ISLAMIC DEVELOPMENT BANK
ISLAMIC RESEARCH AND TRAINING INSTITUTE

UNDERSTANDING ISLAMIC FINANCE:
A STUDY OF THE SECURITIES MARKET IN AN ISLAMIC FRAMEWORK

JEDDAH, SAUDI ARABIA

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بسم الله الرحمن الرحيم

IN THE NAME OF ALLAH, ***MOST GRACIOUS, MOST MERCIFUL***

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FOREWORD

As an international financial institution fostering the economic development and social progress of the member countries of the Organization of the Islamic Conference (OIC) and Muslim communities at large, the Islamic Development Bank (IDB) is responsible, inter alia, for undertaking research and training primarily in the areas of Islamic economics, banking and finance, and other related fields in order to further the development of its member countries and of Muslim communites in non-member countries.

In the realization of this particular responsibility, the IDB established the Islamic Research and Training Institute (IRTI) in 1401H (1981). According to its statutes, IRTI's objective is to undertake research for enabling economic, financial, and banking activites in Muslim countries to conform to *Shari'ah;* to extend training facilites for personnel information in fields related to its activites.

In fulfillment of this objective, IRTI undertakes a number of activities within the framework of its Annual Plan which include conducting in-house research, sponsoring research studies by outside scholars, holding seminars and symposia independently as well as in collaboration with sister institutions, etc.

This paper, "Understanding Islamic Finance: A Study of the Securities Market in an Islamic Framework"was undertaken by Dr. M. A. Mannan as a part of IRTI's External Research Program, while the author was a research professor in the Center for Research in Islamic Economics, King Abdulaziz University, Jeddah.

The Islamic Development Bank attaches great importance to the development of the Islamic Securities Market, and this study has indeed made a case for the development of such a market. It is hoped that the publication of this paper will contribute to enlightened discussion and thinking on a subject which is of vital importance for the development of member countries.

Prof. Dr. Abdel Hamid El-Ghazali
Director, IRTI.

PREFACE

In this study, an attempt is made to present the case for the Islamic Securities Market (ISM) in an objective and academic manner so that it can serve as a basis for an effective policy prescription. A comparative policy approach is adopted in analyzing the framework of the Islamic Securities Market. To the best of my knowledge, the current study presents the most comprehensive work on the subject in the English language. This is not to say that no further work is needed. In fact, this work has raised a number of issues which is expected to provide a basis for further research. It is, however, felt that the policy package that emerges from the analysis should provide a framework for an action program. It should be mentioned here that this work is essentially based on secondary data and authentic English translation of Arabic texts.

It may be noted here that this study was completed as an external research program of Islamic Research and training Institute in late 1982. Then it was subrequently revised for publication

I am particularly pleased to acknowledge the valuable professional help rendered by Professor (Dr.) Nevzat Yalcintas, Dr. Sami Hamoud of the Islamic Development Bank, Mr. William T.C. Ho, Dr. A.I. Aminul Islam, Mr. M.K. Titus, Mr. Eiji Kobayashi of the Asian Development Bank, and others in conducting this study.

I am also thankful to H.E. Dr. Ahmad Mohamed Ali, President, IDS, Dr. Ghazi 0. Madani, Vice President, King Abdulaziz University, Jeddah, and Dr. Omar Z. Hafiz, Director of the International Center for Research in Islamic Economics, for the encouragement and cooperation I received from them in the course of my work.

I am thankful to my wife, Nargis Mannan, daughter, Reshmi, and son, Ghalib, for their assistance and support.

For the excellent typing work, I am thankful to Brs. Muhammad Ayub, Amanul Hoq, and Ibrahim Miyan of The Islamic Research and Training Institute (IRTI).

Lastly, I must mention that I alone am responsible for the views expressed in this study as well as for any errors and shortcomings.

M.A. Mannan

ABBREVIATIONS AND NOTES

IDB	Islamic Development Bank
IFM	Islamic Financial Market
IIC	Islamic Investment Company
ISM	Islamic Securities Market
OECD	Organization of Economic Cooperation and Development
OTC	Over-the-Counter Market
PCII	Pakistan Council of Islamic Ideology
PTC	Participation Term Certificate

Other Notes:

– One Islamic Dinar (ID) is equivalent to one SDR (Special Drawing Rights of IMF); one ID = 1.23 US$ (approximately).

Dollar(s) refers to United States dollars unless otherwise stated.

– All references to the Qur'an and the Ahadith are reproduced from the English translation of authentic Arabic sources. (See references).

ABSTRACT *

This study demonstrates that there is a valid case for the Islamic Securities Market (ISM) from the point of view of the Shari'ah. In this study, the term "securities" is used in its broadest sense to include both long - and short - term debt obligations and shares of all maturities. Thus, here, the term "securities market" approximates "financial market".

A comparative policy approach is adopted in analyzing the framework of the Islamic Securities Market. The study shows that a substantial part of the operations of Western securities markets and the behavior of its participants are considered to be unlawful in Islam. Thus the study examines the nature and characteristics of various securities such as ordinary shares, preference shares, debentures, commercial papers, operation of stock exchanges, purchase of stocks, against "margin", over-the-counter stocks, and operation of the options in the light of the *Shari'ah.* While the behavior of the investors interested mainly in dividends from their investment in shares is looked upon with favor in the *Shari'ah,* the behavior of the speculators, hedgers, and arbitragers is generally questionable.

The fact is that as the Islamic economy is essentially share-economy, the framework of the Islamic Securities Market can be developed on the basis of the Musharaka, Mudaraba and Murabaha (cost-plus) concept. Thus, it is demonstrated that since the cost of investment in securities is mainly a function of the rate of return, the Islamic Securities Market can provide a built-instabilizerto investment and is less prone to speculation. The study indicates that speculative gains have a doubtful validity in the Shari'ah although, this may not be the case with regard to capital gains. It is further suggested that the implications of some aspects of the Islamic concept of sale such as, advance sale (i.e., Bai-al-Salam) and defer-red sale (i.e., Bai-Moajjal) could be far-reaching, if their underlying principles are operationalized in the conduct of the Islamic Financial Markets.

The author is grateful to two anonymous referees for their valuable suggestions for the improvement of the earlier draft prepared in 1982. One of them considers this work to be an "excellent monograph," while the other calls it "pioneering research work." I am grateful for their generous observations.

In this connection a number of problems and issues such as index-linked loan certificates, small and fragmented markets, and the dispersion of the ownership of shares have been high lighted.

This theoretical analysis is further supplemented by a review of the recent attempt to issue Islamic bonds and certificates by Islamic investment companies and banks, coupled with further suggestions of a new package of financial instruments. The study may provide the basis for further research work and a framework for an action program.

Part One:
Conceptual And Theoretical Framework

CHAPTER 1
INTRODUCTION

1.1 Setting of the Problem

This study is based on the hypothesis that there is a valid case for the Islamic Securities Market (ISM) from the point of view of the *Shari'ah. As* a, mobilization of resources is needed to finance development projects in Muslim countries, the structure and scope of the Islamic Securities Market as well as its problem of raising funds require an in-depth examination in the light of the *Shari'ah.*

In this study the term "securities" is used in its broadest sense to include ownership shares, short-term financial and commercial papers, and debt obligations of all maturities. It is mainly due to a similarity of functions that the distinction is not made between "securities markets" in which long-term debt obligations and shares are bought and sold, and "money markets" in which short-term debt obligations are traded. Thus, the term "securities markets" approximates financial markets, although financial markets may embrace all forms of borrowings and lending, whether or not evidenced by the creation of negotiable financial instruments.

The current unfavorable working environment would not, however, be very conducive to the functioning of the Islamic Financial Market (IFM), because its initial and immediate contact point is largely the socio economic settings based on the interest rate. It is important, therefore, to have sound knowledge of the workings of securities markets in contemporary Western and Muslim countries and to see whether they conform in practice with principles of the *Shari'ah* and to what extent Islamic banks and Islamic investment companies can adopt, adapt or reject their mechanics of operation. It is argued, however, that it would be naive to consider the entire operation of Western securities markets as wholly un-Islamic, although a substantial part of it may not be considered to be valid in the *Shari'ah.*

It is necessary then to explicate the nature and characteristics of various securities, such as, ordinary shares, preference shares, bonds, debentures, cornmercial papers, and operation of the second hand securities market (i.e., the stock exchange) in the light of Islamic values. How would stock purchase against "margins" and other forms of dealings, such as, over-the-counter stocks and the operation of stock options in the stock market be viewed in the *Shari'ah?* These are some of the questions which need to be discussed in an academic and objective manner. While the behavior of investors, interested mainly in dividends from their investments in shares, may be acceptable, the behavior of speculators, hedgers, and arbitragers may generally be regarded as questionable in the *Shari'ah.*

The fact is that an Islamic economy is essentially a share - economy based on different investment contracts. It is necessary to discuss analytically the framework of Islamic securities investment based on Musharaka, Mudaraba, and Murabaha, (cost - plus) concepts and other modes of Islamic financing. It is therefore, hypothesized that since the cost of investment in securities based on these concepts is mainly the function of the rate of return, the Islamic Securities Market can provide a built instabilizer to investment and is expected to be less prone to speculation. This brings us to the question: Is all speculation unlawful in Islam? It is necessary, then, to distinguish between speculative gains and capital gains. It can be argued, however, that while speculative gains arising out of transactions of things which either do not exist or are not in actual possession may not be lawful in Islam, capital gains which, can be seen as a part of capital development and consequent growth in income may be considered lawful in Islam.

In this connection, it is important to discuss some aspects of the Islamic concept of sale and their actual and potential implications for securities markets. It can be shown that the underlying principles of advance sale (i.e., Bai-al-Salam), sale on deferred based (i.e., Bai-Moajjal), doctrine of option (i.e., option to cancel the sale), preemption sale (i.e., right to first refusal), etc., can possibly be operationalized in the conduct of the Islamic financial market. Furthermore, there is a need to solve a number of significant problems such as the dispersion of share ownership, fragmented markets, family controlled firms, etc., for the development of the Islamic Securities Market.

The above mentioned theoretical discussion must take cognizance of the recent practical development of Islamic financial instruments. For example, Islamic Investment Companies have already started issuing various securities to raise funds such as Islamic bonds (Al Muqaradha bonds), Al Mudaraba certificates on the basis of profit-sharing, loan certificates on a no-profit no-loss basis, solidarity bonds, and other financial papers. It should be noted that Jordan has also introduced Muqaradha bonds. The issue of floating an Islamic financial certificate is also under consideration by the Islamic Development Bank (IDB). It is, therefore, necessary to examine the economic and Shariah implications for policy decisions and action programs.

1.2 Scope of Enquiry

The study will be guided by the following objectives:

(a) To examine the nature and characteristics of various securities as bought and sold in Western stock exchanges with a view to assessing their acceptability from Islamic perspectives;

(b) To examine the operations of the market mechanism for secondhand securities (i.e., the stock exchange), and thereby to analyze the scope for trading in stocks and bonds by Islamic banks;

(c) To examine the implications of the Islamic concept of sale and investment on the basis of equity participation and their bearing on the development of the Islamic Securities Market;

(d) To review briefly the nature and forms of various types of securities issued by Islamic Investment Companies and banks, and thereby to suggest alternative financial instruments;

(e) To recommend a policy package, for the devising of an Action Program to be adopted by the Islamic Development Bank.

1.3 Key Assumptions

This study is based on the following basic assumptions which are rooted in the *Shari'ah:.*

(a) While Islam abolishes interest, it retains the right to private ownership of property and other means of production subject to the injunctions of the *Shari'ah.*

There is no distinction between ' iriba' and 'interest'. While profit is allowed, profiteering is not encouraged in Islam.

(b) A corporate enterprise or firm in an Islamic economy may frequently have to give up the attempt to maximize profits, sales, or anything else in the interest of a greater social and moral consideration. It may be very relevant to ask: Who are the beneficiaries of the value-added component of its product? Therefore, the firm may not always react to a given demand condition or pareto-optimality.

(c) Monopoly business and speculative business behavior may generally be considered to be hostile to Islam. While Islam discourages them, it accepts the profit motive of the firm subject to moral and social constraints.

(d) The free-market mechanism working through the impersonal and invisible forces of supply and demand may not always help achieve the socioeconomic objectives of an Islamic state. Some control and supervision will be required to provide for those who may not enter the market.

1.4 Method of the Study

This study is primarily based on secondary data, although the author derived a number of significant insights about the functioning of the securities market in an Islamic framework through selected interviews and personal contacts with a number of key professionals of the Islamic Development Bank, Jeddah; the Asian Development Bank, Manila; the World Bank, Washington, D.C.; King Abdulaziz University, Jeddah; and the Islamic Investment Company, Geneva. These discussions and interviews have enabled the author to bring an element of objectivity and new perspectives to the analysis.

Moreovre, the author has also made considerable use of published materials available in the libraries of the IDB, the Asian Development Bank, and King Abdulaziz University, Jeddah. All the references from the Qur'an and the Hadiths are reproduced from the English translation of authentic Arabic sources.

Since the present study assumes some elementary knowledge of both Western economics and the Shari'ah on the part of the reader, the author has avoided repetitions from the Qur'an and the Hadiths to illustrate the Islamic dimensions of the problem.

CHAPTER 2

SOME ASPECTS OF THE ISLAMIC CONCEPT OF SALE AND THEIR IMPLICATIONS FOR ISLAMIC FINANCIAL MARKETS

2.1 Introduction

The main purpose of this section is to demonstrate that the comprehensive nature of the Islamic concept of sale contains a number of significant features which have actual and potential implications for the financial market. We shall see later that underlying principles of advance sale (i.e., Bai-al-Salam), sale on a deferred basis (i.e., Bai Muajjal), option to cancel the sale, right to first refusal (i.e., preemption), etc., can possibly be operationalized in the conduct of Islamic financial markets which would differ fundamentally from existing Western securities markets.

At this stage, it is necessary to define the term "sale" which, in Islam, is treated as "a transfer of property in consideration of a price in money. It has a more comprehensive meaning in Islamic law in the sense that it is applied to every exchange of property for property with mutual consent. It, therefore, includes barter as well as sale, and also loan, when the articles lent are intended to be consumed and replaced to the lender by a similar quality of the same kind. This transaction, which is truly an exchange of property for property, is termed 'quar' in Islamic Law" (Hughes: 1980, p.30).

There are many kinds of sale. Four of these have reference to the thing (ayn) sold: sale of a specific for a specific thing, which is "Mookaizah"; sale of an indeterminate for an indeterminate thing, which is "Sarf"; sale of an indeterminate for a specific thing, which is "Salam"; and the reverse of "Salam" which is the sale of a specific for an indeterminate thing.

It is essential to the legality of a sale, that both of the things exchanged should be delivered and taken possession of before the separation of the parties, and that when they are of the same kind (e.g.,) silver for silver, or gold for gold, they should also be exactly equal by weight. These rules are necessary for the avoidance of 'riba', or 'usury'. It is assumed here that there is no difference between riba and interest.

2.2 Some Aspects of Sale

2.2.1 Salam Sale (Bakal Salam)

We have just seen that there can be no lawful stipulation for a postponement of the delivery of the thing sold except under one particular form of sale. The form alluded to is "Salam". This word literally, means, "an advance", and in a salam sale, the price is immediately advanced for the goods to be delivered at a future fixed time. It is only things of a similar class that can be sold in this way, and as they must necessarily be indeterminate, the proper subject of sale is an obligation. On the other hand, as the price must be actually paid or delivered at the time of the contract, (before the separation of the parties) and must, therefore, even in the case of its being money, be produced, and in consequence be particularised or specified, a Salam sale is strictly and properly the sale of *an obligation fora thing.* Until actual payment of delivery of the price, however, it retains its character as an obligation, and for this reason the price and the goods are both termed "debts" (Hughes: 1980, p.33). In this connection, it is important to note that according to the Hanafi school of law, the Salam sale is not lawful unless the seven following conditions are fulfilled:

"(1) Specification of the subject of the sale, such as wheat, barley; (2) specification of the kind of the subject of the sale, such as wheat of a soil that is watered by means of a canal, or other artificial mode, or wheat of a soil watered by rain, (3) specification of the quality of it, such as of the best or worst kind; (4) the quantity of it be fixed according to a standard of weight, or measurement of capacity; (5) the period of the delivery be fixed, (6) the rate of the capital advance be fixed, provided it be of a nature definable by a rate, as where it is an article of weight, of measurement of capacity, or tale; and (7) the place of delivery be fixed provided the subject of the sale, on account of its weight, requires porterage" (Hamilton: 1982, p. 302).

The abovementioned conditions of a "Salam" sale have a number of direct and indirect implications for the sale and purchase of shares. While the permissibility of a "Salam" sale entitles Islamic investment companies and banks to issue shares, bonds, or investment certificates, the prospectus of the company must provide detailed information as regards expected quantity of the product, and its • target, expected rate of profit or ratio of profit, rights and obligations of the shareholders as clearly as possible, mode of payment of dividend, and so on.

It follows then that debt contracts must be concluded in writing spelling out all the terms and conditions as clearly as possible to avoid future conflicts. As the Qur'an said:

" 0 ye who believe: when ye contract a debt for a fixed term, record it in writing let a scribe record it in writing between you in (terms of) equity... " 282:2.

It is implicit that debt should be utilized for lawful use. Its purpose may be incorporated into the debt contract, if creditors so wish. This is in conformity with the spirit of the Shari'ah. It also follows that all the participants of security markets should have access to full and complete information about the shares concerned.

By implications, a "salam" sale also demands that dividends for the shares should be paid in terms of the currency in which the original payment is made or in terms of the currency of the country in which the sale is concluded. In view of the differences in inflation rates, price-structures, and the fluctuations of exchange rates among countries, it is important for Islamic organizations or banks to issue shares and specify the currency in which dividends are to be paid at the very beginning of the sale.

Thus, as the delivery of the subject of a Salam sale is not immediately incumbent, the place in which the contract is concluded is not absolutely fixed as is the place of the delivery. (It is otherwise in the case of a loan or usurpation, since the repayment of the loan and the restitution of the usurped article are incumbent upon the instant). Now as the place of concluding the contract is not necessarily fixed as the place of delivery, it is requisite that some place be specified, as the uncertainty in this particular case may otherwise produce a contention. Since the price of goods varies in different places, it is therefore indispensable that a place of delivery be specified by the parties. Ignorance, moreover, with respect to the place of delivery, is equivalent to uncertainty with respect to the quality of the goods or the quality of the price. (Hamilton: 1982, p.302).

Despite some differences of opinion between the Hanafi and other schools of Islamic law, the above position appears to be valid in the context of the present social and economic conditions of different Muslim countries. Its implication for the operation of the stock market is also clear, that is, the prevailing foreign-exchange control and nonconvertibility of currency of one country to another, particularly in the case of almost all the least developed Muslim countries, make it imperative that the ratio of profit, mode, and place of payment of dividends to shareholders be clearly specified.

Furthermore, under a Salam sale, the purchaser has the option of either dissolving the sale or sharing the joint property; with the seller, because it is argued that the implication of the sharing property of another with one's own is not in all cases destructive of the right of property of the other". This clearly recognizes the sale and purchase of shares based on joint stock companies.

However, in a dissolution of 'Salam', the stock cannot be applied to the purchase of any thing from the seller until it has been returned. If both parties agree to dissolve a `Salam' contract a, the purchaser is not, in that case, entitled to purchase any thing from the seller in exchange for the stock he has advanced, until that stock has been completely returned to him. "The reason why the capital advanced resembles the subject of the sale is that a dissolution is equivalent to a new sale with relation to a third person (that is, to any person other than the parties themselves) and it is, therefore necessary that the subject of the sale be extant. It is impossible to consider the goods contracted to be provided can be considered as the subject of the sale, since they are not extant; Therefore, it is necessary to consider the price in that light, and this consequently becomes a debt due by the seller, in the same manner as the goods were" (Hedaya by Hamilton: 1982, p.304).

In this connection, the following two important points need to be considered in the context of securities markets. Firstly, the dissolution of the sale may take place either because the parties may have exercised the doctrine of option or right of cancellation within three days of purchase (to be discussed later). In this case, the purchaser is expected to receive in full the payment he has made. (We shall see later that the incorporation of this provision into the operation of the stock exchange is expected to have an important bearing on containing speculative gains and losses.)

Secondly, the dissolution may take place due to the liquidation and failure of the company which originally issued the shares. In that case, the shareholder being the owner of the company must bear the loss to the extent of his contribution. According to Hanafi law, "the profit follows the conditions agreed upon and the loss follows the capital".

Before we conclude our discussion of Salam sales, it is important to state that the basic economic justification of a Salam sale is to encourage productive activities. It creates a built-inpsychological pressure to produce, ensures continuity of supply, and reduces speculation in prices. In order to reap these socioeconomic benefits, the Shari'ah demands that full payment should be made in advance in one instalment.

However, in the light of the complex production processes of the modern agricultural and industrial sectors, it is necessary to examine whether payment of the full price, for example, to a farmer for the supply of corn three to six months later, would encourage unnecessary expenditure on the part of the farmer who may not utilize the money at once.

Since under a Salam sale the full price is to be paid in advance, it should be possible to conceive of a situation where the receiver may need only a part of the payment received in the production of the goods concerned. In such a situation, the receiver will be faced with the following four options:

(1) He may spend the money;
(2) He may keep the remaining balance with him unutilized;
(3) He may opt to retain the balance within an Islamic financial institution; or
(4) He may opt for a series of 'Salam' sales depending on the different process of production (if possible).

While the first option may not be desirable, in that it may encourage unnecessary consumption expenditures, the second one is not encouraged in the Shari'ah, because it amounts to hoarding and it keeping money out of circulation. However in the absence of Islamic facilities among contemporary Muslim countries, the scope for implementing the third option appears to be limited. Once the balance is kept with an Islamic financial institution, it could be used to further productive activities in the sense that a short - term credit line could be extended to private and public borrowers on the basis of profit-sharing. While this remains an important theoretical possibility, its practical application appears to be difficult due to the lack of institutional facilities and the low - level of consumption among farmers in developing Muslim countries which encourages them to spend money instead of keeping it in a financial institution. However, option four appears to be a real possibility under which a series of Salam sales may be concluded depending on the stages of production. Whether this would actually be in terms of the Shari'ah remains a point for consideration. However, the author has discussed this issue with some of the contemporary Shari'ah scholars, such as Dr. Hussein Hamid Hassan and Dr. Sami Hamoud, who hold the view that it is permissible to have a series of Salam sales, under such circumstances.

2.2.2 Sale on a Deferred Basis (Bai-Muajjal)

The main purpose here is not to discuss the relative merits and demerits of Bai-Muajjal, but to indicate that sale and purchase on a deferred payment basis may under certain conditions be acceptable in principle and that it has its possible implications for the financial markets. It is relevant pertinent to reproduce the following observations on Bai-Muajjal from the Report of the Pakistan Council of Islamic Ideology (1980, pp. 15-16) :

> "Bai-Muajjal may be defined as sale under which the price of the item involved is payable on a deferred basis either in lump sum or in instalments. This system could be of considerable use in financing current input requirements of industry and agriculture as well as the financing of domestic and import trade. This system commends itself for its relative simplicity as well as the possibility of some profit for the banks without the risk of having to share in the possible losses, except in the case of bankruptcy or default on the part of the buyer. However, although this mode of financing is understood to be permissible under the Shariah, it would not be advisable to use it widely or indiscriminately in view of the danger attached to it of opening a back-door for dealing on the basis of interest. Safeguards would, therefore, need to be devised so as to restrict its use only to inescapable cases. In addition, the range of mark-up on purchase prices would also need to be regulated strictly so as to avoid arbitrariness and the possibility of recrudescence of interest in a different garb. The State Bank may, therefore, specify and from time to time review and vary the sub-sectors/items for which banks may provide the needed finance under Bai-Muajjal arrangements. It may also lay down the range of the profit margin in general or separately for each sub-sector or item and may impose such other restrictions as may be deemed to be necessary with a view to avoiding the emergence of unhealthy practice."

Furthermore, the principle of deferred payment is also implicit in the following verse of the Qur'an: "If the debtor is in strained circumstances, then (let there be) postponement to the time of case; and that ye remit the debt as alms giving would be better for you if ye did but know" (280:30).

Although the above verse calls for the postponement of the payment of a loan when the debtor is in "strained circumstances", the underlying principle of defer-red payment is recognized. This could be of considerable use in introducing some built-in flexibility provisions in the executing of debt contracts pertaining to firms or enterprises having genuine difficulties in reaching the break-even point in the initial phase of their operations. Once these principles are operationlised, their implications for the securities market, and for the deferred payment of dividends to shareholders become clear, although, their use has to be 'restrictive in scope. Islamic fairness demands that a creditor should have access to the accounts of the company in such cases.

2.2.3 Doctrine of Option in Contracts

The doctrine of option, or the right of cancellation, is one of the distinctive features of Islamic contract law which has far - reaching implications in containing speculative. activities in the securities market. Even when a sale is duly constituted, operative, or immediate in its effect, and free from any grounds of illegality, it still may not be absolutely binding on the parties involved "This brings us to another remarkable peculiarity of Islamic law, viz., the doctrine of option or the right of cancellation. The Prophet (Peace be on him) himself recommended one of his has followers to reserve a "locus penitentia", or option, for 'three days' in all his purchases. This has led to the option stipulation, which may be reserved by either of the parties. But apart from this, the purchaser has an option without any stipulation with regard to things which he has purchased without seeing, and also on account of defects in that which is being sold. The greatest of all defects is the lack of a title or of the right to sell on the part of the seller. The last two options to the purchase constitute a complete warranty of title and against all defects on the part of the seller. (Hughes: 1980, p.33).

The fact is that the Shari'ah demands that the seller disclose all the defects in the article sold. Otherwise the sale is not valid. "When a person has made a purchase and was not aware, at the time of sale or previously, of a defect in the article bought, he has an option, whether the defect be small or great, and he may either be content with it, at the price or reject it. But if it has received a further blemish whether providentially or otherwise, and he then discovers a defect which existed in it while with the seller, he is only entitled to compensation for that defect, and cannot reject the item sold unless the seller is content to take it back with the new blemish which it has sustained in the hands of the purchaser" (Baillie: 1980, p.788).

Now even if the validity of this option is stipulated to be for not more than three days, it constitutes a fundamental departure from the normal sale and purchase of shares in Western financial markets. However, it may be argued that the inclusion of this Islamic condition of sale would increase the flow of information, reduce the scope the for speculative manipulation of market prices, reduce the abrupt and fluctuations of prices, thereby contributing to a greater stability in the financial market. How new information can be used for speculative purposes can be illustrated with the help of the following simple example:

Suppose there is free access to all information about the ABC Corporation. No inside information is available to a particular investor. Suppose that the price of ABC stock is currently $50 per share. Suddenly a new cheaper method is found to make the products produced by the ABC Corporation. It is believed that the stock is expected to be worth $60, if this new information is known.

Suppose that only a few inside people have access to this information who could use it to their advantage by buying at $50 per share and selling instantaneously at a higher price by manipulating this new information. This is not in conformity with the spirit of the Shari'ah. The doctrine of option in contacts, if properly translated into an operational principle, may, therefore act as a built-in stabilizer in some financial market activities. It is to be recognized, however, that the right to exercise an option is not automatic. It has to be specified at the time of entering into the contract. Given the present level and stage of development of the Islamic Security Market, it would not be easy to operationalize this aspect of contract of sale and purchase. This is an area which needs further examination.

2.2.4 Concept of Exchange without Excess

The Shari'ah permits the exchange of "similar for similar" whether of weight or of capacity. This rule is necessary for the avoidance of riba or usury. It is important to clarify this concept of "similarity". When a person has borrowed money in a currency which ceases to be current, he is bound, according to Abu Hanifa, to make repayment of similars though noncurrent; while, according to Abu Yusuf, he is liable for their value on the day that he received the loan. Most of the jurists appear to take the position of Abu Yusuf.

"However", if a person having lent a Bokhara dirhams in Bokhara meets the borrower in an another city where dirhams are not to be obtained, in such circumstances the lender ought, according to Abu Hanifa and Abu Yusuf, either to allow the borrower time to go and return, with the dirhams, trusting him in the meanwhile and taken a surety, or to accept the value of the dirhams. A person borrows articles of weight or of capacity, and when redemanded, they are not procurable; the lender must wait for the return of the proper season, according to Abu Hanifa, whose opinion has been approved. A person borrows grain in a city where it is cheap, and meeting the lender in a city where it is dear, is seized by the latter who demands his right; the borrower cannot, however, be detained, and the lender should be directed to trust him till he has an opportunity of rendering grain in the city in which it was borrowed (Baillie: 1980, p. 803).

A number of significant points follow from the above analysis:

(1) Exchange should be without any "excess". It follows that the debt contract must be settled with reference to the "original legal standard"

(2) Money is used as a medium of exchange.

(3) Since the value of money can rise as well as fall during inflation and deflation respectively, the settlement of a debt contract should be made in terms of the original date of agreement which can be taken as a base year.

Thus, to me, it appears to be in conformity with the principle of "equity" in Islam if adjustments are made to reflect the necessary changes in the value of money. This princile States that a debtor will get back the equal and exact number of units of money if its value does not change. But whether he will get more or less units of money depends on whether there is inflation or deflation in the economy during the period in question. If there is no debasement of currency and no changes in the prices of commodities, during the period of indebtedness of the parties concerned, there will be no change in the number of units paid. It is only when the price level changes that the question of paying a difference arises.

This adjustment of account, as per the agreement of the parties, is very much different from the nature of interest which in economics is defined as rewards for 'waiting' or for 'risk-taking'. Parting from liquidity is fraught with numerous risks for which, according to capitalist theory, the lender is entitled to a 'reward'. In prohibiting the acceptability of this 'reward', Islam does not deny the existence of 'risk', In-deed, it suggests 'risk sharing' as a basic condition for the entitlement of any 're-ward'. "This obviously means that equity in debt contracts cannot be established by accepting arbitrary standards. Islamic organizations and financial institutions have to ponder over these questions to work out a satisfactory basis of indexing." (Mohsin: 1982, p. 40).

The author does not, therefore, find any harm in accepting this question of in-dexation in principle despite some doubts expressed in the Report of the Council of Pakistan Ideology, (1980, p.96) about the validity indexation from the point of view of the Shari'ah`.

It is argued that once indexation is accepted as a matter of principle, it will have far-reaching implications for the Islamic Securities Markets in the sense that it would enable Islamic banks to issue index-linked loan certificates with greater prospects of sale in times such as at present, of inflation. This would also encour-age Islamic banks to identify projects whose return could at least beat inflation.

2.2.5 Principle of Interchange

The Shari'ah recognizes the principle of interchange in transactions under cer-tain conditions. It was noted earlier that like exchange and interchange is also per-missible when transactions of "similar for similar" whether of weight or capacity take place. "It being the general rule that wherever similarity according to a certain legal standard is a condition of the legality of a contract, a knowledge of that simi-larity by the standard at the time of the transaction is also a necessary condition. It is said that raw meat may be lawfully sold for that which is cooked when the quantities are equal; and any excess is forbidden unless there be things in the cooked meat put in for seasoning. Again the meat and milk of the camel, cow, sheep, and goat are of different kinds and one may be sold for the other *with excess* from hand to hand; but any delay in delivery is not allowed" (Baillie, 1980 p.796). It is evident

(See the author's article on "Indexation in an Islamic Economy" published by the Journal of De-velopment Studies, Vol. IV, 1981, Institute of Development Studies, NWFP Agriculture University, Peshawar, Pakistan.

that whenever this 'excess' is allowed, it is clearly due to 'value - added' as we find in the case of cooked meat. It is also evident that the principle of interchange can easily be applicable in the sale and purchase of shares. While the shares of similar industries can be exchanged without any excess, it is to be examined whether the shares of different industries, despite similar face value, can possibly be interchanged with excess. Because the prospects of the profitabilities of different types of industries are not the same, the interchange of shares, if it is at all feasible, may take place with or without excess. Once this principle is operationalised, it tends to increase the flow of investment funds among the different alternative enterprises. Thus, "the switch over effect" needs to be further examined.

2.2.6 Principle of Preemption

The Shari'ah also recognizes the right of preemption (i.e., the right to purchase before it is offered to others, the right of first refusal). "The right of preemption is a power of possessing property which is for sale and is established upon the teaching of the Prophet (Peace be on him). It applies not to movable property but to immovable property. This right of preemption appertains in the first place to the cosharer or partner in the property; secondly, to a sharer in the immunities and appendages of the property, such as the right to water, or to roads, and thirdly, to the neighbor." (Hamilton, 1982 : , Vol. III, p.594). It appears that this position of the Shari'ah has its implications for securities markets in an Islamic economy. While it may put a limit on the complete freedom to sell shares in the case of joint venture projects or projects based on partnership or cosponsorships, it may very well introduce an element of continuity and stability in the functioning of many economic enterprises in an Islamic economy provided the right of preemption is not deliberately exercised to gain monopoly control.

2.3 Conclusion

In summary, Taken.all in all, it can be said that the Islamic concept of sale is unique in several ways. The underlying principles of Salam sale, sale on deferred payment, the doctrine of option, exchange, interchange, and preemption can possibly be extended and operationalised in developing the structure of the Islamic Financial Market.

The Salam sale can provide a basis for the issuance of shares by the Islamic Investment Company and can encourage, productive activities. Sale on a deferred payment basis has the implications for the purchase of shares of large denominations in instalments, the deferred payments of dividends, etc. The doctrine of option may contain speculative activities, if its principles are implemented. The concept of exchange of "similar" things raises the significant issue of the indexation of loan certificates. The principle of interchange with excess is perhaps permissible due to value-added, and the concept of preemption may very well introduce an element of continuity and stability in the functioning of the company. All these hypotheses need to be tested in the field and require further in-depth examination from the point of view of the Shari'ah.

CHAPTER 3

AN ANALYTICAL FRAMEWORK OF THE ISLAMIC SECURITIES MARKET: ITS RATIONALE AND STRUCTURE

3.1 Objective and Rationale

The main objective of this section is to provide socioeconomic justifications for the Islamic Securities Market. Then an attempt will be made to identify some fundamental principles on which the framework of the Islamic Securities Market can be organized.

The justifications for the Islamic Securities Market can be advanced on the following grounds:

(a) Philosophical Basis

The organization of a securities market can be seen as an attempt to express a balanced view of individual freedom and social responsibility in the economic sphere. Its organization would provide a forum for individuals to mobilize financial resources for investment in accordance with the principles of the Shari'ah.

"Because, the freedom giving law that man chooses for himself is the Divine law of justice, "Al-AdI", it is not man-made. By accepting to live in bondage to this Divine law, man learns to be free" (Brohi: 1978, p.194, reproduced from Naqvi, 1981, p. 9). Thus, the sale and purchase of securities on the basis of a predetermined rate of interest and the market behavior of speculators, hedgers, and arbitragers as in Western securities markets are seen as irresponsible social and economic behavior from Islamic perspectives. On the other hand, the curtailment of all individual freedom to manage and organize economic enterprises individually and its replacement by state ownership are also regarded as contrary to the economic role each individual is expected to perform as God's vicegerent on earth. As the Qur'an said: "He is Who hath placed you as viceroys of the earth.. (6: 166).

What is needed then is a trade-off between individual freedom and collective social responsibility. "A fine balancing of individual freedom and social responsibility yields the distinctive Islamic concept of `constrained' individual freedom. These constraints, which are all ethical, have a distinctly voluntaristic strain, emphasizing that true freedom for the individual is best attained simultaneously with the freedom for all. According to this view, individual freedom has meaning only within the framework of the Divine Law, the limits of which Man is not allowed to transgress: "... who transgresseth Allah's limits, verily wrongeth his soul" (65.1). There is nothing authoritarian about this view, because such a stipulation comes naturally to the members of a just society who voluntarily accept limitations to their individual freedom with a view to promoting social welfare" (Naqvi:1981, p.9).

Herein lies the underlying economic philosophy for the organization of the Islamic Financial Market for efficient utilization of "His resources" in so far as it encourages private individuals or groups of individuals to invest in industry, commerce, and the government as well as allowing individual firms to raise funds from the market by floating shares instead of approaching individual investors directly.

(b) Dissemination of Financial Information

The organization of a financial market is expected that a reduce information costs particularly if it is organized under the leadership of the Islamic Development Bank. Since 44 Muslim countries are members of the IDB, it is expected that a huge amount of information would be generated concerning large-, medium -, and small - sized business units, governmental units, domestic, foreign, and private business enterprises, and local Islamic banks. This may include information such as published balance sheets, profit and loss statements, dividend rates, government investment policy, fiscal incentive or tax holiday regions, export business schemes, exchange rate regulations, and so on.

The wide availability of such information greatly increases the mobility of funds. A firm (or investor) whose issues are widely known need not limit its fund raising to its own locality; it can draw from the national and international market.

"Unfortunately, however, many entities -- including very large numbers of farmers, retailers, other small business firms, and households -- are known only locally. Distant investors are unaware of these entities and of the quality of the claims they issue; investors can acquire this necessary information only at considerable cost. Such ignorance and the cost of information constitute an imperfection in finance markets. One effect of this situation is to create some degree of monopoly power for local lenders. Another is to create inefficiency in the allocation of credit and capital; too little capital is made available for use by some units that are not widely known" (Chandler: 1973, p.56).

It should be mentioned that initially the cost of collecting information about the corporate behavior of Muslim countries may present a real problem. What is crucially important from the Islamic point of view is to see the dissemination of financial information among small investors and investors from the least developed regions or countries so that the mobility of funds increases and ensures a greater distribution of income. To achieve this goal, market intervention by introducing regional quotas for shares may perhaps be needed.

(c) Collection and Analysis

Despite the difficulty of the initial collection of basic financial data and data on investment opportunities in the case of the least developed Muslim countries, as compared to advanced countries, such as, the United States and the United Kingdom, once the Islamic Securities Market is organized, it should enable investors to reduce the collection cost and the cost of feasibility studies. There is perhaps a need for an independent agency to see that investors are kept informed about past dividends, the expected rate of profit, and other financial conditions in the various regions of the country and abroad. This is in conformity with the actual practice of market regulations in Islam.

(d) Liquidity Through Marketability

The organization of the Islamic Financial Market is needed to facilitate the change in the ownership of securities. If there is no stock exchange, investors will have to claim their money back from firms which may adversely affect the smooth functioning of a business. "In the absence of facilities for trading in the stock of outstanding claims, each buyer might hold a security until it matured. If this were necessary, many buyers would be unwilling to acquire claims with longer maturities, or would buy them only at very high yields, because buyers might not want these funds unavailable to them for long periods of time. As an alternative to holding long-term credits, a buyer might seek out other buyers, but this would in many cases be time consuming and the scarcity of prospective buyers might cause the claim to be sold at low prices. The claims would be illiquid and risk of loss of capital value would be high. The existence of a highly efficient secondary market for a security markedly increases its liquidity and safety of principal value. Its quick marketability serves one of the requirements of liquidity -- ability to be converted to money quickly" (Chandler: 1973, pp.56-58).

(e) Cooperative Competition

The enhanced marketability of securities in accordance with the provisions of the Shari'ah will at the same time foster the spirit of cooperation and competition. This is what may be called cooperative competition. It would promote the cause of cooperation because all participants of the securities market are bound by the same Divine Law of "Al-Adl". It would also promote the cause of competition because each of the participants is expected to surpass the other in implementing the Islamic laws of investment without resorting to any unfair or manipulative means. This cooperative competition may introduce stability to the value shares.

The value of a security may indeed fall because of less optimistic assessments of its issuer, the appearance of more attractive securities, or general changes in financial markets. But the holder is at least assured that there are many potential buyers who will compete for the security at a price commensurate with the prices of comparable issues.

"To the extent that secondary markets enhance the expected liquidity and safety of value of securities, buyers are encouraged to hold more of them and at lower yields. Issuers of securities can acquire funds at lower costs, which promotes capital formation" (Chandler: 1973, p.58).

(f) Integrated Investment Opportunities

The Islamic Securities Market is expected to provide the scope for integrated investment opportunities as it is expected to provide a guide to institutional assessment of the competing claims for finance. "Any financial development that causes investment alternatives to be compared with one another is bound to produce allocational improvement over a system of segregated investment opportunities. Moreover, just as the availability of financial assets makes saving independent of any concomitant act of investment, so too does finance divorce investment acts from the ability of investors to save. But a securities market is not the only avenue of external finance for a firm, nor the only means by which prospective investment alternatives may be compared. The question at issue is whether a market improves the allocational machinery over and above the functioning of banks and other institutional lenders". (Drake: 1973, p.194). The allocative effects of the securities market can be felt only when special efforts are made to provide an institutional assessment of different types of competing shares. The apparent profit prospects of the company may be misleading, because they may be distorted by market imperfections resulting from monopoly power, exchange control, tariff protection, import quotas, etc. We need a comparative analysis of the monetary, fiscal, and commercial policies of IDB member countries so that the prospective investor is better informed about the state of each economy.

(g) Securities as Collateral

Once Islamic securities are organized, there should be an increase in the flow of investible funds not only in terms of equity participation but also in terms of funding through loans without interest. The Shari'ah permits lenders to ask for security of the loan advanced. The banks' willingness to accept securities as collateral for loans would tend to increase the flow of funds. It may particularly help small firms of the least developed Muslim countries who have difficulties in obtaining loans, because it is highly documented that large, well - known, long - established firms and big businessmen have greater access to local development and commercial banks for loans and finance.

Theoretically, the scope for loan financing without interest tends to be restrictive in nature in an Islamic framework, because Islamic banks are primarily interested in various types of investment financing on the basis of profit-loss sharing. But the Islamic Development Bank being a development bank of 44 Muslim countries provides loans without interest mainly in the area of noncorporate enterprises (i.e., transport, communications, etc.).

However, once the use of securities as collateral has gained currency, it is likely to expand the scope of loan operations, although the long - term interest of an Islamic economy is expected to be better served, if equity participation, leasing, trading, and other profit-sharing activities are encouraged. Nevertheless, a case for loan financing can always be made under certain conditions.

From the preceding analysis one may be tempted to say that there is an apparent similarity of functions between Islamic and Western Securities Markets. What is unique about the Islamic Securities Market? Its uniqueness lies not only in its mode of performing these functions but also in achieving a different set of objectives. In the final analysis, Islamic Financial Market is intended to integrate partnership between labour and capital on a perpetual basis, fostering individual initiative coupled with collective social responsibility. This contention will be clear. when we examine the different types of investment participation within an Islamic framework.

This brings us to the question of identifying some operational principles on which the structure of the Islamic Securities Market can be built.

3.2 Islamic Framework of the Securities Market

Theoretically, a case has already been made for the Islamic Securities Market which can essentially be organized on the principles of Musharaka and Mudarabah financing. This does not preclude the possibility of floating interest-freeloan certificates. The operationalization of the principles of a Mudarabah-based economy will lead to a profound structural change in the existing operation of secular financial markets. Let us discuss briefly the nature and scope of loans, Musharaka, Mudarabah and Murabaha financing.

a) Loans

As noted earlier, the Islamic economy is essentially a share-economy. It is permissible, however, to borrow money from a lender without the lender participating in any profit or loss. Thus, the Islamic Financial Markets can float loan-certificates, if it is absolutely necessary for the enterprise. In this connection, it is important to advance four distinct principles governing loans.

Firstly, loans without interest can be taken only when absolutely needed. Taking a loan without any valid reason is discouraged by the Prophet (Peace be on him) who is reported to have sought refuge from being in debt as well as from sin. A'ij-shah said: The Messenger of Allah (Peace be on him) used to pray while saying prayer: "0 Allah; I seek refuge in Thee from sin and from being in debt". Someone asked him, "How often dost thou, 0 Messenger of Allah; seek refuge from being in debt" ? He said: "When a man is in debt he speaks and tells lies and he promises and breaks the promise" (Bukhari).

Secondly, the very act of lending and borrowing should be clearly written down, and should not be to the disadvantage of the debtor. We have already noted that this of debt contract principle owes its origin to the Qur'an.

Thirdly, Islam has also made provision for granting loans against proper security. Thus, the mortgaging of property as security for the payment of a debt is allowed, and the mortgagee is allowed to derive benefit from it within the framework of the Shari'ah.

Abu Hurairah reported the Messenger of Allah (Peace be on him) to have said: "The mortgaged animal may be used for riding when it is mortgaged on account of what is spent on it, and the milk of a milch animal may be drunk when it is mortgaged, and the expenditure shall be borne by him who rides (the animal) and drinks (the milk)" (Bukhari).

This Hadith shows that "when a person has to spend money on the thing mortgaged, he. is entitled to derive benefit from it. Hence, a house or land can be mortgaged subject to the condition that the possession shall be handed over to the mortgagee who is entitled to live in the house or let it on hire, if he carries out the repairs, and to till the land and have the produce of it if he spends on it. However, the question of granting loans against proper security has its implications, in respect of loan certificates issued by Islamic banks or firms.

The fourth principle governing loans is the principle of repayment. While the creditor has been directed to guard against any injustice to the debtor, the debtor has also been directed to make every sincere effort to repay the loan. It is related to the authority of Abu Hurairah that the Prophet (Peace be on him) said: "Whoever contracts a debt intending to repay it, Allah will pay it on his behalf, and whoever contracts a debt intending to waste it, Allah will bring him ruin" (Bukhari). As a matter of fact, Islam does not justify deferring payments without any valid reasons. Abu Hurairah reported: The Messenger of Allah (Peace be on him) said: "Delaying the payment of debt by a well-to-do person is injustice" (Bukhari). The Prophet (Peace be on him) is reported to have even said: "Deferring payment by one who has the means to pay legalizes his punishment and his honour" (Bukhari).

From the preceding discussion the following hypothesis can be advanced: loans ('qard-hasan'). Interest-free loans for basic consumption need to be encouraged including benevolent. There is little or no scope for loans for commercial purposes where investment is encouraged on the principles of sharing profit. But development loans without interest are also encouraged for the general welfare of the community (i.e., construction of roads, airports, etc.). Because its consumption is generally non-rival in nature, and it is difficult to put price tag.

The above discussion simply confirms that there exists a limited scope for securities based on interest-free loans.

(b) Musharaka

Islam allows investment participation in the form of the Musharaka system whereby financial institutions enter into a partnership with clients for a limited period of time in a project. Both the banks and the clients contribute to the capital in varying degrees and agree upon a ratio of profit fixed in advance.

It should be noted that the distribution of the ratio of profit is subject to a contract between the parties, and losses are shared according to the contribution of capital. Furthermore, there are Musharaka contracts with constant and decreasing participation. The latter form is offered by the Jordan Islamic bank where the participation of the bank decreases over time. The bank also keeps the profit-share of the customer to pay back the capital contribution: However, a case can be made for a Musharaka contract with increasing participation. The basic reason for decreasing participation is to release funds for alternative investment. Similarly, when an alternative does not offer better investment prospects, it is better to increase the participation to reap the benefits of the economies of scale. Furthermore, when joint ventures are undertaken between a bank and private interests under a Musharaka contract, it is desirable that the base of equity ownership should be substantially broadened if the bank divests itself of part of the ownership of such ventures as they become successful. This is in conformity with the spirit of the Shar'iah in the sense that it ensures a greater redistribution of income.

Thus, we see that a guaranteed loan with a specified time limit and without interest can be injected into the productive cycle of the activity in question and can also make a profit for the partners. This question of "limited participation" is significant in developing the Islamic concept of a stock exchange which can offer the scope for sale and purchase of such bank shares, because, the establishment of the Islamic Stock Exchange will facilitate a change in the ownership of securities. Musharaka contracts with constant, decreasing, the and increasing participation can easily be translated into of securities which can be sold and purchased in the securities market.

(c) Mudaraba

Another form of investment which Islam permits is Mudaraba* which combines financial experience with business experience. Under this system, banks provide the capital and clients provide the expertise. Again, the profit is shared according to some agreed upon ratio. In the case of loss, the bank bears all of the financial risk and clients will only lose the value of their labor, if the loss occurs as a result of circumstances beyond their capacity. The economics of cooperation can be derived from the Mudaraba contract, if it is properly implemented. It has a definite economic role to play. As Udovitch (1970, pp.175-176) observed:

> "Sarakhsi's summary of the commenda's economic function is as accurate and to the point as that made by any contemporary student of medieval economic institutions. It includes the most important functions of the commenda in trade which have been described as "the hiring of capital" and the

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"Three Arabic terms are used to designate the commenda: qirad, muqarada, and mudaraba;the terms are interchangeable with no essential difference in meaning or connotation among them. The divergence in terminology was probably originally due to geographical factors. The terms qirad and muqarada apparently originated in the Arabian peninsula, and the term mudaraba was of Iraqi provenance. Subsequently, the difference was perpetuated by the legal schools, the Malikis and Shafi'is adopting the term qirad and to a lesser degree, muqarada, and the Hanafi's the term mudaraba. We, however, has preferred the first term (mudaraba) because it corresponds to that which is found in the book of God, may He be exalted. God, may He be exalted, said: "While others travel in the land (yadribuna fil ard) in search of Allah's bounty", that is to say, travel for the purposes of trade" (Udovitch: 1970, pp.174-175).

"hiring of trade skill". By pointing to its economic function, Sarakhsi also provides an explanation for its widespread use in medieval trade. To paraphrase him, profit can be realized only by the combination of capital and trading activities, and in certain commercial contexts such as long-distance trade, the commenda become the ideal instrument to attain this profitable goal."

Investment through Musharaka and Mudaraba financing provides a number of significant insights for the functioning of the Islamic Security Market. In the first instance, it provides a built-instabilizer for investment, because, under such a system, the cost of capital becomes a function of the rate of return from investment rather than the predetermined rate of interest. Fixed interest rates and uncertain profitability make the functioning of the Western financial markets unstable and provide opportunities for speculative activities. Under the Mudaraba system, the rate of return on capital investment becomes the joint responsibility of financiers and entrepreneurs. Therefore, Mudaraba financing is less prone to speculation and consequent business fluctuations, which have a direct bearing on the securities market.

Secondly, investment through Mudaraba offers a new dimension to the operation of the capital markets in the sense that it allows participation with human capital alone. That is, if a lender provides a loan for productive activities, the debtor is a partner or will become a partner with the other member who participates with either his money or efforts in this particular activity with a view to increasing production as well as profit for the shareholders. Because the lender is also a partner in view of the fact that he is sharing in the risk of profit and loss, it also follows that the Mudaraba investment expands the scope of operation of the capital markets, because it allows not only participation with human capital alone, but also with finance alone as well as in varying combinations of both finance and human capital. Therefore the Significant implication is that the Islamic Financial Markets should be able to float different types of shares and investment certificates with various combinations and permutations.

(d) Murabaha

Under Murabaha investment which can be very short-term in nature, the Islamic bank purchases commodities for be clients and resells at a fixed mark-up or rate of profit on the *stated original cost.* By the price of sale on the original cost of the item to the seller, the customer is provided a modicum of protection against unfair exploitation. The general rule is "that money expended directly on the goods or on services indispensable to their sale (e.g., brokerage fees) may be included, whereas the personal expenses of the merchant and other expenses not directly involved with the goods are not to be figured into the sale cost on which the Murabaha transaction is based. As an additional protection to the customer, lawyers insist that the seller avoid any misleading statements. He must be scrupulous in how he designates the sum serving as the basis of the Murabaha. If he includes various expenses in this sum, he may not, directly or indirectly, lead the buyer to believe that the Murabaha is based on the purchase price, but must use some expression indicating that this is what it cost, and not that this is what he paid for it" (Udovitch: 1970, p.220)

It appears that the Murabaha sale is very popular among Islamic banks, although due care has to be taken in determining the mark-up or rate of profit in trans-acting such a sale. The fact is that the legitimacy of transacting a Murabaha sale on the basis of any sum that is not misleading or fraudulent does not preclude the possibility of fixing the sale price far higher than the original cost. While due profit is lawful, profiteering is not encouraged in Islam. What is needed, then, is to define, as objectively as possible, the limits of the participant's freedom of action in such trans-actions as purchase, sale, deposit, profit rate, credit, etc. It is important for the bank to demonstrate that in such transactions there is a risk involved, and that the amount of time spent by the bank, in addition to providing finance for the proper execution of this investment plan, justifies the rate of profit. However, "one can en-visage other hypothetical conditions under which the use of the Murabaha could have been particularly effective. One is the tantalizing possibility that it served as a form of commission sale. This possibility is supported by the fact that one is al-lowed to acquire goods on credit and then resell them on a Murabaha basis, with the surcharge of either a fixed sum or a fixed rate of profit based on the purchase price. The only limitation placed on the seller is that he informs the buyer that the goods in question were acquired on credit. Honesty and probity require that this information be given, according to Sarakhsi, since customarily goods sold on credit fetch a higher price than those sold for cash. Whether the possibilities of commission sales inherent in the Murabaha were realized in medieval Islamic commercial life is a problem concerning which we can at, this point, make no definitive judgement. Whatever its possibilities, and whatever economic functions it fulfilled, the commenda agent possessed the right to engage in this transaction under the same conditions as applied to any other trader" (Udovitch: 1970, pp.220-222).

(e) Bai-Salam

Under the Bai-Salam arrangement, banks may enter into an agreement with a farmer for the advance purchase of agricultural produce, specifying the complete details of the commodity, its quality, price, and the place and time of delivery and make the payment of the agreed amount at the time of entering into the agreement. When the commodity is produced and supplied to the bank, on the appointed date, the bank is free to sell the commodity as it wishes. It must be emphasized, however, that Bai-Salam is a special type of trading arrangement which is subject to strict stipulations and conditions as laid down in the Shari'ah. It would, therefore, be necessary to enact a law to ensure the fulfilment of these conditions in all respects. It may be pointed out that since there can be a danger of the misuse of price fixation in advance as an exploitation device, an independent agency may have to be set up which should be responsible for exercising proper control on price fixation in respect of Bai-Salam (Pakistan Ideology Council pell: 1980, p.44).

Thus, we see that it should be possible to issue various types of commercial papers under the short-term investment program of Murabaha and the Bai-Salam arrangement. Later, we shall see that there are other modes of Islamic financing, such as, leasing, hire purchase, etc. It should be possible to explore the possibilities of issuing commercial papers to deal with these instrument programs.

3.3 Operational Principles

The preceding analysis introduces the following operational principles of financial markets:

(a) Elimination of riba from all transactions of financial markets.

(b) Application of the doctrine of limited liability (i.e., the bearing of loss to the extent of one's contribution). The limited liability of the parties in the case of transaction with companies is based on the fact that limited companies fall under the purview of personal law, and as in the case of individuals, the companies are also absolved of their liabilities after becoming insolvent" (PCII:1980, p.91).

(c) Distribution of fair dividends among shareholders. This clearly implies the sharing of an agreed percentage of profit and loss to the extent of the shareholder's contribution.

(d) Ensuring the broad-based ownership of shares and investment certificates for a greater distribution of income. The very fact that the Mudaraba system allows individuals without finance to participate in economic enterprise to share the risk of loss and profit is indicative of the fact that the Shari'ah requires a broad-based ownership of securities and investment certificates. It follows that mergers and takeover bids in the securities market need to be supervised very closely under the Islamic system of operation. The literature on the institution of Hisba (which connotes state intervention to promote what is proper and forbid what is improper from the point of view of the Shari'ah) demonstrates that it is permissible in the Shari'ah to check the manipulation of the prices of Securities or monopolistic collusions. This is based on the analogy of state intervention by competent authorities to check prices in the market and to control unfair practices since the days of the Prophet (Peace be upon him) when the first Islamic State was established in Medina. It is also in line with Islam's overall concern for the implementation of 'adl' (justice) and fairplay among different sections of society (Ibn Taymiya: 1982).

3.4 Conclusion

Thus, in conclusion, we can safely say that on the basis of the principles of Musharaka, Mudaraba, Murabaha, loans and other modes of Islamic financing, various types of financial instruments (both short-and - long-term) can be issued. The Islamic concept of sale should also enable us to develop a viable secondary securities market for Islamic securities. In this connection, it is important to note that "there is no claim that what is prohibited is all bad and what is enjoined is all good. Rather, as stated by Al-Shatibi, every Islamic injunction may have both desirable, and undesirable effects, and Islam bases its rules on predominant effects" (Zarqa:1980, p.9).

Thus, the Shari'ah position approximates the "theory of second best" in secular economic theory which states that when the first option is not attainable, it is better to go for the second best. Thus, if the various principles of financing come into conflict with each other and the conflict is unavoidable, the decision is to be made on the basis of the predominant effects.

Part Two :
Western Institutional Framework: A Critique

CHAPTER 4

ISLAMIC PERSPECTIVES ON THE BEHAVIOR OF SECURITIES MARKET PARTICIPANTS

4.1 Introduction

The main objectives of this section are to examine to what extent the behavior of investors, speculators, hedgers, and arbitragers as found within the context of Western securities markets is permissible in Islam. Despite the fact that most individuals who fit one classification also fit some or all of the other classifications, it is important to separate their activities conceptually so that the actions of market participants can be understood from Islamic perspectives. Generally Speaking, fron the the point of view of the Shari'ah (Islamic Law), the behavior of investors who are interested mainly in dividends from their investment in shares is acceptable, the behavior of speculators, hedgers, and arbitragers is generally questionable in the Shari'ah, which makes it necessary to examine their activities.

While new financial instruments/claims and obligations are traded in primary markets, financial assets that are resold are traded in a secondary market which is known as the stock exchange (i.g., The London Stock Exchange, The New York Stock Exchange). Business in the stock exchange is carried out by specially authorized people, called 'jobbers' and 'brokers'. Jobbers buy and sell shares on their own behalf, and they tend to specialize in a certain type of share, for example, shares in engineering companies. 'Brokers' buy and sell shares on behalf of their clients on the basis of a fixed minimum commission. Later, we shall see that the activities of 'jobbers' and 'brokers' have doubtful validity in the Shari'ah. This may require the merger of the activities of 'jobbers' and 'brokers' in the operation of the Islamic stock market. Let us now discuss in brief the action of each of the major market participants.

4.2 Investors

Many individuals and firms buy financial assets for the purpose of investment in order to generate a stream of income. As long as investors receive their income in the form of dividends rather than a predetermined fixed rate of interest, This from of investment is permissible in Islam.[2] However, many investments in the securities market, e.g., gilt-edged securities, consuls, preferred shares, debentures, and short-term commercial paper, carry predetermined fixed rates of interest. We have seen that investment in such securities is not permissible in Islam. Islam permits lawful trading of new or reissued financial assets either in primary or secondary markets as long as the income received is not artificially manipulated or the trading . of financial assets isnot carried out like a gambling transaction involving goods or assets which do not exist.

Although it is not always easy to separate the activities of individual investors from those of other financial asset holders, called speculators, it is very important to separate these activities both conceptually and operationally. Because, speculative gains as distinguished from gains from rational expectations are not permissible according to the Shari'ah.[3]

Islam has tried to discourage speculative business by giving the whole problem a moral bent. Even in the capitalistic society, several attempts have been made to control speculative business.

A number of principles relevant to the operation of financial markets can be drived from the preceding discussions.

4.2.1 Speculation: Bulls, Bears, and Stags

The artificial manipulation of stock prices by speculators (bulls, bears, and stags) rampant in the existing operations of money markets and stock exchanges can hardly be justified in Islam. As a result of uncontrolled speculations, the capital development of a country and the consequent growth of national income become a by-product, of the activities of the securities market, which, in turn, acts like a

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(2) The Qur'an has said: They say trade is like usury. But God hath permitted trade and forbidden usury; Allah will deprive usury of all blessing, but will increase for deeds of charity" (2-275-6).

(3) It is related on the authority of Ma'mar who reported that the Prophet (Peace be on him) said: "He who accumulates stocks of grain during the shortage of it (with a view to profiteering later) is a great sinner" (Muslim and Mishkat). Again, 'Umar reported: The Prophet (Peace be on him) said: "One who imports grain from outside and sells at the market rate, his maintenance is blessed, while he who withholds grain from sale in view of estimated dearness in future, he is thrown away from God's pleasure". Thus, withholding of grain and other commodities to raise their price artificially as well as "Najsh" or deceiving a purchaser through a third party offering a higher price is prohibited (Bukhari). But an auctioneer opening a sale to the highest bidder is allowed in Islam (Tirmidhi).

casino or a bookmaker at a racetrack. According to the Shari'ah, riba and gharar are the two main factors that may make a transaction un-Islamic. Speculative activities are un-Islamic because they are generally associated with gharar (uncertainty). In the Western framework, speculation is also associated with riba, as the transactions of of the financial instruments other than shares involve interest in one way or another.

Furthermore, 'gharar' means hazard, chance, or risk (khatar). In the legal terminology'of the Fuqaha, 'ghrar' is the sale of a thing which is not present at hand; or the sale of a thing whose 'aqiba' (consequence or outcome) is not known; or a sale involving risk or hazard in which one does not know whether it will come to be or not, as a fish in the water, or a bird in the air. It means that this kind of transaction (which is banned in Islam) in its external aspect is tantamount to deceiving the buyer, while in its internal aspect the nature of the object is not known" (Haque: 1977).

Thus, in order to avoid uncertainty, Islamic law denies the power to dispose of the right of ownership at least in the three following situations:

(1) things which as the object of a legal transaction do not exist;
(2) things which exist but which are not in actual possession or the recovery of which may not be expected; and
(3) things which are exchanged on the basis of uncertain delivery and payment.

In addition to these situations, there are several other categories where transaction becomes invalid (batil) or fasic (defective or void). (See: Schacht: 1979, p.135 and Hughes: 1980, p.33).

Since speculative activities introduce a great deal of uncertainty (gharar) they have doubtful validity in the Shari'ah. It should be noted that a 'bull' buys shares hoping that they will rise in price so that he may sell them later at a profit; a 'bear' sells because he believes that the price of shares will fall and therefore, he can sell them at a profit, and a 'stag' applies for the purchase of new issues of shares intending to sell them immediately for a higher price and thus a profit. Now the question is: Can a speculator manipulate prices to his advantages? Although the author's answer is in .the affirmative, it is important to view price movements .in speculative markets from an Islamic perspective. While professional stock market analysts believe in price trends, academic statisticians believe in random walks. Random Walk theorists, e.g., Bachelier (1969) and Kendall (1983), took the probabilistic view of speculative prices and started with the assumption that stock or commodity speculation is a 'fair game' with equal expectation of gain or loss or, more accurately, with an expectation of zero gain.

Although Alexander (1969, p.128) tried to reconcile the conflicting position of the trend and Random Walk theorists by saying that "in speculative market price changes appears to follow a random walk over time, but a move, once initiated, tends to persist." The Random Walk theory can be used as a plea to justify the action of the speculators in the securities market. Whatever justification we may have for random walks in terms of probability theory, the actual operation of the securities market suggests that a speculator can exploit the critical information "easier than others" to his advantage, because there exist certain trend-generating facts that can be manipulated by a successful speculator.

This belief is based on a number of reasons. Firstly, Western securities markets, contain a huge volume of assets created by financial intermediaries, and it is implicit that everyone may not have equal access to all information. Secondly, there is a large group of traders who have, for many years, earned their living by buying and selling securities. This very fact cannot be dismissed as a random walk or as an exception, if it is sustained over a number of years. Lastly, even when new information about a stock becomes available, it takes time for people to adjust to new conditions so that it does get discounted into stock prices. Although adjustment processes may not be smooth, price changes are not random. "Selling into good news" about a corporation can be profitable if overshooting is expected.

The point we are making is that every operation of existing stock exchanges in the West offers a scope for a speculator to manipulate stock prices to make a profit for an asset which does not really exist. This is what is not justified in Islam, as the speculator's main concern is immediate profit regardless of the socioeconomic consequences of the concerned enterprise.

Those who have studied the history of the South Sea Bubble of 1720 and the Wall Street Crash of 1929 (see Prof. Galbraith's, The Great Crash, Hamish, Hamilton) will understand how harmful uncontrolled speculation may be, Recently, the

Government of Kuwait had to launch a rescue fund for small investors caught in the country's multibillion dollar stock market crisis resulting from speculation (Arab News, October 26, 1982). However, it is claimed that speculators tend to check sharp price fluctuations thereby helping to keep the market active and free. In so far as speculation renders this service by helping production and containing the sudden price fluctuations of stock prices, it is in conformity with Islam. But, the evidence shows that speculators are interested in private rather than social gains (Mannan: 1970, p.196).

4.2.2 Speculative Gains-VS-Capital Gains

It follows from the above discussion that speculative gains must be distinguished from capital gains or appreciation. There is a number of significant differences. Firstly, while speculative gain is somewhat manipulated, capital appreciation or depreciation is the natural consequence of past investments. Thus, the purchase of a share entitles one to the ownership of the property of the company to the extent of the sale of a share. The sale of a share in an open market at a profit eventually constitutes capital gains or appreciation. This is permissible in Islam subject to the conditions of sale as stipulated in the Shari'ah. This is like a trade or sale of property at a profit.

Generally speaking, there are three types of eventualities: pretrend, current trend, and posttrend analysis of price movements. For the sake of simplicity, let us categorize the various types of shares into three groups dealing primarily with harvested commodities, nonharvested commodities, and international commodities. These descriptions are chosen to illustrate how fundamental economic analysis can be brought into consideration within the framework of rational expectation.

Let us suppose that a firm or an individual intends to specialize in the sale or purchase of shares of companies dealing mainly with harvested commodities such as grain, soybeans, sugar, and cotton. These commodities have in common a sensitivity to seasonal production cycles. Despite the importance of the demand side, the supply side of the equation tends to be dominant as it constantly faces the supply-oriented variables of farmers' planting intentions, effects of weather and rainfall, the conditions of harvest, storage facilities, and transportation, in addition to the government's price support and price stabilization programs. While in the case of nonharvested commodities, variables such as consumer income, employment level, and price situation affecting the demand side of the equation tend to be dominant. The state of the overall economy affects industrial commodities as they are connected with the overall profit picture, technology changes, political situation, and international tension. Such fundamental economic analysis is within the scope of anyone. The willingness to use the possible checklists of sensitivity factors to develop an intelligent guess or personalized expectation or speculation concerning possible price. movement and to engage in trade accordingly should be seen as the heart of any successful business operation. The point I am making here is that there appears to be nothing wrong in capital gains through such intelligent and logical analysis of market behavior. It would, however, be a mistake to assume that in a business or trading operation everyone will make a profit. The possibility of profit will diminish if such economic analysis, technical timing, and money management are inappropriate.

What is important from the point of view of the Shari'ah is that everyone should have fair and equal access to market information. It is certainly not permissible in Islam for a speculator to attain either a monopoly or monopsony position, thereby influencing the course of the market mechanism either by withholding certain information or by influencing the variables to his advantage.

It follows then that while the legitimate expectation of traders is allowed to enhance the possibility of profit, the unfair manipulation of the market to the detriment of the interests of the community is not allowed. Now the fundamental question is how to ensure fairness in stockmarket operations and where to draw the line between the Islamically desirable and undesirable expectations about the future rise and fall in stock prices. This is an area of Ijtihad (fresh thinking) and Qiyas (reasoning by analogy) within the framework of Islamic laws. Once an Islamic a stock exchange is established, it should not be difficult to prepare a guidelines or rules of business to organize its activities in line with the Shari'ah. Even in the West, a stock exchange can be "referred to court to see if it is acting against the public interest. If the court finds against the stock exchange, it will be given time to amend its practices and make them fairer": (Nobbs: 1981, p.148). There is no reason why Islamic economists and Shari'ah scholars should not be able to examine stock exchange activities from time to time to see whether they are in conformity with the principles of the Shari'ah. This underlines the need for a continuous review of the operation of a stock market in an Islamic framework with a system for monitoring its activities.

Secondly, it is clear that estimating the future prospects of investment differs from speculation in that the former is based on rational expectation which takes all available relevant socioeconomic variables into consideration before making an investment decision, while the latter is intended to make a profit by holding a financial instrument or by selling it short. The investment in ownership shares is concerned with both current income (in the form of dividends and capital formation) and the growth of the enterprise resulting from the reinvestment of a part of the retained earnings. Thus, the capital gains of the investors are concerned with the totality of .the investment, but the speculative gains are not.

Thirdly, it follows that the investor takes into consideration the short - and long-term consequences of his decision to sell his stock and to make capital gains or to take a loss, as the case may be. This is not the case with the speculator: He may not be interested in the real growth of the capital market. The investor may very well be interested in selling his shares either because he needs the cash income or he wants to invest in another enterprise. There are at least eight variables which influ-. ence the stock price, viz: (i) the general business climate or trend (there are times when overpriced stocks sell well and other periods when good stocks sell poorly, depending upon the state of the entire economy and the amount of confidence the public has in it); (ii) the rate of dividends; (iii) the rate of growth of the company; (iv) the ability of a company to compete successfully with its rivals over a period of time; (v) the popularity of the product, whether the market for that product is growing or. decreasing; (vi) the general market price for bonds; (vii) the return on alternative investments; and (viii) the rate of inflation.

Any capital gains resulting from the interactions of these variables and factors, which are in many ways beyond the control of investors, may not be inconsistent with the spirit of Islamic values.

Lastly, it follows that the change of variables other than the expected stream of profit may affect capital gains. This becomes clear if the value of a corporate stock is seen as the present value of the future profits[(4)]. The rate of discount tends to rise if the future is more uncertain or if an income payment is, for example, 5 or 10 years away. Although discounting involves a choice between present and future incomes having an Islamic ethical and moral dimension, a shift in preference to present in-

(4) This can **be expressed** through the **standard present** value formula as follows:

$$PV_s = \frac{R_1}{(i+r)} + \frac{R_2}{(i+r)^2} + \frac{R_3}{(i+r)^3} \ldots\ldots\ldots n \ (1)$$

where PV= Present value of the stock

R1 R2= Expected profit stream in the years one, two; etc.

r= Rate of discount

come instead of the future income from the stock purchase may lower the price of the stock, even if there is no change in the expected stream of profits.

Since expected dividends plus changes in the price of the stock constitutes the return from the stock, the investor's change in preference towards income today may lower the price of the stock thereby affecting his capital gains. The investor's capital gains can be seen in a dynamic framework. His shift in preferences towards present consumption rather than future income from the stock, may affect his capital gains, whereas speculation tends to work in a static framework as his preference is most likely tilted in favor of income today. It should be mentioned here that investor may also have a preference for current income today. This becomes un-Islamic when the preference for income is tempered by consideration for gharar as explained earlier. Thus, what distinguishes one investor from another is the motive behind the respective interest towards present income. Whether the investor's motive is justified Islamically hinges on the extent and level of his exposure to Islamic investment educational programs on business ethics. This is indicative of the need for reorientation programs which may be organized by Islamic banks for the benefit of actual and potential investors and businessmen.

4.2.3 Jobbers and Brokers as Speculators

It is necessary to discuss in some detail the behavior of jobbers and brokers. Just as Islam does not encourage the speculative activities of the security market, Islam does not sanction the behavior of the jobbers and brokers who are actually involved in the process of speculation. A case can, be made for broker services within the framework of an Islamic stock exchange and money market. however, the way these services are offered in the existing stock exchange will require a structural change. In Western stock exchanges, brokers give advice and carry out the instructions of their clients to buy and sell their shares through jobbers. Thus, when a broker instructs a jobber to purchase shares on behalf of his customers, the jobber may have a supply of such shares which he may have purchased at a lower price hoping to sell at a higher price - an activity which tends to push up prices. It is this speculation which has attracted much criticism. When jobbers and brokers transact business, no documents change hand. Each man makes a note in his book. Jobbers have thus been compared to bookmakers at a racetrack. In the Islamic scheme of affairs, it may be necessary for jobbers and brokers to merge, so as to limit the scope of speculation and artificial manipulation of stock prices, and, then, it would then be relatively easy to control their behavior.

Again, under the existing system, the broker works on both sides of the market. He is both buying and selling the same contract for different customers at virtu-ally the same time. Under current Western practices, it becomes difficult to get an unbiased opinion from the broker about a trading position, because he has a stake in the issue. It is said that "before asking someone what he thinks about the price of anything, ask him if he owns any of it. If the answer is "yes" go elsewhere for an unbiased opinion. He cannot give you one 11 (Beleveal: 1967, p.261). Since Islam stresses perfect honesty in all business transactions, it would be necessary to de-fine the exact role of the broker and to control the rate of the broker's commission.

4.2.4 Hedgers

It is important to distinguish the activities of speculators and hedgers. "Hedging occurs when two or more financial assets are held with the expectation they will have offsetting price-movements because of some non-random relationship between them" (Auerbach: 1982, p.146). Fundamentally, a hedge is a protective de-vice intended solely to protect profit through speculative activities, (Beleveal: 1967). As such, it may not be viewed favorably by the Shari'ah. But hedging must be distinguished from the diversification of risk in which an individual expects that if the price of one asset falls from some expected level, another asset in the portfolio will have an offsetting price movement as a matter of random chance.

4.2.5 Arbitragers

"Still another type of financial market participant is the arbitrager, who per-forms arbitrage. One form of arbitrage, simple arbitrage, takes place when an asset is bought and simultaneously sold at a higher price. For example, if a stock is bought for $5.00 on the Paris Bourse (stock exchange) and simultaneously sold for $5.25 on the New York Stock Exchange, the transaction is known as arbitrage. An arbitrager must usually carry an inventory because all his or her sales cannot be made simultaneously with purchases. The arbitrager, therefore, holds a speculative inventory ("takes a position") and cannot be easily distinguished from a speculator" (Auerback: 1982, p.116). If the activity of the simple arbitrager can be compared with that of a trader buying in one market and selling in another depending on the elasticity of demand, then it may have relative validity in the Shari'ah. But, in actual practice, an arbitrager can hardly be distinguished from a speculator, and their activities may well assume the character of gharar transactions.

4.3 Conclusion and Policy Implications

From the preceding discussion, it is clear that in a properly run Islamic Financial Market, there is a definite role for genuine investors who may be interested either in dividends or in capital gains. When the capital gain is seen as a part of cap-ital development and consequent growth in national income, it is perfectly legitimate in Islam. Thus, when stock and share prices are determined by the force of supply and demand, the sale and purchase of securities implies the change in ownership. Profit and loss then become a normal part of the economic transaction, and this is allowed in Islam. But when the true speculator is influencing price trends, in order to make monetary gains, this may not be permissible in Islam.

The second main conclusion is that the activities of the speculator, hedger, and arbitrager, who are connected with each other in a complex and complicated way, do not have an exact counterpart in Islam. They have a very limited role to play in the Islamic Financial Market, although a case can be made for commission agents in the sale and purchase of shares. It is important that Islamic banks initiate action to prepare a code of Islamic conduct for the participants of financial markets coupled with intensive and extensive Islamic investment educational training programs on business ethics for the benefit of actual and potential investors and businessmen. There is a need for a continuous review of the Islamic Securities Market with a built in system of monitoring its activities by an appropriate supervising agency. At the same time, an institutional framework needs to be evolved under which Mudaraba, Musharaka, and Murabaha financial instruments and other similar instruments can be operationalised. This is necessary in order to suit the diverse tastes of investors who may wish to participate in various types of profit-sharing or rent-sharing investments.

CHAPTER 5

WESTERN SECURITIES MARKET OPERATIONS: AN ISLAMIC APPRAISAL

5.1 Introduction

The main objective of this section is to critique the operations of existing securities markets in the light of Islamic principles. In the first instance, it should be pointed out that it would be naive to declare the entire operation of the secular securities market as wholly. un-Islamic. It is true, though, that a substantial part of the operations of the Western securities market may not be lawful according to the Shari'ah. Yet, in several ways, secular financial market operations are of relevance to our understanding of the functioning of the Islamic Financial Market, especially with respect to:

(a) the application of the doctrine of limited liability;
(b) the mechanics of the distribution of dividends among shareholders; and
(c) the provision of financial information to investors.

5.2 Limited Liability

Islam accepts the principle of limited liability. Hanafi law permits some flexibility in the distribution of profits in an'inan' partnership, but is absolutely rigid with regard to the contractual stipulations affecting the distribution of liability. In all partnership forms, as well as in other forms of commercial association, the responsibility for losses is to be assigned strictly in accordance with the size of each party's investment. Any deviation from this rule invalidates the contract. Thus, in Islamic law, "the profit follows the conditions agreed upon, and the loss follows the capital" (Udovitch: 1970, p.129). This principle of limited liability provides encouragement to small investors who might otherwise not be prepared to make their savings available.

5.3 Dividends and Interest-bearing Shares

The Shari'ah permits investment in only those shares, bonds, and investment certificates which entitle the holder to the profits of the company in proportion to the number of shares held, because. Islam believes in risktaking in investment, trade, and business. This position of the Shari'ah immediately makes other forms of investment, both short - and long-term, in securities markets unlawful. The investments in this category include preference shares, debentures, treasury securities and consuls, and commercial papers.

5.3.1 Preference Shares

Preference shares carry a fixed dividend which is met before the ordinary share dividend is fixed.

The choice between buying ordinary shares and buying preference shares comes down to the degree of risk which the investor is prepared to bear. The ordinary share carries a greater risk and, therefore, a greater prospect of high dividends to compensate for the risk. Both of these types of shares carry with them the right to attend and vote at the shareholders' meetings and thus, to exercise some influence over company policy. While investment in ordinary shares appears to be lawful, investment in preference shares is not, because of its association with a predetermined fixed rate of interest. This does not, however, preclude the possibility of introducing the concept of the preference dividend with a predetermined higher ratio of profit within the framework of an Islamic economy. Thus, the intersectoral allocation of resources can be influenced through this mechanism, particularly in favor of sectors which need investment so as to broaden the ownership structure of the means of production and to bring about a more equitable distribution of income.

5.3.2. Debentures

There is another type of investment in a company which is often linked with share acquisition, but it cannot be classified as shares as it does not carry voting rights.

A debenture is really a special type of loan at a fixed rate of interest, which must be paid before any profits are distributed to shareholders. Often, one particular asset of the company (e.g., a piece of land) is assigned as a guarantee for debentures. Clearly, investment in debentures is not permissible in the Shari'ah.

However, the Pakistan Islamic Ideology Council (1980, p.36) maintains that debenture financing, which at present is a very common method of financing fixed investment, may be replaced by the issuance of a new corporate security to be called the "Participation Term Certificate" (PTC) which we shall discuss in some detail later. At this juncture, a distinction between profit and dividend should be clearly made. It is quite possible to conceive of a situation in which the dividend is zero but profit is positive especially when the volume of undistributed profit may be kept at a higher than normal level by the decision of the board of directors of the company.

5.3.3 Treasury Securities and Undated Consuls

In the Western framework, treasury securities and undated consuls are long-term investments with fixed rates of interest. In the case of treasury securities, if an investor invests in $100 worth of stock, he might be repaid anytime between a period t1 and t_2, and he would receive interest of, for example, 5 per cent per annum. As per undated 2-1/2 per cent consuls (consolidated stock), investors will probably never be repaid, but investors will continue to reap the 2-1/2 percent interest indefinitely. However, fixed interest-bearing treasury securities and consuls can easily be replaced by appropriate investment bonds and certificates on the payment of a dividend along lines similar to the PTC.

5.3.4 Commercial Papers

"Commercial paper" refers to short-term promissory notes issued by finance companies and other corporations of high standing. Much of this is sold by the issuer directly to the ultimate buyer, the latter being primarily financial institutions and non-financial corporations with funds to invest for short periods. Some commercial papers are issued to dealers who pay the amount and distribute the paper to buyers all over the country - (Chandler: 1973, p.57). The short-term low-risk debt instruments are issued to meet the different demands for cash during different seasons of the year. They are issued in different denominations and their maturities usually range from 30 days to 270 days.

The trading of prime commercial paper apart, one may view the larger market for the trading of all commercial papers with different levels of default risk. The .abolition of interest from the trading of commercial papers will minimize its importance in an Islamic economy.

In addition to Mudaraba financing, various types of commercial papers of a short-term nature can be issued under Murabaha (cost-plus) investment as well as under a Bai-Salam arrangement. However, due care has to be taken not to because involved in the speculative trading of commercial papers.

It should also be for the part of the bank to act as the agent for the purchase and sale of papers for business firms which do not find it feasible to distribute their issues directly because of the cost of operation. It is permissible under the Shar'iah for that the bank to realize a commission for rendering this service (PCII: 1980; p.37).

Like investment banks, Islamic banks can also perform underwriting functions. Under the underwriting arrangement, investment banks provide bridge finance for periods between the establishment of companies and the floatation of their papers and shares for public subscription. "Bridge financing which carries interest may be replaced by the system of 'firm commitment' under-writing which is compatible under the Shariah" (PCII: 1980; p.55). If this view of the Islamic Ideology Council of Pakistan is operationalised, the scope for trading in prime commercial papers and other securities would tend to expand, thereby increasing the mobility of funds over wide areas. It would also improve the allocation of investible funds and of investment in real capital.

5.4 Secondary Markets for Securities

A 'secondary market of securities' is means facilities for trading in outstanding debt and equity claims. As a matter of fact, a share actually represents the title of ownership of the property and other assets of the business firm or corporation. Since they are negotiable instruments, there is no difficulty in trading these shares in the open market. The market value of these shares may fluctuate. As a result the market price of shares can be equal to the face value, or it can be greater or less than the face value of the securities resulting in capital 'gain' and capital 'loss' respectively.

A simple hypothetical example will illustrate this point. Let us suppose 'A' has purchased a share of $100 from a company. If the market price remains the same as the issue price (i.e., $100) and the company declares a 10 percent dividend, then the yield is 10 percent. If the price becomes twice par value the yield will only be 5 per cent.

From the above mentioned example, a number of relevant questions with clear Islamic dimensions arise. Firstly, it is permissible to receive dividends as a source of income from the investment. However, the declaration of dividends should not be made to the disadvantage of small shareholders who are not in effective control of company.

Secondly, much would depend on whether the substantial increase of the share price is due to (a) the normal capital development of the country, or (b) manipulation by speculators to make speculative gains, as distinguished from capital gains, or (c) a take-over bid by a larger competitive firm to gain monopoly control. Situations (b) and (c) have doubtful validity in the Shari'ah, as the primary objectives which motivate people for speculative gains, merger and take-over bids) in most cases, are not generally consistent with the spirit of Islam.

Despite the claim that mergers and takeovers reduce wasteful competition and bring about the benefits of economies of scale, it is important to examine whether the concentration of economic power in a few hands resulting from mergers and takeovers contributes to the inequitable distribution of ownership shares and the consequent skewed distribution of income.

Thus, far, we have discussed the buying and selling of shares in a general way. At this stage, it is worth commenting on some of the specific aspects of secondary market securities, namly, over-the-counter stocks, buying stocks on margin, and the stock options market.

5.4.1 Over-the-Counter Stocks

The largest security market in the Western world in terms of the number of different stocks and bonds traded is the over-the-counter (OTC) market.

It is a set of arrangements involving brokers and dealers who are located all over the country and who are linked to each other and to buyers and sellers by telephone, teletype, computers, and written communications (including lists of offers to buy or sell) (Chandler: 1973, p. 59).

In principle, there is a case for the trading of stocks through the OTC market in an Islamic economy subject to the Shari'ah conditions of sale. There is, however, limited scope for such trading through the OTC market in the context of present-day Muslim countries.

The OTC market assumes the existence of an efficient communications network and the presence of enlightened and well-informed investors. In both these aspects, Muslim countries will have to go a long way in establishing efficient and quick communications networks among themselves, and in disseminating information among prospective investors. moreover, the Shari'ah requirement pertaining to the disclosure of detailed financial information before any sale takes place would certainly limit the scope of operations of an the OTC market as operated within the framework of the western securities market. There is a clear need for an independent supervision of the operation of OTC market with full authority and power to expel companies or dealers believed to be dishonest and violating the code of conduct designed for the purpose. The point is that the Islamic Financial Market can have its OTC market only when the conditions mentioned are fulfilled.

5.4.2 Buying Stock on Margin

This refers to purchase of shares on credit. Thus, when an investor can make a stock purchase by .paying 50 percent down and getting a loan from the brokerage house for the remainder, this is called a "margin" of 50 percent. The stock certificates are deposited with the broker as security. In the United States, the Federal Reserve Board regulates the minimum margin.

Buying stock on margin as such may not be repugnant to the principles of the Shari'ah, as Islam allows purchase and sale on credit. Furthermore, Bai-Muajjal, which is permissible in the Shari'ah, is a sale under which the price of the item involved is payable on a deferred basis either in a lump sum or in instalments (PCII: 1980, p.97). It would, however, not be advisable to use it widely or in discriminately in view of the danger that it can open a back-door for unrestricted speculation and gambling in the securities market. Therefore, safeguards would, be needed to regulate the' use of "margin" depending on whether there is a need to stimulate the market or curb its speculative activities.

Because buying stock on margin can give speculators the opportunity to extend the scope of their operations, thgeir available cash may buy many more shares giving them the opportunity to manipulate more than market operations.

5.4.3 Stock Options Market

. A 'stock option' is a financial asset that gives the owner the right to buy (i.e., call) or sell (i.e., put) a stock at a particular price (i.e., exercise price or striking price) before a specified date.

In the first place, it appears that there is no apparent conflict between the operation of the stock option market and the principles of the Shari'ah. A shareholder has the right to exercise his option to sell his share in the market just as an owner of a house has a right to dispose of his property in the open market. The Shari'ah also permits selling through auction or open sale to the highest bidder[1].

This apparent compatibility may necessarily mean that the operation of the stock options market even without interest charging should be permissible in Islam. The basic economic objective for having the Islamic Financial Market is to mobilize funds for equity participation on the principles of Mudaraba and Musharaka, and not to encourage speculative activities per se.

Therefore, despite the fact that stock options are financial assets that allow individuals to take a position on stocks at a small fraction of the cost of the stock, the actual operation of the stock options market provides ample opportunity for speculators to speculate on stock prices. They also offer a way to hedge against unfavorable price changes on stocks. Although the operation of the stock option market as such may not be incompatible with the Shari'ah, its operation may provide a scope for speculative activity and may help to stimulate economic growth. Moreover, the operation of a stock options market in an Islamic framework would

(1) Anas reported "the Messenger of Al)ah (Peace be upon him) purchased a piece of hair-cloth and a bowl and he said: who will buy this piece of hair-cloth and bowl? A man said, I take them for one dirham. The Prophet (Peace be upon him) said: who will give more than one dirham? A man gave him two dirhams and bought them from him" (Tirmidhi: reproduced from Muhammad Ali: 1964, p. 298).

imply that all the participants are sufficiently imbued with Islamic business ethics. It is felt that in the absence of any explicit provision for the supervision and enforcement of an Islamic code of business by an independent agency, the operation of a stock option market may not be encouraged as a matter of policy in the context of present socioeconomic realities.

5.5 Conclusion

From the preceding discussion, a number of important conclusions emerge.

The concept of the Islamic Financial Market is compatible with the economic values of Islam. While the floating of shares and earnings in the form of dividends may be permissible, other securities such as preference shares, undated consuls, commercial papers, etc., whose transactions involve predetermined fixed interest would cease to be operative in the Islamic Financial Market. This does not mean that the Islamic Financial Market will not have alternatives to offer. In fact, debenture financing can be replaced by Participation Term Certificates on a profit-sharing basis, and short-term commercial paper could possibly be floated in the market for financing short-term trade and business on the principles of Murabaha (cost-plus).

Because they encourage speculative activities and the unfair manipulation of stock prices, there exists only limited scope for buying stock on margin, and for an over-the-counter stock (OTC) market and a stock options market in an Islamic framework. This is not to suggest that the legitimate purchase and sale of shares and certificates are not permissible in Islam. The Islamic Securities Market needs to be organized to promote investment and to diffuse the ownership of shares. This is an area which requires further examination.

Part Three:
Operational Framework

CHAPTER 6

SOME PROBLEMS AND ISSUES OF THE ISLAMIC SECURITIES MARKET

6.1 Introduction

This section is mainly devoted to identifying a number of key problems and issues of the Islamic Securities Market. Although some of these have been discussed implicitly in the preceding chapters, they are again mentioned here in order to bring them into a sharper focus. Some of them are controversial in nature, but all of them have a real and potential impact on the conduct and organization of the Islamic Securities Market.

6.2 Problems and Key Issues

Some of the problems and key issues are:

(a) indexation;
(b) geographical location and the dispersion of share ownership;
(c) corporate profits and dividend stabilization schemes;
(d) family controlled firms and equity debt ratio;
(e) lack of corporate agricultural enterprises;
(f) narrow, and fragmented market information cost;
(g) option-linked shares / certificates;
(h) preemption sale in securities markets; and
(i) deferred payment for - linked shares / certificates.

(a) Indexation

We have already seen that there exists a controversy among Muslim economists and Shari'ah scholars as regards the scope of indexation in an Islamic economy. Elsewhere I have argued (Mannan 1992) that "indexation as an alternative policy instrument is to be analyzed in terms of the source of the concern. If the indexation is accepted in principle, its justification is to be found in the Islamic concept of justice and fair treatment to all involved in money contracts not in the belief of the self-regulating tendencies of the free-market economy as claimed by monetarists or in the massive governmental intervention in economic affairs as advocated by cost-plus theorists."

The fact is that there is a difference of opinion among Muslim economists about the permissibility and desirability of the indexation of bank loans and advances from the point of view of the Shari'ah. One group of Muslim economists who support indexation argues that "generally inflation is a regressive tax and creates inequities in the distribution of income and, similarly, deflation could be inimical to the business interest. Indexing of principal amount within constraints,commensurate with inflation or deflation, appears to be a logical proposition" (Afzal: 1977). Also, the Report of the Council of Islamic Ideology of Pakistan (1980: p.96) looks with disfavor upon the idea of introducing indexation on the grounds that "under the Shari'ah, currency transactions are not treated differently from commodity transactions in so far as lending and borrowing are concerned."

But there appears to be a difference of opinion among scholars as to whether, today, money should be treated as a commodity or a medium of exchange. It is argued by some scholars that in the earliest days of Islam, the Dinar and Dirham were the currencies, the value of which was dependent on the weight of gold or silver in then and they were acceptable by weight not by counting. In an important sense, money was as good as a commodity because apparently there was no difference between the intrinsic and face value of the money. Therefore, some earlier jurists held the view that in the actual conduct of all commercial transactions, some form of acceptable currency should be used, and because of their intrinsic value, gold and silver coins were considered to be the most acceptable currency. Therefore, opponents of indexation argue that since indexation implies an increase to be paid on the amount originally lent out, it is prohibited in Islam.

Those who do not share these views argue that the concept of money has changed and will continue to change, and that these changing views need to be understood in their historical perspectives. Modern currency is accepted and circulated at a value greatly in excess of its intrinsic worth, based entirely on the trust and confidence of those who use it. Can it then be treated on a par with commodity transactions where there is apparently no difference between the intrinsic and the face value of the commodity ? In our times, however, currency notes are recognized as legal tender despite their wide margin between their intrinsic and their face value. Are they not recognized only to facilitate modern transactions?

Moreover, according to the prevailing view of jurists, the loan of the commodity should be returned in the same kind and quantity irrespective of any change in its price at the time of the return of the loan. does this mean that the borrower under-takes to return the "equivalent or likes" of that which he received, but without any interest? Is it permissible, then, to measure this "equivalent" in terms of money or some other standard medium of exchange ? Can the measurement of this equivalent be made with reference to the base-year value of the goods and services involved? These are some of the questions which require close examination.

Since the Shari'ah requires that the borrower undertake to return the "equivalent or likes" of that which he received but without any interest, it is argued that an "index-linked loan establishes this equivalence" in real terms during both times of inflation and deflation; lenders may get more in money term during inflation, and less during deflation. This is where the question of 'equity' enters the debtor-creditor relationship. It is further said that the elimination of interest from the Islamic economy makes it imperative that the debtor-creditor loan contract be linked to a specific price index mutually agreed upon at the time of the signing of the contract.. Once this is accepted, it will enable the bank to broaden its loan activities within the framework of the Islamic Securities Market.

Its is true it is that inflation might undermine the operating profitability of firms whose shares provide equity securities for investors. But it is also true that indexation may lead to a change in the composition of demand for various financial assets in the sense that it may lead to the depression of the capital values and the increase of the yields of instruments that are not indexed. The question of whether index-linked loan certificates may be issued needs to be examined from the point of view of the Shari'ah.*

In a recent Workshop on Indexation (held in Jeddah, April 25-28, 1987, IRTI-IDB), all the participating jurists and economists were in agreement that the payment of any "excess" over the original amount of a loan is 'riba' and as such it is prohibited. A difference of opinion arises as to whether the indexation of a loan represents this kind of 'excess' which is considered to be 'riba' in the Shari'ah. Scholars who hold the view that this is an excess argue that paper money assumes the functions of the gold and silver monies (dinars and dirhams) in contemporary period. So the Hanafi view (particularly Abu Yusuf's contention that it is the value of "fulus" which should be repaid in case of appreciation or depreciation of "fulus" vis-e-vis gold and silver) is not applicable in the case of paper money because it stands for the gold and silver monies on which there is no consideration for the issue of the appreciation and depreciation of all loans whatever their origin may be. Another view is that the indexation of a loan represents neither an excess nor a shortfall in repayment in real terms. It simply ensures the repayment of the exact amount of the original loan in real terms as paper money is simply a medium of exchange, and this medium of a loan can also be ex-pressed in terms of commodities for which the loan is extended and repayment may be demanded in terms of those exact commodities. The author tends to agree with Abu Yusuf's contention.

(b). Geographical Location and the Dispersion of Share Ownership Islamic banks may issue local equity with a provision for regional quotas. This emphasis on the regional distribution of quotas for the purchase and sale of local equity has a clear Islamic dimension in the sense that it tends to diffuse share ownership, thereby ensuring a better distribution of income. The prior selection of underprivileged or relatively underdeveloped areas or regions in consultation with the member countries of the IDB would help the Bank. adopt realistic social and economic projects.

Once this concept of a quota is introduced within the framework of the Islamic Securities Market, it would tend to interfere with the market mechanism. But the fact is that "the demand for securities is much more amenable to official influence than is their supply. It may be promoted, first, by tax concessions in favour of shareholders. Ness's account of the Brazilian experience provides a rich and detailed illustration of the efficacy with which fiscal incentives may foster the growth of the share market." In brief, the Brazilian incentives included: (1) provisions for shareholders to deduct substantial proportions of the purchase of cost of shares from taxable income; (2) provisions for part personal income tax exemption of dividends, and for concession rates of withholding tax for shareholders in those 'open capital' companies that undertook to achieve a wide dispersion of equity; and (3) provisions for individuals and corporations to discharge a proportion of their tax liabilities by subscribing to special mutual funds ('the 157 funds'), withdrawals from which could not begin for at least two years. The 157 funds, in turn, were required to invest in company securities, particularly new issues. The generous tax-relief provisions not only swelled the 157 funds but seem also to have encouraged the growth of mutual funds generally. The Brazilian fiscal incentives quickly produced striking increases in the volume of share issues, the number of firms issuing, stock exchange turnover and share prices" (Ness: 1974, p. 460).

Again from the point of view of the Shari'ah, a case may be made for the floating of shares in small denominations to encourage the greater participation of people of small means as it may very well lead to a broad-based ownership of stocks, which also has implications for income redistribution. However, what more important is power and authority redistribution, a broad-based ownership of stocks must accompany the broad-based participation of shareholders in the actual decision-making process. This may increase the cost of administration but in terms of human fulfilment, it tends to be more satisfying.

(c) Corporate Profits and Dividend Stabilization Schemes

There are a number of issues having a clear Islamic dimension in corporate profits as well as, dividend stabilization schemes as suggested by some Muslim economists (Mohsin: 1982, p.34). Most of the issues are related to the question of "equity" consideration. Generally speaking, three things can be done with corporate profits. First, a part will be claimed by and therefore flow to government as corporate income taxes. Second, a part of the remaining corporate profits will be paid out to stockholders as dividends. Such payments flow to households, which of course, are the ultimate owners of all corporations. What remains after corporate income taxes and dividends have been paid is called undistributed corporate pro-fits. These retained corporate earnings along with capital consumption allowances are invested currently or in the future in new plants and equipments, thereby increasing the real assets of the investing business" (McConne 1972, p.167). Several questions can now be raised. Firstly, both the rate or level of dividends as well as the amount of retained earnings are decided by the board of directors of the company, who in turn are controlled by the majority shareholders. The minority shareholders, particularly small investors, are simply at the mercy of the majority shareholders. There is a clear need for a built-in mechanism to protect the income of small investors. Is the creation of a dividend stabilization fund a possible an answer to this problem? Secondly, how do the benefits from stabilization fund go to the shareholder who sells his shares ?

If the benefit is not intended for those who sell their shares,then is it lawful to transfer the benefits of a former shareholder to a new shareholder who has contributed nothing to the creation of the old stabilization fund ? The same question can be raised in the case of the proportionate shares of former shareholders in undistributed profits. Does the market price of shares reflect these proportionate shares in undistributed profits ? If not, should we treat them as transfer payments by the shareholders or should we create a loss-compensating reserve built up during the good times to take care of such claims of former shareholders ? This loss-compensating reserve may be distinguished from the one proposed by some for investment depositors of banks. To me, guaranteeing the investor the repayment of his principal even in the case of loss amounts to giving interest. This is not permissible. This is not true in the case of the shareholder, because a part of his income from his investment is retained. Further examination is required examination as to how the benefit of 'undistributed profits may be given to a shareholder once he decides to transfer his ownership shares. The incorporation of this settlement provision may have far-reaching implications in the actual conduct of the Islamic Financial Market. It may very well put a brake on the undue speculative activities of existing share markets. These issues need further explanation.

(d) Family Controlled Firms and Equity Debt Ratio

Family or clan companies are common in underdeveloped countries (Drake: 1973, p.198). Member countries of the IDB are perhaps not an exception. The main problem is that these family controlled firms are generally reluctant to admit outside capital and risk dilution of control. Indeed, where outside equity is admitted, 'unsavory policies detrimental to the interests of the minority (outsider) shareholding groups (with respect to dividend policy, stock manipulation, corporate disclosure, excessive compensation to executives who are family members) are not unknown" (Maniatis: 1971, p.607). Such activities may discourage the demand for equities issued by family controlled firms. Some such firms have attained what they regard as an optimum size and do not wish to expand their operations. Although this hypothesis is yet to be tested in the case of Muslim countries, yet it could present a real problem, because the profit-sharing concept has not yet gained ground in Muslim countries. The institutional rigidities and legacies of the past may, in fact, stand in the way of organizing the Islamic Financial Market.

"Firms that are interested in expansion may finance it with retained profits and/ or bank credit. Bank overdrafts, nominally short-term, are so continuous as to be long-term in effect. Good banking connections permit this system of finance to be perpetuated (indeed, interlocking ownership and direction between banks and other companies), and may lead to a dependence on bank finance which the banks may not wish to curtail" (Drake 1973 pp.180 and 199).

From the above analysis it becomes clear that when a family controlled firm has a high ratio of equity to debt in the capital structure of the firm (a situation in which a firm can easily sell its new issues), it is reluctant to give an entry to outsiders. This may be due to a lack of understanding of the Islamic way of financing. However, when firms have low ratios of equity to debt, which tends to make the new issue too risky for potential subscribers, they may not be interested in raising equity funds by new issues of shares because they have access to cheap bank finance.

"It can be argued that in less developed countries only the most creditworthy firms can sell their securities via a capital market, that these firms also have prime access to bank loans, and hence that such firms have greater freedom of choice between different sources of finance (in terms of availability of funds), for example, between bank loans and security issues. Development of capital-markets provide no reallocation of resources to such firms. We have to examine instead where the buyers of securities obtain their funds, and how they would have used them alternatively; and how the lending bank derives its loanable funds, and to what uses it would have put them alternatively" (Wai and Patrick: 1973, p.259).

Fundamentally, the limited supply of private securities in underdeveloped Muslim countries is not only related to small size, but also to the limited investment horizons of many local businesses coupled with the lack of a proper appreciation of the Islamic concept of investment. Inevitably, it will take time for such firms to reach the point of raising funds through public shares on the basis of Mudarabah financing, thus providing the necessary augmentation of the supply of private paper. Meanwhile, it might be desirable for Islamic banks to raise funds by issuing shares and debentures publicly on behalf of small firms or for governments to increase their own borrowing beyond the amounts needed to finance public sector investment, and induce undercapitalized local firms to cooperate in equity financing with banks.

A simultaneous attempt may be made to sell the concept of Islamic investment through educational programs as well as to bring about change through psychological training. What is needed is institutional reform so that cheap bank finance cannot be made easily available to favored borrowers. Furthermore, a study of the existing local laws, customs, fiscal and monetary policies, incentive systems, etc., may be undertaken in order to suggest measures for the necessary reforms.

(e) Lack of Corporate Agricultural Enterprises

If the Islamically justified goal of a more general participation by the population in financial activity and a more widespread dispersion of share ownership in developing Muslim countries is accepted as a policy goal, then one of the means to achieve that goal lies in the development of corporate agricultural enterprises linking the rural sector of the economy. The heart of distribution lies in the rural areas of most Muslim countries, because this is where the bulk of the population lives.

But the problem is that corporate agricultural enterprises do not exist in most Muslim countries. Most of the member countries of the IDB, including all the 19 least developed Muslim countries, have economies which are dominated by agriculture which is usually organized along smallholder lines. Moreover, the share of manufacturing in total domestic production is around 10 percent in the case of almost all of the least developed Muslim countries. This shows the dominance of the agricultural sector.

Despite this, where securities markets exist, they rarely assist fund-raising by agricultural enterprises, tending rather to be the exclusive preserve of metropolitan industrial and commercial firms.

A conscious policy choice is to be made in favor of the development of corporate agricultural enterprises and agro-based industrial enterprises and a more widespread dispersion of share ownership can perhaps be fostered by reserving some shares in some issues for local workers and farmers. The possibility of setting up a Rural Share Line may be explored through local agricultural banks of Muslim countries just as an equity line is established by the IDB through local industrial banks in some of its member countries. Despite the fact that the industrial sector is weak and small, domestic industrial and commercial corporate concerns should be persuaded or induced to raise funds by public subscription through tax incentives or through other fiscal policy measures.

(f) Narrow and Fragmented Market Information Cost

One of the factors limiting the development of securities markets in Muslim countries could be the narrow and fragmented markets of these countries. These narrow markets are susceptible to discontinuities in supply and demand. They are relatively easy to manipulate which can produce wide price fluctuations. Following Maniatis (1971, p.599), and Drake (1980, p.206,) it can be argued that "generally increasing the yields on equities would not lead to an increase in the demand for them so long as sharp price fluctuations and the consequent risk persist. On the other hand, one cannot expect any sustained augmentation of equity supply and demand, sufficient to iron out discontinuities, to occur unless and until the general yield of equities relative to other assets is increased. It seems, indeed, that an increase in yields is a necessary condition not sufficient condition for improved functioning of the equities market." What is needed, then, is to initiate further research about market structure and performance and potential in individual Muslim countries. The promotion of securities markets should be seen as part of a consistent package of economic policy. It is important to see whether complementary economic and financial development are occurring in these countries. If need be, appropriate supply and demand inducement should be extended. "It is found by experience that they are effective where tried and do not seem to be prohibitive in cost" (Drake: 1980, p.21).

But the gathering of scattered information about corporate behavior among member countries may be a costly proposition. Moreover, the scarcity of accurate information may lead to a lack of confidence which couldact as an inhibition to capital market development.

(g) Option-linked Shares/Certificates

We have already seen that the doctrine of option, or the right to cancellation, is one of the distinctive features of the Islamic concept of sale. Even when a sale is duly constituted, free from any grounds of illegality, it still may not be absolutely binding on the parties involved. The option to cancel the sale within three days of its purchase may not be unlawful in Islam. The question is whether it is possible to introduce this concept in the case of the sale and purchase of shares and stocks which are highly prone to speculative activities. Perhaps a case can also be made for the operationalization of this principle of option in the case of shares of large denomination or where the public may justifiably feel too exposed to the risk of market manipulation and other abuses and may decline to invest.

At an operational level, this doctrine implies that there is a need for adequate regulation for the full disclosure and wide dissemination of accurate information about the companies whose stocks and bonds are traded in order to prevent the various forms of market rigging as well as to protect the interests of minority shareholders. Clearly, there is a need to have an independent supervisory body to implement these regulations. What is important is to create a climate favorable to "clean trading" - an atmosphere which may be created once Islamic business ethics are properly injected into securities market operations through short - and long-term Islamic investment educational programs in the form of training, seminars, etc. Then, the need for the close supervision of transactions may gradually decline.

(h) Preemption Sales in Securities Markets

Is it possible to introduce the concept of preemption in securities markets under certain conditions ? In the context of securities markets, the economics of preemption lies in the fact that it may ensure the stability and continuity of a firm or business company. Whether this stability or continuity is expected to further the cause of Islamic values hinges upon the behavior of the firm or the business objectives of the company. Nevertheless, the introduction of the preemption concept tends to reduce speculative activities, thereby reducing the problem of sudden fluctuations of stock prices. This concept should not, however, be allowed to gain monopoly control of industry or to destroy the base for the broad - based ownership of shares. The predominant effects of the preemption concept need to be analyzed in the light of the Shari'ah. Since the main objective of this section is to identify an issues, its in-depth analysis is a subject matter for further research.

(i) Deferred Payment-linked Shares/ Certificates

The sale and purchase of shares/bonds can be guided by the principle of deferred payment. That is, the payment can be made at some later dates subject to the condition that the time for payment should be known. According to the Shari'ah, it is especially necessary in a sale in which a price is not immediately payable that the time for payment should be known. If the time is not known, then the sale is vitiated. While the payment can be made in terms of the price of the negotiating date, the dividend must be calculated from the date of the actual payment. The use of deferred, payment has to be restrictive and limited, perhaps, to long-term financing where the shares are of a large denomination. Further research and examination are called for. As noted earlier in Chapter 4, the crisis of the Kuwait Securities Market based on transactions involving postdated checks can be linked to the concept of deferred, payment. Therefore, deferred payment should be used with caution so that it does not lead to speculative activity.

6.3 Conclusion

In conclusion, the problems and issues analyzed above are by no means exhaustive. Some of the problems are controversial, some well documented. Nevertheless, all of these problems need to be reviewed afresh in the context of new Islamic initiatives and socioeconomic imperatives. We may not be surprised if we find more disturbing problems in course of our investigations.

CHAPTER 7
ISLAMIC FINANCIAL INSTRUMENTS: A REVIEW

An attempt is made in this section to review some of the existing financial instruments issued by different banks, investment companies, and governments. As noted earlier, it may be permissible in the Shari'ah to issue shares and certificates having different maturities. This could be for an indefinite period in respect of equity financing or for a limited period in the case of Musharaka, Murabaha, or Ijara, etc. The certificates or shares can be project specific or general purpose. The funds generated from the project-specific certificates should not be combined with the assets and liabilities of the issuing authority. This Shari'ah position is designed to protect the ownership rights of the certificate holder who is also authorized to sell them. The issuing authority can, however, assume the role of the Mudarib or custodian of the funds and is, therefore, entitled to a share of the profit, although the funds do not form part of the financial statement of the issuing authority (i.e., bank or investment company as the case may be). The certificate holder can, however, sell his shares either before or after the maturity period in the money market at a price determined by the forces of supply and demand which are influenced by the financial and economic viability of the project. In the absence of any organized secondary market, the issuing authority may, however, develop a mechanism for the periodic purchase and sale of shares, the price of which will be determined by the prevailing market conditions based on the best possible economic, financial, and technical analysis and information. By the same token, at the time of floating project-specific certificates, all basic facts and information regarding the expected investment, the return/profits, the role of the 'Mudarib', the nature of the distribution of profits, the sale and purchase, the mode of financing, and other related particulars need to be highlighted (see: B. Neil's 1980, Hamilton: 1982, Hughs, (1982) concerning Islamic Laws of Sales and Purchase).

7.1 Islamic Financial Certificates and Insurance

It is interesting to note that the Islamic Investment Company (IIC) of the Gulf has already established the first Mudaraba for a period of one and three years with each certificate being $100 in denomination. Assets for this first financial Mudaraba amounted to $7.5 million. The second Mudaraba was established for a period of 5 years, with participation certificates being $100 and $1,000 in denomination and loan certificates $100 in denomination. One-tenth of the profits will be distributed to the managing trustee (i.e., the Islamic Investment Company) for its efforts in "halal" trade and nine-tenths for the bearers of participation certificates (OECD: 1982, p.220). The loan certificates have however combined the dual principles of participation (represented by the Mudaraba certificates) and benevolent loan (Qard Hasan) without any interest but with a guaranteed repayment of principal. Their investors have the option to define the share of investment and loan.

Furthermore, the basic data of the solidarity bonds (Islamic Insurance) shows that the "participant in a solidarity scheme pays in a specific amount in instalments between his minimum age (20 years) and the age of 60. The maximum age for participation is 50 years. The participants' principal is invested in profitable ventures and the profits are re-invested. If he dies before the age of 60, his legal heirs receive the paid-up principal to date, the accumulated profits to date, and in addition the amount which the decreased would have paid in, had he lived to the age of 60. This latter amount is deducted from the Mudaraba profits of all the participants in the scheme, hence the term "solidarity". Otherwise he is paid, at the age of 60, his principal and accumulated profits" (OECD: 1982, p.227).

It may be noted here that Jordan has already introduced Muqarada bonds and the necessary legislation has been enacted to make them operational. The original value of the muqarada bonds is guaranteed by the government. Moreover, the Islamic Development Bank has already set up a task force to consider the ways and means of floating financial certificates. The task force has already submitted its recommendation in favor of floating at least one financial instrument on an experimental basis.

7.2 Interest-free Banking in Pakistan

Pakistan has introduced various modes of Islamic financing and instruments since the launching of interest-free banking on 1 July 1985. Attempts to develop a blueprint for an interest-free economic system in Pakistan date back to 29 September 1977. So far, twelve modes of financing have been specified by the State Bank of Pakistan which can be classified into three broad categories:

(a) loan-related financing;
(b) trade-related financing; and
(c) investment-related financing.

Zaidi (1984) has provided a brief description of these twelve modes of financing, summarized as follows:

7.2.1 Financing by Lending:

(1) Loans not carrying any interest on which the banks may recover a service charge not exceeding the proportionate cost of the operation, excluding the costs of funds and provision for bad and doubtful debts. The maximum service charge permissible to each bank will be determined by the State Bank from time to time.

(2) 'Qarz-e-Hasana' loans given on compassionate grounds free of any interest or service charge and repayable if and when the borrower is able to pay.

7.2.2 Trade-related Modes of Financing:

(3) Purchase of goods by banks and their sale to clients at an appropriate mark-up in price on a deferred payment basis. In case of default, there should be no mark-up on mark-up.
(4) Purchase of trade bills.
(5) Purchase of movable or immovable property by banks from their clients with a Buy-Back-Agreement or otherwise.
(6) Leasing.
(7) Hire-purchase.
(8) Financing for the development of property on the basis of a development charge.

The maximum and minimum rates of return to be derived by banks from the trade-related modes of financing will be determined by the State Bank from time to time.

7.2.3 Investment Type Modes of Financing:

(9) Musharaka or profit and loss sharing.
(10)Equity participation and purchase of shares.
(11)Purchase of participation. terms certificates and Mudaraba certificates.
(12)Rent sharing.

The maximum and minimum rates of profit to be derived by banks from the transactions under the investment mode of financing will be prescribed by the State Bank from time to time. However, should any loss occur, these will have to be proportionately shared among all financiers. (See: Pakistan and Gulf Economist, August 4-10, 1984).

7.3 An Appraisal

The above mentioned development of financial instruments represents a significant milestone towards the eventual establishment of the Islamic Securities Market. Although it is too early to evaluate the financial performance of these instruments, we can draw a number of conclusions from their operations. The pattern of mobilization of funds by the various local Islamic banks shows that there is a great future for the further expansion of 'Muqarada bonds' as well as Mudaraba certificates. For example, direct investments and Mudarabas represent 65 percent and 90 percent respectively, of the total activities of four Islamic banks (the Kuwait Finance House, the Bahrain Islamic Bank, the Dubai Islamic Bank, and the Faisal Islamic Bank of Egypt). In the case of the Kuwait Finance House, however, the Mudarabas and investment operations generate more than 90 percent of revenues. Similarly, the scope of the solidarity bonds to cover other important aspects of life such as marriage, retirement, etc., also seem to be promising.

Dividends paid for depositors of Islamic investment accounts, which amounted to 9 percent in Kuwait against 12 percent in Egypt and 16 percent in Sudan are competitive. The dividend differentials can be explained in terms of the use of funds in the local environment and local commercial banking practices. But, what is more important is the study of the structure of investments that yield dividends. It is perhaps due to the concern for immediate profit resulting from the competition of local commercial banks that their operations have largely concentrated on short-term trade, leasing equipments real estate transactions, and participation in short-term investment projects in the field of agriculture and industry.

It is worth exploring whether local Islamic banks can make investments in public utility projects jointly with the government perhaps on a Musharaka basis. Islamic banks may explore the possibility of issuing certificates covering various sec-tors of the economy such as agriculture, agro-based industries, manufacturing, construction, and shipping.

It is extremely important to provide financial and technical assistance and feasibility studies for promoting private capital flows and identifying investable projects. The identification of partners requires considerable expertise in the member countries of the IDB. The identification of suitable investment opportunities also requires special skills which conventional commercial banks do not normally need. Needless to say, Islamic banks do need such skills on a priority basis, otherwise the further expansion and development of the Islamic Financial Markets will be severely constrained. It appears that recent Islamic securities markets are segregated and bear the following characteristics: (a) lack of coordination and effective cooperation, (b) an extremely limited number, volume, and variety of Islamic stocks traded, and (c) a narrow range of participants with either the government or a few individuals often dominating. We need diffusion not only of ownership shares, but also of market operation.

Thus, policy measures which might increase the size, range, activity, and usefulness of the Islamic Securities market would not be meaningful without the appropriate stock of investable projects. The current concentration on short-term trading is important in itself. What is perhaps more important is to create and develop the capacity of trade from within on a long-term basis.

Clearly, there is a need to develop secondary markets specially designed to deal with Islamic financial instruments. The regulatory mechanism and the code of conduct applicable to Western secondary securities markets may not have a counterpart in an Islamic framework. For example, in the case of 'Mudaraba bonds', the secondary buyer has to wait until the project is in operation or until its initial evaluation has been completed. In other words, secondary securities markets in Islam need to be designed in such a manner as to minimize (if not to eliminate) speculative fluctuations in stock prices and not to permit the transaction of shares one does not possess except in the special case of forward purchases or Bai-Salam deals where Shari'ah allows payments in advance.

As already noted, the nominal value of the Muqarada bond is guaranteed by the government of Jordan. Further examination is required to determine whether the role of the government as a third - party guarantor may be extended not only to providing the guarantee of the nominal value of other Islamic certificates or bonds but also to developing an institutional arrangement whereby a stabilization scheme or cooperative insurance scheme may be organized to even out fluctuations in the rate of profit or return.

While the efforts made by Pakistan in introducing different Islamic modes of financing and instruments are indeed laudable, a few issues can be raised.

It should be examined whether a bank can give loans out of the funds raised through depositors of current accounts. Since the loan is interest-free, the bank charges a servicefee as the cost of rendering the banking service. This issue of loan financing raises both juristic and economic questions. From the juristic point of view, it is not clear whether current account funds can be used for loans which have the risk of loss or default in payment, particularly when banks do not have any mandate to use these funds for this purpase. Although some scholars are inclined to accept this operation as a valid transaction, sufficient security should be obtained before such a loan is extended. The borrower may also be required to pay a cooperative insurance fee to cover the risk of the loan in addition to the service charge. It would, however, be a completely different story, if this loan had loan been extended against any certificate issued by the bank with a guarantee of repayment of the principal after a fixed period of time, and if the objectives of such loan certificates had been clearly spelled out and it was demonstrated that this certificate fund would be utilized for projects with the highest rating Islamically.

Furthermore, such loans can be linked to the question of the creation of credit and consequent inflationary implications for an Islamic economy. The maximum and minimum rates of service charge as determined by the State Bank of Pakistan could be used as an instrument of control of credit. Ways have to be found so that maximum and minimum service charges are related to the actual cost of service. It should be noted here that the question of providing a benevolent loan (Qard Hasan) extended against current account deposits does not arise due to its special nature.

What is needed is a set of criteria for the disbursement of such loans. Even the overdraft facilities extended by the bank in special cases may not appear as a payment in kind which may be treated as equivalent to interest.

It should be noted that in respect of investment-related financing, particularly in the case of Mudaraba and Musharaka (dealing participation), the management fee given to the bank for its role as a 'Mudarib' as well as a portion of the profit, to be utilized for cooperative insurance against investment risks and the share of the certificate owners should be spelled out in the scheme of the distribution of profits.

As has already been seen, Pakistan has introduced interest-free modes of corporate financing, particularly in the form of Participation Terms Certificates (PTCs), as a substitute for debenture-financing. "One of the most conspicuous features of PTC arrangement which has generally been observed is that pending commercial production and generation of operation profit, financial institutions desire to be compensated and compensation takes the form of a discount, usually 12 percent per annum, computed from the date of release of the funds by the financial institution or the syndicate until the entry goes into commercial operation". What is important here is to release the funds in planned phases so that the need for such discounting may not actually arise.

7.4 Choice of Financial Instruments: Some Theoretical Insights

In the development of the Islamic Securities Market, loan finance is not expected to be readily available due to the abolition of interest rates. Relatively speaking, the creditworthiness of borrowers may not be a fundamental consideration in the process of the choice of securities when the choice of security is guided mainly by equity finance.

The demand for a security depends mainly on the yields on competing securities, its maturity, the availability of a secondary market for resale, expectations concerning futures prices, and so on. In addition to these objective factors, there are subjective Islamic ethical variables which influence the forces of the sup-ply and demand of a security. These variables which are beyond secular economics are not properly understood by many people involved in financial markets. *I think, in a properly run Islamic economy, other things being equal, the greater the demand for a security, the more readily a security can be related to the clear* *economic, moral, and ethical imperatives of the Qur'an and the Sunnah.* Suppose an Islamic bank has identified a project in an area of a country where the benefits of the project will go directly to the group of people living below the poverty line (i.e., beggars, the handicapped, the unemployed, poor subsistence farmers, old people, orphans, etc). Let us also suppose that the project is economically viable and financially profitable. Given this information, the demand for a security for such project is expected to be on the high side even if the monetary yield is higher in the case of a competing securities which are *less readily* or remotely related to Qur'anic imperatives. This is an hypothesis which can easily be tested by Islamic banks. It follows that a Muslim investor's indifference map showing the various combinations of risk and return is bound to be influenced by these ethical factors and the consequent optimum portfolio determination. This can be explained by some elementary diagrams as used in contemporary finance theory which formulates portfolio selection on the basis of risk and utility analysis that does not lend itself well to empirical forecasting, but if which does provide theoretical insights which financial managers should consider when determining the mix of financial assets for businesses and individuals to hold.

Important Points

From the preceding analysis, the following important points can be derived:

Firstly, the expected rate of return is to be guided by the Muslim world view in economic matters. This would have two important components: expected pure monetary return (M) and perceived social and spiritual satisfaction Islamically (S).

Secondly, it follows that financial instruments will have two objectives to achieve: to maximize both M and S. It is our hypothesis that the greater the 'S', the more readily a security can be related to the explicit socioeconomic values of the Qur'an. Thus, 'S' could be marginal, positive, or negative depending on how the purpose of the mobilization of funds through equity finance is explained to the people involved.

Thirdly, as mentioned earlier, 'M' depends on a number of variables such as maturity, security, credit risk, and asset convertibility. These are the forces having an impact on the demand for and the supply of securities and, hence, on portfolio determination. For example, the shorter the maturity of a security, the greater might be the demand for it. The easier the marketability of equity assets, the greater might be the demand for it and vice-versa. Again, the demand for a security is expected to increase, should the yields on competing securities decline relative to the yield on a particular security and so on.

Lastly, the investor's attitude may change and his perception may differ. Thus, the family of indifference curves might move upward and to the left. Therefore the investor's optimum portfolio is not absolute. The intelligent guess coupled with the risk performance of various types of portfolio is also needed to improve the quality of the investor's choice.

7.5 Suggested New Types of Islamic Financial Instruments

We have already noted that the despite significant development of Islamic financial instruments, the current structure of the Islamic Securities Market indicates that there is a lack of coordinated effort to mobilize funds; it is also characterized by a limited variety of Islamic stocks as well as by a limited range of participants. It is important for conscious policy measures to be taken by the IDB in particular and other Islamic banks in general to increase the size, range, and volume of activities so that the Islamic Securities Market can be organized. To achieve this objective, this section is devoted to a suggested package of new types of financial instruments. This package is by no means exhaustive, and its range and varieties are to be designed to suit the diverse tastes of investors.

Thus, the following list of 10 broad varieties of new financial instruments gives a baisc outline of each of the instruments. This may very well provide the basis for further examination for the purpose of implementation.

(a) Simple loan certificate,
(b) Index-linked loan certificate,
(c) Islamic short-term commercial paper,
(d) Integrated investment, certificates/shares/bonds (1, 2, 3..... n),
(e) Profit-sharing certificate,
(f) Expected rate of dividend certificate,
(g) Rent-sharing certificate and expected rate of rent certificate,
(h) Firm commitment participation certificate,
(i) Zakat certificate,
(j) Human capital certificate.

(a) Simple Loan Certificate

Islamic banks or an enterprise through Islamic banks can issue pure loan certificates with a guarantee of the repayment of the principal after a fixed period of time. If the objectives of such loan certificates are clearly spelled out and if it is demonstrated that this certificate fund will be utilized for a project with the highest rating Islamically with no profit and no-loss basis, it is expected that banks should be able to sell such certificates. This loan certificate should preferably be issued in small denominations with a short maturity. The certificate holder should be allowed to use this certificate as collateral for overdrafts, if needed. Since this loan is of a benevolent type, the projects for which this fund is to be utilized should be designed in such a way as to further social peace and promote Islamic solidarity in recognition of which the color of such certificate could be "green."

(b) Index-linked Loan Certificate

As noted earlier there is a controversy as regards the indexation of loans in an Islamic economy. However, it is argued that if index-linked loans are permissible, then Islamic banks should be able to mobilize considerable amounts of funds through the issuance of such certificates with different maturities. It is also argued that such certificates should be able to reduce the tendency of hoarding in Muslim countries, if these certificates are designed to protect the real value of savings as well as to ensure the effective utilization of funds in an Islamically justified project not needed by the lenders in the near future. If the certificate is cashed in during the first year, only the original purchase price may be repaid, unless otherwise indicated.

(c) Islamic Short-Term Commercial Paper

Islamic banks can issue short-term commercial paper with maturity ranging from 60 days to 270 days to meet their short-term credit needs. These papers can be marketable. This type of commercial paper is specially suitable for financing short term foreign trade between harvesting periods, short-term business of a seasonal, character and wholesale and retail trade. The main advantage of this paper lies in its ability to tap nonbank idle funds as well as in the flexibility afforded to the borrower quickly by being able to move quickly in and out of the impersonal open market. It should be noted that the funds going into the commercial paper market are marginal funds. The continuous flow of such funds would however depend on the bank's ability to offer an attractive profit ratio through judicious use of funds. For investors, commercial paper, because of its relatively low risk and short maturity, can be a close substitute for treasury bills.

(d) Integrated Investment Certificates/Shares/Bonds (1,2,3,4....n)

These certificates/shares would carry the names of the enterprises in which the funds of the shares would be invested. These certificates or shares can be issued in various combinations of the enterprises, and investors will have a number of choices.

Let us illustrate this point with the help of a simple example. Suppose we wished to find the number of different ways of choosing three projects out of four projects (A, B, C, and D) in terms of risk and profitability. Let us now list all the possible groups of these three projects (A, B, and C) where the same three do not appear in more than one group, i.e., ABC, ADB, ACD, and BCD. Here, each group contains a unique set of three projects which are called combinations of three projects from a total of four projects.(*)

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* From this we can write $\frac{{}^4C = 4.}{3}$ That is, ${}^4C_3$ means the number of three combinations from a total of four items.

Generalizing again, we can say using factorial notation that: the number of combinations of r projects selected from n different project is : $\frac{n!}{(n-r)!r!}$

Using ${}^nC_r$ as a symbol for the number of combinations of r projects taken from n, we may write:

$${}^nC_r = \frac{n!}{(n-r)!r!}$$

If the order of projects is to be expressed in terms of risk, profitability, or Islamic desirability, then, for instance, the combination ABC could be split into six different arrangements: ABC, ACB, BAC, BCA, CAB, and CBA. This is called a permutation. Here, one combination represent six different permutations.

For this may get ${}^4P_3 = 24$. Here ${}^4P_3$ is translated as the number of permutations of three combinations of projects from a total of four different projects.

Generalizing again, we can say using factorial notation:

$${}^nP_r = \frac{n!}{(n-r)!r!} = \frac{4 \times 3 \times 2 \times 1}{(4-3)!} = 24$$

Thus, we see that given a number of projects, there are different possibilities of combinations, and permutations in terms of risk, profitability, and Islamic desirability. Investors will have a wide range of options. A different variety of certificates representing a different combination of projects or a different order of projects can be issued.

Dividends can be distributed on the basis of the performance of each of the papers. We can also introduce the color combination in the form of bar charts on the back of the paper showing the expected share in each of the enterprises. The main advantage of introducing such papers lies in the spread of risk and the pool of resources. The current scope of Muqaradah bonds can easily be expanded into a variety of projects, because these integrated certificates can be issued to promote agricultural, industrial, manufacturing, and service industries.

(e) Profit-sharing Certificate

Banks or investment companies can issue a general profit-sharing certificate, which would not carry the name of any enterprise. The bank or firm will be allowed to invest in any Islamically justified project. The dividends will be calculated on the basis of the average return of all the enterprises. Such certificates can be issued with all maturities and can be marketable. Generally, such certificates/shares are expected to carry low risk; a loss in one project can be compensated by a profit in another.

(f) Expected Rate of Dividend Certificate

The bank may issue such a certificate in the case of the expected rate of dividend of an enterprise based on past performance, current trend and future forecasting. It must be clearly recognized that this is not merely another form of a fixed rate of interest, because the expected rate of dividend can be more or less or equal to the actual rate of dividend. The only difference between this and profit-sharing is that the funds of such certificate holders will be invested in the *least risky projects* and the expected rate of dividend is likely to be lower than the general investment certificate.

(g) Rent-sharing Certificate and Expected Rate of Rent Certificate.

On the analogy of profit-sharing certificates and expected rate of dividend certificates, the general rent-sharing certificate and expected rate of rent certificate can be issued in the various short-and long-term leasing of ships, the renting of mechanical, electrical, and electronic equipment, and real estate transactions. These certificates would be less risky and uncertain than profit-sharing schemes and certificates. It should be noted that the IDB and the IIC are in fact involved in various projects involving leasing and the reale state business. What is important is to further institutionalize the process already initiated by the IDB and IIC.

(h) Firm Commitment Participation Certificate

The significant feature of such a certificate is that the holder need not place the funds immediately at the disposal of the bank. The holder is simply giving the firm commitment of the availability of the certificate funds at short notice (e.g., 10 to 15 days). The certificate holder has the option to indicate the share of investment and of loan. This commitment certificate would lead to the efficient utilization of the funds in the sense that the bank will call for these funds only when needed. The dividends will be calculated on the date of the actual placement of funds on a prorata basis.

(i) Zakat Certificate

Zakat certificates in various denominations can be used to finance projects whose benefits should go exclusively to the poor. We are aware that the Qur'an has specified eight heads of expenditure for Zakat. Although we can possibly alter the ratio of distribution of benefits among the recipients of Zakat revenue, we cannot change the heads of expenditure as specified in the Qur'an as this is not permissible in the Shari'ah.

(i) Human Capital Certificate

Let us now discuss in some detail the question of mobilizing Mudaraba's other half in the form of human capital certificates. We know that Mudaraba is one of the most important Islamic modes of financing an economic project. It represents a contract under which capital is advanced by Islamic investment companies or the banks, and the business and management efforts - technical know-how and skill - are the responsibility of the client, the Mudarib, or labor the "partner" The profit is divided between the investors according to previously agreed terms and conditions. If there is a loss, the client loses his efforts while the invester loses a part or all of his capital/principal.

Thus, there are, two different parts to the contract: one involving money capital, the other human capital. Islamic banks are involved in the mobilization of financial resources; this is the conventional function of banks and will remain so. What is not properly appreciated is the need to mobilize human resources to bring about an appropriate match between the two types of capital envisaged in the contract.

It should be possible for Islamic banks and investment companies to float "human capital certificates" for the purpose of mobilizing human resources. The basic idea is that the bank should first identify the areas of human skill which need to be matched with financial resources in a given set of projects. This should involve the study of the demand for, and supply of skilled personnel in each of the critical areas at both the microlevel and the macrolevel.

The bank or investment company could then issue human capital certificates in such a way that the mobilization of required skilled personnel becomes possible for the implementation of these projects. Such certificates could be sold in an open market on two conditions: first, purchaser of the certificate will be willing to undertake the work of the project on a cooperative basis; second, they will receive the necessary financial resources to execute the project. Certificate holders will receive a part of the salary in terms of money and the balance in terms of a share of the project concerned. The bank can then enter into a Mudaraba contract.

As the certificate holder is not allowed a fixed return on the human capital he has provided, he can receive only an agreed percentage of the net profits of the project. The critical role of banks lies in finding an appropriate match between human capital and finance, thereby fostering the growth of the private sector.

Even if a modified version of the scheme is implemented in a selected pilot project, it is likely to produce the following benefits:

(i) At the macrolevel, this scheme is likely to tackle the problems of stagflation. In other words, the problems of unemployment and cost-push inflation can be handled simultaneously.

(ii) At the macrolevel, it is expected to create a sense of belonging and a participatory spirit. This will boost production, arising from increased motivation and reduced chances of strikes, lockouts, etc.

(iii) It would affect the behavior of the firm and introduce the interdependency of variables which were previously acting as independent variables.

(iv) Consequently, the scheme is expected to affect the corporate behavior of the industry. This will have far-reaching consequences in evolving an Islamic approach to saving, investment, and partnership.

(v) The scheme has serious implications for the future equity financing of projects with which the IDB is involved. It looks beyond the classical and traditional reasons for the failure of equity-financing projects such as cost overruns, problems of implementation and management, etc.

(vi) The scheme is likely to ensure industrial peace, thereby introducing an Islamic basis for cooperation between employer and employee. The expected industrial relations tend to affect productivity favorably and en-sure the continuity of the supply of goods.

It should be mentioned that as economic development continues, the workers' demand for participation in economic decisionmaking can be. justified Islamically. In order to foster workers' cooperation with management, it would be essential to reward their risk taking by combining wages with profit sharing. Human capital certificates provide a unique opportunity for workers to have access to risk income. Moreover, they can contribute to the distribution of risk and then have a direct bearing on productive efficiency. Risk allocation indirectly affects the investor's willingness to supply capital.

(vii) If implemented, this scheme would eventually help the development of the Islamic Securities Market and could be used elsewhere.

(viii) The initial operational cost of the project would be small, due to the forced savings of a part of the salary paid in terms of a share(s).

(vix) Above all, the scheme is in conformity with the spirit of the Shari'ah. It gives a guarantee of a base wage, eliminates interest, and replaces it by profit-sharing. By guaranteeing the base wage, it ensures employment and income distribution.

Thus, human capital certificates can help Muslim countries achieve the dual objectives of the Shari'ah : providing a guarantee of livelihood, and encouraging workers to participate in profit-sharing. In an important sense, this is better than the current fixed wage system under which investors alone bear the risk of changes in output and profits. The structure of wages arranged under the human capital certificate system provides a better deal for workers in the sense that the distribution of risk enhances the productive efficiency of the firm and minimizes the chance of workers being laid off, particularly when the output or income of the firm falls below a critical level.

Thus, the profit-dependent wage as envisaged under the human capital certificate system tends to produce an Islamically justified approach to industrial organization, which depends on working performance and on individually chosen securities portfolios. These portfolios provide some insurance against varying employment situations. It is important to design a pilot project in a particular country where this idea can be tried.

A somewhat similar idea was advocated by an MIT economist, Prof. Martin Weitman, in his book, *The Share Economy* (Harvard), in which he calims to have found a cure-all that will end both unemployment and inflation. The trick, he says, is for United States industry to abandon the practice of paying fixed wages and adopt a scheme that compensates workers in relation to their employer's revenue or profits." The economist acknowledges that his plan is unlikely to be used in its pure form but says that even a modified version would be a strong tonic for the American economy. However, in an editorial, the New York Times dubbed Weltman's proposal "The best ideas since Keynes" (Times: May 20, 1985). Then what about floating the Human Capital Certificate ? Is it worth exploring further ?

It may be argued that the term human capital has a special connotation in economics and refers to capital embodied in persons mainly through education and training. "Human capital obviously cannot be transferred by a sale of certificate issued in its name. A worker who holds such certificates may decide to quit his job and sell his certificate but he takes with him the human capital embodied in him" (Ariff: 1986). It is true that the human capital refers to capital embodied in persons through education and training. But wage is the financial manifestation of em-bodied capital determined by the forces of the demand for and supply of labor in an open market. Thus, when a part of wage gets converted in the form of a "share" at the very beginning of the wage contract, I see no difficulty in this transaction even when a worker quits his job and goes elsewhere. This dependent wage mechanism is embodied in human capital, hence, the name "human capital certificate".

It should be recognized that when workers are required to take a part of their wages in the form of shares, it introduces a participatory management concept into the organization - a concept which is in conformity with the spirit of the Shari'ah, as it is based on the concept of Al-Adl wal-Ahsan.

7.6 CONCLUSION :

In conclusion, we may safely say that a great variety of financial instruments can be issued. However, only a few of them have been suggested here. Marketable and nonmarketable shares as well as open-ended and closed-end shares/certificates with all maturities can be issued depending on the nature and structure of the relationship between labor and capital.

The crucial implication of the introduction of the above mentioned financial instruments is that it may require a complete structural change in the current operations strategies of the IDB and the IIC. This may involve acquiring the controlling interest in some enterprises or in some cases,a pointing a permanent representative to the council or board of directors of a company. This may also involve the setting up of regional .offices to monitor the progress of the projects, etc. At an organizational level, it may mean the considerable delegation of power and authority. Above all, it presupposes considerable knowledge and expertise in local conditions involving the identification of local problems and manpower talents as well as market situations.

Part Four:
A Framework of Action Program

CHAPTER 8

ISLAMIC DEVELOPMENT BANK AND RESOURCE MOBILIZATION

8.1 Introduction : Current Concerns

The establishment of the IDB, a number of local Islamic banks, and the IIC during the '1970's are significant events of our time. In one way or another there is an urgent need to mobilize resources for participation in both short-and long-term investment activities. So far, the actual operations of local Islamic banks have turned out to be special forms of trading houses working somewhat along the lines of a system of merchant banks. This is reflected in the growing popularity and success of Murabaha sales. While there is nothing wrong with this trend, there is a need for a greater effort to expand the scope of other modes of financing such as Musharaka and Mudaraba. It is generally felt that the expansion of these modes of financing would help the development of Islamic capital due to the participatory nature of their operations, indicating the scope for the use of shares. Moreover, it needs to be determined whether the success of these Islamic banks is due to their sound business strategies or their to relatively easy access to the surplus funds of oil-rich countries.

Again, the IDB, which began its operations in late 1975, is mostly involved in foreign trade financing. Its latest Annual Report (The Eleventh: 1985-86) shows that the Bank uses about 80 percent of its funds for trade financing and the remaining for agriculture, industry, and social and physical infrainfrastructure building. What is needed is to expand the scope of operations in the areas of equity-based operations needed for the development of the Islamic Financial System in general and the Islamic Securities Market in particular.

8.2 Future Strategy

What is crucially important for the IDB in particular and local Islamic banks in general is to mobilize resources for increased long-term investment participation programs rather than mere short-term gains from trading. This is not to suggest that short-term trading is unimportant and irrelevant. What is more important is to develop the *capacity of trade by identifying projects,* suitable for participation on a Mudaraba and Musharaka basis. Currently, local Islamic banks are working side by side with commercial banks based on interest. Thus, the immediate gains from short term investment become necessary for Islamic banks to gain the confidence of depositors as to the viability of this operation. This may not be the case with regard to the operations of the IDB which may intensify its efforts in providing the necessary leadership in evolving viable financial markets for the distribution and sale of both primary and secondary securities. While the primary distribution of securities refers to the initial sale of newly created debt or equity claims, secondary markets offer facilities for trading in outstanding debt and equity claims. As noted earlier, the IDB has already established a task force to examine this issue and on the basis of the recommendation of this task force, the IDB is actively considering the flotation a financial instrument.

It would not always be necessary for the IDB to engage in actual trading. What is more important is to help develop the institutional framework of the Islamic Securities Market which would be expected to perform the following functions:

(a) To provide physical facilities for the sale and purchase of shares/bonds/certificates including the trading floor for each group of comparable shares/certificates and to act as a commission agent;

(b) To provide reporting, and communications facilities so that "over-the-counter" (OTC) markets are developed. This is not a market in the sense of some central place at which supply and demand meet; rather, it is mainly a communications network of stocks and bonds dealers;

(c) To determine what issues will be admitted to trading on the exchange. This involves the preparation of a guideline for controlling corporate behavior. The scarcity of accurate information about corporate behavior and prospects leads to 'a lack of confidence' which is considered to be an important obstacle to the development of capital markets (Wai and Patrick: 1973, p.285). The Shari'ah insists on "clean" dealing and unambiguous language under which both primary and secondary sales and the purchase of securities should take place. This involves the investigation and analysis of the present status and probable future performance of the issuer, the quality of the proposed issue, prices and yields on other comparable securities, and prospective market conditions. This culminates in determining price and yield for the new issue.

Thus a corporation issuing new stock for sale to the general public must file a detailed financial statement (prospectus). The companies may also be required to provide the public with information on how many shares of their stock are being bought or sold by officers of the company. Because these persons have privileged information about the company, their buying and selling can indicate to other investors their confidence in the future of the company;

(d) To provide an *Islamic Code of Conduct* for regulating the market behavior of securities market participants. Since the Shari'ah intends to prevent the manipulation of the prices of a stock in the market, it is important to lay down the operational principle of Islamic business ethics to be followed by all concerned. This may require the keeping of a registry of the exchange and of the dealers that conduct stock exchanges and over-the-counter security business. The code of conduct must have a provision for the expulsion or suspension of any member who conducts business in a manner inconsistent with the principles of the Shari'ah.

In each of these areas, the IDB can play an important role in initiating the process of establishing Islamic financial markets. To a great extent, most local Islamic banks were set up by the initiatives of a group of well-motivated individuals. Efforts should be made to broaden the ownership as far as possible in the capital structure of these banks. The long-term success of these banks hinges on their ability to attract sufficient investment funds from the general public. The long-term interest of the IDB also suggests that the IDB may make use of the physical location of local Islamic banks and the IIC in various countries in such way that they can cooperate in the exchange of financial, business, and developmental information. In view of its vast institutional character, the IDB can perhaps play this role efficiently. The establishment of the Islamic Securities Market should be considered to be a logical outcome of such cooperation. Since the core of IDB and IIC operations is oriented towards productive investments, the Islamic Securities Market, if it is properly organized, could make a useful contribution to economic growth and development, particularly in the present situation of recession, stagflation, and zero or negative growth levels in the case of many of the least developed Muslim countries in particular and other developing countries of the IDB in general.

CHAPTER 9

CONCLUSIONS AND MAIN RECOMMENDATIONS: AN AGENDA FOR ACTION

9.1 This study has clearly established a valid case for the Islamic Securities Market from the point of view of the Shari'ah. It has demonstrated that the Islamic concept of sale is unique in several ways. The underlying principles of Salam sale, sale on deferred payment, the doctrine of option, exchange, interchange, and preemption can perhaps be extended and operationlized in developing the structure of the Islamic Financial Market.

The Salam sale could provide a basis for the issuance of shares by the Islamic Investment Company and could encourage productive activities, create a built-in psychological pressure to produce, ensure continuity of supply, and reduce speculative activities. Sale on a deferred payment basis has implications for the purchase of shares of large denominations in instalments, the deferred payment of dividends, etc. The doctrine of option may contain speculative activities, if its principles are implemented. The concept of exchange of "similar" things raises the significant issue of the indexation of loan certificates. The principle of inter-change with excess is perhaps permissible due to value-added, and the concept of preemption may introduce an element of continuity and stability in the functioning of the company. All these hypotheses needed to be tested in the field. (Chapter 2).

9.2 In order to reap the socioeconomic benefits of a Salam sale, the Shari'ah demands that full payment should be made in advance in one instalment. But in the light of the complex production processes of the modern agricultural and industrial sectors, payment of the full price might encourage unnecessary expenditure on the part of the producer who might not utilize all the money at once. The question of a series of Salam Sales might be actively explored.

9.3 The doctrine of option, or the right of cancellation is one of the distinctive features of the Islamic concept of sale. Even when a sale is duly constituted, free from any grounds of illegality, it still may not be absolutely binding on the parties, involved. The option to cancel the sale within three days of its purchase can possibly be introduced in a planned way particularly in the case of shares and stocks which are highly prone to speculative activities or where the public may justifiably feel too exposed to the risk of market manipulation and other abuses and may decline to invest. At an operational level, this doctrine implies that there is a need for adequate regulation for the full disclosure and wide dissemination of accurate information about the companies whose stocks and bonds are traded in order to prevent the various forms of market rigging as well as to protect the interests of minority shareholders. (Chapter 2 and 6).

9.4 It should be possible to introduce the concept of preemption in securities markets under all conditions. In the context of securities markets, the economics of preemption lies in the fact that it may ensure the stability and continuity of a firm or business company. The introduction of the preemption concept tends to reduce speculative activities, thereby reducing the problem of sudden fluctuations of stock prices. This concept should not, however, be allowed to gain monopoly control of industry or to destroy the base for the broad-based ownership of shares. The predominant effects of the preemption concept need to be further analyzed in the light of the Shari'ah. (Chapter-6).

9.5 The sale and purchase of shares/bonds can be guided by the principle of deferred payment on the condition that the time for payment should be known. The recent crisis of the Kuwait Securities Market based on transactions involving post-dated checks can, however, be linked to the concept of deferred payment. Therefore, deferred payment should be used with caution so that it does not lead to speculative activity. (Chapters 2 and 6).

9.6 The Shari'ah permits the exchange of "similar for similar" whether of weight or of capacity. But, this must be done without any "excess". It follows that a debt contract must be settled with reference to the original legal standard. In Islam, money is not seen as a commodity, it is a medium of exchange. (Chapters 2 and 6).

9.7 Once indexation as a policy tool is accepted as a matter of principle, it will have far-reaching implications for the Islamic Securities Market in the sense that it would enable Islamic banks to issue index-linked loan certificates with a greater prospect of sale during inflation. This will also push Islamic banks to identify projects whose return can at least beat inflation. It also has implications for income and employment. (Chapters 2 and 6).

9.8 Once Islamic financial markets are organized, it is imperative that the ratio of profit and the mode and place of payment of dividends to shareholders be clearly specified. This is in conformity with the concept of sale as laid down in the Shari'ah. The prevailing foreign exchange controls and nonconvertibility of currencies of almost all the least developed Muslim countries also indicates the need for the development of the Islamic dinar as a common reference currency of the Muslim world. (Chapter 2).

9.9. The allocative effects of the Islamic Securities Market can be felt only when special efforts are made to provide an institutional assessment of different types of competing shares. The apparent profit prospects of the company may be misleading, because they may be distorted by market imperfections resulting from monopoly power, exchange control, tariff protection, import quotas, etc.We need a comparative analysis of the monetary, fiscal, and commercial policies of IDB member countries so that prospective investors are better informed about the state of each economy. Hence, the need for further research.

9.10 Initially the cost of collecting information about the corporate behavior of Muslim countries may present a real problem. What is crucially important from the Islamic point of view is to see the dissemination of financial information among small investors and investors from the least developed regions or countries so that the mobility of funds is increaseds and ensures a greater distribution of income. To achieve this goal, market intervention by introducing regional quotas for shares may perhaps be needed. (Chapter 3).

9.11 Despite the difficulty of the initial collection of basic financial data and data on investment opportunities in the case of the least developed Muslim counties, as compared to advanced countries, such as, the United States and the United kingdom, once the Islamic Securities Market is organized, it should enable investors to reduce the collection cost and the cost of feasibility studies. There is perhaps a need for an independent agency to see that investors are kept informed about past dividends, the expected rate of profit, and other financial conditions in the various regions of the country and abroad. This is in conformity with the actual practice of market regulations in Islam. (Chapter 3).

9.12 The operational principles of Islamic financial markets are as follows:

(a) Elimination of riba from all transactions of financial markets;
(b) Application of the doctrine of limited liability;
(c) Distribution of fair dividends among shareholders. This clearly implies the sharing of an agreed percentage of profit and loss to the extent of the shareholder's contribution; and
(d) Ensuring the broad-based ownership of shares and investment certificates for the greater distribution of income. (Chapter 3).

9.13 On the basis of the principles of Musharaka, Mudaraba, Murabaha, loans, and other modes of financing, various types of financial instruments (both short and long-term) can be issued. The Islamic concept of sale should also enable us to develop a viable secondary securities market for Islamic securities. (Chapter 3).

(a) Musharaka contracts with constant, decreasing, and increasing participation can easily be translated in terms of securities which can be sold and purchased in the securities market.
(b) It is permissible to float loan certificates, if absolutely necessary. There is scope for the organizing of index-linked loan certificates in an Islamic economy subject to the conditions laid down in the Shari'ah.
(c) Mudaraba financing can provide a built-in stabilizer to investment; it is less likely to be prone to speculation and consequent business fluctuations having a direct bearing on securities markets. With this type of Financing, Islamic Financial Markets should be able to float the different types of shares and investment certificates in varying combinations of both finance and human capital.
(d) It is also argued that it should be possible to issue various types of prime commercial papers under the short- term investment program of "Murahaba" and the "Bai-Salam" arrangement.

9.14 In a properly run Islamic Financial Market, there is a definite role for genuine investors who may be interested either in dividends or in capital gains. When the capital gain is seen as a part of capital development and consequent growth in national income, it is perfectly legitimate in Islam. Thus, when stock and share prices are determined by the forces of supply and demand, the sale and purchase of securities implies the change in ownership. Profit and loss then become a normal part of the economic transaction, and this is allowed in Islam. But when the speculator influences price trends, and is involved in the transaction of things which do not exist-or are not in actual possession, this may not be lawful in Islam. Thus, there is a clear distinction between speculative gains and capital gains.

there is a great need for re-orientation and educational programs on business ethics to be organized by Islamic banks for the benefits of actual and potential investors and businessmen. (Chapter 4)

9.15 The activities of speculators, hedgers, and arbitratgers, who are connected with each other in a complex and complicated way, have no counterpart in Islam. They will not have any role to play in the Islamic Financial Market, although a case can be made for commission agents in the sale and purchase of shares. Yet, it is absolutely necessary to define the exact role of brokers and to control the rate of a broker's a commission. It is important that Islamic banks initiate action to pre-pare a code of Islamic conduct for participants of financial markets. There is a further need for a continuous review of the Islamic Securities Market with a built-in-system of monitoring its activities to by appropriate supervising agency. (Chapter 4).

9.16 The concept of the Islamic Financial Market is compatible with the economic values of Islam. While the floating of shares and earnings in the form of dividends is clearly permissible, other securities such as preference shares, undated consuls, commercial papers, etc., whose transactions involve predetermined fixed interest would cease to be operative in the Islamic Financial Market. This does not mean that the Islamic Financial Market will not have alternatives to ' offer. In fact, debenture financing can be replaced by Participation Term Certificates on a profit-sharing basis. Short-term commercial paper can be floated in the market for financing short-term trade and business on the principles of Murabaha (cost-plus). While investment in preference shares is not justified because of its association with a predetermined fixed rate of interest, this does not however preclude the possibility of introducing the concept of *preference dividends with pre-determined ratio of profit* within the framework of the Islamic Securities Market. (Chapter 5).

9.17 Because they encourage speculative activities and the unfair manipulation of stock prices, there exists only limited scope for buying stock on margin and for an over-the-counter stock (OTC) market and a stock options market in an Islamic framework. This is not to suggest that the legitimate purchase and sale of shares and certificates are not permissible in Islam. The Islamic Securities Market needs to be organized to promote investment and to diffuse the ownership of shares. However, in view of the scarcity of accurate information, it is felt that there is limited scope for over-the-counter market (OTC) operations. The IDB may pro-vide and initiate facilities for the development of the OTC market among local Islamic banks which eventually should be supervised by an independent agency. Furthermore, without any explicit provision for the supervision and enforcement of the Islamic code of business by an independent agency, the operation of stock option markets may not be encouraged as a matter of policy at least during the initial period of its establishment. (Chapter 5).

9.18 In the context of the Islamic Securities Market, some of the problems and key issues discussed are :

(a) indexation;
(b) geographical location and the dispersion of share ownership;
(c) corporate profits and dividend stabilization schemes; family
(d) controlled firms and equity debt ratio;
(e) lack of corporate agricultural enterprises;
(f) narrow and fragmented market information cost;
(g) option-linked shares / certificates;
(h) preemption sales in securities markets; and
(i) deferred payment - linked shares/certificates.

The problems and issues analyzed are no means exhaustive. Some of the problems are controversial; other are well documented.

9.19 Islamic banks should seriously consider issuing local equity with a provision for regional quotas. This emphasis on the regional distribution of quotas would tend to diffuse share ownership, thereby ensuring a better distribution of income. The prior selection of underprivileged or relatively underdeveloped areas or regions would help banks adopt realistic social and economic projects. This may be first promoted by tax concessions in favor of shareholders belonging to poorer regions. (Chapter 6).

9.20 A conscious policy choice is to be made in favor of the development of corporate agricultural enterprises and agro-based industrial enterprises and a more widespread dispersion of share ownership can perhaps be fostered by re-serving some shares in some issues for local workers and farmers. A Rural Share Line may be set up through local agricultural banks of Muslim countries just as an equity line is established by the IDB through local industrial banks in the least developed member countries. It is possible that the hoarding of traditional assets such as gold and silver may be replaced by the Islamically desirable participation in economic activity through shares and bonds. Despite the fact that the industrial sector is weak and small, domestic industrial and commercial corporate concerns should be persuaded or induced to raise funds by public subscription through tax incentives or through other fiscal policy measures. (Chapter 6).

9.21 One of the factors limiting the development of securities markets in Muslim countries could be the narrow and fragmented markets of these countries. These narrow markets are susceptible to discontinuities in supply and demand. They are relatively easy to manipulate which can produce wide price fluctuations. What is needed, then, is to initiate further research about market structure, financial performance, and potential in individual Muslim countries. The promotion of securities markets should be seen as part of a consistent package of economic policy. It is important to see whether complementary economic and financial development are occuring in Muslim countries. (Chapter 6).

9.22 It is clear from our analysis that when family controlled firms in most Muslim countries have a high ratio of equity to debt in the capital structure of their firms (a situation in which a firm can easily sell its new issues), they are reluctant to give an entry to outsiders. This is obviously due to a lack of understanding of the Islamic way of financing. However, when firms have low ratios of equity to debt, which tends to make the new issue too risky for potential subscribers, they may not be interested in raising equity funds by new issues of shares because they have access to cheap bank finance. We need institutional reform so that cheap bank finance cannot be made easily available to favored to borrowers. We also need to study the existing local laws, customs, fiscal and monetary policies, incentive systems, etc. Necessary research may be initiated in each of these areas in order to suggest the ways and means of undertaking necessary reform.

9.23 Fundamentally, the limited supply of private securities in underdeveloped Muslim countries is not only related to the small size, but also to the limited investment horizons of many local businesses coupled with the lack of a proper appreciation of the Islamic concept of investment. Inevitably it will take time for such firms to reach the point of raising funds through public shares on the basis of Musharaka and Mudarabah financing, thus providing the necessary augmentation of the sup-ply of private paper. Meanwhile, it might be desirable for the IDB and Islamic banks to raise funds by issuing shares and debentures publicly on behalf of small firms or for governments to increase their own borrowing beyond the amounts needed to finance public sector investment, and induce undercapitalized local firms to cooper-ate in equity financing with banks. (Chapter 6).

9.24 While there is a clear need to have a built-in mechanism to protect the small investor's income through the creation of *Dividend Stabilization Schemes,* there appears to be a need for a Loss Compensating Reserve to settle the claims of shareholders' entitlements in undistributed profits. The incorporation of this settlement provision will have far-reaching implications in the actual conduct of the Islamic Financial Market, it may very well put a brake on the undue speculative activities of existing share markets. This issue needs to be explored further. (Chapter 6).

9.25 We have already noted that Islamic Investment Companies have started issuing various securities to raise funds (e.g.,) Muqarada bonds, Mudaraba certificates, loan certificates, solidarity bonds, and other financial papers. Although this is significant, a consideration of policy measures which might increase the size, range, activity, and usefulness of the Islamic Securities Market would not be meaningful without the appropriate stock of investible projects. The current concentration of short-term trading is important in itself. What is perhaps more important is to create and to develop the capacity of trade from within on a long-term basis. (Chap-ter 7).

9.26 It is argued that the expected rate of return from securities is to be guided by the Muslim worldview in economic matters. This would have two important components: expected pure monetary return (M)the perceived moral satisfaction Islamically (S). Thus, it follows that financial instruments will have two objectives to achieve to maximize both M and S. It is our hypothesis that the greater the 'S', the more readily a security can be related to explicit socioeconomic explicit values of the Qur'an. Thus, 'S' could be marginal, positive,or negative depending on how the purpose of the mobilization of funds through equity finance is explained to the people involved. Similarly, 'M' depends on a number of variables such as maturity, security, credit risk, and asset convertibility. These are the forces having an impact on the demand for and the supply of securities and hence on portfolio determination. For example, the shorter the maturity of a security, the greater might be the demand for it. The easier the marketability of equity assets, the greater might be the demand for it and vice-versa. Again, the demand for a security is expected to increase should the yields on competing securities decline relative to the yield on a particular security and so on.

9.27 Despite the significant development of Islamic financial instruments, the current structure of the Islamic Securities Market indicates that there is a lack of coordinated effort to mobilize funds; it is also characterized by a limited variety of Islamic stocks as well as by a limited range of participants. It is important for conscious policy measures to be taken by the IDB and other Islamic banks to increase the size, range, and volume of activities so that the Islamic Securities Market can be organized to suit the diverse tastes of investors. To achieve this objective, the following list of 10 broad varieties of new financial instruments which is by no means exhaustive, is suggested:

Simple loan certificate,
Index-linked loan certificate,
Islamic short-term commercial paper,
Integrated investment certificates / shares / bonds (1, 2, 3 ... n),
Profit-sharing certificate,
Expected rate of dividend certificate,
Rent-sharing certificate and expected rate of rent certificate,
Firm commitment participation certificate,
Zakat certificate,
Human capital certificate.
(Chapter 7).

9.28 While we have talked about the mobilization of financial resources through the issuance of variety of shares and certificates from (a) through (i) above, another certificate with unorthodox security which Islamic banks could issue is the Human

Capital Certificate. The basic idea behind this certificate is that the bank should first identify the critical areas of human skill which need to be matched with financial resources in a project(s). This identification process should involve the prior study of the demand for and supply of skilled personnel in each of the critical areas at both the microlevel and the macrolevel . The bank or investment company can issue human capital certificates in such a way that the mobilization of required skilled personnel becomes possible, for the implementation of these projects. Such certificates could be sold in an open market on two conditions: first, the purchasers of the certificate will be willing to undertake the work of the project on a cooperative basis; Second, they will receive the necessary financial resources to execute the project. The certificate holders will receive a part of the salary in terms of money and the balance in terms of a share of the project concerned. The bank can then enter into an Islamic contract of Mudaraba. The main advantage of this certificate is that the initial operation cost of the project would be less due to the forced savings of a part of the salary paid in terms of a share. Moreover, the sense of belonging in the enterprise can also foster group cohesion, thereby fostering the growth of the private sector. The importance of the underlying social psychology of human capital certificates should not be underestimated. It is worth exploring further.

9.29 The crucial implication of the introduction of the above mentioned financial instruments is that it may require a complete structural change in the current operational strategies of Islamic banks. This may involve acquiring the controlling interest in some enterprises or in some cases appointing a permanent representative to the council or board of directors of a company. This may also involve the setting up of regional offices to monitor the progress of the projects, etc. At an organizational level, it may mean considerable delegation of power and authority. Above all, it presupposes considerable knowledge and expertise in local conditions involving the identification of local problems and manpower talents as well as market situations. (Chapter 7).

9.30 Lastly, the establishment of the IDB, a number of Islamic banks and the IIC during the '1970's are significant events of our time. But so far the actual operations of local Islamic banks have turned out to be special forms of trading houses working somewhat along the lines of merchant banks. However, the long-term interest of the IDB suggests that the IDB should make use of the physical location of local Islamic banks and the IIC in various countries in such a way that they can cooperate in exchange of financial, business, and developmental information. The establishment of the Islamic Securities Market should be considered to be a logical outcome of such cooperation and could make a useful contribution to economic growth and development, particularly in the present situation of recession, stagflation, and zero or negative growth levels in the case of many of the least developed and developing Muslim countries. (Chapter 8).

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Appendices

Appendix I

A Profile of Major Islamic Banks and Investment Companies - (as of February, 1988)

Name of Institution, Location, **Address**	Year of Establish-ment	**Shareholders**	Capital, Authorized and Paid-in $millions **1980)**	Activities and Other Information (e.g., Branches, etc.)
1. Nasser Social Bank, 35, Kasr - El Nil Street, P.O. Box 277 Mohamed Farid Cairo, Egypt	1971	100% Government Owned	Authorized and Paid - in 14.3	Development of a pension and social insurance system (21 agencies in Egypt).
2. Islamic Development Bank, P.O. Box 5925, Jeddah 21432,Saudi Arabia	1975	Saudi Arabia Libya UAE Kuwait Other OIC States - 01C Initially 29 members (1986:43 members)	26%Authorized 2,551 16%Paid - in 1.640 (1981) 14%countries and the Muslim 13% 31%	To foster the economic and social progress of OIC member community in nonmember countries through the development process and for trade financing.
3. Dubai Islamic Bank, P.O. Box 1080, Diera, Dubai, U.A.E.	1975	Dubai Kuwait Private share	10%Authorized and 10%Paid - in 13.6	Foregin Branch in Cairo. Subsidiary: Arab Islamic Insurance Company (1979).
4. Faisal Islamic Bank of Egypt, (FIBE),1113 Cornich El Nile St., P.O. Box 2446, Cairo, Egypt	1977	Egyptian interests Saudi & other	Authorized 40 51% Paid -in 19	Islamic Banking activities of short-term nature.
5. Faisal Islamic Bank of Sudan, (FIBS), Faiha Commercial Center, Ali Abdul Latif Street. P.O. Box 10143, Khartoum, Sudan	1977	Sudanese interests Private Saudi Interests Other Arab private interests	40%Authorized 20 Paid -in9 40% 20%	Subsidiaries: (1979) Islamic Insurance company, Islamic Co. for Trade and Finance.
6. Kuwait Finance House, Ahmed Al-Jaber St., Imad Commercial Centre, P.O.Box 24989 Safat, Kuwait	1977	Private interests Public interests (3 Kuwaiti ministers)	51% Authorized 36 49% Paid -in9	Four agencies. Roll-over deposits 10%. Fixed-term deposit 9%. Savings deposits 6.75%.
7. Islamic Investment Co. of Gulf, Shariah, U.A.E.	1978	Islamic Investment Co. Ltd (Nassau) (1977)	11	Off ices in Abu Dhabi, Qatar, Riyadh, Dammam, Jeddah. Al Hafouf, and Makkah.
8. Jordan Islamic Bank for Finance & Investment, P.O.Box **926225,** Amman, Jordan	**1978**	Housing Bank of Jordan Private shareholders	Authorized 13.8 1.3% Paid-in 6.5 **98.7%**	Investment accounts 8.2%. Dividends in 1980. Savings accounts 5.25% dividends. Deposit accounts 9.25% dividends.
9. Bahrain Islamic Bank, P.O.Box **5240,** Manama. Bahrain	**1979**	State of Kuwait State of Bahrain IDB Kuwait Fin.House Dubai Islamic Bank Bahrain private interests	17.4% Authorized 61 10.4% Paid -in15 13.0% 8.7% 4.4% 37.7%	
10. Islamic International Bank for Investment & Development, 4, Addy St., Mesaha Square, P.O.Box 180, Dokki, Giza. Elorman, Giza Cairo, Egypt	1980	Egyptian interests	100%12	
11. Bahrein Islamic Investment co., Manama, Bahrain.	1980	Bahrain Islamic bank Kuwait Fin. House Dubai Islamic Bank Govt. of Bahrain Govt. of Kuwait Bahrain private interests	20% Paid-in 13 20% 15% 20% 14% 11%	
12. Islamic Investment House, Amman, Jordan	1981	Jordanian and Kuwaiti institutional and private investors	Authorized 12	

Name of Institution, Location, **Address** **ment**	Year of Establish- **1980)**	Shareholders	Capital, Authorized and Paid-in$ millions	Activities and Other Information (e.g., Branches, etc.)
13. Islamic Bank, Tehran, Iran	1979	Ali Hajtarkhani, Seyyed Mohammed Beheshti 60% Others 40%	Authorized 115	
14. Pakistan i) All nationalized local commercial banks on profit and loss sharing (PLS) accounts non-interests !oust from July, 1985 ii) specialized banks: - National Investment Trust (NIT) - Investment Corporation of Pakistan (ICP) -House Building Finance Corporation (HBFC) - Small Business Finance Corporation (SBFC) -The Bankers Equity Ltd. (BE) (authorized capital $102m)				All local banking on Islamic principles from, July, 1985, excepting some foreign banks.
15. Islamic Bank Bangladesh Ltd, 75, Motljheel CA., P.O.Box **233,** Dhaka, Bangladesh	1982	Bangladesh participation 30% Foreign participation by Islamic banks, Islamic countries and their nationals 70%		Islamic Commercial banking activities of a short-term nature.
18. First Muslim Interest-Free Business Institution. Johannesburg, South Africa,				
17. Islamic Investment Co.Ltd (IIC), Nassau, Bahamas	1977 1976	Prince Mohammed Al-Faisal Abdel Sattar Gani Al-Saud and others and others.		
18. Holding Islamic Banking Systems, Luxembourg, 25, Cote P.O.Box 150, D'Eich, Luxembourg.	1978			Trust fund activities Holding and consulting functions. Islamic investment activities.
1980 Sheikh Saleh Al-Abdulaziz Al-Rajhi, Sheikh Sulaiman Al-Abdulaziz Al-Rajhi, Sheikh	**1980**	Paid-in (P.Stg.100,000) 0.185 Mohammed Al-Abdulaziz Al-Rajhi IIC Ltd.		Financial advisers to associates in Riyadh.
19. Al Rajhi Co. for Islamic Investments, London, U.K	1981	Prince Mohammed Al-Faisal Al-Saud and others.	Authorized 1000 (1981) Paid-in 310	To manage special projects in Europe for the IIC Ltd. Holding Company.
20. Shar'ia Investment Services S.A., Geneva, Switzerland	1982 (DMI)	Dar-Al-Maal Al-Islami 51%	Authorized	
21. Dar Al-Mal Al-Islamic (DMI), 84, Avenue Louis-Casal. 1218, Cointrin, Geneva., P.O.Box 42, Switzerland				Small-and medium-size industrial business ventures managed by Muslims in U.K.
22. Islamic Investment Co. of U.K.				
23. Tadamon Islamic Bank, P.O.Box 3154, Khartoum, Sudan				
24. Bank of Islam Malaysia, Berhad Peti Surat 1080, Tingkot 9, Bangunan Ibu Pejabat, Pemas Jalan Raja Lau', Sambungan, Kuala Lumpur, Malaysia	1983	Federal Govt of Malaysia 30% State Religious bodies 50% Private shareholders . 20%	Authorised 100 Paid - in 32.9	Islamic : Investment and banking activities
	1983	Kuwait Finance House and Sudanese public	Authorised 5	
25. Islamic Bank International of Danmark S.A., 7 Jembanegade, 1608 Copenhagen-V, P.O.Box 271 Danmark	1983		Authorised D. Kr.50m. Paid in D.Kr.50m.	Islamic Banking activities.
28. Massraf Faysal Al-Islami, P.O.Box 1247, Conakry, Guinea.	1983	Subsidiary of DMI	Authorised 200	
27. Massraf Faysal. Al-Islami P.O.Box 12754, Niamey, Niger.	1983	Subsidiary of DMI	Authorised 20	

Name of Institution, Location, Address	Year of Establish-ment	Shareholders		Capital, Authorized and Paid-in $ Millions 1980)	Activities and Other Information (e.g.. Branches, etc.)
28. Massraf Faysal,Al-Islami B.P. 3381, Dakar, Senegal.	1983	Subsidiary of DMI		Authorised 20	
29. Oatar Islamic Bank. P.O.Box 599, Doha, Qatar.	1983			Authorised OR 200m. Paid - in OR 50m.	
30. Al-Baraka Bank of Sudan, P.O.Box 3585, Hahim Hajju Bldg. Near Medical College, Khartoum, Sudan	1984	Sheikh Saleh Kamil Group		Authorised 200 Paid - in 50	
31. Massraf FaysalAl-Islami of Bahrain, P.O.Box 20492, Chamber of Commerce Bldg, King Faysal Road, Manama. Bahrain.		DMI			
32. Islamic Finance House Public England Ltd. Co.,	1981	Islamic Banking system International Holding Co.	100%	Authorised P.Stg.510,000	
33. Al-Baraka International LTD., 32 Seething Lane, London England EC3R, SBA,	1983	Sheikh Saleh Kamil Group		Authorised 6.2	
34. Kibris Islamic Bank. Kibris Turkish Republic	1982	Private shareholders and others		Authorised 1 Paid-in 1	
35. Al-Baraka Islamic Investment Bank, P.O. Box 1882, Manama, Bahrain	1984	Islamic International Bank		Authorised 200 Paid-in 50	
36. Sudanese Islamic Bank. P.O.Box 6224 Khartoum, Sudan	1983			Authorised Sud.P 20m. Paid-in Sud.P. 18.7m.	—
37. Islamic Co-operative Development, P.O.Box 62, Khartoum, Sudan	1988			Authorised P.Stg.200m. Paid-in P.Stg.3.7m.	—
38. Philippine Amanah Bank, Zambuanga City, Philippines	1973	Philippine Government		Authorised 11.6 Paid-in 5.8	
39. First Interest-free Finance Consortium (FIFC), London, U.K.	1982				
40. Islamic Bank, Durban, South Africa					
41. African-American Islamic Bank, Bahamas		Dar-Al-Mal-Al-Islami			
42. Bait Et Tamwil Saudi Tounsai, Tunis, Tunisia	1984			Authorised 200 Paid-in 25	
43. Al-Baraka Turkish Special Finance Institution, Istanbul, Turkey	1984	Al-Baraka Inv. &Dev. Co. 50% Hak Investment & Trade Co. Islamic Development Bank	10%	Authorised T25 billion Paid-in T25 billion	
44. Faisal Finance Institution, Istanbul, Turkey	1984	DMI: Turkish Partner	51% 10%	Authorised 25 billion Paid-in T25 billion	
45. Al Barakalslamic Bank, Mauritania	1983	Sheikh Saleh Kemel Group			
46. Western Sudan Islamic Bank, Sudan	1981	Sheikh Saleh Kamel Group Faisal Islamic Bank Bahrain Islamic Bank.		Authorised 200 Paid-in 50	
47. Al-Baraka Bank, Dhaka, Bangladish	1986	Sheikh Saleh Kamel Group Local	70% 30%		

Note: Whenever the information was not available, it is shown as (—)

Source:Annual Reports and International Booklets of various Banks. Also, see: *Arab Banking and Finance,* Feb.1984, p. 41 and Traute Wholers-Scharf, Arab *and Islamic Banks,* Paris: OECD, 1983, pp.164-166.

Note: It is reported that other local Islamic Banks and Investment Companies will be established soon in Australia, India, Morocco, Singapore, and Switzerland.

Appendix II

How to Import Through the Islamic Bank

The agent may obtain financing from the Bank in one of two ways:

First

Financing on a partnership basis.

Second

Financing on a Morabaha basis (cost-plus)

Financing Imports on a partnership basis

When seeking financing from the Islamic Bank, the Importer provides full details on the goods to be imported: quantity, initial price, specifications, exporter terms, his address, and the nature of the requested Letter of Credit as well as other details. The application must be accompanied by the initial pro forma or contract, signed by the exporter, as well as documents supporting his personal information and those provided by the company.

Consideration of the economic feasibility study relevant to the operation, in respect of the Bank and the agent, to ensure that the information provided is sound and that the operation fully conforms to Islamic Shari'a. Agreement is reached with the agent on participation terms, namely his participation share in financing, refunding to the Bank of its financing share and guarantees given against noncommitment by the agent to his obligation and to the profit distribution terms agreed upon.

The Credit Department shall be informed and shall notify the correspondent Bank in the country of the exporter, or the bank he indicates, or the nearest bank to him of the contents and terms of the Line of Credit requested by the agent to be opened in favor of the exporter of the goods.

Upon receipt of the relevant documents by the Bank, it is ascertained whether or not they conform to the Line of Credit. They are signed to acknowledge receipt and, if need be, reservations or comments are expressed and, in both cases, they are returned to the sender Bank.

Upon delivery of the goods in conformity with the specifications, they are cleared bythe agent and the bank working in collaboration and according to the agreed conditions.

The agent undertakes the marketing and distribution according to the partnership terms until total disposal of the goods and the assessment of the final results. The

Bank then takes its share of the profits and the agent his share in proportion to his financing of the investment and another share for his contribution to the administration.

Financing of Imports on A Morabaha Basis (cost plus)

The above mentioned measures also apply to financing on a Morabaha basis, expect that, in such a case, the Bank purchases the goods from the exporter, according the to specifications requested by the agent and within the limits of the cost and profit agreed upon, but has only the promise of the agent to (which is legally binding) to purchase such goods. Upon delivery of the goods, the Sale Contract on a profit-sharing basis is signed and the agent receives the goods against a financial obligation to settle the total selling price or part thereof. Refunding is then carried out according to scheduled dates or to marketing rates.

Source: Islamic Banks IAIB, Cairo, August-September, 1981, Page **72.**

Appendix III

AL-Mosharaqa-Al-Motanakissa: New Formula for Real Estate Financing

AI-Mosharaqa-Al-Motanakissa is a new form of financing on a partnership basis; there are those who call it "Al Mosharaqa-al-Tanazoleya". This form of financing is carried out on the basis of a relationship between the Bank, as a financing partner, and the client as a partner whose share in the partnership is his work and some financing. But, the rights of the Bank as a partner in the transactions diminish gradually in proportion to refunds by the client of the financing provided.

If, for example, the total partnership is 100 monetary units out of which the Bank paid 50 units and the balance was paid by the client (supervision and administration being equally shared by the two parties), and if both of them agreed that the Bank would get 50 percent of the proceeds and the client 50 percent with the partnership to run over 3 years, then every time the client refunded part of the Bank financing, the share of the Bank in the partnership would decrease gradually, and by the end of the partnership duration, the Bank financing would be totally reimbursed, leaving the client with total ownership of the project. The basic concept of this financing formula is to allow the client the freedom and flexibility to run his project and man-age it himself as soon as he can set aside some of the income generated by the operations to reimburse the Bank and to pay its profits.

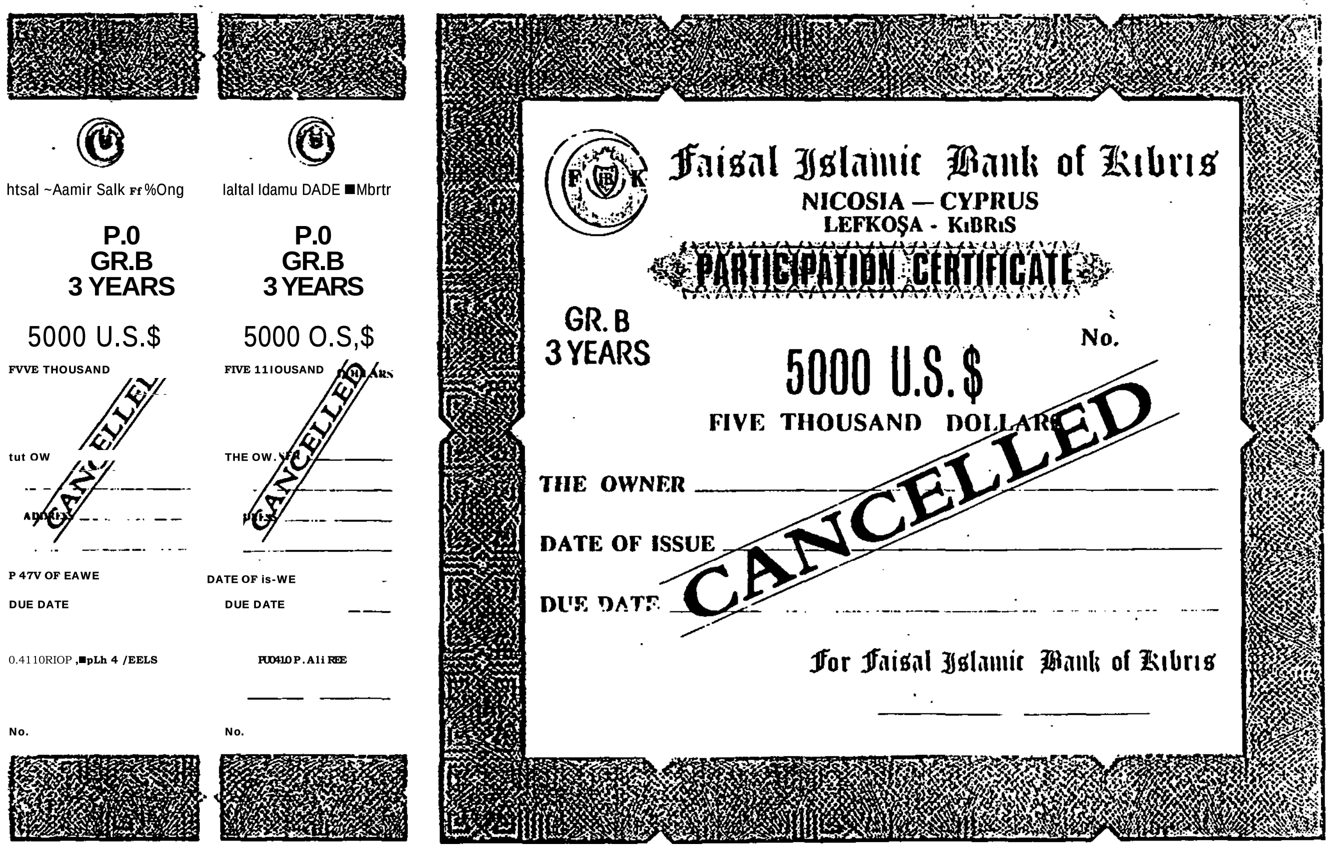
The advantage derived by the Bank, is the rapid movement of its funds through a rapid refund thereof.

Al-Mosharaqa-al-Motanakissa can be used to finance the construction of buildings and houses. In such cases, the Bank provides the financing required by the client to construct a house or building which he dwells in, rents, or transfers the ownership thereof to others, provided he gradually refunds the financing granted at the end of the construction out of the proceeds of monthly rentals (total rentals or a part thereof, according to circumstances). Naturally, the Bank, in addition to every refund, receives its share of the actual profits.

Al-Mosharaqa-al-Motanakissa is a practical formula which can be applied to various financing fields, such as trade, industry, and agriculture, because the agent is keen on dissolving his partnership with the Bank in the shortest possible time. This is why they constantly prefer the Mosharaqa-al-Motanakissa formula.

Source: Islamic Banks IAIB, Cairo, August-September, 1981, Page 71.

Appendix IV
Islamic Financial Instrument : A Simple Participation Certificate



Faisal Islamic Bank of Kibris
NICOSIA — CYPRUS
LEFKOŞA - KıBRıS
PARTICIPATION CERTIFICATE

GR. B
3 YEARS

No.

5000 U.S.$

FIVE THOUSAND DOLLARS

THE OWNER

DATE OF ISSUE

DUE DATE

CANCELLED

For Faisal Islamic Bank of Kibris

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