

**Legal Risks Faced By Investors in Dealing with Islamic Financial
Transactions and Mitigation Actions/Strategies to Keep Off Legal Risks:
The Case of *Murabaha* Transaction**

Mohammad Almohana

University of Exeter

**Degree of
Doctor of Philosophy in Law**

January 2017

Abstract

Background: This research project is based on the subject of legal risks that has faced by investors in dealing with *Murabaha* Islamic transaction. This research project portrays background history of *Sharia* law and about *Murabaha* Islamic transaction. In the context of this Islamic transaction, legal risks and actions/strategies to deal with risks of *Murabaha* has represented under this research study.

Aim and Objectives: The main aim of the research is thus to explore the legal risks associated with *Murabaha* transactions, and to identify ways of mitigating such risks. The research objectives are directed to represent about *Murabaha* transaction, risks involved in *Murabaha* transaction and solutions/actions to mitigate risks.

Methodology: The data collection process has initiated with collection of secondary sources, along with the examination of contracts formed between banks and clients. This will be helpful in acquiring relevant information about the legal risks involved in *Murabaha* Islamic financial transaction.

Results and Analysis: It has been analysed that legal risks in *Murabaha* Islamic financial transaction has negatively impacted interests of the parties involved in it. In contrast to the other investment options, it is considered as a highly risky due to high probability of bad debt risk. It has been analysed that banks can prevent harm from risks involved in this transaction through effective financial strategy.

Conclusion: It can be concluded that *Murabaha* transaction is highly risky investment option in Islamic banking that have involved different legal risks, such as credit risk, liquidity risk, mark-up risk, operational risk, unauthorised agreement risk, transparency risk, commodity risks and others. It can be concluded that lack of new amendments in the *Sharia* system is the big issue that emerges risks in *Murabaha* financial transaction. It is crucial for Islamic banks and other parties involved in *Murabaha* to do proper scrutiny and processing prior undertaken this Islamic financial transaction.

Acknowledgement

On the successful completion of this research project, I am highly grateful to my supervisor, who has provided a good support and assistance. I am also thankful for family members, friends and relatives, who have provided moral support to me. Above all, I am highly thankful to Almighty Allah for staying me blessed.

Table of Contents

Abstract.....	2
Chapter 1: Introduction	7
1.1 Introduction.....	8
1.2 Aims, Objectives, and Research Gap	45
1.2.1 Research gap	46
1.3 Islamic finance and its history: the origins of a modern phenomenon	47
1.4 Differences between the Saudi regime and Sharia law	50
1.5 Islamic jurisdiction.....	62
1.6 Principles of Islamic finance	64
<i>Prohibition of riba</i>	69
<i>Prohibition of gharar</i>	70
<i>Prohibition of maysir</i>	73
<i>Principle of risk sharing</i>	74
<i>Principle of materiality</i>	76
<i>Principle of avoiding exploitation in financial transactions</i>	77
1.7 Risks in Islamic finance	79
1.8 Murabaha	86
<i>The functioning of Murabaha financing</i>	88
<i>Advantages of Murabaha</i>	98
<i>Risks associated with Murabaha transactions</i>	99
<i>Actions for managing risks associated with Murabaha</i>	101
1.9 Research Questions and Sub-Questions.....	101
1.10 Research methodology.....	102
<i>Murabaha Research Approach</i>	103
<i>Research design</i>	104
<i>Contract review and analysis</i>	105
<i>Details of contracts and their justification</i>	105
<i>Data analysis method</i>	107
<i>Limitations of selected research methods</i>	108
<i>Ethical considerations</i>	109
1.11 Organisation of dissertation	110
1.12 Conclusion and Transition	111
Chapter 2: Saudi Legal System	114
2.1 Introduction.....	114
2.2 Overview of Saudi Arabia	114

2.3 Defining Sharia	116
2.3.1 <i>Sharia's Legal Sources</i>	117
2.3.1.1 <i>The Primary Sources of Sharia: the Quran and the Sunnah</i>	117
2.3.1.1.1 <i>The Quran</i>	117
2.3.1.1.2 <i>The Sunnah</i>	118
2.3.1.2 <i>The Secondary Sources</i>	119
2.3.1.2.1 <i>Ijma</i>	119
2.3.1.2.2 <i>Qiyas</i>	119
2.3.2 <i>Islamic Schools (madhhab)</i>	120
2.3.2.1 <i>The Hanafi School</i>	121
2.3.2.2 <i>The Maliki School</i>	122
2.3.2.3 <i>The Shafii School</i>	122
2.3.2.4 <i>The Hanbali School</i>	123
2.4 <i>Saudi Arabian Banking and Financial Laws</i>	123
2.4.1 <i>The Banking Control Law (BCL)</i>	124
2.4.2 <i>The Capital Market Law (CML)</i>	125
2.5 <i>Authorities responsible for the regulation and supervision of Islamic Banking and Financial Activities in Saudi Arabia</i>	126
2.5.1 <i>The Saudi Arabian Monetary Agency (SAMA)</i>	126
2.5.2 <i>The Capital Market Authority (CMA)</i>	127
Chapter 3: <i>Findings and Analysis</i>	129
3.1 <i>Introduction</i>	130
3.2 <i>Religion, law, and banking in Saudi Arabia</i>	132
3.3 <i>Introduction to legal risk of Murabaha – a legal and financial analysis</i>	134
<i>Mitigating legal risks</i>	139
3.4 <i>Findings from the Analysis of the Contracts</i>	143
<i>Risks related to Al Bilad Bank Contracts</i>	145
<i>Risks related to Al Rajhi Bank Contracts: A Glimpse into the Uses and Abuses of Islamic Law</i>	150
3.5. <i>Critical analysis of the contracts</i>	152
3.6 <i>Conclusion</i>	155
Chapter 4: <i>Analysis of the Legal Risks Associated with Murabaha Contracts and Actions to Mitigate Legal Risks</i>	157
4.1 <i>Introduction</i>	158
4.2 <i>Murabaha financing and the associated risks</i>	159
<i>Major risks of Murabaha financing</i>	159
<i>Risks in dealing with Murabaha transactions and its causes</i>	168
4.3 <i>Risk management strategies adopted by Islamic banks</i>	212

<i>The principle of risk-sharing</i>	213
<i>Implications of the risk management guidelines used for Murabaha transactions to avoid legal risks</i>	214
<i>Legal risk management by Islamic banks</i>	221
4.4 Conclusion and transition	244
Chapter 5: Recommendations	250
5.1 Introduction	252
5.2 Summary of findings related to the risks associated with Murabaha contracts	253
5.3 Solutions for the risks associated with Murabaha transactions.....	257
5.4 Summary	282
Annexes.....	285
References	373

Chapter 1: Introduction

1.1 Introduction

The aim of the present research study is to explore the legal risks associated with *Murabaha*, a type of Islamic financial transaction in Sharia law, taking Saudi Arabia's banking firms/institutions as a case study. *Sharia* is the set of rules and the provisions that are helpful in governing the actions of people from Muslim community in the country.¹ *Sharia*, as a set of religious principles, deals with several aspects of life, both public and private, of Islamic followers. Such aspects typically include business implications, religious rituals, crimes, warfare, and family life. It must be noted that in the past several independent jurists interpreted *Sharia* as their legal opinions were based on Quran. Even though *Sharia* is considered as a set of principles, some of its components are treated as laws; whereas, the others are considered as guidelines to live life. This introductory chapter therefore begins with an account of the history and principles of the Islamic finance industry, whose main distinguishing features include the prohibition of lending money with interest and the outright exclusion of uncertain and speculative transactions.²

Islamic finance also requires the equal distribution of profits and losses with respect to the capital proportion.³ This chapter then discusses various risks inherent in Islamic financial transactions, and particularly with respect to *Murabaha*, before touching on possible methods to mitigate these risks.⁴ Next, it identifies the research gap to be bridged, the research questions to be addressed, and the aims and objectives to be met by the present study. The significance of the research can be seen in its contribution to the theoretical and practical development of the Islamic finance industry. The academic significance of this research is that it furthers conceptual, theoretical, and practical

¹Muhammad Ayub, *Understanding Islamic Finance* (John Wiley & Sons Ltd 2007) 21; Natalie Schoon, *Islamic Banking and Finance* (Spiramus Press Ltd 2009) 19.

²Ginena, K. and Hamid, A. 2015. *Foundations of Shariah Governance of Islamic Banks*. New Jersey: John Wiley & Sons, p. 97.

³Azwar, A. and Tajudin, A. 2010. Overview of Islamic finance. [Online]. Available at: <http://www.bankislam.com.my/en/Documents/shariah/OverviewOfIslamicFinance-13122010.pdf> [Accessed on: 8 September 2012].

⁴Pock, A.V. 2007. *Strategic Management in Islamic Finance*. US: Springer, p. 45.

understandings of the Islamic financial system in general, of the legal risks associated with transactions within that system, and of the particular risks of *Murabaha* transactions.⁵ The aim of this PhD is also to fill the gaps in literature. People in most Muslims countries and many non-Muslim ones now have access to Islamic finance services, offered both by small niche banks and conventional ones, in response to increased demand for these services in countries with both high and low Muslim populations.⁶ This study has practical significance not only for financial institutions, but also for investors involved in *Murabaha* transactions, as it will safeguard their interests by improving understanding of the associated legal risks, such as rate of return risk, operational risk, equity investment risk, credit risk, market risk, and liquidity risk.⁷

As the data in this research has been inferred and perceived taking into consideration the recent trends taking place in financial transactions conducted by Islamic banks in Saudi Arabia, the research has provided a theoretical base for further research studies on a similar topic.⁸ The conclusion drawn in the research has been supported by the evidence contained in the literature, which has assisted in improving the feasibility and authenticity of the research. This research will contribute in determining reasons associated with risky nature of *Murabaha* transaction as compared to the other Islamic financial transactions. A review of this research will contribute in determining issues that may be emerged in *Murabaha* transaction and way to deal with such issues at the best possible extent.

Murabaha, which has become the most commonly used form of Islamic financing, is a cost plus profit contract in which the bank does not share profit or loss, but acts as a financial intermediary.⁹ Islamic law, under which interest is illegal and unethical, did not initially approve of *Murabaha*, owing to the

⁵Archer, S. and Karim, R.A.A. 2007. *Islamic Finance: The Regulatory Challenge*. John Wiley & Sons, p. 62.

⁶Ibid, p. 82.

⁷Ibid, p. 89.

⁸Onnaway, L.S. and Powell, R.R. 2010. *Basic Research Methods for Librarians*. ABC-CLIO.

⁹ Islamic finance basics. 2007. [Online]. Available at:
<http://islamicfinanceaffairs.wordpress.com/2007/05/25/islamic-finance-basics-what-is-Murabaha-ijara-and-musharakahmudarabah/>[Accessed on: 23 March 2013].

prohibition of *riba*.^{10,11} This is due to the fact that all losses incurred in a transaction are to be borne by investors. The entrepreneur, in such cases, has no clause providing for recompense for efforts made unless and until the project undertaken is profitable. This chapter reviews the literature on the legal risks accompanying *Murabaha* as a means of financing trade.¹² In pursuit of the objectives set out in Chapter 1, it addresses the identification and evaluation of these risks, along with the background and structure of *Murabaha* transactions.

In Islamic countries like Iran and Sudan, an increasing number of banks operate in accordance with the religious principles derived from the Quran and Sharia law.¹³ Providers of financial services in Islamic countries now include commercial and investment banks, along with mutual insurance and investment companies.¹⁴ Banks are considered major contributors to the growth and development of the industry because of the range of financial services they offer.¹⁵ In Saudi Arabia, Ramady notes that regulations recently introduced under the Banking Control Law support a “universal banking model” permitting banks to provide a wide range of financial services including securities, investments, and banking.¹⁶ They also strengthen and clarify the role of SAMA in regulating the Saudi banking system.¹⁷ Using enhanced supervisory powers, SAMA now issues rules, guidelines and regulations in line with international supervisory developments concerning liquidity, loan concentration ratios, capital adequacy, and reserve requirements.¹⁸ This information source has widely covered banking

¹⁰Ibid

¹¹Ibid

¹²Islamic finance basics. 2007. [Online]. Available at: <http://islamicfinanceaffairs.wordpress.com/2007/05/25/islamic-finance-basics-what-is-Murabaha-ijara-and-musharakahmudarabah/> [Accessed on: 23 March 2013].

¹³Ayub, M. 2009. *Understanding Islamic Finance*. John Wiley & Sons.

¹⁴Ibid

¹⁵Ayub, M. 2009. *Understanding Islamic Finance*. John Wiley & Sons; Sundararajan, V. and Errico, L. 2002. Islamic financial institutions and products in the global financial system: Key issues in risk management and challenges ahead. IMF working paper. [Online]. Available at: <http://kantakji.com/media/8223/y144.pdf> [Accessed on: 12 March 2014].

¹⁶Islamic finance basics. 2007. [Online]. Available at: <http://islamicfinanceaffairs.wordpress.com/2007/05/25/islamic-finance-basics-what-is-Murabaha-ijara-and-musharakahmudarabah/> [Accessed on: 23 March 2013].

¹⁷Ayub, M. 2009. *Understanding Islamic Finance*. John Wiley & Sons, pp. 114.

¹⁸Ramady, M.A. 2010. *The Saudi Arabian Economy: Policies, Achievements, and Challenges*. Saudi Arabia: Springer Science & Business Media.

regulations to regularise operations/activities of banks. Strength of this source is the coverage of other information for sustaining economic position. On the negative, this study is only found good to explore generalise information instead of exploring information in respective to the Islamic transactions.

Another external factor that influences the legal risks of *Murabaha* is the basic law of Saudi Arabia.¹⁹Bowen argues that this restricts freedom of religion by designating Islam as the official religion; non-Muslim practices are neither protected nor recognised, being merely tolerated in private by the government, which signifies that anyone using *Murabaha* who is not Muslim is at risk.²⁰ The basic law has also opposed the Muslim reform movements of the 19th, 20th, and 21st centuries, which have sought to reinterpret various aspects of Islamic law to enhance social and economic development, personal autonomy, and participatory democracy.²¹The reforms were limited to some religious aspects and hence these obstructed development in the social and economic contexts. In contrast to this previous source of information, this source is found pertinent to the thesis that covered information of legal risk to *Murabaha* transaction. This describes basic law as the critical risk to the *Murabaha*. On the side of weakness, this source has presented reform in the basic law to the religious level instead of other aspects. This can be improved through exploring other aspects that imposed legal risks to the *Murabaha* transaction.

Saudi law is nevertheless considered to be gradually becoming positivist, but its religious basis restricts the extent to which banks can hedge their positions with diversified portfolios.²²The Sharia laws for regulating banking transactions are based on Islamic values, such as avoidance of risky transactions, which obstruct banking institutions from participating in global opportunities through confronting risk situations. The regulations in the oil and

¹⁹Ayub, M. 2009. *Understanding Islamic Finance*. John Wiley & Sons, p. 112-113.

²⁰Islamic Finance Basics. 2007. [Online]. Available at: <http://islamicfinanceaffairs.wordpress.com/2007/05/25/islamic-finance-basics-what-is-Murabaha-ijara-and-musharakahmudarabah/> [Accessed on: 23 March 2013].

²¹Bowen, W.H. 2014. *The History of Saudi Arabia*. USA: ABC-CLIO.

²²Islamic finance basics. 2007. [Online]. Available at: <http://islamicfinanceaffairs.wordpress.com/2007/05/25/islamic-finance-basics-what-is-Murabaha-ijara-and-musharakahmudarabah/>[Accessed on: 23 March 2013].

gas sector are also very strict, creating risk for investment banks in transacting with this sector.²³ Thus, all the legal characteristics of the country have a direct influence on the banking sector.²⁴ Using an Islamic contract, therefore, does not only grant advantages, it also presents a number of risks, most of these relating to the fact that such contracts are dictated by religious principles. As context to this, the research discussion explores the legal risks of one type of Islamic transaction, *Murabaha*, along with subsequent causes.

Furthermore, Borscheid et al. (2013) warn that banks face the legal risk of the unenforceability of finance-based contracts, whose fulfilment and the completion of transactions depend on national legislation and regulations.²⁵ This source is good to understand legal risk faced by bank, and the manner in which any financial transaction is influenced by the prevailing regulations in a country. This source is found lacking to exemplify legal risks and its association with legislations enacted in a country. Such legal risks could be said to be external, in that national regulations directly affect business activities, while internal risks include violation of regulations and illegal or fraudulent practices by bank personnel.²⁶ Legal risks are also components of operational risk. For instance, any bank that does not train its people adequately in the legal and regulatory frameworks is exposed to both legal and operational risks.²⁷ Saudi banks are required to abide by SAMA rules and guidelines specifying maximum liability ratios, the issuing of guarantees, letters of credit, and other undertakings.²⁸ Managers who infringe these rules are subject to fines and may be prohibited from undertaking banking practices in certain operational areas for a specified

²³Ibid

²⁴The Kingdom of Saudi Arabia: An overview. 2012. [Online]. Available at: [http://www.ca-suisse.com/C12575DE004F6944/lkpResources/Insight%2014%20ksa%202.pdf/\\$FILE/Insight%2014%20ksa%202.pdf](http://www.ca-suisse.com/C12575DE004F6944/lkpResources/Insight%2014%20ksa%202.pdf/$FILE/Insight%2014%20ksa%202.pdf) Accessed on: 13 March 2015].

²⁵Borscheid, P., Gugerli, D. and Straumann, T. 2013. *The Value of Risk: Swiss Re and the History of Reinsurance*. UK: Oxford University Press.

²⁶The Kingdom of Saudi Arabia: An overview. 2012. [Online]. Available at: [http://www.ca-suisse.com/C12575DE004F6944/lkpResources/Insight%2014%20ksa%202.pdf/\\$FILE/Insight%2014%20ksa%202.pdf](http://www.ca-suisse.com/C12575DE004F6944/lkpResources/Insight%2014%20ksa%202.pdf/$FILE/Insight%2014%20ksa%202.pdf) [Accessed on: 13 March 2015].

²⁷Ibid

²⁸Ibid

period of time.²⁹As Islamic banking is prominently evident in Saudi Arabia, all the risks discussed above are applicable in the country's context.

Islamic banks provide facilities to various stakeholders, e.g. customers, creditors, suppliers, and others, using a range of financial transactions, which are divided into two broad categories, depending on whether profit and loss are shared.³⁰ The non-profit-and-loss sharing modes, also called mark-up, are open to credit risk, liquidity risk, and commodity price risk, among others.³¹ *Murabaha*, which involves selling goods and services at a fixed profit, has no facility for sharing profit or loss among the parties to the transaction.³² Instead, buyer and seller negotiate the mark-up between them. The transaction is completed in two stages. First, the asset owner gives the financier information about the asset and the purchase price, and then the financier purchases the asset from the owner, pays on the spot, and sells it at a higher price to the customer, who pays the amount in instalments.³³ Transparency is essential, so information about cost and profit margin is disclosed to all parties.³⁴

The legal risks facing Islamic banks constitute a significant area of concern for the banking system, as they directly affect the interests of investors and add complexity to the routine functioning of banks.³⁵ For instance, liquidity risk makes it more difficult for banking institutions to provide funds or pay debts

²⁹Center for International Legal Studies (CILS). 2010. *Legal Aspects of Doing Business in the Middle East*. 2nd ed.. Huntington: Juris Publishing, Inc.

³⁰Ariff, M. and Iqbal, M. 2011. *The Foundations of Islamic Banking: Theory, Practice and Education*. Edward Elgar Publishing.

³¹Ibid, pp. 96-98

³²Borscheid, P., Gugerli, D. and Straumann, T. 2013. *The Value of Risk: Swiss Re and the History of Reinsurance*. UK: Oxford University Press, p. 118.

³³Ibid, p. 125

³⁴Sundararajan, V. and Errico, L. 2002. Islamic financial institutions and products in the global financial system: Key issues in risk management and challenges ahead. IMF working paper. [Online]. Available at: <http://kantakji.com/media/8223/y144.pdf> [Accessed on: 12 March 2014].

³⁵Hassan, M.K. and Lewis, M.K. 2007. *The Handbook of Islamic Banking*. Glos: Edward Elgar Publishing, pp. 19-125.

on time, reducing the confidence of investors and generating negative word of mouth.³⁶ Similarly, operational and default payment risks increase the probability of a banking collapse and failure to meet targets.³⁷ Therefore, it has been concluded that the issue of Islamic legal risks is not only destructive for banking institutions; it also affects overall business growth and economic development.³⁸

Among the factors that give rise to legal risks for Islamic banking institutions, the most pertinent is the lack of a clear statutory framework, due to the adoption of different elements of common or civil law.³⁹ Certain distinctive features of Islamic financial products are not easily supported by the prevailing laws. Indeed, commercial banks may be unable to offer these products, which are incompatible with the banking regulations in force in most jurisdictions.⁴⁰ Legal risks for financial institutions also arise from the failure of Islamic courts to enforce Islamic contracts, as well as from the nonstandard nature of such contracts, making negotiation difficult and transactions costly.⁴¹ Steps commonly taken to mitigate these risks include collateral securities, *takaful* coverage, fixed or advance deposits, modified asset ownership, Islamic insurance and standard frameworks.⁴²

Murabaha This chapter reviews the literature on legal risks to Islamic banks arising from *Murabaha* contracts. It first sets out the conceptual

³⁶Borscheid, P., Gugerli, D. and Straumann, T. 2013. *The Value of Risk: Swiss Re and the History of Reinsurance*. UK: Oxford University Press, pp. 2-3.

³⁷ Ibid, pp. 5-6

³⁸Ariff, M. and Iqbal, M. 2011. *The Foundations of Islamic Banking: Theory, Practice and Education*. Edward Elgar Publishing.

³⁹Hassan, M.K. and Lewis, M.K. 2007. *The Handbook of Islamic Banking*. Glos: Edward Elgar Publishing.

⁴⁰Ariff, M. and Iqbal, M. 2011. *The Foundations of Islamic Banking: Theory, Practice and Education*. Edward Elgar Publishing.

⁴¹Hassan, M.K. and Lewis, M.K. 2007. *The Handbook of Islamic Banking*. Glos: Edward Elgar Publishing.

⁴² Ibid, p. 115

framework, then explores *Murabaha* and its structure, before turning to the associated risks and ways of mitigating them.⁴³ It ends with a summary.

The aim of the literature review is to submit the most important pieces that have influenced the content of the dissertation and my argument, which is that it is possible to mitigate the risks described above.

The following short summary serves as a conceptual framework for the study of developments in the financial market, which can be seen to mitigate the risks faced by banks and financial institutions engaged in Islamic finance. The context of this research is Islamic banking, which complies with Sharia law and related principles, including an ethical dimension.⁴⁴ This ethical dimension states that, if an economy is based on the Islamic value and principles, it will lead to an economic structure that will not only cater to the needs of the Muslims but will address humanity at large. Islamic finance offers a wide range of products and has become an integral and fast-growing component of the international financial market.⁴⁵ The total assets of Islamic banks have increased and Islamic securitisation has enjoyed rapidly growing opportunities, while Islamic insurance services, or *takaful*, grew from US\$1.4 to US\$3.4 billion between 2004 and 2007.⁴⁶ This substantial recent growth in Islamic banking and finance has benefited society, investors, shareholders, and bankers alike.⁴⁷

Within the Islamic financial system, *Murabaha* is a trade whereby parties to a contract for the exchange of goods and services disclose information related to cost and profit margin, giving them the opportunity to negotiate the profit margin, and where payment is made on the spot.⁴⁸ Profit is in the form of a mark-

⁴³Hassan, M.K. and Lewis, M.K. 2007. *The Handbook of Islamic Banking*. Glos: Edward Elgar Publishing.

⁴⁴Financing through Musharaka: Principles and application. 2008. Available at <http://ifinanceexpert.wordpress.com/category/islamic-finance/page/10/> [Accessed on: 23 March 2013].

⁴⁵Ibid

⁴⁶Islamic finance for development: Conceptual framework. 2010. [Online]. Available at: <http://adfimi.org/dosyalar/seminerler/128/pdf/19.pdf> [Accessed on: 23 March 2013].

⁴⁷Ibid

⁴⁸Hassan, M.K. and Lewis, M.K. 2007. *The Handbook of Islamic Banking*. Glos: Edward Elgar Publishing.

up, because Sharia law forbids the charging of interest or *riba*.⁴⁹ As ample information is available regarding the topic, the conceptual framework helps in identifying the themes and subthemes of the research, and provides a systematic framework to conduct the study. This also helps in determining the gap in the existing literature, which can be addressed with the current research. It also ensures that the literature that is to be reviewed is in accordance with the research aim and objectives.

Sharia law requires Islamic banks to offer financial products that yield high returns on investment at the minimum level of risk.⁵⁰ The main risks associated with *Murabaha* transactions considered here include liquidity risk, credit risk, default payment risk, and many others.⁵¹ Liquidity risk, in general terms, refers to the risk of not meeting the current liabilities of the business by making optimum use of assets held by the organisation.⁵² Cash is considered a liquid asset, as it helps to increase the purchasing power of other assets held by banks. All financial institutions are required to ensure that their liquidity position is apt to meet customers' demand for the deposited cash at any time.⁵³ If a bank fails to meet the demands of stakeholders, it faces a liquidity risk. Islamic banks tend to own illiquid assets in larger amounts as compared to liquid current assets and liabilities, as a result of mismanagement of their assets and liabilities.⁵⁴

Credit risk refers to the non-fulfilment or failure by borrowers to repay within the specified timeframe.⁵⁵ Price risk also applies to *Murabaha*, as the price of the goods being traded is fixed, such that the client cannot avoid payment of

⁴⁹Karim, S.A. 2010. *The Islamic Moral Economy: A Study of Islamic Money and Financial Instruments*. Universal-Publishers.

⁵⁰Hassan, M.K. and Lewis, M.K. 2007. *The Handbook of Islamic Banking*. Glos: Edward Elgar Publishing.

⁵¹Karim, S.A. 2010. *The Islamic Moral Economy: A Study of Islamic Money and Financial Instruments*. Universal-Publishers, pp. 110-112.

⁵²Ibid, p. 113

⁵³Ibid, p. 114

⁵⁴Kettell, B. 2011. *Islamic Finance in a Nutshell: A Guide for Non-Specialists*. John Wiley & Sons, p. 85.

⁵⁵Wilson, R. 2012. *Legal, Regulatory and Governance Issues in Islamic Finance*. London: Edinburgh University Press, p. 40.

the mark-up by making early repayments.⁵⁶ The bank is exposed to ownership risk by having to maintain the assets until the client has made full payment. It is also at risk of incurring tax liabilities on the sale and acquisition of the asset.⁵⁷

The next section looks in more detail at the structure of *Murabaha* contracts.⁵⁸

The literature review will firstly look into the *Murabaha* contract to explain its content, structure, and operation. Malik et al. note that, throughout its long history, Islamic finance has flourished by offering products in compliance with Sharia standards of fairness. Islam focuses on ensuring justice and equity for society at large, giving equal emphasis to the various dimensions (moral, social, ethical, and religious). With finance and banking, the principle of fairness is essential to all the parties to assist them in taking a well-informed decision with no probability of being cheated or misled. These principles also help in reducing financial burden by adopting the principle related to the sharing of profit and loss.⁵⁹ However, the authors warn of the challenges involved in the use of mark-up in *Murabaha* instruments.⁶⁰ The key rationale behind selection of Malik's article is that it has provided detailed and crucial information relating to the origin of Islamic finance and its different attributes. The article is quite informative in nature and has provided crucial information about the values and propositions of Islamic finance.⁶¹ The information explored in the article is very much valuable and relevant to the study of the key principles of Islamic finance, and hence it is included for review in this section.⁶²

⁵⁶Karim, S.A. 2010. *The Islamic Moral Economy: A Study of Islamic Money and Financial Instruments*. Universal-Publishers.

⁵⁷Siddiqi, A. and Hrubí, P. 2008. *Islamic Investments Funds Versus Hedge Funds*. GRIN Verlag, p. 119-126. Visser, H. 2013. *Islamic Finance: Principles and Practice*. Edward Elgar, p. 11.

⁵⁸Karim, S.A. 2010. *The Islamic Moral Economy: A Study of Islamic Money and Financial Instruments*. Universal-Publishers.

⁵⁹Ibid, pp. 113-115

⁶⁰Malik, M.S., Malik, A. and Mustafa, W. 2011. Controversies That Make Islamic Banking Controversial: An Analysis of Issues and Challenges. *American Journal of Social and Management Sciences* 2(1), pp. 41-46.

⁶¹Karim, S.A. 2010. *The Islamic Moral Economy: A Study of Islamic Money and Financial Instruments*. Universal-Publishers.

⁶²Schoon, N. 2010. *Islamic Banking and Finance*. Spiramus Press Ltd, pp. 11-12.

In addition, Malik et al. further stated that the more general problem of compatibility between Islamic and non-Islamic elements in finance is raised by the case of Blom Bank, of Lebanon, and a Kuwaiti investment company, TID, which failed to make repayment of a US\$10m *wakala*, regarded as a crucial short-term equity instrument.⁶³ To minimise the risk associated with the transaction, the bank had attached a promissory note to the instrument. TID claimed that the instrument should be declared void because this was not consistent with the norms of Islamic finance.⁶⁴ This dispute highlights the incompatibilities between conventional and Islamic finance, which can generate legal risks.⁶⁵ The key strengths of this article is the coverage of descriptive information of the different kinds of risks that are associated with the different kinds of financial transactions.⁶⁶ The research has provided a clear account of these risks with the help of crucial examples. The compliance of the risks with Sharia laws has also been explored in the literature.⁶⁷ On the other hand, this source is lacked at the point of mentioning *Murabaha* transaction and is associated risks; however it mentioned risks associated with other financial transactions. Within this thesis, exploring of *Murabaha* risks will improve findings of Malik *et al.* by specifying one of the Islamic transactions risks.

Notwithstanding these compatibility issues, Monger et al. assert that Islamic financial services have now moved into the mainstream.⁶⁸ A standard product of Islamic banking is *Murabaha*.⁶⁹ This is why this dissertation focuses on *Murabaha*. This is a form of direct trading, facilitated through a participatory agreement that gives equal consideration to all parties to the contract. Ayub

⁶³Ibid, p. 112

⁶⁴Siddiqi, A. and Hrubí, P. 2008. *Islamic Investments Funds Versus Hedge Funds*. GRIN Verlag, p. 120.

⁶⁵Wigglesworth, R. 2010. Court concession raises Islamic finance risk. [Online]. Available at: <http://www.ft.com/cms/s/0/aa3dd5c4-382d-11df-8420-00144feabdc0.html#axzz21JZzNst> [Accessed on: 23 March 2013].

⁶⁶Karim, S.A. 2010. *The Islamic Moral Economy: A Study of Islamic Money and Financial Instruments*. Universal-Publishers.

⁶⁷Ibid, pp. 80-85

⁶⁸Monger, R. and Rawashdeh, M. 2008. Islamic Finance Enters the Mainstream. *Management Accounting Quarterly* 9(3), pp. 1-6.

⁶⁹Saad, N. 2012. Microfinance and Prospect for Islamic Microfinance Products: The Case of Amanah Ikhtiar Malaysia. *Advances in Asian Social Sciences* 1(1), pp. 27-33.

explains that, in a *Murabaha* transaction, a bank purchases assets or goods from a third party on behalf of a client, to whom they are sold at a mark-up price.⁷⁰ This is described as a 'cost-plus' transaction, in which a fixed profit margin is added to the cost incurred in purchasing the assets. The bank undertakes the liability for compensating any losses incurred as long as the asset remains in its ownership.⁷¹ The structure of *Murabaha* is such that the selling price remains fixed even if the client fails to pay the agreed amount.⁷² Ayub's book was selected for review because it provides a rich picture of *Murabaha* as an Islamic finance transaction. The information provided in this book is quite easy and straight forward, enabling clear understanding of the entire process of *Murabaha*.

In this regard, the findings of Ayub (2009) have been demonstrated as a relatively useful and knowledgeable source of information for this dissertation. The views of the author, as reflected in his book, titled '*Understanding Islamic Finance*', states the practicality of the *Murabaha* financial transaction from the users' viewpoint.⁷³ It is observed that a *Murabaha* transaction can be used for different purposes, including trade financing, raw material, stock holding and acquisition, replacement, and consumer durables.⁷⁴ In this context, a *Murabaha* transaction is also used as a base for finance trading and leasing projects.⁷⁵

Murabaha transactions represent the most common and particular mode of financing trade; this form of financing is used for a range of purposes, such as salary and payment of recurrent expenses, inventory and raw material purchase, and fixed assets.⁷⁶ Primarily, this transaction is useful for all dealings related to raw materials and inventory purchase.⁷⁷ In this way, Ayub's book is considered for

⁷⁰Ibid, p. 28

⁷¹Ibid, p. 29

⁷²Ayub, M. 2009. *Understanding Islamic Finance*. US: John Wiley & Sons. See also El-Qorchi. 2005. Islamic Finance Gears Up. *Finance & Development* 42(4), pp. 1-7.

⁷³Ibid, pp. 23-29

⁷⁴Saad, N. 2012. Microfinance and Prospect for Islamic Microfinance Products: The Case of Amanah Ikhtiar Malaysia. *Advances in Asian Social Sciences* 1(1), pp. 27-33.

⁷⁵Majid, S. and Majid, F. 2009. Application of Islamic law in the Middle East: Interest and Islamic banking. [Online]. Available at: <http://www.iraqilawconsultant.com/puplications/majid/article09.html> [Accessed on: 9 July 2015].

⁷⁶Schoon, N. 2010. *Islamic Banking and Finance*. Spiramus Press Ltd, pp. 65.

⁷⁷Saad, N. 2012. Microfinance and Prospect for Islamic Microfinance Products: The Case of Amanah Ikhtiar Malaysia. *Advances in Asian Social Sciences* 1(1), pp. 27-33.

the research work because it aims to deliver an intensive amount of information related to *Murabaha* Islamic financial transactions and their adherence with the banking and financial system.⁷⁸ The selected book has provided a clear account of the *Murabaha* Islamic financing from users' points of view. This book has explored the practical implications of *Murabaha* financing, and hence it is used for discussion in the literature review.⁷⁹ Key strength of the findings by Ayub's included comprehensive information coverage of *Murabaha* and its features. Besides that, knowledge enhancement related to the practical application of *Murabaha* is another key strength of this article. The issues related to this Islamic transaction is found less discussed under this research along with no relevant cases are presented to present *Murabaha* transaction and associated risks that are weaknesses of this study.

Memon argues that compliance with Sharia law means that products such as *Murabaha* must work in favour of human beings rather than corporate entities.⁸⁰ He also estimates that *Murabaha* transactions account for around 40% of the total financing of Islamic banking institutions.⁸¹ This indicates the importance of *Murabaha* in Muslim countries in terms of risk, profitability, and financial soundness.⁸² From users' viewpoint, *Murabaha* can be used for different purposes, including the financing of trade and leasing projects, stock holding and acquisition, payment of salaries and recurrent expenses, or the purchase and replacement of raw materials, fixed assets, and consumer durables.⁸³ Memon's article was selected for analysis as it is a fairly informative piece of work, which includes tools and techniques generally used in the domain of Islamic finance.⁸⁴ In respect to this, his thesis can be used as a point of discussion

⁷⁸Ayub, M. 2009. *Understanding Islamic Finance*. John Wiley & Sons, p. 85.

⁷⁹Saad, N. 2012. Microfinance and Prospect for Islamic Microfinance Products: The Case of Amanah Ikhtiar Malaysia. *Advances in Asian Social Sciences* 1(1), pp. 27-33.

⁸⁰Ibid

⁸¹Memon, N.A. 2007. Islamic Banking: Present and Future Challenges. *Journal of Management and Social Sciences* 3(1), pp. 1-10.

⁸²Ibid, p. 11

⁸³Ayub, M. 2009. *Understanding Islamic Finance*. John Wiley & Sons, pp. 85.

⁸⁴Majid, S. and Majid, F. 2009. Application of Islamic law in the Middle East: Interest and Islamic banking. [Online]. Available at: <http://www.iraqilawconsultant.com/puplications/majid/article09.html> [Accessed on: 9 July 2015].

regarding the functioning of Islamic banking institutions; it provides an ample amount of knowledge about *Murabaha* financial transactions and their usage in the Islamic financial industry, which are the major points of discussion in the current research work.⁸⁵ The article is quite informative and useful, as it provides a clear account of the need of Islamic financial transactions to comply with Sharia law.⁸⁶ This literature source is a very good source of information as it has illustrated descriptive information on the Islamic financial transactions. The article is quite informative and useful, as it provides a clear account of the need of Islamic financial transactions to comply with Sharia law.⁸⁷ The article has explored *Murabaha* financing in a detailed manner, outlining its crucial process and requirements, and this is the key reason that this article is included as a source for review on this topic.⁸⁸ Therefore, it provided for solid material to explain the contract before engaging with the mitigations of the risks. Despite these key strengths of this source, it has one weak area that it has not quoted any direct examples of key risks involved in the Islamic financial transactions.

Murabaha, which was originally considered a simple sales transaction, has more recently been converted into a method of financing, owing to the difficulties and risks involved for Islamic banks undertaking the profit-and-loss sharing mode of financing.⁸⁹ The mark-up is disclosed to all parties involved in the transaction, giving the client the opportunity to negotiate this fixed percentage profit margin to be added to the cost price. Siddiqui notes that the client may repay either as a lump sum or in instalments. There is also a possibility that the client and the supplier are sister concerns or that the client acts as the agent of the bank and purchases the goods from the supplier.⁹⁰ Moreover, Islamic banks

⁸⁵Saad, N. 2012. Microfinance and Prospect for Islamic Microfinance Products: The Case of Amanah Ikhtiar Malaysia. *Advances in Asian Social Sciences* 1(1), pp. 27-33.

⁸⁶Ibid

⁸⁷Ibid

⁸⁸Memon, N.A. 2007. Islamic Banking: Present and Future Challenges. *Journal of Management and Social Sciences* 3(1), pp. 1-10.

⁸⁹Majid, S. and Majid, F. 2009. Application of Islamic law in the Middle East: Interest and Islamic banking. [Online]. Available at: <http://www.iraqilawconsultant.com/puplications/majid/article09.html> [Accessed on: 9 July 2015].

⁹⁰Memon, N.A. 2007. Islamic Banking: Present and Future Challenges. *Journal of Management and Social Sciences* 3(1), pp. 1-10.

that are interested in establishing a separate department for merchant banking can purchase financial products from vendors, again agreeing the terms, including profit, with the purchaser.⁹¹ Thus, *Murabaha* is transformed into a means of finance meeting Sharia requirements. Siddiqui further states that, in particular, the requirement for an interval between the purchase of the asset by the bank and its resale to the client means that the bank bears the risk of any damage occurring to the property before it is sold on to the client on the agreed terms.⁹²

In addition to the basic structure of *Murabaha*, there is a form called 'reverse *Murabaha*', in which a bank or corporation regarded as a floating-rate payer sells commodities to the swap counterparty at a pre-agreed price.⁹³ The transfer of the asset takes place on the date on which the transactions have been performed. The fixed-rate payer sells the commodity to a different broker and makes payment to a floating-rate payer by a deferred mode.⁹⁴ The fixed-rate payer sells the commodity to a different party in order to generate cash.⁹⁵ The article by Siddiqui has provided detailed information about reverse *Murabaha* and its structuring, as well as the process followed in Islamic banking for this kind of transaction.⁹⁶

As per Uberoi and Evans (2008), besides the basic structure of *Murabaha*, there is also use of reverse *Murabaha*, in which banks or corporate entities that are regarded as floating-rate payers sell commodities to the swap counterparty at a pre-agreed price.⁹⁷ The transfer of the property takes place on the date on

⁹¹Majid, S. and Majid, F. 2009. Application of Islamic law in the Middle East: Interest and Islamic banking. [Online]. Available at: <http://www.iraqilawconsultant.com/puplications/majid/article09.html> [Accessed on: 9 July 2015].

⁹²Karim, S.A. 2010. *The Islamic Moral Economy: A Study of Islamic Money and Financial Instruments*. Universal, pp. 12. Siddiqui, S.H. n.d. Islamic Banking: True modes of financing. [Online]. Available at: <http://nzibo.com/IB2/truemodes.pdf> [Accessed on: 13 March 2014].

⁹³Ibid, pp. 16-18

⁹⁴Hunt-Ahmed, K. 2013. *Contemporary Islamic Finance: Innovations, Applications and Best Practices*. John Wiley & Sons, pp. 2-3.

⁹⁵Uberoi, P. and Evans, N. 2008. Profit rate swap. [Online]. Available at: <http://www.allenoverly.com/SiteCollectionDocuments/47753.pdf> [Accessed on: 13 March 2014].

⁹⁶Ibid

⁹⁷Memon, N.A. 2007. Islamic Banking: Present and Future Challenges. *Journal of Management and Social Sciences* 3(1), pp. 1-10.

which the transactions have been performed.⁹⁸ This information is also invaluable to gain a good understanding of Islamic financial principles, which serves as a key rationale for the inclusion of this article in the literature review section. The study has presented descriptive information about Murabaha financing, however the key weakness of this source is that it has not presented practical implications of the financial aspects presented in the study.

Jalil and Rahman emphasise that the Quranic and Sharia principles governing Islamic finance not only forbid the charging of *riba* on loans, they also promote the provision to needy people of *qard al-hasan*, meaning loans without interest, mark-up, or a share in the business for which the loan was made.⁹⁹ Islam also encourages businesses to invest any surplus money in different investment opportunities, the return received being regarded as *halal* (acceptable) profit. *Murabaha* is a form of trading contract based on sale.¹⁰⁰ It is also considered a debt instrument, because the client is not required to pay the cost plus mark-up price on the spot but is enabled to make deferred payments.¹⁰¹ While full information related to the cost and the negotiated mark-up is disclosed to the parties, bringing transparency to the operation, the fact that the client (i.e. the ultimate purchaser) incurs a debt introduces the risk that this party may default on payment.¹⁰² Other legal risks inherent in *Murabaha* contracts include price risk, credit risk, and operational risk.¹⁰³

The global growth and development of Islamic banking is illustrated by the fact that banks, mortgage providers, and investment companies operating in the US have increasingly chosen to use its financial instruments.¹⁰⁴ Such institutions have, for example, adopted *Murabaha* to finance commercial and residential real

⁹⁸Ibid

⁹⁹Ibid, p. 18

¹⁰⁰Eisenberg, D. 2012. *Islamic Finance: Law and Practice*. Oxford University Press.

¹⁰¹Jalil, D.M.A. and Rahman, M.K. 2010. Financial Transactions in Islamic Banking are Viable Alternatives to the Conventional Banking Transactions. *International Journal of Business and Social Science* 1(3), pp. 219-233.

¹⁰²Alexander, A.J. 2011. Shifting Title and Risk: Islamic Project Finance with Western Partners. *Michigan Journal of International Law* 3(3), pp. 572-611.

¹⁰³Ariff, M. and Iqbal, M. 2011. *The Foundations of Islamic Banking: Theory, Practice and Education*. Edward Elgar Publishing, pp. 12-13.

¹⁰⁴Majid, S. and Majid, F. 2009. *Application of Islamic law in the Middle East: Interest and Islamic banking*, pp. 112-116.

estate transactions.¹⁰⁵ Here, the floating-rate payer buys goods from a seller at cost price and sells them at a fixed price of cost plus profit to a fixed-rate payer, who in turn sells them to a broker to generate cash. *Murabaha* is considered a debt financial instrument, as the purchaser pays in instalments.¹⁰⁶ The key point of strength of this study includes comprehensive information of Sharia legal system and *Murabaha* financial transaction. The depth information of the growth in Islamic finance is also enhanced with studying this article. The examples of legal cases to support explanation of *Murabaha* functioning is not clearly mentioned that is major limitation of this study. This can be improved in this thesis through reviewing legal cases of *Murabaha* dealings.

Having established the basic structure of *Murabaha* and its growing importance, this section turns to the different types of legal risk associated with it, the most common of which are credit risk, mark-up risk, cancellation of clients' promises, default on payment, liquidity risk, operational risk, commodity risk as a result of clients changing their minds, and refusal to honour promises.¹⁰⁷ Credit risk, default risk, and liquidity risk arise in the event of non-payment by the client. *Murabaha* transactions are also subject to various kinds of operational risks, including clients breaking their promise to purchase the assets from the bank.¹⁰⁸ The absence of explicit and effective measures for preventing such non-payment can be considered the major risk factor associated with this type of financial transaction.¹⁰⁹ Islamic banking is particularly vulnerable to operational risks, which Izhar considers more critical than market and credit risk, for example, and which thus demand close attention from practitioners and regulators.¹¹⁰

¹⁰⁵ Ibid, pp. 1-3

¹⁰⁶ Shayesteh, A. 2009. Islamic Banks in the United States: Breaking Through the Barriers. *New Horizon – Global perspective on Islamic banking and insurance* 171, pp. 1-5.

¹⁰⁷ Ibid

¹⁰⁸ Memon, N.A. 2007. Islamic Banking: Present and Future Challenges. *Journal of Management and Social Sciences* 3(1), pp. 1-10.

¹⁰⁹ The three principles of Islamic finance explained. 2005. [Online]. Available at: <http://www.iflr.com/Article/1984844/The-three-principles-of-Islamic-finance-explained.html> [Accessed on: 24 August 2012].

¹¹⁰ Izhar, H. 2010. Identifying Operational Risk Exposures in Islamic Banking. *Kyoto Bulletin of Islamic Area Studies* 3(2), pp. 17-53.

Izhar has specifically focused his attention on the banking sectors and its regulations.¹¹¹ In this regard, the author has aimed to demonstrate in his findings that, with specific reference to the banking sector, operational risks can be considered highly critical relative to market and credit risks.¹¹² The author has reflected these findings on the basis of his research and survey of 27 Islamic banks. However, due to the small sample size, the findings of Izhar seem to be biased, as there are a number of other literatures studied in this research work that aim to explore the criticality and significance of other types of risks, including legal and credit risks in the banking sector.¹¹³ In critique to the above study, this study had covered examples of Islamic banks that is key strength of it. However, this article has presented legal risks to the Islamic banks in the general context instead of *Murabaha* transaction. Visser and Visser add risk of asset damage, risk of delayed payment, and risk of non-compliance with leasing agreements to the above list,¹¹⁴ while Sundararajan (2006) emphasises the critical nature of lack of liquidity that is sometimes associated with instruments such as *Murabaha*.¹¹⁵ As the primary aim of Islamic financial law is to prevent the accumulation of money and to ensure that it is used for the betterment of society as a whole, the lack of assets in liquid form and the complexity of accessing essential assets in times of financial emergency are critical aspects of Islamic finance. Thus, Islamic financial instruments tend to be particularly prone to liquidity risk.¹¹⁶ Credit risk is also high in *Murabaha* financing, because the assurance of securing payment depends wholly on the customer's promise.¹¹⁷ This article has discussed the different kinds of risks that are involved in Islamic financial transactions. Owing to

¹¹¹Ahmed, H. 2011. *Product Development in Islamic Banks*. Edinburgh University Press, pp. 15-17.

¹¹²Memon, N.A. 2007. Islamic Banking: Present and Future Challenges. *Journal of Management and Social Sciences* 3(1), pp. 1-10.

¹¹³ibid

¹¹⁴Visser, H. and Visser, H. 2009. *Islamic Finance: Principles and Practice*. UK: Edward Elgar Publishing.

¹¹⁵Memon, N.A. 2007. Islamic Banking: Present and Future Challenges. *Journal of Management and Social Sciences* 3(1), pp. 1-10.

¹¹⁶Sundararajan, V. 2007. Risk Measurement and Disclosure in Islamic Finance and the Implications of Profit Sharing Investment Accounts. *Advances in Islamic Economics and Finance* 1, pp.121-152.

¹¹⁷Iqbal, Z. and Mirakhor, A. 2011. *An Introduction to Islamic Finance: Theory and Practice*. John Wiley & Sons.

such crucial reasons, this literature has been taken into consideration within the literature review section of the research work.¹¹⁸ In addition, some critical risks associated with *Murabaha* Islamic financial transactions have also been elaborated by Sundararajan (2006). It is also reviewed that there can be enormous ways through which some critical risks related to *Murabaha* Islamic financial transactions can be generated.¹¹⁹ As per the research conducted by the author, lack of liquidity can sometimes become quite a critical situation for business organisations that undertake Islamic financial instruments such as *Murabaha*.¹²⁰

As regards the types of operational risk affecting *Murabaha* transactions, Izhar classifies these as Sharia compliance risk, fiduciary risk, people risk, legal risk, and technology risk. Sharia compliance risk may occur if the bank provides money in place of a commodity.¹²¹ This leads to the exchange of money in return for the commodity, which is prohibited by Sharia law. In this situation, payment of an amount greater than the principal amount in exchange for the commodity constitutes the application of *riba* (interest), which Sharia forbids.¹²² Fiduciary risk may arise in the event of non-compliance with the exchange of the commodity against a financial consideration, as agreed in the contract.¹²³ People risk arises when the buyer fails to make a payment to the financier on the due date and in accordance with the agreed terms and conditions, or when the seller fails to provide the commodity as specified in the contract. Legal risk may occur because the profit cannot be equal to the interest, as it is tied with the commodity. In many countries, there is a prohibition on capping the interest rate, but not the profit rate, which can cause legal problems for the parties to a *Murabaha* contract.¹²⁴

¹¹⁸Visser, H. and Visser, H. 2009. *Islamic Finance: Principles and Practice*. UK: Edward Elgar Publishing.

¹¹⁹Ibid, pp. 40-42

¹²⁰Memon, N.A. 2007. Islamic Banking: Present and Future Challenges. *Journal of Management and Social Sciences* 3(1), pp. 1-10.

¹²¹Izhar, H. 2010. Identifying Operational Risk Exposures in Islamic Banking. *Kyoto Bulletin of Islamic Area Studies* 3(2), pp. 17-53.

¹²²Ibid, pp. 1-10.

¹²³¹²³Ahmed, H. 2011. *Product Development in Islamic Banks*. Edinburgh University Press, pp. 1-3.

¹²⁴Ibid, pp. 6-10

Finally, technology risks arise from the rapid changes taking place in the business environment, including the introduction of innovative technologies for carrying out transactions.¹²⁵

The inability of some parties to *Murabaha* transactions to adopt such technologies successfully can lead to technology risk.¹²⁶ Besides, fiduciary risk may also arise in the event of non-compliance with the exchange of commodity against financial consideration as agreed in the contract.¹²⁷ In addition, people risk arises in the *Murabaha* transaction in situations when a party fails to make payment of the price to the buyer on the due date and as per the agreed terms and conditions.¹²⁸ The strength of Izhar's article is that it explored the ways in which failing to comply with Sharia principles gives rise to risk factors in Islamic financial transactions. The example of Islamic banks to support explaining legal risks is found lacking in this article. .¹²⁹

According to Abdul-Rahman (2010), an alternative analysis of the risks involved in Islamic modes of financing entails the division of these into credit risk, market risk, and operational risk. In complex financial transactions such as *Murabaha*, based on sales, credit risk may arise in the form of failure to pay for goods or commodities as agreed in the contract.¹³⁰ In the *Murabaha* contract, debt takes the form of money rather than commodities, and this risk arises due to the significant influence of external factors.¹³¹ Market risk may result from frequent changes in the price of the asset or the commodity purchased by the bank, or because of changes in the market interest rate, as banks use benchmark interest rates to determine the price of various financial products.¹³²

¹²⁵Memon, N.A. 2007. Islamic Banking: Present and Future Challenges. *Journal of Management and Social Sciences* 3(1), pp. 1-10.

¹²⁶Izhar, H. 2010. Identifying Operational Risk Exposures in Islamic Banking. *Kyoto Bulletin of Islamic Area Studies* 3(2), pp.17-53.

¹²⁷Ibid, pp. 17-53

¹²⁸Memon, N.A. 2007. Islamic Banking: Present and Future Challenges. *Journal of Management and Social Sciences* 3(1), pp. 1-10.

¹²⁹Izhar, H. 2010. Identifying Operational Risk Exposures in Islamic Banking. *Kyoto Bulletin of Islamic Area Studies* 3(2), pp.17-53.

¹³⁰Abdul-Rahman, Y. 2010. *The Art of Islamic Banking and Finance: Tools and Techniques for Community-Based Banking*. John Wiley & Sons, pp. 15-19.

¹³¹Ibid

¹³²Ahmed, H. 2011. *Product Development in Islamic Banks*. Oxford University Press.

Jamaldeen adds that Islamic financial transactions may be affected by foreign exchange risk, such as in cases where the bank allows the customer to make payment for the commodities sold in a foreign currency.¹³³ This may result in a decline in the value of the commodity, and the bank may incur a loss as it receives a lower amount when translated into the domestic currency.¹³⁴ This was also to be considered in this dissertation.

Izhar (2010) lists the risks facing Islamic banks, from their various financial transactions, as credit risk, asset risk, rate-of-return risk, fiduciary risk, market risk, legal risk, and non-compliance with Sharia principles.¹³⁵ In the case of *Murabaha*, asset risk arises before the sale of assets to clients. Banks incur expenses in monitoring, managing, and maintaining these assets intact. Developments in the financial market and in governmental activities also give rise to asset, rate-of-return, and price risks.¹³⁶ Non-compliance with Sharia law adversely affects the credibility of the banks concerned; however, in order to attract and retain customers, Islamic banks seek to offer rates of return to depositors similar to those offered by conventional banks.¹³⁷ Other risks arise from the lack of variety of money market instruments and from uncertain legal and regulatory frameworks.¹³⁸ There is also a default risk associated with *Murabaha* transactions, as clients may not provide money against payment for the commodity, as per contractual terms, leading to the formation of a debt if the contract is created for the long term.¹³⁹ The study of these risks helps in addressing the aim and objectives of the research study. This not only discusses the various risks associated with Islamic financial transactions, but will also assist in developing the strategies and techniques for mitigating these risks.

According to Karim and Archer, the legal risks attached to Islamic banks include the absence of detailed legal frameworks; invalid, unauthenticated, or

¹³³ Ibid, p. 120

¹³⁴ Jamaldeen, D.F. 2012. *Islamic Finance for Dummies*. John Wiley & Sons.

¹³⁵ Izhar, H. 2010. Identifying Operational Risk Exposures in Islamic Banking. *Kyoto Bulletin of Islamic Area Studies* 3(2), pp.17-53.

¹³⁶ Ibid, pp. 17-53

¹³⁷ Ayub, M. 2009. *Understanding Islamic Finance*. John Wiley & Sons, pp. 36-38.

¹³⁸ Bellalah, M. 2013. *Islamic Banking and Finance*. Cambridge Scholars, pp. 12-18.

¹³⁹ Ibid, pp.22-26

unreliable legal documents; uncertainty regarding Sharia compliance; and secular legal-political systems.¹⁴⁰ This has been noted in the research conducted for this dissertation. The result may be that legal enforceability is compromised, as the party involved cannot sue the counterparty. Such a legal risk, in the case of a *Murabaha* financial transaction, may arise if the party defaults on payment or loses a major part of the amount invested in the transaction.¹⁴¹ Alternatively, legal risk may arise from the absence of clear and precise information about the rules, regulations, norms, beliefs, procedures, and policies under Islamic law.¹⁴² Thus, parties face difficulty in clearly defining their duties, responsibilities, and authority, and in making effective and efficient decisions.¹⁴³ The absence of proper documentation of the terms and conditions of the contract will also limit transparency among the parties, which in turn will adversely affect their level of commitment and motivation.¹⁴⁴ Finally, if disputes arise among the parties, these may be difficult to resolve because of unpredictable dispute resolution processes.¹⁴⁵ These issues have been reported during performance of my field work in Saudi Arabia, and I will address them in this dissertation.

Ahmed warns that Islamic financial transactions face difficulties and risks because the large number of regulatory authorities seeking to monitor them may result in redundancy and reduplication, making it difficult to complete transactions in a timely manner.¹⁴⁶ It is often unclear what documentation must be completed to satisfy the requirements of the various local and national agencies for full disclosure of information in the interests of transparency.¹⁴⁷ In addition to this, market risk also arises because of the changes taking place in the market interest rate, as banks use benchmark interest rate to determine the price of

¹⁴⁰Izhar, H. 2010. Identifying Operational Risk Exposures in Islamic Banking. *Kyoto Bulletin of Islamic Area Studies* 3(2), pp.17-53.

¹⁴¹Bellalah, M. 2013. *Islamic Banking and Finance*. Cambridge Scholars, p. 12.

¹⁴²Ibid, p. 16

¹⁴³Izhar, H. 2010. Identifying Operational Risk Exposures in Islamic Banking. *Kyoto Bulletin of Islamic Area Studies* 3(2), pp.17-53.

¹⁴⁴Ibid

¹⁴⁵Archer, S. and Karim, R.A.A. 2011. *Islamic Finance: The Regulatory Challenge*. John Wiley & Sons.

¹⁴⁶Ibid, p. 3

¹⁴⁷Ahmed, K.H. 2013. *Contemporary Islamic Finance: Innovations, Applications and Best Practices*. John Wiley & Sons.

different financial products.¹⁴⁸The informative section of this article is very much information as it has provided information related to financial risks in different modes of financing in Islamic financing process. This information comprises an integral part of this research work, and hence it is given value in this study.¹⁴⁹Besides this, a preparation of risk reports helps to provide information regarding the different risks involved, including credit risk, operational risk, liquidity risk, and market risk.¹⁵⁰ There is also a requirement to adopt different measures to mitigate the risk, such as a liquidity management system, legal reforms, deposit protection system, and lender of last resort.¹⁵¹The information taken from this source is used further in generalising a number of valid conclusions.

As financial markets become increasingly interdependent and integrated, the possibility of rapid infectivity grows, multiplying the legal risks for Islamic banks and leaving less and less space for measures to mitigate these unexpected risks.¹⁵² This makes it ever more urgent to identify the main sources of financial risk faced by Islamic banks and their stakeholders,¹⁵³ so that risk management techniques can be used to prevent a situation in which Islamic banking fails to cope effectively with the new global financial environment.¹⁵⁴ Ahmed's book is useful to derive findings and outcomes for my thesis. Moreover, the book posits that, if the objective intensity of risks in the system continues to be unaltered, inadequate interpretation of the new environment can generate a sense of a greater risk.¹⁵⁵ In this situation, it is essential to focus on risk management to maintain the effectiveness of Islamic financial markets. By including such information in my thesis, it would be easy and possible to perform

¹⁴⁸ Ahmed, H. 2011. *Product Development in Islamic Banks*. Oxford University Press.

¹⁴⁹ Izhar, H. 2010. Identifying Operational Risk Exposures in Islamic Banking. *Kyoto Bulletin of Islamic Area Studies* 3(2), pp.17-53.

¹⁵⁰ Ibid

¹⁵¹ Ahmed, A.M.T. 2010. *Islamic Banking: How to Manage Risk and Improve Profitability*. John Wiley & Sons.

¹⁵² Izhar, H. 2010. Identifying Operational Risk Exposures in Islamic Banking. *Kyoto Bulletin of Islamic Area Studies* 3(2), pp.17-53.

¹⁵³ Ibid

¹⁵⁴ Curtis, E.E. 2010. *Encyclopedia of Muslim-American History*. New York: Infobase Publishing.

¹⁵⁵ Ibid

an in-depth analysis and evaluation on the thesis subject.¹⁵⁶ However, the presented research article also features a critical knowledge gap. For instance, the research work does not reflect the procedures and specific aspects of financial risks that can be addressed with the help of various crucial tools such as *Murabaha* contracts.¹⁵⁷ In this way, this literature suffers some critical issues and complications, which may be resolved with the help of the findings from the current research work.¹⁵⁸

Schoon (2011) states that the various risks of concern include interest rate risk, credit risk, price risk, counterparty risk, leverage risk, operational risk, and business risk. Liquidity risk arises from the inability of banks to meet their liabilities, while a major source of interest rate risk is the mismatch between the volume, maturity period, and type of asset, as well as banks' liabilities.¹⁵⁹ Credit risk occurs when the bank is incapable of recovering payment from the counterparty, and a fault has occurred due to a delay in the provision of the service or product as required by the contract.¹⁶⁰ Knowledge about this risk helped in understanding the various risks associated with Islamic finance and Islamic banking. This has also provided an overview as to which techniques will be appropriate to mitigate the risks arising from *Murabaha* financial transactions.

According to Kayed and Mohammed, the risks affecting Islamic financial transactions include credit risk, systematic risk, liquidity risk, market risk, and operational risk.¹⁶¹ The recent depression in economic activity caused a significant decline in the value of investments, while the insufficiency of funds in the market led to a failure to meet financial obligations and a consequent liquidity risk.¹⁶² At the same time, changes in the technology used to conduct financial

¹⁵⁶ Ibid

¹⁵⁷ Ahmed, A.M.T. 2010. *Islamic Banking: How to Manage Risk and Improve Profitability*. John Wiley & Sons, p. 35

¹⁵⁸ Ibid, p. 39

¹⁵⁹ Schoon, N. 2011. *Islamic Asset Management: An Asset Class on its Own*. Oxford University Press, p. 12.

¹⁶⁰ Ibid, pp. 18

¹⁶¹ Ahmed, A.M.T. 2010. *Islamic Banking: How to Manage Risk and Improve Profitability*. John Wiley & Sons. p. 40.

¹⁶² Choudhury, M.A. 2013. *Money in Islam: A Study in Islamic Political Economy*. Routledge, pp. 19-20.

transactions have magnified operational risk.¹⁶³ Behind the above risks lie a range of factors, including political and economic ones.¹⁶⁴ Political factors include changes in trade policies, procedures, rules, and regulations established by governments and regulatory bodies, in the form of funding, initiatives, and grants, among others.¹⁶⁵ Liquidity risk arises due to the presence of long-term assets in large proportion, reducing the ability to cover short-term liabilities.¹⁶⁶ This leads to a mismatch between them in terms of maturity, time-period, etc.¹⁶⁷ The article is included in the literature review section as it has provided information related to credit risk and liquidity risk, which are crucial elements in the evaluation of Islamic financial transactions. Economic factors include changes in business cycles, specific industry factors, customer and end-user drivers, interest, and exchange rates.¹⁶⁸ Credit risk also arises when borrowers and clients repeatedly fail to make payments as contracted, resulting in the formation of debt, which weakens the solvency of banks. Liquidity risk arises from maturity mismatch, i.e. overreliance on long-term assets to pay short-term liabilities.¹⁶⁹ All of these issues will be addressed in this dissertation.

Another categorisation of legal risks affecting *Murabaha* transactions is that of Hawary et al., who identify business, treasury, transaction, governance, and system risks.¹⁷⁰ Treasury risk includes asset liability management risk, which, again, is mainly caused by the use of long-term assets to meet short-term liabilities; this has an adverse effect on the bank's capital.¹⁷¹ Business risk includes displaced commercial risk, which arises from the difference between the

¹⁶³ Ahmed, A.M.T. 2010. *Islamic Banking: How to Manage Risk and Improve Profitability*. John Wiley & Sons, p. 48.

¹⁶⁴ Ibid, p. 56

¹⁶⁵ Schoon, N. 2011. *Islamic Asset Management: An Asset Class on its Own*. Oxford University Press, pp. 1-2.

¹⁶⁶ Ibid, p. 6

¹⁶⁷ Kayed, R.N. and Mohammed, K.M. n.d. Unique Risks of Islamic Modes of Finance: Systemic, Credit and Market Risks. *Journal of Islamic Economics, Banking and Finance* 5(3), pp. 9-34.

¹⁶⁸ Schoon, N. 2011. *Islamic Asset Management: An Asset Class on its Own*. Oxford University Press, pp. 14-15.

¹⁶⁹ Kayed, R.N. and Mohammed, K.M. 2009. Unique Risks of Islamic Modes of Finance: Systemic, Credit and Market Risks. *Journal of Islamic Economics, Banking and Finance* 5(3), pp. 9-34.

¹⁷⁰ Schoon, N. 2011. *Islamic Asset Management: An Asset Class on its Own*. Oxford University Press, pp. 51.

¹⁷¹ Ibid, p. 82

performance of assets and the expected returns on liabilities. The intense level of competition within the industry is another source of business risk.¹⁷²

To conclude this section, it is useful to consider the various sub-divisions of operational risk recently identified by Dar et al. as significantly affecting the decisions of stakeholders in Islamic financial transactions.¹⁷³ These consist of technology risk, people risk, Sharia non-compliance risk, fiduciary risk, and reputation risk. Technology risk, as noted above, arises from changes in the technologies used to perform transactions.¹⁷⁴ A related risk is the shortage of skilled labour required to carry out supporting activities. Sharia non-compliance risk occurs where money is exchanged against a commodity, as this amounts to *riba*.¹⁷⁵ An important source of fiduciary risk is mismanagement of assets and liabilities, which creates debt for the bank and adversely affects its financial structure.¹⁷⁶ The consequent weakening of the bank's creditworthiness has an adverse effect on stakeholders and on the likelihood that timely payments will be made, thus constituting a major risk to reputation.¹⁷⁷

After reviewing the article on 'Islamic Modes of Finance and Associated Liquidity Risk' by Ali (2010), it is inferred that liquidity risk is highly decisive, as it has played a great role in the bank collapse. In my thesis, this information is useful to depict liquidity risk and its direct impact; for example, liquidity directly harms business and investment interests by turning down the confidence of bank depositors and investors.¹⁷⁸ The main factors leading to liquidity risk are presented critically in my thesis. Operational and credit risks are the major

¹⁷²Hawary, D.E., Grais, W. and Iqbal, Z. 2007. Diversity in the Regulation of Islamic Financial Institutions. *The Quarterly Review of Economics and Finance* 46, pp. 778-800.

¹⁷³Dar, M.R., Azeem, M. and Masood, D.O. 2013. Operational Risk Management, Risk Management Approaches, and Risk Mitigation Techniques: Challenges Faced by Islamic Financial Services. *Journal of Business and Management* 11(2), pp. 72-79.

¹⁷⁴Ibid

¹⁷⁵Ayub, M. 2009. *Understanding Islamic Finance*. John Wiley & Sons, pp. 12-15.

¹⁷⁶Schoon, N. 2011. *Islamic Asset Management: An Asset Class on its Own*. Oxford University Press, pp. 1-2.

¹⁷⁷Ibid, pp. 19-20

¹⁷⁸Ali, S.S. 2004. Islamic modes of finance and associated liquidity risks. [Online]. Available at: http://www.sbp.org.pk/departments/ibd/lecture_6_islamic_modes_finance_liquidity.pdf [Accessed on: 25 March 2013].

factors or causes that give rise to liquidity risk.¹⁷⁹ This information contributes, in my thesis, to the definition of measures for mitigating liquidity risk.¹⁸⁰ In his article, Ali discusses one of the approaches available for coping with the liquidity risks in Islamic banks, namely *salam* contracts and their procedures.¹⁸¹ In the article reflected by the author intensive and crucial information regarding the banking contracts and legal procedures followed for the purpose of addressing different types of risks have been elaborated in the most dominating manner.¹⁸² In this regard, the article has specifically focused on liquidity risks and the related regimes within the orientation of the entire financial structure of the market. The article has also focused on different crucial perspectives and modes for the purpose of preventing financial fraud and related issues, which can prove quite crucial and critical for business organisations operating at an international level.¹⁸³ In the context of existing research, the prime rationale behind the inclusion of this research article is that it has empirically focused on the Islamic tools and techniques used by banking organisations for the purpose of mitigating liquidity risks.¹⁸⁴ However, this article only discusses liquidity risks and their mitigation through Islamic financial tools, while other critical and common risks, such as currency risks and credit risks, which are quite common in international financial regimes, have not been discussed critically in this article. This represents one of the significant knowledge gaps in the article, which needs to be fulfilled in the article.¹⁸⁵

¹⁷⁹Schoon, N. 2011. *Islamic Asset Management: An Asset Class on its Own*. Oxford University Press, pp. 1-2.

¹⁸⁰Ibid

¹⁸¹Ali, S.S. 2004. Islamic modes of finance and associated liquidity risks. [Online]. Available at: http://www.sbp.org.pk/departments/ibd/lecture_6_islamic_modes_finance_liquidity.pdf [Accessed on: 25 March 2013].

¹⁸²Cotran, E. and Lau, M. 2002. *Yearbook of Islamic and Middle Eastern Law: 2001-2002*. Brill, p. 12.

¹⁸³Ibid, p. 15

¹⁸⁴Cotran, E. and Lau, M. 2002. *Yearbook of Islamic and Middle Eastern Law: 2001-2002*. Brill, p. 19.

¹⁸⁵Hawary, D.E., Grais, W. and Iqbal, Z. 2007. Diversity in the Regulation of Islamic Financial Institutions. *The Quarterly Review of Economics and Finance* 46, pp. 778-800.

This section reviews some of the extensive literature on ways to mitigate the legal risks of particular concern to the Islamic banking system.¹⁸⁶ For instance, fiduciary risk can be mitigated by the provision of strict regulations, which will also help to maintain shareholders' trust, while the risk of disruption of payment can be made less severe by regulations imposing appropriate penalties.¹⁸⁷ The information from this article is useful to identify actions that have been undertaken for resolving risks and assessing their effectiveness in terms of lessening risks and further generalise key points and findings from the thoughts of this article for my thesis.¹⁸⁸ This literature has been taken into consideration within this research work, as it aims to explore the legal risks, specifically for the purpose of making the discussion more effective and evidential.¹⁸⁹ It also focuses on highlighting the experiences of different financial business organisations that have faced legal risks in financial transactions across the globe.¹⁹⁰ The literature has raised the issue relating to risks of disruption of payments, which can be considered quite severe in the context of international financial transactions.¹⁹¹ In relation to this, the inclusion of the literature in the research work is intended to explore the concept of risks in legal terms, with specific reference to international business transactions.¹⁹²

However, it does not explain the risks of payment disruption in terms of Islamic financial and banking regimes, which can be considered as one of the major gaps in this piece of research.¹⁹³ In this context, the presented research work aims to explore this research gap intensively.¹⁹⁴ Some of the steps Mounira recommends for addressing credit risk, liquidity risk, and risk of payment default

¹⁸⁶ Ibid

¹⁸⁷ Islamic financial architecture. 2009. [Online]. Available at: <http://www.iefpedia.com/english/wp-content/uploads/2009/10/Islamic-Financial-Architecture-Risk-Management-and-Financial-Stability-by-Tariqullah-Khan-Dadang-Muljawan.pdf#page=53> [Accessed on: 25 March 2013].

¹⁸⁸¹⁸⁸ Ibid

¹⁸⁹ Hawary, D.E., Grais, W. and Iqbal, Z. 2007. Diversity in the regulation of Islamic Financial Institutions. *The Quarterly Review of Economics and Finance* 46, pp. 778-800.

¹⁹⁰ El-Gamal, M.A. 2006. *Islamic Finance: Law, Economics, and Practice*. Cambridge University Press, pp. 12-19.

¹⁹¹ Ibid.

¹⁹² Ibid

¹⁹³ El-Gamal, M.A. 2006. *Islamic Finance: Law, Economics, and Practice*. Cambridge University Press, p. 55.

¹⁹⁴ Ibid, p. 69

or destruction include proper management, designed to uphold depositors' confidence;¹⁹⁵ the setting of credit limits for counterparties; clear procedures; proper documentation; collaterals; and guarantees.¹⁹⁶ This is a fairly useful article on Islamic legal risks and ways to lessen or control these legal risks, which will ultimately assist in addressing the final objective of the thesis.¹⁹⁷ This article has been taken into account within the research work as this is an empirical study that aims to explore the overall theatrical perspectives that are generally applied in a real-life financial transaction. Furthermore, this article can be used for the purpose of revealing the effectiveness of Islamic financial laws and their legal implications on companies' business transactions. In direction to this, from the perspective of the empirical evidential findings of the research, the findings of these research articles explore the measures undertaken by Islamic financial institutions in order to address issues related to payment defaults.¹⁹⁸ However, Mounira's article simply highlights a reactive approach for recovering from the payment default issue, but it falls short of exploring the proactive measures elaborated in the Islamic financial regimes for the purpose of addressing legal and financial risk, which can be considered as one of the major knowledge gaps within the article.¹⁹⁹

Liquidity risk is of particular importance because of its role in the recent banking collapse.²⁰⁰ It directly harms business and investment by reducing the confidence of depositors and investors.²⁰¹ Since it often arises from operational and credit risk, one way for Islamic banks to mitigate liquidity risk is to use *salam*

¹⁹⁵ Ibid

¹⁹⁶ Mounira, B.A. and Tunisia, G. 2008. Managing Risks and Liquidity in an Interest Free Banking Framework: The Case of the Islamic Banks. *International Journal of Business and Management* 3(9), pp. 80-95.

¹⁹⁷ Ibid

¹⁹⁸ Dusuki, A.W. 2006. Commodity *Murabaha* Programme (CMP): An Innovative Approach to Liquidity Management. *Journal of Islamic Economics, Banking and Finance* 3(1).

¹⁹⁹ Ibid

²⁰⁰ El-Gamal, M.A. 2006. *Islamic Finance: Law, Economics, and Practice*. Cambridge University Press, p. 19.

²⁰¹ Ibid, p. 16

contracts.²⁰² In addition, Schoon (2010) provides an in-depth analysis of certain other steps, including collateral arrangements, fixed deposit amounts, asset ownership and the imposition of penalties, which can be taken to handle and avoid such risks. For instance, collateral or guarantee arrangements can prove beneficial in mitigating the credit, liquidity and operational risks involved in *Murabaha* transactions.²⁰³ In this context, collateral is an arrangement whereby the bank establishes a kind of security for a financial transaction by taking possession of property on behalf of the client, and guarantees to reimburse any expenses and rents due on such property.²⁰⁴ I have identified further information on the collateral or guarantee arrangement that is useful in controlling the legal risks of the Islamic banking system.²⁰⁵

From the viewpoint of Harwood (2006), collateral is a type of arrangement that establishes a kind of security in financial transactions by taking possession of property on behalf of the client, and guarantees to reimburse any kind of expenses and rents due on such property.²⁰⁶ In this thesis, the above reviewed information from Harwood's study results in the achievement of relevant outcomes to address the defined aim and objectives.²⁰⁷ The study and the findings of Harwood can be considered quite vital and crucial in efforts to explore the existing knowledge gap in this field of research.²⁰⁸ The primary focus of the author's findings is on shipping functions and their effective accounting, which aims to produce some clear inferences regarding securitisation and its relevance in the context of Islamic finance.²⁰⁹ In addition, the presented findings of the author reflect the securitisation of assets for the purpose of borrowing capital amount is quite common, which can result in making liquidity and capital credit

²⁰² Ali, S.S. 2004. Islamic modes of finance and associated liquidity risks. [Online]. Available at: http://www.sbp.org.pk/departments/ibd/lecture_6_islamic_modes_finance_liquidity.pdf [Accessed on: 25 March 2013].

²⁰³ Schoon, N. 2010. *Islamic Banking and Finance*. London: Spiramus Press Ltd.

²⁰⁴ Harwood, S. 2006. *Shipping Finance*. 3rd ed. UK: Euromoney Books.

²⁰⁵ *Ibid*, p. 26

²⁰⁶ Hawary, D.E., Grais, W. and Iqbal, Z. 2007. Diversity in the Regulation of Islamic Financial Institutions. *The Quarterly Review of Economics and Finance* 46, pp. 778-800.

²⁰⁷ Harwood, S. 2006. *Shipping Finance*. 3rd ed. UK: Euromoney Books.

²⁰⁸ *Ibid*, p. 3

²⁰⁹ Hawary, D.E., Grais, W. and Iqbal, Z. 2007. Diversity in the regulation of Islamic Financial Institutions. *The Quarterly Review of Economics and Finance* 46, pp. 778-800.

risks more critical and prominent.²¹⁰ In this regard, this article only highlights the criticality of such types of financial transactions; rather, the research work does not provide any crucial information regarding measures used for the purpose of addressing such crucial risks.²¹¹ In addition, this article does not reflect any critical usage of Islamic financial transactions in handling risk, which is the prime theme of the research work. In this way, this is the primary knowledge gap within the research article, which will be filled effectively with the help of the research findings?²¹² I will refer to Harwood's work at a later stage in this thesis.

Hasan and Dicle (2006) also suggested that various aspects of the Basel II accords, including internal controls, external audits, capital adequacy, and risk management techniques, are useful in addressing some of the risks accompanying *Murabaha* transactions, such as credit risk, risk of late financial compensation and payment, mark-up risk, and longer maturity terms.²¹³ These aspects help in accruing knowledge about the risks associated with financial transactions and the techniques that can be used for mitigation of such risks. Basel II is discussed further in Chapter 4.²¹⁴

Proposed measures to mitigate the legal risks commonly found to affect *Murabaha* transactions can be used to recover losses in the event a customer breaks his promise to lease an asset or defaults on payment.²¹⁵ This information is relevant and helpful in supporting the argument of identifying legal risks linked to Islamic products, as well as the extent to which different actions suggested by different scholars have effectively contributed to lessening the seriousness of the

²¹⁰Kayed, R.N. and Mohammed, K.M. 2009. Unique Risks of Islamic Modes of Finance: Systemic, Credit and Market Risks. *Journal of Islamic Economics, Banking and Finance* 5(3), pp. 9-34.

²¹¹Hawary, D.E., Grais, W. and Iqbal, Z. 2007. Diversity in the Regulation of Islamic Financial Institutions. *The Quarterly Review of Economics and Finance* 46, pp. 778-800.

²¹²El-Gamal, M.A. 2006. *Islamic Finance: Law, Economics, and Practice*. Cambridge University Press, p. 16. Kayed, R.N. and Mohammed, K.M. 2009. Unique Risks of Islamic Modes of Finance: Systemic, Credit and Market Risks. *Journal of Islamic Economics, Banking and Finance* 5(3), pp. 9-34.

²¹³Hasan, M.K. and Dicle, M.F. 2006. *Basel II and Capital Requirement for Islamic Banks*. Islamic Center 2, pp. 235-276.

²¹⁴Risk management guidelines for Islamic banks.

²¹⁵Otto, J.M. 2011. *Sharia Incorporated: A Comparative Overview of the Legal Systems of Twelve Muslim Countries in Past and Present*. Netherlands: Amsterdam University Press.

identified risks.²¹⁶ Following critical review of the book, I have gained a good level of knowledge about effective actions for controlling the impact of these risks on Islamic banking functions and investors' interests, which is useful to my thesis, particularly in completing the section on potential actions to mitigate legal risks.²¹⁷ Overall, this book has greatly contributed in supporting the critical arguments and objectives of the dissertation. Zahan and Kenett argue that, along with advance deposits, risk hedging is a vital tool to ensure the long-term success and sustainability of any financial system, whether Islamic or conventional.²¹⁸ In the case of Islamic banking, they also recommend *takaful* (insurance) as a risk mitigation instrument.²¹⁹ However, the research article nonetheless contains a critical research and knowledge gap. This article only elaborates *Murabaha* financial transactions within financial transactions within Islamic banking and financial regime.²²⁰ Along with *Murabaha*, there are a number of other crucial tools related to Islamic banking transactions and systems, which can also be used by banks and financial institutions for the purpose of averting crucial issues related to Islamic banking transactions.²²¹ In addition, the article does not reveal any critical information about any financial and legal risks related to financial transactions.²²²

Banks and financial institutions should adopt a range of measures to mitigate the various legal risks of *Murabaha*, according to Ahmed.²²³ They should establish risk management systems to identify, measure, and manage the risks involved, including the creation of internal controls and the establishment of an internal rating system, involving the collection and storage of information related

²¹⁶²¹⁶ Ibid

²¹⁷Kayed, R.N. and Mohammed, K.M. 2009. Unique Risks of Islamic Modes of Finance: Systemic, Credit and Market Risks. *Journal of Islamic Economics, Banking and Finance* 5(3), pp. 9-34.

²¹⁸Zahan, M. and Kenett, R.S. 2012, Hedging Instruments in Conventional and Islamic Finance. *Electronic Journal of Applied Statistical Analysis: Decision Support Systems and Services Evaluation* 3(1), pp. 59-74.

²¹⁹Ibid

²²⁰Otto, J.M. 2011. *Sharia Incorporated: A Comparative Overview of the Legal Systems of Twelve Muslim Countries in Past and Present*. Netherlands: Amsterdam University Press.

²²¹Ibid, p. 89

²²²Archer, S. and Karim, R.A.A. 2011. *Islamic Finance: The Regulatory Challenge*. John Wiley & Sons.

²²³Kayed, R.N. and Mohammed, K.M. 2009. Unique Risks of Islamic Modes of Finance: Systemic, Credit and Market Risks. *Journal of Islamic Economics, Banking and Finance* 5(3), pp. 9-34.

to the risks faced in these transactions, as well as provisions or contingency plans for dealing with them should they arise.²²⁴ This would help to bring transparency to the operations of banks, as they would be required to disclose information about their accounting standards, the risks involved, and the quality and adequacy of their capital.²²⁵ Risk reports should be prepared, providing information regarding the various types of risk outlined in the previous section.²²⁶ There is also a need to adopt risk mitigation measures, including the establishment of liquidity management and deposit protection systems, legal reforms, and the designation of a lender of last resort.²²⁷ Parties should be required to analyse and evaluate the risks involved in order to set a cost plus mark-up price. In addition, collaterals and guarantees can be required from the payer to ensure the timely receipt of payments due.²²⁸ Credit risk can be mitigated by setting credit limits for the parties involved in any transaction. To maintain the right balance between profitability and safety, proper consideration must be given to liquidity requirements, so that *Murabaha* helps to generate liquid assets, thus increasing the liquidity of the financing organisation.²²⁹ This information will assist in identifying the appropriate techniques that can be used for managing the risks that are caused by Islamic financial transactions. This information will also help in fulfilling the research objectives and identifying the solution for the research problem.

Karim and Archer assert that banks should demand guarantees and warranties, and should require customers to pay a deposit, so as to mitigate the risks associated with each financial transaction.²³⁰ There is also a need to

²²⁴ Otto, J.M. 2011. *Sharia Incorporated: A Comparative Overview of the Legal Systems of Twelve Muslim Countries in Past and Present*. Netherlands: Amsterdam University Press, p. 16.

²²⁵ Ibid, p. 20

²²⁶ Archer, S. and Karim, R.A.A. 2011. *Islamic Finance: The Regulatory Challenge*. John Wiley & Sons, p. 4-5.

²²⁷ Otto, J.M. 2011. *Sharia Incorporated: A Comparative Overview of the Legal Systems of Twelve Muslim Countries in Past and Present*. Netherlands: Amsterdam University Press, p. 9.

²²⁸ Archer, S. and Karim, R.A.A. 2011. *Islamic Finance: The Regulatory Challenge*. John Wiley & Sons, p. 3.

²²⁹ Ahmed, A.M.T. 2010. *Islamic Banking: How to Manage Risk and Improve Profitability*. John Wiley & Sons, p. 10.

²³⁰ Archer, S. and Karim, R.A.A. 2011. *Islamic Finance: The Regulatory Challenge*. John Wiley & Sons, pp. 18.

manage the risk-sharing properties of investment accounts, both restricted and unrestricted.²³¹ Proper management of the risk-return mix, especially in unrestricted investment accounts, helps to reduce the adverse impact of risks on stakeholders.²³²

Banks and their business partners should build and maintain comprehensive databases to which they can refer to find details of the past performance of the potential parties to a transaction, in order to assess the probability of default, according to Kayed and Mohammed.²³³ These authors also advocate the adoption of collateral and institutional or personal guarantees against credit risk, as well as the development of new hedging products in compliance with Sharia law, thus mitigating the price and market risk.²³⁴ Finally, they agree on the need to maintain sufficient liquidity to meet the requirements of payment and withdrawal.²³⁵

The Islamic Financial Services Board (IFSB) has set out financing strategies that it deems appropriate for companies, financial institutions, and banks, including the use of various instruments, according to Sharia principles, in order to mitigate the credit risks arising at different stages of a financial transaction.²³⁶ Its guiding principles require the establishment of an effective liquidity management framework to mitigate liquidity risks.²³⁷ Banks should conduct due diligence reviews to gather information on the creditworthiness of the other parties.²³⁸ Exit strategies should also be put in place to allow parties to withdraw their investment in a transaction if necessary.²³⁹ Finally, the parties should agree on clearly defined roles and duties in order to ensure that the

²³¹ Ibid, pp. 26-27.

²³² Ibid

²³³ Ibid, p. 6

²³⁴ Ibid, p. 23

²³⁵ Kayed, R.N. and Mohammed, K.M. 2009. Unique Risks of Islamic Modes of Finance: Systemic, Credit and Market Risks. *Journal of Islamic Economics, Banking and Finance* 5(3), pp. 9-34.

²³⁶ El-Gamal, M.A. 2006. *Islamic Finance: Law, Economics, and Practice*. Cambridge University Press, p. 16.

²³⁷ Islamic Financial Services Board. 2005. Guiding principles of risk management for institutions (other than insurance institutions) offering only Islamic financial services. [Online]. Available at: <http://www.ifsb.org/standard/ifsb1.pdf> [Accessed on: 14 March 2014].

²³⁸ Ibid

²³⁹ Ibid

contract is fulfilled effectively and efficiently.²⁴⁰ All this information is used in order to address the research questions, as well as for generalising the findings of the research study.

The need for financial organisations to evaluate the creditworthiness of other parties, in an environment where globalisation has greatly increased the number of potential trading partners, is confirmed by Dar et al.²⁴¹ They suggest that this should be done by establishing a credit rating system as part of a wider risk management system, which would also operate internally, monitoring the performance of employees and other members of the organisation to identify actions with the potential to cause risk, then taking appropriate action to mitigate those risks.²⁴² In order to face intense competition in a globalised world, it is necessary that the creditworthiness of financial organisations is evaluated. This will ensure organisations are capable of entering financial transactions and are informed about the various risks associated with such transactions. This will, overall, reduce the risks and address the aim of this research.

Al-Bashir asserts that there is a need to develop a derivatives market in the Islamic financial system, in order to manage risks in an appropriate manner. Islamic banks have large quantities of long-term assets that are funded by short-term deposits.²⁴³ Thus, a broad range of financial products should be developed in order to mitigate the risks associated with this structure.²⁴⁴ It is also essential to obtain and store information regarding the risks that banks and other organisations face when entering into different financial transactions.²⁴⁵ Banks should also obtain guarantees from institutions and individuals against the risk of

²⁴⁰ Ibid.

²⁴¹ Dar, M.R., Azeem, M. and Masood, D.O. 2013. Operational risk management, risk management approaches, and risk mitigation techniques: challenges faced by Islamic financial services. *Journal of Business and Management* 11(2), pp. 72-79.

²⁴² Ibid, p. 80

²⁴³ Islamic Financial Services Board. 2005. Guiding principles of risk management for institutions (other than insurance institutions) offering only Islamic financial services. [Online]. Available at: <http://www.ifsb.org/standard/ifsb1.pdf> [Accessed on: 14 March 2014].

²⁴⁴ Ibid

²⁴⁵ El-Gamal, M.A. 2006. *Islamic Finance: Law, Economics, and Practice*. Cambridge University Press, pp. 29-30.

non-payment for goods and services provided.²⁴⁶With the help of the literature, the information about the various aspects and dimensions of the Islamic financial market and *Murabaha* transactions and the manner in which it will affect the parties to the transaction.

Schoon (2011) notes that the rules of Islamic finance forbid gambling, interest, and uncertainty, which helps to restrict the occurrence of risk,²⁴⁷ while banks and other finance providers operating on Islamic principles may adopt various measures to mitigate the legal risks that do arise.²⁴⁸ Thus, banks use value-at-risk measures to evaluate and minimise their impact on stakeholders.²⁴⁹ The risk associated with changes in foreign currency exchange rates can be addressed by establishing exchange controls, charged to the relevant parties.²⁵⁰ If the credit rating of a party is below an acceptable level, credit default swaps can be used as a means of speculation to control the associated risk, as long as these are Sharia-compliant.²⁵¹ Finally, assets should be diversified, i.e. allocated in a proportionate manner, in order to control and mitigate risks associated with the investment.²⁵² The article presented by Schoon is an important and effective piece that aims to explore the impact of legal risks and the rationality of the practices used for the management of such critical risks in the most effective and essential manner.²⁵³The article has also referred to the use of swaps and other Sharia-compatible funds for the purpose of preventing losses arising from

²⁴⁶Al-Bashir, M. 2008. *Risk Management in Islamic Finance: An Analysis of Derivatives Instruments in Commodity Markets*. BRILL.

²⁴⁷Schoon, N. 2011. *Islamic Asset Management: An Asset Class on its Own*. Oxford University Press, p. 112.

²⁴⁸Islamic Financial Services Board. 2005. Guiding principles of risk management for institutions (other than insurance institutions) offering only Islamic financial services. [Online]. Available at: <http://www.ifsb.org/standard/ifsb1.pdf> [Accessed on: 14 March 2014].

²⁴⁹Ibid

²⁵⁰Kayed, R.N. and Mohammed, K.M. 2009. Unique Risks of Islamic Modes of Finance: Systemic, Credit and Market Risks. *Journal of Islamic Economics, Banking and Finance* 5(3), pp. 9-34.

²⁵¹Islamic Financial Services Board. 2005. Guiding principles of risk management for institutions (other than insurance institutions) offering only Islamic financial services. [Online]. Available at: <http://www.ifsb.org/standard/ifsb1.pdf> [Accessed on: 14 March 2014].

²⁵²Schoon, N. 2011. *Islamic Asset Management: An Asset Class on its Own*. Oxford University Press, p. 130.

²⁵³Ibid, p. 125

currency and credit risks. In this regard, the inclusion of this article is intended to make the research more compatible and effective.²⁵⁴

This chapter has critically reviewed a range of relevant books and articles that together provide detailed knowledge of the topic of this thesis and constitute a conceptual framework for the study. In particular, this digest of secondary sources, both academic and organisational, provides introductory information on Islamic banking, *Murabaha* transactions, the legal risks commonly associated with *Murabaha*, and the various mitigation actions and strategies that have been proposed and/or used to lessen the impact of these risks.

As discussed in earlier sections, *Murabaha* is a type of Islamic financial transaction whereby a third party is involved in the buying and selling of commodities. It is a sale-based transaction in which a bank, at the request of a client, purchases a commodity from a vendor at cost price, then resells it to the client at cost plus mark-up. The mark-up price is negotiated between the parties involved and all information relating to the cost of the goods is disclosed to ensure transparency.

The legal risks associated with Islamic financial transactions, particularly *Murabaha*, have been shown to include price risk, counterparty risk, fiduciary risk, market risk, interest rate risk, rate of return risk, technology risk, and others. The various measures that should be taken to mitigate such risks include the preparation of risk reports and the requirement of guarantees, warranties, and collateral to act as security against the commodity being traded. There is also a need to allocate assets appropriately in order to reduce any gap that exists between the actual and standard parameters. It has been demonstrated that such risk mitigation actions will encourage the growth and development of the economy, thus helping to address the current weakness of the financial systems of Islamic countries, which remain underdeveloped because of poorly defined rules and regulations and the inadequate documentation of reports and financial

²⁵⁴Islamic Financial Services Board. 2005. Guiding principles of risk management for institutions (other than insurance institutions) offering only Islamic financial services. [Online]. Available at: <http://www.ifsb.org/standard/ifsb1.pdf> [Accessed on: 14 March 2014].

policies. My aim in this dissertation will be to encourage the mitigation of these risks.

1.2 Aims, Objectives, and Research Gap

The main aim of the research is thus to explore the legal risks associated with *Murabaha* transactions, and to identify ways of mitigating such risks. Risk cognisance has become recognised as crucial in quantifying the gains or losses to be expected from particular transactions.²⁵⁵ Addressing the above aim will enhance knowledge regarding significant factors affecting the risks specific to Islamic modes of finance, such as profit and loss sharing (PLS) and the prohibition of debt-based transactions.²⁵⁶ It will also add to the knowledge relating to the management of legal risks and their relationship to potential returns. This signifies that potential gains from Islamic financial transactions are associated with risk-taking ability.

In pursuit of the above aims, the research has three key objectives, each of which implies three questions, as follows:

1. To explore and gain an understanding of the *Murabaha* Islamic financial transaction in terms of its background and structure.
 - What is a *Murabaha* Islamic financial transaction?
 - What are the main features or characteristics of a *Murabaha* transaction, and what is its ultimate benefit to each party?
 - How does a *Murabaha* financial transaction work? What is its basic structure?
2. To determine various legal risks associated with *Murabaha* transactions, such as liquidity risk, commodity risk, mark-up risk, and operational risk, with special reference to Islamic banks.
 - What are the legal risks associated with *Murabaha* transactions?

²⁵⁵Kayed, R.N. and Mohammed, K.M. 2012. Unique Risks of Islamic Modes of Finance: Systematic, Credit and Market Risks. *Journal of Islamic Economics, Banking and Finance* 5(3), pp. 9-34.

²⁵⁶*Ibid*, p. 36.

- How do these risks directly affect the ultimate returns?
 - What problems have financial institutions and individuals encountered due to the risks involved in *Murabaha* transactions?
3. To identify appropriate actions to mitigate the legal risks of *Murabaha*.
- What are the effective methods of managing the legal risks associated with *Murabaha* transactions?
 - What are the legal risks associated with Saudi Arabian system that affect *Murabaha* transaction?
 - How can these actions help in ensuring fair returns for the parties?
 - To what extent will these methods mitigate the legal risks of *Murabaha* transactions?

1.2.1 Research gap

Previous research into this subject covers the major practices of Islamic banks in Saudi Arabia and the risks associated with the general transactions undertaken by banks.²⁵⁷ However, the existing literature has not addressed the legal risks faced by Islamic banks and associated parties in the context of the differences between the theoretical position of basic Sharia law and the actual practices of Islamic banks. It has also failed to focus specifically on *Murabaha* financing contracts and the associated legal risks.²⁵⁸ The present research study seeks to fill these gaps by considering all of the major risks to which Islamic banks are exposed when engaging in various major transactions, but with a specific focus on the legal risks faced by these banks and associated parties in relation to *Murabaha*-based financial transactions, which arise from differences between the practical and theoretical approaches to Sharia law in Saudi Arabia.²⁵⁹ The Gulf nation is a developing economy that has been significantly affected by globalisation. To meet international working standards and expectations, and deal with intensive competition from abroad, it has had to adopt universal financial standards and principles.

²⁵⁷ Garner, J.M. 2013. A Critical Perspective on the Principles of Islamic Finance Focusing on Sharia Compliance and Arbitrage. *Leeds Journal of Law & Criminology* 1(1), pp. 70-90.

²⁵⁸ Archer, S. and Karim, R.A.A. 2011. *Islamic Finance: The Regulatory Challenge*. John Wiley & Sons, pp. 1-2.

²⁵⁹ *Ibid*, pp. 2-3.

1.3 Islamic finance and its history: the origins of a modern phenomenon

In this section, I will briefly present the origins and historical development of Islamic banking. The growth and development of Islamic finance has been influenced by the teachings of Prophet Muhammad since the beginning of the 7th century.²⁶⁰ Scholars believe that the Holy Quran and Sunna have acted as its major sources of inspiration, and have influenced its emergence and its principles, as well as continuing to affect its operation today, both directly and via the coordination and monitoring activities applied by the authority of Sharia²⁶¹.. The importance of Sharia is that it takes Islamic laws as the source of guidance, and further guides humans' way of life. Therefore, it can be stated that Islamic finance and Islamic banking both trace their sources to Islam.

Islamic finance represents only a proportion of the modern global banking industry.²⁶² An account of its evolution and history can be condensed into a period of approximately 60 years.²⁶³ This does not mean that Islamic finance did not exist before this time, but merely that it did not begin to gain popularity until the mid-1960s.²⁶⁴ Since then, it has passed through various popularising and diminishing phases, like any other global financial system and. As Islamic conventions do not align with Islamic finance, its popularity in the West has been curbed.²⁶⁵ Given fundamental principles that focus on equality in transactions and the concept of risk sharing, Islamic economics differ from conventional Western economics, though it nonetheless continues to be practiced in the West. For instance, London has been emerging as a prominent centre for Islamic finance,

²⁶⁰ *ibid*, p. 82

²⁶¹ *ibid*, pp. 98-110

²⁶² Ginena, K. and Hamid, A. 2015. *Foundations of Shariah Governance of Islamic Banks*. New Jersey: John Wiley & Sons, p. 97.

²⁶³ Ariff, M and Iqbal, M. 2011. *The Foundations of Islamic Banking: Theory, Practice and Education*. Edward Elgar Publishing, p. 3.

²⁶⁴ Al-Suwaidi, A. 2004. *Finance of International Trade in the Gulf*. Netherlands: BRILL, p. 116.

²⁶⁵ Ariff, M and Iqbal, M. 2011. *The Foundations of Islamic Banking: Theory, Practice and Education*. Edward Elgar Publishing, p. 78.

with the basic belief behind its success being rooted in the presence of a market for non-Muslims who share the same values found in Islamic countries.²⁶⁶

Islamic banks have offered various kinds of financial services since their establishment, making the Islamic finance industry a multibillion-dollar market.²⁶⁷ Small general banks have grown and offered financial services with the help of "Islamic windows".²⁶⁸ They have also used the structuring and distribution capabilities of larger conventional banks and financial institutions, allowing the Islamic finance industry to experience increasingly large transactions.²⁶⁹ The industry has expanded in non-Muslim countries as well as Muslim ones. Yet, Islamic finance has, since historical times, faced adjustment and coordination problems with respect to the financial practices of non-Muslim countries.²⁷⁰ However, mutual adjustment and agreement have taken place gradually among Islamic and conventional practices, since the development of Islamic Sharia, to develop sound cooperation and coordination with non-Muslim countries.²⁷¹ Simultaneously, the latter have sought to transact with Muslim countries in order to widen their financial and economic base.²⁷² For instance, France and the Netherlands have emerged as major financial centres by making necessary changes in tax and other regulatory frameworks, while the United States has amended its approach and started offering Islamic financial services domestically and offshore.²⁷³

The financial industry has always played a significant role in each economy. Likewise, the Islamic finance industry has had a crucial role in the

²⁶⁶ Brant, R. 2009. Is Islamic finance the answer? [Online] Available at: <http://news.bbc.co.uk/2/hi/business/8025410.stm> [Accessed on: 14 September 2016].

²⁶⁷ Ayub, M. 2009. *Understanding Islamic Finance*. John Wiley & Sons, p. 145.

²⁶⁸ Visser, H. 2009. Islamic finance: Principles and practice. [Online]. Available at: <http://www.kantakji.com/fiqh/Files/Finance/N247.pdf> [Accessed on: 28 August 2012].

²⁶⁹ Pock, A.V. 2007. *Strategic Management in Islamic Finance*. US: Springer, p. 60.

²⁷⁰ Ayub, M. 2009. *Understanding Islamic Finance*. John Wiley & Sons, pp. 6-10.

²⁷¹ Schoon, N. 2010. *Islamic Banking and Finance*. UK: Spiramus Press Ltd, p. 135.

²⁷² Iqbal, M. and Llewellyn, D.T. 2002. *Islamic Banking and Finance: New Perspectives on Profit Sharing and Risk*. Edward Elgar Publishing, p. 112.

²⁷³ Sharia finance. 2012. [Online]. Available at: <http://www.islamic-bank.com/sharia-finance/> [Accessed on: 28 August 2012].

development of the Islamic economy since historic times.²⁷⁴ Funds are mobilised from investors and depositors, to be invested in productive trade and business opportunities.²⁷⁵ A distinguishing feature of Islamic finance is its basis in Sharia, which prohibits the payment and receipt of interest in principle.²⁷⁶ In the modern history of the Islamic financial market, however, interest-based commercial banking has started expanding in the Islamic economy.²⁷⁷ The Islamic financial world has experienced a significant increase in Sharia-compliant businesses, along with interest-based commercial banking, because Islamic finance operates as per the principles of Sharia law.²⁷⁸ It focuses on investing in interest-based ventures and businesses that provide effective goods and services.²⁷⁹ The financial economy of Arab and Muslim countries, including Saudi Arabia, has undergone various changes as a result of this introduction of interest-based transactions.²⁸⁰

The growth and development of the industry intensified in the following years, with the establishment of hundreds of Islamic financial institutions and subsidiaries across the world.²⁸¹ The multilateral Islamic Development Bank was established in Jeddah, Saudi Arabia, in 1975, with the purpose of mobilising funds for various projects, and the Dubai Islamic Bank was established the same year in the United Arab Emirates (UAE).²⁸² The history of Islamic finance is also

²⁷⁴Saeed, A. 1996. *Islamic Banking and Interest: A Study of the Prohibition of Riba and Its Contemporary Interpretation*. BRILL, pp. 98-100.

²⁷⁵Ibid, p. 118

²⁷⁶Askari, H., Iqbal, Z. and Mirakhor, A. 2011. *Globalization and Islamic Finance: Convergence, Prospects and Challenges*. US: John Wiley & Sons, p. 167.

²⁷⁷Saeed, A. 1996. *Islamic Banking and Interest: A Study of the Prohibition of Riba and Its Contemporary Interpretation*. BRILL, p. 65.

²⁷⁸Ibid, pp. 69-70.

²⁷⁹Admin. 2010. The principles of Islamic finance. [Online]. Available at: <http://www.laworld.com/news-and-publications/1-legal-news/44-the-principles-of-islamic-finance.html> [Accessed on: 31 December 2012].

²⁸⁰Nash, J. 2009. The principles of Islamic finance. [Online]. Available at: **Error! Bookmark not defined.**<http://www.laworld.com/news-and-publications/1-legal-news/44-the-principles-of-islamic-finance.html>[Accessed on: 28 August 2012].

²⁸¹What is Islamic finance and what are the principles? 2011. [Online]. Available at: <http://www.grapeshisha.com/living-working/a-basic-guide-to-islamic-finance.html> [Accessed on: 29 August 2012].

²⁸²Moles, P., Parrino, R. and Kidwell, D.S. 2011. *Fundamentals of Corporate Finance*. US: John Wiley & Sons, p. 878.

associated with the emergence and development of many small-scale credit unions and cooperative societies.²⁸³

The Islamic finance industry has undergone significant growth since the 1970s, expanding its scope and widening its appeal to the rest of the world, including non-Muslim countries.²⁸⁴ For example, the Islamic Bank of Britain (IBB) came into existence in 2004 and has provided financial products in compliance with Sharia. The United Kingdom is planning to make London a hub of Islamic finance by issuing sovereign *sukuk* and making favourable changes to tax laws.²⁸⁵ This section has outlined the recent history of Islamic finance. The growing importance of Islamic banks and other financial institutions has reasserted UK's position as a hub for Islamic finance in non-Islamic nations. The sovereign *sukuk* issued by the government of UK is identified by the investors as being an Islamic equivalent of traditional bonds. To promote UK as a sovereign land, the government issued £200 million worth of *sukuk* bonds which are due to mature on July 22, 2019. The next section presents differences between the Saudi regime and Saudi law, as this PhD dissertation will address Islamic finance in a domestic context.

1.4 Differences between the Saudi regime and Sharia law

The Saudi regime is a monarchy that is based on Islam; the government is headed by the king, who acts as commander-in-chief of the country's military forces.²⁸⁶ The king appoints another member of the royal family as crown prince, who thereby assumes the position of heir apparent, i.e. next in line to the throne, and assists the monarch in performing his royal duties.²⁸⁷ The king is responsible

²⁸³Visser, H. 2009. Islamic finance and principles and practice. [Online]. Available at: <http://www.kantakji.com/fiqh/Files/Finance/N247.pdf> [Accessed on: 27 August 2012].

²⁸⁴Usmani, M.T. 2004. *An Introduction to Islamic Finance*. Arham Shamsi, p. 162.

²⁸⁵Farooq, S. 2012. Sukuk's global reach. [Online]. Available at: <http://dawn.com/2012/07/30/sukuks-global-reach/> [Accessed on: 31 December 2012].

²⁸⁶Schoon, N. 2010. *Islamic Banking and Finance*. Spiramus Press Ltd, p. 118. Zhang, Y., Ji, L. and Liu, F. 2010. *Local Housing Market Cycle and Loss Given Default: Evidence from Sub-Prime Residential Mortgages*. International Monetary Fund.

²⁸⁷Siddiqui, S.H. 2010. Islamic banking: True modes of financing. [Online]. Available at: <http://www.nzibo.com/IB2/truemodes.pdf> [Accessed on: 24 June 2015].

for governing the country with the assistance of the Council of Ministers, also known as the cabinet, whose members head the twenty-two government ministries, each responsible for the delivery of a different area of state functioning, such as education, finance, or foreign affairs.²⁸⁸ The king also receives advice from a legislative body that is known as the Consultative Council, or the *Majlis Al-Shura*.²⁸⁹ The Council, which is responsible for enacting amendments to existing laws as well as for introducing new legislation, is comprised of 150 members, each of whom is appointed by the king for a term of four years, which can be renewed at the monarch's discretion.²⁹⁰ The national territory is divided into thirteen provinces, each of which is headed by a governor and a deputy governor.²⁹¹ Each province also has its own provincial council, which is responsible for guiding and advising the governor and directing the efforts necessary to ensure the governance and development of the province.²⁹²

As Saudi Arabia is a Muslim kingdom, its entire judicial system is based on the principles of Islamic law.²⁹³ The king is ex officio the head of the legal system in the country; he acts as a final court with the authority to hear final appeals and issue pardons.²⁹⁴ The Kingdom also has a system of law courts, including Sharia courts, where most Saudi legal cases are heard. As discussed above, Sharia laws govern all aspects of life ranging from married life to business and other commercial matters. It must be noted that Saudi Arabia is the birthplace of Prophet Mohammad, Quran, and by extension, Sharia law. Islamic experts identify Saudi Arabia as the nation to which the Sharai laws apply most strictly. Furthermore, the nation does not have a civil legal code that runs parallel to the Sharia laws. Sharia hold massive significance for the Saudis since it is the *de facto* Constitution of the country. Since 97% of the population of Saudi Arabia is

²⁸⁸ *ibid*, p. 126.

²⁸⁹ About Saudi Arabia. 2015. [Online]. Available at: <https://www.saudiembassy.net/about/country-information/government/> [Accessed on: 7 July 2015].

²⁹⁰ *ibid*

²⁹¹ Schoon, N. 2010. *Islamic Banking and Finance*. Spiramus Press Ltd, p. 118.

²⁹² Siddiqui, S.H. 2010. Islamic banking: True modes of financing. [Online]. Available at: <http://www.nzibo.com/IB2/truemodes.pdf> [Accessed on: 24 June 2015].

²⁹³ Shofawati, A. 2014. *Murabaha* Financing in Islamic Banking: Case Study in Indonesia. *Proceedings of 5th Asia-Pacific Business Research Conference*, p. 108.

²⁹⁴ *ibid*, p. 108.

Muslim, the impact of Sharia laws is strict in Saudi Arabia. Enforceability of Sharia laws in Saudi Arabia relies on muttatawa- the religious police which identifies and detains the violators of Sharia laws, who in turn, are tried in the Courts. These Sharia courts are categorised into three main levels of authority.²⁹⁵ The lowest of these is the court of first instance, where general and summary court proceedings are heard; the second is the Court of Cassation; and the highest is the Supreme Judicial Council.²⁹⁶

In the opinion of Ali and Naysary, the judicial system of Saudi Arabia is undergoing major reform, affecting both the enactment of new judiciary regulations and the establishment of a new set of regulations for the operation of the Board of Grievances.²⁹⁷ In the traditional era, Sharia courts existed in order to resolve general matters of law concerning criminal cases, crimes of violence, family disputes, and land-related disputes.²⁹⁸ Amongst the statutory tribunals, the Board of Grievances was considered to be the most significant, as it exercised jurisdiction over a wide domain, inclusive of disputes concerning the Saudi Arabian government, along with the various government agencies, commercial cases, arbitral awards, and the enforcement of foreign judgements.²⁹⁹ Under the recently introduced judicial reforms, the commercial jurisdiction previously assigned to the Board of Grievances has been transferred to the commercial courts, which follow a similar Sharia structure.³⁰⁰ In recent times, there is said to have been a revival of interest-oriented transactions under Islamic law, with an overlap of the concepts of *fiqh* and Sharia laws.³⁰¹

Islamic jurisprudence is referred as 'Fiqh'; whereas, Sharia is divine law that based on religious practices, such as Quran and Sunnah. The concept of Fiqh overlaps to Sharia because it is human interpretation and understanding to

²⁹⁵ *Ibid*, p. 145.

²⁹⁶ *Ibid*, p. 148.

²⁹⁷ *Ibid*, p. 108.

²⁹⁸ Rosly, S.A. and Zaini, M.A. 2008. Risk-return Analysis of Islamic Banks' Investment Deposits and Shareholders' Fund. *Managerial Finance* 34(10), pp. 695-707.

²⁹⁹ Saudi Arabian law overview. 2015. [Online]. Available at: http://www.saudilegal.com/saudilaw/19_law.html [Accessed on: 9 July 2015].

³⁰⁰ *Ibid*.

³⁰¹ *Ibid*.

the Islamic law of Sharia. Islamic jurists interpreted “Quran and Sunnah” that ultimately expanded Sharia and its basic determinants. These changes are typical of those affecting the contemporary legal systems of a number of Gulf countries, including Saudi Arabia, in response to a perceived need to dismantle the old legal systems originally installed or inspired by European regimes, replacing them with regimes based wholly or in part on Sharia law.

It transpires that this process of the adoption of Sharia law is beset with numerous difficulties, one of the most significant of which is associated with the requirement for a specified technological and economic environment for the effective application of Sharia law.³⁰² Another challenge is associated with the non-existence of an agreed-upon method for the determination of content concerning the law.³⁰³ The Saudi regime is considered by some commentators to have diverged from Sharia law in terms of its practical implementation.³⁰⁴ The misleading notion of such claims has been proved, however, by stating that governance in Saudi Arabia is undertaken according to man-made laws and their respective legislatures.³⁰⁵ Finally, there exist issues in creating uniformity amongst all countries whose legal systems are based on Islamic law.³⁰⁶

The Saudi banking sector, which is considered to be a modern element of the economy, is composed of a total of thirteen commercial banks.³⁰⁷ The regulatory regime governing the banking sector can be seen to be focused on Sharia-based law.³⁰⁸ The Saudi Arabian Monetary Agency (SAMA) is the central bank of the Kingdom of Saudi Arabia, and is said to be one of the major players in the banking system at the global level.³⁰⁹ The agency is required to monitor all

³⁰² Ibid.

³⁰³ Pock, A.V. 2007. *Strategic Management in Islamic Finance*. Springer.

³⁰⁴ Murabaha as a mode of finance. 2009. [Online]. Available at: http://www.albaraka.co.za/Islamic_Banking/Features_of_Marabaha_and_Leasing/Murabaha_as_a_Mode_of_Finance.aspx [Accessed on: 16 July 2015].

³⁰⁵ Hunt-Ahmed, K. 2013. *Contemporary Islamic Finance: Innovations, Applications and Best Practices*. John Wiley & Sons, p. 114.

³⁰⁶ Ibid, p. 114.

³⁰⁷ Ibid, p. 124.

³⁰⁸ Ibid, p. 124.

³⁰⁹ Ibid, p. 155.

Saudi banks in order to confirm that they comply with Islamic law.³¹⁰ Interest based transactions do take place in Saudi Arabia that are considered in equivalent to ‘usury’ or unlawful transaction based on interest. People involved in interest based transactions in Saudi although it is against principles of Islamic law, are perceived as “they do not believe Allah”.³¹¹ It also supervises the banks to ensure that *riba* is not collected from their clients. The agency is considered to be completely transparent and straightforward in its operations, which are managed by a board of directors consisting of a governor, a vice-governor, and three members who are not government officers.³¹² The core objectives of SAMA include the consistent issuance of the Saudi currency, the Saudi Riyal, and the stabilisation of both its external and internal values.³¹³ Another objective is to deal with the banking affairs of the Kingdom, using the authority vested in it by the Banking Control Law of 1966, giving it broad supervisory powers to issue rules, regulations, and guidelines, in accordance with both domestic and international law.³¹⁴ This agency is also responsible for the regulatory control of both the conventional and the Islamic banks, along with exchange dealers operating in the Kingdom. It has the authority to examine applications for the granting of banking licences and to decide ownership of an existing bank.³¹⁵ These various supervisory functions of SAMA are exercised by comprehensive monitoring of the banks, conducted both offsite and onsite.³¹⁶

The Affin Bank is one of the most appropriate examples showing that the requirement to comply with Sharia law is not closely adhered to by the Saudi

³¹⁰Latham and Watkins LLP. 2010. *Doing business in Saudi Arabia*. [Online]. Available at: http://www.lw.com/upload/pubcontent/pdf/pub3507_1.pdf [Accessed on: 18 May 2015].

³¹¹Mirela Nichia, Meral Kagitci and Marcel Vulpoi, ‘ISLAMIC BANKING SYSTEM. THE CASE OF THE KINGDOM OF SAUDI ARABIA’. *Romanian Economic and Business Review – Special issue*, pp. 211, 213.

³¹²Majid, S. and Majid, F. 2009. Application of Islamic law in the Middle East: Interest and Islamic banking. [Online]. Available at: <http://www.iraqilawconsultant.com/puplications/majid/article09.html> [Accessed on: 9 July 2015].

³¹³Köhn, D. 2011. *Mobilising Capital for Emerging Markets: What Can Structured Finance Contribute?* Springer, p. 118.

³¹⁴Oxford Business Group. 2007. *The Report: Emerging Saudi Arabia*. Oxford Business Group.

³¹⁵Köhn, D. 2011. *Mobilising Capital for Emerging Markets: What Can Structured Finance Contribute?* Springer, p. 118.

³¹⁶Ibid, pp. 12-16.

Arabian banks in the modern world.³¹⁷ “*Affin Bank Berhad (AFFINBANK) is a wholly-owned subsidiary of Affin Holdings Berhad which is listed on the Bursa Malaysia. AFFINBANK provides a suite of financial products and services that is catered to both retail and corporate customers*”. One of the most significant questions concerning unfair usage of the Islamic mechanism lies in the assertion that Islamic laws are not incapable of being adopted in a way that ensures universal compatibility; however, there are certain amendments that need to be made.³¹⁸ This incompatibility is not considered to be fatal for Islamic finance, as the problems that arise can be resolved by ensuring the adoption of a mechanism capable of producing fair results, along with adequate compliance with the relevant rules and bylaws.³¹⁹ It can be argued that legal systems of all types face many kinds of problems similar to those affecting the mechanisms adopted by Islamic banks, and that other governing legislatures are unjust and unfair in nature.³²⁰ This overview of the situation indicates that there is a need for certain amendments and adjustments.³²¹ This bank has also provided products and services related to Islamic banking through subsidiary of Islamic banking. Under the regulation of SAMA, Affin Bank deals in banking products that have compliance with principles and law of *Sharia*³²²

In a similar manner, only the English legal system was found to be able to manage and devise equity of redemption, and to uphold the doctrine of undue influence, several centuries after the invention of the mortgage.³²³ In this regard, it is necessary to proceed further and signify approval pertaining to the mechanism of Islamic finance. However, this does not necessarily indicate that

³¹⁷ Knoop, T.A. 2013. *Global Finance in Emerging Market Economies*. London: Routledge.

³¹⁸ Foster, N.H.D. 2006. *Encounters Between Legal Systems: Recent Cases Concerning Islamic Commercial Law in Secular Courts*. Amicus Curiae.

³¹⁹ *ibid.*

³²⁰ *ibid.*

³²¹ Karim, S.A. 2010. *The Islamic Moral Economy: A Study of Islamic Money and Financial Instruments*. Universal.

³²² About Affin Bank <http://www.affinbank.com.my/About-Us/About-AffinBank.aspx>>2016 [Accessed 27 October 2017].

³²³ Ali, H.A. and Naysary, B. 2014. Risk Management Practices in Islamic Banks in Kuwait. *Journal of Islamic Banking and Finance* 2(1), pp. 123-148.

the mechanism adopted by Islamic banks might not be completely Islamic.³²⁴ Thus, the case of Saudi Arabia apparently constitutes a circle that cannot be squared, wherein it may appear that Sharia-based law runs counter to the Western trend; yet the reality is that commerce plays a significant role. Sooner or later, the significance of circulation of credit will be realised in Saudi society.³²⁵ Thus, the concluding remarks of Foster allude to the proposition that there is no such rule of Sharia law in the country, although a portion of Sharia law could be selected and adapted to the Western environment.³²⁶

There are certain other factors that also contribute to the broadening of the difference between Sharia law and actual Islamic banking practices, which include the fact that there exists a common law for both commercial and Islamic banks in the country.³²⁷ The regulations are intended to suit the convenience of both types of bank; thus, common policies are framed on them. This leads to a moulding of the applicability of the rules and regulations on the banking system. In addition, the risk management policies adopted by the Islamic banks are not always in line with Sharia law. For example, the Basel regulations, imposed upon the banking industry at a global level in order to ensure adequate capitalisation, have certain features which are non-compliant with Sharia.³²⁸ This causes a divergence of banking practices from the principles of Sharia law, as the majority of Islamic banks that trade internationally find that they must comply with the Basel regulations in order to retain the confidence of international investors.³²⁹ The Western banking system functions differently to the Islamic system.

³²⁴Köhn, D. 2011. *Mobilising Capital for Emerging Markets: What Can Structured Finance Contribute?* Springer, p. 16.

³²⁵Ibid, p. 145.

³²⁶Foster, N.H.D. 2006. *Encounters Between Legal Systems: Recent Cases Concerning Islamic Commercial Law in Secular Courts*. Amicus Curiae, 2006, Ismal, R. 2005. Assessing Moral Hazard Problem in Murabaha Financing. *Journal of Islamic Economics, Banking and Finance* 5(2), p. 101.

³²⁷Islamic law (Shariah). n.d. [Online]. Available at: http://gulf-law.com/islamic_law.html [Accessed on: 7 July 2015].

³²⁸Ibid.

³²⁹How, J.C.Y., Karim, M.A. and Verhoeven, P. 2005. Islamic Financing and Bank Risks: The Case of Malaysia. *Thunderbird International Business Review* 47(1), pp. 75-94.

The Western style of mortgage financing has not been developed in the Saudi banking system; this is at least in part because interest-free loans are readily available to Saudi nationals from the government itself.³³⁰ However, the waiting time for receiving such loans is considered to be significant.³³¹ In the liberal economic environment of Saudi Arabia, there exist a number of products with great potential to diversify Islamic banking practices that are compliant with Sharia.³³² Such products are often implemented by banks on the basis of well-established consumer preferences and additional surplus-providing products, irrespective of their compliance with Sharia law.³³³

Moreover, there are certain issues pertaining to the religious execution of Sharia law, as Islamic banks use a product named *Tawarruq*, a kind of reverse *Murabaha*, whereby clients are able to obtain systematic loans whose features resemble those of an interest-based debt that is created for the purpose of trading in commodities.³³⁴ *Tawarruq* is also used as a liability, where depositors are provided with a fixed return that is not directly associated with the returns attained through the assets of the bank.³³⁵ It may be stated that *tawarruq* enables a buyer to obtain a commodity from the seller on a deferred payment basis, who in turn, sells it further to a different buyer on spot-payment basis. In such a manner, the buyer actually borrows cash to purchase a commodity in the initial stage. *Tawarruq* is often considered as being non-compliant with the Sharia principles since the intention with which a commodity is purchased is not for ownership purposes. It is often argued that the creation of an interest in the absence of an economic activity or transaction renders *tawarruq* non-sharia

³³⁰Hanif, M. 2011. Differences and Similarities in Islamic and Conventional Banking. *International Journal of Business and Social Science* 2(2), pp.168-172.

³³¹Ramady, M.A. 2010. *The Saudi Arabian Economy: Policies, Achievements, and Challenges*. Springer Science & Business Media.

³³²Hunt-Ahmed, K. 2013. *Contemporary Islamic Finance: Innovations, Applications and Best Practices*. John Wiley & Sons, p. 2.

³³³Holden, K. 2008. Islamic Finance: "Legal Hypocrisy" Moot Point, Problematic Future Bigger Concern. *Boston University International Law Journal* 25, p. 341.

³³⁴Ibid, p. 341.

³³⁵Siddiqi, A. and Hrubci, P. 2008. *Islamic Investments Funds Versus Hedge Funds*. GRIN Verlag, p. 55.

compliant.³³⁶ Thus, the Saudi Arabian banking regime is moving away from its traditional operations, which were in line with the requirements of Sharia law, leading to an increasingly wide divergence from the Sharia-compliant basic law of the Kingdom.³³⁷ The AAOIFI has issued certain Sharia-based standards that support the operation of *Tawarruq*.³³⁸ Firstly, the standards identify three real and distinct parties to the transaction, in the form of a customer, a seller, and a buyer. Furthermore, while the operation involves two sales (namely, sale 1 and sale 2), it is clearly distinguished from a pair of unconnected sales. Thus, in sale 1, customer A would purchase a commodity on a deferred payment basis from seller 1.³³⁹ Customer A is required to obtain real possession of the commodity. Sale 2 occurs when the same customer (A) then sells the same commodity to buyer 1, who could also be called a real or genuine third party.³⁴⁰ Thereafter, the commodity is relocated to the warehouse of buyer 1 from the warehouse of seller 1. The basic concern that arises is with regard to the actual movement of the commodity from one warehouse to the other.³⁴¹ Certain critics have argued that, in practice, Islamic banks introduce elements into *Tawarruq* that are non-compliant with Sharia law. Specifically, it is asserted that, in reality, the seller retains possession of the commodity as collateral security until the complete payment of the deferred amount is settled by the buyer.³⁴² Thus, there exists a certain contradiction between the operation of *Tawarruq* and the way in which it is described as per Sharia law.³⁴³

Warde contributes to this debate by asserting that a majority of Islamic banks would agree with numerous Sharia-based facts and principles. However,

³³⁶ Ahmed, H. 2011. *Product Development in Islamic Banks*. Edinburgh University Press.

³³⁷ Siddiqi, A. and Hrubí, P. 2008. *Islamic Investments Funds Versus Hedge Funds*. GRIN Verlag, p. 55.

³³⁸ Majid, S. and Majid, F. 2009. Application of Islamic law in the Middle East: Interest and Islamic banking. [Online]. Available at: <http://www.iraqilawconsultant.com/puplications/majid/article09.html> [Accessed on: 9 July 2015].

³³⁹ Siddiqi, A. and Hrubí, P. 2008. *Islamic Investments Funds Versus Hedge Funds*. GRIN Verlag, p. 55.

³⁴⁰ International Monetary Fund. 2002. *Islamic Financial Institutions and Products in the Global Financial System: Key Issues in Risk Management and Challenges Ahead*. International Monetary Fund, p. 215.

³⁴¹ *Ibid*, p. 235.

³⁴² *Ibid*, p. 235.

³⁴³ *Ibid*, p. 110.

the realm of finance is also required to respond directly to conditions in the real economy. Thus, it is governed by the principles of profit and loss sharing, interest-based lending, and risk sharing. All such principles and bylaws replace the conventional banking functions, such as speculation, *gharar*, and transactions associated with *haram*—or religiously forbidden and unethical—activities. However, this is considered to be an idealised picture of the theoretical form of Islamic finance, while, in reality, the scenario is very different. The differences can be best understood in terms of the evolving context of the industry, along with its direct interaction with conventional forms of banking and financing. The domain of Islamic finance extends beyond banking functions to include mutual funds, insurance services, securitisation, and other non-banking financial activities. There was a time, in the mid-1970s, when Islamic financial institutions were few in number and easily identifiable. More recently, the phenomenon has become very much more amorphous, as the evolution of the Islamic banking system has gradually blurred the differences between traditional banking and other conventional forms of banking.³⁴⁴

Besides this, Warde rightly highlights another complicating factor that has contributed to causing the divergence between traditional and modern forms of Islamic banking. The modern Islamic banking system, as followed in countries such as Saudi Arabia, is characterised by the increasing number of conventional financial institutions in the country. The proliferation of conventional banks in the Kingdom of Saudi Arabia has also contributed to the broadening gap between the products and services offered by Islamic banks, on one hand, and the corresponding legislative regulations, on the other. Moreover, the conventional banks operating in Saudi Arabia offer a certain range of their versions of Islamic products, along with their conventional products. This breadth of range is an important element of the variation to be found in the totality of Islamic finance products available in the economy of the country.³⁴⁵

³⁴⁴Warde, I. 2010. *Islamic Finance in the Global Economy*. Edinburgh University Press.

³⁴⁵Ibid

Another view of the divergence between the Sharia-compliant regulatory guidelines and modern Islamic financial practices is that of Hassan and Lewis, who affirm that recent developments in the political and economic conditions of Muslim countries, such as Saudi Arabia, have coincided with deliberate choices made by the governments of these Islamic nations as they emerged onto the global stage. It is clear that these choices have been coloured by their experience of colonial practices, leading the countries concerned to focus on repairing their damaged economies. Eventually, with the intention of re-establishing their religious and cultural identities, these Islamic nations developed their economies within national cultures, expressed in different languages, such as Urdu, Arabic, Persian, and English. Under these circumstances, the demand for an Islamic banking system had risen within the global Islamic economy.³⁴⁶

In the present situation, Western economists have studied the influence of Islamic banking upon economic relationships, and have further introduced different aspects of Islamic financing. These aspects could enable the Islamic banking sector to achieve success and to become more profitable through various means. The alternatives proposed by Western economists were partially in line with traditional forms of Islamic banking. Thus, the Islamic banking system has changed in multiple ways over a period of years, due to concomitant changes in the socio-cultural and economic environment of the banking system.³⁴⁷ In this regard, the major areas of concern relate to investment or participatory financing and trade financing. *Murabaha*, *Mudaraba*, and *Musharaka* are the three major Islamic modes of financing that have particular relevance to the fatwas of Islamic jurists, in terms of their operations. However, all three of these modes of financing are related to traditional Islamic financing, as all financial transactions work in accordance with the Islamic legal perspective. The next part of this discussion provides knowledge of legislative/legal requirements.

The legislative requirements are developed by jurisprudence on the foundation of Islamic law, in a process known as *fiqh*. *Fiqh* is considered differing

³⁴⁶Hassan, K. and Lewis, M. 2007. *Handbook of Islamic Banking*. Edward Elgar Publishing.

³⁴⁷Shari'ah rulings and finance. 2015. [Online]. Available at: <http://www.islamic-banking.com/shariah-rulings-finance.aspx> [Accessed on: 14 July 2015].

noticeably from Sharia in this way: *fiqh* refers to the ideas and inferences that are drawn by Muslim scholars, whereas Sharia law means the principles these scholars follow. Such pieces of evidence indicate that the concepts and practice of Sharia and *fiqh* must necessarily remain in harmony. However, it is inevitable that this will not be true in all cases, as there will be certain occasions in which conflicts arise between the two concepts. The two major sources from which the elements of Sharia law are framed are the Sunnah and the Quran. Because of this, some laws are regarded as divine in nature and significantly relevant, irrespective of the timeframe or the situation. Nonetheless, it cannot be denied that Islamic scholars have played a significant role in the process of developing Sharia law. They have been responsible for upholding existing laws, bringing in requisite amendments, and introducing new ones wherever deemed necessary.

The abovementioned requisites could also be applied to the example of the Ottoman Empire as it existed in the 19th century, during which Sharia law was codified. The main intention of this process of codification was not to make Sharia more legalistic in nature; rather, it was intended to resolve religious disagreements. A second intention behind codification was to westernise the legislative system of the country. Indeed, treating the ideas and thoughts of scholars as the basis of the reform of legal principles is considered to be a Western concept. It was previously much easier to develop an understanding of a single codified system, which could be referred to in order to resolve legal disputes. Once this codification was complete, there was a major shift of power over the legal system from Islamic scholars to the government. Thus, the historically established Sharia legislation, which was framed with reference to multiple sources of Islamic law, became more formalised, in response largely to the internal needs and requirements of the system as well as, in part, to the intention to westernise Saudi society to a certain extent. As a result of this process, there are certain elements of Sharia law that are not recognised in the modernised courts of Saudi Arabia, which has led to an increase in the legal risk to parties using financial products offered by Islamic banks. These parties are

exposed to the important risk of not being recognised in the courts. Such non-recognition is a clear example of the ways in which the substantial legal protection provided to parties through Sharia law can differ on the basis of variations in local legislation within the country. After gaining knowledge of differences between the Saudi regime and the nation's laws, the next section explains Islamic jurisdiction.

1.5 Islamic jurisdiction

Owing to the special nature of Islamic jurisprudence, the court of justice is required, as this system often leads to complexity in dealing with the issues that are raised by the counter parties. These issues arise in fields including the economy, politics, theology, etiquette, and marital relations. Given the variety of approaches to jurisprudence that are taken, there is a requirement to simplify the practice of jurisprudence, so reducing this complexity. Thus, to adopt the most comprehensive approach, it is essential that all aspects of Islamic law are covered and a complete view of the Islamic system is obtained. The objective of discussion presented in this section is to shine a light on the principles and theories on which the Sharia laws are based. Further, the implications of the Islamic laws in all aspects of the society, especially in the context of Saudi Arabia will also be presented.

The judicial system of Saudi Arabia has been criticised for not being able to resolve various disputes that arise under its jurisdiction, in spite of the existence of numerous committees whose function is to achieve such resolution.³⁴⁸ Special committees have been formed to implement laws beyond the purview of the judicial branch. All such committees fall under different administrative departments, within ministries such as the Ministry of Industry and Commerce, the Ministry of Information and Business, and even SAMA.³⁴⁹ Committee members are not subject to the same conditions regarding

³⁴⁸Hallaq, H.B. 2009. *An Introduction to Islamic Law*. Cambridge University Press.

³⁴⁹EI-Gamal, M.A. 2006. *Islamic Finance: Law, Economics, and Practice*. Cambridge University Press.

qualifications that apply to the appointment of judges. Thus, the setting up of a huge number of committees, with the intention of supporting the judicial system of Saudi Arabia, has instead exacerbated the situation by creating conflicts with the principles. Recently, the Saudi Arabian government has imposed numerous steps for the creation of a new judiciary law, with the intention of reforming the overall judicial system, which it plans to implement in several stages. An important stage of this entails the transfer of the jurisdiction of the Islamic committees to the courts, although there has been a delay in the application and implementation of the proposed changes because of rigid structure and framework. Even so, the changes in judicial principles and provisions mean that disputing parties face numerous real-time challenges in terms of recognition of their claims in the judicial arena, including in areas such as liquidity, differences in Islamic and Western countries' transactions, and issue of credit risk.³⁵⁰ These issues are exacerbated by the fact that there exists no concept of judicial precedent applicable to many of the cases.

Unlike English contract law, or that of other Western jurisdictions, which tends to be based on general doctrines and legal theories, contract law under the Islamic system is inclined to be highly specialised in its different rules. The rules of Islamic contract law have been developed in order to ensure the regulation of different types of agreement. It is distinct from other legal systems in terms of its application of Islamic banking principles that are quite rigid. There is no all-embracing theory of Islamic contract law that applies to all types of contract, which indicates that it is not essential that all rules be applied. There exist different schools of thought on the application of Islamic law, each of which has its own idiosyncrasies and nuances. This explains why the approaches adopted by the Islamic courts are not recognised in any other courts of justice, for the purposes of validation or enforcement. The fundamental issue is the lack of formal presentation of these approaches in Islamic law. Islamic jurisdictions are concerned only with practice, so a formal statement of contract law simply does not exist within the Islamic system, which means that a student or practitioner of

³⁵⁰Hallaq, H.B. 2009. *An Introduction to Islamic Law*. Cambridge University Press.

English law will fail to understand or acknowledge the major principles or provisions of Islamic contract law.³⁵¹ The principles of Islamic finance are discussed in the next section.

1.6 Principles of Islamic finance

Finance principles represent actions and philosophies governing a set of systems and practices.³⁵² They provide a wide framework for developing and arranging financial transactions in accordance with global standards. Industry participants and financial authorities act in accordance with such principles.³⁵³ The Islamic financial industry similarly operates according to specific rules and principles, which play a significant role by providing a consistent context for transactions and activities within and across national and international boundaries.³⁵⁴ As well as their significance to the general operation of the Islamic financial system, these principles are also concerned with regulating the risks inherent in transactions.³⁵⁵ Because of the critical nature of the advice and services provided by industry participants, it is particularly important for them to be obliged to deliver high standards of service to their clients.³⁵⁶

Islamic financial institutions and participants are governed and regulated by the doctrine of Sharia, commonly termed Islamic law, which has emerged as one of the fastest growing segments of the Islamic finance industry.³⁵⁷ Since the establishment of the Dubai Islamic Bank in 1975, Islamic finance has expanded

³⁵¹ Alhowaimil, I.S. 2013. Frustration of performance of contracts: A comparative and analytic study in Islamic law and English law. [Online]. Available at:

<http://bura.brunel.ac.uk/bitstream/2438/8532/1/FulltextThesis.pdf> [Accessed on: 15 July 2015].

³⁵² Ayub, M. 2009. *Understanding Islamic Finance*. John Wiley & Sons, p. 2.

³⁵³ Mirakhor, A. and Iqbal, Z. n.d. *Islamic Banking*. International Monetary Fund, pp. 117-119.

³⁵⁴ Morrison, R. 2012. *The Principles of Project Finance*. UK: Gower Publishing Ltd, p. 265.

³⁵⁵³⁵⁵ Mirakhor, A. and Iqbal, Z. n.d. *Islamic Banking*. International Monetary Fund, p.119.

³⁵⁶³⁵⁶ Ilias, S. 2010 [Online]. Islamic finance: Overview and policy concerns. Available at:

<http://www.fas.org/sgp/crs/misc/RS22931.pdf> [Accessed on: 1 September 2012].

³⁵⁷³⁵⁷ Ariff, M. and Iqbal, M. 2011. *The Foundations of Islamic Banking: Theory, Practice and Education*. Edward Elgar Publishing, p. 55.

its reach across many countries.³⁵⁸ Presently, it operates in Bahrain, Sudan, the UAE, Egypt, Lebanon, and elsewhere. The global reach of Islamic financial institutions also contributes positively towards enhancing the asset base of the economy.³⁵⁹

In the initial years, Islamic finance was concentrated mainly in South-East Asia and the Middle East, while Islamic financial principles were less prevalent in other parts of the world.³⁶⁰ This situation has been completely transformed in the present decade, with the presence of Islamic finance in almost all economies, both developing and developed.³⁶¹ Thus, Islamic financial principles, such as the prohibition of *gharar* (excessive uncertainty) and *maysir* (gambling), coexist with conventional financial systems in developing countries including the UAE, Malaysia, and Indonesia, where the Islamic sector tends to dominate.³⁶² Although fewer Islamic financial institutions operate in developed economies, they have reported remarkable performance in the last few years, operating through financing windows in collaboration with large conventional banks.³⁶³

The global expansion of Islamic finance institutions has complemented parallel developments in the range of financial products. Initially, there was a very small portfolio of Islamic finance, with many prohibitions.³⁶⁴ Investments in tobacco, alcohol, and ornaments were permitted, with many applicable restrictions. Yet today, Islamic financial products cover a wide range of services, including asset management, exchange settlement, insurance, risk management,

³⁵⁸³⁵⁸ Wilson, R. n.d. The evolution of the Islamic financial system. [Online]. Available at: <http://www.sc.com.my/eng/html/iaffairs/ioscoislamicpdf/aaeuromoneych2.pdf> [Accessed on: 1 September 2012].

³⁵⁹ Mirakhor, A. and Iqbal, Z. n.d. *Islamic Banking*. International Monetary Fund, pp. 121-122.

³⁶⁰ Abdal, A., Al-Smadi, M. and Almsafir, M.K. 2012. Islamic Finance Versus Conventional Finance, From Macroeconomic Perspective: A Review. *Journal of Islamic and Human Advanced Research* 2(4), pp. 419-430.

³⁶¹ Ariff, M. and Iqbal, M. 2011. *The Foundations of Islamic Banking: Theory, Practice and Education*. Edward Elgar Publishing, p. 48.

³⁶² Islamic finance forays successfully in Africa. 2012. [Online]. Available at: <http://www.ventures-africa.com/2012/09/islamic-finance-forays-successfully-in-africa/> [Accessed on: 31 December 2012].

³⁶³ Ibid.

³⁶⁴ Ayub, M. 2009. *Understanding Islamic Finance*. John Wiley & Sons, pp. 6-10.

and many others.³⁶⁵ The Islamic financial service industry has achieved high growth and strong momentum in the market.³⁶⁶ In a changing global financial landscape, Islamic institutions have gone beyond their traditional core-banking role and focused on expanding the role of financial intermediary, offering an Islamic product analogous to each conventional one.³⁶⁷ The wide availability of financial products also enhances the competitive position and image of the Islamic finance system.³⁶⁸

The rapid development of financial products and services has also highlighted the need to standardise and regulate the supervision of transactions by the application of various Islamic principles.³⁶⁹ These Islamic principles help to promote the economic development of the country in three ways. Firstly, it provides a direct link between transactions that are physical in nature and the real economy; secondly, it opposes the production of harmful products and services; and, lastly, it aims to promote social and economic justice in the country. While discussing the theoretical aspects of Islamic principles, the risks faced by Islamic financial institutions are relatively lower than that of their conventional counterparts. Under these principles, agreements between the parties work as techniques for controlling and mitigating the risk factor. Techniques such as up-front payment of commitment fees, appointment of the client as an agent of the bank for the purchase of an asset, and rebate on the mark-up amount assist in providing risk management assurance to investors. Islamic financial institutions, including the Islamic Financial Services Board, the Accounting and Auditing Organisation, and the Islamic Development Bank, in Saudi Arabia, have the task of introducing these principles, while many other

³⁶⁵Iqbal, Z. 2008. The Impact of Consolidation on Islamic Financial Service Industry. *Islamic Economic Studies* 15(2), pp. 80-100.

³⁶⁶Ayub, M. 2009. *Understanding Islamic Finance*. John Wiley & Sons, pp. 29-32.

³⁶⁷Ibid, p. 112.

³⁶⁸Takaful Islamic insurance. 2012. [Online]. Available at: http://www.islamic-banking.com/prohibition_of_gharar_masir_riba.aspx [Accessed on: 29 August 2012].

³⁶⁹Ayub, M. 2009. *Understanding Islamic Finance*. John Wiley & Sons, p. 196.

national and international organisations are also involved in the regulation of the finance industry.³⁷⁰

The legal framework of the Islamic finance industry revolves around and is controlled by Sharia and its interpretation.³⁷¹ Islamic finance and banking activities are significantly different from the conventional banks operating around the world. Sharia control over Islamic banks and other financial institutions in the non-Islamic countries is useful to keep track on banking activities, so as to determine their compliance with the Sharia laws.³⁷² .³⁷³ The principles of the Holy Quran and the teachings of the Sunna (the life of the Prophet Muhammad) are also followed in the Sharia guidelines and legal framework.³⁷⁴ All aspects of Islamic financial transactions are thus governed by the moral codes and religious principles of Sharia, whose basic theme is to ensure that income and wealth are distributed equally among all citizens.³⁷⁵ Moreover, the principles also help investors with the available techniques for mitigating risk. Honesty, transparency, fairness, and avoidance of tort have emerged as its integral elements.³⁷⁶ According to Sharia, money has no intrinsic value; therefore, it should be lent or received with the motive and expectation of earning a profit, which is termed *riba*. *Riba*, as a concept of Islamic finance refers to the interest that is charged on the deposits and loans, which in turn, is prohibited according to the Sharia laws.³⁷⁷ Sharia recommends legitimate, productive trade and investment in assets as the principal means of earning profit and generating

³⁷⁰The rationale of prohibition of riba. 2012. [Online]. Available at: <http://www.financialislam.com/prohibition-of-riba-maysir-and-gharar.html> [Accessed on: 29 August 2012].

³⁷¹Ayub, M. 2009. *Understanding Islamic Finance*. John Wiley & Sons

³⁷²*Ibid*, p. 32.

³⁷³*Ibid*, p. 32.

³⁷⁴Takaful Islamic insurance. 2012. [Online]. Available at: http://www.islamic-banking.com/prohibition_of_gharar_masir_riba.aspx [Accessed on: 29 August 2012].

³⁷⁵Al-Muharrami, S. and Hardy, D.C. 2013. *Cooperative and Islamic Banks: What Can They Learn from Each Other?* International Monetary Fund, p. 112.

³⁷⁶Ariff, M. and Iqbal, M. 2011. *The Foundations of Islamic Banking: Theory, Practice and Education*. Edward Elgar Publishing, pp. 53-55.

³⁷⁷The rationale of prohibition of riba. 2012. [Online]. Available at: <http://www.financialislam.com/prohibition-of-riba-maysir-and-gharar.html> [Accessed on: 29 August 2012].

wealth.³⁷⁸ A key requirement is that the risks emerging from any kind of trading activity should be shared between two parties: one providing the capital and the other using expertise to manage it.³⁷⁹ The concept of profit and loss sharing is also consistent with the philosophy that “profit is for those who bear risk”.³⁸⁰

Sharia also advocates the establishment of a Sharia supervisory committee to facilitate the review and monitoring of financial transactions, products, and services, to ensure they are Sharia compliant.³⁸¹ Owing to the presence of Sharia-compliant norms and rules in all sectors of the Saudi Arabian economy, this committee holds significant importance. The committee also certifies financial transactions and expresses legal opinions regarding these.

The principles other than Sharia governing Islamic financial transactions are:

- Prohibition of *riba*, meaning usury or excess of interest, i.e. increase in capital without any provision of service, or the exchange of commodities in unequal quantities. This emphasises the elimination of debt-based financing from the Islamic economy.³⁸²
- Prohibition of *gharar* (uncertainty), thus ensuring full and proper availability of information in financial contracts and transactions.³⁸³
- Prohibition of *maysir*, meaning the financing of any socially irresponsible or illegal activity³⁸⁴
- A risk-sharing attitude among financial participants should be encouraged, in accordance with the profits and losses.³⁸⁵

³⁷⁸ Al-Muharrami, S. and Hardy, D.C. 2013. *Cooperative and Islamic Banks: What Can They Learn from Each Other?* International Monetary Fund, p. 68.

³⁷⁹ Jaffer, S. 2004. *Islamic Asset Management: Forming the Future for Shari'a-Compliant Investment Strategies*. London: Euromoney Books, p. 101.

³⁸⁰ Temporal, P. 2011. *Islamic Branding and Marketing: Creating a Global Islamic Business*. US: John Wiley & Sons.

³⁸¹ Faboozi, F.J. and Mann, S.V. 2005. *Securities Finance: Securities Lending and Repurchase Agreements*. US: John Wiley & Sons.

³⁸² Kettell, B.B. 2011. *The Islamic Banking and Finance Workbook: Step-By-Step Exercises to Help You Master the Fundamentals of Islamic Banking and Finance*. John Wiley & Sons.

³⁸³ Thomas, A.S. 2006. *Interest in Islamic Economics: Understanding Riba*. New York: Routledge, p. 65.

³⁸⁴³⁸⁴ Kettell, B.B. 2011. *The Islamic Banking and Finance Workbook: Step-By-Step Exercises to Help You Master the Fundamentals of Islamic Banking and Finance*. John Wiley & Sons.

³⁸⁵ Ibid, p. 19

- Materiality, meaning that economic transactions should be real and related to money, and that they must have “material finality”.³⁸⁶
- Avoidance of the exploitation of anyone involved in a financial transaction³⁸⁷

These principles will explain the workings of the financial institutions in Saudi Arabia, along with the basic structure under which they operate. It helps in identifying the appropriate actions that are required to mitigate risks, both legal and those related to *Murabaha*. These principles are explained in detail below.

Prohibition of riba

The principle of prohibiting usury, together with its interpretation, is central to the conduct of Islamic banking and financial transactions.³⁸⁸ The term *riba* literally means that the debtor or borrower is responsible for reimbursing the loan amount, irrespective of the loan size.³⁸⁹ A technical definition of *riba* is: “An unlawful gain derived from the quantitative inequality of the counter values in any transaction purporting to affect the exchange of two or more species which belong to the same genus and are governed by the same legal cause”.³⁹⁰ Thus, no kind of quantitative inequality in the loan amount should afford the parties any kind of benefit that does not comply with the legal standards set up by the government. This definition also emphasises the need to monitor and supervise financial transactions in order to reduce the chances of fraud and forgery.³⁹¹ While *riba*, as so defined, has its roots in the Arab world, the concept of usury was recognised historically by many other populations, including Egyptians, Hittites,

³⁸⁶ Ahmad, A.U.F. and Hassan, K. 2006. Riba and Islamic Banking. *Journal of Islamic Economics, Banking and Finance*, p. 56.

³⁸⁷ *Ibid*, p. 58.

³⁸⁸ Ayub, M. 2009. *Understanding Islamic Finance*. John Wiley & Sons, p. 59.

³⁸⁹ Kettell, B.B. 2011. *The Islamic Banking and Finance Workbook: Step-By-Step Exercises to Help You Master the Fundamentals of Islamic Banking and Finance*. John Wiley & Sons.

³⁹⁰ Thomas, A.S. 2006. *Interest in Islamic Economics: Understanding Riba*. New York: Routledge, p. 65.

³⁹¹ *Ibid*, p. 68.

Mesopotamians, and Phoenicians, prior to the establishment of Islam.³⁹² Finance scholars state that *riba* has emerged as the main motivating factor behind the flow of money and funds from surplus units to deficit units, with the objective of earning higher rent and interest. Therefore, its prohibition was introduced in order to curb such practices.³⁹³

In Islam, the teachings of the Holy Quran and Sunna prohibit any kind of excessive interest over and above the actual principal. These teachings have been interpreted in various languages, and finance scholars agree that usury, or interest, are strictly forbidden in Islamic transactions,³⁹⁴ thus encouraging and promoting the welfare of all members of society.³⁹⁵ It is argued that people depositing money with banks and financial institutions have developed a tendency to earn interest without any kind of effort or risk, whereas prohibiting *riba* will encourage citizens to invest their money usefully and productively by avoiding illegal practices.³⁹⁶ Productive trade and economic avenues provide depositors with adequate interest and profit, thus deterring them from indulging in unscrupulous or illegal activities in order to gain high rents or interest.³⁹⁷

Prohibition of gharar

Islamic law advocates the avoidance of uncertainty, or *gharar*, in contractual agreements, as it can lead to deception.³⁹⁸ The definition of *gharar* is: “the sale of probable items whose existence or characteristics are not certain,

³⁹² Ahmad, A.U.F. and Hassan, K. 2006. Riba and Islamic Banking. *Journal of Islamic Economics, Banking and Finance*.

³⁹³ Ibid, p 44.

³⁹⁴ Kettell, B.B. 2011. *The Islamic Banking and Finance Workbook: Step-By-Step Exercises to Help You Master the Fundamentals of Islamic Banking and Finance*. John Wiley & Sons.

³⁹⁵ Riba, bank interest and the rationale of its prohibition. n.d. [Online]. Available at: http://globalwebpost.com/farooqm/study_res/i_econ_fin/nejatullahs_riba.pdf [Accessed on: 8 June 2012].

³⁹⁶ Ahmad, A.U.F. and Hassan, K. 2006. Riba and Islamic banking. *Journal of Islamic Economics, Banking and Finance*, p. 115.

³⁹⁷ Ariff, M. and Iqbal, M. 2011. *The Foundations of Islamic Banking: Theory, Practice and Education*. Edward Elgar Publishing.

³⁹⁸ Kettell, B.B. 2011. *The Islamic Banking and Finance Workbook: Step-By-Step Exercises to Help You Master the Fundamentals of Islamic Banking and Finance*. John Wiley & Sons.

due to the risky nature which makes the trade similar to gambling”.³⁹⁹ The parties cannot determine the implication of contracts and agreements in advance; therefore, such contracts are deemed to be speculative transactions and, consequently, a form of gambling.⁴⁰⁰

The prohibition of *gharar* also has some practical relevance in the present business world. For instance, one cannot enter into an agreement in which the quantity, value, or any other element of the deal is uncertain, as it would be very difficult for buyers and sellers to sign any contract without being certain of its terms.⁴⁰¹ All material facts and related financial information, including the product description and price, must be clearly stated in order to avoid confusion.⁴⁰²

The imposition of an unclear contract may amount to the misappropriation of wealth, which is also considered unjust according to Islamic principles, hence the prohibition of uncertainty, gambling, speculation, and risk.⁴⁰³ Islamic principles forbid all transactions that result in injustice or the exploitation of either party.⁴⁰⁴ Transparency, disclosure, and accuracy should be cornerstones of all financial and economic transactions, in order to prevent one party from taking advantage of the weaknesses of another.⁴⁰⁵

The main reason for prohibiting *gharar* is to ensure the fully informed consent of each party before entering into any kind of contract or agreement.⁴⁰⁶ This requires full and accurate disclosure, so that parties are fully aware of the hazards, speculation, and risks involved in any transaction intended to be

³⁹⁹Iqbal, Z. and Mirakhor, A. 2011. *An Introduction to Islamic Finance: Theory and Practice*. US: John Wiley & Sons.

⁴⁰⁰Ibid, p. 29-30.

⁴⁰¹Henry, C.M. and Wilson, R. 2004. *The Politics of Islamic Finance*. Edinburgh University Press, p. 120.

⁴⁰²Prohibition of gharar in Islam. n.d. [Online]. Available at: <http://www.kantakji.com/fiqh/Files/Fatawa/A305.pdf> [Accessed on: 13 December 2012].

⁴⁰³Ayub, M. 2009. *Understanding Islamic Finance*. John Wiley & Sons.

⁴⁰⁴Ibid, p. 19.

⁴⁰⁵Iqbal, Z. and Mirakhor, A. 2011. *An Introduction to Islamic Finance: Theory and Practice*. US: John Wiley & Sons, p. 104.

⁴⁰⁶Alwosabi, M. n.d. The prohibition of gharar. [Online]. Available at: http://staff.uob.edu.bh/files/620922311_files/Prohibition-of-Gharar.pdf [Accessed on: 28 August 2012].

binding.⁴⁰⁷ They must have adequate and complete knowledge of the subject matter and its counter values.⁴⁰⁸ This is among the most crucial aspects of financial transactions that affect the exchange price.⁴⁰⁹ In addition, parties should not predetermine the profit likely to be accrued from the contract or agreement. This restriction is again imposed to avoid uncertainty and inaccuracy.⁴¹⁰

The prohibition of *gharar* also improves the financial base of the economy by avoiding any chance of unexpected losses and potential disagreements that may arise on account of insufficient information.⁴¹¹ Contracts free from any kind of uncertainty, risk, speculation, or gambling are more likely to result in productive economic output.⁴¹² Moreover, such contracts reduce the need for expensive and unproductive litigation.

The concept of *gharar* has certain aspects in common with those of *riba*. First, both prohibitions can be seen to disallow gambling, which is also addressed by *maysir*; it is considered illegal to gain from betting or gambling.⁴¹³ Secondly, the intention behind *gharar* is similar to that of *riba*, i.e. to protect the weaker members of society from exploitation.

Finally, a peculiar feature of *gharar* is that forward foreign exchange transactions are restricted under this concept, as exchange rates in such transactions are affected by interest differentials.⁴¹⁴ Another reason for this

⁴⁰⁷Henry, C.M. and Wilson, R. 2004. *The Politics of Islamic Finance*. Edinburgh University Press, p. 136.

⁴⁰⁸Alwosabi, M. n.d. The prohibition of gharar. [Online]. Available at: http://staff.uob.edu.bh/files/620922311_files/Prohibition-of-Gharar.pdf [Accessed on: 28 August 2012].

⁴⁰⁹Ebaugh, H.R. 2009. *The Gülen Movement: A Sociological Analysis of a Civic Movement Rooted in Moderate Islam*. US: Springer, p. 64.

⁴¹⁰Henry, C.M. and Wilson, R. 2004. *The Politics of Islamic Finance*. Edinburgh University Press, p. 155.

⁴¹¹Iqbal, Z. and Mirakhor, A. 2011. *An Introduction to Islamic Finance: Theory and Practice*. US: John Wiley & Sons, p. 104.

⁴¹²Hassan, K. and Lewis, M. 2007. *Handbook of Islamic Banking*. US: Edward Elgar Publishing, p. 38.

⁴¹³Ahmad, A. 2010. *Developments in Islamic Banking Practice: The Experience of Bangladesh*. USA: Universal-Publishers.

⁴¹⁴Islamic finance. n.d. [Online]. Available at: <http://www.acc.com/legalresources/quickcounsel/if.cfm> [Accessed on: 27 August 2012].

restriction is that forward foreign exchange transactions are a kind of investment contract whose subject matter is uncertain.⁴¹⁵

Prohibition of maysir

The prohibition of *maysir* restricts investment in any kind of socially irresponsible or illegal activity.⁴¹⁶ Any games of chance, in which the outcome is uncertain, including animal races, lotteries, casino-type games, and betting, are deemed socially irresponsible.⁴¹⁷ It is believed that participation in such activities nurtures a desire to earn a return from deliberately risky enterprises. Prohibiting *maysir* is intended to address a perceived tendency for members of Islamic societies to engage in activities that will earn them a high return in a short time.⁴¹⁸ In addition, such activities demand no special skills, knowledge, or effort, so they attract a wide customer base,⁴¹⁹ thus hampering economic growth.⁴²⁰ Therefore, Sharia law also prohibits games of chance and gambling. It is often argued that gambling and games of chance are win-lose activities, in that one party earns a significant return while the other loses.⁴²¹ Indeed, gambling losses may be severe enough to result in bankruptcy and insolvency, which lead in turn to many kinds of financial and societal problems.⁴²²

In other words, gambling and betting do not add a surplus to the existing societal wealth; therefore, such activities are restricted to prevent any kind of unnecessary harm to overall societal wealth. Islamic finance should give no

⁴¹⁵Bock, M. 2010. *Governance Risk Management and Financial Product Development in Islamic Financial Institutions*. UK: GRIN Verlag, p. 26.

⁴¹⁶Jamaldeen, F. 2012. *Islamic Finance for Dummies*. New Jersey: John Wiley & Sons.

⁴¹⁷Bock, M. 2010. *Governance Risk Management and Financial Product Development in Islamic Financial Institutions*. UK: GRIN Verlag, p. 10.

⁴¹⁸Henry, C.M. and Wilson, R. 2004. *The Politics of Islamic Finance*. Edinburgh University Press, p. 115.

⁴¹⁹Bock, M. 2010. *Governance Risk Management and Financial Product Development in Islamic Financial Institutions*. UK: GRIN Verlag, p. 7.

⁴²⁰Ibid, p. 9

⁴²¹Bock, M. 2010. *Governance Risk Management and Financial Product Development in Islamic Financial Institutions*. UK: GRIN Verlag, p. 339.

⁴²²Dewar, J. 2011. *International Project Finance: Law and Practice*. UK: Oxford University Press, p. 274.

space to any kind of speculative commercial transactions.⁴²³ Investors should study the relevant economic and financial data before making any investment decisions.⁴²⁴ Altogether, the Islamic finance world should encourage the investment of assets, skills, and labour instead of participation in gambling and speculative activities. These principles will enable identification of the techniques and methods through which the legal risks associated with *Murabaha* can be mitigated, along with the impact of these methods on the returns of transacting parties.

Principle of risk sharing

Another principle of Islamic finance is that risks should be shared fairly among providers of funds and entrepreneurs.⁴²⁵ Specifically, risk is to be proportioned between the parties in the same ratio as that in which they have agreed to share the profits and losses. The risk environment of the financial services industry is changing at a rapid pace.⁴²⁶ Price and risk of reward and return are increasing, and this encourages providers of funds to identify ways to address such risks.⁴²⁷ In addition, lenders and borrowers in the Islamic finance industry have suffered from the issue of unfair distribution of profits and losses.⁴²⁸

In light of this, Islamic finance has introduced the principle of risk sharing in proportion to profits and losses between providers of finance and entrepreneurs, or between borrowers and lenders. The rule is that borrowers and

⁴²³Bock, M. 2010. *Governance Risk Management and Financial Product Development in Islamic Financial Institutions*. UK: GRIN Verlag, p. 9.

⁴²⁴Archer, S. and Karim, R.A.A. 2007. *Islamic Finance: The Regulatory Challenge*. John Wiley & Sons, p. 25.

⁴²⁵*Ibid*, p. 129.

⁴²⁶Freedman, C. and Goodlet, C. 1998. The financial services sector: Past changes and future prospects, pp. 1-14. [Online]. Available at:

[http://mba.schulich.yorku.ca/SSB-Extra/FinancialPolicyResearch.nsf/Lookup/Overview_of_Issues_dp/\\$file/Overview_of_Issues_dp.pdf](http://mba.schulich.yorku.ca/SSB-Extra/FinancialPolicyResearch.nsf/Lookup/Overview_of_Issues_dp/$file/Overview_of_Issues_dp.pdf) [Accessed on: 28 August 2012].

⁴²⁷*Ibid*.

⁴²⁸Archer, S. and Karim, R.A.A. 2007. *Islamic Finance: The Regulatory Challenge*. John Wiley & Sons, p. 136.

lenders should share the profits and losses of the funded enterprise.⁴²⁹ “Funded enterprise” here refers to the manner of distributing the risks in accordance with the capital invested.⁴³⁰ This can also be understood in the sense of equally distributing the risk of investment in light of their venture capital contribution.⁴³¹

Some finance scholars distinguish between two components: the profit-sharing principle and the profit/loss principle.⁴³² According to the former, the profits of funded enterprises or financial transactions are distributed equally between owners and entrepreneurs.⁴³³ A symmetrical relationship exists, whereby the entrepreneur uses his knowledge and efforts to manage the funds provided by the owner.⁴³⁴ The peculiar feature of this finance method is that only the profits of the investment venture are shared, not the losses.⁴³⁵

The profit/loss principle, by contrast, concerns the equal distribution of both profits and losses. As above, the profits are distributed equally between the entrepreneur and the fund provider.⁴³⁶ In the case of a loss, the owner carries the financial risk, while the entrepreneur bears the loss of his time and effort. Thus the profit/loss principle denotes that owner and entrepreneur assume full partnership in the capital, management, and profit/loss distribution of the investment venture.⁴³⁷ Here, the profits or losses of the enterprise or financial transaction are shared between the owner and other capitalists in accordance with the proportion of capital invested.⁴³⁸ Knowledge about this will ensure that

⁴²⁹Abdullah, F., Hassan, T. and Mohamad, S. 2007. Investigation of Performance of Malaysian Islamic Unit Trust Funds: Comparison with Conventional Unit Trust Funds. *Managerial Finance* 33(2), pp. 142-153.

⁴³⁰Ibid.

⁴³¹Ibid.

⁴³²Thomas, A.S., Cox, S. and Kraty, B. 2005. *Structuring Islamic Financial Transactions*. UK: Euromoney Books, p. 47.

⁴³³Ibid, p. 47.

⁴³⁴Çizakça, M. 2011. *Islamic Capitalism and Finance: Origins, Evolution and the Future*. Edward Elgar Publishing.

⁴³⁵Thomas, A.S., Cox, S. and Kraty, B. 2005. *Structuring Islamic Financial Transactions*. UK: Euromoney Books, p. 47.

⁴³⁶Islamic finance. 2010. [Online]. Available at: <http://www.cpaaustralia.com.au/cps/rde/xbcr/cpa-site/Introduction-to-Islamic-financeand-common-terminologies.pdf> [Accessed on: 28 August 2012].

⁴³⁷Ibid.

⁴³⁸Draft of Shariah parameter reference 4: Musharakah contract 2010. [Online]. Available at: http://www.bnm.gov.my/guidelines/05_shariah/04_draft_shariah%20parameter_spr4.pdf [Accessed on: 28 August 2012].

there is proper and appropriate information available regarding the factors that affect the risks specific to Islamic modes of finance, which include profit and loss sharing (PLS) and the prohibition of debt-based transactions.

The principle of profit and loss sharing forms the fundamental basis of financial transactions in Islamic banking and finance activities. The key point of difference between the Islamic finance and conventional banking principles is the fact that the lender is not guaranteed a pre-determined rate of interest. The principle of equal profit, loss, and risk sharing forms the crux of Islamic banking and is adhered to very strictly.

Principle of materiality

The principle of materiality emphasises the linkage of economic transactions with monetary value.⁴³⁹ The reality of economic and financial transactions is quite significant in the Islamic finance world; such transactions must be real and linked to monetary value.⁴⁴⁰ Interpretation of this principle indicates that economic transactions can be real only when the information supporting them is real and honestly based on facts and figures.⁴⁴¹ The relevance, reality, and truthfulness of the financial statement are of crucial importance, as they provide reasonable grounds to rely on financial transactions. Misrepresentation or any sort of false information leads to confusion among investors and depositors, who, in the absence of true and relevant information, may make different judgments regarding financial transactions.⁴⁴² All material information having the potential to affect investors' intentions must be disclosed at the time of a transaction, in order to safeguard investors' interests.⁴⁴³

⁴³⁹ *ibid.*

⁴⁴⁰ Ahmed, J. 2012. Islamic financial transactions must be both lawful and ethical. [Online]. Available at: <http://www.global-briefing.org/2012/04/%E2%80%9Cislamic-financial-transactions-must-be-both-lawful-and-ethical%E2%80%9D/#auth> [Accessed on: 28 August 2012].

⁴⁴¹ *ibid.*

⁴⁴² Islamic finance. 2010. [Online]. Available at: <http://www.cpaaustralia.com.au/cps/rde/xbcr/cpa-site/Introduction-to-Islamic-financeand-common-terminologies.pdf> [Accessed on: 28 August 2012].

⁴⁴³ Simmons, M. 2006. *Security Operations*. US: John Wiley & Sons, p. 203.

Economic and financial transactions should clearly disclose to potential investors and depositors the return likely to be accrued, expressed in either percentage or numerical form.⁴⁴⁴ Availability of complete information about the risk and return increases the likelihood of an informed decision.⁴⁴⁵ Economic and financial transactions can be considered material only when they include the proper and complete set of information required by investors in making investment decisions.⁴⁴⁶

In addition, the consideration of financial transactions should be expressed only in monetary terms, abandoning the older concept of exchanging goods or other things in financial transactions.⁴⁴⁷ The principle of materiality aims to identify the forms of information that are significant to investors in the formulation of investment decisions. This assists investors in obtaining complete information about an organisation's financial position, as well as any other necessary disclosures, thereby playing a key role in assessing the risks.

Principle of avoiding exploitation in financial transactions

Exploitation in financial transactions can be understood as the illegal or improper use of financial or other resources in order to benefit one party at the expense of another.⁴⁴⁸ The principle of and reasoning behind its avoidance are closely related to those of other prohibitions discussed above. Exploitation in financial transactions can take various forms, such as fraud, forgery, misrepresentation of assets or cash, accounts, etc.⁴⁴⁹ The sudden transfer of assets and liabilities to others, differences in incomes and assets, sudden insolvency, and poor or no knowledge of finances, could all be indicators of some

⁴⁴⁴Çizakça, M. 2011. *Islamic Capitalism and Finance: Origins, Evolution and the Future*. Edward Elgar Publishing, p. 119.

⁴⁴⁵Islamic finance. 2010. [Online]. Available at: <http://www.cpaaustralia.com.au/cps/rde/xbcr/cpa-site/Introduction-to-Islamic-financeand-common-terminologies.pdf> [Accessed on: 28 August 2012].

⁴⁴⁶Faboozi, F.J. and Mann, S.V. 2005. *Securities Finance: Securities Lending and Repurchase Agreements*. US: John Wiley & Sons, p. 209.

⁴⁴⁷Ibid, p. 225

⁴⁴⁸Çizakça, M. 2011. *Islamic Capitalism and Finance: Origins, Evolution and the Future*. Edward Elgar Publishing, p. 112.

⁴⁴⁹Ibid, p. 115.

kind of financial exploitation, which is often imposed by intimidation or coercion.⁴⁵⁰ To protect investors and other stakeholders from such exploitation, the Islamic banking system follows principles consistent with Sharia law to avoid *haram* (forbidden) transactions.⁴⁵¹ The ultimate objectives and interpretation of other Islamic principles are somewhat related to this principle.⁴⁵² Like the others, it requires full disclosure of information, materiality, and avoidance of investment in illegal activities, so as to minimise the possibility of fraud, forgery, and misrepresentation. The avoidance of exploitation is also a goal in itself.⁴⁵³

Many transactions result in the exploitation of one or more parties, and this is emerging as one of the most serious problems in global finance today, exacerbated by technological advances.⁴⁵⁴ Regular reviews of financial fraud, scams, and identity theft, among many other ways of exploiting the vulnerable, underline the need for active prevention, not only in Islamic finance but throughout the world.⁴⁵⁵ Financial analysts and scholars argue that the parties involved in financial transactions often lack the knowledge and skills required to make informed investment decisions, making them vulnerable to exploitation, theft, and undue influence.⁴⁵⁶ People require assistance and support before entering into any financial transaction, including everyday ones.⁴⁵⁷

Financial exploitation is considered to be mistreatment in the context of Islamic finance. In general, Islamic financial principles affirm that no party should be permitted to take advantage of another. In other words, financial transactions should not lead one party to become unjustly enriched at the expense of any other party. In-depth understanding of these principles will assist in the

⁴⁵⁰Kechichian, J.A. 2013. *Legal and Political Reforms in Saudi Arabia*. New York: Routledge, p. 125.

⁴⁵¹Kettell, B.B. 2011. *The Islamic Banking and Finance Workbook: Step-By-Step Exercises to Help You Master the Fundamentals of Islamic Banking and Finance*. John Wiley & Sons, p. 15.

⁴⁵²*Ibid*, p. 18.

⁴⁵³Çizakça, M. 2011. *Islamic Capitalism and Finance: Origins, Evolution and the Future*. Edward Elgar Publishing.

⁴⁵⁴*Ibid*, p. 115.

⁴⁵⁵*Ibid*, p. 117.

⁴⁵⁶Kechichian, J.A. 2013. *Legal and Political Reforms in Saudi Arabia*. New York: Routledge, p. 125.

⁴⁵⁷The three principles of Islamic finance explained. 2005. [Online]. Available at: <http://www.iflr.com/Article/1984844/The-three-principles-of-Islamic-finance-explained.html>[Accessed on: 8 June 2012].

determination of factors affecting risks, in particular to Islamic modes of finance, and the measures that can be adopted to mitigate such risks.

This section has set out the principles on which Islamic finance operates. This will help us to understand the risks attached to the *Murabaha* contract, discussed later in the dissertation. Moreover, it supports us in understanding how Islamic banking works. The next section considers the ways in which Islamic finance deals with risk. This is a crucial section for us, as it will help us in understanding the specifics of *Murabaha* contracts and the risks associated with these.

1.7 Risks in Islamic finance

Risk means the probability of loss suffered, which may lead to the unavailability of cash or credit, as well as inefficient operations and loss of asset value.⁴⁵⁸ Risk, in any financial transaction, directly affects the interests of investors by making defaults in payment more likely.⁴⁵⁹ Risk in Islamic finance is a much debated concept, though it is relatively underexplored in the wider literature.⁴⁶⁰ Part of the reluctance to engage with it can be traced directly to the core tenets of Islamic finance, derived from Sharia, which have a long list of prescriptions and proscriptions against risk and interest.⁴⁶¹ Thus, it is unsurprising that scholars have struggled to quantify and specify the dimensions of risk associated with several Islamic finance instruments.⁴⁶² My aim is to contribute to the debate on risk in Islam by looking into possible ways to mitigate it when it comes to *Murabaha* contracts. In particular, there is evidence that the legal position on many different aspects of a given Islamic transaction is tenuous and will change according to the interpretation of different experts.⁴⁶³ In this essence, taking Saudi Arabia into consideration, it is relevant that the state has

⁴⁵⁸ Kechichian, J.A. 2013. *Legal and Political Reforms in Saudi Arabia*. New York: Routledge.

⁴⁵⁹ Usmani, M.T. 2004. *An Introduction to Islamic Finance*. Arham Shamsi, p. 11.

⁴⁶⁰ Ibid.

⁴⁶¹ Chachi, A. 2005. Origin and Development of Commercial and Islamic Banking Operations. *Islamic Economics* 18(2), pp. 3-25.

⁴⁶² Ibid, p. 329.

⁴⁶³ Usmani, M.T. 2004. *An Introduction to Islamic Finance*. Arham Shamsi, p. 15.

no constitution, but instead a basic law comprising 83 articles that stipulate the rights and duties of various bodies and the basic principles of the government.⁴⁶⁴ This makes understanding the exact implications of a transaction difficult, so the literature has meandered around the issue.⁴⁶⁵ Many scholars have decried the tendency to avoid engaging with this issue, arguing that it needs to be addressed in order to deal more easily with international law and conventional legal regimes.⁴⁶⁶ After all, if the counterparties to any given Islamic finance transaction are not even sure about the exact nature of their rights and liabilities, they will be unable ex ante to decide whether it is financially and economically viable for them.⁴⁶⁷

On the other hand, within the context of the global financial crisis of 2008, investors across the globe have awoken to the need for effective risk appraisal, and Islamic finance is no exception to this. The systematic failure of financial regulation causes credit crunch,⁴⁶⁸ and puts the spotlight on risk and its proper assessment, while, on the other hand, many recent narrow interpretations of Sharia have made the task of defining the exact risks attached to Islamic financial instruments even more difficult.⁴⁶⁹

In this context, considering the statistics, the strength of the Islamic banking system can reasonably be represented by the growth in total value of financial assets held by Islamic banks.⁴⁷⁰ According to global financial records, the total value of financial assets was US\$140 trillion in 2006.⁴⁷¹ The Islamic financial market has grown rapidly in the present decade, reaching nearly double this value.⁴⁷² Notwithstanding the concerns noted above, the high proportion of

⁴⁶⁴Kechichian, J.A. 2013. *Legal and Political Reforms in Saudi Arabia*. New York: Routledge.

⁴⁶⁵Ibid, p. 120.

⁴⁶⁶Ibid.

⁴⁶⁷Ibid.

⁴⁶⁸Levine, R. 2010. The governance of financial regulation: Reform lessons from the recent crisis. [Online]. Available at: <http://www.bis.org/events/conf100624/levinepaper.pdf> [Accessed on: 31 December 2012].

⁴⁶⁹Sharia finance. 2012. [Online]. Available at: <http://www.islamic-bank.com/sharia-finance/> [Accessed on: 28 August 2012].

⁴⁷⁰Askari, H., Iqbal, Z. and Mirakhor, A. 2011. *Globalization and Islamic Finance: Convergence, Prospects and Challenges*. US: John Wiley & Sons, p. 98.

⁴⁷¹Ibid, p. 98.

⁴⁷²Usmani, M.T. 2004. *An Introduction to Islamic Finance*. Arham Shamsi, p. 18.

asset holding, together with non-involvement in speculative or risky transactions, appears to have made Islamic banks and financial institutions more flexible in handling the impact of the international economic and financial crisis.⁴⁷³ Some investment and financial analysts have attributed the growth and development of the Islamic financial industry to the capability of Islamic banks to handle the global decline in demand and investor confidence in a proper and efficient manner.⁴⁷⁴ The Islamic finance industry earned global revenues worth around US\$1 trillion in 2009.⁴⁷⁵ The Islamic capital market, on the other hand, achieved revenues of US\$35 billion in 2007. There was some decline in revenue to US\$15 billion in 2008, but growth of around US\$20 billion was reported in 2009.⁴⁷⁶ These figures demonstrate a recent pattern of growth in the Islamic finance industry, which has led to its emergence, in a relatively short span, as a major feature of the global financial landscape.⁴⁷⁷ The industry has enjoyed consistent growth of about 10-15% annually with the establishment of a Jeddah-based multilateral development institution. *Sharia*-compliant banks and financial institutions function in more than 70 countries, with total assets exceeding US\$875 billion, according to some estimates.⁴⁷⁸

Banking in Saudi Arabia consists of two separate yet interdependent systems. Conventional banks function like commercial and investment banks elsewhere in the world, while, for the past two decades, there have also been Islamic banks operating under *Sharia* principles. The two types have functioned side by side, and have provided investors with complementary services.⁴⁷⁹ This has led to significant problems, especially due to the changing nature of interpretations given by Islamic scholars attached to each Islamic bank, on one

⁴⁷³Islamic Sharia Council. 2012. [Online]. Available at: <http://www.islamic-sharia.org/> [Accessed on: 8 September 2015].

⁴⁷⁴Akbarzadeh, S. 2001. *Muslim Communities in Australia*. US: UNSW Press, pp. 191.

⁴⁷⁵Hesse, H. 2008. Trends and Challenges in Islamic Law. *World Economics* 9(2), pp. 175-193.

⁴⁷⁶Ilias, S. 2010 [Online]. Islamic finance: Overview and policy concerns. Available at: <http://www.fas.org/sgp/crs/misc/RS22931.pdf> [Accessed on: 1 September 2012].

⁴⁷⁷Usmani, M. T. 2004. *An Introduction to Islamic Finance*. Arham Shamsi, p. 112.

⁴⁷⁸Understanding Shariah investment. 2008. [Online]. Available at: http://www.rreef.com/content/media/Research_Understanding_Shariah_Investment_June_2008.pdf [Accessed on: 13 December 2012].

⁴⁷⁹Sharia finance. 2012. [Online]. Available at: <http://www.islamic-bank.com/sharia-finance/> [Accessed on: 8 September 2015].

hand, and the lack of standardisation in legal frameworks and procedures for appeal, on the other.⁴⁸⁰ This confusion has intensified the legal risks of various types of Islamic finance instruments offered in the country.⁴⁸¹

Islamic law is subjectively a supplement to Sharia that is specifically not predicted by either the Sunnah or the Quran. The legal system has been framed to represent the attempt of a Middle Eastern country to integrate Islamic law and Islamic culture with the principles of participatory government.⁴⁸² The basic law is the prevailing legal system in Saudi Arabia, covering the specific definitions of all state authorities, including the judiciary, legislative, and executive branches.⁴⁸³ As the system does not envisage a segregation of powers held by the executive and legislative branches, all branches possess undeniable powers that strengthen the current understanding of the law.⁴⁸⁴ This means that the legislative authorities have sufficient power to take legislative decisions.⁴⁸⁵

The banking law of Saudi Arabia embodies the regulations and roles of commercial banks and the central bank, as well as their relationships with foreign banks operating in Saudi Arabia.⁴⁸⁶ The law also provides various provisions through which all the activities of banks are governed.⁴⁸⁷

Overall, governance of banking in Saudi Arabia is handled by the Banking Control Regulation, which licenses all commercial banking and financial institutions.⁴⁸⁸ Licensed money changers are an exception to this rule, but they are not allowed to conduct any other banking activity.⁴⁸⁹ Banking activities such as receiving money by way of fixed or current deposit accounts, issuing letters of credit or guarantee, or the collection and payment of cheques and drafts can be

⁴⁸⁰ Ibid.

⁴⁸¹ Islamic finance. 2005. [Online]. Available at: <http://news.bbc.co.uk/2/hi/business/3548656.stm> [Accessed on: 28 August 2012].

⁴⁸² Kechichian, J.A. 2013. *Legal and Political Reforms in Saudi Arabia*. New York: Routledge.

⁴⁸³ Ibid, p. 112.

⁴⁸⁴ Ibid, p. 116.

⁴⁸⁵ Ibid, p. 125.

⁴⁸⁶ Baamir, A.Y. 2013. *Shari'a Law in Commercial and Banking Arbitration: Law and Practice in Saudi Arabia*. Saudi Arabia: Ashgate Publishing Ltd.

⁴⁸⁷ Ibid, p. 112.

⁴⁸⁸ Islamic finance. 2005. [Online]. Available at: <http://news.bbc.co.uk/2/hi/business/3548656.stm> [Accessed on: 28 August 2012].

⁴⁸⁹ Ibid.

carried.⁴⁹⁰ Specifically, in the case of Islamic banks, their profit-sharing natures enable them to be more stable, yet, overall, the banking sector of Saudi Arabia remains prone to legal risks, as reported in this thesis.⁴⁹¹ The legal involvement of banks is directly related to their legal and regulatory compliance, their contractual rights, the effectiveness of their security, and other such concerns.⁴⁹²

The peculiarities of the Saudi legal system, along with the comparatively low level of investment flowing into Saudi Arabia from the international market, can be seen to have cushioned the country's banks from many of the risks to which the international market has been exposed.⁴⁹³ This is suitably demonstrated by the effects of the global financial crisis, which has resulted in the loss of reputation and image to numerous international banks and financial institutions.⁴⁹⁴ While the Islamic financial industry has also been affected, Islamic banks have shown relative resilience in terms of profitability, bank assets, and external bank ratings.⁴⁹⁵ The impact on them has not been as severe as on conventional banks, largely because the Islamic finance system has followed strict rules that have protected its position.⁴⁹⁶

In 2009, global financial markets began to see a positive transformation, with the financial sector experiencing remarkable growth, resulting in the overall development of regulatory frameworks and Sharia standardisation initiatives.⁴⁹⁷ The rapid growth and development of the global financial market has also benefited Islamic financial markets in terms of increased investment and trading opportunities.⁴⁹⁸ Investors and depositors have started turning to Islamic finance, because of the principles of Sharia discussed above, which prohibit transactions

⁴⁹⁰ Ibid.

⁴⁹¹ McCormick, R. 2010. *Legal Risk in the Financial Markets*. London: Oxford University Press.

⁴⁹² Ibid, p. 113.

⁴⁹³ Ibid, p. 114.

⁴⁹⁴ Saudi Arabian law overview. 2015. [Online]. Available at: http://www.saudilegal.com/saudilaw/11_law.html [Assessed on: 12 March 2015].

⁴⁹⁵ Zuhur, S. 2011. *Saudi Arabia Middle East in Focus*. USA: ABC-CLIO.

⁴⁹⁶ Ibid, p. 125.

⁴⁹⁷ Islamic finance. 2005. [Online]. Available at: <http://news.bbc.co.uk/2/hi/business/3548656.stm> [Accessed on: 28 August 2012].

⁴⁹⁸ Ibid.

that are risky or of uncertain value.⁴⁹⁹ The prohibition of *riba*, the sharing of risk, and the even-handed securing of the interests of both banks and their clients also appear to attract investors to Islamic finance.⁵⁰⁰ For instance, a recently established Islamic savings bank attracted more than 10,000 depositors.⁵⁰¹

The Islamic finance system has been gradually turned similar all over the world after the universal standards. Previously, there were slight differences in its operation across different countries, but international institutions such as the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) and the Islamic Financial Services Board (IFSB) are now establishing universal standards. The growth and development of the Islamic finance industry has made it a significant contributor to the global finance market.⁵⁰² Its strength and its increasing interaction with the Western financial market, as the latter emerges from crisis, have further boosted the growth and development of the industry, as evident from the expansion of Islamic financial institutions.⁵⁰³

In other words, the Islamic and Western finance industries have tended to reinforce one another since 2009.⁵⁰⁴ This mutual support maintains sound liquidity in the economy so that crises can be dealt with effectively. Islamic banks have met the needs of their clients by providing loans without *riba* and by sharing risks and returns, while Islamic insurance companies have provided financial assurance in critical and unexpected situations.⁵⁰⁵ The Islamic finance sector has witnessed phenomenal success in shared ownership and participation with

⁴⁹⁹ Ibid.

⁵⁰⁰ Kettell, B.B. 2011. *The Islamic Banking and Finance Workbook: Step-By-Step Exercises to Help You Master the Fundamentals of Islamic Banking and Finance*. New Jersey: John Wiley & Sons.

⁵⁰¹ Wilson, R. The evolution of the Islamic financial system. [Online]. Available at: <http://www.sc.com.my/eng/html/iaffairs/ioscoislamicpdf/aaeuromoneych2.pdf> [Accessed on: 31 December 2012].

⁵⁰² ⁵⁰² 12,000 delegates to discuss Islamic finance growth. 2012. [Online]. Available at: <http://english.mubasher.info/portal/CASE/getDetailsStory.html?goToHomePageParam=true&storyId=2208276> [Accessed on: 31 December 2012].

⁵⁰³ ⁵⁰³ Islamic Sharia Council. 2012. [Online]. Available at: <http://www.islamic-sharia.org/> [Accessed on: 14 September 2016].

⁵⁰⁴ ⁵⁰⁴ Akbarzadeh, S. 2001. *Muslim Communities in Australia*. US: UNSW Press, p. 189.

⁵⁰⁵ ⁵⁰⁵ Ibid.

financial intermediaries.⁵⁰⁶ In spite of its growth and progress, however, it remains far from achieving the objectives of institutionalising finance structures and minimising shared risk.⁵⁰⁷ The institutional structures of Islamic finance need to be modified within a framework of good corporate governance, in order to ensure sustainable growth, as well as to maintain the ability to meet demand for liquidity.⁵⁰⁸

All financial transactions are associated with certain risks, including liquidity risk, commodity risk, mark-up risk, and operational risk.⁵⁰⁹ For instance, the transaction-banking department faces a major challenge in measuring and monitoring liquidity risks, which may affect a business that lacks sufficient funds to meet its financial commitments on time. Liquidity is linked directly with market conditions, including the supply of and demand for money; thus, an unexpected liquidity crisis in an economy is a risk to transaction banking, preventing banks from offering the required funds to investors.⁵¹⁰ Liquidity risks threaten the easy availability of liquid funds in the market.⁵¹¹ Commodity risk is also a major issue in transactions, as financial institutions are not able to quantify future uncertainties due to fluctuations in commodity prices.⁵¹² However, the effect on Islamic finance is limited, as Sharia principles prohibit transactions that are risky, excessively uncertain, or tied to uncertain future events.⁵¹³ Against the background set out above, this research examines the particular risks associated with the Islamic financial transaction known as *Murabaha*, and further considers ways of mitigating these risks.⁵¹⁴

⁵⁰⁶ ⁵⁰⁶ El-Gamal, M.A. 2006. Islamic finance: Law, economics and practice. [Online]. Available at: <http://www.kantakji.com/fiqh/files/finance/n303.pdf> [Accessed on: 14 September 2016].

⁵⁰⁷ ⁵⁰⁷ *Ibid.*

⁵⁰⁸ ⁵⁰⁸ *Ibid.*

⁵⁰⁹ ⁵⁰⁹ *Ibid.*

⁵¹⁰ Islamic finance. 2005. [Online]. Available at: <http://news.bbc.co.uk/2/hi/business/3548656.stm> [Accessed on: 28 August 2012].

⁵¹¹ Ruozi, R. and Ferrari, P. 2012. *Liquidity Risk Management in Banks: Economic and Regulatory Issues Springer Briefs in Finance*. London: Springer Science & Business Media.

⁵¹² Islamic finance. 2005. [Online]. Available at: <http://news.bbc.co.uk/2/hi/business/3548656.stm> [Accessed on: 28 August 2012].

⁵¹³ *Ibid.*

⁵¹⁴ *Ibid.*

1.8 Murabaha

I will focus on a type of contract, the *Murabaha* contract. I have chosen to work on this contract because it is the most representative of the risks associated with Islamic finance in general. *Murabaha* is a type of Islamic financial transaction—involving a seller, a buyer, and a lender—that is commonly used to provide finance.⁵¹⁵ It is defined as a “mode of Islamic finance that refers to the sale of goods with a pre-agreed profit mark-up on the cost”.⁵¹⁶ The word *Murabaha*, which actually means ‘profit’, is ultimately derived from the Arabic word *riba*.⁵¹⁷ It is essentially a contract of sale in which a commodity is sold for profit. The seller is required to inform the buyer of the cost price of products and services, along with the selling price and the profit margin or mark-up.⁵¹⁸ In the modern world, *Murabahais* the most common and popular mode of Islamic financing; it is a technique used by Islamic banks across the globe.⁵¹⁹ It has been calculated that as much as 80% of the financial operations of Islamic banks belong to the category of *Murabaha*. The following analysis explains the overwhelming predominance of this particular mode of finance.⁵²⁰

Imagine that a client approaches a bank to seek the finance required for purchasing a particular product or service.⁵²¹ The money could be loaned to this customer with interest by a conventional, interest-based bank.⁵²² The customer would then use the loan to purchase the commodity or product in the open

⁵¹⁵Islamic finance. 2005. [Online]. Available at: <http://news.bbc.co.uk/2/hi/business/3548656.stm> [Accessed on: 28 August 2012].

⁵¹⁶Kettell, B.B. 2011. *The Islamic Banking and Finance Workbook: Step-By-Step Exercises to Help You Master the Fundamentals of Islamic Banking and Finance*. New Jersey: John Wiley & Sons, p. 43.

⁵¹⁷Ibid, p. 89

⁵¹⁸Ayub, M. 2009. *Understanding Islamic Finance*. John Wiley & Sons.

⁵¹⁹Murabaha. 2015.[Online]. Available at: <http://www.bankalfalah.com/islamicpk/corporate-banking/working-capital-finance/Murabaha/> [Accessed on: 3 July 2015].

⁵²⁰Al-Shamrani, A.S. 2014. Islamic financial contracting forms in Saudi Arabia: Law and practice. [Online]. Available at: <http://bura.brunel.ac.uk/bitstream/2438/9145/1/FulltextThesis.pdf> Accessed on: 10 July 2015].

⁵²¹Ahmed, H. and Khan, T. 2005. Risk management in Islamic banking. [Online]. Available at: <http://ebooks.narotama.ac.id/files/Handbook%20of%20Islamic%20Banking/Chapter%2010%20Risk%20management%20in%20Islamic%20banking.pdf> [Accessed on: 17 July 2015].

⁵²²Murabaha working capital. 2011. [Online]. Available at: <http://www.midf.com.my/our-product-a-services/development-finance-division/669> [Accessed on: 3 July 2015].

market. Due to the prohibition of *riba*, Islamic banks do not have this option open to them, so their operations and functions are not based on interest.⁵²³ In short, they cannot lend money to a client who is required to pay interest on the loan.⁵²⁴ The bank nevertheless has to make money from its operations to ensure its survival in the market.⁵²⁵ Thus, it cannot normally lend money to its clients at a zero interest rate, even if the provision of liquidity in the form of interest-free loans may represent some small proportion of total finance.⁵²⁶ *Murabaha* is prevented interest based transactions by serving zero interest based loan to the client for buying assets.

The alternative mechanism of *Murabaha* was therefore developed to allow banks to make money from providing finance to their clients without violating the Sharia prohibition of *riba*.⁵²⁷ Rather than lending money to an interest-paying borrower, the bank itself purchases the asset or commodity for cash, and then sells it at a fixed profit to the prospective customer.⁵²⁸ Unlike a straightforward purchase and resale trade, however, the bank allows the client to defer payment, as the client would not have entered into the transaction if he had had the necessary liquidity available to purchase the goods outright.⁵²⁹ Thus, the client enjoys immediate use of the asset without having to pay for it in full at once, while the Islamic bank is able to make a profit in exchange for its services in acquiring the commodity on behalf of the client.⁵³⁰ In order to ensure this transaction meets the Islamic standards of a legal sale, many requirements must

⁵²³Ali, H.A. and Naysary, B. 2014. Risk Management Practices in Islamic Banks in Kuwait. *Journal of Islamic Banking and Finance* 2(1), pp. 123-148.

⁵²⁴Albaraka. 2015. [Online]. Available at: http://www.albaraka.co.za/Islamic_Banking/Features_of_Marabaha_and_Leasing.aspx [Accessed on: 3 July 2015].

⁵²⁵Ali, H.A. and Naysary, B. 2014. Risk Management Practices in Islamic Banks in Kuwait. *Journal of Islamic Banking and Finance* 2(1), pp. 123-148.

⁵²⁶Ahmed, H. 2011. *Product Development in Islamic Banks*. Edinburgh University Press, pp. 86-90.

⁵²⁷*Ibid*, pp. 96-99

⁵²⁸Ali, H.A. and Naysary, B. 2014. Risk Management Practices in Islamic Banks in Kuwait. *Journal of Islamic Banking and Finance* 2(1), pp. 123-148.

⁵²⁹Albaraka. 2015. [Online]. Available at: http://www.albaraka.co.za/Islamic_Banking/Features_of_Marabaha_and_Leasing.aspx [Accessed on: 3 July 2015].

⁵³⁰*Ibid*, pp. 96-99.

be met.⁵³¹ *Murabaha* thus follows the principle of interest prohibition, allowing participants to enjoy profits and fees from the sale of assets or property without interest.⁵³²

Murabaha Many people have questioned the legality of *Murabaha* financing under Sharia law, due to the similarity of the profit or mark-up to interest or *riba*.⁵³³ The bank purchases the goods for the client at an agreed price, and then sells them to the client at cost plus a reasonable profit. Repayment of this sale price including mark-up is usually made in instalments, which the client pays to the bank at agreed intervals.⁵³⁴ The following section demonstrates the functioning of *Murabaha* financing.

The functioning of Murabaha financing

The operational details of *Murabaha* financing are best explained in terms of three steps, the first of which is to establish a contractual relationship between the bank and the client for the bank to purchase a commodity from the seller on behalf of the client. In the second step, the bank engages in a purchase agreement with the seller, and, finally, the third step is where the bank sells the commodity it has purchased to the client at a price that is calculated by adding a mark-up to the base price.⁵³⁵ Since the receivables of a *Murabaha* transaction are debts payable that are due on maturity, it cannot be sold for a price other than its face value in the secondary market.

The client takes physical possession of the goods from the bank and undertakes an obligation to repay the bank the agreed amount. There have been

⁵³¹ Murabaha. 2015. [Online]. Available at: <http://www.bankalfalah.com/islamicpk/corporate-banking/working-capital-finance/Murabaha/> [Accessed on: 3 July 2015].

⁵³² Khaldi, K. and Hamdoni, A. 2011. Islamic Financial Intermediation: Equity, Efficiency and Risk. *International Research Journal of Finance and Economics* 65, pp. 145-160.

⁵³³ Alexander, A.J. 2011. Shifting Title and Risk: Islamic Project Finance with Western Partners. *Michigan Journal of International Law* 3(3), pp. 572-611.

⁵³⁴ Ibid.

⁵³⁵ Ali, S.S. Islamic modes of finance and associated liquidity risks. [Online]. Available at: http://www.sbp.org.pk/departments/ibd/lecture_6_islamic_modes_finance_liquidity.pdf [Accessed on: 24 June 2015].

many instances identified where the customer entering into the *Murabaha* contract and the seller of the commodity are sister concerns. However, in many other cases, a bank customer enters into the purchasing agreement as an agent of the bank, and thereafter repurchases the same commodity from the bank at cost plus a profit, the whole of which must be paid at a predefined date.

In this model, the selling price of the commodity is calculated by adding a profit margin to the cost, that profit margin being set by the bank. For example, if a contract concerns the purchase of a commodity that costs US\$100,000, with a financing period of 10 years, and the bank sets a marginal rate of 5% annually, then the price of this commodity (cost + profit margin) would be US\$150,000. Furthermore, the *Murabaha* financing model is extended to meet the working capital requirements of organisations in the form of inventory financing, which can be considered to be similar to the short- or medium-term conventional loans provided by other financial institutions. Islamic banks provide an inventory financing facility to meet the day-to-day expenses of a business through participation term certificates, which certify that the bank will have a share in the profits of the organisation on a pro-rata basis for a certain period. However, financing in this way is not easy, as the organisation seeking finance is required to demonstrate, with sufficient evidence, that the project or business for which it requires finance is viable and will be profitable in the future.⁵³⁶

In addition to the example above, the mechanism of a mortgage transaction is considered to be a form of *riba* and is thus forbidden within the Islamic jurisdiction. For example, an individual may decide to retain a significant amount of money that has been borrowed from the mortgagee, and, in return, it could be promised that the principal amount, along with the mark-up value, will be recovered. This is deemed to constitute an interest-bearing loan, and it is therefore considered to be a forbidden form of financing. Thus, if an intention to separate the loan from the sale contract is taken to be the basic intention, Islamic

⁵³⁶Hanif, M. 2011. Differences and Similarities in Islamic and Conventional Banking. *International Journal of Business and Social Science* 2(2), pp.168-172.

jurists will condemn both secured and unsecured loans equally.⁵³⁷ Given this obstacle, the Islamic alternative to providing financial assistance for a commodity purchase is the *Murabaha* transaction. In this transaction, the eventual mortgagee is first required to purchase the property from the seller and obtains the direct title, or else title is obtained through a special-purpose vehicle (SPV). Thereafter, the bank can sell the property to the mortgagor on a credit basis; amortisation tables are used and fees are calculated on the basis of the same interest rate used for conventional mortgages. A single legal difference, according to Islamic finance practitioners, is that the mortgagor in such cases is involved as a party in the credit sale contract rather than the loan contract. In response to certain judicial requirements, the government-sponsored organisations that provide assistance with mortgage securitisation ensure that the documents to be signed contain terminology such as “borrower”, “loan”, and “note”. Furthermore, Sharia jurists have argued that such contracts remain one of the most permissible trades, in contrast to forbidden forms of borrowing with interest. As per the jurisdiction, the multiple sales requirements, together with the required use of documentation of title and SPVs, may increase costs associated with tax and other legal requirements. Another major difference pertaining to the jurists’ point is the peculiar structure used by Islamic banks for avoiding late payment penalties.

Other issues found to arise in this model of financing include failure to make due payments, as one of the primary requirements of Sharia law is not to increase the profit element included in the price of the commodity. This requirement presents difficulties for finance companies in monitoring compliance with repayments. To resolve this issue, an edict was passed providing for the levying of a penalty on any borrower who was persistently late in making payments, while, for minor lapses, the principle of mercy (*tarabum*) was introduced, making the provision that late-paying customers having legitimate excuses should not be penalised.

⁵³⁷El-Gamal, M.A. 2006. *Islamic Finance: Law, Economics, and Practice*. Cambridge University Press.

Another issue relates to the presentation of financial statements, as Islamic finance companies were found to be assigning the entire profit to income statements in the same accounting period in which the contract was formed. This approach showed these companies to be achieving better performance than other conventional financing companies. However, many international audit firms claimed that these profits should be spread over the life of the contract, and this issue was eventually resolved with the establishment of the AAOIFI, when it was decided that profits would henceforth be allocated in this manner by Islamic finance companies.

Murabaha is a contract involving the resale of goods by a lender (generally a bank) to a client (hereafter referred to as “the borrower”); the regulations of this mode of financing specifically allow the lender to earn interest on the transaction. However, it is graciously treated by Islam as a legally accepted form of financing, as it follows all the necessary legal principles. There should be certainty with regard to the rights and obligations between lender and borrower. One essential condition that is applied to all such contracts is that the borrower has a shortage of funds. The transaction is marked by two major phases. First, the parties meet and discuss the terms with each other. It is only after reaching a point of agreement that they both enter into the transaction. This discussion also clarifies all the details of the asset that the borrower is willing to purchase. In the second step, the parties must reach consensus regarding a mark-up price and the number of instalments in which the amount is to be paid by the borrower to the lender over a period of time. As per Islamic laws, the terms of the contract should be equally beneficial to both parties.

The execution of the transaction also takes place in a series of planned steps, in accordance with legally mandated guidelines. First, the lender purchases the asset from an outside party at a certain market price. His title should be free from any kind of charges, so that the transfer between the borrower and the lender can take place smoothly. The price at which the lender sells the asset to the borrower is obviously higher than the price he has paid to the outside seller. The borrower pays the mark-up price to the lender in the form

of a pre-scheduled series of instalments. The difference between the two prices represents the profit that the lender earns on the whole sale-purchase transaction. No oral or written contract is entirely free of risk of default by either of the parties, so a *Murabaha* contract is also subject to all such eventualities. In case the borrower fails to pay an instalment, the lender has the right to regain possession of the asset.

There is another slightly different form of *Murabaha* financing, which is referred to as the 'commodity *Murabaha*'. This instrument is used by banks to enhance their short-term liquidity. It has all the constituents of a basic transaction, such as a deferment of instalments over a period of time, along with contractual agreement between the two transacting parties, which, in this case, are both banks. One bank acts as buyer, while the other bank acts as seller. The mark-up price, repayment schedule, and all other important terms are decided in advance by the transacting banks. This commodity *Murabaha* basically performs similar functions to those of a short-term money market instrument, whose basic aim is to provide liquidity to the market. It should be noted that borrowing banks do not intend to keep possession of the underlying assets. Generally, the asset exchanged is a durable commodity having distinct characteristics. Therefore, the purchase and sale take place solely to facilitate liquidity in the market. These are fixed rate transactions (as opposed to floating rate transactions) and have a maximum tenure of one year. However, there may be an additional levy that must be borne by the borrower bank. Such a cost usually varies according to the volume of the contract.

The basic aim of an Islamic bank, in performing a commodity *Murabaha*, is to give a deposit to the customer and to generate returns. The complete depositing process begins with the acceptance of the warrant by the counterparty to the offer generated by the lending Islamic bank. The counterparty purchases the warrant on a deferred payment basis, and the prepayment value is agreed in advance between the two parties.⁵³⁸ Ownership of the warrant is thereby transmitted to the counterparty; however, payment is not made until the

⁵³⁸Schoon, N. 2010. *Islamic Banking and Finance*. Spiramus Press Ltd.

predetermined date. Thereafter, the counterparty requests the Islamic bank to sell the warrant, on its behalf, in the open market and the warrant reaches the end buyer. The counterparty is paid the spot counter value of the warrant, irrespective of the fact that the Islamic bank sells the warrant on its behalf, or the counterparty itself arranges the sale of the warrant in the open market. The counterparty makes the payment to the bank at a predetermined time in the future.

The net result of the movement of cash and warrants in the above procedure is that the Islamic bank is left with a due amount of money adjusted against the offsetting payment made to the counterparty. This offsetting payment is inclusive of a predetermined principal value, plus mark-up, which is performed at a predetermined future date; this creates a synthetic deposit that is taken by the Islamic bank.⁵³⁹ In the first three steps, the Islamic bank acts as a buyer of warrants for principal value. The client owns the warrant and requests the bank to act as agent on its behalf and to execute the sale of the warrant in the spot market. The Islamic bank further arranges for the sale of the warrant to a metal broker, which results in a synthetic interbank deposit that is placed by the Islamic bank along with the client.

Under the deposit-taking process of commodity *Murabaha*, the major aim of the Islamic bank is to take the deposit from the client and then make the repayment at an agreed and predetermined date, with the amount being inclusive of principal plus mark-up. In the case of the reverse *Murabaha*, the structure is such that the Islamic bank purchases the warrant and acts as an agent of the client, thus undertaking the purchasing procedure on behalf of the client. Thereafter, ownership of the warrant is transferred to the counterparty from the Islamic bank and the counterparty makes immediate payment of the due amount. Following the transmission of ownership, the counterparty invites the Islamic bank to sell the warrant on a deferred payment basis. Thus, ownership is again transmitted to the Islamic bank, which then sells the warrant to the end buyer in

⁵³⁹Schoon, N. 2011. *Islamic Asset Management: An Asset Class on its Own?* London: Edinburgh University Press.

return for a countervalue that is paid on the spot. Lastly, the Islamic bank makes payment to the counterparty, as per the predetermined timeline, with the payment amount being the sum of the original principal value and the mark-up.

In case of deposit given, it is significant to note that each step must be undertaken in the correct sequence, and ownership of the warrant must be transferred from one party to the other, before any other action takes place.⁵⁴⁰ In the first four steps, the Islamic bank acts as an agent of the client. Thereafter, the client owns the warrant and sells it back to the Islamic bank on a principal-to-principal basis as deferred payment of the amount, comprising the principal plus the mark-up value. The Islamic bank, as the owner, subsequently sells the warrant to the metal broker in return for an on-spot payment, which results in a synthetic interbank deposit that is made along with the Islamic bank.

The basic nature of *Murabaha* financing is such that the purchase price the customer is required to pay does not change even in the event the customer makes early payment.⁵⁴¹ For instance, in the case of default, or in a situation where the customer voluntarily undertakes to make payment prior to the due date, the amount due is not affected in any way. Such features of *Murabaha* create various legal issues, and the laws are aimed at protecting customers by way of limiting the financial charges that may be imposed upon them as a penalty for any delay in payment or as a reward for early payment. Thus, Islamic banks are required to ensure complete disclosure of the amounts their customers are due to pay, as well as the amounts that have already been collected.

There are certain specific conditions to which all of the parties associated with a *Murabaha* contract are required to adhere. The first and most important condition is the Sharia compliance of all parties. The commodity under consideration must be clearly defined and described in the written contract; however, it is not compulsory that it should be tangible. The market value must be specified, along with the mark-up charged by the lending Islamic bank for rendering the *Murabaha* financing services. In addition, the total amount due

⁵⁴⁰ Cattelan, V. 2013. *Islamic Finance in Europe: Towards a Plural Financial System*. Edward Elgar.

⁵⁴¹ Hassan, K. and Lewis, M. 2007. *Handbook of Islamic banking*. Edward Elgar.

must be clearly defined within the *Murabaha* contract, and must also be mutually agreed by the parties before commencement of the contract. Thus, Islamic banks are expected to add a profit or mark-up value before selling to a client to ensure that the contract is executed on a cost plus mark-up basis. The seller of the commodity is required to disclose any flaws within the commodities. Moreover, the parties are required to explain all aspects of the process of purchasing the commodity, such as the mode of payment, any middlemen involved, installation charges, and duration of supply. It is essential for the profit to be added by the seller before the commodity is sold to the client, in order to ensure that the basic functioning of the *Murabaha* contract is fulfilled. The main reason for this relates to the need to cover the risk of any delay in payment.

These requirements can be summarised by considering the two basic stages in which a *Murabaha* transaction is completed. The first stage entails an undertaking by the participating bank to perform a *Murabaha* transaction at the request of its client, in which the bank makes a promise to purchase the commodity on behalf of the client and the client promises to repurchase it from the bank.⁵⁴² It can be further stated that this promise does not in itself constitute a legally binding contract.⁵⁴³ If the client declines to fulfil his promise, then the bank is at risk for the amount it has spent purchasing the commodity on his behalf.⁵⁴⁴ At the second stage, the client agrees to a deferred payment schedule after receiving the commodity purchased by the bank.⁵⁴⁵ As such, a *Murabaha* transaction is based on two sale contracts, which comprise its main requirements; one is the process by which the commodity is acquired by the bank, and the other is the process by which the commodity is sold to the client.⁵⁴⁶

⁵⁴² Albaraka. 2015. [Online]. Available at: http://www.albaraka.co.za/Islamic_Banking/Features_of_Marabaha_and_Leasing.aspx [Accessed on: 3 July 2015].

⁵⁴³ El-Gamal, M.A. 2006. *Islamic Finance: Law, Economics, and Practice*. Cambridge University Press, p.116.

⁵⁴⁴ Dalel, G. and Bessem, T. 2013. "Mourabaha" Contract and Basis of Islamic Finance. *Interdisciplinary Journal of Contemporary Research in Business* 4(11), pp.157-161.

⁵⁴⁵ International Monetary Fund. 2002. *Islamic Financial Institutions and Products in the Global Financial System: Key Issues in Risk Management and Challenges Ahead*. International Monetary Fund, p. 215.

⁵⁴⁶ *Ibid*, p. 110.

These contracts, for the sale of the commodity concerned, should be real and separate transactions.⁵⁴⁷ Islamic banks use *Murabaha* in order to satisfy many different kinds of financing requirements.⁵⁴⁸ Thus, it is often used to provide finance for the purchase of consumer durables, such as household appliances and cars; to pay for housing or real estate; or to finance the purchase of machinery, raw materials, and equipment for clients operating in the production sector, among others.⁵⁴⁹ The most popular and common application of *Murabaha* is in the financing of short-term trade. In addition, *Murabaha* contracts can be used to provide finance for the import trade and to issue letters of credit.⁵⁵⁰

⁵⁴⁷ Cotran, E. and Lau, M. 2002. *Yearbook of Islamic and Middle Eastern Law: 2001-2002*. Brill, p. 116.

⁵⁴⁸ Albaraka. 2015. [Online]. Available at: http://www.albaraka.co.za/Islamic_Banking/Features_of_Marabaha_and_Leasing.aspx [Accessed on: 3 July 2015].

⁵⁴⁹ International Monetary Fund. 2002. *Islamic Financial Institutions and Products in the Global Financial System: Key Issues in Risk Management and Challenges Ahead*. International Monetary Fund, p. 215.

⁵⁵⁰ Ibid.

Figure 5: Murabahah

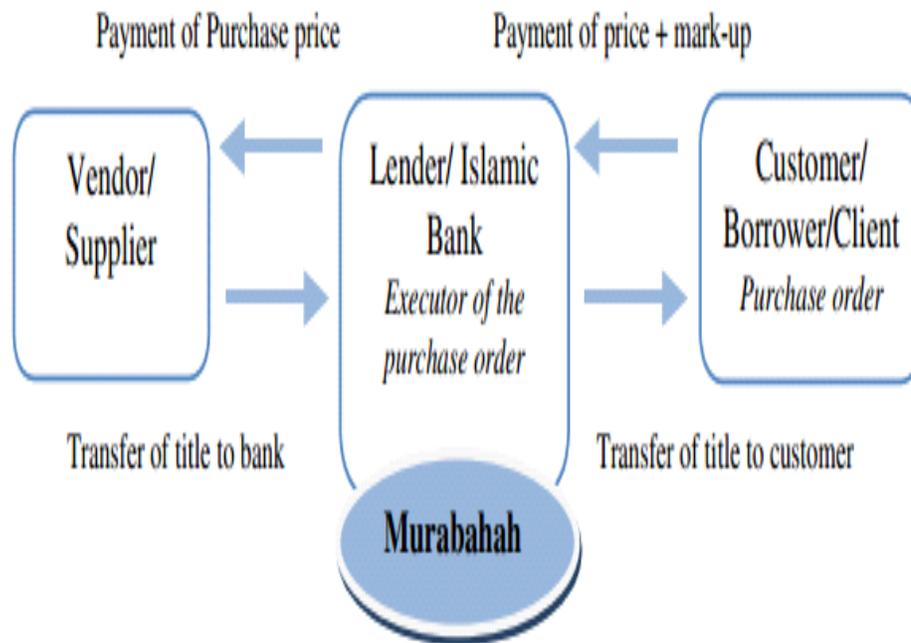


Figure 1: Murabaha Transaction

Figure 1 illustrates the details of a *Murabaha* transaction, in which an Islamic bank buys assets or goods from a third party vendor/supplier, as per a client's requirements.⁵⁵¹ The vendor transfers title to the bank as executor of the purchase order, which is then transfers it to the client and in turn client pays price plus a mark-up profit to the bank⁵⁵²In simple terms, the bank purchases a commodity from a supplier and sells to a borrower at cost plus profit.⁵⁵³ The customer pays this total sum in instalments. The goods most commonly subject

⁵⁵¹Islamic finance. 2005. [Online]. Available at: <http://news.bbc.co.uk/2/hi/business/3548656.stm> [Accessed on: 28 August 2012].

⁵⁵² Kayed, R.N. and Mohammed, K.M. 2012. Unique Risks of Islamic Modes of Finance: Systematic, Credit and Market Risks. *Journal of Islamic Economics, Banking and Finance* 5(3), pp. 9-34.

⁵⁵³Islamic finance. 2005. [Online]. Available at: <http://news.bbc.co.uk/2/hi/business/3548656.stm> [Accessed on: 28 August 2012].

to *Murabaha* include land, cars, machinery, and buildings.⁵⁵⁴The next section presents several advantages of *Murabaha* contracts, in order to reflect their positive aspects on contrary to the legal risks/negative side.

Advantages of Murabaha

Murabaha financing is a mechanism that has long been implemented in Islamic finance. The term refers to a particular type of simple sale that has no significance to the financial transaction.⁵⁵⁵*Murabaha* contracts have been adopted by Islamic banks for the purpose of applying a profit-and-loss sharing system within Islamic banking on a significantly larger scale, in order to resolve the associated difficulties and risks.⁵⁵⁶

The *Murabaha* contract is considered to be the primary manifestation of the price deferred sale.⁵⁵⁷*Murabaha* has now evolved to a point where it has become one of the most popular Islamic financing techniques, reported to have reached a proportion of 70% to 80% of the total volume of Islamic financing.⁵⁵⁸The overall structure of *Murabaha* contracts is comparatively straightforward compared with various other financing techniques offered by Islamic banks.⁵⁵⁹It consists of a declared mark-up that is integrated in the selling price of the commodity being traded in the transaction.⁵⁶⁰ This can be explained by considering the example of a constructor who is in need of financial aid to purchase equipment, the market value of which is US\$50,000.⁵⁶¹ One source of financing available to the constructor is to purchase the equipment from an Islamic bank under a *Murabaha* contract, whereby the bank buys it on his behalf

⁵⁵⁴Khaldi, K. and Hamdoni, A. 2011. Islamic Financial Intermediation: Equity, Efficiency and Risk. *International Research Journal of Finance and Economics* 65, pp. 145-160.

⁵⁵⁵International Monetary Fund. 2002. *Islamic Financial Institutions and Products in the Global Financial System: Key Issues in Risk Management and Challenges Ahead*. International Monetary Fund.

⁵⁵⁶*Ibid*, p. 145.

⁵⁵⁷*Ibid*, p. 110.

⁵⁵⁸Tariq, A.A. 2004. Managing Financial Risks of Sukuk Structures. [Online]. Available at: https://www.google.co.uk/?gws_rd=ssl [Accessed on: 24 June 2015].

⁵⁵⁹*Ibid*.

⁵⁶⁰*Ibid*.

⁵⁶¹*Ibid*, p. 110.

and he in turn buys it from the bank at cost plus mark-up, with payment of the repurchase price deferred for six months.⁵⁶² The final sale price will be US\$60,000, calculated inclusive of the agreed profit margin, transition cost, and the basic commodity value.⁵⁶³

The *Murabaha* financial instrument has numerous advantages for both the Islamic bank concerned and its client, the purchaser.⁵⁶⁴ The duration for which these Islamic banks bear risk is typically shorter than that applicable to alternative financial techniques and aids provided by other financial institutions.⁵⁶⁵ In addition, the profit margin is realised as soon as the transaction involving the sale and purchase is completed.⁵⁶⁶ *Murabaha* financing is considered a virtually risk-free mode of monetary investment, and it provides Islamic banks with a predetermined return on capital invested.⁵⁶⁷ A further argument in favour of *Murabaha* financing is that it provides the possibility for an Islamic bank to earn a profit without bearing the risk of possible losses, except in cases where a buyer defaults on payment or becomes insolvent.⁵⁶⁸ The specific risks attached to this type of contract are discussed in the following section, in order to outline the stakes and discuss the core issue of the mitigation of these risks.

Risks associated with Murabaha transactions

The purpose of this section of the dissertation is to present and understand the risks attached to *Murabaha* contracts. In the current dynamic

⁵⁶²Latham and Watkins LLP. 2010. Doing business in Saudi Arabia.[Online]. Available at: http://www.lw.com/upload/pubcontent/pdf/pub3507_1.pdf [Accessed on: 18 May 2015].

⁵⁶³Köhn, D. 2011. *Mobilising Capital for Emerging Markets: What Can Structured Finance Contribute?* Springer, p. 118.

⁵⁶⁴Murabaha. 2015. [Online]. Available at: <http://www.bankalfalah.com/islamicpk/corporate-banking/working-capital-finance/Murabaha/> [Accessed on: 3 July 2015].

⁵⁶⁵Farooq, M. 2006. Partnership, equity-financing and Islamic finance: Whither profit-loss sharing? [Online]. Available at: <http://www.assaif.org/content/download/33169/174359/file/IF%20partnership.pdf> [Accessed on: 24 June 2015].

⁵⁶⁶Schinas, O., Grau, C. and Johns, M. 2014. *HSBA Handbook of Ship Finance*. Springer, p. 115.

⁵⁶⁷Ibid.

⁵⁶⁸Ibid, p. 86.

business and economic environment, both conventional and Islamic banks operate under varied conditions, with implications for the risks faced by all parties to transactions,⁵⁶⁹ such as credit risk, operational risk, commodity-loss risk, payment default, and asset loss. All financial institutions seek to attract a wide customer base by minimising such risks.⁵⁷⁰ Those faced by parties to *Murabaha* transactions include credit risk, mark-up risk, operational risk, commodity risk, and liquidity risk.⁵⁷¹ Additionally, other legal risks can arise from faults in the system or the insolvency of parties.⁵⁷²

Credit risk occurs when a customer fails to make payment for an asset or commodity, due to financial or other difficulties. Other factors that may lead to credit risk for the bank include the destruction of property or assets before the customer takes possession.⁵⁷³ Defaults in payment or cancellation of promise may also result in liquidity risk. Mark-up risks, on the other hand, arise due to a fluctuation in the market rate of return. Once the rate of return is determined and fixed by banks and financial institutions, it cannot be changed frequently; thus, any modification in the price and quantity remains unfulfilled.⁵⁷⁴ This inflexibility has many adverse effects on banks, creating further pressure on the mark-up margins.⁵⁷⁵ Operational and commodity risks arise where the customer refuses to hold or purchase the asset, and the bank has difficulty in disposing of it by selling it to another party.⁵⁷⁶

Fluctuation in market return also represents a risk for the lender, having estimated the selling price on the basis of returns prevailing in the market.⁵⁷⁷ Market returns can fluctuate very rapidly, making it difficult for banks and other

⁵⁶⁹Islamic Sharia Council. 2012. [Online]. Available at: <http://www.islamic-sharia.org/> [Accessed on: 28 August 2012].

⁵⁷⁰Azwar, A. and Tajudin, A. 2010. Overview of Islamic finance. [Online]. Available at: <http://www.bankislam.com.my/en/Documents/shariah/OverviewOfIslamicFinance-13122010.pdf> [Accessed on: 27 August 2012].

⁵⁷¹Langton, J., Trullols, C., and Turkistani, A.Q. 2011. *Islamic Economics and Finance: A European Perspective*. United Kingdom: Palgrave Macmillan, p. 86.

⁵⁷²Esposito, J.L. 2010. *The Future of Islam*. UK: Oxford University Press, p.96.

⁵⁷³Islamic finance. 2005. [Online]. Available at: <http://news.bbc.co.uk/2/hi/business/3548656.stm> [Accessed on: 28 August 2012].

⁵⁷⁴Ibid.

⁵⁷⁵Hayes, S.L. 1998. *Islamic Law and Finance: Religion, Risk, and Return*. New York: Brill, p. 129.

⁵⁷⁶Morrison, R. 2012. *The Principles of Project Finance*. UK: Gower, p. 265.

⁵⁷⁷Ibid, p. 266.

financial institutions to keep pace with such changes. Losses may then arise as a result of deviations from the expected return.⁵⁷⁸

Actions for managing risks associated with Murabaha

The above discussion has identified a number of significant risks associated with *Murabaha* transactions. When these risks are high, the transaction may not work smoothly and effectively, so it is essential to identify some mitigating actions in order to ensure that they do so.⁵⁷⁹ This section outlines such risk management actions.

Credit and liquidity risks can be mitigated by keeping a certain amount of deposits and promising to purchase assets at the end of the contract period.⁵⁸⁰ This will help to cover losses in case of customer default or breach of contract. The risk of a payment default can be minimised by imposing a penalty on default, which will lead directly to a reduction in defaults.⁵⁸¹ Banks can reduce liquidity risks by entering into *Murabaha* transactions with suppliers and providing the products or commodities to the client only after he has agreed to the specified terms and conditions related to the product.⁵⁸² This action will reduce the incidence of financial default.⁵⁸³ Overall, the main area of concern for financial institutions is liquidity, which must be managed to ensure a sound position. I will develop approaches for risk mitigation in this dissertation, as my aim is to propose a framework to encourage the use of *Murabaha* contracts, while mitigating the associated risks.

1.9 Research Questions and Sub-Questions

⁵⁷⁸Pock, A.V. 2007. *Strategic Management in Islamic Finance*. US: Springer, p. 63.

⁵⁷⁹*Ibid*, p.66.

⁵⁸⁰*Ibid*, p. 69.

⁵⁸¹Islamic finance. 2005. [Online]. Available at: <http://news.bbc.co.uk/2/hi/business/3548656.stm>
[Accessed on: 28 August 2012].

⁵⁸²*Ibid*.

⁵⁸³*Ibid*.

In order to fill the gaps explained above, the research addresses a number of questions that reflect the phenomena to be studied. The main research question is: 'What legal risks are faced by parties involved in the Islamic financial transaction known as *Murabaha*, and how can these risks be mitigated without impacting the very nature of the *Murabaha* contract?' Answering this question is intended to provide deep insight into the risks associated with *Murabaha* and their ultimate influence on the potential gain from such transactions. The assumption is that the areas of risks in question include liquidity, solvency, profitability, and capital adequacy. A secondary research question is: 'What methods can be used to manage the legal risks associated with *Murabaha* transactions?'

In addition to these two questions, the following sub-questions are explored in this dissertation:

- What developments can be observed in the history of Islamic finance?
- What are the major principles of Islamic finance?
- How and to what extent would the various risk dimensions associated with *Murabaha* Islamic financial transactions directly affect the interests of the financial institutions and individuals involved?
- In what manner do the risks associated with *Murabaha* affect the Saudi Arabian legal system?

Answering these questions will provide sound knowledge of Islamic finance and the risks associated with *Murabaha* financing, along with the appropriate risk mitigation actions or strategies.

1.10 Research methodology

The research on exploring legal risks in *Murabaha* transaction is based on secondary information in which pertinent studies by different scholars and legal cases are used to gain understanding of sharia legal system, *Murabaha* transaction and legal risk associated with it. Secondary data about actions undertaken to deal with legal risks of *Murabaha* is also explored under this

research. This thesis is completely based on secondary information and thus, it is a qualitative methodology that used in it. Qualitative methodology in this research helps to reveal trends by reviewing previous scholars' thoughts and opinions for gaining deeper knowledge into the problem.

Murabaha Research Approach

In researching the legal risks associated with *Murabaha* contracts, the qualitative approach was used, as the research required in-depth information regarding this form of Islamic financial transaction, with respect to the structure, features, legal risks/risk dimensions, causes of legal risks, impact on shareholders and on the bank's functioning, and actions to lessen the legal risks has easily been collected.⁵⁸⁴The research undertaken has made use of secondary sources. The information regarding *Murabaha* transactions has been explored and studied to identify legal risks attached to the Islamic banking system, by examining contracts between banks and the other party.⁵⁸⁵ The information explored in this study is secondary in nature, which signifies that the research has used existing knowledge. In addition, secondary data is also used to obtain other researchers' viewpoints on the same topic, in the form of a literature review.⁵⁸⁶The main purpose behind using the contracts as the main method and secondary sources is to cover information about legal risks for exploring the hidden aspects from the perspective of detailed investigation.⁵⁸⁷

This research approach helps to explore existing theory on this topic, as relevant data and information is gathered using a secondary data collection method, i.e. literature review method.⁵⁸⁸ In addition, the inductive approach is

⁵⁸⁴Archer, S. and Karim, R.A.A. 2007. *Islamic Finance: The Regulatory Challenge*. John Wiley & Sons, p. 55.

⁵⁸⁵Ibid, p. 59.

⁵⁸⁶ Ibid, p. 645. Simonton, D.K. 2003. Qualitative and Quantitative Analyses of Historical Data. *Annual Review Psychological* 56, pp. 617-640.

⁵⁸⁷Creswell, J.W. 2002. *Research Design: Qualitative, Quantitative, and Mixed Methods Approaches*. 2nded. London: SAGE.

⁵⁸⁸Ibid, p. 125.

helpful in extending the derived theories and conclusions, regarding the research topic, from past experiences.⁵⁸⁹ The interview method has not been included, owing to the probability of receiving inadequate and/or incorrect data.⁵⁹⁰ In light of the sensitivity of the research issue under consideration, an interview methodology would demand knowledge from top financial executives employed at Islamic banks in Saudi Arabia, which would have been a difficult task.⁵⁹¹

Research design

Research design is one of the key aspects of the research methodology; it reflects the entire range of tasks involved in determining the research problem.⁵⁹² Appropriate research designs commonly used in research include experimental, descriptive, exploratory, cross-sectional design, case study, and causal research design.⁵⁹³ The exploratory research design is followed to perform a study of the legal risks involved in *Murabaha* transactions. This useful design offers a high degree of flexibility to researchers, as it provides an opportunity to have personal insight into the research data and to address the research problem in the most relevant way.⁵⁹⁴ Exploratory research design comprises multiple modes of data collection, namely experience survey, literature survey, and case study method, the latter of which was considered to be a feasible choice for the present research study.⁵⁹⁵

⁵⁸⁹ Jebreen, I. 2012. Using Inductive Approach as Research Strategy in Requirements Engineering. *International Journal of Computer and Information Technology* 1 (2), pp. 162-173.

⁵⁹⁰ McNabb, D.E. 2004. *Research Methods for Political Science: Quantitative and Qualitative Approaches*. M.E. Sharpe, p. 18.

⁵⁹¹ *Ibid*, p. 55.

⁵⁹² *Ibid*, p.115.

⁵⁹³ Axinn, W.G. and Pearce, L.D. 2006. *Mixed Method Data Collection Strategies*. 1sted . USA: Cambridge University Press, p. 158.

⁵⁹⁴ *Ibid*, p. 15. McNabb, D.E. 2004. *Research Methods for Political Science: Quantitative and Qualitative Approaches*. M.E. Sharpe, p. 12.

⁵⁹⁵ *Ibid*, p. 55.

A combination of these methods has been used to address the research problem, owing to the nature of the research and data requirements.⁵⁹⁶ Similarly, various data collection methods—including the review contracts and academic sources—were used in tandem to explore and gain knowledge of *Murabaha* Islamic financial transactions and their related risks, and, thus, the adoption of this approach is quite justified.⁵⁹⁷ Another significant reason behind choosing exploratory research design for this research is its flexibility.⁵⁹⁸ It focuses on critical, rather than descriptive, evaluation, as this focuses on gaining deep insights and ideas regarding the legal risks related to this form of financial transaction, as well as their impact on earnings and existing financial position. Descriptive evaluation, on the other hand, focuses on identifying the frequency with which legal risks occur.⁵⁹⁹

Contract review and analysis

Research strategy, in general terms, refers to various processes and activities carried out for completing the research work in a successful manner.⁶⁰⁰ It primarily emphasises the collection of information related to the research topic from different sources, in order to interpret accurate and valid outcomes of the research work.⁶⁰¹ With respect to this research work, the research strategy has involved the use of secondary sources, along with the examination of contracts formed between banks and clients, as this will be helpful in acquiring relevant information about the legal risks involved.⁶⁰²

Details of contracts and their justification

⁵⁹⁶ Marczyk, G.R., DeMatteo, D. and Festinger, D. 2005. *Essentials of Research Design and Methodology*. US: John Wiley and Sons.

⁵⁹⁷ *Ibid*, p. 55.

⁵⁹⁸ Axinn, W.G. and Pearce, L.D. 2006. *Mixed Method Data Collection Strategies*. 1sted. USA: Cambridge University Press, p. 169.

⁵⁹⁹ McNabb, D.E. 2004. *Research Methods for Political Science: Quantitative and Qualitative Approaches*. M.E. Sharpe, p. 112.

⁶⁰⁰ Axinn, W.G. and Pearce, L.D. 2006. *Mixed Method Data Collection Strategies*. 1sted. USA: Cambridge University Press, p. 15.

⁶⁰¹ *Ibid*, p. 120.

⁶⁰² Rubin, R., Rubin, A. and Haridakis, P. 2009. *Communication Research: Strategies and Sources*. Cengage Learning.

For this, the secondary literature method has been used to learn more about *Murabaha* transactions and the legal risks involved in this kind of financial dealing.⁶⁰³ And further accumulated information has been used to develop the literature review section.⁶⁰⁴ The main rationale behind choosing the secondary method is to explore greater volumes of information, related to *Murabaha* transactions, in statistical and theoretical terms.⁶⁰⁵ This is collected by means of various academic and literary sources, together with *Murabaha* contracts between banks and other parties.⁶⁰⁶ In this research, various books and journal articles—related to Islamic finance introduction, modes of Islamic finance, Basel II and capital requirements for Islamic banking, identification of risk exposures in view of Islamic banking, and risk hedging instruments for mitigating legal risks—have been used.⁶⁰⁷ This has enabled the collection of valuable information regarding steps and measures to be taken to mitigate the legal risks arising in the performance of Islamic financial transactions.⁶⁰⁸ These books and journal articles were reviewed using online sources, as well as the university's library collection. During this process, only eminent authors and recently published articles and books were used.⁶⁰⁹

The library research method, along with contracts formed between banks and their clients, has also been used as a source of information regarding *Murabaha* Islamic financial transactions, related legal risks, and the impact of transactions on different stakeholders. Contracts are also used to provide evidence for the research study, which is helpful in obtaining valid and reliable results of the research.⁶¹⁰ These contracts will provide real-time data and

⁶⁰³ Ibid, p. 98.

⁶⁰⁴ Axinn, W.G. and Pearce, L.D. 2006. *Mixed Method Data Collection Strategies*. 1st ed. USA: Cambridge University Press p. 85.

⁶⁰⁵ Ibid, p. 87.

⁶⁰⁶ Wilkinson, D. 2003. *Using Research Instruments: A Toolkit for Researchers*. London: Routledge.

⁶⁰⁷ Axinn, W.G. and Pearce, L.D. 2006. *Mixed Method Data Collection Strategies*. 1st ed. USA: Cambridge University Press.

⁶⁰⁸ Connaway, L.S. and Powell, R.R. 2010. *Basic Research Methods for Librarians*. ABC-CLIO.

⁶⁰⁹ Axinn, W.G. and Pearce, L.D. 2006. *Mixed Method Data Collection Strategies*. 1st ed. USA: Cambridge University Press.

⁶¹⁰ Ibid, p. 89.

information, which will support the research study.⁶¹¹ It also helps to acquire knowledge regarding different situations—in the course of conducting financial transactions—that lead to the occurrence of legal risk.⁶¹² This method is appropriate for this research study, as it provides comprehensive and detailed information regarding the different legal risks related to Islamic financial transactions, thereby permitting effective analysis of the data.⁶¹³

Data analysis method

In the data analysis method, evidence from literary sources supports the research findings.⁶¹⁴ This helps to maintain the validity and reliability of the results of the research study.⁶¹⁵ In addition, a coding method was used to safeguard the anonymity of the banks and clients between which the contracts have been formed.⁶¹⁶ The contracts were acquired from Islamic banks in Saudi Arabia, taking data security and protection concerns into consideration. The selection of contracts and journal articles has been carried out on the basis of inclusion exclusion criteria, with specific reference to the basic research objectives.⁶¹⁷ Such sources assisted in gathering reliable information regarding the legal risks involved in *Murabaha* Islamic financial transactions. The descriptive analysis method helps in obtaining summarised results, as it contains a large volume of information gathered from different sources. In addition, the descriptive analysis method reduces the large chunk of information available in

⁶¹¹Ibid, p. 96.

⁶¹²Wilkinson, D. 2003. *Using Research Instruments: A Toolkit for Researchers*. London: Routledge, p. 52.

⁶¹³ Axinn, W.G. and Pearce, L.D. 2006. *Mixed Method Data Collection Strategies*. 1sted. USA: Cambridge University Press.

⁶¹⁴Ibid, p. 69.

⁶¹⁵ Axinn, W.G. and Pearce, L.D. 2006. *Mixed Method Data Collection Strategies*. 1sted. USA: Cambridge University Press.

⁶¹⁶Ibid, p. 61.

⁶¹⁷Ibid, p. 63.

different literary sources, so as to present it in a comprehensive and simplified manner.⁶¹⁸

Limitations of selected research methods

A few limitations that came up in the course of this research work are laid out below:

- First, data collection in this study included the incorporation of contracts related to *Murabaha* transactions, as well as the use of various secondary sources.⁶¹⁹ Exploration of these sources was a relatively time-consuming process, though it was required to address the research problem.⁶²⁰ A lot of time was expended while identifying the relevancy and authenticity of the contracts and secondary sources used in the research study.⁶²¹ Another issue was the reluctance of sources to communicate information pertaining to banks and contracts. My initial approach, involving the use of questionnaires, had to be abandoned, and I went in search of bank contracts to examine instead.
- Secondly, the problem definition was not presented in a sufficiently elaborated manner, which is typically essential to improving the degree of understanding of the research audience.⁶²² During the research work, the problem selected for investigation was not defined in a clear and elaborated manner, which affected the data collection process, as well as directing the research in the required direction.⁶²³ Some of the sources identified disagreed with the definitions and formulations adopted in my research.
- Moreover, another limitation was the partial dependence of the research study on information collected from secondary sources, as a result of which it was

⁶¹⁸ Axinn, W.G. and Pearce, L.D. 2006. *Mixed Method Data Collection Strategies*. 1sted. USA: Cambridge University Press, p. 89.

⁶¹⁹ Gratton, C. and Jones, I. 2010. *Research Methods for Sports Studies*. Taylor & Francis, p. 108.

⁶²⁰ Axinn, W.G. and Pearce, L.D. 2006. *Mixed Method Data Collection Strategies*. 1sted. USA: Cambridge University Press, p. 69.

⁶²¹ *Ibid*, p.86.

⁶²² *Ibid*, p. 59.

⁶²³ Connaway, L.S. and Powell, R.R. 2010. *Basic Research Methods for Librarians*. ABC-CLIO, p. 79.

difficult for the researcher to obtain information regarding the existing legal risks present in *Murabaha* Islamic financial transactions.⁶²⁴

- The other limitation of this research study was that no information was obtained through interaction with the banks and parties conducting *Murabaha* contracts. This has restrained the ability to draw from the real-life experiences of parties involved in these contracts.⁶²⁵

Ethical considerations

Identification and selection of relevant sources: The main obstacles identified in the course of this research related to the limited access to academic books, journals, and other sources on this topic. It was necessary for the researcher to make an appropriate selection of sources by considering the time in which they are published.⁶²⁶

Confirmation of authenticity and relevancy of the information: It is crucial for the researcher to collect relevant information for the research study from authentic sources.⁶²⁷ It was required for the researcher to find sources from which the information could be easily accessed.⁶²⁸ Researchers find it difficult to obtain information related to the research topic if they rely solely on secondary sources for data collection. This is because researchers are required to take the consent of the authorised person or entity to collect information.⁶²⁹ To maintain the authenticity of the data, information has been gathered from the readily accessible and reliable secondary sources that have been compiled by renowned academicians and scholars.

Awareness of unpublished works: A researcher should have updated knowledge regarding unpublished works related to the research topic.⁶³⁰ This

⁶²⁴ Ibid, p. 83.

⁶²⁵ Gratton, C. and Jones, I. 2010. *Research Methods for Sports Studies*. Taylor & Francis, p. 99.

⁶²⁶ Ibid, p. 125.

⁶²⁷ Gratton, C. and Jones, I. 2010. *Research Methods for Sports Studies*. Taylor & Francis, p. 56.

⁶²⁸ Ibid, p. 58.

⁶²⁹ Ibid, p. 59.

⁶³⁰ Ibid, p. 65.

helps the researcher to analyse and interpret the information and, consequently, to attain valid and reliable results.⁶³¹ In order to create awareness about unpublished works, it was vital, while conducting the research, to ensure that knowledge of research work that remained unpublished was regularly reviewed and updated.

Confidentiality: In this research study, *Murabaha* contracts, formed between banks and other parties, were evaluated to identify legal risks and related causes.⁶³² Information relating to contracts between banks and other parties is quite confidential and, therefore, it was significant to consider the ethical aspect of confidentiality.⁶³³ This consideration is helpful in preserving the secrecy of information related to the banks and their clients, which ultimately serves to prevent any kind of eventuality.⁶³⁴ Confidentiality is protected through storage of information in password-protected documents in an anonymous manner. In order to protect data, I have recorded information gathered from contracts in coding form, with the actual information being hidden by representing information in different ways.

1.11 Organisation of dissertation

This dissertation has five chapters, whose content is as follows:

Chapter 1: Introduction

This first chapter has outlined the background to the research, including a brief history of Islamic finance and its principles. It has discussed risk in this general context, then described *Murabaha* and considered the legal risks associated with this type of transaction. It has identified a research gap and set out the aims, objectives, and research questions intended to address this gap. It

⁶³¹Connaway, L.S. and Powell, R.R. 2010. *Basic Research Methods for Librarians*. ABC-CLIO, p. 41.

⁶³²Ibid, p. 42.

⁶³³Gratton, C. and Jones, I. 2010. *Research Methods for Sports Studies*. Taylor & Francis.

⁶³⁴Ibid, p.81.

has explained the significance of the study and ends by setting out the proposed methodology.

Chapter 2: Saudi Legal System

The aim of this chapter is to focus on the issues related to Islamic Finance, the regulatory framework followed in Sharia legal system Derivatives in Islamic Finance, and the application of derivatives in Saudi Arabia is also covered. Second chapter provides background information regarding the Islamic Banking System, Financial System and the Legal Structure in Saudi Arabia.

Chapter 3: Findings and Analysis

Chapter three presents the results of the research work, analysing and critically evaluating the primary data collected in the form of contracts and secondary sources. The data are analysed in light of the research aims stated earlier in this chapter.

Chapter 4: Analysis of the Legal Risks Associated with Murabaha Contracts and Actions to Mitigate Legal Risks

This chapter presents an analysis of the legal risks of *Murabaha* transaction and actions to mitigate *Murabaha* transaction risks. This is critical analysis using secondary data sources and contracts evidence.

MurabahaMurabaha

Chapter 5: Recommendations

The final chapter covers appropriate recommendations as to ways in which Islamic financial institutions might minimise the impact of legal risks associated with *Murabaha* transactions. It also offers suggestions for future study.

1.12 Conclusion and Transition

This chapter has introduced the topic of legal risks associated with Islamic financial transactions in the context of a brief history of Islamic finance. It has

noted the rapid growth and development of the Islamic financial system, which has enabled it to meet the financial needs of Muslims throughout the world. It has explained the major principles of Islamic finance and their relationship to the five key principles of Islamic law. The common legal risks associated with *Murabaha* transactions have been identified as credit risk, mark-up risk, operational risk, commodity risk, and liquidity risk, all of which directly influence the integrity of the transaction and are thus of considerable importance. In this dissertation, the legal risks associated with this type of Islamic financial transaction are explored, with the following combination of data collection approaches including contracts and other researchers' viewpoints. Contracts between banks and the other party are quite useful in understanding the legal risks involved in *Murabaha* transactions. The next chapter is the literature review, which presents the critiques of various secondary sources for the purpose of collecting secondary data.

Chapter 2: Saudi Legal System

2.1 Introduction

The aim of this chapter is to focus on the issues related to Islamic Finance, and the regulatory framework followed of Sharia legal system. Additionally, Derivatives in Islamic Finance and the application of derivatives in Saudi Arabia is also covered under this chapter. In this manner, this chapter provides background information regarding the Islamic Banking System, Financial System and the Legal Structure in Saudi Arabia.

2.2 Overview of Saudi Arabia

Saudi Arabia is the birthplace of Islam and also two of the holiest shrines that are Mecca and Medina. It has been explored that Saudi Arabia was established in the year 1932 in the South-West Asia by King Abdulaziz. The total area of Saudi Arabia is around 2.25 million square kilometres, which has a population of 27 million and among them; 8.4 million people are foreign residents. Saudi Arabia is divided into 13 *mintaqah*, which is the administrative division.⁶³⁵ Each of the administrative divisions in Saudi Arabia is governed by the people of Royal family. The official religion that is followed in Saudi Arabia is Islam, and the official language is Arabic. Further, the capital city of Saudi Arabia is Riyadh, and in Saudi Arabia, the monarchy is followed.⁶³⁶ In the country, the King is given the title of Custodian of the Two Holy Mosques, as performs the role of Head of State and the Prime Minister.⁶³⁷

In Saudi Arabia, the constitution is derived from the *Quran* and the *Sunnah*, which are mentioned in *Sharia*.⁶³⁸ The primary sources of *Sharia* are the *Quran* and the *Sunnah*, while the secondary sources include Islamic Scholarly Consensus (*Ijma*) and the analogical reasoning presented by the Muslim Judges (*Qiyas*). The primary sources are used by the government in Saudi Arabia for

⁶³⁵See the official website of the Royal Embassy of Saudi Arabia in Washington. [Online]. Available at : <http://www.saudiembassy.net/about/country-information/> [Accessed on: 15 June 2017].

⁶³⁶Basic Law of Governance 1992, Art. 1, 5 (A) and 5 (B).

⁶³⁷ Ibid.

⁶³⁸ Ibid, Art. 1.

administrative regulations of the State.⁶³⁹ *Sharia* is used by the Islamic Judges (*Qadis*), and these judges are influenced by the *Hanbali Madhhab*, which is a term used for schools. These schools are of Islamic Jurisprudence, which is applied by the courts of Saudi Arabia.⁶⁴⁰

According to the Article 44 regarding the Basic Law of Governance, it can be stated that the authorities of a state also consists of judicial authority, executive authority and legislative authority. In Saudi Arabia, the King is considered to be the ultimate arbiter for all the authorities in Saudi Arabia. It has been explored that the judicial authority of Saudi Arabia includes the *Sharia* court system, the Board of Grievances and also the committees regarding quasi-judicial. Some of the judicial authorities in Saudi Arabia are, the Commercial Papers Law, Anti-Commercial Fraud Law, which is included in the Saudi Arabian Ministry of Commerce and Industry, and the Banking Disputes Settlement Committee of the Saudi Arabian Monetary Agency (SAMA).⁶⁴¹ Further, religious legal opinion, which is *fatwa*, is derived from *Sharia*. Therefore, the provisions under the *Sharia* are applied by the courts of Saudi Arabia. It is also applied to the cases, which do not conflict with the *Quran* and the *Sunnah*.

The Basic Law of Governance under the Article 44 uses a term, regulatory authority for the cases, which are to be referred to the legislative authority of Saudi Arabia. The reason behind the referring of the cases is in the name of God, as God is considered to be the ultimate source of legislation. Further, Article 67 regarding the Basic Law of Governance has specified to the legislative authority that the principles of *Sharia* must be followed while formulating laws.⁶⁴² It has been explored that the legislative authority of the Saudi Arabia is shared by the Council of the Ministers, the King of Saudi Arabia and the Consultative Council (*Majlis al-Shura*). According to the Basic Law of Governance, the King of Saudi

⁶³⁹ Chong, B.S. and Liu, M. 2009. Islamic banking: Interest-free or interest-based. *Science Direct* 17(1), p. 128.

⁶⁴⁰ Visser, H. 2009. *Islamic Finance: Principles and Practice*. Edward Elgar Publishing Limited., P. 16.

⁶⁴¹ See the official website of the Saudi Arabian Monetary Agency (SAMA). [Online]. Available at: <http://www.sama.gov.sa/ABOUTSAMA/Pages/SAMAHistory.aspx> [Accessed on: 15 June 2017].

⁶⁴² See the official website of the Ministry of Commerce and Industry. [Online]. Available at: <http://mci.gov.sa/en/LawsRegulations/Pages/default.aspx> [Accessed on: 15 June 2017].

Arabia can preside over the Council of Ministers. Whenever a new law is formulated, or any amendment is made to the existing law in Saudi, the draft is proposed by *Majlis al-Shura*, which is reviewed in the Council and these reviews are then submitted to the King.⁶⁴³ In Saudi Arabia, *Majlis al-Shura* assumes a legislative competence in the country as *Majlis al-Shura* is the sole representative of the people of the country, as mentioned in the Article 2 and Article 15 of the Council Law of *Shura*. However, in the Article 3, it is mentioned that all the members of *Shura* Council Law are selected by Saudi King. Further, the rights, affairs and the duties are decided by the royal family member. Therefore, it can be stated that none of the members of *Shura* council is elected by the people of the Saudi Arabia. The members of *Shura* Council include Speaker, Vice-Speaker, and the Secretary General. The executive branch in Saudi Arabia is concerned with the *Sharia* and its application. Further, the executive branch involves the preparation of instructions and the development of the regulations, so that legislature is implemented appropriately in the country. The members of the executive branch include ministry subsidiaries, agencies, King, local government and the Council of Ministers.⁶⁴⁴

As per the views of the researcher, it is essential that the principle of power separation is activated in Saudi Arabia and the King of the country fulfils its role of application of legislative authority.⁶⁴⁵

2.3 Defining *Sharia*

It has been explored that Saudi Arabia derives its majority of the power from *Sharia*; therefore, it becomes essential to explore *Sharia*. As per the definition of *Sharia*, it can be stated that *Sharia* is the set of rules and the provisions that are helpful in governing the lives of Muslim in the country.⁶⁴⁶ As per MawilDien, *Sharia* is not a law, but it is helpful in the lives of a Muslim, as it covers various aspects regarding religion, politics and economic criteria. It also

⁶⁴³Shura Council Law1992, Art. 23.

⁶⁴⁴Ibid., Art. 55, 56, 57 (A. B. C) and 69.

⁶⁴⁵Ibid., Art. 44 and 55.

⁶⁴⁶Ayub, M. 2007. *Understanding Islamic Finance*. London: John Wiley & Sons Ltd 2007. P. 21; Schoon, N. 2009. *Islamic Banking and Finance*. England: Spiramus Press Ltd 2009. P. 19.

covers the transaction and laws related aspects. The provisions under the *Sharia* are derived from the *Quran* and also from the Prophet Muhammad sayings.

There are five different degrees provisions of *Sharia*, which can be given as:

- Obligatory (*fard or wajib*) is an obligatory duty in Saudi Arabia, which cannot be omitted as it is punishable.
- Desirable (*mandub or mustahab*) is considered as an action, which is often rewarded, but is not punishable.
- Indifferent (*jaiz or mubah*) is also an action, which is permitted in the country but is different from the law.
- Undesirable (*mukrah*) is an action, which is disapproved, but this action is rewarded if omitted.
- Forbidden (*haram*) is an action, which should not be performed by the individuals as it is punishable.⁶⁴⁷

2.3.1 *Sharia's Legal Sources*

Muslims believes that *Sharia* in Saudi Arabia is related to all the aspects, such as political, economic, social or personal aspects of the people. It is derived from the *Quran*, *Hadiths*, *Salaf*, which defines the relationship of the God with the society and the universe. It also helps in determining the actions which should be done and which should be avoided.⁶⁴⁸

2.3.1.1 *The Primary Sources of Sharia: the Quran and the Sunnah*

2.3.1.1.1 *The Quran*

The *Quran* is considered as the most important source of learning for the Muslims. It also helps the Muslims in governing their life in all the major aspects, and they also consider the *Quran* as their source of legislation. It can be stated that the Allah has sent the *Quran* for the people and was sent to the Prophet Mohammed on the night of the Ramadan. It has been explored that the *Quran* is

⁶⁴⁷ Venardos, A. 2005. *Islamic Banking and Finance in South-East Asia: Its Development and Future*. World Scientific Publishing Co. Ltd. P. 27.

⁶⁴⁸ Ayub, M. 2007. *Understanding Islamic Finance*. London: John Wiley & Sons Ltd 2007. P. 21.

considered to be the main source of the legislation and Islamic Banking Services for structuring purposes. It includes the details regarding the commercial contracts and the contract placed between two witnesses. As per the Quran, *“when you contract a debt for a specified term, write it down. And let a scribe write [it] between you in justice. Let no scribe refuse to write as Allah has taught him. So, let him write and let the one who has the obligation dictate.”*⁶⁴⁹ Further, from the findings of the Quran, it has been explored that *“Get two witnesses out of your own men. And if there are not two men (available), then a man and two women, such as you agree for witnesses, so that if one of them (two women) errs, the other can remind her. And the witnesses should not refuse when they are called (for evidence).”*⁶⁵⁰ The Quran is divided into 114 chapters, and it starts from *Surat Al-Fatihah*, and it ends on *Surat An-Nas*.⁶⁵¹

2.3.1.1.2 The Sunnah

The *Sunnah* is considered as the second most important primary source after *Quran*. It is believed that Prophet Muhammad established the *Sunnah* in Mecca and Medina since 10 years and 13 years, respectively.⁶⁵² In the Holy book, Allah mentioned about Prophet Muhammad and described Prophet Muhammad as a messenger of Allah. It was also mentioned that he was a very good-hearted person and helped people in a unique manner. It is also believed by Muslims that Prophet Muhammad gained his teachings from God through Gabriel, and therefore, accepted the *Sunnah* just like the Holy book, *Quran*. In this context, it is mentioned in the *Quran*, *“Whatever the Messenger has given you take; and what he has forbidden you refrain from. And fear Allah; indeed, Allah is severe in penalty.”*⁶⁵³

It can be further said that the speeches and sayings of Prophet Muhammad that were delivered by him on various occasions and for different purposes are all

⁶⁴⁹ See verse 282 of Surah 2 of the Holy Quran.

⁶⁵⁰ Ibid.

⁶⁵¹ Shah, N.A. 2011. *Islamic Law and the Law of Armed Conflict: The Conflict in Pakistan*. London: Routledge. P. 17.

⁶⁵² Burton, J. 2003. *The Sources of Islamic Law: Islamic Theories of Abrogation*. England: Edinburgh University Press. P. 10.

⁶⁵³ See verse 7 of Surah 59 of the Holy Quran.

mentioned in the *Sunnah*.⁶⁵⁴ The *Sunnah* has been used for the purpose of explaining objectives, various prohibitions, and injunctions that are mentioned in the *Quran*. It can be said that the *Sunnah* governs the life of Muslims in every aspect, for instance, financial transaction costs are also undertaken as per the teachings. Prophet Muhammed said, “*It is forbidden for a person to offer to buy anything for which another person has already made an offer.*” A sale cannot take place if the thing meant to be sold is not present at the time of contract and is forbidden by Prophet Muhammad.⁶⁵⁵

2.3.1.2 The Secondary Sources

2.3.1.2.1 Ijma

Ijma is a minor source of *Sharia*. In Islam, *Ijma* is considered to be the third source of legislation as it comes after the *Sunnah* and *Quran*. *Ijma* is considered to be a rational proof, unlike the *Quran* and *Sunnah*, which are divine revelation. It is an agreement and consensus of opinion among the Muslim scholars that is; it can be stated as a unanimous agreement. It is, however, noted that there is often disagreement among the scholars, which is one of the major problems of *Ijma*. The concept states that there must be an agreement among all the Muslim scholars at a particular point of time on a particular issue. *Ijma* is recognised as a self-governing source of *Sharia* by the jurists. Allah has mentioned in the *Quran*, “*Those who have responded to their Lord and established prayer and whose affair is [determined by] consultation among themselves.*”⁶⁵⁶ Moreover, Prophet Muhammad stated, “*My community shall never agree on an error.*” He was also said, “*I beseeched Almighty God not to bring my community to the point of agreeing on an error, and he granted me this.*”

2.3.1.2.2 Qiyas

One thing is compared to another thing, which is similar in some aspect and can be stated as *Qiyas*. This concept was established when Prophet Muhammad was present and is still in practice. “*Qiyas is obtained through the legal and*

⁶⁵⁴ El-Gamal, M. 2006. *Islamic Finance: Law, Economics and Practice*. Cambridge University Press.. P. 28.

⁶⁵⁵ Kamali, M.H. 1989. *Principles of Islamic Jurisprudence*. The Islamic Texts Society. P. 427.

⁶⁵⁶ See verse 38 of Surah 42 of the Holy Quran.

*philosophical method of analogy, whereby a divine law revealed for a particular situation is applied to another, where some common feature exists in both situations.*⁶⁵⁷

Qiyasis considered as an interpretation and derivation of an existing law, only if the rationale of two laws is same. Qiyas is a source of Islamic Jurisprudence and also a tool of *ijtihad*. There are additional sources of *Sharia* namely, *urf* (custom), *ijtihad* (self-exertion), *istihsan* (something preferable), and *istishab* (legal presumption). In order to avoid injustice and stagnation, these sources are used for personal interpretation, which arises due to the practical application of *Sharia*. It can be said that differing views of the scholars contributed to the evolution of Islamic Jurisprudence such that it is prepared for any event that takes place in present and future. For instance, Banking services in Islam are governed by the provisions of *Sharia* and are considered as secondary, as well as, major sources. Financing contracts in Islam are also derived from the provisions of *Sharia*.

2.3.2 Islamic Schools (madhhab)

It was believed that Prophet Muhammad stayed and explained Islamic law to people for 13 years. During the lifetime of Prophet Muhammad, people did not believe in any other teachings and considered him as the owner of all religious teachings. People further believed that he received orders from Allah, which were divine in nature.⁶⁵⁸

It was in the year 632, after the death of Prophet Muhammad that the Sunni school developed and was of Islamic Jurisprudence.⁶⁵⁹ The main motive behind the emergence of Sunni school was the division of Islam and various issues related to legislation and religion. It was at the beginning of the era of Islam that various historical incidences took place and emerging issues had to be resolved immediately, along with people's needs, and therefore, a group was formed

⁶⁵⁷ Abd Jabbar, H.S.F. 2009. Islamic finance: fundamental principles and key financial institutions. *Company Lawyer* 30 (1), p. 1.

⁶⁵⁸ Burton, J. 2003. *The Sources of Islamic Law: Islamic Theories of Abrogation*. England: Edinburgh University Press 2003. P. 10.

⁶⁵⁹ Venardos, A. 2005. *Islamic Banking and Finance in South-East Asia: Its Development and Future*. World Scientific Publishing Co. Ltd. P. 28.

which comprised of many scholars. The aim of these scholars was to teach people. There are four Sunni schools of Islam, which are called as *madhhab*. The provisions of these schools are based on primary sources, which are *Quran* and *Sunnah* and also follows the principles and rules of Islamic Jurisprudence. It has been observed that the thoughts of scholars of primary sources and that of Islamic faith are in agreement. It is however noted that the views of scholars in relation to secondary sources are different but is accepted as valid in the Islamic law. All the four schools of Sunni are widely spread, and have become official. The books have been developed, which represents jurisprudence and are therefore distributed as per the four Imams of Sunni, which are as follows: Imam Malik ibn Anas al-Maliki, Imam Abu Hanifa, Imam Ahmad ibn Hanbal, and Imam Muhammad ibn Idris al-Shafi'i. In Islam, there are four Sunni schools of jurisprudence, called madhhab.⁶⁶⁰ Each of these schools derives its provisions from the evidence of the primary sources, which are the Quran and Sunnah, in accordance with the rules and principles of Islamic jurisprudence. Generally, there is agreement among the scholars of the Islamic faith and the primary sources. However, there are slightly different views among them in the secondary sources, but these are generally accepted as valid from an Islamic point of view. The four schools of Islamic jurisprudence spread widely among Sunnis and became official. The books represent jurisprudence, and they are attributed to the four Imams of the Sunnis, who were (in historical order): Imam Abu Hanifa, Imam Malik ibn Anas al-Maliksi, Imam Muhammad ibn Idris al-Shafi'i, and Imam Ahmad ibn Hanbal.

2.3.2.1 The Hanafi School

One of the schools of Islam (Madhhab) is the Hanafi School. It is considered to be one of the oldest schools, and it is flexible too. The name of the school has been derived from the name of its founder, who is Abu Hanifa an-Nu'man ibn Thābit, also known as Abu Hanifa. It is significant to note that one of the four schools that are Imam Abu Hanifa was introduced in Baghdad, Iraq. It has been

⁶⁶⁰ Visser, H. 2009. *Islamic Finance: Principles and Practice*. London: Edward Elgar Publishing Limited. P. 15.

observed that this school has derived its jurisprudence mainly from *Quran*. If there is a situation in which absolute jurisprudence is not derived, then in that situation Hanafi School obtains evidence from other sources namely the *Sunnah*. If in some situations the rulings are insignificant, then scholars use secondary sources namely, *Istihsan* (Something preferable), *Urf* (Custom), *Ijma* (consensus), *ijtihad* (Self-exertion), and *Qiyas*(analogy). It can be said that the Hanafi School has been developed in the regions of Egypt, India, the Levant, Iraq, Turkey, Afghanistan, Bangladesh, and Pakistan. After the death of Abu Hanifa in the year 760, Abu Yusuf and Muhammad al-Shaybani preserved his legal views.⁶⁶¹

2.3.2.2 The Maliki School

The second school of Islamic schools is Maliki School, which Sunni Muslims follows till date.⁶⁶² The founder of Maliki School was Malik ibn Anas, and he died in the year 795. It is believed that he was hard working, gained tremendous knowledge and became a famous scholar of his time. Imam Malik uses to give priority to *Qiyas* over *Sunnah*, and the Maliki School was similar to all other schools in terms of its fundamental principles. The school is established in Abu Dhabi, Kuwait, Bahrain, Dubai, Libya, Algeria, Mauritania, and Tunisia.

2.3.2.3 The Shafii School

The third school of Sunni is the Shafii School, and the name has been derived from Shafiji. He was born in the year 767, the year in which Imam Abu Hanifa's death took place. His principles are mainly derived from *Quran*, secondary sources such as the *qiyas*(analogy) and *Ijma* (Consensus) and the teachings of Prophet Muhammad. He preferred *Ijma* to *Ijtihad*, *Istislah* and *Istihsan*.⁶⁶³ In terms of its followers, Shafii School is next to the Hanafi School. It has been observed that around 29% of the Muslims follow Shafii School all over the world. Countries that follow Shafii madhhab are Egypt, Malaysia, Ethiopia, Indonesia, Yemen, Sudan, and Somalia. The death of Imam Shafii took place in the year 820.

⁶⁶¹ Hallaq, W. 2009. *An Introduction to Islamic Law*. Oxford: Cambridge University Press. P. 37.

⁶⁶² Faruq Ahmad, A.U. 2010. *Theory and Practice of Modern Islamic Finance: The Case Analysis from Australia*. Boston: Brown Walker Press. P. 78.

⁶⁶³ Visser, H. 2009. *Islamic Finance: Principles and Practice*. London: Edward Elgar Publishing Limited. P. 16.

2.3.2.4 The Hanbali School

Among all the Sunni schools, Hanbali School is the last school. Imam Ahmad was the founder of Hanbali School, and he has derived his teachings from Imam Shafii; therefore, their schools were also very same in nature. The principles followed in this madhhab were *Ijma*, *Sunnah*, *Qiyas*, and *Quran*. It was observed that Imam Ahmad considered *Qiyas* only if it was necessary and had a different perspective in comparison to other schools. He followed only the teachings of only one single companion. He did not agree with other scholars and supported *Ijtihad*. It has been observed that this school is most flexible and conformist among all the four schools. The courts in Saudi Arabia follow Hanbali madhhab, and it is spread across Qatar and Saudi Arabia. Lastly, it must be stated that *Quran* and *Sunnah* prohibit *ribain* any form, as either receipt or payment. It has been considered as the most distinguishing feature in the economics of Islam.⁶⁶⁴

2.4 Saudi Arabian Banking and Financial Laws

In Saudi Arabia, the start-up of the first commercial bank in the 20th century gave rise to the banking system. The first bank was established in the year 1926 and it was named as the Dutch Commercial Company. In Saudi Arabia, there are total 12 Saudi Banks and about 11 foreign bank branches and these are working under the licensing of the Saudi Arabian Monetary Agency (SAMA).⁶⁶⁵ The main service offerings of SAMS are numerous investment services, corporate banking services, transaction facilities of derivatives, brokerage facilities and provision of credit and debit cards, and establishment of the ATMs and the services of point-of-sale transactions. There are four Islamic Banks which are providing financial and Islamic banking services and these all banks follow the principles of *Sharia 116*. In Saudi Arabia, the Saudi Stock Exchange (*Tadawul*) works in the form of the most capitalised stock exchange in the Arab world. In Saudi Arabia, the issuance of *sukuk* does trade in accordance

⁶⁶⁴ Khalil, E.H. 2006. *An overview of the Sharia'a prohibition of riba' in Abdulkader Thomas (ed), Interest in Islamic Economics: Understanding riba*. London: Routledge. P. 53.

⁶⁶⁵ Al Rajhi Bank, Bank AlBilad, alinma bank, Bank AlJazira, Riyad Bank, The National Commercial Bank, Saudi Hollandi Bank, Arab National Bank, Banque Saudi Fransi, The Saudi British Bank, Saudi Investment Bank, and Samba Financial Group (Samba). See to the Saudi Arabian Monetary Agency (SAMA).

to the Saudi Stock Exchange which are supervised and governed by the Offer of Securities Regulations issued by the Capital Markets Authority (CMA).⁶⁶⁶

In Saudi Arabian financial sector at the world level, takaful is considered as the largest insurance industry. The Gross Written Premiums (GWP) in the year 2011 in the insurance market of Saudi Arabia reached to the amount of 18.504 Saudi Riyal which was 16.837 Saudi Riyals in the preceding year 2010. The Saudi Arabian Monetary Agency governs the functioning of the Saudi Arabian Insurance industry and its functioning is governed by the Cooperative Insurance Companies Control Law and its issuance was made by the Royal Decree No. M/32 on 01/08/2003.⁶⁶⁷

2.4.1 The Banking Control Law (BCL)

In Saudi Arabia, a law has been passed under royal decree No. M/5 dated 11/06/1966 named as Banking Control Law (BCL), which is considered as the primary law, in order to regulate the financial and banking aspects in Saudi Arabia. BCL render a broad range of powers to Saudi Arabian Monetary Authority (SAMA), for the purpose of supervising and regulating the banks in Saudi Arabia and in addition to it, it safeguards the banking mechanism.⁶⁶⁸ For instance, all the applications for the purpose of carrying banking business in Saudi Arabia shall be submitted to SAMA, and it has been stipulated under the Article 3 of the law. Additionally, BCL describes the following such as banking business, discusses licensing, regulate capital adequacy norms, payment orders, bill of exchange, letter of credit, issuance of letter of guarantee, bill discounting and promissory notes. Likewise, other similar papers, commercial papers, opening of current accounts, collection, and payment of cheques, foreign exchange transactions, and other significant factors associated with banking business.

⁶⁶⁶ See the official website of the Royal Embassy of Saudi Arabia in Washington. [Online]. Available at: http://www.saudiembassy.net/about/country-information/economy_global_trade/banking.aspx [Accessed on: 26 November 2013].

⁶⁶⁷ See the official website of the Saudi Arabian Monetary Agency (SAMA). [Online]. Available at: <http://www.sama.gov.sa/sites/samaen/AboutSAMA/Pages/SAMAFuction.aspx>, [Accessed on: 26 November 2013].

⁶⁶⁸ Hasan, Z. 2010. Regulatory Framework of Shariah Governance System in Malaysia, GCC Countries and the UK. *Kyoto Bulletin of Islamic Area Studies* 3(2), p. 96.

However, under all the 26 articles of BCL, it does not furnish a particular framework for the Islamic banking and financial services. In this regard, therefore, Islamic banking and financial services with conventional banking have been supervised and regulated by SAMA, which is covered under BCL (1966). The legal system of Saudi Arabia is based on *Saharia*, as a result of which the Islamic Financial Institutions (IFIs) are operated under the current framework. Additionally, the Banking system under BCL (1966) has not been rescinding or amended and applies to the banking system and in order to regulate the existence and establishment of IFIs in Saudi.⁶⁶⁹

2.4.2 The Capital Market Law (CML)

The Government of Saudi Arabia has issued its long-expected Capital Market Law (CML) on 28th June 2003. The law comprises of ten chapters, which further includes sixty-seven articles, which provide new legislation with the notion to regulate the Capital Market in the Saudi Arabia. The CML was issued by Royal Decree No. M/30 dated, 31/07/2003. The rationale behind introducing such law is to develop and regulate the financial market of Saudi by enhancement and development of the procedures, which could assist to reduce the degree of risk concerning securities transactions. A regulatory body is known as Capital Market Authority (CMA), which deals with the powers for the purpose of regulating and monitoring the issuance of securities and the manner in which the securities are dealt with. In addition to it, CML helps in protecting the interest of investors and citizens from the unsound and unfair trade practices, which include manipulation, fraud, deceit, and forgery. The CML aims to achieve clarity, transparency, efficiency, and fairness in the securities transactions. Moreover, in the articles published under CML, it does not include any specified framework for the *sukuk*. Additionally, the fundamental system in Saudi Arabia is based on *Sharia* principle, though CML does not involve *Sharia* in its provision. Presently, in Saudi Arabia, the publication of *sukuk* is regulated and monitored by Capital Market

⁶⁶⁹Ibid.

Law under CML.⁶⁷⁰ Furthermore, in Saudi Arabia, if the legal framework is deficient for the issuance of *sukuk*, then it may result in the initiation of confusion between conventional debt instruments, bonds, *sukuk*, and shares.

2.5 Authorities responsible for the regulation and supervision of Islamic Banking and Financial Activities in Saudi Arabia

There are two governing authorities that primarily responsible for the control and supervision of the Islamic banking and financial activities in Saudi Arabia and Islamic *sukuk* and cooperative insurance (*takaful*). The regulatory authorities are the capital market authority (CMA) and the Saudi Arabian Monetary Agency (SAMA).

2.5.1 The Saudi Arabian Monetary Agency (SAMA)

The SAMA is considered as the central bank of Saudi Arabia, and it was established under two Royal Decrees, No. 30/4/1/1047 and No. 30/4/1/1046 dates 4th October 1952.⁶⁷¹ The governing body of SAMA is the Board of Directors, and BOD is headed by the Governor, Deputy Governor, and three associate members nominated by the king in accordance with the Royal Decree for a period of four years.⁶⁷² Under the Royal Decree No. 30/4/1/1744, the first Board of Directors was appointed under SAMA in 05/08/1952. Additionally, the appointment of first Governor of SAMA was in 05/08/1952 named as George A. Blowers who is a citizen of the U.S under Decree No. 30/4/1/1743.⁶⁷³

On the contrary, there exist no independent *Sharia* board in Saudi Arabia for the purpose of regulating and monitoring the Islamic banking and financial activities currently operating in Saudi. Additionally, SAMA presently controls the

⁶⁷⁰ Al Elsheikh, A. and Tanega, J. 2011. Sukuk structure and its regulatory environment in the Kingdom of Saudi Arabia. *Law and Financial Markets Review* 5(3), P. 194.

⁶⁷¹ See the official website of the Saudi Arabian Monetary Agency (SAMA). [Online]. Available at: <http://www.sama.gov.sa/sites/samaen/AboutSAMA/Pages/SAMAFfunction.aspx>. [Accessed on: 15 June 2017].

⁶⁷² Ramady, M. 2010. *The Saudi Arabian Economy: Policies, Achievements, and Challenges*. New York: Springer . P. 76

⁶⁷³ See the official website of the Saudi Arabian Monetary Agency (SAMA). [Online]. Available at: <http://www.sama.gov.sa/sites/samaen/AboutSAMA/Pages/SAMAFfunction.aspx>. [Accessed on: 15 June 2017].

cooperative insurance company sector under the Law of Supervision of Cooperative Insurance Companies of 2003 and the associated implementing regulations of 2004 of this law. SAMA further regulates the Islamic financial institutions which undertake the financial and banking activities simultaneously conventional banking business companies under the BCL in 1966.⁶⁷⁴

Under the Article 1 of SAMA, it has been mentioned that the primary objectives of introducing SAMA are to regulate the exchange dealers and commercial banks. There is nowhere written in the articles about the IFIs and Islamic banks. The main reason behind this is because the Islamic financial industry was first established in the year 1963 whereas the Charter was issued on 15/12/1957 which is before initiation of the Islamic financial sector.⁶⁷⁵ The SAMA is known as the central banks of the Kingdom of Saudi Arabia There are several crucial functions of SAMA. The essential functions involve, issuance of the national currency that is the Saudi *Riyal*, minting, supervising the exchange dealers and commercial banks, increasing the currency's cover, supervising the insurance companies and insurance professionals. Furthermore, supervise the credit information organisations, managing the foreign exchange of Saudi Arabia, monitoring the finance companies, operating an intercross bank financial system like SPAN, SADAD, *tadawul*, MAQASA and SARIE and ensuring the growth and development of the financial system.⁶⁷⁶

2.5.2 The Capital Market Authority (CMA)

Under the article 4 of CML, CMA was instituted, and the issuance of it is under the Royal Decree No. M/30 on 2nd July 2003, issued for development and regulation of activities in Capital Markets in Saudi Arabia. It must be perceived that CMA is an independent body, which is directly correlated with the Prime Minister and it has administrative and financial autonomy. The composition of the

⁶⁷⁴ See the official website of the Saudi Arabian Monetary Agency (SAMA). [Online]. Available at: <http://www.sama.gov.sa/sites/samaen/AboutSAMA/Pages/SAMAFuction.aspx>,. [Accessed on: 15 June 2017].

⁶⁷⁵ Ibid

⁶⁷⁶ Ibid

board of CMA comprises of five full-time members, which are nominated by the King in accordance with the Royal Decree.⁶⁷⁷

The primary functions of the CMA are to issue regulations for the capital markets in Saudi Arabia and rules for the purpose of implementation of the provisions of CML. Additionally, CMA monitors and control the dealing in securities and further issuance of securities, which involves the issue of *sukuk*.⁶⁷⁸

The fundamental objectives of CMA are to form an appropriate environment for the purpose of investment with the publication of required rules and regulations, strengthening the transparency. Other such objectives are to provide the disclosure requirement for the listed companies, protection of the interest of dealers and investors from the illegal act in Capital Market and boosting confidence among the investors.⁶⁷⁹ Moreover, under the article 5 of CML, it is authorised to issue the rules and regulations in order to create the contributive environment, which in turn helps in development and growth of the activities relating to investment in Saudi Arabia.⁶⁸⁰

⁶⁷⁷ See the official website of the Capital Market Authority (CMA). [Online]. Available at: <http://www.cma.org.sa/En/AboutCMA/CMLaw/Pages/CH2Article4.aspx> [Accessed on: 15 June 2017].

⁶⁷⁸ Ibid

⁶⁷⁹ See the official website of the Capital Market Authority (CMA). [Online]. Available at: <http://www.cma.org.sa/En/AboutCMA/Pages/default.aspx> [Accessed on: 15 June 2017].

⁶⁸⁰ Hassan, K. and Lewis, M. and Mahlkecht, M. (2011). *Islamic Capital Markets: Products and Strategies*. John Wiley & Sons. P.102.

Chapter 3: Findings and Analysis

3.1 Introduction

This research study aims to elucidate the structure and conduct of *Murabaha* transactions, the legal risks involved their impact on stakeholders, and ways of mitigating them.⁶⁸¹ From analysis of the literature review, certain methods can be used in order to mitigate the legal issues arising from *Murabaha* Islamic financial transactions. These risks can take the form of fiduciary risk, which can be mitigated by the provision of strict regulations that will also help to maintain shareholders' trust. The risk of disruption of payment can be made less severe by regulations imposing appropriate penalties.

In order to achieve this aim, secondary data were collected on the principles of Islamic finance, the structure and current operation of *Murabaha* financial transactions within it, and the associated legal risks, which helped in building a theoretical background for the research.⁶⁸² Data were also gathered on the actions that have been taken or proposed to mitigate these risks, the two sources being the relevant academic and organisational literature, reviewed above in Chapter 2, and a number of contracts formed between Saudi Arabian banks and their clients.⁶⁸³

The global financial sector was thrown into turmoil by events that began in 2007, leading to a sharp and widespread decline in the goodwill and brand image of banks and financial institutions.⁶⁸⁴ This occurred because financial rules and regulations failed, so that financing through equity and debt became riskier and less transparent.⁶⁸⁵ Thus, financial institutions and banks were reluctant to adopt and implement a new financial system.⁶⁸⁶ In short, the global economy has faced various uncertainties in the past decade, due to the occurrence of a debt crisis,

⁶⁸¹Hassan, K. and Mahlkecht, M. 2011. *Islamic Capital Markets: Products and Strategies*. John Wiley & Sons.

⁶⁸²Blaikie, N. 2009. *Designing Social Research*. Polity, How, J.C.Y., Karim, M.A. and Verhoeven, P. 2005. Islamic Financing and Bank Risks: The Case of Malaysia. *Thunderbird International Business Review* 47(1), pp. 75-94.

⁶⁸³Hassan, K. and Mahlkecht, M. 2011. *Islamic Capital Markets: Products and Strategies*. John Wiley & Sons.

⁶⁸⁴Ayub, M. 2009. *Understanding Islamic Finance*. John Wiley & Sons, p. 18.

⁶⁸⁵Ibid, p. 22

⁶⁸⁶Ayub, M. 2009. *Understanding Islamic Finance*. John Wiley & Sons.

financial instability, and the failure of financial regulation.⁶⁸⁷ The Islamic finance industry has inevitably been affected by the global financial crisis and this has led it to become more flexible, thereby bringing changes to the financial system.⁶⁸⁸ The overall growth and development of the Islamic finance industry has been assisted by the recovery in global markets, which began in 2009; by Sharia standardisation initiatives; and by positive changes in regulatory frameworks.⁶⁸⁹ The continued expansion of worldwide financial markets has increased the number of trading and investment opportunities, attracting investors and depositors and thereby boosting the Islamic financial sector.⁶⁹⁰

The practices and activities of Islamic finance are based on principles, rules, and regulations prescribed in the Quran and in Sharia law. These restrict or prohibit speculation (*gharar*), oppression (*zulm*), and the provision of goods and services that harm the wellbeing of the persons involved, among other activities adjudged immoral or harmful.⁶⁹¹ Conversely, these principles promote social justice through the operation of an Islamic tax (*zakat*).⁶⁹² *Such principles can sometimes be at odds with the way international finance works, and this is why efforts have been made to reconcile the two financing systems. The use of Murabaha, a classic Islamic contract, is an example of this desire to make Islamic finance work in the international finance system.*

It has been established in earlier chapters that *Murabaha* has a tripartite basic structure, involving the vendor of a commodity, a bank that purchases it, and a client to whom the bank then sells it at cost plus mark-up.⁶⁹³ Despite the transparency of this arrangement, it has been shown that *Murabaha* is subject to a range of legal risks, each of which can be mitigated by appropriate

⁶⁸⁷ *Ibid*, p. 18

⁶⁸⁸ Askari, H., Iqbal, Z. and Mirakhor, A. 2011. *Globalization and Islamic Finance: Convergence, Prospects and Challenges*. John Wiley & Sons.

⁶⁸⁹ Hassan, K. and Mahlknecht, M. 2011. *Islamic Capital Markets: Products and Strategies*. John Wiley & Sons.

⁶⁹⁰ Iqbal, Z. and Mirakhor, A. 2011. *An Introduction to Islamic Finance: Theory and Practice*. John Wiley & Sons.

⁶⁹¹

Ahmad, A.U.F. 2009. *Theory and Practice of Modern Islamic Finance: The Case Analysis from Australia*. Universal-Publishers.

⁶⁹² *Ibid*, p. 10

⁶⁹³ *Ibid*, p. 15-16

measures.⁶⁹⁴ Therefore, while the contract constitutes a perfect instrument to be used not only in a Muslim finance market, but also internationally, it is not without its risks. *Murabaha* contracts are a key choice for funding transactions, and are favoured internationally due to their flexible nature that facilitates various financial structures, such as providing finances, currency exchange, and hedging.

In this context, the present chapter generates the overall findings of the research by analysing the collected data. First, section 3.2 revisits religion, law, and banking in Saudi Arabia.⁶⁹⁵ Section 3.3 then presents an introduction to legal risks associated with *Murabaha*, providing both a legal and financial analysis.⁶⁹⁶ Next, section 3.4 offers findings from the analysis of contracts. This chapter ends with a summary, after which the findings are further discussed in Chapter 4.

3.2 Religion, law, and banking in Saudi Arabia

Saudi Arabia is governed by a traditional Islamic system wherein the judiciary and legal regime are under the authority of the clergy, while contemporary laws are made by way of royal edicts.⁶⁹⁷ However, although the legal system is considered to be based on Islamic law, the country has no codified Islamic law, which means that Islamic financial institutions operate in a strange environment and under an ambiguous legal framework.⁶⁹⁸ This is because the banking sector is regulated by the Banking Control System 1966, which is applicable without amendments and governs the existence and establishment of the whole sector, including IFIs.⁶⁹⁹ Furthermore, no relevant law had been passed and SAMA had issued no regulation or Islamic banking licences to any company in Saudi Arabia as of 2004.⁷⁰⁰ Despite the existence of

⁶⁹⁴Eisenberg, D. 2012. *Islamic Finance: Law and Practice*. Oxford University Press.

⁶⁹⁵Askari, H., Iqbal, Z. and Mirakhor, A. 2011. *Globalization and Islamic Finance: Convergence, Prospects and Challenges*. John Wiley & Sons.

⁶⁹⁶Visser, H. 2013. *Islamic Finance: Principles and Practice*. Edward Elgar Publishing.

⁶⁹⁷Köhn, D. 2011. *Mobilising Capital for Emerging Markets: What Can Structured Finance Contribute?* Springer, p. 25.

⁶⁹⁸Ibid, p. 45.

⁶⁹⁹Ahmed, H. 2011. *Product Development in Islamic Banks*. UAE: Oxford University Press, p. 110.

⁷⁰⁰Ibid, p. 113.

huge Islamic mutual funds and the issuance of *sukuk*, from 2000 to 2008, and notwithstanding the Capital Market Law of 2003, not a single piece of the legislation has been passed to specifically regulate Islamic finance.⁷⁰¹ The SAMA has set up a separate legal body, the Committee of Settlement for Banking Disputes (CSBD), to hear all cases concerned with banks, including disputes involving Islamic banks.⁷⁰² At the same time, Sharia courts are no longer authorised to hear banking disputes. Thus, all banking disputes in Saudi Arabia are now heard by the CSBD instead of the Sharia court.⁷⁰³

Since Islamic banks implement Islamic law in their financial transactions, the banks also require a separate institutional mechanism of Sharia governance. However, in Saudi Arabia⁷⁰⁴ the functions of Sharia boards are not regulated by any of the standard Sharia guidelines; hence, the Islamic banks have taken the initiative of issuing their own Sharia guidelines and procedures for the purpose of ensuring adequate implementation of the system and proper monitoring of the Sharia-based rules.⁷⁰⁵ The customised Sharia rulings, passed by the banks, ensure that their products and services are offered in the market only after the approval of the Board.⁷⁰⁶ This point definitively belongs above, at the very beginning of Chapter 3.

Overall, it can be reasonably stated that one of the entities of Islamic finance, which is gradually becoming more liberal and is beginning to adopt a Western banking culture, is the banking sector of Saudi Arabia.⁷⁰⁷ In this context, various reforms and amendments are made to the banking sector of Saudi Arabia. This has led to the Islamic banks being ignored and to the rise of the assumption that they do not receive adequate support from the Saudi authorities.⁷⁰⁸

⁷⁰¹ Ayub, M. 2009. *Understanding Islamic Finance*. John Wiley & Sons, p. 16.

⁷⁰² Ahmed, H. 2011. *Product Development in Islamic Banks*. UAE: Oxford University Press, p. 115.

⁷⁰³ *Ibid*, p. 178.

⁷⁰⁴ Ayub, M. 2009. *Understanding Islamic Finance*. John Wiley & Sons, p. 32.

⁷⁰⁵ Hasan, Z. 2012. *Shari'ah Governance in Islamic Banks*. UK: Oxford University Press. pp. 126, 135.

⁷⁰⁶ Ayub, M. 2009. *Understanding Islamic Finance*. John Wiley & Sons, p. 39.

⁷⁰⁷ *Ibid*, p. 40.

⁷⁰⁸

3.3 Introduction to legal risk of *Murabaha* – a legal and financial analysis

This section analyses the legal risks that are associated with *Murabaha* transactions. Various risks are faced by different entities while dealing with the financial instruments. This section critically analyses the risks arising from such transactions in order to fulfil the research aim and the objectives. From the analysis, it has been revealed that the parties to *Murabaha* cannot earn excessive profits from the transaction, as the mark-up price is decided on the basis of the LIBOR or US short T-bills interest rates.⁷⁰⁹ It is also possible that the client rejects the goods or tangible assets on the basis of them not meeting the terms and conditions of the contract, but a client who acts as the agent of the bank can eliminate this risk of rejection of ownership by efficiently examining the goods or commodities being traded before buying them from the bank at cost plus mark-up.⁷¹⁰ It was further revealed that a concern about the ownership of real property by an IFI arises from the existence of the strict liability to pay a fixed amount in case of default.⁷¹¹ The default risk exists where there is negligence or fault on the part of the payer. Islamic financial transactions are also subject to liquidity risk because banks and financial institutions own a high proportion of long-term assets on which they rely to pay short-term liabilities, resulting in a mismatch between assets and liabilities, in terms of maturity period, payment terms, and other criteria.⁷¹²

It has been further found that in order to set the mark-up price as discussed in the previous section, there is a probability of risk related to the price. The fact that the mark-up price is derived from the LIBOR interest rate introduces an element of price risk.⁷¹³ Changes in LIBOR will be reflected in the mark-up

⁷⁰⁹Ibid, p. 16-19.

⁷¹⁰Eisenberg, D. 2012. *Islamic Finance: Law and Practice*. Oxford University Press, p. 7.

⁷¹¹Ibid, p. 10.

⁷¹²El-Gamal, M.A. 2006. *Islamic Finance: Law, Economics, and Practice*. Cambridge University Press.

⁷¹³Ali, H.A. and Naysary, B. 2014. Risk Management Practices in Islamic Banks in Kuwait. *Journal of Islamic Banking and Finance*,2(1), pp. 123-148.

price, whose non-payment would cause the bank to suffer a loss.⁷¹⁴ From the literature review, it was found that a technology risk, arising from rapid changes in the technology intended to improve the efficiency with which financial transactions are processed.⁷¹⁵

The risks discussed above can arise because of a number of reasons. From the analysis, it was found that *Murabaha* transactions are reported to face legal risks because proper documentation is lacking and because the regulatory frameworks, rules, and regulations are inadequate, all of which can adversely affect the capital and financial position of the banks.⁷¹⁶ Among the many other different factors strongly affecting the occurrence of the risks involved are those of a political, economic, social, and technological nature.⁷¹⁷ Political factors include changes in the regulations, trading policies, and procedures set by governments.⁷¹⁸ The economic factors are changes in interest rates, fluctuations in foreign exchange rates, inflation, stages in the business cycle, etc. The social factors that may also pose risks to *Murabaha* transactions include language differences and variations in tastes, preferences, values, beliefs, and culture. It was further found that parties must consider all such factors in order to take appropriate decisions to mitigate these risks.⁷¹⁹

The following paragraphs deal with three major types of risk that were identified in the literature review as being germane to the conduct of *Murabaha* transactions: liquidity, credit, and operational risks.⁷²⁰ Although there are many other types of risks applicable to such transactions, these three are the most prominent that are noticed in the Saudi Arabian financial structure.

The liquidity risk in general terms, arises when banks and other financial institutions are unable to convert current assets or marketable securities into

⁷¹⁴Ibid, p. 156.

⁷¹⁵Abdullah, D.V. and Chee, K. 2010. *Islamic Finance: Understanding its Principles and Practices*. Marshall Cavendish International Asia Pte Ltd.

⁷¹⁶El-Gamal, M.A. 2006. *Islamic Finance: Law, Economics, and Practice*. Cambridge University Press.

⁷¹⁷Ibid, p. 95.

⁷¹⁸Ibid, p. 112.

⁷¹⁹Hasan, Z. and Hasan, Z. 2012. *Shari'ah Governance in Islamic Banks*. Edinburgh University Press.

⁷²⁰Ibid, p. 55-59.

cash and thus fail to meet current liabilities effectively.⁷²¹ They face difficulties in providing funds by the use of different securities and in making the decisions related to maturities and rates that are required to create sufficient liquidity to meet their business needs.⁷²² It is also difficult for them to transform assets to create liquidity within time and at reasonable prices. From a banking viewpoint, the liquidity risk arises from the inability of a bank to meet its obligations on time by using its earnings and its capital holding without incurring unacceptable losses.⁷²³ There are many different factors that give rise to the liquidity risk, such as fluctuations in financial markets, bad judgement, breakdown of the payment system, and imbalance in macroeconomic factors.⁷²⁴ The primary factor underlying the liquidity risk in the case of *Murabaha* is the creation of debt, as it involves the purchase of a commodity which the bank then resells on a deferred payment basis.⁷²⁵ This also incurs operational, dispute, credit, and legal risks, which adversely affect the realisation of the receivables.⁷²⁶ Another liquidity risk facing Islamic banks is the fact that a majority of the Islamic means of finance, including *Murabaha*, involve long-term investment.⁷²⁷ The banks are obliged to retain relatively large amounts of liquid assets, leading to an increase in their cost and the creation of *Murabaha* for a short term, resulting in a reduction in their earnings.⁷²⁸ In addition to the above analysis, it was further found that the use of *Murabaha* to purchase commodities results in excess liquidity so the liquidity risk arises where the parties are not provided with a lender of last resort facility. The liquidity risk also arises from asset-liability duration mismatch, high off-balance

⁷²¹ Schoon, N. 2010. *Islamic Banking and Finance*. Spiramus Press Ltd, p. 62.

⁷²² van Greuning, H. and Iqbal, Z. 2008. *Risk Analysis for Islamic Banks*. World Bank Publications.

⁷²³ *ibid.*

⁷²⁴ Siddiqi, A. and Hrubí, P. 2008. *Islamic Investments Funds Versus Hedge Funds*. GRIN Verlag, p. 89.

⁷²⁵ *ibid.*, p. 226

⁷²⁶ Khan, M.F. and Porzio, M. 2010. *Islamic Banking and Finance in the European Union: A Challenge*. Edward Elgar Publishing.

⁷²⁷ *ibid.*, pp. 18-20.

⁷²⁸ van Greuning, H. and Iqbal, Z. 2008. *Risk Analysis for Islamic Banks*. World Bank Publications.

sheet exposure, and the allocation of governmental liquid instruments to a lower level.⁷²⁹

It was found that the risks arising from *Murabaha* financial transactions are due to the banks processing and not because of the nature of the contract. The aspects and elements involved in the contract are not subjected to any risk to the parties; however, risks are emerged due to inappropriate use of this contract by the banking institutions with least consideration to the principles of Sharia legal system.

In concerning to the credit risk of *Murabaha*, Ariff and Iqbal (2011) state that this arises when a borrower fails to make monetary payments as per the contract.⁷³⁰ In general terms, it occurs because of the non-performance of a contractual obligation or non-fulfilment of one or more of the terms and conditions that constitute the contract.⁷³¹ This commonly takes the form of the client failing to make a payment as agreed in the contract, which results in an increase in the debt for the bank.⁷³² Elgari correctly notes that it is the responsibility of the client to make fixed deferred payments for the goods or commodities being traded as agreed in the *Murabaha* contract.⁷³³ The involvement of Islamic banks in such transactions reflects their failure to receive worthwhile benefit from the execution of the *Mudaraba* mode of finance.⁷³⁴ According to Sundararajan, such sale-based activities and facilities appear on the asset side of the balance sheets of Islamic banks and financial institutions. Credit risk, which arises from payment default and from the operational activities of the bank, can be measured by the traditional approach whereby the counterparty involved in the financial

⁷²⁹ Anam, S., Hasan, S.B., Huda, H.A.E., Uddin, A. and Hossain, M.M. 2012. Liquidity risk management: A comparative study between conventional and Islamic banks of Bangladesh. *Research Journals*, 5, pp. 1-5.

⁷³⁰ Ariff, M. and Iqbal, M. 2011. *The Foundations of Islamic Banking: Theory, Practice and Education*. Edward Elgar Publishing, pp. 12-13.

⁷³¹ van Greuning, H. and Iqbal, Z. 2008. *Risk Analysis for Islamic Banks*. World Bank Publications, pp. 22-26.

⁷³² Warde, I. 2010. *Islamic Finance in the Global Economy*. Edinburgh University Press, p. 35

⁷³³ *Ibid*, pp. 45-49.

⁷³⁴ Elgari, M.A. 2003. Credit Risk in Islamic Banking and Finance. *Islamic Economic Studies*, 10(2), pp. 1-25.

transaction is allocated a rating class.⁷³⁵ There are three components which constitute the credit risk: the loss given default, the potential credit exposure at default, and the probability of default. Default by the borrower is evaluated on the basis of two parameters, namely the number of days by which the payment is overdue and the financial condition of the borrower.⁷³⁶ The probability of default is calculated by the ex-ante allocation of the ratings to the exposures of the counterparty and a particular variety.⁷³⁷ Default exposures are measured in terms of the extent of the discretion that the borrower implements, facility-specific events which affect the value of contingent claims, lines of credit, and prepaying on accounts already drawn.⁷³⁸ Salah et al. explain that having bought the asset from the vendor at cost, the bank takes possession of it and is responsible for its maintenance and repair while waiting deferred payment from the client.⁷³⁹ It is not difficult for conventional financial institutions in the USA to grant a loan by taking the title of goods and reselling them to a client; however, if such institutions operate on Islamic principles, they bear the credit risk. In the period 1997–2001, the Office of the Controller of Currency approved the use of *Murabaha* financing for the purpose of purchasing homes on a case-by-case basis.⁷⁴⁰ In the USA, *Murabaha* is treated as a credit transaction, involving a high credit risk. Thus, restrictions are placed on the ownership of the property in order to manage this risk.⁷⁴¹

The third category of legal risk accompanying *Murabaha* transactions to be considered here is that of operational risks, one type of which, according to

⁷³⁵ Sundararajan, V. 2007. Risk measurement and disclosure in Islamic finance and the implications of profit sharing investment accounts. *Advances in Islamic Economics and Finance*, 1, pp.121-152.

⁷³⁶ van Greuning, H. and Iqbal, Z. 2008. *Risk Analysis for Islamic Banks*. World Bank Publications, p. 100.

⁷³⁷ Ibid, p, 112.

⁷³⁸ Sundararajan, V. 2007. Risk measurement and disclosure in Islamic finance and the implications of profit sharing investment accounts. *Advances in Islamic Economics and Finance* 1, pp.121-152.

⁷³⁹ Salah, I., King and Spalding, 2009. *Legal issues arising in Islamic finance transactions in the United States*. [Online]. Available at: <http://www.kslaw.com/Library/publication/9-09%20Yasaar%20Media%20Salah.pdf> [Accessed on: 18 March 2014].

⁷⁴⁰ Ibid.

⁷⁴¹ van Greuning, H. and Iqbal, Z. 2008. *Risk Analysis for Islamic Banks*. World Bank Publications, p.52.

the literature, is price risk.⁷⁴² This occurs when the seller and the bank fail to decide the price of the commodity as a result of changes in macroeconomic factors. Another issue is non-compliance with Sharia law, which prohibits *riba* in Islamic financial transactions.⁷⁴³ However, if money is exchanged against the loan, it takes the form of *riba*; otherwise, it is considered a profit margin. Another consideration is the risk of ownership of the assets, since in a *Murabaha* transaction; the bank takes the title of the goods from the vendor at the request of the client.⁷⁴⁴ This shifts onto the bank the risk of maintaining the goods in their original form or as specified in the contract until the bank receives payment and transfers ownership to the client. However, another form of operational risk is people risk, which applies to *Murabaha* when the seller fails to provide the goods to the bank and thus to the client as per the agreed terms and conditions.⁷⁴⁵ This may also lead to non-payment if the client refuses to pay for the goods which do not fulfil the contract terms. Finally, globalisation has increased competition in the market, which, in turn, has increased the risks associated with financial transactions.⁷⁴⁶

This subsection has discussed the major legal risks associated with *Murabaha* transactions as reported in the literature. The next section considers their mitigation.

Mitigating legal risks

I found details of a variety of measures that can be taken to mitigate the legal risks associated with *Murabaha* transactions.⁷⁴⁷ These will improve the role the *Murabaha* contract can play in Islamic finance and in international finance.

⁷⁴² Ibid, p. 63.

⁷⁴³ Bloomsbury Publishing. 2010. *Islamic Finance: Instruments and Markets*. A & C Black, p. 73.

⁷⁴⁴ Sundararajan, V. 2007. Risk measurement and disclosure in Islamic finance and the implications of profit sharing investment accounts. *Advances in Islamic Economics and Finance*, 1, pp.121-152.

⁷⁴⁵ Usmani, T. 2004. *An Introduction to Islamic Finance*. Arham Shamsi, p. 5.

⁷⁴⁶ Ibid, pp. 9-10.

⁷⁴⁷ Karim, S.A. 2010. *The Islamic Moral Economy: A Study of Islamic Money and Financial Instruments*. Universal, pp. 22-26.

Islamic banks and financial institutions, like conventional ones, must maintain a capital balance sufficient to meet their obligations and pay their liabilities in a timely way because negative net worth would lead to insolvency.⁷⁴⁸ For this reason, it is necessary to encourage the growth of elements comprising the numerator of the leverage ratio while applying regulatory measures to reduce the total risk that appears in the denominator.⁷⁴⁹ Among the methods which banks use to absorb any capital losses incurred are the standardised approach, the basic indicator approach, and the advanced measurement approach.⁷⁵⁰ The basic indicator approach enables one to determine the reasons behind capital losses in the context of the present situation; however, the advanced measurement approach considers the future context to determine capital losses. They are also required to issue risk reports, which provide information on the various activities which may result in the creation of risk.⁷⁵¹ A separate detailed report should be written for each type of risk to help reduce the risk arising from a lack of clarity in information that the documentation contains.⁷⁵² This increases transparency in the business operations of the banks and helps build trust and loyalty among their stakeholders.⁷⁵³ Transparency in the financial documents works efficiently to find financial risks/gaps. The assessment of that method is performed in light of the International Financial Reporting Standards (IFRS).

Other practices which are also important in ensuring the stability of financial systems and commercial relationships are the credit rights and insolvency systems.⁷⁵⁴ Other measures related to creditor and debtor regimes help boost public confidence in the financial and corporate sectors by assessing,

⁷⁴⁸ Sundararajan, V. 2007. Risk measurement and disclosure in Islamic finance and the implications of profit sharing investment accounts. *Advances in Islamic Economics and Finance* 1, pp.121-152.

⁷⁴⁹ Ibid.

⁷⁵⁰ Izhar, H. 2010. Identifying Operational Risk Exposures in Islamic Banking. *Kyoto Bulletin of Islamic Area Studies*, 3-2, pp. 17- 53.

⁷⁵¹ Sundararajan, V. 2007. Risk measurement and disclosure in Islamic finance and the implications of profit sharing investment accounts. *Advances in Islamic Economics and Finance*, 1, pp.121-152.

⁷⁵² Ibid.

⁷⁵³ Bock, M. 2010. *Governance Risk Management and Financial Product Development in Islamic Financial Institutions*. GRIN Verlag, p. 256.

⁷⁵⁴ Dar, H. and Moghul, U. (eds.) 2009. *The Chancellor Guide to the Legal and Shari'a Aspects of Islamic Finance*. London: Chancellor Publications, p. 32.

managing, and controlling various categories of risk, such as those related to price, corporate failure, and default.⁷⁵⁵ It has also been found that identification of risk, the compiling of risk management reports, and the establishment of credit rating systems can facilitate the mitigation of risk.⁷⁵⁶ Credit rating systems are used to evaluate the creditworthiness of the parties to a transaction by considering a set of criteria for each party.⁷⁵⁷ Sharing the information associated with the different risks among all the parties involved further enhances the transparency of the operations and helps other parties that may face equivalent risks when executing similar transactions in the future.⁷⁵⁸ Default risks can be mitigated or prevented by requiring guarantees and warranties from individuals or businesses, in response to non-payment for the commodity by the parties involved in the execution of the transaction.⁷⁵⁹ It is also important to use various hedging instruments, which help address operational and credit risks.⁷⁶⁰ Hedging instruments are supportive to offset changes between the current and future cash flows and fair value. The assessment of these techniques involves the evaluation of the changes so as to fill any gaps or mitigate the risk of changes.

Since technology risk can arise because the parties have inadequate knowledge of the technology used in the execution of transactions, resulting in failure of those transactions, the appropriate mitigation process is to ensure that those involved are well trained and informed about the relevant technological developments.⁷⁶¹ In order to mitigate the liquidity risk arising from the mismanagement of assets and liabilities, it is necessary to establish an appropriate liquidity risk management framework, including detailed information

⁷⁵⁵Dusuki, A.W. 2006. Commodity *Murabaha* Programme (CMP): An Innovative Approach to Liquidity Management. *Journal of Islamic Economics, Banking and Finance* 3(1).

⁷⁵⁶Sundararajan, V. 2007. Risk measurement and disclosure in Islamic finance and the implications of profit sharing investment accounts. *Advances in Islamic Economics and Finance* 1, pp.121-152.

⁷⁵⁷ Ibid.

⁷⁵⁸Cotran, E. and Lau, M. 2002. *Yearbook of Islamic and Middle Eastern Law: 2001-2002*. Brill, p. 88.

⁷⁵⁹ Ibid, p. 69.

⁷⁶⁰ Köhn, D. 2011. *Mobilising Capital for Emerging Markets: What Can Structured Finance Contribute?* Springer, p. 52.

⁷⁶¹Sundararajan, V. 2007. Risk measurement and disclosure in Islamic finance and the implications of profit sharing investment accounts. *Advances in Islamic Economics and Finance* 1, pp.121-152.

on all aspects of asset-liability management.⁷⁶² The factors which need to be considered for the purpose of mitigating the liquidity risk include the maturity periods of liabilities and the conversion period of the assets which are used to meet the various contractual obligations.⁷⁶³ It is further suggested that developing the derivatives market will help in the management of these risks more effectively.⁷⁶⁴ Credit default swaps are also used for the purpose of speculation and to mitigate risks, with their purchase and sale depending, to some extent, on the credit rating system.⁷⁶⁵ If a party's credit rating is lower than the benchmark, it is not appropriate to use credit default swaps as a risk mitigation tool.⁷⁶⁶ In any case, the proper allocation of assets is necessary in order to meet obligations proportionately.⁷⁶⁷ These tools for risk mitigation work effectively as the extent of risk can be measured efficiently. For example, credit rating reflects "credit risks linked with a financial instrument".

Other strategies which financial institutions and banks can adopt to mitigate risks include the implementation of legal reforms, the adoption of the lender of last resort facility, and the establishment of liquidity management and deposit protection systems.⁷⁶⁸; Risks can also be eliminated by establishing and enforcing strict rules and regulations, backed by the imposition of heavy penalties to encourage the parties to make payments in full and on time.⁷⁶⁹ Heavy penalty provision in *Murabaha* contract is compatible to Sharia law because amount of penalty is further donated for the charity instead taking amount of penalty by bank as its income. Additional steps that might be helpful in mitigating the risks of *Murabaha* transactions include maintenance of proper documentation and the

⁷⁶² Ibid.

⁷⁶³ Cattelan, V. (Ed.) 2013. *Islamic Towards a Plural Financial System. Finance in Europe: Studies in Islamic finance*. Edward Elgar, pp. 23-25.

⁷⁶⁴ Ibid, p. 33.

⁷⁶⁵ Köhn, D. 2011. *Mobilising Capital for Emerging Markets: What Can Structured Finance Contribute?* Springer, p. 16.

⁷⁶⁶ Bovens, M.A.P., T'Hart, P. and Peters, B.G. 2002. *Success and Failure in Public Governance: A Comparative Analysis*. Edward Elgar, p. 52.

⁷⁶⁷ International Monetary Fund. 2010. *Finance & Development, December 2010*. International Monetary Fund, p. 19.

⁷⁶⁸ Ayub, M. 2009. *Understanding Islamic Finance*. John Wiley & Sons, pp. 25-29.

⁷⁶⁹ Bellalah, M. 2013. *Islamic Banking and Finance*. Cambridge Scholars, pp.14-15.

establishment of credit limits.⁷⁷⁰ It has been analysed that the mitigation strategies for dealing with the legal risks associated with *Murabaha* transactions are effective in building investors' trust. It is crucial to deal with risks to keep the parties' interest in *Murabaha* transaction. Altogether, handling legal risks related to *Murabaha* leads to stimulating and building of relationships between the dealer and investor.

3.4 Findings from the Analysis of the Contracts

After the literature review, data relevant to the research topic were also collected from *Murabaha* contracts and other documents provided by two Saudi banks, Al Rajhi and Al Bilad.⁷⁷¹ In Islamic finance, one of the most pertinent contracts is the *Murabaha* contract, which includes buying the commodities, with the requirement of huge funds. In this case, the customer is not capable of making an advance payment or the supplier of the commodity does not trust the customer. Therefore, the financial organisation makes a purchase on behalf of the customer and re-sells that commodity to the same customer clearly stating the cost incurred and the profit margin.

Al Rajhi Bank is a Saudi Arabian bank and the world's largest Islamic bank by capital.⁷⁷² Al Bilad Bank is a joint stock company established in 2004, with its headquarters in Riyadh. Core products and services include retail banking, business finance, and investment.⁷⁷³ It has a capital of 4,000,000,000 Saudi riyals and aims to provide innovative banking products and services to meet the changing needs and demands of stakeholders such as shareholders, employees, and clients.⁷⁷⁴

⁷⁷⁰ Aldohni, A.K. 2011. *The Legal and Regulatory Aspects of Islamic Banking: A Comparative Look at the United Kingdom and Malaysia*. London: Routledge, p. 3-5.

⁷⁷¹ Alexander, A.J. 2011. Shifting Title and Risk: Islamic Project Finance with Western Partners. *Michigan Journal of International Law* 3(3), pp. 572-611.

⁷⁷² Alhowaimil, I. S. 2013. Frustration of Performance of Contracts: A comparative and Analytic Study in Islamic Law and English Law, p. 11.

⁷⁷³ Ibid.

⁷⁷⁴ Bank Albilad. 2012. *Annual Report 2012*. [Online]. Available at: <http://www.bankalbilad.com/sites/en/SiteAssets/Pages/Forms/EditForm/Annual%20Report%202012.pdf> [Accessed on: 23 March 2014].

This section evaluates and discusses the various legal risks identified above by comparing these banks' contracts with the principles and practices of Sharia law.⁷⁷⁵ For example, as noted above, both the Quran and Sharia law forbid the charging of *riba* on monetary loans.⁷⁷⁶ Non-compliance with this restriction results in the occurrence of risk, as people are reluctant to borrow money from any individual or institution operating a practice that is considered unethical.⁷⁷⁷ It is the responsibility of the parties to a *Murabaha* transaction to ensure that it complies fully with the stipulations of the Quran and Sharia law.⁷⁷⁸ *Murabaha* contracts are, nonetheless, risky because they are based on complex partnership principles and are executed in two stages, namely the *promise* and the *contract*.⁷⁷⁹ Thus, the bank invites the client to enter into an agreement by signing two forms: the first constitutes the promise and the second, the contract.⁷⁸⁰ In the *Murabaha* contract, the concept of *riba* is avoided as it works on the idea of cost-plus financing, wherein the commodity is resold to the client at such a price which includes the cost incurred and the profit margin. The terms and conditions applicable to these documents are as follows:

The Promise

The client promises to purchase from the bank the goods specified as well as to sign the contract once the bank receives them, which signifies that the promise between the parties is legal and binding.⁷⁸¹ The client is liable for all costs of any unplanned consequences. This means that all the costs that are involved in the contract should be clearly mentioned and specified to take an informed decision.⁷⁸² The client agrees to pay a specific percentage of the price

⁷⁷⁵ Bryman, A. 2012. *Social Research Methods*. Oxford University Press, pp. 59-63.

⁷⁷⁶ Ayub, M. 2009. *Understanding Islamic Finance*. John Wiley & Sons, p. 12.

⁷⁷⁷ Bovens, M.A.P., T'Hart, P. and Peters, B.G. 2002. *Success and Failure in Public Governance: A Comparative Analysis*. Edward Elgar, pp. 9-10.

⁷⁷⁸ *Ibid*, p. 38.

⁷⁷⁹ Cattelan, V. (Ed.) 2013. *Islamic Finance in Europe: Towards a Plural Financial System*. Studies in Islamic finance. Edward Elgar, pp. 5-6.

⁷⁸⁰ Alhowaimil, I. S. 2013. *Frustration of Performance of Contracts: A comparative and Analytic Study in Islamic Law and English Law*, Publisher, p. 19.

⁷⁸¹ *Ibid*, p. 20.

⁷⁸² *Ibid*, p. 23.

of the goods upon signing the promise agreement. This will be taken as binding the client to the contract. The signature of the parties on the document is held to be binding on both the parties.⁷⁸³ In addition, if either of the parties withdraws from the promised agreement, the innocent party will be held liable for all costs with no remedy, which again signifies that the promise is binding on the parties to the contract.⁷⁸⁴ If the third party withdraws from the contract, the bank is not held responsible, and the client is held responsible for covering all costs. This can be interpreted as the lack of equality of power between the parties.⁷⁸⁵ The last condition states that the parties seeking a remedy will be assigned three arbitrators and the case will not be referred to a court, which further shows that there is no transparency in the judicial system.⁷⁸⁶

The Contract

The contract is signed once the bank receives the goods. These belong to the client at this stage and he is held responsible for them.⁷⁸⁷ The client specifies the details of the goods and his requirements.⁷⁸⁸ If the goods when received do not comply with his specifications, he is held responsible and not the bank. This is a precedent term acknowledged by all parties.⁷⁸⁹ The following subsections identify and discuss the legal risks involved in these documents related to *Murabaha* issued by the two banks, beginning with Al Bilad Bank.⁷⁹⁰

Risks related to Al Bilad Bank Contracts

⁷⁸³ Ibid, p. 26.

⁷⁸⁴ Kettell, B. 2011. *Islamic Finance in a Nutshell: A Guide for Non-Specialists*. John Wiley & Sons, p. 80.

⁷⁸⁵ Kimmel, A.J. 2009. *Ethical Issues in Behavioral Research: Basic and Applied Perspectives*. John Wiley & Sons, p. 18.

⁷⁸⁶ Khan, M.F. and Porzio, M. 2010. *Islamic Banking and Finance in the European Union: A Challenge*. Edward Elgar Publishing, p. 21.

⁷⁸⁷ McKendrick, W. 2015. *Contract Law*. Palgrave Macmillan p. 86.

⁷⁸⁸ Ibid, p. 86.

⁷⁸⁹ Ibid, p. 87.

⁷⁹⁰ Ibid, p. 89.

Source 1 (the promise) states that the bank is authorised to purchase the goods on behalf of the client if agreed upon within Islamic law. This statement does not specify the full details of what is required. The fact that full details of the commodity or goods are not specified in the promise increases the legal risk for the parties involved because the terms and conditions of the promise are not compliant with Sharia law, which states that the client must choose to accept the goods specified in the promise. Banks are therefore required to provide in the promise full details of the goods aligned to the needs and demands of the client. This means the absence of the details of the commodity in the contracts gives rise to the legal risks pertaining to the parties to the contract. In order to reduce these risks, it is advised that the details and the specifications be mentioned in the contract.

Source 7 states that it is not permissible to treat the promise as a form of contract in itself. However, the bank treats this as a binding document, in contradiction to Islamic law. The fact that Al Bilad Bank considers the promissory document exchanged with the client to be binding, without a contract being signed constitutes a legal risk because it denies the client the option of declining to accept the contract along with the promise. By failing to finalise a proper contract with the client to enact the promise regarding the same, relying instead on the promise alone to compose and execute the *Murabaha* contract, Al Bilad Bank is in breach of Sharia law. The fault lies on the part of the banks, as the banks should consider all the aspects of the contracts in order to identify the possible risks and the measures that can be used to mitigate them. This constitutes a legal risk, as Sharia law requires that the client should make a promise to buy the goods from the bank on the agreed terms and conditions. This means that in order to make the promise binding, it is also necessary for the client to sign a contract after the bank has bought the goods from the vendor.

Source 8 states that the bank is not permitted to treat the promise as a form of contract nor is it permitted to specify the profit percentage in the *Murabaha* contract before the signing of the said contract. This again represents a major legal risk for the bank, because the promise does not constitute a

contract and the percentage of profit must be stated in the promise, as the goods are purchased by the bank after the client agrees to the terms mentioned in the promise. In addition, the client signs the contract after the bank has purchased the goods from the vendor. The legal risk arises because the contract does not comply with Sharia law. To eliminate this risk, it is necessary for the bank to provide details regarding the profit percentage made in the promise

Source 16 states that if the bank fears that the client may retract the promise, the bank is permitted to purchase the goods and return them to a third party. This creates another legal risk related to damage and storage for the third party as well as a risk for the bank. Default risk is can be attributed to the fact that the client may retract the promise; a third party is involved in the promise and as per fatwa, the bank has permission to purchase the goods and return them to the third party. However, according to the terms of the promise in the *Murabaha* contract, if the third party withdraws from the contract, it is the client who is held liable for any loss or damage incurred and not the bank. This indicates that the parties to the contract do not share equal responsibility, which can be viewed as a legal risk for the participants.

Source 28 states that the client cannot be held responsible for the expenditure incurred in cases where a third party does not honour the terms of the contract, yet Al Bilad Bank's contracts assert that where the third party does not commit to the agreement, the client is held responsible. Sharia law or fatwa indicates that in the execution of Islamic financial contracts, the client is not responsible for the expenditure incurred if the third party rejects or fails to fulfil the terms of the promise and the contract made. The fact that Al Bilad Bank formulates the promise and the *Murabaha* contract to make the client responsible for loss or damage arising from the adverse actions of a third party thus constitutes a legal risk for all parties in that the terms of the contract and the promise associated with *Murabaha* do not comply with Sharia principles and rulings.

Source 41 states that the bank is permitted to ask the client to appoint a sponsor for the duration of the promise; it is then the sponsor who takes full

responsibility for the *Murabaha* agreement until the contract is signed. This creates a legal risk because Sharia law gives the bank authority to make the client its agent, responsible for executing the promise to purchase the goods from the vendor until the client signs the contract. Under the terms of the contract issued by Al Bilad Bank, the bank shall purchase the goods from the vendor and sell them to the client. This poses a legal risk as the client may refuse to purchase the goods if they do not meet his requirements. This risk arises because Al Bilad Bank does not make the client its agent.

Source 42 states that the bank is permitted to require payment of a pledge to act as a guarantee during the period of the promise; however, it is not to be used until the *Murabaha* contract is signed. This point evidences that the promise is not binding, exposing the bank to the possibility of loss, which again amounts to a legal risk. It has been discussed that the promised agreement is not considered binding unless the client signs the promise document. It is also the case that the bank cannot require the guarantee of a pledge if the promise is not binding. This creates a legal risk for the innocent party in this case; the bank has to bear all unexpected costs arising from the withdrawal of the client from the fulfilment of the promise as well as the contract.

Source 43 states that a bank is not permitted to sell goods until it owns them; this includes not being permitted to make a contract with the client during the period where the goods are outside the bank's ownership. This places a legal liability on the bank. As noted, the bank requires the client to sign two documents, namely a promise and a contract, in order to execute the *Murabaha* transaction. Under Sharia law, a bank cannot sell goods to a client until the bank has ownership of the goods. However, the terms of the *Murabaha* contract and promise provided by Al Bilad Bank indicate that the client should sign the contract after the bank has taken title to the goods, which are considered to belong to the client immediately after the bank purchases them from the vendor. A legal risk arises for the bank if the client withdraws from the contract, making the bank bear the loss so incurred.

Source 48 states that the bank is not required to formally put its name to the financial product. This constitutes a legal risk to the client. Sharia law states that it is not necessary for the bank to put its name to the products provided to the client when formulating the contract associated with a *Murabaha* transaction. This may create a legal risk for the client, as non-declaration of the name of the bank in the contract indicates that the client has to bear all costs associated with the product. Stating the name of the bank in the contract aids in bearing the cost associated with the product until title to the goods passes to the client.

Source 56 states that insurance of the goods remains the responsibility of the client, which is responsible for all risks and thus, the promise document states that the client is responsible for any risks which occur. A similar legal risk is inherent in the contract formulated by the bank, as it entails that the client bears responsibility for all problems associated with the cost as well as the goods. This is contrary to fatwa and Sharia law, which state that all unexpected losses incurred are to be met by the bank and client both through the medium of insurance in respect to the principle of PLS of Sharia legal system. Thus, a legal risk arises from non-compliance with Sharia law.

Source 67 states that the bank is permitted to seek a guarantee in the *Murabaha* contract; this includes a pledge of property or a bank account (tangible and intangible property). Legal risk in the form of default or credit risk may arise at the time of execution of the contract as the client may not be able to make a timely payment for the goods. Sharia or fatwa indicates that the bank can require a guarantee in the form of a pledge of property or control of a bank account so as to mitigate the default and credit risk related to the *Murabaha* contract.

Source 72 states that the bank is not permitted to impose a charge on the client for any delay, yet the Al Bilad Bank contract states that the client is held responsible for any such delay. Sharia law or fatwa reflects the prohibition of the receipt of monetary benefit against non-payment or delay in payment by the client. However, the contract specifies penalty charges to be borne by the client if he fails to make a payment for the goods provided as per the terms and

conditions of the contract. This discrepancy is considered to constitute a legal risk inherent in the *Murabaha* contract.

Finally, it is clear that the promise agreement is not binding according to Islamic law although the bank holds it to be a binding contract between itself and the client. In the event of a breach or dispute between the bank and the client, they must submit to an arbitration tribunal. There is a major legal risk to both parties in this event, as the tribunal may take the opinion of another scholar of Islamic law, since there is no legal precedent to follow.

Risks related to Al Rajhi Bank Contracts: A Glimpse into the Uses and Abuses of Islamic Law

The misuse of *Murabaha* transactions by the banks can harm the finance industry. The commodity *Murabaha* contracts are often misused by the Islamic banks for investing the surplus cash available with them, which is compliant to Sharia law. However, in general practice, for many transactions, the commodity is not exchanged, but there is exchange of cash flow among the banks.

In this context, *Source 1* (the promise) states that the bank is authorised to purchase the goods on behalf of the client if agreed upon in Islamic law.⁷⁹¹ Under Sharia law, a bank is permitted to purchase goods on behalf of a client if the conditions are agreed upon in compliance with Islamic law.⁷⁹² The *Murabaha* facility offered by Al Rajhi Bank is inconsistent with this requirement, in that the terms and conditions of the agreement are specified by the institution at the time of buying goods from the vendor and selling them to the client.⁷⁹³ Thus, the terms favoured by the client are not agreed at the time of buying or selling the goods and there is a legal risk inherent in the contract because it is not fully compliant with Sharia law.⁷⁹⁴ It is possible that the client may refuse to buy the goods from

⁷⁹¹ Majid, S. and Majid, F. 2009. *Application of Islamic Law in the Middle East - Interest and Islamic Banking*. [Online]. Available at:

<http://www.iraqilawconsultant.com/puplications/majid/article09.html> [Accessed on: 09 July 2015].

⁷⁹² Oxford Business Group. 2007. *The Report: Emerging Saudi Arabia*. Oxford Business Group.

⁷⁹³ *Murabaha Working Capital*. 2011. [Online]. Available at: <http://www.midf.com.my/our-product-a-services/development-finance-division/669> [Accessed on: 28 July 2015].

⁷⁹⁴ *Ibid.*

the bank at the cost plus mark-up price on the grounds that the terms of the contract are not favourable.⁷⁹⁵

Source 56 states that insurance of products remains the responsibility of the bank, which is responsible for all risks.⁷⁹⁶ This requirement of Sharia law is violated by the Al Rajhi Bank *Murabaha* agreement, which states that the financing institution and the client shall both be entitled to seek adjudication to resolve any dispute or to compensate the risk arising from a dispute.⁷⁹⁷ There is thus a legal risk from non-compliance with the requirement of Sharia law that risks and problems associated with an Islamic financial contract shall be borne by the bank itself.⁷⁹⁸ By providing that profit and loss, along with costs, shall be shared among the parties involved, the Al Rajhi Bank contract contravenes Sharia law and generates a legal risk.⁷⁹⁹

Source 72 states that to comply with Sharia law, the bank is not permitted to impose a charge on the client for any delay. The Al Rajhi *Murabaha* agreement breaches this legal proscription by requiring a payment to its charity fund in respect of payment default.⁸⁰⁰ While the terms of the Bank's *Murabaha* agreement do not directly involve the institution accepting or demanding interest on late payment, the client is expected to pay a penalty sum to the bank's charity fund calculated as a proportion of a specified annual rate equivalent to the length of time since default.⁸⁰¹ This amounts to an indirect interest charge, in contravention of the Sharia prohibition of *riba*, thus creating a legal risk to the

⁷⁹⁵ *Murabaha as a mode of finance*. 2009. [Online]. Available at: http://www.albaraka.co.za/Islamic_Banking/Features_of_Murabaha_and_Leasing/Murabaha_as_a_Mode_of_Finance.aspx. [Accessed on: 16 July 2015].

⁷⁹⁶ *Murabaha*. 2015. [Online]. Available at: <http://www.bankalfalah.com/islamicpk/corporate-banking/working-capital-finance/Murabaha/> [Accessed on: 03 July 2015].

⁷⁹⁷ *Ibid.*

⁷⁹⁸ *Murabaha Working Capital*. 2011. [Online]. Available at: <http://www.midf.com.my/our-product-a-services/development-finance-division/669> [Accessed on: 28 July 2015].

⁷⁹⁹ *Ibid.*

⁸⁰⁰ Karim, R.A.A. and Archer, S. 2013. *Islamic Finance: The New Regulatory Challenge*. Wiley. p. 16.

⁸⁰¹ Karim, S.A. 2010. *The Islamic Moral Economy: A Study of Islamic Money and Financial Instruments*. Universal. p. 22.

bank because the terms of its *Murabaha* agreement are not properly aligned with Sharia law.⁸⁰²

3.5. Critical analysis of the contracts

Comparison of Sharia and fatwa rulings with the terms and conditions of the *Murabaha* documents issued by the different entities which were involved in dealing with these two instruments helped in identifying the legal risks faced by these entities in executing such contracts.⁸⁰³ This knowledge ensures that the risk that are associated with *Murabaha* financial transactions are thoroughly examined in order to meet the research aims and objectives. Sharia law does not permit banks to make charges against default or delay in payment for goods, yet Al Rajhi was found to do so, albeit indirectly, by requiring penalty payments to its charity fund. This non-compliance with Sharia law constitutes a legal risk for the bank, which could be mitigated by accepting a guarantee or warranty, either personal or institutional.

Sharia law also makes the bank liable for unexpected costs related to the goods purchased until title is transferred to the client, but according to the terms of the Al Rajhi promise and contract, all such costs are to be borne by the client.⁸⁰⁴ This risk can be mitigated by providing comprehensive information about the terms and conditions of contracts.⁸⁰⁵

Another risk associated with the *Murabaha* contract arises because Sharia and fatwa require the bank to obtain the consent of the client to purchase goods

⁸⁰²Kettell, B. 2011. *Case Studies in Islamic Banking and Finance*. John Wiley & Sons. p. 25.
Knoop, T.A. 2013. *Global finance in emerging market economies*. Routledge international studies in money and banking. Routledge. p. 36.

⁸⁰³McKendrick, E. 2015. *Contract Law*. Palgrave Macmillan. p. 86; Sundararajan, V., and Errico, L. 2002. *Islamic Financial Institutions and Products in the Global Financial System: Key Issues in Risk Management and Challenges Ahead*. IMF working paper. International Monetary Fund. p. 69.

⁸⁰⁴Sundararajan, V., and Errico, L. 2002. *Islamic Financial Institutions and Products in the Global Financial System: Key Issues in Risk Management and Challenges Ahead*. IMF working paper. International Monetary Fund.p. 48.

⁸⁰⁵Ibid, p. 68.

from the vendor,⁸⁰⁶ whereas the bank was found to purchase goods from the vendor at cost price and then to promise to sell them to the client at cost plus mark-up.⁸⁰⁷

Sharia law further stipulates that agreement to the promise alone does not constitute agreement to the contract; the bank must obtain the client's agreement to the promise as well as the contract, which the client signs after the bank have purchased the goods.⁸⁰⁸ The bank can sell the goods to the client only after acquiring title to them from the vendor. A legal risk arises where the bank deems the promise itself to be a contract.

Sharia law makes the bank responsible for the cost of insuring its products, but the contracts were found to state that these costs were to be borne or shared by the client, a discrepancy which results in the risk of ownership of goods.⁸⁰⁹

A fatwa requiring non-disclosure of the profit percentage or mark-up until the client has signed the contract was found to be violated by the bank by its disclosure of all relevant and material information regarding the details of the contract in the promise so as to improve transparency.⁸¹⁰

Another fatwa referring to bank contracts states that the client is not liable for any loss incurred by withdrawal from the contract⁸¹¹ when the bank purchases the goods from the client and returns them to a third party. However, the *Murabaha* contract of Al Bilad Bank holds the client responsible for any losses arising from the withdrawal of the third party.⁸¹² This results in a credit risk, as it implies that the client is unable to make payments in a timely manner. Similarly, Sharia law states that the client is not responsible for losses or risks incurred if a third party withdraws from the contract, yet the banks create a legal risk by making the client responsible in the contract for losses arising from the failure of

⁸⁰⁶ Bellalah, M. 2013. *Islamic Banking and Finance*. Cambridge Scholars. p. 25.

⁸⁰⁷ Hassan, K. and Lewis, M. 2007. *Handbook of Islamic Banking*. Edward Elgar.

⁸⁰⁸ *Ibid*, p. 78.

⁸⁰⁹ Ayub, M. 2009. *Understanding Islamic Finance*. John Wiley & Sons. pp. 89, 92.

⁸¹⁰ *Ibid*, p. 969.

⁸¹¹ *Ibid*, p. 15.

⁸¹² Bellalah, M. 2013. *Islamic Banking and Finance*. Cambridge Scholars, p. 5.

the third party to meet the requirements of the contract.⁸¹³ This risk can be mitigated by providing clear information in documents associated with the contract.⁸¹⁴

Sharia law also provides that a client may act as an agent for the bank in order to obtain goods from the vendor at cost price and repurchase them from the bank at cost plus mark-up price, whereas the Al Bilad Bank contract states that the bank shall purchase the goods from the vendor and sell them to the client.⁸¹⁵ This creates the ownership risk that the client may withdraw from the contract because he has not received the goods as per the agreed terms.⁸¹⁶

The bank may demand a pledge to guarantee the terms of the promise, but according to Sharia law, it cannot do so until the client signs the contract.⁸¹⁷ The Al Bilad Bank contract is therefore non-compliant with Sharia in stating that the promise itself is considered binding.⁸¹⁸ It is concluded that it is necessary for the client to sign the promise agreement for the purpose of making it binding and that the bank could then execute the guarantee as soon as the client had signed the contract.

Moreover, the bank cannot sell the goods to the client unless it takes ownership of them from the vendor in accordance with Sharia law.⁸¹⁹ However, the contract as issued by the bank provides for ownership to pass directly to the client from the vendor, in order for the bank to avoid the risk of losses in the maintenance of the goods.⁸²⁰ Our analysis shows that neither Sharia nor *Murabaha* fatwas formally require that the goods being purchased for the client

⁸¹³Bovens, M.A.P., T'Hart, P. and Peters, B.G. 2002. *Success and Failure in Public Governance: A Comparative Analysis*. Edward Elgar, p. 2.

⁸¹⁴Cattelan, V. (Ed.) 2013. *Islamic Finance in Europe: Towards a Plural Financial System*. Studies in Islamic finance. Edward Elgar, p. 19.

⁸¹⁵Chorafas, D.N. 2011. *Stress Testing for Risk Control Under Basel II*. Butterworth-Heinemann, p. 26.

⁸¹⁶Choudhury, M.A.2013. *Money in Islam: A Study in Islamic Political Economy*. Routledge, p. 25.

⁸¹⁷ Colón, J.C. 2014. Choice of Law and Islamic Finance. *Texas International Law Journal* 46, p. 411.

⁸¹⁸ Cotran, E. and Lau, M. 2002. *Yearbook of Islamic and Middle Eastern Law: 2001-2002*. Brill, pp.12-14.

⁸¹⁹ Foster, N.H.D. 2006. Encounters between legal systems: recent cases concerning Islamic commercial law in secular courts. *Amicus Curiae*, pp. 12-16.

⁸²⁰Freedman, C. and Goodlet, C. 1998. *The Financial Services Sector: Past Changes and Future Prospects*. Bank of Canada Technical Report. p. 23.

need to be put in the name of the bank.⁸²¹ Title to the product can legitimately pass directly from vendor to purchaser because the bank acts only as a financing agent between the other two parties.⁸²²

A valid and trustworthy guarantee is quite significant in any such financial contract, as it acts as a security on the part of the seller.⁸²³ In the *Murabaha* fatwa, a pledge of tangible or intangible property is required as assurance for the entire process of buying or selling.⁸²⁴ The bank requires a pledge of property or other assets so that the legal risk of payment default or renunciation of the contract can be prevented.⁸²⁵ This signifies that financial institutions of the Islamic banking system also give importance to ensuring a guarantee for any financial dealing with a bank in the *Murabaha* contract.⁸²⁶

3.6 Conclusion

From the findings of this chapter, it can be concluded that practices associated with Islamic finance have gained popularity since the global financial crisis of 2008. The growth of Islamic finance has brought many changes in procedures and processes, making the economy more flexible and helping it to recover from the recent economic turmoil.

Among Islamic financial transactions, *Murabaha* is a sales contract involving a vendor, a bank, and its client, who share material information to build transparency and trust. On instructions from the client, the bank purchases goods from the vendor and resells them to the client at cost plus a negotiated mark-up based on the LIBOR rate. Payment is usually made in instalments and

⁸²¹Hassan, K. and Lewis, M. 2007. *Handbook of Islamic banking*. Edward Elgar Publishing. pp. 59-60.

⁸²²*Ibid*, p. 26.

⁸²³Hallaq, H.B. 2009. *An Introduction to Islamic Law*. Cambridge University Press. p. 29.

⁸²⁴*Ibid*, p. 23.

⁸²⁵Hanif, M. 2011. Differences and Similarities in Islamic and Conventional Banking. *International Journal of Business and Social Science* 2(2), pp.168-172.

⁸²⁶*Ibid*.

the agreed terms are set out in a promise and a contract, both of which the client is required to sign.

It is further concluded that the legal risks associated with formulating and executing the *Murabaha* contract concern liquidity, credit, technology, people, non-compliance with Sharia, and other factors. Credit and default risks, which may occur if the client fails to make timely payment for the goods, can be mitigated by the bank requiring a guarantee or pledge. Mismanagement of the asset-liability balance in terms of maturities, payments, and so on may introduce liquidity risk, which can be addressed through the adoption of different financial instruments and the establishment of a derivatives market.

The bank can mitigate the risk that the client may repudiate the contract or refuse to take title to the goods by appointing the client as an agent of the bank and giving him authority to purchase the goods from the vendor on its behalf. Price and market risk may also arise from fluctuations in LIBOR or from changing socio-political, economic, technological, or legal factors.

The analysis of the second part of the chapter, while comparing the terms of *Murabaha* contracts issued by Bank Albilad and Al Rajhi Bank with Sharia law and fatwa rulings, revealed the existence of legal risks concerned with the prohibition of *riba*, the binding status of the pre-contract promise, risk-bearing among the parties, withdrawal by the third party, and others. In addition, suggestions of the best means of mitigating these risks in light of the evolving relationships between religion, law, and banking in Saudi Arabia were made.

The next chapter discusses the findings in the context of the literature review.

**Chapter 4: Analysis of the Legal Risks Associated with *Murabaha* Contracts
and Actions to Mitigate Legal Risks**

4.1 Introduction

This chapter discusses the results of the research in the context of the literature review. Thus, a detailed analysis of the findings of the literature search and the results of this research are presented.⁸²⁷ Throughout the chapter, the extent to which the research objectives have been met is revealed by means of developing an outline of the significant areas and organising the findings of the research in a logical form. The risks associated with the *Murabaha* Islamic finance contract are assessed and discussed in this chapter. The *Murabaha* contract involves three parties, such as a seller, a buyer, and a bank, wherein the bank plays the role of mediator between the buyer and seller. The role of the bank in such situations examined in this PhD is quite major as banking institutions' acts, such as compliance or non-compliance with Sharia law, affect buyers and sellers' interests. In the context of banks, this PhD research reflects the risks associated with *Murabaha* that arise for two main reasons: the banking system in Saudi Arabia tends to work against the applicable Sharia law and there is an absence of specific laws for guiding the conduct of Islamic banks.⁸²⁸

The chapter has two main purposes. The first is to provide explanations and interpretations of the results and to answer the research questions. The second main purpose is to provide a justification of the chosen approach and a critical evaluation of the study.⁸²⁹ In pursuit of these aims, the chapter seeks to place the findings in the context of the existing knowledge and literature related to the research topic. It also seeks to identify the implications of the findings for practice and policy.⁸³⁰ Based on the above, recommendations will be made later in the chapter.

⁸²⁷Dusuki, A.W. 2006. Commodity *Murabaha* Programme (CMP): An Innovative Approach to Liquidity Management. *Journal of Islamic Economics, Banking and Finance* 3(1).

⁸²⁸*Ibid.*

⁸²⁹Bellalah, M. 2013. *Islamic Banking and Finance*. Cambridge Scholars.p. 118

⁸³⁰Aldohni, A.K. 2011. *The Legal and Regulatory Aspects of Islamic Banking: A Comparative Look at the United Kingdom and Malaysia*. London: Routledge.

4.2 *Murabaha* financing and the associated risks

Major risks of Murabaha financing

Research has shown that, in banking business in general, risk management is considered to be a major function. Considering the modern financial landscape that has evolved over the past 20 years, the core business of the Islamic banks is heavily reliant on instalment-based financing. Among all the methods of financing, *Murabaha* financing is one of the most common. The major risks to which the parties to *Murabaha* contracts are predominantly exposed are legal risks and credit or default risks. However, such unsystematic risks associated with *Murabaha* financing are considered to be minimised by the banks through tight and deliberate credit valuation. Therefore, the credit valuation system leads to control of credit and default risks. An efficient valuation system significantly helps in controlling and diminishing the risk exposure of credit and default payments in this Islamic contract.

The *Murabaha* contracts considered to be a major source of non-performing financing if it is excessively executed as the provisions for doubtful debts will be reported in the financial statements, reflecting a strong probability of both the specific and general provisions.⁸³¹ This could also result in a decline in the value of the shareholders' capital. It is critically inferred that shareholders' interests are directly linked to the success of an organisation in terms of profitability and sustainability. Therefore, highly doubtful debts negatively impact shareholders' interests, which results in a decline of shareholders' capital. Investing in *Murabaha* and other credit-related instruments, which carry only small margins, can result in the lender securing large margins only through a large volume of transactions.

Murabaha financing is considered to be a source of exposure to liquidity risk for the Islamic banks. More specifically, there are certain circumstances in

⁸³¹Rosly, S.A. and Zaini, M.A. 2008. Risk-return Analysis of Islamic Banks' Investment Deposits and Shareholders' Fund. *Managerial Finance* 34(10), pp. 695-707.

which the average maturity of the deposits is found to be less than the average maturity rates of the *Murabaha* contracts. Even the deposits are found to be sensitive to market returns. In such circumstances, the liquidity risk is found to be due to the non-resalable nature of *Murabaha*, which is considered to be a source of primary risk in association with this instrument. By critically comparing doubtful debts, the liquidity risk associated with *Murabaha* has negatively affected the interests of investors. Liquidity risk causes a problem in terms of receiving timely payment on the due date because of a shortage of liquid assets. This risk is also proportionally linked to the shareholders' capital investment or value as it ensures short-term solvency.

There are other major risks associated with *Murabaha* contracts which indirectly affect the overall liquidity of the parties. Such risks could also be designated secondary liquidity risks arising from the *Murabaha* instrument. They are considered secondary because they arise only when the business risks and the other risks related to the *Murabaha* contract influence the overall liquidity of the Islamic banks. This could be further explained by stating that *Murabaha* contract gives the client the right to refuse to accept delivery for any valid reason. If the client does not accept delivery of the commodity, the bank will find itself encumbered with it unless and until another buyer can be found. Therefore, the risk of cancellation increases the liquidity risk for the bank. Therefore, liquidity risk in *Murabaha* transactions is directly related to the acceptance of the buyer because the banking institution, as a mediator, plays the role of taking the title to goods or services by making the payment on behalf of a buyer.

In a similar manner, if the buyer is found to be incapable of paying the due amount within the specified time, this is considered a credit risk which further exposes the bank to liquidity risk. A positive correlation therefore exists between credit risk and liquidity risk, as the buyer's incapability to pay their debt on time causes credit risks which affect the soundness of the financier or banking institution in terms of liquidity. It is also significant that Islamic banks are exposed to operational risk by the very process of carrying out a *Murabaha* contract, as it would be by being involved in any other sales contract. Furthermore, there are

other litigation or legal risks to which the bank and the other parties are exposed if certain significant laws are violated by the bank or other parties or if some kind of dispute arises between them.

It should further be stated that liquidity risk can arise indirectly from a legal risk if the payment of the due amount is stopped or if any applicable legal requirement is not met. However, Siddiqui pointed out that certain methods have been devised by which the secondary liquidity risk can be alleviated.⁸³² For example, the banks are required to ensure that their clients are maintaining their business accounts with them. The banks generally release the funds applied for in instalments, which contributes to the maintenance and protection of the assets of the banks and helps them to maintain the level of liquid funds at their disposal. Therefore, liquidity risk is a critical area of concern that must be dealt with efficiently in order to avoid a shortage of funds or working capital inefficiency.

There are strict *fiqh* restrictions on the Islamic banks, to the effect that they are unable to raise finance through the securitization of assets that are considered to be predominantly in the form of debt. In addition, due to the slow development of the instruments and gradual recovery of the funds, the Islamic banks are not able to raise funds quickly from the market. This issue becomes more serious where there is no inter-Islamic bank money market. Another issue is that the lender of last resort (LLR) provides a liquidity facility to the banks only in an emergency. Moreover, the facilities provided by the LLR are based on current interest rates. Thus, the Islamic banks are not able to seek any kind of benefit from this mechanism.

The process of executing a *Murabaha* financing agreement involves three major transactions between the bank and its customers and between the bank and a third party. The major risks significantly associated with this process are credit risk, operational risk, mark-up risk, legal risk, and counterparty risk. The findings of the present research have shown that, after *Mudaraba*, *Murabaha*

⁸³²Siddiqui, S.H. 2010. Islamic banking: True Modes of Financing. [Online]. Available at: <http://www.nzibo.com/IB2/truemodes.pdf> [Accessed on: 24 June 2015].

financing is considered to be the transaction performed by Islamic banks that bears the greatest credit risk.

Credit risk is generally defined as the probability of default on the part of the customer i.e. failure to pay the due amount or meet the loan commitment.⁸³³ Credit risk often occurs due to exposure to the probability of failure on the part of the customer to make payment for the commodity or the asset because of financial or other difficulties they are facing.⁸³⁴ According to the law, the risk associated with the asset is also borne by the bank until the asset is transferred to the customer. Thus, in case of any kind of destruction and fraud associated with the asset, the risk is borne by the bank and is considered as contributing to its credit risk. Furthermore, the bank is strongly restricted from charging any amount additional to the agreed value in spite of delayed payment or non-payment by the client of the due amount.

It has been stated, however, that the profit-sharing modes of financing are generally perceived from the banks' perspective as bearing a comparatively high credit risk. Thus, it can be reasonably asserted that the product-deferred modes such as *salam* and *istisna* are comparatively riskier than price-deferred sales modes such as *Murabaha* financing.⁸³⁵ This could be because the product value and the return that might arise at the end of the contract period are not free from uncertainty. There is also the possibility that the counterparty might fail to deliver the goods or commodity in time according to the agreement. Such circumstances might arise for various reasons, such as a natural disaster or production failure. Furthermore, even after the timely delivery of the goods, there could be circumstances in which the price of the commodity being transacted might influence the rate of return for the bank.

⁸³³Ahmad, N.H. and Ahmad, S.N. 2015. Key Factors Influencing Credit Risk of Islamic Banks: A Malaysian Case. [Online]. Available at:http://www.researchgate.net/publication/228423667_Key_factors_influencing_credit_risk_of_Islamic_bank_A_Malaysian_case [Accessed on:1 July 2015].

⁸³⁴Langton, J. Trullols, C. and Turkistani, A.Q. 2011. *Islamic Economics and Finance: A European Perspective*. Palgrave Macmillan.

⁸³⁵Hassan, K. and Lewis, M. 2007. *Handbook of Islamic Banking*. Edward Elgar.

Moreover, Elgari has stated that clients who deal in Islamic banking products realise that the cost of financing these products is higher than it is for the equivalent products issued by the conventional banks. This difference can be explained by considering the example of two individuals, one of whom borrows a sum of 100,000 riyals from a conventional bank for a duration of three years and invests the complete loan amount in buying a car costing 100,000 riyals, while the second person decides to finance the purchase of a similar car through an Islamic bank, using *Murabaha* financing with the payments due to be made in instalments within three years. A comparison of the financial costs to be borne by the two individuals shows that the client using *Murabaha* financing will have to bear a greater cost than the person who has opted for an interest-bearing loan from a conventional bank. This indicates that the excess amount charged through *Murabaha* financing for the delay in payment will be greater than the interest payment on the equivalent conventional loan. The Islamic banks do not dispute this assertion, but respond by stating that their operational risks and their credit risks are very high. Thus, considering the fact that risk and return are directly proportional, it is evident that the price charged by the Islamic banks for bearing such a high risk would itself be high.⁸³⁶

It might be assumed that this discrepancy in cost would damage the competitiveness of the Islamic banks in Saudi Arabia; however, it is important to note that their credit risk is high because they are not able to charge any collateral security. However, this factor is beneficial from the point of view of the clients as they are not required to pay any additional security and are protected by the stipulations of Sharia law.

In order to deal with the risks associated with financial instruments such as *Murabaha*, *ijarah*, *istisna*, and *iqtina*, the Islamic banks charge a comparatively high mark-up for selling the products on credit. At the same time, depending upon the already assumed payment pattern, a comparatively high price is charged for the commodity. The result thereof is a different mechanism for the imposition of the price, while the client is exposed to a comparatively

⁸³⁶Elgari, M.A. 2003. Credit Risk in Islamic Banking and Finance. *Islamic Economic Studies*10(2).

heavy credit burden. However, this could be seen as an advantage for the Islamic bank, in terms of the short-term rate of return. Conversely, it could prove to be disadvantageous for the clients in terms of an increase in the loan amount. This might also prove to be disadvantageous for the Islamic bank in the long term because the client might be more likely to default. This, in turn, would represent a greater credit risk for the lender.

It can be reasonably stated that the level of risk to which the Islamic banks are exposed is highly dependent on the type of customer being dealt with and the type of investment that the client undertakes with the finance provided.⁸³⁷ With due consideration to the circumstances in which a majority of the customers delay making payments, it is not beneficial for the bank to impose an excessively large penalty for any such delay in payment. This is because it would lead to a delay in the payment of the excess amount as well. In addition, it cannot be confidently stated that the bank would be able to recover the excess amount by foreclosing on a mortgage, for example, because this mechanism has been found to work in only a few exceptional circumstances. The major reason for the excess charge is said to be deterrence. Therefore, requiring the clients to pay penalties that are later distributed to the community in the form of charity payments is sufficient to bring a significant level of risk in association with *Murabaha* financing at the same level as it would have been in a conventional bank. Thus, a close comparison of the two types of bank has shown that there is no significant difference between them in terms of their main types of loans from the perspective of credit risk. In fact, the level of risk to which the different types of bank are exposed and the extent to which they are exposed to such risks can, in both cases, be decided with reference to the creditworthiness of the client.

In most modes of financing implemented by the Islamic banks, including *Murabaha*, the market risk is relatively very high. *Murabaha* financing is considered to be the lowest ranked among the several other profit-sharing modes of financing, followed by *ijara*.

⁸³⁷Abusharbeh, M.T.2014. Credit Risks and Profitability of Islamic Banks: Evidence from Indonesia. *World Review of Business Research*43, pp.136-147.

Another significant risk that arises due to the legal obligations applicable to the Islamic banks is inherent in the need to hold the equity and ownership instruments within the bank for investment purposes and all such instruments are typically based on financial contracts such as *mudaraba*. Fiduciary risk arises as a consequence of the equity position risks and it also results from poor investment account management. All such risks can also arise when an Islamic bank is found to be guilty of misconduct or negligence in its handling of the deposits and funds of its investors by way of *Murabaha* contracts. All such legal liabilities owed by Islamic banks further expose them to direct losses from any breach of the fiduciary duty on the part of the bank to its depositors. In addition, there are the indirect losses that result from any decline in the market prices of the listed shares of the bank, which may lead depositors to lose confidence in the shareholders of the bank. As a result; they may decide to withdraw their deposits from the bank.

The Islamic banks also face a risk of adverse deviation in the market level of rates or prices of assets and liabilities due to market factors, external events, or other changes in the economic environment.⁸³⁸ The Islamic banks undertake to distribute risk-sharing funds, which further leads to a rise in the implicit requirements of both of the parties to a given transaction to share both their losses and their profits.

Due to the non-fixed ex ante profit-sharing provisions applicable to the Islamic banks, there is a significant exposure to withdrawal risk. A number of variables affecting the returns, profits and losses of the products offered by the Islamic banks causes uncertainty in respect of the real value of the deposits. Thus, the Islamic banks are under pressure to meet the market standards in terms of providing adequate returns to their depositors as they are aware of the likelihood that they would be held responsible for a lower rate of return.⁸³⁹ Therefore, in order to increase the confidence of depositors in the Islamic banks,

⁸³⁸ Karim, R.A.A. and Archer, S. 2013. *Islamic Finance: The New Regulatory Challenge*. Wiley.

⁸³⁹ Knoop, T.A. 2013. Global finance in emerging market economies. In *Routledge International Studies in Money and Banking*. Routledge.

adequate consideration is given to the profit share of the depositors when determining the mark-up value of the commodities that are transacted through *Murabaha* financing.

Another significant risk for the Islamic banks associated with *Murabaha* financing is liquidity risk as a bank might find that there is a mismatch between the maturity of its assets and of its liabilities. Such a mismatch could lead to the creation of either a surplus or a shortage of cash required for investment. An additional method by which liquidity risk may arise is the difficulty in obtaining cash at an acceptable cost. Due to legal obligations, the Islamic banks are not able to meet their operational liquidity requirements by offering interest-based loans; furthermore, the inter-bank sale of debt holding is also not allowed. This leads to an excessive liquidity risk for the Islamic banks when engaging in *Murabaha* financing agreements.

Dar and Moghul provided an account of the classical or traditional form of a *Murabaha* financing contract in which a person seeking finance requests the financing bank to purchase an asset as an agent. In exchange for the facilities provided by the bank, a profit margin is provided for the purchase value of the commodity. The amount of profit that is to be paid to the bank carries a risk for the bank in case the client fails to repay in full compliance with the terms of the *Murabaha* agreement that he has signed. In addition, there is a risk arising from any fluctuation of asset prices in the market.⁸⁴⁰ Dar and Moghul noted, however, that the risks associated with *Murabaha* financing are mainly theoretical in nature as the trading is usually undertaken in such a manner that the commodity exposure risk is mitigated through a fixed price purchase of the commodity. They also asserted that any fluctuation in the prices of the commodity within the few seconds of the transaction taking place can be considered as minimal. Thus, the actual commercial risks pertaining to *Murabaha* financing or commodity finance are not directly related to trading; rather, they are associated with financing. From the perspective of the Islamic bank, it can be stated that the main risk factor is

⁸⁴⁰Dar, H. and Moghul, U. (eds) 2009. *The Chancellor Guide to the Legal and Shari'a Aspects of Islamic Finance*. Chancellor Publications.

the probability of failure on the part of the customer to payback the due amount. In terms of the customer themselves, they are exposed to the accompanying risk that the cash proceedings undertaken for the venture might turn out to be unprofitable. In the usual form of *Murabaha* financing, the banks do not participate in the potential gains anticipated to accrue from the purchase of a commodity for a business venture.

The Islamic banks are also exposed to fiduciary risks due to the adoption of *Murabaha* financing instruments. For example, the banks are expected to conduct adequate monitoring and screening of the projects as any intentional or unintentional negligence might lead to the bank being exposed to a fiduciary risk. Thus, it is imperative for the banks to perform adequate due diligence. In addition, mismanagement of the funds held by the banks on behalf of their current account holders might lead the banks to be exposed to fiduciary risk. Such risks might also arise when the Islamic banks are already in debt with heavy losses as a result of *Murabaha* financing because the shareholders might lose confidence in the banks' ability to make effective use of the invested funds.

The literature reviewed in Chapter 2 also indicates that fluctuations in market returns can contribute to the risks to which the parties are exposed, more specifically to those faced by the Islamic banks. The banks, in common with other financial institutions, make an estimation of the selling price of the commodity along with the mark-up value as per the prevailing rates and returns for that commodity on the open market. This can turn out to be rather difficult for the banks, especially if there is a high degree of volatility in the prices of the commodity in question, along with significant changes in the rate of return.⁸⁴¹ These factors are likely to hinder the process of anticipating accurately the sale price and the mark-up value. The result is exposure to the risk of loss in the margin that could be earned by the bank by entering into the *Murabaha* financing contract. Such conditions not only add to the overall market risk to the Islamic banks; they can be seen as constituting elements of market risk for the customers as well, owing to the possibility that the selling price may be

⁸⁴¹Pock, A.V. 2007. *Strategic Management in Islamic Finance*. Springer.

depressed after the *Murabaha* financing agreement has been finalised. Under such circumstances, the client would have paid more for a commodity that later became available for a lower price.

Risks in dealing with Murabaha transactions and its causes

1. Risk of Non-Compliance with Sharia law

If the basic law in Saudi Arabia fails to support the operations of Islamic banking, the two types of liquidity risks that the parties face by entering into the *Murabaha* contract are funding liquidity risks and market liquidity risks.⁸⁴²In the first place, the mobility of the asset or commodity under the *Murabaha* contract may lead to a funding risk, because it may not be possible to meet the expected and unexpected cash flow requirements, along with the collateral needs, without disturbing the routine operations. As to market liquidity risk, this may arise because the parties are not easily able to eliminate or offset their positions during a critical shortage of liquid funds. From the personal perspective, it has been analysed that liquid funds shortage not only affects upon the routine operations/transactions due to funding risk but it lets down trust of the investors.

The review has further shown that the Islamic banks are required to adhere to the provision of financial services that are in accordance and compliance with Sharia law. This requirement also applies to asset-based financing in terms of purchasing, owning, transferring and transacting real goods between two counterparties. There is a tendency to structure the transactions and financing instruments so that they broadly replicate conventional debt-based financial contracts, but the contracts created by this process are complex. This complexity arises from the multifaceted layering of the financial transactions and from the involvement of third parties to ensure compliance with Sharia law. Indeed, this process may result both in greater complexity and in increased risks, including the legal risks that are faced at different stages during the execution of

⁸⁴²Al-Shamrani, A.S. 2014. Islamic financial contracting forms in Saudi Arabia: Law and practice[Online]. Available at:<http://bura.brunel.ac.uk/bitstream/2438/9145/1/FulltextThesis.pdf> [Accessed on: 02 May 2015].

Islamic financial contracts such as *Murabaha*.⁸⁴³ Each *Murabaha* contract involves multiple transactions, along with multiple transfers of ownership, in order to ensure Sharia compliance. *Murabaha* contracting enables an agreement to be made which mimics a conventional mortgage. However, this is possible only if a layering of the initial set of transactions is undertaken, along with an increase in the number of counterparties that are involved throughout the life of the mortgage. Thus, there exists a legal risk of non-compliance with Sharia law, as there is a heavy dependence on this process of layering and increasing the number of counterparties. It has been inferred that sharia law compliance is essential for banking institutions and organisations in any sector to prevent legal risks emerged out due to illegal or non-compliance acts. Sharia law regulations support directing actions and decisions in relevance to the lawful provisions that secure interests of the parties involved.

One of the most significant judicial risks associated with a *Murabaha* transaction is the fact that the contracting parties are not judicially liable to disclose the purchase price in the contract.⁸⁴⁴ This results in the non-disclosure of the profit rates that the banks have quoted to their clients; thus, it imposes a legal risk upon the parties, which is directly related to the risk associated with contract-based financing.

Another judicial issue pertaining to the banking system of Saudi Arabia in the context of any *Murabaha* contract is the equipment or asset warranties that are provided to customers at the time of the product purchase, guaranteeing the fitness and appropriateness of the product for its intended use. Thus, under the terms of warranty agreements, the equipment or product is replaced in the event that a defect is found. Such warranties are legally not transferable in the case of a *Murabaha* contract, which further increases the asset risk for the client.⁸⁴⁵ The client is not exposed to such a risk in the case of an asset purchase loan

⁸⁴³Salem, R.A. 2013. *Risk Management for Islamic Banks*. Edinburgh University Press.

⁸⁴⁴Aldohni, A.K. 2011. *The Legal and Regulatory Aspects of Islamic Banking: A Comparative Look at the United Kingdom and Malaysia*. London: Routledge.

⁸⁴⁵Wilson, R. 2012. *Legal, Regulatory and Governance Issues in Islamic Finance*. London: Edinburgh University Press.

agreement with a conventional bank, because the client acts as the first purchaser and thus does not require the transfer of any warranty.

This information explores the deviations linked with *Murabaha* financing which generates legal risks for not only the banks but also other related parties. Such types of legal risk generated for banks and other parties are discussed in the information given in this paragraph. Moreover, recommendations are also given by the authors for Islamic banks as well as their clients in the direction of enhancing and safely undertaking the financial transactions.

Shofawati has recently identified certain deviations associated with *Murabaha* financing that lead to both the banks and the other concerned parties being exposed to a degree of legal risk. The author states that the information that the bank is obliged to provide to give a full account of the *Murabaha* contract leads to it being exposed to a legal risk, which is also borne by the client and the third party.⁸⁴⁶ Conversely, if the information that is required to be provided by the bank pertaining to the existence of the products is not fully disclosed, this leads to a legal risk for the bank. In *Murabaha* financing, the binding contract of the purchase transaction which the bank enters into generally proceeds with ownership of the goods by the client. This leads to the violation of the basic principles of the universal law, wherein the right to sell a derivative and the right of ownership are granted to the individuals concerned. Furthermore, two other legal principles are violated in the conduct of *Murabaha* financing; the first of these is the essence of the seller, the person who is obligated and is able to provide the supply of goods, and the other is the essence of the *Murabaha* contract itself.

Another significant feature of *Murabaha* financing is the practice of disbursement to the customer's account, while the customer is required to pay back the amount to the suppliers. This is because the buying and selling relationship is not realised; rather, it amounts to the existence of a debit and credit relationship. All such legal concerns are major sources of apprehension for

⁸⁴⁶Shofawati, A. 2014. *Murabaha* Financing in Islamic Banking: Case Study in Indonesia. *Proceedings of 5th Asia-Pacific Business Research Conference*.

the Islamic banks to standardise the *Murabaha* contract that is issued by SAMA within the framework designed to minimise the requirements for Islamic purification. However, it is considered that the *Murabaha* contract is one of the most significant instruments through which financing is undertaken by the Islamic banks, and it plays a dominant role within the Islamic banking system of Saudi Arabia. Thus, the Islamic banking industry is in need of developing new sets of financial products based on *Murabaha* financing that would both be fully compliant with Sharia law and meet the needs and expectations of the banks' customers. Shofawati has further recommended that the government should be expected to provide suitable conditions in which financial transactions can be safely undertaken by the Islamic banks and their clients, by means of making appropriate amendments to national rules and regulations. Moreover, the National Sharia Council is expected to keep adequate control over the implementation of *Murabaha* contracts within the Islamic banking framework, to make it more Sharia compliant.⁸⁴⁷ From the inference of theoretical evidence, it has been interpreted that compliance of *Murabaha* contracts with sharia principles is the first and foremost requirement to keep off occurrence of legal risk to the parties involving seller, dealer and bank.

The above paragraph is essential in analysing the factors that generate legal risks for banks and the parties such as clients. Moreover, this paragraph helps in obtaining the mitigation techniques of these legal risks. Thus, this paragraph contributes towards the research aim of identifying the legal risk involved in *Murabaha* and addressing these risks.

The information given in the below paragraph explores the case of a diamond dealer. This case is discussed for explaining the legal risks faced by the parties which are associated with *Murabaha* financing agreement. This case defines the disputes between the client and Islamic banks.

Cotran and Lau use the case of a diamond dealer to explain the legal risks to the parties associated with a *Murabaha* financing agreement. In their example,

⁸⁴⁷Shofawati, A. 2014. *Murabaha* Financing in Islamic Banking: Case Study in Indonesia. *Proceedings of 5th Asia-Pacific Business Research Conference*.

a diamond dealer entered into a *Murabaha* contract as the client of an Islamic bank that was incorporated under Bahamian law. Based on the conditions stated in the *Murabaha* contract, the Islamic bank entered into an agreement to purchase two lots of raw diamonds on behalf of the client from a second dealer based in Hong Kong, at the per piece rate of 7,500,000 US dollars, and the purchase price was duly paid to Hong Kong dealer. The client was obligated to purchase the raw diamonds from the Islamic bank and was required to pay a price inclusive of mark-up, making a total of US\$7,917,450 for each lot of raw diamonds. The client failed to receive any goods, both lots of diamonds having allegedly been lost in transit.⁸⁴⁸ There then arose a dispute between the Islamic bank and the client as to whether the client was liable to pay the stated amount to the bank, in spite of the fact that he had not received delivery of any goods. The case was heard in the High Court, which ruled that the bank was liable for the loss, as it was required to bear the risk of the goods being destroyed, damaged or lost.

The above paragraph is beneficial for giving the real time example of legal risks and disputes generated between the bank of Islam and client when the client entered into *Murabaha*. Thus, the information involved in this paragraph is helpful in analysing legal disputes related to *Murabaha* in the direction of the research objectives.

2. Lack of Conformity of Sharia Banking Law and the Modern Commercial Banking Industry

The application of contract law at the international level leads to three types of legal relationships in association with the client. The first relationship states that there is an obligation on the part of the bank to pay the asset price due to the seller.⁸⁴⁹ The second legal relationship is the one between the bank and the buyer. This is relevant, for example, when the goods purchased under a *Murabaha* contract have been lost in transit. The third legal relationship pertains to the remedies of the seller vis-à-vis the buyer, where a suitable example is of

⁸⁴⁸Cotran, E. and Lau, M. 2002. *Yearbook of Islamic and Middle Eastern Law: 2001-2002*. Brill.

⁸⁴⁹Ibid

the sale of defective goods. As shown by the above case heard in the High Court, it can be reasonably stated that such issues are not restricted to matters of academic interest, but have increasing relevance in the world of international commerce, because of the internationalisation of the Islamic banking sector.

Thus, one of the most significant risks to which all the parties to a *Murabaha* contract are exposed is the fact that Sharia banking law is found to be inherently unsuitable for the modern commercial banking industry. This is because the process of adaptation to the international financial and accounting system has yet to be achieved. There are serious concerns associated with the huge gap between the existing Islamic laws and the internationally adopted financial regulations. This gap serves to further increase the legal risk for all the parties.

Among the numerous benefits for the client who enters into a *Murabaha* contract with a bank is the fact that Sharia law does not allow Islamic banks to ask for collateral security from their clients. Moreover, the banks are not allowed to reschedule the payment of the instalments, as a result of which clients are able to pay off their loans at their own convenience. Nonetheless, clients are exposed to certain risks, such as price risk, liquidity risk and counterparty risk.⁸⁵⁰ The *Murabaha* contract is a long-term one and it is difficult for the client to ask for an extension of the repayment period; this is because the mark-up of the bank would be reduced. The client has no right to reduce the mark-up being charged by the bank; the result of this is that the client faces a liquidity risk.

3. Counterparty Risk

Furthermore, there exists a counterparty risk, which can also amount to the loss of opportunity for the client. This risk arises if the asset to be held through the *Murabaha* contract is essential for the client's business purposes and the bank breaches the contract under Sharia law or refuses to purchase the

⁸⁵⁰ Askari, H., Iqbal, Z., Krichenne, N. and Mirakhor, A. 2011. *The Stability of Islamic Finance: Creating a Resilient Financial Environment for a Secure Future*. New Jersey: Wiley.

asset.⁸⁵¹ Such refusal to purchase could occur because the relevant market prices have changed, so that the asset has become available elsewhere at other than the agreed price.

4. Risk of Capital Loss

In addition, the client is exposed to the risk of capital loss, if the cumulative price of the asset, comprising the purchase price and the mark-up charged by the bank, exceeds the price at which the asset could be sold in future. The client is obligated to maintain a charitable fund in the form of a penalty in the case of default in the timely repayment of the debt. The percentage of payment is defined by the bank as per its own discretion. Sharia law is a shield for the client here, protecting him from the risk of bankruptcy. If the basic law of Saudi Arabia fails to acknowledge Sharia law, the risks faced by clients could become equivalent to those of the borrowers of long-term loans from conventional banks.

It has been stated that the English court does not deal with certain aspects of Islamic financing in a critical manner. In the case of *Murabaha* contracts, the risk of failure to deliver is not recognised, where the issue of default in payment has arisen and the defendant states that he defaulted on payment because the supplier failed to deliver the commodity.⁸⁵² Under the *Murabaha* contract, the supplier is not paid until the client has possession of the supplies. In addition to this, the bank is required to bear the risk of delivery failure. The court treats the transaction as if it were a typical financial transaction, where the risk of delivery failure is borne by the purchaser, or in the case of a *Murabaha* contract, by the client.

5. Risk of Transparency

There is another legal risk that has been found to apply to the third party to a *Murabaha* contract. This arises because the Islamic banks undertake

⁸⁵¹ Ibid

⁸⁵² Aldohni, A.K. 2011. *The Legal and Regulatory Aspects of Islamic Banking: A Comparative Look at the United Kingdom and Malaysia*. Routledge.

Murabaha transactions based on the profit and loss principle, in contrast to interest-based transactions. Thus, if a bank suffers a loss in the transaction of a *Murabaha* contract, its depositors will be exposed to the risk of such losses, which they will share as they also share any profit. If the Islamic banks fail to abide by Sharia law, they may fail to follow fully the special prudential accounting and auditing standards that Islam requires. This would cause investors to be exposed to the risk of transparency.

Furthermore, the findings revealed that the Islamic banks were considered to be offering only the *ijarah* and *Murabaha* transaction facilities.⁸⁵³ Thus, in order to abide fully by Sharia law, the banks should facilitate and enhance the implementation of their real banking activities. This would require the promotion of risk sharing by way of equity-type facilities on the asset side and profit-sharing investment accounts on the funding side. Moreover, the banking system of Saudi Arabia enables the Islamic banks to be reluctant to entering into long-term transactions because there is a risk of illiquidity in the secondary market.⁸⁵⁴ This is also against the Sharia law of disclosure and customer protection; thus, it adds to the risk faced by the third party.

In the opinion of Aldohni, the classical *Murabaha* contract states that the borrower requests the bank to purchase the asset on his behalf and in exchange for this financial service rendered by the bank, he agrees to pay a profit margin. Thus, the actual legal and commercial risks of trading in *Murabaha* are not directly associated with the trading; rather, they are associated with financing. This is because there is a risk of the cash payment proceeding in the case of a venture that does not prove to be legally viable. Furthermore, the presence of *riba* in the transaction is considered to represent injustice in Islamic financing because it represents a potential source of economic injustice.⁸⁵⁵ The parties are considered to be able to make money from a productive application of their

⁸⁵³Lathamand Watkins LLP. 2010. *Doing business in Saudi Arabia*. [Online]. Available at: http://www.lw.com/upload/pubcontent/_pdf/pub3507_1.pdf [Accessed on: 18 May 2015].

⁸⁵⁴Kettell, B. 2011. *Case Studies in Islamic Banking and Finance*. John Wiley & Sons.

⁸⁵⁵Aldohni, A.K. 2011. *The Legal and Regulatory Aspects of Islamic Banking: A Comparative Look and the United Kingdom and Malaysia*. London: Routledge.

assets and commodities, but it is viewed as exploitation on the part of the stronger party to charge the weaker party for the use of money, as it is not considered a tradable mode under Sharia law. One of the most significant legal risks that prove to be an indicator of equality between the parties is associated with the risk to which both the financee and the financing party (usually the bank) are exposed. Thus, Aldohni recommends that lawyers should draft *Murabaha* contracts in a way that ensures that their onerous terms are not inconsistent with Sharia law and that the bank's profit is not construed as *riba*.

6. Risks associate with Contract's Structure

Dar and Moghul identify a legal issue related to the binding nature of the *Murabaha* contract. The parties to the contract are in effect subject to a binding power that is generated by the provisions of Islamic law, because a promise is considered to be an expression of willingness to perform an activity in the future. It invokes trust in the future performance of the action, which does not merely reflect the sincerity of the promisor.⁸⁵⁶ However, in general under English law, the promise is not considered to be legal binding, although it could be enforced if it is executed in support of the required consideration. It can be further argued that the promise generated in the *Murabaha* transaction meets both of the requirements. Firstly, the requisite consideration under English law implies that there is benefit either to the promisor or to the promisee. In the case of a *Murabaha* contract, the interest of the Islamic bank is considered to be impaired if the client or promisor fails to fulfil the promise to buy the commodity that he has ordered, in spite of the commodity meeting the specified description.

Having reiterated that there are three parties to a *Murabaha* contract, namely a seller, a purchaser and a bank, whereby the bank contracts to buy a commodity and resell at a fixed higher price including a mark-up, Cattelan asserts that the major legal risk is associated with the requirements of Sharia law that the bank involved must hold the title of the commodity under transaction for

⁸⁵⁶Dar, H. and Moghul, U. 2009. *The Chancellor Guide to the Legal and Shari'a Aspects of Islamic Finance*. London: Chancellor Publications.

a specific time period during the process of transacting the *Murabaha* instrument. Other associated risks are highly dependent upon the structure of the contract and more specifically the contractual provision of the promise undertaken by the customer to pay.⁸⁵⁷ In this context, my personal perspective is that difficulties may arise in the subsequent enforcement of the promise made by the customer, along with the possibility of appointing the customer as the agent of the bank during the performance of the commodity purchase and the adoption of risk mitigation techniques. Other major legal risks associated with *Murabaha* contracting are connected with the monitoring and screening of the rules and bylaws applicable to the contract.

In the opinion of Ayub, the use of *Murabaha* contracts requires Islamic banks to hold additional assets and exposes them to legal risks; to mitigate these risks, the banks should take very great care in drawing up the various documents related to such contracts, under the guidance of their legal departments. Attention to Sharia law and the AAOIFI standards will enable the banks to ensure Sharia compliance. Thus, the role of Sharia advisors on the banks' supervisory boards is crucial to the successful execution of adequate internal controls for the purpose of Sharia compliance.⁸⁵⁸ Ayub goes on to advise that the Islamic banks must ensure adequate time management of the said documentation in order to avoid the risk of abnormal loss of income. The perspectives of Ayub are favourable to the parties of *Murabaha* contracts as it strengthens risk management and internal Sharia control mechanisms that would avert off emergence of legal risks.

Holden addresses the complexities involved in *Murabaha* contracts and their similarities with the products offered by conventional banks. She notes that the financial institution or Islamic bank acts as the middle-man and is supposed to sell the commodity under the contract at cost plus an agreed profit rate. Apart from the sales price mentioned in the contract, the Islamic banks are not legally allowed to collect any compensation from the customer in the event of default,

⁸⁵⁷ Cattelan, V. (Ed.) 2013. *Islamic Finance in Europe: Towards a Plural Financial System*. Edward Elgar.

⁸⁵⁸ Ayub, M. 2009. *Understanding Islamic Finance*. John Wiley & Sons.

whereas this is possible in the case of the conventional banks. This is because Islamic banks are not allowed under Sharia law to collect any unearned mark-up value from their customers.⁸⁵⁹ For this reason, circumstances have often arisen in which the customer refuses to pay. From my personal opinion, the viewpoints of Holden are quite supportive to avoid risk, the banks generally enter into *Murabaha* contracts only under certain conditions, where for example the customer is well known to them and has reliable creditworthiness.

A further contribution to this discussion is made by Ayub who states that there exist numerous risks for all the parties associated with *Murabaha* financing agreements.⁸⁶⁰ More specifically in case of price risk, the client is considered to benefit if there is an increase in the price of the commodity which is being financed through the *Murabaha* agreement. Such an increase would indicate that the price which the client is obligated to pay under the *Murabaha* financing agreement was less than the market value of the commodity. In such situations, there exist three options for the client, the first of which is to continue with the *Murabaha* agreement for the full term of the contract and realise the benefit from the marginal difference. The second option is for the client to terminate the *Murabaha* contract immediately by defaulting on the remaining payments due, which would allow him to gain certain monetary benefits after the price has risen to its highest level. The third option open to the client is to pay the full amount specified in the *Murabaha* contract without giving any consideration to the price rebate, while adhering to scholarly prohibitions.

Risks affecting Islamic banks

The previous subsection has discussed the risks to which the various parties to *Murabaha* contracts are exposed, especially in the Saudi banking system. This subsection has a narrower focus: that of the risks specifically

⁸⁵⁹Holden, K. 2008. Islamic finance: "Legal hypocrisy" moot point, problematic future bigger concern. *Boston University International Law Journal* 25, p. 341.

⁸⁶⁰Ayub, M. 2009. *Understanding Islamic Finance*. John Wiley & Sons.

affecting the participating Islamic banks. Risks are generally considered to have an influence on both the opportunities for income growth and the values of the assets held by the banks. However, with the assistance of effective risk management, they are able to exploit opportunities for income growth. Since Islamic banking is comparatively new, in comparison with the conventional form of banking, the risks inherent in financial instruments such as *Murabaha* are comparatively poorly understood. Given this novelty and lack of understanding, these risks can usefully be divided into two major categories: risks that are similar in nature to those faced by the traditional types of financing institutions, and those that are unique in nature and relate to the question of compliance with Sharia law. As for risk mitigation, Islamic banks are relatively restricted in terms of the policies that they are able to adopt because they are allowed to use only those measures that are specified in Islamic commercial law.⁸⁶¹ The banking model within the framework of Islamic financing is considered to have evolved as a one-tier Mudaraba along with numerous investment tools. On the asset side, Islamic banks use *Murabaha* financing tools in the form of cost-plus sale and instalment sale for medium- as well as long-term finance.

The major risks to which Islamic banks are exposed in relation to the *Murabaha* contract are legal risks. Related to these legal risks is the risk of liquidity faced by banks because the *Murabaha* contract involves debt creation and the purchase of fixed assets. This can result in a blockage of cash and therefore the elongation of the operating cycle.⁸⁶² As noted above, while the legal provisions of the banking system in Saudi Arabia have been framed according to Sharia law, there are certain areas where the system fails to abide by Sharia or even the basic law of the Kingdom in order to ensure a level playing field for Islamic banks. Certain principles of Sharia law are subject to interpretation by the management teams of individual Islamic banks, which can result in the execution

⁸⁶¹ Ahmed, H. and Khan, T. 2005. Risk management in Islamic banking. [Online]. Available at: <http://ebooks.narotama.ac.id/files/Handbook%20of%20Islamic%20Banking/Chapter%2010%20Risk%20management%20in%20Islamic%20banking.pdf> [Accessed on: 17 July 2015].

⁸⁶² Al-Shamrani, A.S. 2014. Islamic financial contracting forms in Saudi Arabia: Law and practice. [Online]. Available at: <http://bura.brunel.ac.uk/bitstream/2438/9145/1/FulltextThesis.pdf> [Accessed on: 2 May 2015].

of transactions that are generally incompatible with Sharia law and hence could be declared unacceptable and invalid.

The literature review has shown that another significant type of risk to which banks are exposed with regard to the application of Islamic law is credit risk. More specifically, credit risk has three components – namely, default, the level of potential credit exposure to a default, and the probability of default.⁸⁶³ The extent of default by one of the parties is assessed on the basis of two parameters: namely, the financial conditions and the number of days for which the payment has been overdue. In the case of *Murabaha*, credit risk arises because it is a sale-based contract and because the reselling of the asset undertaken by the bank is based on deferred payment, as a result of which the amount of debt owed to the bank will rise. A major factor underlying the credit risk, therefore, is default on the part of the counterparty in the form of failure to pay the debt in full within the specified time. There are many other possible reasons for non-performance by the parties, including both external and internal financial causes and certain moral hazards. Under these circumstances, it is essential for any default on the part of the counterparty that is undertaken intentionally or wilfully to be clearly identified, because Islam does not allow any kind of debt restructuring to compensate for such a default. The reason for the default could be a delay in the collection of an amount due from a client of the bank's client, rather than wilful default on his part, and it can be difficult for the bank to prove that the client has been wilful in defaulting. The provisions of Islamic law are predominantly in favour of the client, who is therefore not normally put under any pressure to prove his or her innocence. It is rather the aggrieved party – the Islamic bank in this case – which would be required to prove the wilful act of default on the part of the client. A credit risk arises for Islamic banks because they are not able to obtain sufficient information regarding the solvency of the client and his ability to pay the due amount. There is, therefore, an asymmetry in the information that is available to Islamic banks.

⁸⁶³ Askari, H., Iqbal, Z., Krichenne, N. and Mirakhor, A. 2011. *The Stability of Islamic Finance: Creating a Resilient Financial Environment for a Secure Future*. John Wiley & Sons.

If a client appears to have defaulted, the Islamic bank may be faced with numerous issues in the form of an interruption to its predetermined cash flow on the asset side, which is adjusted along with the liability side in a planned manner. The profits from *Murabaha* financing agreements predetermined by banks will also be disrupted. Beyond this, the bank will face the extra cost of selling the asset that it has unintentionally acquired on the market. A default also adds to the operations of Islamic banks in the form of an urgent need to conduct an investigation into the actual situation of the client; however, the cost of this investigation is only borne by Islamic banks if it turns out to be an honest default.

Elgari has reflected on the fact that Sharia law provides Islamic banks with a framework for executing financing contracts, commercial contracts, and other relevant transactions. This has led to Islamic banking contracts such as *Murabaha* becoming a mode of buying and selling property. There is a consequent exposure to price risk, because taxes are levied on the same property twice, there being two constituent transactions within the *Murabaha* transaction: that between the seller and the bank, followed by that between the bank and the borrower or client.⁸⁶⁴ This conclusion is supported by the finding that basing their activities on Sharia law exposes Islamic banks to legal risks such as price risk.⁸⁶⁵ This type of risk is generally considered to be incurred when banks are not able to fix the price of a commodity with the appropriate market-up, owing to the dynamics of macroeconomic factors. The literature gives examples of risks and liabilities that are borne by Islamic banks due to their ownership of assets and their liability to pay taxes.⁸⁶⁶ Other elements of risk have been found to relate to implied warranties and the risks of delay and default.

In addition, Hassan and Lewis state that the legal risk to Islamic banks which do not abide by Sharia law is directly associated with the trust and confidence of their investors in the regular operations and functioning of the banks. The intention behind using Sharia law to introduce instruments such as

⁸⁶⁴Elgari, M.A. 2003. Credit Risk in Islamic Banking and Finance. *Islamic Economic Studies* 10(2).

⁸⁶⁵Köhn, D. 2011. *Mobilising Capital for Emerging Markets: What Can Structured Finance Contribute?* Springer.

⁸⁶⁶Kamalpour, A., Schemuth, M., Ahmed, T. and Maski, S. 2009. *Murabaha Financing*. Ashurst.

Murabaha contracts is to promote social equality and interest-free transactions. Any action on the part of an Islamic bank that does not comply with Sharia law works against its corporate image and goodwill in the society in which it operates.⁸⁶⁷ This conclusion is justified by the finding that non-compliance with Sharia law might result in negative word of mouth and low confidence among investors.

Market risks are generally considered to be systematic in nature and to arise from macro-economic factors or other unsystematic sources, and they influence Islamic banks due to instrument- or asset-specific. Market risks can be explained by taking the example of equity or currency prices, where a price risk would arise because they fall into the category of systematic risk. Any movement or fluctuation in the price of a commodity being traded by an Islamic bank under a *Murabaha* financing agreement will expose that bank to market risks. However, such fluctuations can be favourable to the bank as well as unfavourable, and the same applies (inversely) to their consequences for the counterparties.

This paragraph suggests that there are considerable variations in all the legal risks and disputes as a means of nature of the risks. The information which is given in this paragraph also refers that the Islamic banks are facing rate-of-return risk which is a point of concern for these banks. The information also includes how the rate of return is differentiated. While the interest rates fluctuate then it generates disadvantage for the banks of Islam.

According to Kamalpouret al., there is considerable variation in the legal issues and risks that Islamic banks face in terms of the nature of the risks arising from specific requirements of compliance with Sharia regulations. In terms of interest rate risks, Islamic banks are exposed to a similar risk also known as the rate-of-return risk, as suggested by the IFSB. As for their overall exposure to risks related to their balance sheets, Islamic banks suffer from a “squeeze” that result from the extended holding of fixed-return assets such as *Murabaha*

⁸⁶⁷Hassan, K.and Lewis, M. 2007. *The Handbook of Islamic Banking*. Edward Elgar.

contracts.⁸⁶⁸ This is because *Murabaha* contracts are financed by banks' investment accounts, while the expectations of the holders of such contracts with regard to the rate of return are affected by conventional benchmark rates. Thus, whenever there is an improvement in the benchmark results, the expectations of fund providers also rise. In my opinion, the rate-of-return risk is a considerable matter of concern for banks to maintain the trust and loyalty of investors. This is because the rate of return is directly associated with investors' expectations for returns.

However, in the case of Islamic banks, the rate-of-return risk is different to the interest rate risk because they are associated with the results of investment-related activities undertaken at the end of the investment-holding period. There are two major ways in which the rate-of-return risk can be differentiated from the interest-rate risk. Firstly, Islamic banks possess a mix of equity-based and mark-up-based investments. Such mixes of investments lead to a high degree of uncertainty as to the rate of return, in comparison to conventional banks, because the latter operate on the basis of fixed-income financing on the asset side. Secondly, the return on deposits in conventional banks is predetermined, whereas the return on financing instruments such as *Murabaha* contracts is broadly anticipated – but not confirmed – in advance. Furthermore, Kamalpour et al. opine that the risks of rate of return stem from the existence of uncertainty as concerns the returns earned by Islamic banks through their financing practices. Such uncertainty could cause divergence from the expectations of investment account holders. In addition, relatively little flexibility has been observed on the asset side of Islamic banks, as compared to conventional banks in Saudi Arabia. This is because most of the financing undertaken by Islamic banks is in the form of *Murabaha* contracts, which are insensitive to fluctuations in market rates. Since all the liabilities of Islamic banks are interest sensitive, it is further argued that the funding gap will always remain negative. This leaves Islamic banks at a disadvantage when faced by fluctuations in interest rates.

⁸⁶⁸Kamalpour, A., Schemuth, M., Ahmed, T. and Maski, S. 2009. *Murabaha financing*. [file:///C:/Users/22/Downloads/11822825_2%20\(6\).pdf](file:///C:/Users/22/Downloads/11822825_2%20(6).pdf). [Accessed on: 30 June 2015].

The information obtained from above paragraph also involves the discussion of other types of risk namely rate of return risk comes under Muhabara and suggests that the Islamic banks should take this risk into consideration for avoiding the disputes. Thus, this paragraph relates to the research objective of analysing legal risk related to Muhabara.

This paragraph includes legal disputes and risks of banks to be directly liable for the losses of counter parties. It also suggests that if modifications and innovations are applied to the Muhabara agreements, then the significant vulnerability can be invited to the legal risks. It is analysed that every dispute among banks and clients is an example of the potential for these two parties for being exposed to the legal risks.

The legally flawed conduct of banks pertaining to documentation and other aspects of the execution of *Murabaha* transactions by their employees and agents may cause banks to be either directly liable for losses or unable to ascertain the rights of the counterparties. Such lapses would directly expose banks to legal risks. In addition, there is a degree of legal uncertainty when an external parameter plays a significant role and is beyond the control of banks' operations.⁸⁶⁹ Such external parameters can to influence even the most prudently and diligently handled *Murabaha* financing agreements. Moreover, applying modifications and innovations to the mode of conducting such agreements could also invite significant vulnerability to legal risks. For example, the adoption of a new transactional technique might introduce ambiguity amongst the parties regarding the adequate performance of their respective roles. Thus, non-compliance with Sharia law at any stage might expose the bank and the other concerned parties to legal risks. The role of banks is to purchase items on behalf of their clients and then sell them to clients for the principle plus a mark-up value. In practice, the total due amount made due by each bank from each client will differ and the payment terms may also be different. Banks justify such differences by reference to the fact that each step involves a different time period

⁸⁶⁹Izhar, H. 2010. Identifying Operational Risk Exposures in Islamic Banking. *Kyoto Bulletin of Islamic Area Studies*3(2), pp.17-53.

under a unique contractual agreement, which may be seen to magnify the scope for complications and disagreements between banks and their clients. Evidently, any such dispute between a bank and a client is an illustration of the potential for both parties to be exposed to legal risk.

The above paragraph also suggests another risk where the banks can be liable for the losses of the clients. Moreover, it is also analysed that the disputes come up with the potential of parties of being exposed to any risks. Therefore, the information involved in this paragraph helps to suggest another risk for reaching the research aim.

The below paragraph is related to the exploration of two types of risks namely collateral risk and mark-up risk faced by the clients. The content in the paragraph also describes the reason for such risks and actions that can be taken by the banks to overcome these risks.

In the Islamic banking system, banks are permitted to ask for collateral security against the financial assistance that they provide to clients. According to Sharia law, they are not permitted to require such collateral security from clients, but in practice, there are certain circumstances where an Islamic bank will not only charge collateral security but also claim the security against any default on the part of the customer. It can be inferred from this that the client is exposed to a particular credit risk due to the differences between the provisions of Sharia law and the actual Islamic banking practices followed in Saudi Arabia. However, this discrepancy could be considered to work in favour of Islamic banks because their credit risk is thereby reduced. This is because the customer is liable to pay for the collateral security in case of any default in the payment of the due amount. Another significant risk faced by Islamic banks is mark-up risk, which arises when a bank uses a benchmarking rate to determine the different prices that it will charge its various clients. In case of *Murabaha* financing agreements, the mark-up is fixed and added as per the LIBOR rate, which acts as a benchmark rate. Given that the mark-up value of a *Murabaha* transaction is fixed across the period for which the contract exists, a high degree of mark-up risk arises for Islamic banks. This can be explained by considering a situation in which there is

a significant change in the benchmark rate; because the mark-up value of any existing *Murabaha* financing contract is fixed and cannot be adjusted, a bank might suffer a relative loss of profitability. This is an indirect way in which market interest rates influence the profitability of contracts for Islamic banks; thus, they are also exposed to market interest rate risks.⁸⁷⁰ It can be reasonably stated that mark-up risk arises for Islamic banks where there is a high degree of dependence on the accurate calculation of market returns. It is essential for Islamic banks to ascertain that all the market changes have been adequately covered. Any failure on the part of a bank to anticipate changes that might occur in the market could result in exposure to mark-up risk. The commodity or asset price risk and the *Murabaha* price risk should be clearly distinguished. As has been indicated, the basis of mark-up risk for Islamic banks is LIBOR; it arises in the process of financing, not the process of trading.

The above paragraph is essential in evaluating two different and new types of risks faced by the client while entering into *Muharaba* and discussing how to mitigate these risks. Thus, the information is contributing to the aim and objectives of the research.

This paragraph justifies that the *Muharaba* is itself a complex procedure. Another type of risk of the asset is also involved in this transaction agreement. *Muharaba* processes do not make use of *riba*. Thus, *Muharaba* can generate real risk for Islamic banks.

In the context of Sharia compliance, each *Murabaha* contract is a complex transaction, but also minimally harmful to the transacting parties because it does not expose them to the reciprocal potential of profits or losses. This is further explained by Karim, using the example of asset risks held by an Islamic bank. Karim states that asset risks are almost negligible and can be considered non-existent for banks because the timeframe of the execution of the *Murabaha* financing agreement, along with the delivery time of the commodity to the client, is negligible. Indeed, many Islamic banks do not even take physical possession

⁸⁷⁰Ismael, R. 2005. Assessing Moral Hazard Problem in *Murabaha* Financing. *Journal of Islamic Economics, Banking and Finance* 5(2), p. 101.

of the commodity that is being traded under the *Murabaha* financing agreement. In addition, the pricing mechanism implemented by Islamic banks in the majority of *Murabaha* agreements is, as noted above, the interest rate benchmark. However, this benchmark expresses the time value of money, which is considered inimical to the Islamic moral economy.⁸⁷¹ Proponents of change have argued that the *Murabaha* financing agreement is far from compliant with Sharia law because the Quran clearly differentiates between trading (*bai*) and interest (*riba*). Considering this distinction, Islamic jurists have opined that *Murabaha* financing agreements are much less desirable than contracts where the equity holders actually enter a profit and loss-sharing partnership, such as *Musharaka*. The majority of jurists agree that *Murabaha* agreements do not involve the use of *riba*, although while rendering this financial service, banks do take risks related to financing a service, asset, or commodity. Moreover, Karim goes on to warn that the *Murabaha* financing agreement can pose a real risk for an Islamic bank in the sense that it begins with a promise and may result in an effective sale between the intermediary seller and the end-user of the commodity. This is because Islamic banks are responsible for warranting the Sharia compliance of the instrument. From my perspective, Karim's viewpoints about handling of legal risks can be possible through provision of warning.

The above paragraph is helpful in obtaining the information that the *Murabaha* is not only a complex process but also generates real risk for the banks. Thus, this paragraph helps in justifying that *Murabaha* is actually a riskful and complex process.

The below paragraph explores further risks involved in *Murabaha* process with the help of an example of Kuwait Finance House. In this example, it is revealed that not only KFH but also the borrower had to face the risk in the process of *Murabaha*. KFH had to face real ownership risk. The borrower had to face every type of risk faced by the agent in the agent principle agreement.

⁸⁷¹Karim, S.A. 2010. *The Islamic Moral Economy: A Study of Islamic Money and Financial Instruments*. Universal.

However, Islamic banks do adhere to the spirit and letter of the Sharia rules with regard to *Murabaha* financing. This can be illustrated by considering the example of the Kuwait Finance House (KFH), which operates as an automobile dealership in the legal form of a wholly owned subsidiary, with the intention to adhere to the spirit and letter of *Murabaha* contracts. A *Murabaha* financing agreement was signed to provide a financial service for the purchase of a car. Along with its car dealership subsidiary, KFH intends to enter into tangible and real business deals, providing capital-intensive products to market participants in cases where financing through a *Murabaha* agreement would normally be required.⁸⁷² Thus, unlike the traditional form of financing, KFH is exposed to real ownership risk by carrying the inventory of a fully scaled dealership in automobiles, which indicates a clear distinction between this and traditional interest-oriented loans. Moreover, the KFH model is considered equivalent to the concept of mutuality; therefore, technically, in the *Murabaha* contract, the borrower or buyer and the seller or lender agree mutually with the principle of proceeding with the transaction. A promise but not a contractual agreement is made between the parties in order to legally transfer the title of the asset being financed. The buyer typically acts as a wakil within a separate wakala agency contract, under which the buyer is held responsible for the negotiation and processing of the commodity under consideration. Therefore, it can be reasonably stated that the borrower or buyer acts as an agent for the lender, owing to the fact that the commodity under consideration in *Murabaha* financing is generally technical in nature, such as the construction of a factory or the purchase of industrial equipment. In such cases, the borrower is exposed to all the types of risk that would have been faced by an agent in an agent-principal agreement.

The above paragraph helps in defining the risk of ownership faced by the financial house and similar risk faced by the borrower as the agent with the help

⁸⁷²Karim, S.A. 2010. *The Islamic Moral Economy: A Study of Islamic Money and Financial Instruments*. Universal.

of an example. Thus, this information helps in driving the research towards its aim and objective.

The below paragraph summarises all the risk associated with the Muhabara financing agreements.

If one considers collective exposure to the various risks discussed above, a bundled set of risks can be said to exist; indeed, there is a high probability of exposure to such bundled risks in the case of *Murabaha* financing agreements. This collective exposure can be illustrated by stating that in almost all cases of *Murabaha* financing, there are counterparty risks concerning the fact that the counterparty might fail to deliver the commodity in time. There also exists a liquidity risk in association with the probability of non-payment of the due amount by the client in time.⁸⁷³ In addition, there is an operational risk associated with the adequate functioning of Islamic banks. Hence, timely purchase of the commodity under the terms of the contract is ensured, along with adequate due diligence applied to the client. All these risks taken collectively can be seen as bundled risks, which will exert an influence on the effectiveness of Islamic banks.

The above paragraph concludes the risks involved in Muhabara process of Islamic banks and leads to meet the aim of research of analysing the types of risk associated with Muhabara.

Legal risks caused by divergence from Sharia law

This paragraph suggests how the banks and borrowers make an agreement in the process of Muhabara. It also explores that the banks need to make riba free Muhabara process for ensuring that the process of Muhabara is legally visible. It is seen that the banks need to face real ownership risks. However, this risk is eliminated from the modern banks of Islam.

A technical approach to the *Murabaha* model of financing indicates that it is the process whereby the borrower and lender mutually make an agreement to proceed with a transaction involving the sale of a commodity. The borrower

⁸⁷³Ahmed, H. and Khan, T. 2005. *Risk management in Islamic banking*. [Online]. Available at: <http://ebooks.narotama.ac.id/files/Handbook%20of%20Islamic%20Banking/Chapter%2010%20Risk%20management%20in%20Islamic%20banking.pdf> [Accessed on: 17 July 2015].

promises to pay the due amount, including the mark-up value. However, the contractual agreement between the parties does not involve the legal transfer of the title to the commodity. Thus, the borrower or buyer of the commodity fulfils the role of a wakil in a wakala agency contract that is signed separately between the two parties. Under this wakala agency contract, the borrower is held responsible for procuring and negotiating the commodity being considered under the *Murabaha* financing agreement. The borrower is found to be acting as the agent of the seller – Islamic banks in this case. This is an acceptable role for the borrower to play, because the asset whose purchase is being financed is technical in nature in the majority of cases. Some examples of the assets or commodities that are traded through *Murabaha* financing agreements are construction materials and industrial equipment. In such situations, the wakil or agent is eligible to earn a fee for the services rendered to the bank as the agent of the principal, which in this case is the Islamic bank itself. However, in case of a *Murabaha* financing agreement, this agency fee is calculated as part of the cost to the bank; therefore, it is included in the mark-up value that is charged by the bank. It can be included in the actual cost of the assets or the commodity financed through *Murabaha*, along with the final price of the commodity under consideration. The borrower purchases the commodity on behalf of the lender, as a result of which the lender holds the legal title to the asset title until it is transmitted to the borrower, which happens later, when the borrower purchases the asset from the lender at a mutually agreed mark-up price. To ensure that the complete process of *Murabaha* financing is legally viable, the bank is required to undertake riba-free *Murabaha* financing. Thus, there is a need to take into consideration the risk of ownership of the commodity in question. In the modernised form of Islamic banking, the title is transmitted to the bank for a certain fractional moment in time. Therefore, the real ownership risk is almost completely eliminated.

The above paragraph helps in analysing the process of agreement of banks and clients in *Murabaha* and evaluating the ownership risk faced by banks in this process. Thus, this information suggests the risk of ownership and the

method used by modern Islamic banks to overcome these risks which are helpful in the direction of meeting the research aim.

The following paragraph explores that the structure of *Muhabara* process is inappropriate due to the interest rate risk and inflation risk that affects the long-term contracts. This limitation is justified by the help of an example of real estate transaction in the below information. It is also analysed that banks of Islam face issues in the management of risk involved in the *Muhabara*. The techniques of risk management are also suggested in the information given in the below paragraph.

Despite the considerable degree of flexibility inherent in a *Murabaha* financing agreement, it is considered an inappropriate structure for the financing of long-term assets because of the myriad variables affecting all long-term contracts, such as interest rate risk and the risk of inflation. All such risks are capable of changing the overall returns expected and the profitability of the contract because it is difficult to predict future interest and inflation rates. Consequently, *Murabaha* financing agreements are restricted to short-term financing only. This limitation can be further illustrated by looking at the example of a real estate transaction based on *Murabaha* financing. In such a transaction, the terms of the deferred payment would be set by the Islamic bank to incorporate some opportunity cost or time-value cost as a variable in the pricing mechanism. As an alternative to the conventional benchmarks of interest rates, Islamic banks have adopted the rental rate index. However, such indices would be applicable only if the lender holds a certain amount of equity stake in the asset or investment being financed by the *Murabaha* agreement. It has been regularly argued that Islamic banks in Saudi Arabia are relatively less flexible in their asset holdings than conventional banks, which can be instantly passed on to banks' customers via interest rate changes. This is a major reason for the fact that Islamic financing in Saudi Arabia is typically undertaken in the form of *Murabaha* instruments, which are fixed-rate assets.⁸⁷⁴ It has been argued that

⁸⁷⁴How, J.C.Y., Karim, M.A. and Verhoeven, P. 2005. Islamic Financing and Bank Risks: The case of Malaysia. *Thunderbird International Business Review* 47(1), pp. 75-94.

excessive dependence on deferred sale-financing instruments such as *Murabaha* implies that the majority of assets will be less sensitive to the market interest rate risk. This research study has involved a significant amount of discussion regarding the major risks faced by both Islamic banks and the associated parties with reference to the use of *Murabaha* contracts. The legal risks have been shown to be of greater significance than all other forms of risk, indicating the need to integrate such risks into the wider risk-management systems within Islamic banks. It was found that banks face issues in synchronising their general risk management and their legal risk management, leading to difficulties in categorising commercial risks and tailoring to particular risks, which in turn results in even more severe legal risks. More specifically, it is stated that in case of *Murabaha* contracts, banks face various risks including asset risks, legal risks, and fiduciary risks, of which legal risks are the most serious. Thus, the management of legal risk needs to be integrated with that of fiduciary risk and asset risk, in order to ensure a comprehensive approach towards risk management.

The above information suggests how the banks and other parties overcome the issues faced by them in the management of risks associated with the *Murabaha*. In this way, the above information is helpful in achieving one of the objectives of the research.

The below-given paragraph explores two major categories of *Murabaha* namely primary risk involving legislation risk and secondary risk related to demonstration of the non-compliance. Moreover, it is analysed that lack of standardisation of *Murabaha* leads to the exposure of documentation as well as disclosure risk for banks. Moreover, there is a lack of the system of litigation of the disputes which leads to increase the risks associated with the process of *Murabaha*.

Wilson categorises legal risks as either primary or secondary in nature. In this dichotomy, the “primary risk” is a legal term that defines a broad area of risk, or in other words, the contractual risk that would assist in focusing on the likely source of legal risk. It is also defined as the prescriptive layer. As concerns the

definition of secondary risks, Wilson states that these comprise actual examples for the purpose of demonstrating and explaining the application of the primary risks; thus, it is also known as a normative definition.⁸⁷⁵ In the case of *Murabaha* contracts, the primary legal risk to which Islamic banks are exposed is the legislative risk, where the practices of banks do not meet the regulatory requirements of Sharia law. The other primary legal risks are counterparty risk and other contractual and non-contractual risks. The secondary legal risks for banks include the demonstration of non-compliance with Sharia law while undertaking a *Murabaha* transaction, technical defaults in terms of a lack of appropriate documentation, and ambiguity in the authorisation on behalf of Islamic banks. The major legal risks faced by Islamic banks arise from the fact that there are significant distinctive features of the *Murabaha* contract that lead to risks associated with enforcement and documentation. Furthermore, there is a lack of standardisation in *Murabaha* contracts signed between banks and their customers, which exposes banks to the legal risk of documentation and disclosure, as stated in the regulations.⁸⁷⁶ In addition, it is stated that there is no system of litigation for the resolution of disputes concerning the enforcement of the contract by the counterparty. This increases the legal risks associated with Islamic contractual agreements. In his review, Köhn (2011) found that in order to ascertain the gains made by Islamic banks, a margin is set equivalent to that which would have been earned in the case of an interest-bearing asset. Moreover, Islamic banks take ownership or possession of the commodity against which the loan is being granted to the borrower, which is known as *Murabaha*. This possession can be either constructive or physical in nature.⁸⁷⁷ In the case of constructive possession, the bank does not necessarily receive physical delivery of the item, but all the rights, liabilities, and risks attached to the commodity nevertheless remain with the bank.

⁸⁷⁵Wilson, R. 2012. *Legal, Regulatory and Governance Issues in Islamic Finance*. Edinburgh University Press.

⁸⁷⁶Dalel, G. and Bessem, T. 2013. Mourabaha Contract and Basis of Islamic Finance. *Interdisciplinary Journal of Contemporary Research in Business*4(11), pp.157-161.

⁸⁷⁷Köhn, D. 2011. *Mobilising Capital for Emerging Markets: What Can Structured Finance Contribute?*Springer.

The above paragraph contains further information regarding the risks associated with the process of *Muhabara*. Thus, it helps in contributing to the aim of research of identifying some risks related to the process of *Muhabara*.

All the parties associated with *Murabaha* financing are exposed to legal risks pertaining to the possibility of being found to breach the doctrine of undue influence and unjust enrichment. Similarly, if the *Murabaha* transactions involve the imposition of *riba* and if the balance of bargaining power rests with any of the parties, then the associated parties are exposed to legal risk. Furthermore, if there is economic disparity among the goods being traded or a significant disparity in the price of the commodity being traded, the parties to the *Murabaha* agreement are exposed to legal risk. It is considered judicially justified for the associated parties to make money from productive use of the commodities. However, it is considered illegal and exploitative on the part of the stronger party to impose excessive monetary charges on the weaker party, even if they trade in a commodity that is not considered tradable under Sharia law. An equal distribution of risk among all the parties involved in the *Murabaha* transaction is also held to be an indicator of legal acceptability; therefore the lawyers drafting a *Murabaha* contract are expected to take into account uniformity of risk in the terms and conditions of the contract. Furthermore, *Murabaha* financing exposes the parties to numerous legal issues that could be described as non-regulatory in nature, and these are typically addressed by the parties involved in the structuring of the *Murabaha* transaction or those involved in its documentation.

In the estimation of Salah, the situation in numerous non-Islamic countries such as the USA is that the legal risks associated with *Murabaha* financing are no different to those associated with conventional financial instruments.⁸⁷⁸ Salah goes on to state, however, that regulatory approval for *Murabaha* financing is a precondition for such products to be offered by banks, but in spite of such approval, the legal issues do not seem to have been resolved. In the USA and

⁸⁷⁸Salah, I. 2009. Legal issues arising in Islamic finance transactions in the United States.[Online]. Available at: <http://www.kslaw.com/Library/publication/9-09%20Yasaar%20Media%20Salah.pdf> [Accessed on: 2 July 2015].

similar countries, the viability of financing products is highly dependent on their tax treatment. This can be explained by looking at a state property tax, which could be applied to *Murabaha* financing as long as adequate tax is thought to be charged on home finance products, as per the *Murabaha* financing structure. In many cases, the states impose a property transfer tax as well, so that the imposition of tax applies to every transfer of real estate or recording of title deeds. Thus, in *Murabaha* financing, the initial purchase of the home by the bank is subject to the transfer of tax, and the payment of this tax is typically shifted to the customer. In other cases, taxes can be built into the resale price or transferred into lease rental payments.

The below paragraph contains the information regarding the issues related to double taxation. The parties involved in *Murabaha* expose to such legal risks of double taxation. On the other hand, it is analysed that the Islamic banks are exposed to ownership risks. The example related to this issue is provided in the information. It is analysed that Islamic banks are exposed to such risks which are not applicable for other banks providing financing services by conventional mortgage instruments.

The tax authorities of numerous countries have recognised the element of inequality inherent in imposing a double tax payment on Sharia-compliant structures. Such double taxation takes place when transitive instruments such as *Murabaha* are treated as equivalent to conventional financing instruments. In response, the legal bodies of such nations issue rulings against parties on a case-by-case basis with the aim of removing the burden of double taxation from the aggrieved party. Evidently, the parties to *Murabaha* financing are among those exposed to such legal risks. In addition, the structure of *Murabaha* financing carries within it an ownership risk for the concerned parties when this source of financing is used for the purchase of real property. Islamic banks take ownership of a property and become a node in the “chain of title” of the respective property, even if the ownership is held for only a short period. The legal authorities of numerous countries impose various liabilities and responsibilities on both the present and previous owners of real property. As a

result, any Islamic bank participating in *Murabaha* financing for real property is required to recognise such legal risks and take steps to mitigate them. This can be illustrated by the example of a property found to be in breach of environmental regulations; in this case, both the current and prior owners of the property are legally obliged to pay for the property to be cleaned. Because Islamic banks can own a property being traded, albeit momentarily, they are exposed to such risks, which are not applicable to banks that provide financing services through conventional mortgage instruments.

The above information is related to double taxation risk as well as ownership risks faced by clients and banks respectively who are involved in the process of *Muhabara*. Thus, the above information helps in analysing some particular risks which are faced by Islamic banks while entering into *Muhabara*. In this way, this information leads to meet the aim of the research.

The below paragraph suggests that commodity that is going to be traded by *Muhabara* financing agreement is the key indicator of agreement's legal acceptability. With the example, it is made clear that while the Islamic bank provides financial support to the client for purchasing real estate companies' shares then entire transaction involve in *Muhabara* would be legal if the cash assets do not exceed the material value.

The commodity being traded through *Murabaha* financing is a major indicator of the legal acceptability of the agreement. For example, if an Islamic bank finances a client for the purpose of purchasing the shares of a real estate company or any other business with lawful operations, there can be no legal issues related to the bank's purchasing of the shares on behalf of the client. Thereafter, the bank can sell the shares to the client through *Murabaha* financing and the entire transaction will be legal, as long as the cash assets of the company concerned do not exceed its material value and it is not involved in any unlawful activities. In a similar manner, if an Islamic bank sells equipment to a company through *Murabaha* and adds the cost of installation to the selling price, this is legally viable.

The above information helps in analysing that there would be no legal issues while bank purchase shares on the behalf of clients. Thus, this information is essential in evaluating that in what cases the process of *Murahara* is not lead to legal issues.

Andrews adds that *Murahaba* provides a well-known financing approach under Sharia and that it is considered lawful by consensus, whether conducted in terms of cash or credit.⁸⁷⁹ He goes on to state that banks face high risks in *Murahaba* financing because it is thought to provide them with a source of high returns.⁸⁸⁰

The following paragraph explains that there is a major different between convention banks and Islamic banks. The conventional banks are not concerned about the failure of client in making due payment on time, however, the Islamic banks pose penalty for not meeting the deadlines of the payment. Thus, it poses risk for Islamic banks while competing with conventional banks.

By trading a commodity through *Murahaba* financing, the financier is held to have taken the risk of default on behalf of the client, along with the opportunity to use the money forgone.⁸⁸¹ Such opportunities are considered to have arisen within the period in which the money remains blocked –i.e., within the duration of the financing arrangement.⁸⁸² However, under Sharia, time is not recognised as a basis upon which the monetary value to be charged above the principle amount can be determined.⁸⁸³ Sharia law does not enable any further increase in a price already fixed by a contract.⁸⁸⁴ Thus, under Sharia-based financing agreements such as *Murahaba* contracts, if the client fails to make a due payment in time, the

⁸⁷⁹Andrew, M. 2010. Islamic Finance: Four Articles Introducing Islamic Banking And Finance Concepts. [Online]. Available at: <http://www.riskrewardlimited.com/admin/pdf/Islamic%20Finance%20Articles%20by%20MCA.pdf> [Accessed on: 3 July 2015].

⁸⁸⁰Dusuki, A.W. 2006. Commodity *Murahaba* Programme (CMP): An Innovative Approach to Liquidity Management. *Journal of Islamic Economics, Banking and Finance* 3(1).

⁸⁸¹Bellalah, M.2013. *Islamic Banking and Finance*. Cambridge Scholars; Dusuki, A.W. 2006. Commodity *Murahaba* Programme (CMP): An Innovative Approach to Liquidity Management. *Journal of Islamic Economics, Banking and Finance* 3(1).

⁸⁸²Bellalah, M.2013. *Islamic Banking and Finance*. Cambridge Scholars.

⁸⁸³Cotran, E. and Lau, M. 2002. *Yearbook of Islamic and Middle Eastern Law: 2001-2002*. Brill. p. 116

⁸⁸⁴Dusuki, A.W. 2006. Commodity *Murahaba* Programme (CMP): An Innovative Approach to Liquidity Management. *Journal of Islamic Economics, Banking and Finance* 3(1).

financier is not entitled to any financial compensation⁸⁸⁵ because Sharia does not recognise the concept of the time value of money.⁸⁸⁶ In this regard, it can be said that Islamic banks lag behind the conventional form of financing since in conventional banking; the value of time is adequately calculated, allowing conventional banks to impose an additional financial penalty on any client in response to a delay in payment of the due amount.⁸⁸⁷ This difference brings with it an additional sustainability risk for Islamic banks when they are in competition with conventional banks. The sustainability risk is particularly strong in countries such as Saudi Arabia, where both conventional banks and Islamic banks operate and compete for business.

The above paragraph explores the difference between convention and Islamic banks. The Islamic banks need to deal with a risk in the *Muhabara* process due to their recognition of concept of time value of money but on the other hand, conventional banks does not concerned about it. Thus, the identification of this risk also contributes in meeting the research aim.

The two major principles of justice applied to Islamic transactions are reciprocity and equivalence. The equivalence principle emphasises the perceived equivalence between the commodity received by a buyer and the price received by a seller, as is the case in voluntary exchanges between commodity on one side and money on the other. Reciprocity inheres in the seller's advantage of a mark-up being matched by the buyer's advantage of getting the time and opportunity to use the commodity ahead of paying the price.⁸⁸⁸ Both these norms are violated by interest-based financial transactions, but not by their Islamic equivalents. There is a perception of equivalence between the commodity that is acquired by the client through *Murabaha* financing and the price that is received by the seller. This perception is very strong and applies more specifically in cases of the voluntary exchange of money and commodities on both sides. It is assumed that there is an essential reciprocity between the advantage of mark-up

⁸⁸⁵ Ibid.

⁸⁸⁶ El-Gamal, M.A. 2006. *Islamic Finance: Law, Economics, and Practice*. Cambridge University Press, p.116.

⁸⁸⁷ Bellalah, M.2013. *Islamic Banking and Finance*. Cambridge Scholars.

⁸⁸⁸ Ibid.

received by the seller and the corresponding advantage enjoyed by the buyer. This advantage can be understood in terms of the opportunity the buyer has to make use of the commodity before making a full payment for it on a deferred payment basis. The perception in terms of equality is considered acceptable in place of the equality objective, when exchanging certain dissimilar things such as a commodity on one hand and money on the other. However, it cannot be considered acceptable or justified in the case of the exchange of similar things, such as money in exchange for money. Furthermore, there is a requirement for measurable equality, because there is no room for perceptions or estimations without any reasonable basis and where there exists no reciprocity. In addition, the advantages enjoyed by the lender are not known and defined within the financial agreement being signed between the parties, whereas the advantages accruing to the client are not known, nor are they well-defined. Thus, this could be said to be a non-equivalent act, where only the finance provider is required to ensure transparency.⁸⁸⁹

There are certain requirements for the client, when a source of short-term funds is sought to finance a purchase; it is considered to be released as soon as the recovery of the sale is executed.⁸⁹⁰ In such circumstances, the investor – such as an Islamic bank – seeks comparatively low-risk opportunities that are liquid in nature.⁸⁹¹ Some factoring firms bring together businesses with similar purposes to create a single business or a group of businesses in the form of a conventional captive finance subsidiary. For passive investors, including some client businesses, this characteristic is similar to that of a conventional financing subsidiary. Such businesses sign a *Murabaha* financing agreement that is managed by a *mudarib*, or professional firm whose members have collective and administrative skills and who are compensated with a certain percentage of profit-sharing.⁸⁹² As the agent in respect to *Murabaha* contracts, the client identifies and screens out credit sale applicants. *Mudaraba* also enters into these

⁸⁸⁹Choudhury, M.A.2013. *Money in Islam: A Study in Islamic Political Economy*. Routledge, p. 96.

⁸⁹⁰Elgari, M.A. 2003. Credit Risk in Islamic Banking and Finance. *Islamic Economic Studies*10(2).

⁸⁹¹Ibid.

⁸⁹²Ibid.

Murabaha contracts along with the applicants in order to maintain a mark-up that is sufficient to provide a reasonable amount of profit for both the *mudarib* and the investors. The distribution of profits is therefore determined after the deduction of all direct and indirect expenses incurred, along with any bad debt.

The following paragraphs discuss the ways in which *Murabaha* factoring can be used as an effective means to overcome the legal risks associated with *Murabaha*. This has been explained with the help of the agreement between the Mikdashi Appliance Stores Group and the Gulf Short-Term Finance House (GSFH).

The process of the *Murabaha* factoring discussed above can be explained by looking at the agreement between the Mikdashi Appliance Stores Group and the Gulf Short-Term Finance House (GSFH). In this case, Mikdashi was responsible for assessing the creditworthiness of the customers. Thus, for each and every customer sale, the relevant appliance was sold to GSFH by Mikdashi with the application of extremely modest discount rates, which were designed to provide satisfactory returns to GSFH on its capital after deducting bad debts and other expenses.⁸⁹³ Moreover, Mikdashi provided a guarantee for any category of bad debt to which GSFH was exposed.⁸⁹⁴ By means of the *Murabaha* factoring agreement, the investor's needs were thus completely satisfied.⁸⁹⁵ This meant, for instance, investing in commodities where immediate physical possession of the commodity could be avoided, thus eliminating the costs of ownership.⁸⁹⁶ The investors also intended to reverse their respective positions if they experienced a subsequent change in the outlook regarding commodity prices.⁸⁹⁷

⁸⁹³ Abusharbeh, M.T. 2014. Credit Risks and Profitability of Islamic Banks: Evidence from Indonesia. *World Review of Business Research* 43, pp. 136-147.

⁸⁹⁴ Choudhury, M.A. 2013. *Money in Islam: A Study in Islamic Political Economy*. Routledge, p. 96

⁸⁹⁵ Al Baraka. 2015. [Online]. Available at:

http://www.albaraka.co.za/Islamic_Banking/Features_of_Marabaha_and_Leasing.aspx [Accessed on: 3 July 2015].

⁸⁹⁶ Kettell, B. 2011. *Case Studies in Islamic Banking and Finance*. John Wiley & Sons.

⁸⁹⁷ Andrew, M. 2010. Islamic Finance: Four Articles Introducing Islamic Banking And Finance Concepts. [Online]. Available at:

<http://www.riskrewardlimited.com/admin/pdf/Islamic%20Finance%20Articles%20by%20MCA.pdf> [Accessed on: 3 July 2015].

Any owner of a business venture dealing in the manufacturing of goods or the provision of services, such as a textile company, is exposed to the risk of adverse price fluctuation.⁸⁹⁸ The prevalence and level of this risk are such that it might depress the overall earnings of the venture and, as a result, reduce its value.⁸⁹⁹ Thus, in this case, investors would be interested in exploiting the opportunity to purchase the short-term transaction and thereby prevent the further occurrence of losses.⁹⁰⁰

In the above scenario, Islamic banks will engage in a synthetic or artificial *Murabaha* financing agreement, also called an order to purchase.⁹⁰¹ However, this practice can result in devious artifices or *hiyal*, which means that it may be considered to amount to the attainment of substantive illegal gains. Moreover, in modern times, although the *Murabaha* financing agreement is religiously acceptable, there are movements away from investing in all kinds of *Murabaha* financing agreements. Thus, a huge amount of risk is associated with *Murabaha* financing for both Islamic banks and other parties.⁹⁰² Numerous well-established Islamic banks such as AlRajhi Bank and AlBaraka Bank, along with some governmental authorities, have undertaken to phase out deals involving *Murabaha* finance.⁹⁰³

This case is helpful in understanding the suitable actions that can be taken to mitigate the legal risks associated with *Murabaha* and will thus help in addressing objectives 3 of the thesis.

The following paragraph highlight the ways in which *Murabaha* contracts can be undertaken more cautiously and effectively so that the legal risks

⁸⁹⁸ Ayub, M. 2009. *Understanding Islamic Finance*. John Wiley & Sons.

⁸⁹⁹ Andrew, M. 2010. 'Islamic Finance: Four Articles Introducing Islamic Banking And Finance Concepts'. [Online]. Available at: <http://www.riskrewardlimited.com/admin/pdf/Islamic%20Finance%20Articles%20by%20MCA.pdf> [Accessed on: 3 July 2015].

⁹⁰⁰ Ali, S.S. Islamic Modes of Finance and Associated Liquidity Risks. [Online]. Available at: http://www.sbp.org.pk/departments/ibd/lecture_6_islamic_modes_finance_liquidity.pdf [Accessed on: 24 June 2015].

⁹⁰¹ *Ibid*, p. 136.

⁹⁰² *Ibid*, p. 116.

⁹⁰³ *Ibid*.

associated with them can be controlled. For this purpose the measures that can be taken by the bank are discussed.

Furthermore, the literature claims that *Murabaha* equity investment is merely a theoretical cornerstone for investment by Islamic banks.⁹⁰⁴ From this perspective, Islamic banks are seen as passive investors in the businesses of their customers, thereby deriving profit and returns from their business activities.⁹⁰⁵ In the practical sense, *Murabaha*-based financing has not been an extensive phenomenon, owing to certain issues such as illiquidity and moral hazards in case of adverse selection.⁹⁰⁶ Moreover, banks must adopt effective means of enforcing the required accounting standards, fiduciary standards, legal requirements, verification, disclosure requirements, and so forth, which are required before such investments can become a significant vehicle for investment by Islamic banks.⁹⁰⁷ For these and other related reasons, *Murabaha* financing agreements have not been a preoccupation for Islamic banks in their search for innovation in banking practices.⁹⁰⁸ However, it is also true that modes of financing such as *Murabaha* and *Mudaraba* are frequently used in situations where banks are interested in executing the negotiability or securitisation of an investment.⁹⁰⁹ They are also used when a vehicle is required for attaining ownership from an investment.⁹¹⁰ In the majority of cases, the risks to which Islamic banks are exposed by the use of *Murabaha* financing to make a passive investment in a client's business are minimal or absent altogether. This

⁹⁰⁴ Ahmed, H. 2011. *Product Development in Islamic Banks*. Edinburgh University Press, pp. 86-90.

⁹⁰⁵ *Ibid.*

⁹⁰⁶ *Ibid.*

⁹⁰⁷ Ahmad, N.H. and Ahmad, S.N. 2015. Key Factors Influencing Credit Risk Of Islamic Banks: A Malaysian Case. [Online]. Available at: http://www.researchgate.net/publication/228423667_Key_factors_influencing_credit_risk_of_Islamic_bank_A_Malaysian_case. [Accessed on: 1 July 2015].

⁹⁰⁸ *Ibid*

⁹⁰⁹ Abusharbeh, M.T. 2014. Credit Risks and Profitability of Islamic Banks: Evidence from Indonesia. *World Review of Business Research* 43, pp. 136-147.

⁹¹⁰ Ahmed, H. 2011. *Product Development in Islamic Banks*. Edinburgh University Press, pp. 86-90; Ahmad, N.H. and Ahmad, S.N. 2015. Key Factors Influencing Credit Risk Of Islamic Banks: A Malaysian Case. [Online]. Available at: http://www.researchgate.net/publication/228423667_Key_factors_influencing_credit_risk_of_Islamic_bank_A_Malaysian_case [Accessed on: 1 July 2015].

minimisation of risk is because of the participation of a mudarib or an entity with effective control, a role which is played by the Islamic banks in such cases.⁹¹¹

The option of “ownership in transit” enables the buyer of a commodity to obtain credit without imposing upon the seller the burden of a large amount of debt in the form of accounts receivable.⁹¹² Thus, it enables the seller to carry the inventory until and unless the commodity is in the possession of the buyer and the accounts receivable can be issued accordingly.⁹¹³ Thus, this process involves a self-liquidating cycle which makes it appealing to investors who are preoccupied with the short-term delivery of cash.⁹¹⁴ Under this proposal, the manufacturer who is responsible for the shipment of the finished goods over a long transit time enters into a selling agreement with the Islamic bank at a discounted price.⁹¹⁵ The bank then sells the goods to the final customer at a later date and at a price which compensates the bank for the fact that its money has been tied up, and other costs that are associated with the attainment of interim ownership.⁹¹⁶ So far, this proposed financing contract is a commonly implemented *Murabaha* financing instrument in trading at the international level; indeed, it is considered one of the mainstays of Islamic banking.⁹¹⁷ In order to ensure the effectiveness of the instrument and facilitate the optimal usage of *Murabaha* financing and its compliance with the provisions of Sharia law, Usmani has proposed a coordinated effort on the part of Islamic banks.⁹¹⁸ Such an effort

⁹¹¹ Andrew, M. 2010. Islamic Finance: Four Articles Introducing Islamic Banking And Finance Concepts. [Online]. Available at: <http://www.riskrewardlimited.com/admin/pdf/Islamic%20Finance%20Articles%20by%20MCA.pdf> [Accessed on: 3 July 2015].

⁹¹² Ibid.

⁹¹³ Alhowaimil, I. S. 2013. Frustration of Performance of Contracts: A comparative and Analytic Study in Islamic Law and English Law. [Online]. Available at: <http://bura.brunel.ac.uk/bitstream/2438/8532/1/FulltextThesis.pdf>. [Accessed on: 15 July 2015].

⁹¹⁴ Ibid.

⁹¹⁵ Andrew, M. 2010. Islamic Finance: Four Articles Introducing Islamic Banking And Finance Concepts. [Online]. Available at: <http://www.riskrewardlimited.com/admin/pdf/Islamic%20Finance%20Articles%20by%20MCA.pdf> [Accessed on: 3 July 2015].

⁹¹⁶ Usmani, T. 2004. *An Introduction to Islamic Finance*. Arham Shamsi.

⁹¹⁷ Al Baraka. 2015. [Online]. Available at: http://www.albaraka.co.za/Islamic_Banking/Features_of_Marabaha_and_Leasing.aspx [Accessed on: 3 July 2015].

⁹¹⁸ Aldohni, A.K. 2011. *The Legal and Regulatory Aspects of Islamic Banking: A Comparative Look at the United Kingdom and Malaysia*. London: Routledge.

would need to be made with the main aim of streamlining the arrangements and enhancing the volume of the instruments concerned. This approach would have considerable potential in terms of generating a comparatively large volume of business, thereby reducing the initial costs incurred by the bank for the documentation and administration of the instrument.⁹¹⁹

This discussion serves to be highly effective in examining the role of banks in minimising the legal and other risks associated with the *Murabaha* contracts and the extent to which these methods can mitigate the legal risks of these transactions.

The following paragraph discusses the foreign exchange and legal risks associated with *Murabaha* that might arise if fiduciary standards, legal requirements, verification, and other disclosure requirements tend to be ignored. The risks have been explained with the help of an example the shipment of new cars from the Volvo factory in Sweden to their dealer in Gulf countries

On the other hand, if adequate consideration is not given to enforcing accounting standards, fiduciary standards, legal requirements, verification, and other disclosure requirements and if effective means for doing so are not adopted, the parties could be exposed to the legal risks.⁹²⁰ To explain this risk, let us consider as an example the shipment of new cars from the Volvo factory in Sweden to their dealer in Gulf countries.⁹²¹ As per the agreement, the dealer is not obliged to pay the due amount until and unless the cars have landed in the Gulf and been delivered.⁹²² As a result, Volvo is required to ensure a source of finance for the manufacturing and delivery of the cars, including the several weeks of transit from Stockholm to Manama or Jeddah, for example.⁹²³ To do this, Volvo could approach any Islamic bank for financial assistance. In this instance, the Bahrain Islamic Bank was approached.⁹²⁴ The parties entered into a

⁹¹⁹Elgari, M.A. 2003. Credit Risk in Islamic Banking and Finance. *Islamic Economic Studies* 10(2).

⁹²⁰Ibid.

⁹²¹Bellalah, M. 2013. *Islamic Banking and Finance*. Cambridge Scholars, p. 118.

⁹²²Elgari, M.A. 2003. Credit Risk in Islamic Banking and Finance. *Islamic Economic Studies* 10(2).

⁹²³Ali, S.S. Islamic Modes of Finance and Associated Liquidity Risks. [Online]. Available at: http://www.sbp.org.pk/departments/ibd/lecture_6_islamic_modes_finance_liquidity.pdf [Accessed on: 24 June 2015].

⁹²⁴Bellalah, M. 2013. *Islamic Banking and Finance*. Cambridge Scholars, p. 118.

Murabaha financing agreement, under which the Bahrain Islamic Bank purchased the cars from the manufacturer and arranged for them to be loaded and shipped from Stockholm.⁹²⁵The bank continued to own and possess the cars until the end of the transit period and incurred all of the shipping and other costs.⁹²⁶During this process, or the period of transit, the risk of ownership was borne solely by the bank.⁹²⁷The price at which the Bahrain Islamic Bank agreed to purchase the cars from the manufacturer was set so that the bank would earn a satisfactory amount of profit. In this case, the profit was calculated as net of all other expenses, including the tying-up of the capital invested, until and unless the dealer reimbursed the cost of the cars to the bank. Since this was held to be part of the ongoing arrangements at the international level, where a huge amount of financial assistance is provided, the Bahrain Islamic Bank could propose to Volvo a net price for the cars as per standard competitive financing arrangements rendered within the automobile industry.⁹²⁸ A *Murabaha*-based transaction such as this involves only a single contract, described as a *Murabaha* with an order to purchase, and is one of the most commonly used Islamic financial mechanisms.⁹²⁹Under such schemes, although the contract is executed in the most Islamic suitable manner, the financier – in this case, the Bahrain Islamic Bank – is held responsible for a reasonable amount of credit, fiduciary, and legal risk.⁹³⁰ Moreover, when engaged in such *Murabaha* financing transactions, Islamic banks are also exposed to a foreign exchange risk because the exchange risk which would otherwise be borne by the manufacturer is transmitted to the bank.⁹³¹

⁹²⁵Ali, S.S. Islamic Modes of Finance and Associated Liquidity Risks.[Online]. Available at: http://www.sbp.org.pk/departments/ibd/lecture_6_islamic_modes_finance_liquidity.pdf [Accessed on: 24 June 2015].

⁹²⁶Chorafas, D.N. 2011. *Stress Testing for Risk Control Under Basel II*. Butterworth-Heinemann, p. 55.

⁹²⁷Choudhury, M.A.2013. *Money in Islam: A Study in Islamic Political Economy*. Routledge, p. 96.

⁹²⁸Siddiqi, A. and Hrubí, P. 2008. *Islamic Investments Funds Versus Hedge Funds*. GRIN Verlag. p.55.

⁹²⁹Cotran, E. and Lau, M. 2002. *Yearbook of Islamic and Middle Eastern Law: 2001-2002*. Brill, p. 116; Hallaq, H.B. 2009. *An Introduction to Islamic Law*. Cambridge University Press, p. 114.

⁹³⁰Ibid, p. 235.

⁹³¹Ibid, p.110.

The Volvo example demonstrates the organised international effort that needs to be made by the Islamic finance industry in Saudi Arabia, as well as in other parts of the world.⁹³² The aim should be to retain international trade through *Murabaha* financing agreements as the key vehicle for financing through Islamic banks.⁹³³ Such efforts need to be made in order to ensure the satisfaction of both the religious theorists and the stakeholders.⁹³⁴ The basic logic behind such *Murabaha*-based proposals backed by complete compliance with Islamic rules and regulations is to ensure that the parties are exposed to the least possible legal risk.⁹³⁵ However, the banks are required to make a choice between risk exposure and feasibility in terms of the economies of scale⁹³⁶

This discussion is helpful in understanding a detailed understanding of the foreign exchange and legal risks associated with *Murabaha* transactions and the impact of these risks on the ultimate returns of the manufacturer.

These paragraphs highlight the shortcomings in the effectiveness of the *Murabaha* contracts which increases the threat of the legal risks in these contracts. It helps in understanding the ways in which some limitations of the *Murabaha* financing can cause major legal risks for the Islamic banks.

According to Usmani, it would be a mistake on the part of both Islamic banks and their customers to assume that *Murabaha* financing instruments are universal in nature and hence can be used to provide any type of financial support.⁹³⁷ My view favours that of Usmani because certain limitations to *Murabaha* financing obstruct it from universal application. The nature of this financial contract is not supportive for all financial support that should be considered when engaged in this transaction.

Some types of financial services that are rendered by conventional banks and other non-banking financial institutions cannot validly be provided by Islamic

⁹³²Hallaq, H.B. 2009. *An Introduction to Islamic Law*. Cambridge University Press, p. 114.

⁹³³*Ibid*, p. 235.

⁹³⁴*Ibid*, p. 110.

⁹³⁵Hallaq, H.B. 2009. *An Introduction to Islamic Law*. Cambridge University Press, p. 114.

⁹³⁶*Ibid*, p. 110.

⁹³⁷Institute of Islamic Banking and Insurance (n.d.) [Online]. Available at: http://www.islamic-banking.com/Murabaha_sruling.aspx [Accessed on: 28 July 2015].

banks through *Murabaha* financing.⁹³⁸In recent years, some financial institutions have used *Murabaha* agreements to provide finance for client companies to cover their overhead expenses such as staff salaries, property taxes, or electricity and telephone bills.⁹³⁹Such practices are legally completely unacceptable because *Murabaha* financing agreements can specifically be used only for the purchase of commodities by the banks' customers.⁹⁴⁰If funds are required for other purposes, the need cannot be met by *Murabaha* financing agreements; instead, these requirements should be fulfilled through the use of instruments such as leasing and musharaka, because these are compliant with Sharia law for these purposes.⁹⁴¹In cases where a *Murabaha* financing agreement has been made for non-compliant reasons, a legal risk will arise because the agreement will be considered legally enforceable.⁹⁴²From the personal perspective, the applicability of the *Murabaha* must be considered by the parties before opting for this financial transaction for financial support, which leads to the prevention of legal risks.

In addition to the example above, there are certain circumstances where clients or customers obtain funds through *Murabaha* financing without any intention to employ these funds for the purchase of a commodity.⁹⁴³ Instead, such clients enter into the *Murabaha* agreement for an unspecified purpose and in order to satisfy the requirements of the process, they name a fictitious commodity in the documents. Once received, these funds are then used by the client for whatever investment they wish to make. Such an agreement is considered to be

⁹³⁸Ibid, p. 115.

⁹³⁹Institute of Islamic Banking and Insurance (n.d.) [Online]. Available at: http://www.islamic-banking.com/Murabaha_sruling.aspx [Accessed on: 28 July 2015].

⁹⁴⁰Holden, K. 2008. Islamic Finance: "Legal Hypocrisy" Moot Point, Problematic Future Bigger Concern [Online]. Available at: <https://www.bu.edu/law/central/jd/organizations/journals/international/volume25n2/documents/341-368.pdf> [Accessed on: 10 July 2015].

⁹⁴¹Usmani, T. 2004. *An Introduction to Islamic Finance*. Arham Shamsi.

⁹⁴²How, J.C.Y., Karim, M.A. and Verhoeven, P. 2005. Islamic Financing and Bank Risks: The case of Malaysia. *Thunderbird International Business Review* 47(1), pp. 75-94.

⁹⁴³Holden, K. 2008. Islamic finance: "Legal hypocrisy" moot point, problematic future bigger concern. *Boston University International Law Journal* 25, p. 341; Institute of Islamic Banking and Insurance (n.d.) [Online]. Available at: http://www.islamic-banking.com/Murabaha_sruling.aspx [Accessed on: 28 July 2015].

for a fictitious trade, and a very great legal risk arises for any Islamic bank that finds itself involved in any such transaction.

This discussion serves to be highly significant to undertake a detailed examination of the problem experienced by the financial institutions and individuals because of the risks associated with *Murabaha* transactions. In this manner, this discussion will help in addressing the second objective of the thesis.

These paragraphs highlight the measures that can be taken by the Islamic banks while executing the *Murabaha* financing agreement. In this regard, the legal obligations of the Islamic banks in respect of *Murabaha* financing agreement are discussed. Islamic banks are extremely cautious regarding such deals. It is held to be their responsibility to ensure that the intention of the client is in line with the purchase of the commodity specified in the *Murabaha* financing agreement.⁹⁴⁴ Such an assurance can be obtained by the bank through the authorities that sanction the granting of this facility to the customer. After that, the bank must take all possible steps to receive confirmation that the transaction is completely genuine.⁹⁴⁵ One way of doing this, instead of providing funds directly to the customer for the purchase of the commodity, is for the bank to pay the purchase price directly to the supplier of the commodity concerned.⁹⁴⁶ However, if it becomes necessary to make a payment to the customer because a direct payment to the supplier is not feasible, the client should be required to provide sufficient evidence to verify that the purchase has taken place.⁹⁴⁷ Such evidence could be the invoice or a similar document. The third alternative to this verification or confirmation process would be to arrange physical verification by producing for inspection the commodity that the customer claims to have purchased.⁹⁴⁸

⁹⁴⁴Dusuki, A.W. 2006. Commodity *Murabaha* Programme (CMP): An Innovative Approach to Liquidity Management. *Journal of Islamic Economics, Banking and Finance* 3(1).

⁹⁴⁵Salem, R.A. 2013. *Risk Management for Islamic Banks*. Edinburgh University Press.

⁹⁴⁶Abdul-Rahman, Y. 2010. *The Art of Islamic Banking and Finance: Tools and Techniques for Community-Based Banking*. John Wiley & Sons.

⁹⁴⁷Shofawati, A. 2014. *Murabaha Financing in Islamic Banking: Case Study in Indonesia*. *Proceedings of 5th Asia-Pacific Business Research Conference*, p. 108.

⁹⁴⁸Schinas, O. Grau, C. and Johns, M. 2014. *HSBA Handbook of Ship Finance*. Springer, p. 115.

Indeed, it is a legal obligation for an Islamic bank to ensure that the *Murabaha* financing agreement it has signed is genuine and that the sale of the commodity has actually been undertaken using the funds transferred by the bank to the client.⁹⁴⁹ The bank must also ensure that the funds provided are not being misused with the intention of camouflaging the granting of an interest-based loan.⁹⁵⁰

In certain cases, the sale of the commodity comes into effect before the actual acquisition of the commodity from the supplier. Such transactions may be subject to mistakes of this kind when all the relevant documents are signed at one time without considering the various stages involved in the completion of the *Murabaha* transaction.⁹⁵¹ There are certain institutions whose practice is to draw up a single contract for each *Murabaha* agreement; this is signed when the money value is being disbursed or in certain circumstances when the monetary value is being disbursed.⁹⁵² Such practices are completely against the traditional and basic principles of *Murabaha* financing agreements.⁹⁵³

As discussed earlier, the procedure for documenting a *Murabaha* financing agreement is a package of more than one contract, each of which is signed by the parties concerned as each of the different stages of the *Murabaha* process comes into play.⁹⁵⁴ If the basic features or characteristics of *Murabaha* financing are not given adequate consideration, it may appear that the complete *Murabaha* transaction is similar to the conventional form of interest-based financing.⁹⁵⁵ This is because a mere change in the nomenclature of the agreement does not make it lawful as per Sharia law.⁹⁵⁶ Thus, there is a requirement to ensure that the parties fully abide by Sharia law to avoid exposing the Islamic banks involved to

⁹⁴⁹ Ibid.

⁹⁵⁰ Ibid p. 166.

⁹⁵¹ Schoon, N. 2010. *Islamic Banking and Finance*. Spiramus Press Ltd, p. 118.

⁹⁵² Salem, R.A. 2013. *Risk Management for Islamic Banks*. Edinburgh University Press.

⁹⁵³ Shari'ah Rulings and Finance. 2015. [Online]. Available at: <http://www.islamic-banking.com/shariah-rulings-finance.aspx> [Accessed on: 14 July 2015].

⁹⁵⁴ Ibid.

⁹⁵⁵ Salem, R.A. 2013. *Risk Management for Islamic Banks*. Edinburgh University Press.

⁹⁵⁶ Shofawati, A. 2014. *Murabaha Financing in Islamic Banking: Case Study in Indonesia*. *Proceedings of 5th Asia-Pacific Business Research Conference*, p. 108.

legal risks.⁹⁵⁷ The representatives or members of the Sharia boards must ensure that the Islamic banks involved are abiding by Sharia law.⁹⁵⁸ All Islamic banks are monitored by Sharia boards to make sure that in all stages of each transaction, Sharia regulations have been clearly followed, and that all transactions are brought into effect within the due time.

This discussion is highly effective providing a detailed account of the measures that can be taken by the Islamic banks to manage the legal risks associated with *Murabaha* financing agreement. The knowledge obtained with the help of this discussion served to be helpful in exploring the most suitable methods that can be useful in management the risks associated with these contracts and evaluate the extent to which these methods mitigate the risks of *Murabaha* financial transactions.

The discussion in the following paragraphs highlights the additional factors and features of the *Murabaha* contracts that create legal risks for the Islamic banks. In this respect, the issue of real commodities and the divergence from Sharia law have been discussed to examine the ways in which they create risks for the banks.

Commodity transactions at the international level are of major importance for liquidity management.⁹⁵⁹ Some Islamic banks consider such transactions to be asset-based and thus easily converted into *Murabaha* transactions.⁹⁶⁰ Islamic banks enter into *Murabaha* agreements because operations concerned with commodities on the international market may be vaguely defined and inconsistent with the stipulations of Sharia law.⁹⁶¹ In many cases, the transactions prove to be fictitious, so that no commodity is in reality delivered at all.⁹⁶² The parties simply pay the net amount to the beneficiary; in a majority of

⁹⁵⁷Dusuki, A.W. 2006. Commodity *Murabaha* Programme (CMP): An Innovative Approach to Liquidity Management. *Journal of Islamic Economics, Banking and Finance* 3(1).

⁹⁵⁸Bovens, M.A.P., T'Hart, P. and Peters, B.G. 2002. *Success and Failure in Public Governance: A Comparative Analysis*. Edward Elgar.

⁹⁵⁹Schoon, N. 2010. *Islamic Banking and Finance*. Spiramus Press Ltd, p. 118.

⁹⁶⁰Usmani, T. 2004. *An Introduction to Islamic Finance*. Arham Shamsi, p. 116.

⁹⁶¹Schoon, N. 2011. *Islamic Asset Management: An Asset Class on its Own?* London: Edinburgh University Press, p. 196.

⁹⁶²Ibid.

cases, the parties involved in the transaction end up paying different amounts to each other.⁹⁶³ In some cases, real commodities are also traded through *Murabaha* financing agreements, yet are considered to be subject to short sales or forward sales, which are prohibited under Sharia law.⁹⁶⁴ Under these circumstances, Islamic banks are likely to be exposed to additional legal risks.⁹⁶⁵ Moreover, even if transactions are conducted and restricted to spot sales, they are required to be conducted on the basis of the Islamic principles of *Murabaha* financing.⁹⁶⁶

It has been further observed that many financial institutions enter into *Murabaha*-based financial transactions in respect of a commodity that has already been purchased by the bank's client from a third party. This is a practice that is not acknowledged to be Sharia-compliant because under Sharia law, once the client has purchased a commodity from the supplier, it cannot be purchased again by the same client from the same supplier. Furthermore, if an Islamic bank purchases a commodity from the client, rather than the supplier, and then sells it straight back to him, this is considered a use of the buy-back technique, a process which involves only two parties.⁹⁶⁷ Such transactions are also not allowed under Sharia law, more specifically in *Murabaha* financing, because as has been explained, at least three parties should be involved in a *Murabaha*-based transaction.⁹⁶⁸ In fact, if a client approaches an Islamic bank to raise funds for the purchase of a commodity that has already been completed, he is considered to have the intention to offset his liability towards the supplier or to use the funds for the purpose of making some other investment.⁹⁶⁹ In both of

⁹⁶³Shofawati, A. 2014. *Murabaha* Financing in Islamic Banking: Case Study in Indonesia. *Proceedings of 5th Asia-Pacific Business Research Conference*, p. 108.

⁹⁶⁴Bovens, M.A.P., T'Hart, P. and Peters, B.G. 2002. *Success and Failure in Public Governance: A Comparative Analysis*. Edward Elgar.

⁹⁶⁵Shofawati, A. 2014. *Murabaha* Financing in Islamic Banking: Case Study in Indonesia. *Proceedings of 5th Asia-Pacific Business Research Conference*. 108.

⁹⁶⁶Tariq, A.A. 2004. Managing Financial Risks of Sukuk Structures [Online]. Available at: https://www.google.co.uk/?gws_rd=ssl [Accessed on: 24 June 2015].

⁹⁶⁷Wilson, R. 2012. *Legal, Regulatory and Governance Issues in Islamic Finance*. London: Edinburgh University Press, p. 115.

⁹⁶⁸Ibid, p.126.

⁹⁶⁹Alexander, A.J. 2011. Shifting Title and Risk: Islamic Project Finance with Western Partners. *Michigan Journal of International Law* 3(3), pp. 572-611; Ibid, p. 136.

these cases, if an Islamic bank is found to be financing its clients through *Murabaha* financing, the parties are considered to be entering into an agreement that is not legally recognised under Islamic law.⁹⁷⁰ A *Murabaha* financing agreement can be implemented only for the purchase of commodities that have not yet been purchased by the client.⁹⁷¹ It can be concluded that divergence from Sharia law induces various critical legal risks for the parties involved and therefore strict adherence with Sharia law is essential. The next section reveals the risk management strategies employed to confront the risks faced by Islamic banks.

The above discussion serves to be beneficial in examining the legal risks associated with the Islamic banks and will thus be helpful in exploring the legal risks related to *Murabaha* transactions and the problems encountered by the financial institutions and Islamic banks while dealing with these transactions. The overall discussion will be very useful in addressing the second and third objectives of the thesis.

4.3 Risk management strategies adopted by Islamic banks

In order to ensure sound banking practices along with compliance with the rules and regulations imposed on them, Islamic banks are subject to robust and rigorous risk management.⁹⁷² They are required to maintain transparency, governance, and complete disclosure.⁹⁷³ Furthermore, in order to ensure that there is a harmonised implementation of all laws, there are numerous regulations designed to build on and adapt the standards at the global level, with the incorporation of certain unique features of Sharia that are relevant to the risk

⁹⁷⁰Abusharbeh, M.T. 2014. Credit Risks and Profitability of Islamic Banks: Evidence from Indonesia. *World Review of Business Research* 43, pp. 136-147.

⁹⁷¹Alexander, A.J. 2011. Shifting Title and Risk: Islamic Project Finance with Western Partners. *Michigan Journal of International Law* 3(3), pp. 572-611.

⁹⁷²Ibid.

⁹⁷³Alhowaimil, I. S. 2013. Frustration of Performance of Contracts: A comparative and Analytic Study in Islamic Law and English Law.[Online]. Available at: <http://bura.brunel.ac.uk/bitstream/2438/8532/1/FulltextThesis.pdf> [Accessed on: 15 July 2015].

management of the banks.⁹⁷⁴ Islamic financial institutions are aware of global risk management systems because they possess model-based methodologies for dealing with credit, rate-of-return, operational, and market risks, which the Basel II regulations require them to adhere to.⁹⁷⁵

The principle of risk-sharing

Another significant element of Islamic banking principles is the division of risk among investors and the depositors of funds.⁹⁷⁶ Islamic finance places strong emphasis on the principle of proportioning the risk between the providers of the funds and entrepreneurs, in the ratio of their contribution to the capital of the bank.⁹⁷⁷ The risk level in the Islamic financing industry is dynamic in nature because prices and the risks and rewards of any investment will continually vary, along with the growth of the Islamic bank.⁹⁷⁸ This encourages the financial fund providers to contribute ideas for dealing with the associated risks.⁹⁷⁹ The same principle acts as the risk management strategy for Islamic banks.⁹⁸⁰ Therefore, all the risks to which Islamic banks are exposed through *Murabaha* financing affect not only the banks themselves but also the depositors and investors involved.⁹⁸¹ This risk-sharing feature assists Islamic banks in effectively managing their risks.⁹⁸² In addition, this principle can be divided into two major components: the profit/loss principle and the profit-sharing principle.⁹⁸³ The profit-sharing component is particularly relevant to the distribution of the profits generated by

⁹⁷⁴Kettell, B. 2011. *Case Studies in Islamic Banking and Finance*. John Wiley & Sons.

⁹⁷⁵Schoon, N. 2010. *Islamic Banking and Finance*. Spiramus Press Ltd, p. 118.

⁹⁷⁶Ibid, pp. 129-131.

⁹⁷⁷Aris, N.A. et al. 2012. Islamic house financing: Comparison between Bai' Bithamin Ajil (BBA) and Musharakah Mutanaqisah (MM). *African Journal of Business Management* 6(1), pp. 266-273.

⁹⁷⁸Bovens, M.A.P., T'Hart, P. and Peters, B.G. 2002. *Success and Failure in Public Governance: A Comparative Analysis*. Edward Elgar, p. 18.

⁹⁷⁹Ayub, M. 2009. *Understanding Islamic Finance*. John Wiley & Sons, p. 896.

⁹⁸⁰Bellalah, M. 2013. *Islamic Banking and Finance*. Cambridge Scholar, p. 369.

⁹⁸¹Askari, H., Iqbal, Z., Krichenne, N. and Mirakhor, A. 2011. *The Stability of Islamic Finance: Creating a Resilient Financial Environment for a Secure Future*. New Jersey: Wiley, p. 112.

⁹⁸²Freedman, C. and Goodlet, C. 1998. *The Financial Services Sector: Past Changes and Future Prospects*. Bank of Canada Technical Report, p. 196.

⁹⁸³Ibid, p. 129.

the financial transaction.⁹⁸⁴ According to this rule, the profit must be equally distributed amongst the entrepreneurs and the owners.⁹⁸⁵

The *Murabaha* financing agreement is considered one of the most significant Islamic trading activities, along with investments in equities, namely Mudaraba and Musharaka.⁹⁸⁶ The current banking law does not permit commercial banks to undertake these activities.⁹⁸⁷ Moreover, the non-standardisation of the respective contracts makes the negotiation process more difficult, with an increase in the cost of operations.⁹⁸⁸ This is because financial institutions are not protected against any risks that they fail to anticipate or those where the remedies are not enforceable.⁹⁸⁹ There are no standardised contracts, which increase the complexity of the process in terms of monitoring and administration.⁹⁹⁰ Therefore, it is not possible for the Islamic courts to enforce a standardised form of Islamic contracts, which means that the use of Islamic contracts as part of the regular operations of a bank is associated with an increase in the severity of the legal risks that the bank faces.⁹⁹¹

Implications of the risk management guidelines used for Murabaha transactions to avoid legal risks

As per the guidelines, all Islamic financial institutions (IFIs) are required to institute and implement a sound system of risk management to mitigate the risks that are associated with the use of *Murabaha* financing agreements.⁹⁹² A minimum requirement for these risk management policies is the adoption of five

⁹⁸⁴Siddiqui, S.H. 2010. Islamic banking: True Modes of Financing. [Online]. Available at: <http://www.nzibo.com/IB2/truemodes.pdf> [Accessed on: 24 June 2015].

⁹⁸⁵Siddiqi, A. and Hrubci, P. 2008. *Islamic Investments Funds Versus Hedge Funds*. GRIN Verlag, p. 86.

⁹⁸⁶Aris, N.A. et al. 2012. Islamic house financing: Comparison between Bai' Bithamin Ajil (BBA) and Musharakah Mutanaqisah (MM). *African Journal of Business Management* 6(1), pp. 266-273.

⁹⁸⁷Bovens, M.A.P., T'Hart, P. and Peters, B.G. 2002. *Success and Failure in Public Governance: A Comparative Analysis*. Edward Elgar, p. 16.

⁹⁸⁸Hassan, K. and Lewis, M. 2007. *Handbook of Islamic Banking*. Edward Elgar Publishing, pp. 25-29.

⁹⁸⁹Bellalah, M. 2013. *Islamic Banking and Finance*. Cambridge Scholars, p. 26.

⁹⁹⁰Ayub, M. 2009. *Understanding Islamic Finance*. John Wiley & Sons, p. 89; Schoon, N. 2010. *Islamic Banking and Finance*. Spiramus Press Ltd, p. 118.

⁹⁹¹Askari, H., Iqbal, Z., Krichenne, N. and Mirakhor, A. 2011. *The Stability of Islamic Finance: Creating a Resilient Financial Environment for a Secure Future*. New Jersey: Wiley, p. 111.

⁹⁹²Ibid, p. 158.

steps.⁹⁹³ The first is the process of identifying, monitoring, measuring, controlling, and reporting all the risks associated with the *Murabaha* contract.⁹⁹⁴ The second step is setting internal limits to the exposure to risk, according to the capacity and appetite of the IFI. The third step involves addressing all the types of funding sources that are used to finance the *Murabaha* transaction.⁹⁹⁵ The fourth requirement is that the IFI should implement adequate risk mitigation measures for the minimisation of the risks that arise from its *Murabaha* transactions.⁹⁹⁶ The fifth step is to identify the nature and frequency of these risks and report this information to the Sharia committee, the senior management, and the board.⁹⁹⁷ In my opinion, strict adherence to all the requirements of risk management helps to prevent subsequent losses due to the legal risks encountered by the parties involved in the *Murabaha* transaction.

The application of Basel II to the Islamic financial industry has led to improvements to the risk management practices adopted by the industry.⁹⁹⁸ There are three pillars of risk management specified in the Basel II accords.⁹⁹⁹ The first is concerned with the calculation of the capital adequacy ratio or minimum capital charges, through the application of a number of optional methodologies.¹⁰⁰⁰ Capital adequacy rule is the minimum capital reserve to be kept by banking institutions as the reserve bank guidelines. This is important to maintain adequate liquidity and solvency of banking institution. The potential market risks can be mitigated through maintaining “components of adequate capital retention”. These include core capital (tier 1) that constitutes of paid

⁹⁹³ Aris, N.A. et al. 2012. Islamic house financing: Comparison between Bai' Bithamin Ajil (BBA) and Musharakah Mutanaqisah (MM). *African Journal of Business Management* 6(1), pp. 266-273.

⁹⁹⁴ Ibid.

⁹⁹⁵ Ibid.

⁹⁹⁶ Al Baraka. 2015. [Online]. Available at:

http://www.albaraka.co.za/Islamic_Banking/Features_of_Marabaha_and_Leasing.aspx [Accessed on: 3 July 2015].

⁹⁹⁷ Aldohni, A.K. 2011. *The Legal and Regulatory Aspects of Islamic Banking: A Comparative Look at the United Kingdom and Malaysia*. London: Routledge.

⁹⁹⁸ Alhowaimil, I. S. 2013. Frustration of Performance of Contracts: A comparative and Analytic Study in Islamic Law and English Law. Available at:

<http://bura.brunel.ac.uk/bitstream/2438/8532/1/FulltextThesis.pdf> [Accessed on: 15 July 2015].

⁹⁹⁹ Alexander, A.J. 2011. Shifting Title and Risk: Islamic Project Finance with Western Partners. *Michigan Journal of International Law* 3(3), pp. 572-611.

¹⁰⁰⁰ Ali, H.A. and Naysary, B. 2014. Risk Management Practices in Islamic Banks in Kuwait. *Journal of Islamic Banking and Finance* 2(1), pp. 123-148.

capital plus legal reserve plus retained earnings along with general and other reserve. From this core capital, following components are delated including goodwill, treasury shares and net losses. Core capital (tier 2) comprises fair value adjustments, subordinated debt, and assets revaluation reserve. Core capital (tier 3) comprises subordinated loans of short term. Qatar banking institutions needs to follow endorsed approach for capital adequacy computation that plays important role in dealing with different risks, such as credit risk and market risk and operational risk.¹⁰⁰¹ Maintaining capital adequacy as per the IFSB prudential standards is good for banking firms because it assists in sustaining short- and long-term solvency. It is minimum capital charges and essential to be maintained. An adequate/reasonable capital ratio keeps an adequate flow of capital to the banks that ensure sustainable growth and position. These are apply to the Murabaha financing in regularising transaction between client and bank on behalf of buyer in accordance with the minimum capital reserve, to secure from market, credit and operational risks.

There are three main approaches to the calculation of the minimum capital charge: secularisation frameworks, the standardised approach, and the internal rating base approach.¹⁰⁰² The second pillar is a supervisory review, which is considered an integral part of the Basel accords.¹⁰⁰³ It requires capital adequacy, along with the development of adequate techniques for managing risks.¹⁰⁰⁴ Islamic banks are highly exposed to credit concentration risks because of norms based on social equality and the Basel II recommendations are particularly

¹⁰⁰¹ Qatar Central Bank. 2013. Implementation Instructions Basel II Framework. [Online].

Available at:

<http://www.qcb.gov.qa/English/Legislation/Instructions/Documents/BankInstructions/2013/13-017.pdf> [Accessed on: 6 November 2017].

¹⁰⁰² Ibid.

¹⁰⁰³ Ali, S.S. Islamic Modes of Finance and Associated Liquidity Risks. [Online]. Available at: http://www.sbp.org.pk/departments/ibd/lecture_6_islamic_modes_finance_liquidity.pdf [Accessed on: 24 June 2015].

¹⁰⁰⁴ Roberts, E. 2015. An overview of Basel II's Pillar 2. [Online]. Available at: <https://www.researchgate.net/file.PostFileLoader.html?id=55029336d685cc415b8b467b&assetKey=AS%3A273732268953603%401442274267796> [Accessed on: 3 July 2015].

suitable for the management of such risks.¹⁰⁰⁵ Knowledge of Basel II and capital adequacy is useful to maintain an efficient flow of capital to prevent the risks that result from insufficient capital.

The third major pillar of Basel applicable to IFIs is market disclosure, which is closely associated with the operations of IFIs. The disclosures required are of the profits made and losses borne by IFIs in the financial year, their core business activities, and the application and allocation of funds. Therefore, as the operations and practices of risk management within Islamic banking have evolved, it has become mandatory to enhance the disclosure practices of the whole industry.¹⁰⁰⁶

Along with Basel II, the guidelines most directly applicable to the risk management framework of Islamic banks are those issued by the IFSB, which is a significant body for the development of adequate standards of risk management within the Islamic finance industry.¹⁰⁰⁷ Under the credit risk principle, the IFSB standard recognises the exposures of credit risk at various stages of the *Murabaha* financial contract and its major focus is on both types of credit risk.¹⁰⁰⁸ To avoid the occurrence of risk, the IFSB has identified methods and suggested their use.¹⁰⁰⁹ From my personal perspective, knowledge of the financial standards of the International Financial Board is useful to take viable financial decisions that keep of legal risks.

A *Murabaha* financial agreement is intended to facilitate the sale and purchase of a commodity and is based on an agreed profit. Moreover, as discussed earlier, payment is deferred and is inclusive of the principle amount plus a mark-up value.¹⁰¹⁰ Thus, participating Islamic banks are highly exposed to

¹⁰⁰⁵About Saudi Arabia. 2015. [Online]. Available at: <https://www.saudiembassy.net/about/country-information/government/> [Accessed on: 7 July 2015].

¹⁰⁰⁶Salem, R.A. 2013. *Risk Management for Islamic Banks*. Edinburgh University Press.

¹⁰⁰⁷Aris, N.A. et al. 2012. Islamic house financing: Comparison between Bai' Bithamin Ajil (BBA) and Musharakah Mutanaqisah (MM). *African Journal of Business Management* 6(1), pp. 266-273.

¹⁰⁰⁸Zainol, Z. and Kassim, S.H. 2010. An Analysis of Islamic Banks' Exposure to Rate of Return Risk. *Journal of Economic Corporation and Development* 31, pp.59-84.

¹⁰⁰⁹About Saudi Arabia. 2015. [Online]. Available at: <https://www.saudiembassy.net/about/country-information/government/> [Accessed on: 7 July 2015].

¹⁰¹⁰Aris, N.A. et al. 2012. Islamic house financing: Comparison between Bai' Bithamin Ajil (BBA) and Musharakah Mutanaqisah (MM). *African Journal of Business Management* 6(1), pp. 266-273.

credit risks and are obliged to adopt credit risk assessment models to mitigate such risks.¹⁰¹¹The three models in question are expert systems or qualitative methods, hybrid methods, and quantitative methods.¹⁰¹² Banks that use expert systems assess the creditworthiness of borrowers seeking to enter into a *Murabaha* contract on the basis of qualitative methods.¹⁰¹³ All such methods are based on the expert judgement of those who are involved in the credit appraisal process.¹⁰¹⁴ Result-based expert systems combine analysis of the creditworthiness of the obligator with the observations and practical experience of the expert responsible for the application of the analysis.¹⁰¹⁵ The basic objective is to design and then merge the rules of the experts with experience drawn from the behaviour of the clients.¹⁰¹⁶In addition, the rules require banks to consider information concerning the type of contract, the prevailing market conditions, and other factors that might influence the behaviour of the client.¹⁰¹⁷ Therefore, when a bank considers entering into a *Murabaha* financing agreement, its experts face challenges pertaining to the identification of the criteria by which they can make an evaluation of the degree to which the buyer will be able to comply with the obligations placed on him by the agreement.¹⁰¹⁸

If the characteristics of the *Murabaha* financing agreement make it appropriate to use a statistical model, there is a need to assess whether the agreement carries any credit risk or legal risk.¹⁰¹⁹There are two major types of data that can be considered by Islamic banks for the modelling of the types of risk to which they are exposed: the present and past behaviour of the client or

¹⁰¹¹ Ibid.

¹⁰¹² Zainol, Z. and Kassim, S.H. 2010. An Analysis of Islamic Banks' Exposure to Rate of Return Risk. *Journal of Economic Corporation and Development* 31, pp.59-84.

¹⁰¹³ Alhowaimil, I. S. 2013. Frustration of Performance of Contracts: A comparative and Analytic Study in Islamic Law and English Law. [Online]. Available at: <http://bura.brunel.ac.uk/bitstream/2438/8532/1/FulltextThesis.pdf> [Accessed on: 15 July 2015].

¹⁰¹⁴ Salem, R.A. 2013. *Risk Management for Islamic Banks*. Edinburgh University Press.

¹⁰¹⁵ Ahmed, H. 2011. *Product Development in Islamic Banks*. Edinburgh University Press.

¹⁰¹⁶ Aris, N.A. et al. 2012. Islamic house financing: Comparison between Bai' Bithamin Ajil (BBA) and Musharakah Mutanaqisah (MM). *African Journal of Business Management* 6(1), pp. 266-273.

¹⁰¹⁷ Alhowaimil, I. S. 2013. Frustration of Performance of Contracts: A comparative and Analytic Study in Islamic Law and English Law. [Online]. Available at: <http://bura.brunel.ac.uk/bitstream/2438/8532/1/FulltextThesis.pdf> [Accessed on: 15 July 2015].

¹⁰¹⁸ Ahmed, H. 2011. *Product Development in Islamic Banks*. Edinburgh University Press.

¹⁰¹⁹ Ibid.

counterparty, and data concerning the losses faced by the parties due to the associated risks.¹⁰²⁰ However, in the specific case of the *Murabah* financing agreement, there are certain issues concerned with the application of this model, which are related to the adherence to legal guidelines that apply to the collection of the requisite information about the borrower, to ensure due diligence.¹⁰²¹ In addition, there are problems regarding data unification and data clearance that create issues for Islamic banks.¹⁰²²

Any Islamic bank that makes exclusive use of only one of the empirical models of risk assessment, whether qualitative or quantitative,¹⁰²³ in its risk management strategies in *Murabaha* financing agreements may find that it achieves poor results due to forecasting errors.¹⁰²⁴ Both of the models have been found to be useful and both can be employed in advance in order to ensure a logical system that makes use of qualitative empirical data and through which the linguistic rules can be expressed.¹⁰²⁵ The results can then be derived using a quantitative analysis.¹⁰²⁶

There are other additional risks associated with the guarantees that accompany *Murabaha* financing agreements.¹⁰²⁷ Islamic banks mitigate their risk exposure through the application of such guarantees and the collateral that is granted by the counterparties.¹⁰²⁸ Therefore, risk mitigation is expressed in the form of a reduction in the exposure at default (EAD) and loss given default (LGD) through the adoption of these guarantees.¹⁰²⁹ The reduction in EAD and LGD is

¹⁰²⁰ Salem, R.A. 2013. *Risk Management for Islamic Banks*. Edinburgh University Press; Warde, I. 2010. *Islamic Finance in the Global Economy*. Edinburgh University Press, p. 145.

¹⁰²¹ Warde, I. 2010. *Islamic Finance in the Global Economy*. Edinburgh University Press, p. 145.

¹⁰²² Al Baraka. 2015. [Online]. Available at:

http://www.albaraka.co.za/Islamic_Banking/Features_of_Marabaha_and_Leasing.aspx [Accessed on: 3 July 2015].

¹⁰²³ Ibid.

¹⁰²⁴ Aldohni, A.K. 2011. *The Legal and Regulatory Aspects of Islamic Banking: A Comparative Look at the United Kingdom and Malaysia*. London: Routledge.

¹⁰²⁵ Ahmed, H. 2011. *Product Development in Islamic Banks*. Edinburgh University Press.

¹⁰²⁶ Ariff, M and Iqbal, M. 2011. *The Foundations of Islamic Banking: Theory, Practice and Education*. Edward Elgar Publishing, p. 78.

¹⁰²⁷ Warde, I. 2010. *Islamic Finance in the Global Economy*. Edinburgh University Press. p. 145.

¹⁰²⁸ Ibid.

¹⁰²⁹ Pock, A.V. 2007. *Strategic Management in Islamic Finance*. US: Springer, p. 60.

expressed in the form of risk weights.¹⁰³⁰ There are also certain rules that are specific in nature, where guarantees are applied, and for which the use of specific collateral is or is not eligible.¹⁰³¹ After that, the monetary value of the collateral is allocated towards the reduction in the risks related to different clients.¹⁰³² Therefore, both the credit and legal risk could be reduced through an enhancement of the check-list of references as per past performance, the maintenance of a comprehensive database, and the characteristics of the clients.¹⁰³³

Among the other risk-mitigating measures that could be adopted by Islamic banks are those that are legal in nature.¹⁰³⁴ There are two major techniques – point-in-time rating and qualitative-quantitative rating.¹⁰³⁵ Point-in-time ratings are adopted in preference to through-the-cycle ratings. However, there are many financial institutions that hire credit analysts who will prepare and use their own credit rating systems.¹⁰³⁶ In order to validate a credit rating system, there is a consequent need to validate the predefined internal systems to ensure the appropriate modification of parameters in line with the requirements of the contract and with market conditions. These criteria must be examined carefully to minimise any qualitative elements and thereby move towards the adoption of quantitative criteria.¹⁰³⁷ Data integrity also plays a significant role in ensuring that the system generates high-quality results; therefore, Islamic banks are required to adhere to certain criteria as to the definition, usage, and collection of data.¹⁰³⁸ The first step is for banks to follow the history of the guarantor and the

¹⁰³⁰ Chorafas, D.N. 2011. *Stress Testing for Risk Control Under Basel II*. Butterworth-Heinemann.

¹⁰³¹ Ariff, M and Iqbal, M. 2011. *The Foundations of Islamic Banking: Theory, Practice and Education*. Edward Elgar Publishing, p. 78.

¹⁰³² Schoon, N. 2010. *Islamic Banking and Finance*. UK: Spiramus Press, p. 135.

¹⁰³³ Ibid, p.98-110; Schoon, N. 2010. *Islamic Banking and Finance*. UK: Spiramus Press Ltd, p. 135.

¹⁰³⁴ Saeed, A. 1996. *Islamic Banking and Interest: A Study of the Prohibition of Riba and Its Contemporary Interpretation*. BRILL, p. 65.

¹⁰³⁵ Saeed, A. 1996. *Islamic Banking and Interest: A Study of the Prohibition of Riba and Its Contemporary Interpretation*. BRILL, pp. 98-100.

¹⁰³⁶ Zhang, Y., Ji, L. and Liu, F. 2010. *Local Housing Market Cycle and Loss Given Default: Evidence From Sub-Prime Residential Mortgages*. International Monetary Fund.

¹⁰³⁷ Ginena, K. and Hamid, A. 2015. *Foundations of Shariah Governance of Islamic Banks*. New Jersey: John Wiley & Sons, p. 97.

¹⁰³⁸ Pock, A.V. 2007. *Strategic Management in Islamic Finance*. US: Springer, p. 45.

obligators, taking into account the period over which the data that has been used for the calculation of their ratings has been gathered.¹⁰³⁹ Islamic banks must ensure that they keep up-to-date data management technology in place for deriving these ratings.¹⁰⁴⁰ It is also essential for banks to adhere to the circumstances and dates of their defaults; thereafter, the focus is laid on the PDs, in association with the rating grades.¹⁰⁴¹ The next section will present the legal risk management that is to be assured by banking firms, as per Islamic law.

Legal risk management by Islamic banks

In certain countries such as Saudi Arabia, the banking sector comprises both Islamic and conventional banks.¹⁰⁴² This imposes an additional pressure upon the legal and regulatory bodies in these countries to apply common regulations to both types of bank, despite the significant differences between the two in terms of their operative functioning.¹⁰⁴³ For this reason, a common legal framework is developed.¹⁰⁴⁴ There are no separate regulatory laws governing the operations of Islamic banks that can support and govern the overall functioning of the sector.¹⁰⁴⁵ The literature further indicates that there is a mixed approach in which a similar regulatory framework is implemented for the areas that have direct applicability to conventional banks and Islamic banks.¹⁰⁴⁶ However,

¹⁰³⁹ Ibid, p. 49.

¹⁰⁴⁰ Ariff, M and Iqbal, M. 2011. *The Foundations of Islamic Banking: Theory, Practice and Education*. Edward Elgar Publishing, p. 3.

¹⁰⁴¹ Al-Suwaidi, A. 2004. *Finance of International Trade in the Gulf*. Netherlands: BRILL, p. 116.

¹⁰⁴² Aris, N.A. et al. 2012. Islamic house financing: Comparison between Bai' Bithamin Ajil (BBA) and Musharakah Mutanaqisah (MM). *African Journal of Business Management* 6(1), pp. 266-273.

¹⁰⁴³ Ali, H.A. and Naysary, B. 2014. Risk Management Practices in Islamic Banks in Kuwait. *Journal of Islamic Banking and Finance* 2(1), pp. 123-148.

¹⁰⁴⁴ Azwar, A. and Tajudin, A. 2010. Overview of Islamic Finance. [Online]. Available at: <http://www.bankislam.com.my/en/Documents/shariah/OverviewOfIslamicFinance-13122010.pdf> [Accessed on: 8 September 2012].

¹⁰⁴⁵ Zainol, Z. and Kassim, S.H. 2010. An Analysis of Islamic Banks' Exposure to Rate of Return Risk. *Journal of Economic Corporation and Development* 31, pp.59-84.

¹⁰⁴⁶ Bellalah, M. 2013. *Islamic Banking and Finance*. Cambridge Scholars.

separate regulations and guidelines are issued to cover specified areas of the Islamic banking sector.¹⁰⁴⁷

The jurisdiction of Saudi Arabia that is applicable to the banks is inclusive of the Basel capital framework and is applicable to both conventional and Islamic banks.¹⁰⁴⁸ Furthermore, the regulatory capital adequacy requirements include prescriptions that are generally based on the prudential standards issued by the IFSB.¹⁰⁴⁹ In addition, the IFSB follows certain principles for the provision of guidance in terms of the adjustment required in the Basel capital framework in order to preserve certain salient features of Islamic banks, which adhere strictly to this guidance. However, according to Kammer et al., it is difficult to maintain unification in the capital ratios of Islamic banks owing to the fact that they are spread across different nations.¹⁰⁵⁰ This difficulty can be explained by considering the differences in the jurisdictions of certain nations; for example, the alpha factor represents the ratio of total risk to which Islamic banks are exposed and which is directly transmitted to their shareholders, as proposed by the IFSB.¹⁰⁵¹ It also covers the difference between the banks in terms of the risk exposure and risk-sharing product.¹⁰⁵² A further significant legal restriction relates to the fact that an Islamic bank is not permitted to issue or publish a financial statement unless and until the Sharia board approves its Sharia compliance and signs off the statement.¹⁰⁵³

¹⁰⁴⁷ Aris, N.A. et al. 2012. Islamic house financing: Comparison between Bai' Bithamin Ajil (BBA) and Musharakah Mutanaqisah (MM). *African Journal of Business Management* 6(1), pp. 266-273.

¹⁰⁴⁸ Ibid.

¹⁰⁴⁹ Ali, H.A. and Naysary, B. 2014. Risk Management Practices in Islamic Banks in Kuwait. *Journal of Islamic Banking and Finance* 2(1), pp. 123-148.

¹⁰⁵⁰ Andrew, M. 2010. Islamic Finance: Four Articles Introducing Islamic Banking And Finance Concepts [Online]. Available at: <http://www.riskrewardlimited.com/admin/pdf/Islamic%20Finance%20Articles%20by%20MCA.pdf> [Accessed on: 3 July, 2015].

¹⁰⁵¹ Kammer, A. et al. 2015. Islamic Finance: Opportunities, Challenges, and Policy Options. [Online]. Available at: <https://g20.org/wp-content/uploads/2015/05/IMF-Note-on-Asset-Based-Financing-such-as-Sukuk-for-Infrastructure-April-2015.pdf> [Accessed on: 30 June 2015].

¹⁰⁵² Andrew, M. 2010. Islamic Finance: Four Articles Introducing Islamic Banking And Finance Concepts. [Online]. Available at: <http://www.riskrewardlimited.com/admin/pdf/Islamic%20Finance%20Articles%20by%20MCA.pdf> [Accessed on: 3 July 2015].

¹⁰⁵³ Aris, N.A. et al. 2012. Islamic house financing: Comparison between Bai' Bithamin Ajil (BBA) and Musharakah Mutanaqisah (MM). *African Journal of Business Management* 6(1), pp. 266-273.

In addition, one of the most important objectives of legal advisories is to ensure that the agency responsible for supervision has full operational independence and is supported by adequate and appropriate resources.¹⁰⁵⁴ It is also essential for both Islamic banks and the IFSB to maintain robust accountability practices and a well-designed governance structure.¹⁰⁵⁵ It has been stated that the Islamic banks are not capable of overseeing activities such as mutual funds and banking¹⁰⁵⁶ because these activities require a cross-sectional approach that covers the securities market, insurance, and banking activities.¹⁰⁵⁷ These complexities not only underscore the significance of the authorities operating at the national level but also account for a major source of legal risk for Islamic banks.¹⁰⁵⁸

More specifically, in the case of *Murabaha* financing, it is essential for the core principles of Islamic financial regulation that are applicable to the banking sector to be adequately adhered to by Islamic banks.¹⁰⁵⁹ Along with these core principles, there are other noteworthy principles that are propounded by the Basel Committee on Banking Supervision¹⁰⁶⁰ that are gradually being implemented by the IFSB and which Islamic banks have a duty to adhere to.¹⁰⁶¹ Furthermore, the most important legal risk to which Islamic banks are exposed arises from the fact that the IFSB is taking strong steps to develop structural and prudential indicators of Islamic bank financing that are in line with International

¹⁰⁵⁴ Andrew, M. 2010. Islamic Finance: Four Articles Introducing Islamic Banking And Finance Concepts. [Online]. Available at: <http://www.riskrewardlimited.com/admin/pdf/Islamic%20Finance%20Articles%20by%20MCA.pdf> [Accessed on: 3 July 2015].

¹⁰⁵⁵ Aris, N.A. et al. 2012. Islamic house financing: Comparison between Bai' Bithamin Ajil (BBA) and Musharakah Mutanaqisah (MM). *African Journal of Business Management* 6(1), pp. 266-273.

¹⁰⁵⁶ Bellalah, M. 2013. *Islamic Banking and Finance*. Cambridge Scholars.

¹⁰⁵⁷ Ibid.

¹⁰⁵⁸ Andrew, M. 2010. Islamic Finance: Four Articles Introducing Islamic Banking And Finance Concepts. [Online]. Available at: <http://www.riskrewardlimited.com/admin/pdf/Islamic%20Finance%20Articles%20by%20MCA.pdf> [Accessed on: 3 July 2015].

¹⁰⁵⁹ Ali, H.A. and Naysary, B. 2014. Risk Management Practices in Islamic Banks in Kuwait. *Journal of Islamic Banking and Finance* 2(1), pp. 123-148.

¹⁰⁶⁰ Ibid, p. 102.

¹⁰⁶¹ Kammer, A. et al. 2015. Islamic Finance: Opportunities, Challenges, and Policy Options. [Online]. Available at: <https://g20.org/wp-content/uploads/2015/05/IMF-Note-on-Asset-Based-Financing-such-as-Sukuk-for-Infrastructure-April-2015.pdf> [Accessed on: 30 June 2015].

Monetary Fund (IMF) indicators. More specifically, Islamic banks are comparatively more exposed to such legal risks in the context of traditional practices such as *Murabaha* financing.¹⁰⁶²

In countries such as Saudi Arabia, Islamic banks do not differ from conventional banks in terms of the corrective enforcement actions they take to counter such legal risks or their dispute resolution processes. Islamic banks are well-known for the adequate regulatory treatment that is applied to their profit-sharing investment accounts (PSIAs) and their exposure to the risks pertaining to their *Murabaha* financing agreements.¹⁰⁶³ The supervisory and regulatory guidelines to which Islamic banks adhere are intended to ensure that in future, banks do not treat PSIAs as pure deposit accounts and that they adhere to IFSB guidance for setting the alpha factor in order to avoid undermining the loss-absorbency feature.¹⁰⁶⁴

The standing facilities are established by central banks and collateralised or revised *Murabaha* contracts are used to facilitate liquidity management.¹⁰⁶⁵ Additionally, Islamic inter-bank instruments, collateralised and uncollateralised, have been developed and adopted in the form of *Murabaha* contracts, most often collateralised with commodities.¹⁰⁶⁶ However, the key priority for the imposition of instruments such as *Murabaha* contracts is to strengthen the supply of Sharia-compliant liquidity instruments, along with the sovereign sukuk.¹⁰⁶⁷ In addition, the basic intention is to develop the infrastructure necessary for deeply rooting the monetary inter-bank markets of IFIs.¹⁰⁶⁸

¹⁰⁶² Aris, N.A. et al. 2012. Islamic house financing: Comparison between Bai' Bithamin Ajil (BBA) and Musharakah Mutanaqisah (MM). *African Journal of Business Management* 6(1), pp. 266-273.

¹⁰⁶³ Al-Shamrani, A.S. 2014. Islamic Financial Contracting Forms in Saudi Arabia: Law and Practice. [Online]. Available at: <http://bura.brunel.ac.uk/bitstream/2438/9145/1/FulltextThesis.pdf> [Accessed on: 10 July 2015].

¹⁰⁶⁴ Andrew, M. 2010. Islamic Finance: Four Articles Introducing Islamic Banking And Finance Concepts. [Online]. Available at: <http://www.riskrewardlimited.com/admin/pdf/Islamic%20Finance%20Articles%20by%20MCA.pdf> [Accessed on: 3 July 2015].

¹⁰⁶⁵ Bellalah, M. 2013. *Islamic Banking and Finance*. Cambridge Scholars.

¹⁰⁶⁶ Ayub, M. 2009. *Understanding Islamic Finance*. John Wiley & Sons.

¹⁰⁶⁷ Askari, H., Iqbal, Z., Krichenne, N. and Mirakhor, A. 2011. *The Stability of Islamic Finance: Creating a Resilient Financial Environment for a Secure Future*. New Jersey: Wiley.

¹⁰⁶⁸ Aris, N.A. et al. 2012. Islamic house financing: Comparison between Bai' Bithamin Ajil (BBA) and Musharakah Mutanaqisah (MM). *African Journal of Business Management* 6(1), pp. 266-273.

Salem asserts that a major risk associated with *Murabaha* financing pertains to the failure by a client of an Islamic bank to repay in full or in part the financial assistance that the bank has provided.¹⁰⁶⁹ Islamic banks avoid such risks through the imposition of security, promissory notes, third-party guarantees, and the contractual terms that provide all relevant details of the *Murabaha* goods that were sold to the third party, on either cash or a credit basis.¹⁰⁷⁰ All such measures are taken by Islamic banks to ensure that clients deposit all these instruments with the bank until the due amount has been fully repaid.

If the due amount is not paid in time because of factors beyond the control of the client, Islamic banks are morally obliged to reschedule the debt.¹⁰⁷¹ On the other hand, if the client is found to have been capable of ensuring full repayment of the due amount, yet it has not been paid on time, then a fine or other penalty can be imposed.¹⁰⁷² The size of any such fine is generally dependent on the normal rate of return applicable to the total funds invested by the bank, which could otherwise be called the opportunity cost of capital.¹⁰⁷³ In certain cases, the recovery of the advance payment is not possible, so in these circumstances, the amount is recovered through security.¹⁰⁷⁴ Thus, these are certain mitigating measures undertaken by the Islamic banks in response to the financial and legal risks to which they are exposed when entering into *Murabaha* financial agreements.¹⁰⁷⁵

¹⁰⁶⁹ Aris, N.A. et al. 2012. Islamic house financing: Comparison between Bai' Bithamin Ajil (BBA) and Musharakah Mutanaqisah (MM). *African Journal of Business Management* 6(1), pp. 266-273.

¹⁰⁷⁰ Salem, R.A. 2013. *Risk Management for Islamic Banks*. Edinburgh University Press.

¹⁰⁷¹ Albaraka. 2015.[Online]. Available at:

http://www.albaraka.co.za/Islamic_Banking/Features_of_Marabaha_and_Leasing.aspx [Accessed on: 3 July 2015].

¹⁰⁷² Aldohni, A.K. 2011. *The Legal and Regulatory Aspects of Islamic Banking: A Comparative Look at the United Kingdom and Malaysia*. London: Routledge.

¹⁰⁷³ Ali, H.A. and Naysary, B. 2014. Risk Management Practices in Islamic Banks in Kuwait. *Journal of Islamic Banking and Finance* 2(1), pp. 123-148.

¹⁰⁷⁴ Ali, S.S. Islamic Modes of Finance and Associated Liquidity Risks. [Online]. Available at: http://www.sbp.org.pk/departments/ibd/lecture_6_islamic_modes_finance_liquidity.pdf [Accessed on: 24 June 2015].

¹⁰⁷⁵ Alhowaimil, I. S. 2013. Frustration of Performance of Contracts: A comparative and Analytic Study in Islamic Law and English Law. [Online]. Available at: <http://bura.brunel.ac.uk/bitstream/2438/8532/1/FulltextThesis.pdf> [Accessed on: 15 July 2015].

The thesis is about exploring legal risks of one of the selected Islamic financial transaction namely *Murabaha* to prevent effect of *Murabaha* transaction risks to the clients and banking institution as whole.

In my work, exploration of the legal risks of *Murabaha* from the legal contracts is the originality of this research project. The consideration to the legal contracts of *Murabaha* has led to reflect risks in this Islamic financial transaction from the personal experiences of the parties involved that is the novelty.

This thesis adds new knowledge in terms of stating risks in *Murabaha* transaction with personal evidence that would provide base to compare with other Islamic financial transactions. The below discussion is showing the personal evidences which can be viewed for having in depth aspect of risks involved in Islamic financial transactions and how an investor can avoid such critical risks in the most effective manner.

The findings discussed above have been supported by reference to the literature, in which the consensus is that the numerous risks borne by Islamic banks are high in degree, indicating the comparative difficulty of risk management.¹⁰⁷⁶ There is an essential requirement for adequate identification of the major risks to which the banks are exposed due to the complexities of *Murabaha* financing.¹⁰⁷⁷ This is to enable the smooth functioning of transactions and to ensure that they are performed with accuracy. The legal risks associated with *Murabaha* financing are very different in nature compared to other types such as credit, operational, liquidity, and commodity risks. Thus, a more specialised and effective approach is required in order to deal with legal risks.

Evidence uncovered during the literature review and analysis of the documentary data of Abdul-Rahman (2010) and About Saudi Arabia (2015) indicates that the functioning of Islamic finance enables financial institutions and banks to hold and maintain an appropriate capital balance in order to meet

¹⁰⁷⁶Alexander, A.J. 2011. Shifting Title and Risk: Islamic Project Finance with Western Partners. *Michigan Journal of International Law* 3(3), pp. 572-611.

¹⁰⁷⁷Ibid

obligations in time.¹⁰⁷⁸ Through such an initiative, banks and other financial institutions are able to mitigate the risk of insolvency because the holding of negative net worth, which might lead to bankruptcy and insolvency for the institution, would be predictable and avoidable.¹⁰⁷⁹ In this regard, Islamic banks constantly search for different methods which they can adopt to absorb any losses that are incurred through the holding of inadequate capital.¹⁰⁸⁰ The most common methods adopted by Islamic banks in this regard are the basic indicator approach, the standardised approach, and the advanced measurement approach.¹⁰⁸¹

There is also a requirement to develop and maintain a system of risk-related reports through which information can be communicated regarding the different activities in which banks engage and which may result in the occurrence of risk.¹⁰⁸² Each bank should prepare a separate and individual report that provides a detailed and in-depth analysis of each type of risk.¹⁰⁸³ The use of such a reporting format helps banks to avoid the risks that might otherwise arise from any lack of clarity in the information carried in their documentation. The disclosure of an adequate amount of information regarding the risks also enables companies to maintain transparency with stakeholders. Additionally, the insolvency system and credit rights are significant in ensuring the stability of commercial relationships and financial systems. There are other tools that debtors and creditors can use and regimes that help to build the confidence of

¹⁰⁷⁸ Abdul-Rahman, Y. 2010. *The Art of Islamic Banking and Finance: Tools and Techniques for Community-Based Banking*. John Wiley & Sons, About Saudi Arabia. 2015. [Online]. Available at: <https://www.saudiembassy.net/about/country-information/government/> [Accessed on: 7 July 2015].

¹⁰⁷⁹ Ahmed, H. 2011. *Product Development in Islamic Banks*. Edinburgh University Press.

¹⁰⁸⁰ Ahmed, H. and Khan, T. 2005. Risk management in Islamic banking. [Online]. Available at: <http://ebooks.narotama.ac.id/files/Handbook%20of%20Islamic%20Banking/Chapter%2010%20Risk%20management%20in%20Islamic%20banking.pdf>. [Accessed on: 17 July 2015].

¹⁰⁸¹ Ahmad, N.H. and Ahmad, S.N. 2015. Key Factors Influencing Credit Risk Of Islamic Banks: A Malaysian Case. [Online]. Available at: http://www.researchgate.net/publication/228423667_Key_factors_influencing_credit_risk_of_Islamic_bank_A_Malaysian_case [Accessed on: 1 July 2015].

¹⁰⁸² Abusharbeh, M.T. 2014. Credit Risks and Profitability of Islamic Banks: Evidence from Indonesia. *World Review of Business Research* 43, pp. 136-147; Ibid.

¹⁰⁸³ Ibid.

the public in the corporate and financial sectors.¹⁰⁸⁴ Such regimes assist in identifying, controlling, and managing a different set of risks, inclusive of default risk, corporate failure, and price risk.¹⁰⁸⁵ In addition, the establishment and identification of credit rating systems and risk management reports will assist in managing these risks.¹⁰⁸⁶ A well-functioning credit rating system allows an evaluation to be made of the creditworthiness of the parties associated with transactions such as *Murabaha* financing.¹⁰⁸⁷ Credit ratings are assigned to all borrowers according to the associated parameters, attributing a level of ability or capacity to pay back the due amount to the lender.¹⁰⁸⁸ Thus, the credit rating is calculated by considering the financial transactions previously performed by the borrower and the manner in which the due amount was paid back.¹⁰⁸⁹

Default risk is also mitigated through the issuing of warranties and guarantees by clients, whether individual or corporate.¹⁰⁹⁰ Such warranties or guarantees are given against a default on the part of the client to pay the due amount or against his refusal to accept the commodity under consideration.¹⁰⁹¹

Alternatively, there are numerous hedging instruments adopted by Islamic banks that are consistent with adherence to Sharia law. Such instruments assist in preventing the credit, operational, and technological risks faced by Islamic banks when executing *Murabaha* financing agreements. My views in this context are in favour of adopting hedging instruments that abide by Sharia law. This is because the use of hedging instruments is efficient enough to hedge probable risks and successive losses in the future. Such technological risks fall within the category of asset risks that are borne by the bank until the asset in question is transmitted to the client. During the process of transmission, for example, the

¹⁰⁸⁴Warde, I. 2010. *Islamic Finance in the Global Economy*. Edinburgh University Press. p. 145.

¹⁰⁸⁵Ibid, p. 112.

¹⁰⁸⁶Wilson, R. 2012. *Legal, Regulatory and Governance Issues in Islamic Finance*. London: Edinburgh University Press. p. 115.

¹⁰⁸⁷Ibid, 126.

¹⁰⁸⁸Zainol, Z. and Kassim, S.H. 2010. An Analysis of Islamic Banks' Exposure to Rate of Return Risk. *Journal of Economic Corporation and Development* 31, pp.59-84.

¹⁰⁸⁹Ibid.

¹⁰⁹⁰Zhang, Y., Ji, L. and Liu, F. 2010. *Local Housing Market Cycle and Loss Given Default: Evidence From Sub-Prime Residential Mortgages*. International Monetary Fund.

¹⁰⁹¹Ibid, p. 86.

technology of the asset may become obsolete due to the emergence of a new and better technology, which may well result in a decision on the part of the client not to complete the transaction.¹⁰⁹² To prevent such risks, it is essential that Islamic banks acquire adequate knowledge of the asset being transacted under the *Murabaha* agreement.¹⁰⁹³ The banks thus need to build up and maintain a knowledge base concerning the technology underlying the assets in which their clients deal and any other substitutable advanced technology which is or may soon be available in the market.¹⁰⁹⁴ Appropriate and timely use of such a knowledge base will allow an Islamic bank to reduce significantly the technology risk to which it is exposed.¹⁰⁹⁵ Moreover, communicating such knowledge to the client may be seen as rendering an additional service, thus contributing positively to the bank's customer relationship management.¹⁰⁹⁶

In addition, any mismanagement of the asset and liabilities could lead to the occurrence of liquidity risk. Therefore, it is essential to ensure that there is an adequate framework for liquidity management.¹⁰⁹⁷ There are numerous parameters that need to be considered for the mitigation of liquidity risk, such as keeping adequate records of the maturity periods of assets, along with their conversion periods.¹⁰⁹⁸ It is then necessary to see that the conversion periods match well with the maturity periods in order to ensure that the assets are sufficient at all times to meet the corresponding liabilities.¹⁰⁹⁹ Islamic banks are required to implement the derivatives for the management of the risk in an efficient manner. They can also use credit default swaps for this purpose because they are influenced by the credit rating of the clients or the borrowers. If

¹⁰⁹²Schoon, N. 2010. *Islamic Banking and Finance*. Spiramus Press Ltd, p. 118.

¹⁰⁹³Siddiqi, A. and Hrubí, P. 2008. *Islamic Investments Funds Versus Hedge Funds*. GRIN Verlag, p. 86.

¹⁰⁹⁴Siddiqi, S.H. 2010. Islamic banking: True Modes of Financing.[Online]. Available at: <http://www.nzibo.com/IB2/truemodes.pdf> [Accessed on: 24 June 2015].

¹⁰⁹⁵Tariq, A.A. 2004. Managing Financial Risks of Sukuk Structure.[Online]. Available at: https://www.google.co.uk/?gws_rd=ssl [Accessed on: 24 June 2015].

¹⁰⁹⁶Usmani, T. 2004. *An Introduction to Islamic Finance*. Arham Shamsi, p. 116.

¹⁰⁹⁷Ibid, p. 145; Schoon, N. 2011. *Islamic Asset Management: An Asset Class on its Own?* London: Edinburgh University Press, p. 196.

¹⁰⁹⁸Shofawati, A. 2014. *Murabaha Financing in Islamic Banking: Case Study in Indonesia. Proceedings of 5th Asia-Pacific Business Research Conference*, p. 108.

¹⁰⁹⁹Shari'ah Rulings and Finance. 2015.[Online]. Available at: <http://www.islamic-banking.com/shariah-rulings-finance.aspx> [Accessed on: 14 July 2015].

the credit rating of any of the parties concerned is found to be low, then it will not be possible to make use of credit default swaps in this way.¹¹⁰⁰

In response to the legal and other major risks to which they are exposed when engaged in *Murabaha* financing, Islamic banks adopt risk management policies which involve the identification, measurement, strategic addressing, and monitoring of these risks.¹¹⁰¹ The sound strategic approaches taken by banks include the creation of a risk management environment, the clear identification of risk strategies, and the setting of firm objectives by each institution.¹¹⁰² Such steps are taken through the establishment of systems that are able to identify, monitor, measure, and control the risks.¹¹⁰³ Furthermore, in order to ensure the effectiveness of risk management strategies and processes, Islamic banks are required to establish effective internal control systems to ensure that all appropriate measures are taken and none of the legal requirements are overlooked.¹¹⁰⁴ Another aspect of risk management to be undertaken by Islamic banks is the preparation of periodic risk reports, each covering a particular aspect or type of risk such as legal, credit, operational, and market risks.¹¹⁰⁵ Islamic banks should also ensure adequate compliance with their legal obligations by each establishing a special unit to enhance their comparability and transparency by making appropriate disclosure of the quality of capital, risk exposures, accounting standards, and capital adequacy.¹¹⁰⁶

In addition to the measures taken by Islamic banks themselves, it is essential to have national institutions and facilities whose role is to support the

¹¹⁰⁰Shofawati, A. 2014. *Murabaha* Financing in Islamic Banking: Case Study in Indonesia. *Proceedings of 5th Asia-Pacific Business Research Conference*, p. 108.

¹¹⁰¹Ibid, p. 156; Salem, R.A. 2013. *Risk Management for Islamic Banks*. Edinburgh University Press.

¹¹⁰²Ibid, p. 145.

¹¹⁰³Ibid, p. 186; Shari'ah Rulings and Finance. 2015. [Online]. Available at: <http://www.islamic-banking.com/shariah-rulings-finance.aspx> [Accessed on: 14 July 2015].

¹¹⁰⁴Dusuki, A.W. 2006. Commodity *Murabaha* Programme (CMP): An Innovative Approach to Liquidity Management. *Journal of Islamic Economics, Banking and Finance* 3(1).

¹¹⁰⁵Ibid.

¹¹⁰⁶Ibid, Salem, R.A. 2013. *Risk Management for Islamic Banks*. Edinburgh University Press.

banks. These include facilities provided by a lender of last resort, mechanisms of legal reform, a liquidity management system, and a deposit protection system.¹¹⁰⁷

Another aspect of the risk management of Islamic banks concerns the legal obligations under which they operate regarding real property transacted through *Murabaha* financing.¹¹⁰⁸ When real property is being traded, ownership of that property, even for a brief duration, may lead an Islamic bank to become involved in legal proceedings; therefore, Islamic banks ensure in-depth due diligence regarding such property through both physical verification and documentary assessment.¹¹⁰⁹ In addition, Islamic banks seek indemnities from customers, but such indemnities are insufficient for the level of legal exposure faced by the banks.¹¹¹⁰ A number of Islamic banks in certain countries operate a separate subsidiary for every single financial transaction.¹¹¹¹ However, such risk mitigation measures are very costly for the banks that use them. Indeed, such risk management strategies put the lender at a competitive disadvantage compared to those offering conventional mortgage-financing products.¹¹¹²

Schinas, Grau, and Johns list the three major risks that Islamic banks face¹¹¹³ in terms of their risk management tools. The first is refusal on the part of the customer to purchase the commodity from the bank,¹¹¹⁴ the second is late payment of the due amount, and the last is the risk of default.¹¹¹⁵ The risk of refusal on the part of the client to purchase the asset that has already been purchased by the bank can be managed through a promise made by the client at the beginning of the process to purchase the asset and make payments in

¹¹⁰⁷Shofawati, A. 2014. *Murabaha* Financing in Islamic Banking: Case Study in Indonesia. *Proceedings of 5th Asia-Pacific Business Research Conference*. 108

¹¹⁰⁸Rosly, S.A. and Zaini, M.A. 2008. Risk-return analysis of Islamic banks' investment deposits and shareholders' fund. *Managerial Finance* 34(10), pp. 695-707.

¹¹⁰⁹Schinas, O. Grau, C. and Johns, M. 2014. *HSBA Handbook of Ship Finance*. Springer. p. 115.

¹¹¹⁰Saudi Arabian Law Overview. 2015.[Online]. Available at:

http://www.saudilegal.com/saudilaw/19_law.html [Accessed on: 9 July 2015].

Saudi Arabian Law Overview. 2015.[Online]. Available at:

[udilegal.com/saudilaw/19_law.html](http://www.saudilegal.com/saudilaw/19_law.html)"http://www.saudilegal.com/saudilaw/19_law.html [Accessed on: 9 July 2015].

lable at: <http://www.kslaw.com/Library/publication/9-09%20Yasaar%20Media%20Salah.pdf>

[Accessed on: 2 July 2015].

¹¹¹³Salem, R.A. 2013. *Risk Management for Islamic Banks*. Edinburgh University Press, p. 125.

¹¹¹⁴Ibid, p. 166.

¹¹¹⁵Ibid.

instalments of the amount due to the lender. Such a promise also assists the lender in covering the risk undertaken while taking the title to the commodity covered by the *Murabaha* financing agreement. Since penalties for late payment are prohibited in Islamic finance, the only undertaking that the client can be required to make is to deposit a significant amount of money that will be paid to a charity in case of late payment.¹¹¹⁶ Such a mechanism can act as a deterrent to a breach of contract.¹¹¹⁷

Lastly, Schinas et al. propose that insurance cover be used to mitigate the risk of default on the part of the client.¹¹¹⁸ They argue that the risk could be to a great extent negated through the realisation of collateral or securities taken from the borrower with the intention of covering any such losses.¹¹¹⁹ Thus, so-called *takaful* insurance schemes can be operated in the context of the ownership risk associated with *Murabaha* contracts.¹¹²⁰ Such insurance policies could be taken out to cover both the counterparty default risk and the asset risk that arises from the fact that until the asset is purchased by the client, it is considered the responsibility of the Islamic bank.¹¹²¹

Of all the major risks to which Islamic banks are exposed such as mark-up, operational, legal, liquidity, and commodity risks, legal risks are unique in nature.¹¹²² Such risks could be minimised by Islamic banks if they deliberately monitored all the legal aspects of the contractual agreements concerned before proceeding with the process of *Murabaha* financing.¹¹²³ There is also a transaction risk for Islamic banks, which can be treated as a component of the

¹¹¹⁶Schinas, O. Grau, C. and Johns, M. 2014. *HSBA Handbook of Ship Finance*. Springer, p. 59.

¹¹¹⁷Ibid, p. 115.

¹¹¹⁸*Murabaha*. 2015. [Online]. Available at: <http://www.bankalfalah.com/islamicpk/corporate-banking/working-capital-finance/Murabaha/> [Accessed on: 3 July 2015].

¹¹¹⁹Pock, A.V. 2007. *Strategic Management in Islamic Finance*. Springer.

¹¹²⁰Perry, F.V. and Rehman, S.S. 2011. Globalization of Islamic Finance: Myth or Reality? *International Journal of Humanities and Social Science* 1(19), pp.107-119.

¹¹²¹Oxford Business Group. 2007. *The Report: Emerging Saudi Arabia*. Oxford Business Group.

¹¹²²*Murabaha as a mode of finance*. 2009. [Online]. Available at: http://www.albaraka.co.za/Islamic_Banking/Features_of_Marabaha_and_Leasing/Murabaha_as_a_Mode_of_Finance.aspx [Accessed on: 16 July 2015].

¹¹²³*Murabaha Working Capital*. 2011. [Online]. Available at: <http://www.midf.com.my/our-product-a-services/development-finance-division/669> [Accessed on: 28 July 2015].

legal risk.¹¹²⁴ Transaction risks arise from the potential for a party to fail to abide by the accounting standards that are enforced by the regulatory authorities. Thus, to mitigate the transactional risk, it is essential for the Islamic bank to understand the transactional record-keeping requirements and to ensure adequate transparency.

The major risk to which Islamic banks are exposed in relation to *Murabaha* financing is that of a default in payment on the part of the client, according to Hunt-Ahmed, who makes a number of suggestions of ways to mitigate this risk.¹¹²⁵ The borrower can be asked to donate a specified amount to a fund that can then be used by the bank for a charitable purpose on behalf of the borrower, in case of default.¹¹²⁶ Thus, the bank will have effectively extracted a penalty from the client for being in default of payment of the due amount but crucially, this will not count as income for the bank.¹¹²⁷ Hence, the bank's operation of the *Murabaha* transaction will remain compliant with Sharia law.¹¹²⁸ However, such penalties do not amount to the payment of monetary compensation on the part of the client and will not resolve the cash flow issues faced by the bank as a result of the failure of the client to pay the due amount.¹¹²⁹ Nevertheless, it may act as a mechanism by which delinquency and delay on the part of the client will be avoided. It is arguable that requiring payment of any such compensation for delinquency or delay is contrary to Sharia principles.¹¹³⁰ Instead, Islamic banks can stipulate that late payment will automatically trigger a change in the instalment schedule whereby, if the client fails to pay even a single instalment on time, the remaining instalments will immediately become due and

¹¹²⁴ Ibid.

¹¹²⁵ Hunt-Ahmed, K. 2013. *Contemporary Islamic Finance: Innovations, Applications and Best Practices*. John Wiley & Sons, p. 114.

¹¹²⁶ Ibid, p. 124.

¹¹²⁷ Hunt-Ahmed, K. 2013. *Contemporary Islamic Finance: Innovations, Applications and Best Practices*. John Wiley & Sons, p.101.

¹¹²⁸ Ibid, p. 155.

¹¹²⁹ Langton, J. Trullols, C. and Turkistani, A.Q. 2011. *Islamic Economics and Finance: A European Perspective*. Palgrave Macmillan.

¹¹³⁰ Latham and Watkins LLP. 2010. *Doing business in Saudi Arabia*. [Online]. Available at: http://www.lw.com/upload/pubcontent/pdf/pub3507_1.pdf [Accessed on: 18 May 2015].

the element of deferred payment will be eliminated.¹¹³¹ This adverse rescheduling would impose undesirable hardships on the client, who would therefore be likely not to default in the payment of the original instalments in order to avoid this outcome. Such rescheduling of instalments would appear to be feasible because it is done in the conventional banking system, where rescheduling is generally accompanied by an increase in interest charges.¹¹³² However, in *Murabaha* financing, such rescheduling is not allowed; thus, no additional payment may be charged to the client for the same.¹¹³³

In order to avoid the legal risks associated with the execution of *Murabaha* financing contracts, it is considered to be optimum on the part of the Islamic bank to purchase the commodity on behalf of the client and ensure that it takes possession of said commodity.¹¹³⁴ The bank can also take possession of the commodity after its purchase by a third person who has been appointed as an agent of the bank, before ownership of the commodity is finally transmitted to the customer.¹¹³⁵ In this version of the *Murabaha* financing transaction, the client first purchases the commodity on behalf of an Islamic bank and takes possession of it;¹¹³⁶ the client then purchases the commodity from the bank on a deferred payment basis. The initial possession of the commodity by the client is in his capacity as an agent of the bank. He acts as a trustee,¹¹³⁷ since ownership of the commodity does not yet rest with the financier – the Islamic bank in this case – but the risk associated with the commodity does, and the financier could be logically implicated as a consequence of ownership with possession.¹¹³⁸

¹¹³¹ Majid, S. and Majid, F. 2009. Application of Islamic Law in the Middle East - Interest and Islamic Banking. [Online]. Available at: <http://www.iraqilawconsultant.com/puplications/majid/article09.html> [Accessed on: 9 July 2015].

¹¹³² Köhn, D. 2011. *Mobilising Capital for Emerging Markets: What Can Structured Finance Contribute?* Springer, p. 118

¹¹³³ Ibid, p. 125

¹¹³⁴ Köhn, D. 2011. *Mobilising Capital for Emerging Markets: What Can Structured Finance Contribute?* Springer, pp. 12-16; *Murabaha* as a mode of finance. 2009. [Online]. Available at: http://www.albaraka.co.za/Islamic_Banking/Features_of_Marabaha_and_Leasing/Murabaha_as_a_Mode_of_Finance.aspx [Accessed on: 16 July 2015].

¹¹³⁵ Ibid, p.175.

¹¹³⁶ Knoop, T.A. 2013. *Global finance in emerging market economies. Routledge international studies in money and banking.* Routledge.

¹¹³⁷ Ibid, p. 89.

¹¹³⁸ Ibid, pp. 116-118.

However, when the client later purchases the commodity from the financier as part of the transaction, the risk associated with the commodity is transmitted to the client along with its ownership.

Islamic banks must also avoid the practice of buy-back in order to mitigate the legal risk associated with *Murabaha* financing contracts.¹¹³⁹ Thus, Islamic banks purchase commodities from a third party instead of buying it from the client himself, to resell it to the client on a deferred payment basis.¹¹⁴⁰ Therefore, a *Murabaha* financing agreement in which a buy-back agreement is signed between the parties is, in effect, no different to the interest-based loans provided by conventional banks, and the legal risks to which the parties are exposed under such circumstances are comparatively very high.¹¹⁴¹

The risks associated with *Murabaha* financing can nevertheless be reduced to zero by Islamic banks if they employ certain strategies in their practice.¹¹⁴² However, some practitioners describe the strategies used for *Murabaha* financing as synthetic;¹¹⁴³ in other words, such strategies are artificial in nature.¹¹⁴⁴ In reality, Islamic banks and their customers agree that a second sale will occur at the same instant as title to the commodity passes to the bank under the first sale.¹¹⁴⁵ Therefore, the risk for the bank of damage to the commodity, or indeed its loss, is infinitesimal.¹¹⁴⁶

Customers are encouraged to waive all claims on the bank in a similar manner to the seller, including claims for any defect found in the commodity purchased or any warranty violation.¹¹⁴⁷ In a majority of occasions, the bank will

¹¹³⁹ Kammer, A. et al. 2015. Islamic Finance: Opportunities, Challenges, and Policy Options. [Online]. Available at: <https://g20.org/wp-content/uploads/2015/05/IMF-Note-on-Asset-Based-Financing-such-as-Sukuk-for-Infrastructure-April-2015.pdf> [Accessed on: 30 June, 2015].

¹¹⁴⁰ Ibid.

¹¹⁴¹ Karim, S.A. 2010. *The Islamic Moral Economy: A Study of Islamic Money and Financial Instruments*. Universal.

¹¹⁴² Köhn, D. 2011. *Mobilising Capital for Emerging Markets: What Can Structured Finance Contribute?* Springer, p. 16.

¹¹⁴³ Ibid, p.110.

¹¹⁴⁴ Ibid, p. 125; Kettell, B. 2011. *Case Studies in Islamic Banking and Finance*. John Wiley & Sons, p. 112.

¹¹⁴⁵ Ibid, p. 136.

¹¹⁴⁶ Ibid, p.145; Karim, R.A.A. and Archer, S. 2013. *Islamic Finance: The New Regulatory Challenge*. Wiley, p. 131.

¹¹⁴⁷

appoint the client as its agent in obtaining or purchasing the goods, thereby reducing the probability of error in the goods or commodity to be purchased. Thus, the burden or cost associated with the delivery of the goods is eliminated. Sometimes, financing agreements under the *Murabaha* contract are made without any specification of the date of delivery of the goods and the customer is left to determine the required date independently. There is also a provision in *Murabaha* financing where the customer is allowed to enter into a contract with the seller for the purchase of the commodity, even before the *Murabaha* financing agreement is signed.¹¹⁴⁸ When this approach is taken in practical banking transactions, the connection between the Islamic bank and the asset is negligible and the associated risk becomes merely theoretical.¹¹⁴⁹

Islamic banks can ensure effective risk mitigation through adoption of the above-mentioned approaches, effectively eliminating the risk of ownership.¹¹⁵⁰ However, banks are still exposed to the risk that a client will break the promise he has made, because it is not binding.¹¹⁵¹ A solution to this risk has been proposed and the OIC Academy has approved it. The suggestion is that the client construes the undertaking signed for the purchase of the commodity as a contract or promise.¹¹⁵² From my personal perspective, a contract or promise signed by the client can be used as proof to avert potential broken promises in the future. It is a good way to keep proof related to the purchase of a commodity on behalf of the bank.

In its original form, the classical law does not recognise or enforce the client's promise. However, in an opinion rendered by numerous adherents of the Maliki school of Sunni Islam, such promises should be treated as gratuitous

Ibid, p. 145.

¹¹⁴⁸International Monetary Fund. 2002. *Islamic Financial Institutions and Products in the Global Financial System: Key Issues in Risk Management and Challenges Ahead*. International Monetary Fund.

¹¹⁴⁹Ismael, R. 2005. Assessing Moral Hazard Problem in *Murabaha* Financing. *Journal of Islamic Economics, Banking and Finance* 5(2), p. 101; Ibid, p. 101.

¹¹⁵⁰Izhar, H. 2010. Identifying Operational Risk Exposures in Islamic Banking. *Kyoto Bulletin of Islamic Area Studies* 3(2), pp.17-53.

¹¹⁵¹Ibid, p. 115.

¹¹⁵²Kamalpour, A., Schemuth, M., Ahmed, T. and Maski, S. 2009. *Murabaha financing*. [Online]. Available at: file:///C:/Users/22/Downloads/11822825_2%20(6).pdf [Accessed on: 30 June 2015].

acts.¹¹⁵³ In this interpretation, the service rendered by an Islamic bank should be considered a loan or a gift with a huge monetary value.¹¹⁵⁴ Thus, the client should be legally bound by a promise given for certain cause or motive (*sabab*), which means that the promise can rely upon the undertaking.¹¹⁵⁵

This can be illustrated by considering the example of a person who promises another person that if the latter becomes involved in the act of demolition of his house, the former will be obliged to take out a loan to rebuild it. Thus, if the promise demolishes or destroys his house, the judicial administration will oblige the promisor to take out a loan for the rebuilding of the house. In light of this, the Maliki school views the promise made by a customer in a *Murabaha* transaction as an order to purchase, which is therefore binding on the customer.¹¹⁵⁶ However, the customer will be bound only to the limit of the out-of-pocket expenditure or losses incurred by the bank due to a breach of promise on the part of the customer to buy the commodity.¹¹⁵⁷ Thus, any profit which the bank may have lost as a result of the promise not fulfilling his promise to purchase is not covered under these specifications.¹¹⁵⁸

Through the above-mentioned phenomenon, the *Murabaha* financing agreement is strengthened as an order to purchase, since under the rules of synthetic *Murabaha* financing, banks are required to rely on it and avoid any problems by practical means.¹¹⁵⁹ Firstly, as described above, banks arrange for the simultaneous closing of the initial sale and the resale of the commodity.¹¹⁶⁰ In this case, banks avoid the risks associated with assuming ownership of the

¹¹⁵³ Islamic Law (Shariah). (n.d.). [Online]. Available at: http://gulf-law.com/islamic_law.html [Accessed on: 7 July 2015].

¹¹⁵⁴ Kamalpour, A. Schemuth, M. Ahmed, T. and Maski, S. 2009. *Murabaha Financing*. Ashurst.

¹¹⁵⁵ Ibid.

¹¹⁵⁶ Hanif, M. 2011. *Differences and Similarities in Islamic and Conventional Banking*. *International Journal of Business and Social Science* 2(2), pp.168-172.

¹¹⁵⁷ Institute of Islamic Banking and Insurance (n.d.) [Online]. Available at: http://www.islamic-banking.com/Murabaha_sruling.aspx [Accessed on: 28 July, 2015].

¹¹⁵⁸ Hunt-Ahmed, K. 2013. *Contemporary Islamic Finance: Innovations, Applications and Best Practices*. John Wiley & Sons, p. 2.

¹¹⁵⁹ How, J.C.Y., Karim, M.A. and Verhoeven, P. 2005. Islamic Financing and Bank Risks: The case of Malaysia. *Thunderbird International Business Review* 47(1), pp. 75-94.

¹¹⁶⁰ Holden, K. 2008. Islamic Finance: "Legal Hypocrisy" Moot Point, Problematic Future Bigger Concern. [Online]. Available at: <https://www.bu.edu/law/central/jd/organizations/journals/international/volume25n2/documents/341-368.pdf> [Accessed on: 10 July 2015].

commodity by selling it simultaneously to the customer.¹¹⁶¹ The second case applies if the *Murabaha* financing agreement executed by an Islamic bank meets all the legal requirements of conventional (non-Islamic) banking law, as it does in the majority of cases. In such a case, the law is likely to interpret the initial promise by the customer as binding on him.¹¹⁶² Thirdly, the bank may require a sizeable monetary down payment towards repurchase, i.e. the second sale. The practice of taking down payments assists banks in defraying the losses that may be incurred by a failure on the part of the customer to purchase the commodity under consideration.

However, there are legal risks for the bank associated with the contract unless the terms of the promise and the contract state that all unexpected costs related to the product shall be borne by the client. Providing comprehensive information on the terms and conditions of the contract can mitigate this risk. Another risk associated with the *Murabaha* contract arises from the fact that Sharia law or fatwas provides that the bank must act with the consent of the client in purchasing the commodity from the vendor.¹¹⁶³ On the other hand, the bank purchases the asset from the vendor at cost price and makes a promise to the client to resell it to him at the cost plus mark-up price.¹¹⁶⁴

Islamic banks adopt a number of measures for the mitigation of legal and other risks associated with their operations and products.¹¹⁶⁵ These include requiring guarantees and warranties from individuals and financial institutions to maintain security of payment. In addition, there is a need to prepare risk reports because it serves to gather and communicate information regarding the different risks involved in banks' transactions.¹¹⁶⁶ Using this information, banks are then able to design and adopt measures to mitigate any risks that have been

¹¹⁶¹Hassan, K. and Lewis, M. 2007. *Handbook of Islamic banking*. Edward Elgar Publishing, p.14.

¹¹⁶²Holden, K. 2008. Islamic finance: "Legal hypocrisy" moot point, problematic future bigger concern. *Boston University International Law Journal* 25, p. 341.

¹¹⁶³Siddiqi, A. and Hrubic, P. 2008. *Islamic Investments Funds Versus Hedge Funds*. GRIN Verlag, p. 55.

¹¹⁶⁴Ibid, p. 89.

¹¹⁶⁵Foster, N.H.D. 2006. *Encounters between legal systems: recent cases concerning Islamic commercial law in secular courts*. Amicus Curiae, p. 89.

¹¹⁶⁶Hallaq, H.B. 2009. *An Introduction to Islamic Law*. Cambridge University Press, p. 114.

identified¹¹⁶⁷ In addition, it is necessary for banks to establish a credit rating system because it facilitates the gathering of data regarding the creditworthiness of individuals, businesses, or financial institutions involved in the transactions.¹¹⁶⁸ Moreover, the assurance of the creditworthiness of the borrowers will strengthen the confidence of banks' investors as to the safety of the money that they have invested.¹¹⁶⁹

Sharia law allows IFIs such as banks to set their *Murabaha* mark-up rates with reference to the LIBOR rate.¹¹⁷⁰ In a majority of such transactions, the intermediary (in our case, the bank) appoints the client or end-user to act as its agent in the purchase of the commodity from the seller on the bank's behalf. Until the time the commodity is transferred, the risk of ownership is only held by the intermediary. While this only amounts to a basic risk, there are many other risks, as discussed above, that lead Islamic bank to be reliant upon risk-mitigation methods such as Islamic hedging instruments.¹¹⁷¹ Thus, the growth in the use of instruments such as *Murabaha* financing agreements has given rise to the development and adoption of more risk-mitigation solutions for Islamic banks and IFIs.¹¹⁷² While offering basic Islamic instruments and solutions, Islamic banks may also opt for more aggressive and complex structures to serve their clients' requirements.¹¹⁷³ These risk management tools are adopted to suit the convenience and opinions of both owners and clients.¹¹⁷⁴

Among the retail products offered by Islamic banks are fixed-rate *Murabaha* contracts, while commercial banks offer facilities which rely on floating

¹¹⁶⁷International Monetary Fund. 2002. *Islamic Financial Institutions and Products in the Global Financial System: Key Issues in Risk Management and Challenges Ahead*. International Monetary Fund, p. 215.

¹¹⁶⁸Ibid, p. 235.

¹¹⁶⁹Freedman, C. and Goodlet, C. 1998. *The Financial Services Sector: Past Changes and Future Prospects*. Bank of Canada Technical Report, p. 92.

¹¹⁷⁰Ibid, p. 110.

¹¹⁷¹Cotran, E. and Lau, M. 2002. *Yearbook of Islamic and Middle Eastern Law: 2001-2002*. Brill, p. 116.

¹¹⁷²Dalel, G. and Bessem, T. 2013. "Murabaha" Contract and Basis of Islamic Finance. *Interdisciplinary Journal of Contemporary Research in Business* 4(11), pp.157-161.

¹¹⁷³Dar, H. and Moghul, U. (eds.) 2009. *The Chancellor Guide to the Legal and Shari'a Aspects of Islamic Finance*. London: Chancellor Publications, pp. 125

¹¹⁷⁴Dusuki, A.W. 2006. Commodity *Murabaha* Programme (CMP): An Innovative Approach to Liquidity Management. *Journal of Islamic Economics, Banking and Finance* 3(1), El-Gamal, M.A. 2006. *Islamic Finance: Law, Economics, and Practice*. Cambridge University Press, p. 116.

rates as their benchmarks.¹¹⁷⁵ In these circumstances, Islamic banks face a situation of liquidity mismatch, which arises because their deposits are usually made for a short tenure of three to six months, compared to the corresponding Islamic investments, which are made for a longer duration.¹¹⁷⁶ An additional risk arises from fixed-rate versus floating-rate exposure.¹¹⁷⁷ Moreover, corporate clients tend to need a comparatively sophisticated set of products to assist them in managing their risk positions vis-à-vis the banks.¹¹⁷⁸ For example, hedging tools are required by Islamic banks to assist them in managing foreign exchange (FX) risk and interest rate risk. To serve this purpose, Islamic banks have developed dedicated Islamic forward FX contracts and profit rate swaps.

There are numerous IFIs, including banks that offer hedging solutions that are Sharia-compliant. However, their standardisation is not as robust, nor is their documentation as comprehensive, as products available through conventional banking institutions.¹¹⁷⁹ These relatively weak features of Sharia-compliant hedging instruments mean that they are offered at unattractive prices in the market compared to conventional hedging instruments or products.¹¹⁸⁰ For example, conventional hedging instruments are provisioned benefits in accordance with International Accounting Standards (IAS), while Sharia-compliant hedging instruments are limited to the principles of Islamic law. However, if the market for Islamic hedging instruments manages to grow, this issue of price differences would be resolved.¹¹⁸¹

The basic objective behind the use of Islamic profit rate swaps is effectively the same as that which applies to conventional interest rate swaps, which in general is to protect against the harmful effects of interest rate

¹¹⁷⁵Elgari, M.A. 2003. Credit Risk in Islamic Banking and Finance. *Islamic Economic Studies* 10(2).

¹¹⁷⁶Dusuki, A.W. 2006. Commodity *Murabaha* Programme (CMP): An Innovative Approach to Liquidity Management. *Journal of Islamic Economics, Banking and Finance* 3(1).

¹¹⁷⁷Ibid.

¹¹⁷⁸Ibid.

¹¹⁷⁹Bellalah, M. 2013. *Islamic Banking and Finance*. Cambridge Scholars, p. 118.

¹¹⁸⁰Cattelan, V. 2013. *Islamic Finance in Europe: Towards a Plural Financial System*. Studies in Islamic finance. Edward Elgar, p. 18.

¹¹⁸¹Chorafas, D.N. 2011. *Stress Testing for Risk Control Under Basel II*. Butterworth-Heinemann, p. 55.

movements.¹¹⁸² In other words, such hedging instruments are designed to protect Islamic banks from the fluctuating rates of borrowing and ensure an effective risk-control mechanism.¹¹⁸³ Islamic financial institutions are also likely to benefit in terms of their balance sheet management, as has been the experience of conventional banks for many years.¹¹⁸⁴

The Islamic profit rate swap is an agreement through which profit rates are exchanged between the floating-rate party and the fixed-rate party. Such an agreement is implemented through the series-based execution of Sharia-compliant contracts. In the current Islamic financial market, a further contract is used to ensure that the transaction reaches maturity. This is called a waad contract, which is a unilateral binding promise, meaning that it is binding in one direction only. Before both the reverse *Murabaha* stage and the commodity *Murabaha* stage within the structure, a waad element ensures that the promisor enters into both types of trade, and the waad remains in force until the process of swapping has been completed.¹¹⁸⁵ The wide-ranging underlying structure of the profit rate swap is associated with an asset-backed Sharia-compliant structure, where a plain (or vanilla) commodity *Murabaha* is used.¹¹⁸⁶ The structure of the commodity *Murabaha* is designed in such a manner that it is free from certain prohibited features such as gharar (uncertainty), riba (interest or usury), and maysir (gambling).¹¹⁸⁷ The payment obligation on each party is calculated by means of different pricing formulae.¹¹⁸⁸ In the case of the Islamic profit rate swap, the principal is notional in nature and not exchanged, but instead is netted off

¹¹⁸²Choudhury, M.A.2013. *Money in Islam: A Study in Islamic Political Economy*. Routledge, p. 96.
Choudhury, M.A.2013. *Money in Islam: A Study in Islamic Political Economy*. Routledge, p. 96.

11.

¹¹⁸⁴Ibid, p. 136.

¹¹⁸⁵Ali, S.S. Islamic Modes of Finance and Associated Liquidity Risks. [Online]. Available at: http://www.sbp.org.pk/departments/ibd/lecture_6_islamic_modes_finance_liquidity.pdf [Accessed on: 24 June 2015].

¹¹⁸⁶Aris, N.A. et al. 2012. Islamic house financing: Comparison between Bai' Bithamin Ajil (BBA) and Musharakah Mutanaqisah (MM). *African Journal of Business Management* 6(1), pp. 266-273.

¹¹⁸⁷Askari, H., Iqbal, Z., Krichenne, N. and Mirakhor, A. 2011. *The Stability of Islamic Finance: Creating a Resilient Financial Environment for a Secure Future*. New Jersey: Wiley, pp. 56-59.

¹¹⁸⁸Ibid, p. 89.

through the application of muqasah, which means the offsetting of the difference between the respective principal amounts¹¹⁸⁹

To explain the operation of a basic profit swap in combination with the *Murabaha* structure, it would be helpful to look at the example of a hypothetical situation in which Bank A could be presumed to find itself¹¹⁹⁰ Bank A holds a fixed-rate investment through the purchase of an Islamic asset that is to mature in five years, with payment being made in semi-annual instalments.¹¹⁹¹ Bank A intends to swap the fixed-rate payment with an investment in a floating-payment profile. Bank A might then decide to enter into an Islamic profit rate swap with Bank B, where Bank B will be the counterparty to the swapping agreement. Bank A enters into a waad agreement and thereby promises to enter into commodity purchases. Bank B then sells the commodity in question to Bank A on a *Murabaha* basis, with the selling price being set as the sum of the principal and a fixed-profit margin. The selling price is due after completion of the subsequent transaction, which relates to the floating rate portion. Within six months, the counterparty (in this case, Bank B) gives a waad undertaking of its intention to purchase the commodity under consideration.¹¹⁹² Bank A then sells the asset to bank B at a price comprising the principal plus the mark-up value, on the basis of the prevailing market rate. Thus, the commodity *Murabaha* is transacted between two parties¹¹⁹³

There are numerous ways in which Sharia-compliant hedging can be executed and each method has its own particular advantages and disadvantages. One is the use of forward FX hedging instruments, where two

¹¹⁸⁹ Ayub, M. 2009. *Understanding Islamic Finance*. John Wiley & Sons.

¹¹⁹⁰ Al-Shamrani, A.S. 2014. *Islamic Financial Contracting Forms in Saudi Arabia: Law and Practice*. [Online]. Available at: <http://bura.brunel.ac.uk/bitstream/2438/9145/1/FulltextThesis.pdf> [Accessed on: 10 July 2015].

¹¹⁹¹ Andrew, M. 2010. *Islamic Finance: Four Articles Introducing Islamic Banking And Finance Concepts*. [Online]. Available at: <http://www.riskrewardlimited.com/admin/pdf/Islamic%20Finance%20Articles%20by%20MCA.pdf> [Accessed on: 3 July 2015].

¹¹⁹² Ahmed, H. and Khan, T. 2005. *Risk management in Islamic banking*. [Online]. Available at: <http://ebooks.narotama.ac.id/files/Handbook%20of%20Islamic%20Banking/Chapter%2010%20Risk%20management%20in%20Islamic%20banking.pdf> [Accessed on: 17 July 2015].

¹¹⁹³ Al Baraka. 2015. [Online]. Available at: http://www.albaraka.co.za/Islamic_Banking/Features_of_Marabaha_and_Leasing.aspx [Accessed on: 3 July 2015].

currencies are held with dissimilar interest rates.¹¹⁹⁴ The Sharia position regarding the swapping or exchange of two types of currencies is the exchange of the counter values on a simultaneous basis.¹¹⁹⁵ Under the forward FX mechanism, the exchange rate is locked as per the rates in force on the date of the contract.¹¹⁹⁶ However, the delivery of the two counter values is deferred to a future date, when delivery is made on a spot basis.¹¹⁹⁷ Under Sharia law, it is essential that delivery be made on the date of execution of the contract, but this is not a standard practice in the current FX market.¹¹⁹⁸ However, a promise to sell or buy currencies on a single date is not prohibited under Islamic law.¹¹⁹⁹ Moreover, the delivery of the currency to be made as a complete contract is concluded only on the delivery date.

Another mechanism commonly used for the commodity *Murabaha* is where both the bank and the customer are required to enter into two different *Murabaha* contracts for the facilitation of an FX forward contract.¹²⁰⁰ The customer will buy the commodity at spot value and sell it back to the bank at the purchase price.¹²⁰¹ The purchase price will be inclusive of an agreed profit and payable on a deferred basis.¹²⁰² To complete the other part of the FX forward deal, the bank will purchase another commodity which it then sells to the customer.¹²⁰³ The sale will be subject to a mark-up value and the customer will again make the payment on a deferred basis.¹²⁰⁴ After this, both the bank and the

¹¹⁹⁴ Aldohni, A.K. 2011. *The Legal and Regulatory Aspects of Islamic Banking: A Comparative Look at the United Kingdom and Malaysia*. London: Routledge.

¹¹⁹⁵ Alexander, A.J. 2011. Shifting Title and Risk: Islamic Project Finance with Western Partners. *Michigan Journal of International Law* 3(3), pp. 572-611.

¹¹⁹⁶ Ibid, p. 55.

¹¹⁹⁷ Alhowaimil, I.S. 2013. Frustration of Performance of Contracts: A comparative and Analytic Study in Islamic Law and English Law. [Online]. Available at:

<http://bura.brunel.ac.uk/bitstream/2438/8532/1/FulltextThesis.pdf> [Accessed on: 15 July 2015].

¹¹⁹⁸ Ali, H.A. and Naysary, B. 2014. Risk Management Practices in Islamic Banks in Kuwait. *Journal of Islamic Banking and Finance* 2(1), pp. 123-148.

¹¹⁹⁹ Ibid.

¹²⁰⁰ McKendrick, E. 2015. *Contract Law*. Palgrave Macmillan, p. 86.

¹²⁰¹ Ibid, pp. 96-99.

¹²⁰² Ahmed, H. 2011. *Product Development in Islamic Banks*. Edinburgh University Press, pp. 86-90.

¹²⁰³ Ibid, p. 114.

¹²⁰⁴ Ahmad, N.H. and Ahmad, S.N. 2015. Key Factors Influencing Credit Risk Of Islamic Banks: A Malaysian Case. [Online]. Available at:

customer will sell the commodities that they have bought back into the market to ensure the recovery of their initial investment.¹²⁰⁵ This procedure is very commonly used by FIFs because its structure is more or less similar to the normal functioning involved in the *Murabaha* contract which is characteristic of a majority of Islamic money-market operations.¹²⁰⁶ However, the cost associated with the process of incorporating commodity-based transactions has provided an impetus for FIFs to explore other modes of hedging.¹²⁰⁷

The strongest part of this work is the critical evaluation of different risks in *Murabaha* transaction. However, weak part of this research is the non-inclusion of the primary data.

The theoretical and practical knowledge of the research subject in the depth manner with significant emphases on the experimental and empirical research is the approach gained within this research. Altogether, this thesis is based on realistic issues of *Murabaha* transaction and it is conducted in a well elaborated and extensive manner for being compliance with a doctorate degree

4.4 Conclusion and transition

From the literature review and analysis of contracts, it can be concluded that legal risks are encountered by the parties' to *Murabaha* contracts due to the non-compliance with Sharia law of the banking system in Saudi Arabia. It has been interpreted that the parties are exposed to funding-liquidity and market-liquidity risks, while Islamic banks face additional risks, namely to do with debt creation, price, and deterioration in goodwill. Furthermore, if Islamic banks do not adhere to Sharia law, the risks faced by their clients when entering into *Murabaha* contracts are price, counterparty, liquidity, capital loss, and bankruptcy

http://www.researchgate.net/publication/228423667_Key_factors_influencing_credit_risk_of_Islamic_bank_A_Malaysian_case [Accessed on: 1 July 2015].

¹²⁰⁵Abusharbeh, M.T. 2014. Credit Risks and Profitability of Islamic Banks: Evidence from Indonesia. *World Review of Business Research* 43, pp. 136-147.

Abusharbeh, M.T. 2014. Credit Risks and Profitability of Islamic Banks: Evidence from Indonesia. *World Review of Business Research* 43, pp. 136-147.

diembassy.net/about/country-information/government/ [Accessed on: 7 July 2015].

¹²⁰⁷Abdul-Rahman, Y. 2010. *The Art of Islamic Banking and Finance: Tools and Techniques for Community-Based Banking*. John Wiley & Sons.

risks. Lastly, the chapter has discussed the risks faced by third parties, these being depositors, sellers, and investors. All the types of risk pertaining to the *Murabaha* contract have been discussed in this thesis, with particular attention paid to the most substantial risks –i.e. those related to the legal conditions under which *Murabaha* transactions are conducted in Saudi Arabia. Depositors are equally exposed to the losses being suffered by Islamic banks because the principle of equal profit and loss is adhered to in the Islamic banking system. This fact can be backed up by a well know Islamic banking model, which reflects the two-tiered *mudaraba*. This model reflects that in Islamic finance when a bank enters into a profit sharing contract, it affects its both sides of balance sheet. For instance, at the asset side it has a contract with entrepreneur to have a share of his profits in place of interest and at liability side the bank has a contract with the depositor in which it has agreement to share profits.

Furthermore, if banks fail to comply with the prudential guidelines provided by Sharia law, investors are exposed to the risk of transparency due to non-compliance with the disclosure norms with reference to customer protection.

All the relevant relationships between the parties have been examined, and it has been found that not only banks but also their clients and third parties are vulnerable to the legal risks under discussion. These relate to the failure of banks to abide by the legal obligations and regulations in the documentation of their *Murabaha* contracts. In Saudi Arabia, Sharia law and other essential Islamic religious bylaws apply to banks during the conduct of all their transactions, including *Murabaha*. Banks are legally bound not to impose on the client any penalty for failure to make due payment of instalments according to the agreed repayment schedule. This legal obligation leads to an increase in the counterparty risk for banks. Moreover, banks are not able to collect collateral or any other compensation to reduce their credit risk, which further increases the credit risk to which they are exposed by their legal obligations. It has also been shown that banks are obliged to bear the risk of loss in the transit of assets, which further increases the legal risk associated with the *Murabaha* transaction. Banks' clients are protected by Sharia law in all the relevant areas but if an

Islamic bank fails to abide by the provisions of Sharia law, then its clients are likely to be exposed to both asset risk and counterparty risk.

The major differences between the Saudi banking regime and the requirements of Sharia law have been discussed in this chapter in order to assess the extent to which the parties are exposed to legal risk when entering into a *Murabaha* financing contract. It was explained that Saudi Arabia is a monarchy that is governed by decree and its banking regime follows regional regulatory norms. Being an Islamic state, Saudi Arabia has a judicial system that operates within the framework of Islamic law. The Kingdom has special Shariacourts where Sharia-based legal cases are heard. The country's banking system is supervised and governed by the Saudi Arabian Monetary Agency (SAMA). It is the responsibility of SAMA to ensure that a straightforward and transparent banking system is maintained. In this regard, SAMA ensures that Islamic banks comply with Sharia law.

However, the Saudi Arabian government has introduced numerous reforms to the judicial system of the Kingdom; as a result of which, some significant differences have been observed between the reformed judicial system on one hand and the strict provisions of Sharia law regarding finance on the other. These differences have arisen because the judicial reforms require that a common procedure be used to resolve grievances within both the Islamic and the conventional banking systems. Indeed, there are many areas where Saudi law requires that common grounds are considered for the resolution of financial disputes. The result is that certain aspects of the Islamic banking regime have been compromised and there is a consequent widening of the divergence between Islamic banking practice and Sharia compliance.

It can be concluded that the contemporary legal system has been strongly influenced by European legal systems. Moreover, the regulations governing Islamic finance in Saudi Arabia have been revised to ensure the universal compatibility of Islamic banks and to attract international depositors and investors. In a similar manner, the risk management practices of Islamic banks were found not to be framed as per complete adherence to Sharia law. The Basel

It accords have been imposed on Islamic banks in Saudi Arabia, just as they have been imposed on commercial banks, and they are not necessarily in line with Sharia law, which indicates that the divergence between the theoretical concepts of Sharia law and their practical application in Islamic finance is widening. Products such as *tawarruq* that are commonly provided by Islamic banks have been shown to have features that resemble those of the interest-based loans issued by conventional banks. There are also certain areas where Islamic banks apply a simple interest rate to the loans that they grant and the deposits they receive. This practice is consistent with the belief that compound interest rates are prohibited, while simple interest rates are acceptable under the guidelines. Overall, it can also be concluded that the functioning of Islamic banks and the products they offer are being made to fall in line with those of commercial banks. Such steps are undertaken in order to receive universal recognition and ensure the future stability of Islamic banks.

Each Islamic bank has a Sharia supervisory board, which is directly responsible for ensuring that the functions and products that the bank offers are Sharia-compliant. Since in practice Islamic banks, decision on the individual advisors is undertaken own by Sharia supervisory boards, the boards cannot be said to be independent, which reduces their capacity to judge fairly whether the practices of any particular Islamic bank are indeed fully compliant with Sharia-based law. Therefore, given the extent and strength of the non-Islamic influences noted above, it can be reasonably stated that there is likely to be a significant divergence between the practical application of Sharia-based law to the banking sector of Saudi Arabia on one hand and the theoretical fundamentals of Sharia on the other.

All of this result in the parties associated with the products issued by Islamic banks, such as *Murabaha* financing agreements, being exposed to considerable legal risks. More specifically, these risks arise because the parties are likely to find that what they believe to be their legal rights, on the basis of the theoretical position defined by Sharia law, are not in fact recognised within the judicial system, so that parties in a dispute on this basis are not able to seek

justice. All the real-time challenges faced by the parties due to the numerous reforms that have been introduced into the judicial system reveal that there is no concept of judicial precedent in many of the cases, thereby increasing the legal risk faced by the associated parties.

It can be generalised that a *Murabaha* transaction involves the signing of three agreements, by the Islamic bank, its client, and a third party. As per the first agreement, between the bank and its client, the latter is not obligated to purchase from the bank the commodity that the bank is directed to purchase on his behalf. Moreover, if the client refuses to accept the commodity, the bank is not legally permitted to require any payment from the client as a penalty. In addition, until the time that the commodity is sold to the client, the ownership risk rests with the bank. These facts indicate that Islamic banks bear a very considerable risk of default on the part of the client and a further major risk of damage to or loss of the asset.

Islamic banks charge a mark-up value above the principal amount or the purchase value that it has paid the seller for the asset, which they set by reference to the LIBOR rate or other market rates, thus keeping their products in line with the interest-based loans of conventional banking, where the interest rates are set according to market rates. Although the banks are not directly exposed to interest rate risks, they are exposed to fluctuations in market returns and thus to market risk.

An important difference between the two banking regimes is that commercial banks are able to reschedule their customers' repayments in the event of a default on the payment of one or more instalments, while Islamic banks are not legally permitted to reschedule instalments in this way. In a similar vein, Islamic banks are not allowed to charge a penalty for any default on the part of the client in paying back the due amount, which means that they are highly exposed to the counterparty risk due to the legally binding nature of the transaction. If Islamic banks fail to abide by the rules and regulations imposed by Sharia law, they are again exposed to legal risks.

On the other hand, if an Islamic bank fails to abide by an agreement and thereby does not purchase a commodity in time, it is the client who is exposed to a legal risk because clients are not provided with any legal cover to indemnify them against business losses borne by them. This could be considered advantageous for Islamic banks. The *Murabaha* financing agreement is a financial product provided by an Islamic bank to a client against the mark-up value charged by the bank; however, unlike conventional banks, Islamic banks are not able to charge any collateral security against the due amount. In the same context, clients in the *Murabaha* financing are also not legally bound to provide any security against the financial assistance. As per Sharia legal system, there is a prohibition to invest in uncertain and risky transaction and thus, collateral and any other security against due amount are not needed due to minimum risk exposure. It can be reasonably concluded that Islamic banks are highly exposed to a number of legal risks related to their engagement in *Murabaha* transactions. In response, they employ a range of risk management policies, including those prescribed under the internationally recognised Basel II accords. The other risk management strategies most commonly adopted by Islamic banks are the basic indicator approach, the standardised approach, and the advanced measurement approach.

Also available to Islamic banks are a number of operational strategies for mitigating the counterparty default risk. One possible practice is for banks to impose on their clients what amounts to penalties in the case of a default, but to require them to be paid to a charity, rather than the bank itself. Because this practice does not provide any income for Islamic banks, it is permissible under Sharia law. Islamic banks must ensure that they abide by all the legal guidance provided by Sharia law in the conduct of their business. When they enter into a *Murabaha* financing agreement, they must ensure that the counterparties are reliable and financially stable, to which purpose they adopt a credit rating system. Furthermore, there are other hedging instruments that Sharia law allows banks to make use of. Thus, it can be reasonably stated that Islamic banks take effective

steps for the management of the risks to which they are exposed by their involvement in *Murabaha* financing agreements.

The next chapter will be a discussion of a number of recommendations with regard to legal risks to investors of *Murabaha* contracts. Additionally, it will offer recommendations for the parties involved in *Murabaha* transactions and future academicians.

Chapter 5: Recommendations

5.1 Introduction

This chapter discusses solutions and recommendations for the risks associated with Islamic legal transactions (*Murabaha*). This transaction is a trade between a seller and buyer for a product in which a bank plays the role of the financier. The role of the Islamic bank in a *Murabaha* transaction is to make purchase price payment to a seller/supplier after it has transferred the title/authority of the product to the bank. Later, the title/authority of the product is transferred to the customer in return for the price, along with a mark-up profit. A *Murabaha* transaction involves a mark-up price, which is allowed under Islamic law, to ensure that the parties abide by Sharia law. Under Sharia law, the transaction in which the bank is involved as a financier must abide by the principle of prohibition of *riba*, which means that financial transactions cannot involve receiving or paying interests in addition to the principal amount.

The parties in a *Murabaha* transaction must accept a number of legal risks that make it extremely risky, compared to other Islamic transactions, including operational, commodity, asset-loss, payment default/credit, mark-up, and liquidity risks. These risks will exert an influence on the parties involved because they can result in significant financial loss. It is important to prevent the occurrence of legal risks where possible and the subsequent effects in order to ensure the viability of *Murabaha* contracts. For each of the risks associated with this type of transaction, it is advisable to adopt certain measures to lessen the probability that a particular risk and its consequences will need to be faced. Dealing with all the possible risks involved in *Murabaha* contracts makes the whole transaction less risky and more similar in terms of risk to other Islamic transactions. The prime focus of this chapter is to present applicable and pertinent solutions for the identified major risks so that the parties involved in *Murabaha* transactions can best enjoy its advantages.

This chapter consists of two main sections designed to maintain a logical flow of information. The first section outlines the risks associated with *Murabaha* transactions; the risks will be briefly presented because knowledge of them will

help to align recommendation/solutions with risks. This section will also present key points related to the legal risks involved in *Murabaha* contracts to demonstrate the importance of these contracts.

The second section of the chapter will offer recommendations for the risks discussed previously. To ensure that the proposed solutions are in alignment with the risks they deal with, they will be provided under the headings of particular risks. The principle focus of this section is to present applicable and measurable solutions to the risks associated with *Murabaha* transactions to ensure applicability in the real means. This is because solutions that are directly applicable for particular risks will make *Murabaha* contracts less risky, and bring them to a similar level to *Istisna* and *Musharaka* contracts.

The flow of information in this chapter, from identifying legal risks to presenting solutions, will help in relating causes and courses of action together. The interlinking of causes and courses of action/strategies guarantees a resolution of the risks in the best possible manner.

5.2 Summary of findings related to the risks associated with *Murabaha* contracts

Based on this paper's overall review of *Murabaha* contracts, it has been interpreted that this transaction is relatively risky compared to other Islamic transactions due to the numerous risks associated with it. The parties to such contracts can encounter credit default or payment default, mark-up, and asset-loss risks. In *Murabaha* transactions, parties' interests can be considerably influenced by a broad range of risks, ranging from operational to liquidity risks. The significant risks associated with *Murabaha* transactions are discussed in brief below:

Non-clearance of the Saudi banking system

Non-clearance of the Saudi banking system is a critical issues/risk due to the outdated working norms and systems within the banking system in Saudi Arabia. There have been no serious modernisation of the Kingdom's banking

system for a long time, which creates differences between the Saudi banking system and the Islamic banking system, with resulting differences in judgements. This ultimately worsens investors' confidence in the country's banking system due to the absence of legal clarity.

The existence of independent Sharia boards

Another problem is the inconsistency and differences between Sharia law as applied by the independent Sharia boards of banking institutions. Each banking institution has an independent Sharia board that plays a role in determining the legitimacy of banking transactions. The Ijtihad source of Sharia law causes large differences between the banking transactions each bank is allowed to perform; one bank will be able to do some that another cannot. This results in critical issues for customers such as invalid transactions and large disparities between possibilities. For example, one banking institution may be allowed to perform non-Islamic transactions, while another bank will be strictly prohibited from carrying out the same transaction by its Sharia board.

In the context of *Murabaha* contracts, the matter of concern for safeguarding investors' interests is the way the contracts are used without coherency or consistency, and in accordance with a 1,400-year-old format that has not changed.

Unauthorised agreements:

Another risk associated with a *Murabaha* contract is that at an initial stage, the buyer instructs the seller to provide the commodity, and this instruction does not constitute an actual purchase unless it is integrated with a binding promise. There is no agreed contract or agreement between the parties due to a lack of mutual trust. This absence of agreement means the deal is not legally binding, which may make a contract void. This means that there is a high probability of a denial that a promise has been made or a cancellation of a promise by the client. In the context of unauthorised agreement issue, a situation in which bank ask the client to sign a promise contract to save the side is not legally permitted and allowed by Sharia law.

Payment default risk or credit risk

Another legal risk associated with this transaction are payment default and credit risks, which occurs due to delayed payment by a party. The payment is usually made after the due date or when a default in payment is apparent in a credit transaction. Since the bank has signed a contract to purchase a product for the client and to sell it to him at an agreed price to be paid later, there is a higher chance of a delay in payment. In this context, *Murabaha* assets are considered equivalent to a debt payment. If the party defaults on the due date and is incapable of paying, the price of the products is forfeited, along with the mark-up price.

Liquidity risk

The problems associated with obtaining cash or a cash equivalent at a reasonable rate is referred as liquidity risk. There are two types of risk here, namely asset liquidity risk and funding liquidity risk. There are also other causes of liquidity risk in Islamic banking, such as the prohibition of *fiqh* in the securitisation of current assets. In addition, raising liquid funds is a critical issue facing Islamic banks, and a major reason for their slow development. Islamic institutions also face liquidity risk due to the prohibition on earning interest, which prevents banks from benefiting from the concept of a lender of last resort, which helps institutions to meet liquidity needs on the basis of the payment of interest. Islamic banks make payments to sellers on behalf of buyers. Thus, in the case of a payment default by a seller, the bank can face liquidity difficulties, which can complicate routine functioning. In these transactions, the product in question cannot be sold at a different price in the market; it can be sold only at face value. In short, assets under *Murabaha* transactions cannot be sold on, and therefore constitute a liquidity risk for bank, especially if deposits are sensitive to market returns or if the average maturity of *Murabaha* contracts is longer than the average maturity of deposits. It has also been established that there is a secondary liquidity risk associated with *Murabaha* transactions, which can arise

when a business or another risk related to *Murabaha* contracts influences a bank's liquidity.

Mark-up risk

Mark-up risk emerges when there is a fluctuation in the market rate of return. If the rate of return is fixed by financial institutions or banks, it cannot be changed freely, due to which the price and quantity remain fixed. This inflexibility has a negative effect on banks and creates further pressure on the mark-up margin.

Commodity risk

This risk in terms of the *Murabaha* transaction is due to the high probability of future uncertainties that need quantification in the best possible way. If there is a situation in which financial institutions are incapable of measuring future uncertainties, it could cause a problem in determining commodity price fluctuations. In the Islamic context, the possibility of fluctuations in future commodities is higher because Sharia prohibits dealing in uncertain future transactions.

Operational risk

This is another major risk associated with *Murabaha* transactions, in which a seller transfers the title/authority of a commodity to a bank after receiving payment. Then, the customer/borrower has to make a payment of the price of the products, plus the mark-up. The operational risk is if the customer/borrower denies purchasing the product or commodity from the lender or Islamic bank that made the purchase on the customer's behalf. Disposing of a received product/commodity to another party is not easy for an Islamic bank, which creates a risk regarding managing commodities and future sales transactions. This risk not only stems from the internal processes of the transaction, but also issues related to people and technology. In terms of human resources, one operational risk commonly encountered by Islamic banks is a shortage of skilled and knowledgeable people and religious restrictions on women that keep their participation limited. As for technology, Islamic banks are less reliant on

information technologies than conventional banks, which create obstacles for banking operations. Operational risks have to be mitigated through the smooth functioning of the operational process, thereby making *Murabaha* transactions less complicated for the parties involved.

Asset-loss risk

This risk comes about due to the transfer of a product/commodity's title from the vendor/supplier to the customer/client. During this transfer, there is a risk of asset-loss due to theft or deterioration in quality. This possibility of incurring losses naturally influences banks. In addition, it influences purchasers/clients in terms of not satisfying the product need.

Market risk

This risk is caused by macro-environmental factors and unsystematic asset risk. Changes in asset or commodity prices are market-specific risks that influence clients' choices; they create an additional burden in terms of paying a higher price and mark-up. However, changes in asset and commodity prices also affect Islamic banks or IFIs because a fall in prices causes a risk of price differentiation and a loss due to lower asset or commodity prices.

The next section will detail solutions/recommendations for the identified legal and financial risks. The recommended solutions are offered with all parties' interests in mind, so that *Murabaha* transactions can be made less risky.

5.3 Solutions for the risks associated with *Murabaha* transactions

Solution for the risk of non-clearance of the Saudi banking system

The issue of the Kingdom's antiquated banking system can be resolved by adopting certain recommendations, as stated below:

The Saudi banking system should be updated, along with the creation of a new Islamic banking system. This would help banking institutions in the country to work efficiently in accordance with Sharia law. Moreover, it would help other banks to work in coordination with Islamic law, without any ambiguity.

It is also recommended that the country adopt recent technological and economic developments in the prevailing legal environment to ensure effective application of Sharia law. This would help to keep Sharia law aligned with recent legal developments.

Solution for risks caused by independent Sharia boards

The issue of the existence of independent Sharia boards can be resolved by creating a Sharia board that works in compliance with SAMA. The provision of an independent Sharia board for each banking institution should be eliminated. The Sharia board created under SAMA would then issue fatwas for all banking institutions. This board must play a supervisory role to keep a check on banking activities in consideration of fatwas. If this is implemented, it would be possible to mitigate the differences between banking transactions that are due to different board or fatwas. After the creation of one Sharia board, all banks would operate/work under one fatwa and governance to keep validity and consistency between different banking transactions.

In respect to the mitigating issue of differences, it is crucial that all the legal rules and regulations are made clear for banking institutions in Saudi Arabia so they understand how to ensure that Sharia law and Western trends do not run counter to each other.

Solutions for risk caused by unauthorised agreements

The risk of unauthorised agreements can be mitigated by completing all the legal formalities related to a contract that contributes towards its legality. The contract should not only be verbally communicated between the two parties buying or selling a commodity but there should also be an agreed document in which both parties provide their voluntary consent and promise to complete the stated obligations on their part. A well-constructed contract is the main requisite to prevent unauthorised agreement risks from arising. In a *Murabaha* contract, if a party executes a deal to sell a product on the basis of other party's approval, in a way which is not valid and authorised, it is necessary to initiate the contract only after the formation of the complete contract, within which the offer,

acceptance, intention of the legal relationship, and consideration in the form of money/payment are included.

In addition to including all the variables of a valid contract, the risk of an unauthorised transaction can be mitigated through a written agreement in an explicit manner. The explicit written agreement will clearly reflect the agreement terms and conditions. This means that the agreement's terms and conditions not only clearly contain the promises of the contracting parties but also details penalties in the event of a non-fulfilment of a promise. This explicit written contract states the consequences if any party is guilty. An explicit written contract agreement avoids the issue of misinterpretation and miscommunication because it explicitly mentions the major requirements that need to be met by the contracting parties and the consequences in the case of non-compliance with the specified requirements of a contract.

The risk of unauthorised agreement in *Murabaha* financing arrangements can be mitigated through the participation of a third party. The buyer and seller of a product can accept the assistance of bank or any other party (legal advisor) to make an agreement concerning buying and selling a commodity valid. The bank or any other party can play a role in securing the interest of the buyer or seller in the case of any misconception or a refusal to abide by a promise. In this case third-party intervention needs to be free from parties' personal interests and selection. This is because the personal intervention of any party may raise the possibility of conflict because it could create a high prospect of cheating or biased decisions.

In order to obviate the risk of an unauthorised agreement, it is recommended to make use of *Ilzham* (binding) because it makes a contract lawful. *Ilzham* in a contract ensures that the contracting parties agree to a deal because they have signed a contract after agreeing on all the terms and conditions. The signed contract means that there is a legal binding between both contracting parties. Legality is an important component of a contract and should be given strong consideration. According to my understanding, a signed

document is valid proof that both parties are voluntarily involved in a particular deal for the buying and selling of a product.

The buyer, seller, and bank in *Murabaha* contract are recommended to engage in a proper verification and reading-out of all the terms and conditions prior signing a contract. The parties to a contract that perform the proper verification before signing it can easily avoid the issue of confusion and ambiguity that can bring about a conflict. The buying party, at the initial stage, should verify the selling party to build up trust. In addition, the existence of the selling party should be confirmed by the buyer to avoid the effects of a deal that falls through. It is essential that the contracting parties keep a hardcopy of the signed agreement for future reference. This will not only prevent exploitation and manipulation, but can be used as a legal proof in case of any fault.¹²⁰⁸

The banking institution in a *Murabaha* transaction is also recommended to make use of a security option to avoid the risk of an unauthorised agreement. This security option helps save banking institutions from possible financial loss in case of cancellation of a promise by a client. The security can be used to cover losses due to an unauthorised agreement. In financial deals, it is vital that the financier make a payment to the third party after the securitisation or security assets. Securitisation minimises unexpected losses due to termination of the contract because it can be used as a supporting instrument to mitigate financial losses.

The bank can initiate a provision for penalties and loss-sharing in case of the cancellation of a promise or deal. Penalty and loss-sharing can force buyers to agree to a deal, which lessens the probability of a cancellation or refusal. This financial liability would fall on the party that denies having agreed to complete the deal after giving consent in verbal or non-verbal form, through the introduction of a burden of financial loss in the form of a penalty. This could potentially prevent the risk of an unauthorised agreement when the buyer and seller agree to sell and buy a particular product or commodity, with the banking institution that is the

¹²⁰⁸ Salem, R.A. 2013. *Risk Management for Islamic Banks*. New York: Edinburgh University Press.

financier playing a mediatory role. The probability of a broken promise by the contracting party causes problems for banking institutions concerning a shortage of liquid assets, disrupting the cash management system, and bad debts that could eventually result in bankruptcy.¹²⁰⁹

In addition to the provision of a penalty, banking institutions should consider the records of previous transactions involving the involved party as a part of the assessment of credibility and goodwill. Such an assessment would be helpful to track whether or not previous agreements or contracts were fulfilled under legal considerations and valid terms and conditions. This would secure the interests of banking institutions in the future based on previous records of a party, helping to decide whether further financial dealings should be executed with a certain party. This type of provision in financial agreements will be helpful in limiting the possibility of cancelling a contract after it has been initially agreed. This can result in penalties for contracting parties in the case of the cancellation of an agreement without any valid reason, because the interests of the other party are at risk. A party to *Murabaha* transaction should consider to examining the interests of the other contracting parties to avoid the possibility of a void contract.

Unauthorised risks can also be mitigated by sharing information about the different risks associated with the transactions that can improve operational transparency and further help other parties handle similar transaction risks that may arise in the future. Information-sharing leads to strong ties among parties because it ensures that the contract information is presented without any manipulation. This suggestion is helpful to initiate agreements due to the emphasis on a trustworthy relationship in which the interests of all parties are secured to the greatest possible extent. This suggestion follows the principle of sharing profits and losses, with less involvement in risky and uncertain transactions.

The risk of unauthorised agreements in *Murabaha* transactions can be lowered through the formation of a legal committee that checks up on agreement

¹²⁰⁹Visser, H. 2013. *Islamic Finance: Principles and Practice*. England: Edward Elgar Publishing.

fulfilment on the part of the contracting parties so that interests are not harmed. The committee would help to prevent denial and cancellation of a contract by any party without a justified reason. The motive behind forming a legal committee is to secure the interests of the counterparties by monitoring the current situation at the level when the contracting parties first entered their agreement. Conflicting issues that result from the cancellation of an agreed deal could be handled efficiently by the committee because it would be easy to identify the root causes of the risk and the measures to be undertaken to secure parties' interests. The involvement of a committee in handling authorised agreements saves time in the usually lengthy legal proceedings. The support and intervention of a legal committee helps to guarantee that the right decision is made because the final decision will be taken after a proper investigation of the causes and consequences affecting the contracting parties. Therefore, forming a committee is the best measure to help reach a legitimate decision after all the proceedings.

The risk of signing a contract that is not permissible under Sharia can be obviated by adopting the option to return the goods to the third party. The bank can ask the third party/owner of the goods to accept their return if the client does not complete the transaction and its related formalities. The right to return goods to the third party is an option that can be used by the banking institution. The risk of an unauthorised agreement in *Murabaha* agreements is relatively high due to the possibility of a cancellation of a promise by the purchasing party. The reason for this is the absence of a valid contract formation and legal binding process, which can cause a cancellation. The cancellation of a contract may prove favourable for the declined party. However, it can also have a serious effect on the seller and financier parties. The previous suggestions could be helpful in mitigating the risk of unauthorised agreements to a good extent. A contract can be made lawful only if it covers all aspects of a valid contract, from the offer to consideration.

Payment default risk or credit risk

It is recommended that exposure to credit risk be controlled by more efficiently supervising and reviewing the use of margin loans in *Murabaha* transactions. The proper securitisation of margin loans would help to determine the risk of a payment default in respect to buyers. This is a good way to measure the debt-paying potential of a buyer, which must be determined by the banking institutions prior to making any buying transaction on behalf of the buyers. Margin loans that brokers and dealers offer to customers are counted as unsecured loans and are thus subject to scrutiny by those seeking to exert control over market abuses that may lead to depression or recession. Enhanced scrutiny of such loans would help to reduce the risk of default. It is crucial to find the potential ability of the buyer to pay off short- or long-term obligations on the due date. Assessing susceptibility to credit risk would make it possible to reduce potential losses arising from extending credit beyond the potential of those receiving loans to repay. Knowledge of the purchasing party's ability to pay back debt would ensure that the possibility of a payment default or a bad debt is reduced. However, it is not easy to gain adequate knowledge of a client due to the probability of information being hidden from the financier, which is a "capital impairment risk."¹²¹⁰ Banking institutions need to attempt to obtain information about the purchasing party prior agreeing for making payments to sellers on their behalf.

Banking institutions that engage in *Murabaha* transactions make use of cross-referencing. In credit risk management, cross-referencing helps to determine the party's ability to make a payment, being the best way to verify information about the party on whose behalf the bank is playing the role of financier.¹²¹¹ Verification is important for banking institutions in respect of financing policy and the management of credit risk because it helps uncover the real financial ability of the purchasing party and helps to track records of payments being made by the due date.

¹²¹⁰Swartz, N.P. 2013. Risk management in Islamic banking. *African Journal of Business Management* 7(37), pp. 3799-3809.

¹²¹¹Murabaha. 2013. [Online]. Available at: http://www.bnm.gov.my/guidelines/05_shariah/CP_Murabahah_122013.pdf [Accessed on: 10 November 2016].

The issue of credit or payment default risk can also be mitigated by inducing the purchasing party in a contract to make payments on time to avoid legal proceedings and penalties. Moreover, strict rules and regulations should be enforced by banking institutions with a clear warning of the heavy penalties incurred by payment defaults. Heavy penalties may lower the risk of payment default by inducing purchasers to make payments on time.

In *Murabaha* transactions, credit risk must be managed effectively to secure bank insolvency and competitiveness because delayed payments or a default on payment can slow down a bank's growth. Banks can therefore adopt the principle of profit-sharing to transfer the risk of debt default to depositors. This would help banks combat the issue of insolvency.

Another method to control and manage credit risk is collecting information about hedging options, which would facilitate the recovery of credit to the greatest possible extent. Hedging is the best way to prevent the risk of payment default because it covers financial losses due to changes in price or money value by the adoption of two positions.

Credit risk can also be mitigated through collateralisation, safeguarding the interests of the Islamic bank or financial institution providing the *Murabaha* loan by ensuring the creditworthiness of the borrower. The most effective means of reducing credit risk is to elicit the help of a collateral manager, who would offer support by determining the advisable extent of credit exposure in integration with the legal requirements and by helping the bank to manage the credit risk through cross-product collateralisation. In addition, sukuk can be used by banks to reduce the credit risks that stem from *Murabaha* transactions. Sukuk acts as collateral within the transaction, known as "collateralised *Murabaha*." The use of collateralised *Murabaha* to manage against credit risk is a good option for an unsecured commodity because it gives the right to the financier, such as a bank, to sell assets in the possession of the purchaser if the buying party fails to clear bank dues or debts on time. Under Islamic law, collateralised *Murabaha* is defined as an "Islamic monetary instrument that provides a sharia-compatible financing backed by assets as collateral, in return for cash. The financier has the

right to repossess and sell the assets/securities if the customer failed to repay dues.”¹²¹² This action combines the *Murabaha* financing structure with the sukuk model to guarantee assets, so as to reduce the risk of a credit or payment default. For Islamic banking institutions that deal in *Murabaha* transactions, collateralised financing is essential to secure otherwise unsecured commodities and also has the advantage of bringing about involvement in the sukuk market, contributing to the growth of a sukuk portfolio.

Credit default swaps are used with the amount sold and purchased, depending to some extent on the credit rating system. If a party has a low rating compared to the benchmark, credit default swaps are not used for risk management because proper asset allocation is necessary to meet the obligations in proportion. Controlling the credit risk in this way would be positive in terms of performing asset allocation in an efficient way to reduce the credit burden in the same period. Asset allocation gives the leverage to arrange capital finance or funds to make payments on time.

Credit evaluation is also a good way of identifying, measuring, and controlling credit risks, and keeping lending decisions in step with guidelines. This recommendation would lead to a reduction in risk for the entire process aspects, both the market and buyers' risk. Looking at the market risk in the credit evaluation helps to compute whether the current market status/position in Saudi Arabia is favourable for *Murabaha* financing. However, the buyers' risk, would help to determine buyers' capability of paying the principal amount, plus a mark-up, on time.

Banking institutions are recommended to make use of asset-backed credit risk management to reduce the probability of a credit default by ensuring that the approval of credit is backed by adequate assets. Asset-backed credit risk management leads to back-up credit or payment being paid to the seller on behalf of the buyer in the *Murabaha* transaction. This means that payment

¹²¹² Ulus, S. n.d. Collateralised Financing. [Online]. Available at: <http://www.iifm.net/sites/default/files/session-files/Collateralised%20Financing%20by%20Mr.%20Sabri%20Ulus.pdf> [Accessed on: 12 November 2016].

default risk can be mitigated by requesting warranties and guarantees from the parties with regard to non-payment for goods. This suggestion would lessen the possibility of payment default risk because security has already been received on the payment made to the party.

Securitisation vehicles ensure a sound review of creditworthiness before the approval of *Murabaha* loans. Banking institutions are recommended to develop and enact a comprehensive suite of effective policies and techniques to identify and control credit risk to reduce the probability of loss through bad debts. The policies for credit risk control involve the determination of market risk (probability of liquidity crisis) and history of the buying party (taxes payment, income, expenditure, and debts).

The option of loan loss reserves is another efficient way to prevent credit loss. This suggestion helps to combat losses due to credit payment default or delay by the purchasing party. A loan loss reserve secures the solvency of the banking institution by meeting the needs of sufficient liquid assets or cash and cash equivalents. This would make it possible for banks or financiers to take advantage of opportunities to achieve prosperous growth. The availability of sufficient cash is a matter of concern for banking institutions to fulfil day-to-day transactions, and investment and loans are needed. The maintenance of loan loss reserve at the mandatory level is to be executed by Islamic banks, similarly to the regulatory requirements adopted in different jurisdictions.

Credit risk can be prevented through the “income and loss recognition” as outlined by the AAOIFI Standards No. 1.¹²¹³ These standards enable the determination of the probability of income and loss in different Islamic financial transactions and modes of finance. With the adoption of loss recognition standards, banking institutions in Saudi Arabia can prevent losses that are due to payment defaults because loss recognition standards help to compute the probability of loss and their subsequent effects on the market position. The

¹²¹³ Hassan, K. and Lewis, M. 2009. *Handbook of Islamic Banking*. England: Edward Elgar Publishing.

adequate determination of loss defaults will help in taking preventive measures at the initial stage of agreeing to a *Murabaha* transaction.

Another recommendation to avoid credit risk is the formation of a credit rating system. This could help in risk identification and compiling risk management reports. Moreover, credit rating systems help banking institutions to measure the creditworthiness of the parties to *Murabaha* contracts because they take into account a set of criteria for each party. A credit rating system is the best measure to determine credit-paying ability to prevent payment default risk.

Credit risk can also obviate by using credit derivative tools, which is one of the new options for banking institutions to safeguard against credit risk. The use of credit derivatives in managing risk helps to separate credit from credit risk because it focuses on attracting investors who are likely to be interested in investing in default credit. As part of this credit risk management tool, certain sequential steps are carried out to determine exposure to credit risk and related features such as packaging, securitisation, and marketing. As per Islamic law, credit derivatives are not fully considered because it is prohibited to sell debts to other investors. In this situation, it is crucial to separate secured and unsecured debt to improve the evaluation of credit in terms of debt transparency. Debt transparency is important in order to measure the probability of credit default. Transparent debt clearly demonstrates the creditworthiness of the debt holder, and can be used as a base to make a financing decision.¹²¹⁴

The high probability of credit risks in *Murabaha* transactions can be mitigated to a good extent by use of aforementioned suggestions. Credit risk management is important to secure consequences and effects such as funding crises and bankruptcy. The risk of credit and payment defaults to banking institutions threatens their sustainability in the short run, causing problems in the management of day-to-day transactions.

Solutions for liquidity risk

¹²¹⁴ Ahmed, H. and Khan, T. (n.d.). Risk management in Islamic banking. [Online]. Available at: http://www.isfin.net/sites/isfin.com/files/risk_management_in_islamic_banking.pdf [Accessed on: 21 November 2016].

Liquidity risk is a critical issue, directly affecting the processing of *Murabaha* transactions, along with routine operational work. The recommended solutions for dealing with liquidity risk are outlined below:

Banking institutions are recommended to control liquidity risk by maintaining adequate liquid assets in relation to liquid liabilities. Banks can maintain the standard ratio between liquid assets to liquid liabilities or short-term debts in the proportion of 2:1. This means that the proportion of liquid assets should be double the current or short-term liabilities. The maintenance of this standard liquidity would help ensure the availability of adequate liquid assets to cover current liabilities. However, this would be difficult for Islamic banks since the availability of liquid assets depends on compatible money market instruments and lender-of-last-resort facilities. To measure their liquidity effectively, it is recommended that banks continuously review the liquidity gap by determining the proportion of liquid assets to total assets or liquid liabilities. As per my understanding, knowledge of the gap between current assets and current liabilities and trends in increments/decrements helps when taking viable investment decisions. In *Murabaha* transactions, accurate knowledge of the liquidity gap would help financing banks to take decisions over whether it can provide finance to the selling party.

Liquidity risk can also be mitigated by banks by developing an appropriate liquidity risk management framework that covers all aspects of asset-liability management. This framework would help banks to prevent the risk to liquidity that arises from mismanagement of liabilities and assets. In order to prevent this, banks need to review factors such as the conversion period of assets and the maturity period of liabilities that are used to meet their various obligations under *Murabaha* contracts.

The parties to *Murabaha* transactions are recommended to accept the help of investors in managing liquidity risk. Islamic banks should comply with the high-quality liquid asset requirements of Basel III. As per Basel III, the key consideration of banking institutions is to maintain highly liquid assets instead of current and liquid assets. Islamic banks have to hold corporate debt, treasury

bonds, and cash. The proportion of highly liquid assets should be higher than that of net cash flows. This would effectively manage the difference between expected cash inflows and cash outflows, so that the aim of 100 percent coverage can be achieved. The key focus of liquidity coverage in the Basel Accords is on holding high-quality liquid assets, which assist in dealing with liquidity crises by being easily converted into cash. As per the Basel Accords, there are three categories of high-quality liquid assets: level 1, level 2A, and level 2B. These levels specify different highly/easily convertible liquid assets within less time. The Level 1 category of highly convertible or quality liquidity assets involves foreign withdrawal resources, securities issued by sovereign entities or multilateral bank-guaranteed securities. Level 2A assets cover securities guaranteed by government entities and development banks, while investment-grade debt securities and common stock that is publicly traded are involved in Level 2B assets.¹²¹⁵

An Islamic bank's liquidity position is directly related to the quality of its capital, which should be strengthened to provide resilience against potential liquidity crises. Banking institutions are recommended to prevent liquidity crisis by making decisions favourable for the working capital management. This would help banking institutions manage working transactions without any issue of liquidity. Effective working capital management is predominantly based on the current status of cash inflows and cash outflows. This is one of the most effective ways of measuring liquidity because cash inflow assessment relative to cash outflow would help banking institutions to avoid funding shortfalls. The use of cash assessment by banks makes it easier to compute the value of cashflows assets and liabilities, along with derivatives. Adequate cash outflows in proportion to cash inflows should be achieved to lessen liquidity crisis stresses.

Banks can control risks related to liquidity shortage/crisis through limits. This action will help banks to manage daily transactions within certain limits, so as to secure liquid assets for the contingent situation. The limiting framework for

¹²¹⁵Basel Committee on Banking Supervision. 2013. Basel III: The Liquidity Coverage Ratio and Liquidity Risk Monitoring Tools. [Online]. Available at: <http://www.bis.org/publ/bcbs238.pdf> [Accessed on: 15 November 2016].

controlling liquidity problems within *Murabaha* transaction will secure banks from big liquidity stresses because they prohibit banks from excessive involvement in riskier transactions. As per Islamic law, banks operating in the Middle East should strictly abide by the principle of refraining from risky or uncertain transactions.

In addition, banks should provide an early payment discount offer to the contracting party to maintain their strong liquidity position. Contracting parties will often be interested in this option because it gives them the opportunity to save money. Additionally, it will help banking institutions to enhance the availability of cash or cash inflows before the due date, helping turnover and the debt collection process. An improvement in the process of debt collection would enable banks to meet the Basel III requirements of keeping the proportion of current or highly liquid assets equal to current liabilities.

Islamic banks can deal with the liquidity risk by maintaining adequate cash or liquid assets so as to avoid acute insufficiency of cash in hand. This can be done through a salam contract, which is one of the best options to reduce and control liquidity risk; the risk of insufficient liquidity is mainly associated with operational and credit risk.

The risk of liquidity can be controlled in an efficient way through internal and external auditing, which stimulating operational efficiency. Banking institutions must clearly define their liquidity requirements in order to ensure the availability of adequate liquid assets, so it is recommended that they establish a strict internal administration in this matter, along with external regulatory measures. The control and management of liquidity risk also requires the application of deposit management to potential new investments. Moreover, reserves should be maintained to promote liquidity efficiency and ensure low exposure to liquidity risk.

Liquidity risk can be also be reduced through “Roll-Over Option Facilities.” This option would help banking institutions combat against market distortions because it emphasises a systematic aspect of managing liquidity risk. Through this, it would be possible for banking institutions to spread liquidity risks among investors on a large scale. Roll-over option facilities act as a rationing instrument

that reduces the issue of liquidity shortage due to asymmetric information. This option leads to liquidity risk being dissipated by reducing liquidity coverage ratio on the one hand and increasing net stable funding on the other.

Banking institutions involved in *Murabaha* transactions are also recommended to understand and link market liquidity risks and funding liquidity risks. This integration is essential to secure short-term solvency because high market liquidity risk causes problems for ongoing operations/processes. Efficient interlinking of the liquidity risk associated with market and funding helps to bring about a balanced strategy for managing liquidity soundness. This is because the effective association of market and funding liquidity helps when taking viable funding decisions to people in a market, or on behalf of any selling party. Integrating the funding strategy with the market status decreases the probability of a liquidity risk in a crisis.

Banking institutions are also recommended to adopt internal control mechanisms to limit liquidity risk. For this, banks should hire or accept the assistance of trained, skilled, and competent human resources for effective implementation of internal controls. Internal control, with the help of skilled and knowledgeable personnel, ensures maintenance of an adequate proportion of current assets to current liabilities. Controlling liquidity problems with internal audits and controls will help scrutinise funding decisions in terms of time and risk. As for time, internal audits will be helpful to predict whether funding for third parties on behalf of the buying party to earn the price plus mark-up is the right decision at a particular time or not. However, in terms of risk, the suggestion will help to determine whether the offer of funds is risky in each specific situation.

When facing liquidity risk, banks are recommended to calculate their asset value in accordance with the prevailing standards of financial reporting, so as to take the best financing decision. This not only reduces the probability of market risk but raises the confidence of counterparties. This suggestion is the best way to hold investors' confidence and drives easy access to funding for banking institutions in case of illiquidity. Based on my knowledge, following the financial or supervisory standards of Islamic law will ensure that the bank remains

pessimistic about clients/investors and other stakeholders in times of adverse liquidity conditions.

Altogether, it is necessary for banking institutions to monitor and control liquidity risks for long-term sustainability because cash acts as lifeblood in corporations. A cash or liquid asset crisis or shortage makes running day-to-day operations difficult for banking institutions and impacts on long-term plans. The maintenance of liquidity risk leads to goals like adequate cash inflow for assets/liabilities being achieved, and adequate liquid assets for the contingent situation.

Solutions for mark-up risk

In order to counter mark-up risk, it is recommended that Islamic banks exercise particular care when applying benchmark rates, which will enable them to rate different financial instruments more accurately. The mark-up rate, in the context of *Murabaha*, is determined by adding together the benchmark rate and an appropriate risk premium, a calculation that needs to be adjusted to meet changing market conditions. A failure by Islamic banks to vary their mark-up rates in accordance with changes in the benchmark rate is a major factor underlying mark-up risk. In a given market, changes in the interest rate affect the values of both the benchmark rate and the risk premium, making it crucial for IFIs to take account of market changes when setting mark-up prices. Variations in the market rate have a direct influence on the current financial position that serves as a base to determine risk premium and benchmark rate. The existing market position decides a rate of interest and risk factor that is proportionally linked to the risk premium. Based on my understanding, a proper valuation of the market risk is important due to its significant impact on setting the benchmark rate.

Accurate computation of *Murabaha* profits is necessary because banks often do not appear to give due consideration to the period between disbursement and acceptance, when determining the profit or mark-up associated with their *Murabaha* transactions. According to Frisen (2008), time is the key factor in financial analyses because the time index can remain same over the years or be discrete and therefore financial valuations have to include the

time factor.¹²¹⁶ In particular, it is suggested that Islamic banks take account of the period taken to complete the sale of the commodity to the client when computing the *Murabaha* profit. When considering the time factor in *Murabaha*, profit computation is helpful to compute the present and future value of the money. The time factor in money valuation helps in considering the impact of time on monetary value and inflation or deflation, credit crunches, and economic crises. These factors have a direct relationship with money's worth and earning power. When dealing with mark-up risk, a good understanding of the "time value of money" can make financial decision profitable because it involves calculating the worth of money in the future, along with opportunity costs. The high probability of money loss due to changes in market conditions causes uncertainty in getting funds back. Time-value considerations are a vital matter of concern to secure financial soundness.

For market fluctuations, it is recommended to use forward transactions. This contract considers the future price of financial assets to mitigate gaps in the present and future value of assets that result from fluctuations.¹²¹⁷ The parties involved in the forward contract agree to deal at the predefined level in future, although financial assets are valued at the price determined in the present. The risk of price changes in financial instruments due to market volatility can easily be hedged with financial forward transactions. According to the current market conditions, the existence of the same price of financial instruments over decades is possible because the possibility of price fluctuations is relatively high, due to rapid changes in the existing system and ongoing development. This is also crucial for investors who deal in or are likely to be interested in dealing in the financial commodity market, and must know the value of price fluctuation. Price fluctuations in the market negatively affect returns on investments in the future, which result in financial and capital loss.¹²¹⁸

¹²¹⁶Frisen, M. 2008. *Financial Surveillance*. New Jersey: John Wiley & Sons.

¹²¹⁷Burton. 2010. *Intro to Financial Markets and Institutions*. M.E. Sharpe.

¹²¹⁸*Ibid*, p. 558.

Another useful technique to deal with mark-up risks in *Murabaha* transaction is “fair value pricing” in which value of an investment should be determined in consideration of market fluctuations because this will lead to an estimate of fair value. It is essential that market fluctuations be valued and considered so that differences in the value in the future can easily be compensated. Fair value pricing is the best way to reduce future losses that are caused by fluctuations in the market, such as currency inflation or deflation and changes in interest rates. Any changes to the value determinants have a significant effect on the prices of commodity or securities. For instance, an increase in interest rates has a negative effect on the price of securities, which in turn increases finance costs. In such a situation, the financier or buyer of securities needs to leverage an increased cost of interest to keep the price of securities high.¹²¹⁹ There is a positive correlation between market fluctuations and the price of securities.

IFIs can prevent the risk of mark-up through contracts because they will help banks to lessen the effect of future prices and market volatility. Futures contracts are not considered valid in Islam because it prohibits dealing in uncertain and risky transactions, but consideration about the future is not prohibited by Islamic law. The valuation of securities and commodities in accordance with predefined requirements is a good way to reduce the probability of risk. This is the best alternative to secure interests from future losses in the form of financial costs as the result of value changes.¹²²⁰ From the perspective of Ahmed and Khan, future contracts or dealings in a commodity at a future date is not allowed in Islam because Islamic financial law does not give permission to postpone a contract or deal for the buying or selling of a company at a future date. This can be permitted in Islamic banks on a large scale, which is not in current practice. This suggestion will help Islamic banks to extent the scope of contracts to ultimately contribute towards the stimulation of Islamic financing.

¹²¹⁹Taher, N. and Al-Hajjar, B. 2013. *Energy and Environment in Saudi Arabia: Concerns & Opportunities*. New York: Springer Science & Business Media.

¹²²⁰Andersen, T.J. and Schröder, P.M. *Strategic Risk Management Practice: How to Deal Effectively with Major Corporate Exposures*. London: Cambridge University Press.

Risk management through future contracts should be used to manage market fluctuations risks. The adoption of future contracts has been proved as a good start for Islamic institutions to combat currency risks that directly affect current commodity prices and mark-up margins.¹²²¹

Solutions for commodity risk

It is recommended that IFIs acquaint banking staff with the factors that cause extreme fluctuations in commodity markets such as strict regulations, the changing patterns of world trade, and geopolitical risks. A good knowledge of the factors underlying commodity risks would allow them to be managed proactively and more efficiently. Enhancing the knowledge of employees in the context of commodity markets and factors causing risks will help in performing tasks in the right way so that commodity risk exposure and its effect are prevented. Employees are involved in the processing of *Murabaha* transactions with the parties and thus knowledge enhancement in the context of commodity market fluctuations would help in avoiding dealing that may cause risk for banking institutions. In sum, greater employee knowledge about commodity risks would ensure they follow Islamic principles like the prohibition of *gharar*, or risky/uncertain transaction dealings.

Strict regulations on the movement of commodities from buyers to sellers across a location cause problems in the form of excise duties. It is necessary to consider the way and extent to which strict regulations cause fluctuations in the commodity market and their consequences. Similarly, global trade patterns create difficulties for buyers and sellers when dealing in commodity markets. A good knowledge of market trade will help to develop strategies that allow transactions to be carried out in commodity markets without any financial loss or problems. Market fluctuations in the commodity market can make it difficult to deal in commodities. All the factors that subject financial transactions to market risks must be considered deeply to prevent future negative consequences.

¹²²¹ Ahmed, H. and Khan, T. n.d. Risk management in Islamic banking. [Online]. Available at: http://www.isfin.net/sites/isfin.com/files/risk_management_in_islamic_banking.pdf [Accessed on: 21 November 2016].

Commodity risks impact banking institutions or financiers, as well as buyers, by creating a financial burden. Changes in commodity prices due to the abovementioned causes have a considerable impact on sustainability in the long run.

Commodity risks in *Murabaha* transaction can be mitigated through commodity bonds or loans. In the Islamic law, commodity bonds or loans are the only way of paying the principal with mark-up, instead of an amount of interest. Commodity bonds are interrelated with commodity prices in the two ways. One is the “loan or bond type whereby a repayment is made with the financial equivalent of a fixed amount of a commodity.”¹²²² The other is “as an option type, where the investor can choose whether to receive a fixed financial sum or the financial value of a fixed amount of a commodity.”¹²²³ The use of commodity bonds/loans option to deal with commodity risks is a kind of debt rescheduling, leading to improvements in creditworthiness and liquidity that plays a crucial role in short- and long-term sustainability.

The banking institutions that deal in *Murabaha* contracts can experience the advantage of a strong relationship with investors or clients because it enhances creditworthiness or credit-paying ability, which is the prerequisite to gain a debtor’s confidence in terms of the ability to pay debts on the due date.¹²²⁴ A hedging policy should be adopted as an alternative strategy to control commodity risks in the context of *Murabaha*, allowing banks to hedge the risk, even in a situation of market fluctuation. Hedging is the best course of action to deal with market fluctuation, which directly affects the functioning of transactions in the commodity market. Hedging can eliminate financial loss or risk due to unexpected changes in market actions and policies. It will help the parties to a *Murabaha* contract to hedge risks and will have a positive effect on the parties. Hedging will not eliminate and reduce risk in financial transactions, but reduces the probability of risk due to market fluctuations.

¹²²²Daniel, J. 2001. *Hedging Government Oil Price Risk, Issues 2001-2185*. International Monetary Fund. p.12.

¹²²³Ibid, p. 12.

¹²²⁴Ibid, p. 12.

Banking institutions are recommended to make use of commodity swaps to deal with this risk. In this option, the process of buying and selling should be carried out at the fixed rate, not for a single period but rather many periods in the near future. A commodity swap is a tool for managing risk through “exchanging a fixed price to a floating price.”¹²²⁵ The option of a commodity swap in Islamic financial transactions ensures income streams in the future with a high level of sustainability. Counterparties have the advantage of substantial credit exposure, which prevents other emerging risks like credit and liquidity risks. This option is different for future and forward contracts, which are recommended for managing other risks in *Murabaha* financing. Commodity swaps are suitable for many transactions, while future contracts or forward contracts deal only in one single transaction in the future. The swap option reduces the risk of income loss due to market variations to a large extent, with extensive credit coverage.¹²²⁶

Another effective solution to mitigate commodity risk is the formulation and implementation of a “comprehensive commodity risk management framework.”¹²²⁷ This framework must be used by banking institutions or contracting parties on a consistent basis to manage risks more substantially. It is recommended to cover wider aspects in the commodity risk management framework because more information in the framework helps to prevent commodity. This framework must cover constraints related to the market at the micro- and macro-economic levels, which will prevent rises in commodity risks due to market constraints.¹²²⁸ The main focus of this approach to comprehensive commodity risk is to trade off costs and risks when making a viable financial decision. The mitigation of commodity risk causes or associated factors will help in efficient financial decision-making in compliance with Islamic law.¹²²⁹

¹²²⁵Ibid, p. 12.

¹²²⁶Daniel, J. 2001. *Hedging Government Oil Price Risk, Issues 2001-2185*. International Monetary Fund.

¹²²⁷Yépez-García, R.A. and Dana, J. 2012. *Mitigating Vulnerability to High and Volatile Oil Prices: Power Sector Experience in Latin America and the Caribbean*. New York: World Bank Publications.

¹²²⁸Ibid, p. 139.

¹²²⁹Ibid, p. 139.

The above-mentioned solutions for commodity risk in *Murabaha* transactions have a high chance of being effective because they are aligned with the causes of commodity risks. All solutions, from the knowledge enhancement of employees to the formulation of comprehensive commodity risk management, are designed to mitigate the risks to the counterparties. The conclusion is, therefore, that the commodity risks of *Murabaha* transactions can be reduced efficiently through the correct application of the recommended solutions.

Solutions for operational risk

The management and mitigation of operational risk is also essential for IFIs to sustain their competitive position by high productivity, strong customer satisfaction, sound profitability, and low costs. One of the most efficient ways to control operational risk is to establish a system of regular internal assessment to identify any potential loopholes in the operation of the *Murabaha* transaction. Banking institutions should also formulate effective operational plans with clear definitions of roles, responsibilities and punishments to enhance their operational efficiency. It is recommended that banks direct the practices of their staff specifically towards their corporate objectives. Ineffective operations are the ultimate effect of poor operational policies and management, which in turn worsen productivity, profitability, and competitive ability. In short, the adequate functioning of any Islamic banking institution is directly associated with its operational efficiency.

The operational risk associated with *Murabaha* transactions should be controlled by an efficient schedule to avoid any kind of deferred issues during the operational processes. The use of electronic or online technology is a further measure that could be adopted by Islamic banks to mitigate operational risk effectively by facilitating information flow, while improving access to market information, thus bringing forward the required changes to the existing system. Recent technological advancements can help in reducing work complications for all parties involved. The adoption of technologies in Islamic banks would make operational processing faster and minimise manual errors that directly complicate

processing. Operational efficiency can be improved with newer technologies because it would be easier to compute the accurate mark-up margins involved in *Murabaha* financing.

Operational risk can be handled through the adoption of the new technology of “mobile communication,” which promotes interactive communication. The parties involved in the transaction can obtain a solution for any query or any other assistance within minutes. Mobile communication technology stimulates interconnectivity, making communication hurdle-free and minimising complications in terms of approaching concerned people using mobile technologies, Islamic banks could maintain continuous communication with counterparties and easily communicate messages related to changes and dues. Mobile communication technology gives counterparties the option to communicate through text and audio messages. The process of communication with counterparties would be made much easier through the adoption of mobile communication technology.

The provision of more frequent training opportunities could be another solution to control operational risk because it facilitates the alignment of human efforts with the strategic goals of Islamic banks. Training people can be an efficient initiative to deal with the issue of skills shortages and a lack of professional people. Training enhances people’s knowledge along with their confidence and in turn, contributes towards promoting quality and excellence of service. The probability of ambiguity and errors in the workplace is also reduced by the provision of training. Training employees is not only fruitful for organisations in terms of keeping service excellent, work productivity high, and error minimisation, but it will also contribute to employees’ self-interest and professional goals such as good appraisal and work performance and less defaults. Employees’ work-life balance can be improved through training because work burdens can be lessened by limiting the errors performed in the work process. Considered in total, this is a good solution that would direct employees’ actions in the direction of achieving success within their organisation and as an individual.

The contingency approach is another suggested solution to deal with operational risk because it can help in combating the effects of external events. The use of the contingency approach would be useful in the prevention of indirect losses such as market fluctuations, economic crises, and natural tragedies. The focus when adopting the contingency approach is to lessen the impact of risks at the high level so as to sustain the existing position. However, *gharar* is not permitted in Islamic banking transactions because there is a high possibility of uncertain risk in the deal, which negatively affects its current value and profits. In this situation, the contingency approach should be followed to deal with uncertain market risks at certain levels.

Operational risks in *Murabaha* transaction processing can be addressed by adopting standardised procedures. A standardised process helps banking staff perform their tasks in the correct manner because the possibility of complications and misconceptions is reduced. This would help in keeping check on mistakes and easily tracking the issues in the operational process because standardised processes involve step-by-step processes that ensure operational excellence. Standardised processes would be effective in managing employees' roles and actions and directing them towards the end goals, and the issue of the low availability of skilled and professional personnel. Training with standardised processes can be easily understood, without ambiguities and queries. Implementation of standardised processes and systems within Islamic banks would make operational processes faster and reduce the chance of errors.

The problem of shortages of skilled and professional people can be surmounted through effective retention policies. Retaining skilled banking employees is important to ensure that operations proceed in the right manner. In *Murabaha* transactions, the operational process is quite complex because the financier/bank and the buyers of a product initially enter into a contract. The contract is primarily to buy a particular product on behalf of the buyer from a seller by making a payment and in consideration to this, banking institutions obtain the product cost and a mark-up margin later. After, the financier/bank and the seller enter into a legal contract in which the seller

transfers the title of the product in the name of the bank after receiving payment and later, transfers the title of the product to the buyer. In this process, it is essential to maintain coordination among the counterparties, which can only be managed with support from skilled and knowledgeable staff.

Based on this evaluation, operational risk is extremely important in financial deals. An inefficient operational process results in a poor quality of service, client dissatisfaction, and lower productivity. Therefore, adoption of effective measures for to maintain operational efficiency in Islamic banks is important to mitigate errors directly related to operational processes.

Solutions for asset-loss risk

Asset-loss risk is critical when buying a product on behalf of the purchasing party. It can be mitigated by strictly following the principle of profit and loss-sharing in Islamic law. This can help banking institutions avoid asset-loss in the case of faults or damages during asset transitions. Profit- and loss-sharing would secure the interests of the buying party such as banks in *Murabaha* transactions. There can be a prior agreement with the party that asset-loss is not fully borne by a purchaser because the risk of asset-damage during the process is not the sole liability of only one party in the transaction.

Asset-loss risk can also be reduced by not taking possession of the product from the seller on behalf of the buyer. The banking institution can only make a payment for goods after transferring the title in the name of the banking institution. By doing this, both the buyer and seller are directly involved in transferring the good/products from the seller to the buyer. The asset risk during this process is not a liability of the financier or banking institution.

Asset-loss risk during *Murabaha* transactions can be obviated by taking out product or commodity insurance. This can help prevent damage loss sustained from assets through the provision of insurance coverage or claims. The burden of financial costs in terms of asset-loss or damage can be almost completely avoided through insurance. From my perspective, insurance coverage assists in minifying financial burdens in these situations.

Backing up assets can also be done to secure a bank against asset-loss. Any fault in the quality of the assets is not a liability of the financier or banking institution because the main deal in terms of the assets concerns the buyer and seller of the commodity. In this respect, this method is a good way to prevent asset-loss and its subsequent effects.

Asset-loss due to new developments that make products outdated can be mitigated through future contracts. Here, future contracts mitigate the gap in the present and future values of the product. Advances in technology are quite rapid and for this reason it is crucial to consider the costs and risks associated with such deals.

All the above-mentioned solutions can be easily adopted because they do not have complicated requirements. The proposed solutions for asset-loss such as equal sharing of losses, an insurance policy for asset-loss coverage, assets-backed securities, and future contracts ensure minimal financial burdens for banking institutions. In total, the risks of asset-loss depend on the contract terms and conditions between the bank and the buying party in the *Murabaha* transaction.

Solutions for market risk

Emerging market risks like market volatility and rapid fluctuations can be prevented by choosing the option of future and forward contracts. These contracts deal specifically with future deals because market stability is uncertain. Cost-risk frameworks or cost-benefit frameworks should be used to mitigate market risks because they will help in computing the probability of loss due to market risks. Securitisation and commodity swap bonds can also be used to mitigate the market risks facing *Murabaha* transactions.

5.4 Summary

This thesis has explored the risks affecting *Murabaha* contracts and their related causes and consequences. It has emerged from the analysis that Islamic

banks are exposed to different types of financial risks such as credit, liquidity, counterparty, and market risks. The solutions or courses of action proposed above would greatly support IFIs in mitigating the legal risks associated with *Murabaha* transactions. All these measures should be applied effectively and the results of their application carefully measured. The adoption of these recommendations would make it possible for IFIs to control the risks inherent in engaging in *Murabaha* transactions and reduce the likelihood of subsequent losses. Indeed, it is crucial for Islamic banks to mitigate or reduce their exposure to these legal risks in order to maintain strong and productive relationships with their investors in the long run.

The climate, in which the legal risks are understood, monitored, limited, and where possible eliminated will facilitate sustainable improvements in investors' confidence, thus helping to ensure the long-term competitive position of Islamic institutions in the competitive financial market. It can be concluded that the legal risks associated with *Murabaha* can be mitigated through solutions such as adopting a lender-of-last-resort facility, deposit protection systems, the implementation of legal reforms, and the establishment of liquidity management structures. Some of the risks of *Murabaha* financial transactions can be minimised by encouraging the parties to make payments in a timely manner, enforcing strict rules and regulations, and imposing heavy penalties. Finally, the maintenance of proper documentation and the establishment of strict credit limits are useful steps towards mitigating the risks affecting *Murabaha* financial transactions.

This chapter has reflected on the associated legal risks of *Murabaha* transaction and their causes and consequences. In addition, the findings provide useful ways to deal with legal risks affecting banking institutions that deal with Sharia-compliant products and services. Banking institutions assess the risks in *Murabaha* transactions that influence the contracting parties. On the basis of the research findings, it is concluded that the legal risks of *Murabaha* transactions can reasonably be controlled, and whether or not they are entirely avoidable can also be determined. The work conducted in this thesis

provides beneficial information for prospective investors to assess risks and returns and provides a basis to identify the benefits of making an investment in a *Murabaha* transaction. The associated costs in terms of risks and subsequent losses have also been analysed to provide recommendations about how to deal with different legal risks. It can be summarised that Islamic financial transactions, especially *Murabaha*, can efficiently comply with modern demands, meet investors' requirements, and avoid the legal risks currently associated with these transactions, by dealing with the causes of the risks. Effective dealing with the causes of and constraints to the risks affecting *Murabaha* transaction is required primarily to secure the interests of investors. Identifying and improving the existing formulation of the *Murabaha* laws to make them fit for the modern context is also needed urgently to maintain investors' loyalty and confidence in this transaction.

Based on the findings, it can be concluded that the *Murabaha* contract is not suitable for the contemporary world due to its antiquated format, which has not been updated. However, growth of Islamic finance keeps up demand of *Murabaha* financing. For this reason, *Murabaha* contracts need to be amended and updated, so that it has been implemented in respect to the requirements of the contemporary period. *MurabahaMurabaha*. This will require developing a new version of the *Murabaha* format by the Sharia Board to lessen and mitigate the legal risks associated with the contract that have an impact on the involved parties.

Annexes

Annex 1

TRANSLATION

IN THE NAME OF GOD THE COMPASSIONATE THE MERCIFUL



Re: Adoption of Profitable Resale & Its Models

Enclosures: 6

Decision of the Legitimate Committee No. (34)

Thanks be to God Almighty, and prayers and peace be upon our Prophet Muhammad and all His relative and companions, and further:

The Legitimate Committee of Bank Albilad, in its meeting (the twenty-third after the bicentennial) held on Monday 24/07/1426A.H., corresponding to 29/08/2005A.D., in the city of Riyadh at the headquarters of the bank, has viewed the final version of Adoption of Profitable Resale & Its Models presented by the banking group of companies.

After deliberation, discussion, and viewing the “Rules of the Profitable Resale Contract” issued by the Legitimate Committee in Decision No. (15), and studying models of “Request for Profitable Resale,” “Pledge of Purchase,” “Sale Contract,” and the remaining models related to “Profitable Resale,” as well as carrying out the necessary amendments relating thereto, from the seventy-five after the century, held on Saturday 04/05/1426A.H. to the seventy-eight after the century held on Tuesday

07/05/1426A.H., the Committee decided on its permission in the format attached to the decision, and stresses the importance of commitment to “Rules of the Profitable Resale” issued by the Legitimate Committee in Decision No. (15), and “Rules of Credits & Collection” issued by the Legitimate Committee in Decision No. (48).

May God grant success to all and make the work to His satisfaction, with God’s knowledge, and prayers be upon our Prophet Muhammad and His relatives and companions.

The Legitimate Committee

Dr Abdullah Bin Mousa Al Ammar (Member); Dr Abdul Aziz Bin Fozan Al Fozan (Member)

(Signature)

(Signature)

Dr Yousif Bin Abdullah Al Shibaili (Member); Dr Mohammed Bin Saoud Alusaimi (Member &

Secretary)

(Signature)

(Signature)

(Four signatures)

PO Box 140, Riyadh. (11411)

Kingdom of Saudi Arabia

Tel: (+96611) 291 888

Fax: (+96611) 291 5101

***This translation has been done to the best of our knowledge and ability of
the
Bank Albilad letter re. Decision of Legitimate Committee Decision No. (34).***

Translation by:

Layla S. Ghannam

Tel: 07939 450 833

Annex 2

TRANSLATION



**Under incorporation
Shari'agroup**

Founder working group

IN THE NAME OF GOD THE COMPASSIONATE THE MERCIFUL

REGULATIONS OF THE PROFITABLE RESALE CONTRACT

Terminology:

- **The first seller:** The seller to the bank, who might be the exporter of the goods in external contracts.
- **The committed topurchase:** The client, or claimant of goods, ordering the purchase.
- **Second seller:** The bank
- **Phase of promise:** Starts at the client's order to purchase the goods, until the bank's purchase thereof.
- **Phase of ownership:** Starts at the bank's purchase of the goods until the client's sale thereof.

- **Phase of sale:** Starts at the bank's sale to the client until settlement of the instalments.

Phase of commitment to purchase:

- The bank may purchase the goods based on the request by its client, as long as this is in compliance with the Sharia regulations of the sale contract.
- The party committed to purchase may request the bank to buy the goods from a specific source only, and the bank has the right to apologise to process the transaction in the event of the client's refusal of other, more suitable, offers by the bank.
- The party committed to purchase has the right to give specifications about the goods to be bought by profitable resale due to the fact he is the party who will eventually purchase the goods by profitable resale.
- The bank may make documentary credit in the form of profitable resale for the party ordering the purchase, and enter into partnership with the applicant for the credit in the part that is not covered upon establishment of the credit.
- The bank may not establish documentary credit based on the client's request and account and then, upon arrival of the goods in the name of the client who imported them, exchange the previous credit for profitable resale.
- One document may be prepared and duly signed by the client that includes the desire and promise to purchase, and there is no

objection to it being a request that depends on the bank and is signed by the client.

- **The promise document should not cover or hold a provision for a binding promise for both parties or one thereof.**

(Four signatures)

Tel: (+96611)2730054; Fax: (+96611) 2730057; PO Box, 301701, Riyadh.

11373

- **The bank should not obtain a binding undertaking from the client to purchase the goods, or an agreement that determines the profit ratio in the profitable resale contract prior to signing the contract or a similar document with a binding description.**
- **The client may receive offers of prices for goods, whether addressed to him personally or not addressed at all, which would then be considered directional and not an acceptance. It is preferable for these offers to be in the bank's name in order for them to be considered an acceptance from the seller, which would then remain valid until the end of the specified period. If an acceptance is issued by the bank, then the sale is automatically contracted between the bank and the seller.**
- **If the client issues a response of acceptance to the seller's first response, whether addressed to him personally or not addressed at all, the bank would therefore not have the right to carry out the profitable resale procedure to the party ordering the purchase.**

- **Any previous contractual correlation between the client ordering the purchase and the first seller, if any, must be cancelled, and this dismissal by the two parties must be genuine and not fictitious. The contract concluded between the client and the first seller must not be transferred to the bank.**
- **There should not be a deferred profitable resale procedure in gold, silver, or currency.**
- **It is not permissible to issue cheques that are negotiable for debts of the profitable resale or others, if the substitute of these cheques derives from credits. However, if it is for the purchase of goods, then it is permitted.**
- **Renewal of the profitable resale of the same goods is not permissible.**
- **The bank and the client ordering the purchase after the promise and prior to conclusion of the Profitable Resale Agreement can amend the clauses of the promise from what they were, whether for the purpose of profit or another purpose.**
- **In the event of the bank fearing that the client will purchase, then the bank may purchase the goods optionally, to be able to return the goods when necessary.**
- **The client may not be granted an authorisation to purchase on behalf of the bank and sell the same to himself with an agreed profit within a maximum limit, which is known as a rounded profitable resale.**
- **The bank may notify its client at the start of the dealing that the client**

would obtain a profit at such-and-such a rate during the period of the promise.

- The bank can enter as a partner with the client for the purchase of certain sold goods, and there is no objection to the bank selling its share as a profitable resale to the client after finalising the purchase by the two partners and the receipt of the dividends.
- Agreement is permissible between the bank and the client to enter into partnership in a project or a specific deal with the promise from each to the other – a non-binding promise – to purchase the other's share on a date after the current or deferred profitable resale, at the market price, or for an agreed amount, subject to this being in a new contract.

The specimen in the profitable resale

- The bank may not purchase the goods from the party promising the purchase and at the same time sell them to that party by a profitable resale at a higher price, because this is legitimately forbidden. The bank needs to ascertain that the first buyer is a third party, and not the client or his agent. If the first seller happens to be the client or his agent, then the sale becomes void.
- There may not be a conversion to sell the goods, such as the client's establishment or his company being in the name of his wife or a relative, such as his son, his father, or brother, when it is in reality owned by the client himself, in which case the bank may not sell what was bought from the client if that is known to the bank, whether by profitable resale or partnership. On the other hand, if that company or establishment is wholly or partially owned by a relative,

then there is no objection to the bank selling to the client's relative, because the pact of each party is independent from the other, and thus the conversion is no longer required.

- If the party from whom the bank will be buying the goods is partially owned by the ordering body or not, or the ordering body is partially owned by the buyer, then the following will be considered:

- If the purchase order does not indicate that the goods should be bought from a specific company, then the bank may purchase the goods from any company, even if the ownership of the ordering party represents the majority, or if the selling company itself owns the majority of the ordering company because the possibility of a complicity would then be negated.

(Four signatures)

Tel: (+96611)2730054; Fax: (+96611) 2730057: PO Box 301701, Riyadh, 11373

- Otherwise, if the ordering party indicates the goods are to be purchased from a company partially owned by the ordering party, if that party has a small percentage of the company, but not reaching one half, then similarly to any shareholder requesting purchase of the goods from a company in which he holds shares, there is no prohibition on it because the possibility of the complicity is very limited. However, if he has a majority of shares or vice versa, the transaction would then be illegitimate due to the possibility that the target is financial improvement and not related to the goods. In the exceptional circumstances that the goods in the required specifications are only available at that particular company, then the purchase is allowed for those particular goods.

- The bank may not enter into a profitable resale arrangement if complicity of any type is clear between the purchase-promising party

and the seller.

- The sample legitimately forbidden is materialized if the seller is an agent of the party promising the purchase because a purchase from the agent is the same as a purchase from the originator himself.

Commissions and expenditures:

- It is not legitimate for an agreement to be entered into by the bank and the client to charge correlation commission, which is whether the bank grants facilities for the client to finance the profitable resale under a specific cover, and the client does not use the whole cover, and the bank then takes from the client an agreed percentage for non-use.
 - If profitable resale by the party ordering the purchase is completed by way of collective funding, then the bank that is organising the transaction can charge a fee thereof, which the participants in the finance should bear.
 - The party promising the purchase should be charged with any of the expenses and commissions relating to the letter of credit in the case of the original seller not implementing his commitments.
 - The bank is not to obtain from the client an undertaking for the addition of an unknown matter for the price of the goods after signing the contract because this would entail ignorance of the price, which is legitimately not permitted.
 - The bank has no right to deduct the additional expenses of the contract from the client's account without his notification and acceptance.

The goods in the profitable resale:

- **The bank should ascertain that the goods being sold by profitable resale are legitimately permitted, because it is not allowed to enter a profitable resale for items such as alcohol, forbidden sacrifices, pigs, statues, and others.**
- **The goods promised to be bought by profitable resale may be shares in a company, subject to their compliance with the permitted shares regulations.**
- **The goods promised to be bought may be moral rights, such as a trade name, trademark, ingenuity invention, and others, because these are legitimate, can be dealt with, and can be transferred by offers.**
- **The profitable resale may be in benefits where the bank rents the benefit then sublets the same to the client with additional information.**
- **The goods of the profitable resale cannot be charges for separate services, such as charges for commissions, insurance, and transport, because they are not supposed to be items for sale. On the other hand, this could be the case if the service charges were included in the price of the goods.**

The guarantees relating to the commencement of the transaction:

- **The bank cannot hold the client responsible for bearing risks for the goods he ordered for purchase, and not accept an undertaking from him.**

- **The client who ordered the purchase cannot be responsible for bearing guarantees for damages or destruction incurred on the goods during the shipping or storage period.**
- **The bank cannot take from the client, in any manner, any cash sum at the stage of the promise, whether on the margin of seriousness, as an advanced guarantee payment on account of the price of the goods that the client will purchase, as a deposit, or any other cash sum.**
- **The bank cannot take from the client promissory notes or deed orders.**

(Four signatures)

Tel: (+96611)2730054 Fax: (+96611) 2730057; PO Box 301701, Riyadh. 11373.

- **The bank can request the client who is ordering the purchase to transfer his salary to the bank during the period of the promise, on the condition that that salary does not remain with the bank for a specific period prior to the purchase of the goods.**
- **The bank can request the client who is ordering the purchase to provide a guarantor during the period of the promise, subject to binding this guarantor with the sale of the goods to the client and ascertaining the debt to be due to him.**
- **It is permitted to speed up submission of the guarantees in the promise period, such as a warranty, mortgage or other, subject to it not being used until the profitable resale contractis signed.**

Ownership phase:

- **The bank cannot sell goods in a profitable resale prior to its ownership thereof. The signing of the profitable resale contract should not take place prior to contracting the first buyer for the purchase of the profitable resale goods and taking into possession the goods in reality, or by a judgment empowerment, or handing over the documents authorising the takeover. The sale by profitable resale is considered illegitimate if the first purchase contract is void and unsuitable to be an estate of the bank.**

- **The contract between the bank and the seller can take place via a meeting of the two parties and concluding the sale contract, directly after negotiation of its details. It is also permitted for the contract to be concluded via two notices of mutual affirmation and acceptance in writing or through correspondence in any manner of modern communication commonly used according to its known rules.**

- **Originally, the bank itself should purchase the goods directly from the seller, and it is also permitted to do this through an agent other than the party ordering the purchase.**

- **The bank cannot authorise its client in the purchase to sell the profitable resale to the party ordering the purchase.**

- **The two parties can come to an agreement, upon the authorisation of the bank to others to purchase the goods, for the authorisation not to be public, so that the agent can act as an interent before the other parties, and also to manage the purchase directly in his name, but for the benefit of the bank, the authoriser; however the disclosure of the agent in his real capacity is best.**

- **The sale does not have to be registered in the bank's name because the ownership of the sale is transferred to the bank by the contract and does not need to be registered, which is merely a legal procedure to confirm the contract.**
- **The documents, contracts, and paperwork, which are issued upon conclusion of the sale contract, are not to be in the name of the client. However, the client's name can be mentioned in the shipping policy, together with the name of the bank or its agent as a precautionary measure.**

The bank's receipt of the goods

- **The bank's receipt of the goods needs to be checked as being a genuine procedure or through a judgment prior to the bank selling the same to its client by profitable resale from the party ordering the purchase.**
- **The guarantee is transferred from the first seller to the bank by receipt or by enabling the same. The separation point at which the goods' guarantee is transferred from the first seller to the bank and from the bank to its agent should be clarified during the period of the transfer from one party to the other.**
- **The method of receipt of items can vary according to their condition and the different traditions relating to its receipt. Just as the receipt can be physical, by accepting it by hand, or transporting or transferring it to the recipient or his agent, it can also take the form of a judgement and intention, together with the ability to act accordingly, if there is no sense of receipt of the portables, if any.**

- A receipt by judgment of the bank of its agent of the shipping documents upon purchase of the goods from the foreign market, as well as its receipt of the storage certificates which designate the goods from the stores –a procedure that needs to be carried out by suitable and reliable methods.
- Sorting out the goods bought by the bank at the seller's storage facilities in a specific manner means that it is considered that they have been correctly received, if one of the following matters has been observed:
 - If the sorting procedure is previewed by a bank delegate.
 - If the bank receives documents to prove its ownership of the sorted goods.

(Four signatures)

Tel: (+96611)2730054; Fax: (+96611) 2730057; PO Box 301701, Riyadh. 11373

- If the goods are numbered, which numbers of the sorted goods are registered in favour of the bank.
 - Originally, the bank itself should receive the goods from the seller's stores or from a place specified in the delivery terms. The bank can also authorise someone other than the first seller and the party ordering the purchase to carry out that procedure on its behalf.
 - Insurance for the goods of the profitable resale is the responsibility of the bank in the ownership phase, which it carries out at its own expense as the owner of the goods. The bank is also responsible for

the risks incurred relating thereto, and the compensation, if any, goes to the bank alone, to which the client has no right prior to the transfer of ownership to the client. The bank has the right to add the expenses to the sale cost afterwards, and then to the price of the profitable resale, subject to the insurance being cooperative.

Sale phase:

- **The bank has to conclude a profitable resale contract separately to the promise to purchase, which should not be considered a bargain sale.**
- **The bank should not make the profitable resale contract automatically concluded by merely owning the goods; the bank is also not to bind the client who is ordering the purchase to receive the goods and settle the price of the profitable resale in the event of his refraining from concluding the profitable resale contract.**
- **The bank can disclose the price of the goods and its profit in the profitable resale to the party that ordered the purchase, subject to the total price of the goods being specified and known to the two parties when signing the sale contract. It is not permitted in any way to link the determination of the price or gain in a future order, such as an indication of (libor) or (sibor). There is no objection to mentioning the indications known during the promise phase to be used in determining the rate of profit, subject to the profit being specific, and when the profit does not remain linked to the indication or the time.**
- **The bank and the client who is the party pledging the purchase upon conclusion of a profitable resale contract are to agree on amendments to**

the contract articles away from what was agreed on in the promise, whether in relation to the term, profit, or other.

- **Agreement can be reached for settlement of the goods' price in the sale of the profitable resale for the party ordering the purchase, in convergent or spaced instalments, when the goods' price becomes a debt due by the client and should be settled at the time agreed upon. It is not permitted to request an increase later due to an increase in the term or lateness, with or without a reason.**
- **The bank can give a condition to the client, in the profitable resale contract, that in the event of his receipt of the documentation relating to the subject goods, the guarantee for the goods are transferred to the bank, merely by the contract. The bank can also prove to the client an option of deficiency in the description, if such a description appears to be in breach of the documentation.**
- **A term can be determined in the profitable resale contract to release the bank from the responsibility of a hidden defect – which is known to the bank upon sale –called a “sale of quittance.”**
- **If the bank does not condition its quittance from old hidden defects which appear after the contract, then its responsibility is limited to the old hidden defects, without the occurring ones.**
- **The bank can condition the client that if the client refrains from taking over the goods on the specified date after the conclusion of the profitable resale contract, then the bank has the right to terminate the contract or sell the goods on behalf of the client for his account and charge the costs from the price, after which the bank will reimburse the balance, if the price is not sufficient.**

Guarantees of the profitable resale and handling debts:

- **The bank can condition the client to accept the occurrence of due instalments prior to their maturity if the client does not settle the instalments without an appropriate reason. The bank must disclaim, on this occasion, part of the entitlements, subject to not being conditioned in the contract.**

- **The bank can request that the client guarantees are legitimately indicated in the profitable resale contract of the party ordering the purchase, such as a third-party guarantee, or a transferred promise or property of the client, despite the pledge being a sum in a current or an investment account, or the pledge being goods, subject in the contract, whether the pledge is occupational or official without occupation. The pledge needs to be gradually resolved in accordance with the rate of settlement.**

(Four signatures)

Tel: (+96611)2730054; Fax: (+96611) 2730057; PO Box 301701, Riyadh. 11373

- **The bank can request the client to present cheques or bonds on order after conclusion of the profitable resale contract of the party ordering the purchase, as a guarantee for the debt, subject to the text indicating that the bank has no right to use the cheques or bonds, only on the due dates of the debt, despite the cheques and bonds being due.**

- **Transfer of ownership of the goods to the client cannot be**

conditioned until after settlement of the price; thus, it is permitted to postpone registration of the goods in the name of the client who is purchaser, as a guarantee for settlement of the price, and the bank has to give the buyer a reversed bond to confirm its ownership of the goods.

- The bank can, in the event of obtaining a pledge from the client, condition it being authorised to sell the pledge for the purpose of settlement from its price, without reverting to the judiciary, in the event of the client's delaying settlement and his failure to handle the sale of the pledge himself.
- The bank can state in the profitable contract of the party ordering the purchase that it has the right to claim from the client an increase in the pledge in the event of a decrease in the price of the pledge to the debt remaining due to him.
- The bank cannot condition the client to pay a penalty in the event of his lateness in settlement, whether such a penalty was determined upon conclusion of the contract, or was agreed based on its estimate upon occurrence of the damage, and whether the client was insolvent or delayed.
- Postponement of the date for settlement of the debt is not permitted against an increase in its value – scheduling of the debt – whether the client was solvent or insolvent.
- The financing bank can bind the procrastinate client to bear all the actual expenses paid by the bank for extracting the debt.
- The bank can disclaim part of the price upon the buyer's expediting

settlement of his obligations if it was not accordance with a condition agreed on in the contract.

- Rescheduling the debts can take place without an increase if it was in the same currency. If it was in another currency, then it is totally forbidden.

THE LEGITIMATE COMMITTEE

Dr Abdullah Bin Mussa Al Ammar (Member)
Fawzan Al Fawzan (Member)
(Signature)

Dr Abdul Aziz Bin
(Signature)

Dr Yousif Bin Abdullah Al Shibaili (Member)
Saud Al Ussaimi (Member &
(Signature)

Dr Mohammed Bin
Secretary)
(Signature)

Tel: (+96611)2730054; Fax: (+96611) 2730057; PO Box 301701, Riyadh. 11373

***This translation has been done to the best of our knowledge and ability of
the
Founder Team Document.***

Translation by:

Layla S. Ghannam

Tel: 07939 450 833

Please accept our sincere greetings,

Director of the Property Investment Authority

Promotion of completion of request:

Signature of the director of the Procedures Support Authority

This specimen is resent after completion of the required action to the Property Finance Authority by Fax No. 4798118.

(Six signatures)

This translation has been done to the best of our knowledge and ability of the letter to the director of the Support Procedures Authority.

Translation by:

Layla S. Ghannam

TEL: 07930 450 033

Annex 4

TRANSLATION



Date: / / **AD**

Specimen No. 2

No.:

Messrs / (Name of Property Estate Agent)

Re: Evaluation of property

Peace and God's blessings be upon you, and further:

Approval has been given by us for the purchase and sale of plot of land no. , block no. , of plan no. , district , (a copy of the deed is enclosed),

We kindly request you to evaluate the above-mentioned land and advise us of the outcome of your evaluation, as per the specimen relating thereto.

Please accept our sincere greetings,

Director of the Credit Control Authority

(Six signatures)

***This translation has been done to the best of our knowledge and ability of
the***

letter to the Property Estates Agents

Translation by:

Layla S. Ghannam

Tel: 07939 450 833

Client's share	
Bank's share	
Profit margin (% decremental)	
Total profit	
Total indebtedness	
Method of payment	
Value of instalment	
Date of firstinstalment's maturity	
Date of Instalment maturity	

Please accept our sincere greetings,

Director of the Property Finance Authority

(Six signatures)

This translation has been done to the best of our knowledge and ability of the second letter to the director of the Credit Control Authority.

Translation by:

Layla S. Ghannam

T. L. 07030 450 033

We authorise you to deduct the advance payment (participation share) in the above-mentioned amount from our account at Bank AIBilad No.

.

Please accept our sincere greetings,

Name:

Signature:

(Six signatures)

This translation has been done to the best of our knowledge and ability of the

third letter to the director of the Credit Control Authority.

Translation by:

Layla S. Ghannam

Tel. 07030 450 033

Please accept our sincere greetings,

Director of the Property Finance Authority

Promotion of completion of request:

Signature of the director of the Procedures Support Authority

This specimen is resent after completion of the required action to the Property Finance Authority by Fax No. 4798118.

(Six signatures)

This translation has been done to the best of our knowledge and ability of the

fourth letter to the director of the Credit Control Authority.

Translation by:

Layla S. Ghannam

TEL: 07930 450 033

Retrieved profit	
Balance of indebtedness	

We therefore expect settlement of the balance amount of the client's indebtedness and advise us thereof via the enclosed specimen.

Please accept our sincere greetings,

Director of the Property Finance Authority

Promotion of completion of request:

Signature of the director of the Procedures Support Authority

This specimen is resent after completion of the required action to the Property Finance Authority by Fax No. 4798118.

(Six signatures)

This translation has been done to the best of our knowledge and ability of the

fifth letter to the director of Credit Control Authority.

Translation by:

Layla S. Ghannam

T. 07000 450 000

Annex 9

TRANSLATION



Date: / / **AD**

Specimen No. 10

No.:

The Respected / Director of the Credit Control Authority

Re: partial settlement of property indebtedness

Peace and God's blessings be upon you,

**As per the approval of the Credit Committee by decision no. dated
on the purchase and sale (jointly) of the plot of land in favour of the client
, for the sum of
Riyals,**

**and because the client wishes for partial settlement of the indebtedness of
the financed property to the sum of
Riyals, and for it to be deducted from his account no. :**

**, we therefore request payment of the above sum from the client's account
and to promote the same to us for completion, as well as to advise us of
the remaining amount of the client's indebtedness after settlement.**

Please accept our sincere greetings,

Director of the Property Credit Authority

Promotion for completion of the request:

The deduction has been made as mentioned above, and the calculation of the balance of the client's indebtedness been calculated in Riyals to be settled consecutively in instalments, the first instalment being due on and the final instalment on .

Director of the Procedures Support Authority

This specimen is resent after completion of the required action to the Property Finance Authority by Fax No. 4798118.

(Six signatures)

This translation has been done to the best of our knowledge and ability of the sixth letter to the director of Credit Control Authority.

Translation by:

Layla S. Ghannam

TEL: 07030 450 033

Riyals) to be paid on _____, and this is our confirmation thereof.

Please accept our sincere greetings,

Director of the Property Credit Authority

(Six signatures)

This translation has been done to the best of our knowledge and ability of the letter re. Partial Clearance.

=====

Translation by:

Layla S. Ghannam

Tel. 07020 450 833

Annex 12

TRANSLATION



Notification of the arrival of goods

promised for purchase

The Honourees,

God's peace, blessings, and mercy be upon you:

With reference to your pledge of purchase on / / in respect of the goods from the exporter , and whereas:

the mentioned goods in their relative specifications have arrived on / / as per bill of landing no.

atport / airport on steamer / airline

(For credit of external profitable resale)

the mentioned goods have been handed over to warehouse as
per delivery note / bill
no.

(For credits of external profitable resale)

They are ready to conduct the profitable resale contract with you for the price specified in the "Statement of Cost of Goods" relating thereto, after which they will be handed over to you.

Kindly contact us as soon as possible in order to carry out the necessary steps.

Please accept our sincere greetings,

Clerk in charge
Director of centre

Seal of centre

(Four signatures)

Bank: AlBilad Saudi Joint Stock Company, Capital SR 3,000,000,000,
Commercial Reg. No. 1010208295, Head Office:
PO Box 140, Riyadh, 11411. KSA.

***This translation has been done to the best of our knowledge and ability of
the***

notification of the Arrival of Goods Document.

Translation by:

Layla S. Ghannam

TEL: 07030 450 833

Annex 13

TRANSLATION



Statement of Cost of Goods of

Profitable Resale

The Honourees,

God's peace, blessings and mercy be upon you:

Our Reference: Request for Profitable Resale on / /

Below are the detailed particulars of the clarification of the mentioned profitable resale, as well as the value of the bond due for settlement on / / .

Particulars	???	Riyals
Cost of documentation	Costing:	
Expenditures		

Insurance	
? Issue of credit	
? Telex	
? Post	
? Amendment	
Cost of goods	
(X) Rate of profit	% for a period of
Total value of sale of goods	

Bond no. in favour of:	Date of entitlement	Amount of bond in favour of:

Kindly peruse the above particulars and adhere to the date of settlement for the amount of the bond on the due date.

Clerk in charge	Seal of centre
Director of centre	

**Bank: AlBilad Saudi Joint Stock Company, Capital SR 3,000,000,000,
Commercial Reg. No. 1010208295, Head Office:
P O Box 140 Riyadh 11411, KSA.**

(Four signatures)

***This translation has been done to the best of our knowledge and ability of
the***

particulars of the Cost of Goods Document

Translation by:

Layla S. Ghannam

Tel: 07939 450 833

Annex 14

TRANSLATION



Partial

clearance

**The
(The client)**

Honourees,

God's peace, blessings, and mercy be upon you:

With reference to bond no. _____ issued on _____ to the sum of _____
which is due for payment on _____ withdrawn from the Honouree
in favour of Bank AlBilad.

We ratify by this clearance document that the sum of _____ (only
Riyals) has been settled from this bond in our favour and deducted from your current
account no. _____ from our branch _____ .

Therefore, the remaining balance of the bond ordering the settlement is
(only
Riyals), which is due for settlement on _____

This is our ratification for the above.

Issued on _____ / _____ / _____ .

Clerk in charge
Director of centre

Seal of centre

Bank: AlBilad Saudi Joint Stock Company, Capital SR 3,000,000,000,
Commercial Reg. No. 1010208295, Head Office:
PO Box 140, Riyadh, 11411. KSA.

(Four signatures)

*This translation has been done to the best of our knowledge and ability of
the*

Partial Clearance Document.

Translation by:

Layla S. Ghannam

Tel: 05330 450 000

Annex 15

TRANSLATION



Particulars of Property & Statement of Prices

Specimen no. 1

Particulars of property

**No. of deed
issue**

Issued by

Date of

**City:
street**

District:

Name of

Block:
sq.m

Plot no.

Area in

Particulars of estate

Name of owner	Percentage of ownership	Identification no.
1.		
2.		
3.		
4.		
5.		

Value of the property

Value of the property in numbers	
Value of the property in words	

Fees for the pursuit:

Total cost of pursuit:

We, acknowledge:

Name	Percentage	Cost of pursuit (Riyals)
1.		
2.		
3.		

That we are the only beneficiaries of the pursuit of the property at the percentages and value referred to above, and we bear the responsibility for any beneficial claim issued by other parties.

Name:

Signature:

Date:

(Six signatures)

***This translation has been done to the best of our knowledge and ability of
the
Particulars of Property & Prices.***

Translation by:

Layla S. Ghannam

TEL: 07030 450 933

Annex 16

TRANSLATION



Promise for purchase

Thanks be to God Almighty, and prayers and peace be upon our Prophet Muhammad and all His relative and companions, and further:

On the day / / , corresponding to / / , in the city of , an agreement was concluded between each of:

1. Bank AlBilad, a Saudi joint stock company, Trade Register No. 1010208295 issued on 10/03/1426 AH, its address: Riyadh PO Box 1404, Riyadh, Postal Code 11411, Telephone 479888, Fax 4798898

Represented in this agreement by Mr , in the capacity of first party, referred to hereafter as (Bank)

2. Company/Establishment , established in accordance with the regulations in force in , according to Trade Register No. , issued on / / , its headquarters being , its address: PO Box , Postal Code , Telephone , Fax

Fax _____, represented in this venerable pledge
, in the capacity of _____, Status/Residence card no. _____, issued
on _____

_____ second party, referred to in this
pledge as (client)

Preface:

Whereas the client applied to the bank for a request to purchase the item described in the attached (Request for Profitable Resale) dated ____ / ____ / _____, and the client promising the bank the purchase according to the following:

First: Rate of Profitable Resale

The client promises the bank to purchase the item described in the (Request for Profitable Resale) after its possession by the bank at the actual cost which is borne by the bank in addition to a profit at the rate of ____% of the mentioned cost.

Second: Expenses, Losses, and Damages

- The bank bears any expenses, losses, or damages relating to the item until sale to the client. The client is not to bear any of these prior to signing the sale contract.
- The bank is not to be responsible for any losses or damages incurred by the client in the event of the bank's failure to provide the item requested by the client, because it was merely a pledge between the two parties and is not binding for them.
- The client bears all losses and damages incurred by the bank in the case of submitting incorrect particulars, information, or documentation.

Third: Undertakings

- The client undertakes not to own a company or an establishment (exporter/seller) or any part of which exceeds 30% of its capital.
- The client undertakes non-existence of any contract between him and (exporter/seller) for purchase of the item pledged to be bought profitably, whether via written, verbal, or other. The client will bear full responsibility and expenses if it proven otherwise.

(Four signatures)

**Bank: AlBilad Saudi Joint Stock Company, Capital SR 3,000,000,000,
Commercial Reg. No. 1010208295, Head Office:
PO Box 140, Riyadh, 11411. KSA.**

- The client promises to approach the bank for the purchase of the item and to sign the sale contract within a period not exceeding three working days from the date of notification, otherwise the client will be considered in breach of the promise and the bank will be able to deal with the item pursuant to the interest of the bank.

Fourth: Notifications and notices

- 1- The address indicated at the start of this pledge for each party is the formal address.
- 2- All notifications and correspondence between the parties are to be despatched via fax, personal hand delivery, or any method adopted by the bank, to the addresses indicated at the start of this pledge, unless otherwise agreed in writing.
- 3- The client undertakes to notify the bank in writing in the event of any change in its addresses indicated to the bank.

Fifth: Reference of litigation

- This pledge is subject to and interpreted in accordance with the provisions of the Islamic Sharia, Regulations and Rules in force in the Kingdom of Saudi Arabia.
- The documentary credits, if any, which are established pursuant to this pledge are subject to the uniformed assets and practices of the amended documentary credits in (1993A.D.) Issue (500), and the subsequent amendments not contrary to the provisions of the Islamic Sharia.
- In the event of a dispute or controversy between the parties, God forbid, it should be resolved amicably.
- In the event of an amicable resolution, arbitrament in the dispute is to be carried out by the Sharia courts in the Kingdom of Saudi Arabia.

Sixth: Copies of the pledge

This pledge has been issued in two identical copies, each of which has been signed by both parties and handed over to them.

Blessings and peace be upon our Prophet Muhammad and all His relatives and companions.

First party (Bank)

Second party (Client)

Represented by:

Represented by:

Signature:

Signature:

(Four signatures)

**Bank: AlBilad Saudi Joint Stock Company, Capital SR 3,000,000,000,
Commercial Reg. No. 1010208295, Head office:
PO Box 140, Riyadh, 11411. KSA.**

***This translation has been done to the best of our knowledge and ability of
the***

Promise for Purchase Document

Translation by:

Layla S. Ghannam

Tel: 07939 450 833

Annex 17

TRANSLATION



Specimen No. 8

Request for Early Settlement

With reference to the Contract of Property Sale dated / / A.D., I advise you of my wish to settle all my indebtedness incurred by this contract, and kindly request you to put aside part of my indebtedness upon my notification thereof.

Client:

Name:

Signature:

Date: / / A.D.

For the use of the Banking Group for Companies

Date: / / A.D.

() We have no objection to accepting the early settlement and advise you that you have to settle

Riyals.

() We refuse your request

Specialised clerk:

Name:

Signature:

Director of Property Finance Authority:

Name:

Signature:

Director general of the Banking Group for Companies:

Name

Signature:

For the use of the client in the event of the authority's approval of his request:

I agree, subject to deduction of the requested sum for early settlement from my account to your bank no.: **Branch:**

I do not agree, and shall continue settlement of the indebtedness as per the contract.

Name:

Signature:

This specimen is resent after completion of the required action to the Property Finance Authority by Fax No. 4798118.

(Six signatures)

This translation has been done to the best of our knowledge and ability of the

Request for Early Settlement Document.

Annex 18

Translation by:
Layla S. Ghannam
T. 07030 450 833

TRANSLATION



Request for

Profitable Resale

The Respected Director of Bank Al Bilad Branch,

Greetings,

**We, company/establishment:, of:,
operating in the field of:,
and in our capacity as one of your clients, we request purchase of the
items specified below, and undertake to purchase them from you after your
receipt and arrival of the same in accordance with the documentary credit
agreement in the format of the profitable resale applicable by yourselves.**

Please accept our greetings,

Payment terms:

At Sight

Shipment date

Other

At () Days from

Negotiation date:

Beneficiary (Name and address)

To be established by:

Courier

Full

Brie

Transmission

Transmission

Date of expiry:

(Please indicate exact date)

Place of expiry:

Advising bank

Currency and amount

not

Toleranc

exceeding

In figures:

In words:

All banking charges outside KSA / opening bank are for account of:

Applicant

Beneficiar

Partial shipment/deliveries

Not allowe

Allowed

Transshipment

Not allowe

Allowed

Presentation of documents () days from

Shipment date

Others (specify

Credit is to be:

Revolving

Standb

Confirmed

Transferable

Confirmation

Not required

Required

Instructions:

Charges are

For the account of:

Applicant

Beneficiary

Shipment By:

Sea

Air

Please specify

Other

Truck

From

To

Latest date of shipment

(Please indicate exact date)

Trade term

CIF

FOB

Others

CF

(Please specify)

Goods (brief description without excessive details):

**Bank: AlBilad Saudi Joint Stock Company, Capital SR 3,000,000,000,
Commercial Reg. No. 1010208295, Head Office:
PO Box 140, Riyadh, 11411. KSA.**

(Four signatures)

Documents required:

Si Signed invoice(s) in triplicate, one of which must be certified by _____ and legalised by _____

Ce Certificate of _____ origin in triplicate, one of which must be certified by _____ and legalised by _____

.

Packing lists i

Certificate of weigh

Full set of at least three original clean (on board) ocean bills of landing made out to the order of _____ an

marked freight prepaid/collect and notif

Original airway bill to the order of _____ signed by the carrier or his agent marked freight prepa

Collect and notif

Truck consignment note showing goods consigned to us and marked freight prepaid collect

Insurance policy or certificate in duplicate issued to the order of Bank AlBilad in the currency of this credit for

at least 110% of invoice value

Insurance policy: Marine Air certificate for CIF value plus 10% covering Institute cargo clauses (A

Institute war clauses Cargo Air carg

Institute strikes clauses Cargo Air cargo

All risks covered from warehouse to warehouse

Other risks (Please specify)

If CFR or FOB shipment, insurance to be covered by applicant

Documents required

In case of shipment in container, a certificate issued by the beneficiary stating that a label with name and fax/cable

Telex address of the applicant, along with a copy of packing list/list of contents, has been affixed on the inside part of the container's door.

Phyto-sanitary certificat

Inspection/analysis certificat

Other requirement	
Additional conditions:	Special Instructions: Shipping mark Shipment in container
Customer signature	
National/Iqama ID	
Issued from	Dated

(Four signatures)

This translation has been done to the best of our knowledge and ability of the

Request for Profitable Resale Document.

Translation by:

Layla S. Ghannam

Tel: 07939 450 833

, Fax

Fax

Represented in this venerable contract _____, in the capacity of _____, status/residence card No. _____, issued on ____ / ____ /14 A.H.

_____ second party, referred to in this pledge as (client)

Preface:

Where the client has been notified of the arrival or nomination of (goods/documentation of goods), and upon the client's desire for (all the goods/the bank's share of the goods), particulars of which have been detailed in the request and pledge to purchase the goods by profitable resale on _____, or the Request and Partnership Contract of _____, the two parties, in their full competence which is considered legitimate and regular, have agreed on the following conditions and regulations:

First: The previous preface and the aforesaid are an integral and complementary part of this contract.



Second

The bank has sold to the client the goods described in the request and pledge to purchase by profitable resale

Dated _____ for a total price of _____ (only _____).



The bank has sold to the client its share of the good amount to _____ % of the total good described in the request and partnership contract dated _____ for the price of _____ (only _____).

Fifth:

- **The client alone bears whatever expenditures incur after the sale, such as customs fees, delay penalties, transport charges, and others, and has no right to retrieve the same from the bank.**
- **The bank has the right to claim from the client the expenditures and additions borne by the bank in the cost of the documentation, if issued after the signing of this contract and they arose afterwards. The client would then have the right to two options, either to retain the goods or return them if they still exist.**

Sixth:

- **In the event of breach by the client – stipulated in the facilities contract – all the obligations become due immediately, without the need for a legal transaction. The bank has the right to sell what is in its possession of funds, rights, guarantees, mortgages, or estates of the client in settlement of any due obligations, in addition to expenses incurred by the bank thereof.**
- **The bank has the right to place a hold on all the client's balances, in which case the bank will not be bound to honour any cheques or payment orders made from these accounts until such time when the client settles all its obligations. In the case of a deficiency in the sale price of the bank's entitlements, it will have the right to claim the difference from the client, and in the case of an increase in the sale price of the bank's entitlements, that surplus would be the right of the client.**

Seventh:

- **The client has issued a bond in favour of the bank as a guarantee for settlement of the debts due to it.**
- **The client has, in addition to the guarantees stipulated in the facilities contract, the following guarantees:**

- **The guarantees submitted by the client, whether precedent to this contract or subsequent, would be considered as a guarantee for the settlement of the debts due to it.**

Eighth:

The client has authorised the bank to deduct his dues from any account or funds or deposits belonging to the client, without the need for any transaction or notification.

Ninth:

The client has granted the bank an irrevocable power of attorney to take over any rights or funds due to the client from others, without any condition or restriction. This power of attorney will remain valid until the bank has received all its rights.

Tenth:

- **The client confirmed receipt of documentation relating to the goods specified in the request for purchase.**
- **The client confirmed that he would not deal with the sold goods, such as sale or consumption, prior to signature of this contract.**
- **The client confirmed that he is free from any debts or rights to others that might impede his obligations towards the bank.**

Eleventh:

- **The client undertakes not to enter any future financial obligations, directly or indirectly, which might impede his obligations towards the bank.**
- **The bank's late claim for its rights is not to be considered a concession for the same because the bank has the right to claim its rights at any time.**
- **The debt can be degraded in the event of one of the parties' wish to**

expedite settlement of the debt or part of, as per the following conditions:

- **Non-existence of a previous agreement between them to degrade the debt.**
- **The degradation of the debt must be as agreed between them on settlement.**
 - **In the event of the client's procrastination of settlement of the due debt in accordance with this contract, the client bears all the expenditures relating to payment of the debt, such as solicitor's fees, collection offices, and others.**

Bank: AlBilad Saudi Joint Stock Company, Capital SR 3,000,000,000, Commercial Reg. No. 1010208295, Head Office: PO Box 140, Riyadh, 11411. KSA.

(Four signatures)

- **In case of a contradiction between the client's claim and the bank's records in relation to the transactions carried out by them, the bank's records are accredited and bound to the client, unless the client presents evidence of his claim.**
- **The bank confirms the client's right to compensation if there is a defect, deficiency, or violation in a conditional specification, as per the following conditions:**
 - **Subject to that defect or deficiency occurring prior to purchase by the client.**
 - **That the claim is made by the client to the bank upon receipt of the goods and knowledge of the defects, deficiencies, or breach of conditional specifications.**
 - **The client is to call upon the insurance company upon receipt and discovery of the defect, deficiency, or breach of a conditional**

specification.

Twelfth: Notices and notifications

- The address indicated at the start of this contract for each party is the formal address.
- All notifications and correspondence between the parties are to be despatched via fax, personal hand delivery, or any method adopted by the bank, to the addresses indicated at the start of this contract, unless otherwise agreed in writing.
- The client undertakes to notify the bank in writing in the event of any change in its addresses indicated to the bank.

Thirteenth: Law and jurisdiction

- This contract is subject to and is interpreted pursuant to the provisions of the Islamic Sharia, regulations and rules in force in the Kingdom of Saudi Arabia.
- In the event of a dispute or controversy between the parties, God forbid, it should be resolved amicably.
- In the event of an amicable resolution, arbitration over the dispute is to be carried out by the Sharia courts in Riyadh in the Kingdom of Saudi Arabia.

Fourteenth: Copies of the contract

This contract has been issued in two identical copies, each of which has been signed by both parties and handed over to them, as confirmation of the accuracy of the contract and its validity and obligations to its privions.

Blessings and peace be upon our Prophet Muhammad and all His relatives and companions.

First party (bank)

Second party (client)

Represented by:

Represented by:

Signature:

Signature:

(Four signatures)

***This translation has been done to the best of our knowledge and ability of
the***

Sale Contract Document.

Translation by:

Layla S. Ghannam

Tel: 07930 450 833

Annex 20

TRANSLATION



CONTRACT OF SALE OF PROPERTY BY INSTALMENTS (PROFITABLE)

Contract No. 3

IN THE NAME OF GOD THE COMPASSIONATE THE MERCIFUL

Thanks be to God Almighty, and prayers and peace be upon our Prophet Muhammad and all His relative and companions, and further:

On the day / / corresponding to / / A.H. in the city of , this contract was issued between each of the following:

Bank Al Bilad, represented in signature of this contract by the respected: in his capacity of , whose address is PO Box 40, Al Riyadh, 11411, Tel: 479888

(First party "seller")

[In the case of individuals] the respected: , national as per (Civil/residence card) no. issued in dated / / , whose address is:

[In the case of establishments and companies] Establishment/company
, Trade Register No. _____, issued in _____ on ____ /
____ / ____ A.H., its address is:

represented in signature of this contract by the respected:
, who is a _____ national, as per (Civil/residence card) no.
issued in _____ dated ____ / ____ / ____ A.H.

(Second party "buyer")

Preface

Where the first party owns the land no. _____, located within block
no. _____ of plan no. _____
, district _____, city of _____, as per deed no.
issued by _____
, on ____ / ____ / ____ A.H., in a gross total area of _____ sq.m. (only
square metres), the borders and landmarks of which are indicated in that
deed, and on which a building of _____ has been constructed
comprising floors in addition to the annexes, which are _____,
duly referred to in this contract as "the property."

And where the second party wishes to purchase the property mentioned in
the preface, the two parties have entered a contract, while in their
legitimate and competent status, based on the following:

First: The previous preface is considered an integral part of this contract
and complementary thereto, while not contradicting its provisions.

Second: The first party has sold to the second party the property, subject
of the contract mentioned in the preface, at a total price of _____

Riyals (only Saudi Riyals), and the second party has accepted this sale.

(Six signatures)

Third: The second party is committed to hand over to the first party the price of the sold property in () consecutive instalments distributed to instalment, according to the following:

Value of the first instalment: Riyals due for payment on / / .

Balance of the instalments are fixed in total to instalments, the value of each being Riyals, due for payment consecutively at the end of each from the date of the previous instalment's maturity, and the final instalment being due on / / . The second party has issued for the first party a bond order in the value of the share of the first party in the amount of Riyals (only Riyals).

In the event of the second party wishing to expedite settlement of some instalments or all of them prior to the date of their maturity, an agreement is to be reached between the two parties relating thereof at the time, without the first party being obliged to accept of the same or indicate a specific amount or percentage of the debt to be expedited.

Fourth: The second party that accepted the property deed, subject to the contract, is to remain in the name of the first party and to postpone evacuation until his settlement of the value of the first party's share of the property in the (second) article of this contract in accordance with the

instalments due from the second party, as well as their due dates in the (third) article of this contract.

Fifth: The second party acknowledges the fact that he has legally and in due diligence previewed the property subject to the contract, and has accepted it in its condition to be handed over to him vacant of occupancy and any entitlements to others, and which has become under his disposal from the date of issue of this contract. Therefore, any obligations or expenses that become due on this property later should be borne by the second party, such as consumption expenses, maintenance, electricity, water, telephone, and others.

Sixth: The second party acknowledges that he has mortgaged the property subject to the contract, and therefore the second party is unable to dispose of it in any way, whether by transfer of ownership or registration of the same. He also does not have the right to put it under the rights of others such as rent or other, as well as not having the right to add any building or construction or carry out any refurbishments therein, except after settlement of the price indicated in the (second) article of this contract or by obtaining the written specific and clear approval of the first party.

Seventh: In the event of the acceptance of the first party of part of conditional actions by the second party with the approval of the first party, such as construction and refurbishment of buildings and others, in that case the second party is bound to bear any expenses incurred thereto, as well as being obliged to obtain the necessary permits on his own expense with the observance of the technical conditions and instructions of the relative administrations and municipalities and what it has issued of permits and leeways, as well as compliance with the entitlements of easement decided for the interest of other neighbouring owners. In the event of the second party's breach of any of these rules, he alone will bear

the responsibility and consequences thereof. The first party would have the right to claim the necessary compensations without breaching the right of official parties or others in carrying out the appropriate procedures to protect their entitlements towards the second party.

Eighth: The second party granted the first party, as per this contract, up until fulfilment of all his obligations, an absolute and non-isolated authorisation that cannot be cancelled for taking over any entitlements or sums that are due to him from others or any party whether official or non-official, thus without restriction or conditional fulfilment to the first party of all his entitlements that are due by the second party.

Ninth: The second party acknowledged being discharged of any debts or entitlements to others that might hinder implementation of his obligations towards the first party which are incurred in this contract, as well as undertaking not to be bound by any consequent financial obligations, directly or indirectly, that might hinder implementation of this contract or interruption in the settlement of the instalments due thereof.

Tenth: If the second party fails to settle an instalment on the due date, he would be bound to settle two instalments for any unpaid instalment, which would include being late in settlement as a result of the claim and implementation procedures. The first party can take the legitimate and regular procedures to reserve his entitlements prior to the second party, who would bear in this case all the consequences incurred thereof such as expenses and others.

(Six signatures)

Eleventh: The first party has the right to automatically deduct the value of his entitlements that incur in this contract, whether wholly or partially, from any accounts or funds or deposits which belong to the second party without the need for a warning or notice of any other procedure, and his objection to such action is unacceptable for whatever reason.

Twelfth: The regular address of each party to this contract is the address indicated therein, and all correspondents and notices relating to this contract are sent to each party at the regular address. The regular address cannot be changed unless a written notification is sent from any one of the parties to the other by registered post, thus indicating the replacement address.

Thirteenth: Non-implementation by the first party at any time of any rights guaranteed to him by this contract should be considered as a concession on his part to practise that right or any other right at any time thereafter.

Fourteenth: All disputes occurring between the two parties in relation to this contract should be arbitrated by specialised legal courts in the Kingdom, if such a dispute cannot be resolved amicably.

Fifteenth: This contract has been issued in two identical originals and each party has received one copy to work accordingly.

Success is from God.

The first party (seller)

The first party

Name:

Signature:

The second party (buyer)

The second party

Name:

Signature:

First witness

Name:

Signature:

Second witness

Name:

Signature:

(Six signatures)

***This translation has been done to the best of our knowledge and ability of
the***

Sale of Property Contract by instalments.

Annex 21

Translation by:

Layla S. Ghannam

TEL: 97020 450 833

TRANSLATION



Statement of cost of goods of profitable Resale

Date:

Branch:

The Honourees,

God's peace, blessings, and mercy be upon you:

Our reference: Request for profitable resale on / / .

Below is a detailed statement for clearance of the abovementioned profitable resale and the cost of the bond order due for payment on / / .

Statement	H	Riyal
Cost of documents		

at Expenses Insurance Issue of credit Telex Post Amendment		
Cost of goods		
(X) Percentage of profit % for a period of		
Total cost of sale of goods		

No. of bond order	Date of maturity	Amount of bond order

Kindly peruse the above statement and undertake to settle the value of the deed order on the due date.

Clerk in charge Director of centre	Seal of centre
---------------------------------------	----------------

Bank: AlBilad Saudi Joint Stock Company, Capital SR 3,000,000,000,
Commercial Reg. No. 1010208295, Head Office:
PO Box 140, Riyadh, 11411. KSA.

(Four signatures)

***This translation has been done to the best of our knowledge and ability by
the
Statement of Cost of Goods of Profitable Resale.***

**Translation by:
Layla S. Ghannam
Tel: 07939 450 833**

References

- 12,000 Delegates to Discuss Islamic Finance Growth. 2012. [Online]. Available at:
<http://english.mubasher.info/portal/CASE/getDetailsStory.html?goToHomePageParam=true&storyId=2208276> [Accessed on: 31 December 2012].
- Abd Jabbar H, 'Islamic finance: fundamental principles and key financial institutions' (2009) *Company Lawyer* 30 (1) 23, 32
- Abdal, A., Al-Smadi, M. and Almsafir, M.K. 2012. Islamic Finance Versus Conventional Finance, From Macroeconomic Perspective: A Review. *Journal of Islamic and Human Advanced Research* 2(4), pp. 419-430.
- Abdullah, D.V. and Chee, K. 2010. *Islamic Finance: Understanding its Principles and Practices*. Marshall Cavendish International Asia Pte Ltd.
- Abdullah, F., Hassan, T. and Mohamad, S., 2007. Investigation of performance of Malaysian Islamic unit trust funds: Comparison with conventional unit trust funds. *Managerial Finance* 33(2), pp. 142-153.
- Abdul-Rahman, Y. 2010. *The Art of Islamic Banking and Finance: Tools and Techniques for Community-Based Banking*. John Wiley & Sons.
- About Saudi Arabia. 2015. [Online]. Available at:
<https://www.saudiembassy.net/about/country-information/government/>
[Accessed on: 7 July 2015].
- Abusharbeh, M.T. 2014. Credit Risks and Profitability of Islamic Banks: Evidence from Indonesia. *World Review of Business Research* 43, pp. 136-147.
- Ahmad A, *Theory and Practice of Modern Islamic Finance: The Case Analysis from Australia* (Brown Walker Press 2010)
- Ahmad, A. 2010. *Developments in Islamic Banking Practice: The Experience of Bangladesh*. USA: Universal-Publishers.
- Ahmad, A.U.F. 2009. *Theory and Practice of Modern Islamic Finance: The Case Analysis from Australia*. Universal-Publishers.
- Ahmad, A.U.F. and Hassan, K. 2006. Riba and Islamic banking. *Journal of Islamic Economics, Banking and Finance*.

- Ahmad, N.H. and Ahmad, S.N. 2015. Key Factors Influencing Credit Risk Of Islamic Banks: A Malaysian Case. [Online] Available at: [http://www.researchgate.net/publication/228423667 Key factors influencing credit risk of Islamic bank A Malaysian case](http://www.researchgate.net/publication/228423667_Key_factors_influencing_credit_risk_of_Islamic_bank_A_Malaysian_case)[Accessed on: 1 July 2015].
- Ahmed, A.M.T. 2010. *Islamic Banking: How to Manage Risk and Improve Profitability*. US: John Wiley & Sons.
- Ahmed, H. 2011. *Product Development in Islamic Banks*. Edinburgh University Press.
- Ahmed, H. 2011. *Product Development in Islamic Banks*. Oxford University Press.
- Ahmed, H. and Khan, T. n.d. Risk management in Islamic banking. [Online]. Available at: http://www.isfin.net/sites/isfin.com/files/risk_management_in_islamic_banking.pdf [Accessed on: 21 November 2016].
- Ahmed, J. 2012. Islamic financial transactions must be both lawful and ethical. [Online]. Available at: <http://www.global-briefing.org/2012/04/%E2%80%9Cislamic-financial-transactions-must-be-both-lawful-and-ethical%E2%80%9D/> [Accessed on: 28 August 2012].
- Ahmed, K.H. 2013. *Contemporary Islamic Finance: Innovations, Applications and Best Practices*. US: John Wiley & Sons.
- Akbarzadeh, S. 2001. *Muslim Communities in Australia*. US: UNSW Press.
- Al Elsheikh A and Tanega J, ' Sukuk structure and its regulatory environment in the Kingdom of Saudi Arabia' (2011) *Law and Financial Markets Review* 5 (3) 183, 200
- Al Rajhi Bank, <<http://www.alrajhibank.com.sa/en/about-us/pages/sharia-group.aspx>> accessed 15 June 2017
- Albaraka. 2015. [Online]. Available at: [Accessed on: 3 July 2015].
- Albaraka. 2015. [Online]. Available at: http://www.albaraka.co.za/Islamic_Banking/Features_of_Marabaha_and_L_easing.aspx [Accessed on: 3 July 2015].

- Al-Bashir, M. 2008. *Risk Management in Islamic Finance: An Analysis of Derivatives Instruments in Commodity Markets*. BRILL.
- Aldohni, A.K. 2011. *The Legal and Regulatory Aspects of Islamic Banking: A Comparative Look and the United Kingdom and Malaysia*. London: Routledge.
- Alexander, A.J. 2011. Shifting Title and Risk: Islamic Project Finance with Western Partners. *Michigan Journal of International Law* 3(3), pp. 572-611.
- Alhowaimil, I.S. 2013. Frustration of Performance of Contracts: A comparative and Analytic Study in Islamic Law and English Law. [Online]. Available at: <http://bura.brunel.ac.uk/bitstream/2438/8532/1/FulltextThesis.pdf> [Accessed on: 15 July 2015].
- Ali, H.A. and Naysary, B. 2014. Risk Management Practices in Islamic Banks in Kuwait. *Journal of Islamic Banking and Finance* 2(1), pp. 123-148.
- Ali, S.S. 2004. Islamic Modes of Finance and Associated Liquidity Risks. [Online] Available at: http://www.sbp.org.pk/departments/ibd/lecture_6_islamic_modes_finance_liquidity.pdf [Accessed on: 24 June 2015].
- Al-Muharrami, S. Mr. Daniel and C. Hardy, D.C. 2013. *Cooperative and Islamic Banks: What can they Learn from Each Other?* International Monetary Fund.
- Al-Shamrani, A.S. 2014. Islamic Financial Contracting Forms in Saudi Arabia: Law and Practice. [Online]. Available at: <http://bura.brunel.ac.uk/bitstream/2438/9145/1/FulltextThesis.pdf> [Accessed on: 10 July 2015].
- Al-Suwaidi, A. 2004. *Finance of International Trade in the Gulf*. Netherlands: BRILL.
- Alwosabi, M. The Prohibition of Gharar. [Online]. Available at: http://staff.uob.edu.bh/files/620922311_files/Prohibition-of-Gharar.pdf [Accessed on: 28 August 2012].

- Anam, S., Hasan, S.B., Huda, H.A.E., Uddin, A. and Hossain, M.M. 2012. Liquidity risk management: A comparative study between conventional and Islamic banks of Bangladesh. *Research Journals* 5, pp. 1-5.
- Andersen, T.J. and Schrøder, P.M. *Strategic Risk Management Practice: How to Deal Effectively with Major Corporate Exposures*. London: Cambridge University Press.
- Andrew, M. 2010. Islamic Finance: Four Articles Introducing Islamic Banking And Finance Concepts. [Online]. Available at: <http://www.riskrewardlimited.com/admin/pdf/Islamic%20Finance%20Articles%20by%20MCA.pdf> [Accessed on: 3 July 2015].
- Angelo Venardos, *Islamic Banking and Finance in South-East Asia: Its Development and Future*, (World Scientific Publishing Co. Ltd 2005) 27
- Archer, S., Karim, A.A., R.A.A. 2007. *Islamic Finance: The Regulatory Challenge*. US: John Wiley & Sons.
- Ariff, M and Iqbal, M. 2011. *The Foundations of Islamic Banking: Theory, Practice and Education*. Edward Elgar Publishing.
- Ariff, M. and Iqbal, M. 2011. *The Foundations of Islamic Banking: Theory, Practice and Education*. UK: Edward Elgar Publishing.
- Aris, N.A. et al. 2012. Islamic house financing: Comparison between Bai' Bithamin Ajil (BBA) and Musharakah Mutanaqisah (MM). *African Journal of Business Management* 6(1), pp. 266-273.
- Askari, H., Iqbal, Z. and Mirakhor, A. 2011. *Globalization and Islamic Finance: Convergence, Prospects and Challenges*. US: John Wiley & Sons.
- Askari, H., Iqbal, Z., Krichenne, N. and Mirakhor, A. 2011. *The Stability of Islamic Finance: Creating a Resilient Financial Environment for a Secure Future*. New Jersey: Wiley.
- Axinn, W.G and Pearce, L.D. 2006. *Mixed method data collection strategies*. 1st ed. USA: Cambridge University Press.
- Axinn, W.G. and Pearce, L.D. 2006. *Mixed method data collection strategies*. 1st ed. USA: Cambridge University Press.
- Ayub, M. 2009. *Understanding Islamic Finance*. John Wiley & Sons.

- Ayub, M. 2009. *Understanding Islamic Finance*. US: John Wiley & Sons.
- Ayub, M. 2009. *Understanding Islamic Finance*. US: John Wiley & Sons.
- Azwar, A. and Tajudin, A. 2010. Overview of Islamic Finance. [Online]. Available at:
<http://www.bankislam.com.my/en/Documents/shariahSharia/OverviewOfIslamicFinance-13122010.pdf> [Accessed on: 8 September 2012].
- Baamir, A.Y. 2013. *Shari'a Law in Commercial and Banking Arbitration: Law and Practice in Saudi Arabia*. Saudi Arabia: Ashgate Publishing, Ltd.
- Bank Albilad. 2012. Annual Report 2012. [Online]. Available at:
<http://www.bankalbilad.com/sites/en/SiteAssets/Pages/Forms/EditForm/Annual%20Report%202012.pdf> [Accessed on: 23 March 2014].
- Bank Negara Malaysia, 2010. Draft Of Shariah *Sharia* Parameter Reference 4: Musharakah Contract. [Online], pp. 1-25. Available at:
http://www.bnm.gov.my/guidelines/05_shariahSharia/04_draft_shariahSharia%20parameter_spr4.pdf [Accessed on: 28 August 2012].
- Basel Committee on Banking Supervision. 2013. Basel III: The Liquidity Coverage Ratio and Liquidity Risk Monitoring Tools. [Online]. Available at:
<http://www.bis.org/publ/bcbs238.pdf> [Accessed on: 15 November 2011].
- Basic Law of Governance 1992, Art. 1, 5 (A) and 5 (B)
- Bellalah, M. 2013. *Islamic Banking and Finance*. Cambridge Scholars.
- Bellalah, M. 2013. *Islamic Banking and Finance*. UK: Cambridge Scholars.
- Beng Soon Chong & Ming-Hua Liu, 'Islamic banking: Interest-free or interest-based', Science Direct (2009)
- Blaikie, N. 2009. *Designing Social Research*. Polity.
- Bloomsbury Publishing. 2010. *Islamic Finance: Instruments and Markets*. A & C Black.
- Bock, M. 2010. *Governance Risk Management and Financial Product Development in Islamic Financial Institutions*. GRIN Verlag.
- Borscheid, P., Gugerli, D. and Straumann, T. 2013. *The Value of Risk: Swiss Re and the History of Reinsurance*. UK: Oxford University Press.

- Bovens, M.A.P., T'Hart, P. and Peters, B.G. 2002. *Success and Failure in Public Governance: A Comparative Analysis*. Edward Elgar.
- Bowen, W.H. 2014. *The History of Saudi Arabia*. USA: ABC-CLIO.
- Brant, R. 2009. Is Islamic finance the answer? [Online] Available at:
<http://news.bbc.co.uk/2/hi/business/8025410.stm> [Accessed on: 14 September 2016].
- Bryman, A. 2012. *Social Research Methods*. Oxford University Press.
- Burton J, *The Sources of Islamic Law: Islamic Theories of Abrogation* (Edinburgh University Press 2003)
- Burton. 2010. *Intro to Financial Markets and Institutions*. M.E. Sharpe.
- Capital Market Authority (CMA),
<<http://www.cma.org.sa/En/AboutCMA/CMALaw/Pages/CH2Article4.aspx>
> accessed 15 June 2017
- Capital Market Authority (CMA), available at:
<http://www.cma.org.sa/En/CME/Pages/default.aspx>, accessed 15 June 2017
- Capital Market Authority (CMA), available at:
<http://www.cma.org.sa/En/AboutCMA/CMALaw/Pages/Ch2Article5.aspx>,
accessed 15 June 2017
- Cattelan, V. (Ed.) 2013. *Islamic Finance in Europe: Towards a Plural Financial System*. Edward Elgar.
- Center for International Legal Studies (CILS). (2010). *Legal Aspects of Doing Business in the Middle East (2nd Ed.)*. Huntington: Juris Publishing.
- Chachi, A. 2005. Origin and Development of Commercial and Islamic Banking Operations. *Islamic Economics* 18(2), pp. 3-25.
- Chorafas, D.N. 2011. *Stress Testing for Risk Control Under Basel II*. Butterworth-Heinemann.
- Choudhury, M.A. 2013. *Money in Islam: A Study in Islamic Political Economy*. UK: Routledge.
- Çizakça, M. 2011. *Islamic Capitalism and Finance: Origins, Evolution and the Future*. Edward Elgar Publishing.

- Colón, J.C. 2014. Choice of Law and Islamic Finance. *Texas International Law Journal* 46, p. 411.
- Connaway, L.S. and Powell, R.R. 2010. Basic Research Methods for Librarians. USA: ABC-CLIO.
- Cotran, E. and Lau, M. 2002. *Yearbook of Islamic and Middle Eastern Law: 2001-2002*. Brill.
- Creswell, J.W. 2002. *Research Design: Qualitative, Quantitative, and Mixed Methods Approaches*. 2nd ed. London: SAGE.
- Dalel, G. and Bessem, T. 2013. "Murabaha" Contract and Basis of Islamic Finance. *Interdisciplinary Journal of Contemporary Research in Business* 4(11), pp. 157-161.
- Daniel, J. 2001. *Hedging Government Oil Price Risk, Issues 2001-2185*. International Monetary Fund.
- Dar, H. A. and Moghul, U. F. 2012. *The Chancellor Guide to the Legal and Shari'a Aspects of Islamic Finance*. UK: Harriman House Limited.
- Dar, M.R. Azeem, M. and Masood, D.O. 2013. Operational risk management, risk management approaches, and risk mitigation techniques: challenges faced by Islamic financial services. *Journal of Business and Management* 11(2), pp. 72-79.
- Denscombe, M. 2012. *The Good Research Guide: For Small-Scale Social Research Projects*. New York: McGraw-Hill International.
- Dewar, J. 2011. *International Project Finance: Law and Practice*. Oxford University Press.
- Dusuki, A.W. 2006. Commodity Murabaha Murabaha Programme (CMP): An Innovative Approach to Liquidity Management. *Journal of Islamic Economics, Banking and Finance* 3(1).
- Ebaugh, H.R. 2009. *The Gülen Movement: A Sociological Analysis of a Civic Movement Rooted in Moderate Islam*. Springer.
- Eisenberg, D. 2012. *Islamic Finance: Law and Practice*. Oxford University Press.
- El-Gamal M, *Islamic Finance: Law, Economics and Practice* (Cambridge University Press 2006)

- El-Gamal, M.A. 2006. *Islamic Finance: Law, Economics, and Practice*. UK: Cambridge University Press.
- Elgari, M.A. 2003. Credit Risk in Islamic Banking and Finance. *Islamic Economic Studies* 10(2), pp. 1-25.
- El-Qorchi, 2005. Islamic finance gears up. *Finance & Development* 42(4), pp. 1-7.
- Esposito, J.L. 2010. *The Future of Islam*. Oxford University Press.
- Faboozi, F.J. and Mann, S.V. 2005. *Securities Finance: Securities Lending and Repurchase Agreements*. John Wiley & Sons.
- Farooq, M. 2006. Partnership, Equity-financing and Islamic finance: Whither profit-loss-sharing [Online]. Available at: <http://www.assaif.org/content/download/33169/174359/file/IF%20partnership.pdf> [Accessed on: 24 June 2015].
- Farooq, S. 2012. Sukuk's Global Reach. [Online]. Available at: <http://dawn.com/2012/07/30/sukuks-global-reach/> [Accessed on: 31 December 2012].
- Foster N.H.D. 2006. *Encounters between legal systems: recent cases concerning Islamic commercial law in secular courts*. Amicus Curiae.
- Frisen, M. 2008. *Financial Surveillance*. New Jersey: John Wiley & Sons.
- Garner, J.M. 2013. A Critical Perspective on the Principles of Islamic Finance Focusing on Sharia Compliance and Arbitrage. *Leeds Journal of Law & Criminology* 1(1), pp. 70-90.
- Ginena, K. and Hamid, A. 2015. *Foundations of Shariah Sharia Governance of Islamic Banks*. New Jersey: John Wiley & Sons.
- Gratton, C. and Jones, I. 2010. *Research Methods for Sports Studies*. UK: Taylor & Francis.
- Hallaq W, *An Introduction to Islamic Law* (Cambridge University Press 2009)
- Hallaq, H.B. 2009. *An Introduction to Islamic Law*. Cambridge University Press.
- Hanif, M. 2011. Differences and Similarities in Islamic and Conventional Banking. *International Journal of Business and Social Science* 2(2), pp.168-172.

- Hans Visser, *Islamic Finance: Principles and Practice* (Edward Elgar Publishing Limited 2009)
- Harwood, S. 2006. *Shipping Finance*. UK: Euromoney Books.
- Hasan Z, 'Regulatory Framework of Shariah *Sharia* Governance System in Malaysia, GCC Countries and the UK' (2010) *Kyoto Bulletin of Islamic Area Studies* 3 (2) 82, 115
- Hasan, M.K. and Dicle, M.F. 2006. Basel II and Capital Requirement for Islamic Banks. *Islamic Center* 2, pp. 235-276.
- Hasan, Z. 2012. *Shari'ah Governance in Islamic Banks*. Oxford University Press.
- Hassan K and Mahlkecht M, *Islamic Capital Markets: Products and Strategies* (John Wiley & Sons 2011)
- Hassan, K. and Lewis, M. 2007. *Handbook of Islamic banking*. Edward Elgar.
- Hassan, K. and Mahlkecht, M. 2011. *Islamic Capital Markets: Products and Strategies*. John Wiley & Sons.
- Hawary, D.E., Grais, W. and Iqbal, Z. 2007. Diversity in the regulation of Islamic Financial Institutions. *The Quarterly Review of Economics and Finance* 46, pp. 778-800.
- Hayes, S. L. 1998. *Islamic Law and Finance: Religion, Risk, and Return*. New York: Brill.
- Henry, C.M. and Wilson, R. 2004. *The Politics of Islamic Finance*. Edinburgh University Press.
- Hesse, H. 2008. Trends and Challenges in Islamic Law. *World Economics* 9(2), pp. 175-193.
- Holden, K. 2008. Islamic finance: Legal hypocrisy" moot point, problematic future bigger concern. *Boston University International Law Journal* 25, p. 341.
- How, J.C.Y., Karim, M.A. and Verhoeven, P. 2005. Islamic Financing and Bank Risks: The case of Malaysia. *Thunderbird International Business Review* 47(1), pp. 75-94.
- How, J.C.Y., Karim, M.A. and Verhoeven, P. 2005. Islamic Financing and Bank Risks: The case of Malaysia. *Thunderbird International Business Review* 47(1), pp. 75-94.

- Hunt-Ahmed, K. 2013. *Contemporary Islamic Finance: Innovations, Applications and Best Practices*. John Wiley & Sons.
- Hunt-Ahmed, K. 2013. *Contemporary Islamic Finance: Innovations, Applications and Best Practices*. John Wiley & Sons.
- Ilias, S. 2010. Islamic Finance: Overview and Policy Concerns. [Online]. Available at: <http://www.fas.org/sgp/crs/misc/RS22931.pdf> [Accessed on: 1 September 2012].
- Institute of Islamic Banking and Insurance (n.d.). [Online]. Available at: http://www.islamicbanking.com/MurabahaMurabaha_sruling.aspx[Accessed on: 28 July 2015].
- International Monetary Fund. 2002. *Islamic Financial Institutions and Products in the Global Financial System: Key Issues in Risk Management and Challenges Ahead*. International Monetary Fund.
- International Monetary Fund. 2002. *Islamic Financial Institutions and Products in the Global Financial System: Key Issues in Risk Management and Challenges Ahead*. International Monetary Fund.
- International Monetary Fund. 2010. *Finance & Development, December 2010*. International Monetary Fund.
- Iqbal, M. and Llewellyn, D.T. 2002. *Islamic Banking and Finance: New Perspectives on Profit Sharing and Risk*. Edward Elgar Publishing.
- Iqbal, Z. 2008. The Impact of Consolidation on Islamic Financial Service Industry. *Islamic Economic Studies*15(2), pp. 80-100.
- Iqbal, Z. and Mirakhor, A. 2011. *An Introduction to Islamic Finance: Theory and Practice*. US: John Wiley & Sons.
- Islamic Banking and Finance (Spiramus Press Ltd 2009)
- Islamic Finance Basics. 2007. [Online]. Available at: <http://islamicfinanceaffairs.wordpress.com/2007/05/25/islamic-finance-basics-what-is-MurabahaMurabaha-ijara-and-musharakahmudarabah/> [Accessed on: 23 March 2013].

- Islamic Finance for Development-Conceptual Framework. 2010. [Online]. Available at: <http://adfimi.org/dosyalar/seminerler/128/pdf/19.pdf>[Accessed on: 23 March 2013].
- Islamic Finance Forays Successfully in Africa. 2012. [Online]. Available at: <http://www.ventures-africa.com/2012/09/islamic-finance-forays-successfully-in-africa/> [Accessed on: 31 December 2012].
- Islamic Finance, 2010. [Online]. Available at:<http://www.cpaaustralia.com.au/cps/rde/xbcr/cpa-site/Introduction-to-Islamic-financeand-common-terminologies.pdf>[Accessed on: 28 August 2012].
- Islamic finance. 2005. [online]. Available at: <http://news.bbc.co.uk/2/hi/business/3548656.stm> [Accessed on: 28 August 2012].
- Islamic Financial Architecture. 2009. [Online]. Available at: <http://www.iefpedia.com/english/wp-content/uploads/2009/10/Islamic-Financial-Architecture-Risk-Management-and-Financial-Stability-by-Tariquallah-Khan-Dadang-Muljawan.pdf#page=53> [Accessed on: 25 March 2013].
- Islamic Financial Services Board. 2005. Guiding principles of risk management for institutions (other than insurance institutions) offering only Islamic financial services. [Online]. Available at: <http://www.ifsb.org/standard/ifsb1.pdf> [Accessed on: 14 March 14 2014].
- Islamic Law (Shariah *Sharia*). (n.d.). [Online]. Available at: http://gulf-law.com/islamic_law.html. [Accessed on: 7 July 2015].
- Islamic Sharia Council. 2012. [online]. Available at: <http://www.islamic-sharia.org/> [Accessed on: 28 August 2012].
- Islamic Sharia Council. 2012. [online]. Available at: <http://www.islamic-sharia.org/> [Accessed on: 14 September 2016].
- Ismael, R. 2005. Assessing Moral Hazard Problem in Murabaha *Murabaha* Financing. *Journal of Islamic Economics, Banking and Finance* 5(2), p. 101.

- Ismal, R. 2005. Assessing Moral Hazard Problem in MurabahaMurabaha Financing. *Journal of Islamic Economics, Banking and Finance* 5(2), p. 101.
- Ismal, R. 2005. Assessing Moral Hazard Problem in MurabahaMurabaha Financing. *Journal of Islamic Economics, Banking and Finance* 5(2), p. 101.
- Izhar, H. 2010. Identifying Operational Risk Exposures in Islamic Banking. *Kyoto Bulletin of Islamic Area Studies* 3(2), pp. 17-53.
- Izhar, H. 2010. Identifying Operational Risk Exposures in Islamic Banking. *Kyoto Bulletin of Islamic Area Studies* 3-2, pp. 17- 53.
- Jaffer, S. 2004. *Islamic Asset Management: Forming the Future for Shari'a-compliant Investment Strategies*. London: Euromoney Books.
- Jalil, D.M.A. and Rahman, M.K. 2010. Financial Transactions in Islamic Banking are Viable Alternatives to the Conventional Banking Transactions. *International Journal of Business and Social Science* 1(3), pp. 219-233.
- Jamaldeen, D.F. 2012. *Islamic Finance for Dummies*. John Wiley & Sons.
- Jamaldeen, F. 2012. *Islamic Finance for Dummies*. New Jersey: John Wiley & Sons.
- Jebreen, I. 2012. Using Inductive Approach as Research Strategy in Requirements Engineering. *International Journal of Computer and Information Technology* 1(2), pp. 162-173.
- Kamali M, *Principles of Islamic Jurisprudence* (The Islamic Texts Society 1989)
- Kamalpour, A. Schemuth, M. Ahmed, T. and Maski, S. 2009. *MurabahaMurabaha Financing*. Ashurst.
- Kammer, A. et al. 2015. Islamic Finance: Opportunities, Challenges, and Policy Options. [Online]. Available at: <https://g20.org/wp-content/uploads/2015/05/IMF-Note-on-Asset-Based-Financing-such-as-Sukuk-for-Infrastructure-April-2015.pdf> [Accessed on: 30 June, 2015].
- Karim, R.A.A. and Archer, S. 2011. *Islamic Finance: The Regulatory Challenge*. John Wiley & Sons.

- Karim, S.A. 2010. *The Islamic Moral Economy: A Study of Islamic Money and Financial Instruments*. Universal-Publishers.
- Karim, S.A. 2010. *The Islamic Moral Economy: A Study of Islamic Money and Financial Instruments*. Universal-Publishers.
- Kayed, R.N. and Mohammed, K.M. 2009. Unique Risks of Islamic Modes of Finance: Systemic, Credit and Market Risks. *Journal of Islamic Economics, Banking and Finance* 5(3), pp. 9-34.
- Kayed, R.N. and Mohammed, K.M. 2009. Unique Risks of Islamic Modes of Finance: Systemic, Credit and Market Risks. *Journal of Islamic Economics, Banking and Finance* 5(3), pp. 9-34.
- Kechichian, J. A. 2013. *Legal and Political Reforms in Saudi Arabia*. New York: Routledge.
- Kechichian, J. A. 2013. *Legal and Political Reforms in Saudi Arabia*. New York: Routledge.
- Kettell, B. 2011. *Case Studies in Islamic Banking and Finance*. John Wiley & Sons.
- Kettell, B. 2011. *Islamic Finance in a Nutshell: A Guide for Non-Specialists*. John Wiley & Sons.
- Kettell, B.B. 2011. *The Islamic Banking and Finance Workbook: Step-By-Step Exercises to Help You Master the Fundamentals of Islamic Banking and Finance*. John Wiley and Sons.
- Khalidi, K. and Hamdoni, A. 2011. Islamic Financial Intermediation: Equity, Efficiency and Risk. *International Research Journal of Finance and Economics*, (65), pp. 145-160.
- Khalidi, K. and Hamdoni, A. 2011. Islamic Financial Intermediation: Equity, Efficiency and Risk. *International Research Journal of Finance and Economics*, (65), pp. 145-160.
- Khalil E, 'An Overview of the Sharia'a Prohibition of Riba' in Thomas A (ed), *Interest in Islamic Economics: Understanding riba*(Routledge 2006)
- Khan, M.F. and Porzio, M. 2010. *Islamic Banking and Finance in the European Union: A Challenge*. Edward Elgar Publishing.

- Kimmel, A.J. 2009. *Ethical Issues in Behavioral Research: Basic and Applied Perspectives*. John Wiley & Sons.
- Knoop, T.A. 2013. *Global finance in emerging market economies. Routledge international studies in money and banking*. Routledge.
- Köhn, D. 2011. *Mobilising Capital for Emerging Markets: What Can Structured Finance Contribute?* Springer.
- Köhn, D. 2011. *Mobilising Capital for Emerging Markets: What Can Structured Finance Contribute?* Springer.
- Langton, J. Trullols, C. and Turkistani, A.Q. 2011. *Islamic Economics and Finance: A European Perspective*. Palgrave Macmillan.
- Latham and Watkins LLP. 2010. Doing business in Saudi Arabia. [Online]. Available at: http://www.lw.com/upload/pubcontent/pdf/pub3507_1.pdf [Accessed on: 18 May 2015].
- Levine, R. 2010. The Governance of Financial Regulation: Reform Lessons from the Recent Crisis. [Online]. Available at: <http://www.bis.org/events/conf100624/levinepaper.pdf> [Accessed on: 31 December 2012].
- Majid, S. and Majid, F. 2009. Application of Islamic Law in the Middle East - Interest and Islamic Banking. [Online]. Available at: <http://www.iraqilawconsultant.com/puplications/majid/article09.html> [Accessed on: 9 July 2015].
- Malik, M.S., Malik, A. and Mustafa, W. 2011. Controversies that make Islamic banking controversial: An analysis of issues and challenges. *American Journal of Social and Management Sciences* 2(1), pp. 41-46.
- Marczyk, G.R., DeMatteo, D. and Festinger, D. 2005. *Essentials of Research Design and Methodology*. US: John Wiley and Sons.
- McCormick, R. 2010. *Legal Risk in the Financial Markets*. London Oxford University Press.
- McKendrick, E. 2015. *Contract Law*. Palgrave Macmillan.
- McNabb, D.E. 2004. *Research Methods for Political Science: Quantitative and Qualitative Approaches*. M.E. Sharpe.

- Memon, N.A. 2007. Islamic Banking: Present and Future Challenges. *Journal of Management and Social Sciences* 3(1), pp. 1-10.
- Memon, N.A. 2007. Islamic Banking: Present and Future Challenges. *Journal of Management and Social Sciences* 3(1), pp. 1-10.
- Ministry of Commerce and Industry, available at:
<http://mci.gov.sa/en/LawsRegulations/Pages/default.aspx>, [Accessed 15 June 2017]
- Mirakhor, A. and Iqbal, Z. n.d. *Islamic Banking*. International Monetary Fund.
- Moles, P., Parrino, R. and Kidwell, D.S. 2011. *Fundamentals of Corporate Finance*. John Wiley & Sons.
- Monger, R. and Rawashdeh, M. 2008. Islamic Finance Enters the Mainstream. *Management Accounting Quarterly* 9(3), pp. 1-6.
- Morrison, R. 2012. *The Principles of Project Finance*. UK: Gower Publishing.
- Mounira, B.A. and Tunisia, G. 2008. Managing Risks and Liquidity in an Interest Free Banking Framework: The Case of the Islamic Banks. *International Journal of Business and Management* 3(9), pp. 80-95.
- Muhammad Ayub, Understanding Islamic Finance (John Wiley & Sons Ltd 2007) 21.
- Muhammad Ayub, Understanding Islamic Finance (John Wiley & Sons Ltd 2007)
- MurabahaMurabaha* as a mode of finance. 2009. [Online]. Available at:
http://www.albaraka.co.za/Islamic_Banking/Features_of_Marabaha_and_L_easing/MurabahaMurabaha_as_a_Mode_of_Finance.aspx [Accessed on: 16 July 2015].
- MurabahaMurabaha* Working Capital. 2011. [Online]. Available at:
<http://www.midf.com.my/our-product-a-services/development-finance-division/669> [Accessed on: 28 July 2015].
- MurabahaMurabaha*. 2013. [Online]. Available at:
http://www.bnm.gov.my/guidelines/05_shariahSharia/CP_MurabahaMurabaha_122013.pdf [Accessed on: 10 November 2016].

- MurabahaMurabaha. 2015. <http://www.bankalfalah.com/islamicpk/corporate-banking/working-capital-finance/MurabahaMurabaha/> [Accessed on: 3 July 2015].
- Nash, J. 2009. The principles of Islamic finance. [online]. Available at: <http://www.laworld.com/news-and-publications/1-legal-news/44-the-principles-of-islamic-finance.html> [Accessed on: 28 August 2012].
- Niaz A Shah, *Islamic Law and the Law of Armed Conflict: The Conflict in Pakistan* (Routledge 2011)
- Otto, J.M. 2011. *Sharia Incorporated: A Comparative Overview of the Legal Systems of Twelve Muslim Countries in Past and Present*. Netherlands: Amsterdam University Press.
- Oxford Business Group. 2007. *The Report: Emerging Saudi Arabia*. Oxford Business Group.
- Perry, F.V. and Rehman, S.S. 2011. Globalization of Islamic Finance: Myth or Reality? *International Journal of Humanities and Social Science* 1(19), pp. 107-119.
- Pock, A. V. 2007. *Strategic Management in Islamic Finance*. US: Springer.
- Prohibition of Gharar in Islam. n.d. [Online]. Available at: <http://www.kantakji.com/fiqh/Files/Fatawa/A305.pdf> [Accessed on: 13 December 2012].
- Ramady M, *The Saudi Arabian Economy: Policies, Achievements, and Challenges* (Springer 2010)
- Ramady, M.A. 2010. *The Saudi Arabian Economy: Policies, Achievements, and Challenges*. Saudi Arabia: Springer Science & Business Media.
- Ramady, M.A. 2010. *The Saudi Arabian Economy: Policies, Achievements, and Challenges*. Springer Science & Business Media.
- Riba, Bank Interest and the Rationale of its Prohibition. [Online]. Available at: http://globalwebpost.com/farooqm/study_res/i_econ_fin/nejatullahs_riba.pdf [Accessed on: 8 June 2012].
- Roberts, E. 2015. An overview of Basel II's Pillar 2. [Online]. Available at: <https://www.researchgate.net/file.PostFileLoader.html?id=55029336d685c>

- [c415b8b467b&assetKey=AS%3A273732268953603%401442274267796](#)
Accessed on: 3 July 2015].
- Rosly, S.A. and Zaini, M.A. 2008. Risk-return analysis of Islamic banks' investment deposits and shareholders' fund. *Managerial Finance* 34(10), pp. 695-707.
- Royal Embassy of Saudi Arabia in Washington, available at:
<http://www.saudiembassy.net/about/country-information/> [Accessed 15 June 2017]
- Royal Embassy of Saudi Arabia in Washington, available at:
http://www.saudiembassy.net/about/country-information/economy_global_trade/banking.aspx> accessed 15 June 2017
- Rubin, R., Rubin, A. and Haridakis, P. 2009. *Communication Research: Strategies and Sources*. Cengage Learning.
- Ruozi, R. and Ferrari, P. 2012. *Liquidity Risk Management in Banks: Economic and Regulatory Issues Springer Briefs in Finance*. London: Springer Science & Business Media.
- Saad, N. 2012. Microfinance and Prospect for Islamic Microfinance Products: *The Case of Amanah Ikhtiar Malaysia. Advances in Asian Social Sciences* 1(1), pp. 27-33.
- Saeed, A. 1996. *Islamic Banking and Interest: A Study of the Prohibition of Riba and Its Contemporary Interpretation*. BRILL.
- Salah, I., King and Spalding, 2009. Legal issues arising in Islamic finance transactions in the United States. [Online]. Available at:
<http://www.kslaw.com/Library/publication/09-09%20Yasaar%20Media%20Salah.pdf> [Accessed on: 18 March 2014].
- Salem, R.A. 2013. *Risk Management for Islamic Banks*. Edinburgh University Press.
- Saudi Arabia Monetary Agency (SAMA),
<<http://www.sama.gov.sa/sites/samaen/AboutSAMA/Pages/SAMAHistory.aspx>> accessed 15 June 2017

- Saudi Arabia Monetary Agency (SAMA),
<<http://www.sama.gov.sa/sites/samaen/RulesRegulation/BankingSystem/Pages/BankingSystemFD01.aspx>> accessed 15 June 2017
- Saudi Arabia Monetary Agency (SAMA), available at:
<http://www.sama.gov.sa/sites/samaen/RulesRegulation/BankingSystem/Pages/BankingSystemFD03.aspx>, > accessed 15 June 2017
- Saudi Arabia Monetary Agency (SAMA), available at:
<http://www.sama.gov.sa/sites/samaen/RulesRegulation/BankingSystem/Pages/BankingSystemFD03.aspx>, > accessed 15 June 2017
- Saudi Arabian Law overview, 2015. [Online]. Available at:
http://www.saudilegal.com/saudilaw/11_law.html [Assessed on: 12 March 2015].
- Saudi Arabian Monetary Agency (SAMA), available at:
<http://www.sama.gov.sa/ABOUTSAMA/Pages/SAMAHistory.aspx>,
[Accessed 15 June 2017]
- Saudi Arabian Monetary Agency (SAMA), available at:
<http://www.sama.gov.sa/sites/samaen/AboutSAMA/Pages/SAMAFunction.aspx>,> accessed 15 June 2017
- Saudi Arabian Monetary Agency (SAMA), available at:
<http://www.sama.gov.sa/sites/SAMAEN/Insurance/Pages/LawsandRegulations.aspx>,> accessed 15 June 2017
- Saudi Arabian Monetary Agency (SAMA), available at:
<http://www.sama.gov.sa/sites/samaen/AboutSAMA/Pages/SAMAFunction.aspx>,> accessed 15 June 2017
- Schinas, O., Grau, C. and Johns, M. 2014. *HSBA Handbook of Ship Finance*. Springer.
- Schinas, O., Grau, C. and Johns, M. 2014. *HSBA Handbook of Ship Finance*. Springer.
- Schoon, N. 2010. *Islamic Banking and Finance*. London: Spiramus Press.
- Schoon, N. 2010. *Islamic Banking and Finance*. Spiramus Press.
- Schoon, N. 2010. *Islamic Banking and Finance*. Spiramus Press.

- Schoon, N. 2011. *Islamic Asset Management: An Asset Class on its Own*. London: Edinburgh University Press.
- Schoon, N. 2011. *Islamic Asset Management: An Asset Class on its Own?* London: Edinburgh University Press.
- Sharia Finance. 2012. [Online]. Available at: <http://www.islamic-bank.com/sharia-finance/> [Accessed on: 8 September 2015].
- Shari'ah Rulings and Finance. 2015. [Online]. Available at: <http://www.islamic-banking.com/shariahSharia-rulings-finance.aspx> [Accessed on: 14 July 2015].
- Shayesteh, A. 2009. *Islamic banks in the United States: breaking through the barriers*. NewHorizon – Global perspective on Islamic banking and insurance.
- Shofawati, A. 2014. Murabaha *Murabaha* Financing in Islamic Banking: Case Study in Indonesia. *Proceedings of 5th Asia-Pacific Business Research Conference*.
- Shura Council Law 1992, Art. 23
- Siddiqi, A. and Hrubí, P. 2008. *Islamic Investments Funds Versus Hedge Funds*. GRIN Verlag.
- Siddiqui, S.H. n.d. Islamic Banking: True modes of financing. [Online]. Available at: <http://nzibo.com/IB2/truemodes.pdf> [Accessed on: 13 March 2014].
- Simmons, M. 2006. *Security Operations*. US: John Wiley & Sons.
- Simonton, D.K. 2003. Qualitative and Quantitative Analyses of Historical Data. *Annual Review Psychological* 56, pp. 617-640.
- State Bank of Pakistan. 2014. About the bank: Core functions. [Online]. Available at: http://www.sbp.org.pk/about/core_functions/index.htm [Accessed on: 23 March 2014].
- Sundararajan, V. 2007. Risk measurement and disclosure in Islamic finance and the implications of profit sharing investment accounts. *Advances in Islamic Economics and Finance* 1, pp.1 21-152.

- Sundararajan, V. and Errico, L. 2002. Islamic financial institutions and products in the global financial system: Key issues in risk management and challenges ahead.
- Sundararajan, V., and Errico, L. 2002. Islamic Financial Institutions and Products in the Global Financial System: Key Issues in Risk Management and Challenges Ahead. *IMF working paper*. International Monetary Fund, p. 69
- Swartz, N.P. 2013. Risk management in Islamic banking. *African Journal of Business Management* 7(37), pp. 3799-3809.
- Taher, N. and Al-Hajjar, B. 2013. *Energy and Environment in Saudi Arabia: Concerns & Opportunities*. New York: Springer Science & Business Media.
- Takaful Islamic Insurance. 2012. [Online]. Available at: http://www.islamic-banking.com/prohibition_of_gharar_masir_riba.aspx [Accessed on: 29 August 2012].
- Temporal, P. 2011. *Islamic Branding and Marketing: Creating A Global Islamic Business*. US: John Wiley & Sons.
- The Kingdom of Saudi Arabia: An Overview, 2012. [Online]. Available at: [http://www.ca-suisse.com/C12575DE004F6944/lkpResources/Insight%2014%20ksa%202.pdf/\\$FILE/Insight%2014%20ksa%202.pdf](http://www.ca-suisse.com/C12575DE004F6944/lkpResources/Insight%2014%20ksa%202.pdf/$FILE/Insight%2014%20ksa%202.pdf). [Accessed on: 13 March 2015].
- The rationale of prohibition of Riba. 2012. [Online]. Available at: <http://www.financialislam.com/prohibition-of-riba-maysir-and-gharar.html> [Accessed on: 29 August 2012].
- The three principles of Islamic finance explained. 2005 [Online]. Available at: <http://www.iflr.com/Article/1984844/The-three-principles-of-Islamic-finance-explained.html> [Accessed on: 08 June 2012].
- Thomas, A. S., Cox, S. and Kraty, B. 2005. *Structuring Islamic financial transactions*. UK: Euromoney Books, p. 47.
- Thomas, A.S. 2006. *Interest in Islamic Economics: Understanding Riba*. New York: Routledge.

- Uberoi, P. and Evans, N. 2008. Profit rate swap. [Online]. Available at:
<http://www.allenoverly.com/SiteCollectionDocuments/47753.pdf> [Accessed on: 13 March 2014].
- Ulus, S. n.d. Collateralised Financing. [Online]. Available at:
<http://www.iifm.net/sites/default/files/session-files/Collateralised%20Financing%20by%20Mr.%20Sabri%20Ulus.pdf>
 [Accessed on: 12 November 2016].
- Understanding Shariah *Sharia* Investment. 2008. [Online]. Available at:
http://www.rreef.com/content/_media/Research_Understanding_Shariah_Sharia_Investment_June_2008.pdf [Accessed on: 13 December 2012].
- Usmani, M.T. 2004. *An Introduction to Islamic Finance*. Arham Shamsi.
- Van Greuning, H. and Iqbal, Z. 2008. *Risk Analysis for Islamic Banks*. World Bank Publications.
- Venardos A, *Islamic Banking and Finance in South-East Asia: Its Development and Future*, (World Scientific Publishing Co. Ltd 2005)
- Verse 282 of Surah 2 of the Holy Quran
- Visser H, *Islamic Finance: Principles and Practice* (Edward Elgar Publishing Limited 2009)
- Visser, H. 2009. Islamic Finance and Principles and Practice. [Online]. Available at: <http://www.kantakji.com/fiqh/Files/Finance/N247.pdf> [Accessed on: 27 August 2012].
- Visser, H. 2013. *Islamic Finance: Principles and Practice*, 2nd. ed. England: Edward Elgar Publishing.
- Visser, H. and Visser, H. 2009. *Islamic Finance: Principles and Practice*. UK: Edward Elgar Publishing.
- Warde, I. 2010. *Islamic Finance in the Global Economy*. Edinburgh University Press.
- Waren, C.S. 2015. Commerical law. [Online]. Available at:
<http://www.oxfordislamicstudies.com/article/opr/t236/e0156> [Accessed on: 24 October 2015].

- What is Islamic Finance and What are the principles? 2011. [Online]. Available at:
<http://www.grapeshisha.com/living-working/a-basic-guide-to-islamic-finance.html> [Accessed on: 29 August 2012].
- Wilkinson, D. 2003. *Using Research Instruments: A Toolkit for Researchers*.
London: Routledge.
- Wilson, R. 2012. *Legal, Regulatory and Governance Issues in Islamic Finance*.
London: Edinburgh University Press.
- Wilson, R. n.d. The Evolution of the Islamic Financial System. [Online]. Available
at:
<http://www.sc.com.my/eng/html/iaffairs/ioscoislamicpdf/aaeuromoneych2.pdf>
df [Accessed on: 31 December 2012].
- Yépez-García, R.A. and Dana, J. 2012. *Mitigating Vulnerability to High and
Volatile Oil Prices: Power Sector Experience in Latin America and the
Caribbean*. New York: World Bank Publications.
- Zahan, M. and Kenett, R.S. 2012, Hedging Instruments in Conventional and
Islamic Finance. *Electronic Journal of Applied Statistical Analysis:
Decision Support Systems and Services Evaluation* 3(1), pp. 59-74.
- Zainol, Z. and Kassim, S.H. 2010. An Analysis of Islamic Banks' Exposure to
Rate of Return Risk. *Journal of Economic Corporation and Development*
31, pp. 59-84.
- Zhang, Y., Ji, L. and Liu, F. 2010. *Local Housing Market Cycle and Loss Given
Default: Evidence From Sub-Prime Residential Mortgages*. International
Monetary Fund.
- Zuhur, S. 2011. *Saudi Arabia Middle East in Focus*. USA: ABC-CLIO.