



ISLAMIC DEVELOPMENT BANK
ISLAMIC RESEARCH AND TRAINING INSTITUTE

ISLAMIC FINANCIAL INSTRUMENTS TO MANAGE SHORT-TERM EXCESS LIQUIDITY



*Research Paper
No. 41*

ISLAMIC RESEARCH AND TRAINING INSTITUTE

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The Islamic Research and Training Institute (IRTI) was established by the Board of Executive Directors of the Islamic Development Bank (IDB) in 1401H (1981.) The Executive Directors thus implemented Resolution No. BG/14-99, which the Board of Governors of IDB adopted at its Third Annual Meeting, held on 10 Rabi Thani 1399H (14 March 1979.) The Institute became operational in 1403H (1983.)

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**ISLAMIC FINANCIAL INSTRUMENTS
TO MANAGE SHORT-TERM EXCESS
LIQUIDITY**

Osman Babikir Ahmed

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FOREWORD

The Islamic Research and Training Institute (IRTI) of the Islamic Development Bank (IDB) is undertaking research in the areas of Islamic banking and finance, Islamic economics and economic cooperation between the member countries. Recently, IRTI has paid special attention to the problems of the practices of Islamic financial institutions and the evolution of Islamic financial instruments and markets. In this area, an important issue has remained the matter of managing the short-term excess liquidity of Islamic financial institutions. The present paper formally discusses this issue and presents a number of suggestions.

The research consists of four chapters. Chapter 1 describes the nature of the problem of the management of short-term liquidity by Islamic financial institutions. Chapter 2 presents an overview of financial instruments prevailing in the conventional money markets. The author evaluates these instruments in the light of the opinions of Islamic scholars with a view to exploring the relevance of these financial instruments for Islamic financial institutions. In Chapter 3, the author explores the possibility of developing Islamic financial instruments which can be considered at par with conventional money market instruments so that these instruments can be used by Islamic financial institutions in managing their short-term liquidity. Finally, in Chapter 4, the author presents a comparative appraisal of conventional money market instruments vis-a-vis his proposed Islamic financial instruments. The author suggests that there are a wide variety of instruments based on profit sharing and deferred trade-based Islamic modes of financing which Islamic financial institutions can use in managing their short-term liquidity.

The management of short-term liquidity by Islamic financial institutions is an important research area. It is expected that IRTI will continue to study this subject in the coming years. In this regard, the

present paper is considered to be of interest as a first attempt. It is hoped that the paper will generate interest and provoke thoughts for further research so that appropriate financial instruments can be developed that institutions which follow the *Shari 'ah* can use while competing with their conventional counterparts.

Dr. Ma'bid Ali Al Jarhi
Director, IRTI

INTRODUCTION

INTRODUCTION

1.1 Origin and Background of the Problem

Ideally the proper use of liquidity requires that banks satisfy two objectives:

- (i) that they at all times have enough liquidity to meet current demand for money by depositors; and
- (ii) that they direct part of liquidity to profit-generating investments.

Liquidity and profitability are two divergent objectives and commercial banks try to solve the problem of mismatching arising therefrom. This problem which faces all banks is much more acute when one speaks about liquidity of a short-term nature. In this case, it is not easy for a bank to achieve these two objectives. In this connection, the issue of financial instruments arises and in particular those used in managing short-term excess liquidity. This paper is concerned with financial instruments that can be used by Islamic banks (IBs) to manage short-term excess liquidity. Thus, it is necessary to define what is meant by the terms short-term borrowing/lending and liquidity.

First, what is short-term borrowing/lending? In lending operations, "short-term funds" refers to money borrowed for a period of from 30 days to one year. It is an obligation maturing in less than one year, (Euromoney Publications, Project Financing, 4th ed., p. 292).

However, in money markets short-term securities mature in not more than one year from the date of issue. Different financial instruments

in the money market have different maturities, ranging from a few days up to a year. For instance:

- (i) commercial paper usually matures in six months or less. Other types of commercial papers are issued for terms of nine months or less.
- (ii) short-term bills run for twelve months before reaching maturity.
- (iii) short-dated papers are bills of exchange drawn for a short-term, not exceeding three months after the date of issue.
- (iv) short-term exchanges, in connection with foreign exchange, are bills which are payable at any time within eight or ten days of the date of issue.

Therefore, short-term means that financial assets (instruments) mature after a short period extending from a few days up to a year. In modern money markets there are also deals that are finalized for a few days or even for a few hours as in the case of overnight and daylight transactions.

Second, what is liquidity?

Liquidity is defined as the quality of "nearness" to free spending power in an asset. Money is by definition completely liquid. Other assets vary in the degree of their liquidity, depending on whether they meet two, not wholly consistent, criteria. The more liquid an asset is, the more readily (in terms of time and other transaction costs involved) it may be converted into money. The second characteristic of liquidity is the degree of freedom from the risk of fluctuations in capital value, (Pearce, David W. (editor) (1986), *Dictionary of Modern Economics*).

Liquidity also means the ease with which an asset can be spent or exchanged for another asset. The most liquid asset is cash; "near" money can be exchanged for money. There, is a continuum of degrees of liquidity,

from completely liquid to "tied up", having no liquidity at all, (Moffat, Donald W. (1983), *Economics Dictionary*).

Liquid assets are those assets held in cash or in something that can be readily turned into cash, e. g., deposits in a bank current account, trade debts, etc.. Liquid assets are sometimes called floating assets, consisting of cash and other assets continually undergoing conversion into cash. They are to be distinguished from fixed assets which are acquired for use in business, such as, premises, plants and machinery, (Ryder, F. R. and Jenkins, D. B. (editors) (1974), *Thomson's Dictionary of Banking*).

Thus, liquidity implies:

- (i) an investment objective in which the bank desires the ability to convert holdings into cash in a short period of time and without a substantial loss.
- (ii) a condition for security in which the market may experience a high level of volume without a significant change in market value.
- (iii) a high presence of liquid assets (cash or cash equivalents) in a business.
- (iv) a completely liquid asset which is money because it exists as wealth in a form for immediate spending. A highly, though not completely, liquid asset is an item which can be converted to money quickly and with little or no loss of value.

Hence for the purposes of this paper, when the term *short-term* is used, it implies a short period not exceeding a year. It may be from one to twelve months. Money market transactions executed and liquidated within a few hours or overnight are referred to here as *very short-term*.

Liquidity here means either financial assets in a completely liquid form, such as, cash or those that are highly liquid, i. e., assets easily convertible to cash with little or no loss in value.

Short-term excess liquidity is managed through the money markets. In the developed, and some developing, economies, money markets are regarded as an organized mechanism through which the borrowing and lending of short-term surplus funds are undertaken. The assets dealt with in these markets are chiefly characterized by relatively high liquidity, i. e., readily convertible into cash without significant loss.

Conventional banks are important participants in money markets. Through these markets, they can easily convert their short-term surplus funds into monetary assets generating profits. When banks face a liquidity squeeze, they sell these monetary assets for liquidity, without a large loss. These monetary assets are short-term instruments which can be easily liquidated.

Because they operate in accordance with the *Shari'ah* rules, IBs cannot openly deal with conventional money markets and, therefore, cannot use these interest-based money market instruments. IBs need financial instruments which are, on the one hand consistent with *Shari'ah* legal opinion, and, on the other, allow IBs to achieve the two divergent objectives of liquidity and profitability, especially in the short term.

Thus, the purpose of this research is to determine what financial instruments can be developed for IBs for investing their short-term surplus funds. In order to organize on a *Shari'ah* basis a market that provides an investment outlet for temporarily surplus funds, there must be:

- (i) a *supply* of temporarily idle cash that is seeking short-term investment in an earning asset. Moreover, this supply is expected to be reasonably regular.
- (ii) a *demand* for the temporarily available cash.

Unless otherwise indicated.

Due to the nonexistence of a developed money market, and, in consequence, due to the less popular, developed financial instruments based on Islamic legal opinion, IBs that have short-term excess liquidity remain separate from IBs that are in need of it. The former pay the price in terms of losing profitable opportunities, and the latter suffer as they are unable to obtain these idle funds for the purpose of adjusting their liquidity positions and having relevant assets on their balance sheets.

The problem may thus be defined as: What short-term financial instruments can be developed for IBs on an Islamic basis which may help these banks manage their temporarily idle balances?

1.2 Significance of the Study

First, the problem of IBs' with short-term idle liquid balances is serious. Many IBs hold large cash reserves which earn no return, largely because they cannot keep time deposits or invest in treasury bills which yield interest.

Second, IBs' experts and managers have long recognized this problem. In 1989, the fifth meeting of IBs' experts held in Abu Dhabi discussed the problem of developing investment instruments that are highly liquid in order to meet liquidity requirement as well as to achieve profits.

Third, the Islamic *Fiqh* Academy (WA) discussed the issue of financial instruments and their central role in developing and investing Muslim financial resources. The IFA then strongly recommended that this issue be thoroughly studied by Muslim scholars.

Finally, in reviewing the literature on Islamic financial markets and on Islamic financial instruments, it appears that there is no differentiation between short-term financial instruments (money market instruments) and long-term instruments (capital market instruments). Therefore, this paper concentrates on financial instruments which absorb excess liquidity in the short term.

1.3 The Study Assumptions

This study is governed by the following which are more likely facts than assumptions:

- (i) Apart from the liquidity kept for legal reserve requirements, IBs hold large cash reserves that earn no return. In particular, there are short-term idle balances with IBs.
- (ii) The absence of appropriate financial instruments hinders IBs in the use of these temporarily idle balances and reduces their profitability.
- (iii) There is another group of IBs which are in need of these idle funds in order to adjust their liquidity positions and have relevant assets on their balance sheets. Due to the absence of marketable Islamic financial instruments, these IBs are also prevented from receiving available resources from other IBs.
- (iv) Even though some IBs have temporarily idle cash balances, while other IBs have a demand for such balances, the lack of Islamic financial instruments prevents the continuous flow of available resources. The supply of idle funds is expected to be regular and revolving. However, without such instruments this goal cannot be easily realized.
- (v) Instead of being handled on a commercial (profit-and-loss) basis, the current practice of handling excess liquidity is in most cases based on a cooperative (qard) arrangement which to a limited extent allows IBs interest-free access to each other's excess liquidity.
- (vi) There are legal and institutional bottlenecks that might hinder the development of appropriate Islamic financial instruments.

- (vii) The growing experience of some Islamic financial institutions, including IBs, is promising and can be developed to produce the needed financial instruments.

1.4 Research Methodology and Structure

The study examines the theoretical aspects of the issue. Published and unpublished material has been used to inject fresh ideas and thinking into the study. Moreover, *fatawa* (Islamic legal opinions) of jurists (Muslim *fuqaha*) have been used without going into the details of the differences among the schools of Islamic *fiqh* (*mazahib*).

Chapter 2, reviews financial instruments commonly used in the money markets of different developed and developing economies. It further evaluates these conventional instruments from an Islamic perspective. *Fiqh* opinions have been explored to assess the consistency of these instruments with *Shari'ah* rules and to determine their suitability for adoption by IBs.

Chapter 3, discusses the necessary requirements which must be satisfied for financial instruments to be found to be in accordance with *Shari'ah* rules. In this chapter an attempt is also made to describe conditions that may help in developing the needed short-term Islamic financial instruments.

Chapter 4, as a synthesis of the preceding chapters, describes conventional financial instruments which have been adapted to an interest-free doctrine and, as such, would be appropriate for Islamic banks to adopt. More importantly, the chapter describes financial instruments based on different Islamic modes of finance. There are many Islamic financing techniques which can provide the basis for the development of financial instruments.

**CONVENTIONAL FINANCIAL
INSTRUMENTS: REVIEW AND
ASSESSMENT ON AN ISLAMIC BASIS**

CONVENTIONAL FINANCIAL INSTRUMENTS: REVIEW AND ASSESSMENT ON AN ISLAMIC BASIS

There are many diverse financial instruments found in money markets. They may vary from one country to another, depending on the nature of the economy within which the money market operates, but most of these instruments are similar in nature. This chapter reviews the conventional financial instruments commonly used in the money markets of different developed and developing economies and assesses them to determine whether they can be used as Islamic financial instruments.

2.1 Negotiable Certificates of Deposit (NCDs)

Negotiable Certificates of Deposit (NCDs) date from 1961 when the American Citibank introduced its so-called "negotiable" time certificates of deposit which were offered to corporate customers as being marketable. NCDs soon became well established and a secondary market developed so that the holder could sell his NCD in order to disinvest.

NCDs are issued for funding purposes, but equally important, they are issued to meet the customer's needs, e.g. an investment outlet for a corporation with temporarily surplus funds available. In Germany large corporations keep their surplus liquid funds in the form of large deposits with banks. The market for 'wholesale' money, or large deposits from customers, is very flexible and very competitive.

Interest rates on NCDs are in most cases determined by market forces. On issuing NCDs, the bank gives interest to holders. Moreover, on using the proceeds from NCDs as short-term loans to borrowers, the bank fixes the predetermined interest rate as a percentage of the amount of the loan. This entire practice is prohibited by *the Shari'ah* as it involves a predetermined interest rate.

2.2 Commercial Papers (CPs)

The market in Commercial Papers (CPs) is large. CPs comprise short-term, unsecured promissory notes of industrial and commercial utilities and financial borrowers. They are generally sold on a discount basis to institutional investors. CPs are viewed as a high quality instrument. Most CPs have maturities of three to six months and are regarded as investments with short-term liquidity.

In the United States, CPs can be issued on an overnight basis with the longest permissible maturity being 270 days and the average maturity being fifteen days. The Italian CP is based on an exchange of letters between the parties backed by a bank guarantee to the buyer of the letter who will receive interest. Although the bank may not issue Eurocommercial paper, it may buy it and place it with an institutional investor. The paper is issued for 30 to 45 days.

The chief advantage of a CP is low cost as well as financing flexibility. It establishes a market presence among institutional investors. The commitment of the bank to pay a CP's value reduces the risk of an investment. Therefore, a CP carries a low interest rate, (Hindi, M. Ibrahim, (1993), pp. 62-63):

Dealing in CPs involves the use of interest rates twice:

First, when the industrial entity or the financial borrower issues a CP and sells it to the buyer at a discount, the buyer pays less but is paid back the full face value of the CP at maturity. This is a transaction on an interest rate basis. In real terms the discount rate is an interest for the period between the date of selling the CP to investors and the maturity date, (Barakat, S. Ahmed, (undated?), p. 83.

Second, when the bank guarantees paying the value of a CP at maturity, it in reality gives the issuing entity a credit (overdrawing) for interest. In doing so, the conventional bank guarantees the payment of the full face value of CPs to buyers, for a reward. But

guaranteeing is *a gratis* contract in *Shari'ah* laws. All *fiqh* schools agree that the provision of guaranty is an act of *tabaroa* (donation).

Therefore, it is unlawful that an Islamic bank with excess liquidity engages in CP transactions as this practice is contaminated by *riba* by the selling of money for money with an increase and by receiving interest for the provision of a guarantee. Upon dealing in CPs the traditional bank receives interest for debt as it pays on behalf of the real debtor (the issuer). Moreover, it does not take a fixed commission for specific administrative work; it takes a variable commission that varies positively with the value of the CP as well as with the ' risk involved. Therefore this is not a commission, it is interest.

2.3 Banker's Acceptance (BA)

As applied to a time draft or bill of exchange, acceptance is the drawee's signification of intention to pay at maturity. Acceptances are of two types : commercial (trade) acceptance and banker's acceptance :

- (i) **Commercial acceptance** is a bill of exchange drawn by the seller (drawer) on the purchase of goods sold and accepted by the purchaser (drawee). The bill has a definite maturity and is usually payable at the drawee's (acceptor's) bank. When accepted, the draft will be paid by an acceptor according to its tenor without qualifying conditions (Encyclopedia of Banking and Finance (1983), p. 931).
- (ii) **Banker's acceptance** , as defined by the Board of Directors of the United States Federal Reserve System, is "*a draft or bill of exchange, whether payable in dollars or other money, accepted by a bank or a trust company engaged generally in the business of granting bankers' acceptances*", (Ibid, p. 69; see also : Yahia, Saeed (1983), p. 315). However, banker's acceptance is in fact a broader term, including other firms' acceptances in the business

referred to as discount houses, (Hamoud, Sami H. (1982), pp. 301-302; Barakat, S. Ahmed, p.89). A BA is therefore a time draft, accepted by a commercial bank. It

is "an order to pay a specified amount of money to the bearer on a given date", [Kidwell, D. S. and Peterson, R. L., (1981), PP. 444 - 446]. It is supported by a third party or acceptance house, and it is usually issued to finance the shipment or temporary storage of goods. By "accepting" the draft, the bank makes an unconditional promise to pay the holder of the draft a stated amount at a specified date. Thus, the bank effectively substitutes its own credit for that of a borrower and in the process issues a negotiable instrument that may be freely traded. BAs are trade-related. The most frequent original maturity is 90 days.²

In the United States, the BA market is highly liquid and is supported by dealers and brokers. The principal investors are foreign central banks and commercial banks. In Italy, BAs are regarded as a successful monetary instrument. They are quite important at a time when credit ceilings are imposed on banks' loans since they are a means of evading the ceiling.

A banker's acceptance generates commissions for the bank as the bank acts on behalf of the drawee / purchaser to pay the value of the accepted bill to the beneficiary / seller. A banker's acceptance is also discountable. In the United States, yields (discount basis) vary with money rates. Banks become substantial purchasers and holders of banker's acceptances, posting fixed rates above or below the market rates at which the banks stand ready to buy bills. This practice involves the payment / receiving of interest to / by the banks.

² There is what is called 'qualified acceptance' which varies the effect of the bill as drawn. Qualified acceptance can be: (i) conditional, which makes payment by the acceptor dependent on the fulfilment of a stated condition; (ii) partial, an acceptance to pay only part of the amount for which the bill is drawn; or (iii) qualified to place, an acceptance to pay only at a particular specified place, (See: Klien, Gerald (1995), p.254)

Now, what is the impact of banker's acceptance on the relationship between the bank and the bearer (beneficiary) on the one hand and between the bank and the customer (drawee) on the other?

Regarding the impact of the banker's acceptance on the financial relationship between the seller (drawer) and the bank, upon accepting the bill, the bank (as an acceptor) becomes *primarily* liable and the purchaser (drawee) becomes *secondarily* liable. According to the Saudi Commercial Law, "if the acceptor accepts the bill, he becomes obliged to pay its value on the specified date", (Yahia, Saeed (1983), p. 316).

Hence, from the legal point of view, the bank is obliged to pay, *under all circumstances*, the value of an accepted / guaranteed bill to the bearer / drawer on behalf of the drawee.

As for the extent of the impact of the banker's acceptance on the financial relationship between the bank and the purchaser / drawee, the following question arises : Can the bank charge the drawee for the action of paying the value of the accepted bill on his behalf?

In order to answer this question, there are two positions that should be *clearly differentiated* in order to understand the *Shari 'ah* view : (i) the position of the bank *before* the maturity date of the accepted bill and (ii) its position *when* the bill tenor expires.

(i) First, when the bank accepts the bill there is certainly a *legitimate benefit* that the bank's customer (drawee) acquires because the bank, on his behalf, facilitates all payments so that the drawer receives the value of the accepted bill. But in order to provide that service, the bank will surely *incur* administrative expenses in terms of using its utilities and personnel to handle all of the procedures related to the acceptance of the bill. The bank has to be *compensated for this administrative and technical effort*.

Therefore, from the date of acceptance and up to the date when the accepted bill matures, the bank will act as a guarantor to the drawee and will take a commission for its administrative work only.

This commission will not in any way be related to either the bill value or to its tenor. It will be a fixed amount commensurate to the efforts that other banks would make in handling similar banker's acceptances, (Hamoud, Sarni H. (1982),PP. 301 - 302).

- (ii) Second, if the bank accepts the bill, and when the bill matures the drawee has not secured the amount of money necessary to meet the bill value and the bank pays it from its own funds, then, in that case, the bank becomes creditor to the drawee and has to ask the drawee for the debt which originated with the paying of the accepted bill. In this case, if the bank charges any amount more than the paid value of the accepted / guaranteed bill, this increase is interest for a loan and is strictly prohibited by *Shari 'ah rules*.

According to the understanding of some Islamic economics scholars³, if the bank accepts the bill, it becomes a guarantor to the drawee even if the latter is already a creditor to the bank by an amount less than, exactly equal to, or more than the provision needed to be paid to the beneficiary. Therefore, the bank, they believe, would be a guarantor to the drawee in all cases, whether the drawee is a creditor or a debtor to the bank. In that case, the bank is not allowed, in the *Shari 'ah's* view, to take any charges as a commission.

2.4 Repurchase Agreements (Repos)

Repurchase agreements (repos) consist 'of the sale of a short-term security with the condition that, after a period of time, the original seller will buy it back at a predetermined price, (Kidwell, D. S. and Peterson, R. L.; op. .cit., PP. 448-450). This dual transaction has developed into a meaningful money market instrument in its own right in different money markets.

³Monzer Kahf is one of those scholars who believes that if Islamic banks practice banker's acceptances, *they* would do SO AS guarantors not agents.

Repos are most commonly made for one day or for very short terms. The unique feature distinguishing repos from other money market instruments is that they may be used to shorten the actual maturity of a security to meet the needs of the borrower and lender.

Repos provide the investor with a money market instrument with precisely the needed maturity thus eliminating all price risk. For example, an investor may wish to invest funds for a very short period of time, say, for three days. A treasury bill with a maturity of three days could be purchased, held for three days, and then resold in the secondary market. However, if this alternative involves price risk (if interest rates rise during the three day interval), the investor will suffer a capital loss. Three-day repos provide the investor with a money market instrument with precisely the needed maturity, thus eliminating all price risk.

From the standpoint of the temporary sellers of securities, repos represent a source of funds and for the buyer, an interest-earning investment.

In Japan there is what is called a *gensaki market*⁴ with transactions based on a sale and repurchase agreement, (Wilson, J. S. (1993), pp. 250-252). Banks sell bonds in the *gensaki* market to raise necessary funds, buying time until market conditions improved. All transactions in the market are normally arranged through the securities companies, which often act as brokers and are then responsible for screening the creditworthiness of the relevant paper.

Repurchase agreements are one of the lending techniques used by dealers in conventional money markets, where dealers usually issue certificates and sell them temporarily to investors through repos brokers. At the same time dealers establish a contract to repurchase these certificates from the same investor at a price relatively higher than the purchasing price. Repos end by returning certificates to the dealer and

⁴ The name *gensaki* derives from the fact that both a present and a future transaction must occur in carrying out a complete transaction in this market.

money to the investor. The difference between the purchase price and the repurchase price is interest on the loanable funds.

From the *Shari'ah* view point

- (i) Repos are no more than short-term loans being provided by an investor to the dealer (issuer) and guaranteed by certificates under consideration. In addition to this, the ownership of the certificate is not transferred in all cases to an investor; it remains with the dealer. Hence, the transaction is merely a provision of money for a short term at interest.
- (ii) Repos are dual transactions necessarily involving the sale and repurchase by the original seller of a short-term security at a predetermined price. This prefixing of price is certainly not sanctioned by the *Shari'ah* because price, in the *fiqh* view, must not be decided before the action of repurchasing has started.
- (iii) The object repurchased is a security, representing cash money not an asset or usufruct. If a loan is in cash; it is only its principal which is repaid without an increase.
- (iv) Repos are also very similar to sale on credit (*Bai al eena*), as well as to two sales in one contract. These sales are prohibited (Zuhaili, W. (1985), PP. 466-472).

Thus, the conventional practice of repurchase agreements is, from the *fiqh* point of view, a purely interest-based transaction, and, as such, it is not suitable for IBs.

2.5 Financial Futures and Options

The collapse of the postwar Briton Woods exchange rate system in 1971 gave rise to an increase in the volatility of currencies and interest rates that was to provide the essential background to the development of

futures and options. Financial futures and options derive from the application of the techniques of commodity futures and trade stocks options to financial instruments and currencies.

Futures and options are not securities, although they will typically involve the right to buy and sell securities at a predetermined time in the future. A futures contract is the obligation to buy or sell a security at a specified time and price. An option on the other hand, involves the right, but not the obligation, to buy or sell at specified prices and times. In the case of American options, the option can be exercised at the specified price on any day up to the expiry date. European options, on the other hand, can only be exercised at the expiry of the option.

Futures and options can either be exchange traded or traded over the counter (OTC). Futures, when traded OTC are usually known as 'forward contract'. Exchange traded instruments differ from those traded OTC in that they are in standardized amounts for the instruments concerned, and delivery or expiry is usually in a three-month cycle. This has the advantage of increasing liquidity.

There are two main types of options:

- (i) a put option which gives the right to sell, and
- (ii) a call option that gives the right to buy. There is also a third option called a straddle or a double option which gives both the right to sell and buy.

The price agreed upon is called the 'contract price' or the 'striking/exercise price' of a security. This 'contract price' differs from the 'market price'. The contract is called an option contract because it gives the buyer the right to exercise the agreement or to abstain from doing so. As a compensation for this right, the buyer pays a "premium" to the other party who is called the 'writer'.

An option in *fiqh* tradition is the right of the contractor (the buyer in particular) to cancel or conclude the contract if a justifiable *Shari'ah* reason appears, (Abu Ghudda, A. A. (1985),- PP. 42-43).

In *fiqh* terminology, an option can also be classified in accordance with the legislative purpose for it. This option is either to safeguard the contract partner against defect and detriment (*darar*) or to obtain an advantage for him. This is known as the '*caution and defect*' option.

This option is considered to be an exception to some established *fiqh* principles, such as: (i) -the principle of the prohibition of hazard (*garar*) and, (ii) the principle of the prohibition of folly (*jahala*) or ignorance, (Abu Ghudda, A. A., (1985), PP. 86-87).

This leads to the following question : Does the option contract, as practiced in conventional markets, contradict *Shari'ah* requirements?

First, conventional option contracts include two contracts in one. There is the option contract to buy or sell the security and for this contract the option writer receives a premium from the buyer (investor). This contract is separate from the other contracts of selling (buying) the securities under consideration. In most cases; when the time comes to exercise the right, i.e., the option, securities actually remain with the buyer, he does not discharge them to the writer. The writer and buyer reconcile the difference between striking prices and market (current) prices on the expiry date. The writer may not even own the securities of the call option, He may occasionally buy securities from the market if prices rise and hand them over to the buyer on the expiry date.

Second, conventional options are purely abstract rights which are - not useful in themselves. They are separate from the contract's object whether this object is securities or shares, and 'these rights have their own prices. Therefore, it is illegal from the *Shari'ah* perspective to exercise a contract on such a purely abstract right. It is a gambling.

Fiqh jurists mention that abstract rights are not compensated for, e.g., the right of *shufa'* (preemption right), (Ibn A'abdeen, *AlHashya*,

Vol.4, p. 14). Rights for which *fiqh* jurists recognize compensation are those resulting from an action in the past, such as the requital (*qisas*) or retaliation right that can be replaced or requited by blood money (*diya*).

Third, the contract object is a purely abstract right, which does not have a material existence. The real intention of the two contract parties is to profit from price differences and not to actually own shares.

Moreover, a judgment regarding an option can also be formed by comparing it with the down payment sale known in *fiqh* terminology as the '*urbun*' sale or the '*arabun*' sale.

According to *fiqh* opinion, '*urbun*, i.e., the earnest, can be explained as follows : a person buys a commodity and pays the seller an amount of money. If later the buyer takes possession of the object sold, this advanced or earnest money is discounted from the object's price. If the buyer does not take possession of the object, the seller would take the earnest money. This interpretation of '*urbun*' is agreed upon by all *fiqh* legists (Al Dareer, S. M. A. (1994), p. 468).

This *fiqh* interpretation of '*urbun*' shows that it is a sale containing an option for the buyer only. If he concludes the transaction, '*urbun*' is part of the commodity price and, conversely, if he refrains and prefers to abrogate the deal, he loses the money he paid as '*urbun*' to the advantage of the seller. This is a conditional option for which earnest money is paid in case the buyer declines to conclude the contract. It is an option for the buyer only. For the seller the contract is compulsory and legally binding (*lazim*) , (Al Dareer, S. M. A. (1994), pp. 448-449).

However, the conventional option is quite different from the '*urbun*' sale:

- (i) In the conventional option contract, money is paid in advance to exercise the right of buying or selling, not to buy or sell the commodity itself. In the '*urbun*' sale earnest money is paid as part

of the commodity price if the contract is concluded, and the option is reserved for the buyer only excluding the seller from this right.

- (ii) According to the formal opinion of most *fiqh* jurists, '*urbun* is not legal for the buying of, for example, shares.
- (iii) From the *fiqh* point of view, it is illegal to sell a currency for the same,' currency or a currency for another one (*sarf*) on an '*urbun* basis. In an exchange (*sari*) transaction, a conditional option is not valid even without making a compensation and on this point the four great founders of *fiqh* doctrines unanimously agreed.

Therefore, if *sarf* is not valid on a conditional option basis, it is certainly not valid on an '*urbun* basis.

- (iv) . If '*urbun* is an advance payment, independent of the commodity ,' price, it does not satisfy the '*urbun* requirement as interpreted and defined in *fiqh*. It becomes the sale of an option itself not the commodity.'
- (v) In its eighth session, the Islamic *Fiqh* Academy (IFA) formed a judgment about '*urbun* sale. In the opinion of the IFA, '*urbun* sale is lawful if the waiting period is restricted for a certain time. '*Urbun* is counted as part of the price if buying is completed, but it goes to the seller if the buyer declines ' to conclude the transaction", (IFA Magazine (1415H/1994), 8th issue, Vol. I., p. 793).

Thus, in view of this formal legal judgment of the IFA, which is a supreme *fiqh* authority, the conventional 'option contract is not legally adjustable to the *Shari'ah* verdicts (*ahkam*) of '*urbun* sale. Further, and more important, the IFA has made a clear legal' judgment deploring the current conventional forms of option contracts, (IFA Magazine (1413H/1992), p. 715).

2.6 Treasury Bills (TBs)

Large banks and primary dealers in TBs constitute the most important elements in the New York money market in the United States. The principal assets in which they operate are the TBs and the securities of federal agencies which represent the core of the national money market. Of the several kinds of government securities, the TB occupies a special place in the money market. The short maturity of the TB makes it much sought after for inclusion in the reserves of both financial and business corporations. They are issued on a discount with original maturities of three, six and twelve months.

In the case of Germany, the Federal Government or the public authorities, acting in conjunction with the Bundesbanken (the Central Bank of Germany), issue TBs and treasury discount paper to provide short-term financing for part of the public borrowing requirements. The Central Bank also issues what is known as liquidity paper. It offers TBs from time to time, usually with a maturity of three days; to absorb short-term surplus liquidity in the banking system.

In France, *Bonds du Tresor a' taux fixe* (BTF), which are TBs, are issued with a maturity of less than one year on a discount basis. They are issued at a weekly auction in large denominations and are, therefore, held by banks.

The volume of the market of TBs is large, and financial institutions seek to include them in their reserves. However, this tool is sold on a discount basis, and the investor buys it for less than its face value. If he wants to disinvest before maturity, he gets back at least the value he has already paid to the issuer (the government). The new holder redeems it for its face value and obtains the difference as interest.

Thus, this transaction involves the paying of interest on the one hand, and an exchange of debt for less than its face value on the other. Such a transaction is certainly not sanctioned by the *Shari'ah* rules, and is therefore unsuitable for IBs.

2.7 The Gilt-edged Market (UK)

The discount houses of London supplement the facilities of the stock exchange in those bonds in which it is particularly important to have an active quantum, because they are near-liquid assets. These financial securities add to the quantum of liquid instruments available to institutions, such as, banks that have a regular need of such means of adjustment.

In this market, gilt-edged bonds are traded because they are near-liquid assets. Bonds are issued by the Bank of England, and there is a range of instruments used with different maturities. Banks and financial institutions buy these near-liquid instruments in order to maintain their liquidity position and to obtain profits.

It is obvious that dealing in this type of short-term financial instrument is conducted on an interest rate or a discount basis. The bond is sold for less than its face value so as to be redeemed at the face value, so that the difference between the buying price and the face value is the interest paid to the bank as a reward. The transactions undertaken through this money market instrument are clearly contaminated by interest and are therefore against *Shari'ah* rules.

2.8 The Interbank Market

In the interbank market much of the money is lent overnight, i.e., on a day-to-day basis, or at weekends for three days. However, quite a lot of money can also be borrowed for very short periods of time. The main item in the period money would be borrowed for one to three months. Banks may also borrow for seven days, fifteen days, or for almost any amount of time up to twelve months.

In the United States borrowers using daylight overdrafts repay funds in the morning but do not receive newly borrowed funds until later the same day. This institutional practice often creates a daylight overdraft that might last for three hours or more. Repayments frequently occur even if a borrower renews or rolls over amortization obligations with the same lender.

In many other developed economies, the interbank market in short-term money is very important, especially as a means of marginal adjustment. In Italy, for example, the interbank market in short-term money is very important. Large banks tend to be net borrowers, while small banks tend to leave their surplus cash with large commercial banks at interest.

In Germany, the core of the money market is comprised of interbank dealings in central bank balances. The market is similar to the market in federal funds in the United States. Thus, the interbank money market enables domestic credit institutions to make available to others (mainly banks) their excess central bank balances or where necessary to borrow (or buy) such balances in order to add to their own liquidity on the basis of a narrow margin⁵.

However, this practice is clearly not sanctioned by *Shari'ah* rules because it is trading in balances (cash money) with central banks. Money from the *Shari'ah* point of view is not traded for money with an increase or on deferred payment, (see : Chapter 3, Section 3.3.1). IBs having short-term excess liquidity would not adopt such techniques of finance based on trading in cash balances for interest.

2.9 Swaps

Banks in different countries set up and trade interest rate swaps. An interest rate swap is an exchange of differing interest payments at regular intervals between participants in the transaction. A classical coupon swap is a financial transaction in which a stream of fixed rate interest payments is exchanged for a stream of floating rate interest payments in the same currency. In essence, swapping is somewhat similar to borrowing one currency and lending another for the same period.

⁵ However, unlike banks used to do in the United States, the Gennan banks for the most part do not trade in central bank balances, buying and selling on the basis of a narrow margin. Gennan banks are concerned with managing their liquidity - if they have a surplus, they dispose of it; if they need funds, they buy them.

There are also 'basis' swaps which swap floating rate interest payments on some given basis, e.g., LIBOR with payments on another basis, e.g., the United States prime rate. In a cross currency swap, the parties exchange interest payments in one currency for those in another currency.

A cross currency swap may be due to differences in the risk assessment of borrowers in markets for fund-raising in different currencies. For example, an American firm wanting Saudi Riyals, but unknown in the Saudi Arabian market, and a Saudi firm seeking United States dollars, but little known in the United States can each borrow in their home currency and swap the interest and principal at an agreed exchange rate.

A swap transaction involves exchanging debts which carry interest payments. It also involves borrowing and lending currencies. This dealing is carried out on a discount basis and plainly contradicts Shari'ah rules:

First, it implies an exchange of debts carrying interest for other debts that have been committed on an interest basis. A debt is sold on a discount basis for less than its original value.

Second, a swap transaction also involves the selling of a currency in exchange for another on a deferred basis. This is the selling of a currency without immediate holding of the currency itself.. In money exchange transactions, currencies under consideration should be exchanged immediately according to the rules of money exchange (*sari*) in the *Shari'ah*. In a swap transaction, there is no immediate exchange, one currency is sold, but it is not received by the buyer until sometime in the future.

Third, in a swap transaction, there is no real holding of the currencies under consideration. Assume, for example, that an American enterprise has surplus funds in dollars, but needs money in sterling pounds to finance business in the United Kingdom. At the same time, a British concern has surplus funds in sterling pounds but it needs money in dollars to pay for business in the

United States. The British enterprise would buy, for example, US\$ 1.8 million in exchange for one million sterling pounds with an exchange rate of £ 1 : US\$ 1.8. In this way each enterprise is able to secure the funds needed in the other country.

The interest paid is annual payments already agreed upon, but it almost equals the difference between the rates paid on each currency. At maturity, the buying and selling transactions are reversed so that the British enterprise pays to its American correspondent the amount in dollars, and the latter pays to the former the amount in sterling at an exchange rate of £ 1 = US\$ 1.8.

Therefore, swaps involve the payment of interest on debts initiated at the liability of each party to the swap contract.

Fourth, a swap transaction includes two contracts in one, or two sales transactions in one. In this deal, the buyer buys and sells, and the seller is inversely selling and buying. The Prophet (Pbuh) is reported to have prohibited this type of transaction involving two sales in one.

2.10 Foreign Exchange Market

Instruments in the foreign exchange market are used in making payments between currencies. It is the process of exchanging one country's currency with that of another.

In some countries, e.g., Hong Kong, the foreign exchange market is the main sector of the money market. In this market much of the business is done through brokers, and especially through international brokers. The Tokyo dollar market is a domestic market for transactions in foreign currencies. Apart from overnight, a typical period is three to six months. However, overnight is most common. The banks set internal limits on these transactions which are unsecured. In Germany, in order to achieve a temporary absorption of liquidity,

the central bank conducts foreign exchange transactions under repurchase agreements with credit institutions. In these transactions, a chain of delivery of specific assets held by the central bank is transferred to the banks for a limited period.

The act of buying and selling currencies as such is not prohibited by the *Shari'ah*, as long as the currencies are different, e.g., buying United States dollars and paying instantly the equivalent of another currency according to the prevailing exchange rate.

However, in international money markets, currencies are, in reality, dealt with on a basis of deferred payment, and this contradicts the money exchanging rules (*sarf* rules) of the *Shari'ah*. IBs would be permitted to construct foreign exchange contracts in money markets on a spot basis, but not on a forward selling of cash margin basis.

2.11 Eurodollar and Eurobond Markets

Eurodollars are interest-covering dollar deposits in banks outside the United States. Eurodollar markets are largely based in London. It was the difficulty of attracting funds by issuing CDs that encouraged large banks in the United States to enter the Eurodollar market. The growth in the use of Eurodollars increased steadily in the late 1960s, (Wilson, J. S.,(1970).

Eurodollars include deposits in foreign branches of United States banks. A bank accepting a Eurodollar deposit receives, in settlement of the transaction, a dollar balance with a bank in the United States, whereas a bank making a Eurodollar deposit or loan (other than an advance by a United States bank branch to its own head office) completes the transaction with a transfer from its United States bank balance.

The general pattern of operations is for banks to borrow in Eurocurrencies for on-lending to domestic borrowers in the same Eurocurrency in due course. The loan must be repaid in the relevant Eurocurrency with the borrowing customer usually carrying the exchange risk, although he may cover himself by buying forward. Sometimes a bank may hedge the exchange risk and charge the customer in its pricing. From time to time, swap operations (whether in currencies or in maturities) may be undertaken. Much use can be made of interest rates futures, especially

on the basis of the Eurodollar contract in order to manage interest rate exposure.

Eurodollars are very similar to NCDs and, indeed, came into existence as a replacement for NCDs. Eurodollars are also used as a substitute for time deposits and carry interest as do deposits.

A bank that acquires Eurodollar deposits lends the proceeds mobilized therefrom for interest. The acceptance of Eurodollar deposits also involves an exchange of money (dollars) for money with interest. This transaction implies that the same currency is exchanged for itself with a difference. Therefore, dealings in Eurodollar markets in this manner lead to transactions based on interest, and [Bs cannot make use of such markets⁶.

2.12 Central Banks Intervention (Treasury Bills)

The liquidity of banks is greatly influenced by the intervention of central banks. This is known as "mopping up". Mopping up is in fact a rescue operation taken by the central bank when there are surplus funds. The central bank sells treasury bills to banks and financial institutions, thus mopping up their surplus funds.

The German Bundesbanken, for example, intervenes in different ways to regulate the market by means of:

- (i) refinancing policy which implies lending by the Bundesbanken to credit institutions through the purchase of bills and the granting of loans against collateral;
- (ii) rediscounting policy which is the buying and selling of trade bills and treasury bills from and to banks; and

⁶ Sometimes, Eurodollars are used for conversion into another currency. This practice is not prohibited by the *Shari 'ab* rules if the exchange and receiving of both currencies are carried out instantly.

- (iii) loaned policy which is the granting of loans at interest against the collateral of certain securities and debt registered claims.

Conventional central banks intervene through treasury bills. This intervention basically depends on the buying and selling of securities by central banks in developed economies to financial institutions including banks. Securities are either dealt with on an interest basis or, alternatively, on a discount basis.

However, in both cases, money is either bought or sold for interest and the entire transaction plainly contradicts *sarf* rules specified by the *Shari 'ah*, (see : Chapter 3, Section 3.3.1).

2.13 Conclusion

It is obvious from the above review that conventional banks encounter no problem regarding the use of or the need for short-term funds. They have full access to the money market either as lenders or borrowers. They do not face the problem of "mismatching", that is, using short-term deposits to finance long-term lending which may create a severe liquidity crisis.

However, an assessment, from the Islamic point of view, of these conventional instruments and their relevance for Islamic banks (IBs) discloses that all of these conventional short-term financial instruments are based on interest rates. None of them in their current form could be adopted by any financial institution adhering to the Islamic rules of banking and finance.

However, this finding does not imply that all of these instruments are completely inappropriate for adoption by Islamic banks. In reality some of them might be amended and adapted in such a way as to be compatible with *Shari 'ah* rules, whereas others can never be adapted to meet *Shari 'ah* requirements. Chapter 3 is connected with finding out which of these conventional money market financial instruments can be made to suit the needs of Islamic banks with regard to the utilization of their short-term excess liquidity.

**ISLAMIC FINANCIAL INSTRUMENTS:
REQUISITES AND FEATURES**

ISLAMIC FINANCIAL INSTRUMENTS: REQUISITES AND FEATURES

3.1 Preface

An Islamic financial instrument could be defined, in general, as "a *certificate representing a common share in funds mobilized to be invested for the purpose of sharing in profit. This certificate is issued by an investor, it is negotiable and convertible to money*", (Hassan, H. H., (1993), p. 21). However, this definition does not mention the *Shari'ah* conditions for negotiating and converting an Islamic instrument into money or into any asset in a highly liquid form. An Islamic certificate representing a common share in a fund is not negotiable for more or less than its face (nominal) value until the funds mobilized therefrom change their form so that they predominantly become properties and usufructs. If the certificate represents assets in a cash form or in a debt form, then the rule is different; its negotiability will be governed by the *Shari'ah* rules concerning the exchange of money (*sarf*) and the selling of a debt, . (see : Section 3.3 below).

It is actually more difficult to conceive of a short-term rather than a long-term Islamic financial instrument. In the long-term there is enough time to deal with such issues as, holding (*gabd*), ownership transfer, profit realization and distribution. The following requisites need to be fulfilled by short-term Islamic financial instruments:

- (i) Profit formation
- (ii) Negotiability
- (iii) Contracting and ownership transfer
- (iv) Holding
- (v) Liquidation
- (vi) Other factors

3.2 Profit Formation

In considering a financial instrument, it is vital to take into account the profit element. All banks, including IBs, seek satisfactory profit subject to the constraints of liquidity and safety. The conflict between liquidity and profitability may be regarded as the central problem in the management of the funds of any bank. Bank managers *'feel pressure from the stockholders for greater profits, which may be earned by investing in longer-term securities, and reducing idle cash balances. On the other hand, managers are actively aware that these actions greatly reduce liquidity, which may be needed to meet deposit withdrawals and credit demand of long-standing customers'* (Reed, E.W. (et al.) (1984), p. 108)

Profitability and liquidity requirements could be met by placing excess funds in short-term investment activities. An Islamic bank can carefully choose those profit-generating projects whose assets could be easily liquidated on demand without a large loss. However, it is difficult, if not impossible, to find interest-free, profitable investments that meet the condition of profitability and at the same time do not contradict the *Shari'ah* rules. The *Shari'ah* specifies certain requirements for deals, and these requirements take time to fulfill. The following conditions must be met if a contract is to be lawful:

- (i) Proposal and acceptance should be clear and identical, in the sense that both parties to a contract should know and agree on the object under consideration and its price.
- (ii) Two parties of the contract, the buyer and the seller, should legally be able to exercise the rights and duties, i. e., they should have the *Capacile de Jouissance*.
- (iii) The contract object, i.e., the investment area, must from the point of view of the *Shari 'Oh* be a permissible/licit (*halal*) object as well as a valuable one. Therefore, it is not permitted, for example, to trade or invest in pigs or

alcohol, although they have economic utility, (Al Gaziri,
pp.

163-166; Al Zuhaili, W. Pp. 172-182; Sabiq, S.(1977), 'pp. 129).

Therefore, from an Islamic perspective, buying and selling, i.e., contract construction, should be genuine and real not an artificial action or simulation. The requisites stated by *fuqaha* (*fiqh* legists) demand that there be enough time for a transaction and therefore for a profit to materialize. Given these requirements, IBs might be unable to make use of a short-term financial instrument which is in accordance with the *Shari'ah* rules and at the same time realize a profit. This problem can be solved by a money market for short-term financial instruments.

3.3 Negotiability

Negotiability means that "*a financial instrument can be readily passed on or endorsed from one person to another, this must be in writing, payable to the bearer at a specified time and must bear the name of the drawer. Negotiability implies also that the title to the instrument passes on delivery*", (Scharf, T. and Shetty, M. C. (1972), p. 37).

According to the *Shari'ah* an Islamic financial instrument can be negotiated since it represents a common share in the total assets of an enterprise. But there are some restrictions on its negotiability:

- (i) An instrument is negotiable for an equivalence of its nominal value . from date of buying that instrument (certificate), i.e., during the *ex-ante* investment period, before the issuer uses proceeds in financing investments. This is so because the *Shari'ah* does not allow the selling of money for money with an increase or decrease.
- (ii) After starting a business activity, it is permissible to sell the instrument for its nominal value, or for more or less, just like an asset. In this respect the value (price) of the instrument depends on: (a) the financial position of the enterprise issuing this certificate; (b) the prospective income; (c) the relative price of certificates of a similar nature and maturity; and (d) the past performance of the enterprise.

- (iii) During the life span of the project, its assets may change into debts. In this respect it is illegal to sell the instrument unless in accordance with what is decided by the *Shari'ah* with respect to dealing with debts.

These restrictions. on the negotiability of an Islamic financial instrument can be elaborated as follows :

3.3.1 A cash-based instrument: an *ex-ante* investment period:

If the proceeds of an Islamic certificate (instrument) are in the form of cash, then the negotiation of this instrument is regulated by the rules of money exchange (*sarf*).

There are four conditions for *sarf*

- (i) the holding of the currency before the two parties separate;
 - (ii) the identity of the two currencies being exchanged;
 - (iii) no option; and
 - (iv) no delay.
- (i) Holding is required to avoid "delay *riba*" (*riba al nasaa*) and to determine the exchange price according to the current market price. The Prophet (Pbuh) is reported to have said "gold for gold, like for the like, from hand to hand, silver for silver, like for the like, from hand to hand", (Al Zailai', *Nasb al Raya*, Vol. IV). The Prophet (Pbuh) has also prohibited "the selling of one currency available now for another which is absent or not available at the present time."

Thus, according to these *Shari'ah* rules, if, in a *sari* deal, the buyer and seller separate without either of them holding currency from the other, the deal is invalid due to nonholding, and it becomes a contract of selling debt for debt.

- (ii) The identity of the two currencies offered for exchange means that one unit of a currency is exchanged for one unit of that currency, and there is no profiteering from this deal (increase *riba*, i.e., *riba al fadl*).
- (iii) In a *sarf* contract it is not permitted for either of the parties (the buyer or seller) to impose an option as this would hinder holding which is a condition for the validity of the contract, (Al Zuhaili, W. (1984), p. 638),
- (iv) A *sarf* contract must be free of delay (*nasaa'*), because the holding of the two currencies is due before the two parties separate. Any delay in immediately receiving the currencies implies the postponing of holding and, therefore, nullifies the contract.

Given these four conditions, if the instrument's assets are in a cash form, investors who have a share in this project would negotiate this share (a financial instrument) according to *sarf* rules.

3.3.2 An asset-based instrument

Proceeds can take the form of assets, such as, buildings, vehicles, equipment and usufructs. There is a consensus as to the permissibility of selling shares that represent a combination of assets, even if these assets include debts payable by others. What matters in this concern is that the dominant part of the total assets should be in a tangible form, (Hassan, H. H., (1993), p. 24).

3.3.3. A debt-based instrument

If proceeds are changed into debts, the investor who holds shares would, in case he needs to give up these shares for cash, negotiate according to the rules of buying and selling debts.

The exchanging and selling of debts is an issue that is extensively elaborated by *fiqh* legists. We may be precise in this concern to discuss key points that are appropriate for the negotiability of Islamic financial

instruments that represent debt. In this regard, *fiqh* legists have elaborated an exchange of debts at levels of (i) selling a debt for a debt and, (ii) selling a delayed debt for a delayed debt.

3.3.3.1 Sale of a debt for a debt

Fiqh jurists differentiate between (i) the debt sold to a debtor and (ii) the debt sold to another party, not indebted himself.

(i) Debt sold to a debtor

If the debt is to be sold to or exchanged with a debtor, then the debt itself would either be (a) a stable debt (*dain mustagir*) or, (b) an unstable debt (*dain gair mustagir*).

(a) Stable debt

This is the debt that a debtor owes to his creditor, and the latter owns it, such as, the compensation for damage or the value of a stolen object or *ijara* recompense after the realization of a usufruct by a leaseholder.

Such a debt can be sold to the debtor himself either for compensation (*iwad*) or for a grant. Al Shirazi mentioned that *`as for debts, they should be differentiated first: if the creditor's ownership of them is stable like a compensation (fine) for the loss and loan recompense (equivalent), then it is legal to sell such debt to a debtor before receiving, because here an ownership of debt is stable, and it is like the object sold after being received first'*, (Al Shirazi, *Al Muhzab*, Vol. I, pp. 279-80).

However, the majority of Hanafi, Shafii and Hanbali jurists exclude the permissibility of selling a debt for indemnity, if it is *salmi* capital, and if it is an exchange (*sari*) compensation. They do not recognize the legality of any transaction involving these two if they are not received. They justify this by saying that if a creditor gives debt as capital for *salami*, the capital provider has ignored or dropped the 'authenticity' condition of receiving

salam capital before the separation of the two parties of the *salam* contract, (Hammad, N. K., (1990) p. 140).

Moreover, Shafii and Hanbali legists impose an 'authenticity' condition for the selling of debt to the debtor in order that the contract should be free from delay *riba*. The Shafii and Hanbali jurists also invalidate the reconciliation of currencies in debt. Al Sarkhasi mentions that '*if he says - the creditor (debtor) I sold my dinar you (the debtor) owe to me for your ten dirham I owe you, this is illegal, because it is a debt for a debt*', (Al Sarkhasi, *Takmilat al Magmu'*, p. 107).

Maliki and Hanafi jurists and Ibn Taymia (Hanbali) legalize this currency debt reconciliation. However, Maliki jurists restrict this legality by imposing the condition that a debt should be mature. Ibn Guzai stated that '*if one of the debts is gold and the other is silver (currencies) reconciliation is authentic if the debts are mature debts, and it is illegal if they are not yet mature debts*', (Ibn Guzai, *Fiqh Laws'*, p. 320).

(b) Unstable debt

These are debts not fully owned by a creditor in the sense that the debtor has not received its counterpart recompense, such as, the *ijara* revenue for which the lessee has not yet utilized the leased object or received the usufruct resulting therefrom.

Fiqh jurists adopt two divergent positions upon the sale of such debt:

1. Hanbali jurists invalidate its sale to a debtor, as the creditor's ownership of this debt is not complete, (Al Bahwati, *Kashaf Al Qinaa*, Vol. III, p. 294).
2. Hanafi and Shafii jurists legalize such unstable debts to a debtor treating them as stable debts. They see no difference between stable and unstable debts.

(ii). Debt sold to a third party

Fiqh jurists offer different legal opinions of debt sold to a third party:

First, Hanbali and some of Shafii jurists consider it to be legal to sell debt to a third party either for counterpart recompense or on a grant basis, (Ibn Taymia, *Al Fatawa*, p. 506).

Second, the Hanafi, Zahiri and also some Shafii' jurists do not endorse the legality of selling a debt to a third party either for reward or without reward. If the creditor said to another person : `I bought from you such and such an object for the debt you owe to me, and the seller accepts this, then this is illegal as the buyer (creditor) sold what he did not have at hand, or what he was not *canonically powerful* to hold or receive. They further argue that the debtor may reject giving the equivalent of debt, (Ibn Nugaim, *Al Ashbah wa al Nazair*, p. 357).

Hanafi jurists exclude from the prohibition of selling debt to a third party the following:

- (a) if the third party is an authorized agent to receive the debt;
- (b) if the creditor reconciles a debt to the advantage of this third party, and
- (c) if the third party is a legatee or the heir.

Third, the Shafii *Imams*, Al Shirazi, Al Nawawi and Al Sabki endorse the selling of all debts to a third party except *salam* debts; hence the creditor can sell a debt to a third party if `*a debt matured and the debtor is recognizing the debt rights*', (Hammad, N. K. (1986), p. 159).

Fourth, and finally, Maliki jurists approve the selling of a debt to a third party given that certain conditions are observed:

- (a) the debtor and creditor should be living in the same area;
- (b) the buyer of a debt should pay the price as quickly as possible;
- (c) the debtor should recognize the debt rights and not deny them;

- (d) the debt should not be a currency, and it should not be sold for a currency because in currency exchange immediate receiving is a prerequisite;
- (e) the debt should be one that is legally held or received, it should not, for example, be food; and
- (f) the debt should be sold in exchange for a different object or for a similar one for the equivalent amount.

Therefore, concerning the selling of a debt for a debt, *fiqh* rules may be summarized as follows:

- (a) With the exception of *salam* capital and currency equivalent compensation, a stable debt may be sold to a debtor if it is free from delay *riba*.
- (b) Reconciliation of a stable debt between a debtor and a creditor is legal according to Maliki and Hanbali jurists with the former imposing the condition that debts for reconciliation should be mature.
- (c) Selling of an unstable debt to a debtor is unlawful in the judgment of Hanbali scholars whereas for those of the Hanafi and Shafii schools of thought, it is lawful as is a stable debt.
- (d) Hanbali and Shafii jurists legalize the selling of a debt to a third party. although Shafii scholars exclude *salam* debt from this permission. Maliki scholars approve' this act and restrict the approval by certain conditions, such as, the recognition of the debt right by the debtor and the stipulation that the third party should pay the price as quickly as possible.

Therefore, in view of these formal *fiqh* opinions concerning the selling of debt, a short-term Islamic instrument representing debts at a certain period of time may be liquid in the sense that it is liable for a relatively quick liquidation without a large loss for the holders and, more importantly, at the same time conforming to the principles of the *Shari 'ah*.

There are two possibilities for the liquidation of such a debt-based instrument:

- (i) it may be liquidated by selling to the issuer (a debtor) particularly if the debt is a stable debt.
- (ii) it may also be liquidated by selling to a third party (a new investor or holder) in accordance with the formal *fiqh* judgment of selling debt to a third party other than the debtor.

3.3.3.2 Sale of a delayed debt for a delayed debt

As mentioned earlier, in discussing debt matters, *fiqh* scholars differentiate between the sale of a debt for a debt and the sale of a delayed debt for a delayed debt. However, a debt resulting from, for example, *nnurabaha*-based financial instrument may be regarded as a delayed debt (*nasa'* or *kali'*). While *fiqh* jurists have different opinions on the sale of a debt for a debt, they are almost unanimous in prohibiting the sale of a postponed debt for a postponed debt or the sale of what is known in *fiqh* as *al kali' -bi- al kali'*. The *fiqh* opinion concerning this is explained below in order to reveal the implications of *al kali' -bi- al kali'* on the negotiability of the perceived Islamic financial instrument.

First, the evidence for prohibiting the sale of one postponed debt for another is provided by the Prophetic tradition (*hadith nabawi*) in which Al Dar Quatni and AI Baihaqui narrated that Ibn Omer said `the Prophet (pbuh) prohibited sale of *al kali' -hi- al kali'* ". *Hadith* jurists have mentioned that this saying is a doubtful one, and Shafii scholars have said that the *hadith* (tradition) legists are doubtful about it.

However, all *fiqh* schools accept this tradition, along with its meaning and significance, and on this basis they argue for the prohibition of selling *al kali' -bi- al kali'*, (Hammad, N. K. (1986), p. 10). Moreover,

fiqh scholars have shown unanimous agreement on the illegality of selling one postponed debt for another.

Second, the sale of a postponed debt for a postponed debt takes the following different forms :

- (i) The sale of a postponed debt, not yet in the debtor's liability, for another postponed debt. This form is like a transaction in which somebody buys on delay an object described upon the seller's word for a delayed price upon the buyer's word, (Ibn A'arafat, *Al Hudu'd*, p. 252).

Maliki jurists call this sale *`an initiation af a debt by a debt'* This form is not allowed as the contract does not produce benefits to its parties and it is merely an evasive attempt to legalize *riba*.

- (ii) The sale of a postponed debt, already in the debtor's liability, for a delayed debt different in kind from the first one. In this form the debt buyer is the debtor and its seller is the creditor.

Maliki jurists call this form *`an abrogation of a debt by a debt'* *Fiqh* scholars unanimously agree that this form is illegal for the reason that it is a pretext or an excuse for delayed *riba*. Therefore it is forbidden.

- (iii) The sale of a delayed debt, already in the debtor's liability, for another future time with an increase. If the creditor accepts the delaying of the debt payment without an increase or for less than the face value, this is not prohibited.

This form is also prohibited as it conceals delayed *riba* and Maliki jurists also classify it as *`an abrogation of a debt by a debt'*.

- (iv) The sale of a delayed debt, already in a debtor's liability, to another person, not the debtor, for a delayed price described upon the buyer's word. This is prohibited as it is contaminated by *garar* or the uncertainty arising from the

inability of the seller, i.e., the creditor, to pay (submit) this debt (which is in

the liability of his debtor) to the debt buyer. Maliki jurists call this form of debt sale the '*sale of a debt for a debt*'.

Maliki jurists are of the opinion that if the debt is sold to a third party for an asset to be received later or for the delayed usufruct of a specified object, then this form of debt sale is legal as it is, they believe, the sale of a debt for an asset, not a debt for a debt, (Al Kharshi, Vol. V, p. 77).

Shafii scholars, such as, Al Shirazi and Al Nawawi, believe in the permission of this form of debt sale if the debt buyer receives the debt from a debtor and the debt seller (creditor) receives immediately the equivalent compensation from a buyer before they leave the place where they have been involved in the selling of the debt.

This form of debt sale may not be applicable to the case of a creditor selling a debt for a third party in exchange for a debt owned by a creditor to this third party and both debts are (a) equal in amount, (b) typical in kind, (c) identical in character and (d) of the same maturity. Such debt selling is classified as a reconciliation, (Hammad, N. K. (1986), pp. 21-22).

- (v) The final form of sale of *al kali' bi al kali'* is the sale of a postponed debt, already in the debtor's liability, to another person who is also a creditor to the same debtor, for a delayed debt already in the same debtor's liability. -

This form is prohibited for the reason that there is *garar* arising from an inability of both creditors to submit what they have sold to each other. Each of them has sold his debt to another, not to a debtor. This is prohibited even if both debts are typical in kind, equal in amount, and have the same maturity date.

Therefore, given these formal *filth* judgments concerning the sale of a delayed debt for another-delayed debt, it may be asked if there is any possibility of negotiating/ liquidating, for

example, *murabaha-based*, instruments representing debts without transgressing or breaking the prohibition of selling a delayed debt for a delayed debt?

The answer is that there is little possibility for negotiating/liquidating such *murabaha-based* instruments backed by debts. In view the *fiqh* opinions regarding the sale of one delayed debt for another, it is nearly impossible to negotiate such debt-based instruments.

The lawful scope for such negotiation/liquidation is through such very limited avenues as :

- (i) the selling of *murabaha* debts to a third party, not a debtor, for an asset or for a usufruct of a specified asset. Even this solution does not entirely serve the purpose of negotiating/liquidating the financial instrument as it leads to obtaining tangible assets not liquidity.
- (ii) if the person who bought the *murabaha* debt received it from the debtor, and the bank received the equivalent reward from the debt buyer immediately without a delay or if any delay occurred, it was not a substantial one.
- (iii) if the creditor (the bank) sold his debt, already in the debtor's liability, to a third party being a creditor to the same debtor for a debt already in the debtor's liability, and both debts are (a) identical in kind, (b) equal in amount, (c) similar in character and (d) have the same maturity date. Here the bank benefits only if the new debtor is presumably more creditworthy than his preceding debtor.

In conclusion, it seems that these restricted avenues would not be of much help in establishing the required negotiability of the financial instrument if the negotiation of this instrument requires selling a delayed debt for a delayed debt.

The solution may lie in applying the principle of selling '*a debt for a debt*', and not the principle of selling '*a postponed debt for a postponed debt - al kali'- bi - al kali* ". An investor in *murabaha-syndicated*

financing, holding a share, may negotiate the selling of this debt-based share either with the issuer (the debtor) or, alternatively, with another party. This suggested negotiation could be adopted in accordance with the *fiqh* rules controlling the selling of a debt to a debtor or to a third party not the debtor himself (see above).

3.4 Contracting and Ownership Transfer

The Islamic instrument needs to be an instrument whose ownership can be transferred from the seller to the buyer. In contemporary financial markets, the transfer mechanism by which the ownership of stocks or shares is transferred from holders to purchasers is based on laws different from *Shari'ah* laws. The *Shari'ah* permits the disposition of the title ownership, but it imposes conditions that may not always be required by other laws: It might, therefore, be useful to discuss here contract theory from an Islamic perspective and to see its implications for the ownership transfer of a financial instrument.

In *fiqh* literature, a contract is an action which a person intends to do, such as, selling, hiring, and pawning (Ibn Taymia, *Contract Theory*, pp. 18-21; Al Gassas. A. B., *Akham Al Oilman*, Vol. 2, p. 294ff). This is, however, the general meaning. The specific meaning is the connection of a proposal with an acceptance for a lawful objective (Ibn A'abdeen, *Rad al Muhtar*, Vol. 2, p. 355).

In law, a contract is defined in the same way, but it differs from the *Shari'ah* definition as a contract in the understanding of the law might be for an unlawful objective from the point of view of the *Shari'ah*, (Zuhaili, W. (1984), pp. 81-82).

The impact of the Islamic contracting system on ownership transfer of financial instruments may be classified as follows :

Division of assets⁷

In *fish* understanding, assets take different forms with the main types being : (i) valuable and valueless assets; (ii) fixed and moveable assets; (iii) assets composed of similar parts (*mithli*) and those of dissimilar parts (*gimi*)⁸.

- (i) A valuable asset (*mal mutagawam*) is one that has financial value, capable of being a counterpart compensation in contracting, and can be possessed and one the use of which the *Shari'ah* permits, such as, food, real estate, etc. A valueless asset is one whose value is not possible to rate as it is not at one's disposal or at hand, and one the use of which the *Shari'ah* forbids unless for necessity, such as, the pig meat.

This classification of assets is valid because in *fish* what is valuable (*mutagawam*) can be a substance for contracting while the valueless asset cannot be. In modern law the valuable asset is any asset that is useful for all people. So in law most, not all, things can be objects of contracting unless for illegal purposes and forbidden uses.

Thus, in order to be able to transfer a financial instrument from one investor to another, it has to be backed (representing) by a valuable asset which is neither forbidden nor filthy (*nagis*) asset,

- (ii) The division of assets into fixed and moveable categories is also relevant for the ownership transfer of financial assets. In *fish* there is a system of preemption (*shuf'a*) which affects the ownership transfer of fixed assets. *Shuf'a* gives the partner or

⁷Assets" here mean finance or property (in Arabic, "ma!") . *Ma!* means all that an individual owns. In Hanafi *fish* literature *mal* is everything that people desire and like by nature, and that • which is saved for a time of need, whether it is a fixed or a moveable asset (see : Abu Gayb, S. (1982), p. 344):

⁸In understanding of the *fish* jurists assets could also be classified as : assets depleted by consumption and those remain after.

neighbor of the owner of, for example, an agricultural land, the right to buy this land even if the owner has already sold it to another person. It is a compulsory right to buy the land for the price agreed upon with the first buyer.

Therefore, the *shuf'a* system may delay the transfer of ownership of a certificate representing fixed assets in the case of joint venture projects.

- (iii) The classification of assets into those of similar component parts (fungible assets) and those of different component parts (nonfungible assets) also has implications for the ownership transfer of certificates (instruments) representing these assets.

Fungible assets are usually alike in the market, while nonfungibles are not similar. Therefore, reconciliation is possible between fungible assets, such as, wheat, because there can be a single price for such things. They can be debt. Nonfungible assets, such as, trees cannot have a single price, and, therefore, they cannot be debt and are not liable for reconciliation.

Fungible assets can be compulsorily distributed between owners in the case of joint investments if the need arises for this. A partner in fungible assets can take his share in the absence of other partners. Therefore, an instrument representing jointly owned fungible assets can easily be transferred from one investor to another. Nonfungible assets, on the other hand, cannot be distributed in the absence of other partners in the case of joint investment. Hence, instruments representing these nonfungibles cannot be easily transferred from one investor to another.

Therefore, the classification of assets (finance) in *fish* differs from the understanding of assets in modern law. The *fish* classification affects the ownership transfer of financial instruments representing these assets especially in the case of assets of a short-term nature.

3.5 Holding of a Financial Instrument

In the *Shari'ah*, a commodity, or any contract object under consideration has to be held instantly or, as is more likely, held after a short period of time by the buyer. Holding is required immediately in the case of exchanging money for money or gold for gold. When a financial instrument is sold, how is it held? Should it be held itself, i.e., a real holding (*gabd hageegi*) or should it be held according to simulated holding (*gabd hukmi*)?

In *fiqh* literature, all *fuqaha* agree that holding (*gabd*) implies the acquisition of a thing by a buyer and his ability to control it; this thing is either taken by hand or otherwise (Ibn Guzai, A., *Fiqh Laws*, p.328). Al Kasani said "*the meaning of gabd is the ability of holder on the object, and lifting of obstacles*", (Al Kasani, *Badai ' Al Sanai'*, Vol. 5, p.148).

In fact holding differs as to whether it concerns the holding of the fixed assets or moveable assets. Hanafi, Shafii, Maliki, Hanbali and Zahiri scholars all agree that the *gabd* of fixed assets is to leave it to its buyers, (Hammad, N. K. (1990), p.71). The *gabd* of moveable things, such as, money, etc., requires taking the moveable object by hand or leaving it to the buyer to handle as he wishes, (Ibn A'abdeen, *Rad al Muhtar*, vol. 4, p.561).

In this regard, holding by registration, i. e., transferring ownership through official documents, allows the buyer to use the car and gives him full access to it.

Therefore, a financial instrument can be classified as a mobile asset in that when sold, it has to be taken over by the buyer. Ibn Hazm said that "*gabd of a mobile thing completes by transfer*", (Ibn Hazm, *Al Muhalla*, Vol. 8, p.89). Thus, applying the principle of real holding (*gabd hageegi*), a financial instrument must be transferred to the buyer, i.e., a handed over.

However, *fuqaha* have discussed the concept of simulated holding (*gabd hukmi*) as a substitute for real holding under certain circumstances.

Because a financial instrument is a mobile asset, can it be handled in accordance with the principle of simulated holding?

According to Hanafi jurists, *gabd hukmi* can take the following forms:

- (i) if the buyer asks the seller to give an object bought to another person and the seller does so accordingly;
- (ii) if the seller; on behalf of the buyer and with his consent, sells the object that the latter bought from the former, although the buyer has not yet received the object;
- (iii) if the buyer buys, for example, bread and gives the seller a bag to put the bread in and,
- (iv) if the buyer buys wheat and asks the seller to grind it, and the seller does so accordingly.

All of these are approved forms of simulated holding. Thus, a financial instrument can be governed by these forms without transgressing the rules of *gabd* as required by the *Shari'ah*. For example, a financial instrument can be transferred from one investor to another without being really held if both of them delegate someone who proceeds to sell or liquidate this instrument on his behalf. Therefore the requirement of *gabd* can be met, using the principle of *gabd hukmi*, if the financial instrument represents moveable assets.

What, however, happens when a financial instrument represent a debt? How can the *gabd* requirement be met in the case of debt?

In this case, the *fuqaha* say that a creditor is considered to be holding his debt, i.e., *gabd hukmi*, from his debtor if he owes the same debtor the same amount of debt.

A debtor can exchange what he owes to his creditor for a different currency, but he has to pay instantly. A creditor does not pay the equivalent, as he already has money (debts with his debtor). Thus, although immediate holding is a requisite in a money exchange contract, here the debtor is regarded as holding the equivalent which is a debt he is

obliged to repay to the creditor. This is approved as *gabd hukmi*. Ibn Gudama mentioned in Al Muqni that "it is permissible to cash one of the currencies from a debtor, and the transaction is an exchange of currency for debt", (Ibn Gudama, *Al Muqni*, Vol. 4, p.154). The evidence for this is the famous saying narrated by Ibn Omer who is reported to have said that "I used to sell camels in Nageea for *dinars* and take *dirhams*, and sell for *dirhams* and take *dinars*, so I came to the Prophet (pbuh) asking about this deal and he replied "it is right and licit if you and the buyer left the market place with all debt between you cleared", (Al Baihagi, *Sunan Al Baihagi*, Vol. 5, p. 284).

If there are two dealers, each one obliged to the other for the same amount of debt which is typical in currency and maturity, they can reconcile their debt so that each is free and there is no need for *gabd* because what is owed is regarded as being held (*gabd hukmi*), (IFA Magazine (1990), p. 727). Hanafi, Maliki, Shafii (such as, Al Sabki) and Hanbali (Ibn Taymia) jurists said that if one person owes another *dinars* and the other owes him *dirhams*, then they can exchange with each other what each is obliged to pay. This exchange is sanctioned and the debt is cleared without a need for holding, (Ibn Taymia, *Nazariat Al Aqd (Contract Theory)*, p. 235).

Therefore, assuming that a financial instrument represents debts, i.e., the proceeds of certificates being converted into debts then when it is negotiated, it can easily be circulated by the rule of simulated holding. An investor can reconcile the value of a financial instrument, e.g., a debt, with others for cash or for another debt, or he can negotiate it with the issuer for currency different from the currency upon which the instrument is issued. The principle of *gabd hukmi* introduces flexibility in circulating short-term financial instruments because in practice it is difficult to meet the requirement of real holding in the short term.

3.6 Liquidation and Conversion

Can IBs create a financial instrument which meets the condition of liquidity, given that the doctrine adopted is the one which measures liquidity in terms of stocks⁹.

Does the financial instrument lose the characteristic of being liquid due to the difficulty of the quick liquidation of the assets that it represents? Real liquidation as well as simulated liquidation has an effect on the liquidation of a short-term financial instrument.

It is relevant here to see the *fiqh* opinion with respect to :

- (i) an abrogation of *mudaraba* contract and
- (ii) fixing a limit of time for the completion or ending of *mudaraba*.

This is important owing to the fact that most Islamic financial instruments are *mudaraba*-based.

The *fuqaha* differ on the fixing of a limit of time for the end of a *mudaraba* contract, i.e., planned liquidation; some of them sanction it whereas others disapprove.

Hanafi jurists approve the arrangement for *mudaraba* liquidation. Al Kasani mentions that "*If capital is taken for mudaraba for a year, in our opinion (the Hanafi) it is permissible*" (Al Kasani, *Bada'i 'Al Sanai* ', Vol. 8, p. 363).. He adds that fixing a limit of time is approved because *mudaraba* is a delegation /procurement, and delegation can be with a deadline or without.

⁹ Liquidity may be regarded as either a stock or a flow concept. To measure liquidity in terms of **stock** viewpoint, one must appraise the holdings of assets that may be turned into cash. When viewing liquidity from a flow approach, one considers not only the ability to convert liquid assets, but also the ability of the economic units to borrow and to generate cash from operations.

Hanbali jurist, Ibn Gudama, also mentions that "*it is lawful to specify a deadline for mudaraba liquidation as the capital owner can say to mudarib act on these dirhams for a year, if the year ended do not buy or sell*", (Ibn Gudama, *Al Mugni*, Vol. 5, p. 69).

Maliki, Shafii and Zahiri scholars all prohibit fixing a limited time for *mudaraba* liquidation, (Al Ramli, *Nihayat Al Muhtag*, Vol. 5, p.225; Ibn Hazm, *Al Muhalla*, vol. 9, p. 116).

Therefore, following the Hanbali and Hanafi points of view, *mudaraba-based* financial instruments can be created and designed to be redeemed at a certain time in the future, (Abbadi, Abd Alla A.R., 1982).

Another issue which affects the liquidation of *mudaraba-based* financial instruments is the option to abrogate the *mudaraba* contract. The *fugaha* all agree that the capital owner has the right to cancel the contract wherever he wishes and to liquidate the capital if a *mudarib* has not yet started work.

If, however, the *mudarib* has started working, the Shafii, Hanafi and Hanbali jurists are all of the opinion that the capital owner has the right to annul the contract and to liquidate the capital. The Maliki school adopts the opinion that if a worker has begun to work, then the capital owner does not have the right to annul the *mudaraba* contract, (Al Khafeef, Ali (1962), p. 62ff.).

If we adopt the *fish* opinion of the Shafii, Hanafi and Hanbali schools, then a *mudaraba-based* financial instrument can be liquid, as the capital owner has the right to nullify the contract if he realizes that it is not feasible.

The concepts of real and simulated liquidation affect the liquidation and the conversion of a short-term financial instrument. After launching investment activities, if the proceeds of financial instruments are partly or wholly changed into tangible assets, and if it is then possible to liquidate these assets in the short-term, the profit (loss) can be accounted for and

paid to investors and the, principal (or less than principal in the case of a loss) can also be accounted for and repaid to investors.

As it is occasionally difficult to liquidate certain types of assets, how can the matter of liquidation and conversion be solved ?

. Shafii and Hanbali scholars legalize the distribution of profit while work on the project is continuing and before the final liquidation of the project. If a loss appears at the final liquidation of the project, then profit is taken back to compensate for the loss.

The WA issued the resolution (No. 5) that *"the parties to mudaraba deserve profit when it is realized, own it by final liquidation or simulated liquidation and it is, i.e. the profit, not distributed for good by a temporary distribution. For a project that generates a flow of revenue, it is lawful to distribute that revenue before final liquidation. This distributed part is considered as an amount paid under reconciliation"*, (IFA Periodical, Fourth Issue).

As for the final distribution of profit in the short-term, some Islamic financial institutions¹⁰ adopt the principle of simulated liquidation so that funds in short-term investments can be repaid and their profit distributed although the project continues operating. In this regard, the WA issued a resolution stating that *"What is divided is the profit which is a surplus over capital. The profit amount is known either by actual liquidation or by simulated liquidation, i.e., evaluation. It is the profit which is distributed between certificate holders and mudaraba workers according to mudaraba conditions."*

It is, therefore, clear that an Islamic financial instrument can theoretically be liquidated and converted even if it is of a short-term nature, taking into account and relying upon the *fish* opinion of *some fiqh* schools regarding:

(i) fixing a limit of time for the *nmdaraba* contract,

¹⁰Such as, Al Baraka Group. See : Klmja, I.M., Islamic Unit Investment Funds, (1993).

- (ii) the option to cancel and abrogate *mudaraba*, and
- (iii) real and simulated liquidation.

However, in practice, and in the case of short-term *mudaraba* and *musharaka* instruments "*income would be unknown while past performance and future prospects may be of little relevance. Income on short-term instruments is determined by immediate factors and it would require substantial research on the part of buyers to know the nature of the project or the consignment in which the company is using the funds and the prospects for income. Since the issuing company may know this better than any one else, it may be the only agency able to redeem short-term securities. Hence, short-term mudaraba and musharaka instruments may in general have to be held by investors until maturity if not redeemed by the issuing company,*" (Chapra, M. U., (1986), p. 166).

Chapra also thinks that in contrast with short-term *mudaraba* and *musharaka*, short-term *murabaha* and leasing instruments may tend to be relatively more liquid because the rate of return on these would be known. He believes that there are risks associated with these methods of financing even if the conditions laid down by the *Shari'ah* are abided by, and therefore even these instruments may in general tend to be less liquid than short-term interest-based instruments.

3.7 Other Factors

Apart from the above, the following factors also influence the creation of short-term Islamic financial instruments.

3.7.1 The legal system

The legal and judiciary systems in the countries in which IBs are mainly based are undeveloped, especially the legislation regarding companies and business activities in general and those regarding financial and money markets in particular.

There are no regulations to systematize the legal relationships between issuers and investors of financial certificates.

Regulations and legislative procedures are occasionally changeable.

- (iii) Laws are interrupted and interpreted in different ways.

3.7.2 The accounting system

The accounting systems in countries in which IBs operate lack both adequacy and efficiency. There is a severe shortage of accountants. The General Auditor's Office in these countries is usually concerned with the auditing and scrutiny of the accounts of public entities. It takes time for auditors' reports to be circulated and published. Only a few companies declare their final accounts publicly in the press.

There is also a lack of authorized evaluators and liquidators in the private sector. In most cases, private companies and economic units rely upon foreign auditors or evaluators. However even they cannot evaluate and audit to the standard required due to incomplete and inaccurate data and information included in documents and records.

In addition, due to the lack of a proper accounting system, taxes are accounted by estimation and personal judgment. Therefore, business profit taxes and other duties are unfair and unstable.

3.7.3 The administrative system

Administrative procedures in these countries are lengthy, complicated and slow and powers are overlapping. There is an acute shortage of skilled professionals; and a large part of the work is completed on a manual handling basis. The social and cultural setup does not encourage the efficient completion of work. Civil servants are still greatly

influenced by traditions and old habits and are unwilling to adopt modern management methods and techniques.

All these factors may make it difficult for IBs to develop a system of short-term financial instruments.

**CONCLUSION AND RECOMMENDATIONS:
ADAPTING AND DEVELOPING FINANCIAL
INSTRUMENTS ON AN ISLAMIC BASIS**

CONCLUSION AND RECOMMENDATIONS: ADAPTING AND DEVELOPING FINANCIAL INSTRUMENTS ON AN ISLAMIC BASIS

The issue of a short-term excess liquidity is one of the problems facing IBs. However, this problem is exacerbated by the fact that there is neither a money market in the countries where most IBs operate, nor adequate and efficient financial instruments that can be used to manage these surplus funds in order to recycle them among IBs themselves or among other financial institutions.

The seriousness of this problem is increased since some IBs hold temporarily idle balances whereas other IBs need these balances, and both groups are unable to benefit from these funds due to the lack of short-term financial instruments which are not in contradiction of *Shari 'ah* laws.

In contemporary money markets the term 'short-term' involves deals for a very short period of time not exceeding overnight or even a few hours. In this paper, "short-term" means that financial assets mature for a period of time extending from a few days up to a year.

An assessment of conventional financial instruments reveals that some of them can be adopted by IBs if they are adjusted to *Shari 'ah* rules while others are, to a great extent, not suitable for IBs. In addition, short-term Islamic financial instruments could originate from an application of Islamic modes of finance. Therefore, in this concluding chapter, recommendations are made at two different levels:

- (i) adapting conventional short-term financial instruments so that they are compatible to the *Shari 'ah* and,
- (ii) developing new financial instruments by applying the most popular Islamic techniques of financing.

It is, therefore, concluded here that some conventional financial instruments could be adapted on an Islamic basis to enable Islamic banks to adequately manage their short-term liquidity whereas other instruments are not suitable for that purpose.

4.1 Conventional Financial Instruments: Possible Adaptations

First : The following instruments may suit IBs if they are reformed to meet Shari 'ah requirements :

Negotiable Certificates of Deposit (NCDs)

It may be asked if this interest-based instrument can be adapted for use by IBs? It is possible to issue NCDs on the basis of *mudaraba* in the sense that an Islamic bank with a short-term surplus fund can hand it to another bank in need of it, so that the former is the owner of the capital (*Rab al Mal*) while the latter is the worker (*mudarib*). In other words, the bank which receives the surplus short-term liquidity is the "receiving" bank which is *an. issuer* of NCDs and the bank that provides this short-term liquidity is the "offering" bank , i. e., the *buyer* (holder) of NCDs. To differentiate this instrument from conventional NCDs, the suggested interest-free NCDs can be termed *mudaraba-based redeemable certificates of deposits (MRCDs)*.

The funds mobilized through MRCDs are, of course, of a short-term nature. This characteristic implies that:

- (i) the *offering* (investing) bank should restrict the *receiving* (issuing) bank to the use of these funds in certain projects on the basis of specified or restricted *mudaraba* in order that the project can be easily liquidated on the request of the investing bank which may at any moment face an urgent illiquid position.

In this connection, the spot (cash) market of foreign currencies could be one place to employ such short-term

funds. An Islamic bank keeping MRCD funds can trade in spot transactions on the basis of spot prices for a spot sale and buy. The most important condition here is the immediate exchange of currencies and in case the currencies are similar in kind, that they should not be exchanged for an increase, otherwise, a debts' *riba* would be committed and the transaction would be illicit from the *Shari'ah* perspective.

An Islamic bank can, therefore, participate in this market, buying and selling currencies, without transgressing the *Shari'ah* rules of dealing in exchange transactions. At the same time, it may perhaps realize some profit, though possibly at a low level, and remain relatively liquid.

Because in practice an Islamic bank may not be able to directly undertake this business, it may assign a spot trader as an authorized agent in the money market. This agent can be one of the listed money market companies.

- (ii) The MRCDs' funds would also preferably be allocated to trade activities for the sake of easy liquidation on demand without incurring a large loss.

MRCDs can be negotiated according to the condition that, when MRCDs' proceeds are deployed and changed into another form, then the majority of this new form of capital should be tangible assets and usufruct. Under this condition MRCDs can be priced according to a current evaluation of assets and usufruct. However, there is no room to negotiate MRCDs for more than their face (nominal) value if proceeds are still in a cash form. In such a case, the rule of money exchanging (*sarf*) is applied. On the condition that MRCDs' proceeds are in a debt form, the rules of buying and selling debts are applied.

Therefore, NCDs issued by conventional banks contradict the *Shari'ah* rules as they are dealt with on an interest-rate basis. However, this practice could be adopted by IBs on the basis of . *mudaraba* and in certain short-term investments. . .

Commercial Papers (CPs)

Commercial Papers (CPs) are generally sold on a discount basis. Banks guarantee to pay the value of CPs on behalf of industrial and commercial utilities to the buyer who will receive interest. Commercial and industrial utilities issuing CPs usually get open lines of credit from banks to pay the value of a CP at the date of maturity. CPs are, therefore, marketable.

An Islamic alternative to CPs might not be possible as long as CPs are in reality a debt in the form of an `IOU'. Therefore, if CPs are considered to be *debts*, they should, from the *Shari'ah* point of view, be repaid in an amount *exactly equal* to their *face value*. They are not *negotiable* for more or less than their face value.

Moreover, the Islamic *Fiqh* Academy prohibits the discounting of CPs, (The Islamic *Fiqh* Academy's Decision No. 66 / 2 / 7, Seventh Session, Jeddah 1412H).

Bankers' Acceptances

The solution for Islamic banks in the use of banker's acceptance is to act as agents for traders dealing in trade and to take fixed commissions.

Those who consider banks to be guarantors suggest that a different solution for Islamic banks might lie in acting as a partner to the customer. The bank as a partner would guarantee the other party(ies) in the

partnership contract on the condition that the partnership is a limited company

Repurchasing Agreements (Repos)

IBs with short-term excess liquidity can participate (on a *mudaraba* basis) in investment funds established by investment companies or other Islamic banks. The sponsoring body, for example, an Islamic bank, would issue certificates each representing an investment unit, i. e., a share in the fund. An Islamic bank with short-term excess liquidity can buy some of these investment units for two purposes:

- (i) to have profitable (though low) assets at hand instead of holding cash balances at a zero profit margin, and
- (ii) to convert these short-term financial assets into liquidity in a period of insolvency and contingencies, i. e., when there are heavy withdrawals from current accounts and reserves.

The question arises : Can the issuer (sponsoring body) of certificates, i.e. the investment 'units, buy back these certificates from banks that prefer to have liquidity? This situation involves an application of the concept of repos used in the conventional money markets on an interest basis. Is it feasible to introduce such a concept on an Islamic basis?

Repos are important in the absence of an Islamic financial market. The commitment to repurchase may come from the issuing bank or from other financial institutions. In all cases, repurchasing requires that some liquid funds should be kept available.

Assume that a commitment to repurchase comes from the issuing bank - the bank that established an investment fund and in consequence issued certificates and sold them to IBs with short-term liquidity. Assume also that one of the IBs holding these *mudaraba-based* certificates faces

" This opinion originated with and is advocated by Dr. Monzer Kahf, senior research economist at IRTI/IDB. .

on illiquid situation and decides to sell these certificates. On what basis can the issuing bank repurchase its certificates?

As long as the certificates represent a share in the assets of the investment fund, they can be priced according to the current market value of the fund's assets provided that these assets are in the majority tangible assets and usufructs. The repurchase price at which the issuing bank buys back may be exactly equal to, less than or higher than the selling price at the beginning of the issuing.

How is the repurchase price determined? -

In classical repurchasing agreements prices are fixed in advance. If the investor feels that the current securities' prices are higher than the prefixed repurchase price, he will not resell it to an issuer. If, on the other hand, the current price is lower than the prefixed (repurchase) price, he will resell them to an issuer.

However, in *Shari'ah* rules, the advanced fixing of prices is not permitted, particularly if it is positively associated with speculation. From an Islamic perspective, the repurchase price of a certificate is determined according to the measures approved by the IFA as explained earlier in Chapter 3¹²:

The issuing (Islamic) bank can occasionally announce repurchasing certificates at a certain price determined fairly and objectively by experts. This pricing can be according to the market situation and the financial position of the issuing bank.

Therefore, the concept of repos can be adapted to suit IBs as financial institutions observing *Shari'ah* rules in their dealings.

¹² The reader is requested here to refer also to the Islamic .*Fiqh* Academy (WA) resolutions published in the *IFA Magazine*, Fourth Session, Vol. IV, (1988), pp. 2162 - 2163.

Treasury Bills (TBs)

TBs could be adapted to a *mudaraba* basis. *Mudaraba* bonds could be issued, so that the government collects the proceeds from banks with short-term liquidity and acts as the *mudarib*. This could be done on a continuous basis so that the government could secure a constant flow of funds through the frequent issuing of *mudaraba* bonds. Investment activities financed by the proceeds of *mudaraba* bonds have to be carefully studied and chosen so that they can be liquidated within the specified period - three months, six months, or so up to a year.

Mudaraba-based TBs can be used to finance certain investment projects or for any other feasible investment activities. The value of these TBs would be amortized gradually over time or repaid at the end of the period with profits realized.

A third party may, if the need arises, act as a guarantor to investors (*mudaraba-based* TBs holders) since the formal legal opinion of the IFA is that it is lawful for an independent concern to provide this guarantee on the basis that it is not rewarded for it:

In addition to *mudaraba-based* TBs, TBs could be *musharaka-based*. Governments can issue TBs on a *musharaka* basis to finance specific projects, so that TBs would represent investment units of equal value. However, the possibility of enlarging TBs on a *musharaka* basis is limited as long as the funds raised are of a short-term nature.

Gilt-edged Markets

Dealings in gilt-edged bonds could be amended to be on a *mudaraba* basis with the issuing body mobilizing resources from banks with excess liquidity and employing them in short-term activities ready for liquidation in the short term.

Interbank Markets

Interbank market dealings in cash balances held with central banks can be undertaken either on a cooperative basis or on a *mudaraba* basis.

Foreign Exchange Market Dealings

IBs can also be involved in foreign exchange market dealings by constructing foreign exchange contracts in money markets on a spot basis, not on a forward selling or on cash margin basis.

Eurodollar Transactions

Dealings in Eurodollars are interest-based and are, therefore, unsuitable for IBs; they are suitable for IBs only when they are used for conversion into another currency.

In that case, they can be used by IBs if the *exchange* and *receiving* of currencies are carried out immediately on the spot because this is a *sarf* deal.

Central Bank Intervention

This intervention basically depends on the buying and selling of securities by central banks in developed economies to institutions including banks. Securities are either dealt with on an interest payment or, alternatively, on a discount basis. However, in both cases money is either bought or sold for interest and the entire deal plainly contradicts the *sarf* rules specified by the *Shari 'ah*.

Second, the following money markets instruments¹³ are of little or no relevance for Islamic banks:

¹³ Money market instruments are issued for a short period of time not more than a year whereas capital market instruments are issued for more than a year or perhaps for a couple of years.

Options

Options are in many aspects not consistent with the *Shari'ah* rules; they are different from options mentioned by the *fuqaha*.

Swaps

Swaps involve exchanging debts which carry interest payments; they also involve borrowing and lending currencies and are carried out on a discount basis.

4.2 Developing Short-term Islamic Financial Instruments

Before discussing how short-term financing instruments can be developed by applying Islamic modes of financing, it is necessary to keep in mind the basic conditions that must be fulfilled as elaborated in Chapter 3. Any Islamic financial instrument that recycles the short-term surplus funds of IBs would be governed by these requisites.

As has been mentioned previously, although it is difficult (though not impossible) to satisfy the condition of profitability in the short term, Islamic financial instruments can be negotiated, transferred and acquired, i.e., they can be held, liquidated and converted to liquid (cash) assets.

Provided that these necessary conditions are met, Islamic techniques can be used to find short-term investment outlets for IBs and, in consequence, to suggest relevant instruments. There are many Islamic modes of finance that can be a basis for the development of financial instruments, but the modes listed below are viewed as the most appropriate as a basis for short-term financial instruments.

Murabaha

Through *murabaha*, or *bai muajjal*, IBs finance some short-term profit-generating activities. For the last twenty years or so, most IBs

have used *murabaha* as a mode of finance. The statistics and annual reports of IBs make it clear that nearly ninety percent of the investment of IBs was

through *murabaha*. Although it is not advisable for IBs to concentrate on *murabaha*, its use is unavoidable. *Murabaha* is a relevant method for IBs to put their short-term surplus funds into profit-generating activities and at the same time secure the necessary liquidity whenever it is needed. The question is: Can there be any financial instrument originating therefrom and can it be negotiated?

The answer to this question depends on the form of debt created as the *murabaha* contract is established. Therefore any negotiation of this debt would be regulated by the rules of selling and exchanging debt as laid down by *fiqh* opinion as discussed earlier.

Musharaka

Musharaka is another mode of finance adopted by IBs. Through *Musharaka* "financial institutions enter into a partnership with clients for a limited period of time in a project. Both the bank and the client contribute to the capital in varying degrees and agree upon a ratio of profit in advance" (Mannan, M. A., (1993), p. 22).

Because the funds are of a short-term nature, IBs can be involved in:

- i. Local trade partnership
- ii. Foreign trade (imports and exports)
- iii. Working capital for industry and/or agriculture.

Local Trade Partnership

A financial instrument can be developed from financing local trade. However, as long as the share of a bank is a common share in the goods (e.g., cash crops), the bank can sell this share. The certificate representing this share can be negotiated to be sold either for a partner or for other party(ies) without transgressing the Islamic rules because it represents a share in real goods at hand. Its price can be equal to, less than or more than its nominal face value, depending on the prevailing price of the concerned goods.

However, there are different *fiqh* points of view regarding a common debt owned by two parties. These opinions have the following implications for the negotiability of *musharaka-based* financial instruments:

. Assume that a group of IBs having short-term excess liquidity financed a project on a partnership basis, or an individual Islamic bank did the same with a single partner so that the transaction produced a common debt shared by the group of banks or the single bank and a partner. Can this debt be negotiable so that, for instance, a bank in urgent need of liquidity can take its share in the debt resulting from transaction ?

Regarding this, the *fuqaha* have mentioned that a creditor has no right to claim the debt of other partners (creditors) from a debtor. A creditor who wishes to get his money back, should claim his own share in debt. If this creditor claims and wishes from a debtor more than his share in debt, the debtor remains indebted to the other creditors. A creditor can release his share in debt (*Ibra'*, i.e., acquittal), or grant or exchange for an asset, or even pledge, transfer or use it as rent to hire an asset. As a result, a creditor is free to handle his own share in debt. This freedom introduces flexibility into such *musharaka-based* instruments. A partner can redeem his share in debt or behave as he prefers with his share as long as this share in debt is backed by real assets, goods and usufructs.

Another aspect of the same point is : Can a creditor delay receiving his share in debt ? In this respect, the *fuqaha* have said that if a creditor has the right and freedom to release his share in debt, then he necessarily has the same right and freedom to delay receiving his share.

There are some *fish* jurists who do not accept this, among them is Abu Haneefa who believed that this delaying of debt on the part of the creditor is not permissible as it implies the division of debt before being held or received. He mentioned that the basis of debt division is sorting, (i.e., *farz*) so that the debt share of every creditor is isolated and separate from that of other creditors. Al Kasani also held the same point of view, (Al Kasani , *Badai ' al Sanai'*, Part 6, p. 7).

Abu Yusuf had a different opinion, which was that a creditor who has a share in a common debt can delay his share and it is a licit action.

Therefore, in the case of *mushraka*, unit investments resulting from this and representing a share in common stock or equity can be negotiated according to the current market value of these common assets. If, in the end, the common stocks are converted into debts, then the rules governing the sale of debts or the sale of a delayed debt for another postponed one are applicable here:

Financing Foreign Trade

In foreign trade financing, it usually takes time to collect the proceeds of exports or to pay the value of imports. In this respect there are two possibilities:

- (i) if the transaction is for importing commodities, and if the bank (as a partner) received the goods or the necessary documents (e.g., bill of lading, packing list, etc.) of the imported goods, it can negotiate these documents (as an instrument) as long as the arrival (and holding) of these documents is regarded as the arrival (and holding) of the goods. In other words, the arrival of documents is classified as the simulated holding (*gabd hukmi*) of goods, (Hammad N. K., (1990), *Studies in Principles of Debt in Islamic Fiqh*). The documents can be regarded as an ownership instrument, and the bank can sell it for its market value.
- (ii) if, on the other hand, the transaction is for exporting commodities, the bank will also be in a position to negotiate the commercial papers originating from the transaction, if the transaction is carried out through a confirmed documentary letter of credit, and the bank is certain that the value of the exports will be paid- by the corresponding bank.

In this case, commercial papers represent the ownership of the proceeds of exports which are, i.e., the proceeds, in the form of cash. The negotiation of such commercial papers is governed by the *fish* rules of exchanging a currency for a currency, i.e., the *sari* rules.

Financing Working Capital

When a bank finances working capital on a *musharaka* basis, for example, in buying raw materials for an oil-processing unit, the bank may:

- (i) either end the transaction by selling its share to the partner on a *murabaha* basis, or
- (ii) continue its participation up to the end of the processing cycle.

If the bank decides, before the start of oil processing, to end the transaction on a *murabaha* basis, it can sell its share at the current (market) value of the raw materials. Thus, the bank can negotiate the certificate (as a financial instrument) which proves its share.

If the bank chooses the other alternative, it can sell its share in the expected products according to the rules of selling an object of *salam* for the reason that the product is not at hand and is merely expected according to an already prepared feasibility study and also according to the contract conditions. Hence, the financial instrument can be negotiated accordingly.

Mudaraba

It is also conceivable that IBs can invest their short-term surplus funds using the *mudaraba* mode of finance. The striking feature of *mudaraba* is that the financier (*rab al ma!*) is burdened with the whole loss normally incurred, and not attributable to the deliberate action or negligence of the other party, i.e., the *mudarib*.

IBs can use their short-term surplus funds in short-term activities, such as, trade, using the *mudaraba* technique. The negotiation of financial instruments resulting from *mudaraba* can be governed by the same rules governing musharaka-based financial instruments¹⁴.

If an Islamic bank with short-term excess liquidity wants to become involved in a quick return and easily liquidated investment, then *Shari'ah* requirements may impose rigidity in the negotiation of the *mudaraba*-based certificates originated therefrom, particularly if they are short-term instruments. For instance, the *Shari'ah* requirements on the abrogation of a *mudaraba* contract affect the negotiability of short-term instruments that might arise in connection with financing by this mode.

If short-term *mudaraba* contract is scheduled to continue, then there can be periodic liquidation depending on the principle of simulated liquidation (*tandeed hukmi*) to see if a profit has materialized¹⁵

The doctrine of simulated liquidation would, more likely, introduce flexibility into short-term *mudaraba*-based financial instruments. Without resorting to real liquidation and the finalization of the *mudaraba* contract, *mudaraba* can continue and at the same time secure the necessary liquidity when needed.

The *fuqaha* have also raised such points as:

- (i) the authority of the capital owner in managing *mudaraba* capital,

¹⁴There are, moreover, *Shari'ah-related* issues affecting the negotiation of *mudaraba*-based certificates with respect to capital and retained profits. For detailed elaboration, the reader should refer to : Ibn Rushd, *Bidayat Al Mujtahid*, Vol. 2, pp. 334 - 335; Al Khafeef, A. (1962), pp. 67 - 71; The Islamic Fiqh Academy, *Fourth Session's Proceedings*.

I'm unable to locate in the literature of Islamic economics a detailed analysis of real and simulated liquidation as viewed and prescribed from the Islamic perspective.

- (ii) the interdealing between the *mudarib* and the capital owner. Can the former buy from and sell to the latter?
- (iii) the power vested in the *mudarib*¹⁶.

Such issues also influence the degree to which a *mudaraba*-based instrument can be freely and easily negotiated.

Bai-al Salam (salam sale)

Salam is one of the Islamic sales sanctioned for necessity (*daru'ra*). It is, in *fish* terminology, "selling an object on description for another object given instantly", (Hammad, N. K. (1994), p. 3). In reality, there are many definitions for *salam* according to the conditions specified by the *fuqaha*. The evidence for the legitimacy of *salam* is, however, provided by the Holy *Oura'n, Sunna* and *ijmaa*:

Salam sale is important as it includes agricultural products and all that can be covered by that description. Moreover, it is not necessary that the seller of a *salam* product be the producer of that product, (Hamoud; S. H., (1984), p. 4). IBs can make extensive use of this contract in different investment activities, (Omer, M. A. H. (1991), pp. 70-73).

It is assumed here that *salam*, as a technique, is used to finance short-term investments, such as, agricultural products extended for one production cycle (usually less than a year). Regarding current applications of this concept, it is appropriate to quote two forms of *salam* suggested by Nazih Hammad in his paper "*Salam Fiqh and its Current Applications*"¹⁷:

- (i) IBs can establish a *salam* contract with an oil-producing company. The latter would commit to provide the bank with the specific described oil at a certain time in the future and at a certain place.

¹⁶ For a detailed discussion, see: Al Khafeef, A.(1962), pp. 76 - 85. See the bibliography and references.

In the next stage, when the contract is signed and the price - is paid, and up to the date of receiving the oil, the bank can establish what is known as "parallel *salam*" contracts with oil users - or with mediators. In these contracts, the bank commits itself to sell oil typical in substance to what it already bought from the oil-producing company.

- (ii) An Islamic bank buys a quantity of cement on a *salam* basis as discussed in (i) above. The contract states that a cement factory is to keep the quantity separately at its stores. The bank can delegate power. to the factory to sell cement in cash or on a deferred basis.

These contracts established in (i) and (ii) above could also be negotiated on parallel *salam*.

However, as in the case of *mudaraba*-based financing instruments, the negotiability of *salam*-based instruments are governed by the *fish* rules regulating the reconciliation, deletion, selling and exchanging of debts, as discussed earlier in Chapter 3.

Istisnaa'

This type of finance was not used very extensively in the past because industrial activities were not very developed. This explains why *istisnaa'* was not developed and elaborated by the *fuqaha*:

There are different definitions of *istisnaa'*: "*the selling of an asset, not a selling of work*"; (Dunia, S. A., (1990),,p. 29) and "*contract upon which an object - which is manufactured -is instantly bought; the seller is committed to give this object manufactured by his own materials, according to .specific characteristics and at a specific price*", (Al Zarqa, M. A. (1994), pp. 20-22).

With the *istisnaa'* contract it is not necessary to pay the price instantly, unlike with the *salam* contract where the instant payment of the

price is a necessary condition.
flexibility.

This characteristic gives *istisnaa'*

As in other modes of finance, financial instruments can originate from the transaction. IBs can use their short-term surplus funds to finance production on the basis of *istisnaa'*. The bank buys industrial products on an *istisnaa'* basis and then the bank sells these manufactured products on a *salam* basis on the date of maturity of the *istisnaa'* contract or at a date latter.

There may be some reservation that as *istisnaa'* products are not at hand, which is a debt, and selling them in accordance with *salam* is also a debt. Then this deal is prohibited as it is the selling of a debt for a debt. However, a counterargument to this reservation may be that:

- (i) The object of *istisnaa'* is known with regard to its kind, description and amount (Al Kasani, *Badai'Al Sanai'*).
- (ii) Ibn Nugaim mentioned that an *istisnaa'* object is a well-known object and if the object is not well-known, the *istisnaa'* contract is invalid, (Ibn Nugaim, *Al Bahr al Raig*, Vol. 6, p. 186).
- (iii) The *istisnaa'* contract does not have to be bound to a certain period of time. However, it is also a valid and lawful contract if bound to a short period of time, for example, less than a month, (Dunia, S. A. (1990), p. 33).
- (iv) In *istisnaa'*, the seller (in this case the bank) is not necessarily the producer. Therefore, the bank can arrange contracts so that whenever it appears that the customer (producer) who has to discharge *istisnaa'* goods is unlikely to be able to honor his promise, the bank can buy goods from the market to fulfill its promise.
- (v) The certainty of receiving industrial products, in the case of the *istisnaa'*, is much higher nowadays than receiving agricultural produce, in the case of *salam*. Hence, a bank can take all the

necessary actions to be certain that *istisnaa'* goods will be ready at the agreed date.

Thus, the process of financing through *istisnaa'* contracts and selling according to *salam*, or *murabaha*, has the potential to produce financial instruments that can be negotiated.

Other *fish* issues associated with *istisnaa'* having an impact on financial instruments originating from such transactions can be stated as follows:

- (i) Do the parties to the contract have the right to abrogate it at the *ex-ante* period of production? Some *fuqaha*, e.g., Hanafi, say that both contracting parties have this right, while others reject this viewpoint and state that the contract is obligatory.
- (ii) Is the contract obligatory to the two parties after the object is manufactured but is not yet seen by a buyer (the bank)? Here also the Hanafi *fuqaha* believe that the contract is not obligatory.
- (iii) After the object is seen by the buyer (the bank), is it obligatory for the buyer to take the object? *Fish* jurists (particularly the Hanafi) argue that if the object under consideration conforms to its description in the contract, then the buyer is obliged to take it.

Al Kasani mentioned that if the object is manufactured according to the description in the contract, the producer has no option and it remains the right of the buyer to enjoy it. Al Zarqa mentioned that Abu Yusuf held a different view that, if the manufacturer finished the product and it is identical to the description in the contract, then neither the producer nor the buyer has the option : the former is obliged to submit the product and the latter is under obligation to accept, (Al Zarqa, M. A. (1994), pp. 37-45). In addition, there is a *fish* opinion that argues for obliging a buyer to take the manufactured product from the start.

Ijara

Ijara is defined by *fish* jurists as "a contract to make use of an asset for a while in exchange for a countervalue", (Abu Sulieman, A. A.E. (1992), pp. 19-22). It is a selling of usufructs. *Ijara* is sanctioned by the Holy *Qur'an*, *Surma* and *ijmaa'*.

Financial instruments derived from *ijara* depend on the idea that:

the bank owns an asset which produces a benefit (usufruct) or provides services. This asset can be leased for a short period, for example, three months. Leasing certificates can be circulated. When the lessee puts his hands on the hired assets, or he has full access to it, he can sell or negotiate this right with other parties, (Hamoud, S. H., 1989).

- ii. the bank can buy leasing certificates in an asset, and sell them to others with margin. This practice does not contradict the *Shari'ah* since the bank sells leased certificates representing the benefits or services of the leased assets.
- iii. the Islamic bank can also participate in buying an asset amenable to leasing; the bank can hire its share in this asset.

However, the feasibility of having an *ijara*-based financial instrument depends on the conditions specified for the *ijara* contract. The *fuqaha* divided these conditions into four groups as: (i) contracting or session conditions; (ii) execution or effectiveness conditions; (iii) validity conditions, and (iv) obligatory or binding conditions.

- (i) Session conditions refer mostly to the contractor who should be a mature person;
- (ii) Effectiveness conditions require that a lessor should either be the owner, of the leased asset or the sponsor or authorized agent. The *fuqaha* do not approve the *ijara* contract if the lessor is an unauthorized agent (*fudu'li*). The approval of such a contract

- (iii) depends upon the consent of the original owner of the asset. This is the point of view of Maliki and Hanbali scholars, (Al Kasani, *Badai ' Al Sanai '* , Vol. 4, p. 177).
- (iii) Validity conditions include requisites concerning the object under consideration and the *ajr* (countervalue) for a lessor.

The *ijara* object, i.e., the usufruct for the interest of which a contract is essentially constructed must be well-known and specified in the sense that the asset producing it is known, the period over which it is obtained is determined and the specification of the work is agreed upon when hiring a worker. A lessee should be able to obtain the object (a usufruct) so that it is legally forbidden to hire a stolen car or, as the *fuqaha* occasionally mention, a runaway camel. The usufruct should also be a licit object, so that it is not permissible to hire a person for hijacking or putting into jail someone who has not been condemned.

As stated earlier, the *ajr* should be known, and it should not be identical to the contracted usufruct.

- (iv) The obligatory conditions require that the hired asset must not be defective making it difficult or impossible for a lessee to obtain a usufruct. This is because a usufruct is obtainable over a period of time and, if the leased asset is defective, then this prevents the lessee from obtaining the usufruct. In this case, according to *fish* opinion, the lessee has the option to either continue or discontinue (cancel) the contract, (Al Kasani, *Bcidai Al Sanai*, p. 195).

prices of services or usufructs.

However, the three main forms of *ijara*-based instruments mentioned in (i), (ii) and (iii) can be negotiable instruments given the conditions specified for the *ijara* contract. Such instruments can be bought and sold according to the current or expected prices of services provided. by, or usufruct obtained from, the leased asset. The negotiation of these financial instruments is governed by market prices affecting the

Ijara instruments can also be liquid as the *ijara* contract is binding instantly in the opinion of some *fish mazahib*, such as, the Shafii and Hanbali jurists. *Ijara* countervalue is paid instantly, so that a bank involved in *ijara* can have a continuous flow of money to meet any urgent needs for liquidity.

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THE ISLAMIC DEVELOPMENT BANK (IDB)

Establishment of the Bank

The Islamic Development Bank is an international financial institution established in pursuance of the Declaration of Intent issued by the Conference of Finance Ministers of Muslim countries held in Jeddah in Dhul Qa'da 1393H (December 1973). The Inaugural Meeting of the Board of Governors took place in Rajab 1395H (July 1975) and the Bank formally opened on 15 Shawwal 1395H

(20 October 1975).

Purpose

The purpose of the Bank is to foster the economic development and social progress of member countries and Muslim communities individually as well as jointly in accordance with the principles of *Shari 'ah*.

Functions

The functions of the Bank are to participate in equity capital and grant loans for productive projects and enterprises besides providing financial assistance to member countries in other forms of economic and social development. The Bank is also required to establish and operate special funds for specific purposes including a fund for assistance to Muslim communities in non-member countries, in addition to setting up trust funds.

The Bank is authorized to accept deposits and to raise funds in any other manner. It is also charged with the responsibility of assisting in the promotion of foreign trade, especially *in* capital goods among member countries, providing technical assistance to member countries, extending training facilities for personnel engaged in development activities and undertaking research for enabling economic, financial and banking activities in Muslim countries to conform to the *Shari 'ah*.

Membership

The present membership of the Bank consists of 53 countries. The basic condition for membership is that the prospective member country should be a member of the Organization of the Islamic Conference (OIC) and be willing to accept such terms and conditions as may be decided upon by the Board of Governors.

Capital

The authorized capital of the Bank is six billion Islamic Dinars,. The value of the Islamic Dinars, which is a unit of account in the Bank, is equivalent to one Special Drawing Right (SDR) of the International Monetary Fund. The subscribed capital of the Bank is now 3654.78 million Islamic Dinars payable in freely convertible currency acceptable to the Bank.

Head Office

The Bank's Headquarters is located in Jeddah, the Kingdom of Saudi Arabia and the Bank is authorized to establish agencies or branch offices elsewhere.

Financial Year

The Bank's financial year is the Islamic lunar Hijra year.

Language

The official language of the Bank is Arabic, but English and French are additionally used as working languages.



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