FINANCIAL INTERMEDIATION IN THE FRAMEWORK OF *SHARI'AH*

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The paper seeks to examine the position of the shari'ah on the creation and transfer of financial instruments. In this connection, the paper also highlights the role of financial instruments as a method of mobilizing financial resources for investment and explains the rules and regulations governing the different contracts of investment, as well as their returns, from the viewpoint of shari'ah. The paper argues that financial instruments represent a common share in the ownership and that they have limited liability, but where financial instruments stand for debts payable by a third party, the negotiation of debts is stipulated by shari'ah. The paper argues that it is justified to issue several financial certificates for one single salam sale operation. Shari'ah does not, however, allow salam certificates to be sold at a price other than its face value before the delivery of the goods in question. It is maintained that financial instruments can be issued for specific and general types of investment having different maturities. The proceeds of financial instruments resulting from their sales can be invested through various modes of Islamic financing, such as leasing, equity participation, etc.

1. DEFINITION OF FINANCIAL INSTRUMENT

A financial instrument is a certificate representing a common share in a fund raised for investing and making a profit, issued by the body handling this investment or the body acting on its behalf, which provides for its negotiation and conversion into liquid money when required.

2. ASPECTS OF A FINANCIAL INSTRUMENT

Given the above definition of financial instrument, it follows that it has certain aspects. If we relate and conform them to the rules of *shari'ah,* it becomes permissible and valid from the *shari'ah* point of view: in connection with its issuance, investment of its proceeds, sharing of profits accruing from such investment, negotiation and conversion into cash when required. I shall attempt delineating and expounding these aspects, and the related *shari'ah* principles and rules involved in each one of them.

2.1 Title of Ownership

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A financial instrument represents a share in a financial claim. As such, it is a title of ownership and does not constitute money, properly indicating ownership, in exactly the same way as in the shares of joint-stock companies, where the share represents a title of ownership of the net assets of the company and not money per se. Consequently, negotiation and transfer of ownership pertains to the object of the certificate and not to the certificate itself, which is regarded from the legal point of view as a proof of the claim, method of negotiation and transfer of ownership.

Shari'ah permits the disposition of the title of ownership and even goes so far as to permit, according to the Malekites and some jurists, the disposition of debts through pawning and selling under certain conditions. They consider the receipt of a debt bond which they call "title testimony" as actual payment of the debt under which the pawn contract is committed and by which the stipulation for actual receipt ordained in the Quranic verse "then a pledge in hand" is fulfilled, regardless of whether the pawning of debt is carried out by the debtor himself or any one else.

2.2 Common Share in Ownership

The share represented by a financial instrument is a common one and not a specific one, in the same way as in the case of the shares of a joint stock company. Like the shareholder, the holder of the financial instrument owns a common share in the net assets of the enterprise or the activity which is financed through the financial instrument.

Under the *shari'ah,* common ownership is permissible at inception, permanently and eventually, as *shari'ah* considers it legal to deal in it through legal means such as selling, pawning or donating.

2.3 Title of Common Ownership of the Financial Aggregate

A financial instrument after it is issued and sold, but before the proceeds are invested, represents a share in the common ownership of the financial aggregate. Therefore, dealing in this certificate and disposing of it is subject to the rules of disposition in money, that is, of selling money. Consequently, it should be sold at its face value. In this case, it is revocation of the purchase contract and is not a new contract, according to the majority of jurists. Preferably, the prospectus should state that negotiation of the financial instruments is not permissible during the period of issuance and sale and the period required for the enterprises to start functioning. After embarking on investment operations and transferring of liquid funds into assets such as

equipment, land, buildings, commodities, etc, the object of the financial instrument is transformed into a common ownership title in the aggregate of related properties, benefits and entitlements. At this time, it is permissible to deal in them through the legal means of dealing, in accordance with the rules governing dealings in financial and not pecuniary shares. Negotiation is permissible if the financial instrument certificate represents a common share in a financial asset, e.g. financing the purchase of an aeroplane and leasing it to gain profit. This financial instrument, in this case, represents a share in the ownership of the aeroplane, that is, the ownership of an asset. The same applies where the financial instrument is issued for financing a foreign trade operation. The financial instrument in this case represents a common share in the assets of these commodities. It is also applicable in the case of factories, agricultural land and buildings, when the financial instruments are issued for financing any of these enterprises or activities. There is no restriction as to the negotiation of shares in financial assets and in their disposition in a legal way such as selling, pawning or donating.

The common share represented by the financial instrument can be the usufruct of one or more assets, e.g. issuing financial instruments for financing the lease of an aeroplane or a ship for re-leasing to gain a profit, or leasing land for cultivating and gaining profit out of it. The bearer of the financial instrument of such enterprises or activities owns a common share in the usufruct of the property or properties, and not in the ownership of particular property.

According to the *shari'ah*, ownership can be of the usufruct as well as the property. Disposition of the ownership of the usufruct is permissible, in exactly the same way, as in the case of the ownership of the property, with or without a compensation and at a lower or a higher value than what has been paid for the usufruct. If some one leases a ship or an aeroplane for a million dinars, he is entitled to re-lease it at a lower or a higher value, since he is in possession of the usufruct, and he is free to use it by himself or to transfer this right to another. However, the proceeds emanating from the issuing of financial instruments allocated for financing the lease and re-lease operations, after embarking on the activity (i.e. after leasing and payment of rent) are transformed into usufructs in which the financial instrument represents a share. When the re-leasing is carried out, the usufruct changes into a debt to be paid by the lessee. In this case, the certificates represents net debts payable by a third party, and is governed by the rules applied in the negotiation and disposition of debts. In other words, disposition of this certificate in this case is a disposition of debt payable by a third party. Disposition of debts by selling is not permissible according to the majority of jurists. However, it is permissible according to Malekites, except under certain conditions, the most important of which is that the recompense or compensation for the certificates should be a commodity and not cash money. Disposition through pawning is permissible according to the Malekites, and so these certificates can be used in pawning, even if they represent net debts to be paid by others. These certificates, in

this case, are subject to all the rules applicable for debts.

The same holds in the case when issuance is for a single operation of lease and re-lease, as it undergoes these three stages: (1) the pecuniary stage (after marketing the certificates), (2) the usufruct stage (after leasing and before re-leasing for a deferred rent), and (3) the debt stage (after transferring the usufruct ownership to a third party in return for a rent payable by this third party). The prospectus should contain the rules of negotiation under each stage. If the issuance is made for the purpose of financing a series of operations of lease and re-lease, or in other words, to finance an activity of leasing and re-leasing, carried out constantly, the rules of disposition of debts are not applicable. This is because, while there are debts payable by a third party in consequence of leasing for a deferred rent, there are titles of ownerships of the objects leased but not yet re-leased. Even the rules of disposition of money are applicable here because the financial instruments in this case do not represent solely a debt or solely money, but an aggregate of money, usufructs and debts. In other words, they represent a share in the net assets of the relevant activity or enterprise, in much the same way as in the case of the joint stock company.

The share in a joint stock company represents a common share in the title of ownership which includes properties, usufructs, debts payable by a third party, cash in hand, or cash kept with a third party, i.e. a share in the assets of the company. The *shari'ah* rule is that what is not permissible on its own is permissible in subordination, and what is not permissible at inception is not permissible permanently.

Thus, a debt cannot be pawned at inception, according to the Shafeites. However, if the pawned object is damaged while it is in the mortgagee's possession, the mortgagee has to pay the value of this pawned object, as this value is considered as a debt payable by the one who caused the damage to the object pawned by the mortgagee pending repayment of the debt of the mortgager. The mortgager is not to be redeemed by the one who caused this damage as the actual relation is between the two parties, the mortgager and the mortgagee.

It is not permissible to single out the fetus of an animal for sale. However, it is permissible to sell the animal together with its fetus. Some entitlements are not permitted to be disposed of independently, such as the right of passage and the right of water. However, when there is an ownership title, it can be disposed of. By analogy, it is not permissible for debts to be sold independently. However, it is permissible to sell them as part and parcel of the assets, usufructs and entitlements.

If the financial instrument stands for debts payable by a third party, negotiation and

disposition of such a financial instrument are subject to the rules of disposition of debts stipulated by *shari'ah*. When a bank issues financial instruments for financing a *salam* (forward buying of goods) operation, the proceeds of these instruments, before paying to the receiver of the price, i.e. the *salam* seller, are owned by the holders of these instruments and regarded as money. Consequently, disposition of these instruments in this case is subject to the rules of disposition of money, as mentioned earlier. When the *salam* if fulfilled, and the price is delivered to the receiver upon contract conclusion, the status of the title of the financial instrument holder is changed from money into debt. This is so, because the *salam* commodity is a specified debt payable by the receiver of the price (i.e. the seller) till he delivers it according to the specifications made in the contract, whereupon the certificate holder is not entitled to dispose of it or transfer its title to a third party, as the disposition of the *salam* commodity before getting possession of it is not permissible as stipulated by the *sunna*. Issuing financial instruments to finance *salam* trade is permissible, but negotiation of these instruments is associated with legal *shari'ah* difficulties. This is so, because the certificate represents money before the seller receives the price, and it represents a debt after the delivery. Disposition of the cash money share or the debt share is not permissible, as indicated earlier. Even the Malekites who permit disposition of normal debts in certain circumstances and under particular conditions, forbid the disposition of *salam* commodity, if it has not yet been received. Financial instruments may be issued for financing one single *salam* operation, or a number of *salam* operations. If the financial instruments are issued for financing a series of *salam* operations, i.e. to finance *salam* contract trading activities, so that they form a consecutive flow of operations of buying, receiving and re-selling, the certificate does not represent a share in money or a share in a pure debt at any particular time, and would represent a common share of a combination of money not disposed of, debts constituting a *salam* commodity to be delivered by the recipients, commodities that have already been delivered, and the proceeds of selling some of these commodities. In this case, negotiation of shares in a financial aggregate, and not to the rules of negotiation of money or pure debt shares, on the ground that what is not permissible independently is permissible subordinately, i.e. in association with others, as indicated earlier. This is analogous with the case of companies. The share in a company represents financial assets such as buildings, equipment, material and productive goods, and usufructs of leased properties such as buildings, vehicles and equipment that are leased for the enterprise, and debt payable by others who buy the goods. There is consensus as to the permissibility of selling shares that represent this combination of assets even if they include debts payable by others. What matters is the dominant and not the insignificant. The insignificant here in this context are the debts. Moreover, the enterprise or the company realizes other moral titles that increase the financial value of the share.

Therefore, it is suggested that financial instruments should not be issued for financing

one single *salam* operation, otherwise, they would lose the most important component of the financial instrument, that is, negotiability and the transferability into cash when required. Instead, it is recommended that issuance would be for financing *salam* operations in a particular commodity or a group of commodities, so that they include several consecutive contracts conducted in a well planned and organized way so as to ensure a continuous flow of dealings. In this way, *mudaraba* is for a fixed period and not for a fixed transaction. Nevertheless, there is nothing against the Islamic bank issuing financial instrument certificates for financing one single operation of *salam* provided that the prospectus states that the financing will be for a single transaction, say, jute or tea, and that it is not negotiable. The liquidity issue can be overcome by loaning or disbursing an amount of the future profits, under guarantee of these certificates.

However, the non-permissibility of disposition of the *salam* commodity, being a debt payable by the seller before he actually delivers it, does not prevent that person from selling in *salam* a commodity of the same kind of the commodity he has bought, taking into account that the due date for receiving this commodity is prior to the date he has been committed for delivery. This is so, because this commitment of his is personal and binds him and not a third party. In this case he is disposing of the debt the recipient owes him, and consequently there is no aleatory involved. For, in case the recipient of the price does not deliver the goods, the damage does not extend to one with whom he enters into a contract, as his commitment is not associated with the receiving or non-receiving of the goods he has bought in *salam*.

2.4 The Financial Right and Limited Liability

Financial instruments have a title to the assets and do not extend to the belongings of a particular person. This is similar to the case of shares in a company, unlike the interest-based bonds issued by companies which constitute unlimited liability, because they represent debts payable by the issuing company, which is committed to reimburse the value of bonds together with the interest agreed upon regardless of the outcome of the activity. In addition, the bond-holder does not bear any risk of the damage, destruction or loss that may be encountered by the company issuing these bonds, because the right of the holder is not related to the company assets, but rather to the company's liabilities. The bond-holder shares the profits of the company and does not share its losses. The Islamic financial instrument, on the other hand, being a share in the title of the enterprise or activity, requires its holder to share equally in profits as well as losses, because it is the outcome of his title. The outcome of the title is divided between the title holders according to their shares. They are to bear any damage, destruction or loss encountered, on the ground that everybody has to bear the damage of his property. It then follows that the financial instruments are profit-sharing bonds, bearing the risks of investment in accordance with the principles and rules of the Islamic *mudaraba* and *musharaka*.

The relationship between the holders of the financial instruments and the one who invests the proceeds thereof, is that of the fund provider and the *mudarib* (entrepreneur), and not that of a lender or a borrower. The returns are divided in accordance with the terms and conditions set forth in the prospectus which forms the intent in the *mudharaba* contract, while agreeing to purchase the instrument constitutes acceptance in this contract of the terms and conditions set forth in the intent, i.e. the prospectus. The issuer of the financial instrument may be the *mudarib*, i.e. the entrepreneur who invests their proceeds, or he may be handling it on behalf of a third party, in return for a commission, as many parties can participate in the issuing operation, with each one of them having a certain role, in return for a specified consideration as agreed upon, while there is only one entrepreneur handling the investment of the instrument's proceeds.

The *shari'ah* does not forbid issuing financial instruments by their holders, so long as issuing is made on the basis of the Islamic partnership, the contract partnership is shared by the instrument holders, with management undertaken by themselves, too. In this case, whoever conducts the management task shall be doing this by proxy or on behalf of the others and not in the capacity of a *mudarib*, and for the share in the profits of the enterprises or for a fixed fee. In this case, the enterprise for the financing of which these instruments have been issued, is thus owned by the instrument holders according to their share of participation, and they also take up its management and bear its consequences. The person who undertakes actual running of the business is treated as an employee and not as a *mudarib*. In the former case, although the enterprise is owned by the instrument holders who financed it through the issuance of these instruments, the one who is assigned the management of the enterprise is a *mudarib*, who has the authority to make investment decisions by himself within the terms and conditions set forth in the *mudaraba* contract included in the issuance notice and annexures concluded with the *mudarib*, that is, the entrepreneur who runs the investment, whether an individual or a company. The issuance notice is regarded in this context as a partnership contract (articles of association) for those who purchase these instruments. The term "partnership" used in this context signifies the broad Islamic concept, that is, the participation in providing the funds required for the enterprise, although they may not be a company organized according to the law of companies.

2.5 Allocation of the Proceeds of the Financial Instruments

One of the important aspects of financial instruments is the purpose for which finance is being raised. What counts here is the use of the funds that underlines the issuance of these instruments. If the instrument represents a common share in the title of funds meant for personal use, charity or any such specific purpose, it cannot be regarded as a financial

instrument. For instance, if instruments are issued to indicate the share of each holder in the ownership of a property for personal use, these instruments cannot be regarded as financial instruments in the sense meant here, because the aim of issuing financial instruments is, as will be seen, to facilitate mobilization of savings and raising of funds required for investment and development, in a way that would combine both the stability of investment enterprises, the long term one in particular, and the need for liquid cash when the provider of funds finds himself in a situation requiring liquidity. These considerations are not implied in the instruments which represent shares in the ownership of a property not meant for investment. We shall see that the profits accrued from investing the proceeds of the financial instruments in a particular enterprise or an activity are distributed between the entrepreneurs who stand as *mudarib* and the instrument holders who stand as the fund providers in the context of the *mudaraba* contract represented by the prospectus and all relative annexures issued subsequently, after deduction of the amounts paid to those who contributed to the operation on the premise that they are under employment contract with the enterprise and not a *mudaraba* contract.

2.6 Negotiability and Liquidity of the Financial Instrument

Another aspect of the financial instrument is that it is negotiable through legal means such as selling, pawning and donating. What is sold, pawned or donated in this connection is what the instrument represents and not the instrument in itself. The transaction medium should be in actual money terms. The selling of a financial instrument means selling of the common share in the financial aggregate represented by a particular issuance. The financial instrument is considered a proof or a testimony of the transfer of title of the sold share, and receiving it is considered as receiving this share.

The price of the financial instrument, i.e. the price of the common financial share represented by the instrument, is determined according to supply and demand. The contract is effected on the basis of proposal and acceptance of the proposal, in much the same way as in all the dispositions regarding a common share in private property or properties. A bank, a group of banks, an institution, a company or an individual may issue public offer for a fixed period agreeing to purchase the financial instrument at the price that is indicated. In determining the price at which the instrument is to be purchased, the purchaser can follow all possible means which naturally include the financial position of the enterprise or activity in which the financial instrument represents a common share. The purchaser can also include any other consideration that he deems would fulfil an Islamic objective. According to *shari'ah*, there is no harm that the purchaser determines the price so long as the instrument holder is free to sell at this price to any one or at a higher price to another person. However, practical considerations require that whoever undertakes to purchase should offer prices that are commensurate with

the financial position of the enterprise or activity without exaggeration so as to ensure the liquidity of the financial instrument.

3. TYPES OF FINANCIAL INSTRUMENTS

Financial instruments can fall into different types and categories, depending on the criteria used. The major classifications of financial instruments are presented in the following:

3.1 Classification of Financial Instrument according to Period of Investment

A financial instrument can fall into three categories according to length of time: short term, medium term and long term. The basis of this classification is the uses to which the proceeds of these instruments are put. For example, if the proceeds of the financial instruments are put to a long term investment, they are referred to as long term instruments.

The above approach is acceptable from the *shari'ah* point of view, because, as we have stated earlier, the instrument represents a common share in a particular enterprise or activity or even in the overall activity of the bank. It follows, then, that the duration of the instrument is that of the related enterprise or activity. Since *shari'ah* permits a fixed term *mudaraba*, regardless of whether this term is long or short, the issuance of these instruments in this way is Islamically permissible.

The instrument does not necessarily have to be a fixed term, as *mudaraba* is permissible without a time limit, and the instrument represents a common share in that particular enterprise and ends with its termination.

To sum up, *shari'ah* principles are not against issuing financial instruments of any specified duration, whether long, medium or short or even without a time limit; they are associated with a particular enterprise and end with the termination of the enterprise. This is determined according to the nature of investment to be financed by the proceeds of the instruments.

3.2 Classification of Financial Instruments according to Allocation of Proceeds Thereof

The financial instrument proceeds can be allocated for a particular operation or a specific enterprise, and may be invested in a certain activity, or even for the overall activity of the issuing bank or financial institution. So, the instrument issued for financing a particular transaction, such as purchasing an aeroplane and leasing it, or purchasing a certain commodity

and selling it at a profit (*murabaha*), terminates at the end of the operation, and its bearer gets back its nominal value together with its share in the profits or minus its share in the loss. During its short life, it can be circulated in accordance with the *shari'ah* rules, as mentioned earlier.

Examples of an instrument issued for financing a particular or a specific enterprise are those issued for a housing project or establishing a factory. The instrument holder in this case is a partner in the title of this enterprise to the extent of his share as specified by the instrument. As such, he shares in the profits of the enterprise and bears its losses to the extent of his share.

The instrument issued for financing a particular activity such as trading in a certain kind of commodity, buying land and erecting buildings on it, or in the agricultural or animal production activity, represents a share in the title of the net assets of such activity, with profits and losses distributed on this basis.

The financial instrument may represent an unconditional deposit with the bank. That is to say, it is not directed to a specific operation, enterpriser activity. The proceeds of these instruments become a part of the overall funds invested in the bank. Profits and losses are thus apportioned, divided and distributed on this basis, and the Islamic bank is considered a *mudarib* authorized to make investments of all types.

The above classification is permissible in the *shari'ah*. The rules of *shari'ah* are applied in connection with each type and specified in the terms and conditions of the *mudaraba* contract embodied in the financial instrument prospectus. These terms and conditions are binding and should be observed by the entrepreneur who makes use of the proceeds of the financial instruments, in his capacity as a *mudarib*. If he violates these terms and conditions, by utilizing the proceeds assigned for a particular operation in purposes other than this, he is held responsible and liable for it.

4. ISSUING FINANCIAL INSTRUMENTS

Issuing financial instruments is considered as a public offer of intent of the fund raiser who would utilize the proceeds of the issued financial instruments, or the bank or the institution that undertakes this issuance on behalf of the one who will make use of the proceeds. Therefore, the prospectus should include all the terms and conditions of the *mudaraba* contract. The buying of the financial instrument is considered as the buyer's acceptance of the terms and conditions of the *mudaraba* contract contained in the prospectus. Therefore, the prospectus should include sufficient information on the following:

Firstly, there should be adequate information about the enterprise, activity or operation for the financing of which the financial instruments are issued. This shall include its description, purpose and the feasibility study conducted for it, stating the capital required for investment, the projected profit, the duration required for execution, and other components of the feasibility study. This can be given in summary form in the prospectus, while giving access to the full study for any one who wishes to read it in detail. The objective behind this is to fulfill the condition of awareness of the object of the contract which is investment in a particular enterprise or activity. If the financial instrument is issued to attract savings to participate in the overall activity of an Islamic bank, such as those known as deposit certificates, then this should be pointed out in the prospectus together with necessary information about the bank's financial position, volume of investments, average profit usually realized, and other particulars that would enhance awareness about the nature of investments in which the buyer of the financial instrument will participate.

Secondly, there should be a clear exposition of the method of distributing the profits between the instrument holders (as the *mudaraba* fund providers) and the party who invest the proceeds of these instruments.

Thirdly, there should be sufficient information on the person, the institution or the company for whom this issuance has been made, that is, the party which will conduct the investment of the proceeds.

In sum, the prospectus should include all the requirements of a *mudaraba* contract, where the issuing bank or banks constitute the offerer, and the buyer of the financial instrument after perusal of the prospectus constitutes the acceptor. The most important requirement in this contract is the awareness of the object of the *mudaraba*, method of distributing the returns, and the body which will utilize the proceeds of the issued financial instruments.

The legal status of the bank issuing the financial instruments would vary according to the task performed by it. If its role is to issue the instruments, on behalf of the utilizer of the issuance proceeds, then the bank in this case is acting as a paid agent in the issuance process and shall perform all the duties and bear all the responsibilities of the agent. The bank, in this case, is acting as an agent for the *mudarib* for whom the financial instruments are issued, and not as an agent for the instrument holders, on the assumption that they are not known to the issuing body beforehand, i.e. before issuance. If the bank is handling issuance to be invested by the bank itself, it is in this case playing the role of *mudarib*. The bank is thus entitled to deduct the issuance expenses from the proceeds, if this is stipulated in the conditions of the

mudaraba contract set forth in the prospectus, which shall then be applied to the relationship between the bank and the holders of the issued instruments.

The bank issuing the financial instruments is responsible for the authenticity of the information given in the feasibility study and the soundness of the economic analysis of this study, in accordance with the observed practices. This responsibility arises by virtue of its being a *mudarib* responsible for the contents of the feasibility study conducted by it and publicized, leading the public to buy these financial instruments - unless there have been unforeseen factors that led to failure of achievement of the results in the feasibility study. In other words, if the bank issuing the instrument proves the authenticity of the data and correctness of the analysis conducted in the feasibility study, it will not be held responsible for any outcome of the investment operation that may be at variance with this study.

If the bank issues these instruments on behalf of the one who utilizes their proceeds, then both the bank and the investor shall be held responsible to the instrument holders who are the fund providers, for the authenticity of the data and the soundness of the analysis included in the feasibility study.

If the status of the Islamic bank issuing the instruments is that of a *mudarib* investing the issuance proceeds in a particular enterprise or a specific activity, then being a trustee of funds, it should be careful not to mix these funds with other deposits or the shareholders entitlements, and should keep separate accounts for them, because those are other people's money put as a trust under the bank's control, and the bank has no ownership title over them.

The Islamic bank issuing the financial instruments, as a *mudarib*, may purchase some of these instruments and be a *mudarib* of its funds and of others, in accordance with the *mudaraba* contract included in the prospectus.

The bank issuing the financial instrument may undertake to buy the instruments that have not been sold, provided that this undertaking is included in the prospectus. This means that the *mudarib* undertakes to invest other people's money within the amount of the proceeds of selling the issued financial instruments, and its own money in respect of the remaining amount required for financing the project. From the *shari'ah* point of view, it is permissible for the *mudarib* to offer a project at a certain investment cost; the bank, in this case, becomes a *mudarib* of its own funds as well as the funds of others. The financial instruments issued to cover this cost shall be distributed on the same basis.

The Islamic bank may entrust any activity involved in the issuing and marketing of the

financial instruments, such as project bookkeeping, to a specialized individual or institution for a fee. The prospectus can include a proposal made by the issuing bank to form a special committee or to assign an agent to undertake the monitoring of the progress of the project, to ensure the appropriateness of its accounting system, and to safeguard the interests of the instrument holders, in return for a fee borne by the project, in order to give confidence to the people who subscribe to these instruments.

5. NEGOTIATION OF FINANCIAL INSTRUMENTS

As stated earlier, one of the most important aspects of the financial instrument is the *shari'ah* legal channels of negotiation such as selling, donating and pawning, in accordance with the conditions and rules governing these means. This is so because the financial instruments represent a common financial share in a financial aggregate of assets, utilities and right. The negotiation is concerned with this share, as was mentioned earlier, and the instrument is the testimony of the title and receiving it stands for receiving this share. Negotiation of the financial instruments raises some *shari'ah* issues which are discussed below.

5.1 Disposition of the Common Share

The share of financial instruments means the selling of the common financial share represented by the instrument. *Shari'ah* permits the disposition of the common share, provided that the assets, the common share of which is sold, should be known to the parties. Therefore, periodical data and information on the specified project or the particular activity in which the paper represents a share, should be prepared and made accessible to the parties dealing in these financial instruments issued for financing this project or activity, so that the buyer of the financial instruments can be aware of the financial position of the project in which he buys a common share. In this case, it is like the share in a joint-stock company, as it represents a common financial share in the net assets of the company. Selling it means selling this share in the company. Dealers in the company's stock should be provided with sufficient information on the financial position, so that awareness of the object of the sale is realized and aleatory is avoided.

5.2 Receiving the Common Share

In contracts, receiving is of major importance. In selling, for instance, receiving determines who is to bear the liability of damage or destruction of the commodity. In the pawning contract, pawning becomes effective by receiving. In donating, it transfers the title and makes it binding. Jurists maintain that common title of assets, i.e. common title of a share in a

particular property, is receivable and can be delivered. That the title is common does not prevent the ability to deliver as it is one of the conditions for the validity of the contract. The one in possession of a common property is considered holder of an apportioned title. Receiving the financial instrument certificate is regarded as receiving the financial share represented by this certificate. Jurists have stated, in the context of debt pawning, that receiving the debt bond is akin to receiving the debt or the right represented by this bond, making the pawning contract valid and binding. The same applies in the case of the shares of joint-stock companies where receiving the bond stands for receiving what the bond represents, which is the common share in the company's net assets.

5.3 Methods of Negotiation of Financial Instruments

Since the financial instruments represent a common share in particular fund or funds, as was noted above, the procedures applicable on the common share are also applicable on the instruments as well. Consequently, the instrument holder may dispose of it with or without compensation. He can also present it as a guarantee for a loan. The financial instrument, therefore, can be involved in the contracts of selling, donating and pawning. Determining the price of the instrument for sale is subject to supply and demand. Selling is carried out through offering and acceptance, as is the case in the specified financial assets.

Originally, negotiation of the financial instrument should be carried out in the Islamic stock exchange markets where supply and demand of these instruments come together. Consequently, the price is determined in the same way as in the ordinary stock exchange markets. However, such an Islamic stock exchange market may need time to come into being. At the same time, ordinary stock exchange markets may be reluctant to deal in these instruments for some time till dealers realize the significance of these instruments and accept dealing in them. Therefore, if the operations of issuing Islamic financial instruments are to be viable, the bank or any other body issuing these instruments, or a group of Islamic banks coming together, is required to make a public offer undertaking to buy specific instruments at specific prices determined periodically. When this public offer is issued, it becomes binding on the one who has issued it for the duration specified in the public offer of the instruments covered by this undertaking. This ensures their liquidity and ability of conversion into cash money on demand. These can be accomplished through the mobilization of savings for investment in medium and long term projects, ensuring the instrument holder of its liquidity on demand. The Islamic banks have failed to achieve this target through the investment deposits kept with them, as the term of deposit and the permissibility of withdrawing it before due date, come short of the duration of the involved project.

The *shari'ah* permits making public offer with fixed deadlines for acceptance, binding the offerer to abide by the deadline he has fixed. Similar rules relating to wages are abundant in Islamic jurisprudence.

The bank or a group of banks which issue this public offer or undertake to buy, have the right to determine the price at which they may buy in accordance with the supply and demand, or in view of the financial position of the project or the activity financed by the financial instruments that they undertake to buy, issued periodically (monthly or quarterly or biannually or annually). They may also combine the two methods or take other considerations into account for purposes of determining the price at which they are agreeable to buy.

The *shari'ah* rule in this connection is that the one who undertakes to buy, that is, who makes the public offer is, free to decide the price at which he accepts to buy. At the same time, the instrument holder is also free to sell it or not to sell it at this price. However, the desire for the success of the financial instruments and for the achievement of the Islamic objective underlying their issuance, the prices declared by the Islamic bank or banks should be just and rewarding. They should also reflect the current state of affairs and the actual financial position of the project. In addition, they should be attractive to potential investors. Otherwise, the whole process may collapse, and may endanger the main function of the Islamic banks as mobilizers of savings for investment and development. Financial instruments are the best means for attaining this end. For, the existing system of depositing that is prevalent in the Islamic banks does not realize this target in the area of medium and long term investment, as pointed out earlier.

Shari'ah rules should be observed in selling or liquefying the financial instruments through the bank undertaking to buy them. So, the instruments should not represent money only or just debts, as was explained earlier.

The instrument represents only money after it is issued and sold but prior to the commencing of the activity, that is, before transforming the money into commodities, equipment, buildings etc. Therefore, the prospectus should include that these instruments are not negotiable during subscription period or the subsequent period required for preparations for starting the activity as determined by the feasibility study of the project, which may vary from one project to another.

In this case, nothing can prevent the purchaser from revoking the purchase of the financial instrument. Thus, the purchase contract can be rescinded and the instrument returned to the issuer. By this, the holder of the instrument is reimbursed without any increment. The

instrument holder, in this case, may ask for a transfer of ownership to another after this revocation and his contract abrogation, or condition that he is paid by the one who replaced him the original price he paid for the instrument without any increment, so that he may not sell a common share in money for money with an increment which is *riba al-fadl*. The prospectus should indicate these arrangements as well and display them on the back leaf. The issuing bank is not obliged to accept the revocation because it is a contract which cannot be concluded, unless there is mutual consent of the parties, or abrogation that cannot be fulfilled unless they mutually agree upon it. Moreover, the bank, in case of revocation and reimbursement, is not obliged to accept a replacement, as long as the bank is agreeable to the revocation. However, the issuing Islamic banks may be advised to follow a flexible and lenient policy in this connection, in order to ensure success of the financial instrument system, and to remove the fears of those who may desire to buy them and deal in them. Facilitating these procedures will increase the value of the financial instruments, and will act as an incentive for people to buy them.

As for the donation contract, the instrument holder is permitted to donate it to whoever he wishes after buying it, during the subscription period before commencement of the project. That is so, because the donations are represented by a contract to give away contributions, and contributions made in money are permissible and there is no *riba* in them. Pawning is also permissible during that period according to those who maintain permissibility of money pawning. After starting the investment operations, pawning the financial instrument is not controversial for those who maintain permissibility of pawning what is common, because the instrument represents a common share in specific assets. Possessing this instrument by the mortgagee is considered as possessing the pawned share, in exactly the same way as pawning of debts, where receiving the bond stands for receiving the pawned debt.

6. UTILIZATION OF THE ISSUANCE PROCEEDS

The purpose of issuing financial instruments is to mobilize savings by the Islamic banks and to direct them to investments in different areas, in a way that would ensure the continuity of the project or activity especially of the medium and long term nature. At the same time, these financial instruments provide liquidity on demand. The proceeds of the financial instruments resulting from the sale can be invested in the modes of investment that are acceptable to *shari'ah*.

6.1 Investing in a Specific Project

Financial instruments may be issued to finance a specific project, regardless of whether

this project is undertaken by the bank issuing the financial instruments or undertaken by another bank or institution on behalf of the issuing bank which issues these instruments. The party carrying out the investment is the *mudarib*, who is confined to invest in a particular or specific project, on condition that this party maintains records of accounts separate from the other projects and activities practiced by it. From the *shari'ah* point of view, the project has an independent financial liability, which is separate from the liability of the *mudarib*, since the *mudarib* does not own this project any more than the share entitled to him through his acquisition of the instruments. His role in the project is that of a trustee, who invests the other party's money with a share in the profits from the project and without bearing investment risks, except for those that have been caused by his laxity or infringement of the *mudaraba* conditions set forth in the prospectus, a summary of which is given on the back leaf of the bond.

The duration of the financial instrument is connected with that of the project specified in the feasibility study and indicated in the prospectus and on the back leaf of the financial instrument. The project may not have a specific duration, in which case the instrument issued for its financing becomes indefinite and the *mudaraba* in this case will have no time limit.

The project may be completely owned by the issuing bank, and the issuance proceeds are thus the cost of the project, as worked out by the feasibility study and indicated in the prospectus. The details of these are made available to whoever is interested in subscribing to the project by buying some of the instruments issued for its financing. In this, we have a case of sale contract made by the bank issuing the financial instruments to whoever is interested in buying them. The prospectus is the public offer, and actual buying of these instruments is the acceptance.

6.2 Investment in a Specified Activity

What has been stated regarding investment of the proceeds of the commercial instruments in a specific project, applies in the case of a specific activity. It is restricted *mudaraba* confined in this activity. As such, the *mudarib* is not to go beyond it. He is to maintain separate accounts for this activity. The prospectus may not indicate certain duration for this activity, and it can be indefinite in time. All these are permissible by *shari'ah*, provided that the prospectus spells out the nature of this activity. Thus, the prospectus is an offer addressed by the bank issuing the commercial instrument, meeting acceptance on the part of those who buy the financial instruments.

6.3 Leasing

The proceeds of the financial instrument may be invested in leasing with an intention of releasing. In this case, the prospectus should indicate the nature of this activity, and whether it is one operation or a series of operations. The financial instrument, in this case, represents a common share in the usufruct, that is, the usufruct of the equipment, aeroplane, or ship. When negotiating these instruments, due observance should be given to what was presented earlier: that the negotiation of these instruments should be made in case the instrument represents a debt payable by a third party such as the lessee of the aeroplane. The issuer of the financial instrument may be the possessor of the usufruct. The issuer of the instrument, then, is the lessor, i.e. the seller of the usufruct, and the buyer is the lessee, i.e. the owner of the usufruct.

6.4 Equity Participation

Shari'ah does not forbid investing the proceeds of commercial instruments in equity participation, whether it is permanent or diminishing. The holders of such instruments are thus subscribers or participants in the project according to the proceeds of these instruments. Negotiation of these instruments means disposition of the share represented by them. In diminishing participation, the prospectus should stipulate the procedure for extinguishing the instrument, that is, redeeming the nominal value of the instrument after a prescribed period together with disbursement of the return that has been realized during the diminishing participation.

7. RETURNS OF THE FINANCIAL INSTRUMENTS

Financial instruments represent shares in a particular project or activity. The return paid to the holders of these instruments is the return paid to the fund provider in *mudaraba*. The prospectus indicates the method of distributing the return to the parties of the *mudaraba* contract, i.e. the ratio of payment to the holders of the instruments, the proceeds of which are used to finance the project, and the entrepreneur who runs the project as a *mudarib*. A summary of the profit distribution method should be indicated on the back leaf of the financial instrument together with the other terms and conditions of the project or activity, regarding duration, projected profit, etc. It is permissible from the *shari'ah* point of view that distribution be made according to the discretion of the issuer of the financial instrument, and this should be included in the prospectus.

Usually, the return is calculated at the end of the involved project or activity if it has a time limit. *Shari'ah* does not forbid calculations of the return on the project or activity periodically such as every one, two or three years, according to the financial position of the project or activity, and the distribution of the return on the instrument to the holders who are the owners of

the project. However, these distributions are temporary by their nature, in the sense that what matters is the final closing of accounts at the end of the project or the closing of the activity. In case the project has realized a loss or has realized a profit less than the profit declared, the *mudarib* must pay it back. This is so because it is not acceptable that profits are declared and he gets his share in them and at the end of the project, it becomes clear that they were not real profits. As for the holders of the financial instruments, what they get is not refundable, because this amount can either be profit or part of the capital which is owned by them, and consequently there will be no problem adjusting the returns which have been already received.