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Introduction

In his *Address to the Nobility of the German Nation* in 1520, Martin Luther wrote:

> A cobbler, a smith, a peasant, every man, has the office and function of his calling, and yet all alike are consecrated priests and bishops, and every man should by his office or function be useful and beneficial to the rest, so that various kinds of work may all be united for the furtherance of body and soul, just as the members of the body all serve one another.[1]

A cobbler was said to have asked Luther how he could serve God within his trade of shoe making. Luther's answer was not that the cobbler should sell a "Christian shoe," but rather that he should make a good shoe and sell it at a fair price.[2] Most interesting in Luther's quote is the similarity of his message to Sunni Islamic traditions, wherein – at least in theory – there are no distinct categories of clergy and laity, and wherein all righteous acts – including fair dealings in the marketplace – are considered important parts of religious life.[3]

The term "Islamic finance" brings to mind an analogy to the concept of a "Christian shoe," rather than to good products that are fairly priced. Indeed, we shall see that the primary emphasis in Islamic finance is not on efficiency and fair pricing. Rather, the emphasis is on contract mechanics and certification of Islamicity by "Shariʿa Supervisory Boards." To the extent that "Islamic" financial products also cost more than the conventional products that they seek to replace – partly because of relative inefficiency, and partly to cover otherwise unnecessary jurist and lawyer fees – one may make partial analogies between those certifications and the European pre-Reformation practice of selling indulgence certificates. Thus, quoting Luther at the outset seems doubly appropriate, since he was simultaneously driven to oppose religious peddling through the sale of indulgences as well as usurious practices camouflaged by the mechanics of legitimate business and finance.[4]

In fact, the expression "Islamic finance" suggests two competing forces at work. The noun "finance" suggests that Islamic financial markets and institutions deal with the allocation of financial credit and risk. Thus, Islamic finance must be essentially similar to other forms of finance. On the other hand, the adjective "Islamic" suggests some fundamental differences between Islamic finance and its conventional counterpart. Observers of the theory and practice of Islamic finance sense this tension between attempts to be essentially similar to conventional finance (emphasizing competitiveness and efficiency) and attempts to preserve a distinctive Islamic character (emphasizing Arabic contract names and certification by religious scholars). We shall see in future chapters that this "Islamic" distinction often can be preserved only at a cost, and minimization of that cost – driven by competitive pressures – may render it a distinction of form without substance.

Finance without Interest?

Most readers encounter Islamic finance first through grossly simplistic statements such as "Islam (or the Qur'an) forbids interest." This has given rise to countless jokes about "how one can get an Islamic interest-free mortgage loan." Even relatively sophisticated journalists follow this process of false reductionism, followed by tongue-in-cheek qualifications. For instance, in a recent article in *Fortune* magazine, Useem (2002) reported on typical Islamic financing through credit sales, known by the Arabic name *murabaha*, the details of which we shall examine in some detail in Chapter 4. Reflecting on the transaction, he exclaimed:

> The result looked a lot like interest, and some argue that murabaha is simply a thinly veiled version of it; the markup [bank's name] charges is very close to the prevailing interest rate. But bank officials argue that God is in the details.

This tongue-in-cheek quotation of the statement that "God is in the details" may otherwise be viewed as offensive and condescending. However, it is surprisingly tolerated, and sometimes nurtured, within Islamic finance circles. It reflects the prevailing form-above-substance approach of that industry. Islamic financial forms are derived, albeit loosely, from classical sources of Islamic jurisprudence, which process of derivation gives the industry its "Islamic" label.

In fact, there are numerous instances wherein reporters begin by stating that the distinguishing feature of Islamic finance is the prohibition of interest and then proceed to report the interest rate that Islamic instruments pay. For instance, Reuters' August 13, 2002, coverage of Bahrain's \$800 million *sukuk* (the Arabic term for "Islamic bonds") followed their characterization of Islamic financial products as "interest-free" with a report that those *sukuk* will pay "4 percent annual profit." Customary explanations that the transaction is asset-based, or that what appears similar to interest is in fact profit in a sale or rent in a lease, can often leave the uninitiated reader more perplexed about the "interest-free" characterization. To provide concrete understanding of the mechanics and justifications of Islamic finance, we now proceed to consider two examples of popular Islamic structures at the retail and investment banking levels.

Example 1: Home Mortgage Transaction

For the first example, we begin with a conventional mortgage transaction as conducted in many states in the United States. The main components of my mortgage loan transaction in the state of Texas are illustrated in Figure 1.1.

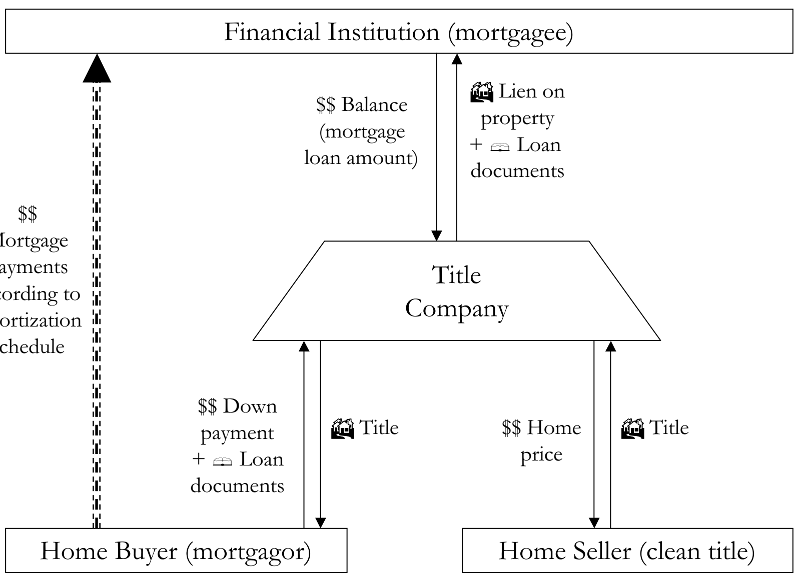

Fig. 1.1. Home Mortgage Transaction

The "closing" of this transaction took place at the title company offices. I brought a certified check for the amount of my down payment on the house (20 percent of the price plus closing costs), payable to the title company. The latter simultaneously collected the balance (80 percent) from my prospective mortgagee and subsequently issued a check to the seller for the sale price. I signed mortgage loan documents for the amount my mortgagee paid, promising to make mortgage payments according to the agreed-upon amortization schedule. I also had the option to prepay my balance, thus saving on financing charges, and obtaining clean title to the property at an earlier date, if I wished. In the meantime I received a title to the property, while my mortgagee obtained a lien thereon, thus restricting my ability to sell it without its permission.

The mechanics of this mortgage transaction are similar to numerous other forms of secured lending that evolved in modern times, made possible through searchable title databases that protect borrowers' and lenders' interests. Most Islamic jurists consider this transaction a form of forbidden *riba* (discussed in greater detail in Chapter 3), characterizing the various components of my mortgage as shown in Figure 1.2. According to this characterization, I borrowed a certain amount of money from my mortgagee and promised to pay a larger amount of money in the future. This constitutes an interest-bearing loan of money, which the overwhelming majority of jurists (though not all) consider to be a form of the forbidden *riba*.[5] Thus, by separating the loan from the sale contract for which it was intended, jurists equally condemn secured loans (such as mortgages) and unsecured loans (such as credit card balances).

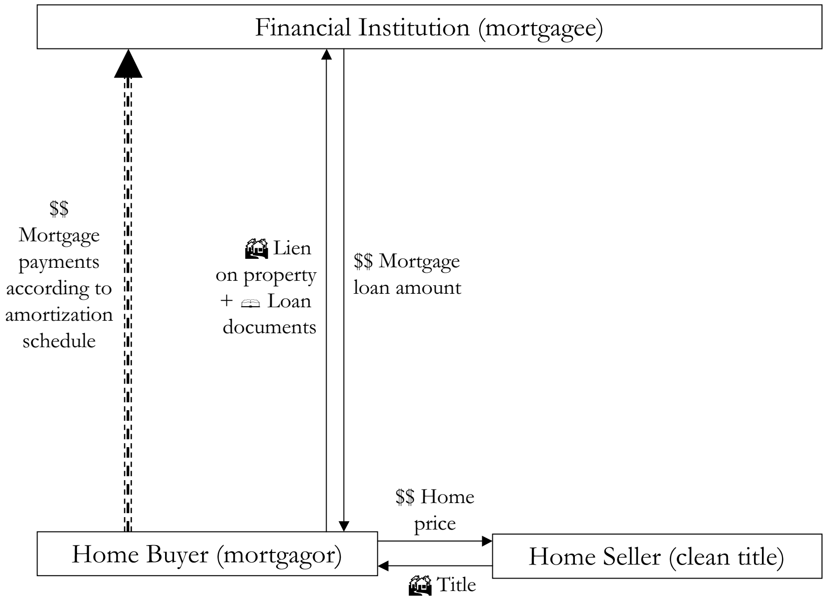

Fig. 1.2. Juristic Characterization of Mortgage Loan

One "Islamic" alternative that has been very popular in Islamic finance is the use of multiple sales in a *murabaha* transaction, as shown in Figure 1.3. In this transaction the eventual mortgagee must first purchase the property from the seller, obtaining title either directly or through a special-purpose vehicle (SPV). Then, the bank may turn around and sell the property on credit to the mortgagor, using amortization tables that are often calculated based on the same interest rate

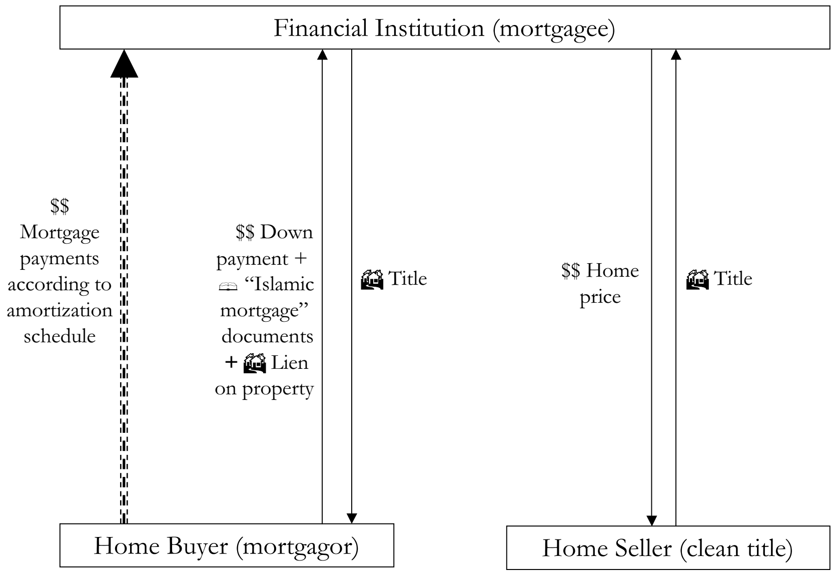

Fig. 1.3. *Murabaha* Alternative for Home Finance

used for conventional mortgages. One juristic difference, according to Islamic finance practitioners, is that the mortgagor in this case is involved in a credit sale contract, rather than a loan contract. In fact, because of requirements of some jurisdictions in the United States, and government-sponsored enterprises that assist with mortgage securitization, signed documents often contain terms such as "note," "loan," "borrower," and "interest." However, jurists have argued, the contract remains one of permissible trade rather than forbidden borrowing with interest. Depending on jurisdiction, the requirement of multiple sales, special-purpose vehicles, and documentations of title may add tax as well as legal costs. A second major difference to which jurists point is the peculiar structure that Islamic banks use for late payment penalties. We shall return to the basic secured lending transaction and its "Islamic alternative" in Chapter 4.

Example 2: Islamic Bond (Sukuk) Structure

For our second example, we consider a highly celebrated US$100 million corporate Islamic bond (*sukuk*) issue by Tabreed Financing Corporation in March 2004. The corporate entity "Tabreed Financing Corporation" is a limited company SPV incorporated in the Cayman Islands for the purpose of issuing the *sukuk* described here. The certificates issued by this SPV would act as an Islamic alternative to bond issues by the United Arab Emirates' National Central Cooling Company, nicknamed Tabreed (the Arabic word for "cooling"). The Shariʿa advisors characterized the bond structure that they approved as follows:[6]

1. Structure and Mechanism

We have reviewed the proposed structure and the transactions entered into in respect of the Sukuks, the principal features of which are as follows:

1.1 On a future date to be agreed between the parties, ... , the Issuer will declare that it will hold the Trust Assets (defined below) upon trust absolutely for the holders of the Sukuks. The Trust Assets (the **"Trust Assets"**) comprise:

  1.1.1 Certain specified central cooling plants (the **"Initial Plant"**) which the Issuer will purchase from Tabreed on a future date to be agreed between the parties;

  1.1.2 ...

  1.1.3 ...

  and will be purchased by the Issuer using the net proceeds received from the issuance and sale of the Sukuks.

1.2 The Issuer will lease the Plant back to Tabreed, for which Tabreed will be obliged to make rental payments to the Issuer. The Issuer will pass these rental payments on to the holders of Sukuks.

1.3 ...

1.6 ...

1.7 Upon maturity of the Sukuks, or if earlier, upon the acceleration of the Sukuk following the occurrence of a Dissolution Event under the documentation, Tabreed will purchase the Plant from the Issuer.

The bond structure is thus as illustrated in Figure 1.4. We shall study other lease-based as well as sale-based Islamic bond or *sukuk* structures that have become popular in recent years in Chapter 6. The example shown here is typical in many respects: Principal plus interest is passed to *sukuk* holders in the form of rent of a property that is sold to the SPV and purchased back at maturity. Any event that could interrupt the payment of "rent" (e.g., destruction of the leased property) is characterized as a "dissolution event," prompting the continuation of payments in the form of repurchase price. As we shall see in Chapter 6, this reduces the risk structure essentially to that of conventional bonds, allowing *sukuk* issuers to obtain the same credit ratings they would obtain for conventional bonds, and to pay the same interest they would pay based on that credit rating. Needless to say, however, transactions costs are increased because of the creation of SPVs, as well as payment of various jurist and legal fees for structuring the bond issuance. Moreover, there may be hidden legal risks in *sukuk* structures that get uncovered

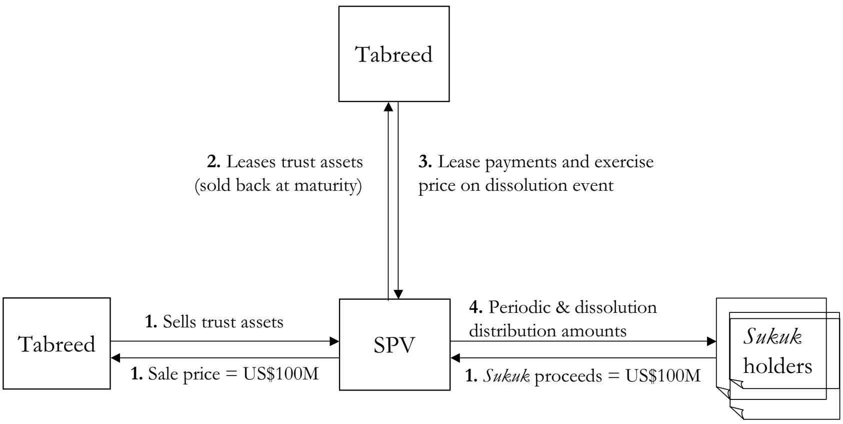

Fig. 1.4. Tabreed *Sukuk* Structure

only upon default. We shall discuss the potential advantages and disadvantages of various *sukuk* structures in Chapter 6.

1.1 Distinguishing Features of Islamic Finance

The most obvious distinguishing feature of Islamic finance (self-referentially) is the central importance of Islamicity certification (often called Shariʿa compliance) for various contracts. Indeed, the recent Kuwaiti Islamic banking law, enacted in 2003 as an amendment to the Kuwaiti Central Bank and bank regulation law,[7] states explicitly that "Islamic banks are banks that perform banking operations – including all operations that the Trade Law lists, as well as those conventionally considered part of banking operations – according to the rules of Islamic Law (Shariʿa)."[8] Most of the banking law amendment deals with licensing and capitalization issues (articles #87–92), relationship with the Central Bank (articles #94–5, 97–8), relationship to depositors and investment account holders (a unique feature of Islamic banks, article #96), and restrictions on ownership and trading in certain types of real assets (article #99).

Most of those legal provisions are similar for Islamic and conventional banks. In addition to the thorny issue of investment account holders (discussed in Chapter 8), the main distinguishing features of the Islamic banking section of the law are listed in articles #93 and #100:

93. An independent religious-law (Sharʿiyyah) supervision board must be established for each [Islamic] bank, consisting of at least three members, to be appointed by the bank's general assembly. The incorporation documents and by-laws of the bank must dictate the existence of this board, its composition, portfolio, and means of performing its tasks.

If disputes should arise between members of the Shariʿa supervision board regarding religious legal characterization [of some transaction], the bank's board of directors may forward the question to the *fatwa* board [issuer of religious edicts] of the Ministry of Awqaf and Islamic Affairs, which is deemed the ultimate authority on the matter.

The [Shariʿa supervisory] board must submit an annual report to the bank's general assembly, containing its assessment of the degree of adherence of the bank's operations to Islamic Shariʿa, and any comments or reservations that it may have in this regard. This document must be included in the bank's annual report.

100. On all matters not explicitly addressed in this special section [on Islamic banking], Islamic banks are subject to the [general] rules of this [banking] law, provided that they do not contradict Islamic Shariʿa.

The tone of this Islamic banking law clearly illustrates the central role of jurists in Islamic finance, as well as the general nature of the industry.[9] In this regard, we may think of classical jurisprudence and modern finance as the two parents of contemporary Islamic finance. The Kuwaiti choice to add a section to the conventional banking law – highlighting deviations of Islamic banking practice wherever appropriate – makes it clear that the starting point in this formula is conventional financial practice, from which Islamic finance deviates only insofar as some conventional practices are deemed forbidden under Shariʿa.

In other words, Islamic finance is not constructively built from classical jurisprudence. Rather, Islamic alternatives or modifications of conventional practice are sought whenever the latter is deemed forbidden. Thus, Islamic finance is a prohibition-driven industry. In this regard, the talented jurist Ibn Taymiyya (d. 728 A.H./1328 C.E.) famously stated that two prohibitions can explain all distinctions between contracts that are deemed valid or invalid: those of *riba* and *gharar*. We shall study those two prohibitions in great detail in Chapter 3. For now, we investigate the general economic advantages and disadvantages of a financial industry driven by religious prohibitions.

Prohibition-Driven Finance

Recent students of law and economics have maintained that the primary purpose of transaction law is often the enhancement of economic efficiency. For instance, Judge Richard Posner, perhaps the most significant figure in contemporary economic analysis of Anglo-American common law, wrote:

Often, the true grounds of legal decision are concealed rather than illuminated by the characteristic rhetoric of opinions. Indeed, legal education consists primarily of learning to dig beneath the rhetorical surface to find those grounds, many of which may turn out to have an economic character.[10]

In this regard, the majority of legal scholars engaged in this type of analysis have found prohibitions – injunctions against certain types of financial transactions conducted by mutual consent, such as interest-bearing loans – to be puzzling. For instance, Posner denounced Adam Smith's support for laws against interest-based borrowing and lending as paternalistic and efficiency reducing.[11] Students of this field also find usury laws (against charging excessive interest) imposed in most states to be puzzling. Jolls, Sunstein, and Thaler (2000) expressed this puzzlement as follows:

> *Puzzle*. A pervasive feature of law is that mutually desired trades are blocked. Perhaps most puzzling amid this landscape . . . are bans on conventional "economic" transactions, such as usurious lending, price gouging, and ticket scalping. Usury, or charging an interest rate above a certain level, is prohibited by many states in consumer lending transactions. . . . Not surprisingly, economists and economically oriented lawyers often view these laws as inefficient and anomalous.

Mutual consent also plays a crucial role in Islam. The Qur'an reads: "let there be among you trade by mutual consent."[12] The same emphasis is echoed in the Prophetic tradition: "I shall meet God before I give anyone the property of another without the latter's consent, for trade requires mutual consent."[13] However, mutual consent in this context is considered a necessary but not-sufficient condition for validity of economic transactions. For instance, the majority of jurists strongly denounced the December 2002 *fatwa* issued by al-Azhar's Institute of Islamic Jurisprudence, which the public viewed as legitimizing the collection of interest on bank deposits. The *fatwa* (discussed in some detail in Chapter 8) characterized the depositor-bank relationship as that of an investor and his investment agent and legitimized collection of a fixed profit percentage (interest) as follows:

> Those who deal with the International Arab Banking Corporation – or any other bank – thus forwarding their funds and savings to the bank to be their investment agent in the bank's permissible dealings, in exchange for a predetermined profit that they receive at prespecified time-periods. . . .
>
> This transaction, taking this form, is permissible and beyond any suspicion, since there is no text in the Book of Allah and the Prophetic tradition that forbids such a transaction wherein the profit or return is prespecified, provided that both parties mutually consent to the transaction. . . .[14]

Despite this appeal to mutual consent, most jurists, including all those involved in the area of Islamic finance, vehemently opposed the *fatwa*.

Recall that Posner rejected Adam Smith's attitude toward interest-bearing loans as paternalistic and efficiency-reducing. Within the quasi-religious context of Islamic jurisprudence and finance, there is no doubt that religious injunctions are by definition paternalistic. Indeed, the charge of "paternalism" sounds compassionate when attributed to the Divine and therefore will not be contested. With regard to efficiency reduction, consider the following simple and well-known example, which suggests that paternalistic injunctions against dealings to which parties mutually consent can in fact be efficiency-enhancing.

		Player 2	
		Cooperate	Defect
Player 1	Cooperate	4,4	0,5
	Defect	5,0	1,1

Fig. 1.5. Prisoners' Dilemma

In the standard two-prisoners' dilemma shown in Figure 1.5, each player has a choice to cooperate or defect, with the shown payoffs (the first payoff in each cell is for the row player, and the second is for the column player). For each of the two players, the dominant strategy, regardless of the opponent's choice, is to defect (and get 5 instead of 4, or 1 instead of 0, depending on opponent's action). Thus, the unique Nash equilibrium (wherein each player plays the best response to the other's selected action) is defection for both players, whereby each player would receive 1.

In this well-known game, it is very clear that the equilibrium outcome of the prisoner's dilemma, to which players will gravitate if left to their own devices, is inefficient. Mutual cooperation would yield 4 for each, instead of 1. In this case, a paternalistic divine command "thou shalt not defect" can in fact be efficiency-enhancing. In a dynamic setting, Glaeser and Sheinkman (1998) explained ancient usury laws, which forbade all interest on loans, as a form of a priori social insurance. In societies with pervasive poverty, the cooperative charitable lending rule provides transfers from fortunate individuals born with wealth to those less fortunate. Thus, the prohibition of mutually consensual interest-based lending can enhance ex ante efficiency by encouraging the cooperative outcome.

In Chapter 3 we shall see that classical jurists envisioned the two major prohibitions in Islamic jurisprudence of financial transactions – those against *riba* and *gharar* – to be efficiency-enhancing. That is not to say that the manner in which injunctions against *riba* and *gharar* have been obeyed in Islamic financial practice necessarily achieved such increases in efficiency. On the contrary,