhtilaf*) are inevitable as part of any modernisation of financial instruments.

For some commentators, the concept of netting is more consistent with the *muqasah* rather than the *musawamah* (a cost plus sale without disclosure of its original price and acquisition costs) that has been utilised by the *Tahawwut*. *Muqasah* is defined as a form of clearance of obligation and setting off debts of the debtor and creditor when the debts are identical in all aspects or when the debt is of different value, the smaller debt is deducted from the larger debt. Both debtor and creditor are indebted toward each other where the debts are of the same amount and value, and both parties have agreed to set off their debts and terminate their obligations accordingly.[57] According to the Sharia Advisory Council – Central Bank of Malaysia, *muqasah* is a common practice and acceptable even where two parties are indebted

[56] Although note the discussion of basic risk under the heading Early Termination of Non-Fully Delivered Terminated Transactions and DFT above.
[57] Ahcene Lahsasna, *Sharia Non-Compliance Risk Management and Legal Documentations in Islamic in Islamic Finance* (John Wiley and Sons, 2014).

to each other and the debts are settled based on the payment of the difference between the amount of the two debts.[58] *Muqasah* allows the settlement of debts in different currencies between two parties as in the case of *sarf* (currency exchange).[59] This contract has been regarded as the Islamic version of netting. Even if netting is similar to *muqasah*, its effect in relation to insolvency in unclear in Islamic jurisprudence.[60] Moreover, the Islamic equivalent of netting does not address issues of multi-party netting or netting involving multiple transactions between parties. The Sharia-based netting is focused on the transactions between two parties.

Another important issue is the lack of market adoption on the *Tahawwut*. Prior to the creation the *Tahawwut*, Islamic banks developed their own Shariah-compliant hedging documentation at significant cost to the industry.[61] Since 2003, the industry has designed OTC Islamic derivatives, i.e. Islamic profit rate swaps, and cross currency swaps.[62] The markets have developed their own internally approved and agreed template Shariah compliant hedging documentation, so there is less incentive to use the *Tahawwut*. If these markets adopt this mater agreement, they will have to re-negotiate and revisit their existing documents, which is undesirable given the time and costs that may be required to amend the existing documents.

[58] Central Bank of Malaysia, *Sharia Resolutions in Islamic* Finance (BNM, 2nd Edition, 2010) 142.
[59] Sole and Jobst, above n 34.
[60] Philip R. Wood, *Set-Off and Netting, Derivatives, Clearing Systems, Volume 4* (Sweet & Maxwell, 2007)
[61] See from the report of Norton Rose Fulbright, 'A Year in the Life of ISDA/IIFM Master Agreement' [21/03/2017] http://www.nortonrosefulbright.com/knowledge/publications/60521/a-year-in-the-life-of-the-isdaiifm-*tahawwut*-master-agreement.
[62] Ibid.

6.6.5 Multiple Interpretations of “Market Quotation”

The adoption of “Market Quotation” and “Loss Method” in the *tahawwut* may create issues in interpreting market quotation itself. Several cases show that there were some difficulties in defining market quotation in financial crises.[63] This method was found in the 1992 ISDA version and then changed in the 2002 ISDA Master Agreement due to its inherent weaknesses as noted in paragraph 6.4.2. The fall back is the ‘Loss’ method with the determining party calculating what their loss is using reasonableness and doing so in good faith, discussed above at 6.4.2. The problems with this approach have been also discussed at the same section.

6.6.6 Lack of Netting Legislation in Muslim Countries

Another major issue of the *Tahawwut* is that the lack of netting legislation in Muslim majority countries where Islamic finance has flourished. Most Middle Eastern countries (i.e. Bahrain, UAE, and Qatar) do have some rudimentary, but insufficient provisions.[64] In Central Asia in countries with Muslim majorities (such as Kazakhstan) there is no netting legislation nor is it being considered.[65] In countries where close out netting is unenforceable, this creates legal uncertainties for *Tahawwut*’s users. Netting may effectively work as long as there is certainty that this arrangement is enforceable in each of the relevant jurisdictions, in particular in the event of insolvency of one of the parties.[66] For this reason, Malaysia, one of the market

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[63] “Valuing Close Out Payments in the OTC Global Derivatives Markets” [21/09/2018] https://www.allens.com.au/pubs/baf/fobafoct02.htm, see also Edmund Parker and Aaron McGarry, ‘The ISDA Master Agreement and CSA: Close Out Weaknesses Exposed in the Banking Crisis and Suggestions for Change’ (2009) *Butterworths Journal of International Banking and Financial Law* 16-19, 18.

[64] Peter M Werner, ‘Update on Netting in Asia’ (2011) Conference on Cross-Jurisdictional Netting and Global Solutions, available at https://www.lse.ac.uk/collections/law/projects/lfm/P%20Werner,%20Netting%20in%20Asia.pdf.

[65] Ibid.

[66] Philipp Peach, ‘Netting and Resolution Powers – Global Problems, Local Solutions?’ (Conference Paper, London School of Economics, 2011).

leaders in Islamic hedging, in 2005 stated that the methodology in determining the close out amount under the conventional interest rate swap could also be applied onto Islamic profit rate swaps.[67] This may not work effectively if the insolvency law in that country is not completely consistent with close out netting.[68] This thesis argues that Islamic countries should adopt legislative solutions which balance the enforceability of close-out netting with national policy and regulatory considerations.[69] As close out netting is the primary means of mitigating credit risk associated with OTC derivatives,[70] the lack of netting legislation in the most of Muslim countries may create legal risks concerning the enforceability of netting provisions under the *Tahawwut*.

Indonesia as another important market in the global Islamic finance does not have netting legislation. Enforceability of the netting rule of the 2002 ISDA Master Agreement refers to general principles of law based on the *Indonesian Civil Code* which recognises a limited form of set-off (*perjumpaan hutang*), such as in Articles 1425 to 1434. This concept is also explained in *Indonesian Bankruptcy Law*.[71] But this appears only to apply to bilateral netting. The *Indonesian Civil Code* ICC recognizes that the set-off is one of the reasons to nullify a contract.[72] There is disagreement on the issue of whether those articles of the *Indonesian Civil Code* can be directly applied because the termination of the contract needs to be requested by a receiver.[73] In the *Indonesian Bankruptcy Law*, only the receiver can request termination of a preferential transfer transaction entered into by the debtor before its

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67 Mahfudz, above n 21.
68 Yow, above n 19.
69 Ibid.
70 Mengle, above n 21.
71 Law Number 37 of 2004 on Indonesian Bankruptcy and Suspension of Payments.
72 Article 1381 of the Indonesian Civil Code.
73 Amy Rachmi Budiati, et al, 'Standarisasi Perjanjian Transaksi Derivatif OTC Domestik Berdasarkan Prinsip Dalam ISDA Master Agreement Dihubungkan dengan Ketentuan Kepailitan di Indonesia' (2016) 13(2*) Bulleting Hukum Kebanksentralan*, 23.

bankruptcy, if such transaction is considered detrimental to the creditors.[74] Article 1266 of the *Indonesian Civil Code* also states that judicial intervention is required to terminate the obligations of the counterparties under the agreement. This rule should be waived to make the set-off system in Indonesia comparable to close out netting system under the ISDA Master Agreement. Hence, in the event of early termination, contracting parties can directly off against each other to determine a single close out amount without the judicial decision of the courts.

6.6.7 Advantages of the *Tahawwut*

The *Tahawwut* could be a benchmark for Islamic derivatives documentation. This includes the adoption of global standard documentation in OTC Islamic derivatives markets. This documentation may also benefit both the issuers and Islamic investors since they have a template for their derivatives agreements.[75] From Islamic point of view, the *Tahawwut* is viewed as a pan-madhab (across all schools agreement) that spans major schools in the Sunni traditions.[76] Although, the *Tahawwut* does not establish universally binding market rules, its adoption in the ISDA documentation has led market players developing Sharia compliant versions adapted from the document. In 2004, for instance, the market mirrored the ISDA 2002 Master Agreement when the Malaysian CIMB Bank created Islamic Profit Rate Swaps by

[74] These include: (1) the preferential transfer was performed by the debtor before it was declared bankrupt; (2) the debtor was not obligated by contract (existing obligation) or by law to perform the preferential transfer; (3) the preferential transfer was prejudiced the creditors' interests; and (4) the debtor and such third party had or should have had knowledge that the preferential transfer would prejudice the creditors' interests.

[75] Saadiah, et al, above n 2, 222.

[76] Sole and Jobst, above n 34, 25.

replicating conventional interest-rate swaps through the Islamic Swap Master Agreement adopted from the ISDA version for interest rate swaps. [77]

The adoption of the *Tahawwut* could deliver economic efficiencies in Sharia compliant hedging markets. It may reduce the time committed to the negotiations process and consequently, has an impact on reducing legal expenses. Prior to this document, participants in the Islamic markets might be developing their own in-house documents, which were different from dealer to dealer based on specific negotiations and customizations for contractual parties. This lack of uniformity in legal terms and definitions made negotiations difficult and time consuming, especially for novice investors with little experience in this new market. Hence, this standard may reduce legal costs in respect to negotiating the Islamic law requirements of each derivative transaction. Moreover, the less transaction costs in drafting the OTC Islamic derivatives may also lead to a competitive pricing of these derivatives. This might attract market participants to use the *Tahawwut*.

Tahawwut may also enhance transparency. All of the materials economic and legal terms must be defined in the agreement. Therefore, an uninitiated investor in the Islamic derivatives market will be prompted to consider all of the key issues associated with Islamic derivatives transactions. In effect, even if the parties to the agreement are experienced dealers and a beginner investor, the document will put them on equal footing.

Tahawwut may also enhance liquidity. Standard terms consistently applied across Islamic derivatives transactions provide a common reference point, a contractual benchmark for all participants. If all participants use the same document, then the sale and assignment of Islamic derivatives is more easily facilitated. Without a standard form the market can become

[77] Michael Mahlknecht, "Islamic Capital Market: A Growing Area for Investments" in Angelo M. Venardos, *Current Issues in Islamic Banking and Finance: Resilience and Stability in the Present System* (World Scientific Publishing, 2010) 255.

fragmented, as investors search not only for the most favourable pricing, but also for the most favourable contract form. A standard contract form for Islamic derivatives is analogous to standardised future contracts traded on a future exchange; it provides a common denominator upon which all parties can transact.[78] Based on a survey, most Islamic hedging documentation is hard to understand. The terminologies mostly used are Arabic terms and concepts.[79] Documentation often requires additional documentations and procedures, which can be cumbersome. For instance, an investor needs to sign multiple contracts before and after the transaction. In addition, they also need to read and understand the whole document that is more rigid than conventional hedging documentation, and for some clients, they may not understand the Islamic terms used in the contracts. As the industry is relatively new and Sharia resolutions vary across jurisdictions, it is important that global harmonization especially with regard to documentation is established as many of businesses involved in hedging activities are those with cross-border transactions.

6.7 A Way Forward

Islamic financial institutions have developed Islamic alternatives to hedging transactions, and the collaboration between IIFM and ISDA has resulted in developing standard documentation for Islamic hedging transactions. What needs to be done is that the International Financial Supervisory Boards (IFSB) review the market practices on hedging transactions particularly on its risk legal frameworks. Moreover, Islamic derivatives are extending to new

[78] Hal S. Scott and Annan Gelpern, *International Finance: Transactions, Policy, and Regulation* (Foundation Press, 20th Edition, 2014), 975, for the same logic as in the case of the ISDA 2002 Master Agreement.
[79] Saadiah, et al, above n 2, 222.

jurisdictions and territories leading to a pressing demand for Sharia complaint standard products, as well as collateral documentation in order to manage credit risk.[80]

The Accounting Auditing Organization of Islamic Financial Institutions (AAOIFI) should also review on the product templates of the *Tahawwut*. This may create a broader acceptance within the Islamic hedging markets. Currently, the markets have been developing their own Sharia version that differs from one jurisdiction to another. The Sharia parameters on hedging transactions of the *Tahawwut* would be beneficial for the market as their benchmark. Without positive responses of those Islamic standard setting bodies, the *Tahawwut* would be left behind in the market place.

6.8 Summary

This chapter finalises the previous discussions starting with the arguments on how Islamic finance adopts risk management up to creating Sharia compliant-profit rate swaps through a method of selective Sharia rules (Chapter 2). This chapter continues the argument of the previous chapter that to avoid uncertainties (*gharar*) in Islamic derivatives transactions, it is imperative to develop a standardised rule that may reduce those uncertainties.

The introduction of the ISDA/IIFM *Tahawwut* Master Agreement does not only provide such standardization, but also open the door to largely untapped markets and opportunities. Though it may take some time until Islamic banks are able to integrate the ISDA framework into their own agreements and structures, the long-term advantages of standardization will provide banks with incentives to make the transition. However, there are

[80] 'Bahrain's IIFM and ISDA publish Islamic credit support deed for variation margin', http://businesspulse.qa/en/eqstory/ZAWYA20170330081404/.

some continuing issues. These difficulties relate to close out netting mechanism for non-concluded transactions, whether use the use of market quotations and loss method reduces the ability of the *Tahawwut* to reduce counterparty risks in the event of market distress. The most important deficit is the lack of netting system in the insolvency laws of Muslim jurisdictions. Until these difficulties are resolved, Islamic hedging (particularly derivatives) will struggle to compete with the current global regulatory model. Furthermore, other difficulties relate to the credit support for OTC Islamic derivatives; this needs to be reviewed by the IFSB as part of its role in harmonising Basel Accords in Islamic markets. The AAOIFI has an important role in reviewing the practice of Islamic hedging from Sharia and accounting perspectives. This is an urgent task considering that Islamic derivatives use different types of contacts and arrangements that completely different with their conventional peers.

The next chapter will discuss another pivotal issue that goes beyond derivatives but relates to another risk management instrument in Islamic finance namely insurance. The creation of Islamic version of insurance is imperative since modern Islamic financial markets cannot be separated from the insurance system. Through a method of selective Sharia rules (Chapter 2), the-so-called *takaful* was introduced to create economic effects of insurance system under Islamic finance.

CHAPTER 7: ISLAMIC INSURANCE (*TAKAFUL*)

7.1 Introduction

Modern Islamic insurance is a reflection of selective Islamic Juristic choices. It provides a rich source to analyse on how the approach developed in Chapter 2 operates in practice. Insurance, including Islamic insurance, is one of the most important risk management vehicles in a modern financial economy. Islamic financial institutions (IFIs) provide such a mechanism allowing mutual risk protection for Islamic financial markets. Since some elements of conventional insurance are not allowed under Islamic law, Muslim scholars have used techniques referred to in chapter 2 to select various medieval Islamic juristic rules to be used in developing Islamic insurance (also known as *takaful* in Arabic terminology). The selective Sharia rules allow companies or operators to choose which Islamic rulings best fit with their business strategies and interests.

This chapter commences by discussing the definition and types of conventional insurances and the Sharia objections to these arrangements. It then discusses various operational models of Islamic insurance derived from different Sharia justifications. This is followed by an examination of common issues and challenges in the industry and concludes with a summary.

7.2 Conventional Insurance

7.2.1 Risk Sharing vs. Risk Transfer

Conventional insurance typically involves risk transfer although some types of insurance, such as mutual insurance, involves risk sharing.[1] Risk transfer involves the individual risk being transferred to the insurer. In contrast, in risk sharing, the risk is shared within the group of policyholders. The insurer is the collective of policy holders that commit to share the risks with each other, so that all policy holders are both insurers and insured. Thus, each policyholder is liable to cover the risk of the other policyholder in the same group.

There are two common models of insurance namely joint-stock company insurance and mutual insurance (cooperative)[2] as follows.

7.2.2 Joint Stock Insurance

A Joint-stock insurance company is established and organised as a profit-oriented vehicle.[3] It is owned by its shareholders. Insurance companies sell a financial service namely risk protection. The company's profit will be based on the actuarial predictions of risk occurrence as well as investments profits. If these predictions are accurate, the premiums collected will be sufficient to cover payout of claims and operating expenses and return a profit to shareholders. As will be seen in the discussion below, in this type of insurance, unlike mutual insurance, a single premium is charged for insurance cover; this premium is final. Policyholders are not obliged to contribute further or additional premiums if the collected premium is not

[1] See from a broader perspective on the definition of insurance in Herbert S. Denenberg, 'The Legal Definition of Insurance: Insurance Principles in Practice' (1963) 30 (3) *Journal of Risk and Insurance* 319, 327-328.
[2] Ibid.
[3] Emmet J. Vaughan and Therese Vaughan, *Fundamentals of Risk and Insurance* (Wiley, 10th Edition, 2008) 75-77, 77.

sufficient to cover claims. In addition, the profits earnings both from the investment and surplus of the risk fund are available for distribution to shareholders as dividends.[4]

Joint-stock insurance is based on a risk transfer model.[5] The insured (an individual) transfers specified risks to the insurer (insurance company). Thus, the insurer indemnifies the insured up to a certain limit for the specified risks that may or may not occur.[6] This model utilizes an exchange contract whereby the premium is a price paid by the insured to the insurer for protection against a specified risk. The actual value of that protection depends on the actual loss that may be more or less than the paid premiums. The delivery of the protection also depends on whether the risk that occurs is covered by the insurance policy. As will be seen from the discussion below, it is an issue for *takaful* scholars whether the uncertainty whether compensation will ever be payable means that conventional insurance can never be Sharia compliant.

7.2.3 Mutual Insurance

Mutual insurance is typically considered to be a risk sharing arrangement between policyholders against specified risks. More conservative views argue that it also involves risk transfer as its mechanism transfers risk from one individual to a group. Unlike joint stock insurance company, it also includes sharing losses, on some equitable basis, by all members of the group. Policyholders own the underwriting pool of fund. [7] Consequently, profits and losses of the insurance fund belong to the policyholders.[8] Mutual insurers commonly have no paid-in

[4] Ibid.
[5] Zainal Abidin Mohd Kassim, 'The Primary Insurance Models' in Serap O. Gonulal (ed), *Takaful and Mutual Insurance: Alternative Approaches to Managing Risks* (World Bank, 2013) 21-30, 23.
[6] Vaughan and Vaughan, above n 3, 20.
[7] Ibid 77.
[8] Kassim, above n 5, 23.

capital as a guarantee of solvency in the event of deficiencies of the underwriting fund. As a consequence, a mutual insurer needs to set aside reserves or contingency funds sufficient to protect such adverse contingencies as unexpected claims, very large claims or decline in investment returns. Any surplus can be returned to policy holders or used to reduce future premiums.[9]

Unlike a joint-stock insurance company, the premium paid by the insured to the mutual insurance is not final. The insured has a contingent liability to pay additional premiums if losses exceed advance premiums. The advance premium that is collected is intended to be sufficient to cover all losses and expenses. If it is not, the additional costs are paid out of the accumulated surplus,[10] or by additional premium payments. As will be seen from the discussion below, mutual insurance has some similarities with Islamic *takaful* models.

7.3 Mutual Insurance in Islamic Law

Mutual insurance that contains a risk sharing mechanism, mutual assistance, and cooperation is considered consistent with Islamic principles.[11] This is because that insurance is based on a gratuitous act (donation), free from *gharar* (uncertainty), and *riba* (interest).[12] Based on this, the various conferences in the Muslim world that were held during the 1960s and 1970s mostly argued that mutual insurance run by benevolent societies and groups for the purpose of social and financial services for their members was not against Islamic principles and thus

9 Vaughan and Vaughan, above n 3, 77
10 Ibid 78.
11 Zamir Iqbal and Abbas Mirakhor, *An Introduction to Islamic Finance: Theory and Practice* (John Wiley and Sons (Asia) Pty Ltd, 2007) 122-123.
12 In 1960s, the Second Conference for Islamic Research Assembly was held in Al-Azhar University, Cairo, issued a Sharia resolution on the permissibility of mutual insurance, referred as cooperative insurance in their *fatwa*, see Aly Khorshid, *Islamic Insurance: A Modern Approach to Islamic Banking* (Routledge, 2004) 73.

lawful.[13] This view has been endorsed in Saudi Arabia,[14] as well as in Indonesia.[15] The mutual group operates the fund to protect business interests,[16] and not intended to generate profits.[17]

The special features of mutual or co-operative-based insurance are that each member acts both as the insured and simultaneously the insurer. The participants enjoy benefits of security as well as bear the costs of indemnifying the other participants. The principle of solidarity means that policy holder insures others against their risks. As with all forms of insurance, it provides an indemnity against actual losses. The contribution (premium) of each member varies depending upon the number of occurrences of the insured risks and the indemnities that have been paid. If the fund is in deficit, the members are responsible for covering that deficit. If the fund is in surplus, the members have a right to claim back such surplus or have it reduce premiums in successive insurance premiums according to their contributions.[18]

One of the important features of mutual insurance and Islamic insurance is that its purpose is not to create profits but to benefit its policy holders (members).[19] Permissible insurance based on Islamic principles could not be based on a profit oriented organisation such as a joint stock company. This view has not been popular in jurisdictions offering Islamic insurance, such as Saudi Arabia where a joint stock company is a pre-requisite to offering insurance products. Scholars argue that an Islamic-based cooperative insurance needs

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[13] Ibid 72.
[14] See W. Jean Kwon, 'Islamic Principles and Takaful Insurance: Re-evaluation' (2007) 26(1) *Journal of Insurance Regulation* 53, 60.
[15] Nahdhatul Ulama (NU) and Muhammadiyah as the largest Muslim organisations in Indonesia opined that mutual insurance in the form of a cooperative is permissible as long as it uses a gratuitous contract (tabarru or ta'awuniy) not an exchange contract (aqd mu'awadah), and avoids maysir (speculation), gharar (uncertainty), and riba (interest). Furthermore, the Indonesian Ulama Council (MUI) in 2001 also issued a fatwa on the permissibility of 'asuransi ta'awuniy' (cooperative insurance), see Husni Mubarrak, 'Kontroversi Asuransi di Indonesia: Telaah Fatwa Majelis Ulama Indonesia (MUI) tentang Badan Penyelenggara Jaminan Sosial (BPJS)' (2016) 12(1) *Jurnal Tsaqafah* 105-130, 116-117.
[16] Al-Ghamdi, above n 11, 216-117.
[17] Ibid 201.
[18] Ibid 206.
[19] Ibid 201.

modification to allow the pooling (underwriting) fund to be invested in profitable investments. The purpose is not to generate profit but to act as a buffer against an unforeseeable quantity and value of claims.[20] This view is prevalent in practice. The restrictions imposed by Sharia law are discussed in the next section.

7.4 Prohibited Elements in Commercial Insurance

Commercial insurance has some elements which are considered not to be Sharia compliant.[21] These include excessive uncertainty (*gharar)*, speculative and gambling elements (*maysir)*, and interest and exchange money for money without equal countervalues (*riba)*.[22] These prohibited elements are examined below.

7.4.1 *Gharar* (Uncertainty)

The concept of *gharar* (uncertainty) is relevant to modern insurance.[23] The contractual agreement between insurance companies and their policyholders to exchange a particular risk

[20] Ibid 202.

[21] For instance, in 1926 the Supreme Islamic Family Court in Egypt viewed the contract of life insurance as contrary to Islamic law. In 1972, a seminar held in Morocco recommended several points in which one of them is the prohibition of life insurances, in Samir Mankabady, 'Insurance and Islamic Law: The Islamic Insurance Company' (1989) 4(3) *Arab Law Quarterly* 199-205, 201.In 1972, The National Fatwa Committee (Malaysia) also issued a resolution that life insurance practiced by insurance companies is a void (*fasid*) transaction and thus prohibited (*haram*), Renat I. Bekkin 'Islamic Insurance: National Features and Legal Regulation' (2007) 21(1) *Arab Law Quarterly* 3-34, 20. In 1985, the *Majma al-Fiqh* (Grand Council of Islamic Scholars) in Jeddah, Saudi Arabia, argued that commercial insurance including life insurance is against Islamic principles, see Aly Khorshid, *Islamic Insurance: A Modern Approach to Islamic Banking* (Routledge, 2004), 73.

[22] Bekkin above n 21, 20.

[23] Sharia scholars characterise four common features of *gharar*. These include: (1) uncertainty of the existence of the subject matter; (2) uncertainty of the availability of the subject matter; (3) uncertainty of the quality of the subject matter; and (4) uncertainty of the quantity and timing of completion and delivery. The existence of these uncertainties at the inception of the contract creates uncertainty and ambiguity of the contract and thus prohibited in Islamic law, see Mohammad Hashim Kamali, 'Uncertainty and Risk-Taking (Gharar) in Islamic Law' (1999) 7(2) *IIUM Law Journal* 199-216, 210.

protection product does not meet the standard exchange contract requirements (*al-bay*) under Islamic law.[24] In the Islamic standard exchange, there should be certainty on the existence and the availability of the product, the quality and quantity of the product, and the time of delivery. Thus, the exchange contract under conventional commercial insurance involves uncertainties (*gharar*) because those elements are not present. In commercial insurance, the companies and the policyholders do not exactly know whether the insured risk will occur and whether compensation will be paid. Moreover, the policyholders do not know the exact value of actual compensation. This is because the compensation depends on the policyholders' actual loss. Thus, the value, quality, and quantity of the protection product at the inception of the contract is uncertain. There is a further difficulty that the time of delivery is uncertain because it depends on the occurrence of the specified risks. These arguments have been widely accepted in scholarly works of Islamic finance in which the contractual agreement of commercial insurance does not meet a legally valid exchange contract under Islamic law due to the elements of uncertainty (*gharar*).[25]

However, this is not a unanimous view. The insurance system operates to pool risk creating security and protection for modern society. This has been viewed as involving no unfairness, gambling, excess risk, or contention and economically beneficial to society and to individuals.[26] Although at the individual level there may be some uncertainty, in aggregate, risks can be quantified and valued through various modern mathematical and statistical

[24] See Tom Baker and Jonathan Simon (ed), *Embracing Risk: The Changing Culture of Insurance and Responsibility* (University of Chicago Press, 2002) 36. They describe how a Western perspective of insurance could appear in conflict with Islamic law.
[25] For instance, the *Fiqh* Academy of Organization of Islamic Countries (OIC) based in Jeddah, in 1985 issued a *fatwa* on insurance as follows: "the commercial insurance contract, which earns fixed premiums as practiced by commercial insurance companies, involves significant *gharar* that makes contract null and void. This form of transaction is prohibited by the standard rules of Shariah", Resolution No. 9, see Omar Clark Fisher, *a Takaful Primer: Basics of Islamic* Insurance (Thomson Reuters, 2013) 16.
[26] Frank E. Vogel, and Samuel Hayes, III, Islamic Law and Finance: Religion, Risk, and Return (Kluwer Law International, 1998) 151.

models.[27] Pooling or aggregating risk has the effect that when these risks occur, the insured effectively shares the costs of those risks. Thus, in essence, an insurance company is an intermediary which aggregates, quantifies, and shares risk on sound technical principles.[28] Hence, the insurance system cannot be merely seen at the micro level of the contractual agreement between a company and its policyholders but it should also be viewed at the macro level where the company quantifies and managed the pooling risks based on sound modern techniques.

7.4.2 *Maysir* (Gambling)

It is often claimed that commercial insurance involves gambling (*maysir*). Commercial insurance operates as a zero sum game whereby one party may win or lose at the expense of the other party. That is, a policyholder pays periodical premiums and either wins by receiving compensation, by way of the indemnity if the risk occurs or losses if the insured event does not occur. Similarly, the insurer wins if it receives premiums and there is no occurrence of a covered event or loses if compensation is payable when an insured event occurs. Therefore, the payment of the sum insured as an exchange for the premium paid depends upon chance; this implies gambling (*maysir*) that is prohibited in Islamic law.[29]

This view is also not unanimous. Gambling is motivated by profit.[30] In insurance, policy holders take out insurance to provide protection and security against specified risks that may

[27] See Mohd. Masum Billah, 'Islamic Insurance: Its Origins and Development' (1998) 13(4) *Arab Law Quarterly* 386-422,410
[28] Samir Mankabady, 'Insurance and Islamic Law: The Islamic Insurance Company' (1989) 4(3) Arab Law Quarterly 199-205, 201.
[29] For this argument, see also Mehmet Asutai and Abdurrahman Khalil Tolefat (ed), *Takaful Investment Portfolios* (Wiley, 2013) 21.
[30] Ibid.

happen in the future and cause severe harm to themselves and their beneficiaries.[31] The gambler hopes to win with no element of co-operation. In contrast, the parties in mutual insurance, for instance, are bound together in a spirit of mutual co-operation and goodwill in providing material security for others.[32] In the insurance system, the policyholders may not increase their wealth if the specified events happen while with gambling the gamblers' wealth increases if they win.[33] With insurance, the chance of loss (risk) exists whether or not there is an insurance contract in effect. Thus, gambling creates a risk, while insurance provides an instrument to transfer an existing risk.[34]

7.4.3 *Riba* (Interest)

Riba has also been seen as a problem for conventional commercial insurance. Muslim jurists and scholars compare insurance contracts, such as an exchange contract, with a number of contracts sanctioned by Islamic law. One such example is the analogy made between insurance and exchange of currencies (*sarf*).[35] Islamic law applies *sarf* on the basis of equality and on the spot transactions.[36] The advocates of this view argue that commercial insurance is similar to an exchange of money for money. Both premium and protection or compensation are considered a kind of money leading the prohibition of insurance.[37] Moreover, in commercial insurance, the money exchange is conducted on unequal basis which is prohibited

[31] Ibid.
[32] Billah, above n 27, 414.
[33] Ibid.
[34] Vaughan and Vaughan, above n 3, 42.
[35] Khorshid, above n 21, 64.
[36] The main hadith that is always related to the discussion of *riba* is one which was reported by 'Ubadah bin Samit that the Prophet (peace be upon him) said: "Gold for gold, silver for silver, wheat for wheat, barley for barley, dates for dates and salt for salt, like for like, equal for equal and hand to hand, if the commodities differ, then you may sell as you wish provided that the exchange is hand to hand" (Sahih al-Muslim), see ISRA, *Islamic Financial System: Principles and* Operations (ISRA, 2012)178
[37] Khorshid, above n 21, 63.

under *sharf* principles. In other words, the compensation received by policyholders is normally higher than the premiums paid in any given year.[38] Thus, they may consequently obtain a sum much higher than what has been paid so that this is an unjustified increase in capital, and thus prohibited.[39] In addition, *riba* would also occur when the compensation is not simultaneous with payment; any delay in delivering the counter-value in a money exchange is also considered as *riba*. This principle is derived from the currency exchange principles (*sharf*) under Islamic law.

There is another objection that investment activities in commercial and mutual insurance may involve interest-based instruments or portfolios such as bonds, deposits, and equities that contravene Sharia principles. This leads to non-*halal* income that is also used for compensation of the insured. The intermingling of the non-*halal* revenues with the risk fund of the insured may result the money used for compensation becoming *haram* (impermissible).[40] This issue would be simply addressed considering that current Islamic financial industry has provided a Sharia screening mechanism to provide permissible assets to be invested in (paragraph 5.3 of Chapter 5).

7.4.4 Risk Transfer

The transfer of risk from the policyholders to the insurer is also considered unacceptable under Islamic law. This is based on an analogy (*qiyas*) that such risk transfer transactions are

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38 Ibid.
39 ibid.
40 For instance, the Fatwa Committee of the National Council for Islamic Religious Affairs in Malaysia issued a fatwa concerning a life insurance in 1972 states that "the life insurance as provided by present day insurance companies is a business transaction which is void because it contradicts the Islamic principles as it contains the elements of *gharar* (uncertainty), *riba* (interest/usury) and *maysir* (gambling)". See Omar Clark Fisher, *a Takaful Primer: Basics of Islamic* Insurance (Thomson Reuters, 2013) 16.

similar to *gharar* (uncertainty) contracts and thus prohibited.[41] The majority of scholars have not allowed this arrangement.[42] Islamic law only allows the contract of guarantee (*kafalah*) in the form of a gratuitous contract (*tabarru'*).[43] As we will be seen in the discussion below, the above issues have been overcome by modifying the commercial and mutual-based insurance through the utilisation of medieval Islamic juristic rules particularly the exposition of the concept of donation (*tabarru*) and social responsibilities (*takaful*).

7.5 The Islamic Insurance System: Definition of *Takaful*

Islamic insurance is also called *takaful* which literally means "mutual or joint responsibility" or "solidarity".[44] This Arabic word comes from the word *kafala* meaning "to support", "to guarantee each other", "to bail", and "be responsible".[45] This word is also connected to another words such as *aman* and *ta'min* meaning "security", "peace", "safety", "protection", "re-assure", "guarantee", and "safeguard".[46] As a result, *takaful* has various meanings representing joint responsibility and solidarity to protect and guarantee each other.

In modern Islamic finance, the word *takaful* refers to an insurance system based on Islamic juristic rulings derived from various medieval Islamic contracts and concepts.[47] Technically, in this insurance system, participants separately contribute or donate to a pooling fund that is used to pay claims for losses suffered by the participants or policy holders.[48] Some

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[41] See Vogel and Hayes, above n 26, 154.
[42] Ibid.
[43] Ibid.
[44] Hans Wehr, *A Dictionary of Modern Written Arabic Third Edition (Edited by J Milton Coman)* (Spoken Language Service, 1976) 834.
[45] Ibid 833.
[46] Khorshid, above n 21, 11.
[47] See Simon Archer, Rifaat Ahmed Abdel Karim, and Volker Nienhaus (ed), *Takaful Islamic Insurance: Concepts and Regulatory Issues* (Wiley, 2011).
[48] Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI), Financial Accounting Standards No. 12 (2004/2005) AAOIFI.

portion of the total contribution of the participants is directed towards donation or *tabarru* denoting a premium made by participants or policyholders to assist those of them who need financial security.[49] Another portion of the total contribution goes to the investment account of the policyholders (this will be further illuminated in the following sections). By this mechanism, the risks of each participant are shared with other participants as a result of a mutual guarantee against defined risks,[50] reflecting a socially organised vehicle to practice the principles of cooperation and mutual assistance.[51]

Risk sharing is the underpinning concept for the establishment of modern *takaful* in which risks of the participants are shared among participants through the system of donation (*tabarru*). Modern *takaful* modifies contractual exchange-based contracts used by commercial insurance by using contractual mechanisms derived from medieval Islamic juristic rulings based on the concept of donation.[52] In practice, this model is governed by a hybrid structure consisting of a commercial management company (the shareholders' fund) and a separate risk fund or underwriting pool (the participants' *takaful* fund).[53]

7.6 *Takaful* Operational Models

Similar to the conventional insurance industry, *takaful*-based insurance also divides its business into general (non-life insurance) and family insurance (life insurance). For general

[49] Ibid 406. AAOIFI's new definition of *takaful* in its Sharia Standards 26 (2) 2007 defines *takaful* as "an agreement between persons who are exposed to risks to protect themselves against harms arising from the risks by paying contributions on the basis of commitments to donate (*iltizam bi al-tabarru*)".
[50] Bank Negara Malaysia, 'Takaful' [30/09/2016] http://www.bnm.gov.my/index.php?ch=174&pg=500&ac=428. See also Malaysia Takaful Association that defines it as a mechanism in which at least two parties agreeing to jointly guarantee one another in the event of a loss, as a consequence of being afflicted by a calamity. [30/09/2016], http://www.malaysiantakaful.com.my/About-MTA/Takaful-Definitions.aspx.
[51] Billah, above n 27, 405.
[52] Bekkin, above n 21, 3-34.
[53] Archer, et al, above n 47, 11.

insurance, all contributions or premiums paid by participants is regarded as a donation and is attributed to the *takaful* fund (risk fund). For life insurance, the premium is divided into donation to the risk fund and the investment fund.[54] The allocation of surplus of these funds depends on a particular model chosen by Islamic insurance companies (discussed in the following section). The general *takaful* is commonly designed for a short-term usually annual basis. Life insurance is intended to provide long-term risk protection for policyholders and their families.[55]

There are variable contractual models for Islamic insurance across jurisdictions.[56] At least four operating models exist in practice:

(i) The agency-based operating model (*wakalah*);
(ii) The profit and loss sharing-based model (*mudharabah*);
(iii) The hybrid model as the combination between model (i) and (ii); and
(iv) The agency-profit sharing combined with Islamic endowment (*wakalah-mudharabah waqf*).

7.6.1 Agency (*Wakalah*) Model

The *wakalah* model is based on an agency agreement between the insurance company and its policyholders. The insurance company acts as an agent on behalf of the policyholders in managing the risk fund and the policyholders' investment fund. Under this model, the risk fund (also known as the underwriting fund) as well as the investment fund exclusively belongs

54 Bekkin, above n 21, 12.
55 Archer, et al, above n 47, 12.
56 Safder Jaffer, et al, 'Takaful (Islamic Insurance): Concept, Challenges, and Opportunities' (Research Report, Milliman, 2000) 14.

to policy holders. Consequently, the company has no right to any share in the surplus of these funds.

In practice, virtually all *takaful*-based insurance operates as limited liability corporations (this corporation model will be further discussed in Chapter 8). Shareholders of *takaful*-companies are required to provide a reserve fund (known as *qard al hasan* acting as interest-free loan) to cover any deficit in the policy holder risk fund. The loan is refundable in various schemes depending on the law of jurisdiction where the Islamic insurance companies operate. For instance, some jurisdictions requires the loan to be refunded when the risk fund is in surplus[57] or by requiring policyholders to pay increased premiums in the following year.

The agency agreement in Islamic insurance is not practical in the modern insurance industry. Islamic insurance companies are commonly based on joint-stock companies with shareholders whose demand dividends. The agency-based model creates little incentives for the shareholders since they do not share any surplus from the risk fund or any profits from the investment fund. Consequently, the companies have less incentive to increase earnings from the investment fund.[58] In practice, the companies may charge excessively high agency fees to compensate for reduced opportunities for dividends. These fees are commonly included in the insurance's premium paid by policy holders. Moreover, the premium often includes performance fees that are quantified in relation to the performance of the underwriting surplus or the investment profits. These fees are not ideal for the *wakalah*-model and may create Sharia issues because the fees change the nature of the *wakalah* (*agency*) becoming more closely

[57] Abdul Rahim Abdul Wahab, Mervyn K. Lewis, and M. Kabir Hassan, 'Islamic *Takaful*: Business Models, *Shariah* Concerns, and Proposed Solutions' (2007) 49(3) *Thunderbird International Business Review* 371-396, 383.
[58] Zaharudin Abd. Rahman, *Contemporary Islamic Finance Architecture* (IBFIM, 2014) 292.

aligned with the *mudharabah* (profit sharing). [59] To address this issue, Islamic insurance has moved to the *mudharabah* model.

7.6.2 Profit Sharing (*Mudharabah*) Model

This model is based on a risk-sharing agreement derived from *mudharabah* contract. Under this agreement, the policyholders and the companies enter into a profit sharing contract (*mudharabah*) to manage the risk fund or underwriting fund. The policyholders provide capital in the form of premiums to pay out claims by policyholders, whilst the companies provide entrepreneurial skills in managing that capital. Thus, the companies will invest the risk fund in Sharia compliant investment schemes for profit. Any profits accrues from investments are shared between the policyholders and the companies in a predetermined ratio. It should be noted that the profit is not the same as surplus (excess of premiums over claims). This profit is earned from the investment activities of the risk fund not from the balance between the remaining risk fund and actual losses covered by that fund. In practice, the companies are also entitled to share in the surplus of the risk fund (underwriting surplus). This is inevitable since the companies operating *takaful* are based on a joint stock company with shareholders whose demand dividends. However, this creates Sharia issue because the risk fund (*takaful* fund) is theoretically designed for social and not for profit-oriented motives as will be discussed in the following section.

Similar to the *wakalah* (agency) model, the companies in this *mudhararabah* model are required to provide an interest free loan (*qard al hasan*) to maintain solvency of the risk fund.

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59 Muhammed Altuntas, Thomas Berry-Stolzle, and Anje Erlbeck, 'Takaful Charity or Business? Field Study Evidence from Micro Insurance Providers' (2011) 30 *Journal of Insurance Regulation*.

The loan is refundable when the fund is in surplus.[60] However, in practice, the repayment of this interest-free loan is highly unlikely in a competitive market. The operator prefers to maintain the contribution level as competitive as possible to attract customers into their products. This may imply an unrecoverable loan and reflect the factual transfer of the underwriting risk from the policyholders to the *takaful*-companies' shareholders.[61]

The *mudharabah*-based model raises not only practical issues but also Sharia issues. First, the treatment of the surplus (or deficit) as a *mudharabah* profit and the premiums or contributions as capital is controversial. This practice puts in jeopardy the concept of donation (*tabarru*) as the form of the contribution to the risk fund. For the advocates of Islamic insurance, the *tabarru* cannot be designed for profit motives and should not converted into a commercial-based contract (known as *tijari* contract in Islamic law).[62]

Second, the profit sharing model raises the issue of the liability of the risk fund particularly responsibility in covering any deficit in the risk fund. If the contributions or premiums paid by policyholders are treated as capital, it is the capital owners (the policyholders) that bear the losses. However, in practice, it is the shareholders that need to cover the loss by providing a repayable interest-free loan (*qard al hasan*) to cover the deficit of the risk fund.[63] This practice is problematic for Muslim scholars. This is because the main principle in a *mudharabah* contract is that if the two contracting parties agree to enter into a loan contract, each of them is obliged to share the repayment of that loan (see paragraph 8.6.6 of following Chapter 8). In the *mudharabah*-based insurance, it is only one party that is liable

[60] International Shariah Research Academy for Islamic Finance (ISRA), *Islamic Financial System: Principles and Operations* (ISRA, 2012), 517.
[61] Volker Ninhaus, 'Solidarity, Cooperation, and Mutuality in Takaful' in S. Nazim Ali and Shariq Nisar, *Takaful and Islamic Cooperative Finance: Challenges and Opportunity* (Edward Elgar, 2016) 22-47.
[62] Adiwarman A. Karim, *Islamic Bank: An Analysis of Fiqh and Finance* (RajaGrafindo Persada, 2008).
[63] Abdul Rahim Abdul Wahab, Mervyn K. Lewis, and M. Kabir Hassan, 'Islamic *Takaful*: Business Models, *Shariah* Concerns, and Proposed Solutions' (2007) 49(3) *Thunderbird International Business Review* 371-396, 377-381.

for that loan which is practically subject to the responsibility of shareholders. If the deficit occurs for more than one financial year, the companies may face serious financial difficulties.[64] Companies charge the direct costs of claims handling and all management expenses to the risk fund before the underwriting surplus or deficit is calculated.[65] This modification may serve the need of the companies to handle the deficit of the risk fund. Malaysia allows the *mudharabah*-based model, but it is seriously challenged in many other countries.[66]

Third, the companies must maintain shareholders' funds which requires suitable investment strategies.[67] The companies tend to increase risk funds either by increasing premiums for existing policyholders or attracting new policyholders or to increase its portion of profits. An aggressive investment policy increases the risks to the risk fund itself, and may lead to undesirable speculative activities with the companies acting as a risk taker. The choices are undesirable for the *takaful* industry. Raising premiums could make the companies uncompetitive compared to conventional commercial insurance. There must also be a sufficiently large number of policyholders to get the benefit of economies of scale. Payment to the companies can be adversely affected mainly by investment performance. Falling profits may lead the operator to increase its share of the profit and lower the share of the participants.[68] This model is preferred by *takaful*-companies because it provides significant incentives for companies,[69] but it creates Sharia issues that may jeopardise its legitimacy among Sharia scholars or those clients who are concerned on Sharia principles.

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64 Archer, et al, above n 47, 14.
64 Ibid.
65 Ibid.
66 Ibid.
67 W. Jean Kwon, 'Islamic Principle and Takaful Insurance: Re-evaluation' (2007) 26(1) *Journal of Insurance Regulation* 53, 65.
68 Ibid 65.
69 See, eg, Hayat Khan, 'Gift Exchange Anomaly: Evidence from Incentive vis-à-vis Performance of Islamic Insurance Operators' (2015) 22(14) *Applied Economic Letters* 1175-1178; and Hayat Khan, 'Optimal Incentives for Takaful (Islamic Insurance) Operators' (2015) 109 *Journal of Economic Behaviour and Organization* 135-144.

To address the deficiencies of this model, Sharia scholars searched for alternatives that may satisfy not only Sharia requirements, but also efficiency and business practicalities. As a result, the third model namely the combination of the agency (*wakalah*) and the profit sharing model (*mudharabah*) were designed for these purposes as discussed below.

7.6.3 Hybrid Model: Combination of *Wakalah* and *Mudharabah*

Under the hybrid model, the companies and their policyholders enter into two separate contractual agreements. The first step is for both parties to enter into an agency agreement (*wakalah*) to manage the risk fund. The parties then enter into a profit sharing agreement (*mudharabah*) to manage the investment fund.[70] Under the first agreement, the policyholders have a right to receive surplus of the risk or underwriting fund, *takaful* fund, whilst the companies receive upfront agency fees in managing that risk fund. In relation to the second agreement, the companies share a portion of profits from investment funds.[71] Under this model, companies receive incentives from managing the risk fund as well as the investment fund.[72] This hybrid model reduces Sharia issues of the previous models (the *wakalah* and the *mudharabah* model). Deriving benefits from the risk fund (through agency fees) and the investment fund (through sharing profits) are legitimate under Islamic law. Moreover, this model is preferable for companies since their incentives are derived from the risk funds (through agency fees) and the investment funds (through sharing on profits). In sum, this hybrid model is more feasible for the industry compared to the previous models.

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70 Zaharudin Abd. Rahman, *Contemporary Islamic Finance Architecture* (IBFIM, 2014) 293.
71 Ibid.
72 See Hayat Khan, above n 69.

Similar to the previous models, this model utilizes an interest free loan to cover any deficit of the risk fund. The loan is repayable when the fund is in surplus. However, due to Sharia requirements, the operator cannot borrow money from the participants' investment fund to cover that deficit.[73]

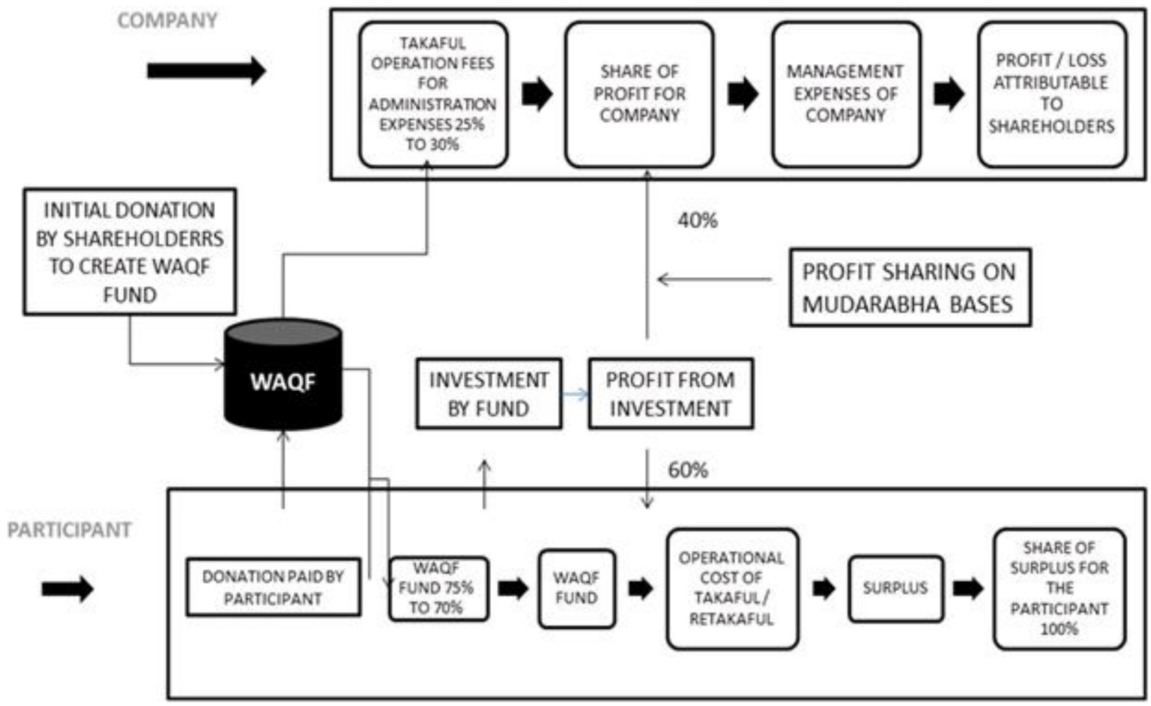
The next Islamic insurance model utilize the concept of *waqf*.

7.6.4 Endowment (*Waqf*) Model

This model uses a *waqf* (endowment) concept for establishing *takaful*. The risk fund is solely designed as a *waqf* fund to pay out policyholders insured claims. Unlike the previous models, in this model, the shareholders of the company establish the *waqf* fund. Subsequently, this *waqf* fund is contributed to by regular payments by policyholders. The *waqf* fund acts as the risk fund used as a donation (*tabarru*) under the *waqf* system.[74] This *waqf* fund consists of contributions both from shareholders and policyholders. However, under the *waqf* system, the shareholders as well as the policyholders have no rights over the fund. The fund now becomes the property of the *waqf* which can be used for the benefit of all policyholders as well as shareholders.[75] *Waqf*-based insurance is illustrated in the following figure.

[73] Archer, et al, above n 47.
[74] Ibid 294.
[75] Ibid.

Figure 7.1. *Takaful*-based *Waqf* Model.[76]



The *waqf*-based agreement cannot be used as the sole operating principle in this model. In practice, the companies also employ the contract of agency (*wakalah*) and profit sharing (*mudharabah*). The agency contract is used in managing the *waqf* fund. Profit sharing is used in managing the investment fund. The operator receives incentives from both funds in the form of agency fee and profit sharing respectively. In theory, any deficits in the fund are not recouped from shareholders or policyholders. However, in practice, it is inevitable that the shareholders of the companies need to provide a reserve fund which is refundable when the fund is in surplus. Having discussed various operational models of *takaful*, the table below summarizes the differences between the previous discussed models.

[76] Mohd Fadzli Yusof, *Fundamentals of Takaful* (Kuala Lumpur, IBFIM, 2011) 29-44.

Table 7.1. Features of *Takaful* Models

Item	***Wakalah***	***Mudharabah***	**Hybrid *(wakalah & mudharabah)***	***Waqf***
Contractual Agreement	Agency (*wakalah*)	Profit Sharing Contract (policy holders act as a capital contributor, and the takaful operator act as an entrepreneur)	Agency for the underwriting fund, and profit sharing for investment fund	*Waqf* (*waqf* contribution acting as a donation), Agency, and Profit Sharing
Incentive System	Agency fee and or performance fee	Profits from investment funds, and sharing surplus of the underwriting funds	Agency fee and or performance fee, and profit from investment activities	Agency fee and or performance fee, and profit from investment activities
Share of investment fund	None	Pre-agreed percentage	Pre-agreed percentage	Pre-agreed percentage
Share of Surplus of underwriting fund	None	Pre-agreed percentage of surplus	None	None
Loss of Investment	Borne solely by policy holders	Ibid	Ibid	Ibid
Operating Expenses	Borne solely by shareholders' fund except for direct expenses of the Takaful fund	Borne solely by shareholders' fund except for direct expenses of the Takaful fund	Borne solely by shareholders' fund except for direct expenses of the Takaful fund	Borne solely by shareholders' fund except for direct expenses of the Takaful fund
Deficit in Takaful fund	*Qard al Hasan* (non-interest loan) from shareholders' fund	Ibid	Ibid	Ibid
Creating of the Takaful fund	Policy holders' contributions	Ibid	Ibid	Initial *waqf* fund from shareholders' fund and policy holders' fund

Liquidation of Takaful fund[77]	Accrue to policy holders' only	Ibid	Ibid	Waqf amount must go to another existing *waqf* fund and cannot be disbursed among policy holders

7.7 Islamic Insurance (*Takaful*): Risk Sharing or Risk Transfer?

Risk allocation mechanisms in *takaful* insurance companies have features of both risk transfer and risk sharing. First, under the models referred to in the previous sections, *takaful* involves a risk transfer from an individual to a group. At an initial stage when an individual takes out a policy under a *takaful* scheme, the policyholder transfers risks to the other policyholders in the same group. Risks of all policyholders of the *takaful* are collectively shared and indemnified by all members of the group. Second, it involves risk sharing. In theory, if the risk fund is not sufficient to cover the underwriting risks, the deficit will be covered by an interest-free loan (*qard*) provided by the insurer company, this fund is refundable once the risk fund is in surplus or through the increased premiums for the existing shareholders. Third, it also involves risk transfer from policyholders to the *takaful* company. This occurs if the risk fund is in deficit. The companies commonly need more capital to cover the deficit. If other measures do not cover the deficit in the fund, such as using contingency reserves, then an outright transfer would be the final resort.[78] At this point, the risk is transferred to the company and its shareholders.

Additionally, *takaful* also involves risk sharing particularly in Islamic limited liability stock Islamic insurance companies. The mandatory *qard* (loan) facility requires sufficient

[77] Sheila Nu NuHtay, Mustapha Hamat, Wan Zamri Wan Ismail and Syed Ahmed Salman, 'Takaful (Islamic Insurance): Historical, Shariah, and Operational Perspectives' (2015) 9(1) *International Business Management* 65-69.
[78] Ahcene Lahsasna, *Shariah Issues and Resolutions in Contemporary Islamic Banking and* Finance (IBFIM, 2014) 407.

shareholders' fund to cover the deficit in the risk fund. If the shareholders' funds are insufficient to cover the deficit, the company may borrow funds from third parties to cover the deficit. If the company fails, the third parties who have debt claims over the company will lose their funds as the liability of shareholders is limited to their invested capital. This mechanism enables the policyholders of the companies as well as their shareholders to shift or transfer the risks of the risk fund to a third party.

7.8 A Hybrid Model: A Trade-off between Social and Profit Motives

The hybrid model of Islamic insurance enables the pooling funds which are managed on a mutual basis by a company. But there are competing interests of policy holders and company shareholders seeking a profitable investment through dividend payments. A critical question is what legal form (mutual or a joint stock company) best accommodates Islamic insurance requirements. There have been three common Islamic insurance standards related to this question. Saudi Arabia practices a cooperative-based Islamic insurance but requires all insurers to be joint stock companies. Malaysia adopts a joint-stock company with a limited liability entity based Islamic insurance. Indonesia gives an option to Islamic insurance to choose between a joint stock company and cooperative; most of the operators have chosen the first one. Pakistan has developed a *waqf*-based insurance. Each of these models has their own complexities and challenges.

Under the traditional Islamic insurance model which is based on mutual insurance, all underwriting surpluses (the risk fund surplus after costs and reserves) are allocated to the policyholders. But where the insurer is a joint stock company this rule has been modified. In Malaysia, the Islamic insurance companies share the underwriting surplus as in the various cases above. Some Middle East Islamic insurance companies share surplus in the form of *wakalah* (agency) performance fee. [79] In Indonesia, the *fatwa* of Indonesian Ulama Council (MUI) allows a portion of the underwriting surplus to be shared with the shareholders on the basis of the agreement between the participants and the *takaful* companies.[80] This is almost invariably the cease with joint stock company insurers. Where the structure is a hybrid *takaful* this effectively incorporates aspects of both mutual and commercial insurance. This leads to a 'rainbow of practices with mutual at one end and stock insurers at the other'.[81] Even if a strict model is used which allocates all underwriting surpluses to policyholders, *takaful* companies may increase fees beyond the actual cost of managing the fund. In this situation, the operator may indirectly share in the underwriting surplus form the operation of the risk fund.[82] What is missing from the regulators is any provision requiring disclosure of costs of administering the risk fund and any sums paid to the operator in excess of those costs.

It is clear that *takaful* companies must make profits from their operations in order to provide incentives for shareholders to invest in the company. In Malaysia, a *mudharabah* (profit sharing) model was firstly introduced to the market. This model enabled the *takaful* companies to share profits from the risk pooling fund either from the investment of premiums or from the surplus of the underwriting funds. Malaysia modified the *mudharabah* model by creating the hybrid model (combination of *mudharabah* and *wakalah*). This new model enables the companies to share the profits from the investment fund as well as to obtain a performance fee (*wakalah* fee) from the underwriting fund. The objective of this new model remains the same that is providing financial incentives to the company and its shareholders.

[79] Kassim, above n 5, 90.
[80] Sharia Advisory Boards (DSN) – Indonesian Ulama Council (MUI), 'Fatwa No. 53/DSN-MUI/III of 2006 on Islamic Insurance'.
[81] Ibid.
[82] Ibid.

A co-operative-based *takaful* (as a reflection of a social insurance) may face two institutional obstacles. This is because the legal system of many countries do not accept mutual or co-operative forms of company without share capital. Even if mutual or co-operative are accepted as insurance undertakings, they need to be able to raise enough capital from policy holders to meet regulatory capital adequacy and solvency requirements. These two obstacles are temporarily resolved by the application of the hybrid structure whereby the pooling funds are managed on a mutual basis but are managed by a *takaful* operator, which is a company with shareholders.[83]

7.9 The Treatment of *Takaful* Fund's Liability

The consequence of a hybrid structure is that the *takaful* or risk fund must be separated from the shareholders' fund. Accounting Auditing Organization for Islamic Financial Institutions (AAOIFI) states that the risk fund is "a separate legal entity (*shakhsiyyah i'tibariyyah*) which has an independent financial liability".[84] This means that the fund will cover specified risks of each of its contributors with the terms of the policy. One argues that this status only occurs in the internal setting (relevant for the relations between the *takaful* operator and the participants) but not with third parties.[85]

The status of the risk fund as defined by the AAOIFI implies that it is the risk fund that is responsible when the fund is in deficit. This is because the participants own the fund and are also liable to cover its loss. As a matter of practicality the fund cannot by itself provide additional capital in the case of deficit. As a result, in most jurisdictions, the *takaful* company

[83] Archer, et al, above n 47, 2.
[84] Ibid.
[85] Ibid 12.

is forced by law to provide an interest-free loan (*qard hasan*) to recover the loss, which is refunded when the fund is in surplus.[86] The status of the risk fund as having a separate legal personality needs to be developed to solve this practical issue. For the discussion of the legal personality in Islamic law is provided in Chapter 8.

Takaful operators are invariably incorporated as limited liability entities. This creates complexities whereas the fund is in deficit and the operator decides to raise funds to cover the deficit from the third parties. In such case, when the operator becomes insolvent, the third parties who have claims over the company's debts have no rights to claim more than the asset of the company. It means that the operator may shift the risk of loss to the third parties. In theory, *takaful* reflects the risk sharing mechanism among participants whereby the liability of each participant towards risks of other participants might be assumed as unlimited. However, the status of a limited liability of the *takaful* operator may imply such mechanism impractical.

7.10 *Takaful* Solvency Requirements

All *takaful* models share a similar mechanism to address the insolvency of the risk fund through the application of interest free loan (*qard*) provided by the *takaful* operators. The *qard* facility may not be supported by legal requirements depending on the jurisdiction either because it has been declared not to apply (such as a Saudi Arabia) or it is in a jurisdiction with no specific regulations for Islamic insurance. This gives rise to problems in deciding what amounts are required to maintain the solvency of the fund and on the winding up of fund that had a large *qard* injection.

[86] Ibid 11.

The *qard* is required in practice but not compulsory from an Islamic point of view. If the fund is in deficit, the operators may face difficulties in raising funds. Thus, the operators need an immediate method providing the risk fund with additional capital resources for solvency purposes. The Islamic Financial Services Board (IFSB) suggests that the *qard* facility must be ready and sufficient in the shareholders' fund. [87] From a regulatory perspective, this means that the *takaful* companies must maintain sufficient capital for the purpose of providing a *qard* facility for the risk fund.

The obligation to provide a *qard* facility may contain a revenue transfer or an appropriation of profits from the operators to the risk fund. This facility may reduce the shareholder's equity and be taken as capital transfer to the fund.[88] In Indonesia, for instance, local regulators particularly the Indonesian Financial and Services Authorities (OJK) prohibits *takaful* companies from distributing profits to shareholders if there is insufficient *qard* reserve in the shareholder's fund.[89] Some commentators suggest that if the risk fund is continuously insolvent after the application of several *qard* facilities, the *qards* should be donated to the fund especially in otherwise the *takaful* companies cannot continue its business.[90] Elgari argues that the donation of a *qard* facility to the risk fund by the shareholders demonstrates *takaful*'s cooperative nature that is the core of *takaful* undertaking. Islamic law does not restrict such an application.[91] He suggests that that the operators remain responsible for *qard* facility and must

[87] Islamic Financial Services Board, *Standard on Solvency Requirements for Takaful (Islamic Insurance)* Undertakings (IFSB, 2010) 3.
[88] Ajmal Bhatty, 'The Growing Importance of Takaful Insurance' [2/01/2017] http://www.oecd.org/finance/insurance/46116115.pdf.
[89] Regulation of Indonesian Financial Services Authority No 72 /POJK.05/2016 on Financial Health of Sharia Insurance and Re-Insurance Companies, article 6 s 8.
[90] Islamic Financial Services Board, *Standard on Solvency Requirements for Takaful (Islamic Insurance)* Undertakings (IFSB, 2010) 14-15.
[91] In Abdusalam Ismail Onagun, 'Solvency of Takaful Fund: A Case of Subordinated Qard' (2011) 18(1) *Islamic Economic Studies* 1-16, 16.

be ready if the *qard* cannot be restored.[92] However, in practice, this means that the risk is transferred to the shareholders.

The *qard* facility is related to the issue of capital adequacy. In *takaful* practices, the shareholder's fund is not the only equity attributable to the shareholders; it also includes a *qard* facility for the risk fund. *Qard* is a kind of capital in the pooling fund and refunded if the fund is in surplus, when the *qard* has been paid out to cover the deficit, the pooling fund owes the *qard* to the *takaful* company. The *qard* may thus represent an asset of the shareholders' fund and a liability of the *takaful* fund.[93]

The application of *qard* facility also reflects the difficulties of the companies in dealing with the deficit. In theory, the participants may be called upon additional contributions to pay the deficit after utilisation of the *qard*. The deficit of the *takaful* fund might also be shared with the future participants through future pricing increases. However, in practice, it is difficult to apply this mechanism given that participants would presumably be at liberty not to renew their policies, and to take new and cheaper insurance with another *takaful* provider that did not carry a burden of deficits to be recouped. [94]

7.11 Regulatory Concerns on Solvency of the Risk Fund

There are some regulatory consequences of this *qard* facility. First, the shareholders should maintain sufficient *qard* reserve in the shareholders' fund. For instance, Indonesian Sharia insurance regulation obligates the *takaful* companies to maintain sufficient *qard* reserve

[92] Ibid.
[93] Archer, et al, above n 47, 193-216.
[94] Archer, et al, above n 47, 205.

in the shareholders' fund. The regulation also does not allow the companies to distribute the surplus of the risk (underwriting) fund if there are remaining unsettled *qard*.[95] Second, the repayment of that loan must take into account the ability of the risk fund to meet future liabilities and *takaful* participants' reasonable expectations. Third, can there be a surplus in the risk fund during the period where *qard* has not been fully repaid from the risk fund. Sharia insurance regulation in Indonesia, for instance, prefers to reduce the surplus until the *qard* is fully recovered. Fourth, jurisdictions offering Sharia insurance should state clearly the time period of the *qard* repayment by the risk fund. And fifth, jurisdictions offering Sharia insurance should also provide exit strategies if the *qard* cannot be fully recovered after exceeding a specified time period. In this case, whether the liability to provide loans to the risk fund can be extended to the investment accounts of policyholders. These five points shall important to the development of solvency requirements of risk (underwriting) funds of *takaful* companies.

7.12 Challenges to Modern *Takaful* Insurance

In Muslim societies, family is the principal source of support and security.[96] But where this is not available, support and assistance tend to be based on community-level welfare and food security. For instance, in Indonesia support for the needy and indigent is based on the Islamic precept of *zakat* (an earmarked levy on wealth, sometimes provided to the mosque). Moreover, local organised-zakat institutions that established in many parts of the country, i.e. Dompet Dhuafa, Lazismu, and Lazisnu, and Zakat House, provide a very effective social

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[95] *Indonesian Services Authority Regulation* No 72/POJK.05/2015 on Financial Health of Sharia Insurance and Re-Insurance Companies.
[96] Ahmad Ehtisham, 'Social Security and the Poor: Choices for Developing Countries' (1991) 6(1) *the World Bank Research Observer* 105-127, 111.

security system in identifying and assisting the indigent in local communities.[97] Since resources are generally locally provided, events that affect the whole community make this community support unreliable. If there is a breakdown in these traditional forms of support and assistance, some form of risk pooling is desirable. Third, there may be little community awareness of the differences between *takaful* insurance and conventional insurance which is prohibited.[98]

Developing countries, including Muslim nations, have relatively sophisticated social security mechanisms that incorporate aspects of redistribution of wealth to those in need. But the reseources for such schemes are locally based, and the practices cannot withstand sustained shocks. Moreover, the social cohesion that underlines these arrangements is increasingly susceptible to the challenge of contemporary Muslim societies. There is a role for the state as well private business actors to provide formal insurance system by pooling risk across localities. The *takaful* insurance system is new to Muslim markets. *Takaful* insurance can be seen as a complement to the traditional social security system. These traditional system of social security are unsuitable mechanisms to protect commercial interests and businesses involving high volume trading and valuable infrastructure and equipment.

7.13 Summary

This chapter shows the development of *takaful* insurance as a modern development from Islamic principles based on shared risk. As with other modernising approaches, various juristic opinions have been utilised to legitimise a particular form of Islamic insurance. The Islamic

97 Hilman Latief, 'Islamic Philanthropy and the Private Sector in Indonesia' (2013) 3(2) *Indonesian Journal of Islam and Muslim Societies* 175-201.

98 A personal experience of the writer showed that some of the Muslims are reluctant to access *takaful* insurance because of their doubts over Sharia legitimacy.

insurance system has modified the mutual and commercial-based conventional insurance to fit the juristic rulings particularly prohibition of *riba*, *gharar* (uncertainty), and *maysir* (speculation and gambling). The Islamic insurance has created a hybrid arrangement between a proprietary and mutual insurance, and generates distinctive characteristics compared to its conventional counterparts.

The practice of Islamic insurance still raises some issues particularly with regard to the relationship between the company, its shareholders, and policyholders. The differing approaches in the various jurisdictions have resulted in market fragmentation and divergence on regulatory and Sharia standards. Effectively *takaful* insurance operations are undertaken by joint stock companies (limited liability entities) rather than by cooperatives. This practice is inevitable due to some institutional obstacles in the adoption of a cooperative based *takaful*. A joint stock *takaful* has elements of risk sharing and risk transfer in relation to which there is continuing debate. The problem for the *takaful* industry is how to remain competitive whilst remaining Sharia compliant.

The next chapter will discuss another pivotal concept to the financial industry, the limited liability corporation. The difficulty is that Islamic finance struggles with the concept of a limited liability corporation due to the fact that medieval Islamic juristic rules do not recognise the-so-called ‘artificial person’. The limited liability corporation has been a major development in modern contracts that enable the expansion of industrialisation because the risks of the capital owners are limited to their capital contribution. The existence of the limited liability corporation is integral to risk management that is central to this thesis.

CHAPTER 8: LIMITED LIABILITY IN ISLAMIC LAW

8.1 Introduction

As discussed in chapters 2 and 7, Islamic financial institutions (IFIs) largely operate under as limited liability corporation. Islamic scholars continue to debate the legitimacy in Islamic law of a limited liability corporation. There are serious reputational risks for limited liability corporation if they are deemed not to be Sharia compliant. The limited liability corporation is closely related to risk management techniques where the investor risks only their capital contributions. The limited liability corporation is crucial to capital markets.[1] Its absence from Islamic markets would effectively shut out most Muslim countries from financial markets.[2]

This chapter argues that the concept of a limited liability corporation can be accommodated within Islamic principles. The chapter begins with a discussion of the nature of a corporation and its legal personality and limited liability. It then examines liability of Islamic business ventures partnership models, *shirkah* and *mudharabah* (a type of profit and loss sharing contracts). The focus is then turned to the liability models of Islamic *dhimmah* (legal capacity) developed by contemporary Muslim jurists. This substantive section deals with liability of modern Islamic finance institutions.

[1] See Timur Kuran, 'Why the Middle East is Economically Underdeveloped: Historical Mechanisms of Institutional Stagnation' (2004) 18(3) *Journal of Economic Perspectives* 71-90.
[2] Ibid.

8.2 Corporation as a Legal Person

To understand the meaning of corporation, it is imperative to understand the concept of a legal person or legal personality. Legal personality can be defined as "the capacity for legal relations" of a person.[3] A person is "any being whom the law regards as capable of rights and duties".[4] Legal personality may be attributed to a person whether a natural person (human being) or an artificial person or juristic person (corporation, company, etc.).[5] The law recognises and gives legal effect to a juristic person.[6] This concept emerged in the English common law by the House of Lords in *Salomon v. A Salomon & Co. Ltd.*[7] The decision confirmed that a company is a separate legal entity and separate from its shareholders, so the debts of the company are not the debts of Salomon, as one of its shareholders.[8] Consequently, shareholders are not liable for company debts beyond their investment in shares.

8.3 Limited Liability Company

The underpinning concept of a company is that it has legal personality and is a separate legal entity. Thus, the liability of shareholders or other members of the company is limited to their shares only. Investors are not liable, directly or indirectly (or by way of indemnification, contribution, or otherwise) for any debts, obligations or liabilities of the company, or of third parties.[9] This protects the personal wealth of investors or shareholders and management against

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[3] Bryant Smith, 'Legal Personality' 37(3) *The Yale Law Journal* 283-299, 299.
[4] John William Salmond, *Jurisprudence* (London: Sweet & Maxwell. 1924) 329.
[5] Discussion on whether or not the corporation is real or imaginary, natural or artificial, see Arthur W. Machen, Jr, 'Corporate Personality' (1911) 24(4) *Harvard Law Review* 253-267.
[6] Arthur W. Machen, Jr, 'Corporate Personality' (1911) 24(4) *Harvard Law Review* 253-267, 261.
[7] More discussion on a separate legal entity, see Leonard S. Sealy, *Cases and Materials in Company Law* (Cambridge University Press) 37-45.
[8] Ibid.
[9] Jonathan R. Macey, 'The Limited Liability Company: Lessons for Corporate Law' (1995) 73 (2) *Washington University Law Journal* 433, 433-434.

any possible risks in business undertakings including losses to bank customers of deposits or savings.[10]

8.4 Anglo American Limited Partnership

Unlike corporations where the company and shareholders have limited liability, in a limited liability partnership at least one of the partners must be a general partner who has unlimited liability for all of the debts and obligations of the partnership.[11] A partner with limited liability does not participate in the management of the business. If the partnership fails or becomes insolvent or bankrupt, creditors sue only the general partner not the partners with limited liability.

The limited liability partnership does not depend on the partnership having separate legal personality, which it does not, but from the separation of ownership and management.[12] This is evident in the Old Regime French *societe en commandite simple* that formed the basis for the Anglo American limited partnership, first enacted by New York in 1882.[13] It was derived from the *commenda* of the Medieval Italian city-states which viewed as a (morally necessary) consequence of the separation of ownership and management. This separation gave limited liability to sleeping partners, that is, partners who were not involved in hands-on management of the business.[14] It is important to notice that the Anglo American limited partnership can trace

[10] See for instance, Saul Levmore, 'Partnerships, Limited Liability Companies, and Taxes: A Comment on the Survival of Organizational Forms' (1992) 70 *Washington University Law Quarter* 489, 492.
[11] Peter C. Aslanides, et al, 'Limited Partnership: What's Next and What's Left?' (1978) 34(1) *The Business Lawyer* 257-305, 259.
[12] Amalia D. Kessler, 'Limited Liability in Context: Lessons from the French Origins of the American Limited Parnership' (2003) 32(2) *The Journal of Legal Studies* 511-548, 513.
[13] Ibid 511.
[14] Ibid.

its origins to the *commenda* practice inspired by the *qirad* or *mudharabah* (profit and loss sharing contract) in the Muslim Medieval partnership practices.

8.5 The Effect of Limited Liability Companies

One of the adverse impacts of limited liability is that creditors bear the risks of corporate failure.[15] This means that the risk is shifted from the company and its members to creditors, but may also, particularly in the case of bank failure, be shifted to the public more generally. This has the effect that the costs generated by corporation are externalized so that shareholders and directors gain benefits but do not suffer losses beyond their investment. Limited liability allows investors to engage in risky enterprises to generate higher profits, while the costs associated with failure are largely borne by creditors and "innocent" victims such as employees. This can result in over-investment in risky enterprises which may generate large profits and underinvestment in businesses offering only modest gains.[16] But on the positive side, it allows innovation, new enterprises and development.

Limited liability is the best vehicle to protect the shareholders from the risks. It enables the accumulation of large pools of capital under centralised management as is the case with the large modern, publicly held corporations.[17] Limited liability also provides incentives for the public to be involved in economic activities without risk if the company fails. The modern corporation separates ownership (shareholders) and management. But it is no longer true to say that since shareholders bear minimum risks they may be uninterested in the management of the

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[15] Lawrence Mitchell, 'Close Corporations Reconsidered' (1989) 63 *Tul. Law Review* 1143, 1172-80, see also Paul Halpren, Michael Trebilcock & Stuart Turnbull, 'An Economic Analysis of Limited Liability in Corporation Law' (1980) 30 *University Toronto Law Journal* 117, 148.
[16] Macey, above n 10, 448.
[17] Kessler, above n 13, 513.

corporation. Although shareholders have no say in the day to day running of a corporation, they have an important role in the annual general meeting, in electing Directors. At least in relation to large corporations, shareholders activism and institutional investors wield significant influence.[18]

8.6 Islamic Partnership

In Islamic law, the term business partnership is often referred to the Arabic word of *shirkah*. However, there is no a single standard understanding of what is the technical meaning of the word in Sunni traditions. Each Islamic legal school (*madhab*) has their own terminology. The word *shirkah* itself literally means participation of any type.[19] The understanding of the concept of *shirkah* has been developed and transformed by different Islamic legal schools with different understandings of the concept.[20]

The general features of *shirkah* can be described as follows. These include the sharing of cash money or wealth; the sharing of entrepreneurial skills, labours or management; and the sharing of credit worthiness or goodwill (*al-wujuh*). Each party's contribution depends on the agreement between the contracting parties. Generally, participation is classified into unlimited (*mufawadah*) and limited contribution (*inan*). If it is unlimited, one particular party contributes

[18] Ibid.

[19] See, eg, Imran Ahsan Khan Nyazee, *Islamic Law of Business Organization: Organisations* (International Institute of Islamic Through, 2000) 27; and Nicholas H.D. Foster, 'Islamic Perspective on the Law of Business Organisation I: An Overview of the Classical Sharia and a Brief Comparison of the Sharia Regimes with Western-Style Law' (2010) 11 *European Business Organization Law Review* 3-34, 14.

[20] Abraham L. Udovitch, 'Labor Partnership in Early Islamic Law' (1967) 10(1) *Journal of the Economic and Social History of the Orient* 64-80. See also Shelomo Dov Goitein, *A Mediterranean Society: The Jewish Communities of the Arab World as Portrayed in the Documents of the Cairo Geniza* (University of California Press, 1983).

all work and capital. Where the contribution is limited, a party contributes either work or capital.[21]

There are two common categories of Islamic partnership.[22] The first is simply co-ownership (*shirkah al-milk*) of a particular asset,[23] often called as proprietary partnership.[24] Co-ownership is common in Muslim societies particularly where an asset cannot not be divided or distinguished, i.e. ships, or animals.[25] Individual co-owners cannot sell their share without the permission of the other co-owners.[26] This co-ownership is not for the purpose of profit.[27] It has received little discussion by scholars.[28] Typically, co-ownership takes two forms either an ascertained asset (‘*ayn*) or debt (*dayn*).[29] In these types of co-ownership, assets are intermingled either through the act of the owners (i.e. voluntary by a joint purchase of an asset) or by the act of others (mandatory –without any action or approvals of the partners, i.e. inheritance).[30] Co-ownership of *‘ayn* (co-owned asset) is accepted by a majority of Schools, but there is disagreement regarding co-ownership of a debt.[31]

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21 Nyazee, above n 20, 30.
22 This categorization is derived from *Majallat al-Ahkam al-Adliyah*, see Imran Ahsan Khan Nyazee, *Islamic Law of Business Organization: Partnerships* (Islamic Book Trust, 2002) 35, see also Abraham L. Udovitch, *Partnership and Profit in Medieval Islam* (Princeton University Press, 1970) 17, Zuhaili also classifies partnership into these two categories, see Wahbah Al-Zuhayli, *Financial Transactions in Islamic Jurisprudence. Vol.1* (translated by Mahmoud A. El-Gamal, and revised by Muhammad S. Eissa) (Dar Al-Fikr, 2001) 448.
23 Nyazee, above n 20, 35.
24 Abraham L. Udovitch, *Partnership and Profit in Medieval Islam* (Princeton University Press, 1970) 17.
25 Ibid 24.
26 Regarding this principle, Nyazee argues whether or not the sale of share in a corporation is permissible, “a co-owner can sell his share without the permission of the other co-owners according to some schools. It is for this reason that the Islamic Fiqh Academy (OIC) attempts to validate the sale of the shares held in a corporation. The reasoning, however, is defective, because they treat a corporation like a *sharikat al-aqd* and a partner cannot sell his share in a partnership to an outsider without the specific permission of the other partners. This is true in *fiqh* as well as in law”, see Nyazee, above 20, 37.
27 Wahbah Al Zuhayli, *Financial Transactions in Islamic Jurisprudence. Vol. 1* (translated by Mahmoud A. El-Gamal, and revised by Muhammad S. Eissa) (Damascus: Dar Al-Fikr, 2001) 448.
28 Udovitch, above n 25, 19.
29 Nyazee, above n 20, 35.
30 See, eg, Nyazee, above n 20, 36; Al Zuhayli, above n 28, 449; and Udovitch, above n 25, 16-17.
31 Nyazee, above n 20, 36.

The second category of *shirkah* is a contractual partnership to conduct business undertakings (*shirkah al-aqd*). This kind of partnership is recognised in the Western law. In this chapter, the primary focus will be given to this form of contractual partnership.

8.7 Islamic Contractual Partnership

8.7.1 Hanafi School

The Hanafi School, one of the earliest schools in Sunni traditions, recognised two important aspects of contractual partnership, mutual consultation (*mufawadah)* and mutual delegation of authority and powers *(inan)*.[32] *Mufawadah* consists of mutual agency (*wakalah*) and guarantee or suretyship (*kafalah*) of all partners. In this arrangement, the partnership extends to all things including capital, profit, and loss. Hanafi is the only school *mazhab* that recognises the validity of this type of *mufawadah*.[33] When the communality does not comprehend all things, a partnership then becomes *inan* partnership whereby the communality is specified. In other words, *inan* partnership allows inequality of assets, profits, and loss that can vary according to agreement; there is no requirement that it be related to investment amount of the individual partner.[34] *Inan* also allows having mutual agency (*wakalah*), without mutual suretyship (*kafalah*).[35] *Inan* has been described as:

[32] Udovitch, above n 25; and Nyazee, above n 20 35. Meanwhile according to Zuhaili, above n, 449, Hanafi School enumerates six types of *shirkah al-aqd* including the two types mentioned in Udovitch, above n 25, and Nyazee, above n 20.
[33] Udovitch, above n 25, 42.
[34] Ibid, 129-231, see also Abraham L. Udovitch, 'Labor Partnership in Early Islamic Law' (1967) 10(1) *Journal of the Economic and Social History of the Orient* 64-80, 65.
[35] Udovitch, above n 25, 65.

> "a contract, based either on *wakalah* or on *wakalah* as well as *kafalah*, that permits participation from both sides with wealth (*mal*), work (*'amal*), or credit-worthiness (*wujuh*) and the sharing of profits in an agreed upon ratio".[36]

According to the Hanafi school, the liability of partners is unlimited.[37] The partners are liable in proportion to their share of the total investment. There is no limit on the amount of the partnership's liability. Each partner is responsible for their share of the partnership's indebtedness regardless of the amount, or by how much it exceeds the value of that partner's own share of the company's assets.[38]

However, in term of the *mutalaba* (the way in which the creditors could identify from whom the demand for repayment can be made) the rights of creditors can be characterised as follows. In *mufawadah* (mutual consultation), all partners are jointly and severally liable for debts since all partners are mutual agents (*wakalah*) and mutual guarantors (*kafalah*).[39] Each partner can independently of other partners exceed the limit of capital (*istiada*), i.e. through credit purchase. Consequently, if a partner purchases on credit and exceeds the capital limit, the other partners are liable for such debts, the liability is equally shared by all parties.[40] In *inan*, the liability for debts is several but not joint. It means that third parties could only look to the partner with whom they dealt with for the entire debt. If an obligation is jointly undertaken by both partners, the third parties can demand satisfaction from each of them proportional to the share of liability assigned to them in the partnership contract.[41]

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36 Nyazee, above n 20, 102.
37 Udovitch, above n 25, 41; and Nyazee classifies type of contractual partnership in Hanafi School by the way of *mufawada* or *inan*, Nyazee, above n 20, 87.
38 Udovitch, above n 25, 41.
39 Ibid 67-68.
40 Nyazee classifies type of contractual partnership in Hanafi School by the way of *mufawada* or *inan*, see Nyazee, above n 20, 87.
41 Ibid 143-145.

8.7.2 Maliki School

The Maliki School classifies Islamic partnership based on the form of investment (cash, labor, credit, and combination of cash and labor). It distinguishes between *mufawadah* (a general mandate), and *inan* (restricted mandate).[42] Although, *mufawadah* and *inan* are identical with Hanafi's terminologies, they have different meanings.[43] Maliki's *mufawadah* is quite similar with the Hanafi's *inan*. For instance, unlike in Hanafi law whereby there is no restriction on partner buying an asset on a credit basis without the approval the other partner, the Maliki's *mufawadah* requires the partner to get the other partner's permission for credit purchases.[44]

There are two important rules in Maliki's partnership. The first rule is *tafwid*, "the delegation of discretionary authority to conduct trade with each other's capital".[45] In *Mufawadah*, each partner confers upon other partners full or unrestricted authority to dispose of their joint capital in any acceptable manner to earn benefits from any business undertakings. Meanwhile in *inan*, some limitations are imposed on each partners' independent action with regard to their joint capital.[46] Consequently, the action of partners is restricted to certain rules agreed upon at the inception of the partnership.

The second rule is a strict equilibrium (*takafu*) between elements of input (capital, labor, equipment) and elements of output (profits and liabilities).[47] This implies one-to-one ratio between the proportion share of the capital, labor, and equipment a partner contributes and their share of profits and losses. For instance, if a partner contributes one percent out of the accumulated capital, she or he is also entitled to one percent of the profits and liable for one

[42] Ibid 143.
[43] Ibid 195-196.
[44] Ibid 196.
[45] Ibid 145.
[46] Ibid 147.
[47] Ibid.

percent of losses and other obligations.[48] The liability of all partners in the Maliki's school is both joint and several.

8.7.3 Shafii School

Unlike the Hanafi and Maliki School, the Shafii School views co-ownership of wealth as the underlying principle (*asl*) and a prerequisite of all partnership. The intermingling (*ikhtilat*) reflects the ownership of all parties that becomes the designation of all partnership.[49] Hence, the Shafii's law only recognises the partnership of wealth. Shafii jurists consider that the *mufawadah*, *shirkah al-abdan* (labour-based partnership), as well as shirkah al-wujuh (creditworthiness-based partnership) are void as they only recognise "the *shirkah al inan* incorporating the contract of *wakalah* (agency) and having its subject matter as wealth."[50]

In Shafii law, the partnership capital is mingled making it undifferentiable and has has the same denomination and quality.[51] These requirements (intermingling and same currency) become an impediment especially in a region that had different currencies, i.e. gold, silver, and copper, as well as in long-distance trade.[52] The partnership model of Shafii School is best suited for local trade in a region that adopts a single currency.[53] According to Nyazee, due to its rigidity the Shafii's partnership has not been applied widely in the practice.[54]

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[48] Ibid.
[49] Udovitch, above n 25, 32.
[50] Nyazee, above n 20, 210.
[51] Udovitch, above n 25, 32.
[52] Ibid.
[53] Ibid.
[54] Nyazee, above n 20, 210.

The right to profit and liability in Shafii partnerships is best explained by virtue of ownership of capital and the proportion of profit and loss based on that ownership.[55] This means that there is no flexibility in distributing ratio of profit and liability for losses except the distribution is based on the portion of invested capital.[56]

8.7.4 Hanbali School

As with the Hanafi and Maliki, the Hanbali School recognises two types of partnership (*shirkah*), *shirkah al-mal* (co-ownership) and *shirkah al-aqd* (contractual partnership).[57] The Hanbali School divides the contractual partnership into five types including *mufawadah*, *inan*, *mudharaba*, *al-wujuh* (creditworthiness), and *al-abdan* (work).[58] According to Nyazee, the partnership-version of this school is more advanced than Maliki and Shafii, and is quite similar to the Hanafi.[59] For example in defining *shirkah al-inan*, the Hanbali, like the Hanafi and unlike the Shafii, do not stipulate the mingling of capital (*khalt*, or *ikhtilat*), all that they require is that is to be ascertained and be present. For them, *al-inan* is simply a kind of partnership whereby two persons participate with their wealth and work for the purpose of the sharing the profits between them. [60] Each partner may sue and be sued for the debts of the partnership or those due to it. However, unlike the Hanafi school, the partner does not have the right to form another partnership or to invest the money by way of *mudharaba* (profit sharing partnership – see the following section).[61]

55 Udovitch, above n 25, 31,
56 Ibid.
57 Nyazee, above n 20, 215.
58 Ibid.
59 Ibid.
60 Ibid.
61 Ibid 220.

Like the other Schools, the liability of partners is unlimited in a specific circumstance. If the agent-manager raises credit beyond the limit of the capital, that partner is personally liable for the debts. In other words, the liability of investors is limited to their capital invested. However, if the purchase is approved by other partners, all partners are liable for the debts arising from such a purchase.[62]

8.8 Unlimited Liability and the Profit/Risk Principle (*Al-Kharaj Bi Al Dhaman*)

In Islamic legal maxims (*qawa'idul fikhiyyah*)[63], there is an entitlement to profits from the possession of property only if one also bears the risks of its loss (*al-kharaj bi al-dhaman*).[64] Profits are linked to liability.[65] One of the great classical Muslim scholars Al-Kasani argues as follows.

> "In the case of *dhaman* (liability for bearing loss), if the *mudharib* [entrepreneur, author's translation] were made to bear the liability for loss, he would be entitled to the

[62] Ibid 221.

[63] Islamic legal maxims commonly take the form of short phrases or sentences that express a general principle or objective of the Shariah. One of its definitions states that it is as "general rules that apply to all of their related particulars. They are abstract statements of the rules and principles of Islamic legal principles". This understanding is inline the work of Taj al-Din al-Subki (d.771/1370) stating "the *qa'idah* [single form of *qawa'id*] is the generally valid rule with which many particular cases (*juz'iyat*) agree, whose legal determinations can be understood from it (i.e. the *qa'idah*)". Wolfhart argues that *qawa'id fiqhiya* is a naturally *madhab*-specific legal principles, however, there are also *qawa'id* which are said to be acknowledged by all schools, i.e. *al qawa'id al kubra* (major principles) also called *al qawa'id al-khams* (five principles), see Wolfhart P. Heinrichs, 'Qawa'id as a Genre of Legal literatures' in Bernard G. Lewis, *Studies in Islamic Legal Theory* (Brill, 2002) 365-384.

[64] *Al-kharaj bi al-dhaman* is a well-known legal maxim. It is considered as *al-qawa'id al-kuliyyah* (common legal maxims, author's translation) in *Majallat al-Ahkam al-'Adliyyah, and* and frequently used by those who wrote on the history of the discipline of *al-qawaid al-fiqhiyyah* as an example of legal maxims that originated from prophetic traditions in identical words. For example, Ibn Hajr al-Asqalani (d. 852/1449) in his *Bulugh Al-Maram Min Adillat Al-Ahkam* mentions that this maxim is derived from a saying of the Prophet: "Aishah (RAA) narrated that Allah's Messenger [peace be upon him] said, "*al-kharaj bi al-dhaman*". This hadith is found in the five major Sunni *hadith* collections (Sahih al-Muslim (d.261/875), Sunan Ibn Majah (d.273/887), Sunan Abu Dawud (d.275/889), Sunan al- Tirmidhi (d. 279/893) and Sunan al-Nas'i (d.303/916), see Imam Ibn Hajr Al-Asqalani, *Bulugh Al-Maram Min Adillat Al-Ahkam* (Attainment of the Objective to According to Evidence of the Legal Judgments) [translated by Nancy Eweiss and edited by Selma Cook) (Dar Al-Manarah, 2003) 301.

[65] Vogel and Hayes, above n 368.

entire profit (of the *mudharabah*). This is due to his *dhaman*, and it is the revenue (*al-kharaj*) of the *dhaman*. The Prophet (peace be upon him) said: "revenue is based upon the corresponding liability for bearing loss." Thus, if the liability for bearing the loss falls on him, the *kharaj* belongs to him too".[66]

Thus, any investment activities based on the separation between profits and losses whereby the investors are qualified to receive profits without bearing liability for losses or risks is not accepted.[67]

From this perspective, all partners that receive benefits in Islamic partnership are liable for the losses. However, there are different views concerning joint and several liability discussed above. In general, any debts incurred in that partnership needs to be fully covered either by a particular party or all parties involved in that business undertaking.

8.9 No Legal Personality in Islamic Contractual Partnership

Most scholars take the view that an Islamic partnership has no legal personality as a company or as a legal person.[68] This means that the partnership cannot sue or be sued in its own name. Therefore, if legal action is taken against this business partnership all partners

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[66] Al-Kasani, *Bada'i al-Sana'i*. Vol.7, p. 3545, cited in Udovitch, above n 25, 41; and Nyazee classifies type of contractual partnership in Hanafi School by the way of *mufawada* or *inan*, see Nyazee, above n 20, 70. Ibn Qudamah, the Hanbali jurist, also shares the similar view of Al-Kasani, see Udovitch, above n 25, 41. In a nutshell, it is argued that the maxim (*al-kharaj bi al dhaman*) needs to be applied as a general rule in all contracts, see Umar F. Moghul, 'No Pain, No Gain: The State of the Industry in Light of an American Islamic Private Equity Transaction' (2007) 7(2) *The Chicago Journal of International Law*, 478

[67] See Asyraf Wajdi Dusuki and Nurdianawati Irwani Abdullah, *Fundamentals of Islamic Banking* (IBFIM, 2011) 280.

[68] See various arguments on this in Nicholas H.D. Foster, 'Islamic Perspective on the Law of Business Organisation I: An Overview of the Classical Sharia and a Brief Comparison of the Sharia Regimes with Western-Style Law' (2010) 11 *European Business Organization Law Review*, 3-34, 14.

names would need to be listed in the writ, meaning they are being sued as individual not collectively under the partnership name.[69]

8.10 Islamic Contractual Partnership: Liability for Debts

In Islamic law, a contractual partnership does not apply to debts in the form of loans due to the prohibition of *riba* (interest). Al-Sarakhsi from the Hanafi school, takes the view that authorisation of interest or usury-based loan in this partnership is invalid.[70] This is because partner cannot take out loans even though this partner was authorised to raise money through credit facilities. Second, any authority granted for raising interest-based loans is unwarranted under Islamic law.[71]

A distinction can be drawn between debts arising from interest-based loans and debts arising from credit purchases. It is clear that the above statement refers the prohibition of interest-based loans in partnership transactions. However, it does not refer to the debts arising from credit purchases. In an Islamic partnership, partners are allowed to raise money beyond the initial investment. For instance, *shirkah mufawadah* an asset could be purchased on credit basis from seller-creditors beyond the limit of the initial capital. As a result, if the partner buys on credit and exceeds the capital limit, the other partners are liable for such debts as they provide a guarantee or surety (*kafalah*). Accordingly, the liability is unlimited and shared equally among the partners.[72]

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[69] Sayyid M. Hasanuzzaman, 'Limited liabilities of Shareholders: An Islamic Perspective' (1989) 28(4) Islamic Studies 353-361. In some circumstance, one particular partner would be sued rather than all partners, since that partner is obliged to all business undertakings under a partnership.
[70] Nyazee, above n 20, 82.
[71] Ibid 83.
[72] Ibid 87.

There is a type of Islamic partnership, *shirkah al-wujuh* (credit partnership), where two parties form a partnership based on their skill or labour with the capital from a third party. The liability of all partners for the credit purchases arising from this type of partnership is unlimited only if the action is within the scope of the partner's authority. The risk of loss and payment to creditors is distributed in accordance with the contract stipulation.[73]

8.11 Limited and Unlimited Liability Under *Mudharabah*

8.11.1 *Mudharaba*: Definition and Scope

Mudharaba (*qirad* or *muqarada*)[74] commonly refers to a type of partnership whereby one partner contributes capital while the other partner contributes labour or entrepreneurial skill.[75] This type of contract has been referred to as *commenda*.

> "An arrangement in which an investor or group of investors entrusts capital or merchandise to an agent-manager, who is to trade with it and then return to the investor(s) the principal and a previously agreed-upon share of the profits. As a reward for his labor, the agent receives the remaining share of the profits. Any loss resulting from the exigencies of travel or from an unsuccessful business venture is borne exclusively by the investor(s); the agent is in no way liable for a loss of this nature, losing only his expended time and effort".[76]

[73] Ibid 86; and Al-Zuhayli, above n 28, 471.
[74] It is also called *qirad,* and *muqarada*. The different terminologies emerge due to different usage of this contract in different geographical area. The word *qirad* and *muqarada* was used by the jurists in Medina, while the word *mudharaba* was used in Iraq, see Nyazee, above n 20, 244.
[75] Ibid 246.
[76] He refers this definition to a unilateral *commenda*, see Udovitch, above n 25, 170.

This type of contract has been viewed as a prototype for a limited partnership.[77] One of the greatest modern Syrian Muslim scholars Al Zuhaily argues that this contract provides a basis for the modern corporation.[78] His view is that the modern corporation is not unlike a silent partnership in Islamic scholarship.

> "In a modern joint liability company the partners share in capital ownership, while some of them work as active partners working on behalf of the silent partners. In limited partnerships, the partners who have limited liability are considered the silent partners, and the company's business is viewed as work on behalf of those silent partners. In particular partnerships, one partner is entrusted with the capital to invest on behalf of the others, who are considered silent partners in a *mudharaba*". [79]

Other scholars disagree.[80] Nyazee takes the view that under the general principles of Islamic partnership the liability of all partners is unlimited. This may result from the absence of legal personality in partnership that gives rise to unlimited liability.[81]

In *mudharaba*, an agent's activities may be restricted (*muqayyadah*, limited) or unrestricted (*mutlaqo*, unrestricted).[82] It is argued that under an unlimited mandate, agent-managers have unlimited authority in managing a business except for taking out loans.[83] An unlimited mandate allows agent-managers to invest the investor's capital with a second agent to share in the profits even though the first-agent is not involved in the business undertakings. The agent-manager simply invests the investor's capital in another *mudharaba* with a second

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77 See, eg, Udovitch, above n 25, 170; and Al-Zuhayli, above n 28, 492.
78 Al-Zuhayli, above n 28, 492.
79 Ibid.
80 Nyazee, above n 20, 244.
81 Ibid 53 and 81.
82 Udovitch, above n 25, 204.
83 The stipulation of unlimited mandate commonly may include: (1) buy and sell all types of merchandise as he sees fit; (2) buy and sell for cash and credit; (3) give goods as bid'a, leave them as a deposit or pledge; (4) hire helpers as needed; (5) rent or buy animals and equipment; (6) travel with the capital; (7) mingle it with his own resource; (8) give it as a commenda to a third party; and (9) invest it in a partnership with a third party. Ibid, 204

agent.[84] This seems to be a functional equivalent of financial intermediary whereby the first agent acts as an intermediary between the *robbul mal* (capital provider) and the second-agent (entrepreneur). In the modern world of Islamic finance, this mechanism is called a two-tier *mudharaba* used as the theoretical base for an Islamic bank's intermediary function – accumulating money from the surplus units to be allocated to the deficit units.

8.11.2 Liability under *Mudharaba*: Limited/Unlimited

In *mudharaba*, profits and risks are shared by all partners (capital provider and agent-manager); the investor risks capital, while the agent risks their time and effort.[85] In most cases, the investor is not liable with the agent for transactions with third parties. [86] In other words, the liability of investor for debts is limited. However, the limited liability of the investor in this context is different from limited liability of modern corporations. Due to absence of legal personality in Islamic partnership, the other partner or agent-manager is liable for those debts in some circumstances.

Unlike modern limited liability that results from the theory of a separate legal entity of a juristic person (i.e. the company), the limited liability of the *mudharaba* investor arises out of the particular arrangement. The *mudharaba* was used in a long-distance trade whereby two parties (investor and agent-manager) had been separated geographically for most of the duration of the contract. Third parties who had commercial transactions with the agent-manager were not aware of the investor's existence.[87] Occasionally, the agent-manager might increase

[84] Udovitch, above n 25, 205.
[85] See, eg, Ibid 171 and Nyazee, above n 20, 265-67.
[86] Udovitch, above n 25, 171.
[87] Ibid 239.

the investment over the original investment (*istidana*) by borrowing or purchasing goods from third parties without the approval of investors. In this case, the agent-manager is responsible for the debt if the project fails; investors are only liable to the extent of their invested capital.[88] Under this arrangement, the investor has limited liability.[89]

This does not occur if other partners approve the transaction such as where the agent-manager increases the investment capital (*istidana*) through loans or any another means from third parties with the approval of the original investors. If the project fails, all partners (investor and agent-manager) are liable to cover the debts proportionally or under the initial agreement between the parties.[90] This is, however, not a universally held view.

Nyazee takes the view that the liability principle in *mudharaba* contract is no different to any other kind of partnership that is unlimited. The agent-manager is also liable for any debts incurred by the partnership when the agent purchases an asset beyond the initial investment. If the agent-manager exceeds the investment with the approval of the partner or investors, all partners (agent manager and investors) are jointly liable for the loss arising from the credit purchase. If the agent-manager exceeds the investment without the approval of the partner, the agent is the only party liable for the debts.[91]

88 Ibid 242.
89 Ibid.
90 Ibid 243.
91 Nyazee, above n 20, 265-67. Taqi Usmani also shares this view, see Muhammad Taqi Usmani, *An Introduction to Islamic Finance* (Brill, 1998) 32.

8.11.3 Limited Liability Partnership and *Mudharaba*: A Liability Perspective

There are some differences between a limited liability partnership and *mudharaba* in relation to the liability of partners. The liability of sleeping partners in *mudharaba* is limited to their invested capital where the agent-manager does not exceed the initial capital. When the agent-manager exceeds the initial capital through credit purchases with permission of sleeping partners, they become liable for the debts incurred, and thus the liability of partners is not limited to their shares but extends to the debts. This is also applied to the liability of the agent-manager for such credit.[92] In a limited liability partnership, the agent-manager is personally liable for all the debts and has no recourse to the non-working or limited partner beyond the capital contributed by them.[93] In a limited liability partnership, a limited partner is entitled to profits from all the credit raised, even when this credit exceeds the capital of the initial investment or the capital of the firm; the limited partner enjoys limited liability, which is not accepted in *mudharaba* due to the violation of the principle of *al-kharaj bi al-dhaman* (profits come with risk of loss).[94]

8.12 Liability and Legal Personality in Islamic Law

As discussed above, the liability of investors is unlimited in most cases of Islamic partnership. Contemporary jurists look upon the concept of legal personality of a juristic person to give a theoretical basis for limited liability under Islamic law. When examining legal personality of a juristic person in Islamic law, the common view is that there is no equivalent

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92 Nyazee, above n 20, 89-90.
93 Ibid.
94 Ibid.

term in traditional Islamic texts.[95] However, this should not mean that Islamic law does not recognise the concept of legal personality. *Dhimmah* as *ahliyah* (legal capacity) is used as an approximate concept to define a legal personality under Islamic law.[96] *Ahliyah* (legal capacity of natural person) consists of *ahliyyat al-wujup* (capacity to acquire rights) and *ahliyyat al-ada'* (capacity to execute).[97]

The discussion of legal capacity (*dhimmah*) in Islamic law gives a theoretical background for the recognition of limited liability and a juristic person under Islamic law.

8.12.1 Legal Capacity (*Dhimmah*) of a Natural Person

Dhimma (legal capacity) has two distinctive meanings. Both meanings are based on a natural human being as its legal object. First, it denotes a person as being subject to a legal obligation (*dayn*) in relation to money or fungible goods, and occasionally also to a religious obligation toward God (prayer, fasting, pilgrimage).[98] *Dhimma* (legal capacity) is the basis of personal obligation, and not identical with the obligation.[99] The creditor has a claim against the *dhimma* of its debtors. Such a claim is limited to the present property of the debtor; debtors are not obliged to work for their creditor in order to pay off debts, but are entitled to retain enough to support themselves and their dependants. If the debtor dies, creditors can only seek

[95] This also admitted by scholars who argue the existence of legal personality under Islamic law even tough there is no equivalent word of legal personality. Mahmood Mohamed Sanusi, 'The Concept of Artificial Legal Entity (Saksiyyah I'Tibariyah) and Limited Liability in Islamic Law' in Mahmood Mohamed Sanusi, *Islamic Banking and Finance Shariah and Legal: Issues and Challenges* (Aslita, 2012) 175, See also Mahdi Zahraa, 'Legal Personality in Islamic Law' (1995) 10(3) *Arab Law Quarterly* 193-206.

[96] Mahdi Zahraa, 'Legal Personality in Islamic Law' (1995) 10(3) *Arab Law Quarterly* 193-206, 202.

[97] Sanusi in Sanusi, above n 99, 175.

[98] See, eg, Stanley N. Katz (ed), *The Oxford International Encyclopaedia of Legal History* (Oxford University Press, 2009) in section 'Legal Personality in Islamic Law', see also B. Lewis, Pellat and Joseph Schacht (ed), *The Encyclopaedia of Islam: New Edition. Volume* II (Brill, 1991) 231.

[99] B. Lewis, Pellat and Joseph Schacht (ed), above n 102, 231.

satisfaction from the estate, not from the heirs.[100] The concept of *dhimma*, in this sense, is equivalent what is termed in modern law, the debtor's estate.[101]

Secondly, *dhimma* refers to legal capacity (*ahliyya*) which provides a conceptual basis for legal personality under Islamic law. The *Encyclopaedia of Islam* defines *dhimma* as "legal quality that makes the individual a proper subject of law, that is, a proper addressee of the rule which provides him rights or charges him with obligations".[102] Other definitions are that *dhimmah* enables any human being to oblige and be obliged,[103] or "a juristic container presumed in a person in order to encompass all its debts and obligations that are related to it",[104] or "a matter presumed to be a place for rights and duties".[105]

Jurists take a different view in relation to the recognition of legal capability (*ahliyah*) in a human being. Most Muslim scholars (*jumhur*) agree that *dhimmah* is endowed on every individual from the moment of birth and ends with the death of that individual.[106] Some assume that only an adult qualifies based on his or her ability to be wise, thus they can have *dhimmah*.[107] Meanwhile, Al-Sanhuri states that *dhimma* is a "juristic description that is presumed by the legislator to exist in a human being and according with which (the person) becomes able to oblige and be obliged".[108] In other words, he suggests that *dhimmah* is not automatically embedded in a person, but rather it needs a legislative recognition to be endowed to a person.[109]

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100 Stanley N. Katz (ed), *The Oxford International Encyclopaedia of Legal History* (Oxford University Press, 2009).
101 See, eg, Ibid. in section "Legal Personality in Islamic Law"; Lewis, Pellat and Schacht (ed), above n 102, 231.
102 Lewis, Pellat and Schacht (ed), above n 102, 231.
103 Al Jarjani, *Al-Ta'rifat* in Walid Mohammed Almajid, 'Can Electronic Agents Be Granted Legal Personality under Islamic Law? A Conceptual Rethink is Imperative' (2010) 24 *Arab Law Quarterly* 393-416, 404.
104 Ibid.
105 Ibid.
106 See, eg, Almajid, above n 107, 404; and Lewis, Pellat and Schacht (ed), above n 102, 231.
107 Al-Qarafi, *Al-Furuq*, Vol. 3 cited in Almajid, above n 107, 404.
108 A. Al-Sanhuri, *Masadir al-haqq fi l-fiqh al-Islami, Vol. 4*, Almajid, above n 107, 405.
109 This definition is interesting when compared to a modern legal personality. A company is given legislative recognition as legal personality from the date of incorporation a company to a specific legal rule.

The discussion on when a person acquires capacity (*dhimmah*) relies heavily on the conceptualisation of two capabilities (*ahliyah*): that is the capacity to acquire rights and bear obligations (*ahliyat al-wujup*); and capacity to perform or exercise those rights and obligations (*ahliyat al-ada*). The first corresponds to a view that *dhimmah* is embedded equally in every human being. Some scholars do not differentiate between *dhimmah* (legal capacity) and *ahliyat al wujup* (capability to acquire rights and obligations).[110]

The second capacity namely *ahliyat al-ada'* (capability to perform or exercise rights and obligations) depends on the degree to which a person has full capacity for executing rights and duties having reached the age of maturity or a person that is endowed by the court or legislation to perform those rights and duties.[111]

Dhimmah embraces all rights and obligations both religious or non-religious including financial matters.[112] In the word of Al-Sanhuri, *dhimmah* is a description that allows all rights and duties whether non-financial such as prayer or even financial rights of (a) religious nature such as donation (*zakat*). This concept is broader than Western notions of capacity.[113]

8.12.2 ***Dhimmah* and Artificial Persons**

To develop the legal personality of a juristic person in Islamic law, the concept of *dhimma* can be extended to non-human forms. Most contemporary Islamic scholars, by analogy (*qiyas*), argue that capacity in artificial persons is recognised by early Islamic institutions such as *waqf* (endowment), and *bait al mal* (public treasury). This capacity is equivalent to a natural

110 Al-Qarafi, *Al-Furuq*, Vol. 3, Almajid, above n 107, 407.
111 Ibid.
112 Al-Zarqa, Al-Fatlawi, and Al-Sanhuri, Almajid, above n 107, 408-409.
113 Al-Sanhuri, ibid 407.

person's capacity to acquire rights and obligations as well as capacity to execute rights and obligations.[114] This view is shared by contemporary Muslim scholars.[115]

The basis of this view is that in *waqf*, the founder of *waqf* establishes an endowment on a perpetual basis for a specific purpose. The *waqf* then becomes autonomous (independent) from the founder to serve only the interests of the foundation and its beneficiaries. Like a real person, the *waqf* can own estates, receive donations and acquire privileges, such as tax exemptions. The supervisor, *nazir* or *mutawalli*, represents the *waqf* before the judge and the authorities in general. The supervisor purchases estates and invests funds on behalf of the foundation within the framework of the founder's stipulations. The acts and functions of supervisor on behalf of the *waqf* in managing funds indicate that the *waqf* is a legal personality.[116] This understanding is similar to the proposal of the Accounting Auditing Organization of Islamic Financial Institutions (AAOIFI) which takes the view that the risk fund in *waqf*-based insurance can be justified under a legal person concept (see paragraph 7.9 of Chapter 7).

Some scholars argue that *dhimmah* is limited to human beings.[117] *Shariah* law never envisaged that *dhimmah* could provide a shield against liability or as a corporate veil meant to protect shareholders from liability.[118] If a *waq*f is required to pay damages owing to the commission of a tort involving that *waqf*, the beneficiaries, and not the *waqf*, have to bear responsibility for the payment of such damages.[119]

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[114] Sanusi, above n 99, 175.
[115] See, eg. Hasanuzzaman, above n 72, 357; Zahraa, above n 99, 202; Sanusi, above n 99, 175; and Usmani, above n 95, 154.
[116] See, eg, Hasanuzzaman, above n 72; Zahraa, above n 99; and Sanusi, above n 99, 175; and Usmani, above n 95, 154.
[117] See, eg, Nabil A. Saleh, *The General Principles of Saudi Arabian and Omani Company Laws* (Namara Publications, 1981) 79-80; and J. Schacht, *An Introduction to Islamic Law* (Clarendon Press, 1984) 125-126.
[118] Nabil A Saleh, 'Arab International Corporations: The Impact of the Shariah' (1993) 8(3) *Arab Law Quarterly* 179-183, 181.
[119] Cited from Ibn Qudama, *al-Muhgni*, ibid 636.

Nyazee rejects the argument that Islamic law permits legal personality to non-humans including its limited liability theory.[120] He objects to the use of analogy (*qiyas*) as the basis of deriving the concept of legal personality rather than general principles, i.e. Islamic partnership.[121] There is the added difficulty that it breaches the principle *al-kharaja bi al dhaman* (profits come with risks). Such reasoning suffers from an inherent problem in that it involves the examination of the Sharia regimes in terms of the concepts of modern Western law. This approach seems inappropriate and risky considering that two systems are so different in terms of their history, conceptual basis and commercial context. The Western limited liability corporation grew up out of various commercial and social phenomena such as Western trading empires, the Industrial Revolution, capital markets and an interest and speculation-based financial system.[122] Saleh[123] without rejecting legal personality under Islamic law argues that a juristic person emerged in the contemporary Islamic law scholarships under the influence of the Western law.[124] If the limited liability of a modern corporation is considered under Islamic law, this will add some consequences that will be discussed in the next section.

8.13 Current Status of Limited Liability Companies in Islamic Law

Once Islamic law permits legal personality of a juristic person, it should also accept that a modern corporation is a separate legal entity. A corporation is a juristic person that has legal capacity and the power of a natural person. Under the modern law, a company has the legal capacity to enter into contracts, own property or initiate legal action under its own name. The company is a distinct legal entity separate from its shareholders and directors.[125] At the time of writing, no jurisdiction offering Islamic financial products and services has issued a

[120] Nyazee, above n 20, 186.
[121] Ibid.
[122] Ibid.
[123] Saleh, above n 128, 179-183.
[124] See, eg. Saleh above n 128, 179-183; Saleh, above n 126, 79-80; and Schacht, above n 126, 125-126.
[125] See for instance the *Corporations Act 2001* (Cth), s 124 in Australia in Rhett Martin, *Banking and Finance in Principle* (Thomson and Law-book Co, 2008) 27.

fatwa on the permissibility of a corporation as a juristic person. It is notable that almost without exception IFIs use a limited liability corporation as their legal basis.

In practice, it seems that the Sharia advisors do not object to the idea of a limited liability of a corporation. This is evident when considering the fact that most of contemporary IFIs are incorporated under a limited liability company structure. The governance structure of IFIs requires these IFIs to establish Sharia Supervisory Boards (SSBs) to ensure that their operations are Sharia compliant. The silence by SSBs on this issue either means they have no objection on the limited liability corporations or that they follow the *fatwa* of *Fiqh* Academy of Organisation of Islamic Countries (OIC) that allows the use of a limited liability company in the Islamic finance industry.[126] The *fatwa* of the OIC that "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".[127]

A further issue flowing from the recognition of limited liability companies in Islamic law is whether the reliance on *waqf* requires not for profit institutions. *Waqf* appears to be similar to modern foundations as acknowledged in European law which is also another type of legal personality.[128] In practice, the *waqf* system has been used as profit oriented vehicles in the Islamic insurance industry (paragraph 7.6.4 of Chapter 7). In short, the recognition of a limited liability corporation does not limit the corporation to non-profit activities.

Limited liability corporations have become a standard legal form of incorporation for current global IFIs. As noted above there is an absence of *fatwas* on the question of Sharia compliance and SSBs have been silent on this issue. It is argued that it is implicit that limited

[126] Organization of Islamic Countries (OIC) Fiqh Academy, Resolution 63/1/7, para.12 of 1992 [25/10/2017] http://www.fiqhacademy.org.sa.
[127] Ibid.
[128] Doris Behrens-Abouseif, 'The *Waqf*: A Legal Personality?' (in English) in Astrid Meier, Johannes Pahlitzsch, Lucian Reinfandt (Hg.), *Islamische Stiftungen Zwischen Juristischer Norm und Sozialer Praxis* (Akademie Verlag, 2009) 55-60.

liability corporations are Sharia compliant. This recognises the need for Islamic institutions, business, and individuals to be part of a modern financial system. Without the limited liability corporation, Muslim institutions and business could not flourish or develop or participate in modern business and markets.

8.14 Summary

This chapter argues that Islamic finance can accommodate the concept of the limited liability corporation. Islamic law recognises unlimited and limited liability. Unlimited liability is based on the concept of Islamic contractual partnership particularly *musharakah* and *mudharabah*. Limited liability is derived from the extension of the concept of *dhimmah* (capacity) to juristic persons under modern interpretations of Sharia rules. In most types of Islamic partnerships, the liability of investors is unlimited. However, in a *mudharaba* partnership, the liability of investors is limited to their capital. Any debts arising out of the initial investment without the approval of the investors will not be treated as investor obligations, unless the investors approve to the excess. The concept of *dhimmah* may legitimize the use of the limited liability corporation by IFIs. Under this concept, it is possible for the investors to shift and limit risk exposures.

This chapter is important as it demonstrates the capacity of the Islamic financial industry to adopt modern developments arguing by analogy with earlier models of financial institutions. This is particularly important for the viability of Islamic financial institutions and for the progress and competitiveness of Islamic businesses and their capacity to participate in modern markets. The next two chapters discuss Islamic finance practices in Indonesia and Australia.

CHAPTER 9: ISLAMIC FINANCE IN INDONESIA

9.1 Introduction

Indonesia is one of the best examples of centralized Sharia regulatory regime in the Islamic financial industry. In this country, legitimacy of local Islamic financial products and services is derived from non-state agency Sharia Advisory Boards – Indonesian Ulama Council (DSN-MUI) rather than through formal regulatory mechanisms or courts.[1] They set their own juristic rules. *Fatwas* produced by that body play an important role in harmonising Sharia opinions for local financial industries. The *Indonesian Islamic Banking Law of 2008* directs Indonesian regulators to adopt DSN-MUI *fatwas* as a national benchmark.[2]

The *fatwas* of the DSN-MUI are consistent with the global trend of financial *fatwas*, referred to in the previous chapters. These *fatwas* allow adoption of various juristic rules in defining local Islamic financial forms.[3] In Indonesia the juristic rules from four Islamic legal schools are the predominant basis for following a selective Sharia rule (paragraph 2.4 of Chapter 2).

[1]There is no formal relationship between the MUI and Indonesian government. The Government has no authority to select its members and to guide the directions of this organization. However, they have been established and funded by the government through the Ministry of Religious Affairs, see Muhamad Ali, 'Islam and Economic Development in New Order's Indonesia (1967–1998)' (2004) 12 *East-West Centre Working Paper*. Furthermore, MUI headed by a board of directors in the Jakarta's headquarter. It has more than 150 regional branches at the provincial and district levels. Its members consist of different Islamic organizational backgrounds such as *Nadhlatul Ulama* (NU), *Muhammadiyah,* Islamic United (*Persis*), and many others. The central headquarter does not have a clear relationship with all its branches including the complication of *fatwa*s produced by the central and local branches. In the area of Islamic economics, the role of this organization is very central in influencing public perceptions about Islamic banking industry, for instance, in January 2004, MUI issued a *fatwa* (No. 1/2004) restating the prohibition of interest of conventional banks and confirming that interest is part of *riba* in the Qur'ān, and defining the term broadly to mean any 'additional charges levied on the postponement of agreed payments'. See, Tim Lindsey, 'Between Piety and Prudence: State Syariah and the Regulation of Islamic Banking in Indonesia' (2012) 34(1) *Sydney Law Review* 107.

[2] *Islamic Banking Law No* 21 of 2008 s 1(12).

[3] Indonesia is known as a Muslim majority country where most Muslims follow the Shafi'i school, see for instance, Michael B. Hooker, *Indonesian Islam: Social Change Through Contemporary Fatawaa* (Hawai University Press, 2003) 9. In practice, the largest Muslim organization in the country namely Nadhlatul Ulama (NU) was (and still is) devoted to the Shafi'i doctrine, see Akhmad Minhaji, *Islamic Law and Local Tradition: A Socio-Historical Approach* (Kurnia Salam Semesta, 2008) 259.

This chapter first discusses the Indonesian financial regulatory system particularly the position of Islamic financial institutions. It then discusses Sharia regulatory frameworks in Indonesia. This is followed by an examination of local Islamic financial instruments and most importantly Sharia compliant derivatives and its regulation.

9.2 The Indonesian Financial Regulatory System

The two chief financial regulators in Indonesia are its central bank, Bank Indonesia, and Indonesian Financial Services Authority. Bank Indonesia as the central bank is responsible for macro prudential regulation, monetary, payment systems and foreign exchange. The Financial Services Authority, is responsible for an integrated regulatory and supervisory system for all financial activities in Indonesia.[4] The Financial Authority Services is responsible for supervision, enforcement, and sanctions in relation to financial institutions. Prior to the establishment of this Financial Services Authority, Bank Indonesia and the Ministry of Finance separately regulated the banking and financial markets. The Financial Services Authority assumed the statutory powers from the Ministry of Finance.[5] The next section discusses Indonesian Islamic financial institutions (IFIs) and the applicable regulations.

[4] The establishment of OJK is based on *Indonesian Financial Services Authority Law* No 10 of 2011.

[5] Indonesian Financial Services Authority's main roles include: (1) ensuring that the overall activities within the financial services sector are implemented in an organized, fair, transparent, and accountable manner; (2) promoting a financial system that grows in a suitable and stable manner; and (3) protect interest of consumer in the financial market. Thus, the working area of OJK includes capital markets, Non-Bank Financial Institutions (NBFI) such as pension, insurance, finance companies, venture capital, and guarantee companies, and banking regulation and supervision, see Eko Saputro, *Indonesia and ASEAN Plus Three Financial Cooperation: Domestic Politics* (Palgrave Macmillan, 2017) 182.

9.3 Regulation of Indonesian Islamic Financial Institutions

Indonesia has a complex Islamic financial industry consisting of IFIs with a wide range of products and services. These local IFIs are summarised below:

Table 9.1. Types of Islamic Financial Institutions in Indonesia in 2017

ISLAMIC BANKING INSTITUTIONS
A. Islamic banks
B. Islamic Units (UUS) under Conventional Banks
C. Islamic Rural Banks (BPRS)
ISLAMIC CAPITAL MARKETS
A. Islamic Shares (*Saham Syariah*)
B. Islamic Bonds (Sovereign and Corporate *Sukuk*)
C. Islamic Mutual Funds (*Reksadana Syariah*)
D. Islamic Hedging Derivatives (*Tahawwut*)
NON-BANK ISLAMIC FINANCIAL INSTITUTIONS
A. Islamic Insurance (*Takaful*)
1. Islamic *Takaful* Companies
2. Islamic Insurance Units under Conventional Insurance Companies
B. Islamic Pension Funds (*Dana Pensiun Syariah*)
C. Islamic Financing Institutions (*Lembaga Pembiayaan Syariah*)
1. Islamic Leasing
2. Islamic Venture Capital Funds
3. Islamic Project Financing
D. Islamic Special Financing (*Pembiayaan Khusus*)
1. Islamic Guarantee Institutions (*Perusahaan Penjaminan Syariah*)
2. Islamic Export Financing
3. Islamic Pawnshop (*Pegadaian Syariah*)
E. Islamic Microfinance (*Lembaga Keuangan Mikro Syariah*)

Source: Financial Services Authority.[6]

[6] Indonesian Financial Services Authority (OJK), 'Roadmap Pengembangan Keuangan Syariah Indonesia 2017-2019' (OJK, 2017) [9/7/2018] https://www.ojk.go.id/id/kanal/syariah/berita-dan-kegiatan/publikasi/Documents/Pages/Roadmap-Pengembangan-Keuangan-Syariah-Indonesia-2017-2019/Roadmap%202017-2019(1).pdf.

From the above figure, local IFIs are categorized under Islamic banking institutions, Islamic capital markets, and Non-Bank financial institutions. Rather than discuss all these financial institutions, this chapter focuses on some areas that have been discussed in the previous chapters particularly local Islamic hedging derivatives (hedging) and insurance (*takaful*) along with applicable regulations and Sharia compliance aspects.

The term "Islamic" or "*Syariah*" attached to the local IFIs (Table 10.1) refers to the juristic opinions of the DSN-MUI.[7] The *Islamic Banking Law of 2008* defines local IFIs as financial institutions operated under the principles of Sharia derived from *fatwas* of an institution [the DNS-MUI] that has an authority to issue *fatwa* pertaining to banking and financial transactions in the Indonesian jurisdiction.[8] This referral to the DSN-MUI also includes the insurance system based on Sharia principles (*Takaful*).[9] It is clearly stated that the Sharia principles in Islamic insurance are derived from *fatwas* of an authorised body (referred to the DSN-MUI).[10] This means that the DSN-MUI's *fatwas* are the basis of defining the term "Islamic" in relation to the modern Indonesian Islamic financial industry.

All IFIs are regulated and supervised by the Indonesian Financial Services Authority (OJK). Prior to this, Bank Indonesia regulated all banks including Islamic banks. The Ministry of Finance regulated non-banking financial institutions such as the capital market, insurance companies, cooperatives, venture capital, etc. Derivatives markets are regulated and supervised by Bank Indonesia and the Financial Services Authority as well as the Commodity Futures Trading Regulatory Authority (BAPPEBTI) under the Ministry of Trade. Bank Indonesia is

[7] *Indonesian Islamic Banking Law* No 21 of 2008 s 2.
[8] *Indonesian Banking Law No* 21 of 2008 s 1(12).
[9] It is defined that Islamic insurance (takaful) as: "a collection of agreements consisting of an agreement between an Islamic insurance company and policy holders as well as an agreement between policy holders for the purposes of managing policyholder's contributions based on the principles of Sharia to mutually help and protect one another", *Insurance Law* No 40 of 2014 s 1(2).
[10] *Insurance Law* No 40 of 2014 s 1(3).

responsible for derivatives transactions in the banking sectors particularly in relation to foreign exchange and interest rate. The Commodity Futures Trading Regulatory Authority regulates and supervises commodity derivatives traded in exchanges and off exchanges.[11] The Financial Services Authority is responsible for ensuring market integrity through a series of regulations including customer protection for derivatives participants.[12]

The *Indonesian Islamic Banking Law* of 2008 governs all Sharia banking institutions operated in Indonesia. Prior to this law, the legitimacy of IFIs was not clear. For instance, the *Banking Law* No. 7 of 1992 recognised the term profit sharing banks (*bank bagi hasil*) following the principles of Islamic commercial law (*muamalat*) without further clarification of the basis upon which Islamic juristic rules have been derived. [13] The *Indonesian Banking Law* of 2008 then clarifies the status of Islamic banks including the meaning of Sharia principles as derived from the *fatwas* of the DSN-MUI.[14] In addition to the Sharia legitimacy of local IFIs, the law also provides measures to boost local IFIs, for instance, requiring Islamic banking units or windows under conventional banks to convert to full pledged Islamic banks within 15 years after the law or when these units exceed 50 per cent of its parent conventional bank's assets.[15]

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[11] Definition of exchanged-traded derivatives and off exchange derivatives is provided in Chapter 4 on "Hedging and Derivatives".

[12] OJK regulation covers all consumer protection for all manners of financial services and business players in Indonesia, see *Indonesian Financial Services Authority (OJK) Regulation* No. 1/PJOK.07/2013.

[13] *Indonesian Principles of Banking Law* No 7 of 1992 amended *Law No 14/1967.*

[14] There are several BI regulations were introduced following the enactment of the *1998 Bank Law* including *The Bank Indonesia Regulation (the PBI, Peraturan Bank Indonesia) No 6/24/PBI/2004 on Commercial Banks Conducting Business based on Shariah Principles* which later on amended by *PBI No 7/35/PBI/2005*. Furthermore, Bank Indonesia introduced *PBI No 8/3/PBI/2006 on the Conversion of Commercial Bank's Business to Commercial Banks Conducting Business based on Shariah Principles and Establishment of Shariah Offices by Conventional Commercial Banks*.

[15] Article 68 of *Indonesian Islamic Banking Law* No. 21 of 2008 states that "in a case that an Islamic banking unit under a conventional bank has reached at least 50 per cent from the total asset of its conventional bank or in 15 years after the commencement of this law, the conventional bank is compulsory to spin off its Islamic banking unit to become an Islamic full-pledge bank". In addition, although the Indonesian Islamic Banking Law No 21 of 2008 gives more legal certainty for Islamic banks, the regulations of Islamic banking instruments issued by the Central bank of Indonesia are still relying, directly or indirectly, on MUI rulings. In 2008, for example, BI released a Code of Islamic Banking Products that aims to create consistency in the market by defining the commonly used forms of Islamic financial transactions. It identifies the MUI fatwa, BI regulation and accounting standard relevant to each transaction type, as well as the kind of Islamic banking institution authorised to offer each product. The Financial Accounting Standards Board (*Dewan Standar Akuntansi Keuangan*, DSAK) of the Indonesian Accountants Association (*Ikatan Akuntan Indonesia*), working with BI and Islamic financial institutions, has also prepared various Statements of Financial Accounting Standards (PSAKs) for Islamic banking. Again, all were approved by MUI's DSN before issue. See, Hanim Hamzah, 'Recent Legal and Regulatory Developments for

Following that law, there had been acquisitions of existing banks or the businesses of Islamic branches or spin-offs of Islamic windows/branches into separate Islamic banks. Examples include a conventional commercial bank that has Islamic Banking Unit/branches (*Unit Usaha Syariah,* UUS) which purchased a relatively small conventional bank to be converted into an Islamic commercial bank (*Bank Umum Syariah*, BUS) and merging of its Islamic units/branches into this new Islamic commercial bank. Similarly, a conventional commercial bank that had no Islamic branches (UUS) purchased a relatively small conventional bank and converted it into an Islamic commercial bank (BUS). A further illustration is where a conventional commercial bank converted its Islamic branch into an Islamic commercial bank.[16]

Meanwhile, in relation to financial products, sharia compliant derivatives or hedging (*tahawwut*) have been legally recognised under the *Commodity Futures Trading Act 2011* as part of on-exchange derivatives.[17] Bank Indonesia regulates and supervises derivatives transactions in the banking sectors.[18] A detailed analysis of Sharia compliant derivatives regulation will be provided in the section of "Regulation of Sharia Compliant Derivatives" below.

Takaful as part of the national insurance system is governed by the *Insurance Law* No. 40 of 2014. Indonesian Financial Services Authority is the regulator for *takaful* companies under that law. The OJK supervises and enforces risk-based supervision and governance and risk management requirements.[19] It also requires the insurance company to increase its fund to protect policyholders, for instance, by increasing capital adequacy requirements for insurance

Islamic Banking and Finance in Indonesia' in Angelo M. Venardos (ed), *Current Issues in Islamic Banking and Finance: Resilience and Stability in the Present* (World Scientific Publishing, 2010) 99 and 104.

16 Khatibul Umam, *Trend Pembentukan Bank Umum Syariah Pasca Undang-Undang Nomor 21 Tahun 2008: Konsep, Regulasi, dan Implementasi* (BPFE UGM, 2009) 3.

17 *Futures Commodities Trading Law* No 10 of 2011 amended Law No 32 of 1997 s 1(7).

18 *Flow of Foreign Exchange and the Exchange Rate System Law* No. 24 of 1999 s 4 states that "Bank Indonesia shall, in order to implement the prudential principle, prescribe provisions of various types of Foreign Exchange Transactions which is conducted by a bank", see also *Bank Indonesia Law* No.23 of 1999 amended by Law No. 6 of 2009.

19 International Monetary Fund (IMF), 'Indonesia: Financial System Stability Assessment' (Report, IMF, 2017) 42.

companies.[20] The Indonesian insurance sector is dominated by conglomerates. About half the insurers belong to conglomerates, typically led by banks but with a number of other and non-financial entities within the group.[21]

In Indonesia, Islamic insurance providers are structured as stockholding companies with stockholders rather than policyholder as owners. A limited liabilities corporation is used in *takaful* markets, although the *Insurance Law* of 2014 also recognises other forms of insurance including co-operative-based insurance.[22] The limited liability corporation model can be used by *takaful* companies to earn profits rather than for being limited to social benefits. The definition of *takaful* is closely related to the model of cooperative mutual guarantee (*ta'awuni*). [23] However, there is no clear statement in *fatwa* that Islamic insurance could be either a stockholder company (limited liability corporation) or a co-operative model.

Although local IFIs are governed by local regulators, their Sharia legitimacy has been derived from non-state officials (the DSN-MUI). It thus allows the devolution of Sharia where the legitimacy is located within the *fatwas* of that governing body. The next section will examine the Sharia regulatory system in Indonesia.

9.4 Sharia Regulatory System in Indonesia

9.4.1 History of Indonesian Banking Sharia Standards

From 1991 to 1998, local regulations did not require Islamic banks to adopt *fatwas* of a particular organization. When the first Indonesian Islamic bank (*Bank Muamalat*) was

[20] Ibid 43.
[21] Ibid 43.
[22] *Insurance Law* No 40 of 2014 s 6.
[23] *Fatwa* on General Guidelines for Islamic Insurance of the DSN-MUI No. 21/DSN-MUI/X/2001.

established in 1991, the existing law and regulations were silent on the Sharia legitimacy of local IFIs.[24] An article in the *Banking Law* of 1992 mentioned that the Islamic juristic rule related to financial transactions (*muamalat*) was the governing mechanism for Islamic banks (referred to a profit sharing bank).[25] This article did not elaborate how the Islamic juristic rule was to be implemented in Islamic banks. At that time, the *Bank Muamalat* set up its own private Sharia rules derived from their own Sharia boards on products offered to the markets.

The *Banking Law* of 1999 gave Bank Indonesia the authority to create Sharia regulatory system for Indonesian financial markets.[26] In 2000, Bank Indonesia created the Bureau of Islamic Banking (*Biro Perbankan Syariah*) which later on became the Directorate of Islamic Banking (*Direktorat Perbankan Syariah*) to collaborate with the DSN-MUI in formulating Sharia standards for the financial industry. Bank Indonesia also formally recognised the *fatwas* of the DSN-MUI as the only *fatwas* recognised in Indonesia.[27] The next section examines how Islamic products are structured in Indonesia.

9.4.2 A Centralised Model

Indonesia has a centralised model of Sharia regulation. This model involves the presence of a single authority, the DSN-MUI, that makes substantive determinations as to whether a particular financial activity or instrument is Sharia complaint. This organization is responsible for determining Sharia compliance by different types of financial instruments

[24] *Banking Law* No 7 of 1992. This law also did not recognise Islamic banks but rather profit-sharing banks. In addition, *Peraturan Pemerintah No 72 Tahun 1992 tentang Bank Berdasarkan Prinsip Bagi Hasil* [Government Regulation No 72 of 1992 on Banks Applying Profit Sharing Principles] was also silent on this matter.
[25] *Banking Law No 7 of 1992 s 2.*
[26] *Bank Indonesia Law* No 23 of 1999.
[27] *Surat Keputusan Direksi Bank Indonesia Nomor 32/34/1999 tentang Bank Berdasarkan Prinsip Syariah* [Decree of Bank Indonesia Management No 32/34 of 1999 on Banks Applying Islamic principles] section 32.

offered by financial market participants such as Islamic banks, Islamic insurance companies, Islamic capital markets, Islamic derivatives markets, and other IFIs.

IFIs in Indonesia must appoint Sharia Supervisory Boards (*Dewan Pengawas Syariah* in local terminology).[28] This body ensures that the transactions of respective IFIs comply with Sharia juristic rules of the DSN-MUI. They do not make an independent determination of Sharia compliance as will be discussed in the case of Australia (Chapter 11). The DSN-MUI also recommends to local regulators for the appointments of Sharia Supervisory Boards members or the registration of a Sharia advisor. They also advise on any new financial products.

Existing laws and regulations in Indonesia make the *fatwas* of the DSN-MUI binding rulings on matters of Islamic finance, which must be followed not only by the IFIs making a referral but by courts, arbitrators, and SSBs generally. This creates a uniform framework for the conduct of Islamic financial activities.[29] The financial *fatwas* of the DSN-MUI set out not only the types of transactions which may be deemed Sharia compliant and therefore permissible, but may also contain substantive requirements or define the rights of parties for each type of transactions. In this way, the DSN-MUI operates as a central Sharia authority in the Indonesian jurisdiction.

The Indonesian centralised model of Sharia regulation limits costs and provides some benefits for regulators, issuers, and investors. First, it can be argued that the centralised model reduces transaction and monitoring costs in relation to the Islamic financial transactions. IFIs do not need to pay financial, legal, and independent Muslim jurists to structure and draft documents for a transaction. There are monitoring costs for the ongoing oversight of activities

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[28] *Islamic Banking Law* No 21 of 2008 s 32.
[29] *Islamic Banking Law* No 21 of 2008 s 26(2), and *Bank Indonesia Regulation* (PBI) No 6/24/PBI/2004.

by Sharia Supervisory Boards or other compliance staff. Furthermore, in Indonesia, the DSN-MUI conducts training or workshops for the markets in drafting documents and transactions approved by the DSN-MUI's *fatwas*.[30] The cost for attending those workshops is likely to the smallest for Islamic finance participant in a centralised model because the greater degree of standardisation achievable. In addition, a uniform understanding across the market on how Islamic finance activities must be conducted also drives down the costs. These cost reductions result from, *inter alia*, the ease of finding precedential documents, negotiation, and finding or training Sharia compliance staff as discussed earlier on. IFIs also face less risk that an activity will be deemed non-compliant, sometimes termed Sharia risks.[31]

Second, a centralised determination of Sharia compliance can reduce opportunities and incentives for individual IFIs to innovate in structuring transactions. It also makes it more difficult for IFIs to customise transactions to the needs of a specific issuer or investor. If customization is required, the IFIs can forward the proposal of that product to the DSN-MUI for more consideration. This process will be discussed in the following section.

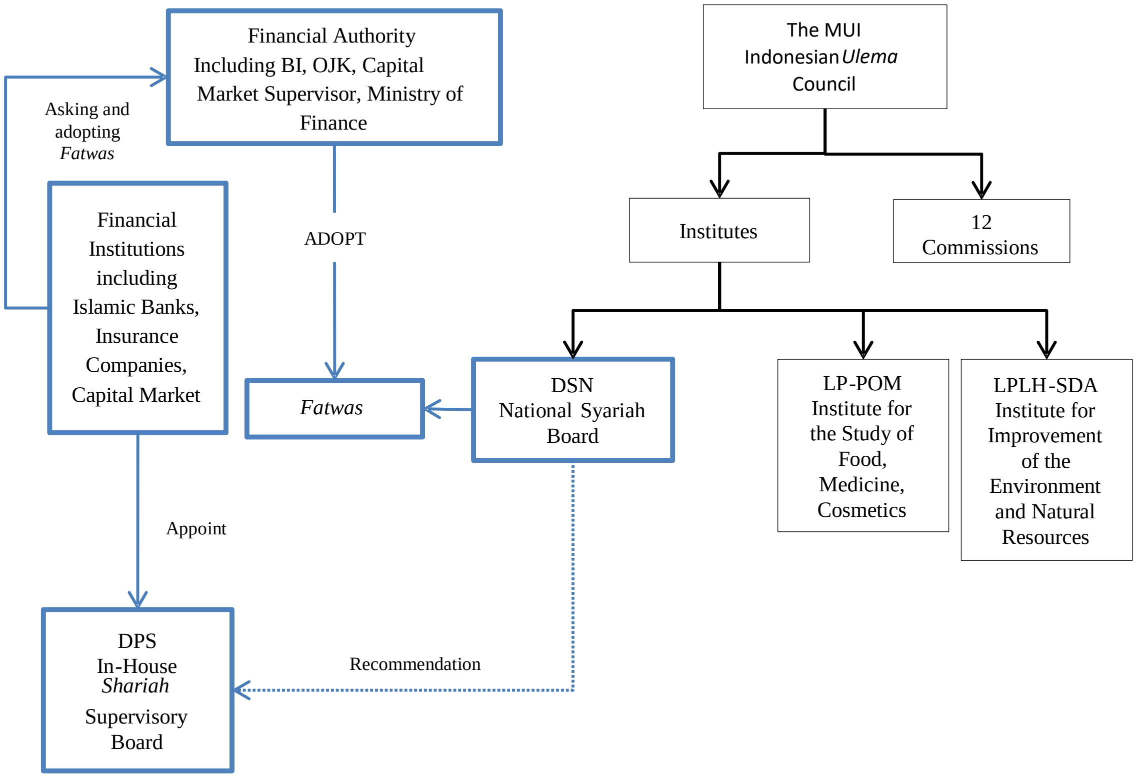
9.5 Deriving National Financial *Fatwas* in Indonesia

As discussed above, all existing Sharia guidelines and provisions on local Islamic products are required to adopt the DSN-MUI Sharia standards reflected in their financial *fatwas*. Until 2014, at least 58 *fatwas* on Islamic banking products and services have been issued by this body.[32] This number may be increasing considering that various new Islamic

[30] One of the leading actors in disseminating the fatwas of the DSN-MUI and how to draft a documentation based on those fatwas is "Iqtishod Consulting" in which its trainers are the members of the DSN-MUI, see their website on https://www.iqtishadconsulting.com.
[31] Islamic law is no longer perceived as "law" but as "risk" when the *fatwas* issued by Muslim scholars are only to serve financial actors through legalistic approach mimicking and replicating conventional financial forms, see K Balz, 'Sharia Risk? How Islamic Finance Has Transformed Islamic Contract Law' (2008) Islamic Legal Studies Program Harvard Law School.
[32] Majelis Ulama Indonesia, *Himpunan Fatwa Keuangan Syariah: Dewan Syariah Nasional* (Penerbit Erlangga, 2014).

structures coming into the markets including Sharia compliant derivatives. The *fatwas* vary from those which are pursuant to the application or request from IFIs when they submit a product proposal, and also other relevant *fatwas* relating to Islamic banking and finance which are independently initiated by the DSN-MUI.[33] The following figure summarises the role of the DSN MUI within the Indonesian Sharia regulatory system.

Figure 9.1. Sharia Regulatory System in Indonesia



Source: modified from the DSN-MUI.[34]

Local regulators have adopted the DSN-MUI's financial *fatwas*. These *fatwas* became the raw material for the Bank Indonesia's codification of Sharia rules for Indonesian banks.[35]

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33 Ibid.

34 Indonesian Ulema Council (MUI), [2/07/2018] <http://www.mui.or.id>.

35 Bank Indonesia, Codification of Islamic Banking Products, [17/06/2018] <http://www.bi.go.id/en/perbankan/syariah/Documents/CODIFICATIONOFISLAMICBANKINGPRODUCTS.pdf>.

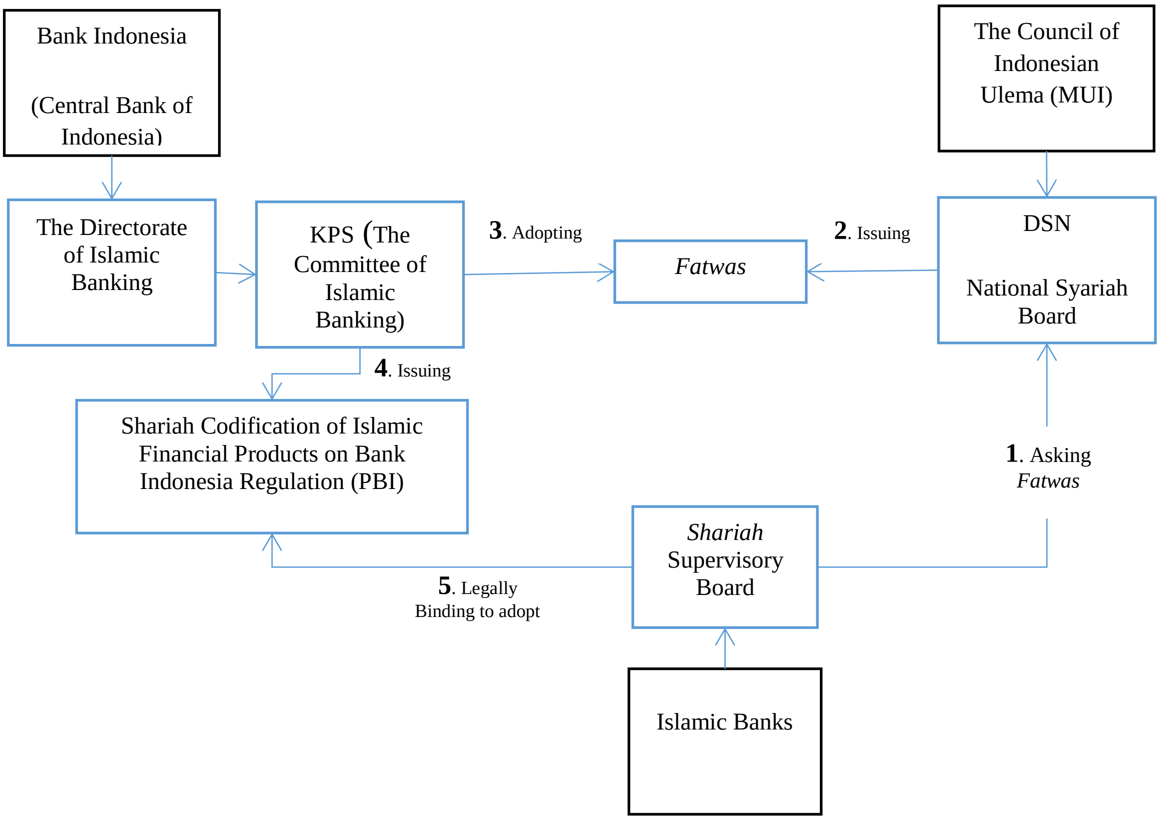
An Indonesian accounting standard setting body, the Financial Accounting Standards Board (*Dewan Standar Akuntansi Keuangan,* DSAK) of the Indonesian Accountants Association (*Ikatan Akuntan Indonesia*) also uses the DSN-MUI's *fatwas* in formulating accounting treatment for Islamic financial transactions.

Within the DSN-MUI, there is the organizing committee (*Badan Pelaksana Harian*) which has been pivotal in drafting Islamic financial *fatwas* when requested by the market participants. It consists of Muslim jurists, lawyers, bankers, regulators, and academics representing a broad range of interests within organization. Although a *fatwa* is approved by consensus among the DSN-MUI members (about 24 members) it may involve consideration of interests beyond merely the juristic view. Thus, a *fatwa* of the DSN-MUI is drafted with Sharia, financial, legal, and banking expertise and a sense of public interest and responsibility. The national Sharia standards are agreements between those interested parties that have interests in a particular outcome from the particular *fatwa*.

Independently of the DSN-MUI, the National Committee for Islamic Banking (KPS) under of Bank Indonesia was also set up by the government to translate the DSN-MUI's *fatwas* into regulations.[36] The diagram below sets out the relationship between the DSN-MUI and the committee in developing local Sharia standards.

[36] *Indonesian Islamic Banking Law* No 21 of 2008 s 26(4)(5).

Figure 9.2. The Relationship between the DSN and the Islamic Banking Committee (KPS)



Source: Modified from Al-Banna.[37]

It is noted, however, that the KPS had been a passive participant in the process of Sharia certification. Its effectively operated only for two years, from 2008-2010. This was due to disputes concerning its position in the Indonesian Sharia regulatory system.[38] This is due to the fact, as elaborated earlier, that Sharia standards in the form of *fatwas* are the responsibility of the DSN-MUI. Thus, effectively the committee no longer has a role to play.

[37] Shofwan Al Banna Choiruzzad, 'More Gain, More Pain: The Development of Indonesia's Islamic Economy Movement (1980s-2012)" (April 2013) 95 *Indonesia* 125.
[38] Ibid, 164.

As noted previously, in Indonesia Sharia standards are by nature a private rule set up by a non-state agency representing discussion, negotiation, and compromise between bankers, academics, experts, representatives of financial regulators, and Sharia scholars.

9.6 Structuring Islamic Products in Indonesia

The DSN-MUI's *fatwas* have been also used as providing a foundation for the national Codification of Islamic Banking Products and Services.[39] This establishes specific measures and guidelines in ascertaining Sharia aspects of a product before its launch into the market place. For instance, according to that codification, a *murabahah* contract (see paragraph 2.4 of Chapter 2) is

> "a transaction to buy and sell of specified goods at value equivalent to the price of the goods with an added margin defined in advance by both parties. The seller provides information on the price of the goods in advance to the buyer".[40]

An Islamic bank then adopts such a definition in a way that enables customers to clearly understand the product. For instance, one of the largest Indonesian Islamic banks defines one of their financing products based on *murabahah* contracts as

> "financing based on transaction of buy and sell contracts between the bank and a customer. The bank first purchases a required product and then sells the product to a

[39] The *Bank of Indonesia Regulation* (PBI) No 10/17/PBI/2008 Section 2 (1), *Bank Indonesia Regulation* (PBI) No 7/46/PBI/2005 on Funding and Financing Contracts of Banks offering Business based on Shariah, and the *Bank Indonesia Regulation* (PBI) No 10/17/PBI/2008 on Codification of Islamic Banking Products have set out interest-free scheme guidelines.
[40] *Bank Indonesia Regulation* (PBI) No 10/17/PBI/2008 on the Codification of Islamic Banking Products.

customer at a selling price which comprises the actual cost of the product and the agreed profit margin."[41]

However, there is no uniformity in describing Islamic products and services despite the obligation to refer to the Bank Indonesia's codification. Different terms may be used by the banks, to refer to a particular product although the products are substantially similar to each other.

If there is no existing *fatwa* for a proposed product, the bank then needs to obtain a DSN-MUI *fatwa*.[42] The organising committee of the DSN then undertakes a detailed analysis on that proposal. This committee may invite the bank and their Sharia Advisers to advise them of the results. The committee usually also invites Sharia jurists to explore a legal basis from various sources of Islamic commercial law books. This may lead to a draft *fatwa*. The next step is the presentation of the *fatwa* draft in the DSN's plenary meeting (*rapat pleno*) attended by the all members of DSN-MUI. The final result is the *fatwa* approval signed by the chairman of the DSN-MUI. This *fatwa* is then forwarded to regulators, the Indonesian Financial Authority.[43]

Setting Sharia standards is a very complex process. There has been a trade-off between the Islamic legitimacy and the practicalities of a particular contract to be offered in the markets as examined in the Chapter 2 on the section of "Pragmatism in Islamic Finance". On the one hand, regulators need to set up effective and competitive financial instruments to facilitate the growth of the Islamic financial industry. On the other side, regulators are required to adopt Sharia standards developed by the DSN-MUI. To balance out these competing considerations,

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[41] Bank Syariah Mandiri, 'Laporan Manajemen' [2/07/2018] http://www.syariahmandiri.co.id/wp-content/uploads/2010/03/AR_BSM_2015_laporan_manajemen_final.pdf, 79.
[42] *Bank Indonesia Regulation* (PBI) No 10/17/PBI/2008 section 2(2).
[43] Before the establishment of Indonesian Financial Authority, all fatwas od the DSN-MUI related to banking and financial transactions are forwarded to Bank Indonesia.

the process of Sharia certification as illustrated in the previous sections of this chapter is not monopolised by Muslim scholars or jurists but also regulators, lawyers, academics, as well as bankers and practitioners. Their interests combine to establish Sharia standards. The next sections refer to continuing issues relating to local IFIs.

9.7 IFIs as Limited Liability Corporations

There are no *fatwas* on the permissibility of limited liability corporations in Indonesia. This is also the position in other jurisdictions such as in Malaysia and Australia. In Indonesia, all local IFIs are limited liability corporations and the *Indonesian Islamic Banking Act 2008* requires Islamic banks to become limited liability companies (*Perseroan Terbatas*).[44] These include all foreign banks operating in the country. All *takaful* operators operate as joint-stock companies.[45] As examined in Chapter 8 on “Liability of Investors in Islamic Law”, the DSN MUI may adopt some juristic rules that are present to allow limited liability corporation. The lack of *fatwa* indicates that modern financial institutions cannot operate otherwise than as limited liability corporations and that is amounts to an acceptance that this is inevitable if Islamic financial institutions are to survive at all.

9.8 The DSN-MUI and Islamic Dispute Resolution

The Indonesian *Ulama* Council (MUI) has set up an independent arbitral body (Basyarnas national Sharia arbitration board) to settle disputes in relation to Indonesian Islamic

[44] *Indonesia Islamic Banking Law* No 21 of 2008 s 7.
[45] OJK, ‘Directory of Non-Bank Islamic Financial Institutions (IKNB Syariah)’ (OJK, 2018).

financial and banking activities.[46] The *Indonesian Religious Courts Law* No 3 of 2006 on the amending the *Indonesian Religious Courts Law* No 7 of 1989 granted authority to the DSN-MUI to be involved in dispute resolutions by giving their Sharia opinions in relation to Sharia economic and financial activities in the country.

The next section will examine regulations of particular products in particular Sharia compliant hedging derivatives known as *tahawwut*.

9.9 Indonesian Regulation of Sharia Compliant Derivatives

9.9.1 Derivatives Exchanges and Markets

In Indonesia, there are exchanged traded and over-the-counter (OTC) derivatives. Local exchanges are fully owned by the government and allowed to organise system trading and procedures including margin requirements.[47] OTC derivatives are locally known as the Alternative Trading System ("SPA"). The *Commodities Futures Trading Act of 2011* defines the SPA as a trading system that deals with the sale and purchase of derivatives contracts other than futures contracts and Sharia compliant derivatives contracts that are conducted off exchanges and bilaterally between counterparties with the prerequisite of withdrawal margin rules from these counterparties to be registered in local clearing houses.[48] Commodity Futures Trading Regulatory Authority (BAPPEBTI) then issues a series of rules for SPA trading for

[46] Tim Lindsey, 'Between Piety and Prudence: State Syariah and the Regulation of Islamic Banking in Indonesia' (2012) 34 *Sydney Law Review* 107, 120.
[47] *Futures Trading Markets Law* No 32 of 1997 s 6(c).
[48] *Commodities Futures Trading Law* No 10 of 2011 s 1(10).

supervisory purposes.[49] The current definition of the SPA has incorporated OTC derivatives trading onto exchange platforms and reports OTC trades to a central repository.[50]

Indonesian OTC financial derivatives are mostly foreign exchange derivatives transactions. These derivatives have increased following the development of legal infrastructure for these derivatives such as the introduction of regulations concerning foreign exchanges transactions against the *rupiah* and vice versa.[51] Bank Indonesia (BI) also urged local banks to use money market derivatives between banks to support the country's financial market.[52] All market dealers for OTC foreign exchange derivatives must report transactions daily to BI.[53] BI also facilitates the foreign exchange swap facility for Indonesian banks.[54] This

[49] Bappebti Regulation on Alternative Trading System, *Peraturan Kepala Bappebti Nomor 88/BAPPEBTI/Per/01/2011 tentang Sistem Pengawasan Tunggal (Supervisory System) dan Sistem Perdagangan dalam Transaksi Sistem Perdagangan Alternatif.*

[50] *Commodities Futures Trading Law* No 10 of 2011 s 10, 11, 12.

[51] Particularly Bank Indonesia Regulation "PBI 18/18" [*Bank Indonesia Regulation* (PBI) No. 18/18/PBI/2016 on Foreign Exchange Transactions against Rupiah between Banks and Domestic Parties] and "PBI 18/19" [Bank Indonesia Regulation (PBI) No. 18/19/PBI/2016 on Foreign Exchange Transactions against Rupiah between Local and Foreign Banks]. "PBI 18/18" regulates derivatives transactions based on foreign exchanges against Indonesian rupiahs between local banks and domestic parties. BI sets a minimum amount for each type of transactions (spot, plain vanilla derivatives, and call spread options). In transacting call spread options, parties are required to avoid structured foreign exchange products against rupiahs, except in the following circumstances: (1) they are supported by an underlying transaction; (2) the value of a foreign exchange structured product transaction against rupiahs is no more than the nominal value under the underlying transaction; (3) the term of the foreign exchange structure product transaction against rupiahs is no more than the term under the underlying transaction; and (4) the transaction is conducted based on dynamic hedging to ensure that the parties to call spread options are not exposed to foreign exchange risks as a result of market rates being above the estimated rates in the initial call spread options. "PBI 19/18" regulates foreign exchange derivatives against rupiahs between local and foreign banks. BI also sets a series of rules on each derivative transaction including some restrictions in trading call spread options as stated previously. "PBI 18/19" also sets some restrictions for local banks with their foreign partners including: (1) providing credit or financing in rupiah and/or foreign exchange (subject to certain exemptions, i.e. financing or guarantees related to investment activities in Indonesia for which a counter guarantee from a prime bank has been obtained); (2) placements in rupiah; (3) purchasing commercial paper in rupiah issued by foreign parties; (4) intercompany invoicing in rupiah; (5) intercompany invoicing in foreign exchange in order to provide credit or financing overseas; and (6) capital participation in rupiah. Moreover, "PBI 18/19" disallows local banks to transfer rupiah overseas. However, banks may transfer rupiah to accounts held by foreign parties and or held jointly by foreign parties and Indonesian parties, in banks in Indonesia, subject to certain requirements.

[52] Reuters, "Indonesian Regulators Want Banks to Trade More Derivatives" April 8, 2016 [09/07/2018] http://www.reuters.com/article/indonesia-moneymarket/indonesian-regulators-want-banks-to-trade-more-derivatives-idUSL3N17B2L5.

[53] Oxford Business Group, 'The Report: Indonesia 2014' (Oxford Business Group, 2015), 114.

[54] To enhance the practice of foreign exchange derivatives, BI issued PBI No. 16/19/PBI/2014 concerning Amendment to Bank Indonesia Regulation Number 15/17/PBI/2013 concerning Hedge Swap Transactions to Bank Indonesia to encourage the growth of derivative transactions in domestic foreign exchange market, see Bank Indonesia, "Press Release Bank Indonesian Regulation" [07/07/2018] http://www.bi.go.id/en/peraturan/moneter/Documents/faq_pbi_161914.pdf.

product is one of the money market instruments employed by BI.[55] The BI's swap facility operates as follows: (1) spot foreign exchange is sold to Bank Indonesia; (2) a forward contract made by Bank Indonesia with the initiator of the swap; and (3) rupiahs given to the initiator of the swap. This facility is mainly used for hedging purposes.[56]

Indonesia has yet to establish counterparty clearings (CCPs) for OTC financial derivatives although it was planned for at the end of 2018.[57] Bank Indonesia proposes to establish CCPs to enable central clearing for OTC financial derivatives; to act as a guarantor of OTC derivatives transactions; and to provide risk management processes in money markets.[58] At present, the OTC interest rate or foreign exchange derivatives are required to report to Bank Indonesia.[59]

Derivatives exchanges in Indonesia adopt the global benchmark of derivatives exchanges explained in Chapter 4. There are some outstanding matters for the establishment of CCPs for OTC financial derivatives transactions. These central counterparties are also important in the case that Sharia compliant hedging (*tahawwut*) if introduced into local markets. The next section examines the Sharia compliant derivatives in Indonesia.

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55 This facility offers a party to borrow foreign currency abroad and to arrange a swap contract with an onshore bank, where the borrower receives rupiah rather than that foreign currency on spot rate and locks in the right to exchange the rupiahs for a foreign currency at a predetermined date in the future at the same rate. The borrower thus locks the rate of rupiahs at that specified date without influenced by movements of the foreign exchange rates. The bank in turn has the right to "re-swap" the contract with BI. This enables the bank to reduce the risks of their swap contract. Commonly, the initiator of the swap pays a premium to its bank partner. The BI also sets a premium for the banks that "re-swap" with BI. Through this facility, local banks tend to re-swap with BI if they are uncertain, and they tend to retain the swap when they have confidence in the rupiahs, see David C. Cole, Hal S. Scott, and Philip A. Wellons (ed.), *Asian Money Markets* (Oxford University Press, 1995) 117-118.
56 Ibid 118.
57 The Jakarta Post, 'Indonesia to Establish Clearing House for Derivatives in 2018' [16/06/2018] http://www.thejakartapost.com/news/2016/07/22/indonesia-to-establish-clearing-house-for-derivatives-in-2018.html.
58 Bank Indonesia, 'BI Siapkan Pembentukan Central Counterparty di Indonesia' [11/07/2018] http://www.bi.go.id/id/ruang-media/info-terbaru/Pages/BI-Siapkan-Pembentukan-Central-Counterparty-di-Indonesia.aspx.
59 See IMF, 'Indonesia: CPSS-IOSCO Recommendations for Securities Settlement Systems – the Equity and Corporate Bonds Securities Settlement Systems' (2012) IMC Country Report No.12/186.

9.9.2 Sharia Compliant Derivatives

In Indonesia, Sharia compliant derivatives have been recognised under the *Commodity Futures Trading Act 2011* as part of on exchange-traded derivatives. [60] These derivatives are traded in the country's futures markets.[61] The law also authorises the DSN-MUI to define types of "commodities" as the underlying values of Sharia derivatives. [62]

The recognition of Sharia derivatives was preceded by a series of events held by Jakarta Future Exchanges (JFX) and DSN-MUI since 2010. In 2011, DSN-MUI issued a *fatwa* on commodity trading based on Sharia principles in future exchanges.[63] Bank Indonesia adopted this *fatwa* to introduce Sharia commodity derivatives transactions into Indonesia.[64] It adopted only one of the proposed contracts under the *fatwa*, namely *murabahah* (cost plus profit). However, Bank Indonesia did not adopt the MUI's definition of *murabahah* in the *fatwa* of *murabahah*.[65] The term *murabahah* according to Bank Indonesia is best described as referring to *tawarruq* (a reverse *murabahah*) as examined in Chapter 2 section 2.5. This product represents a legalistic approach towards Islamic financial instruments where modern financial theories such as risk management have been integrated into the structure of the product.

After the issuance of *fatwa* on the permissibility of commodity futures under certain Sharia requirements, the Jakarta Future Exchanges (JFX) launched Sharia commodity markets ("JFX Sharia") for the first time in Indonesia.[66] This facility allows banks to manage their liquidity using commodity markets such as palm oil, rubber, tea, and chocolate. The *fatwa*

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[60] *Indonesian Futures Commodities Trading Law* No 10 of 2011 s 1(7).
[61] *Indonesian Futures Commodities Trading Law* No 10 of 2011 s 1(4).
[62] Bappebti Regulation No *94/BAPPEBTI/Per/04/2012 on the objects of futures trading in Indonesia (Komoditi yang Dapat Dijadikan Subyek Kontrak Berjangka, Kontrak Derivatif Syariah, dan/atau Kontrak Derivatif Lainnya yang Diperdagangkan di Bursa Berjangka).*
[63] DSN-MUI's *fatwa* on No. 82/MUI/VIII/2011 on Commodities Trading based on Islamic Principles.
[64] *Circular Letter of Bank Indonesia* No. 14/3/DPM/2012 on Commodity Trade Certificates based on Sharia Principles.
[65] DSN-MUI's fatwa No. 04/DSN-MUI/IV/2000 on *murabahah.*
[66] Bulletin of Futures Exchanges, 'JFX Gebrak Ekonomi Syariah' (2011) October Edition. (Bappebti/MJL/127;/X/2011/Edisi Oktober), 5.

requires the exchange to assure the availability of these commodities that will be transacted with multiple deals. In JFX Sharia, the buyer has legal ownership of the commodity represented by an electronic certificate. Thus, the buyer has a full control of the commodity as well as a right to receive the commodity within seven days. This Sharia trading facility was not designed for the purpose of speculation, see discussion at 5.8 of chapter 5. Thus, Bank Indonesia did not allow a commodity trader member to conduct transactions with a party that acts as both the commercial member and the commodity consumer. This transaction is also conducted on a random basis to avoid the same commodity returning to the same person via a netting arrangement. As with many other futures contracts, this JFX Sharia allows commodity users (customers) to transact online and deal directly with commodity brokers.[67]

In 2015, to expand the application of Sharia derivatives, DSN-MUI issued a *fatwa* on hedging (*Tahawwut*).[68] Bank Indonesia then adopted some part of this hedging *fatwa*.[69] This *fatwa* was designed to overcome the difficulties of local Islamic banks in conventional foreign exchange derivatives.[70] These foreign exchanges derivatives such as swaps and options were considered to be prohibited.[71] This made it difficult for Islamic banks to hedge against adverse movements of their foreign currencies transactions and reserves. Prior to this *fatwa*, Sharia banks were allowed to exchange foreign currencies on a spot basis preventing them from using various alternatives to hedge their market risks particularly foreign exchange risks.[72]

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67 See Asyraf Wajdi Dusuki, et al, 'The Application of Commodity Murabahah in Bursa Suq Al-Sila's Malaysia Vis-à-vis Jakarta Future Exchange Shariah Indonesia: A Comparative Analysis' (2013) 5(1) *ISRA International Journal of Islamic Finance.*

68 DSN-MUI's Fatwa No. 96/MUI/III/2015 on Tahawwut (Hedging).

69 *Bank Indonesia Regulation* (PBI) No. 18/2/PBI/2016 on Hedging based on Sharia Principles.

70 This has been discussed in detail in the Chapter 5.

71 See Fatwa on Foreign Exchanges issued by DSN-MUI No. 28/DSN-MUI/III/2002.

72 Foreign Exchanges based on spot basis based on DSN-MUI's Fatwa No.28/DSN-MUI/III/2002 on Foreign Exchanges (*Al-Sharf*).

9.9.3 Issues for Sharia Compliant Derivatives

Indonesia has not yet adopted any *fatwa* that legitimizes the trading mechanism in on-exchange derivatives particularly margin rules. *Fatwas* on Islamic hedging in Indonesia has been dominated by the contractual arrangements creating derivative-like features in Islamic finance. These *fatwas* are imperative considering that margin rules may involve speculation and gambling as described in Chapter 4 paragraph 4.4.2. The trading mechanism of Sharia compliant futures might involve those prohibited elements.[73] One view is that the margin payment is allowed as it represents a margin deposit, an equivalent to a deposit.[74] Others argue that the focus on initial margins neglects other margins in futures trading.[75] There is the view that there are some gambling elements in the margin system including the initial margin (a betting tool), and the variation margin (game of chance) that allow one party to gain at the expense of another.[76] All these concerns have not yet been addressed by the DSN-MUI.

As discussed in Chapter 4 paragraph 4.4.3, internationally, OTC derivatives transactions are moving towards central counterparties (CCPs), allowing these entities to arrange multilateral OTC derivatives contracts. The implications of this needs close examination by the DSN MUI.

The DSN-MUI has not yet discussed the master agreement for Sharia compliant derivatives transactions. So far, the global derivatives swap industry has used ISDA documentation to simplify documentation for swap transactions. Thus, the International

73 See for instance Noor Suhaida Kasri, "Maysir in the Crude Palm Oil Futures Contract: A Critical Analysis of the Resolution of the Malaysian Securities Commission Sharia Advisory Council" (2013) International Sharia Research Academy for Islamic Finance (ISRA) Research Paper No. 63, see also Noor Suhaida Kasri, 'A Critical Analysis of the Resolution of the Sharia Advisory Council of Securities Commission Malaysia: A Case Study of the Crude Palm Oil Futures Contract' (2013) 5(2) *ISRA International Journal of Islamic Finance*.
74 See for instance, Mohammad Hashim Kamali, 'The Sharia Perspectives on Futures' in Asma Siddiqi (ed), *Anthology of Islamic Banking* (Institute of Islamic Banking and Insurance, 2000) 176.
75 Kasri, above n 73, 75.
76 Ibid.

Islamic Financial Market (IIFM) in coordination with ISDA has developed documentation for OTC Sharia derivatives (Chapter 6). Indonesia is one of the founders of the IIFM. This close connection with the organization should be taken into consideration by the DSN-MUI in setting up observations towards the ISDA/IIFM *Tahawwut* Master Agreement. This master agreement would support the practice of the hedging *fatwa* issued by the DSN-MUI.

The next section will explain how derivatives documentation takes place in Indonesia markets. This would also provide some pointers as to how ISDA/IIFM documentation could be utilised in local Sharia compliant OTC derivatives.

9.9.4 Master Agreements for Sharia Compliant Derivatives

Indonesian has adopted two standard agreements for OTC derivatives transactions, the 2002 ISDA Master Agreement and Indonesian Derivative Master Agreement ("PIDI").

Bank Indonesia selectively adopted provisions of the ISDA 2002 Master Agreement by a Bank Indonesia Circular Letter.[77] ISDA did not participate in drafting this Indonesian version and takes no position as to its suitability in any form for use in any particular transaction. Accordingly, prospective users must independently ascertain such suitability.[78]

The Indonesian equivalent to the ISDA agreement has been tailored to include certain local terms and laws. The netting procedure of the modified ISDA agreement must be based on Indonesian law. The difficulty is that Indonesia does not have netting legislation. Therefore, enforceability of the netting rule as prescribed in the 2002 ISDA Master Agreement is based

[77] *BI Circular Letter of Bank Indonesia* No. 18/35/DPPK on Foreign Exchange Transactions against Rupiah between local banks and Foreign Parties.
[78] Indonesian Derivatives Master Agreement (PIDI)'s footnote, 1.

on general principles of law based on the Indonesian Civil Code (ICC). In local terminology, netting is often referred to as set off (*perjumpaan utang).*[79] This concept is also explained in *Indonesian Bankruptcy Law*.[80] However, there are disagreements on the application and enforceability of set-off in the netting system particularly in OTC derivatives transactions. Local law experts suggest that the Indonesian Civil Code rule could be directly applied, while others take a different view arguing that netting application needs to be requested by a receiver as suggested by *Indonesian Bankruptcy Law*.[81] The Indonesian modified ISDA suggest that that counterparties should waive this rule.[82] This implies that the application of set-off rule in the *tahawwut* may not need courts approvals.

The Indonesian language is a formal language of the modified ISDA Master Agreement.[83] Dispute resolution is undertaken by the Indonesian National Arbitration Board (BANI) in accordance with *Indonesian Arbitration Law*.[84] PIDI also allows counterparties to select other arbitration institutions for dispute resolution.[85] If this occurs, Indonesian cases indicate that Indonesian courts often act inconsistently in relation to the enforcement of foreign arbitral awards.[86]

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79 *Indonesian Civil Code*, part 1425-1434.
80 *Bankruptcy and Suspension of Payments Law* No 37 of 2004.
81 Amy Rachmi Budiati, et al, "Standarisasi Perjanjian Transaksi Derivatif OTC Domestik Berdasarkan Prinsip Dalam ISDA Master Agreement Dihubungkan dengan Ketentuan Kepailitan di Indonesia" (2016) 13(2) *Bulleting Hukum Kebanksentralan*, 23.
82 Section 9(6) of the PIDI.
83 Section 10 of the PIDI states that "this Agreement has been prepared in Indonesian and English. In the event of any conflict or inconsistency between the Indonesian language version and English language version of this Agreement, the Indonesian language version shall prevail".
84 *Indonesian Arbitration Law* No 30 of 1999.
85 Section 13(b) of the PIDI.
86 For more discusses on this issue, see Gatot Soemartono, "Interpretation and Application of the New York Convention in Indonesia" in George A. Bermann (ed), *Recognition and Enforcement of Foreign Arbitral Awards: The Interpretation and Application of the New York Convention by National Courts* (Springer, 2017) 495.

9.9.5 The ISDA-IIFM*Tahawwut* in Indonesia

To apply the ISDA-IIFM *Tahawwut* Master Agreement in Indonesia, some adjustments are needed. Some amendments to the ISDA master agreement have been referred to above. This is in part because most the provisions of the *tahawwut* are derived from the ISDA Master Agreement. The first requirement is that the *tahawwut* should change some provisions in relation to the peculiarities of Indonesian law including among others the termination mechanism such as netting and the close out netting system. Second change relates to Sharia opinions which need adjustments in relations to each transaction under the *tahawwut*. As discussed in paragraph 6.6 of Chapter 6, each transaction that is attached to the document needs further Sharia approvals from respective Sharia scholars. Since Indonesia has some *fatwas* concerning Sharia compliant derivatives contracts, these juristic rules could be attached as an underlying contract to each transaction under the *tahawwut*. In addition, Sharia compliant derivatives in Indonesia are not contrary to the concept of *wa'ad* (unilateral promise) and *murabahah* as the chief concept underpinning the *tahawwut* (see discussion at 6.6). These two concepts have been widely used in Indonesia commodity derivatives markets. In addition to those particular changes, the close out netting of the *tahawwut* should also be introduced in Indonesia. This would prompt issuance of additional *fatwas* by respective Sharia boards including Bank Indonesia and Financial Services Authority (OJK).

This section has examined regulatory frameworks of local Sharia compliant derivatives. It is suggested that the implementation of global regulatory standard for the Sharia derivatives known as the *tahawwut* needs to be adjusted to local laws.

9.10 Conclusion

This chapter discussed the regulation of Islamic finance in Indonesia. While the emphasis has been on the Sharia regulatory system in Indonesia, it also referred to the regulations of Islamic derivatives, Islamic insurance (*takaful*), and limited liability entities in Indonesian context. The DNS-MUI's *fatwas* have been used as the core ingredients for local Sharia regulations. Their *fatwas* have been used in creating a centralised Sharia standard that governs local IFIs. This model involves the presence of a single authority that is the DSN-MUI that makes substantive determinations as to whether a particular financial activity or instrument is Sharia complaint. This organization is thus responsible for determining Sharia compliance with regards to different types of financial instruments offered by various market participants.

Devolution of Sharia also takes place in Indonesia. Sharia determinations are not made by state officials or institutions such courts but from the private actors in this case DSN-MUI. The next chapter will examine Islamic finance in Australia from a regulatory perspective. It provides a useful comparator to Indonesia. Australia is a jurisdiction where Islamic finance is a very small component of the financial industry and where Islamic finance has had to adapt to regulation dealing with conventional financial institutions and financial products.

CHAPTER 10: ISLAMIC FINANCE IN AUSTRALIA

10.1 Introduction

Islamic financial institutions (IFIs) in Australia have not been the subject of regulatory concerns. They play a very small role in the Australian financial sector and this is likely to continue having regard the number of Australian Muslims. Most IFIs are local to Muslim populations such as in Melbourne, and Sydney. The Australian position provides a useful comparator to the Indonesian regulatory system. In contrast to Indonesia, Australian IFIs receive little or no special accommodation within the Australian regulatory system. Australian IFIs must adapt to a regulatory system established to deal with conventional banking and financial instruments. This advantages IFIs in Australia and is an inhibiting factor preventing expansion beyond a very small retail sector catering to local Muslim communities.

In relation to Sharia regulation of Islamic finance, Australian IFIs practice a decentralised model in contrast to the Indonesian centralised model (Chapter 9). Australian IFIs develop Sharia rules for financial transactions derived from the juristic rulings of their respective Sharia Supervisory Boards (SSBs) or other overseas Sharia advisory agencies. These Sharia rulings are not the subject of local regulation. It means that IFIs can choose their Sharia opinions without following a Sharia standard recognised by local regulators. In this type of Sharia regulation, local markets seeking to practice Islamic finance face challenges including a legal recognition of various Sharia transactions under local regulations and a tax treatment of multiple steps involved in Islamic financial products and services.

First, this chapter discusses the Australian regulatory model known as "Twin Peak Model" and examines how IFIs fit within this regulatory model. It then refers debates on Sharia aspects and regulatory concerns particularly on taxation treatments of Islamic products as well as some of the obstacles in developing Islamic finance in Australia. It highlights various IFIs in Australia and their Sharia compliant aspects and products.

10.2 Islamic Finance and the Twins Peaks Model

Australia adopts a functionally-based model – the 'twin peaks' model whereby the financial regulators operate on functional lines. The twin peaks, Australian Securities and Investment Commission (ASIC) and Australian Prudential Regulation Authority (APRA) are independent statutory bodies. [1] ASIC is responsible for market conduct and consumer protection. APRA is responsible for prudential regulation. The Reserve Bank of Australia (RBA) is responsible for monetary policy and financial stability, including ensuring a safe and reliable payment system.[2] The twin peaks model was introduced in 1998 based on recommendations of the Financial System Inquiry (the Wallis Inquiry).[3] The model is aimed at combining market and government mechanisms to regulate the banking and finance industries.[4] Government involvement operates to prevent market failure and also to facilitate efficient running of the markets.[5] This model is directed towards systemic stability, market conduct, and consumer protection.[6] Under this model, it is necessary to ensure the objectives of each

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[1] *Australian Securities and Investments Commission Act* (Cth), No 51 of 2001; *Australian Prudential Regulation Authority Act* (Cth), No 50 of 1998; *Reserve Bank Act* (Cth), No 4 of 1959.

[2] For instance, a securitisation based on Islamic law, the legal separation of securitized assets from the bankruptcy estate of the originator in a true sale securitization carries the possibility of bankruptcy courts or insolvency officials in Islamic jurisdictions to invalidate the substantive non-consolidation and "re-characterize" an asset sale as an unsecured loan, see Andrew Godwin, 'Surveying the Twin Peaks of Australia's Financial System' in Sheelagh McCracken and Shelley Griffiths (ed), *Making Banking and Finance Law: A Snapshot* (Ross Parsons Centre of Commercial, 2015) 11-26, 12.

[3] Caner Bakir, 'the Governance of Financial Regulatory Reform: The Australian Experience' (2009) 87(4) *Public Administration* 910-922, 910.

[4] For more in-depth description and analysis of the current framework than is provided below, see Sheelagh McCracken and Anna Everett, *Everett and McCracken's Banking and Financial Institutions Law* (Thomson Reuters, 7th Edition, 2009).

[5] Financial System Inquiry (Cth), *Financial System Inquiry Final Report* (1997) 14.

[6] See Andrew D Schmulow, 'The Four Methods of Financial System Regulation: An International Comparative Survey' (2015) 26 *Journal of Banking and Finance Law and Practice* 151, 165.

regulator and the boundaries between them.[7] This is because a market participant may be regulated by both regulators. Further, to ensure that comprehensive supervision is achieved and that issues do not fall between the cracks, it is necessary to achieve effective collaboration between regulators. This requires consultation, information sharing and mutual cooperation in areas such supervision and enforcement action.[8] Both APRA and ASIC have been the subject of scathing criticism in the 2019 report by the Royal Commission on Banking and Financial Services.

10.2.1 Reserve Bank of Australia

Since the establishment of twin peaks model, the Reserve Bank of Australia's (RBA) main function is to set monetary policy, ensure systemic stability, and operate as a payment system regulator. Unlike many central banks, it is not involved with prudential regulation of banks or other deposit-taking institutions. [9] The RBA, which is formally independent of the Federal Government, has responsibilities covered by the *Reserve Bank Act 1959* (Cth), and is also lender of last resort.[10]

[7] Andrew Godwin, 'Surveying the Twin Peaks of Australia's Financial System' in Sheelagh McCracken and Shelley Griffiths (ed), *Making Banking and Finance Law: A Snapshot* (Ross Parsons Centre of Commercial, 2015) 11-26, 12.
[8] Godwin in McCracken and Griffiths (ed), above n 1, 12-13.
[9] McCracken and Everett, above n 1, 69.
[10] Schmulow, above n 6, 169.

10.2.2 APRA (Australian Prudential Regulation Authority)

APRA is responsible for the regulation of financial sectors, and developing administrative practices and procedures in performing regulatory roles.[11] APRA regulates authorised deposit-taking institutions (ADIs) including Australian incorporated banks, Australian representative offices and branches of foreign banks, building societies, credit unions, specialised credit institutions and providers of purchased payment facilities as well as life and general insurance companies, and participants in the superannuation industry.[12]

APRA has developed a regulatory framework for financial institutions in Australia under the *Banking Act 1959* (*Cth*). Banking supervision principles include those published by the Basel Committee on Banking Supervision (BCBS). The framework includes requirements concerning capital adequacy, credit risk, market risk, securitisation, liquidity, credit quality, etc.[13] This function is designed to minimise the risks, and to protect the interests of depositors, insurance policy holders and superannuation fund members.[14]

10.2.3 ASIC (Australian Securities and Investments Commission)

ASIC acts under the *Australian Securities and Investment Commission Act 2001* (Cth) and administers the *Corporations Act 2000* (*Cth*) (Corporation Act), including the provisions governing the operation of companies in Australia (including foreign companies carrying on business in Australia), corporate fundraising, financial reporting, takeovers and compulsory

[11] *Australian Prudential Regulation Authority Act* 1998 (Cht), 6.
[12] Greg Hammond and Rowan Russel, 'Australia' in Rene Bosch, Homburger, *Banking Regulation*: Jurisprudential Comparisons (Thomson Reuters, 2012) 1-22, 1.
[13] Ibid 2.
[14] McCracken and Everett, above n 1, 19.

buyouts and external administration and insolvency.[15] It has a broad regulatory role. It regulates Australian companies, corporate professionals (i.e. liquidators, auditors), financial markets, financial services and product providers, and consumer credit. In the finance sector, its chief role is to ensure market integrity and consumer protection.[16]

10.2.4 IFIs within Australian Regulatory Frameworks

Australia adopts three main types of financial institutions as follows: (1) Australian Deposit-taking Institutions (ADIs); (2) Non-IDI Financial institutions; and (3) Insurers and Fund Managers. The table below shows these institutions and their main regulators.

Table 10.1. Australia's Principal Financial Institutions

Type of Institutions	**Characteristics**	**Regulators**
Authorised Deposit Taking Institutions (ADIs)		
Banks, Building (BS) Societies, and Credit Unions (CU)	Banks provide a wide range of financial services to all sectors of the economy, including (through subsidiaries) funds management and insurance services. Building societies and credit unions provide deposit, personal/housing loan and payment services to its members.	APRA
Non-Deposit Taking Institutions (Non-IDIs)		
Money market corporations (MMC), Finance companies (including general financiers and pastoral finance companies) (FC), and Securitisers (SC)	MMCs operate primarily in wholesale markets, borrowing from, and lending to, large corporations and government agencies. Other services, including advisory, relate to corporate finance, capital markets, foreign exchange and investment management. FC provides loans to households and small- to medium-sized businesses. Finance companies raise funds from wholesale markets and, using debentures and unsecured notes, from retail investors. While Securitisers provide Special-purpose vehicles that issue securities backed by pools of assets (e.g. residential mortgage-backed securities). The securities are usually credit enhanced (e.g. through use of guarantees from third parties).	ASIC
Insurers and Funds Managers		
Life insurance companies	Provide life, accident and disability insurance, annuities, investment and superannuation products. Assets are managed in statutory funds on a fiduciary basis, and are mostly invested in equities and debt securities.	APRA

[15] Hammond and Russel in Bosch, above n 12, 2.
[16] McCracken and Everett, above n 1, 25.

General insurance companies	Provide insurance for property, motor vehicles, employers' liability, etc. Assets are invested mainly in deposits and loans, government securities and equities.	APRA
Health insurance companies	Provide insurance for private health costs. Assets are invested mainly in deposits and loans, government securities and equities.	APRA
Superannuation and approved deposit funds	Superannuation funds accept and manage contributions from employers (incl. self-employed) and/or employees to provide retirement income benefits. Funds are controlled by trustees, who often use professional funds managers/advisers. ADFs are generally managed by professional funds managers and, as with superannuation, may accept superannuation lump sums and eligible redundancy payments when a person resigns, retires or is retrenched. Superannuation funds and ADFs usually invest in a range of assets (equities, property, debt securities, deposits).	APRA
Public unit trusts	Unit trusts pool investors' funds, usually into specific types of assets (e.g. cash, equities, property, money market investments, mortgages, overseas securities). Most unit trusts are managed by subsidiaries of banks, insurance companies or merchant banks.	ASICs
Cash management trusts	Cash management trusts are unit trusts which are governed by a trust deed and open to the public and generally confine their investments (as authorised by the trust deed) to financial securities available through the short-term money market.	ASIC
Common funds	Trustee companies pool into common funds money received from the general public, or held on behalf of estates or under powers of attorney. Funds are usually invested in specific types of assets (e.g. money market investments, equities, mortgages).	State and Territory Authorities
Friendly societies	Mutually owned co-operative financial institutions offering benefits to members through a trust-like structure. Benefits include: investment products through insurance or education bonds; funeral; accident; sickness; or other benefits.	APRA

Source: Reserve Bank of Australia June 2016.[17]

[17] Reserve Bank of Australia, 'Main Type of Financial Institutions' [22/03/2018] http://www.rba.gov.au/fin-stability/fin-inst/main-types-of-financial-institutions.html#nonadi.

In Australia, IFIs such as banks and cooperatives, and insurance are regulated by APRA. Other IFIs such as Islamic fund managers, *sukuk* (are also commonly known as Islamic bonds or also referred to Islamic securitisation) issuers are subject to ASIC. ASIC exercises jurisdiction in matters that would fall outside jurisdiction of APRA, such as supervision of financial securities, financial instruments and stock exchanges. Like APRA, ASIC has considerable scope to supervise IFIs through the conditions it imposes on its licensees and the need for self-reporting of breaches. It has civil and criminal jurisdictions, has powers to investigate corporations, inspect books, call witnesses, require disclosure on the detail of financial products, and hold public hearings. ASIC, therefore, has considerably more powers than APRA and is the main policing body of the financial services industry. This includes cross-border surveillance activities, both in traditional overseas markets (UK, Europe and US) and more locally, such as in Indonesia.[18]

Table 10.2. IFIs in Australia

Name	**Type of Institutions**	**Financial Services**	**Establishment and Headquarter**
MCCA (the Cooperative), and MCCA Asset Management	The Cooperative holds a cooperative, the MCCAAM as Asset Management status	Finance (house), Superannuation, and Investment	The Cooperative Est. 1989, the Asset Management Est. 2009, Melbourne
Crescent Wealth	Asset Management including Superannuation	Finance, Investment, Superannuation	Est. 2011, Melbourne
Islamic Cooperative Finance Australia Limited (IFCAL)	Cooperative	Finance (house, vehicle, small business finance), investment	Est. 1998, Sydney

[18] See Salim Farrar, 'Accommodating Islamic Banking and Finance in Australia' (2011) 34(1) *UNSW Law Journal* above 413, 426.

Equitable Financial Solution	Asset Management	Investment Finance	Est. 2011, Sydney
Salic Super	Asset Management	Superannuation	Sydney
Iskan Finance	Asset Management	Finance (house)	Est. 2001, Sydney
Amanah Islamic Finance	Mortgage Manager	Finance (house)	Est. 2014, Melbourne
LM Investment Management Limited	Asset Management	Investment	Liquidated
Hyperion Fund Management	Asset Management	Investment	Islamic Fund est. 2011, Brisbane
Brisbane Islamic Investment Fund	Asset Management	Investment	Brisbane

Source: Various Sources

Most local IFIs are registered under a fund manager regulated by the APRA. A large number of Islamic fund managers have been attracted by the country's growing fund management industry.[19] In Australia, Islamic based fund managers use their own preferred Sharia standards, independently of, and over and above regulatory requirements.

There are also IFIs operated under a cooperative scheme. This type of IFIs were created by local Muslims to serve their community. These include MCCA Limited (Muslim Community Co-operative Australia) and Islamic Cooperative Finance Australia (IFCAL). To upgrade their business activities, some IFI based cooperatives changed their status to conduct wider financial services. The MCCA, for instance, changed its legal status from a cooperative

[19] Michael T. Skully, 'Australia: Islamic Finance Down Under' in Sasikala Thiagaraja, Andrew Morgan, Andrew Tebbutt, and Geraldine Chan, (ed.), *The Islamic Finance Handbook*, (Wiley, 2014) 11-22, 13.

to a limited liability company. Since 2009, the MCCA has not admitted new members while existing members are encouraged to redeem their shares from the cooperative and invest in MCCA Asset Management.[20]

At the time of writing, there are no Islamic banks, Islamic insurance companies (*takaful*), or Islamic bonds (*sukuk*). Although there are foreign banks operating in Australia which have Islamic subsidiaries overseas such as HSBC, the Arab Bank, and Kuwait Finance House, they do not offer these instruments in domestic markets. Long-established nonbank mortgage lender FirstMac has played a market funding role for some Islamic finance institutions, such as MCCA mortgage pool for many years.[21] In addition, the Westpac Banking Corporation has also provided the Special Interbank Placements for financial institutions offering Islamic finance products.[22]

Based on the previous discussion, Australian IFIs are subject to existing regulations. Although there are no Islamic banks in Australia, other Islamic financial institutions follow principal types of Australian financial institutions such as fund managers, superannuation funds, and cooperatives. This is the most convenient way to practice Islamic finance within existing regulations.

10.3 Accommodating IFIs in Australian Regulation

There are some proposals to accommodate Islamic finance from a regulatory perspective. First, Islamic finance should have a separate legislative regime because of the

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[20] Muslim Community Co-operative (Australia) Limited, '*2016 Annual Financial Report'* [1/03/2017] http://cdn2.hubspot.net/hubfs/431648/Annual_Report_2016_-_MCCACOOP.docx.pdf?t=1488266283296, 4.
[21] Skully in Thiagaraja et al, above n 19, 19.
[22] Ibid.

unique characteristics of Islamic finance.[23] *Shariah* compliance requires a different framework for its effective operation because of unique structure of products which are not taken into account in the current regulatory regime.[24] There are several barriers to achieving a separate legislative regime. These include political and social difficulties, and the constitutionality of a separate regime.[25] The current Australian political climate is unlikely to support a separate legislative regime for Islamic finance.[26] There may also be constitutional questions on whether the Australian Constitution would allow religiously based law to be introduced.[27] The other barrier is that the market for Islamic products in Australia is extremely small so that legislatures are unlikely to introduce costly measures to accommodate Sharia compliance.

The alternative is that Islamic finance may be accommodated by a partial legislative reform, with parity potentially achieved by regulatory bodies such as the Australian Taxation Office (ATO) issuing administrative guidelines. This option is less controversial but less certain.[28]

Islamic finance could also be accommodated by legislative amendments of some guidelines in relation to IFIs' transactions to ensure equal treatment. This method is widely accepted and has been adopted by ATO in their discussion paper on these issues.[29] Possible reforms include reforms to stamp duty, GST, limited or partial changes to the income tax

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[23] Abu Umar Faruq Ahmad, 'Opportunities of Islamic Finance in the Australian Market in the Aftermath of the Global Financial Crisis' (2011) 7(4) *Journal of Islamic Economics, Banking and Finance* 44-64, 60.

[24] Abu Umar Faruq Ahmad, Noor Mohammad Osmani and Mohd Fazlul Karim, 'Islamic Finance in Australia: The Potential Problems and Prospects' (2010) Paper of the Seventh International Conference – The Tawhidi Epistemology: Zahat and Waqf Economy, Bangi, Malaysia, 221.

[25] Kerrie Sadiq and Ann Black, 'Embracing Sharia-Compliant Products Through Regulatory Amendment to Achieve Parity of Treatment' (2012) 34 (1) *Sydney Law Review* 189, 200.

[26] See for further discussion on this issue, Sadiq and Black, above n 25, 200.

[27] Brett Freudenberg and Mahmood Nathie, 'The Constitution and Islam: Are Tax Reforms Possible to Facilitate Islamic Finance?' (2010) 20(1) *Revenue Law Journal* 1-36.

[28] Sadiq and Black, above n 25, 200.

[29] Ibid.

regime that affect payments and returns of Islamic products such as *murabaha* (cost plus profit financing).[30] This is little prospect of significant reform on these issues in the near future.

10.4 Decentralized Model of Islamic Financial Regulation in Australia

Islamic finance in Australia necessarily operates on a decentralization approach to Sharia compliance. There is greater flexibility of local IFIs to adopt a particular *fatwa* in the process of their product Sharia certifications. Unlike the centralization of Sharia in Indonesia where IFIs are obliged to adopt Sharia standards or *fatwas* derived from their national Sharia Advisory Boards, Australian IFIs are free to choose their own preferable *fatwas* in offered products. Moreover, there is also no guidance or direction from the local regulators such as APRA in terms of a particular Sharia standard that should be adopted for their products and services.

One particular issue is that courts will have difficulties in deciding legal disputes that may occur between local IFIs and their clients. In Indonesia Courts do not exercise independent judgment on what is, or is not, permissible in Islamic law as High Courts or judges defer their judgments to the determinations of the centralized Sharia boards. So long as the centralized board approved the transaction, it would be deemed Islamic and enforced on that basis. However, in Australia, such a mechanism is absent. The courts may have difficulties in judging disputes in Islamic financial industry. Unless it is clearly stated in the agreement between IFIs and its customers that the contract itself is governed by local law rather than Islamic law.

[30] Justin Dabner, 'Islamic Finance: Australia reacts belatedly. And impetuously?' [12/01/2017], Available at SSRN: http://ssrn.com/abstract=2701039, 20-21.

10.5 Defining "Sharia" or "Islamic" in Australian IFIs

Contrary to the Indonesian centralised model where the term "Islamic" or "Sharia" refers to juristic rulings of the DSN-MUI, the term "Islamic" under Australian IFIs refers to a particular authority whereby its *fatwas* derived to legitimize their financial transactions. Moreover, the term "Islamic" is not affiliated to a particular Islamic legal school (*madhab*). This means that local Australian IFIs may adopt various *fatwas* derived from various Islamic legal schools (*madhahib*). By this understanding, it is possible in these circumstances to adopt selective Sharia rules in legitimizing Sharia compliant financial products in local markets. This approach has been advocated in earlier chapters as a *modus operandi* for modernising Islamic financial law.

As a result, there have been various approaches to seeking Sharia legitimacy of the products offered to the markets. One institution gains its Sharia legitimacy from local Muslim scholars, some depend on the international Sharia standards body such as AAOIFI based in Bahrain or a *fatwa* institution of Al-Azhar in Egypt, and others hire a private Sharia consultant in the Middle East.[31]

The lack of an authoritative source that determines the Sharia compliant aspects of local IFIs leads to some challenges for local regulators. There are debated on the legitimacy of Islamic financial transactions the subject of review by the Australian Board of Taxation. Some commentators argue that some products do not reflect "authentic" contracts under Islamic law. Thus, this modern form of *murabahah* product is said to lose its legitimacy and authenticity.[32]

[31] For instance, The MCCA appointed local and overseas Sharia advisors based in Dubai. Meanwhile, Crescent Wealth entered an agreement with Dar Al Sharia Legal & Financial Consultancy (Dar Al Sharia), a subsidiary of Dubai Islamic Bank. The agreement includes Shariah advisory and certification across all investments products of the firm. Another Islamic finance institution Islamic Cooperative Finance Australia Limited (ICFAL) employs three local members of Shariah boards to assist that the products and services offered by the firm in line with the Shariah principles. Iskan Finance also adopted fatwas from Al-Azhar University in Egypt. Various sources from the IFIs' websites.

[32] Maria Bhatti, 'Taxation Treatment of Islamic Finance Products in Australia' (2015) 20(2) *Deakin Law Review* 263.

ATO has not adopted a particular view of the validity of Sharia products. The issue of the tax treatment of Islamic products continues to create difficulties.

10.6 Tax Treatment for Islamic Products

The Australian Taxation Office (ATO) adopts the view that the economic substance, rather than the form, of a transaction is the predominating principle relevant in viewing Islamic products for tax purposes. Although contractual forms of Islamic financial transactions might be different to their conventional counterparts, the substance might be similar. The Johnson Reports with the UN Committee's Working Group suggested that the 'legal approach' (taxing according to legal 'form') would produce anomalies in relation to Islamic financial instruments when compared with conventional products, and that an 'economic substance' approach should be preferred.[33] The Board of Taxation review paper also takes the view that in order for Islamic instruments to be treated equally to a conventional product under Australian regulatory frameworks, the profit market-up component such as in *murabahah* transactions is to be treated as if it is interest.[34]

Although such an approach is convenient, it causes discomfort to Islamic scholars which should be recognised by local regulators. The difficulty for Australian regulators, including in this description the Australian Taxation Office, is that there may be a lack of expertise in relation to Sharia compliance requirements. APRA as the main banking regulator does not have a member status or even an observer status with the two main organizing bodies of Islamic finance – AAOIFI (Accounting Auditing Organization for Islamic Financial

[33] Ibid.
[34] See more discussion on this, see Bhatti, above n 38.

Institutions) and IFSB (Islamic Financial Services Board). Thirty institutions from non-Islamic countries registered as either a member or an observer.[35] This is no doubt because of the small number of Islamic financial institutions in Australia and their limited operations at the retail end of the market.

The Australian Taxation Office Review considers that most Islamic products are equivalent to conventional products in terms of their economic substance. This followed the review of various Islamic financial products including *murabahah* (cost-plus-profit financing) and other products.[36] For *murabahah*-based financing (discussed in paragraph 2.5 in Chapter 2), the review accepted that mark-up in *murabahah* should be treated as interest for taxation law purposes, in order for *murabahah* to be treated equally with conventional products. A cost-plus-profit sale is regarded as being similar to a conventional fixed interest mortgage — in terms of its structure and the deductibility of the profit mark-up. Consequently, the economic substance of an Islamic mortgage product using cost plus profit sale is treated the same as a conventional mortgage.[37]

In relation to other products such as interbank financing based on *tawarruq* (reverse *murabahah*) (discussed in paragraph 2.5 in Chapter 2), the Board indicated that the economic substance of that product is equivalent to conventional debt instruments despite the form of the arrangement being different. Instead of the bank offering the debt instrument directly to financiers, an investment agent will facilitate the financing arrangement (using the capital contributed by the financiers) by making the initial commodity purchase and selling it to the bank at a profit on deferred payment terms. The bank then sells the commodity to access the

[35] George Michail, 'Is Islamic Finance Wanted in Australia' (2015) 12(42) *Islamic Finance News* 20-21, 21.
[36] The Board of Taxation, 'Review of the Taxation Treatment of Islamic Finance' [07/05/2017] http://taxboard.gov.au/files/2015/07/Islamic_Finance_Discussion_Paper.pdf.
[37] Ibid 21.

cash and repays the cost plus profit to the Investment agent (Financiers) in accordance with the agreement.[38]

For some Australian IFIs, the conventional terminology that has been applied to Islamic transactions may cause confusion. The Board of Taxation Review indicated that any legislative response should not use the word "interest". Instead it was proposed that returns be identified as they are derived as profits, rentals or fees' saying that this approach is consistent with the Sharia concept of finance.[39] Despite this, the Muslim Community Cooperative Australia (MCCA) currently uses the term "interest" rather than "rent" in their contractual documentations for home financing due to the legislative requirement.[40] This is based on the view that as long as the substance reflects Sharia compliance aspects, it is unimportant if in its legal form it is called "interest". [41] Crescent Investments Australasia (CIA) takes the view that *murabahah* products are Sharia compliant, and agrees with the characterization which was proposed by the Review and how products were to be taxed.[42] Other commentators also suggest that an economic substance approach is appropriate for Islamic financial products for income tax purposes.[43]

The Board of Taxation Review accommodates Islamic financial contracts from the perspective of economic substance rather than from its contractual form. The Australian Taxation Office or Boards of Review have no function to determine the authenticity of Islamic

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38 Ibid 32-33.

39 MCCA, 'MCCA Submission to Board of Taxation on the Review of the Taxation Treatment of Islamic Finance' [07/05/2017] https://cdn.tspace.gov.au/uploads/sites/70/2015/07/MCCA.pdf, 4.

40 MCCA, "Property Finance", [15/03/2017] http://www.mcca.com.au/faq/mcca-property-finance#_Toc472073513.

41 Ibid.

42 Crescent Investments Australasia, submission to the Australian Government, Board of Taxation, *Review of the Taxation Treatment of Islamic Finance* (2010). [07/05/2017] https://cdn.tspace.gov.au/uploads/sites/70/2015/07/Crescent_Investments_Australasia.pdf.

43 Brett Freudenberg and Dr Mahmood Nathie, Submission to the Australian Government, Board of Taxation, *Review of the Taxation Treatment of Islamic Finance* (2010) 17 December 2010, Certified Practising Accountants (CPA) Australia, Submission to the Australian Government, Board of Taxation, *Review of the Taxation Treatment of Islamic Finance* (2010) 17 December 2010 [07/05/2017], https://cdn.tspace.gov.au/uploads/sites/70/2015/07/CPA_Australia6.pdf, 30.

financial contracts within Australia. It is also not the Board's function to prefer one particular school (*madhab*) over another.

10.7 Substance over Form

As noted above the approach adopted in the taxation review is that economic substance should prevail over the form of the instrument or transaction. In theory, substance and form equally reflect juristic rules applied to financial contracts.[44] But in practice it may be that there is "substance over form" or "form over substance". Some commentators argue that Sharia places greater importance on the substance over form.[45] However, in practice, form may prevail over substance. Many IFIs offer products that are in substance similar to their conventional interest-based products in terms of its economic outcomes.[46] In western jurisdictions, Islamic contracts may be difficult to enforce. Western courts are unable to determine the Sharia legitimacy of a particular product. As a result, economic substance in evaluating Islamic products is often used for tax purposes, such as in the case of Australia.

The formulation of the substance and the form in Islamic transactions has several regulatory implications. First, in a country that adopts "the substance over form", the documentation of Islamic transactions is not very different to their conventional equivalents. In Australia, for instance, the term "interest" is widely used in legal documentations of Islamic

[44] International Sharia Research Academy (ISRA), 'Application of "Substance over Form" Principle in Islamic Finance' [06/05/2017] http://ifikr.isra.my/fatwa/-/fatwa/getFatwaDetail/4079.

[45] See, eg, Mahmud El-Gamal, *Islamic Finance: Law, Economics, and Practice* (Cambridge University Press, 2006)106; A.H. Haider,"Jurisprudential schizophrenia: On form and function in islamic finance" (2007) 7(2) *Chicago Journal of International Law* 605-622; and Abdulazeem Abuzaid, "Towards Genuine Sharia Products with Lessons of the Financial Crisis" in Habib Ahmed, Mehmet Asutay and Rodney Wilson, *Islamic Banking and Financial Crisis: Reputation, Stability and Risks* (Edinburg University Press, 2014).

[46] In 2007, the Sharia board of the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) Taqi Usmani claimed that 85 per cent of the Gulf Islamic bonds (sukuk) do not really comply with Islamic law because the substance of these products are similar with conventional interest-based bonds, see Reuters, "Most Sukuk 'Not Islamic', body claims" [07/05/2017] http://www.arabianbusiness.com/most-sukuk-not-islamic-body-claims-197156.html.

transactions such as Islamic home financing. In addition, profits generated from the *murabahah* (cost plus profit financing) contracts are treated as if profits are conventional interest to avoid double taxation.[47] Second, the formulation of "the substance" and "the form" also reflects the debates on which Sharia opinions should be adopted by a particular Islamic financial institution. This divergence of opinions (*ikhtilaf*) is inevitable in Islamic law traditions. This results an additional issue particularly on which pronouncements by Sharia scholars encroach upon the legal enforceability of a particular product.[48] In addition, the terminology "the substance over form" (the substance more important that the form) is confusing. For instance, profits in *murabahah* are commonly treated as equivalent to interest in a commercial loan for tax purposes. These two notions – profits and interest – are semantically different, but not treated as substantially different in banking practice. In the case of that product, the form is Islamic, while the substance is similar to interest-based finance. In such a situation, it is the task of Islamic institutions to ensure that product offered is based on a particular Sharia opinion as a form of Islamic finance consumer protection. And third, the legalistic approach in developing Islamic finance have the result that the economic substance of this Sharia compliant finance is similar to its conventional counterparts. As discussed in chapter 2 the global Islamic finance industry generally adopts a legalistic approach in developing their Islamic markets. The consequence is the creation of various Islamic products that duplicate, mimic, and adopt conventional forms. This is the only way that various medieval Islamic contracts could be structured within the modern financial industry.

[47] In United Kingdom, for instance, the legislators follow the approach of the economic substance of the transaction rather than its legal form. They treat the profit received from *murabahah* similarly to interest in a conventional loan transaction, see Tareq Moqbel, 'the UK Islamic Finance Taxation Framework and the Substance v Form Debate in Islamic Finance' (2015) 18(1) *Legal Ethics* 84-86, 86.

[48] Heiko Hesse, Andreas A. Jobst, and Juan Sole, 'Trends and Challenges in Islamic Finance' (2008) 9(2) *World Economics*, 184-185.

10.8 Major IFIs in Australia

10.8.1 Muslim Community Cooperatives Australia (MCCA)

The MCCA was initially established as a cooperative to fulfil the Islamic financial needs of their members.[49] It was created in February 1989 with 10 members and initial capital of $22.300, operating in Burwood, a suburb of Melbourne, Victoria.[50] Some local Muslims provided an initial capital for its establishment without the involvement of foreign investors such as Middle East wealthy Muslims.[51] Currently, the MCCA has around 7500 shareholders and members.[52] On 1997, the MCCA opened its Sydney branch,[53] and has mobile offices in Perth.[54] In addition, the firm holds an exemption to double stamp duty in Victoria.[55] Their objective is to be "a leading provider of specialized financial and wealth management services catering to the needs of Muslim Australians".[56]

In 2008, this cooperative changed its legal status to a regulated Managed Fund under the Australian Securities and Investments Commission (ASIC) regulation.[57] Under this new status, the firm manages their client funds through various investment schemes.[58] However, this license does not authorise the firm to give personal financial advice to investors and cannot recommend the investors for a suitable investment based on their financial needs.[59] Moreover,

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49 MCCA, 'History' [22/12/2017] http://www.mcca.com.au/history.
50 Algoud and Lewis, above n, 144. For detail on the MCCA, see Abdullah Saeed, 'The Muslim Community Cooperative of Australia as an Islamic Financial Service Provider' in Abdullah Saeed and Shahram Akbarzadeh, *Muslim Communities in Australia* (UNSW Press, 2001) 188-205, 189.
51 Saeed in Saeed and Akbarzadeh, above n 58, 190.
52 The MCCA Submission to Board of Taxation on the Review of the Taxation Treatment of Islamic Finance, [15/03/2017] http://taxboard.gov.au/files/2015/07/MCCA.pdf.
53 Saeed in Saeed and Akbarzadeh, above n 58.
54 The MCCA Submission to Board of Taxation on the Review of the Taxation Treatment of Islamic Finance, [15/03/2017] http://taxboard.gov.au/files/2015/07/MCCA.pdf.
55 MCCA, 'Islamic Financial Services: What Role for Australia' [15/03/2017] http://www.melbournecentre.com.au/WebsiteUpdate_011208/MCFSSymposium211108_ChaabanOmran.pdf.
56 MCCA, 'Vision and Mission' [22/12/2017] http://www.mcca.com.au/vision-mission.
57 MCCA, 'History' [22/12/2017] http://www.mcca.com.au/history.
58 Ibid.
59 Ibid.

the firm has also an Australian Credit License that allows them to provide financing facilities to their clients.[60] In addition, local regulations are not concerned with Sharia compliance aspects. Despite this, the firm voluntarily discloses their Sharia aspects in the Product Disclosure Statement (PDS), a statement that is required by the *Australian Corporations Act 2001*.

The MCCA use traditional Islamic contracts that have been modified and widely used by modern Islamic finance institutions including *murabahah* (cost plus profit financing) and other products.[61] The Sharia advisors of the MCCA issued a *fatwa* (an Islamic legal verdict) on the permissibility of the above product. The firm defines this contract as "a particular kind of sale where a seller agrees with a purchaser to provide a specific commodity to the purchaser for the deferred payment of the sale price that includes a certain profit added to his cost. The basic feature of *murabahah* is that the seller discloses the actual cost incurred in acquiring the commodity, and the added profit. This profit may be in lump sum or may be based on a percentage."[62] Commonly, the practice of IFIs is to modify this *murabahah* contract by adding additional arrangements such as *wa'ad* (unilateral promises), and *wakalah* (agency contract). This product has been claimed by the company to conform to both *Shariah* principles and Australian Laws, in particular the National Consumer Credit Protection (NCCP) law.[63] The Board of Taxation Reviewed regarded this structure as equivalent to a conventional interest-based mortgage. However, the form of the arrangements is quite different. In contrast to a

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[60] Ibid.
[61] Murabahah financing is only available in Victoria State, [[12/02/2017], http://cdn2.hubspot.net/hubfs/431648/MCCA_Website_Rates_22122015.pdf?t=1450764340343.
[62] MCCA, 'Property Finance' [05/03/2018] http://www.mcca.com.au/faq/mcca-property-finance.
[63] MCCA, 'How It Works' [05/03/2018] http://www.mcca.com.au/how-it-works, and http://cdn2.hubspot.net/hub/431648/file-2482610729-pdf/pdf/Frequently_Asked_Questions.pdf?t=1450641216709.

conventional mortgage, the firm (financier) will purchase the property and then sell it at cost plus a profit to the client who will repay the cost plus profit on a deferred payment basis.[64]

MCCA also utilises investment products whereby investors give a restricted mandate (*muqayyadah*) to the firm to invest funds.[65] This investment product allows investors to invest in a specific asset class. The firm makes a sub-scheme (also referred sub-fund) that separates it with other sub-schemes. It means that the return and performance of each sub-scheme is not affected by other sub-scheme.[66] In addition, since the interest has been removed in compensating the repayment of the clients' funds, the firm has to deal with a return on investments to maintain positive expectations of their clients. Hence, the firm relies on its past performance and conventional rate of return benchmarks to attract more funds. For instance, on its Income Fund, the firm sets the average return of 12 months deposit in 4.33 per cent, that is relatively higher than the conventional Bloomberg AusBond Bank Bill Index.[67] This past performance was then set to indicate current returns per annum of the MCCA's income fund.[68] The above mentioned funds are managed in the same manner as conventional unit trusts but differ in their mode of financing and in the nature of their investment which must be Sharia compliant. The MCCA considers that the returns of the investments are to be distributed on a half yearly basis. This period could be changed if the fund is able to make monthly distributions; these distributions are credited to the investors' funds balance.[69]

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64 The Board of Taxation, "Review of the Taxation Treatment of Islamic Finance" (2010) [05/05/2017] http://taxboard.gov.au/files/2015/07/Islamic_Finance_Discussion_Paper.pdf.
65 MCCA, 'Property Funds' [03/05/2018] http://cdn2.hubspot.net/hubfs/431648/MCCA_Property_Fund_LR_OCT.pdf?t=1488266283296.
66 Ibid.
67 The MCCA Income Fund Report per September 2015.
68 The institution gives note that these rates of returns are not guaranteed and are determined by future revenue of the Fund and may be owned than expected. Investors are taking risk of losing some or all of their principal investment. The investment is not a bank deposit.
69 MCCA, 'Product Disclosure Statements' [05/03/2017] http://cdn2.hubspot.net/hubfs/431648/Product_Disclosure_Statement_PDS.pdf?t=1488266283296.

MCCA is required under the regulation to use the term interest rather than rent in their home financing documentation.[70] The National Consumer Credit Protection (NCCP) requires all financial institutions under its guidance to use the term interest in the paperwork of financial instruments including home finance contracts, regardless of whether these are intended to be Sharia compliant.[71] This causes difficulties for MCCA because of client sensitivity to the use of the word “interest”. Hence, their Sharia Advisors issued an opinion that “the term "interest" in such documentation has the meaning of "rent" (for *Ijarah Muntahia Bittamleek* based products),[72] that contract dictates the determinate principle of the meaning and purpose of the objective of the contract and not the words and expressions.[73] MCCA has submitted to the Australian Taxation Board review requesting removal of the word “interest” in their contractual documentations.[74]

10.8.2 Crescent Wealth

Crescent Wealth is a fund manager that provides Sharia compliant investment funds including superannuation.[75] The firm, which was established in February 2010[76], has launched an Islamic index the Thomson Reuters Crescent Wealth Islamic Australia Index.[77] The firm

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70 MCCA, ‘Property Finance’ [15/03/2018] http://www.mcca.com.au/faq/mcca-property-finance#_Toc472073513.
71 Ibid.
72 Ibid.
73 Ibid.
74 The MCCA Submission to Board of Taxation on the Review of the Taxation Treatment of Islamic Finance, [15/03/2017] http://taxboard.gov.au/files/2015/07/MCCA.pdf, 4.
75 Superannuation, or super, is Australia’s compulsory long-term savings plan that enables participants to save money for retirement period. Superannuation operating standards are in the *Superannuation Industry (Supervision) Regulation 1994*. Trustees of registrable superannuation entities (RSEs) must hold a Registrable Superannuation Entity License (RSE license) issued by Australian Prudential Regulation Authority (APRA). See Sheelagh McCracken, Joanna Bird, John Stumbles, and Gred Tolhurst, *Everett and McCracken’s Banking and Financial Institutions Law, 8th edition* (Thomson Reuters, 2013) 91-96.
76 Crescent Investments Australasia: Shariah Compliant Wealth Management. The paper was submitted on Discussion paper on the review of the taxation treatment of Islamic finance, banking and insurance products released 13 October 2010 [25/12/2016] http://taxboard.gov.au/files/2015/07/Crescent_Investments_Australasia.pdf.
77 Crescent Wealth, ‘Our Story – Crescent Wealth’ [25/12/2017] http://www.crescentwealth.com.au/about-us/our-story-about-us/.

has also opened a new office in Kuala Lumpur, Malaysia to build its network across South East Asia and the Middle East.[78] In 2014, the firm has 1920 members.[79]

In Australia, superannuation is a privately managed occupational pension system, which provides a channel (both mandatory and voluntarily) for long-term savings and investment for retirement.[80] It is part of the national economic strategy for funding the retirement where almost 90 per cent of all employees, including both full time and part time are covered in this privately funded pension system.[81] A percentage of employee's earnings are deducted for investment into this fund.[82] Australia has become one of the world's largest pension market. Superannuation is a major source for the growth of Australian Islamic wealth managers.[83]

Crescent Wealth also set out procedures for Sharia compliant investment. This firm developed Sharia screening on their funds, see paragraph 5.8 in Chapter 5. This was a jointly effort between the firm and Thomson Reuters and the Accounting Auditing Organization of Islamic Financial Institutions (AAOIFI).[84] Particularly, the firm states that if they invest in a company that earns between 0-5 per cent profit from any non-compliance income, the firm donates that income to charity. The firm has set up a foundation to manage *haram* income by

78 Crescent Wealth, 'Crescent Wealth Surpasses $100 Million Benchmark' [25/12/2017] http://www.crescentwealth.com.au/crescent-wealth-surpasses-100-million-benchmark/.

79 APRA, '2014 Superannaution Fund level Profiles and Financial performance' [25/12/2017] http://www.apra.gov.au/Super/Publications/Documents/1505-SFL-profiles-performance-2014.xls.

80 "Superannuation" is a British Commonwealth term used to describe saving for retirement within a legal framework of taxes and regulations intended to facilitate retirement financing. Meanwhile, in North America, the fund is called "pension plan", see G. Kingston, 'Superannuation: A Guide to the Field for Australian Economists' (2005) Working Paper, School of Economics, University of New South Wales.

81 Organisation for Economic-Cooperation and Development (OECD), 'Pensions at a Glance in 2007: Public Policies across OECD Countries' (OECD Paris, 2007).

82 The Superannuation Guarantee (Administration) Act 1992 (The Act) requires employers to make the SG (Superannuation Guarantee) contribution on (at least) a quarterly basis or these workers may incur an SG charge.

83 Talal Yassine, 'Roadmap To Building Islamic Wealth: The Australian Example' [25/12/2017] http://www.crescentwealth.com.au/roadmap-to-building-islamic-wealth/.

84 See, eg, Crescent Wealth, 'Our Investment Principles – Crescent Wealth' [25/12/2017] http://www.crescentwealth.com.au/islamic-super/our-islamic-compliance-principles/; and Thomson Reuters, 'Islamic Indices: Index Methodology' http://thomsonreuters.com/content/dam/openweb/documents/pdf/tr-com-financial/methodology/thomson-reuters-idealratings-islamic-indices-methodology.pdf, 3.

donating it to Australian registered charities. The firm also states that they would not invest in any company that earns above 5 per cent of their income from prohibited sources as defined by their above Sharia screening standards.[85] These Sharia requirements have been developed by their Sharia scholars.

Crescent Wealth also offers Sharia compliant superannuation, and investment schemes. The collected funds are then invested in various assets classes including Australia and international shares, property and infrastructure, and cash and fixed income. The structure in managing those funds is similar to other fund managers with some special characteristics related to Sharia compliance. The investors or clients hold units in a fund. These units are then pooled to purchase units in specific wholesale funds such as property funds listed in property and infrastructure securities. The Total Return Benchmark for these funds is the Reserve Bank of Australia Cash Rate plus 3 per cent. The firm expects to deliver a total return (income and capital growth) based on this benchmark.[86]

10.8.3 Islamic Cooperative Finance Australia Limited (ICFAL)

Islamic Co-operative Finance Australia Limited (ICFAL), located in New South Wales, was officially registered by the Registry of Co-operatives, Department of Fair Trading, the Government of the State of New South Wales, in May 1998 under the *Co-operatives Act 1992* (NSW) to function as co-operative within this State.[87]

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[85] Ibid.
[86] Ibid.
[87] ICFAL, 'Profile' [05/05/2017] http://www.icfal.com.au/about_us.html.

As a cooperative, ICFAL is different to common banking institutions. New members must be registered and pay a non-refundable amount. Members must purchase a minimum amount of shares within the cooperative. This amount is used to invest in the various businesses engaged in by the institution. The cooperative does not take out loans to fund their activities but instead use collected funds for specific purposes. These include the general membership fund, Hajj (pilgrimage), superannuation fund, and children's education fund. [88] When the new members become active members, they may be eligible to apply for finance from the co-op. The minimum period for eligibility is one year. New members are then required to deposit a percentage, i.e. 10 per cent of the expected financing. For instance, if the purchase price of a property is $ 1 million, the member is required to deposit $100.000 with the co-op before commencement of the mortgage.[89]

The above sections discussed Australian IFIs offering products and services to local markets. The Sharia legitimacy of these products is derived from their Sharia Supervisory Boards or other Sharia advisory agencies overseas. The operation of these institutions is based on existing Australian regulations. There are no Islamic banks, however, there exist co-operatives offering Islamic financial instruments, Sharia compliant fund managers, and superannuation funds.

10.9 Summary

In Australia institutions have developed their own Sharia justifications for products and services offered to the markets. Local regulators do not concern themselves with issues related

[88] ICFAL, 'FAQ' [25/12/2017] http://www.icfal.com.au/faq-2/.
[89] Ibid.

to Sharia compliance. The taxation office treats that the substance of Islamic products and services as being the same as interest-based products. The recognition of "substance over form" in some Islamic products such as *murabahah* financing would avoid double taxation for this product making it competitive with conventional interest-based loans. By allowing a regulation particularly in a secular jurisdiction to view Islamic instruments as no different economically with its conventional peers, the approach would be functional in the context where there is no specific regulation and no Sharia standardisation on Islamic financial products and services. This recognition is required as a prerequisite to ensuring equal tax treatment of Islamic finance transactions in Australia.

Most of the products and services offered by those institutions have adopted the most common Islamic products such as *murabahah*-based financing to suit local market expectations. This product reflects the legalistic approach of Islamic finance in facing modern financial transactions as discussed in Chapter 2 of this thesis. The next chapter is the conclusion for the thesis.

CHAPTER 11: CONCLUSION

11.1 Overview

The central theme of the thesis is the driving force of *fatwa* and the capacity of Sharia law to mould and adapt modern financial instruments and the operation of modern Islamic financial institutions. Sharia provides the basis for innovation and change in Islam and Islamic finance. It is not predicated on static views unrelated to the needs of society and business. The practice of *fatwa* shopping reflects this legal pluralism with different views enriching opportunities for diversity and change. The thesis demonstrates the importance of *fatwa* shopping as a means of establishing coherent Islamic finance law and creating a legitimate method for structuring modern Islamic finance.

Islamic finance, as part of the global financial industry, is subject to national and international banking and financial regulation with some adaptation for unique Islamic characteristics. Islamic finance relies on *fatwas* of their Sharia Advisory Boards. These *fatwas* play a central role in developing products and services to offer in the market place. For example, in designing the *halal* certification for financial instruments, modern Muslim scholars consider not only normative aspects of contractual elements of those instruments, but also the importance of risk management. This demonstrates that contrary to popular Western perceptions, *fatwas* can be a dynamic modernising force for adapting Islamic law to changing modern conditions. This thesis has used selective Sharia rules, various medieval juristic rules particularly from the Sunni tradition to show how they have been used as a force to modernise Islamic Law.

Giving effect to this approach through selective Sharia opinions and *fatwa* shopping does not jeopardise the legitimacy of Islamic finance nor undermine confidence in the financial industry and its financial products. Chapter 2 argues that selective Sharia opinions (*fatwa* shopping) reflect a continuation of the classical method, *talfiq* (amalgamation). Doctrinal selections are made by a Muslim jurist toward a particular interpretation that best fits the circumstances, regardless of whether or not this interpretation is from the scholar's own legal school (*madhab*). The application of this approach finds expression in the views of Muslim scholars or Sharia Supervisory Boards (SSBs) in IFIs who review and select various Islamic juristic rulings from different schools to certify modern Islamic financial products and services. It also operates where IFIs review and select *fatwas* to legitimise their financial products and service proposals. This approach is used as a basis for adapting medieval Islamic commercial contracts which have significant problems in terms of feasibility and practicality in modern banking transactions. This approach takes a middle path between strict literal interpretation and practicality allowing for the development of Islamic financial instruments that obey Islamic juristic rulings but also take into account economic and modern financial considerations. The use of this mechanism allows Islamic finance to be sustainable, meet the needs of a modern financial industry and manage financial risk and prevent market failure. This thesis argues that the underlying proposition for accommodating various juristic rules in a particular product is based on the public interest safeguarding financial institutions, its depositors and the community.

11.2 Sharia and Legal Pluralism

The thesis argues that the development of modern Islamic financial institutions and financial products cannot be separated from a pluralist approach which recognises the diversity of opinions and the need for legitimacy and practicality in modern Islamic finance. Crucial to this process of modernisation is the proper appreciation of the impact and importance of selective Sharia opinions or *fatwa* shopping (Chapter 2). This method involves combining Islamic juristic rulings in the form of *fatwas*. The thesis argues that this methodology is a legitimate method of developing medieval Islamic contractual arrangements to meet the needs of a modern financial industry. It regards this process as inevitable. Different juristic rules are viewed as a rich resource rather than posing difficulties. Using this approach, medieval Islamic contracts are utilised on a functional basis and as a means of exploring modern functional equivalents. These approaches have enabled Islamic finance law to adopt a more comprehensive framework for conceptualising modern financial transactions. A broader interpretation of selected Sharia rules in the form of *fatwas* recognises the financial and economic realities of diverse circumstances, where Islamic financial institutions (IFIs) operate. Modern Islamic financial transactions are a paradigm illustration of the dynamism of Islamic law. These transactions reflect the plurality of juristic opinions that have been part and parcel of Muslim legal traditions for centuries. The modernisation of Islamic financial transactions has had to deal with contrasting ideas as part of a dynamic process. Whilst a range of sources may be used in structuring modern financial instruments the position of modern financial transactions represents a distinctive understanding and application of traditional Islamic contracts.

It is also pivotal to the discussion of modern Islamic finance to consider the role of Sharia Supervisory Boards (SSBs). SSBs are fundamental to the modern Islamic financial interpretation. The capacity of the SSBs to interpret authoritatively governs how various Sharia opinions derived from various classical sources are understood. This capacity is important to access various Sharia opinions both from contemporary and classical scholars and to interpret these sources for modern application. Moreover, SSBs represent a unique and normatively different basis for developing regulations for IFIs. The *fatwas* of SSBs define the character of Islamic finance within an Islamic financial system.

11.3 *Fatwa* Shopping and Sharia Standardisation

It is frequently said that *fatwa* shopping works against Sharia harmonisation in the market place. But as this thesis shows, *fatwa* shopping plays an important role in developing Sharia standards in the Islamic finance industry,[90] and in the standardisation of Sharia in some jurisdictions. In Malaysia, the Sharia Advisory Council (SAC) of the Bank Negara Malaysia employed *talfiq* (described as *fatwa* shopping in a modern form in this thesis) in deriving a final resolution for Islamic products.[91] The General Council for Islamic Banks and Financial Institutions (CIBAFI) found there is a consensus in 90% of *fatwas* in the fields of Islamic finance.[92] The International Sharia Research Academy for Islamic Finance (ISRA) based in Malaysia found that *fatwas* relating to Islamic financial products and services in Malaysia and the Gulf Cooperation Countries (GCC) have more similarities than differences and that a clear difference is only evident in relation to certain Islamic principles.[93]

The law governing Islamic finance should adopt a pluralistic methodology where different Sharia opinions from the same or different Islamic schools (*madhahib*) are seen as a rich resource for developing Islamic financial instruments. The abundance of various Sharia opinions prompted the practice of selecting the most favourable *fatwas* mirroring modern financial transactions. The classical debates in Sunni traditions also tend to signal that there is

[90] Standardisation can be defined as setting up global Sharia standards by codifying the principles and precepts of Islamic commercial law, see Wafica Ali Ghoul, "The Standardization Debate in Islamic Finance: A Case Study" (2011) A Paper presented at the 8th International Conference on Islamic Economics and Finance, Doha 18 December, 2.
[91] Mohd Hafiz Jamaludin and Ahmad Hidayat Buang, "An Analysis of the Views of the Supporters and Opponents in the Usage of Talfiq in Islamic Law" (2017) 25(3) *Jurnal Syariah* 363-394.
[92] Wafik Grais and Matteo Pellegrini, 'Corporate Governance and Shariah Compliance in Institutions offering Islamic Financial Services' (2006) 4045 World Bank Policy Research Paper.
[93] Mohamad Akram Laldin, Mohamed Fairooz Abdul Khir, and Nusaibah Mohd Parid, "Fatwas in Islamic Banking: A Comparative Study Between Malaysia and Gulf Cooperation Council (GCC) Countries" (2012) ISRA Research Paper No. 31.

no obligation to follow a single restrictive *fatwa.* This leaves individuals free to seek guidance from various *fatwa*s from different schools (*madhahib*). It is argued that *fatwa* shopping is as an unavoidable reflection of legal pluralism allowing the search for a Sharia opinion that will satisfy the unique requirements of the individual.

Various juristic views within Sunni legal traditions have permitted product innovation and development necessary for modern financial transactions and the need for risk management and financial efficiency. It has allowed Islamic banking to increase its share in the global financial markets (see paragraph 1.2 of Chapter 1). Conversely, rigid Sharia harmonisation may limit innovation in the industry. Thus, divergence of opinions can be good for business in the sense that it allows financial institutions to introduce various products directed to specific consumers or markets.

11.4 Managing Risk in Islamic Finance Law

The mainstream theory of Islamic finance is the risk sharing principle, discussed in chapter 2. The dominance of the risk sharing theory is challenged by modern Islamic financial products. Through a legalistic approach, various conventional financial vehicles can be justified as alternative versions of Islamic instruments with similar economic outcomes. Conventional financial risk management typically involves risk transfer and risk shifting. For example, the creation of Sharia compliant derivative-like features also establishes the creation of risk transfer methods in Islamic finance. One of the most important risk shifting vehicles is the limited liability corporation. In practice, IFIs rely on the concept of the limited liability corporation as the most important risk shifting vehicle in a modern economy. But it is to be noted that at the time of writing, there is no single *fatwa* prohibiting the limited liability corporation. The explanation may be that a modern economy and financial institutions cannot exist without limited liability corporations. Were it otherwise IFIs effectively could not operate or participate in a modern financial industry.

11.5 Sharia law and Modern Hedging Instruments

Currently, modern Islamic finance lacks financial instruments which hedge and manage financial risks. Islamic financial institutions can only flourish and grow if appropriate financial debt and risk management instruments can be developed. Chapters 4 (hedging and derivatives), 5 (Derivatives in Islamic Law), 6 (Legal Frameworks for Sharia Compliant Hedging Derivatives), 7 (*Takaful* Insurance), and 8 (Liability of Investors in Islamic Law) examine the various methods for managing risks within a modern financial system. The thesis argues that Sharia law can accommodate the range of financial instruments developed to manage financial risks in the global financial industry. It does so by recognising that Sharia law is pluralist in nature and allows a diversity of approaches to determining Sharia compliance. The thesis argues that the modern development of Islamic financial law can be achieved through the modern approach to deriving Sharia law which draws on multiple schools of Sunni thought using a process of selecting, reviewing, and combining Islamic juristic rulings.

One of the most important financial risk management tools are derivatives. These instruments are pivotal to managing and hedging risks that may jeopardise the business position of financial institutions including IFIs. The basic features of derivatives such as options, forwards, futures, and swaps respectively deliver economic benefits by mitigating risks from unknown future events. The key distinctions of importance in chapter 4 are between options, forwards, futures, and swaps. These distinctions are important in assessing those conventional derivatives from the point of view of *Sharia* compliance.

As derivatives deliver economic benefits to the economy, it is important to have these types of contracts in modern Islamic finance. Despite disagreements by Muslim scholars particularly whether derivatives are prohibited, because of *gharar* or uncertainty (see paragraph 5.3 of Chapter 5), the development of processes to derive modern *fatwa* on Islamic finance provides the basis for arguing that there are Sharia compliant equivalents. This is examined in Chapter 5. This chapter argues that common objections on derivatives instruments do not have a strong foundation in Islamic law. Islamic juristic rules can be used to develop Islamic hedging through derivatives-like instruments. The modern method of selective Sharia opinions is able to correct inefficiencies or inequitable IFIs practices and embed modern risk management. Chapter 5 argues that certain Islamic juristic rules may be adapted to accommodate derivative-like features in Islamic finance.

Sharia compliant hedging derivatives are a type of hedging following the requirements of Islamic law. The principal prohibitions against speculation, are avoided by ensuring that Sharia compliant hedging derivatives contracts are derived from Islamic contracts and that the underlying values are Sharia compliant. In addition, the economic activities of assets or values used for Sharia compliant derivatives must be Islamically permissible (*halal*). Thus, these assets are evaluated in qualitative and quantitative screenings developed by Sharia Supervisory Boards of respective IFIs. Sharia compliant derivatives can be used for risk management purposes and limit the use of speculation and gambling in its transactions. The development of Sharia compliant hedging derivatives allows Islamic banks and IFIs to engage in global finance.

Chapter 5 also takes the position that there are Sharia compliant derivatives including Islamic profit rate swaps. These contracts perform similar economic functions of interest rate swaps as the basic form of swaps in conventional derivatives that have been widely practiced in derivatives markets. These Sharia derivatives have been developed based on the juristic rules of Islamic contracts namely *murabahah* (cost plus profits sale), *tawarruq* (reverse *murabahah*), and *wa'ad* (promise). However, to be accepted in global derivatives regulation, these Sharia compliant derivatives need to mirror global derivatives standardisation benchmarks. This is discussed in Chapter 6.

Chapter 6 continues the theme of how Islamic financial products can be adapted to manage risks arising in the Islamic finance industry. It is argued that it is imperative to develop a standardised rule for Islamic derivatives. The introduction of the ISDA/IIFM *Tahawwut* Master Agreement provides standardization, as well as opening the door to largely untapped markets and opportunities for developing Sharia compliant derivatives. Chapter 6 argues that Islamic profit rate swaps need to be regulated in a fashion consistent with global risk regulatory schemes. In relation to Islamic profit rate swaps, the global benchmark of OTC derivatives trading mechanism, the ISDA Master Agreement should be applied. Although there are still some difficulties with the Sharia aspects of the Islamic master agreement (ISDA/IIFM *Tahawwut* Master Agreement), it provides a stepping stone towards modern Sharia compliant derivatives transactions.

It may take some time until Islamic banks are able to integrate the *Tahawwut* into their own agreements and structures, the global standardization frameworks of the ISDA Master Agreement (as the main ingredients of the *Tahawwut* framework) will provide banks with incentives to make the transition. However, there are some continuing issues. These relate to close out netting mechanism for non-concluded transactions, whether the use of market quotations and loss method reduces the ability of the *Tahawwut* to mitigate counterparty risks in the event of market distress. The most important deficit is the lack of netting system in the insolvency laws of Muslim jurisdictions. Until these difficulties are resolved, Islamic hedging (particularly derivatives) will struggle to exist in the global financial industry.

Another important method of managing risk is insurance. This is examined in Chapter 7. Islamic insurance, *Takaful*, is relatively modern. Despite the continuing debates on avoiding speculation and uncertainty, there is now acceptance of the general principles of insurance subject to varying qualifications in different jurisdictions. The difficulties have involved the issue whether *Takaful* must be based on a co-operative or mutual model where risk is shared or whether conventional style insurance involving risk transfer is permissible. Other difficulties have involved the issue of whether there can be a contract of insurance involving payment of premiums or a mere donation (*tabaruu*) and not a contractual arrangement. Further complications are encountered when insurance is offered through a joint stock company which provide challenges to the co-operative nature of insurance. Chapter 7 takes the view that insurance is a necessary part of any modern financial industry and Sharia rules must take into account practical considerations which include competitiveness, shareholder investment and risk management. Islamic insurance is imperative since modern Islamic financial markets cannot be separated from the insurance system. Furthermore, this formal *takaful*-based insurance complements traditional social security schemes that have flourished in Muslim traditions. Consistently with the themes of this thesis, the various models of *takaful*-based insurance reflect the modern processes of formulating Sharia rules for a modern financial industry.

Chapter 8 discussed another pivotal risk management vehicle, namely the limited liability corporation. Islamic financial institutions (IFIs) are corporations. Traditionally, medieval Islamic juristic rules did not recognise that an ‘artificial person’ could have legal status. But as chapter 8 indicates an examination Islamic juristic rules provides a foundation for not only recognising unlimited liability, but also limited liability. The former is derived from the concepts of *musharakah* and *mudharabah*, while the latter derived from the extension of the concept of *dhimmah* to a juristic person under modern interpretations of Sharia rules.

11.6 Indonesian and Australian approaches

Indonesia and Australia provide a useful contrast between a centralised system governing Islamic finance such as in Indonesia and the Australian system which has no special provision for IFIs. Chapter 10 argues that in Indonesia, the legitimacy of local Islamic financial products and services have been derived from non-state agencies known as the Sharia Advisory Boards – Indonesian Ulama Council (DSN-MUI) rather than through state agencies and courts. DSN-MUI set their own juristic rules and perform the role of harmonising of Sharia opinions in the Indonesian financial industry. Islamic juristic rulings of the DSN-MUI are consistent with the global trend of financial *fatwas* allowing the adoption of various juristic rules in defining Indonesian Islamic financial forms. Although Indonesia is a Muslim majority country which follows the Shafi'i school, the reliance of this particular school has been absent in Islamic finance; juristic rules from the other three Islamic legal schools (Hanafi, Maliki, and Hanbali) have been dominant in following a selective Sharia rule method.

The position of the very few Islamic Financial Institutions (IFIs) in Australia is very different. Chapter 10 indicates that Australian IFIs practice decentralized Sharia regulation. Local IFIs develop their own Sharia justifications for products and services offered to the markets. Australian regulators are not concerned with Sharia compliance aspects of Australian IFIs. Some adaptation has occurred in relation to taxation. For the purpose of applying taxation law, the taxation office examines the substance of local Islamic products and services with profit as being the same as interest-based products. The recognition of "substance over form" in relation to some Islamic products such as *murabahah*-credit facilities avoids double taxation for this product making it competitive with conventional interest-based loans. This functional approach is effective where there is no specific regulation and no Sharia standardisation on Islamic financial products and services. Most products and services offered by Australian IFIs use the most common Islamic products such as *murabahah*-based financing.

Islamic finance in Australia is subject to the local legal system. Islamic financial contracts are governed by Australian law with Islamic law relevant only to the structure of the transactions. The Australian legal system has not introduced different legal rules for Islamic financial transactions. The current Australian legal framework already facilitates Islamic financial transactions, especially retail products offered either by cooperative or fund managers, but within the existing framework of its private law. The effect is that Islamic finance can co-exist in a jurisdiction where there is no special provision for Sharia compliant products. But Islamic finance is disadvantaged when it comes to taxation. This has precluded the introduction of fully-pledged Islamic retail banking products in Australia. Sensitivity to legal diversity could be the gateway to success in this country. For example, legislative amendments to Australian tax law would enable the Islamic retail banking market to evolve in Australia. Although discussions on this subject were initiated almost a decade ago, the Australian Government has not yet been willing to facilitate such legislative amendments.

11.7 Conclusion

In summary, Sharia standardisation is not confined to a single interpretation of a particular legal school (*madhab*), but accommodates different views thus providing a plausible method of achieving modernisation of Islamic Law and finance. This method can be applied to particular Islamic banking products by allowing Sharia scholars in particular Islamic banks to adopt different Islamic juristic rulings in developing modern Islamic financial products and services.

Contemporary Islamic finance law reflects juristic pluralism in modern banking and the finance industry. This law is governed by the spirit of pre-modern contracts and arrangements and by the economic considerations of balancing risk and expected return.[94] Banking and commercial laws are primarily tax driven and as such Islamic banking may lose out on the tax benefits available to conventional banking practice if Islamic finance law does not consider modern approaches in structuring financial contracts.[95] In order to be viable, Sharia compliant instruments must be competitive in the financial market. If they are not Islamic banking will be limited to standard retail banking and play no role in the developing and financing of large infrastructure. Islamic products need to meet modern financial needs without losing the spirit of Sharia.

94 Compared to Kilian Balz, 'Islamic Law as the Governing law under the Rome Convention: Universalist Lex Mercantoria vs. the Regional Unification of Law' (2001) 8(1) *Yearbook of Islamic and Middle Eastern Law Online* 73-85.

95 Razeen Sappideen, 'Islamic Banking in Australia: The Need for Meaningful Pluralism', a paper presented in Sharia and Legal Pluralism in Western Sydney University, 7th July 2010.

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