

# **Maqasid al Shari'ah in the Prohibition of Riba and their Implications for Modern Islamic Finance**

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## Introduction

Islamic finance was revived at institutional level with the establishment of Islamic banks during the last quarter of the 20<sup>th</sup> century. Along with the new institutions of Islamic banks, Islamic insurance companies and other Islamic finance companies came about new “financing” practices of a few classical contracts that, inter alia, include Murabahah to the purchase orderer, Istisna' backed by a parallel Istisna' and financial lease. These and similar new practices of ancient contracts raised intensive discussions about the Shari'ah validity of the addition of conditions to, and/or the combination of contracts for the sole purpose of transforming them into tools of financing. The dust of these discussions has not been settled yet and the raised red flags have not been lowered when, at the end of the century, a new stream of Fatawa came about Tawarruq, Sukuk and paid-for guarantee [al Kafalah bi Ajr] that introduced new dimensions in the Twenty First Century Islamic finance that were considered absolute taboo; these new dimensions include the provision of cash/personal financing to individuals and corporations and the hedging in future commodities and currencies. A closer look at these new Fatawa indicates that there is an exerted effort to deal with or mitigate the risks of Islamic financing and to make it match the interest-based finance.

This paper aims at re-visiting, from the angle of modern finance, the objectives of Shari'ah in regard to the prohibition of Riba and examining the consistency of such Fatawa with these objectives and whether there are any Shari'ah-intrinsic alternatives that satisfy the same finance purposes which such Fatawa thought to achieve.

The paper consists of two sections. In Section One I will discuss the objectives of the prohibition of Riba. I will further argue that there are certain “risks of Islamic financial contracts” that are an immediate outcome of the nature of the Islamic finance contracts. Carrying these risks by the finance provider is intended by the prohibition of Riba. I will therefore study the General characteristics of the financial contracts that are “named” in the classical Shari'ah literature, the rationale of the prohibition of Riba and attempt to re-derive the objectives or “the Maqasid” of this prohibition. Section Two will discuss the implications of the Maqasid of the prohibition of Riba and delineate the

methodological principles of creating new financial products while preserving the objectives of the prohibition. It will discuss the nature of Islamic financial intermediation, especially in its institutional form that was not known in the classical Fiqh literature. Finally, it will offer a few examples of Maqasid-friendly modalities of reducing the risk of financing and will attempt to show that all the purposes used to justify some of the controversial Fatawa can be achieved by such modalities without taking the risk of Maqasid violation or losing some of the basic characteristics of which Islamic finance stand proud as compared to conventional interest-based finance.

## **Section One**

### **The Objectives of the Prohibition of Riba**

Intrinsically and by its own nature, Riba-based financing is **purely personal** as it solely depends on the integrity (interpreted as ability to pay back) of the borrower and obtained collaterals. This also implies that Riba-based financing is **not target-oriented** or is detached from the objective for which financed means are going to be used. Detachment from the use of funds leads in turn to another problem that arises from the fact that personal financing can be put to any kind of usage **regardless of ethical or moral values**. In other words, Riba-based financing does not provide for a say about the moral criteria or ethical screening of the finance. It is also **assumptive** as it attributes a growth to debts while debts are a kind of asset that is not able to grow because of its abstract nature. The assumptive nature of Riba-based financing applies not only to assuming an increment but also to assuming a rate of increment that is attributed to the non-able to grow asset. Finally, Riba-based financing allows for the creation of multiple layers of pure financing on a small base of real market. This means, because of its nature that permits attributing increment to a non-growing asset, it goes even farther from reality to permits pure debts exchanges and transactions so that the **size or amount of financing in any society exceeds by many folds the size of real market transactions**. Of course, one may argue that some of these problems can be tackled by additional means, regulations and laws but this is incorrect as any regulations that violates the nature of a transaction are bound to die out because of the market pressure. Additionally, no regulations can cover all potential outcomes of the market forces once you found the market on unrealistic assumptions. We will approach this section through three headings: the Prohibition of Riba, Shari'ah-friendly financing contracts and their characteristics and finally deriving the objectives of the prohibition of Riba.

#### **a) The Prohibition of Riba (interest)**

Islam, like other monotheistic religions, condemns and prohibits Riba. The prohibition of Riba in Islam is given in strong and clear-cut terms. The Qur'an Says "But God has permitted the sale and forbidden the Riba;" (2: 275) and, "God destroys/eliminates the Riba;" (2: 276) and, "O ye who believe, fear God and quit what remains of the Riba if ye are indeed believers; but if ye do it not, take notice of war from God and His Messenger" (278-9). No other sin is prohibited in the Qur'an with a notice of war from God and His Messenger!

The Traditions of the Prophet Muhammad contains several statements that condemn Riba and consider its practices as one of the gravest sins that

invoke a curse or wrath from God. In one of the Sayings, the Prophet mentions that: “The Wrath of God is on the taker of Riba, its giver, its writer and its two witnesses.

### **Definitions of Riba and interest**

Riba is an Arabic word that means increment/increase. But the Qur’an did not mean any increment as it refers to an increment in a specific transaction, “the” Riba that was common and known among the Arabs and other nations at the time of revelation. This is why the reference in the Qur’an came to “the” Riba. This transaction was done in either of two ways: 1) deferment of an already existing and due debt to a new maturity provided the amount of debt is increased; and, 2) giving a loan that is due with an increment after a given period of time. The Qur’an itself implies this definition as it states: “But if ye repent ye shall have your principal, doing no injustice (against others) and no injustice is done against you” (2: 279). This part of Verse 2: 279 has two important indications: 1) it defines Riba as any increment above the principal of a debt or a loan; and 2) it describes such an increment as unjust. The exclusion of profit, being an increment in sale, is given by Verse 2:275 “But God made sale permissible.”

To be exact, **Riba is defined**, in regard to financial transactions,<sup>1</sup> **as any contractual increment in a loan or debt due to the time element.**

**This is exactly what we know today as interest.** Both legally and financially, interest is defined as an increment paid by the debtor to the creditor for granting a loan or for extending the maturity of an existing debt. Obviously, the Shari’ah does not recognize a counterpart for this increment. Consequently, once a debt is created (notice that a loan creates a debt) any increment above the principal of the debt is Interest and it is the “Prohibited Riba” according to the terminology of the Qur’an.

To understand why interest is prohibited we need to revisit the basic concept of debts. What is a debt? A debt is an inter-personal relation that is a liability on one party and an abstract asset to the other. By its nature and in real life a debt is not liable to increase or decrease; it is not able to produce increments because it has no intrinsic utility other than being an ingredient of wealth. In other words, debt can’t have different values at different times and places unless we create additions in the form of assumptions; that is by creating a debt market and valuating or assessing debts in relation to time. Additionally the amount of an increment in a debt is also assumptive; it depends on the conditions and externalities in the imaginary market that we create for debts. Of course, this may sound astonishing to many of us who are accustomed to talking and hearing about debts’ markets and interest all through their lives! Are debts, in fact, able to increase or decrease or to produce increments? And how can this

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<sup>1</sup> We exclude from this definition Riba al Buyu' because of its irrelevance to financing as the time element is not necessarily an ingredient of it.

take place except in our imagination that we illusion to be true and real? Of course once a market is created for any thing, be it a thin air, there will be a demand and supply for it on speculative grounds, exactly as people exchange indices, in a fantasy-created pure speculation-based index market, although indices are neither real assets nor goods or services! We must remember that the Shari'ah recognizes real things and real growth whether by the nature of a real asset or by the effect of market forces on real assets, goods, or services.

Additionally, all real things/assets that may grow may also loose substance and/or value and the owners of such things/assets are exposed to losses exactly by virtue of the same argument that justifies their entitlement to increments. But a debt, among all assets, is not liable to decrease and does not expose its owner to such kind of losses; brush aside the issue of default because every debt can be secured by all kinds of guarantees and collaterals and because the nature of default risk is different from the risk of increase and/or decrease that result from natural factors or from the interaction of market forces. A default risk is fault in the debt itself; it is of the kind of a faulty product or a product that does not maintain its normal characteristics; a defaulted debt is like delivering rotten apple in a sale contract that is very different from the price risk that affects the owner of the apple. This is why the default risk is compensated by a risk premium over and above interest that is "the price of money.

It may be argued that a debt giver has made a sacrifice and she deserves compensation without which she would have not made such a sacrifice. While the idea of a sacrifice is a legitimate one, the basic principles of private ownership prevent allowing any part of the increment of the debtor's property to be deserved by any other person since any growth that may take place in the debtor's property can only be deserved by the owner of a property. In other words, since the property of the lender has been transformed to become an abstract asset that is not able to create increments by its own nature (a debt) it is inconsistent with the implications of the principle of private ownership for a lender to claim any part of the property of the debtor.<sup>2</sup> Additionally, there are no measuring tools or criteria to estimate the contribution of a loan to increments especially that an asset is also exposed to decline by the same virtue it may develop increments. Consequently, a personal loan must remain personal and deserves thanks, gratitude and appreciation from the borrower and may be a reward from God too but it is not a contributor to value creation, PERIOD.

## **b) Alternative financing contracts and their characteristics**

Notwithstanding the several attempts to encode the Shari'ah, the fact is

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<sup>2</sup> This is in contrast to giving the same sum on the basis venture capital by a sleeping partner. In this case the owner remains an owner of the asset that is in the hand of the active partner, even after the original capital is transformed into intermediate goods and/or final goods, and consequently she deserves increments that may take place her property.

that its bulk remains not coded in the form of articles of law but its rulings are found in the writings of Shari'ah specialists through the centuries as Islam does not establish a religious hierarchy with a law-giving authority. We will study the Shari'ah alternative financing contracts in an attempt to understand their essential characteristics and find out more about the Islamic financing principles and rationale of the prohibition of interest. It has become known over the last four decades of theorization and practice that the Shari'ah financing contracts are of three major kinds: Sharing-based, sale based and lease based.

On the other hand, from a historical point of view Islamic financing products can be classified in two categories: 1) classical contracts that existed throughout centuries and are derived from the practice of the Prophet's community in Madinah; and 2) hybrid contracts that are developed over the past half a century and are practiced in contemporary Islamic finance and banking.

### **Classical Financing Contracts**

Classical writings on Shari'ah, some of which date back to twelve centuries ago mentioned three essential sharing-based financing contracts, namely, equity sharing (Musharakah), equity sharing with a sleeping partner (Mudarabah) and crop-sharing (Muzara'ah). They also mentioned three sale-based financing contracts: deferred payment sale (al bay' al 'ajil), forward sale with cash advance (Salam) and manufacturing financing sale ('Istisna'). Lastly, classical writings also mentioned leasing (Ijarah) as a form of financial contracting.

Although this paper does not intend to go through the by-now well known descriptions and conditions of each of these contracts, one stop is necessary at the deferred payment sale at a higher-than-the-cash price because it gives a demarcation of interest vis-à-vis financing sale.

The permissibility of deferred payment financing sale is mentioned in no less than the Qur'an itself. Verse 2: 275 begins: ". . . They [Riba takers] say: 'Sale is just like Riba,' but God has permitted sale and forbidden Riba."

Claiming that cash sale is just like interest lending is logically incorrect and exposes the claimant to be ridiculed and accused of foolishness, insanity or loss of rationale because cash sale is very remote from interest lending and has no similarity to it. What is, obviously, similar to interest lending is deferred payment sale at a price that is higher than the cash price. Here the similarity is obvious.<sup>3</sup> Interestingly, the Qur'an did not ridicule this claim or accused it of irrationality; this is in spite of the fact that in many instances/occasions the Qur'an invokes the rationality argument by statements such as: "will they not understand?" "so you

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<sup>3</sup> Some may argue that even cash sale is similar to interest lending from the point of view that profit is an increment like interest. This kind of similarity seems very simplistic because of two reasons: 1) sale may involve a loss too but lending does not; and 2) profit is commodity/market-based while interest is time-based. And I may add that those who argue for such a similarity do not deny that the permissibility in the verse refers to both cash sale and deferred-payment sale.

may understand,” “Do you not understand?” “in order that you may rationalize” all such phrases came in Chapter 2 itself; and “have you no rationale?” “if you have reason,” “don’t you reason,” “so that they may have mind to rationalize with!” and many like Verses throughout the entire Holy Book. This implicitly means that some similarity is acknowledged but yet the Qur’an quickly directs the attention to the permissibility of the sale that is similar to interest lending and the prohibition of the latter; as if it says; while certain similarity is acknowledged there are differences that warrant the permissibility of deferred payment sale-based financing and the prohibition of interest/lending-based financing. This is why the overwhelming majority of scholars argue that the permitted sale in this Verse, though general and applies to any kind of sale, refers, in specific, to deferred-payment [i.e., financing] sale. This is also supported by bringing in a Verse (2: 282) about debts confirmation and documentation immediately after the Verses that deal with the prohibition of interest and permissibility of deferred-payment sale financing (2: 275-281) because deferring the payment creates a debt that need to be documented.

The unavoidable immediate implication of the Verse 2: 275 is that debt-creating **financing is permissible and recognized in Shari’ah** while the verse condemns Interest-based lending and prohibits any increment on it. Thus rendering loan giving a non-profitable activity and shifting it from business arena to personal spheres; it approves a kind of sale that fulfills the same objectives including giving a reward for the time value of the sold commodity (rather than money lent). In other words, this Verse establishes a very important rule that: **Debt-creating financing is an acceptable and rewarding business activity at the same time that it prohibits Riba (interest)**. This plainly means that the creation of debts is not a thing that is discouraged or disliked in Shari’ah and avoidance of creating debts is not an objective of the prohibition of Riba.

The similarities between deferred-payment sale at a higher than the cash price and interest lending are apparent and include: 1) the purchaser gets the asset/goods at the time of the contract and pays later; 2) the amount she may end up paying is about the same in both transactions; 3) the seller gets compensated for the time span between the contract and the maturity of the debt; and, 4) a debt is created. But the dissimilarities are not so clear and the Verse did not elaborate on them.

### **Hybrid Islamic financing contracts and financial intermediation**

The industry of financial intermediation is new to the Islamic Shari’ah.<sup>4</sup> It has been developed in the Western countries over the past four centuries or so. Recognition of financial intermediation as an independent industry is vital to

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<sup>4</sup> Although one has to recognize that classical Shari’ah writings discussed the idea of “al Mudarib Yudarib” but the whole institutional setting and the idea of collecting savings from persons of excess savings and channeling them to persons of need for business and consumption activities was not known, especially that funds provision by intermediaries may take different methodologies that may not be Mudarabah-based.

understanding the hybrid financial contracts and those scholars and researchers who fail to recognize this industry still argue for preferences of sharing over other modes of financing instead of taking such preference to be decided by players on the basis of market circumstances and forces.

When a merchant sells at a deferred price or lease an asset she is providing financing to the purchaser or the lessee. But if a corporation specializes in getting the savings of those who have them and channeling them to businesses that need them for investment, that is a specialized industry of financial intermediation. In other words, financial intermediation is a specialty of those who recruit deposits and provide funding while merchants and producers provide commercial credit from their own resources while dealing with the daily decisions of a production line or buying and selling of goods and services.

The role of Islamic financial engineering over the last four decades has been to develop contracts that fit this new industry and its success/failure can be assessed on the basis of the extent to which new contracts maintain the main characteristics implied by the prohibition of Riba and preserve the objectives of this prohibition.

There are numerous Islamic financial products in the market and they are increasing by the day. New products are always developed through a process of combining existing contracts and arrangements. We have essentially **nine** main hybrid Islamic financing contracts practiced in Islamic banks today: Murabahah to the purchase orderer, installment sale, Mudarabah investment deposit, current account deposit, three-party Istisna', leasing to the purchase orderer, compound Salam, Buy Back and Tawarruq. Although assessing how close/far each of these contract to consistency with the objectives of the prohibition of interest is outside the limit of the present paper, it must be said that some of the applications of new hybrids amounts to pure interest-based rescheduling of debts and are consequently in violation of the basic objectives of the prohibition of Riba.

### **General characteristics of financial products in Shari'ah**

Islamic financial products are contracts that abide by the axioms and rulings of Shari'ah. The main principles that govern financial contracts in the Islamic law are two folds: 1) general principles of contracting that include civil aptitude, consent and legal permissibility. These are common between all legal systems and societies, although there are variations in their minute details. For instance while the Islamic law defines the civil aptitude for financial contracts as age 18 in addition to sanity, some states or countries carry the age limit to 21. 2) However the second group of principles is important. It covers a specific Islamic view point and includes: moral commitment / ethical foundation, Shari'ah permissibility, balance and realism or validity.

To be acceptable from a Shari'ah point of view, a finance product must be **morally sound**. This is a general human standard preached and adopted by the Shari'ah. It means that an Islamic financing institution can't use its resources to

support drugs, alcohol, gambling, porno industry, environmentally harmful products, and/or any other production or distribution of any material or service that does not have a humanly acceptable ethical foundation. In this regard, Islamic financing is very similar to what is known as ethical investment. Yet, the following points will show that Islamic financing is, in fact, more demanding than ethical investment.

The principle of **Shari'ah permissibility** refers to matters that the Islamic law requires. These include pork and other swine products and other meat whose animals are not slaughtered in a manner that satisfies the Shari'ah requirements. It also includes the prohibition of interest that will be discussed later.

The principle of **balance** requires that the obligations of each party be equivalent to the obligations of the other, so that there is no excessive load on either party. This principle rules out excessive overcharge and it stands against the charge of interest too. As we will discuss it later, interest is an obligation on one party against a presumed opportunity cost of the other. These obligations are obviously unbalanced!

Lastly, the principle of realism or validity means that all financing contracts must be **founded on real, in contrast to presumed or deemed**, transactions, exchanges or things and assets. This principle rules out any contract that is based on pure assumptions. Interest itself is one example, both in its very existence and in its rates, all are assumptive as we will discuss in more detail later. Another example is trading indices such as DJII or NASDAQ, because an index is a mere mental calculation that does not represent any real ownership. On the other hand, one can own and trade units in an indexed fund because the fund owns shares in companies that are represented in the index.

### **What is wrong with interest?**

I argue that understanding the differences between interest-loan-based financing and debt-creating sale financing is extremely essential to comprehend the objectives of the prohibition of Riba (interest) because these differences elucidate the crucial point of the distinction between seemingly similar transactions.

The basic difference between interest financing and Islamic financing is that interest financing is done in a loan contract hence it is based on a postulate that a debt may be assigned or may give entitlement to an increment while in reality a debt can't produce any increment. This is at the same time very much linked to, or you may call it the other facet of the property rights. Property rights give to the owner of an asset the entitlement to all and any increments that may happen in her asset and preclude any other person from any claim on increments that may happen in other persons' assets. In other words, a person whose asset does not produce any increment has no claim to an increment and consequently

can't and must not have any entitlement on increments that happens in other persons' assets.

This is the ideological foundation for the prohibition that is consistent with the characteristic of realism of our Shari'ah because in reality the lender's asset is a debt and a debt is abstract and, by its nature, can't create increments.

The implications of accepting the idea that a debt to have increment are:

- 1) It is a gross violation of the principles of private ownership that requires entitling an asset owner of all increments that may happen in her owned asset and that no entitlement may be assigned to any other person. Furthermore because it is based on mere a assumption, allowing any entitlement to increments to be assigned to any person other than the owner amounts to a gross disturbance in the property rights and gives room for other violations too.
- 2) You need another unrealistic assumption about the valuation of the increment (the rate of interest) that is to be assigned to an asset (a debt) that does not create increment.<sup>5</sup> This has been done by creating an artificial market for exchanging debts. This market is built in fact on pure speculation and purely speculative market forces, unlike markets of assets, goods and services; it is therefore very volatile by its nature;
- 3) Once you allow a debt to have an increment you will have to allow it to be rescheduled with increment and you will have to allow discounting with a reduction; both these two transactions do not create or add value in the economy; and,
- 4) You will have to allow other transactions on debts, pure, including exchanging them through inter-bank transactions and a whole set of pure financial or monetary transactions that do not essentially add value but only transfer wealth from one person to another. The Shari'ah takes a close look at these transactions and finds them done in isolation from real production and exchange; they do not affect inventories on the shelves or goods and services reaching consumers; they only enrich some individuals and impoverish others; they are like a zero-sum game; and finally
- 5) Withholding finance from activities other than those related to producing and/or exchanging goods and services helps channeling all finances in the economy to support activities that exclusively produce/exchange goods and services. This is not only economically wiser but it is also socially more just. In other words, preventing finance that is provided solely on the credit worthiness of the user of funds regardless of the purpose of their use creates a better social justice environment than personal financing.

### **c) The Objectives of the prohibition of Riba**

Accordingly, we can proceed to establish the objectives of Shari'ah from the prohibition of interest as follows:

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<sup>5</sup> This is in contrast with actual increase when you assign the increment to the owner of the asset that creates it.

- 1) Affirming the Shari'ah characteristic of realism and maintaining its internal consistency in not allowing any transaction that is not a real life activity. There are several forms of expressing the negative statement of this objective; one of these forms is preventing finance from activities that are not meant on their own or for what their nature defines or from activities that are used only as a vehicle to reach objectives other than what the nature of the contract implies. Another form is preventing return from being assigned to an asset that does not produce return. Yet another form is avoiding distributing any thing other than the real value added or value created in an asset.
- 2) Upholding the sanctity of property rights and respecting the consistency of entitlements with the rights of ownership.
- 3) Disallowing debts trade and exchange along with similarly unrealistic purely speculative transactions that are not based on real production or exchange such as creating unreal assets like index units properties because these activities do not create value and only transfer wealth between individuals.
- 4) Redirecting or re-channeling the human and other resources used in purely speculative, non-value-adding activities such as trading debts toward real production and exchange of goods and services.
- 5) Preventing debt discounting and rescheduling for increment because these are non-productive activities as they only transfer wealth from one person to another. The alternative that the Shari'ah provides for rescheduling is interestingly mentioned in the Qur'an within the same sequence of Verses that deals with the prohibition of Riba (interest) that is: giving time to pay or even forsaking the principal of the debt itself. On the other hand, the Shari'ah permits discounting for early payment provided it does not become a business practice (not in the contract and only between the two parties).
- 6) Preventing the use of business finances for what can be tagged as 'Abath عبث, i.e., activities that have no disclosed purpose or whose purpose is not desired to be disclosed because of the embarrassment it may cause as such activities are either non-productive or involves certain degree of shame or do not belong to business although they may be honorable or legitimate.
- 7) Sending personal finance to where it belongs as a personal service based on direct contact and involvement between the finance provider and user. Thus personal financing can be evaluated, judged and granted or not on the basis of the personal relations and bonds that exist between the user of funds and their provider. The answer to the question "who will give you a loan?" becomes "your mother or a person who very well knows and loves you" This does not mean that a personal loan is not useful; it rather means that it must remain personal and not changed into a business activity that aims at making money. As such, giving a loan is rewardable by God as known in the Shari'ah because it becomes an act of benevolence..

- 8) Re-channeling all business financing toward the production and exchange of goods and services or toward value creation and closing doors in the face of all the uses of finance that unnecessarily inflate the quantity/size of financing in a society relative to the real market of production and exchange.

Finally, it should be noted that the prohibition of Riba (interest) is never meant to be a prohibition or elimination of materially rewarding financing in general and of debt-creating financing in specific.

## **Section Two**

### **Implications of the Maqasid of the prohibition of Riba**

There are two important results that arise from the objectives “Maqasid” of the prohibition of Riba/interest: 1) A loan is a means of providing personal finance and it should remain “personal;” and, 2) any efforts that aim at creating new Islamic financial Hybrids should observe the Maqasid in the process of developing new contracts. In this section, I will study these implications and proceed to look into the nature and characteristics of Islamic financial intermediation and give a few examples of Shari’ah-friendly methodologies of risk mitigation.

#### **i) Main implications of the prohibition of interest**

##### **Loans and personal finance**

It is really enlightening that our traditional Fiqh text-books assign loans and lending to the category of charities and benevolence because when you talk about “personal” you need to have personal information, personal relation and personal touch, passion and care. These are the essence of benevolence and charity. This is why a loan is also due at any time because “there must be no charge on benevolence doers,” as the Qur’an [9: 91] hinted. In other words, it seems that the immediate implication of the prohibition of interest is to remove Lending activities from the business arena and send them to the charitable arena that usually consists of both individuals who have close ties and bondages to each other and non-profit organizations that act also on the basis of creating personal data base and relations as a loan is given to a person who has temporary “needs” that call for “relief” with temporary liquidity. Loans and personal financing are not considered, in our Shari’ah, as tools for mobilizing resources for investment, trade and business! Of course, this does not mean the prohibition of issuing loans to businesses but it means that lending to businesses

is an exception not a rule and whenever it is done, it should **abide by the rules of benevolence and charity** not re-formulated as a profit generating activity.

### **Observing the Maqasid**

I don't intend to go into the Usul controversial issue of priorities between Maqasid and direct or specific texts, but I want to argue that, from a financial-cum-economic point of view, the lack of full observance of the objectives of the prohibition of Riba may render a hybrid contract into a mere superficial cover up of what is prohibited and makes Islamic financing completely ineffective and inefficient in performing its essential characteristics. For instance, while financing commodity trade is absolutely permissible and is consistent with the Maqasid, the mere fulfillment of the conditions of owning/possessing is not a sufficient, although it is necessary, condition unless the objective (Maqsad) of helping/facilitating trade or exchange of goods and services is also observed. The criteria for this Maqsad is obviously the assurance that financed commodity/service actually reaches a user.<sup>6</sup> To put it in other words, providing finances for contracts that are meant for what they are in contrast to contracts used for what they are not.

If this kind of Maqasid observance is loosened, Islamic financing, as a unique financing methodology that is value-oriented and value-based, will lose its merits and substance because the moment you enter the arena of providing "personal finance" the financing methodology become incapable of fulfilling any moral and ethical standards and ceases to be real and value additive.

### **ii) Nature and characteristics of Islamic financial intermediation**

Financial intermediation is an industry that recruits savings from persons who have them but don't know how or don't like to directly invest them and distribute financing to persons who need funding but don't have sufficient resources. It came into existence with the practice of bankers that notice that not all depositors (essentially for safety and convenience purposes) withdraw their savings at once, the point that allows bankers to provide some of these savings to users of funds without risking be unable to pay deposits on demand. Financial intermediation in the West uses the loan as a basic contract for deposits and for financing. This is done mainly for historical reasons: 1) it is a desired contract by depositors as it guarantees their deposits, so why not use it also for financing so that the banker would also be guaranteed; and 2) it was permissible for a Jew to take interest from the gentiles and most early bankers were Jewish.

The initiation and rise of Islamic banking in the last few decades of the twentieth century disturbed a four century status quo! Islamic banks have been a

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<sup>6</sup> Avoiding of vain ('Abath) transactions can be achieved by defining the user of finance as either a business that uses it to help obtaining inputs (that may be assets, goods for sale or primary and intermediate goods for industry) for its business, or a final consumer

blowing evidence that financing doesn't have to take the form of lending or a loan contract. With Islamic banking, financing is now redefined as offering goods, services and means of investment for a delayed counterpart. Accordingly, Islamic financial intermediation is also redefined as recruiting resources from those who have surpluses, either as sleeping partners with the intermediary institution (Arbab al Mal 'Sing. Rabb al Mal') for depositors who want to use their savings for return generation or on loan basis from those who prefer guaranteeing their principals, and giving financing to those who need them on the basis of Murabahah, Ijarah and/or venture capital (Mudarabah investment).

Funds in Islamic financial intermediaries come from three sources that can be summed in two from the point of view of using them. **1) Shareholders funds** about which the management behavior is Wakalah-based; **1) demand deposit funds** that are given to the bank, not to the management, as guaranteed loans in the Thimmah of the bank and the management acts on behalf of the bank on Wakalah basis too since the funds become a property of the bank against "Inshighal its Thimmah" that is represented as Credit records in the bank accounts; and **3) investment funds** of Arbab al Amwal through Mudarabah contracts with the bank, not simply its management. The management of an Islamic financial intermediary, as an institution, plays with the depositors' money on the basis of Wakalah granted to the Bank and assigned by its decision making body to the management in regard to funds provided by investment depositors. The management also plays on the basis of Wakalah granted by the decision making body of the institution in regard to the institution's "own property." This "own property" term includes shareholders' equity plus demand deposits for which the institution's Thimmah is charged [Munshaghilah].

In other word, an Islamic financial intermediary institution is a wakalah-based entity. On the one hand, it is a Wakalah from shareholders to management, like any other company but with the exception that demand deposits are treated, from the point of view of investment decisions and profit/loss distribution on the same footing as if they were shareholders money; and on the other hand it is a Wakalah from investment deposits' owners to the institution itself that is in turn reassigned to the institution's management.

This concept of Wakalah implies an extra precaution on two grounds: the Wakil in Shari'ah has very limited power when it comes to Tabarru'ah (contributory) contracts. A point that requires specific permission from the property owner for giving Tabarru'at: and on the other hand, a wakil is required to be extra cautious in selecting investments and uses of funds. A point that may induce the Wakil to have a preference of more security over less of it and of less venturous uses of funds over risky alternatives. This may partially explain why Islamic bankers have been preferring Murabahah and Ijarah over Mudarabah, as a contractual vehicle, for their Uses of funds.

A step further may be taken on a theoretical basis that is to dare saying that Islamic bankers must, on pure Shari'ah ground, have a preference for Murabahah and Ijarah over Mudarabah because of the security and risk considerations.

We also question the wisdom of some traditional Islamic finance writings that have been calling on Islamic banks to use the Mudarabah contract on their asset side as if it is better, according to Shari'ah, to take more risk. Some times this theoretical preference is mixed up with the premise of "al Ghunmu bi al Ghurum" as if taking risk is what justifies deserving a return and therefore the more risk an Islamic bank takes the better Islamic it is!

In fact, the Shari'ah does not assign any moral value to risk taking, it does not have any reference to preferring more risk over less risk and it does not make risk the cause for earning a return.<sup>7</sup> The realism of our Shari'ah is manifested in the axiom that one has an entitlement to a return either by expending human hours or by owning an asset that actually and factually produces a return;<sup>8</sup> This means that return in financing is only justified by owning an asset that is not only characterized by having a potentiality to create an increment but also that actually, in contrast to presumably or supposedly, has produced an increment. This is factuality as it exists on the ground!

Before we attempt to distinguish Islamic banking, as a financial intermediary methodology, from direct financing we need to revisit the idea of mark up in Murabahah and see how it is built up within the Islamic perspective of financial intermediation. Dates of payment and delivery have an effect on prices of goods and services. This is a known fact in both Shari'ah studies and conventional studies. Accordingly, any commodity/service would have a spectrum of prices according to its date of payment and date of delivery. If we take, for simplicity, three of these prices, fix the date of delivery at a given point for the three of them and define them as: a) a price with payment before delivery; b) a price with payment at the time of delivery; and, c) a price with payment after the date of delivery, we will notice that, under the condition of "all other conditions or things are the same, price (a) is the lowest among them, then comes price (b) then the highest is price (c). This may partially be explained by time value of commodities and means of payment but more important is the fact of the acquisition and use of a commodity. When you use a commodity without having to pay for it at the time of acquisition you are deriving utility from it and you would be willing to pay more for that. By the same token, when you pay for it but defer the acquisition and use to a later date you would like to pay less for the commodity. This is why we find our classical Fuqaha calling the Salam sale as a sale of the Mahawij (the needy ones) or sale of Mustarkhisin (cheap price seekers). Once we establish that a commodity has such differences in prices because of the dates of payment and delivery we can explain that a mark up in

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<sup>7</sup> In fact, if risk taking justifies return the Kafalah, which is a case of extreme risk taking, must be most rewarding in terms of return. But it is known, in Shari'ah as declared by the OIC Islamic Fiqh Academy's resolutions that a reward on Kafalah is more prohibited than Riba because it amounts to an increment on a promise to give a loan while Riba is an increment on an actually given loan.

<sup>8</sup> What is added by some scholars that entitlement to a return can also be caused by "guarantee" refers to a special kind of a Guarantee that is a guarantee of principal as in Sharikat al Wujuh or of man hours as in the case of Taqabbul in Sharikat al Sana'i'; accordingly this kind of guarantee boils down to labor or principal!

Murabahah is neither derived from the interest concept nor it is based essentially on the time preference for money (although time preference of money is not inconsistent with it and we have no reason to argue against it)<sup>9</sup>. Rather the mark up is essentially derived from the time structure of commodity prices.

Merchants usually provide commercial credit directly to their customers as is known and practiced especially in trades between wholesalers and retailers; they use their own equity resources and very often depend on credit facilities from banks, especially by discounting commercial papers and promissory notes. On the other hand, Islamic banks undertake providing finance to individuals and businesses using the resources that consists mostly of depositors' funds. Their kind of financing is thus based essentially on financial intermediation. They do not need to open stores and show rooms to justify their earning of a mark up as the latter is, financially and morally, justified by the fact that prices of commodities vary in regard to the dates of payment and delivery. Therefore the price differential between the case of immediate payment and delivery (the buy price in Murabahah) and the deferred-payment price (the marked-up sell price in Murabahah) of a commodity is not a mimic of Interest; it is rather a real market-base differential because people, in reality (and Shari'ah goes along with reality) do have such differences in prices because the dates of payment and delivery do in fact affect prices.<sup>10</sup>

Finally, the distinctive feature of Islamic financial intermediation vis-à-vis direct commercial credit is the point that Islamic financial intermediaries must not act on their own initiatives in creating a financing process; they must only act on an initiative from a customer. This means that the Islamic financial intermediary is not a direct investment industry; it is rather a support institution of businesses by providing financing to their investments and purchases. This also means that whenever Islamic banks undertake buying or owning assets on their own initiatives (of course outside buying goods and services for their own personal needs to practice their business), they are in violation of the basic definition of

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<sup>9</sup> We argue that time value of money as a justification for interest is not a reality but an illusion because when we keep money on hand (or better, means of payment on hand) there will be no increase in it and no "time value of money" ever appears. Time value of money is only claimed to exist when we give money as a debt to another person or only when money is in another person's hand we claim an increment caused by "the time value of money." Furthermore, although human preference for cash on hand is a fact of life because such a preference gives us a higher degree of choice at each moment of time, this preference does not necessarily give us an "assured increment" as an alternative use may result in losses instead of increments. It is only when we create a market for interest loans (or rather increment in debts) that the alternative of keeping cash on hand becomes "assuredly positive." This we argued its unrealistic nature earlier in this paper.

<sup>10</sup> This is obscured in today's practices of Islamic banking because of the structure of the market of financial intermediation. The financial intermediation industry is overwhelmingly dominated by interest-based lending to the extent that interest practices are a de facto price setter in this industry. The choice of Islamic banks is very limited to either go along the market or get out of business!

Islamic financial intermediation and turn into merchant direct commercial credit providers!

### **iii) Examples of Shari'ah-friendly methodologies of risk mitigation**

In a recent book on Risk Management in Islamic Banks,<sup>11</sup> Khan and Ahmad argued that Islamic banks not only face the type of risks that conventional banks face but they are also confronted with “new and unique risks as a result of their unique asset and liability structures.” According to Khan and Ahmad, this new type of risks is an immediate outcome of their compliance with the Shari'ah requirement. They added that even in regard to common or conventional risks, the nature of risks that Islamic banks face is different from those counterpart risks faced by conventional banks. The obvious implication of this argument is that Islamic banks need variant “risk identification processes” and different risk management approaches and techniques and require different kind of supervision as well. Similar argument appeared a few years earlier in an IMF publication by Luca Errico and Mitra Farahbaksh.<sup>12</sup> Although they conceded that capital minimum requirement should take into consideration assets composition, i.e., the PLS investments versus non-PLS investments,<sup>13</sup> they argued that the capital minimum requirement needed to for risks' coverage should be higher in Islamic banks that in conventional banks because their PLS assets are not collateralized.

The main focus of these two writings on Islamic banks is addressed especially from the point of view of supervisory authorities and minimum capital requirement. While we agree with these writings on the points that Islamic finance entails, in fact, a different kind of risk some of the risks referred to, such as legal and litigation risks, are purely procedural caused by the fact that courts are not yet fully familiar with Islamic finance.<sup>14</sup>

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<sup>11</sup> IRTI publication 2003.

<sup>12</sup> Luca Errico and Mitra Farahbaksh, “Islamic Banking: issues in Prudential Regulation and Supervision,” IMF Working Paper No. WP/98/30, 1998.

<sup>13</sup> Ibid., p 17.

<sup>14</sup> In another paper I argued that the asset structure of Islamic banks is not substantially any different from conventional banks a fact that makes them in need to neither a different style of risk management nor more or stringier capital requirement. Additionally, since the larger portion of their deposits are Mudarabah-based investment deposits that basically shares risks with equities, the capital requirement may be less in Islamic banks than in conventional banks. See “Basel II: Implications for Islamic Banking,” paper presented at the 6<sup>th</sup> International Conference on Islamic Economics and Banking - -Jakarta, Nov 22-24, 2005

However, Islamic financial products pose a different kind of risk challenges that focus on the risks to investor and undertakers. Undertaker risk relates essentially to covering the issued product. The experience in the Middle East, South East Asia and Pakistan, in this regard, indicates that there is a strong appetite for Islamic financial products to the extent that each issue is always over-subscribed and purchaser and investors hold on to them to the extent that little room is left for a secondary market. This demand is derived essentially from religious enthusiasm rather than from economic calculation. Many researchers feel that with the enlargement of the Islamic financial market this enthusiasm may not continue, undertakers will then need to resort to economic rationale which appeals to all potential investors regardless of their religion and/or religiosity. Investors' risk is a matter of worry for beneficiaries of new Islamic financial products and Islamic bankers.

Promoters of Islamic public issues, such as Sukuk, look for means of mitigating these risks in anticipation that religiously-motivated demand will sometime faint and a new motivation must be offered to investors. Here comes the role of new Fatawa that attempt to find out means to reduce risk of such issues and other new Islamic financial products. It is clearly noticeable that the pace of Fatawa has been expedited over the last few years, especially since two years of the past millennium and some of them seem to have been very controversial.

To understand the effects of some of the "new" Fatawa and assess their consistency with the specific Maqasid of the prohibition of Riba we shall first review the extent and nature of risks involved in Islamic finance, then suggest Maqasid-friendly methodologies for risk mitigation that can be considered alternatives to the hazy "new" Fatawa.

### **Risk profile of Islamic financial Contracts**

Without having to re-iterate the description and characteristics of the Islamic financial contracts, their risk profile can be described as being derived from the axiom of realism. What goes on in real life is what is accepted in Shari'ah without any "additives" or assumptions. In other words, the nature of these contracts defines their risk profile. The fundamental financing elements in the Islamic financial contracts are:

1. **There must asset basis to justify earning:** Assets are either handed over to a manager (entrepreneur) or retained for leasing or obtained for resale.
2. **The asset base of financing must be the kind that produces increments** either by its very nature (e.g., fruits or usufruct) or by the effect of real market forces (e.g., goods and services).<sup>15</sup>

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<sup>15</sup> How about money, can it be a principal in a sharing finance? One may quickly answer "no" because money does not grow. The classical Islamic literature on finance contracts recognizes

3. **The investor (property provider) earns by virtue of ownership** of an asset that grows. This is apparent in sale and lease financing and implied in the agency content of sharing (continued ownership of money provider into bought assets).
4. **Moral and Shari'ah screening** is essential for Shari'ah compatible investment and financial contracts.

These characteristics have their own risk profile. The basic point (that Islamic financial products are essentially based on real market transactions, i.e., assets, goods and/or services) requires that we deal with the real risk of owning goods, services and productive assets. Hence, we have a combination of **price risk** and an **opportunity cost risk**, the latter is usually expressed as interest rate risk as we live in a market that is over-ridden by interest!<sup>16</sup> The **credit risk or risk of default** always exists whenever a contract creates a debt and the **moral hazard** risk crops up in any inter-personal relationship.

What may be emphasized is that while price risk is uniquely important in Islamic financing, it is drastically reduced through the “binding promise” is Murabahah and financial lease while it remains an issue of consideration in other forms of finance (sharing and asset-based investment). As for moral hazard risk it is apparently much greater in sharing finance than in lending-based finance which means that if moving away from interest means adopting on Musharakah and Murabahah the moral hazard risk will be multiplied many folds. On the other hand, one can hardly find any substantial difference in the nature and extent of opportunity cost risk and credit risk between Islamic finance and conventional finance.

### **Examples of Maqasid-friendly approaches for risk mitigation**

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this apparent fact but adds that money can be exchanged for other goods, assets and factors of production; it can, therefore, be used as a principal in sharing finance provided that the first step of using it (the step of buying goods, etc.) is founded on the basis of agency contract. In other words, by virtue of the agency contract, that is implicit in all sharing-based finances, the ownership of money provider is transferred to the asset an agent/partner buys and hence money becomes amenable to grow and can be used as a principal in a sharing finance contract.

Debt is another real, though intangible, asset that cannot be used as a principal in sharing because it is not amenable to growth. It is not treated like money, in the Shari'ah literature, because it is not readily available for purchasing good and factors of production as it takes time and effort to collect it. It requires an explicit and separate agency contract that may involve fees and/or other charges. But once it is collected, it becomes cash or other assets, then a sharing-based financial relationship may be contracted.

<sup>16</sup> As the Islamic finance accounts for only a small fraction of the interest-dominated conventional finance market, Islamic finance products and dealers are price takers, not price setters, in this globalized market if they want to be not thrown out! The **credit risk or risk of default** always exists whenever a contract creates a debt and the **moral hazard** risk crops up in any inter-personal relationship.

In this section, I will discuss a few arrangements of risk mitigation that are intrinsic to the classical Shari'ah literature and go on to imply that these arrangements provide a variety of potential applications that may reduce the need to using risk mitigation Fatawa that raise Shari'ah clouds that are dared sometimes by some products thrown in what is called "the Islamic capital market."

To minimize the investors' risk in new Islamic financial products, especially Sukuk and corporate investments, a handful of arrangements can be used, namely: revenue sharing, service and usufruct-based finance, principal insurance, collaterals, third party guarantee, reverse Murabahah and Murabahah line-of-credit.

### **Revenue sharing and Revenue Sharing Sukuk**

The idea of revenue sharing is based on applying the Muzara'ah methodology to fund provision in Mudharabah. While Mudharabah assigns a share of net profit to the fund provider (Rabb al Mal), revenue sharing financing assigns a share of the gross revenue to the provider of assets that are used in the production process. Revenue sharing financing is thus a combination of Wakalah to purchase or build fixed assets and a Muzarah-based partnership between assets' owner and assets' operator.

In a Sukuk-type application, a trust (that represents the pool of investors) provides funds on Wakalah basis to an SPV that constructs (through an Istisna' contract that may be concluded with the operator itself) the required airport, toll road or corporate factory and hands it over to the operator (the management) on revenue sharing. The airport is thus owned by the trust and investors receive a percentage of the total revenues of the airport. Revenue sharing may be applied to financing infrastructures as well as to corporate productive projects.

This arrangement allows investors to get a practically guaranteed positive (above zero) return because total revenues are always positive. Consequently compared to Mudharabah, revenue sharing provides returns to investors even when the operator/management is loosing. An element that reduces the need to worry about investors' return or to tp produce "new" Fatawa to guarantee returns that may be dubious from Shari'ah point of view such as issuing debt-based tradable Sukuk.

On the other hand, revenue sharing arrangements do not provide protection against variations in the return of the investors so it is still classified in the area of sharing finance like Mudharabah and Musharakah. Stability of projects and strength of their feasibility studies will be crucial for assuring smaller variations in return.

However, similar to Mudharabah and Musharakah, revenue sharing arrangements can be supplemented by either one of the two following structures or by both of them together: 1) a condition that imposes a cap on the net profit of the operator/management or on the return to investors whereby surpluses above

the cap are either rendered to the other party or scaled at different percentages; and, 2) creating a fund, contributed to by deductions from investors' distributions and any concerned third party or by the surplus above the cap, for equalizing the investor's return over distribution periods as well as for principal guarantee.

### **Service and usufruct-based finance**

In an economy of ever increasing inflation and rising cost of labor (improving level of living), service and usufruct-based financing and Sukuk provide an excellent shelter against erosion of returns and/or principal. The reason is: payment of returns is in kind, i.e., in terms of either service units or units of usufructs. This is another Shari'ah compatible hedge against inflation without resorting to doubtful Fatawa vehicles that may involve a form or another of indirect interest.

### **Principal insurance and collaterals**

The Shari'ah rule on collateral taking is well known. It applies to debts. This means that any debt-creating finance or debt-representing Sukuk may be supported by collaterals. Collaterals provide a tool to guarantee not only the debt of a principal but also the debt of rentals as well as the in-kind debt of services and usufructs. Consequently, while services and usufruct financing hedge against inflation they can also be supported by collaterals that guarantee, in fact, both principal and return. This is simply because services and usufructs financing is based on the sale of Manafi' contract.

### **Third party guarantee: deposit guarantee**

Third party guarantee can be offered by any entity/person that has interest in a financing contract without being a party to it. It may cover the principal as well as the return. For instance a government, based on its own resources may offer a third party guarantee for financier who provide funds, on Mudharabah or Musharakah basis, to certain strategic or infant industries so that a minimum return is guaranteed to investors in addition to guaranteeing their principals. The only requirement is that the guarantor must be financially and legally independent from the managing partner (the Mudharib) because Mudharabah and Musharakah are Amanah hand contract that can only be charged in case of neglect, abuse or violation of the contract conditions but can't be charged for commercial losses. Consequently, we can always create an interested outsider-to-the-contract guarantor who can provide a third party guarantee such as an SPV that is not owned by the managing partner.

The practice of a third party guarantee may also be applied to Islamic bank investment deposits when the government provides such a guarantee with no charge to the depository banks (being the Mudharib) . This is done in Sudan when the government created a deposit guarantee corporation nourished by

contributions from Mudharabah depositors, the government and the central bank. Depository banks can also contribute to such a corporation for a special fund that covers operational risks.

However, the same principle is also invoked by deposit guarantee funds that are established by certain Islamic banks and nourished by deductions from Arbab al Mall's shares of profit before distribution. This practice started with the provisional act that established the Islamic bank of Jordan but a few other Islamic banks do practice it too for the purpose of "smoothing out dividends distribution over the years." Similar funds can also be created for Sukuk either for each issue alone or by creating an international Sukuk guarantee corporation. Offered guarantee can be extended to cover the principal and a certain return as well.

### **Reverse Murabahah and Murabahah line of credit**

The way of applying reversed Murabahah is simple. Islamic finance providers needs for funding rely on their own resources and on deposits obtained either on loan basis or Mudharabah basis. More funds can be obtained on the basis of reversed Murabahah in which the Islamic bank is the purchase orderer. Obviously applying reverse Murabahah to the purchases of the bank for its own use will limit financing through this methodology to a small amount. But if we apply it to the purchases of the Islamic bank that are part of its own Murabahah financing it may extend to be a source of funding for a major part of its operation.

Reverse Murabahah is a contract in which an Islamic bank is a finance user not a finance provider! Finance provider may be a central bank, another Islamic or conventional bank or certain corporations/entities with large sums that need to be invested in an almost secured though modest return the same way Murabahah gives the Islamic banks an almost secure and modest return.

The ground for Shari'ah legitimacy of reverse Murabahah is no different from that of Murabahah itself. If, at the time of the second sale in Murabahah the Islamic bank is permitted to make a mark up gain that become known and predetermined for the period of the created debt, the Islamic bank can also be a purchaser is such a Murabahah! The only condition that distinguishes such transactions from Tawarruq is the realism or truthfulness property of the transaction. A reverse Murabahah must maintain its truthfulness the same way truthfulness must be maintained in Murabahah itself. It must be intended to transfer ownership of goods from the hand of a supplier to the hand of a user (that is the Islamic bank in reverse Murabahah). Realism condition can be fulfilled if the transaction is genuine in a sense that it provides for the actual bank's purchases that it needs for its customer whereby the purchased goods and services actually change hands and end in the ownership of the bank and will then be genuinely sold to the Islamic bank's customers through Murabahah or lease contracts. On the other hand, in Tawarruq goods are purchased and sold only as a vehicle for financing as, unlike in reverse Murabahah, they do not end up with a final user for actually using them for its own industry or consumption.

A simple way of creating genuine reverse Murabahah is by adding a line of credit and a Wakalah contract along with two accounts one for a demand deposit and the other for a reverse Murabahah deposit. Whereby the Islamic bank, for certain Murabahah financing the Islamic bank wants to provide to its customers, it can transact a reverse Murabahah, by virtue of the Wakalah, for purchasing goods and services it provides to its clients and transfer funds from the current account of the finance provider to its reverse Murabahah account, of course this will include the contacted mark up.

Reverse Murabahah arrangements can be used with the central bank, as a final resort funds provider to Islamic banks. It can also be used with large corporation deposits and as an alternative to inter-bank transactions-cum-financing. Some form of reverse Murabahah, though without the name, has been used for decades by the Islamic Development Bank in financing national development financing institutions in the Muslim countries by what it called “extending line of credit.”

Finally what needs to be noticed is that, like Murabahah, reverse Murabahah creates debts and can't therefore be traded or discounted because of the prohibition of interest. In other words, no secondary market can be created for reverse Murabahah, it is an arrangement that can be advanced prior to granting the Murabahah to the bank customers.

### **Bundles/packages financing: applying the majority rule**

The simple form of a bundle is common stocks. They represent a group of assets, tangible and intangible, including cash and receivables. Yet, they can be traded at a market price that may be different from the face value if the majority of the assets they represent can have prices different than their face value. But if the majority of the group consists of assets subject to Hawalah or Sarf, then the rule that applies to the majority applies to the group. Consequently, the recognized ruling of Shari'ah is that common stocks may not be traded at a market price if the majority of the company's assets is in the form of receivables and cash.<sup>17</sup>

Creating bundles of goods, services, receivables and may be cash and securitizing them is not restricted to common stocks, it can be done by Islamic banks and other financing and refinancing institutions. The IDB has been doing the same in transferring contracts to the Islamic Unit Investment Fund for two decades and it's been used as a means to discounting (securitizing) its investments at the IUIF.

Bundling lays the ground for a series of financial products that can respond to all personal financing needs and consequently rendered baseless the

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<sup>17</sup> Although this is a theoretical case or at least very rare in real life as long as intangible assets are included because any difference between the book value and the market capitalization is attributable to these intangibles.

argument for “a genuine need” for Tawarruq. If there is a need for a certain form of “personal financing” it can be satisfied by means that do not allow themselves to be abused as what actually happens in the case of Tawarruq that is often used to overcome the barriers placed by the prohibition of interest on rescheduling for increment and on abusing the financing for “Abath” or objectives that crisscross the moral screening of Islamic finance and can’t be otherwise financed according to the Shari’ah criteria.

### **Hedging through options (not trading options)**

Finally, hedging existing positions may be differentiated from trading options.

While buying options for the purpose of price speculation may be argued as fictitious and profiteering without owning a real asset that may have an independent demand and supply for its own intrinsic utility/productivity, covering an existing position through buying or selling an option may be looked at as a means to reduce potential variations in prices and then tame price speculation.

Accordingly, one way hedging through options can be found useful and permissible, a matter that can also be used in Islamic financial innovation.

## **Conclusion**

A word is needed for conclusion. This paper is an attempt to determine and define the Maqasid of the prohibition of Riba from the main texts in the Qur’an and in a contemporary context that takes into consideration a contemporary interpretation of the Islamic concept of returns/revenues generation. We noticed that although the condition of being asset based is a necessary condition for Islamic financing, it is not sufficient. We need two more conditions to pass the criteria of Islamicity: the underlying asset must be of the kind that is liable to produce return, growth or increment and the transaction must be genuinely meant for what it is for or what defines it. Together, these three conditions channel financing contracts in the desired/designed direction that is meant by the prohibition of Riba and at the same time makes it, by the nature of described processes, subject to the moral/ethical screening that the Shari’ah at large calls for and aims at.

We have within the limits of the Maqasid of the prohibition of Riba a host of means that makes the risk management in innovative Islamic financial engineering a challenging arena that does not leave room to resort to dubious and counterproductive interest-mimicking approaches of financing that very often

contradict the essence and basic objectives “Maqasid” of the prohibition of interest as well as other regulations of Islamic financing.