THE NEGOTIABILITY OF DEBT IN ISLAMIC FINANCE
AN ANALYTICAL AND CRITICAL STUDY

by

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A thesis submitted in partial fulfillment of the requirements for the degree of
Doctor of Juridical Science (S.J.D.)
at the
Georgetown University Law Center
2014
Chapter 1

Introduction

Islamic finance is a new, promising, and growing industry that serves Muslims and non-Muslims around the world. Many Western countries host Islamic financial institutions to benefit from Islamic financial businesses in their jurisdictions. Yet, while some aspects of Islamic finance are growing rapidly, others, such as the Islamic debt market, still face challenges. Among the challenges that the Islamic debt market still faces are: non-liquidity and non-diversity.

Most Muslim countries have the legal structure to trade debt securities in the primary and secondary markets. They allow both kinds of banking and financial systems, conventional and Islamic. However, the Islamic debt market in most Muslim countries is not as attractive and competitive as the conventional debt market.

Islamic bankers have created mechanisms that helped develop the Islamic debt market, while remaining within the bounds of Islamic law. One of those mechanisms is sukuk, the Islamic version of a bond. Sukuk instruments are structured in such a way as to avoid usury, which is forbidden in Islam. Sukuk have been very successful and popular. Many sizeable issues of sukuk are held, especially by governments in the Gulf countries. Nevertheless, the debt market continues to struggle. The main reason for these problems is the prohibition against trading of debt adopted by contemporary Islamic scholars.

Solving these problems is very important to the economy in general. A developed, tradable and diverse debt market makes the financial market competitive
and efficient, so that it is not dominated by only a few banks. It is a critical source of funds that helps companies grow and expand. Moreover, it is an investment vehicle for investors who are looking for stable and predictable income. Meeting these needs will encourage the whole economy to grow and develop. Muslim countries need to handle the challenges of the Islamic debt market in order to achieve a strong and growing economy.

This thesis reveals how the growth of the Islamic debt market is restricted by non-liquidity and non-diversity, while other aspects of Islamic finance continue to grow and develop. Because the main cause of the non-liquid and non-diverse debt market is the position of contemporary Islamic scholars regarding the negotiability of debts, this thesis offers solutions to this problem by analyzing, discussing and criticizing this position. Finally, I propose a methodology for establishing the permissibility of trading debts in Islamic finance.

1.1 Islamic Finance Growth

Since its initial development in 1970, the Islamic financial industry has experienced considerable growth, not only in Muslim countries but also in the western world. The number of Islamic financial institutions increased from one in 1970 to at least 265 in 2005. These institutions are operating in approximately forty
countries, with total assets topping $262 billion,\textsuperscript{1} and deposits of more than $202 billion.\textsuperscript{2}

During the last decade, the growth rate of the Islamic financial industry exceeded the growth rate of the conventional financial industry by an estimated rate of 20-30%.\textsuperscript{3} According to a report by HSBC Bank, the compound annual growth rate of the Islamic financial industry for 2006-2009 was 28%. The expected assets for 2010 were $1.003 trillion.\textsuperscript{4} In 2012, some Islamic financial experts said the global Islamic finance and banking sector was poised for a year-on-year growth rate of 25%, which would see the industry valued at $5 trillion in 2016.\textsuperscript{5}

Oil is one of the main reasons for the rapid growth of the Islamic financial industry. The high price of oil means huge liquid assets for the oil-producing countries that are members of the Gulf Cooperation Council (GCC). The governments of these countries invest almost $1 trillion dollars outside the GCC, and the private sector invests $500 billion more. Ninety percent of these transactions go to the United

\begin{itemize}
  \item \textsuperscript{1} Islamic Banks: A Novelty No Longer, BUSINESSWEEK.COM (Aug.7, 2005), at http://www.businessweek.com/stories/2005-08-07/islamic-banks-a-novelty-no-longer.
  \item \textsuperscript{2} Babback Sabahi, Islamic Financial Structures as Alternatives to International Loan Agreements: Challenges for American Financial Institutions, BEPRESS LEG. SER. (2004), at http://law.bepress.com/expresso/eps/385.
  \item \textsuperscript{3} Jeffery Woodruff, Demystifying Corporate Sukuk 61 (2007).
  \item \textsuperscript{4} HSBC seeks big growth, sukuk pickup in 2010, REUTERS (Feb. 15, 2010), at http://www.reuters.com/article/2010/02/15/us-islamicbanking-summit-hsbc-idUSTRE61E2JD20100215.
  \item \textsuperscript{5} Islamic finance industry to hit $5 trillion by 2016, TRADEARABIA NEWS SERVICE (June 28, 2012), at http://www.tradearabia.com/news/bank_219700.html.
\end{itemize}
States of America (USA) and European countries. Certain investors and GCC governments require some of these transactions to be compliant with *Shariah* (Islamic law). The high volume of liquidity and *Shariah* compliant transactions encourage Islamic financial growth in both GCC countries and the western world.

Three of the largest Islamic financial transactions were required by Muslim governments to be compliant with *Shariah*. In 2004, “the largest government Islamic bond issuance was by the Department of Civil Aviation of the United Arab Emirates for $750 million.” The second largest was by the Bahrain Monetary Agency for $250 million which was “led by Citigroup, with heavy involvement of the Norton Rose law firm to structure the deal.” The third largest issuance was by a western government, “the German Federal State of Saxony-Anhalt for €100 million, which was heavily marketed in the Arab countries of the GCC as the first ever Western-government issued Islamic bond.”

Now the numbers are booming. In 2012, Arnold & Porter advised Turkey in its first offering of Islamic bonds. The bonds brought in $1.5 billion and they are due in 2018. Again in 2012, Clifford Chance LLP, advised the Saudi Arabian General

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7 MAHMOUD EL-GAMAL, OVERVIEW OF ISLAMIC FINANCE 13 (U.S. Department of Treasury 2006).
8 *Id.*
9 *Id.*
Authority of Civil Aviation (GACA) in a domestic issuance of an SAR (Saudi Arabian Riyal) 27.1 billion ($7.2 billion) sukuk, due in 2022.11

Turning to the private sector, in the early part of 2006 corporate bond issuances totaled $10.2 billion. The most notable was the Dubai Ports issuance of the largest sukuk to date: a two-year convertible $3.5 billion bond.12 In 2005, an estimated $11.4 billion in corporate sukuks were issued, up from $5.5 billion and $4.6 billion in 2004 and 2003, respectively.13 Sovereign issuances in 2006 totaled $2.7 billion, up from $706 million in 2005, $1.5 million in 2004, and $1.2 million in 2003.14

Speaking of the continued growth of the Islamic bond market, Mohammed Dawood, managing director at HSBC Amanah said, “the GCC’s sukuk issuances are set to reach $30bn-35bn in 2013, up 33 percent from 2012 . . . .”15 At present, Saudi Arabia’s Islamic financial assets make up more than one-quarter of the GCC’s total Islamic assets. According to a February 2013 report from Kuwait Financial House, Saudi Arabia issued $10.5 billion in sukuk in 2012, a 278% increase over 2011.16

12 EL-GAMAL, supra note 7, at 5.
13 Id.
14 Id.
16 Saudi Arabia: Debate continues over global sharia standards, OXFORD BUSINESS GROUP (Apr. 9, 2013).
According to Ernst & Young forecasts, by 2015, “Saudi Arabia’s share will grow to more than half [of the GCC’s total Islamic assets] . . .”\(^\text{17,18}\)

The rapid growth of Islamic finance is not only in Muslim countries, but also in the western world, especially in the financial centers of Europe. For example, in the United Kingdom, there are five Islamic banks and seventeen conventional banks providing Islamic services.\(^\text{19}\) There are also twenty law firms and four accounting firms providing Islamic professional services.\(^\text{20}\) There are twenty *sukuk* listed on the London Stock Exchange that are raising $11 billion.\(^\text{21}\) There are fifty-five institutions that provide education and training in Islamic finance products.\(^\text{22}\) In addition, “the UK market for Islamic mortgages has grown to about £500m, some 0.3% of the total UK mortgage market.”\(^\text{23}\)

\(^{17}\) *Id.*

\(^{18}\) ERNEST & YOUNG, RAPID GROWTH MARKET (2012).

\(^{19}\) DUNCAN MCKENZIE, ISLAMIC FINANCE 2010 8 (2010), at www.ifsl.org.uk.

\(^{20}\) *Id.* at 6.

\(^{21}\) *Id.* at 4.

\(^{22}\) *Id.* at 6.

\(^{23}\) *Id.*
Luxembourg is trying to attract Islamic investments. There are fifteen sukuks listed on the Luxembourg Exchange market, for a combined value of €5 billion. Luxembourg is the first non-Muslim country managing significant Islamic funds. There are forty Islamic funds managed by sophisticated international investment companies. With 7%, Luxembourg is the country with the fourth largest percent of Islamic funds after Kuwait with 9%, Saudi Arabia with 19% and Malaysia with 23%.

1.2 Islamic Debt Market

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24 Id.
26 Id.
27 Id.
Though Islamic finance has developed over the last ten years, it still faces many challenges that hinder its competition with conventional finance. In Arab countries, which make up a large part of the Islamic world, the financial markets are “suffering from many shortcomings . . . . The main ones consist in most cases in the lack of diversification of investment instruments that meet the needs of market operators; the narrowness or the absence of a secondary market where financial papers can be traded thereby restricting their liquidity and the readiness of investors to acquire them.”

The limited secondary market and the lack of liquidity are especially hard on the Islamic debt market. According to the International Monetary Fund (IMF), the debt market in the Middle East and North Africa (MENA) “stood at US$155.3 billion in 2008, accounting for a meager 0.2% of the total world debt market of US$83.3 trillion in 2008.” In 2008, the equity market and bank assets constituted 66.8% of the total MENA capital market of US$2.4 trillion, while the debt market in the region constituted only 6.4% of the total capital market, which is “significantly lower compared to a world average of 37.6% for the debt market representation.”

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29 Arab Monetary Fund, Contribution of the Arab Monetary Fund to the Development of Arab Capital Markets 27 (2003).


31 Id.
This significant difference indicates that debt instruments are not attractive to Muslim investors who are seeking funds. While there are large sums of money invested in the equity market (both primary and secondary), the debt market is still very limited and undesirable and within this limitation, most of this market is dominated by the public sector. Because of their volume of liquid assets, a more in-depth study of GCC countries is appropriate.

In the primary debt market of 2003-2009, GCC governments issued US$135.1 billion in bonds. They dominated the bond market in the GCC with a 55.6% share. The financial services and real estate sectors, “were the most predominant sectors and

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32 Id.
issued bonds worth US$47.9 billion and US$18.8 billion, respectively, during the same period.”

The secondary market in the GCC is characterized by lower trading activity and a lack of transparency. The debt instruments in the GCC markets are very thinly traded. For the entire year of 2008, there were only eighty-five trades executed with a value of SAR1.3 billion (US$345.9 million) in the region. Secondary sukuk trading only commenced in Saudi Arabia in June 2009. In 2010, there were only fifty-seven sukuk trades on the Saudi Arabian stock exchange (Tadawul), compared to just six trades in 2009.

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34 Id.
35 Id. at 8.
36 Id. at 10.
37 Id. at 19.
38 Id.
Moreover, in Saudi Arabia, only a third of sukuk issuances are listed on the Saudi Exchange Market.³⁹ In the Saudi sukuk market, “domestic issuers have preferred private placements rather than public issuances.”³⁴⁰ One of the main reasons is the prohibition, adopted by current Islamic scholars, of trading debt in the secondary market. Currently, there are only eight sukuk listed on Tadawul (the Saudi Exchange Market).³⁴¹

![Pie Chart: Listed and Unlisted Sukuk Percentage In Saudi Arabia]

Saudi Arabia is the biggest economic and financial market in the GCC. The total value of sukuk issues for 2013 in the GCC was $27.453 billion.³² Saudi Arabia had 60% with total value of $16.518 billion.³³ UAE had 26%, a total value of $7.116

³⁴⁰ Id.
³⁴¹ Id.
³³ Id.
billion,\textsuperscript{44} followed by Qatar with a total value of $2.057 billion and Bahrain with a total value of $1.588 billion.\textsuperscript{45}

\begin{figure}[h]
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\end{figure}

Saudi Arabia, the strongest economy in the region, with established exchange markets and a high value of \textit{sukuk} issuances, has only eight listed \textit{sukuk}. This makes the debt market risky because it lacks easy exit strategies. Thus, some of the “debt

\textsuperscript{44} \textit{Id.}
\textsuperscript{45} \textit{Id.}
issues [were] bought by long-term investors planning to hold them to maturity.\textsuperscript{46} The Islamic debt market will be more expensive because of the risk factor, making it undesirable to domestic and international investors. As a result, the Islamic debt market is “illiquid, domestic institutional participation is limited, and retail participation is virtually non-existent.”\textsuperscript{47}

1.3 Why is the Islamic debt market illiquid and non-diverse?

An active debt market is very important for the Middle East and Muslim countries for both the public sector and the private sector. It would be “an important step toward more established and diverse financial markets in the region so it will broaden the range of funding sources for corporations and it would present investors, including retail investors, with an important asset class with qualities not found elsewhere.”\textsuperscript{48} It is also critical for governments because “a vibrant debt market would offer greater flexibility for fiscal and monetary policy makers.”\textsuperscript{49}

The economy in GCC countries is very strong. However, despite considerable efforts by the GCC to push the debt market forward, the debt market remains limited and illiquid. Nevertheless, “the development of a debt capital market in the Gulf is likely to be a drawn-out process and is bound to face some continued resistance on

\textsuperscript{46} Id. at 22.

\textsuperscript{47} NCB CAPITAL, supra note 30, at 7.

\textsuperscript{48} Id. at 2.

\textsuperscript{49} Id.
The cultural grounds referenced is Islam as a religion. The Islamic finance industry is based on Islamic rules that govern Islamic financial transactions.

There are many restrictions dealing with debt in Islam as a religion. The first important restriction imposed by Islamic law is the prohibition of usury. Usury is issuing debt or a loan, and collecting it back at a premium. Usury is completely forbidden in Islam. Many scholars and experts try to find solutions for Islamic banks in order to avoid usury and make the transactions comply with Shariah. That is how sukuk, the Islamic version of bonds, was created. This Islamic debt instrument significantly changed the Islamic capital market. In the last ten years, many sukuk were issued. It raised the volume of alternative investments in the Islamic capital market.

Though many GCC governments and companies issue sukuk as alternative instruments to avoid usury, the secondary market is still illiquid and sukuk trading is not as attractive as trading in the equity market. The second rule, the non-negotiability of debt, is the reason for this problem.

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50 Id. at 26.
51 See Chapter 2, Overview of Some Islamic Law and Finance Principles and Concepts.
52 These scholars who found solutions to avoid usury focus on formalities rather than substantives. In contrast, some scholars who are considering substantives rather than formalities are against Islamic finance industry generally and believe that most of Islamic finance transactions are prohibited. See Saleh Alhosayyen, Islamic Banks, Pros and Cons (2009).
1.4 Does Islamic Law Forbid Trading and Negotiating Debts?

Many current Islamic finance scholars assert that, according to Islamic law, Muslims are not allowed to buy or sell any kind of debt in the secondary market. For example, if a company has an account receivable on its balance sheet, it cannot sell this account to a third party. The argument is that debt is non-tradable and non-negotiable in Islamic law. If an investor holds a debt security in the capital market, he is not allowed to trade this debt on the secondary market. It is, according to theses scholars, forbidden under Islamic law.

Experts in Islamic finance acknowledge that the prohibition of trading debt is a major hurdle to the development of the Islamic debt market and an obstacle to the existence of the secondary debt market. However, there are few papers and articles that criticize the non-negotiability of debts economically or legally, because it is thought to be a religious principle and cannot be disputed. Debt is approached the same way as usury.

Professor Frank Vogel (former member of Harvard Law School faculty, now an independent scholar and legal consultant in Islamic law)\textsuperscript{54} wrote a book in 1998 with Professor Samuel Hayes entitled \textit{Islamic Law and Finance: Religion, Risk and Return}. In this book he states, “One almost indispensable resource for accomplishing [the development of Islamic finance] is a secondary market capable of providing acceptable liquidity for investors. There is much debate about what kinds of

\textsuperscript{54} Frank E. Vogel, \textit{at} http://frankevogel.net.
investments can be traded in a secondary market. Islamic law forbids the sale or trade of financial contracts, which explains why financing of accounts receivable is difficult. On the other hand if a contract or security represents a direct claim on a real asset, it may be sold or traded.”

M. Kabir Hassan is a Professor in the Department of Economics and Finance at The University of New Orleans in Louisiana, and the editor of The Global Journal of Finance and Economics. In his paper, “Islamic banking: an introduction and overview”, he states that “for many years Islamic banks were hampered in liquidity management by the absence of an equivalent infrastructure [to conventional bank]. Islamic law has restrictions on the sale of debt that inhibit Shariah acceptable secondary markets.” In very broad terms, he explains that a secondary market in Islamic finance is not permitted under Shariah law.

Ridha Saadallah is a Professor of Economics at the University of Sfax in Tunisia. He previously worked with the Islamic Research and Training Institute of the Islamic Development Bank. He states, “there is a general agreement among the jurists that the sale of debt is not allowed. The rationale usually given for this position is that the sale of debt involves riba (interest) as well as gharar (excessive

56 Contributors to Handbook of Islamic Banking at xi (Kabir Hassan & Mervyn Lewis eds., Edward Elgar 2007).
57 Kabir Hassan & Mervyn Lewis, Islamic banking: an introduction and overview, in Handbook of Islamic Banking 1, 6 (Kabir Hassan & Mervyn Lewis eds., Edward Elgar 2007).
58 Id.
uncertainty) both of which are prohibited by the Shariah”. He indicates that all Islamic scholars adhere to the prohibition of the sale of debt, which causes the illiquid secondary market. A reader with no background in Islamic jurisprudence will believe that trading debt is forbidden in Islamic law, because Islamic law forbids usury.

Mohammed Alamin is an expert in Islamic finance and currently the head of the Shariah Complaint Department at Unicorn Investment Bank in Bahrain. In his book Global Sukuk and Islamic Securitization Market, he has surrendered to that common impression. He says, “any Islamic debt market will be smaller than the conventional in terms of size. This is based on the Shariah principles that prohibit the sale of debts for debt, the non-permissibility to securitize receivables or the Shariah insistence in relating debt market to the real economy.” He wrote an entire book on his belief that the debt market is significant, and sukuk is a smart solution to avoid usury; however, he got stuck on the principle in Islamic law of forbidding the trade of debts.

1.5 Contribution

The goals of this thesis are to challenge the notion that Islamic law forbids trading debt, and to assert that trading debt is permissible under Islamic law. This thesis does not claim that 1,400 years of Islamic scholars misunderstood Islamic law.

59 Ridha Saadallah, Trade financing in Islam, in HANDBOOK OF ISLAMIC BANKING 172, 188 (Kabir Hassan & Mervyn Lewis eds., Edward Elgar 2007).

60 MUHAMMAD AL-BASHIR & MUHAMMAD AL-AMINE, GLOBAL SUKŪK AND ISLAMIC SECURITIZATION MARKET: FINANCIAL ENGINEERING AND PRODUCT INNOVATION 29 (Koninklijke Brill 2012).
This thesis offers the perspective that trading debt and financial contract is permissible and consistent with Islamic jurisprudence and Islamic schools of legal thought. In addition, it will distinguish and emphasize the differences between usury and negotiating debt. It will analyze the history of how this idea became a belief and why no one has challenged it. This thesis establishes new views regarding the negotiability of debt in Islamic finance based on Islamic law sources and methodologies.

This is significant, in particular, for western Islamic financial specialists. These specialists do not have direct access to Islamic jurisprudence because of language barriers, terminology, and methodology. This thesis hopes to remove those obstacles, and provide a new Islamic legal interpretation to Islamic finance specialists with western legal and financial backgrounds.

Chapter 2 provides an overview of Islamic law concepts which are important for understanding the explanations and discussions in this thesis. In addition, Chapter 2 clarifies the Islamic methodologies and sources necessary to understand the legal basis for permitting debt trade in Islamic law.

Chapter 3 explains the position of each school of Islamic legal thought on trading debt. Additionally, the differing positions of contemporary Islamic scholars and Islamic law schools will be explored. The resolutions adopted by these organizations, and the negative effects of the resolutions will be analyzed and explained.
Chapter 4 is the heart of this thesis. It explains and criticizes the arguments of contemporary Islamic scholars who forbid the trading of debt. Then it proposes a new rule, consistent with Islamic fundamentals and principles, that establishes the permissibility of debt trade in Islamic finance.

The views of this thesis are contrary to the majority. However, it is critical to remove this significant hurdle so the economies of Muslim countries, and Islamic finance in particular, can continue to develop. This thesis does not intend to challenge Islam as a religion. It challenges an idea that is thought to be a main principle in Islamic finance. Change takes time, but the first step is to change thoughts, ideas, and minds. This thesis aspires to be the first step to a global change in the Islamic debt market.
Chapter 2

Overview of Some Islamic Law and Finance

Principles and Concepts

The main purpose of this chapter is to provide an overview of the principles of Islamic law and finance that are critical to understand the arguments of Islamic scholars regarding the tradability of debts. These principles are also important to evaluate, analyze, and criticize these scholarly arguments.

The first part of this chapter is an overview of Islamic law sources, from which Islamic scholars derive Islamic rules. It describes some methodologies that Islamic scholars use to decide if a legal issue falls under Islamic law and whether a legal issue is allowed or forbidden according to Islamic rules.

The second part of this chapter clarifies that there are many schools of legal thought under Islamic jurisprudence. Therefore, Islamic scholars often have different opinions regarding each legal issue based on the school of legal thought that he belongs to. The negotiability of debt is one of these issues for which Islamic schools of legal thought maintain different positions.

The third part explains Islamic finance principles. These principles, *riba* (usury) and *gharar* (uncertainty), control significant legal issues related to finance and commerce, such as the negotiability of debt.

Finally, the fourth part illustrates some transactions which are used commonly in modern Islamic finance, but not in conventional finance. These Islamic commercial transactions are used to avoid usury and uncertainty in modern finance.
2.1 Islamic Law Sources

Generally, scholars divide Islamic law sources into two types. Divine sources, or primary sources, make up the first type. They are called divine sources because they are from God and the prophet Mohammed. Muslims are obligated to obey these sources. They are also called primary sources because Islamic scholars must attempt to base provisions and rules on these sources first. If the provision or rule cannot be based on the primary source, secondary sources are used. Non-divine sources, or secondary sources, make up the second type. These are non-divine because they are man-made. They are called secondary because they are used if primary sources are not available. The primary sources are the Quran and the Sunnah. The secondary sources are the Ijma and the Ijtihad. The following section explains all these sources in Islamic law.

2.1.1 Quran

The Quran is the first and the most important source of Islamic law. Muslims define the Quran as “the book, which Allah (God) revealed in his speech to his prophet Muhammad in Arabic, and this has been transmitted to us by continuous testimony” and “which is written between the two covers of the Holy Book.”

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1 SHAH ABDUL HANNAH, USUL AL FiqH (ISLAMIC JURISPRUDENCE) 6 (1999).
2 Id.
3 Id.
4 These will be explained later in this part.
5 These will be explained later in this part.
6 ABDUL HANNAH, supra note 1, at 6.
The Quran constitutes 114 unequal chapters (Surah). Each Surah contains several parts (Ayah).\textsuperscript{8} These Ayahs are not equal, either. Some Ayahs have 100 words: some only have one.\textsuperscript{9}

The Quran was revealed gradually: not all at one time.\textsuperscript{10} It took twenty-three years to complete the whole revelation. This period is divided into two parts. The first thirteen years is the Makkah part. The prophet Mohammed was in Makkah and lived with non-Muslim Arabs. The next ten years is the Madinah part. The prophet Mohammed moved to Madinah and established the first Islamic state.\textsuperscript{11}

The larger part of the Quran was revealed in Makkah, the rest in Madinah. Because Muslims in Makkah lived with non-Muslims, the Makkah part, “mostly deals with beliefs, disputation with unbelievers and their invitation to Islam . . . .”\textsuperscript{12}

The Madinah part deals more with legal subjects, because Muslims had their own state at that time. The Madinah part deals with legal rules regarding family, society, politics, economics, etc.\textsuperscript{13}

\textsuperscript{7} TĀHĀ JĀBĪR FAYYĀD 'ALWĀNĪ, SOURCE METHODOLOGY IN ISLAMIC JURISPRUDENCE: UṢŪL AL FIQH AL ISLĀMĪ 7 (New rev. English ed. 1994).
\textsuperscript{8} ABDUL HANNAN, supra note 1, at 6.
\textsuperscript{9} General Knowledge of Holy Quran, at http://www.qurannetwork.com/quraninfo.html(The Quran has 6,235 Ayahs, and 77,439 words).
\textsuperscript{10} Id.
\textsuperscript{11} MOHAMMAD HASHIM KAMALI, PRINCIPLES OF ISLAMIC JURISPRUDENCE 20 (3rd rev. and enlarged ed. 2003).
\textsuperscript{12} ABDUL HANNAN, supra note 1, at 6.
\textsuperscript{13} YAHAYA YUNUSA BAMBALE, AN OUTLINE OF ISLAMIC JURISPRUDENCE 52 (2007).
The legal material of the Quran is contained in about 500 Ayahs\(^\text{14}\) (only 8% of the Ayahs in Quran). These Ayahs were revealed “with the aim of repealing objectionable customs such as infanticide, usury, gambling, and unlimited polygamy.”\(^\text{15}\) Some Ayahs enforce some kinds of worship to Allah, such as prayer and fasting. Other Ayahs deal with charities, oaths, marriage, divorce, custody of children, fosterage, paternity, inheritance, bequest, relationships between rich and poor, and justice.\(^\text{16}\)

Legal Ayahs are limited compared with other subjects and cover various legal fields. They are usually brief with little detail or explanation. For example, prayer, which is the most important worship in Islam, is enforced by three words, “establish regular prayer.”\(^\text{17}\) Details, such as how to pray and how many times, are not described. Additionally, usury is clearly forbidden in the Quran. “Allah hath permitted trade and forbidden usury.”\(^\text{18}\) However, the definition of usury, or how Muslims can recognize usury, or how to distinguish between trade and usury is not explained in the Quran. Other sources are needed to derive Islamic rules and provisions, which are not expressed in the Quran. The most important source in

\(^{14}\) ABDUL HANNA\, supra note 1, at 6.

\(^{15}\) Id.


\(^{17}\) Quran (24:56).

\(^{18}\) Quran (2:275).
Islamic jurisprudence, after the Quran, is the Prophet Mohammed’s statements (Sunnah).

2.1.2 Sunnah

Sunnah is the second most important source of Islamic law. The literal meaning in Arabic is “beaten track” or “established course of conduct.” According to Islamic scholars, “Sunnah refers to all that is narrated from the Prophet Mohammed, his acts, his sayings and whatever he tacitly approved.” Sometimes, the word (Hadith) is used instead of Sunnah. Sunnah and Hadith have become synonymous, meaning “conduct of the prophet.” However, Sunnah is usually used for the source in general, but hadith is used for each single text.

Islamic scholars classify Sunnah into legal Sunnah and non-legal Sunnah. Legal Sunnah consists of “the prophetic activities and instructions of the prophet as the head of the state and as judge.” Non-legal Sunnah “consists of the natural activities of the prophet, such as the manner in which he ate, slept, dressed and such other activities which do not form a part of Shariah.”

19 KAMALI, supra note 11, at 58.
20 ABDUL HANNAN, supra note 1, at 8.
21 KAMALI, supra note 11, at 61.
22 KAMALI, supra note 11, at 110; ABDUL HANNAN, supra note 1, at 8.
23 ABDUL HANNAN, supra note 1, at 8.
24 Id.
To avoid confusion with the Quran, there was no attempt to record the Sunnah during the lifetime of the prophet Mohammed.\textsuperscript{25} About a century after the prophet’s death, scholars began collecting and classifying hadiths.\textsuperscript{26} Due to the length of this period, scholars should examine these hadiths to be sure they came from the prophet Mohammed himself. Before the hadith were recorded, they were classified into strong and weak.\textsuperscript{27} To classify a hadith as strong or weak, Islamic scholars trace the provenances of each hadith based on an historical prospective. Specifically, Islamic scholars examine all narrators and determine whether or not they are honest and trustworthy. A hadith is classified as strong if “it is reported by highly trustworthy or by trustworthy narrator.”\textsuperscript{28} For example, if a hadith was heard directly from the prophet by Ibn Omar (first generation) then Omar told the hadith to Nafe (second generation) and finally Imam Malik (third generation) reported the hadith in his book, this hadith is strong because all reporters are trustworthy according to Islamic scholars historical tracing. On the other hand, a hadith is considered weak if one the reporters is unknown in terms of identity or conduct, a violator of any important practice, or a liar.\textsuperscript{29} Strong hadiths are legitimate sources of Islamic law while weak hadiths may not be legitimate sources.\textsuperscript{30}

\begin{itemize}
\item \textsuperscript{25} \textsc{Weeramantry}, supra note 16, at 35.
\item \textsuperscript{26} \textsc{Id}.
\item \textsuperscript{27} \textsc{Kamali}, supra note 11, at 110.
\item \textsuperscript{28} \textsc{Abdul Hannan}, supra note 1, at 10.
\item \textsuperscript{29} \textsc{Id}.
\item \textsuperscript{30} \textsc{Kamali}, supra note 11, at 111.
\end{itemize}
The total number of all hadiths is 11,830. Only 4,400 hadiths are considered strong. The rest are weak. Most hadiths are statements of the prophet. Not all hadiths are legal Sunnah. Some scholars say that there are only 2,000 hadiths that are considered legal Sunnah.

The Sunnah generally emphasizes details and explains broad topics in the Quran. For example, while the Quran simply says to pray, the Sunnah explains in detail how to pray and how many times Muslims must pray. The Sunnah also explains the concept of usury. It divides usury into many kinds, and distinguishes them. The Quran merely states that usury is forbidden.

2.1.3 Ijma (unanimity)

*Ijma* is the third source of Islamic law. The classical understanding of ijma is “the general [unanimity] among Islamic scholars of a particular age in relation to the legal rule correctly applicable to the situation.” Simply put, all the Islamic scholars of one age must have the same opinion regarding a specific legal matter. Unanimity of Islamic scholars on an issue of a particular time is a requirement of ijma, and “the agreement must be expressed by clear opinion of all scholars of the time.”

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32 *Id.*
33 *Id.*
34 Kamali, *supra* note 11, at 78.
36 Abdul Hannan, *supra* note 1, at 19.
According to early Islamic scholars, “only such ijma are considered binding.” If there is only a majority opinion, it is not binding.

Islamic scholars use ijam as a limited source for Islamic rules, because “it is extremely difficult to prove ijma.” Of course it is difficult to prove that all Islamic scholars in the world have the same opinion on a particular issue. It is even more difficult if there is no text from the Quran or the Sunnah regarding this issue. Usually, provisions that are proven by ijma are also proven by the Quran and the Sunnah. For example, there is unanimity on prayer, fasting, Islamic tax (Zakat), pilgrimage, stealing, killing, etc. These issues are all proven by the Quran and the Sunnah, not only by ijam. On topics without supporting text from the Quran or the Sunnah, there are differing opinions.

2.1.4 Ijtihad (Personal Reasoning)

Practically, Ijtihad is a very important source of Islamic law after the Quran and the Sunnah. The main difference between ijtihad and the revealed sources of Shari'ah is “the fact the ijtihad is a continuoud process of development whereas divine revelation and prophetic legislation discontinues after the demise of the prophet.”

Ijtihad is the main instrument of interpretation of Islam as a religion, relating it to the

37 Id.
38 Id.
39 KAMALI, supra note 11, at 468.
40 Id. at 468.
changing conditions of real life. Ijtihad is “the methodology which gives Islamic law its adaptability to new situations and capacity to tackle all new issues and problems.”

Ijtihad is based completely on personal reasoning. There is no revelation from God to correct the reasoning a scholar uses to deduce an Islamic rule or provision. Therefore, Islamic scholars over the centuries have tried to find methodologies to organize Islamic reasoning. These methodologies help Islamic scholars to derive Islamic rules and provisions if there is no text from the Quran or the Sunnah. The rules derived through ijtihad methodologies are not on the same level of authority as that of the Quran or Sunnah. There is room for differences of opinions. No scholar believes he is the only one who is right. Many methodologies may be used if there is no text from the Quran and the Sunnah, such as qiyas, maslahah, and istashab.

1. **Qiyas (analogical reasoning):** Qiyas is a “comparison to establish equality or similarity between two things.” Technically, qiyas is “the extension of a Shariah ruling from an original case to a new case because the new case has the same effective cause as the original case.” The original case is regulated by a text of the

41 *Id.*

42 *ABDUL HANNAN, supra* note 1, at 36.

43 *Id.*

44 *Id.*

45 *Id.*

46 *BAMBALE, supra* note 13, at 72.

47 *ABDUL HANNAN, supra* note 1, at 20
Quran or the Sunnah. *Qiyas* “seeks to extend the original ruling to the new case.”48

Generally, “the emphasis of *qiyas* is identification of a common cause between the original and new case.”49 For example, the Quran and the Sunnah forbid liquor (the original case). The reason is that liquor is an intoxicant (the effective cause). Islamic scholars extend the provision of the original case (prohibition) to wines (the new case) because they have the same effective cause (intoxicating).50

2- **Maslahah (public interest):** *Maslahah* literally means benefit or interest.51 Islamic rules are made in the public’s interest, especially in regards to protection of life, religion, intellect, lineage, and property.52 Practically, “when law cannot be made on the basis of Quran and Sunnah or through *qiyas*, law is made on the basis of *maslahah* or public interest.”53 For example, prisons are not mentioned in the Quran as punishment and were not used by the prophet Mohammed when he ruled the Islamic state. However, when the Islamic empire was growing, the rulers of the empire established prisons to punish criminals as other states and empires were doing at that time. The prisons were in the public interest.54

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48 KAMALI, supra note 11, at 264.

49 Id.

50 KAMALI, supra note 11, at 268.

51 Id. at 351.

52 BAMBALE, supra note 13, at 83.

53 ABDUL HANNAN, supra note 1, at 27.

54 Id.
3. **Istishab (presumption of continuity):** *Istishab* means “those facts or rules of law and reason, whose existence or non-existence have been proven in the past and which are presumed to remain so far for lack of evidence to establish any change.”\(^{55}\) One kind of *istishab* is the presumption of original absence.\(^{56}\) Original absence is “a fact or rule which had not existed in the past and is presumed to be non-existent.”\(^{57}\) Thus, if there is no rule to forbid eating some kinds of foods, such as an avocado (previously unknown in Arab lands), scholars should continue presuming that eating avocado is not forbidden. It should be allowed based on the presumption of original absence.

### 2.2 The Islamic Schools of Legal Thought

The textual sources in Islam (Quran and Sunnah) are limited. Most Islamic rules are based on personal reasoning (*ijtihad*), which is a completely human source.

\(^{55}\) Kamali, *supra* note 11, at 384.

\(^{56}\) Abdul Hannan, *supra* note 1, at 30.

\(^{57}\) *Id.*
As a result, during former centuries of the Islamic empire, many schools of legal thought were developed. These schools of law are important in Islamic law, because “the absence in Islam of council like the councils of the early Christian Church or Buddhism, wherein doctrinal pronouncements were made with authority, the development of law [in Islam] was thus naturally steered in the direction of juristic activity rather than toward authoritative religious pronouncements.” Another important factor is “the absence of a formal priesthood or clergy, [since] the hierarchical structure of the Christian priesthood and the rigid rules of training preceding admission to its ranks had no counterpart in Islam.”

These schools evolved in the second and the third centuries of Islam and adopted the Islamic sources and methodologies described above. Their

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58 See WEERAMANTRY, supra note 16, at 47 (There is a division in Islam between Sunnis and Shiites. The vast majority of Muslims are Sunni. Shiites constitute 10-15% of the Muslim population (see Mapping the Global Muslim Population, at http://www.pewforum.org/2009/10/07/mapping-the-global-muslim-population/). Political disputes cause the division. After the Prophet died, Shiites did not recognize the legitimacy of the three Caliphs: Abu Bakr, Omar, and Othman. They recognized only the legitimacy of the fourth Caliph, Ali. In addition, the Shiites believe the Islamic empire from Caliph Ali until Ottoman Empire is illegitimate. On the other hand, Sunnis recognize the legitimacy of all four Caliphs and the whole Islamic empire. The Shiites are isolated and have their own traditions and literature. The four Islamic schools discussed in this chapter are Sunnis. They developed and spread under the rule of the Islamic empire all during history).
60 WEERAMANTRY, supra note 16, at 46.
61 Id.
62 Id.
interpretations are not binding. If a judge or a ruler chooses one of their opinions, it is binding as a rule of state, not a rule of God. They are four schools: Hanafi, Maliki, Shafi, and Hanbali.

All schools agree on the principals of Islam (such as praying, fasting, etc.) and the sources of Islamic law (Quran, Sunnah, ijam, and ijtihad). They differ in the interpretation of the Quran and the Sunna, and methodologies regarding ijtihad. The Hanafi School is described as the most rational. It is very conservative concerning which hadiths to accept as a source of law. Many hadiths are refused because they are believed to be weak. Hanafi relies heavily on *qiyaṣ* methodology. If there is conflict between a *hadith* and *qiyaṣ*, the Hanafi School sometimes prefers *qiyaṣ* methodology

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64. *Id.*

65. Nurit Tsafrir, *The History of an Islamic School of Law: The Early Spread of Hanafism* (Harvard University Press 2004) (This is the first and earliest school formed by Abu Hanifa (699–767 A.D.) in Iraq. Abu Hanifa did not write any books on law himself, but his followers recorded his discussions and opinions, which were the basis of this school.)

66. *The Islamic School of Law: Evolution, Devolution, and Progress*, supra note 59, at 41 (The second school of law was founded by Malik bin Anas (d. 795 A.D.) in Madinah. Malik was a famous scholar at that time. He gathered all his opinions in a book called *al-Muwatta* (the Leveled Path). This is the basis of the Maliki School. His followers explained, detailed, and added to his book to establish a deep and thoughtful school).

67. The third school was founded by Imam al-Shafi (d. 820 A.D.). He was originally a follower of Imam Malik, but he later moved to Egypt and established his own school of thought. Imam Shafi wrote the first book on Islamic methodology (*Alresalah*). He was “a great thinker, had an unusual grasp of principles, and a clear understanding of the judicial problems.” Understand-Islam.Org (2009).

68. The fourth school was founded by Imam Ahmad bin Hanbal (d. 855 A.D.) in Baghdad. Imam Hanbal “did not establish a separate school himself; this was rather done by his disciples and followers.” Understand-Islam.Org (2009).

over the *hadith*. The Hanbali School is the most traditional school. It relies heavily on hadiths and traditions. The Hanbali School prefers weak hadiths rather than *qiyaṣ*. The Maliki and the Shafi schools are somewhere in between the Hanbali and the Hanafi.

Sometimes a school has its own methodology. The Hanafi School has *istiḥsān*, “a method of exercising personal opinion in order to avoid any rigidity and unfairness that might result from the literal enforcement of the existing law.” This methodology is rejected by the other three schools for being too broad and possibly undermining many traditions. The Maliki School has “the transmitted legal practice of Madinah people” methodology. Since the Prophet lived in Madinah the last ten years of his life and died there, “a whole generation was able to transmit from a whole generation who had been alive at the time of the Prophet.” Thus, Imam Malik relied on the religious practice of Madinah people because he believed it is transmitted from the practice of the Prophet himself. The other three schools reject this methodology, because the companions of the Prophet spread out after his death.

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71 Makdisi, *supra* note 69, at 3.
72 Zacharias, *supra* note 70, at 504.
73 Kamali, *supra* note 11, at 218.
74 *Id.*
and not all of them lived in Madinah. This methodology is paramount in the Maliki School as it bases many of its arguments on this methodology.76

These differing methodologies have produced a large volume of Islamic jurisprudence literature. There is a debate among the Islamic schools of law on each legal issue. The negotiability of debt is one of the issues on which the Islamic schools have differed. I will explain the various opinions regarding the negotiability and tradability of debt in Islamic law in chapter 3.

2.3 Islamic Finance Principles

In general, Islamic finance is “a prohibition-driven industry.”77 In other words, Islamic law is based on what is prohibited in the Islamic law sources. Bankers and specialists thus create contracts and engage in transactions that do not include any of the prohibitions. “The instigating factor for prohibition-based contract invalidation can almost always be attributed to the two factors labeled riba and gharar.”78 Understanding riba (usury) and gharar (uncertainty) is necessary to comprehend why scholars forbid the negotiability of debt in the current Islamic financial market.

2.3.1 Riba (Usury)

76 Zacharias, supra note 70, at 497
77 MAHMoud A. EL-GAMAL, ISLAMIC FINANCE: LAW, ECONOMICS, AND PRACTICE 46 (Cambridge University Press 2006).
78 Id.
Ribá is a grievous sin in Islam. The Quran “vehemently condemns ribá”\(^{79}\) in several Ayahs: “O you who have believed, do not consume usury, doubled and multiplied, but fear Allah that you may be successful”\(^{80}\)[;] “Allah has permitted trade and has forbidden interest”\(^{81}\)[;] “O you who have believed, fear Allah and give up what remains [due to you] of interest, if you should be believers. And if you do not, then be informed of a war [against you] from Allah and his messenger.”\(^{82}\) Though the Quran forbids ribá in several Ayahs, the Quran does not provide a comprehensive explanation of what constitutes ribá.\(^{83}\) Interpreters of the Quran define ribá as “a pre-Islamic practice of extending delay to debtors in return for an increase in the principal.”\(^{84}\) Because this practice existed during the record of revelation, it is the only kind of usury the Quran explicitly forbids.\(^{85}\) Ibn Hanbal, the founder of the Hanbali School, stated, “this practice (pay or increase) is the only form of ribá, the prohibition of which is beyond any doubt.”\(^{86}\)

Islamic scholars rely on the Sunnah to define and explain usury. Two main hadiths clarify the rule of ribá: “Gold for gold, silver for silver, wheat for wheat, barley for barley, dates for dates, and salt for salt, like for like, hand to hand, and any


\(^{80}\) Quran (3:130).

\(^{81}\) Quran (2:275).

\(^{82}\) Quran (2:279).

\(^{83}\) Vogel & Hayes, supra note 79, at 72.

\(^{84}\) Id. at 73.

\(^{85}\) Id.

\(^{86}\) Id.
increase is *riba*”[87] and “every loan that attracts a benefit is *riba*.”[88] Accordingly, Islamic scholars classify *riba* into two kinds: *riba* in sales and *riba* in loans.

### 2.3.1.1 Riba in Sales

Generally, *riba* is interpreted as “a prohibition of interest charged on loans.”[89] This is an oversimplified concept, because “the concept of *riba* applies to more than loans, it applies equally to all transactions be they loan or sales.”[90] The first *hadith*, “gold for gold”, shows that “the actual reach of the *riba* prohibition goes beyond compensation for lending money.”[91] The *hadith* establishes two rules, “that certain goods can be exchanged for each other as long as exchange is present barter. Exchange of goods within a single type is permitted only in equal amounts.”[92] The first rule prohibits “all sales within a single type with inequality, with or without delay (*riba* al fadl).”[93] The second rule prohibits “all exchanges with delay among the listed goods with or without equality or identity of type (*riba* alnasia, *riba* of delay).”[94] The *riba* alnasia seems to forbid delayed sales of any of these goods for gold or silver, but because there are other hadiths that prove the prophet purchased on

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[87] See EL-GAMAL, *supra* note 77, at 50 (Reported by Muslim on the authority of Abu Said Al-Khudriy).


[90] *Id.*


[92] *Id.*

[93] *Id.*

[94] *Id.*
credit, so “delay sales are permitted as long as currency is only one of two
considerations.”

Although the hadith only mentions six kinds of goods (gold, silver, wheat,
barley, dates, and salt), Islamic scholars apply the rule to other goods using Alqiyas (analogy) as a source of Islamic law. The rule is not restricted to these six kinds of
goods. Islamic scholars believe these goods were specifically mentioned in the
hadith because they were the common goods at that time. Hanafi and Hanbali
scholars “extended the prohibition to all fungible goods measured by weight or
volume, whereas Shafi and Maliki jurists restricted it to monetary commodities (gold
and silver) and storable foodstuffs.”

A farmer has 100 kg of dates. He wants to sell them to another farmer who
has a different kind of dates. The transaction must be in the present, with the same
amount of dates (100 kg). What if one party has superior dates and the other party has
inferior ones? They want to trade the dates. Must the quantity be equal? According to
the rule established by the hadith, they must be equal. When approached about this
case, the prophet Mohammed said to “[sell] the dates at the best possible market price
followed by the procuring of superior dates with the monetary proceeds thereof, this

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95 Id.
96 See page 27
97 El-GAMAL, supra note 77, at 51.
98 Id.
99 Id.
being the most equitable and efficient means to attain the same intended outcome.\textsuperscript{100} It is critical to “note that the prophet did not disapprove of the gain made in the exchange of dates but merely of the fact that superior dates were exchanged for inferior dates without impliedly an objective yardstick to assure an equitable exchange.”\textsuperscript{101}

The meaning and the application of \textit{riba} al fadl may be better understood in light of its context, a barter economy.\textsuperscript{102} Economically, \textit{riba} al fadl has “little to do with every day commercial loans and much to do with the encouragement towards engaging in equitable and efficient commercial transactions, which the \textit{[hadith]} exemplifies through an exchange of like for like, equal for equal or alternatively selling the commodity for cash at the best market price and thereafter buying with the cash any other commodity at market price.”\textsuperscript{103} Further, the \textit{hadith} “[does] not stipulate a fair price or specific price [at] which the buying and selling ought to take place, and leaves such price to be determined by the parties in implied recognition of the inherent equity in mutual consent and the market forces of supply and demand competition.”\textsuperscript{104}

\textbf{2.3.1.2 Riba in Loans}

\textsuperscript{100} BALALA, supra note 89, at 75.
\textsuperscript{101} Id.
\textsuperscript{102} Id. at 73.
\textsuperscript{103} Id.
\textsuperscript{104} Id.
The most important hadith in the modern economy is that every loan that is associated with a benefit is riba.\textsuperscript{105} The word loan in the hadith means “the loan of fungible [assets] including money.”\textsuperscript{106} “Benefit” in the hadith “includes interest on a money loan.”\textsuperscript{107} This kind of riba includes “a pre-Islamic practice of extending delay to debtors in return for an increase in the principal . . . .”\textsuperscript{108} This practice is banned in the Quran. Many Westerners think riba is limited to this kind of transaction. That is a misunderstanding about riba. Most Islamic jurisprudence is about riba in sales, which is used to forbid the sale of debts.

2.3.2 Gharar (Uncertainty or Speculative Risk)

Gharar is the second most important principle in Islamic finance. The Quran only condemns one kind of gharar, which is gambling.\textsuperscript{109} The Sunnah forbids gharar in general, but does not provide a clear definition. It does mention some kinds of gharar transactions that clarify the meaning of gharar. “The prophet forbade the sale of the pebble and the sale of Gharar.” “[D]o not buy fish in the sea, for its [sic] Gharar.” “[T]he prophet forbade the sale of what is in the wombs, the sale of the contents of the udder . . . the prophet forbade the sale of grapes until they become

\textsuperscript{105} Vogel & Hayes, supra note 79, at 77.
\textsuperscript{106} Id.
\textsuperscript{107} Id.
\textsuperscript{108} Id. at 73.
\textsuperscript{109} (2:219)
black, and the sale of grain until it is strong.”110 From these hadiths, Islamic scholars derive a definitions of gharar. Professor Mustafa Al-Zarqa defines gharar as “the sale of probable items whose existence or characteristics are not certain, the risky nature of which makes the transaction akin to gambling.”111

Most businesses contain some level of risk. Forbidding gharar does not mean forbidding all kinds of risks. Professor El-Gamal says, “gharar encompasses some forms of incomplete information and/or deception, as well as risk and uncertainty intrinsic to the objects of contract.”112

Islamic scholars distinguish between major gharar and minor gharar. Major gharar invalidates commercial contracts., Minor gharar does not.113 Professor Al-Darir distinguishes major gharar from minor gharar. According to his research, there are four conditions for major gharar, which invalidates the contract:114

1. The first condition is that “gharar must be excessive to invalidate a contract…,115 minor uncertainty about an object of sale does not affect the contract.”116 For example, if a buyer wants to purchase 1000 kg of dates, and the seller provides

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110 Vogel & Hayes, supra note 79, at 88.
111 El-Gamal, supra note 77, at 58.
112 Id.
113 Balala, supra note 89, at 40.
114 Al-Saddiq Muhammad Al-Amin Darir, Al-Gharar in Contracts and Its Effects on Contemporary Transactions page number (Islamic Research and Training Institute 1997).
115 El-Gamal, supra note 77, at 58.
116 Id.
approximately 1000 kg (the seller knows there is no less than 950 kg and no more
than 1050 kg), the contract will be valid. However, if the seller does not know if there
is 500 kg or 1000 kg, then it is considered major *gharar* and the contract is invalid.

2. The second condition is that the contract itself “must be a commutative financial
contract,”\textsuperscript{117} such as selling, leasing, etc. Accordingly, “giving a gift that is randomly
determined (e.g., the catch of a diver) is valid, whereas selling the same item would
be deemed invalid based on *gharar.*”\textsuperscript{118}

3. The third condition is that the *gharar* “must affect the principal components”\textsuperscript{119} of
the contract, such as consideration or goods, in order to invalidate the transaction. For
example, if an owner sells a car without determining the price, the contract would be
invalid because it contains major *gharar*. It is major *gharar* since the price is
unknown and it is a principal component of the contract. If the price and the car are
determined, but the service agreement after the purchase is not determined, then the
contract is valid.

4. The final condition is “if the commutative contract containing excessive *gharar*
meets a need that cannot be met otherwise, the contract would not be deemed invalid
based on that *gharar.*”\textsuperscript{120} For example, the prophet Mohammed and Muslims were

\textsuperscript{117} Id.
\textsuperscript{118} Id.
\textsuperscript{119} Id.
\textsuperscript{120} Id. at 59.
dealing with salam (advance purchase). 121 Salam is “a sale whereby the seller undertakes to provide some specific commodities to the buyer at a future date for an advance, mutually agreed price paid in full.”122

Therefore, “the object of sale does not exist at contract inception . . . .”123 This is major gharar. “[T]hat contract allows financing of agricultural and industrial activities that cannot be financed otherwise, it is allowed despite that gharar.” 124

Islamic scholars agree on the general principles and conditions of gharar. The details and application of these general principles and conditions to particular transactions are where different viewpoints emerge.125

Economically, gharar is forbidden in Islam “to ensure full consent and satisfaction of the parties in a contract . . . .”126 Islamic financial law requires “full disclosure and transparency and [sic] through perfect knowledge from contracting parties of the counter values intended to be exchanged.”127 The prohibition of gharar “protects against unexpected losses and the possible disagreements regarding

121 VOGEL & HAYES, supra note 79, at 145.
122 Humayon, A. Dar, Incentive compatability of Islamic Banking, in HANDBOOK OF ISLAMIC BANKING, 85, 94 (Kabir Hassan & Mervyn Lewis eds., Edward Elgar 2007).
123 EL-GAMAL, supra note 77, at 59.
124 Id.
125 VOGEL & HAYES, supra note 79, at 91.
127 Id.
qualities or incompleteness of information.”128 Accordingly, “all Islamic financial and business transactions must be based on transparency, accuracy, and disclosure of all necessary information so that no one party has advantages over the other party.”129

2.4 Islamic Financial Transactions

Many of the conventional financial transactions are forbidden in Islamic law because they are based on interest. Thus, Islamic scholars turned to traditional Islamic jurisprudence to find acceptable commercial contracts, which Islamic Bankers and specialists developed in order to make them applicable in the modern life. The next section explains some of typical commercial contracts used in the Islamic finance industry.

2.4.1 Musharakah (Partnership)

*Musharakah* is an Arabic word that literally means “sharing.”130 In business, Islamic scholars define *musharakah* as “a joint enterprise in which all the partners share the profit or loss of the joint venture.”131 *Musharakah* is “often perceived to be the preferred Islamic mode of financing.”132 Basically, it is “an ideal alternative for

128 *Id.*
129 *Id.*
130 MUHAMMAD TAQI UŞMĀNĪ, AN INTRODUCTION TO ISLAMIC FINANCE 17 (Kluwer Law International 2002).
131 *Id.*
the interest-based financing with far reaching effects on both production and
distribution.”¹³³

In *musharakah*, “partners contribute capital to a project and share its risks and
rewards.”¹³⁴ Profits are shared between partners on “a pre-agreed ratio, but losses are
shared in exact proportion to the capital invested by each party.”¹³⁵ For example, A
contributes $100,000 and B contributes $300,000. They agree profits will be split
evenly, 50% for each partner. This is permissible according to Islamic scholars. In
terms of loss, they must share it “in exact proportion to the capital invested by each
party,” which, in this example, is 25% and 75%.

According to Islamic scholars, it is impermissible to “fix a lump sum amount
for any one of the partners, or any rate of profit tied up with his investment.”¹³⁶ In the
previous example, A cannot be assigned $50,000 of profit per month, the rest going to
B. The profits must be a pre-determined ratio. In addition, in a *musharakah* contract,
profits and losses cannot be prioritized.¹³⁷ In other words, no party can be superior “to
others in terms of profit distribution or loss allocation, and no pre-fixed return can be
promised to any.”¹³⁸

¹³³ UŞMÂNI, *supra* note 130, at 17.
¹³⁴ Mirakhor & Zaidi, *supra* note 132, at 51.
¹³⁵ *Id.*
¹³⁶ UŞMÂNI, *supra* note 130, at 23.
¹³⁸ *Id.*
In a *musharakah* contract, all partners have the right but not the obligation to participate in the management of the project.\textsuperscript{139} This “explains why the profit-sharing ratio is mutually agreed upon and may be different from the [percentage] investment [of each] in the total capital.”\textsuperscript{140} No one partner can be held liable to guarantee capital or profit to other partners.\textsuperscript{141} However, if any “mismanagement and delinquency are proved”\textsuperscript{142} or if there is any kind of breach of the *musharakah* contract,\textsuperscript{143} then the responsible partner “may be held liable to guarantee capital contributions of the other parties”\textsuperscript{144} and any damages incurred.

### 2.4.2 Mudarabah

*Mudarabah* is another kind of partnership in Islamic law, used for financing purposes.\textsuperscript{145} *Mudarabah* is a partnership “where one partner gives money to another for investing it in a commercial enterprise.”\textsuperscript{146} In other words, the first partner contributes the capital while the other partner manages the business without contributing any capital.\textsuperscript{147} If both partners contribute capital then the partnership is considered as *musharakah*, not *mudarabah*.

\textsuperscript{139} Mirakhor & Zaidi, *supra* note 132, at 51.
\textsuperscript{140} *Id.*
\textsuperscript{141} EL-DIN, *supra* note 137, at 58.
\textsuperscript{142} *Id.*
\textsuperscript{143} *Id.*
\textsuperscript{144} *Id.*
\textsuperscript{145} VOGEL & HAYES, *supra* note 79, at 138.
\textsuperscript{146} UŞMÂNI, *supra* note 130, at 31.
\textsuperscript{147} *Id.*
There are no restrictions on the number of partners contributing capital, or on the number of working partners.\textsuperscript{148} Profits must be “shared between the two [or more] parties in accordance with a profit-sharing ratio pre-stipulated at the time of the contract.”\textsuperscript{149} Profit cannot be a fixed amount or any percentage of the capital employed.\textsuperscript{150} There are no restrictions on the profit-sharing ratio in mudarabah.\textsuperscript{151} It is completely based on the consent of all partners.\textsuperscript{152}

“[I]n the absence of infringement, default, negligence or breach of contract provisions by the [working partners] . . .” losses must be borne by the partners who contributed the capital.\textsuperscript{153} The partners who contributed capital suffer the loss of their capital. The working partners suffer the loss of their work and efforts.\textsuperscript{154} Even if the partners sign a contract agreeing that working partners share losses, the stipulation is invalid, according to Islamic scholars.\textsuperscript{155}

There are some important differences between musharakah and mudarabah. In musharakah, the capital comes from all partners. In mudarabah, the capital only

\textsuperscript{148} MUHAMMAD AYUB, UNDERSTANDING ISLAMIC FINANCE 320 (John Wiley & Sons Ltd. 2007).
\textsuperscript{149} EL-DIN, supra note 137, at 57.
\textsuperscript{150} AYUB, supra note 148, at 320.
\textsuperscript{151} USMĀNI, supra note 130, at 33.
\textsuperscript{152} Id.
\textsuperscript{153} Mirakhor & Zaidi, supra note 132, at 223.
\textsuperscript{154} Id.
\textsuperscript{155} USMĀNI, supra note 130, at 35.
comes from some partners.\textsuperscript{156} In \textit{musharakah}, “all partners can participate in the management of the business and can work for it…”\textsuperscript{157} In \textit{mudarabah}, the partner who contributes the capital “has no right to participate in the management.”\textsuperscript{158} Only the partner who is responsible for executing the business has the right to manage it.\textsuperscript{159} They also differ in terms of profits and loss. “In \textit{musharakah} all partners share the loss to the extent of the ratio of their investment.”\textsuperscript{160} In \textit{mudarabah}, the loss is suffered only by the partners who contributed capital.\textsuperscript{161} The partner who did not contribute any capital loses only his time and effort.\textsuperscript{162} The liability of the partners in \textit{musharakah} is “normally unlimited,”\textsuperscript{163} so if the liabilities of the business exceed its assets, “the business is liquidated and all the excess liability shall be borne \textit{pro rata} by all the partners.”\textsuperscript{164} In \textit{mudarabah}, the liability of the partners who contributed the capital is limited to their investment,\textsuperscript{165} “unless he has permitted the [working partner] to incur debts on his behalf.”\textsuperscript{166}

\textbf{2.4.3 Murabahah (Cost-Plus or Markup)}

\textsuperscript{156} Id. at 30.
\textsuperscript{157} Id.
\textsuperscript{158} Id.
\textsuperscript{159} EL-DIN, \textit{supra} note 137, at 57.
\textsuperscript{160} USMĀNI, \textit{supra} note 130, at 30.
\textsuperscript{161} Id.
\textsuperscript{162} Id.
\textsuperscript{163} Id.
\textsuperscript{164} Id.
\textsuperscript{165} Id. at 31.
\textsuperscript{166} Id. at 31.
*Murabaha* is the most popular Islamic financial instrument. “[M]ost of the Islamic banks and financial institutions use *murabaha* as an Islamic mode of financing.”¹⁶⁷ Linguistically, it is derived from the Arabic word “ribh,” which means profit.¹⁶⁸ In classic Islamic jurisprudence, *murabaha* is simply a sale. The seller in *murabaha* tells the purchaser expressly what the goods cost the seller, and how much profit he is looking to make.¹⁶⁹ That factor distinguishes *murabaha* from other kinds of sales.¹⁷⁰ *Murabaha* is “a trade contract, stipulating that one party buys a good for its own account and sells it to the other party at the original price plus a markup.”¹⁷¹

In a *murabaha* contract, the seller must inform the buyer of “all items of expense which are included in the cost if these are not known through custom”¹⁷² and then “adds some profit thereon.”¹⁷³ The profit could be a “lump sum or may be based on a percentage.”¹⁷⁴ The profit “can be seen as a payment for the services provided by the intermediary, but also as a guaranteed profit margin.”¹⁷⁵ The buyer may pay the

¹⁶⁷ *Id.* at 65.
¹⁶⁹ USMĀṆĪ, *supra* note 130, at 65.
¹⁷⁰ *Id.*
¹⁷¹ VISSER, *supra* note 168, at 57.
¹⁷² VOGEL & HAYES, *supra* note 79, at 140.
¹⁷³ USMĀṆĪ, *supra* note 130, at 65.
¹⁷⁴ *Id.*
¹⁷⁵ VISSER, *supra* note 168, at 57.
seller immediately after the contract, delay the payment as a sale on credit, or pay in installments.  

Nowadays, murabaha is commonly used as a mode of financing. Practically, if a customer wants to buy a car, which costs $100,000, the customer requests the bank to officially purchase the specific car. The customer promises to re-purchase the car from the bank with a markup. The bank determines the markup according to many factors (expenses, administrative fees, etc.), including how many installments the customer needs and how long it will take to pay the full price. The bank determines these factors, the customer agrees, then the bank purchases the car and sells it directly to the customer. The customer pays the total price in installments as agreed with the bank.  

2.4.4 Ijarah (Lease)  

Ijarah is an Arabic word meaning, “to give something on rent.” In Islamic jurisprudence, ijarah means, “to transfer the usufruct of a particular property to another person in exchange for a rent claimed from him.” Therefore, the term ijarah “is analogous to the English term ‘leasing.’” Ijarah was not originally a

\(^{176}\) Id.  
\(^{177}\) VOGEL & HAYES, supra note 79, at 140.  
\(^{178}\) VOGEL & HAYES, supra note 79, at 140.  
\(^{179}\) USMĀNĪ, supra note 130, at 109.  
\(^{180}\) Id.  
\(^{181}\) Id.
financing contract. Rather it was a sale of usufruct, \textsuperscript{182} which means “its rules follow closely the rules for ordinary sales.”\textsuperscript{183}

In Islamic financing, \textit{ijarah} is “a contract under which a bank buys and leases out an asset or equipment required by its client for a rental fee.”\textsuperscript{184} During the period of lease, the lessor (bank) owns the asset.\textsuperscript{185} The lessor assumes the risk of ownership and is responsible for insurance and major maintenance\textsuperscript{186} but “has the right to renegotiate the terms of the lease payment at agreed intervals.” This is important “to ensure that the rental remains in line with market leasing rates and the residual value of the leased asset.”\textsuperscript{187}

Some clients want to own the assets at the end of the lease. In this case, Islamic banks use an additional single contract, which is called a “hire-purchase” contract.\textsuperscript{188} In this contract, the lessee agrees to pay a prearranged amount of money at the end of the lease to purchase the asset from the lessor.\textsuperscript{189} This contract “basically mimics financial leasing practices of conventional finance.”\textsuperscript{190} The Islamic bank and customer sign the two contracts, the lease and the hire-purchase. “[T]he bank

\textsuperscript{182} VOGEL & HAYES, \textit{supra} note 79, at 143.
\textsuperscript{183} Id.
\textsuperscript{184} Id.
\textsuperscript{185} Mirakhor & Zaidi, \textit{supra} note 132, at 52.
\textsuperscript{186} Id.
\textsuperscript{187} Id.
\textsuperscript{188} VOGEL & HAYES, \textit{supra} note 79, at 144.
\textsuperscript{189} Id.
\textsuperscript{190} Mirakhor & Zaidi, \textit{supra} note 132, at 52.
purchases a building, equipment or an entire project and rents it to the client, but with the latter’s agreement to make payments into an account, which will eventually result in the lessee’s purchase of the physical asset from the lessor.”

There are several reasons why more and more Islamic banks are using lease contracts as a mode of financing. First, in a lease contract “the lessor retains legal title to the property being financed, assuring an effective security interest.” In other words, Islamic banks retain ownership of the asset, avoiding the risk of customer default (where the customer owns the asset and cannot continue paying the installments). Second, the lease contract includes “flexibility in payment terms and negotiability or transferability.” Third, “in some jurisdictions leasing offers tax savings compared with sale,” which minimizes the cost of finance, making lease finance preferable to Islamic banks.

2.4.5 Sukuk (Islamic Bonds)

Sukuk are bonds structured according to Shariah principles. Sometimes they are called Islamic bonds, Islamic debt securities, or Islamic trust certificates. Sukuk were created “to meet the requirements of those investors who wanted to invest their

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191 *Id.*

192 VOGEL & HAYES, *supra* note 79, at 144.

193 *Id.*

194 *Id.*

195 MUHAMMAD AL-BASHIR & MUHAMMAD AL-AMINE, GLOBAL SUKŪK AND ISLAMIC SECURITIZATION MARKET: FINANCIAL ENGINEERING AND PRODUCT INNOVATION 57 (Koninklijke Brill 2012).

196 *Id.*
savings in *Shariah*-compliant financial instruments.”¹⁹⁷ Modern Islamic scholars and bankers focused on creating alternative financial instruments for Muslim investors. *Sukuk* attracts Muslim investors, because they have some of the features of conventional bonds, and but are structured to be complaint with *Shariah* principles.¹⁹⁸

There are important differences between conventional bonds and *sukuk*. Conventional “bonds are contractual debt obligations whereby the issuer is contractually obliged to pay to bondholders, on certain specified dates, interest and principal.”¹⁹⁹ Conversely, “under a *sukuk* structure the *sukuk* holders each hold an undivided beneficial ownership interest in the underlying assets.”²⁰⁰ Therefore, “*sukuk* holders are entitled to share in the revenues generated by the *sukuk* assets as well as being entitled to share in the proceeds of the realization of the *sukuk* assets.”²⁰¹ In other words, “*sukuk* are based on an exchange of an underlying asset but with the proviso that they are *Shariah*-compliant; that is, the financial transaction is based on the application of various Islamic commercial contracts.”²⁰²

¹⁹⁷ Mirakhor & Zaidi, *supra* note 132, at 53.
¹⁹⁸ *Id.*
²⁰⁰ *Id.*
²⁰¹ *Id.*
There are different *sukuk* based on the Islamic commercial contracts. For example, there are *sukuk musharakah*, *sukuk murabaha*, and *sukuk ijarah*.\(^{203}\) The next chapter explains these structures in detail. Moreover, it will focus on how non-tradability of debts negatively affects *sukuk* structuring (securitization) and the *sukuk* market (secondary market), even though *sukuk* are based on the exchange of an underlying asset.

\(^{203}\) Islamic commercial contracts such as *musharakah*, *mudarabah*, *murabaha* and Ijara which are explained previously.
Chapter 3

Islamic Scholars and the Negotiability of Debt

3.1. Introduction

This chapter serves three purposes. The first is to illustrate the flexibility and diversity of Islamic jurisprudence, especially in regard to the negotiability of debt. The second is to explain the position of contemporary Islamic scholars regarding such negotiability. The final purpose is to demonstrate how the position of contemporary Islamic scholars negatively affects Islamic finance in general and the sukuk secondary market in particular.

The first section of this chapter is composed of the opinions and arguments of previous Islamic scholars. There are also explanations of Islamic jurisprudence and the different schools of thought regarding the tradability of debt. Two Islamic Fiqh (jurisprudence) Academies are compared and contrasted, and the standard issued by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) is explained. These academies and the AAOIFI are universal. Their resolutions and standards are important for Muslims around the world. They are especially important for bankers and lawyers who do not have an Islamic jurisprudence background.

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1 These two Academies are different from the four Islamic schools of though. They are modern and authoritative. They consist of scholars from all four schools and from different Muslim countries. More details are in the next section.
The second section explains how forbidding the negotiability of debts negatively affects the *sukuk* secondary market. The section also shows how this has been an obstacle for the growth of Islamic securitization.

3.2. Classic Islamic jurisprudence and the tradability of debt

When Islamic scholars analyze the tradability of debt, they use the word “sale” because it is the basic contract in trading and the rules of a sale contract are applied generally to other kinds of contracts.² In discussing the permissibility of the sale of debts, Islamic scholars have developed two categories: the sale of debt for executed consideration, and the sale of debt for executory consideration. Each category has its own restrictions, types, and provisions.

3.2.1 Sale of Debt for Executed Consideration

There are two types of sale of debt for executed consideration: the sale of debt for executed consideration to the original debtor and the sale of debt for executed consideration to another person. For instance, A borrows $1000 from B. B sells the debt to A for executed consideration. This is the sale of debt to the original debtor. If B sells the debt to C for executed consideration, it is the sale of debt to another person. Each type has its own provisions.

The majority of Islamic scholars believe Islamic law permits the sale of debt to the original debtor.³ There is one condition on this contract. The consideration shall

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be equal or less than the debt. To be more would be riba, which is forbidden in Islamic law.\(^4\) The most important argument concerning this opinion is the freedom of contract in Islamic law. Ibn Taimiah states, “The underlying principle in contracts and [conditions] is permissibility and validity. Any contract or [condition] is prohibited and void only if there is an explicit text [in Quran or Sunnah] proving its prohibition and voiding.”\(^5\) Freedom of contract is critical. Islamic scholars repeatedly use this rule as an argument. The majority of Islamic scholars are satisfied with this option for selling debt.

The sale of debt to another person is common, but complicated. There is no shared or majority opinion regarding this type of debt sale. There are three groups with three different opinions on the matter. The first group, made up of the Hanafi and the Hanbali schools, claims this debt sale is completely forbidden in Islamic law.\(^6\) The second group, Maliki, believes it is permitted but with restrictions.\(^7\) The third group, Shafi, believes it is completely permissible in Islamic law.\(^8\)

The first group argues that this transaction contains gharar (uncertainty).\(^9\) Gharar exists because the person who purchases the debt cannot be sure he will

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\(^4\) See page 34.
\(^5\) Ibn Taymiah, Majmo’a Al Fatawa 3:474 (King Fahad Center 1994).
\(^6\) Alkasaney, Bada’i’ Alsana’i 5:182 (Dar Alhadeeth 1996); Ibn Qudamah, Alsharh Alkabeer 5:765 (DarAlhadeeth 1996).
\(^7\) Alhattab, Mawahaeb Aljaleel 4:368 (Dar Elfekr 1992) (date of first edition).
\(^8\) Alnaway, Rawdhat AlTalebeen 3:224 (Dar Alem Alkotob 2003).
receive it on time, or receive it at all. The prophet Mohammad forbade any sale of 
gharar. Therefore, the sale of debt to another person is prohibited.

The third group argues an opposite position. The sale is permissible because freedom of contract is one of the main principles in Islamic law. Furthermore, there is no specific text in the Quran or Hadith that forbids the sale of debt to another person. No one can forbid something that God does not forbid. In terms of risk, any transaction includes risk. That does not mean it is forbidden. The risk in a sale of debt to another person is not major gharar. It is classified as regular gharar, which is permissible in Islamic law.

The second group chooses a middle ground. Because of freedom of contract, the sale of debt to another person is permissible. However, the parties must avoid any forbidden issues such as riba and gharar. In order to avoid these forbidden issues, the purchaser must believe the debtor has the ability to pay the debt. The core of the transaction is permissible, and all proposed requirements are issues outside the transaction.

10 Id.
11 See page 38.
12 Id.
13 ALNAWAWAY, supra note 8, at 3:224.
14 Id.
15 See page 38.
16 ALNAWAWAY, supra note 8, at 3:224.
17 ALHATTAB, supra note 7, at 4:368.
18 Id.
19 Id.
So, two of the four schools of thought believe the sale of debt for executed consideration is permissible. The other two schools believe it is forbidden. Based on their argument, they are concerned about the uncertainty associated with the transaction, but not with the transaction itself. Thus, if the two parties engaged in the transaction avoid major uncertainty, the sale of debt for executed consideration to another person would be permitted since only major gharar is forbidden in Islamic law.

3.2.2. Sale of Debt for Executory Consideration

This is the more complicated and controversial sale of debt for two reasons. First, there is a hadith from the prophet Mohammed which forbids the sale of “kali” for “kali”. Literally, this hadith means “the exchange of two things both delayed” is forbidden. However, this hadith has weak authentication. According to Islamic law, if the hadith has weak authentication, scholars cannot base their argument upon it. Second, forbidding the sale of two things both delayed “is said to have near universal application” which means, it is not exactly an ijma but it is close to it since the vast majority of Islamic scholars forbid this kind of transaction. These two elements play a significant role when Islamic scholars analyze the sale of debt for executory consideration.

20 The prophet did not use the word dayn, which literally means debt. Instead, he used the word delayed, which is different. Some Islamic scholars use the word debt to discuss the provision of delayed consideration. This is one of the main reasons the concept of debt is vague and confusing in Islamic finance.

21 VOGEL & HAYES, supra note 9, at 115.

22 See page 23.
Islamic scholars separate the sale of debt for executory consideration into three types. The first is when the debts for both parties have been created in the transaction. Practically, it is the sale of executory consideration for executory consideration.\(^{24}\) These debts are not due before the transaction. For example, A came to B to purchase a car for $100,000. They agreed that A would pay the money within six months and B would deliver the car after three months. This is called, “Ibtida aldayn by aldayn.”\(^{25}\) According to Islamic jurisprudence, there is unanimous consensus among Islamic scholars that prohibit this sale.\(^{26}\) Although, the hadith that forbids the sale of kali for kali has weak authentication, the meaning of the hadith is still applied. In this transaction, A must pay, or B must deliver the car at the time of the transaction to make the contract enforceable. Maliki does exempt one situation. One party may delay the payment or the delivery of goods for three days.\(^{27}\) These three days are considered close enough to be part of the time of transaction.\(^ {28}\) In short, if two parties create new debt in a transaction, and both considerations are delayed, then Islamic scholars unanimously forbid this transaction under Islamic law.

The second type is the sale of debt for executory consideration to the debtor. For example, A owes B $1000 to be paid after one year. B sells the debt to A for 1000

\(^{23}\) VOGEL & HAYES, supra note 9, at 115.
\(^{24}\) Again, the concept of debt is unclear which affects the negotiability of debt in Islamic finance. See Chapter 4.
\(^{25}\) VOGEL & HAYES, supra note 9, at 116.
\(^{26}\) Id.
\(^{27}\) ALHATTAB, supra note 7, at 4:368.
\(^{28}\) Id.
kg of dates paid after six months. The majority of Islamic scholars believe this transaction is prohibited because it is similar to selling kali for kali, which is unanimously prohibited among Islamic scholars.\textsuperscript{29} On the other hand, some scholars, such as Ibn Taymiah and Ibn Alqayyem, believe this type of transaction is permissible because there is no text from Quran or Sunnah that explicitly forbids it. The \textit{hadith}, kali for kali, is weak\textsuperscript{30} so it is not a legitimate source for Islamic law provisions. Additionally, the ijma of Islamic scholars only speaks to the first type of transaction (two parties create new debt in a transaction, and both considerations are delayed), so this ijma cannot be applied to this type.\textsuperscript{31} Thus, because of the freedom of contract principle, this transaction would be permitted. Thus, while majority of Islamic scholars forbid the sale of debt for debt to the debtor, some respected scholars believe it is permitted in Islamic law.

The last type is the sale of debt for executory consideration to a person other than the debtor. For example, A owes B $1000. After a year, B sells the debt to C for 1000 kg dates to be paid after six months. The argument regarding this sale is the same as the previous one. The majority forbids the sale because it is similar to selling

\begin{footnotes}
\item[29] KURDEY, \textit{supra} note 3, at 97.
\item[31] Id.
\end{footnotes}
kali for kali.\textsuperscript{32} Again, the minority disagrees, believing the sale is permissible, because the \textit{hadith} is weak and the ijama is limited to the first type of transaction.\textsuperscript{33}

In short, the sale of debt for executed consideration is permitted by two schools of thought. The other two schools forbid the sale of debt for executed consideration because, significantly, the uncertainty (\textit{gharar}) associated with the transaction. On the other hand, there is only one kind of the sale of debt for executory consideration which is unanimously forbidden. The others are forbidden by the majority of Islamic scholars while the minority allows them because the ijma is limited.

\begin{itemize}
\item \textbf{The sale of debts}
\item For executory consideration
\item To the debtor or another person with previous debt
\item Creating new debts
\item Unanimous Prohibit
\item Minority permit
\item Majority prohibit
\item For executed consideration
\item To another person
\item Shafi and Malik permit
\item Hanafi and Hanbali prohibit
\item Vast Majority permit
\end{itemize}

\textsuperscript{32} N\textsc{aser} N\textsc{ashawy}, \textsc{Bay Aldayn} 156 (Dar Alfekr Aljame’ey 2007).

\textsuperscript{33} T\textsc{aymia}, \textit{supra} note 4, at 29:509; A\textsc{lqayem}, \textit{supra} note 2, at 4:105.
The scope of this dissertation is limited to the sale of debt for executed consideration to another person because it is the most common practice in the secondary debt market. Therefore, if there are varied positions among Islamic Schools of legal thought regarding the sale of debt for executed consideration, why then is there an impression among current bankers and lawyers that the sale of debt is completely forbidden in Islamic law?

3.3. Modern Islamic Fiqh (Jurisprudence) Organizations and the Tradability of Debt

It is first important to consider the difference between the past and present Islamic legal opinion (fatwa). Fiqh changes with the times, for better or for worse.

In the past, four common schools of thought generally represented the Islamic Fiqh, but they were unorganized. Any scholar could add to a school of thought if he followed the main principles of the school. Consequently, the scholars of one school may have had many different opinions and arguments as long as they shared the main principles of the school. These opinions were not binding unless a judge chose one Fiqh opinion to make a decision. Thus, the Fiqh became binding because it was adopted in a judicial decision, not on the authority of the school of though. This allowed Islamic jurisprudence to be broad, diverse, and flexible.

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34 See page 29.
35 Id.
36 Id.
Modern Islamic Fiqh is structured by modern organizations. Two Fiqh academies adopt decisions and resolutions in different fields of Islamic jurisprudence. The first academy is in Jeddah and consists of 54 members who are Islamic scholars from different schools and countries. The second academy is based in Makkah and consists of 24 members who are Islamic scholars from different schools and countries. Their methodology is to adopt interpretation based on the majority opinion. Their resolutions are understood by non-Islamic scholars to be true Islamic law, without considering the debates behind the resolution. The resolutions attempt to summarize thousands of years of accumulated Islamic jurisprudence in two or three pages. This section analyzes the resolutions related to the negotiability of debts. The standard, issued by the Shariah’s Board of the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), which regulates the sukuk industry, is also analyzed.

3.3.1. The Islamic Fiqh Academy in Jeddah

On November 19, 1998, the Islamic Fiqh Academy in Jeddah adopted a resolution with number (11/4)101:

It is not permissible to sell a deferred debt by the non-debtor for a prompt cash, from its type or otherwise, because this results in Ribá [usury]. Likewise, it is not permissible to sell for a deferred cash, from its type or otherwise, because it’s similar to the sale of (kali for kali),

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39 Islamic Fiqh Academy in Jeddah, at http://www.fiqhacademy.org.sa/
which is prohibited in Islam. There is no difference whether the debt is the result of a loan or if it is a deferred sale.40

This resolution refers to the sale of debt for cash. The sale of debt for cash has two parts: the sale of debt for prompt cash (executed consideration) and the sale of debt for deferred cash (executory consideration). There are different arguments for each part, but the ultimate decision is the same. The transaction is forbidden.

The academy decided the sale of debt for prompt currency is forbidden because it is a kind of usury in sales. It is considered usury in sales, because the two considerations are the same type. Debt and cash are both money. The two considerations must be equal and paid at the time of transaction. In the modern practice of debt sales, the debt is not the same amount as the prompt cash. Therefore, selling debt in this situation is forbidden. This is the argument used to forbid the sale of debts for prompt currency. Because there is no ayah or hadith, the academy uses the argument of riba to forbid the sale of debt. As a result, non-experts in Islamic jurisprudence would understand that the sale of debts is forbidden as usury in Islam.

The academy decided the sale of debt for delayed cash is not permissible because it is kali for kali sale. They use the hadith without explaining that it is weak, or differentiating between the several kinds of debt sales, or mentioning that there are different opinions among Islamic scholars. Thus, it is implied that the sale of debt for executory consideration is always impermissible.

On June 28, 2006, the academy adopted a new resolution regarding the sale of debt, numbered (17/7) 158

“Some permissible kinds of … sale of debts:

1- The sale of debt to a person who is not the debtor if:

A. Selling the debt for different and prompt currency, and shall be the price of the day.

B. Selling the debt for particular commodity.

C. Selling the debt for particular usufruct.”

In this resolution, the academy gives more details than the previous resolution written in abbreviated text. In this resolution, the academy mentions some permissible kinds of debt sales. The permissible kinds are based on the riba in sales arguments. As explained before, if the two considerations are the same type, then they must be equal and delivered at the time of the transaction, pursuant to Islamic law.

Otherwise, it is considered as riba in sales. If one consideration is different from the other, the transaction is permissible, even with unequal amounts and delivered at a time other than the time of transaction. The academy emphasizes that if the other consideration is different from the original debt, then the sale of debt is allowed.


\[42\] See page 35

\[43\] Id.

\[44\] Id.
Therefore, the sale of debt itself is not a concern in Islamic jurisprudence. The concern is, whether the transaction includes *riba* in sales.

Because debt represents money, the academy considers the debt equivalent to money, and applies the rules and restrictions of *riba* in sales to any transaction that includes the sale of debt. The academy emphasizes that if the type of the consideration is different from the type of debt, then it is allowed.

### 3.3.2. The Islamic Fiqh Academy in Makkah

On January 10, 2002, the Islamic Fiqh Academy in Makkah adopted an important resolution that still affects the world’s Islamic finance industry. The resolution discusses the forms of the sale of debts. There is only one permissible form. “The permissible forms of the sale of credit include the credit selling [sic] to the debtor himself at the present price.”\(^{45}\) This provision is consistent with traditional Islamic jurisprudence. The vast majority of Islamic scholars allow this form and believe it is permissible.\(^{46}\)

The resolution lists two prohibited forms and gives some practical examples. The first prohibited forms is, “[o]ffering the sale of debts to debtor at a deferred price which is more than the debt itself . . .” because “[i]t constitutes a kind of *Riba* (usury), which is prohibited according to *Shariah* (Islamic law).”\(^{47}\) The second type

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\(^{46}\) See page 53.

is, “[o]ffering the sale of debts to a person other than the debtor at a delayed price of similar or other kind . . .” because “[i]t constitutes a form of selling kali for kali (debts for debts), which is prohibited according to the Islamic Shariah.”

There are several problems with this resolution. First, the resolution connects the sale of debt to the debtor, for executed consideration and executory consideration, but the sale of debt to another person for only executory consideration. The resolution does not mention anything about the sale of debt to another person for executed consideration, though such those actions are important in modern Islamic finance. Second, the Academy supports the second prohibition with the hadith, without disclosing that it is a weak hadith. Third, the resolution interpretes the hadith, kali for kali, as debt for debt and that might mislead the reader. Literally, in Arabic language, kali is one kind of debt but it’s meaning is coextensive with the meaning of debt. Kali for kali is unanimously prohibited but other kinds of debt, such as the sale of debt for executed consideration, is not mentioned in the kali hadith, otherwise prohpited.

Additionally, the resolution lists several practical examples. The most important is securitization. The resolution states, “It is not permissible to securitize debts into securities that may be circulated in secondary market . . .” because “it constitutes a sale of debts to a person other than the debtor in a way that includes

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48 Id.
49 See page 56.
Riba (usury).” Alternatively, the academy provides a solution to comply with Shariah. The solution is “selling them through commodities, provided the buyer takes their delivery at the time of signing the contract, even though the value of the commodity is less than the value of the commercial paper.”

The resolution forbids the whole securitization industry. The argument is built on riba in sales, just like the academy in Jeddah when it forbade the sale of debt for cash. The academy in Makkah provides a possible solution, selling debts for commodities. The only advantage of this solution is to comply with the perceived Islamic law, though it does not address the needs of investors and corporations. This resolution cuts off significant business for the Islamic finance industry. It has negative effects on Islamic finance generally, and the Islamic debt market in particular.

3.3.3. Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI)

The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) is a significant player in the Islamic financial industry. It is “an Islamic international autonomous not-for-profit corporate body that prepares accounting, auditing, governance, ethics and Shariah standards for Islamic financial institutions

51 Id.
and the industry.”52 It has issued 88 standards: “(a) 48 on Shariah, (b) 26 accounting, (c) 5 auditing standards, (d) 7 governance, (e) 2 codes of ethics.”53 The Shariah standards translate the traditional language of Islamic law for practitioners, such as bankers and lawyers. The most relevant standard for this thesis is the Shariah standard number 17.

On May 8, 2003, the Shariah board of AAOIFI issued standard 17 to regulate Islamic bonds (sukuk). This standard clearly states, “It is permissible to securitize assets, usufructs and services, but it is not permissible to securitize debts to be negotiable.”54 The main thrust of the standard is that the sukuk must be related to tangible assets, usufructs, or services in order to be negotiable in the secondary market. If the sukuk represents debt, it is not negotiable. These standards are written for non-experts in Islamic jurisprudence. These non-experts might get the wrong idea that negotiability of debt is totally prohibited in Islamic law. They would probably believe this is a rule in Islamic law based on riba (usury) and gharar (uncertainty). These restrictions present a significant hurdle to the development of sukuk and Islamic securitization.

The two academies based their arguments on the riba in sales prohibition (gold for gold and silver for silver). Today, most transactions involve money. These

53 Id.
two elements imply that Islamic law forbids the sale of debt. This implication is especially significant for practitioners who do not have any background in Islamic jurisprudence. They will not be able to differentiate between *riba* in sales and *riba* in loan usury. They will believe that the sale of debt is as repugnant as usury. The *Shariah* board of AAOIFI issued standard 17 to confirm the prohibition and stated that “it is not permissible to securitize debts to be negotiable.”

3.4. The Effect of the Non-Tradability of Debts on Sukuk Industry

*Sukuk* are financial instruments, created by Islamic bankers and specialists as an alternative to conventional bonds. *Sukuk* were created to avoid *riba*. *Sukuk* comply with traditional Islamic jurisprudence, allowing commercial Islamic transactions to be compliant with Islamic law. There are many kinds of *sukuk*. Each kind is based on an Islamic commercial transaction. *Sukuk* are attractive for governments and companies in the Gulf Corporation Council (GCC) and many entities seeking funds permissible under Islamic law issue *sukuk*.

Although many entities, especially governments, have issued *sukuk*, these instruments have faced several obstacles in the secondary market. As explained in chapter 1, while *sukuk* created to avoid *riba* and make debt instruments attractive for Muslims, the secondary market is still illiquid and limited. The main reason is the

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55 The *Shariah*’s Board of the Accounting and Auditing Organization for Islamic Financial Institutions Standards for Islamic Banking 240 (2010).

56 *sukuk* murabaha, *sukuk* salam, *sukuk* isitsna, *sukuk* ijarah, *sukuk* musharak and *sukuk* mudarabah, etc.

57 See chapter one, *Introduction*. 
non-tradability of debt in Islamic Finance according to the two resolutions of the Fiqh academies. This chapter examines the structure of each kind of sukuk and shows how the non-tradability of debt affects whether each sukuk is tradable in the secondary market.

Many Islamic bankers search the Western financial industry for instruments complaint with Islamic law in order to develop the sukuk industry. Many specialists believe securitization is useful.

3.4.1 Sukuk Negotiability in the Secondary Market

In this section, each sukuk structure is explained to show how the non-tradability of debt affects the negotiability of such sukuk in the secondary market. It is important to mention here that each sukuk is packaged as one deal. Therefore, all parties know in advance all of the procedures, steps and the final result.

3.4.1.1 Sukuk Murabaha

As explained in Chapter 2, in Islamic jurisprudence murabaha “is a trade contract, stipulating that one party buys a good for its own account and sells it to the other party at the original price plus a mark-up.”\textsuperscript{58} The mark-up reflects the services of the seller, or simply a profit margin for the seller. The payment may be in cash or installments.\textsuperscript{59} In financing, “murabaha is used as a form of a sales contract in which the financial institution or investors buy an asset and then later sell it to the

\textsuperscript{58} HANS VISSE R, ISLAMIC FINANCE: PRINCIPLES AND PRACTICE 57 (Edward Elgar Publishing 2009).

\textsuperscript{59} Id.
‘borrower’ at a marked-up price, which includes a profit component. Payments are made in installments, either on a deferred basis or through upfront payment with deferred delivery.”60

There are several parties involved in a transaction using *murabaha* to issue *sukuk*. The first party is a company or any business entity that needs funds. The second party is a special purpose vehicle (SPV), created by the company to manage the transaction. Third, a vendor will provide the commodity or the assets. Fourth, the investors will finance the transaction and buy the *sukuk*. The structure of the *sukuk* would be as follows:

The SPV, which is created by the company seeking funds, issues *murabaha sukuk* to investors and collects funds from investors. The SPV purchases assets from the vendor and pays with the proceeds of the sukuk. The company on behalf of the SPV takes delivery of the assets. Then, the company purchases the assets from the SPV on a deferred payment plan and makes payments to the SPV while the SPV passes the payments on to the investors after deducting a service fee.61

Although “most of the Islamic banks and financial institutions are using *murabaha* as an Islamic mode of financing,”62 *murabaha sukuk* are non-negotiable

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61 MUHAMMAD AYUB, *UNDERSTANDING ISLAMIC FINANCE* 403 (John Wiley & Sons Ltd. 2007).

62 MUḤAMMAD TAQĪ USMĀNĪ, *AN INTRODUCTION TO ISLAMIC FINANCE* 65 (Kluwer Law International 2002).
and non-tradable in the secondary market.\textsuperscript{63} Murabaha sukuk represents “entitlements to shares in receivables from the purchaser of the underlying murababa, they are not negotiable instruments that can be traded on the secondary market because Shariah does not permit trading in debt.”\textsuperscript{64} The Accounting and Auditing Organization for Islamic Financial Institutions Shariah standard number 17 clearly determines that murabaha sukuk are not negotiable if the underlying asset is delivered to the end buyer.\textsuperscript{65}

3.4.1.2 Sukuk Salam

\textit{Salam} literally means “futures”.\textsuperscript{66} Islamic scholars consider a contract as salam when “a buyer pays in advance for a designated quantity and quality of a certain commodity to be delivered at a certain agreed date and price.”\textsuperscript{67} The buyer must pay the full price when he signs the contract. The seller must deliver the designated quantity of the commodity on the agreed date. Salam contracts were allowed during the life of the prophet Mohammed, particularly for the production of agriculture goods.\textsuperscript{68} Salam

\textsuperscript{63} CLIFFORD CHANCE LLP, DUBAI INTERNATIONAL FINANCIAL CENTRE SUKUK GUIDEBOOK 46 (Dubai International Financial Centre 2009).

\textsuperscript{64} Id.

\textsuperscript{65} THE SHARIAH’S BOARD OF THE ACCOUNTING AND AUDITING ORGANIZATION FOR ISLAMIC FINANCIAL INSTITUTIONS STANDARDS FOR ISLAMIC BANKING 240 (2010).


\textsuperscript{67} Id.

\textsuperscript{68} UŞMĀÑĪ, supra note 62, at 129.
contracts were very important “to allow farmers access to capital (price of salam), with which they can buy seeds, fertilizer, and other materials to grow their crops.”  

In modern Islamic finance, salam is used for small farmers and traders. Pursuant to salam agreements, “a trader in need of short-term funds sells merchandize to the [investment] bank on a deferred delivery basis. It receives full price of the merchandize on the spot that serves its financing need at present.” By the due date, the trader “delivers the merchandize to the [investment] bank [and] the bank sells the merchandize in the market at the prevailing price.” The price the investment bank pays to the trader is usually less than the market price, so “the transaction should result in a profit for the [investment] bank.” The structure for issuing sukuk using salam would be as follows:

- SPV issues sukuk, which represent an undivided ownership interest in certain assets (the “Salam Assets”) to be delivered by obligor;
- The SPV signs a contract with an obligor to provide commodities and sell it to the end buyers;

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70 MOHAMMED OBAIDULLAH, ISLAMIC FINANCIAL SERVICES 95 (Scientific Publishing Centre, King Abdulaziz University 2005).
71 Id.
72 Id.
73 Id. at 96
• *Salam* certificates are issued to investors, and the SPV receives the *sukuk* proceeds;

• The *sukuk* proceeds are passed on to the obligor, who will deliver the commodity in the future;

• On the agreed date, the SPV receives the commodities from the obligor, then the SPV assigns the obligor as an agent to sell the commodities to the end buyers;

• On behalf of the *sukuk* holders, the obligor sells the commodities for a profit; and

• The *sukuk* holders receive the commodity sale proceeds.

*Salam* is used by many midsized corporations for liquidity. However, using it for *sukuk* is still “rare in comparison to some of the more prevalent structures like *sukuk al-ijarah*. The limited use of this structure can be attributed to a number of factors, namely the non-tradability of the *sukuk*. 75 Thus, “secondary market trading of *Salam Sukuk* is considered impermissible on the grounds that the certificates represent a share in the *Salam* debt [receivables,]” 76 which are forbidden according to Islamic scholars. *Salam sukuk* represent the right to receive the commodity in the future, and the right to receive profit by selling the commodity. Because they

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75 CLIFFORD CHANCE LLP, *supra* note 63, at 34.

76 *Id.*
represent debt, AAOIFI specifies in standard number 17, that salam sukuk are not negotiable at all.\textsuperscript{77}

\subsection*{3.4.1.3 Sukuk Istisna}

*Istisna* literally means “commission to manufacture.”\textsuperscript{78} In this contract, “the buyer pays the price either in one or multiple installments, and a liability is established on the manufacturer to deliver [in the future] the object of sale as described in the contract.”\textsuperscript{79} Like salam, in istisna the seller sells a nonexistent product that he will deliver in the future.\textsuperscript{80} There are some differences between istisna and salam. First, “the subject of istisna is always a thing which needs manufacturing, while salam can be effected on anything, no matter whether it needs manufacturing or not.”\textsuperscript{81} Second, “it is necessary for salam that the price is paid in full in advance, while it is not necessary in istisna.”\textsuperscript{82} Finally, “the time of delivery is an essential part of the sale in salam while it is not necessary in istisna that the time of delivery is fixed.”\textsuperscript{83}

\textsuperscript{77} \textit{THE SHARI`AH’S BOARD OF THE ACCOUNTING AND AUDITING ORGANIZATION FOR ISLAMIC FINANCIAL INSTITUTIONS STANDARDS FOR ISLAMIC BANKING} 240 (2010).
\textsuperscript{78} \textsc{Vogel & Hayes}, supra note 9, at 146.
\textsuperscript{79} \textsc{El-Gamal}, supra note 69, at 90.
\textsuperscript{80} \textit{Id.}
\textsuperscript{81} \textsc{Uşmâni}, supra note 62, at 136.
\textsuperscript{82} \textit{Id.}
\textsuperscript{83} \textit{Id.}
In modern Islamic finance, *istikna* is used in “the construction industry, [such as] apartment buildings, hospitals, schools and universities.”\(^8^4\) It is also used in the “development of residential/commercial areas and housing finance schemes”\(^8^5\) and “financing high technology industries such as the aircraft industry, locomotive and shipbuilding industries.”\(^8^6\) *Istisna sukuk* are structured as follows:

The SPV, which is created by the company looking for funds for a project, issues *sukuk* and sells them to investors. The sukuk represents an undivided ownership interest in the asset that will be manufactured or built in the future. *Sukuk* proceeds are used to pay the builder for building and delivering the future project. When the project is done, the SPV leases the project to the end lessor. The end lessor pays monthly installments to the SPV and the returns are distributed among the *Sukuk* holders.\(^8^7\) At the end of the lease, the project will be liquidated and proceeds will be distributed also among the *Sukuk* holders.

Although the *istikna* structure seems ideal for financing manufacturing and construction, “the structure of *sukuk al-istikna* has not been that widely used.”\(^8^8\) The

\(^8^4\) AYUB, *supra* note 61, at 269.
\(^8^5\) Id.
\(^8^6\) Id.
\(^8^8\) CLIFFORD CHANCE LLP, *supra* note 63, at 40.
main reason is “the prevailing view that sukuk al-istsna are not tradable during the construction period.” During the construction period, sukuk represent the right to receive the manufactured item in the future, so it is not allowed to be tradable according to the two Fiqh Academies. Moreover, when the SPV sells the manufactured item to the end buyer, the sukuk are not tradable, because they represent the right to receive the money in the future. Therefore, sukuk istsna are very restricted in terms of negotiability in the secondary market.

3.4.1.4 Sukuk Ijarah

As explained in Chapter 2, in Islamic jurisprudence, ijarah means “to transfer the usufruct of a particular property to another person in exchange for a rent claimed from him.” In Islamic finance, ijarah is “a contract under which a bank buys and leases out an asset or equipment required by its client for a rental fee.” During the period of lease, the lessor (the bank in this case) owns the asset. The structure for issuing sukuk using ijarah is as follows:

- The owner of the asset creates an SPV and sells the assets to the SPV with the understanding that the original owner will lease back the asset from the SPV;

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89 Id.
90 Id.
91 UŞMĀNĪ, supra note 62, at 109.
92 Abbas Mirakhor & Iqbal Zaidi, Profit-and-loss sharing contracts in Islamic finance, in HANDBOOK OF ISLAMIC BANKING 49, 52 (Kabir Hassan & Mervyn Lewis eds., Edward Elgar 2007).
93 Id.
94 SALMAN SYED ALI, ISLAMIC CAPITAL MARKET PRODUCTS: DEVELOPMENTS AND CHALLENGES 30 (Islamic Development Bank 2005).
• The SPV then issues ijara sukuk for sale to investors, which represent an undivided ownership interest in the underlying asset;

• The sukuk sale proceeds provide funds to SPV to pay for the assets purchased from the originator;

• A rent-pass-through structure is adopted by the SPV to pass on the rents collected from the originator-cum-lessee to sukuk holders; and

• The sukuk contract embeds a put option to the sukuk-holders that the originator is ready to buy the sukuk at its face value on maturity or dissolution date.

_Ijarah sukuk_ is the most commonly used sukuk structure. It is preferable for investors in the Middle East and accepted by Shariah scholars.°5 Ijarah sukuk represent actual ownership of the underlying asset (which is not a debt or receivable) from the issuance of the sukuk until the expiration of the lease. According to AAOIFI Shariah standard number 17, _ijarah sukuk_ are negotiable and tradable in the secondary market.°6 This is the reason _ijarah sukuk_ are the most commonly used sukuk by investors in the Middle East. The other kinds of sukuk, such as _murabaha_, _salam_ and _istikna_, are non-tradable.

3.4.1.5 Sukuk Musharakah and Mudarabah

°5 CLIFFORD CHANCE LLP, _supra_ note 63, at 13.

In Islamic finance, *musharakah* is “a joint enterprise in which all the partners share the profit or loss of the joint venture.” In *musharakah*, “partners contribute capital to a project and share its risks and rewards.” Profits are shared between partners on “a pre-agreed ratio, but losses are shared in exact proportion to the capital invested by each party.”

*Mudarabah* is also a partnership. In *mudarabah* some partners contribute capital while other partners manage and prosecute the business without contributing any capital.

In terms of *sukuk* structuring, *musharakah* and *mudarabah* are very similar. The major difference is that in *musharakah*, the asset or project is owned by the *sukuk* holders and the originator. In *mudarabah* the asset or project is owned only by the *sukuk* holders. The originator manages the project without being the owner. The structure of *musharakah sukuk* would be as follows:

- SPV issues *sukuk*, which represents an undivided ownership interest in an underlying asset or project;
- The investors subscribe for *sukuk* and pay the proceeds to SPV;

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98 Mirakhor and Zaidi, *supra* note 66, at 52.
99 *Id.*
101 Mirakhor and Zaidi, *supra* note 92, at 56.
• SPV enters into a *musharakah* arrangement with originator, and the contributions by the SPV and the originator collectively compromise the *musharakah* assets;

• On each periodic distribution date, the SPV and originator shall receive a pre-agreed percentage share of the profits generated by the *musharakah* assets;

• Issuer SPV pays each periodic distribution amount to the investors using the profit it has received from the *musharakah* assets; and

• Upon maturity, any remaining asset would be liquidated and distributed between the SPV and the originator in accordance with the same profit sharing ratios. The SPV then pays such dissolution returns to the investors redeeming the *sukuk* certificates.

*Musharakah* and *mudarabah sukuk* represent actual ownership of an asset or project from the beginning until maturity. *Musharakah sukuk* are tradable and negotiable in the secondary market, according to the AAOIFI Shariah board standard number 17.\(^{103}\) Although *musharakah* and *mudarabah sukuk* are tradable, they are not commonly used because of the disapproval of Islamic scholars,\(^{104}\) who believe Islamic banks did not follow the exact requirements and rules set by the AAOIFI.\(^{105}\)

\(^{103}\) *The Shariah’s Board of the Accounting and Auditing Organization for Islamic Financial Institutions Standards for Islamic Banking* 240 (2010).

\(^{104}\) Clifford Chance LLP, *supra* note 63, at 27.

\(^{105}\) In 2008, the AAOIFI issued a statement criticizing the practice of *musharakah* and *mudarabah sukuk*. It stated that the practice was not in line with Islamic law, because “the credit on the *Sukuk* was based on the credit worthiness of the provider of the purchase undertaking and not the assets underlying the *sukuk*.” Norton Rose (continued…)
Thus, three kinds of *sukuk* are completely non-negotiable: *sukuk murabaha*, *sukuk salam* and *sukuk istisna*. Two kinds of *sukuk* are negotiable, *sukuk musharkah* and *sukuk mudarabah*. However, these are not preferable and there are disputes between bankers and Islamic scholars about them. Only *sukuk ijarah* is both negotiable and preferred by Islamic scholars and investors. The resolution of non-tradability of debt adopted by the two Islamic Fiqh Academies and the AAOIFI is the main reason the secondary *sukuk* market it largely illiquid and limited.

### 3.5. Securitization as an Instrument to Develop Sukuk

Islamic bankers and specialists would like to benefit from the Western financial industry, using its financial instruments if they are compliant with Islamic law. Securitization is one technique that may be useful to make the *sukuk* market more liquid and diverse. Zamir Iqbal writes about liquidity and diversity as “some areas of improvement in the banking and capital market sector”¹⁰⁶ that “need immediate attention….“¹⁰⁷ He says:

> Islamic banks are operating with a limited set of short-term traditional instruments, and there is a shortage of products for medium- to long-term maturities. In other words, the secondary markets lack depth and breadth. An effective portfolio management strategy cannot be

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¹⁰⁷ Id. at 5.
implemented in the absence of liquid markets, as opportunities for diversification become limited. Since the needs of the market regarding liquidity, risk, and portfolio management are not being met, the system is not functioning at its full potential.\textsuperscript{108}

In terms of solutions, Iqbal proposes “offering new products with different risk-return profiles that meet the demand of investors, financial intermediaries, and entrepreneurs for liquidity and safety.”\textsuperscript{109} He suggests that “securitization is a prime candidate”\textsuperscript{110} to achieve that purpose.

Mohammed Albashir, in his book \textit{Global Sukuk and Islamic Securitization Market: Financial Engineering and Product Innovation}, describes this vision:

The AAOIFI \textit{Shariah} board has provided some guidelines to help the industry to adhere to its core objectives and strike a [make a balance between the substance and the form]. From a practical point of view, it is believed that securitization is better placed to help in achieving this objective if it is adopted and adapted to Islamic finance principles. This is supported by the fact that most Islamic finance products are based on asset backing, and the concept of asset securitization is particularly amenable to the basic tenets of Islamic finance. Asset securitization describes the process of issuing certificates of ownership as a pledge against existing or future cash flows from a diversified pool of assets to investors. Thus,
Securitization is highly advocated as the next phase development for the *sukuk* market.\footnote{Muhammad al-Bashir & Muhammad al-Amine, Global Sukūk and Islamic Securitization Market: Financial Engineering and Product Innovation 244 (Koninklijke Brill 2012).}

The question is whether securitization will be “the next phase development for the *sukuk* market….” Most Islamic finance products are based on asset backing.\footnote{There are two kinds of sukuk in this context, asset-backed sukuk and asset based sukuk. In asset-backed sukuk, such sukuk “involve granting the investor (sukuk holder) a share of a tangible asset or business venture. In this structure, there is a true sale transaction, where the originator sells the underlying assets to a (SPV) that holds these assets and issues the sukuk backed by them.” See, What Is the Difference Between Asset-Backed Sukuk and Asset-Based Sukuk?, Investment & Finance, http://investment-and-finance.net/islamic-finance/questions/what-is-the-difference-between-asset-backed-sukuk-and-asset-based-sukuk.html. On the other hand, the asset-based sukuk “the initial sale of the original assets by the originator to the SPV does not take place, so the ownership of assets remains with the originator of the sukuk.” However, “the AAIOFI ((2008 )) standards, state that such asset- based sukuk are not Shariah compliant because there is no transfer of assets to the sukuk holders.” See, Sweder Winbergen & Sajjad Zaheer, Sukuk Defaults: On Distress Resolution in Islamic Finance 7 (2013).}

Securitization may be an appropriate Islamic finance instrument, because it is also based on asset backing.\footnote{Andreas A. Jobst, The Economics of Islamic Finance and Securitization, 13 Journal of Structured Finance, 2007, at 15.} The essential factor of securitization is the asset intended to be securitized.\footnote{Jonathan Lipson defines securitization “as a purchase of primary payment rights by a special purpose entity that (1) legally isolates such payment rights from a bankruptcy (or similar insolvency) estate of the originator, and (2) results, directly or indirectly, in the issuance of securities whose value is determined by the payment rights so purchased.” Jonathan C. Lipson, Re: Defining Securitization, 85 S. Cal. L. Rev. 1229, 1231 (2012).} The most common type of securitization is the securitization of...
receivables\textsuperscript{115} because “it ensures a continuous flow of income to cover the periodic payments on the securitized assets and usually entails the purchasing of a leased asset, a mortgaged property, unsecured commercial loans or credit card payment systems, which are then securitized and sold on the capital market.”\textsuperscript{116} Unfortunately, receivables “are a form of debt”\textsuperscript{117} according to contemporary Islamic scholars. Debt cannot be securitized and traded in the secondary market, pursuant to the resolution of the Fiqh Academy in Makkah and the AAOIFI Shariah standard, which states, “It is permissible to securitize assets, utilities and services, but it is not permissible to securitize debts to be negotiable.”\textsuperscript{118} Thus, mortgages, credit cards, and car loans, which are typical securitized assets,\textsuperscript{119} cannot be securitized and traded.

Theoretically, securitization could be used, if the securitized assets are not receivable. Practically, securitization is linked to assets generating money in the future to “ensure a continuous flow of income to cover the periodic payments on the securitized assets.”\textsuperscript{120} Most of these assets are receivables which cannot be securitized. If Islamic institutions use securitization under the prohibition of trading

\textsuperscript{116} Id.
\textsuperscript{117} Mohammed Obaidullah, Securitization in Islam, in Handbook of Islamic Banking 191, 195 (Kabir Hassan & Mervyn Lewis eds., Edward Elgar 2007).
\textsuperscript{118} Accounting & Auditing Org. for Islamic Fin. Inst., Shariah Standards No. 17, 4-6 (2003).
\textsuperscript{119} Haluk Gurulkan, Islamic Securitization a Legal Approach 62 (The Institute For Law and Finance at Johann Wolfgang Goethe University 2010).
\textsuperscript{120} Balala, supra note 114, at 130.
debts, Islamic securitization will be limited compared to conventional securitization.\footnote{121} Given that debts are not tradable in Islamic finance, securitization will be very difficult. The obstacles facing securitization are more than \textit{sukuk}. The non-tradability of debts in Islamic finance affecting the \textit{sukuk} secondary market affects securitization at the root.

3.6. Conclusion

The non-tradability of debts is not an absolute rule in Islamic law. Traditional Islamic jurisprudence classifies the tradability of debts into several types. Each kind has its own restrictions and provisions. The most important type is the sale of debt for executed consideration. It is permitted by two schools of thought in Islamic law. It should be permitted by the other schools of thoughts if there is only minor \textit{gharar} (uncertainty) associated with the transaction. However, the Islamic Fiqh Academies adopted resolutions prohibiting the tradability of debts in the modern economy. The AAOIFI summarized in a single sentence: “It is permissible to securitize assets, utilities and services, but it is not permissible to securitize debts to be negotiable.” This rule negatively affects Islamic finance in general, and the \textit{sukuk} secondary market in particular.

The next chapter explains why the Islamic Fiqh Academies forbid the tradability of debts. The resolutions on which they base their arguments are clarified, analyzed, and discussed. It argues that the negotiability of debts should be allowed for

\footnote{121} Sam R. Hakim, \textit{Islamic money market instruments}, \textit{HANDBOOK OF ISLAMIC BANKING} 161, 161 (Kabir Hassan & Mervyn Lewis eds., Edward Elgar 2007).
several reasons explained in details within the chapter. Further, it argues that allowing the tradability of debts is consistent with other Islamic rules, such as *riba* and *gharar*, and consistent with traditional Islamic jurisprudence principles and theories.
Chapter 4
Criticizing the Resolutions of Islamic Fiqh Academies
Regarding the Tradability of Debts

4.1. Introduction

The Islamic Fiqh academies in Jeddah and Makkah set an obstacle to the growth and development of Islamic finance by resolving that the tradability of debt and securitization is forbidden, although no text from the Quran and Sunnah forbids it. The first section of this chapter explains how Islamic jurisprudence recognizes debts through two fundamental theories: property and rights in Islamic jurisprudence. The resolutions will be evaluated to determine the extent to which they are compliant with Islamic jurisprudence.

The second section analyzes the arguments of the Fiqh Academies. The Islamic Fiqh Academies forbid trading debt by applying riba in sales and gharar rules. An analysis of the Academies’ arguments for applying the riba rule shows it is not applicable. Major gharar and minor gharar are distinguished. Only major gharar is prohibited in Islamic law. There is no reason to forbid debt trading that involves minor gharar, based on Islamic law.

The third section clarifies the legal basis for permitting the trading of debts in Islamic law. Trading debt is permissible in Islamic law based on three methodologies: istishab (presumption of continuity), qiyas (analogical reasoning), and maslahah mursalah (general benefit). This section explains how applying these methodologies would permit trades of debt in Islamic finance. This chapter argues that permitting the
tradability of debt is consistent with Islamic jurisprudence principles, fundamentals, rules, and concepts.

4.2. The Theoretical Foundation of Debt in Islamic Jurisprudence

4.2.1 Property Theory in Islamic Jurisprudence

The concept of property is “an essential building block of Islamic contract law.”¹ Only things that are considered property may be traded in Islamic law.² The Arabic word for property (mal) is mentioned many times in the Quran and Sunnah without a definition. In Islamic jurisprudence, “the concept of mal is left wide open on the basis of people’s customs and usages.”³ After Islamic schools of law emerged, Islamic scholars contributed to the evolution of Islamic contract law by defining the meaning of mal.

There are two conceptions of mal: The Hanafi school and the majority (Maliki, Shafi, and Hanbali).⁴ The Hanafi school defines mal as “non-human things, created for the interest of human beings, capable of possession and transaction therein by free will.”⁵ The most critical element of this definition is “capable of possession.” The Hanafi school requires that “mal be physically possessable and preservable.”⁶ This requirement excludes anything that cannot be physically possessed. Therefore,

² Id.
⁴ Islam, supra note 3, at 363.
⁵ Id.
⁶ Vogel & Hayes, supra note 1, at 94.
“all usufructs, debts, mere rights such as the right to development, the right of pre-
emption, the right to water, etc., are not considered as mal.” 7 The Hanafi school
considers only tangible things as mal. Therefore, only tangible things are tradable.

The majority of Islamic schools adopt a different approach. Physical
possession is not essential to their conception of mal.8 The majority defines mal as
“[a] thing on which ownership is conferred and the owner when he assumes it
excludes others from interference . . . .”9 Additionally, mal has some kind of benefit.10
Hence, the two requirements for mal are excluding others from interference and
benefit. The majority does not require mal to be “physically possessable and
preservable.”11 As a result, the majority’s conception of mal includes both tangible
and intangible things.

There is debate between Hanafi and the majority about whether usufructs and
rights are mal. In Islamic jurisprudence, usufructs are “the benefits taken out of
material things by way of their utilization which are ostensible, such as residing in a
house, riding in a car, the wearing of a cloth and the work of an employee.”12 Rights
in Islamic jurisprudence are “what the law recognizes for an individual to enable him
to exercise a certain authority or bind others to perform something in relation to

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7 Islam, supra note 3, at 363.
8 Abdullah Almousa, The Sale of Rights in Islamic Jurisprudence, 45 JUSTICE J. SAUDI
   ARABIA 170, 188 (2010).
9 Islam, supra note 3, at 365.
10 Id. at 364.
11 VOGEL & HAYES, supra note 1, at 94.
12 Islam, supra note 3, at 366.
him.” As explained above, “the Hanafi school recognizes property only in material things which have tangible substance or corpus.” The Hanafi school does not recognize usufructs and rights as mal because they cannot be physically possessed. In contrast, the majority recognizes usufructs and rights as mal. The majority definition does not require physical possession.

The groups also differ on whether debt is mal. Since the Hanafi school requires physical possession, they do not consider debt as mal. The majority believes that debt is mal, like all other rights. This disagreement on the definition of mal has affected many other legal issues. One of these issues is the tradability of debts.

4.2.1.1. Islamic Fiqh Academy views on property

In 1988, the Islamic Fiqh Academy in Jeddah adopted an important resolution regarding several kinds of financial rights. The academy resolved that business names, corporate names, trademarks, literary productions, and copyrights are tradable pursuant to Islamic law. This resolution has been the cornerstone for modern business in Islamic countries. These rights did not exist before and the position of Islamic scholars was unclear. The academy cleared up any confusion, saying, “Business

13 Id.
14 Id.
15 Almousa, supra note 8, at 188
16 OSAMAH ALLAHIM, THE SALE OF DEBT AND ITS APPLICATIONS IN CONTEMPORARY LIFE
1/88 (2012).
17 Id. at 1/87.
name, corporate name, trade mark, literary production, invention or discovery, are rights belonging to their holders and . . . can be traded.”

In 1986, the Islamic Fiqh Academy in Makkah resolved an important issue regarding copyrights and patents. The academy concluded, “the conditions have changed with the change of time, and there is great difference between then and now, [so] these conditions require new look [sic] that safeguards the right of every person who makes an endeavor.” As a result, “it is necessary that author or inventor has a right to what he has authored or invented and this right is his legal ownership, and nobody is allowed to take this ownership without his permission.” The Academy emphasized the differences between the past and the present. The newly established provisions were not recognized by earlier Islamic scholars.

The arguments used to permit the trading of these rights are significant. First, “[b]usiness name, corporate name, trademark, literary production, invention or discovery, are rights belonging to their holders and have, in contemporary times, financial value which can be traded. These rights are recognized by Shariah and should not be infringed. Second: It is permitted to sell a business name, corporate name, or trademark for a price in the absence of any fraud, swindling or forgery, since it has become a financial right.”

18 Islamic Fiqh Academy (Jeddah), Resolutions and Recommendations of the Council of Islamic Fiqh Academy 89 (1st ed. 2000) (“First: Business name, corporate name, trade mark, literary production, invention or discovery, are rights belonging to their holders and have, in contemporary times, financial value which can be traded. These rights are recognized by Shariah and should not be infringed. Second: It is permitted to sell a business name, corporate name, or trademark for a price in the absence of any fraud, swindling or forgery, since it has become a financial right.”).

19 Islamic Fiqhouncil (Makkah), Resolutions of the of Islamic Fiqh Council Makkah 244 (2006) (The academy noted how much the situation involving these issues has changed, “The transcriber used to spend years in transcribing a large book in order to produce a copy, . . . . after the advent of the printing press, the issue has become totally different. The author may spend most of his life in writing a useful book and publish it in order to sell it, then another person takes a copy of this book and publishes it by copying [and] the same thing can be said about the inventor.”).

20 Id. at 245.

21 Id.
discovery, are rights belonging to their holders.” These rights are property and therefore tradable. Second, these rights have “financial value” that did not exist in the past. If people consider a thing valuable, then it is tradable in Islamic jurisprudence, even if the thing had no value before. This two-part argument establishes financial rights which can be traded and sold pursuant to Islamic Fiqh Academies.

Given these two resolutions, the two Fiqh academies support the position of the majority conception of mal (property). They believe mal is not limited to physical possession, as the Hanafi school believes. Mal includes things that have financial value, even if they cannot be physically possessed. Usufructs and rights have financial value, so they are mal. However, one right in Islamic jurisprudence is debt.

4.2.2 Rights and Obligations Theory in Islamic Jurisprudence

The rights and obligations theory is fundamental in Islamic jurisprudence. Most Islamic jurisprudence literature explains and analyzes the rights and obligations in Islamic law. Traditional Islamic jurisprudence is classified according to sources of rights and obligations. Islamic scholars explain each legal provision in each source and discuss the opinions of other schools of law if they adopt different provisions. Contemporary Islamic scholars write about the rights and obligations theory as an introduction to Islamic jurisprudence literature.

22 ISLAMIC FIQH ACADEMY (JEDDAH), supra note 18, at 89.
24 Id. at 10.
Islamic law is a religious law at its core. Islamic scholars divide rights into two major parts: God’s rights and people’s rights. They discuss the provisions and rules that control and regulate God’s rights, such as praying, fasting, and pilgrimaging. Muslims must fulfill these obligations for the satisfaction of God. The people’s rights are the rights that people owe each other, such as contractual rights, marriage rights, etc. The people’s rights are a big part of Islamic jurisprudence. Many texts from the Quran and Sunna regulate God’s right. This is not the case with people’s rights. Thus, there is more room for personal reasoning (ijtihad) with respect to people’s rights.

People’s rights in Islamic jurisprudence are classified into two kinds: property rights and non-property rights. Property rights are those related to property, such as contractual rights, lease rights, etc. Generally, they can be traded. Non-property rights are not related to property, such as marriage rights, custody rights, alimony rights, etc. These cannot be traded. Describing property rights as tradable and non-property rights as non-tradable is a generality. There is debate among Islamic scholars as to the details in each provision.

25 Almousa, supra note 8, at 178
26 Id.
27 Id.
28 ALZARQA, supra note 23, at 25.
29 Almousa, supra note 8, at 178.
30 Id. at 179.
Property rights in Islamic jurisprudence are also divided into two kinds: real rights and personal rights.\textsuperscript{31} Real rights are related to things, such as ownership rights and collateral rights.\textsuperscript{32} Personal rights are related to people, such as right to the delivery of goods in a sales contract.\textsuperscript{33} Real and personal rights are often combined when performing business transactions.\textsuperscript{34} Islamic jurisprudence distinguishes between real rights and personal rights because each category has its own legal provisions. Personal rights are called obligations in Islamic jurisprudence. When Islamic scholars mention the obligations theory, they mean the personal rights theory.\textsuperscript{35}

\begin{itemize}
\item \textsuperscript{31} ABDULRAZZAQ ALSANHOURI, RIGHTS SOURCES IN ISLAMIC JURISPRUDENCE 12 (1954).
\item \textsuperscript{32} Almousa, supra note 8, at 179.
\item \textsuperscript{33} ALZARQA, supra note 23, at 26.
\item \textsuperscript{34} Id.
\item \textsuperscript{35} Id. at 61.
\end{itemize}
Obligations in Islamic jurisprudence are divided into four categories. The first category is the obligation to deliver fungible property (money or goods). This category is called *dayn*, which literally means debt. The second category is the obligation to deliver a “specific existing thing” (this particular horse or this particular car). This category is called *ayn*. The third category is the obligation to deliver services (under this category, Islamic scholars discuss labor rules). The fourth category is the obligation to refrain from doing something. The first category, *dayn* or debt, is the central subject of this thesis. As explained previously, Islamic jurisprudence considers debt a personal right to receive any fungible property (money or goods) that must be delivered in the future. How does Islamic jurisprudence deal with the tradability of debt in this broad meaning?

**Trading debts (personal property rights) in Islamic jurisprudence**

Chapter 3 explained the position of Islamic scholars regarding the tradability of debts. This chapter focuses on their position regarding selling debts for executed consideration to a third party because it is the scope of this dissertation. The Hanafi School completely prohibits that transaction. According to them, debt is not property, so it cannot be sold. The Maliki and Shafi schools permit the sale of debt for executed consideration to a third party. This is consistent with their conception of debt as

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37 *Id.*
38 VOGEL & HAYES, *supra* note 1, at 94.
40 *Id.* at 85.
41 *Id.*
property. The Hanbali School agrees that debt is property. However, Hanbali prohibits the sale of debt for executed consideration to a third party. They are concerned about the uncertainty (gharar) associated with the transaction. They do not have a concern with the transaction itself.

The two Fiqh academies support the majority conception of mal (physical possession is not required) and recognize rights as an independent kind of property. Thus, they resolved that “business name, corporate name, trademark, literary production, invention or discovery, are rights belonging to their holder” and they are tradable because these rights are property. Nevertheless, the two Fiqh Academies forbid trading debt although they consider debts as personal rights. The question is why do they prohibit trading debt and securitizing receivable while they permit trading other kinds of rights? The next section clarifies their argument.

4.3 The arguments of the Islamic Fiqh Academies to forbid trading debt (explanation and discussion)

As stated in Chapter 2, Islamic finance is “a prohibition-driven industry.” Islamic Law determines what is prohibited in finance and business. Legal issues not prohibited by Islamic law are permitted. In Islamic finance, there are two main principles which Islamic finance tractions must avoid in order to be permissible: riba (usury) and gharar (uncertainty). There is no text from the Quran or Sunnah that

42 Islamic Fiqh Academy (Jeddah), supra note 18, at 89.
forbids selling debt to a third party. The arguments used by the Islamic Fiqh Academies to adopt the prohibition are based on riba and gharar.

This section explains the Islamic Fiqh Academy arguments to forbid the sale of debt to a third party and how they apply the rules of riba and gharar to trading debt. Their arguments are analyzed to determine whether they are consistent with Islamic jurisprudence theories. This section does not criticize the rule of riba or gharar. They are clearly stated in the Quran and Sunnah. This section merely criticizes the application of these rules to trading debt.

4.3.1 Riba and the tradability of debts

*Riba* is a terrible sin in Islamic law. Most Islamic finance provisions are based on avoiding riba. Most westerners think that riba is simply charging interest on loans. This is incorrect. There are two kinds of riba in Islamic law: riba in loans (interest) and riba in sales (like for like). The Islamic Fiqh Academies forbid the sale of debts representing money to a third part by applying the rule of riba in sales.

The Islamic Fiqh Academy in Jeddah states, “It is not permissible to sell a deferred debt by the non-debtor for a prompt cash, from its type or otherwise, because this results in riba (usury).” The Islamic Fiqh Academy in Makkah states, “It is not permissible to securitize debt into securities that may be circulated in secondary

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44 See page 33.

market . . .” because “it constitutes a sale of debt to a person other than the debtor in a way that includes riba (usury).”\(^{46}\)

According to the riba in sales rule, in any sale transaction, if the exchanged considerations are within a single type, they must be equal. If they are not, it is riba and prohibited.\(^{47}\) So, if the exchanged considerations are gold or dollars, then they must be equal and delivered at the same time. If the exchanged considerations are different, gold for dates or money for cars, then no riba rule applies. For example, A owes B $1000. B sells the debt to C for $800 cash. The Islamic Fiqh Academies assert that in selling debt for money, the considerations are a single type based on the following three arguments.

### 4.3.1.1 Debts do not have actual existence

**Explanation**

Some Islamic scholars do not differentiate between debt itself (right to receive money or goods) and what that the debt represents (money or goods), although they do theoretically.\(^{48}\) If the debt represents money, it is dealt with as if it is money not a right to receive money in future. If the debt represents food, it is dealt with as if it is food not a right to receive food in the future. For example, A owes B 1000 kg of dates; the value of the dates is $1000. B sells the debt to C for $800 cash. This

\(^{46}\) The Muslim World League in Makkah, at http://www.mwl-en.com/2012/05/23/resolutions-of-the-islamic-fiqh-council-16th-session-1422h/.

\(^{47}\) See page 35.

\(^{48}\) Theoretically, they believe that debt is an obligation. In practice, they ignore the independency of debt, just like the Islamic Fiqh Academy in Jeddah, which forbids the trading of debt if the debt represents money and the consideration is cash. See page
transaction would be allowed according to them. If B sold the debt for 800 kg of dates ($800 value), that would be prohibited according to them. Their argument is in the first transaction the considerations are different but in the second transaction the considerations are within a single type. The same concept is applied to debt that represent money. A owes B $1000. B sells the debt to C for $800 cash. This transaction would be prohibited. If B sells the debt for 800 kg of dates ($800 value) that would be permitted. They ignore that debts are rights to receive (things) in the future and deal with debts as they deal with the subject of the debt directly. Thus, according to them, in trading debts, the creditor who sells the debt for money is selling money that the creditor will receive in the future for money he receives now. Essentially, these schools believe that the creditor sells money for money, which is prohibited according to the *riba* in sales rule.

Why do some Islamic scholars ignore the nature of debt as a personal right and deal directly with the subject of the debt that will be received in the future? These Islamic scholars argue that there is no actual existence for the debt itself. In reality, the value of the debt comes from the money that will be paid in the future, not from the debt itself.⁴⁹ In other words, the value of debt is completely dependent on the money that will be paid in the future.⁵⁰ Debt should be considered money because the two are inseparable. Therefore, the sale of debt to a third party for money should be

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⁴⁹ IBN HAZM, ALMOHALLA 7/452; ALLAHIM, supra note 16, at 1/351.
⁵⁰ *Id.*
recognized as money for money, which is prohibited according to the *riba* in sales rule.

**Discussion**

1. Again, Islamic scholars argue that there is no actual existence for the debt itself. What is actual existence? There are two explanations and each explanation should be discussed. First, if actual existence means physically exist, these Islamic scholars are right. Debt does not physically exist. However, the majority of Islamic schools do not require physical possession for something to be considered mal.\(^{51}\) Intangible assets, such as rights and debts, are recognized as mal and can be traded. The Islamic Fiqh Academies have confirmed that position and consider modern rights, such as business name, corporate name and trade mark, to be *mal*. The Hanfai School argues that debt does not have actual existence since the Hanafi School requires physical possession. However, it is illogical for other Islamic scholars, who do not require physical possession, to adopt the same argument. Since the majority of Islamic schools do not require physical possession, debt is considered mal. It is a personal property right and an intangible asset. It is different from cash, which is considered a tangible asset.\(^{52}\)

\(^{51}\) *See* page 87.

\(^{52}\) FASB Accounting Standards Codification, 305-310 (In the modern economy, financials deal with debt and receivables as independent kinds of assets, which are different from money. Therefore, in any financial statement, the account receivable is independent from the money account and both of them are assets. When a company wants to sell account receivables, financial banks treat the account differently from the money that the company owns.).
Second, if actual existence means abstract existence, this is wrong. According to the obligations theory in Islamic jurisprudence, debt has actual abstract existence and is considered a personal right.\textsuperscript{53} For example, in a sales contract, A sells a car to B for $100,000. They agree that A will deliver the car at the time of the contract and B promises to pay the money after one year. In this contract, two obligations are created. Under the first obligation, A must deliver the car and transfer title to B. Under the second obligation, B must pay A, but performance is deferred for one year. This obligation is a debt created by a contract called a credit sale. A owns the debt after finalizing the contract, not the money. The sales contract is legally binding and a new legal relationship is created between the debtor (B) and the creditor (A). The debtor must pay the money after one year and the creditor is entitled to receive the money after one year.\textsuperscript{54}

In short, actual existence is not a requirement for a thing to be tradable according the three schools of legal thought and the two Fiqh Academies. Also, according to the obligations theory in Islamic jurisprudence, debt has legal abstract existence and is considered a personal property right.

2. This group of Islamic scholars argues that debt is completely dependent on the money itself. That does not mean the debt and the money have the same provisions. Debt depends on other factors, such time and the solvency of the debtor. These

\textsuperscript{53} See page 90.

\textsuperscript{54} MAHA-HANAAN BALALA, ISLAMIC FINANCE AND LAW: THEORY AND PRACTICE IN A GLOBALIZED WORLD 99 (Tauris Academic Studies 2011) (2010).
combined factors make debt different from money. Islamic jurisprudence deals with
debts and money differently. If someone owns money, the relationship between the
owner and the money is considered a real right. The owner can do whatever he wants
with the money. In the relationship involving debt, there is no direct relationship
between the creditor and the money. The debtor is in the middle. The debtor has the
responsibility to pay the money in the future. That makes a significant difference
between debt, as personal right, and money, as a real right, in Islamic jurisprudence.

Two examples will illustrate this difference. In our first example, A purchases
1000 kg dates from B. A receives the dates, but does not have storage. A stores his
dates in B’s storage. A fire burns B’s storage, including A’s dates. Thus, A loses his
dates and cannot ask B for a replacement if there is not neglect from B.\(^{55}\) In our
second example, A purchases 1000 kg of dates from B, to be delivered after one year.
The fire burns B’s storage, including the dates owed to A. B still owes 1000 kg of
dates to A.\(^{56}\) In the first case, A had a direct relationship to the dates, but in the
second case A had a relationship with B, not with the dates.

Another example may be helpful. A company owes A $1,000,000. The
company also owes B $1,000,000. The company bankrupts and has only $1,000,000.
Neither A nor B can claim all of the remaining cash. They must share the remaining
cash based on the share they deserve, pursuant to Islamic jurisprudence.\(^{57}\) Neither A

\(^{55}\) Alzarqa, supra note 23, at 36.
\(^{56}\) Id.
\(^{57}\) Alzarqa, supra note 23, at 34.
nor B as creditors have a direct relationship to the cash owned by the company. A and B merely own debts.

Therefore, Islamic jurisprudence deals differently with the debt (as a right) and the subject of the debt that will be received in the future. Accordingly, in trading debt, the sale of debts for money is different from the sale of money for money. If they are different, different provisions of law should apply.

4.3.1.2. Debt is equivalent to money

Explanation

The difference between this argument and the previous one is that the previous one ignores the independence of debt and deals with the debt as if it is money not a right to receive the money. On the other hand, this argument acknowledges that the debt is different from the money and considers the debt as a right to receive the money, not the money itself. However, although these scholars acknowledges that debt is different from money, they argue that “debt is equivalent to money, thus a transaction of debt for money is equivalent to a transaction of money for money, attaching all the *riba* rules pertaining to the exchange of money for money.”

These scholars argue that debt is equivalent to money based on two premises. First, “money and debt are conceptually equivalent and, therefore, a right to receive money is conceptually equivalent to money.” This argument is similar to the previous one, but they try to express it in a way that acknowledges the independence

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58 BALALA, *supra* note 54, at 102.
59 *Id.*
of debt, and gives debt the same legal characteristics as money. The second premise is “money and debt are equivalent in value…. “60 The value of 1000 kg of dates received after one year is equivalent to 1000 kg of dates received now. Also, a $1,000 debt due a year from now is worth $1,000 in cash now. In short, these scholars argue that money and debt are conceptually equivalent and have the same value. The sale of debt for money is equivalent to the sale of money for money. As a result, the riba in sales rule should be applied, which results in the prohibition of the transaction.61

Discussion

1. The Nature of Money is Different from the Nature of Debt

Understanding the nature of money is critical to deciding whether debts are equivalent to money. The hadith that forbids riba in sales mentions only six kinds of riba.62 None of them is money. Two of them are gold and silver. Using the qiyas methodology, Islamic scholars extend the rule to any kind of money, because it has the same cause and effect as gold and silver.63 The concept of money is not determined by the Quran and hadith. Islamic scholars must rely on how specialists determine and define money, then they apply the riba in sales rule. Money is defined differently by economists and lawyers.

60 Id.
61 Id.
62 See page 35.
63 VOGEL & HAYES, supra note 1, at 75.
Economically, money is “a medium of exchange, a unit of account, and a store of value.”64 These three functions together distinguish money from other assets in the economy, such as stocks, bonds, real estate [and] art.65 First, money is a medium of exchange, which “is an item that buyers give to sellers when they purchase goods and services.”66 If a buyer purchases an asset, he is confident that the seller will accept money.67 Therefore, “to qualify as money, [it] must be the universal means of exchange…”68 This function “excludes bills of exchange, Treasury bills, straps, postal orders, gold bars, etc., which are objects of purchase and sale and not in universal use as a medium of exchange.”69

Second, money is a unit of account. This means it “is the yardstick people use to post prices.”70 For example, if someone wants to compare the cost between two cars, he will use money to make the comparison. Thus, “when we want to measure and record economic value, we use money as the unit of account.”71 This function of money excludes other kinds of assets, such as bonds, stocks, and debts. These other

64 N. GREGORY MANKIW, PRINCIPLES OF ECONOMICS 628 (3rd ed. 2004).
65 Id.
66 Id. at 629.
67 Id.
68 Universal in one jurisdiction.
69 ROYSTON MILES GOODE & CENTRE FOR COMMERCIAL LAW STUDIES, PAYMENT OBLIGATIONS IN COMMERCIAL AND FINANCIAL TRANSACTIONS 3 (1983).
70 Id.
71 MANKIW, supra note 64, at 629.
72 Id.
kinds of assets are not used as units of account. Their economic values are measured by money.

Third, money is a store of value. It “is an item that people can use to transfer purchasing power from the present to the future.” For example, someone sells goods or services and receives money in exchange. He can use this money to buy any kinds of goods now or in the future. However, “money is not the only store of value in the economy.” Any person “can also transfer purchasing power from the present to the future by holding other assets.”

Legally, money is defined as “all chattels which, issued by the authority of the law and denominated with reference to a unit of account, are meant to serve as universal means of exchange in the State of issue.” The legal definition includes two of the functions emphasized by economists: a medium of exchange and a unit of account. However, the legal definition includes other important characteristics. According to the legal definition, “to qualify as money, a coin or note must be issued by or under the authority of the State.” Moreover, the note or coin “must show on its face the amount for which it is effective in law to discharge an obligation” and that “means that when used as currency they are valued in law at their face value, not their

73 Id.
74 Id.
75 Id.
77 GOODE AND CENTRE FOR COMMERCIAL LAW STUDIES, supra note 69, at 2.
78 Id.
intrinsic worth.”\textsuperscript{79} These two additional legal characteristics, issuance and value, exclude other kinds of assets not issued by the state, and their values are determined by the market.\textsuperscript{80}

Economically and legally, the nature of money is different from the nature of debt. Economically, debt is not a medium of exchange or a unit of account. These two functions are critical to the differences between money and other assets. Because debts do not have these functions, they are not equivalent to money. Legally, while debt may be issued by the state, it is not the universal means of exchange. Furthermore, debt value is not determined by the state as is with cash. Debt is not the universal means of exchange and its value is not determined by the state, so it is not equivalent to money.

2. The Value of Money is Different from the Value of Debt

Some Islamic scholars assert that the value of debt has the same value as money (or any property) that will be received in the future. They ignore an important component of any credit transaction, which is time value. Time value means a “dollar paid in the future is worth less than a dollar today.”\textsuperscript{81} Thus, to “make an investment is

\textsuperscript{79} Id.

\textsuperscript{80} Between 1835 and 1866, private banks in the USA used to issue currencies traded among the people. The period is called Free-banking Era. However, the National Bank Act of 1863 ended that era and granted the authority of issuing currencies nationally to the federal government. See Banking Without Regulation : The Freeman : Foundation for Economic Education, , http://fee.org/the_freeman/detail/banking-without-regulation.

\textsuperscript{81} WILLIAM J. CARNEY, CORPORATE FINANCE: PRINCIPLES AND PRACTICE 38 (2nd ed. 2010).
to part with money today in exchange for a return payment (or series of payments) in
the future.” 82 In other words, “cash in hand (liquidity) is worth ... more than the right
to be paid the same amount in the future.” 83 Thus, “the translation of the future value
into present value” is called the valuation process. 84 Because some people prefer
present consumption to future consumption, “future values need to be discounted to
make them comparable with present values ...” 85 This is called discounting. 86 Time
value, valuation, and discounting are considered when determining the value of debt.

In Islamic finance, as well as conventional finance, “the time value of money
in economic and financial transactions is recognized.” 87 So, “in a trade transaction, if
the payment of price is deferred, the time value of money will be included in the price
of the commodity.” 88 Also, “in a leasing contract, time value is an integral part of the
rent that parties agree upon.” 89 Time value was also recognized by the prophet

82 Id.
83 Balala, supra note 54, at 102.
84 CARNEY, supra note 81, at 38.
85 Fahim Khan, Time Value of Money and Discounting in Islamic Perspective, 1 REV. OF
86 CARNEY, supra note 81, at 38.
87 Fahim Khan, Islamic methods for government borrowing and monetary management,
HANDBOOK OF ISLAMIC BANKING 285, 295 (Kabir Hassan & Mervyn Lewis eds., Edward
Elgar 2007).
88 Id.
89 Id.
Mohammed himself. Particularly, the prophet Mohammed exercised the discounting concept in _salam_ contracts.\(^{90}\)

_Salam_ is a sale where “the seller undertakes to supply some specific goods to the buyer at a future date in exchange for an advanced price fully paid at spot.”\(^{91}\) Thus, “the price is cash, but the supply of the purchased goods is deferred.”\(^{92}\) _Salam_ is “beneficial to the seller, because he received the price in advance.”\(^{93}\) Further, it is “beneficial to the buyer also, because normally, the price in _salam_ used to be lower than the price in spot sales.”\(^{94}\)

Credit sales, _bay al mo’ajal_, are permissible in Islamic law.\(^{95}\) In these transactions, the seller delivers the goods immediately. The buyer defers payment. The payment is higher than paying “in spot”, because of the time value. As explained in chapter two, most Islamic banking finance is based on _murabaha_ finance. _Murabaha_ finance is built substantively on time value. Islamic banks profit from the value differences between purchasing goods in spot and selling them to customers on credit. Accordingly, “Islam does have a concept of time preference.”\(^{96}\)

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\(^{90}\) MUHammad Taqi Usmani, _An Introduction to Islamic Finance_ 129 (Kluwer Law International 2002).

\(^{91}\) *Id.* at 128.

\(^{92}\) *Id.*

\(^{93}\) *Id.* at 129.

\(^{94}\) *Id.*


\(^{96}\) Khan, _supra_ note 85, at 299.
In modern Islamic finance, “there is no independent Islamic benchmark available to be used for pricing Islamic financial instruments, particularly for pricing the sukuk.”

However, time value, and the valuation process is recognized in Islamic finance as well as conventional finance. Conventional finance has a well established process to evaluate this component, “LIBOR is being mostly used as a reference point for pricing these [sukuk].” LIBOR is used as a benchmark for sukuk if such sukuk will be traded internationally. If the sukuk will be traded nationally, the interest rate of the local national bank “serves as a benchmark for the government’s Islamic securities issued at the national level.”

In conclusion, the value of a debt or a receivable is different from money paid in spot because of the time value. Because of time value, the value of receivables is discounted to be less than its face value. Time value and discounting are recognized by conventional finance and Islamic finance. Islamic finance institutions rely on the interest rate (such as Libor) to evaluate Islamic instruments, such as sukuk. Debt is not equivalent to money conceptually or in value. Therefore, the riba in sales rule should not apply to the sale of debts for money.

4.3.1.3. The transaction in general is equivalent to riba transaction

97 Id.

98 LIBOR (London Interbank Offered Rate) is “a benchmark rate that some of the world’s leading banks charge each other for short-term loans. LIBOR is administered by the ICE Benchmark Administration (IBA).” See London Interbank Offered Rate (LIBOR) Definition, INVESTOPEDIA, http://www.investopedia.com/terms/l/libor.asp.

99 Khan, supra note 85, at 299.

100 Id.
Explanation

Some Islamic scholars argue that the general sale of a debt transaction is equivalent to a *riba* transaction because they have the same result. Both exchange money for money with unequal amounts.\(^{101}\) For example, A owes B $1000 due after one year. B sells the debt to C for $800 cash. After one year, C will receive $1000 in exchange for the $800 that he paid to B. In a *riba* in sales transaction, two considerations of the same kind (gold for gold or silver for silver) are exchanged for different amounts ($1000 for $800). Of course, this is prohibited in Islamic law. Thus, they argue, the same rule should be applied to the sale of debt for money because they have the same result.

The difference between this argument and the previous one, is that these Islamic scholars acknowledge that debt is independent from money, and not equivalent to it. They do not focus on the transaction itself, but on the result of the transaction. Since they have the same result, money for money with the different amounts, the same provision (prohibition) should apply.

Discussion

In this section, the contracts bai al-inah, *tawarruq*, and *murabaha* will be analyzed to determine whether they are *riba*. In bai al inah (sale and buy back), the financier sells goods (which already owned by him) to a client as a credit sale and, at the same time, buys back the goods from the client at a cheaper price.\(^{102}\) The goods


are not the real subject of the transaction. The purpose of the transaction is for the 
client to get cash in a way that avoids *riba*. The majority of Islamic schools forbid bai 
al-inah because it is very similar to *riba* and has the same result.\textsuperscript{103} At the end of 
transaction, the financier pays money to the client, and the client owes the financier 
more than he paid.

The majority of Islamic schools have developed the tawarruq transaction as 
an alternative to facilitate financing without using *riba* or bai al-inah. The term 
tawarruq “is derived from the word al-warq … .”\textsuperscript{104} Al-warq means derham, the 
silver coins of the Islamic empire.\textsuperscript{105} Technically, tawarruq is “the purchasing of a 
commodity on credit by the *mutawarriq* (seeker of cash) and selling it to a person 
other than the initial seller (third party) for a lower price on cash.”\textsuperscript{106} The majority of 
Islamic schools permit a tawarruq transaction. The Islamic Fiqh Academy in Makkah 
confirmed that tawarruq is permitted.\textsuperscript{107} It is not like *riba* because there are three 
parties in this transaction: the mutawarriq, the seller, and the purchaser. The 
mutawarriq buys goods from the seller on credit. Then the mutawarriq sells the goods 
to the purchaser and receives cash. According to the majority of Islamic schools, the

\begin{footnotesize}
\begin{itemize}
  \item \textsuperscript{103} *Id.*
  \item \textsuperscript{104} IMAN MIHAJAT, THE REAL *TAWARRUQ CONCEPT* ISLAMIC ECONOMIC FORUM FOR 
    INDOONESIAN DEVELOPMENT (ISEFID) 5 (2009).
  \item \textsuperscript{105} *Id.*
  \item \textsuperscript{106} *Id.*
  \item \textsuperscript{107} ISLAMIC FIQH COUNCIL (MAKKAH), *supra* note 19, at 395.
\end{itemize}
\end{footnotesize}
transaction is different from *riba*, because the source of cash is different from the creditor.\textsuperscript{108}

The concept of *tawarruq* has been altered to create *murabaha* financing, with the bank acting as the manager of finance. As explained in chapter 2, *murabaha* is the most popular Islamic financial instrument. In a *murabaha* contract, “the bank agrees to buy an asset or goods from a third party [based on the market price], and then resells the goods to its client with a mark-up.”\textsuperscript{109} If the client needs cash, not goods, the bank sells the goods on behalf of the client to a third party based on the market price (without the mark-up). Then the bank receives the cash and transfers it to the client. The difference between *tawarruq* and *murabaha* is that in *tawarruq* the person who needs cash purchases and sells the goods himself. In *murabaha*, the bank purchases the goods and resells them to the client. Then the bank resells the goods on behalf of the client to a third party. These complex transactions are implemented within a few hours. The client does not leave the bank office until all *murabaha* components are finished. At the end of the transaction, he will leave the bank with cash and an obligation to pay to the bank more than what he received. He receives cash equal to the market price but he owes the bank the market price plus the markup. Nevertheless, the *murabaha* transaction is permitted according to the majority of Islamic scholars. The Islamic Fiqh Academy in Jeddah issued a resolution in 1988 to

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\textsuperscript{108} *Id.*

confirm that the murabaha transaction is permissible. They argue that a murabaha transaction is a real sale contract with multiple parties. Unlike riba and bai al-inah, the client receives the cash from a third party, not the bank. Thus, the source of cash is different from the creditor.

The main difference between bay al-inah on the one hand and tawarruq and murabaha is whether the source of the cash is the same party as the creditor. Bai al-inah is forbidden according to the majority because the financier is the source of cash and also the creditor. So the sales contract is equivalent and has the same result as a riba contract. On the other hand, tawarruq and murabaha are allowed because the source of cash is different from the creditor. The result of these two transactions is distinct from the result of a riba transaction. So, according to the majority of Islamic scholars and the two Fiqh Academies, there is no reason to forbid them.

The argument used to permit tawarruq and murabaha can also be applied to the sale of debts and receivables. In the sale of debt, there could be three parties and the source of money be different from the creditor. For example, A sells a car to B for $100,000 due after one year. Then, A sells the debt to C for $90,000. C waits one year and receives $100,000 from B. A is the creditor, B is the debtor, and C is the third party. The creditor delivers goods or services on credit to the debtor. The creditor sells the debt to a third party. The third party will wait until the due date and receives money from the debtor. In each relationship (creditor and debtor, creditor and third

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110 Islamic Fiqh Academy (Jeddah), supra note 18, at 86.
111 Id.
112 Islamic Fiqh Council (Makkah), supra note 19, at 395.
party, debtor and third party), none of the parties receives money from the same party he pays money to. So, the result of the sale of debt is different from riba because in each relationship the source of cash is not the creditor. Therefore, the sale of debt should be permissible, because the argument for tawarruq and murabaha should also be applied to the sale of debt.

4.3.2 Gharar (Uncertainty or Speculative Risk)

Explanation

Some Islamic scholars try to forbid trading debt using gharar (uncertainty or risk). Gharar, the second major principle in Islamic finance, is forbidden by Sunnah. The Sunnah does not provide any definition or explanation of gharar. Islamic schools, however, have set a general rule for gharar in financial transactions. There are four conditions that must be present to apply the gharar rule. First, the gharar must be excessive. Second, the contract must be “a commutative” financial contract, which means not a gift or donation. Third, the gharar must affect one of the main components of the contract. Fourth, there is no need for the contract and there is an alternative. If these conditions are present, the contract is forbidden because of the gharar rule.

113 See page 39.
114 Id.
Some Islamic scholars argue that trading debts is forbidden because all four conditions of the *gharar* rule are present in the sale of debts transaction. First, *gharar* exists and sometimes is excessive. The purchaser is not always sure he will receive the money at the time due, or if he will receive the total amount due. The debtor may die or go bankrupt. Second, the sale of debt is a commutative contract. There are at least two parties and the purchaser will be affected by the *gharar*. Third, *gharar* must affect one of the main components of the contract. The debt is a main component of the contract. Forth, usually there is no need for the sale of debt. If the purchaser is looking for profit, there are many permitted ways, other than trading debt. As a result, the *gharar* rule should be applied to trading debt, and would be a forbidden transaction.

**Discussion**

Islamic jurisprudence distinguishes between major *gharar* and minor *gharar*. Minor *gharar* is permitted. Major *gharar* is not. All commercial and financial transactions include some risk and uncertainty. Only transactions which include high risk and uncertainty, making them akin to gambling, are forbidden in Islamic law. Credit sales are permitted, although there is risk. If the risk is considered minor, not major, the transaction will be permissible. If all kinds of risk were forbidden, commercial and business transactions would be very limited. The type of risk

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116 Id.

117 See page 39.
involved in the sale of debt is the same type of risk involved in the credit sale transaction, not greater nor lesser. If the credit sale transaction is permitted the sale of debts should also be permitted. Otherwise, both of them should be prohibited.

Some Islamic schools permit the sale of debt when certain conditions are met, in order to avoid major gharar.\textsuperscript{118} The purchaser must believe the debtor has the ability to pay the debt. The purchaser must have full information of the debtor’s solvency. Finally, the debtor and the purchaser must not be enemies.\textsuperscript{119} The purpose of these conditions is to minimize gharar as much as possible. Centuries ago, when the Islamic schools first set them, these conditions were appropriate. Now there is a sophisticated industry to evaluate debts and examine how much risk is involved. There are special international standards to evaluate debts and distinguish high risk from low risk. These could be used to evaluate gharar on a case by case basis, taking the place of the conditions to avoid major gharar.

Each bank and financial institutions has its own risk assessment department, many getting assist from rating agencies, to evaluate and assess the risk associated with any particular debt securities. The rating shows how likely the debtor will be able to pay the debt by the due date. Debt securities are classified into different levels. The chart below shows the debts securities rating scale.\textsuperscript{120}

\textsuperscript{118} KURDEY, supra note 115, at 111.
\textsuperscript{119} ALLAHIM, supra note 16, at 1/355.
The first three levels, AAA (lowest risk), AA (lower risk), and A (low risk) would be considered minor *gharar*. In Islamic finance, debts in these three levels would be permissible to trade. The levels Ba or BB and below would be considered major *gharar*. Debts in these levels would not be permissible to trade. The levels Baa or BBB (medium risk) would be controversial. Conservative schools would forbid trading debts classified as Baa or BBB, considering them major *gharar*. The more liberal schools would permit trading debts classified at this level, considering them minor *gharar*. This modern sophisticated ranking system can achieve the same result as the conditions required by some Islamic schools to minimize *gharar*.
There is always risk and uncertainty in trading debt. However, this normal risk does not justify the prohibition of all trade of debt. It is unreasonable, impractical, and inconsistent with the gharar rule. Since Islamic jurisprudence distinguishes between major and minor gharar, debts with major gharar should be distinguished from debts with minor gharar. Because it is more practical and consistent with Islamic finance principles, the Islamic finance industry should rely on the modern credit rating standards to determine the risk of debts and avoid major gharar.

4.4. Islamic legal basis for permitting the negotiability of debt

Trading debts should be permissible in Islamic law based on three methodologies: istishab, qiyas, and maslahah mursalah. These methodologies are recognized by all four Islamic schools of law. This section shows how these methodologies could be a basis for permitting the trading of debts in Islamic law.

4.4.1. Istishab (Presumption of Continuity)

As explained in Chapter 2, istishab is a methodology used by all Islamic schools of legal thought to determine the whether such a legal issue is prohibited or permitted.121 In istishab, there is a presumption that a rule is still valid because of “lack of evidence to establish any change.”122 For example, the general rule regarding

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121 See page 28.
122 MOHAMMAD HASHIM KAMALI, PRINCIPLES OF ISLAMIC JURISPRUDENCE 384 (3rd rev. and enlarged ed. 2003).
food and drinks in Islamic law is permissibility except what is prohibited specifically by Quran or Sunnah, such as pork or alcohol. If there is a new kind of food unknown during the Prophet’s life, the presumption is that eating these kinds of food is permissible if there is no specific text from the Quran and Sunnah that forbids it. In short, *istishab* holds that “when there is a ruling in the law, whether prohibitory or permissive, it will be presumed to continue until the contrary is proved.”

The general rule for contracts and commercial transactions in Islamic law is that they are presumed permissible if there is no text from the Quran or Sunnah that forbids them. Ibn Taymiiah, a prominent thirteenth century Islamic scholar said, “The underlying principle in contracts and stipulations is permissibility and validity. Any [contract or stipulation] is prohibited and void only if there is an explicit text [from the Quran, the Sunnah or ijma] or a *qiyas* proving its prohibition and voiding.” This rule is very important to modern Islamic finance. Most of today’s transactions were unknown during the period of revelation. Contemporary Islamic scholars decide whether they are permissible based on the general rules of contracts.

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123 *Id.* at 386.
124 *Id.*
125 *Id.* at 388.
126 VOGEL & HAYES, supra note 1, at 98.
127 *Id.*
128 MUHAMMAD TAQI USMANI, AN INTRODUCTION TO ISLAMIC FINANCE 152 (Kluwer Law International 2002).
The sale of debt is permitted based on that underlying principle. However, the Islamic fiqh Academies exclude the sale of debt from the general principle of permissibility, by applying the *riba* in sales rule. The previous section criticized the arguments for applying the *riba* in sales rule, and argues it is not applicable to debt. Based on *istishhab*, the sale of debt should be presumed permissible. There is no text from the Quran or the Sunnah that forbids the sale of debt, and the *riba* in sales rule is not applicable. Debt should be classified by debt rating professionals to minimize *gharar*.

4.4.2. Qiyas (analogical reasoning)

If there is no text from the Quran or the Sunnah, *qiyas* is the preferred Islamic legal methodology.\(^\text{129}\) As explained in chapter 2, *qiyas* is “the extension of a *Shariah* ruling from an original case to a new case because the new case has the same effective cause as the original case”\(^\text{130}\) and “the emphasis of *qiyas* is identification of a common cause between the original and new case.”\(^\text{131}\) For example, liquor is forbidden by the Quran and the Sunnah. The effective cause is that it is an intoxicant. Islamic scholars apply the original case, the prohibition of liquor, to new cases, such

\(^\text{129}\) See page 27.

\(^\text{130}\) SHAH ABDUL HANNAH, USUL AL FQH (ISLAMIC JURISPRUDENCE) 20 (1999).

\(^\text{131}\) Id.
as wine, because they are both intoxicating.\textsuperscript{132} \textit{Qiyas} is recognized as a source of Islamic laws and rules by all four Islamic schools of law.\textsuperscript{133}

Trading debt could be permitted in Islamic law by applying \textit{qiyas} to trading debt and comparing it with \textit{tawarruq} and \textit{murabaha}. As explained in the previous section, \textit{tawarruq} and \textit{murabaha} are accepted by the majority of Islamic schools and the two Fiqh Academies because the source of cash is from someone other than the creditor. In contrast, bai al-inah is forbidden by the majority and the two Fiqh Academies because the creditor is also the source of cash. The effective cause which makes \textit{tawarruq} and \textit{murabaha} acceptable is that the source of cash is different from the creditor. This effective cause may also exist in the sale of debt. None of the parties receive money from a party who is considered a creditor in the transaction. For example, A sells a car to B for $100,000. B promises to pay after one year. A sells the debt to C for $90,000. C waits one year and receives $100,000 from B. A is the creditor. B is the debtor. C is the third party. The creditor delivers goods or services in a credit sale to the debtor. Then, the creditor sells the debt to a third party and receives money from him. The third party waits until the due date and receives money from the debtor. Thus, in each relationship (creditor and debtor, creditor and third party, debtor and third party), no party receives money from the same party to whom he pays money.

\textsuperscript{132} \textbf{KAMALI}, \textit{supra} note 122, at 268.
\textsuperscript{133} \textit{Id.} at 254.
By applying *qiyaṣ*, the permissibility of *tawarruq* and *murabaha* could be extended to the sale of debts for money. The effective cause that makes *tawarruq* and *murabaha* permissible exists in the sale of debt, too. The source of cash in these transactions is not the creditor. The *qiyaṣ* methodology shows that the permissibility of trading debt is consistent with other Islamic finance rules and provisions.

**4.4.3. Maslahah (General benefit)**

*Maslahah* is an Islamic Law source adopted by all four Islamic schools of law. It means general benefit or public interest. Islamic schools of law recognize *maslahah* (general benefit or public interest) as an important grounds for establishing new rules and laws. Three conditions must be met. First, the benefit must be real. Second, the benefit must be general, not limited to one person or a few people. Third, there can be no conflict with the Quran or the Sunnah. If these conditions are met, the benefit may be established as a law or rule in Islamic jurisprudence. On the basis of *maslahah* Islamic scholars permit currency, establish prisons, and impose agriculture land tax. Many rules related to the state and unknown during the Prophet’s life are established based on *maslahah*.

There will be a major public benefit if trading debt is permitted. The economy of the Muslims countries will be grow, develop and be more efficient. Since the

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134 *Kamali, supra* note 122, at 351 (In this context I will use general benefit, to not be confused with interest as charged on loans.).

135 *Kamali, supra* note 122, at 358.

136 *Id.*

137 *Abdul Hannan, supra* note 130, at 26.
financial market is an important part of the economy, a developed and diverse debt market makes the financial market competitive and efficient and not dominated by a few banks. It facilitates varied sources of fund that assist companies to grow and expand. Also, it serves as an investment vehicle for investors who are looking for stable and predictable income. However, because of the prohibition of trading debts, Islamic debt market is illiquid and non-diverse. That makes the debt market in Muslims countries an inefficient tool to contribute to economic growth.

The rest of this section explains how allowing the trading of debts would make the Islamic debt market more liquid and diverse. Liquidity and diversity would make the Islamic debt market attractive to investors and competitive with the conventional debt market. Muslims economies would be strengthened, so the benefits of liquidity and diversity are general, not limited to a few people. Debt trading does not conflict with any text from the Quran or the Sunnah. Further, *riba* and *gharar* are not applicable to trading debt as explained in the previous section. Therefore, *maslahah* methodology should be applied.

### 4.4.3.1 Liquidity

Saudi Arabia has the strongest economy and financial market in all Muslim countries. The Saudi government established a modern and sophisticated legal structure for trading debt securities. Some conventional bonds are already traded in the Saudi debt market. However, in terms of Islamic debt securities, despite the effort of the Saudi government, only a third of *sukuk* issuances are listed on the Saudi
Exchange Market because of the prohibition of trading debts in the secondary debt market.\footnote{138} The Saudi government has tried many solutions to avoid the non-tradability of debt in Islamic finance. One solution was devised by the Saudi General Authority of Civil Aviation (GACA).\footnote{139} In October 2013, the GACA issued guaranteed \textit{sukuk} with a total value of SR15.211 billion ($4.056 billion) and a profit rate of 3.21 percent annually.\footnote{140} The structure of the \textit{sukuk} is \textit{murabaha}.\footnote{141} It is due in 2023.\footnote{142} The deal “was 1.9 times oversubscribed with strong demand from a wide range of investors, including banks, sovereign funds, pension agencies, insurance companies and corporations.”\footnote{143} The funds generated by this \textit{sukuk} “will be used for the construction of the new King Abdul Aziz International Airport in Jeddah.”\footnote{144} The head of capital markets & corporate finance in the Hong Kong and Shanghai Banking Corporation (HSBC) Saudi Arabia commented: “This \textit{sukuk} has been launched as one single issuance, and in doing so has become the largest single-tranche \textit{sukuk} ever issued in

\cite{138} \textsc{Saudi Hollandi Capital}, \textit{supra} note39 at 3.
\cite{139} \textsc{Abir Atamech}, \textit{Sukuk Quarterly Bulletin} 4Q 2013 3 (2014).
\cite{140} HSBC and NCB Capital announce completion of SR15bn GACA \textit{sukuk}, \textsc{Arab News} Oct. 7, 2013, \textit{at} http://www.arabnews.com/node/466953.
\cite{141} Al-Jadaan advises on largest \textit{sukuk} in the Kingdom of Saudi Arabia, \textsc{Al-Jadaan & Partners Law Firm}, \textit{at} http://www.aljadaan.com/?module=announcements&page=details_en&id=126.
\cite{142} \textit{Id.}
\cite{143} \textit{Id.}
\cite{144} \textsc{Islamic Finance News, Deals of the Year Handbook} 4 (Nazneen Halim, et al. eds., Red Money Group 2013).
Saudi Arabia.” Because it is such a large issuance, the *sukuk* is guaranteed by the Ministry of Finance in Saudi Arabia.\(^{146}\)

The Saudi government, represented by the Ministry of Finance (who guarantees of the *sukuk*) was very interested in marketing the *sukuk* among Saudi investors. The government does not necessarily need funds, but it wanted to support and develop the debt market.\(^{147}\) However, the debt market in Saudi Arabia is illiquid and investors may avoid purchasing the *sukuk* because of the lack of an exit strategy. The government needed a way around the non-tradability of the *sukuk* in the secondary market. So, the *sukuk* was “approved by the Saudi Arabian Monetary Agency (SAMA) to be eligible for repo arrangements and has also been assigned zero percent risk weighting for capital adequacy calculation purpose.”\(^{148}\) Hence, “investors can hold this *sukuk* as an investment, but also use it as an effective liquidity tool by using it to guarantee cash from the central bank.”\(^{149}\) If an investor needs cash, the government will repurchase the *sukuk* from the investor at a face value (based on the repo-agreement) instead of selling it on the secondary market. This arrangement offers an exit strategy for investors. The *sukuk* is less risky, because now investors do

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\(^{146}\) *Id.*

\(^{147}\) For the 2013 fiscal year, “total revenue is projected to be around (US $301.6) billions in 2013 and expenditure to be around (US $246.7) billions. As a result, a surplus of SR 206 (US $54.9) billions should be realized.” *SAUDI MINISTRY OF FINANCE, SAUDI BUDGET FOR 2014 1* (2013).

\(^{148}\) HSBC and NCB Capital announce completion of SR15bn GACA *sukuk*, *supra* note 140.

\(^{149}\) *Id.*
not have to hold it until maturity. This solves the problem of liquidity in this particular transaction, especially for domestic investors. All these complicated arrangements are because of the prohibition of trading debt. If trading debt were permitted, the government would encourage the debt secondary market, which would be healthier and more efficient and effective option.

The illiquid secondary market is a significant obstacle to developing the debt market in Muslim countries. Saudi Arabia made a huge effort to help the debt market by establishing a platform for the trading of debt and finding a solution to promote many *sukuk* deals. However, this kind of solution only works deal by deal. It is not a systemic solution. Moreover, this solution might be attractive to domestic investors, but not international investors. Permitting the trading of debt will be a systemic solution for all kinds of *sukuk* and all types of investors. Most of the current *sukuk* that is unlisted because of the prohibition would be listed and traded, and would provide the secondary debt market with liquidity.

4.4.3.2. Diversity

If the tradability of debt is permitted, the secondary *sukuk* market would be diverse, not limited to a few kinds of *sukuk* as it is now. The *Sukuk* Report 2013, issued by the Islamic Financial Market Organization (IFIM), states that the “*Ijarah Sukuk* structure has been the most popular and widely used structure for International … issuance.”

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150 *The International Islamic Financial Market, IIFM Sukuk Report 24 (3rd Edition 2013).*
As explained in the previous chapter, *sukuk ijarah*, the prevalent form of international *sukuk* issuances, is preferred by investors because the two Fiqh academies and AAOIFI have approved its trade in the secondary market. There is no religious risk in *sukuk ijarah* because no Islamic scholars oppose its tradability in the secondary market. Solutions, such as the solution used by Saudi Arabia, used to solve the tradability problems might not work with an international issuance.

Though Islamic banks are very important in Islamic finance, they cannot enter the *sukuk* market because of the prohibition on trading debt. Baljeet Grewal, the managing director and vice chairman of the Islamic Financial Services Board (IFCB), said, “As at end-2010, … the Islamic banking sector worldwide is valued at approximately US $850 billion in terms of assets, [so] Islamic banking assets [deposits] represented 83.4% of overall Islamic assets, followed by *sukuk* funds (11.3%) and Islamic funds [equity fund] (4.6%).”

sukuk market because most of their revenue are considered receivables, which are not tradable pursuant to the two Fiqh Academies.

For example, Al-Rajhi Bank, the biggest Islamic bank in the Middle East and North Africa, had total assets of SR 267,383 million ($71,302 million) at the end of 2012. According to the bank’s financial statement, “Net financing accounted for 64.3% of the consolidated total assets of the group as at December 31, 2012, and represents the main driver of revenue and balance sheet growth.”

Looking at the chart above, “installment [sic] sale is by far the largest financing product overall, accounting for nearly three-fourths of net financing, followed by corporate mutajara.” Although the installment sale is the largest financing product and net financing is “the main driver of revenue and balance sheet growth,” Al-Rajhi Bank cannot securitize it and sell it on the secondary market. An installment sale is a receivable, which cannot be securitized and traded according to

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153 Id. at 31.
154 Id. at 32.
155 Id.
the Fiqh academies. Securitizing this product may not be a useful financial strategy for the bank, but Islamic bank managers cannot even entertain the possibility. They must follow the rules set by Islamic scholars. This is true for all Islamic banks around the world, not only Al-Rajhi Bank.

If debts and receivables could be traded in Islamic finance, Islamic banks could securitize their account receivable. Islamic banks would enter the sukuk market and contribute to its development. Many kinds of sukuk would be issued, so the sukuk market would be diverse. International investors would likely be attracted to the sukuk issued by Islamic banks because of their solvency. This dynamic would make the sukuk market more diverse, successful, and more attractive.

In conclusion, the whole economy of Muslim countries would benefit from the permissibility of trading debts. The Islamic debt market would be more liquid and diverse. It would be an efficient source of funds for new and growing companies and it would be an investment vehicle for investors who are looking for stable and predictable income. The benefits would strengthen and stabilize the economies of Muslim countries and do not conflict with any text from the Quran or the Sunnah. Thus, there are Islamic legal grounds for permitting the trading of debt in Islamic finance.
Conclusions

The challenges posed by the non-liquidity and non-diversity of the Islamic debts market make the market an inefficient tool on contributing to Muslim economic growth. Islamic scholars and experts created sukuk as an Islamic debt instrument to avoid riba (usury), but the sukuk market still struggles with the prohibition of the trade of debt due to the prohibition of the two Fiqh Academies.

The two Fiqh Academies have argued that trading debt is forbidden because of riba and gharar (uncertainty). They apply the riba in sales rules for debts, based on three premises: first, the debt does not actually exist physically, so selling debt for money is considered selling money for money. I have argued, however, that physicality is not required in order to be considered mal (property), a position adopted by the majority of Islamic schools of legal thought. Pursuant to the theory of obligations in Islamic jurisprudence, debt has an independent existence as a personal right and it may be tradable; second, they argue that debt is equivalent to money conceptually and in value. I have explained that, in fact, they are different and cannot be equivalent. Debts have characteristics that distinguish them legally from money in Islamic law. Also, since Islamic law recognizes time value, debts and cash have different values. Third, they argue that the result of a transaction in which debts are traded is equivalent to riba. Both end with cash being offered for delayed money in a different amount. I have pointed out that in the sale of debt for money, the source of cash is from someone other than a creditor. In a riba transaction, the creditor is the same person as the source of cash. Thus, according to the argument I present on
opposition to these three premises, the *riba* in the sales rule is not applicable in the trading of debt.

The second argument of the two Fiqh Academies pertains to *gharar*. *Gharar* is a real concern in trading debts. However, as only major *gharar* is forbidden in Islamic law, Islamic finance could rely on the modern debt rating standards to evaluate the riskiness of a debt, which is not uncommon in Islamic finance. Islamic finance institutions rely on LIBOR to evaluate the price and cost of *sukuk*. Thus, if a debt is rated low risk based on the modern debt rating standards, then it should be permissible to securitize and trade it. Low risk is equivalent to minor *gharar* in Islamic law. With this proposal, Islamic finance can avoid *gharar* and benefit from low risk debts and *sukuk*, rather than forbid the entire practice.

Therefore, if *riba* rules are not applicable, and *gharar* can be avoided by the modern, sophisticated debts rating standards, there should be a new rule regarding the negotiability of debt in Islamic finance based on Islamic methodologies and law sources. Trading and securitizing debts should be permitted in Islamic law, with one condition, that the debt should be considered low risk. This new rule, the permissibility of trading debts, is supported by three Islamic legal bases, *istishab*, *qiyas*, and *maslaha*, which are recognized by all four Islamic schools of legal thought:

First, trading debts is permitted in Islamic law based on *istishab* (presumption of continuity). An action is permitted if there is no text in the Quran or the Sunnah forbidding it. This is the general rule that governs all business and commercial
transactions in Islamic law. There is no text in the Quran or the Sunnah that forbids trading and securitizing debts; therefore, it should be presumed permissible.

Second, trading and securitizing debts is permitted in by *qiyaṣ* (analogy). *Tawarruq* and *murabaha* transactions are permitted in Islamic law because the source of cash is someone other than the creditor. The reason for permitting *tawarruq* and *murabaha* is also applicable in trading debts. Thus, it should be permitted as well.

Third, trading debts should be permissible based on *maslaha* (general benefit). There are many benefits in permitting the trading of debts. First, it will make the Islamic debt market liquid and diverse, and thus attractive to international and domestic investors. Second, it will also strengthen and stabilize Muslim economies.

Permitting the trading of debts is more consistent with the principles and theories of Islamic law than is forbidding it. It is consistent with the obligations theory that debt is a personal right. It is consistent with the *mal* (property) theory that debt may be sold according to the three Islamic schools of legal thought, all of which consider debt as property. It is consistent with other modern Islamic financial transactions that are permitted by the two Fiqh Academies, such as *tawarruq* and *murabaha*.

There would be significant positive effects on Islamic finance generally and the Islamic debt market particularly if securitizing and trading debts is permitted. The non-tradability of debts is the main obstacle in developing modern Islamic finance. Most Islamic financial instruments are structured and built on the non-tradability rule, which causes major problems. The ability to securitize and trade debts would make
the Islamic debt market liquid, diverse, and attractive to both international and domestic investors. Further, it would facilitate the growth and development of Islamic finance, and promote new and creative ways to improve the international and domestic Islamic financial industry. A special financial study would show how the Islamic finance industry would change radically if the prohibition of securitizing and trading debts was repealed.
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