IIUM Journal of Economics and Management 9, no. 2 (2001): 165-86

DEVELOPMENT OF *MUë•RABAH* INSTRUMENTS: UNDERSTANDING THEIR PROFITABILITY, SECURITIZATION AND NEGOTIABILITY ASPECTS

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ABSTRACT

This paper attempts to examine the securitization, negotiability and profitability aspects of three types of *muèŒrabah* instruments; namely, asset-enfaced *muèŒrabah* instruments, currency-enfaced *muèŒrabah* instruments representing monetary contributions and currency-enfaced *muèŒrabah* instruments representing real assets. This paper begins with a distinction between *ribŒ* (usury) and profit and concludes that an exchange of currency-enfaced *muèŒrabah* instruments in varying amounts entails *ribŒ* while an exchange of asset-enfaced *muèŒrabah* instruments will generate legitimate profits. The current practice is to issue currency-enfaced *muèŒrabah* instruments but treat them as asset-enfaced *muèŒrabah* instruments. This position is analyzed and policy implications are drawn for future development of *muèŒrabah* instruments.

JEL classification: G10, P43, Z12

Key words: *MuèŒrabah* instruments, Islamic finance, Financial instruments

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1. INTRODUCTION

Financial systems channel funds in an economy from their surplus economic units lacking appropriate investment opportunities to the deficit economic units blessed with such opportunities. Surplus units and deficit units could be domestic and foreign households, businesses, and states. The surplus units interested in returns on their surplus funds surrender their funds to the deficit units through direct and indirect financing channels. Direct financing is accomplished through private placements, brokers, dealers and fund managers. Indirect financing is channeled to the deficit units through financial institutions like commercial banks, finance companies, insurance companies and others. So the surplus units and the deficit units contact one another through a network of financial markets and institutions in the economy. Surplus units and the deficit units benefit by employing their funds in remunerative activities. The participants make such financial contracts that satisfy their liquidity, denomination, maturity and risk diversification needs (Anwar, 1995, 877). These contracts provide funds to the deficit units and financial claims to the surplus units. These documentary claims, called financial instruments, may be traded in the financial markets.

Financing businesses by channeling funds from the surplus units to the deficit units through the primary markets is found to be perfectly Islamic (Anwar, 1995, 868). However, dealings in the secondary markets depend on how the primary securities are enfaced and what currencies (commodities) they are traded against. Trading of financial instruments in the secondary markets is the selling and buying of one's entitlements in the company's assets and profits associated with them. Profits from trading of the financial instruments, like those of assets represented by the instruments, fluctuate with changes in the business and market conditions.

A challenge before Muslim investors is to develop such financial instruments that are not only compatible with the dictates of Islamic *Shar¥cah* but also meet profitability, liquidity, denomination, maturity, and risk diversification requirements of the participants. Both equity-financing and debt-financing are possible under Islam. Islamic debt-financing can be done in the form of trading contracts of *salam*, *istisnŒc* and *mu'ajjal*. On conclusion of these trading contracts, the price of the traded articles automatically assumes the status of debt-financing. Equity-financing is done on the basis of various forms of *mushŒrakah* and *muèŒrabah* partnerships. The scope of this study is limited to *muèŒrabah*-financing.

Access to liquidity is of prime importance for the survival and success of financial institutions. It is well understood that securitization, negotiability, and marketability of financial claims generate "liquidity by expanding the menu of options available to the market participants," (Iqbal, 1999, 123). Negotiability is a mechanism to arrive at a willing buyer and willing seller position in exchange contracts. The *Qur'Œn* encourages trading with mutual willingness.[1] Therefore, negotiability is a legitimate process in Islam. The basis of negotiability of *muèŒrabah* instruments is risk-adjusted returns expected to accrue to the *muèŒrabah* instrument holders. Securitization is the process of rendering liquidity to an illiquid asset by transforming it into tradable securities. Normally, a large financial claim is split into multiple small claims for sale in the financial markets in order to help people of small means to own and trade these securities. Securitization is legitimate as it can facilitate observance of the *Qur'Œn*ic verdict that ". . . (wealth) may not (merely) make a circuit between the wealthy among you . . ." (*al-Qur'Œn*, 59:7). The aim of this study is to focus on the profitability, securitization and negotiability aspects of *muèŒrabah*-financing as fulfillment of liquidity needs of market participants depends on them.

2. PROFITABILITY FRAMEWORK OF A *MUë•RABAH* ENTERPRISE

The system of *muèŒrabah*-financing was initially suggested by Hashim ibn [C]Abd al-ManŒf ibn Qusayy during the fifth Century A.D. in order to control the destructive potential of 'ritual suicide' called *i'tifŒd*. Ritual suicide was committed by Meccans if they experienced business disasters (Ibrahim, 1982, 343-5). The Muslims continued the pre-Islamic practice of *muèŒrabah* for financing their trade ventures.

MuèŒrabah is an agreement between financiers who provide 100 percent capital and entrepreneurs who manage the capital for earning profits using their business acumen. The purpose of *muèŒrabah* partnership is to seek earnings. Capital contribution could be in the form of real assets or in the form of money. Contributions to the *muèŒrabah* fund represent claims of the contributors. Documents representing those claims are *muèŒrabah* instruments. If the contributions are in real assets then the instruments can be enfaced with those assets and if the contributions are in money then the instruments can be enfaced in terms of currency units. Monetary profits arising from application of the *muèŒrabah* fund are shared between financiers and entrepreneurs according to a profit-sharing ratio (PSR) agreed between both parties at the initiation of a *muèŒrabah* contract.

Monetary loss, if any, is deducted from the *muèŒrabah* funds.

MuèŒrabah contracts represent a mechanism to pool funds for profit-seeking activities. The funds may be utilized to meet costs of several commercial activities like production of commodities,[2] establishment and expansion of business networks, discovery of new technology, marketing strategies and so on. However, *muèŒrabah*-financing, *per se*, does not generate earnings. For example, a *muèŒrabah* fund may be used to buy a piece of land "underneath which there is plenty of gold. But that gold does not make us rich until we dig it out, melt and sell it," (Mohamad, 1999, xiii). In other words, although profit-seeking requires much background effort in the area of management, processing, marketing, research and development, product innovation and others, the profit itself cannot be realized without an act of exchange.[3]

It is obvious, therefore, that *muèŒrabah* instruments themselves cannot generate earnings without engaging in exchange activities. Pools of *muèŒrabah* funds are utilized for commercial activities. The entrepreneurs may use the funds directly to buy commodities for sale. Otherwise, the fund can be invested into productive activities and the output so generated can be sold for earning business profits. In any event, earnings can only result from exchange activities undertaken by the entrepreneurs.

The exchange can be a spot exchange or a deferred exchange. The exchange could be of two similar commodities or two dissimilar commodities.[4] A gain resulting from an exchange of similar commodities in different amounts is considered *ribŒ* (usury). Money[5] is also treated as a commodity in exchange transactions because commodities like gold and silver were used as money during the advent of Islam.

RibŒ in spot exchange of similar commodities is evident from the following *úad¥th*. The Prophet (pbuh) said "gold for gold, silver for silver, wheat for wheat, barley for barley, dates for dates, salt for salt, like for like, equal for equal, hand to hand. If these types differ, then sell them as you wish, if it is hand to hand," (ImŒm Muslim and ImŒm NawŒw¥, n.d., 14). It is obvious from this *úad¥th* that spot (hand to hand) exchange of similar commodities in different amounts is disallowed because the difference in the amount would be *ribŒ*. This *úad¥th* also indicates that spot exchange of dissimilar commodities in same as well as dissimilar amounts is allowed. Hence, any gain accruing in spot exchange of different commodities is also allowed.

According to the *Qur'Œn*, *ribŒ* is present in deferred exchange of similar products in unequal amounts. The *Qur'Œn* says, ". . . if ye repent (from *ribŒ*) ye shall have your capital sums: deal not unjustly, and ye shall not be dealt with unjustly," (*al-Qur'Œn*, 2:279). That means Islamic justice is served when lenders receive only principal amounts of their debts. In other words, whatever commodity is indebted (deferred exchange) that commodity shall be received in its original amount. If your debt is in money then you are entitled to retrieve the same amount of money. A charge above the principal amount is *ribŒ*. In other words, gains obtained from deferred exchange of similar commodities are *ribŒ*.

If a charge above the principal amount of debt were allowed, then that charge would represent a compensation for the duration of the debt. Prohibition of such charge is tantamount to prohibition of time value of money. Therefore, the verse prohibits a charge in the sense of time value of money[6] because it is treated as *ribŒ*.

In sum, gains from exchange of similar commodities are *ribŒ* irrespective of whether the exchange is on spot basis or deferred basis. However, gains may result whenever heterogeneous commodities (or monies) are exchanged. A gainful exchange of heterogeneous commodities is permitted. Gains resulting from spot and deferred exchange of different commodities are permitted because ". . . Allah hath permitted trade and prohibited usury" (*al-Qur'Œn*, 2:275).[7] Trading (selling) is permitted[8] but the traders are also supposed to adhere to several other Islamic principles. For example, exchange must be, *inter alia*, by mutual willingness of the parties involved because Allah commands, "O ye who believe! Eat not up your property among yourselves in vanities: but let there be amongst you traffic and trade by mutual goodwill . . ."[9] (*al-Qur'Œn*, 4:29).

In sum, profits do not result merely when parties seal a *muèŒrabah*[10] contract. Accrual of Islamically legitimate profits must involve exchange of heterogeneous commodities.[11] The *muèŒrabah* contracts, in addition to providing funds, also provide a basis for sharing profits that may result from application of those funds since ratios for sharing profits among the partners are to be agreed upon at the initiation of a *muèŒrabah* contract. Loss, if any, must be deducted from the *muèŒrabah* fund.

In general, returns on *muèŒrabah* contributions will depend on the outcome of the trading activities undertaken by the entrepreneurs. As returns from application of the funds may vary, so the value of the claims represented by the *muèŒrabah* instruments may also vary. Therefore, prices of *muèŒrabah* instruments are negotiable depending on the anticipated profits.

Conceptually, holders of these *muèŒrabah* instruments may confront a situation of:

a. Capital gains if value of the assets increases[12] without business profit or loss.
b. Capital loss if value of the assets decreases. There is neither business profit nor loss.
c. Business profits but neither capital gain nor capital loss.
d. Business losses but neither capital gain nor capital loss.
e. Earnings due to both business profits and capital gains.
f. Losses due to both business losses and capital losses.
g. Earnings due to domination of business profits over capital losses.
h. Earnings due to domination of capital gains over business losses.
i. Loss due to domination of business losses over capital gains.
j. Loss due to domination of capital losses over business profits.

It is concluded above that earnings from spot and deferred exchange of similar commodities in different amounts are *ribŒ*. If similar commodities are exchanged at their *par* values then there is no *ribŒ*. Earnings resulting from a spot or a deferred exchange of heterogeneous products are legitimate business profits. Therefore, in order to earn legitimate profits, the principle of trading heterogeneous commodities shall be meticulously observed in trading of financial instruments in the primary as well as secondary markets.

There are three possibilities regarding the status of *muèŒrabah* instruments representing contributions to the *muèŒrabah* funds: asset-enfaced instruments representing real assets[13] contributed to the *muèŒrabah* funds; currency-enfaced instruments representing money contributed to the *muèŒrabah* funds; and currency-enfaced instruments representing assets purchased with the money contributed to the *muèŒrabah* funds. Entitlement to the profits and capital gains depends on the status accorded to the *muèŒrabah* instrument. Discussion on entitlements, securitization and negotiability under each scenario follows.

3. SCENARIO 1: ASSET-ENFACED MUë•RABAH INSTRUMENTS

When *muèŒrabah* contributions are made in the form of real assets,[14] then the contributed assets may be inscribed on the *muèŒrabah* instruments. So the *muèŒrabah* instruments would be asset-enfaced instruments. Each *muèŒrabah* instrument would represent the articles entrusted to the *muèŒrabah* enterprise. However, some investors may want to contribute money instead. In that case, the money may be used to purchase real assets and those assets can be inscribed on the *muèŒrabah* instruments. Otherwise, currency-enfaced *muèŒrabah* instruments can be issued to the contributors of the money.[15]

Securitization, in the sense of splitting overall entitlements into several tradable instruments of smaller denominations is possible, though cumbersome, for the real assets. In this case, the original investors will have to create securities so that each security represents specific assets contributed to the *muèŒrabah* business. In addition, profit-sharing ratio must be split for the sake of entitlement of business profits pertaining to each security. For example, suppose investors contribute 10 computers to a *muèŒrabah* business. Entrepreneurs employ those computers in profit-seeking activities. Perhaps they design software programs for sale. The profits, if any, are to be shared in the ratio of 70:30 (70 percent for investors and 30 percent for entrepreneurs). Now suppose the investor creates 10 securities, each representing one computer. In that case, each security may be inscribed with a profit-sharing ratio of 7 percent. If there is a business profit of $100,000 then the bearer of each security will get $7000 on account of business profits in addition to the computer mentioned on the security. In addition, the *muèŒrabah* instrument bearers can realize capital gains or losses by selling their computers. Hence, in the case of asset-enfaced *muèŒrabah* instruments, securitization of principal as well as the profit-sharing ratios is possible. Allocation of the profit-sharing ratios would depend on the profit expected from use of the article(s) contributed to the *muèŒrabah* enterprise.

Asset-enfaced instruments evidence real assets and, if traded, would represent exchange of real assets against money. So, selling of the *muèŒrabah* instruments would be an exchange of two heterogeneous commodities. Therefore, the asset-enfaced *muèŒrabah* instruments can be negotiated freely and earnings, if any, would be legitimate.[16] Returns to the bearer of asset-enfaced *muèŒrabah* instruments comprise capital gains representing appreciation in the price of the assets and entitlement to a proportion of business profits resulting from business activities. However, the *muèŒrabah* business must be liquidated in order to realize the capital gains and the business profits.

4. SCENARIO 2: CURRENCY-ENFACED *MUD•RABAH* INSTRUMENTS REPRESENTING MONETARY CONTRIBUTIONS

Currency-enfaced *mudŒrabah* instruments are created when contributions to a *muèŒrabah* enterprise are made in money and the contributions are inscribed in currency units on the *muèŒrabah* instruments. In this situation, the claim of every financier is the amount of money contributed to the enterprise and business profit according to profit-sharing ratios agreed upon with the entrepreneurs. In this case, all *mudŒrabah* assets and the relevant profits are ascertained in money terms. If the *muèŒrabah* asset yields a business profit, then the profit is shared among the partners according to the profit-sharing ratios agreed among them at the beginning of the *muèŒrabah* contract. If the *muèŒrabah* asset yields a business loss, then the loss is deducted from the *muèŒrabah* capital. If the business breaks even, then the contributors get their capital amount. Profits or losses related to *muèŒrabah* assets can be realized only when the *mudŒrabah* enterprise is liquidated[17] whereby all the *muèŒrabah* assets are converted into money. If the value of the assets is less than the original value of the fund, then the leftover property is under the ownership of the financiers. But, if the value of the assets is higher than the original fund value then the assets represent common ownership. *MuèŒrabah* claims of the financiers represent money from the beginning till the conclusion of the *muèŒrabah* business.

Gainful negotiation of *muèŒrabah* instruments representing face values in monetary units is not justified because they represent exchange of an instrument representing money with money, i.e., exchange of similar commodities. If negotiated, then the difference between the price and the face value of the instrument would be *ribŒ*.

However, selling the instruments at *par* value is allowed because a spot and a deferred exchange in equal amounts will negate *ribŒ*. In that case, the new bearer of the instruments will be entitled to the proportionate gains in place of the current bearer. Why would market participants trade at *par*? Spot exchange at *par* can take place if the current bearer of the instruments anticipates poor returns, but the buyers anticipate favorable returns on liquidation (termination) of the *muèŒrabah* enterprise. Spot exchange, at *par*, is also possible when both the sellers and the buyers expect favorable returns, but the seller wants to employ the proceeds in another activity deemed more remunerative. Deferred exchange at *par* is also possible when both the buyer and the seller anticipate favorable returns at termination of the *muèŒrabah* contract, but the buyer hoped to employ the proceeds in a more profitable activity at maturity of the contract. If the instruments are negotiated, then such an action provides undue favor to the bearer (financier) over the entrepreneurs since the negotiability is based on the perceived returns resulting from entrepreneurial efforts.

Bearers of currency-enfaced *muèŒrabah* instruments are entitled to business profits resulting from commercial activities on liquidation of the *muèŒrabah* enterprise only. Capital gains are irrelevant because the principal is in the form of the same currency units. The business profits can be realized only when the *muèŒrabah* instruments mature with liquidation.

Securitization, splitting of entitlements into smaller denominations, of the principal amount is possible with appropriate inscription of the profit-sharing ratio on each security. However, negotiation is not permitted because trading of currency-enfaced securities would mean exchange of a currency with itself.[18] If negotiated, then gains accrued would be *ribŒ*. Of course, exchange at *par* values is permitted.

Currency-enfaced *muèŒrabah* instruments can be negotiated when they are inscribed in one currency but sold in terms of another currency. If a *muèŒrabah* instrument is enfaced in Iranian riyal and its bearer wants to sell against the US dollar, then trading of the *muèŒrabah* instruments would be a trading of two heterogeneous commodities and, therefore, gains from such transactions would be permissible. The currency-enfaced *muèŒrabah* instruments can, of course, also be negotiated and sold against real assets.

5. SCENARIO 3: CURRENCY-ENFACED *MUë•RABAH* INSTRUMENTS REPRESENTING REAL ASSETS[19]

This is a hybrid concept. *MuèŒrabah* contributions are made in the form of money and the monetary contributions are inscribed on the *muèŒrabah* instruments in terms of currency units. However, the currency-enfaced *muèŒrabah* instruments are deemed to represent proportionate value of real assets in the *muèŒrabah* enterprise. This is justified on the pretence that the money is used to purchase real assets of the enterprise. In other words, currency-enfaced *muèŒrabah* instruments are pretended to be asset-enfaced *muèŒrabah* instruments. Hassan (1997, 29) writes, "Once the project has been established and the monetary subscriptions have been changed into tangible property, utilities, and third party rights, the instrument would represent a joint share in the total assets of the project." Most scholars serving on *Shar¥cah* advisory councils of Islamic financial institutions and the *fiqh* academy of the OIC ascribe to this view. The Islamic financing community operates on this basis since their operations would then resemble the stock market operations.

As the monetary contributions into a *muèŒrabah* fund are deemed to represent real assets, the *muèŒrabah* instruments are deemed negotiable and tradable *in lieu* of the real assets. Therefore, prospects of capital gains and business profits dictate market price of the *muèŒrabah* instruments. In other words, negotiations of the instruments will depend on the future value of the assets and performance of the *muèŒrabah* business. Transfer of *muèŒrabah* instruments means transfer of rights on the assets represented by the instrument in addition to the applicable capital gains and business gains.[20] In this way, each bearer of a *muèŒrabah* instrument is presumed entitled to gains during the lifetime of the project beyond the monetary contribution made to the *muèŒrabah* fund. Therefore, if a bearer of *muèŒrabah* instruments decides to sell his *mudŒrabah* instruments prior to liquidation, then he may receive compensation for holding the currency-enfaced *muèŒrabah* instruments for a certain time period due to prospects of future profits. In other words, the *muèŒrabah* instrument bearers would be effectively rewarded with the time value of money, which is *ribŒ*.

However, if the *muèŒrabah* bearer continues to hold his *muèŒrabah* instruments until liquidation of the project then he will receive the profits according to his profit-sharing ratio. The dividends are viewed as a composite benefit that includes both the capital gains and business profits.

In a nutshell, the sale of the ‘principal with profits’ hinges on the belief regarding the time value of money. If the notion of time value of money is Islamic then the negotiated price will reflect capital gains as well as operating profits expected to accrue during the holding period of the *mudŒrabah* instruments. If time value of money is denied then the *muèŒrabah* instruments represent nothing more than the money contributed until termination of the project. Negotiability of the currency-enfaced *muèŒrabah* instruments is not permitted and they can be traded only at *par* value.

6. CONCLUDING REMARKS

Some issues pertinent to *muèŒrabah* instruments such as access of liquidity to the entrepreneurs, duration of a *muèŒrabah* instrument, acceptance of time value of money and contemporary approach towards Islamization of banking and finance are critically examined in this section.

It is a fallacy that the currency-enfaced *muèŒrabah* instruments represent assets in a company.[21] Money contributed into a *muèŒrabah* fund does not represent the assets because ownership of the financiers dissolves as soon as the entrepreneur uses the money to buy business assets. The assets assume the status of a trust managed by the entrepreneur. The value of the trust comprising principal, capital gains and business profits represents common claims of the financiers and the entrepreneurs that would be realized only when the *muèŒrabah* enterprise is terminated. The point is that the assets of the *muèŒrabah* enterprise do not represent sole ownership of holders of *muèŒrabah* instruments, rather it represents a common claim of both parties. So the returns, if any, are not due to the sole contribution of the investors. The returns are due to the joint application of financial as well as human capital. In practice, the *muèŒrabah* instruments are assumed to represent entitlements of the financiers only, they do not represent entitlement of the entrepreneurs. The practice of allowing negotiation and sale of *muèŒrabah* instruments to financiers is unfair to the entrepreneurs because the financiers can obtain liquidity against their entitlements but entrepreneurs cannot. Fairness demands either both parties be allowed to sell their entitlements or wait until the maturity of the *muèŒrabah* instruments. Hence, the creation and marketability of such *muèŒrabah* instruments that provide liquidity access against entitlements to both financiers as well as entrepreneurs are of immense importance. This may be accomplished by creating tradable securities representing only profit proportions in favor of each party. Currency-enfaced *muèŒrabah* instruments carrying both the principal and the associated profit-sharing ratio are negotiated in the same currency on the basis of potential profits, not the principal. If so, then the sale of profit proportions, without principal, can also be negotiated on the basis of the expected profits. Such provision can allow both the financiers and the entrepreneurs to convert their potential profits into liquidity. Securitization of entitlement to profits in the form of coupons representing various profit proportions is also possible. Securitization of the proportions can be done independently by the financiers and the entrepreneurs. Each profit-sharing coupon may be sold against a suitable price in the financial market. If done, then both the financiers and the entrepreneurs have been treated on an equal footing.[22]

A *muèŒrabah* enterprise has to be liquidated in order to realize the capital gains and the business profits. Therefore, *muèŒrabah* financing shall preferably be short-term in nature. *MuèŒrabah* was not meant for financing long-term ventures. In fact, the duration of a *muèŒrabah* contract during the Prophet's (pbuh) time used to be for a trading season.[23]

If the *muèŒrabah* contract continues for a longer duration, then the capital gains and the business profits shall be assessed, and accounts with respect to earnings and losses shall also be settled periodically. That is, a *muèŒrabah* contract might continue with renewed commitments. In other words, a *mudŒrabah* instrument can be rolled-over at maturity of each period after settling accounts and with renewed contributions of the partners. Of course, terms and conditions of the *muèŒrabah* contract will also be renewed. If the entrepreneurs also contribute funds in the renewed *muèŒrabah* contract, then the *muèŒrabah* will change into a *mushŒrakah*.

For investors such as widows and retirees, the *muèŒrabah* investment may be the only source of income and, therefore, they may require periodic withdrawals[24] from their *muèŒrabah* shares in order to meet their bread and butter needs. The necessary withdrawal may be made out of their share in the principal[25] or expected profits. A bar on such withdrawals may be sustained for short-term *muèŒrabah* investments. But, a bar on periodic withdrawals from medium-term and long-term investments would defeat the real purpose of owning the capital.[26]

Only commodity money, like gold and silver, was in vogue during the advent of Islam. Different currencies, like *dirham* and *dinŒr*, were composed of different materials or minted in different quantities. As the currencies, in fact, had a status of different commodities, so benefits related to their spot and deferred exchange represented legitimate earnings. Of course, earnings associated with spot and deferred exchange of the same currency are *ribŒ*. As earnings from deferred exchange of money (i.e., debts) are prohibited, therefore, time value of money is also prohibited. In fact, when *ribŒ* is interpreted on the basis of the background practices of the Arabs, it becomes very clear that it was the charge, in the sense of time value of money, which was prohibited. The practice was as follows. "A person would be indebted to another person up to a fixed period of time. When the maturity date of that loan would arrive, he would say (to the borrower): would you pay or increase (the amount due from you)? If he paid he would take (the money in repayment). Otherwise (the borrower) would increase the amount due to him (the creditor) and the latter would extend the due date of the loan," (Alkaff, 1986, 37).

Vogel and Hayes (1998, 2) state, "Islamic finance remains subject to a variety of misunderstandings by both Muslims and non-Muslims. For example, it is widely known that Islamic finance prohibits the charging of interest on loans. But most do not know that Islamic law does not reject the notion of the time value of money."[27] They also claim, "Time is money in financial markets. Instruments are priced as a function of the cash flow connected to them as well as risks that surround them. All things being equal, an investor would rather obtain money sooner than later, and a capital user would rather delay payments to which it is obligated," (Vogel and Hayes 1998, 204). This *ribŒ*-ridden mentality has permeated and polluted minds of the Muslims practicing Islamic finance. Unfortunately, some scholars have been supportive of the trend. They have ironically approved such financial instruments and innovations that reward time value of money. It is done due to financial compulsions to emulate conventional practices by people of *ribŒ* mentality instead of sticking to the fundamental dictates of the *Qur'Œn* and *Sunnah*. For example, the Pakistan Federal Shariat Court (1995, 173) mentioned that Ibn QudŒmah wrote, "It is permissible if the seller of a commodity says that he sells it by such amount if the payment is on the spot and by such (excess) amount if the payment is after a certain time." Zarqa (1997, 235) in his discussion on *istisnŒc* argues that "Needless to say, the deferred price of goods acquired against such certificates would be higher than the spot price of the same goods. This price differential is clearly tolerated by the *Shar¥cah* as a legitimate facet of trading activities." He further claimed that the Fiqh Academy of the OIC has reaffirmed the legitimacy of this price differential. If so, then such differentials will also apply to the *salam* and *mu'ajjal* sales. This has prompted Vogel and Hayes to say "Thus, in both credit *(nas¥'ah)* and forward purchase *(salam)*, i.e., in sales where counter-value is currency paid either in advance or after delay, the law allows the parties to agree on price differentials compensating for the delay in contract fulfillment" (Vogel and Hayes, 1998, 77).

Charging against time on credit-selling is controversial. A brief summary of the debate on increasing the price of a good in return for deferment is given in Saadallah (1994, 84-92). Proponents of legitimacy of time value of money reason that: credit-sales promote trading; the difference paid by the buyer and received by the seller is price of the use of the item during the period of indebtedness; a contract involving deferred payment is an independent contract, its validity cannot be judged in relation to other contracts; compensation for time in a credit-sale contract cannot be specified separately; reduction is allowed for early payment due to a *úad¥th* and therefore, by analogy, increase is allowed for credit sales; and as immediate payment is preferred to deferred payment, this means that time makes a difference in an otherwise fair contract. So, time value of money may be included in credit-sales. The opponents of the charge against time value of money argue that certain sales constitute *ribŒ*. It is controversial whether credit-selling represents sales or *ribŒ*. Such credit-selling is prohibited because, in such situations, ban takes precedence over permission; the credit-selling is a result of coercion rather than mutual consent; when an item carries two prices: a cash price and a credit price then this boils down to the forbidden category of two-in-one transactions; because cash price is lower than the credit price, only cash price may be charged since the Prophet (pbuh) has said that two-in-one transactions shall either end up in a lower price or in *ribŒ*; and an increase in loan amount due to deferment is no different than such an increase in sales, both falling under the category of *ribŒ*.[28]

Charging against time value of money is a common practice in the operations of Islamic financial institutions. Proponents of these practices would argue that it is trading, which, of course, is not a new excuse. The same excuse was made by *ribŒ*-takers earlier to which the *Qur'Œn* responded, "Those who devour usury will not stand except as stands one whom the Satan by his touch hath driven to madness. That is because they say: 'Trade is like usury,'"(*al-Qur'Œn*, 2:275). The point is that if the deferred exchange contracts include compensation for time, then they contain *ribŒ*. Absence of *ribŒ* demands that the deferred price must equal to the spot price of an article.

It is understood that Islamic banks cannot obtain compensation from their customers if their repayments are delayed. Obviously if such compensation was allowed then the banks would be charging in the sense of time value of money. Of course, charging of such compensation would amount to violation of the *Qur'Œn*ic injunction that says, ". . . if the debtor is in a difficulty, grant him time till it is easy for him to repay," (*al-Qur'Œn*, 2:280). Therefore those who legitimize incorporation of time value of money in *salam*, *istisnŒ*ᶜ and *mu'ajjal* sales, put forward contradictory proclamations because, on the one hand, they denounce time value of money but, on the other hand, they legitimize inclusion of time value of money in deferred sales.

There is no doubt that interest in conventional financing is a charge representing the time value of money. Replacement of the conventional financial system with an Islamic financial system demands demolishing such charges. If so, then verdicts allowing charge against time value of money would not only hurt the cause of Islamization of the financing system but it will also perpetuate the *ribŒ*-based financial system.

Islamic finance aims at a niche market consisting mainly of those Muslims who seek to participate in a widening range of Islamic financial transactions. In reality, it does not offer niche products; rather, it reformulates available conventional financial products following recommendations of their *Shar¥ᶜah* advisors. It is, again, not in the interest of Islamization to discover Islamic means for satisfying conventional financing procedures and objectives like profit maximization. Instead, there is a dire need for innovating means that would be consistent with Islamic objectives like *al-ᶜadl wa al-iúsŒn*. But, in reality, they have focused on the provision of those services to customers that are provided by their conventional counterparts and they are interested in the same financing objectives as their counterparts. They base their profit-making decisions along similar lines in which their conventional counterparts base their interest-making decisions. Muslims need to shun the copious approach, follow correct Islamic perceptions, and give priority to faith over economic gains. Performance indicators applicable to Islamic finance have to be different than those applied in conventional finance. Muslims'actions must comply with *Qur'Œn*ic injunctions related to business behavior. If they continue to copy conventional practices, despite their illegitimacy, then they will always linger behind.

Islamic finance introduces complications in order to incorporate recommendations of the *Shar¥ᶜah* advisors into, otherwise, simpler transactions. These cosmetic changes make "Islamic" transactions more expensive to the customers than similar deals through their conventional counterparts. Sooner or later the customers will realize that there is no real difference between the so-called Islamic financial products and the comparable conventional products. If this happens, then the customers may refuse to bear the extra cost on the pretence of superficial *Shar¥ᶜah* compliance. Already, such customer reaction is surfacing. For example, Vogel and Hayes (1998, 9) have found that, "These 'synthetic' *murŒbaúah* transactions are unacceptable to the devout Muslim, and accordingly there is now a movement away from *murŒbaúah* investment of all types. Al-Rajhi bank, al-Baraka, and the Government of Sudan, are among the institutions that have vowed to phase out *murŒbaúah* deals."

In sum, current trends and strategies of providing copious products would be self-destructive because, on the one hand, realization of truth by the customers regarding Islamicity of their transactions would curtail demand for such financing products and, on the other hand, higher costs resulting from unnecessary compliance with superficial *Shar¥ᶜah* requirements render these products more expensive compared to similar conventional products. These factors may disappoint the customers of the Islamic banks. Therefore, it is a must for Islamic finance to improve their products by concentrating on Islamic techniques that do not contradict the injunctions of the *Qur'Œn* and *Sunnah* in order to benefit from the niche market.

ENDNOTES

1. See *al-Qur'Œn* (4:29).

2. Commodities refer to all tradable goods and services.

3. Exchange means to give and receive in return.

4. Similar commodities cover both homogeneous as well as differentiated products like dates of all types. Dissimilar commodities refer to different and heterogeneous products only.

5. Money has the same status in exchange as any other commodity. In other words, money must be a commodity with its own intrinsic value in an Islamic economic system, otherwise recovery of the principal stressed in the *Qur'Œn* (2:279) would be meaningless. A recent *fatwŒ* has declared that use of paper money is *úarŒm*. See Vadillo (1991) for details.

6. Views regarding the prohibition of time value of money differ. Time value of money is a key concept in business financing. Therefore, a detailed discussion on time value of money is included in a later section.

7. The preceding part of the same verse says, "they say, trade is like *ribŒ*." Trading (or in this case, selling) is confused with *ribŒ* transactions because both are income-generating exchange contracts. It is reminded to them that income from exchange of heterogeneous commodities (including money) is due to trading but income from exchange of similar commodities is *ribŒ*. There was no need to spell out the distinction between trade and *ribŒ* because it was (and is) obvious.

8. Recall that the Prophet (pbuh) and his eminent Companions including Ab´ Bakr, [C]Umar and [C]UthmŒn were also traders.

9. Mutual willingness is an essential factor in trading. However, exploitation on the pretense of mutual willingness is not allowed. For example, *ribŒ* is

prohibited even though it happens with mutual consent of the parties. Similarly, the practice of the people of Mad¥nah to meet farmers outside the town and purchase grain from them, was disallowed (Afzal-ur-Rahman, 1975, 44) by the Prophet (pbuh) even though the trading must have been conducted with mutual willingness. A detailed discussion of tenets and injunctions related to trading and marketing is given in Anwar and Saeed (1996).

10. Even a *mushŒrakah*, like a *muèŒrabah*, cannot generate profits by itself. *MushŒrakah* and *muèŒrabah* are modes to finance production for trade. Profits accrue in the course of trading. Debt-financing is done by deferred exchange contracts like *bay[c] bithaman Œjil (bay[c] mu'ajjal), salam*, *istisnŒ[c]* and *ijŒrah*. These are trading activities that directly generate profits.

11. In exchange activities, earnings accrue to sellers. Therefore, one may focus on the sale aspect in exchange as done in the *Qur'Œn* while referring to the distinction between sale and *ribŒ*.

12. Assets are generally revalued by accountants on the basis of expected prices of the assets for computing profits. These computations do not represent actual profits. Actual profits will accrue only if the assets are traded.

13. Following Vogel and Hayes (1998, 173), real assets are assumed to represent properties other than money and monetary obligations, like debts.

14. Some scholars insist that *muèŒrabah* contributions must be in the form of money. However, *muèŒrabah* contribution both in the form of money and also in the form of goods is permissible. See D. M. Qureshi (1984, 8).

15. Further discussion on currency-enfaced *muèŒrabah* instruments will follow.

16. In fact, the investors can create two sets of securities: asset-enfaced securities (AES) representing real assets, and profit-sharing-enfaced securities (PSES) representing entitlements to business profits. The AES representing claims on assets and the PSES representing claims on business profits can be sold separately. Perhaps it is not permissible. If business loss accrues then owners of AES shall bear the loss. The loss may be recovered by selling the real assets in the *muèŒrabah* enterprise. However, two questions arise. First, is how to select the real assets from all assets of the *muèŒrabah* business. Second, although bearers of PSES would benefit if business profits are realized,

they have no role in sharing the losses. So one can see ambiguities *(gharŒr)* and injustice imbued in separate securitization of entitlements to real assets and business profits. This is an issue that deserves attention of *Shar¥ah* scholars.

17. The term ‘liquidation’ is generally used when a business goes bankrupt because of excessive debts. Therefore a company’s assets are converted into money to settle the debts. However, liquidation is used here in the sense of converting *muèŒrabah* assets into money.

18. This is a controversial position. Negotiability depends on whether time value of money is recognized in Islam. A digression on the issue of time value of money is presented later.

19. *MuèŒrabah* instruments represent money contributed and the money so contributed represents assets of the enterprise. So, the *muèŒrabah* instruments are considered direct representatives of money but indirect representatives of the assets.

20. The capital gains would represent changes in the book value of the assets. Actual gains cannot be realized without selling those assets. Hence, the *muèŒrabah* enterprise must be liquidated first to realize the capital gains (or losses), otherwise they would merely represent a book-keeping entry.

21. Paper money is enfaced in currency units like the *muèŒrabah* instruments. Therefore, currency notes, like the *muèŒrabah* instruments, can also be claimed to represent certain assets. Since such is the case, can negotiations of currency notes be allowed? No society allows such negotiation of a currency against itself because it would generate unjustified return (*ribŒ*).

22. Islamic legitimacy of trading these coupons, however, is not clear. Also see footnote 16.

23. The Iranian decision to allow short-term *muèŒrabah* contracts solely in trade and commercial operations (Yasseri, 1999, 4) is consistent with the Prophetic tradition and the original purpose of *muèŒrabah*.

24. Hassan (1997, 56) holds the view that the *muèŒrib* may distribute some profits to the holders of the instruments and credit them to the profit account.

25. Withdrawals from the principal may require changing profit-sharing ratios

as their contribution to the *mueÆrabah* will be diminishing on each withdrawal.

26. *MushÆrakah* certificates issued in Iran are based on guarantee of principal and interim returns (Yasseri, 1999, 4-5). Final settlement takes place at maturity. A similar arrangement can be instituted for *mueÆrabah*. In such situations, two matters have to be settled. Firstly, the legitimacy of giving dividends in fixed amounts prior to realization of actual profits seems fine provided overpayments, if any, can be recovered from the subscribers. But, if the certificates were continuously changing hands through dealings in the secondary markets, then how can the bearers of *mushÆrakah* certificates be identified for recovery of overpayment? Secondly, if the project ends in loss, then the loss has to be recovered from the principal holders. How can they be identified?

27. It is well known that interest represents time value of money. If this is so, then how is it that Vogel and Hayes stated that interest is prohibited while time value of money is permitted? Does it mean that interest and time value of money are two distinct concepts, or does it mean that interest is allowed in the name of time value of money?

28. The arguments favoring or opposing payment against time are based on the presumption that credit-selling takes place between actual buyers and actual sellers (traders). This presumption is faulty in the case of banking transactions because the banks are not actual traders. They are merely financiers even though they exploit the trading channels to fulfil their financing aims. A detailed study on the application of time value of money in Islamic banking operations is given in Anwar (2000, 4-9).

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