ISLAMIC LAW AND THE FINANCE OF INTERNATIONAL TRADE

By

Alice de Jonge
Syme Department of Banking & Finance
Monash University
Caulfield East, Victoria 3145
Australia
Tel: (61)(3) 9903 2587
Fax: (61)(3) 9903 2292
Email: alice.dejonge@buseco.monash.edu.au

ABSTRACT

The aim of this paper is to provide readers interested in the law of international trade finance with an insight into the rules and principles governing the recent entry of Islamic banks into this area; and the issues which may arise when attempts are made to apply those rules in practice. By way of background, the reader is first provided with an overview of the emergence of modern Islamic banking. The paper also introduces both the main sources of Islamic law (Shariah), and those principles of Shariah jurisprudence which have shaped the evolution of modern Islamic finance. Part three of the paper then explores some of the particular legal issues which may arise when an international trading transaction is financed in accordance with the Islamic concept of *murabaha* (cost-plus-financing). While the exploration reveals some apparently irreconcilable contradictions between certain aspects of traditional Shariah jurisprudence and the modern law and practice of international trade finance, what it also reveals is the emergence of a new synthesis between Western practice and Shariah principles. The paper concludes that the emergence of this 'new Ijtihad' of Islamic cross-border trade finance is both promoted by, and is helping to strengthen, the current growth of Islamic involvement and influence in this area.

Key Words: Shariah; riba; gharar; murabaha; cost-plus financing; international trade financing.

JEL Classification: F23; F34;F33; K29; K33.

Working Paper 96/4 **August 1996**

Allah has permitted sale (bay') but prohibited usury (riba)"
(Quran, ii, 276).

"Islam does not accept that it is more difficult for a rich man to enter the kingdom of heaven than for a camel to get through the eye of a needle. The Muslims think that the Christians are very prudish about money."
(Carl Muller, *Colombo: a novel* (1995) 76).

INTRODUCTION

Islamic banking is a subject about which many non-Muslims know little and understand even less. Indeed, for most Australian businesses, the only indirect contact they are ever likely to have with an Islamic bank or financial institution is when an importer in a Muslim country arranges credit for an international purchase through such an institution, and some of the documents get passed on to the Australian exporter or its bank. Given the growing importance of Islamic banking, however, it is clearly important for Australian exporters, and their banks, to gain some understanding of Islamic financial instruments and of the principles underlying them. In an attempt to help provide such an understanding, this paper explores some of the legal issues raised by the use of Islamic banking products in the context of international trade.

Part one of this paper takes a brief look at the emergence of modern Islamic banking. Part two then provides an overview of the main sources of Islamic banking law. With this background established, part three of the paper then explores some of the particular legal issues which may arise when an international trading transaction is financed in accordance with the Islamic concept of *murabaha* (cost-plus-financing), the basic product used in cross-border Islamic trade finance. The exploration reveals an inherent tension between certain immutable concepts embedded in traditional Shariah jurisprudence on one hand, and modern laws governing the finance of international trade on the other. This tension, however, is itself now giving rise to a new synthesis of Western law and Shariah principles as attempts are made to both respect the basic principles of Islamic belief, and at the same time accommodate the needs of modern commerce.

1. THE BIRTH AND GROWTH OF MODERN ISLAMIC BANKING

Islamic banking goes back, in theory, as early as the seventh century, but it was only practised and implemented in this century.[1] Although the possibility of Islamizing the banking system was mooted as early as the 1890s[2], the first modern experiment with Islamic banking was not undertaken until 1963 in the Egyptian town of Mit Ghamr. Even then, care was taken to ensure that it projected no Islamic image, for fear of being seen as a manifestation of Islamic fundamentalism which was anathema to the political regime at the time.[3] The bank, which earnt its income from profit-sharing investments rather than from interest, flourished. By the time it was ultimately dissolved in 1967 (mainly due to government pressure), there were nine such banks in the country.[4] The Mit Ghamr experiment was later renewed by its founder in 1971, this time with government support as a state-run enterprise called the Nasser Social Bank.[5]

At a multi-national level, the Organisation of the Islamic Conference (OIC) played a major part in the establishment of the Islamic Development Bank (IDB) in 1975.[6] The IDB was established in Jeddah with sponsorship from the Saudi ruling family,[7] and now plays a major role in international trade financing among member countries and between the industrialised world and member countries.[8] Gulf business interests played a large part in the rapid expansion

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1 Muhammad Alosimi, 'Islamic Banking: Books and Dissertations - Annotated Bibliography', *Netscape*, citing *AFA-BANK Digest*, 2 March 1994 - 3 March 1994, Special Issue, 1.

2 Nicholas B. Angell, 'Islamic and Western Banking: A comparison with consideration of selected legal issues' (1994) 37 *Private Investments Abroad* 16.1, 16-13. Angell traces the emergence of modern Islamic banking to Egypt in 1893 when two distinguished scholars formed a political party for the purpose of bringing about an Islamic renaissance, including opposition to interest-based banking. Cf Nicholas Dylan Ray, *Arab Islamic Banking and the Renewal of Islamic Law* (1995) 5; who finds early mention of an Islamized banking system emerging in the commentaries during the 1940s.

3 Mohamed Ariff, 'Islamic Banking', (1988) 2:2 *Asian-Pacific Economic Literature* 46.

4 *Ibid.*

5 Nicholas Dylan Ray, *Arab Islamic Banking and the Renewal of Islamic Law* (1995) 6. The Nasser Social Bank was declared an interest-free commercial bank, and so was not chartered as an ordinary bank in Egypt. Its charter makes no reference, however, to Islamic (Shariah) law: Ray, 6 at n 13; Ariff, above n 3, 46 and Angell, above n 2, 16-13.

6 See Ray, above n 5, 6-7 for details.

7 *Ibid.* The capital of the Islamic Development Bank was set at two billion IMF Special Drawing Rights (called 'Islamic Dinars' by the IDB), which have been fully subscribed by 43 of the member governments of the Islamic Conference, which constitute the membership of the bank: *Ibid.* See also Angell, above n 2, 16-13 and 16-14. It is interesting to note, however, that the majority of its profits in fact come from interest bearing deposits with foreign banks, something not permitted for other Islamic banks: Ray, above n 5, 6.

8 These transactions employ the Islamic *murabaha* contract. The bank has also given interest-free loans and *mudaraba* (profit-and loss-sharing) financing to certain member countries, and has recently developed a mechanism whereby the contract can be used as part of a larger structure designed to encourage countertrade transactions. The arrangement makes use of IDB *murabaha* financing under the IDB's Import Trade Financing Programme together with a revolving escrow account: Mohd Effat, 'Proposed Mechanism to

of Islamic banking during this era. By 1977, the growing number of Islamic banks led to the formation of the International Association of Islamic Banks (IAIB) to facilitate cooperation between banks from different parts of the world.[9] Information exchange between the banks is also facilitated by a growing number of research institutes and university research programmes devoted to the study of Islamic economics and banking.[10]

Islamic banking has now become a US$50-$80 billion industry in terms of assets held, with more than 100 interest-free Islamic banks currently active in at least 45 different countries.[11] Two countries, Pakistan and Iran have established completely Islamic national banking systems.[12] Malaysia has developed parallel Islamic and conventional systems, offering a range of sophisticated interest-free instruments and investment products.[13] Elsewhere in Southeast Asia, Islamic banking has spread to Brunei, Indonesia (Bank Muamalat Indonesia)[14] and the

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Promote Counter Trade Among Islamic Countries' in Bakri Salih Shata and Mohd Effat, *Promoting Countertrade in the Middle East and Africa*, paper presented to the *Seminar on Counter-Trade and Offsets*, Centre for Management Technology, Jakarta, 29-30 April 1993.

9 *Ibid* 7. The IAIB has since been accorded observor status by many international organisations, including the United National Conference on Trade and Development (UNCTAD), the United Nations Industrial Development Organisation (UNIDO) and the Economic and Social Council of the United Nations.

10 *Ibid* 8-9. Many banks have also established their own research centres and educational training programmes. The BIMB Institute of Research and Training Sdn Bhd (BIRT), for example, is a wholly-owned subsidiary of Bank Islam Malaysia Berhad, which offers regular seminars and training programmes on Islamic Banking and Finance, usually in Kuala Lumpur, and is considering offering a similar seminar in Australia: personal correspondence, Mohd Nasir Mohd Yatim, Head, Consultancy and Training, BIRT.

11 On the growth of Islamic banking worldwide see Shameela Chinoy, 'Interest-free Banking: The Legal Aspects of Islamic Financial Transactions (1995) 12 *Journal of International Business Law* 517; Mohsin S. Khan and Abbas Mirakhor, 'Islamic Banking: Experiences in the Islamic Republic of Iran and in Pakistan (1990) 38:2 *Economic Development and Cultural Change* 353, 353-354; Rodney Wilson, 'Islamic Banking and its Impact on the International Financial Scene' (1995) 10 *Journal of International Business Law* 437, 439-441 and Angell, above n 2, 16-13 and 16-14.

12 See further Mohsin S. Khan and Abbas Mirakhor, 'Islamic Banking: Experiences in the Islamic Republic of Iran and in Pakistan (1990) 38:2 *Economic Development and Cultural Change* 353 and Abbas Mirakhor, 'The Progress of Islamic Banking: the Case of Iran and Pakistan' in Chibli Mallat (ed), *Islamic Law and Finance* (1988) 91. A third country, the Sudan, also decided to Islamize all national banks in 1983, following the example set by Iran and Pakistan. Many Islamic banks opened as a result of this decision, and the Sudan now has seven Islamic banks, the most of any country. Following a change of government in 1985, however, the laws which made Islamic banking mandatory were repealed: Angell, above n 2, 16-23 and 16-24.

13 See *New Straits Times* (Kuala Lumpur), 25 March 1996; *New Straits Times* (Kuala Lumpur), 22 March 1996; Murray Hiebert, 'Banking on Faith: Islamic Instruments are becoming more popular', *Far Eastern Economic Review*, 13 April 1995, 54-55; Sudin Haron, 'Islamic Banking: a matter of no interest' (June 1995) 2 *JASSA* 13 and Tan Sri Dato' Jaffer Hussein, Keynote Adress by Y. Bhg Tan Sri Dato' Jaffar Hussein, Governor, Bank Negara Malaysia at the 12th Central Banking Course, 8 September 1993' (1994) 9:1 *Bank Negara Malaysia Quarterly Bulletin* 74.

14 For an excellent discussion of the development and history of Islamic banking in Indonesia see 'Islam: Coming in from the cold?', Chapter 7 in Adam Schwarz, *A Nation in Waiting: Indonesia in the 1990s* (1995) 162.

Philippines (Philippine Amanah Bank).[15] Islamic financial institutions are now found in most parts of the world including the United Kingdom, Scandinavia, North America and Africa.[16]

Conventional western financial institutions have also begun offering Islamic financing products. Notable examples include the London-based operations of Kleinwort Benson, Citibank and ANZ Grindlays, all of which structure and participate in billions of dollars of trade-financing arrangements annually for Islamic customers.[17]

2. ISLAMIC LAW AND THE REGULATION OF BANKING ACTIVITIES

(a) Shariah: Sources and Principles

Shariah is the revealed law of Islam and encompasses the whole body of ethical and legal rules elucidated through the discipline of fiqh (Islamic jurisprudence). The two primary sources of Shariah are the Quran (holy scriptures) and the equally binding rules deduced from the sayings and conduct of the Prophet Muhammad, known as Traditions or *Hadith* and collected in the Sunnah. The Quran and the Sunnah are supplemented by the two 'dependent' sources of *fiqh*, namely *Ijma* (consensus of the community of scholars) and *Qiyas* (reasoning by analogy).[18]

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[15] Established by Presidential Decree in the 1980s as a response by the Philippines Government to the Muslim rebellion in the south, the Philippine Amanah Bank (PAB) was established without reference to its Islamic character in the bank's charter, and is not, strictly speaking, an Islamic bank, since interest-based operations continue to co-exist with the Islamic modes of financing: Ariff, above n 3, 49; citing Mastura, Michael O., 'Islamic banking: the Philippine experience' in M. Ariff (ed) *Islamic Banking in Southeast Asia* (1988).

[16] See n 11 above.

[17] Stella Cox, 'Western Institutions Offering Islamic Financial and Banking Products', paper delivered to the Conference on *Islamic Banking & Finance: Moving into International Markets*, 22-23 April 1996, London. The ANZ Banking Group has, for example recently cooperated with two major Islamic Finance Institutions in setting-up an Islamic import-finance facility to help finance the regular import of raw materials and commodities by State-owned enterprises in Pakistan. The arrangement is structured so that the Islamic bank buys on sight payment from the foreign supplier and sells on deferred payment to the SOE. The facility enables the SOE to make repayment through exports: Adil Ahmad, 'Cross Border Islamic Trade Finance', paper presented to the ICM Conference on *Islamic Banking & Finance: Moving into International Markets*, 23 April 1996, London, 2.7.

[18] Shameela Chinoy, 'Interest-free Banking: The Legal Aspects of Islamic Financial Transactions (1995) 12 *Journal of International Business Law* 517. For more detailed discussion, see also Noel Coulson, *Commercial Law in the Gulf States: The Islamic Legal Tradition* (1984), 1-17 and Ray, above n 5, 24-30.

The four traditional Sunni schools of Islamic law (the Hanafi, the Maliki, the Shafi'i and the Hanbali), were established during the eighth and ninth centuries.[19] During this era, traditional scholars reviewed local practices, both legal and popular, in light of the principles of behaviour enshrined in the Quran and the Sunnah. Each rule or practice was then approved, modified or rejected according to whether it measured up to or fell short of these criteria. Gradually, the rules considered most appropriate were formulated and recorded in the earliest legal manuals, as a succession of individual nominate contracts and separate institutions.

It is these authoritative early medieval manuals which have always been, and which remain, the principal repository of Shariah. The process by which they gained this status is usually explained by reference to the phenomenon known in Islamic legal history as 'the closing of the door of *itjihad*'. At the risk of oversimplification, this can be described as a stage where respect for the legal jurists of the past reached such a height that their ability to discern the correct expression of the divine law was considered insurpassable. Future jurists became bound to respect, and to imitate without restatement or reformation, the rules laid down by their classical predecessors, and this, in turn, effectively denied to Islamic law the opportunity to develop a general theory of Contract, and caused it instead to remain crystallised as 'a law of contracts'.[20]

The Islamic principles which have shaped the evolution of modern Islamic finance can be found in that part of the Shariah known as '*Muamallat fiqh*', which pertains to commercial transactions. Within this area of *fiqh*, the two most fundamental limiting principles on commercial and banking activity are the prohibitions on *riba* (interest or usury) and *gharar* (uncertainty in the operation of a contract). Other key principles enshrined in the Shariah relevant to Islamic finance are *maisir* (speculation or gambling) and *haram* (prohibited commodities). Considerable divergences have, however, always existed between the four schools of law, and between individual scholars, as to the true meaning of each of these terms.[21]

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[19] The four scholars after whom the schools were named are Abu Hanifa (d.767), Anas Ibn Malik (d. 796), Muhammad Al Shafi (d. 820) and Ahmad Ibn Hanbal (d. 855): See further Noel Coulson, *Commercial Law in the Gulf States: The Islamic Legal Tradition* (1984) 14-17, and Ray, above n 5, 25-26. Since most Muslims today are Sunnis, these four Schools have retained the dominant position reached during the early stages of the development of Islamic jurisprudence.

[20] Noel Coulson, *Commercial Law in the Gulf States: The Islamic Legal Tradition* (1984) 17.

[21] Shameela Chinoy, 'Interest-Free Banking: The Legal Aspects of Islamic Financial Transactions' (1995) 12 *Journal of International Business Law*, 518; citing Shahrukh Rafi Khan, *Profit and Loss Sharing: An Islamic Experiment in Finance and Banking* (1987), 48, 58. There exists a codification of the Shariah rules of obligations, the *Majalla* produced under the Ottomans in 1876, and this has certainly been widely used, in

The result, not surprisingly, has been to leave the translation of these principles into modern financial products open to many different interpretations, and in the absence of any universally acknowledged set of rules, considerable divergences have developed between institutions.

There is, however a fair degree of agreement as to the basic principles involved, and the following generalisations can probably be made. First, the word '*riba*', though often translated as 'usury' or 'interest', comes from the Arabic root meaning 'to increase' or 'to gain', and is specifically forbidden in the Quranic references to interest bearing loans. The prohibition on *riba* is clear, but Islamic scholars have yet to reach agreement on whether it should be interpreted to mean all kinds of interest, or usurious rates of interest only. Angell notes that it is the latter view which is now codified in a majority of the Arab Civil and Commercial Codes. In practice, however, any banking or financial institution that describes itself as 'Islamic' most likely has adopted the traditional and overwhelming majority view, which is that any level of interest is prohibited.[22] Strictly interpreted, this means that the lender cannot accept any unearnt gift, advantage or benefit from the borrower connected to, or resulting from the loan.

The Islamic ban on *riba* does not mean that capital is costless in an Islamic system. It simply means that the notion of a fixed or pre-determined rate of interest for the provider of capital is discarded. Instead, the Islamic banking system formally rests upon the contract of *mudaraba*; a 'solid and entrenched institution of traditional Islamic law'.[23] The mudarabah has been described as the 'most authentic' form of Islamic financing now available,[24] and its undisputed validity rests on the view that just as Islam encourages both trade and commercial enterprise, it also recognises the right of all those who share in the risks involved to profit from the surplus generated by such enterprise. The owner of capital (*rabbul-mal*) may therefore participate in a commercial venture by allowing an entrepreneur/borrower to use the capital for productive

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the Arabic and English translations, as a convenient work of reference, particularly in the Gulf States and the United Arab Emirates. But this Code is based on the doctrine of the Hanafi School of Shariah, the school sponsored by the Turkish Ottoman Empire, while it is the Hanbali school, and to a lesser degree the Maliki school, of Shariah which today predominates in Saudi Arabia, the Gulf States and the Emirates. It is accordingly the Hanbali and Maliki textual authorities which command most respect and occupy a dominant position in current Islamic jurisprudence: Noel Coulson, *Commercial Law in the Gulf States: The Islamic Legal Tradition* (1984) 6.

22 Angell, above n 2, 16.01[1] and 16.02 [1].

23 Coulson, above n 20, 97.

24 Abbas Mirakhor, 'The Progress of Islamic Banking: the Case of Iran and Pakistan' in Chibli Mallat, *Islamic Law and Finance* (1988) 91, 106.

purposes, and may share in the profits, if any, generated. Losses, however, must be borne wholly by the *rabbul-mal*, and the borrower-manager (*mudarib*) loses only his work.

In the modern *mudaraba*-based bank, the deposits of the customers provide the capital and the bank provides the work and expertise involved in investing it. Profits and losses are split in a pre-arranged proportion after a small percentage for costs and fees has been taken by the bank. On the lending side, the Islamic bank makes, or aims to make its profits from participation in commercial ventures. In the case of *mudaraba* investment, the Bank does not participate in the actual management or running of the venture, but simply provides the capital. Alternatively, the bank can finance a venture by way of equity participation (*musharaka*); in which the partners (ie. the bank and its client) use their capital jointly to generate a surplus. Profits or losses are shared according to an agreed formula based on the equity ratio. In all cases, however, the Bank must place its investments with care, and cannot, for example, invest in an enterprise tainted with *riba*, *gharar*, or *haram*.

Interpreted broadly, the concept of *riba* encompasses all types of illicit gain or unjustified profit and enrichment, and it is this broad notion of *riba* which is most closely linked to the concept of *gharar*. Arising from the same desire to prevent exploitation, *gharar* was developed as a general concept requiring that transactions should be free from uncertainty, speculation or risk. Although not expressly forbidden in the *Quran*, rules for the avoidance of *gharar* were formulated by jurists as a means for aggregating the various commercial practices which individually were forbidden in the Quran or (more especially) the Sunnah.[25]

According to one traditional scholar, *gharar* is present in a sale contract whenever lack of knowledge concerning either the price or the subject matter leaves one of the parties unduly at risk.[26] *Gharar* is averted if both the price and the subject matter are proved to be in existence at the time the transaction is concluded, if their qualities are known and their quantities determined, if the parties have control over them so as to ensure that the exchange takes place, and finally, if any term of time involved is precisely determined. Clearly these rules could exclude many transactions in modern international trade, including, for example the sale of that

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[25] Coulson, above n 20, 11 and Ray, above n 5, 29.

[26] Ray, above n 5, 30-31, citing 'the great 12th-century Miliki jurist Ibn Rushd'.

which the seller does not yet own. In practice, however, a large number of exceptions and qualifications to the principle have been recognised, in the light of commercial realities.[27] These recognised exceptions have also provided a convenient precedent for contemporary legislation recognising, for example, the validity of a promise to contract.[28]

(b) National Legislation

The process of adapting Islamic law to the needs of modern commerce has been a particularly problematic one for national legislatures in Islamic countries. Legislators in the Gulf States, and in Malaysia, Indonesia and Pakistan, have all faced the dilemma of how far pre-existing systems of Islamic law could be preserved and/or rejuvenated without at the same time compromising the needs of international commerce.

In strict Islamic legal theory, the Shariah, as the revealed law of God, is said to have supremacy over all other claims to legal sovereignty. Consequently, once the need to introduce modern commercial legislation was recognised, the problem for all the Islamic nations became how to achieve this without appearing to replace or usurp the Shariah. The answer to this problem lay in the juristic principle known as *ibaha*, "tolerance" or permission", a principle which holds that all forms of commercial agreement are legitimate, provided that neither the *Quran* or the *Sunnah*, as interpreted by authoritative *ijma*, prohibits them.[29] This view has provided justification for a wide range of modern commercial legislation, but has also been criticised as a compromise leading to the dilution of the Islamic nature of the legal system.[30]

The Gulf States have taken different approaches in the introduction of modern commercial legislation. Kuwait, the United Arab Emirates (UAE) and Bahrain have each enacted comprehensive Civil and Commercial Codes, along with a range of more specific legislation. The legislation of Oman and Qatar is less comprehensive, and follows a trend to enact a single

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[27] Development of these exceptions has, for example, paved the way for recognising the validity of a contract for sale of goods yet to be manufactured (*istisna'*) and a sale with advance payment for future delivery (*bay' salam*).

[28] Nabil Saleh, 'Financial Transactions and the Islamic Theory of Obligations and Contracts' in Chibli Mallat (ed), *Islamic Law and Finance* 13, 22. See also Coulson, above n 20, 21.

[29] Coulson, above n 20, 99-102.

[30] Peter Irwin, 'Commercial Legal Regulation in the Gulf States' paper presented to the *20th Anniversary Conference of the Asian Studies Association of Australia*, 8-11 June 1996, Melbourne, 3-4.

code, again with further legislation in relation to specific matters. In the somewhat different case of Saudi Arabia, legislation has been introduced on a far more *ad hoc* basis, and the introduction of modern codes has been avoided.[31] The same is also true of Pakistan, though for very different historical reasons.[32]

As the western appearance of the legislation would suggest, the overall effect of its adoption has been to marginalise the Shariah in most commercial cases. But this has by no means always or necessarily been the case. In the past, some courts have, on occasion, been reluctant to apply Western-style legislation legalising practices which traditional Islamic law would prohibit.[33] Policies underlying the legislation have also been complex and often contradictory, and it has not always been interpreted or administered in a way that a literal approach might suggest.[34] Where there are gaps in the enacted legislation, different approaches have also been taken in applying the prescribed sources of law to find a solution.

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31 *Ibid.* For more detailed coverage, see Angell, above n 2, 16.15 - 16.20.

32 Saudi Arabia, unlike most of the other Arab countries has no Civil Code, and the question of *riba* is not addressed in legislation. Officially, the Shariah, as interpreted by Saudi jurists, is the law, and it is assumed that that all banking is in accord with the Shariah: an inevitable situation given the country's a long history of rule under traditional Islamic kingship. Not surprisingly given this history, Saudi jurists and scholars have taken a very conservative view of *riba*, and this played a part in the difficulties experienced by banks in enforcing bad loans during the 1980s (a period of declining oil revenues). As part of a general trend to have commercial matters dealt with separately, this led to Banking disputes being removed to a Banking Committee, under the supervision of the Saudi Arabian Monetary Agency: *Ibid* 12.
In Pakistan, on the other hand, there is a national Constitution, which grew out of the country's tumultuous origins in the circumstances of the 1947 break-away from the Hindu majority parts of India. Not surprisingly give the Islamic fervour of the times, the 1947 Constitution expressly provides that the elimination of *riba* is a national objective (*Constitution*, article 38(f)). It was only in 1979, however, that the government finally began implementing measures to achieve this objective, with the enactment of the *House Building Finance Corporation Ordinance* of that year. No changes were made to the institutional structure of the banking system, and the commercial banks remain under the supervision and control of the Central Bank. Between 1980 and 1993 new non-interest based financial instruments were created and circulated, but banks worked under a 'dual window' system which allowed interest-based operations to continue; and it was not until 1985 that all domestic-currency financial operations were brought under non-interest-based modes of financing. A *Banking Tribunal Ordinance* was enacted in 1984: *Ibid*, and see Mohsin S. Khan and Abbas Mirakhor, 'Islamic Banking: Experiences in the Islamic Republic of Iran and in Pakistan (1990) 38:2 *Economic Development and Cultural Change* 353, 365-372.

33 In November 1991, for example, a decision of the Federal Shariah Court of Pakistan led to considerable chaos and uncertainty in that country. In *Mahmood ul Rahman Faisal and Ors v Secretary, Ministry of Law and Ors*, the Federal Shariah Court declared all provisions pertaining to the receipt or payment of interest, as contained in 22 different statutes, repugnant to Islam; and held that 'mark-up' as charged by domestic banks when providing import-finance was un-Islamic. The provisions declared unconstitutional included section 18 of *The Enforcement of Sharia Act* 1991; a provision which expressly protects interest-based foreign currency lending. An appeal was lodged by a number of banks and the federal government, and widespread scepticism that the decision was capable of being enforced in a country with extensive foreign debt prevailed: Shameela Chinoy, 'Interest-Free Banking: The Legal Aspects of Islamic Financial Transactions' (1995) 12 *Journal of International Business Law* 517, 522, citing 44 PLT 1992, Federal Shariah Court 1.

34 Irwin, above n 30, 1.

In most cases where express legislative provisions are inadequate to cover a situation, the legislation allows the courts to have regard to established custom, Islamic jurisprudence, general principles of law and principles of natural justice in reaching a decision.[35] The application of these different sources of law has, on a number of occasions, enabled courts in Islamic states to go behind the formalities of commercial paper in a way that no Western court ever would.

A 1979 decision of the Dubai Supreme Court of Appeal, Civil Division, provides a goods example of how this has occurred. The issue to be decided in the case was whether or not the endorsement of two delivery orders perfected the title of the Respondent Company (the indorsee) in the goods specified therein, or whether the Appellant (the original supplier of the goods) retained a lien over that proportion of the goods which remained undelivered because the original purchaser had not paid for them. The Court began by stating its duty to be the application of 'the Dubai Law of Contract ... in accordance with the provisions of the Islamic Shariah, the second source of law in Dubai', and then held that 'The Dubai Law of Contract and the provisions of the Islamic Sharia do not know the doctrine of transferring a good title in a commercial paper by endorsement.'[36]

The decision shows the Dubai Court of Appeal going behind the formalities of a commercial paper, as recognised in Western law, and invoking the principles of the Shariah to determine the issue. In that respect, it is very similar to an earlier (1978) decision of the Civil Court of Ras al Khaima, where certain bills of exchange were also held not to binding on the drawee who had accepted them, on the basis that the original drawer had not performed his obligations according to the underlying contract.[37] Understandable in the context of the late 1970s, these decision now appear, nearly 20 years later, as something of an over-reaction and an impractical response

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[35] Irwin, above n 30, 5; citing *Judicature Act* 1971 (Bahrain); Article 75, Law Establishing the Union Supreme Court (UAE); Article 5, *Commercial Law* 1990 (Oman) and the Kuwaiti *Commercial Code* (1961). See also His Excellency The Grand Imam, Jadulhaqq Ali Jadulhaqq, The Sheik of Al-Azhar, 'The Islamic Shari'a: An Eternal Legislative Source', speech to the Symposium of the International Union of Advocates, 15-19 February 1987, Cairo, in *Proceedings International Bar Association first Arab Regional Conference* Cairo 15-19 February 1987, vol. 1, *Arab Comparative and Commercial Law: The International Approach* (1987), 111.

[36] Coulson, above n 21, 5, citing Appeal No. 59/79, *Al Shirawi Trading and Contracting Company v Mohammed Abdul Rahman al Saad al Bawardi*. In the event, the Court of Appeal allowed the appeal in form, but order the Appellant to pay compensation to the Respondent Company equivalent to the value of the undelivered goods under the original contract.: *Ibid.*

[37] Coulson, above n 20, 3, citing *Ras al Khaima Asphalt Company & Bank of Oman v Lloyds Bank & Ors*, Arabic record of the Ras al Khaima Civil Court, Suit No. 397/78.

to the problem. They can be contrasted with the present development of Islamic Banking, which certainly recognises, *inter alia*, delivery orders, bills of exchange and other commercial papers. The formal and nominal legal basis for such recognition remains, however, the traditional contracts recognised by Shariah, as re-interpreted in the light of current social economic and commercial realities.

(c) Fatwas and other legal Directives on Islamic Banking

In addition to the legislation, individual Islamic financial instruments and transactions are also governed by fatwas (authoritative opinions) issue by the Shariah Supervisory Boards of individual banks, and by other authoritative institutions.

The IAIB, for example, in fulfilling its goal of promoting uniformity in the implementation of Islamic legal doctrines governing Islamic bank activity has appointed a Higher Religious Supervisory Board of Islamic jurisprudents, whose interpretations (of the Shariah) are intended to be normative for all member banks. However, because each bank also has its own religious supervisory board (a condition for bank membership in the IAIB), significant divergences of doctrine have emerged.[38] Moreover, there are many banks that are not members of the IAIB, but who may recognise fatwas issued by a completely different body or bodies. The al-Baraka banks, for example, are not (with one exception) members of the IAIB, but are subject to fatwas issued by an al-Baraka Supervisory Committee. In Pakistan, none of the banks have religious supervisory boards, and no Pakistani bank is an IAIB member.[39] Instead, the Pakistani banks are bound by the declarations and decrees of the country's Central Bank, the State Bank of Pakistan.[40] Quite the opposite is true of Malaysia, where the articles of all licensed Islamic banks must provide for the establishment of a Shariah advisory board.[41]

In the case of most Islamic banks, therefore the internal management structure of the institution is such that it is effectively controlled by its Religious Advisory Board. Moreover, each bank will have its own series of fatwas which will dictate whether, or in what manner, certain types of

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[38] Ray, above n 5, 7.
[39] Ray, above n 5, 7, n 17.
[40] *Ibid* 7-8. But cf Richard T de Belder & Mansoor Hassan Khan, 'The changing face of Islamic banking' (1993) 12 *International Financial Law Review* 23, 25.
[41] Article 5(b), *Islamic Banking Act* (*Acta Bank Islam*) 1983 (Malaysia).

transactions can be undertaken. It can readily be appreciated that the concept of the controller of a bank being a board of religious scholars is a concept with which many western bankers and lawyers would not be familiar, and this has also been a source of misunderstanding in the area of international trade finance.

3. CROSS BORDER TRADE FINANCING: THE ISLAMIC *MURABAHA*

The basic product used in modern cross-border Islamic trade finance is the *murabaha* contract. *Murabaha* is generally defined as an arrangement whereby the bank, on request of a client, buys goods (merchandise, machinery etc.) which are then sold to the client for the price at which they were purchased with the addition of a negotiated profit margin, to be paid normally by instalments on a deferred payment basis. It is a cost-plus-profit contract under which the bank no longer shares profits or losses, but instead assumes the capacity of a classic financial intermediary.

Although the result was probably not intended by the earliest advocates of Islamic banking, *murabaha* has now become the most commonly used form of Islamic financing.[42] Whether or not the first 'practitioners' of Islamic banking were fully aware of the Shariah preference for partnership and profit sharing as the basis for most, if not all interest-free financing, what they were (or soon became) aware of, was the fact that participation financing can be very risky. This is particularly so in a world where Islamic banks compete with conventional banks and where the interest rate for loans sets a limit to the participation ratios of Islamic banks (when entrepreneurs compare the offers of Islamic banks with conventional alternatives). Not surprisingly, the early Islamic banks soon began to look for alternative ways to employ funds. Their starting point was that *riba* in financial transactions is forbidden, while profits from trade are permissible. Consequently, the Islamic banks went beyond the scope of the customary activities of commercial banks and became traders themselves. Instead of providing money, the Islamic banks provide the goods their clients need.[43]

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[42] Ray, above n 5, 35.

[43] Volker Nienhaus, 'The Performance of Islamic Banks: Trends and Cases, in Chibli Mallat (ed), *Islamic Law and Finance* (1988) 129, 156.

Thus it was that the early expectations and hopes that Islamic banks would be active mainly in the field of corporate financing on a participation basis - thereby providing badly needed risk capital especially to smaller enterprises - were disappointed. Instead, the evidence indicates that most funds of Islamic banks are in fact employed in various kinds of trade, rent, and leasing (*ijara*) activities which provide fixed returns for the bank. Only a small fraction of the total financing is based on participation principles, and even where Islamic banks do take recourse to participation techniques (*mudaraba, musharaka*), this is done rarely in medium and long term corporate financing but mainly in short term trade financing.[44] As regards the percentage of overall Islamic financing that is both asset based and cross-border, one experienced estimate places it at somewhere between $US5 billion and $US10 billion, or somewhere between 10-25 percent of total financing assets.[45]

The modern *murabaha* contract operates in a manner fundamentally different from its medieval predecessor, and is the result of experiments with a number of possible Islamic alternatives to Western trade financing using interest-based letters of credit.[46] The problem faced by the pioneers of modern Islamic banking was that the prohibition on *gharar* in traditional Islamic jurisprudence essentially prohibits contracts of sale where the seller does not own the object of sale at the time of contracting. In international trade financing, however, the bank will rarely, if ever, own the object desired by the client importer when the initial agreement to finance the

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[44] Adil Ahmad, 'Cross Border Islamic Trade Financing', paper delivered to ICM Conference on *Islamic Banking & Finance: Moving into International Markets*, held in London, 22-23 April 1996, 1.4. Nienhaus notes the difficulty of obtaining accurate figures regarding the operations of Islamic given that 'The annual reports of most Islamic banks do not disclose very much about the types of financing (trade or corporate, short or long term) and give no breakdown of financing according to the techniques and types of contracts (participation or fixed returns for the bank).' He concludes, however, that some statements and figures can nevertheless be found which support the thesis that short term trade financing is clearly dominant in most Islamic banks. Also, some Islamic banks emphasise that they do not classify themselves as development banks or investment banks but explicitly as commercial banks, not dealing with long term projects but with short term trade finance. This approach is justified, they say, both by the presence in most Islamic countries of specialized, state-run banks to meet the demand of the corporate sector for longer-term financing, and by the fact that it is very risky for Islamic banks to finance medium and long term projects, given that most of their deposits are of short term nature.: Volker Nienhaus, 'The Performance of Islamic Banks: Trends and Cases, in Chibli Mallat (ed), *Islamic Law and Finance* (1988) 129, 157-158.

[45] Adil Ahmad, 'Cross Border Islamic Trade Finance', paper presented to the ICM Conference on *Islamic Banking & Finance: Moving into International Markets*, 23 April 1996, London, 1.4. Ahmad is the Head of the Islamic Finance Section of ANZ Banking Group in London.

[46] One early possibility examined, for example, was a form of *musharaka* partnership in which the Islamic bank would finance the purchase of inventory and share in the profit from its sale. This system, however, was severely flawed, not only because of the possible delays and uncertainties involved with respect to repayment, but also because its use was basically precluded for financing of capital goods: Ray, above n 5, 45-46.

import is reached. The traditional *murabaha* is thus inadequate to deal with this sort of transaction as it cannot be validly concluded on an object not owned by the bank.

The solution eventually found to this problem was to separate the client's promise to buy (which is concluded first) from the *murabaha* sale, which, in theory at least, is only contracted once the bank owns the object of sale. This contractual arrangement raises such a plethora of problems from an Islamic legal viewpoint, that it often makes the Islamic nature of the *murabaha* transaction somewhat uncertain.[47] The result is that while the basic legality of the *murabaha* contract is not questioned by any of the four Sunni schools of law in practice, its modern implementation has been regarded with apprehension by a number of Muslim jurists.

One objection to *murabaha* which comes, in particular, from the Hanbali and Maliki schools is that it is simply a device or stratagem (*hila*) whose function is to attain an illegal end through legal means. In particular, jurists have condemned the use of the contract of sale to render possible what is in fact the loan of money for interest. According to one traditional Maliki scholar, this can be seen to occur where one person tell another 'buy for me [from a third party] such and such an object for ten dinars in cash, and I will buy it from you for 12 dinars on credit'.[48] The fact that the *murabaha* seller becomes entitled to a pre-determined amount under this arrangement shows, according to some critics, that it is simply a device for 'admitting interest through the back door'.[49]

Examining the *murabaha* transaction from a different angle, however, others have reasoned that the transaction described above does not necessarily constitute *riba*, and would only do so if the buyer for 12 dinars turned around and sold the object for less than he had paid. This would demonstrate that his intention was to borrow the price of the object and not use it himself or to engage in normal trade. Where the buyer's intention in buying the goods is to use them or trade with them for profit, then since business and trade are legal, the transaction cannot be said to constite *hila*.[50]

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47 Ray, above n 5, 46.
48 *Ibid*, 56.
49 Ariff, above n 3, 52.
50 Ray, above n 5, 56-57.

Another objection to the *murabaha* contract, as put forward by Islamic jurist M. Siddiqi, is that the modern *murabaha*, which allows the buyer to finance the purchase with deferred payment (as against simply accepting a mark-up on the market price of the commodity), enables the lender to earn a pre-determined profit without bearing any of the risk. This is, perhaps, a good example of the sometimes thin line which separates legitimate trade from illegal riba.[51] Strictly speaking if the fee charged by the Islamic bank is based on the *duration* of the credit, rather than on a calculation of the bank's exposure to risk, then this would be akin to interest, and not permissible under Islamic law.

This objection is overcome, and the contract is justified, on the basis that title passes to the Islamic financier under a *murabaha* arrangement at a precise and identifiable point in time. Those who support the arrangement point out that the bank must first acquire the asset, and take responsibility for it, before it is delivered to the client. The fact that in the process the bank assumes certain risks between purchase and resale is what must make the transaction Islamically legitimate. The services rendered are quite different from those of a conventional bank which simply lends money to the client to buy the goods, and the added risk involved (rather than the deferral of repayment) is what justifies the bank's entitlement to profit from the arrangement.[52]

The murabaha sale:

The orthodox view that the bank cannot legally sell to the client the *murabaha* sale object until it obtains legal ownership of the object has been upheld in a number of authoritative fatwas and regulations. A regulation of the IAIB for example states that in the legally correct *murabaha*, '"Selling is postponed until the bank gets actual ownership and possession of the goods and becomes responsible for any defects therein".'[53] A fatwa of the Faisal Islamic Bank of Egypt maintains that sale must await the bank's receiving the article,[54] as does the doctrine on *murabaha* published by the Islamic International Bank for Investment and Development (IIBID).[55] A 1983 fatwa issued by the Second Conference of Islamic Banks states that the

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51 Nabil A. Saleh, *Unlawful gain and legitimate profit in Islamic law*: Riba, gharar and Islamic banking (1986) 95, citing M. Siddiqi, *Issues in Islamic Banking* (1983) 49 and 137 ff.

52 Ariff, above n 3, 52.

53 Ray, above n 5, 48, citing IAIB, *Directory of Banks and Financial Institutions Members of the Association* (1990) 36-37.

54 *Ibid*, citing Faisal Islamic Bank of Egypt, *fatawa hay'a al-raqaba al-shar'iyya* (*fatwa* no 8) 11-12.

55 *Ibid*, citing Al-Ghazzali (ed), *bay' al-murabaha* (Cairo: Islamic International Bank for Investment and Development - no date) 12. The IIBID, not to be confused with the IDB, is the second largest Islamic bank in Egypt, and is 100 percent Egyptian owned: Angell, above n 2, 16-21.

modern *murabaha* operation is allowed providing the bank takes full possession of the object before selling it, including bearing the risk of its loss and the responsibility for returning it if it is defective.[56] However, not all Islamic banks follow these rules, and there are references in Kuwait Finance House (KFH) fatwas to sales occurring before the bank has taken possession of the sale object.[57]

The promise to buy:

The second part of the modern *murabaha* arrangement is the client's undertaking to purchase. Medieval *fiqh* has nothing which resembles a promise to purchase an article in the future. Such an agreement, referring as it does to an article not owned by the seller and not seen by the buyer, could have been interpreted as nothing but an utter nullity due to the high degree of *gharar* involved. Some scholars have therefore criticised the Islamic banks for treating the client's 'promise to purchase' as binding.[58] For obvious practical reasons, however, the majority of modern fatwas and regulations treat the promise to purchase as binding. A 1979 fatwa issued by the First Conference of Islamic Banks and upheld by a fatwa of the Second Conference states that both the client's promise to buy the article requested, and the bank's promise to sell the said object are binding.[59] A further fatwa of the Faisal Islamic Bank of Egypt upholds this view, citing the view of a Hanbali scholar, Ibn Shubrama, who held that promises were valid as long as they neither permit that which is forbidden nor forbid that which is permitted.[60] The fatwa also presents citations from the Sunnah urging Muslims to honour their obligations. A Kuwait Finance House fatwa is also based on the view of Ibn Shubrama, and in addition asserts that what is morally binding can be made legally so if the public interest (*maslaha*) is thereby served.[61]

There are other authoritative views, however, which hold the opposite. The International Association of Islamic Banks and the Faisal Islamic Bank of the Sudan have expressed the view that a promise to buy is not binding, and that the person who ordered the goods is allowed the

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[56] *Ibid*, citing Y. al-Qaradawi, *bay' al-murabaha li al-amir bi al-shira'* (Cairo: Maktaba al-Wahba, 1987) 10.

[57] *Ibid*, citing KFH, vol 2, fatwa number 63.

[58] Ray, above n 5, 51.

[59] Fatwa of the First Conference of Islamic Banks (in Dubai), May, 1979; in al-Qaradawi, Yusuf, *bay' al-murabaha li al-amir bi al-shira' kama tajrih al-masarif al-islamiyya* (Cairo: Maktaba Wahba, 1987) 10; translated and extracted in Ray, above n 5, Appendix 1, 183-184.

[60] Ray, above n 5, 53, citing FIBE, fatwa number 47.

[61] Ray, above n 5, 53, citing KFH fatwa, in al-Qaradawi, Yusuf, *bay' al-murabaha li al-amir bi al-shira' kama tajrih al-masarif al-islamiyya* (Cairo: Maktaba Wahba, 1987) 9.

right to withdraw against payment of reasonable compensation.[62] A fatwa of Shaikh 'Abd al-'Aziz Ibn Baz (Highest Legal Authority of Saudi Arabia) also indicates that the bank must purchase and take possession of the goods 'without the client being bound to fulfil his spoken or written promise [to buy the article]'.[63]

In light of the above, it can be said that the first aim in structuring an import financing *murabaha* arrangement to ensure conformity with Shariah lies in ensuring that the Islamic financier, at some time, takes legal title to the goods. The second aim is to minimise the bank's exposure to risk, including the risk involved where there are doubts about the binding nature of the client's promise to purchase. The instruments used to achieve these aims include:

a) back-to-back letters of credit (with or without an agency agreement);
b) sight letter of credit together with a separate guarantee;
c) single usance letter of credit;
d) an 'offshore' *murabaha* which combines an agency (wakala) arrangement and a local *murabaha*.

a) Back-to-back Letters of Credit

Once the Islamic financier has agreed in principle to finance the purchase, the first step is for the bank[64], or the client as agent for the bank, to agree on the commodity specifications with the overseas supplier. Having identified the goods to be purchased, the purchaser and the Islamic financier then enter into a *murabaha* agreement by which the client promises to buy the *murabaha* object for a sale price which is agreed upon in advance, and the financier, in return, agrees to pay for, and take title in the goods, and then to sell them to the *murabaha* borrower. There is usually a provision that makes the agreement between the parties subject to a

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62 Ray, above n 5, 53, citing IAIB, *Directory of Islamic Banks and Financial Institutions Members of the Association* (1990) 36-37 and Al-Najjar, *Encyclopaedia of Islamic Banking*, vol 5, 332.

63 Al-Quaradawi, Yusuf, *bay' al-murabaha li al-amir bi al-*shira (1987) 11-12. Fatwa of Shaikh 'Abd al-Aziz Ibn Baz, issued 10 April 1982. As translated and extracted in Ray, above n 5, 54. This traditional approach is understandable, coming as it does from one of the most conservative authorities in the Islamic world. Chinoy notes, however, that even a strict interpretation of this approach would allow the bank to mitigate its risk by providing for the client to submit a form of request for the relevant goods before initiating the purchase. While this may not create a contractual obligation to purchase the asset, it would seriously prejudice the relationship between the customer and the bank if the client failed to proceed with the purchase: Shameela Chinoy, 'Interest-Free Banking: The Legal Aspects of Islamic Financial Transactions' (1995) 12 *Journal of International Business Law* 517, 520.

64 In practice, the bank may even, on occasion, be in a better position than the client to obtain quantity and payment discounts form a supplier who prefers dealing with the bank as it gets paid quicker and with less risk: Shameela Chinoy, 'Interest-Free Banking: The Legal Aspects of Islamic Financial Transactions' (1995) 12 *Journal of International Business Law* 517, 520.

condition-precedent that the bank must have received the goods from the supplier.[65] In principle, it is essential to the validity of the *murabaha* sale that the buyer must be aware of the original price, including all the costs necessary to obtain the commodity, and the bank's profit, which may be either a fixed amount or a percentage of the first price.[66]

The next step is to establish the back-to-back letter of credit arrangement. The *murabaha* purchaser opens a term letter of credit for the marked-up amount in favour of the Islamic financier, upon which the Islamic financier opens a back-to-back sight letter of credit in favour of the supplier, for a sum equal to the marked-up amount paid by the *murabaha* purchaser less the agreed-upon profit margin. The Islamic financier usually requires that the purchaser's letter of credit be opened by a top (preferably government-owned) bank in the purchaser's country. This bank is typically a conventional bank.[67]

Once the overseas supplier receives the sight letter of credit from the Islamic bank, the shipping documents are presented and payment is collected. Property in the goods is thereupon transferred to the financier. The bank holds legal title, but rarely takes possession of the commodity involved. The bank should, in theory, retain title to the goods as proof of its ownership until the client pays off its debt. In practice, title passes to the client when the bank presents the documents to the *murabaha* purchaser and becomes entitled to receive payment of the marked-up amount under the usance credit issued in its favour.

A number of the fatwas and regulations cited above suggest that the bank must take actual possession of the *murabaha* object in addition to legal title. There are a number of ways in which banks have overcome this requirement to take possession. In some countries, such as Pakistan, the authoritative Shariah advisory body, the Council of Islamic Ideology, has clarified that it is sufficient that the supplier sets aside the item for the bank and hands it over to the person authorised by the bank. This has effectively served to eliminate the handling of goods by

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[65] Adil Ahmad, personal correspondence with the author, April 1996.

[66] Adil Ahmad, 'Cross Border Islamic Trade Finance, paper presented to the ICM Conference on *Islamic Banking & Finance: Moving into International Markets*, held in London 22-23 April 1996, 2.2.
The mark-up covers handling charges, transaction costs and the premium for risk. It should, in theory, be calculated taking into account the profitability of the commodity, and the work and degree of risk involved in obtaining it. In practice, the duration of any credit period is also commonly taken into account in calculating the premium: Ray above n 5, 58.

[67] Adil Ahmad, Personal Correspondence with the author, April 1996.

Pakistani banks.[68] Another way in which banks have avoided the need to handle the goods is by concluding a contract of agency (*wakala*) with the shipping company. In this case, since the shipping company/carrier is the bank's agent, it can be asserted that the Islamic bank possesses the sale object.[69]

As explained above, the bank should sign the contract with the client only after it has acquired title to the goods to ensure compliance with the fundamental Shariah rule that the transaction should not be a sale of something the vendor does not own.[70] This requirement is commonly fulfilled by making the original agreement between the bank and its client subject to a condition precedent, so that it only comes into force to bind the parties provided that the bank has received the goods from the supplier.[71] Herein also lies the great advantage of the back-to-back credit arrangement, which generally involves a simple structure, and a clearly set-out flow of trade documentation that leaves no doubt as to the bank's legal title prior to on-delivery to the client.

The most obvious disadvantage for the Muslim importer of the back-to-back arrangement compared to conventional import financing is the increased cost involved in opening and operating under two letters of credit, rather than the single payment mechanism used by conventional banks. From the financier's point of view, the most obvious disadvantage of agreeing to accept title to goods, and, in effect, trading in commodities rather than in currency, lies in the far greater risk exposure involved. While the risks involved in collection of the debt from the client are minimised through use of the term letter of credit, there still remains the very real risk either that the goods may be lost or damaged before delivery to the purchaser/client, or that fraudulent documents may be presented. The bank may also become subject to liabilities associated with ownership of the goods, including liability for death injury or property damage.[72]

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[68] Shameela Chinoy, 'Interest-Free Banking: The Legal Aspects of Islamic Financial Transactions' (1995) 12 *Journal of International Business Law* 517, 520; citing Rodney Wilson (ed) *Islamic Financial Markets* (1991) 176.

[69] Ray, above n 5, 48, n 126; citing fatwa 60, part 2, KFH in *IBID* fatwa book 155.

[70] See also Shameela Chinoy, 'Interest-Free Banking: The Legal Aspects of Islamic Financial Transactions' (1995) 12 *Journal of International Business Law* 517, 520, on the legal effect of a contract for sale of that which the seller does not own.

[71] Adil Ahmad, personal correspondence with the author, April 1996.

[72] See further David Silver, 'Legal and Contractual Issues: Standardisation and Successful International Transactions', paper presented to the ICM Conference on *Islamic Banking & Finance: Moving into*

In modern *murabaha* transactions the risk of total loss is nearly always covered by insurance. Theoretically the bank is liable for it, but in practice insurable risks are borne by the client who reimburses the bank for the insurance. In the case of defect in the *murabaha* object, the majority opinion holds to the medieval view, as indicated by the IAIB regulation and the Second Conference of Islamic Banks fatwa cited above. This view holds that in the case of damage to the goods before on-delivery to its client, it is the bank which, in theory, retains liability for the defects. Moreover, under the medieval doctrine of sale contracts, any inherent defect in the article sold transfers an unconditional right of recission of the contract to the buyer.[73] This right of recission for defect (*khiyar al-'ayb*), according to the medieval doctrine, cannot be waived by the buyer by a stipulation in the contract, such a stipulation itself being a nonentity.[74] Nor should the bank extract a guarantee from the client that it will purchase the asset in any event, since this would sever the link between the bank's income from the transaction and its risk in the transaction.[75]

However, not all the major Islamic banks hold to this view. Apparently, it is relatively common to include in the agreement between the Islamic bank and the purchaser a provision whereby the purchaser indemnifies the bank vis-a-vis any defects in the goods.[76] In the case of KFH, for example, its practice is to stipulate in all sales contracts that any defect in the sale object, except an insufficiency in the quantity shipped, is the liability of the buyer. This practice stems from a very carefully worded fatwa issued by the KFH Shariah Supervisory Board in response to the question 'Is is permissible to make a [sale] contract for goods, with a stipulation exonerating the seller from [liability for] all defects present in such goods?' The fatwa provides that:

> [Such a contract] is permissible both if [the buyer] examines the goods himself, or if they are described to him [in such a way as to] eliminate ignorance [of the goods] which could lead to dispute. However, any lack in the quantity of the goods [as opposed to defects in their quality] remains the liability of the seller. [This latter case] results in the sale price being reduced by an amount [proportionally] corresponding to the missing goods, with the buyer having the right to rescind the contract.[77]

International Markets, held in London, 22-23 April 1996, 10; and Shameela Chinoy, 'Interest-free Banking: The Legal Aspects of Islamic Financial Transactions (1995) 12 *Journal of International Business Law* 517, 524.

[73] Ray above n 5, 49. For more detailed examination of the option to rescind for defect see Coulson, *Commercial Law in the Gulf States: The Islamic Legal Tradition* (1984) 65-66.

[74] Ray, above n 5, 49, n 128.

[75] Chinoy, above n 67, 520.

[76] Adil Ahmad, personal correspondence with author, April 1996.

[77] Bait al-Tamwil al-Kuwaiti, *al-fatawa al-shar'iyya fi al-masa'il al-iqtisa-diyya*, vol 2 (1987) 19, fatwa no 61; as translated and extracted in Ray, above n 5, 181.

The conditions placed on the buyer's liability for defects in this fatwa can be interpreted to mean that the buyer is, in effect, liable only for defects in the goods if (i) he or she has examined the goods[78]; or (ii) if the goods have been described in such a way as to leave the buyer in no serious doubt as to their true condition. In other words, the buyer is liable for all defects which are reasonably to be expected having regard to the description applied to the goods. If the defects are such that their presence could not possibly be consistent with this description, but must lead to dispute, the sale contract is, it would seem, neither binding nor permissible.

As to the time at which the goods must comply with the description provided to the buyer, article 68 of the Vienna Convention may provide an answer. The answer may also depend upon whether or not the bank knows that the goods are defective, before the shipping documents are presented to the purchaser. Where the bank is so aware, it has a clear duty, in its role as seller, not to proceed with the deal, since to do so would involve a fraud upon the purchaser. It will rarely. if ever, be the case, however, that the bank actually examines the goods before passing the conforming documents to the buyer. The KFH usual practice is to conclude the contract of sale with the client as soon as it receives acknowledgment that the exporter has been paid.[79] The goods, at this stage, will inevitably still be in transit. Under article 38 of the Vienna Convention, 'the risk (of loss of or damage to the goods) in respect of goods sold in transit passes to the buyer from the time of conclusion of the contract'.[80]

An even more complex problem arises where documents presented by the supplier appear to conform on their face with the terms of the credit, but there are doubts as to whether the requirements of the contract of sale have in fact been satisfied. What are the respective legal rights and obligations of the bank, and of its client, in such a case?

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[78] Compare *Goods Act* 1958 (Vic), section 89(3)(b). This paragraph excludes the sellers warranty of merchantable quality in contracts for the sale of goods as regards defects which examination ought to have revealed in all cases where "the buyer has examined the goods or a sample of the goods before the sale is made".

[79] Ray, above n 5, 49.

[80] *United Nations Convention on Contracts for the International Sale of Goods*, opened for signature 11 April 1980, *Sale of Goods (Vienna Convention) Act* 1987 (Vic) Schedule 1, art 68. It should be noted that Egypt and Iraq are the only two Islamic countries which have ratified the Vienna Convention: see list of signatory countries.
Even where the rule expressed in art. 38 of the Vienna Convention is not expressly made applicable to the contract between the bank and the murabaha client-purchaser, however, an Islamic court or tribunal could still have reference to it as an 'established custom', and/or on the basis of 'general principles of law' and/or 'principles of natural justice'; all of which are sources of law to which courts in the Arab states can refer in the absence of express legislative or contractual provision.

So far as the bank is concerned, its duty in regards to a letter of credit issued subject to the ICC's *Uniform Customs and Practice for Documentary Credits* (1993 revision) (hereafter, UCP 500) is clear.[81] The bank must accept documents which, on their face appear to conform with the terms of the Credit and to the specific documentary requirements of the UCP 500. The bank which wrongly rejects documents presented under an irrevocable letter of credit is liable to the buyer for any consequent loss. Where an issuing or confirming bank accepts documents which, on a reasonable interpretation are in compliance with the terms of the credit, it is protected from any allegations of negligence in this respect under both common law and art. 15 of the UCP 500. The bank need do no more than take reasonable care in examining the documents to ensure that they conform on their face with the terms of the credit, and it has been accepted by the courts that "[i]t is no part of the function of a bank, ... to speculate upon the value to a buyer of a given document".[82]

The rule that, absent proven fraud by seller, the bank is entitled to pay under a credit against apparently conforming documents is based on the principle that the credit is a separate, autonomous contract from the contract of sale. Article 4 of the UCP 500 makes clear that, from a legal point of view:

> In Credit operations all parties concerned deal with documents, and not with goods, services and/or other performances to which the documents may relate.

It would also appear that even where the bank has an interest in the transaction as pledgee it cannot look behind the documents. The question arises, however, as to whether the situation is different where the bank is in fact dealing in goods, in that it has an interest as purchaser taking title to the goods under a *murabaha* arrangement. In other words, as regards its legal relationship with a supplier/ credit beneficiary who presents conforming documents, does the *murabaha* bank, as a purchaser, have a right to refuse payment under a credit on the ground of a breach of the underlying sales contract? On the other side of the *murabaha* equation, there is also the question as to whether or not the *murabaha* borrower can refuse to accept non conforming goods, even where the shipping documents passed on by the bank conform with the terms of the back-to-back credit arrangement.

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[81] Letters of Credit issued by Islamic banks are commonly issued subject to the UCP 500, as are those issued by conventional banks.

[82] *Commercial Banking Co. v Jalsard* [1973] AC 279, at 281. Argument put forward by Counsel for appellant bank, and accepted by the Privy Council.

As regards the bank's relationship with the supplier/ credit beneficiary, the need to ensure certainty in banking and financial transactions would seem to point towards the need to ensure that all banks which issue letters of credit are bound to honour the terms of such credits, regardless of any interest the bank may have in the underlying contract, whether as pledgee, as buyer or otherwise. Moreover, the legal system of most Islamic countries would allow the credit beneficiary to enforce the terms of the credit against the bank, and even to claim interest on the judgement debt.[83]

This does not mean, however, that the bank is left with no remedy at all against the defaulting seller. The solution would appear to lie in separating the bank's role as financier from its role as buyer. As financier, and as the issuer of an irrevocable promise to pay upon presentation of specified documents, the bank must honour that pledge strictly according to its terms. As buyer, however, the *murabaha* bank has what Burnett refers to as 'two rights to reject'. The first of these is the right to repudiate the contract of sale if the documents do not conform with the terms of that contract, and the second is the buyer's separate right to reject non-conforming goods. Since apparently conforming documents have been accepted, the bank's right, as buyer, to reject those documents, is lost. What it retains, however, is its separate right to reject the goods as not being of the contract description, and it can sue to recover the price already paid against the conforming documents and possibly related damages.[84]

In practice however, the bank is unlikely to want to incur the expense and time involved in suing a foreign exporter, even where such a course is theoretically open to it. An alternative remedy is to insert a stipulation in the sale agreement whereby the client-buyer guarantees the completion of the agreement by the foreign supplier. This practice is followed by KFH, which has seen fit to stipulate in its sale contracts that '"the *murabaha* borrower has confirmed his liability for the actions of the exporter and has guaranteed the exporter in the proper realization of the operation".'[85] The KFH fatwa dealing with such stipulations concerned a case where:

> Documents arrived from a *murabaha* credit, confirmed by a sale contract, but the buyer was unable to receive the goods for a reason beyond his control and beyond the control of Kuwait Finance House, this reason being that the goods had not arrived. Compensation was sought from the insurance companies, and subsequently from the

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[83] Shameela Chinoy, above n 67, 522-523. See also n 32 above.
[84] Robin Burnett, *The Law of International Business Transactions* (1994) 173-5.
[85] Ray above n 5, 49; KFH vol 2, fatwa no 63.

> shipping company which had misplaced the goods, whereupon the shipping company confirmed the sound condition of the goods, but was unable to deliver them.

The issue to be decided was whether or not liability remained with KFH, despite the presence of the guarantee provided by the *murabaha* borrower. The answer provided by the Shariah Supervisory Board states that:

> If the [*murabaha* borrower] promising to buy [the goods] guarantees the exporter with respect to all shortcomings in fulfilment of his obligations, the that guarantee is acceptable according to Islamic law, as a completion guarantee. Thus the [*murabaha* borrower] promising to purchase [the goods] will be liable for the damage [to the goods]. However, there will be no way to force him to conclude the contract of sale which he promised to conclude, since the object of the contract will be absent or defective.[86]

The statement in the fatwa that the buyer is no longer bound to conclude the contract of sale probably affords little relief in practice. Since the documents presented by the seller-bank conform with the usance letter of credit in its favour, the bank which issued the letter of credit must pay according to the terms of that credit. Given the buyer has guaranteed the exporter's fulfilment of the contract, it is reasonable to assume that if the buyer failed to conclude the contract, he would forfeit most, if not all of the amount paid to the seller-bank under the credit. Alternatively, if the amount due under the usance letter of credit is not collected, but the buyer has provided collateral to the bank, he would forfeit the collateral.

The KFH fatwa cited above has been severely criticised by at least one commentator as deviating from both the Spirit of the Shariah and the letter of fiqh.[87] The basis for these criticisms is that the fatwa is aimed at making *murabaha* no different from Western trade financing by removing from the Islamic bank the risks associated with owning and possessing the object of sale. KFH is, however, far from being the only Islamic bank to go beyond the established rules in this fashion.[88]

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[86] Bait al-Tamwil al-Kuwaiti, *al-fatawa al-shar'iyya fi al-masa'il al-iqtisa-diyya*, vol 2 (1987) 20, fatwa no 63; as translated and extracted in Ray, above n 5, 182.

[87] Ray, above n 5, 49.

[88] Adil Ahmad, personal correspondence with author, April 1996.

b) Letter of credit plus Guarantee

One mechanism used to overcome the potential problems involved in the bank's exposure to documentary risk under the back-to-back credit arrangement described above involves the use of a sight letter of credit in combination with a bank guarantee. Here also the first step is to for agreement to be reached with the overseas supplier on the specifications of the goods being provided. The client/purchaser and the bank then enter into the *murabaha* contract, on terms similar to those described above. In other words, the bank agrees to provide the goods, and the client/purchaser in return agrees to make payment for the goods.

The next step is for the purchaser to open a sight letter of credit in favour of the foreign supplier. Simultaneously, the purchaser also arranges issuance of a bank guarantee for the marked up price favouring the Islamic financier, in order to secure its payment obligation under the *murabaha* agreement. The terms of the bank guarantee are commonly such that they effectively insulate the bank against any default by the *murabaha* borrower who has agreed to buy the goods, and also protect it against any failure or shortcomings by the exporter in fulfilment of its obligations.

Upon receipt of the guarantee, the Islamic financier confirms the letter of credit, thereby adding its own promise to pay. Once the goods have been shipped, the supplier presents the shipping documents to the Islamic financier and receives payment. The Islamic financier then forwards the documents to the purchaser, receives payment under the bank guarantee. The purchaser takes possession of and title to the goods upon receipt of the shipping documents.

The main advantage of the arrangement just described is the advantage for the Islamic financier in having the security of a bank guarantee from the purchaser. In effect, the guarantee serves to eliminate the documentary risk involved in the back-to-back credit structure. For precisely this reason, however, the legality of the arrangement under Shariah remains questionable, since the guarantee serves to sever the link between the bank's income from the transaction and its risk in

the transaction.[89] In practice, however, a similar guarantee from a *murabaha* purchaser has been expressly held to be acceptable, as seen in the case of the KFH fatwa cited above.

The main disadvantage of the credit plus guarantee arrangement would appear to the increased costs that are involved for the Muslim importer, who is required to arrange issuance of two bank instruments at the same time, and for a single transaction. One way of avoiding these costs is to finance the transaction through a single, term letter of credit.

c) Single Usance L/C

As with the previous two arrangements, once the commodity specifications have been agreed upon with the foreign supplier, the *murabaha* agreement is entered into between the purchaser and the Islamic financier. The purchaser then opens a structured term letter of credit in favour of the supplier. The credit is somewhat complicated and involves a separate sight payment confirmation from the bank and a conditional direct reimbursement to Islamic bank clause.[90] The complexity of the arrangement is by far its greatest drawback, as getting the details correct so as to avoid legal difficulties can be a problem. At the same time, however, it also involves the lowest costs for the Muslim importer, and for this reason alone is often to be preferred.

d) 'Offshore' Murabaha: Combination wakala plus local Murabaha

This is a relatively recent innovations in Islamic trade financing, which has been used, for example, to provide pre-shipment finance to exporters in developing countries, while at the same time encouraging hard currency inflows.[91] The arrangement involves the use of an agency agreement, whereby an offshore (usually Islamic) bank in a foreign jurisdiction enters into an agency agreement with the local bank in the Muslim exporter's country. The agent is

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89 Chinoy, above n 67, 520, maintains that In principle, the bank ought not to extract such a guarantee from the client, although it is permitted to mitigate its risk by requiring the client to submit a (non-binding) form of request for the relevant goods before initiating the purchase of the goods.

90 Questioned further about this arrangement, Adil Ahmad of the ANZ Banking Group, London, was unable to disclose more of this proprietary product: personal correspondence addressed to author, April 1996.

91 The arrangement has been used, for example, by the London-based ANZ Banking Group as a way of providing pre-shipment finance for local exporters in Pakistan, and also encouraging export sales and improving inflows of hard currency from overseas: Adil Ahmad, 'Cross Border Islamic Trade Finance', paper presented to the ICM Conference on *Islamic Banking & Finance: Moving into International Markets*, 23 April 1996, London, 2.6.

appointed to sell, on behalf of the local bank (the principal), goods manufactured by the Muslim exporter in the principal's country.

The Principal under the *wakala* agreement also enters into a local *murabaha* contract with the Muslim exporter, under which the exporter agrees to sell, and the bank agrees to buy, the products manufactured by the exporter-client. Once the local bank obtains legal title to the goods it passes the documents onto its offshore agent, which then passes them to the foreign purchaser in order to receive payment. The foreign currency payment received from the foreign purchaser can then be channelled back to the developing country where the principal under the *wakala* agreement is located. This enables the bank to share in the profits from the exporter's sale, and helps to encourage the inflow of foreign currency into the country.

CONCLUSION

All that can be said with confidence, it seems, is that the laws governing Islamically-financed international trade transactions will be neither the traditional Shariah of the medieval manuals nor straightforward imported Western law. They will represent an amalgam of those Western laws which reflect current commercial realities and the dictates of the Quran and the Sunnah.[92] In the case of import-export financing, the formal and nominal legal basis may be the traditional contract of *murabaha*. But the real justification for the complexity of activities involved (which go well beyond the scope of *murabaha* as envisaged by the medieval jurists) lies in fresh interpretations of the basic texts of Shariah in the light of the prevailing social and economic climate. What remains missing, however, is any definable or systematic collection of 'Islamic' principles which is backed by the authority of any group, official or unofficial, or even a State Government. It is still far to early to speak even of an embryonic code of Islamic principles governing *murabaha* import-export financing. As Noel Coulson has noted,

> Such principles as have been formulated have appeared only in the context of an immediate and restricted issue, and appeal to them has had an undeniably opportunistic flavour.[93]

Expressed in a negative way, what this means is that the law of Islamic bank financing remains an area which is full of uncertainties; uncertainties which, from one Western perspective,

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[92] Coulson, above n 20, 107.
[93] *Ibid.*

represent the 'sword of Damocles'[94] which hangs over the head of any Western banker or business person daring to do business with a Muslim country. This uncertainty goes not only to the question of whether the Shariah might be applied, but the degree of severity if it is.

Some commentators have suggested as a means of relieving this uncertainty, the enactment of 'incisive legislation', along the lines of the Commercial Code of Kuwait and other Gulf States which have seen a need to adapt to the existing international world of commerce. The problem is, however, that while legislation along the lines suggested may well be readily accessible, in English translation and have a format and a content which is familiar to the Western lawyer; the principal repository of Shariah jurisprudence must still remain, as it always has been, the authoritative Arabic manuals dating from early medieval times. And to ascertain the relevant law from these texts requires not only an in-depth knowledge of the Arabic language but also a familiarity with Islamic legal method, in terms of the history, the jurisprudence and the substantive law of the Shariah. There is also the problem that commercial legislation can still be interpreted simply as a means of codifying the rules of Shariah to protect the basic integrity of the Islamic state; and can be applied accordingly.

In light of this reality, it is the informal, rather than the formal reality of the processes which are now occurring that become more interesting. As Coulson and Ballantyne have recognised, what appears to be occurring in the area of Islamic financing law is a new development of the Shariah by deductive processes, by consensus and by analogy. Ballantyne goes so far as to refer to 'a new process of *Ijtihad*'[95]; a process whereby existing commercial laws and practices are being reviewed in the light of fresh interpretations of the basic precepts of the Quran and Sunnah.

Adil Ahmad of the ANZ Banking Group in London further suggests how this two-sided process might continue to expand in practice. In discussing the future of Islamic cross-border trade financing, he tells of a world where Islamic forms of financing are extending across more borders, and for longer periods of time. The process of expansion envisaged is one where

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[94] William M Ballantyne, 'The Shari'a and its Relevance to Modern Transnational Transactions' in *Arab Comparative & Commercial Law: The International Approach* (Proceedings IBA First Arab Regional Conference: Cairo 15-19 February 1987), vol 1 (1987) 20.

[95] *Ibid* 23.

Islamic financiers are becoming more self-confident in seeking and originating trade financing structures, with the end result being the emergence of specialised Islamic trade funds onto the international scene. The process is also facilitated, as it must be, by the involvement of more Western Banks in Islamic finance.[96] Particularly where co-operation between the Conventional and the Islamic institution is to the benefit of both sides, the logic of self-interest must surely lead to a practical consensus on mutually acceptable interpretations of the Shariah. The process is one which could, given the time and massive effort needed, produce a genuine Islamic law of cross-border trade financing which would recognise the needs of international commerce within the bounds of Islamic legality.

[96] Adil Ahmad, 'Cross Border Islamic Trade Finance', paper presented to the ICM Conference on *Islamic Banking & Finance: Moving into International Markets*, 23 April 1996, London, 3.

GLOSSARY OF TERMS

murabaha (Pakistan)/ al-murabahah Malaysia) (Mark-up or cost-plus-financing)
In Pakistan, the term *murabaha* encompasses the purchase of goods by banks and their sale to clients at appropriate mark-up in price on a deferred payment basis. Similarly, in Malaysia, the concept of *al-murabahah* refers to the sale of goods (by the bank) at a price that includes a profit margin as agreed by both parties.

bay 'mu'ajjal or (deferred payment sale).
Known in Malaysia as *bai' bithaman ajil*, the concept is similar to *murabaha*, except that the sale is on a deferred payment basis, in instalments or in a lump-sum payment. The price of the product is agreed to between the buyer and seller and cannot include any charges for deferring payment.

Mark-down and debt-trading
In Pakistan, defined as purchase of trade bills and notes of credit on the basis of mark-down in price.

In Malaysia, the islamic banks also provide pre and post-shipment financing for production, commerce and services by way of sale/purchase of trade documents and papers. These pre and post-shipment Islamic bank-acceptance drafts are governed by the Islamic concept of *bai'-al-dayn* or mark-down. The concept refers to a short-term facility with a maturity of not more than one year, and only documents evidencing debts arising from bona fide commercial transactions can be traded.

Guarantees (kafalah)
The term refers to the guarantee provided by a person to the owner of a good, who has placed or deposited his goods with a third party, whereby any subsequent claim by the owner with regard to her goods must be met by the guarantor, if it is not met by the third party. Islamic banks provide shipping guarantees and other guarantees in accordance with this principle.

Hire Purchase
In Pakistan, Hire-purchase in import financing is presented as a joint-ownership contract, whereby the bank agrees to finance the purchase of the imported machinery, and the user pays a fixed rental and part of the principal (purchase price) and in proportion, the ownership rights are transferred to the user.

In Malaysia, the concept is known by the Islamic term *al-ijarah thumma al-bai* (hiring followed by sale and purchase), and is primarily applicable to financing of consumer goods and durables, rather than to international trading transactions.

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