

Islamic Finance in Saudi Arabia: Developing the Regulatory Framework

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Abstract

Saudi Arabia and Islam have had a very close relationship since the establishment of Saudi Arabia. Thus, Saudi Arabia chose Islam to govern all its laws. Since 1952, with the discovery of oil, the country has witnessed a huge development including the establishment of the Saudi Arabian Monetary Authority (SAMA) as a Central Bank. SAMA was expected to only allow financial activities that did not conflict with the teachings of Islamic law, as stated in its Charter. However, since its existence, SAMA has supervised and licensed conventional banks that charge *Riba* (interest or usury) and all the regulations made by SAMA have been designed to deal with conventional banks. Consequently, there is a difference between the law, Islamic law, and the practice.

Over the years a dramatic improvement in Islamic finance has been realised. Many countries and international organisations that specialised in Islamic finance have set especial regulations that suit such finance. Nonetheless, Saudi Arabia as a regulatory body preferred not to join this trend and continued adopting and practising the same regulations that were made for conventional finance. This thesis seeks to develop the regulatory framework towards Islamic finance by shedding light on the legal challenges and difficulties that may encounter Islamic finance in Saudi Arabia, which may prevent the Kingdom of Saudi Arabia from being the leading country for developing Islamic finance. To help in identifying these challenges, an Islamic financial product *Sukuk* (Islamic bonds) is chosen to be a case study to show some of the challenges in practice.

The thesis firstly discusses Islamic principles toward finance, then the legal environment of Saudi Arabia and how Islamic finance is practised in the Kingdom. It then introduces the new development in the legal environment in response to the Saudi Vision 2030 which can be a tool to help solving the obsricales that Saudi Arabia is encountering. Then the thesis discusses some challenges related to sharia boards in financial institutions, such as not having sharia governance as part of the corporate governance of financial institutions that market their products as being compliant with sharia law; in addition, the absence of a Central Sharia Board that should help in ensuring the conformity of financial products to sharia law. The thesis proposes that

the regulators should develop and adopt especial regulations framework that could help the development of Islamic finance. The thesis defines *Sukuk* and shows how it differs from other financial instruments in conventional finance. Then, it identifies some of the challenges that face *Sukuk* and its development in the country. Moreover, it looks at a very recent development in the Saudi legal system, which is in response to the Saudi Vision 2030 and the recent interest that was shown by decision-makers, such as the Chairman of the CMA, the Minister of Commerce and Industry, the Deputy Minister for Internal Trade, and also both the Governor and Vice-Governor of the SAMA, in response to the Vision 2030 which could contribute to the development of Islamic finance. As far as the researcher is aware, hardly any studies have addressed this issue with respect to the new development that Saudi Arabia is currently witnessing in response to the Saudi Vision 2030 and the recent developments taking place in neighbouring countries which broadly share similar cultural and religious values. Finally, the thesis proposes some recommendations to develop Islamic finance including some guidelines for establishing a Central Sharia Board, and also, a sharia supervisory governance for Islamic financial institutions which should have a positive effect on Islamic finance in the country.

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Definitions of Arabic Terms

<i>Al-jahbadh:</i>	One of the names for people who work as bankers.
<i>Al-Masalih al Mursalah:</i>	Public interest if not leading to prohibition.
<i>Al-Risala:</i>	The message and it is a name of a book.
<i>Ashab al-Hadith:</i>	People of traditions or a person who tries their best to follow the traditions of the prophet.
<i>Ashab al-ray:</i>	Rationalists or the partisans of personal opinion.
<i>Ashab:</i>	Followers.
<i>Amal Ahl al-Medina:</i>	The practice of the people of Madina.
<i>Bay al-dayn:</i>	Selling debt.
<i>Bay al inah:</i>	Form of finance where an owner sells his asset on a deferred basis, then buys it back from the purchaser on a cash basis at a price that is usually lower than than the original selling price.
<i>Darab fi al-Ard:</i>	Journeying through the land seeking the bounty of God or travelling from place to place looking for capital or financial opportunities.
<i>Diwan Al-Malaki:</i>	Royal Court.
<i>Fiqh:</i>	Islamic jurisprudence.
<i>Fiqh al-muamalate:</i>	Islamic Commerical Jurisprudent.
<i>Gharar:</i>	Risk or uncertainty.
<i>Hadith:</i>	Traditionas of the Prophet or a report of the sayings or actions of the prophet.
<i>Hajj:</i>	Pilgrimage or visiting Makkah at a certain time.
<i>Haram:</i>	A forbidden action.
<i>Hiyal:</i>	Plural of hila and legal tricks.
<i>Ijara:</i>	Leasing contract.
<i>ijara financing:</i>	Leasing financing.
<i>Ijma:</i>	Consensus.
<i>Ijtihad:</i>	Self- exertion or diligence to endeavor, strive, put one-self out, work hard

<i>Isnad:</i>	Chain of narration of a <i>Hadith</i> or the list of individuals who narrate a <i>Hadith</i> all the way back to the Prophet.
<i>Isthsan:</i>	Preferable matters or juristic preference.
<i>Istishab:</i>	Legal presumption.
<i>Istisna:</i>	Order to manufacture.
<i>Madhab:</i>	School of thought or school of classical Islamic jurisprudence.
<i>Madhabs:</i>	Plural of <i>Madhab</i> , schools of thought.
<i>Maisir:</i>	Gambling.
<i>Majlis Ash-Shura:</i>	Consultation Council.
<i>Makhraj fiqhia:</i>	A legal existence from a hardship.
<i>Mudaraba:</i>	Entrepreneur or trustee of a venture.
<i>Mufti:</i>	A sharia scholar who provides sharia answers.
<i>Murabaha:</i>	Trade with mark-up or a mark-up sale.
<i>Musharaka:</i>	Partnership contract.
<i>Nizam:</i>	Regulation.
<i>Qiyas:</i>	Analogical reasoning by sharia scholars.
<i>Quran:</i>	The Islamic sacred book, words of Allah.
<i>Riba:</i>	Usury or interest.
<i>Riba al-fadl:</i>	Riba of excess.
<i>Riba ansia:</i>	Riba of delay.
<i>Sa'a:</i>	A unit of measurement.
<i>Sadd Al-Dharai:</i>	Blocking pretences or, in other words, not allowing action that leads to committing a prohibition.
<i>Sahaba:</i>	Companions of the prophet.
<i>Sakk:</i>	Any certificate representing a contract or conveyance of financial rights, money transactions or obligations which are sharia compliant.
<i>Salam:</i>	Forward selling.
<i>Sarrafeen:</i>	One of the names for people who work as bankers See <i>al-jahbadh</i> and <i>Sayarifah</i> .
<i>Sarf:</i>	Exchange of money for money.
<i>Sayarifah:</i>	People who work as bankers or in money exchange.
<i>Shirakah:</i>	Partnership.

<i>Shura:</i>	Consultation.
<i>Suftajah:</i>	People who work as bankers or a bill of exchange between three parties (the payor, the payee and the transmitter).
<i>Sukuk:</i>	Islamic bonds or certificates of equal value representing an undivided share in the ownership of assets or projects; sharia-compliant bonds alternative.
<i>Sunna:</i>	Prophet Muhammad's words or acts and way of life, prescribed as normative in Islam. Also see <i>Hadith</i> .
<i>Sunni:</i>	Adherent of the <i>Sunna</i> group; the main stream group in Islam.
<i>Taqlid:</i>	Conformism or following the opinions of other scholars.
<i>Tawaruq:</i>	Securitsation.
<i>Tawarruq:</i>	A financial product when a person need to obtain liquidity.
<i>Ulema:</i>	Sharia scholars.
<i>Ummah:</i>	Nation or community <i>of Muslims</i> .
<i>Urf:</i>	Customs.
<i>Usoul al fiqh:</i>	The legal rulings derived from the principles of jurisprudence.
<i>Walla:</i>	Reserving the right to inherit.
<i>Rab Al-maal:</i>	Provider of funds.

Abbreviations

AAOIFI:	Accounting and Auditing Organization for Islamic Financial Institutions.
ACRSD:	Appeal Committee for the Resolution of Securities Conflicts.
BCL:	Banking Control Law.
CAGR:	Compound Annual Growth Rate.
CMA:	Capital Market Authority.
CML:	The Capital Market Law.
CRSD:	Committee for Resolution of Securities Disputes.
ECP	East Cameron Partners.
FCA:	Financial Conduct Authority.
FSA:	Financial Services Authority.
GCC:	Gulf Cooperation Council.
GDP:	Gross Domestic Product.
HMRC	Her Majesty's Revenue and Customs.
IFRS:	International Financial Reporting Standards.
IFSB:	The Islamic Financial Services Board.
IFFIm	International Finance Facility for Immunization.
IPO:	Initial Public Offering.
JSC:	Joint Stock Company.
KSA:	Kingdom of Saudi Arabia.
LDCIF:	Legal Development Committee for Islamic Finance.
MCB:	Muslim Council of Britain.
SABIC:	Saudi Arabian Basic Industries Corporation
SAR:	Saudi Arabian Riyal.
SCS:	Sarawak Cororate Sukuk.
SEDC:	Sarawak Economic Development Corporation.
SGDBs:	Saudi Government Development Boards.
SPV:	Special Purpose Vehicle.
SRI:	Socially Responsible Investing.

Chapter One: Introduction

1.1 Overview

Over the past four decades Islamic finance has experienced a tremendous growth and most major financial institutions are now involved in one way or another in this particular form of finance.¹ Islamic financial institutions are now operating in at least 105 countries,² and more countries have introduced, or are considering introducing, legislation that complies with the regularity framework of this industry.³ The total assets held globally under Islamic finance in 2010 reached \$1 trillion,⁴ and in 2015 \$2 trillion,⁵ showing that the global assets of Islamic finance grew by 18% during that period.⁶ They are expected to reach \$2.7 trillion by the end of 2018 and \$3.5 trillion by 2021.⁷

Islamic finance law has been a part of Islamic law since its inception more than 1400 years ago and is built on basic principles that are deeply rooted in the teachings of the sharia, that is the Quran and the teachings of Prophet Muhammad, and the legal rulings derived from the principles of jurisprudence (*Usoul Alfiqh*).⁸ However, it has been argued that the impact and influence of European colonisation in the Muslim world lessened both the spirit and the status of this legal framework.⁹ In the early 1970s, Islamic financial law began to regain its importance within the banking sector as a growing number of Muslim countries decided to adopt this particular financial system with its conformity with Islamic principles.¹⁰

With respect to the context of this study, there is a strong relationship between the Islamic faith and Saudi Arabia. As Islam is a religion originating from the Arabian

¹ Craig R Nethercott and David M Eisenberg, *Islamic Finance: Law and Practice* (Oxford University Press 2012) 2.

² Ibrahim Warde, *Islamic Finance in the Global Economy* (2nd edn, Edinburgh University Press 2014) 1.

³ Ibid.

⁴ Hussein Elasrag, *Corporate Governance in Islamic Finance Basic Concepts and Issues* (Lap Lambert Academic Publishing 2014) 8.

⁵ Saudi Arabian Monetary Authority, 'Speech of H.E. Governor of SAMA at the First Islamic Banking and Finance Research Conference' (2016) <<http://www.sama.gov.sa/en-US/News/Pages/News14032016.aspx>> accessed 12 December 2017.

⁶ TheCityUK, 'Global Trends in Islamic Finance and the UK Market' (TheCityUK 2017) 8.

⁷ Ibid.

⁸ Samir Alamad, *Financial Innovation and Engineering in Islamic Finance* (Springer International Publishing 2017) 107.

⁹ Hjh Siti Jabbar, 'Islamic Finance: Fundamental Principles and Key Financial Institutions' (2009) 30 Company Lawyer 23.

¹⁰ Ibid.

Peninsula, in Mecca and Madinah, both these cities are now located in Saudi Arabia.¹¹ In addition, Islam has played an important role there since the establishment of the first Saudi State in the eighteenth century.¹² Indeed, the Saudi legal system has been built on the premise that the law of God should act as the main legal structure of the country.¹³

At the beginning of the development of modern Saudi Arabia and the establishment of the Saudi Arabian Monetary Authority (SAMA) as a Central Bank in 1952,¹⁴ which is responsible for regulating commercial banks and exchange dealers as stated in its Charter,¹⁵ SAMA was expected to only allow financial activities that did not conflict with the teachings of Islamic law. This means that it should not engage with, or approve of, trades and finances that have *Riba* (interest or usury) which is prohibited in Islam¹⁶ in any commercial, industrial, or agricultural enterprise, as stated in its Charter.¹⁷ Engaging with financial acts that are prohibited by sharia law was expected to be avoided as the Basic Law of Governance states in different places that the Kingdom should be governed by sharia law which should govern all laws of the State.¹⁸

However in the absence of successful examples of central banks that regulate Islamic finance at that time anywhere in the world, SAMA had to supervise financial activities on a conventional financial basis, including allowing financial institutions and banks to deal with *Riba*.¹⁹ SAMA was established with the support of the United States of America (USA) which provided technical assistance.²⁰ Arthur Young an economist and financial expert from the USA, who was an adviser to the U.S. Government and to the governments of various other countries,²¹ proposed a plan of setting up a central bank

¹¹ Frank E Vogel, *Islamic Law and Legal System of Saudi: Studies of Saudi Arabia* (Brill 2000) 18.

¹² Abdullah S Al-Uthaymeen, *تاريخ المملكة العربية السعودية (History of Saudi Arabia)* (Vol I, Riyadh publisher 1999) 152. Also see 3.2.1 below.

¹³ Abdullah S Al-Uthaymeen, *البحوث والتعليقات في تاريخ المملكة العربية السعودية (Comments and Studies in the History of the Kingdom of Saudi Arabia)* (2nd edn, Altwba 1990) 67.

¹⁴ Royal Decrees number 30/4/1/1046 (20/4/1952).

¹⁵ Art. 1 Charter of SAMA 1957.

¹⁶ See 2.7.1 below.

¹⁷ Art. 6 (a and d) Charter of SAMA 1957.

¹⁸ See 3.2.3 below.

¹⁹ John R Presley and Rodney Wilson, *Banking in the Arab Gulf* (MacMillan Academic and Professional 1991) 34.

²⁰ Fayaz Ahmad Lone and Salim Alshehri, 'Growth and Potential of Islamic Banking in GCC: The Saudi Arabia Experience' (2015) 3 *Journal of Islamic Banking and Finance* <http://jibfnet.com/journals/jibf/Vol_3_No_1_June_2015/4.pdf> accessed 2 May 2017

²¹ James R. Fuchs, 'Truman Library - Dr. Arthur N. Young Oral History Interview' (*Trumanlibrary.org*, 2017) <<https://www.trumanlibrary.org/oralhist/young.htm>> accessed 19 April 2018.

then wrote the Charter of twelve articles for SAMA which has still not changed.²² In the Charter it has been stated in more than one place that SAMA should work in accordance with sharia and should not engage with interest.²³ But since it has been in existence SAMA has supervised conventional banks that charge interest (*Riba*) and all the regulations made by SAMA have been designed to serve conventional banks which mostly depends on interest, therefore it is against the Saudi Law.²⁴ So, there is difference between law and practice.

As mentioned earlier that SAMA was established with the support of the USA and then Mr. George A. Blowers, American citizen was the first Governor of SAMA,²⁵ as Saudi was just beginning to engage with banking activities and needed experts in the field to make a strong start.²⁶

However, this has its consequences as SAMA engaged and licensed banks that work on the pure conventional financial system which contredect with Islamic principles in more than one aspect as going to be discussed in the thesis.²⁷ Engaging with activities that may include prohibited acts could be justified at that time on the basis of necessity, as in Islam necessity permits prohibited matters.²⁸ However, after 1970, Islamic finance started to gain in popularity and several countries and organisations started to regulate this type of finance.²⁹

The Islamic financial services sector in Saudi Arabia is one of the main players in the international sharia-compliant industry. This industry showed its strength by continuing to grow even during the global economic crisis.³⁰ Nonetheless, Saudi Arabia as a regulatory body preferred not to join this trend of sharia-compliant finance and continued adopting and practising the same regulations that were made for

²² Ahmed Banafe and Rory Macleod, *The Saudi Arabian Monetary Agency, 1952-2016* (Springer International Publishing 2017) 28b.

²³ See 3.4.2 below.

²⁴ Barbara A Roberson, *Shaping the Current Islamic Reformation* (Routledge, Taylor et Francis Group 2003) 160.

²⁵ 'Historical Preview' (*Sama.gov.sa*, 2017) <<http://www.sama.gov.sa/en-US/About/Pages/SAMAHistory.aspx>> accessed 10 December 2017.

²⁶ Fayaz Ahmad Lone and Salim Alshehri, 'Growth and Potential of Islamic Banking in GCC: The Saudi Arabia Experience' (2015) 3 *Journal of Islamic Banking and Finance* <http://jibfnet.com/journals/jibf/Vol_3_No_1_June_2015/4.pdf> accessed 2 May 2017

²⁷ See 2.2 below.

²⁸ Yasmin Safian, 'Necessity (*Darura*) in Islamic Law: A Study with Special Reference to the Harm Reduction Programme in Malaysia' (PhD, the University of Exeter 2010) 72.

²⁹ Kabir Hassan and Mervyn Lewis, *Handbook of Islamic Banking* (Edward Elgar 2007) 401.

³⁰ The Report Saudi Arabia 2014, *Oxford business Group*, 73.

conventional finance, which created some challenges for Islamic finance, this includes taking many of the financial disputes including the Islamic ones to special committees, which could legalise *Riba* even though *Riba* is against the sharia, rather than taking the disputes to the courts to be determined by judges whose independence is granted by law.³¹

In addition, leaving individual financial institutions to label their own financial products as sharia-compliant without regularity supervision from the Central Bank or any other authority left Islamic financial institutions with no sharia governance system or national sharia advisory body. This lack of supervision could affect customer confidence with regard to the genuineness of the sharia-compliant products that are offered by the financial institutions.³²

SAMA was not that keen to even license financial institutions that avoid transactions or contracts that include practices that may contradict with sharia. For example, Al-Rajhi bank, the first designated Islamic bank in Saudi Arabia that wanted to avoid *Riba* transactions, was only granted a licence from SAMA in 1987, after much lobbying for more than five years. The licence then granted was on the condition that the bank would not use the word Islamic in its title as this would imply that the other banks were non-Islamic.³³ The situation has not changed much since the establishment of SAMA. However, a very recent development in the Saudi legal system, made in response to the Saudi Vision 2030 announced in April 2016,³⁴ may have a positive impact on such finance. This is going to be discussed in the course of this thesis.

Based on the above premises, this thesis seeks to shed light on the legal challenges and difficulties that may face Islamic finance in Saudi Arabia and so may prevent the Kingdom of Saudi Arabia from being the leading country for developing Islamic finance. The thesis discusses some challenges, such as not having sharia governance as part of the corporate governance of financial institutions which provide financial

³¹ Barbara A Roberson, *Shaping the Current Islamic Reformation* (Routledge, Taylor et Francis Group 2003) 159. Also, see 3.3.3.3.

³² Samir Alamad, *Financial Innovation and Engineering in Islamic Finance* (Springer International Publishing 2017) 86. Also, see 4.7 and 4.8.

³³ Barbara A Roberson, *Shaping the Current Islamic Reformation* (Routledge, Taylor et Francis Group 2003) 162.

³⁴ Saudi Vision 2030, 'Saudi Vision 2030 the Council of Economic Affairs and Development Issued the Decision No. (3-31/37) dated 19 April 2016' (Saudi Vision 2016) 81 <<http://vision2030.gov.sa/en/media-center>> accessed 4 June 2017.

products advertised as being compliant with sharia law, in addition, to not having a Central Sharia Board to ensure the conformity of financial products to sharia law.

The thesis proposes some solutions such as establishing a committee, the Legal Development Committee for Islamic Finance (LDCIF), to reconsider the current regulations and help to draft regulations that could contribute to the development of Islamic finance; and in addition, creating a Central Sharia Board to be an authority for approving any financial product or instrument by the financial institutions; also it would introduce a sharia governance by the regulators to be adopted by financial institutions that offer Islamic finance products. Such solutions have been inspired by some recent practices of some other countries or recommended by some international organisations that seek to develop the Islamic finance.

In order to show how some of the challenges may affect Islamic finance, the thesis uses an Islamic financial instrument *Sukuk*, which are a form of Islamic bond, as a tool to show the nature of such challenges existed. *Sukuk* according to market parlance are considered to be negotiable financial instruments provided they do not involve any prohibited products or transactions.³⁵

Sukuk have been chosen as an example for use as they can be organised and built on different forms of Islamic financial contracts, and because of their popularity in many countries including Saudi Arabia.³⁶ In addition, *Sukuk* have caught the attention of the developers of Islamic financial markets as such instruments can fill the gap caused by the lack of long-term instruments available in conventional markets such as Treasury bonds and bills, which cannot be accepted under sharia law because they generate their return from *Riba*.³⁷ According to the measures set out in Basel III³⁸ for

³⁵ Ali Alshamrani, 'Sukuk Issuance and Its Regulatory Framework in Saudi Arabia' (2014) 2 Journal of Islamic Banking and Finance 306.

³⁶ Abdullah Al Elsheikh and Joseph Tanega, 'Sukuk Structure and its Regulatory Environment in the Kingdom of Saudi Arabia' (2011) 5 Law and Financial Markets Review 190.

³⁷ Khalid Alsaeed, 'Sukuk Issuance in Saudi Arabia: Recent Trends and Positive Expectations' (PhD, University of Durham 2012) 9.

³⁸ Basel III is an internationally agreed set of measures developed by the Basel Committee on Banking Supervision in response to the financial crisis of 2007-09. The measures aim to strengthen the regulation, supervision and risk management of banks. Please see 'Basel III: International Regulatory Framework for Banks' (*Bis.org*, 2017) <<https://www.bis.org/bcbs/basel3.htm>> accessed 18 December 2017. See 6.3 below.

example *Sukuk* can provide an alternative to interest-bearing debt securities, to be held by Islamic banks as high-quality liquid assets.³⁹

Furthermore, there are some recent signs indicating that the current growth in Islamic financing in Saudi Arabia is due to an enormous demand from Saudi investors. The demand comes from both a social and an economic spectrum, because *Sukuk* are considered to be sharia-compliant, and so they are associated with the competitive returns generated by such products.⁴⁰ Thus, Saudi Arabia should pay more attention to the Islamic finance market by setting forth the best regulations and practices to develop this type of finance which is becoming ever more popular.⁴¹

1.2 Research Objectives

Bearing in mind what has been mentioned in the overview above, this thesis attempts to find out whether Islamic finance is provided by relevant laws and regulations that could contribute to the development of Islamic finance in Saudi Arabia. Islamic finance is built on sharia principles that establish justice and provide for the elimination of exploitation in commercial transactions.⁴² These principles also discourage inequitable gains and injustice by prohibiting for example *Riba*.⁴³ Thus, Ayub stated that economists should focus on risk-related capital and investment mechanisms which could remedy many socio-economic problems.⁴⁴

As far as the researcher is aware, hardly any studies have addressed this issue with particular respect to the new development that Saudi Arabia is currently witnessing in response to the Saudi Vision 2030,⁴⁵ and the recent developments taking place in neighbouring countries which broadly share similar cultural and religious values.⁴⁶

³⁹ Basel Committee on Banking Supervision, 'Basel III: The Liquidity Coverage Ratio and Liquidity Risk Monitoring Tools' (Bank for International Settlements 2013) 19 <<https://www.bis.org/>> accessed 11 December 2017.

⁴⁰ Khalid Alsaeed, 'Sukuk Issuance in Saudi Arabia: Recent Trends and Positive Expectations' (PhD, University of Durham 2012) 9.

⁴¹ TheCityUK, 'Global Trends in Islamic Finance and the UK Market' (TheCityUK 2017) 19.

⁴² Fahad Al-Zumai and Mohammed Al-Wasmi, '2008 Financial Crisis and Islamic Finance: An Unrealized Opportunity' (2016) 29 *International Journal for the Semiotics of Law - Revue internationale de Sémiotique juridique* 457.

⁴³ Muhammad Ayub, *Understanding Islamic Finance* (Wiley 2013) 9.

⁴⁴ *Ibid.*

⁴⁵ See 3.6 and 6.6 below.

⁴⁶ See 4.11 below.

Based on this, the following key objectives can be derived:

- 1- to explore and explain the current legal situation governing Islamic finance in Saudi Arabia, to show the distinction between law in theory and law in practice;
- 2- to identify some of the possible challenges that may face Islamic finance in Saudi Arabia;
- 3- to propose solutions that may help Islamic finance in Saudi Arabia to gain the confidence of its investors and clients;
- 4- to use the *Sukuk* instrument in Saudi Arabia, an Islamic financial product, as a tool to discover the challenges that facing Islamic finance in practice.

1.3 Research Questions

Based on the above objectives, this thesis attempts to answer one main research question which is: What are the legal challenges facing Islamic financial products in Saudi Arabia? In order to answer this question, there are other questions that may be formulated such as: What does Islamic finance mean and what kind of principles does this type of finance has to follow?

The thesis will then move to another issue linking Saudi Arabia with Islamic law and finance by raising another question: To what extent does Saudi Arabia commit to its own Islamic laws with respect to Islamic financial institutions in the Kingdom? This should be followed by a further question: What laws are really being applied to Islamic finance in Saudi Arabia? This question would show the distinction between law in theory and law in practice.

Answering these previous questions would lead to the next question which is: Why are Islamic finance institutions governed by laws and regulations that are designed for conventional financial institutions? After this question, the thesis will highlight the risks that can accrue when specific regulations are not provided by answering the following two questions: What, if any, are the potential shortcomings in the way Islamic financial institutions in Saudi Arabia deliver the contracts to their customers? And what are the consequences of not adopting special laws and regulations for Islamic finance?

Furthermore, an attempt will be made to answer the question: To what extent is it important to have special requirements for sharia boards in financial institutions, such as electing board members and insuring their independency?

As the thesis takes *Sukuk* to be used as the subject of a case study, there is a need to raise a question about the meaning of the *Sukuk* and how they differ from other financial instruments in conventional finance such as bonds and shares and then to answer a question: How is the *Sukuk*, as an example of an Islamic finance instrument, dealt with in Saudi Arabia? Finally the thesis will answer the question: What are the challenges facing the development of *Sukuk*?

1.4 Research Rationale

The debates among the public, the sharia scholars and the academics on the legality, from the sharia point of view, of engaging in financial activities whether through conventional or Islamic financial institutions⁴⁷ have attracted the attention of the researcher from an early stage.

As a result, the researcher became keen to investigate the reasons behind the slow development of Islamic financial institutions in Saudi Arabia, although this country has the potential to be among the top actors and providers of such finance; and also, to find out more about the existence of conventional banks that provide financial products and contracts that contain *Riba* (interest).

This made the researcher interested in trying to find out the reason why Islamic law, which is the law of the country, is not always followed in this context. In 1992 Abdulaziz bin Baz the Grand Mufti of Saudi Arabia at that time, responded to a question about working in banks in Saudi Arabia that deal with *Riba*. He stated that unfortunately, most of the banks in Saudi Arabia and outside of the country deal with *Riba*; those banks should be avoided, by people not working in, or dealing with them.⁴⁸ Then he

⁴⁷ Yussef Alkhozim, *تحول المصارف المركزية إلى مصرف مركزي إسلامي (The Transformation of Conventional Central Banks to Central Islamic Bank)* (Dar Al-Salam 2004). Also, M. Shaghil, *Islamic Economics a Global Perspective* (1st edn, SB Nangia 1989). Also see Sami Hassan Homoud, *Islamic Banking: The Adaptation of Banking Practice to Conform with Islamic Law* (Graham & Trotman 1985). And Frank E Vogel and Samuel L Hayes, *Islamic Law and Finance: Religion, Risk, and Return* (Koninklike Brill 2006). M. Shaghil, *Islamic Economics A Global Perspective* (1st edn, SB Nangia 1989). Wael B. Hallaq, *An Introduction to Islamic Law* (1st edn, Cambridge University Press 2009). Abdulrazak Al-Hiti, *المصارف الإسلامية بين النظرية والتطبيق (Islamic Banking at the Crossroads: Theory Versus Practice)* (Dar-Osama Publisher 1998).

⁴⁸ Abdulaziz Bin Baz, *مجموع فتاوى ومقالات متنوعة (Collection of fatwas and Various of Articles)* Vol 7 (Maktabat al-Maarif lil-Nashr wa-al-Tawzi 1992) 282.

said conventional banks would quickly disappear as the king has now agreed to Islamic banks being established.⁴⁹ As a matter of fact, the government stated upon its establishment, as stipulated in the Basic Law of Governance in more than one article, that the country is ruled and governed by Islamic Law (sharia). For example, the Basic Law of Governance states that “governance in the Saudi Arabia derives its authority from the Book of God and the Sunna, both of which govern this Law and all laws of the State”.⁵⁰ Also, the SAMA Charter is based on sharia-compliant principles, as stated, for instance, in Article 6 (a) and (d):

The Agency shall not undertake any of the following functions: (a) acting in any manner which conflicts with the teachings of the Islamic Law; the Agency shall not charge any interest on its receipts and payments; (b) engaging in trade or having an interest in any commercial, industrial, or agricultural enterprise.⁵¹

From the above, it can be seen that Saudi Arabia chose to be governed in all aspects of its governance, including finance, by Islamic law. This means that any law or regulation that contradicts with sharia should be avoided, whereas the thesis is going to show that this is not always the case. Thus, this thesis seeks to examine the issue in depth and attempts to make possible recommendations to contribute to the field of Islamic finance in Saudi Arabia. The recommendations will be about developing proper regulations that would assist such finance to grow in the right legal environment. In order to examine the way Islamic finance is dealt with in Saudi, the researcher chose one of the Islamic finance products that has become increasingly popular in many countries.⁵²

Sukuk is an Islamic financing instrument that might be one of the most appropriate choices to increase the efficiency and effectiveness of the financing system for Saudi Arabian corporates and might possibly serve to meet their funding needs instead of the prohibited options, such as bonds, that exist now.⁵³ For this reason, *Sukuk* were chosen as an example to highlight the challenges that may face Islamic finance in Saudi Arabia.

⁴⁹ Ibid.

⁵⁰ Basic Law of Governance 1992, Art 7.

⁵¹ Ibid Art. 6.

⁵² Abdullah Al Elsheikh and Joseph Tanega, 'Sukuk Structure and its Regulatory Environment in the Kingdom of Saudi Arabia' (2011) 5 Law and Financial Markets Review 190.

⁵³ See 5.4.1 below.

1.5 Research Methodology

This thesis focuses on sharia law within the specific context of Saudi Arabia by investigating how Saudi Arabia chose to adopt sharia law and by analysing its practices using *Sukuk* as an example. Hence, this research is mainly concerned with investigating the application and effectiveness of the Islamic finance legislation in the Kingdom of Saudi Arabia and broadly adopts a combination of the examination of primary and secondary sources together with some empirical research as well.

This thesis reports “research about law” more than “research in law”.⁵⁴ Thus, in addition to consulting the relevant secondary literature in the area, the thesis also analyses some primary sources such as religious texts, the Quran and the *Sunna*; and also several legal documents such as the Saudi Basic Law of Governance, the Law of the Judiciary, the Law on Supervision of Finance Companies, Saudi Arabia Banking Control Law and the Charter of the Saudi Arabian Monetary Agency.

Then the thesis engages with secondary literature on this subject for the library-based or doctrinal method, which can be used, as Ian Dobinson and Francis Johns stated, to ask what the law is in a particular area,⁵⁵ by collecting and then analysing a body of case law, together with any relevant legislation (so-called primary sources) and may include secondary sources on the legislation, to describe a body of law and how it applies.⁵⁶

Secondary sources are used in this thesis such as a large number of books in Arabic and English on the topic of Islamic finance and Saudi regulations. In addition, a great number of articles were reviewed, and other theses were consulted. Moreover, financial reports were reviewed to obtain some current figures showing the developments in Islamic finance in general and in Saudi Arabia in particular. Also, press releases from the government and well-recognised financial institutions were included especially concerning the most recent development in the laws and regulations of finance that have not yet been discussed in academic circles.

⁵⁴ Paul Chynoweth, 'Legal Research', *Advanced Research Methods in the Built Environment* (John Wiley & Sons 2008) 31.

⁵⁵ Ian Dobinson and Francis Johns, 'Legal Research as Qualitative Research', *Research Methods for Law* (2nd edn, Edinburgh University Press 2017) 21.

⁵⁶ *Ibid.*

This thesis also provides a comparative analysis between Saudi Arabia, several of its neighbouring countries and the UK. The UK has been chosen to show the way Islamic finance is treated in a Western country especially with regards to the recent regulations relating to corporate governance.⁵⁷

This comparative analysis attempts to show how several neighbouring countries of Saudi Arabia, all of which broadly share similar cultural and religious values that relate to Islam, have developed their own regulations to provide a better environment for Islamic finance institutions while Saudi Arabia has not yet applied any new laws or regulations regarding this issue.

Moreover, in order to gather in-depth relevant information, interviews were conducted in this research; five face-to-face semi-structured interviews with high experts in this field took place. Semi-structured interviews are characterised by their unique flexibility;⁵⁸ they are less rigid in format than the structured interviews and involve an interview guide rather than an interview schedule. The guide is designed as a prompt for the interviewer to ensure that all issues in the interview are covered.⁵⁹

These kinds of interviews are commonly described as ‘in-depth interviews’ to suggest that such interviews are intended to produce elaborate and detailed answers or complex description.⁶⁰ It is sufficiently structured to address specific dimensions of the research question whilst also leaving space for study participants to offer new meanings to the topic of study.⁶¹ It responds to an imperative for finely-tuned qualitative analysis in order to open up new possibilities in understanding complicated phenomena often accepted as unproblematic.⁶² This is why the semi-structured interview was chosen. As the researcher seeks to understand the complexity involved in the regulation of Islamic finance under regulations that were designed for conventional finance, then the researcher attempts to encourage the interviewees in suggesting reforms if needed. Thus, most of the questions were open-ended. Some interviewees were asked different sub-questions from others, depending on the type

⁵⁷ See 4.11 below.

⁵⁸ Anne Galletta, *Mastering the Semi-Structured Interview and Beyond* (New York University Press 2013)1.

⁵⁹ Gabriele Griffin, *Research Methods for English Studies* (2nd edn, Edinburgh University Press 2013) 186.

⁶⁰ *Ibid.*

⁶¹ Anne Galletta, *Mastering the Semi-Structured Interview and Beyond* (New York University Press 2013)2.

⁶² *Ibid.*

of position and field they worked in but almost all of them were asked the same main questions.

Usually easy and general questions would be asked at the beginning of the interview such as a question about the difference between conventional financial institutions and Islamic financial institutions. Then the questions went more in-depth: for example The researcher suggested looking at the relationship between Islamic financial institutions and SAMA, by asking whether SAMA is regulating the financial institutions in ways that do not conflict with the sharia law as it was stated in its Charter; and whether the current practices of the Islamic financial institutions truly comply with the Islamic principles, and, if not, why not?

Also, the researcher asked the interviewees their opinions as to whether Islamic financial institutions are benefiting from not having especial regulations to ensure the compliance of their products to sharia law; and also about the sharia boards in financial institutions, trying to understand the current situation and which different financial institutions deal with such a board; then, going further to discuss the sharia governance and the advantages of it introduced by the regulators. In addition, some questions related to the judicial role and the different special committees that Islamic financial institutions have to go to in case of disputes, whether between other financial institutions or with consumers, seeking suggestions from their point of view?

Also, questions were put asking about their thoughts about establishing a Central Sharia Board and, discussing some examples of the recent development in other countries towards Islamic finance and whether such examples can be beneficial if adopted in Saudi Arabia? Finally, questions were asked about their thoughts on better regulations for Islamic finance?

All interviews were conducted in the Arabic language, as all participants were Arabs. The researcher approached a number of people knowing that not all would respond; five of the people approached were interviewed. The participants were selected as they are experts in this field and from a range of professional backgrounds. For example, the participants included one academic, chosen for his involvement and publications in this area, a member of the Sharia Board Advisory Department in a well-known Saudi Islamic bank and the head of the Sharia Board Advisory Department in another renowned Saudi Islamic banking provider.

These interviews were conducted to evaluate the existing efforts already made in this field and to find out about the possible challenges facing Islamic finance in Saudi Arabia. A member of the SAMA, the central bank of Saudi Arabia, was interviewed to find out the point of view of the regulators about Islamic financial institutions. Finally, a top executive of the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) in Bahrein who has shown an interest in the Saudi Islamic finance market was also interviewed.

These interviews were designed to help the researcher in his understanding of the criteria applied to regulate Islamic finance in Saudi Arabia and to find out whether both conventional and Islamic finance can be managed under the same regulations; and also, to find out whether the existing laws are actually applied in real life, to identify if there is a gap between law and practice, and whether the current regulations are deemed appropriate to enhance the development of Islamic banking and finance. Furthermore, the interviews were useful in finding out what the interviewees would suggest for reforms if needed.

The interviewees are considered experts in one or more aspects of this field of Islamic finance and the legal challenges possibly facing this industry in Saudi Arabia even though they do not have written publications on this topic. Thus, the interviews were useful for gathering their perspectives, points of view and opinions on this issue.

With regards to the interview protocols, most of the questions were open-ended to give the chance for interviewees to give more in-depth answers and to justify their answers. The questions also provided opportunities for gathering the participants' points of view about Islamic finance contracts and how they are regulated in Saudi Arabia. Also as William Harvey stated, it is generally advisable to avoid asking highly educated people close-ended questions as they do not like to be in the "straightjacket" of such questions.⁶³

The interview method is beneficial to this thesis as it collects different particular perspectives from certain people, who have been selected because of their close relation to the topic, and to understand how and why they have this particular perspective.⁶⁴ The interview method helps the researcher to gain knowledge from

⁶³ William S Harvey, 'Strategies for Conducting Elite Interviews' (2011) 11 *Qualitative Research* 434.

⁶⁴ Catherine Cassell and Gillian Symon, *Essential Guide to Qualitative Methods in Organizational Research* (SAGE 2004) 11.

interviewees who may not be able to express their views in the media or in their publications to protect their work position.

Such knowledge can be gained when the right methodology is used and the questions are allowed to flow smoothly during the interview: starting with questions that can be answered by the interviewee easily and without potential distress, and more difficult questions can be held back in order to give time for both interviewer and interviewee to relax and feel that they know each other.⁶⁵ In addition, the anonymity of their names that have been guaranteed by the researcher helps to gain the interviewees' confidence which is part of the ethical framework that is going to be highlighted now.

For ethical reasons, each one of the interviewees was contacted individually to enquire about their acceptance to be interviewed and to find the best and safest way to be contacted with regards to arranging times for the face-to-face interviews, and the way to receive the consent forms. The participants were informed, via the information sheet and consent form in different ways, either by verbal or email communication, that taking part of this interview is completely voluntary.

In addition, full consent has been gained by each participant signing the written consent form which was delivered to the participants by the best possible method as suggested by each participant: sent out via email or by hand distribution before the interview and to be returned either before or on the day of the interview. More forms were available at the interview.

Participants in each interview were fully informed about the purpose of the research and the procedures that would be used. Interviewees were given information on the project on the initial contact and this was explained again at the beginning of the interviews. There was an information sheet that was sent via e-mail or by hand to be signed before the start of the interviews to ensure that they had read it. The information sheet consisted of a comprehensive summary of the nature of the research and details of what their own participation would involve. Also, it included contact details of the interviewer and his supervisor so that any additional queries could be answered.

⁶⁵ Ibid 17.

In addition, the topic of the thesis is not a politically sensitive topic in Saudi Arabia; which made the possible harm to participants relatively small if adequate safeguards were followed.

The most likely source of possible harm is an interpersonal (rather than political) conflict if participants criticise the way their organisations or department work in cooperating with Islamic finance, which may affect the relations with their managers at work. To minimise this harm it is critical that anonymity is preserved as far as possible.

Nevertheless, the researcher explained to the participants that there might still be a possible risk of identification, even though it may be fairly small; and that they had the right to either not participate, or to withdraw their participation at any point or to avoid answering particular questions. To further limit the possibility of identification participants were given a non-identifying pseudonym, to be 'participant A' and 'participant B' for example.

The only other identifier to differentiate the samples would be to describe the participants as for example a member of the Sharia Board Advisory Department in a Saudi Islamic bank or an academic doctor in one of the Universities in Saudi Arabia, as will be seen soon. Some participants did not mind waiving their anonymity but the researcher made all participants anonymous for extra protection as they did not ask to reveal their names. Other ethical considerations are stated in the ethical proposal that has been approved by the University of Exeter by the ethical committee and this can be found in index 1.⁶⁶

As stated above, for ethical reasons and in order to guarantee the participants' anonymity, the names of the interviewees have not been disclosed. Instead, they are mentioned in this thesis using non-identifying pseudonyms as follows:

Participant A is a member of the Sharia Board Advisory Department in a Saudi Islamic bank 1.

Participant B is the head of the Sharia Board Advisory Department in a Saudi Islamic bank 2.

Participant C is a top executive of AAOIFI.

⁶⁶ Please see appendix 1 below.

Participant D is a high position member of the SAMA.

Participant E is an academic doctor in one of the Universities in Saudi Arabia who has a notable involvement and publications in this area.

1.6 Research Limitations

Despite the rigour of this work and the depth of its analysis, this thesis has evident limitations. First, although Islamic finance is used in many countries, in this thesis the discussion is only limited to the legal challenges facing Islamic financial in Saudi Arabia. References to several other countries are made but the primary focus remains on Saudi Arabia and the way it deals with Islamic finance from a legal point of view. In addition, this work introduced and discussed some of the laws and regulations that play a vital role, whether positive or negative, in the development of Islamic financial institutions.

Thus, the focus is on the key regulations in relation to Islamic finance. Thirdly, the analysis of the *Fatwas* (plural of *fatwa* which is an Islamic decision about a case), including the interviews and decisions on the compatibility of financial contracts to sharia, was based only on the four major Sunni schools of thought (*Madhabs*), Hanafi, Maliki, Shafi and Hanbali, as these have a significant influence on *Fatwas* in sharia boards in Saudi Arabia.

Finally, another limitation which can be considered a contribution from a different angle is that as Saudi Arabia is currently upgrading its laws to comply with the Saudi Vision 2030, there seems to be a lack of academic work on this issue in light of these recent developments; thus, the researcher resorted to gathering information from newspapers or press releases from the government organisations.

1.7 Research Contribution

It is hoped that this thesis will make a significant contribution to knowledge in the field of Islamic finance. The thesis emphasises the importance of Islamic finance to Saudi Arabia by showing the strong relationship between Islam, including its financial side, and Saudi Arabia, a country that declares Islamic law as its governing law. This point was developed further to show that there are differences between the law in theory and in practice with regards to Islamic finance in Saudi Arabia.

In addition, an important contribution is made by the researcher to identify some the legal challenges and shortages that hold Saudi Arabia back from being a major hub of Islamic finance, even though it enjoys certain special features that would place it at the top of the Islamic finance sector.

The thesis tries to give a clear explanation why things were developed in the way they did before, and in particular, why regulations were adopted that were built on conventional finance which included the practice of prohibited transactions in Islam. But now we have reached the situation, as stated earlier, because of the strength of the Islamic finance sector and because of the Saudi Vision 2030 for the future. When all these things are coming together; it is now the time for moving to the next stage of development when the financial institutions have to ensure that products that are marketed as compliant to sharia law really are sharia-compliant to avoid losing the confidence of the consumers. Furthermore, this research has provided a significant contribution as it has managed to gather the views and opinions of very important actors and decision-makers within the Saudi Islamic finance industry.

This thesis makes a number of recommendations about possible solutions that Saudi Arabia can adopt to make the most of the Islamic finance sector, which should develop Islamic finance even further. It is the time to develop products which are genuinely compliant with sharia law; such development would be achieved by pushing regulators to create a Central Sharia Board identifying its position and legal responsibilities, also setting up standards for sharia governance in financial institutions that provide Islamic financial contracts by the regulators, the Saudi Arabian Monetary Authority and the Capital Market Authority (CMA), to ensure the independence of the sharia boards and increase the trust of customers and shareholders in the compliance of their finances to sharia.

This thesis addresses the new and current shift with regard to the legal developments that Saudi Arabia is adopting as part of the Saudi Vision 2030. In this respect, this work may constitute the first academic work, as far as the researcher is aware, that highlights the new laws and regulations that may contribute to the development of Islamic finance in the country and because of the Saudi Vision 2030 for the future. Suggestions are given by the researcher on the type of regulations that need to be adopted by the regulators.

1.8 Organisation of the Thesis

This thesis attempts to illustrate the ways by which Islamic financial contracts in Saudi Arabia are governed and seeks to demonstrate the need to develop the existing domestic laws with regard to Islamic financing and banking. The central argument of this work is that the current laws in Saudi Arabia implemented to control Islamic banking and finance have serious shortcomings in the way they deal with Islamic banking and finance in this modern era. Hence to develop this argument the thesis is organised around seven chapters, as explained below.

The first chapter has provided an overview of the work and has highlighted the researcher's motivation for choosing this topic. Then the research objectives were presented followed by the research questions, which gave more focus on the research; the methodology adopted throughout this research to build this work was also presented. Also, this chapter has highlighted the limitations of this work and, finally, the contribution of this research to the academic field was stated.

Chapter Two aims to provide the reader with a clearer understanding of the meaning of Islamic finance and Islamic banks,⁶⁷ in addition to mentioning the reason behind the growing popularity of such finance.⁶⁸ Also, the foundations of Islamic finance are presented including the sources of Islamic law⁶⁹ and the different Islamic schools of thought as they have a significant influence on Islamic finance in Saudi Arabia and in other countries as well.⁷⁰

This chapter also explains the basic foundations relating to the prohibition of certain types of financial contracts in Islam based on the Quran and the *Sunna*. The analysis of the Quran and the *Sunna* involves a close examination of selected verses and relevant interpretations, as highlighted in that chapter.⁷¹ The chapter also provides the underlying reasons for the different kinds of prohibited contracts, such as gambling, *Gharar*, selling debts, and usury in sales and in loans. Then, a brief explanation is provided regarding the meaning and function of the different contracts available in Islamic finance, such as *Murabaha*, *Musharaka*.⁷²

⁶⁷ See 2.2 below.

⁶⁸ See 2.4 and 2.5 below.

⁶⁹ See 2.3 below.

⁷⁰ See **Error! Reference source not found.** below.

⁷¹ See 2.7 below.

⁷² See 2.8 and 2.9 below.

Chapter Three introduces the Saudi legal system and the way Islamic banking and finance is practised in that country.⁷³ The chapter examines the structure of the Saudi Arabian legal system,⁷⁴ and then discusses the laws and government bodies governing finance and banking, such as the Banking Control Law and the Saudi Arabian Monetary Authority.⁷⁵ The chapter then categorises the different types of commercial banks in Saudi Arabia.⁷⁶ Finally, it introduces the new development that is currently taking place in different sectors including finance and the laws brought in to respond to the Saudi Vision 2030.⁷⁷

Chapter Four raises the importance of sharia boards for financing activities in Saudi Arabia and focuses on sharia boards in Saudi financial institutions including banks. The chapter first presents the meaning of the notion of sharia-compliance that sharia boards in financial institutions are required to guarantee in all the financial products they approve;⁷⁸ then, the chapter provides the reasons behind the different *Fatwas* on a certain financial product depending on the different Islamic schools of thought and their position with regards to *Hila* (a legal ruse or stratagem),⁷⁹ and how the law in Saudi Arabia looks at *Hila*.⁸⁰ The chapter presents the main interview findings and highlights some of the challenges that Islamic finance appears to be facing.⁸¹ The chapter also highlights the situation of sharia boards in Saudi Arabia seen from a legal standpoint,⁸² and how its corporate governance compares with the current situation in Saudi Arabia's neighbouring countries within the GCC.⁸³ Then, rules for sharia governance for Saudi regulators are suggested by the researcher.⁸⁴ Finally, the chapter discusses the idea of creating a Central Sharia Board to supervise individual sharia boards in financial institutions.⁸⁵

Chapter Five introduces the notion of *Sukuk* in Islamic finance to be used as a case study and as an example of the way Saudi Arabia deals with Islamic finance. *Sukuk*

⁷³ See 3.2 below.

⁷⁴ See 3.3 below.

⁷⁵ See 3.4 below.

⁷⁶ See **Error! Reference source not found.** below.

⁷⁷ See 3.6 below.

⁷⁸ See 4.2 below.

⁷⁹ See 4.3 and 4.4 below.

⁸⁰ See 4.5 below.

⁸¹ See 4.6 below.

⁸² See 4.7 and 4.8 below.

⁸³ See 4.9 also 4.10 and 4.11 below.

⁸⁴ See 4.11.7 below.

⁸⁵ See 4.12 below.

are one of the current popular instruments that Islamic finance has invented to replace conventional ways of finance which do not comply with Islamic principles. These financial instruments have been chosen because they can be organised and built on different forms of Islamic financial contracts and also, because of their popularity in many countries including Saudi Arabia.⁸⁶

Sukuk are studied in detail⁸⁷ and compared with other financial instruments to show the difference between conventional and Islamic finance.⁸⁸ The chapter provides the necessary contextual knowledge to understand further issues relating to *Sukuk* in the next chapter;⁸⁹ and it also gives examples of ways to form *Sukuk* instruments.⁹⁰

Chapter Six deals with *Sukuk* and its regulations to provide an example of the way Saudi Arabia regulates Islamic finance and the challenges facing such finance. The chapter starts by illustrating the growing interest in *Sukuk* among investors in Saudi Arabia;⁹¹ then the difficulties facing *Sukuk* in Saudi Arabia are discussed,⁹² and how the authorities intend to encourage such finance,⁹³ especially bearing in mind the new Saudi Vision 2030.⁹⁴ Finally, suggestions are made to enhance the use of *Sukuk* in Saudi Arabia.⁹⁵

Finally, Chapter Seven concludes the thesis, summarises the main findings of the study and highlights a number of legal suggestions and recommendations to develop the sector of Islamic finance in Saudi Arabia in order to enhance its attractiveness for Islamic finance investors.

⁸⁶ See 1.1 above.

⁸⁷ See 5.2 and 5.3 below.

⁸⁸ See 5.4 below.

⁸⁹ See 5.5 also 5.6 and 5.7 below.

⁹⁰ See 5.8 below.

⁹¹ See 6.2 and 6.3 below.

⁹² See 6.4 below.

⁹³ See 6.5 below.

⁹⁴ See 6.6 below.

⁹⁵ See 6.7 below.

Chapter Two: Overview of Islamic Finance

2.1 Introduction

In order to examine Islamic financial contracts in Saudi Arabia, identifying the challenges that are facing this sector, and attempting to suggest solutions to develop this market; it is essential to clarify the meaning of Islamic finance and the pillars on which this sector depends on.⁹⁶ Thus, this chapter highlights what is meant by Islamic finance, and then a brief history of this type of finance is presented showing its increasing popularity.⁹⁷

The chapter also highlights the link between Islamic finance and sharia law⁹⁸ by explaining the different schools of thoughts that have an impact on financial contracts in terms of validity.⁹⁹ This constitutes an important step to develop an argument about sharia boards in Chapter Four.¹⁰⁰

In addition, major rules in Islamic finance are discussed showing the prohibited acts in Islamic financial contracts that differentiate this type of contracts from conventional financial contracts.¹⁰¹ Furthermore, examples of Islamic financial contracts are introduced to provide a greater understanding about this kind of finance and give the basic knowledge needed when discussing certain challenges later in the thesis.¹⁰²

2.2 Defining Islamic Finance and Islamic Financial Contracts

This chapter presents Islamic finance with particular reference to the history of Islamic banks in order to show the gap in period when the Islamic finance almost lost its identity in many Muslim countries because of the Western colonialists which has its impact on the development on this finance. Also, this chapter highlights the underlying principles of the four distinct schools of thought.

⁹⁶ See 2.2 below.

⁹⁷ See 2.4 below.

⁹⁸ See 2.3 below.

⁹⁹ See 2.6 below.

¹⁰⁰ See 4.4 and 4.6 below.

¹⁰¹ See 2.7 **Error! Reference source not found.** below.

¹⁰² See 2.9 below.

An exploration of the main sources of Islam is also shown, the Quran and the *Sunna*, which conducted as essential in determining whether or not a contract complies with Islamic precepts.

The Islamic economic system is governed by several basic principles, perhaps the most important of which is that the entire universe is made and controlled by one God. According to Islamic belief, humans are created by God to represent Him on earth and ensure the fulfilment of His commands.¹⁰³ While these commands cover almost every aspect of human life, they are not exhaustive, as this would unduly constrain human deeds, nor are they too uncertain, which would make every sphere of life dependent on human perceptions and desires.¹⁰⁴

Thus, Islam promotes a balanced way to govern human life which provides a wide basis for rational judgment in human activities, to choose and decide on the basis of our assessment of facts, reasons and experience.¹⁰⁵ However, this is tempered by certain rules that cannot be infringed upon, making them not dependent on human assessment.¹⁰⁶ This suggests that, from an Islamic point of view, even human reason, despite its potentially vast capabilities, cannot claim to have unlimited access to truth, as this is only possible through the rules of God.

In several areas of human life confusion and conflicts can occur between reason and desires, leading people to make the wrong decisions. For instance, some ancient theories claimed to be rational by promoting reason, yet have been shown to be fallacious through the advancement of science.¹⁰⁷

According to Islamic beliefs, Almighty God has not only provided guidance in terms of moral issues or worship, but also in all aspects of human life, including socio-economic fields.¹⁰⁸ Muslims have to work within the limits of these commands, based upon the belief that on the day of judgement they will be asked five questions. One of these pertains to the acquisition and use of wealth, meaning that Muslims have to earn and

¹⁰³ Mufti Muhammed Usmani, *An Introduction to Islamic Finance* (1st edn, Quranic Studies Publishers 2010) 9.

¹⁰⁴ Ibid.

¹⁰⁵ Ibid 10.

¹⁰⁶ Ibid.

¹⁰⁷ Ibid.

¹⁰⁸ Ibid.

spend their wealth in a way that is permissible within the divine rules.¹⁰⁹ The result of this is that Islamic institutions have specific ways of dealing with finance that can explain the reason for introducing Islamic finance.¹¹⁰

Islamic finance has been a part of Islamic law since its inception more than 1400 years ago. However, it has been argued that the impact and influence of European colonisation in the Muslim world lessened both the spirit and the position of Islamic finance. In the early 1970s, Islamic financial returned to prominence in the banking sector, with a great number of Muslim countries deciding to adopt this financial system in conformity with Islamic principles and laws.

The rate of adoption increased further with the oil boom in many Gulf States.¹¹¹ Today, a quarter of the world population is Muslim, which justifies the need to adopt a financial system that complies with their religious requirements.¹¹² More recently, the global financial crisis of 2007 triggered a loss of confidence in the financial and banking system of Western countries, igniting hopes in the Islamic finance as a viable alternative.¹¹³ Others argued that one of the vital reasons behind the success of Islamic banks is not the contracts themselves but the support for this kind of finance from certain rich Muslim countries that have huge oil reserves.¹¹⁴

Nevertheless, it has been argued that the noticeable increase in Islamic finance is not solely due to economic grounds, but because ethical standards are also critical.¹¹⁵ This gives extra acclaim to Islamic finance,¹¹⁶ as will be further explained later on in the thesis.¹¹⁷ Investors have become more conscious of the benefits of ethical and socially responsible investments, which are supported by Islamic finance, hence the increased popularity of these institutions. Effectively, the theoretical framework of

¹⁰⁹ Mohamed Ariff and Shamsher Mohamad, *Islamic Wealth Management: Theory and Practice* (Edward Elgar Publishing 2017) 375.

¹¹⁰ Mufti Muhammed Usmani, *An Introduction to Islamic Finance* (1st edn, Quranic Studies Publishers 2010) 10.

¹¹¹ Hjh Siti Jabbar, 'Islamic Finance: Fundamental Principles and Key Financial Institutions' (2009) 30 *Company Lawyer* 23.

¹¹² Benjamin C. Esty, *Modern Project Finance: A Casebook* (New York: John Wiley & Sons) 429.

¹¹³ Rasem N Kayed and M. Kabir Hassan, 'The Global Financial Crisis and Islamic Finance' (2011) 53 *Thunderbird Int'l Bus Rev* 558.

¹¹⁴ Hjh Siti Jabbar, 'Islamic Finance: Fundamental Principles and Key Financial Institutions' (2009) 30 *Company Lawyer* 23.

¹¹⁵ Aulia Fuad Rahman and Hosam Alden Riyadh, 'Islamic Finance: Current, Future Trends and Challenges' (2016) 4 *Journal of Islamic Banking and Finance* 26.

¹¹⁶ Ahmed Mohamed Badreldin, 'Measuring the Performance of Islamic Banks by Adapting Conventional Ratios' [2009] *SSRN Electronic Journal*.

¹¹⁷ See below at 2.7.1 and 6.3.

Islamic finance is always accompanied by the establishment of justice and the elimination of exploitation in commercial transactions, even though there are still some deficiencies in performance in the current financial institutions.¹¹⁸ Furthermore, one of the key objectives of Islamic banks is to reach the socio-economic aims of the Islamic religion to reach full-employment, socio-economic justice, the development of the economy, an equitable distribution of income and wealth and a smooth utilisation of investments and savings making sure that a fair return is gained by all parties.¹¹⁹

This can be seen by the Islamic prohibition of some acts that could affect the socio-economic justice such as the prohibition of *Riba* (interest or usury) and *Gharar* (ambiguity or excessive uncertainty) that will be introduced soon¹²⁰ and prohibition of the sale of some productions that could effects the social welfare such tobacco, pornography and alcohol.¹²¹ On the other hand, the Islamic encouragement for Zakat (almsgiving) and the profit- and loss -sharing financial contracts¹²² another example the socially responsible *Sukuk*.¹²³

Therefore, while the aims of the conventional financial system are based on principles of profit maximisation or the creation maximum returns on capital, Islamic finance seeks to benefit society in terms of equity and prosperity.¹²⁴ Zubairu and Sakariyau, for instance, stated that “for conventional banks the ultimate objective is profit maximization, which is in line with the capitalist worldview on which these banks are founded upon. This situation is not so for Islamic banks as they are founded on the basis of the religion of Islam.”¹²⁵

¹¹⁸ Fahad Al-Zumai and Mohammed Al-Wasmi, '2008 Financial Crisis and Islamic Finance: An Unrealized Opportunity' (2016) 29 International Journal for the Semiotics of Law - Revue internationale de Sémiotique juridique 457.

¹¹⁹ Ibid.

¹²⁰ See 2.7 below.

¹²¹ Shakir Ullah, Dima Jamali and Lan Harwood, 'Socially Responsible Investment: Insights from Shari'a Departments in Islamic Financial Institutions' (2014) 23 Business Ethics: A European Review 219.

¹²² See 2.9 below.

¹²³ See 5.2 below. Also, Fahad Al-Zumai and Mohammed Al-Wasmi, '2008 Financial Crisis and Islamic Finance: An Unrealized Opportunity' (2016) 29 International Journal for the Semiotics of Law - Revue internationale de Sémiotique juridique 457.

¹²⁴ Zaman m. Raquibuz and Movassaghi Hormoz, 'Islamic Banking: A Performance Analysis' (2001) 12 Journal of Global Business 31, 38.

¹²⁵ Umaru Zubairu, Olalekan Sakariyau and Chetubo Dauda, 'Evaluation of Social Reporting Practices of Islamic Banks in Saudi Arabia' (2012) 17 Electronic Journal of Business Ethics and Organization Studies 41.

Furthermore, Vogel and Hayes have explored the ways in which Islamic finance helps the economy to grow by attracting rich Muslims. They claim that Islamic finance is therefore the best choice for individuals who do not wish to commit a sin by investing their money with conventional banks which deal with interest made.¹²⁶

Moreover, Anas points out that “Islamic finance in general, and particularly the Islamic banks, is the establishment of justice and elimination of exploitation in business transaction. This can be done by the prohibition in all sources of illegal “unjustified” enrichment and the prohibition of dealing in transactions that contain excessive risk or speculation.”¹²⁷ Ayub also states that justice plays a major role in sustaining an economic system for the purposes of long-term business, as stipulated by Islamic principles and doctrine.

Thus, economists who have been trying to develop Islamic financial contracts for about forty years, to ensure their balanced and equitable growth and their benefit to individuals as well as to societies, should not forget to avoid injustice.¹²⁸ This is considered one of the main principles of Islamic finance which is distributive justice,¹²⁹ which the reason for prohibiting *Riba* and *Ghara*.¹³⁰ Ayub believes that as Islam already discourage inequitable gains and injustice by prohibiting for example *Riba*. Thus, economists should focus on risk- related capital and investment mechanism which could remedy many socio-economic problems.¹³¹

2.3 An Overview of the Sources of Islamic Law

Islamic finance is a branch of Islamic law derived from the Quran, the direct words of God and His last book delivered to Prophet Muhammad, peace be upon him. The Holy Quran is the main and primary source of Islamic law giving general and specific rules about trading. For example, the Quran states: “O you who have believed, do not consume one another's wealth unjustly but only [in lawful] business by mutual consent” [4:29]. In addition, many verses in the Quran relate to finance, some of which will be

¹²⁶ Frank E Vogel and Samuel L Hayes, *Islamic Law and Finance: Religion, Risk, and Return* (Koninklijke Brill 2006) 25.

¹²⁷ Elmelki Anas and Ben Arab Mounira, 'Ethical Investment and the Social Responsibilities of the Islamic Banks' (2009) 2 *International Business Research* 123.

¹²⁸ Muhammad Ayub, *Understanding Islamic Finance* (Wiley 2013) 9.

¹²⁹ Emma Santen, 'Islamic Banking and Finance Regulation in Malaysia: Between State Sharia, the Courts and the Islamic Moral Economy' (2017) 39 *Company Lawyer* 23.

¹³⁰ See 2.7.2 below.

¹³¹ Muhammad Ayub, *Understanding Islamic Finance* (Wiley 2013) 9.

used in this thesis to clarify the law or to show compatibility between Islamic contracts and Sharia.

The Quran covers a wide area of human life ranging from prayer, belief, commerce and transactions to criminal acts. The Quran does not distinguish between the concepts of law and morality, unlike the secular system. In the Quran, the two are inextricably linked and cannot exist without the other. Commercial aspects, contracts, trade and other economic matters have been discussed in seventy to eighty verses of the Quran.¹³²

However, more details and cases have been tackled in the *Sunna*, which is considered to be the second main and primary source of law for Muslims. The *Sunna* can be defined as the sayings and teachings, deeds and tacit approvals of Prophet Muhammad, which have been reported in the form of *Hadith*. The term *Hadith* is sometimes used as a synonym to the *Sunna* although in certain aspects there are slight differences. For example, the *Sunna* can be more general to show the path and way that the Prophet chose for his life, it can be used to interpret and provide more details about a verse of the Quran, it can set new guidance or demands, that is, when an issue is not mentioned in the Quran, explanations are given by the prophet to clarify God's precepts regarding a specific situation.¹³³ The importance of adhering to the *Sunna* is obvious in the following verse of the Quran: "Indeed you have in the Messenger of Allah an excellent example for the one who hopes in Allah and looks to the Last Day" [33: 21]. Another verse adds:

"Obey Allah and obey the Messenger; but if you turn away - then upon him is only that [duty] with which he has been charged, and upon you is that with which you have been charged. And if you obey him, you will be [rightly] guided. And there is not upon the Messenger except the [responsibility for] clear notification" [24: 54].

Because the restrictions in the Quran and *Sunna* can be either very broad or very specific, human understanding of the meaning of the Quran and *Sunna* is required. This must be done by qualified Islamic scholars and specialised jurists who have the

¹³² Jonathan Ercanbrack, *The Transformation of Islamic Law in Global Financial Markets* (Cambridge University Press 2015) 23.

¹³³ Muhammad Ayub, *Understanding Islamic Finance* (Wiley 2013) 22.

ability and skills to use the primary sources as a guide to make a decision on an issue that is not explicitly stated in these sources.

Thus, beside the Quran and the *Sunna*, another source is used: the *Ijma* (consensus). It is considered as a secondary source in Islam and refers to the ruling pronounced by unanimity or consensus among sharia scholars.¹³⁴ Therefore, it is not a divine revelation like the two primary sources, but it is a rational proof.¹³⁵ *Ijma* has different levels, the highest of which is the consensus of the prophet's companions after his death which the vast majority of Muslims accept.

The next level of *Ijma* relates to the consensus of the generation of scholars following the Prophet's death till the Day of Judgment. This *Ijma* is a vital source for the derivation of laws. As reported in a prophetic narration, the "*Ummah* (community of Muslims) will not unite on misguidance."¹³⁶ Another secondary source is the *Qiyas* (the legal and rational use of analogy), it is a divine law reveals how a specific case can be applied to another case that shares common features.¹³⁷

In addition, there are other sources of sharia which are considered minor sources that scholars use when needed to apply their *Ijtihad* (Self-exertion) such as the saying or choice of a companion of the prophet, *Urf* (customs), *Istislah* (public interest), *Istishab* (legal presumption) and *Istihsan* (preferable matters) (See figure 1).¹³⁸

While the Quran and *Sunna* are considered as perfect and immutable texts by Muslims, human ability to understand them may be imperfect or erroneous, thus giving rise to divergences of opinion among Islamic jurists on certain issues. This eventually led to the emergence of different schools of thought in Islam which play a vital role in Islamic finance as certain schools hold different views regarding the prohibition or permissibility of certain transactions, as explained in the following sections.

¹³⁴ M. Shaghil, *Islamic Economics a Global Perspective* (1st edn, ISBN 81-7024-263-0, SB Nangia 1989) 37.

¹³⁵ Mohammad Hashim Kamali, *Principles of Islamic Jurisprudence* (The Islamic Texts Society 1989) 228.

¹³⁶ Muhammad Ibn Majah, (سُنَن ابْن مَاجَه) *Sunan Ibn Majah* (Maktabat al-Maarif lil-Nashr wa-al-Tawzi 1997). Vol. 5, Book 36, Hadith 3950 <<https://sunnah.com/ibnmajah/36>> accessed 28 October 2014.

¹³⁷ Hij Siti Faridah Abd Jabbar, 'Islamic finance: fundamental principles and key financial institutions' (2009) 30 *Company Lawyer* 30.

¹³⁸ Mutawalli Barajili, *دراسات في أصول الفقه: مصادر التشريع* (*Studies in the Principles of Jurisprudence in Islam: Sources of Legislation*) (Al- Sunna publisher 2010) 37.

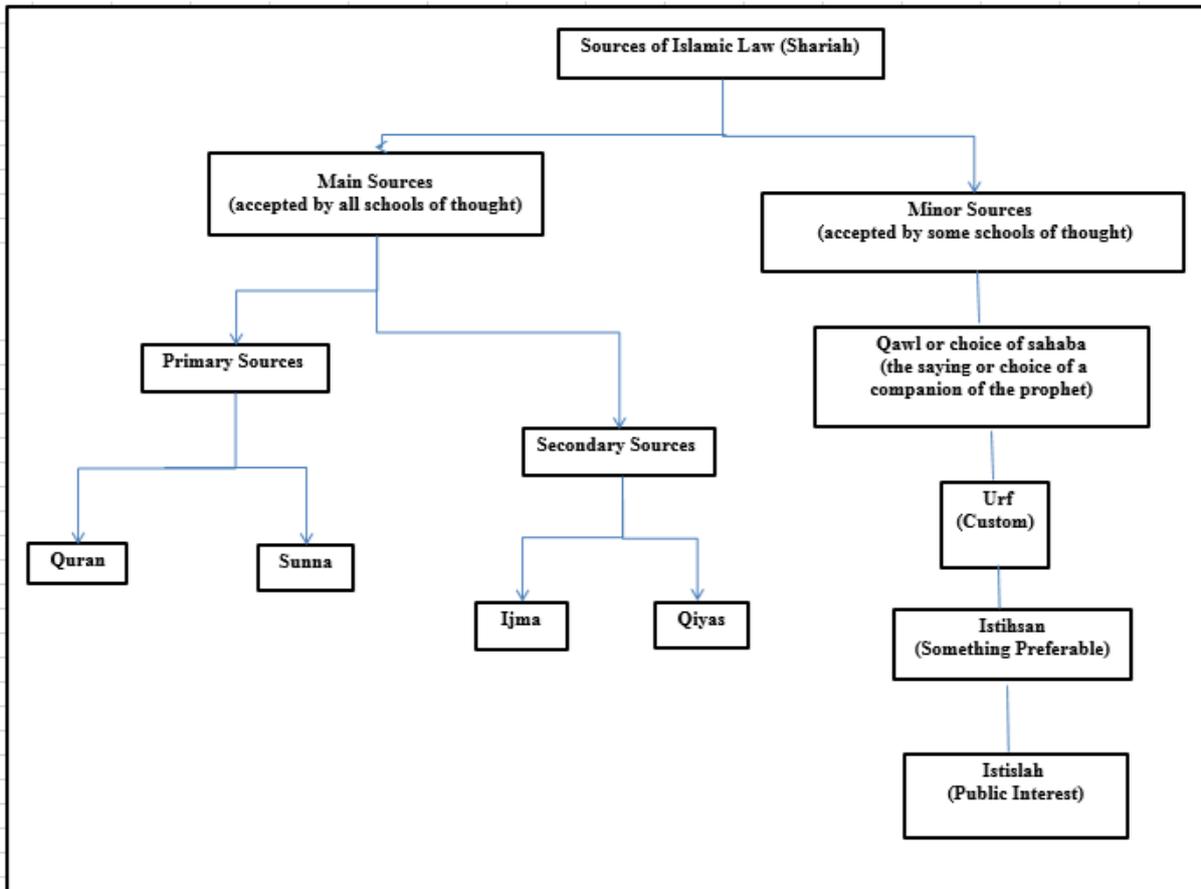


Figure 1: The source of Islamic law

Source: made by the researcher.

2.4 History of Islamic Banks

It is important to briefly introduce the stages that Islamic finance and banking went through since its establishment, and gap in period when they almost lost their identity in many Muslim countries because of the Western colonialists which has its impact on the development on this finance globally.

More focus on Saudi Arabia is going to be presented in the next Chapter.¹³⁹ An Islamic bank can be defined as “a financial institution whose statutes, rules and procedures

¹³⁹ See below at 3.4 and 3.5 below.

expressly state its commitment to the principle of sharia, and the banning of the receipt and payment of interest on any of its operations.”¹⁴⁰

During the pre-Islamic period, people of Makkah used to trade and finance in different ways; for example, the trading system with neighbouring countries was mainly based on caravans travelling to the south of the Arabian Peninsula in the winter and to the north in the summer. Tradespeople used to either travel themselves or give money to a trustworthy person to invest their money with a share of the profit in return.¹⁴¹ Another financing method was to lend money upon usury.¹⁴²

After, the prohibition of certain financial practices, as stated in the Quran and the *Hadith* (prophetic traditions), Prophet Mohammed started to educate people to avoid what had been prohibited, starting with his close relatives.¹⁴³ From that time a positive change in the economic, political, social and judicial spheres started to develop, which marked the beginning of the establishment of a financial system without interest to mobilise resources and finance productive activities and meet consumers’ needs.¹⁴⁴

Lieber described that period as follows: “From the seventh century AD onwards, Muslims succeeded in developing long distance trade and international commerce on a scale which surpassed anything known before.”¹⁴⁵ Chachi cited a number of historians who confirmed the existence of bankers during that time, called by different names in Arabic such as *Sayarifah* or *Sarraffeen* or *Jahabidhah*. Banks, Lieber explains, were called *Dawawin Al-jahabidhah*. He added that in 913 AD, the Abbasid Caliphs “established what is called *Diwan Al-jahabidhah* (plural *Dawawin al-jahabidhah*) with branches in the main trade cities conducting almost all modern banking functions albeit without recourse to interest.”¹⁴⁶ Then, around 1000 AD *al-jahbadh* became like a modern banker, since, as well as the main functions as

¹⁴⁰ Uzaimah Ibrahim, Aishath Muneeza and Rusni Hassan, 'Conflicts Facing Islamic Banking in Malaysia: Dual Banking System Versus Dual Legal System' (2012) 6 Australian Journal of Basic and Applied Sciences 247.

¹⁴¹ Sami Hassan Homoud, *Islamic Banking: The Adaptation of Banking Practice to Conform with Islamic Law* (Graham & Trotman 1985) 19.

¹⁴² Ibid 21.

¹⁴³ Hij Siti Faridah Abd Jabbar, 'Islamic finance: fundamental principles and key financial institutions' (2009) 30 Company Lawyer 24.

¹⁴⁴ Abdelkader Chachi, 'Origin and Development of Commercial and Islamic Banking Operations' (2005) 18 Journal of King Abdulaziz University-Islamic Economics 11.

¹⁴⁵ Alfred E. Lieber, 'Eastern Business Practices and Medieval European Commerce' (1968) 21 The Economic History Review 230.

¹⁴⁶ Abdelkader Chachi, 'Origin and Development of Commercial and Islamic Banking Operations' (2005) 18 Journal of King Abdulaziz University-Islamic Economics 10.

“administrator of deposits and a remitter of funds from place to place via the medium of the *Sakk* (cheque) and especially of the *Suftajah* (bill of exchange), *Al-jahbadh* was called upon to grant huge loans to the caliphs, the viziers and other court officials.”¹⁴⁷

However, after the 13th century, the economic and financial developments started to slow down as the whole Islamic Empire at that time was facing many challenges, such as lack of organisation and an increased bureaucracy, in addition to deviations from Islam and sharia particularly in the political sphere. In addition, long wars against the Crusaders, Mongols and Tartars caused the destruction of many parts of the Empire.¹⁴⁸

Moreover, the Turco-Persian wars, which lasted about three centuries, affected the economic recovery of Iraq.¹⁴⁹ Because of these challenges and other historical circumstances, many Islamic economic activities and the Islamic system of financial intermediation became displaced by Western institutions while the Muslim world remained for centuries in a state of prolonged decay and deterioration until the mid-20th Century AD. This period for the Muslim world can be considered similar to the Dark Ages in Western Europe which was between the fall of the Roman Empire and the end of the 12th Century.¹⁵⁰

Furthermore, according to Vogel, the Islamic banking and finance system represents an assertion of religious law in the commercial arena, which is principally secular in other parts of the world. However, direct and indirect pressure from Western colonialists affected the legal system in most Muslims countries, especially in the commercial and civil sphere.

A small number of Muslims countries, such as Saudi Arabia and some countries in the Arabian Peninsula were not under the rule of colonisation.¹⁵¹ With the end of Western colonisation, there has been an increasing desire among a great number of Muslims to live in greater conformity with Islamic precepts, leading to the widespread adoption of Islamic finance.¹⁵² In addition, as the Muslim population around the world is more

¹⁴⁷ Ibid 10.

¹⁴⁸ Ibid 12.

¹⁴⁹ Ibid.

¹⁵⁰ Ibid 15.

¹⁵¹ Frank E Vogel and Samuel L Hayes, *Islamic Law and Finance: Religion, Risk, and Return* (Koninklike Brill 2006) 19.

¹⁵² Ibid.

than 1.5 billion and represents about 23% of the earth's population, the global spread of the Islamic religion can be counted as one of the reasons for the dramatic growth of Islamic finance.¹⁵³

The modern form of Islamic finance started to appear in the 1940s whereby an Islamic financial movement began in a village in Pakistan. This work was based upon the receipt of deposits from rich land owners, which were then lent to poor farmers to help them develop their farms.¹⁵⁴ No extra money was given to the depositors, except for a small charge to cover the expenses of the institution. Unfortunately, this institution faltered in the 1960s due to a lack of qualified staff as Merah stated.¹⁵⁵

This idea of Islamic finance gradually spread in different places in different forms, such as sharia-compliant savings and investment funds for Muslims in Malaysia who wanted to go on *Haji* (pilgrimage) in the 1950s. Also, in Egypt in 1963, local savings banks which were compliant with sharia principles were founded and attracted more than fifty-nine thousand depositors over a period of only three years. Unfortunately, these banks closed because of political problems at that time.¹⁵⁶

In 1971, the Nasser Social Bank, the first modern Islamic bank, opened and in the following year, the conference of the Ministers of Foreign Affairs of Islamic countries gave recommendations about the need to find an international Islamic bank for Islamic countries. This manifested as the Islamic Development Bank, which opened in 1977. However, this institution only dealt with governments. In 1975, the Dubai Islamic Bank opened providing all banking and investment services for individual investors. In 1977, there were three Islamic banks in three countries: the Faisal Islamic Bank in Sudan, the Faisal Islamic Bank in Egypt and the Kuwait Finance House. By 1992, there were more than ninety Islamic banks; this number increased to 167 by 2001 and 396 by 2008. In addition, more than 320 conventional banks had an Islamic branch in 2008, including HSBC and City Bank, dealing with about US\$200 billion.¹⁵⁷

Up until this point, this chapter has explained the meaning of Islamic finance and has described the sources of Islamic law, it has then set out the development of this finance

¹⁵³ Tina Harrison and Essam Ibrahim, *Islamic Finance: Principles, Performance and Prospects* (Springer 2016) 3.

¹⁵⁴ Hamed Merah, *عقود التمويل المستجدة في المصارف الإسلامية: دراسة تأصيلية تطبيقية (Emerging Financing Products in the Islamic Banks; A Theoretical and Practical Study)* (1st edn, al-Miman Publisher 2011) 40.

¹⁵⁵ Ibid.

¹⁵⁶ Ibid.

¹⁵⁷ Ibid 42.

including the gap in during the period when Islamic finance almost lost its identity in many Muslim countries, thereby impacting on the development of Islamic finance. This should help to give more understanding as why some countries, including Saudi Arabia, had to engage with a system of finance that was not built on Islamic principles.

2.5 Islamic Banking and Finance and the 2007 Crisis

It is believed that the widespread distrust for conventional banking brought about by the global economic crisis is supporting the growth of Islamic finance, providing an opportunity for its expansion into new markets around the world.¹⁵⁸ This can be seen in a comparison between the loss of \$80 billion reported in February 2008 by conventional banks and the lenders in the Gulf and Malaysia, the global hubs of Islamic finance, who barely reported any loss.¹⁵⁹

The development in the Islamic financial sector has been characterised by remarkable growth rates.¹⁶⁰ The total assets held globally under Islamic finance in 2010 reached \$1 trillion,¹⁶¹ while it reached \$2 trillion in 2015 this shows that the global assets of Islamic finance grew by 18% during that period as stated by TheCityUK,¹⁶² while it is expected to reach \$2.7 trillion by the end of 2018 and \$3.5 trillion by 2021.¹⁶³ This seems to reflect the apparent resilience of Islamic banks to the direct effects of the international financial crisis and the resultant global economic downturn.¹⁶⁴

Moreover, Askari believes that because the financial crisis has been the result of excessive debt and leveraging, he suggests that to avoid such a crisis in the future, the current financial system has to be reformed, arguing that the Islamic financial system would prevent these serious risks by prohibiting debt and risk-shifting in favour of risk-sharing and equity finance, which would give more stability, as advocated by

¹⁵⁸ Rasem N Kayed and M. Kabir Hassan, 'The Global Financial Crisis and Islamic Finance' (2011) 53 *Thunderbird Int'l Bus Rev* 560.

¹⁵⁹ Frederick Perry and Scheherazade Rehman, 'Globalization of Islamic Finance: Myth or Reality' (2011) 1 *International Journal of Humanities and Social Science* 117.

¹⁶⁰ Mohamad Zaid Zin, 'Growth and Prospect of *Sukuk* in Islamic Finance' [2012] *Global Islamic Finance Magazine* 69 <<https://www.scribd.com/document/81809488/Global-Islamic-Finance-Magazine>> accessed 10 May 2014.

¹⁶¹ Hussein Elasrag, *Corporate Governance in Islamic Finance Basic Concepts and Issues* (Lap Lambert Academic Publishing 2014) 8.

¹⁶² TheCityUK, 'Global Trends in Islamic Finance and the UK Market' (TheCityUK 2017) 19.

¹⁶³ *Ibid.*

¹⁶⁴ CRS Report for Congress, 'Islamic Finance: Overview and Policy Concerns' (Congressional Research Service 2010) 8 <<https://fas.org/sgp/crs/misc/RS22931.pdf>> accessed 18 February 2013.

several economists including Milton Friedman and Irving Fisher.¹⁶⁵ In addition, a study pointed out that sharia principles can protect Islamic banks from engaging in such instruments that have badly affected the conventional banks and caused the global financial crisis.¹⁶⁶

Furthermore, Rasem and Kayed strongly argued that the global economic crisis might not have happened under an Islamic financial system since most factors that contributed to the crisis are forbidden under the rules of Islamic law and finance. Even though the Islamic financial industry is only about forty years old, it endured the consequences of the global financial crisis but remained relatively positive in the midst of the crisis, suggesting that it offers a recognised level of stability in the global finance system.¹⁶⁷ For example, during the last global financial crisis, Islamic branches of banks that have both Islamic and conventional branches in Pakistan were less prone to the risk of deposit withdrawals during the crisis than the conventional branches, which indicate that customers have more trust on Islamic finance.¹⁶⁸

Nonetheless, a study found that Islamic banks performed differently from conventional banks during the period of the last crisis. For instance, in 2008 aspects related to business models in Islamic banks helped to contain the adverse impact on profitability, while in 2009 some Islamic banks showed weaknesses in risk management practices, which caused a decrease in profitability.¹⁶⁹ This can be explained as the impact of the crisis moved to the real economy which Islamic finance should be built on.¹⁷⁰ Finally, the study mentioned that during the crisis, credit and asset growth in Islamic banks were more than twice higher than conventional banks, which, therefore, justifies the need to study Islamic banks and finance in more detail.¹⁷¹

¹⁶⁵ Hossein Askari, 'Islamic Finance, Risk-Sharing, and International Financial Stability' (2012) 7 Yale Journal of International Affairs 2.

¹⁶⁶ Habib Ahmed, 'Financial Crisis: Risks and Lessons for Islamic Finance' (2009) 1 ISRA International Journal of Islamic Finance 18.

¹⁶⁷ Rasem N Kayed and M. Kabir Hassan, 'The Global Financial Crisis and Islamic Finance' (2011) 53 Thunderbird Int'l Bus Rev 563.

¹⁶⁸ Moazzam Farooq and Sajjad Zaheer, 'Are Islamic Banks More Resilient During Financial Panics?' (2015) 20 Pacific Economic Review 17.

¹⁶⁹ Fouad Bisisu, *The Developing Role of Islamic Banking and Finance: From Local to Global Perspectives* (Emerald 2014) 66.

¹⁷⁰ *Ibid* 56.

¹⁷¹ Jemma Dridi and Maher Hasan, 'the Effects of the Global Crisis on Islamic and Conventional Banks: A Comparative Study' (2010) 10 IMF Working Papers 21.

This rapid development in the Islamic financial sector means that there is a need to evaluate its development and ensure that this sector provides genuine Islamic contracts, hence effectively serving the needs of Muslim investors. Even though certain activities in Islamic finance did not succeed, the constant innovations of this sector show the desire for Muslims to explore alternative solutions and find sharia-compliant alternatives to conventional banking.¹⁷²

A number of international organisations, that chose to develop Islamic finance believing that it would open a new window of finance, are making considerable efforts to implement standards to regulate Islamic banks globally. For instance, at the end of 2002, the Islamic Financial Services Board (IFSB) was founded with its headquarters established in Kuala Lumpur, Malaysia. This organisation works as a global standard-setting body of supervisory agencies that have a vested concern in guaranteeing the soundness and stability of the Islamic financial services industry, which is defined broadly to include banking, the capital market and insurance. In advancing this mission, the IFSB promotes the development of a prudent and transparent Islamic financial services industry through introducing new, or adapting existing, international standards consistent with sharia principles, and recommending them for adoption.¹⁷³

In addition the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) which was established in 1991 and counted as one of the most vital organisations that aims to develop Islamic financial activities.¹⁷⁴ It is based in Bahrain, is an international not-for-profit organization primarily responsible for development and issuance of standards for the global Islamic finance industry. Since its establishment it has issued a total of 100 standards in the areas of Sharia, accounting, auditing, ethics and governance for international Islamic finance.¹⁷⁵

2.6 Islamic Schools of Thought and its Impact on Islamic Finance

At the establishment of Islam, Prophet Muhammad was the source whom people could gain Islamic knowledge from and learn the teaching of Islam as he was the sole

¹⁷² Hamed Merah, *عقود التمويل المستجدة في المصارف الإسلامية: دراسة تأصيلية تطبيقية (Emerging Financing Products in the Islamic Banks; A Theoretical and Practical Study)* (1st edn, al-Miman Publisher 2011) 40.

¹⁷³ 'Background of The Islamic Financial Services Board (IFSB)' (*ifsb.org*, 2014) <<http://www.ifsb.org/background.php>> accessed 25 October 2014.

¹⁷⁴ 'Accounting and Auditing Organization for Islamic Financial Institutions' (*aoofi.com*, 2017) <<http://aoofi.com/about-aoofi/?lang=en>> accessed 2 January 2018.

¹⁷⁵ *Ibid.*

recipient of divine revelation. After his death in Median 632 AD, the four successive “rightly guided” caliphs, who were close to the prophet in his lifetime, became the leaders. As they had acquired considerable knowledge of the primary sources of Islam, the Quran and the *Sunna*, they had full authority to interpret the sharia according to their time.

Also, they had the knowledge, piety and religious authority. Even though they had the authority to interpret the sharia, the Caliphs used to consult many other companions of the Prophet, especially those who used to be close to him.¹⁷⁶ Islam then gradually spread to other lands and certain Muslim scholars and companions of the prophet (*Sahaba*) travelled to different places to deliver the message of Islam. As the Muslim territories expanded, many new issues arose that needed to be considered and decided, which made it difficult to have a central authority that could unite all the opinions. This, as a result, set the stage for the emergence of different Islamic schools of thought.

There are four Sunni schools of thought or *Madhab*. (*Madhahib* is the plural term and *Madhab* is singular and it means doctrine.)¹⁷⁷ This can be organised historically as: the Hanafi *Madhab*, the Maliki *Madhab*, the Shafi *Madhab* and the Hanbali school. These schools were named after their founding scholars who lived between 700 and 850 AD. The term *Madhab* originally meant a group of students, legists (experts in the law), judges and jurists who had adopted the doctrine of a particular leading jurist.¹⁷⁸ The four schools do not disagree on basic Islamic principles and concepts, which means that all four schools basically agree on all issues that are relevant to Islam as a socio-religious force and on the finality and sufficiency of the Quran and the *Hadith* as the ultimate law for Islam.¹⁷⁹ They only differ on the interpretation of certain specific rules, or on the type of *Hadith* used to build their opinions. For instance, one scholar may have interpreted a *Hadith* of the prophet that another scholar may not have acknowledged; a scholar may have accepted a particular *Hadith* as authentic while others may have rejected it because of their doubts about its authenticity.

¹⁷⁶ Angelo M Venardos, *Islamic Banking and Finance in South-East Asia* (World Scientific Pub Co 2012) 17.

¹⁷⁷ MAE Bulbulia, 'The Ethical Foundations and Distinctive Features of Islamic Law' (1985) 18 *The Comparative and International Law Journal of Southern Africa* 225 <<http://www.jstor.org/stable/23246953>> accessed 25 January 2016.

¹⁷⁸ Wael Hallaq, *An Introduction to Islamic Law* (Cambridge University Press 2009) 33.

¹⁷⁹ Etim Okon, 'The Sources and Schools of Islamic Jurisprudence' (2012) 3 *American Journal of Social and Management Sciences* 108.

Nonetheless, it is widely accepted by Muslims that no one school can be declared wrong in their judgements.¹⁸⁰

In addition, one of the main reasons behind the existence of more than one *Madhab* relates to the early divisions among jurists between two main trends: (1) *Ashab al-ray* (rationalists) and (2) *Ashab al-Hadith* (people of traditions or *hadith*). The former were jurists who used human reasoning to solve legal problems particularly when there were not so many sound *Hadiths* to be consulted or applied. The latter, on the other hand, always tried to base their opinions solely on *Hadiths*. They often cared more about *Hadith* and considered that the most important element in a *Hadith* was its chain of narration (*Isnad*), that is, the list individuals who narrate the *Hadith* all the way back to the Prophet. Indeed, the *Ashab al-Hadith* attaches great importance to the credibility and integrity of all narrators. Sound knowledge of the chain of narration grants the ability to assess the authenticity of a *Hadith* and should be applied and considered in making decisions and pronouncing a *Fatwa* (an Islamic decision about a case).¹⁸¹

The difference between these schools mainly relates to the methodology they adopt in interpreting the law. It is important to introduce the four schools of thoughts as some Islamic financial contracts are recognised as valid by some schools and seen as invalid by others, which may have caused some difficulties in setting international standards for Islamic finance. For example, most of sharia scholars in Saudi Arabia follow the Hanbali *Madhab*. While Shafi'i *Madhab* is the commonly apply in Malaysia. This may sometimes be a challenging aspect for sharia boards, as further discussed in Chapter Four of this thesis. All four schools of thoughts agree on the primary sources of Islam, the Quran and the *Hadith*. However, when an issue is not clearly stated or when a decision cannot be based on these primary sources, there are some differences which secondary and the minor sources that should be applied first as going to be shown here.¹⁸² For Example Hanafi *Madhab* chose *Ijma*, *Qiyas*, *Ijtihad*, *Istihsan* and *Urf*.¹⁸³ Also gives particular importance to *Qiyas* and *Raa'y* (personal opinion) rather

¹⁸⁰ Hij Siti Faridah Abd Jabbar, 'Islamic finance: fundamental principles and key financial institutions' (2009) 30 *Company Lawyer* 23.

¹⁸¹ Christopher Melchert, *The Formation of the Sunni Schools of Law, 9th-10th Centuries C.E.* (Brill 1997) 1.

¹⁸² See 2.3 above.

¹⁸³ *Ibid*.

than making direct deductions from the *Hadith*.¹⁸⁴ This school in addition, it uses *Hilah* (artifice, device and stratagem) more than other schools,¹⁸⁵ as further explained in Chapter Four.¹⁸⁶

Whereas, Maliki *Madhab* used an additional source after *Ijma* and *Qiyas* called the practice of the people of Madina (*Amal Ahl al-Medina*). As it was the place the Prophet lived most of his life and died in Madina.¹⁸⁷ Also this *Madhab* used the jurisprudence principles of *al-Masalih al-Mursalah* (public interest if not leading to prohibition) and *Sadd Al-Dharai* (blocking pretences or, in other words, not allowing action that leads to committing a prohibition).¹⁸⁸ The latter principle limited the school's rulings regarding the diversity of financial contracts because of the fear that they may lead to dealings involving *Riba* which will be discussed in Chapter Four.¹⁸⁹

The third madhab is the shafi, this school which combined and merged opinion (*Raa'y*) and *Hadith*. However, the school had its own approach regarding the minor sources of sharia, as it limited the use of the juristic discretion (*Istihsan*) and the public interest or considerations of public welfare (*Istislah*). Nevertheless, it developed and opened up the use of *Qiyas* as well as the primary sources and *Ijma*.

Finally, The Hanbali Madhab the founder of this school travel to seek knowledge to different places from different schools of thought. He focused on the *Hadith* more than *Fiqh*. The School sources are the Quran, the *Sunna* as much as possible, then *Ijma* and *Qiyas*, then the minor sources of sharia.

2.6.1 The Impact of Islamic Schools of Thought

The differences between the above schools explain why certain Islamic contracts are accepted in certain financial institutions or countries and not in others, depending on the chosen school in that area. However, almost all of the above four Imams stated that if their opinion or *Ijtihad* were found to be in conflict with an authentic *Hadith*, their

¹⁸⁴ Muhammad Junaid Sharif and Muhammad Ijaz, 'Madhhab in Islamic Law and The Dissemination of Sunni's Legal Text' (2014) 5 VFAST Transactions of Islamic Research 3
<<http://vfast.org/journals/index.php/VTIR/article/view/278/324>> accessed 15 October 2015.

¹⁸⁵ Muhammad Tahir Mansoori, 'Is "Islamic Banking" Islamic? Analysis of Current Debate on Sharia Legitimacy of Islamic Banking and Finance' (2011) 50 Islamic Studies 384.

¹⁸⁶ See 4.4.1 below.

¹⁸⁷ Hans Visser, *Islamic Finance: Principles and Practice*: (2nd edn, Edward Elgar 2013) 17.

¹⁸⁸ Ibid.

¹⁸⁹ See 4.4.3 below.

opinions ought to be ignored and the *Sunna* be given preference over it.¹⁹⁰ Furthermore, during the period of the development of the schools of the thought, the *Ijtihad* was effectively applied, then the door of *Ijtihad* started to close and sharia scholars began adopting *Taqlid* (conformism) which is following other scholars' opinions instead of giving their own opinion or *Ijtihad*.

As a result, sharia scholars started following the views and the *Ijtihad* of past scholars rather than their own knowledge by basing their own *Ijtihad* on past *Fatwas*.¹⁹¹ One of the reasons for the rise of *Taqlid* is that scholars do not feel that they are sufficiently qualified to practice *Ijtihad*, arguing that if *Ijtihad* is continually re-evaluated, there may be a risk of the laws of Islam being constantly changed and clashing.¹⁹² Scholars at that time use the *Taqlid* of their own *Madhab* so a Shafi'i scholar would only apply *Fatwa* that was proven by a Shafi'i school and would ignore other *fatwas* from other schools. This decrease in the interest of using *Ijtihad* among scholars began in the ninth century and became widespread in the next century. As a result, Islamic financial contracts were affected by this situation, as there was no development in the use or format of the financial contracts.

However, since recent times, most scholars have not been confined to a single school of thought for their interpretation of the Islamic law. Even though many may belong to a specific school of thought in terms of their skills and training, they will often combine the views of different schools of thought and adopt any *fatwa* from any school if a *Hadith* supports their *Ijtihad*. This helps to open the door to the development of Islamic financial contracts.¹⁹³ This is, at least, the case in Saudi Arabia which is the contextual focus of this thesis. Most scholars on sharia boards in financial institutions are open to all schools of thought when a new financial contract is being studied.

2.7 Major Rules in Islamic Finance

Like other forms of finance, Islamic finance pertains to the ways of making money and, because humans have different needs in their lives, the different ways existing to deal

¹⁹⁰ Abdul-Rahman bin Qasim and Mohammed bin Qasim, *مجموع فتاوى شيخ الإسلام أحمد ابن تيمية* (*The Collection and Edition of Ibn Taymiyyah's Sharia Opinions*) (King Fahd Complex for the Printing of the Holy Quran 2004) 154.

¹⁹¹ Frank E Vogel and Samuel L Hayes, *Islamic Law and Finance: Religion, Risk, and Return* (Koninklijke Brill 2006) 32.

¹⁹² M. Shaghil, *Islamic Economics a Global Perspective* (1st ed, SB Nangia 1989) 48.

¹⁹³ Frank E Vogel and Samuel L Hayes, *Islamic Law and Finance: Religion, Risk, and Return* (Koninklijke Brill 2006) 32.

with these needs. Thus, in Islam, several ways and contracts aim to fulfil such needs. Also, certain rules show God's will and how to comply with His rules, as well as the actions and trade practices that should be avoided. Therefore, Islamic finance can be described as the provision of financial services that comply with sharia.¹⁹⁴ In more detail, it describes the financial approaches that comply with the rules and principles of Islamic commercial jurisprudence (*Fiqh al-Muamalat*).

The focus of Islamic commercial jurisprudence is on contracts, so these rules show what sorts of contracts are acceptable or not. In general, any commercial endeavour and contract in Islam is permissible, except in cases of obvious prohibition. Islamic finance institutions should have certain ethical advantages over other kinds of financial institutions because of their link with religion whose purpose is the welfare of individuals and society as a whole.¹⁹⁵

However, with regards to banks, Islamic banks, like conventional banks, serve as a financial intermediary and trustee of the money of people. Nonetheless, one of the differences is that Islamic banks do not accept the receipt or the payment of interest or usury on any of their related operations, which are referred to as *Riba*. This rejection of interest-based commerce forces the banks to pay off their depositors with a share in profits and losses.¹⁹⁶ This difference presents an element of mutuality in Islamic banking, because depositors must operate as clientele with some inherent ownership rights. These institutions provide financial aid for Muslims who want to invest and do so in compliance with Islamic law and principles.

Another difference between Islamic and conventional banks is that Islamic banks have certain explicit social obligations to benefit society.¹⁹⁷ This is because the Islamic perspective holds that business transactions should never be dissociated from the moral principles of society. One of the goals of Islamic banking is to establish social justice by keeping out all forms of financial activities that are socially or morally injurious, assuring ownership of wealth legitimately acquired, by allowing everyone to

¹⁹⁴ Hjh Siti Jabbar, 'Islamic Finance: Fundamental Principles and Key Financial Institutions' (2008) 30 Company Lawyer 23.

¹⁹⁵ Mufti Muhammed Usmani, *An Introduction to Islamic Finance* (1st edn, Quranic Studies Publishers 2010) 10.

¹⁹⁶ *Ibid.*

¹⁹⁷ Elmelki Anas and Ben Arab Mounira, 'Ethical Investment and the Social Responsibilities of the Islamic Banks' (2009) 2 International Business Research 125.

keep any surplus wealth and avoid the accumulation of wealth in the hands of wealthy people.¹⁹⁸

Following the above premises, it seems pertinent to discuss key prohibitions in Islamic finance and further to explore its fundamental meaning. There are three clear elements that nullify Islamic contracts: *Riba*, *Gharar* and *Maisir* (gambling or speculation).¹⁹⁹ Essentially, the prohibition of these three aspects constitutes a prudential regulation and a risk management measure. Islamic law also prescribes a number of other norms and restrictions in an attempt to avoid unfair gains and injustice. In addition, any contract made for products and sale of goods and services that is prohibited in Islam would be impermissible. For instance, pornographic materials, alcoholic drinks, pork-related foodstuffs, armaments and other socially detrimental activities cannot be traded in Islam. Therefore, the following sections focus on exploring the importance of these three elements highlighting the fundamental principles to which they relate.²⁰⁰

2.7.1 *Riba*

A fundamental principle in Islamic finance is that *Riba* transactions constitute a severe sin, that is, all transactions generating interest, as clearly stated in both the Quran and the Sunna. However, it is not always absolutely clear what can be considered as *Riba*. It has been claimed by certain scholars that any prefixed return in any sort of businesses is considered *Riba* and therefore prohibited while others argue that *Riba* relates to the specific situations that arose during the establishment of Islam and that cannot be compared to modern commerce.²⁰¹ The different views on the meaning of *Riba* can be justified because *Riba* has more than one type.²⁰² The Quran has explicitly prohibited *Riba*, but it doesn't state all its types in details.²⁰³ Nonetheless it is essential for sharia scholars, bankers and academics to clearly understand *Riba* and its types.²⁰⁴

¹⁹⁸ Ibid.

¹⁹⁹ Hjh Siti Jabbar, 'Islamic Finance: Fundamental Principles and Key Financial Institutions' (2009) 30 Company Lawyer 23.

²⁰⁰ Michael Ainley and others, 'Islamic Finance in the UK: Regulation and Challenges' (Financial Services Authority 2007) 4 <http://www.fsa.gov.uk/pubs/other/islamic_finance.pdf> accessed 26 March 2015.

²⁰¹ Muhammad Ayub, *Understanding Islamic Finance* (Wiley 2013) 43.

²⁰² Ashfaq Ahmad, Kashif Rehman and Asad Humayoun, 'Islamic Banking and Prohibition of Riba/Interest' (2011) 5 African Journal of Business Management 1764.

²⁰³ Ali Abdulrahim Ali, 'The Role of Islamic Jurisprudence in Finance and Development in the Muslim World' (2010) 31 Company Lawyer 123.

²⁰⁴ Muhammad Ayub, *Understanding Islamic Finance* (Wiley 2013) 43.

This prohibition of interest in any form of financial transaction is not specific to the Islamic religion; rather, this can also be found in the early Jewish and Christian traditions in addition to Greek philosophers such as Aristotle who condemned obtaining wealth by the practice of charging interest on money. Aristotle made it clear that interest transformed money into a commodity and that such transactions should not be happening because the idea of money is merely to facilitate the exchange of products rather than making it a product itself.²⁰⁵ Plato also mentioned this idea in *The Republic* arguing that interest is a profiteering process which is not suitable with the law.²⁰⁶

However, other Greek thinkers such as Demosthenes understood this idea from a different angle, claiming that the borrower has the authority even though he needs to pay interest, while the lender is in the weaker position because he only has a written promise that the borrower will pay his or her debt in the future.²⁰⁷ This, according to him, justifies the right for the lender to charge interest. The Romans as well did not agree on usury but with the influence of the elite, interest became acceptable; in fact, the interest rate became so high that the government set a maximum rate of twelve percent.²⁰⁸ Moreover, Adam Smith in *The Wealth of Nations* noted the ban of interest as a hallmark of Islamic finance arguing that the permission of interest made people lend without considering potential profit and the potential cost of default.²⁰⁹ Roy Harrod, a famous Western economist, considered that the abolition of interest was the simplest way to prevent the collapse of capitalism. In *Economic Dynamics* he expressed his fascination for an interest-free economy: "It is not the profit itself, earned by services, by assiduity, by imagination, or by courage, but the continued interest accruing from the accumulation that makes that profit taker eventually appear parasitical."²¹⁰ He also added that an interest-free society which is a "totally new kind of society" would be the final correct answer to all that is justly advanced by the critics of capitalism.²¹¹

²⁰⁵Abdel-Rahman Ahmad, 'Riba, its Economic Rationale and Implications' (2002) 19 Journal of Islamic Banking and Finance.

²⁰⁶ Abdul Al-Azim Abu Zayd, *فقه الربا دراسة مقارنة وشاملة للتطبيقات المعاصرة* (*Jurisprudence of Usury, a Comprehensive Study for all Practices*) (ktab INC 2004) 13.

²⁰⁷ Ibid 14.

²⁰⁸ Ibid 15.

²⁰⁹ Benjamin C Esty, *Modern Project Finance* (John Wiley 2004) 429.

²¹⁰ Fayaz Ahmad Lone, *Islamic Banks and Financial Institutions* (Springer 2016) 124.

²¹¹ Ibid.

Moreover, Anas and Mounira discussed certain ethical principles regarding *riba* arguing that financial transactions should be free from interest directly or indirectly connected to a genuine economic transaction. Furthermore, they argued that it is unethical to profit from indebtedness or the trading of debts. As an alternative, the investee and investor can avoid that by sharing the risks and profits made from a venture, an asset or a project.²¹²

It can be said that the main aim of prohibiting *Riba* is to distribute wealth among people, as Islam seeks to build up an economic environment based on fairness and justice through the prohibition of interest or *Riba*.²¹³ The concept of interest can be defined in different ways and one of the definitions suggested is the following: “The excess of money paid by the borrower to the lender over and above the principal for the use of the lender’s liquid money over a certain period of time.”²¹⁴

From an Islamic perspective, the Quran prohibits *Riba* in many different verses. The first of these verses states: “O you who have believed, do not consume *Riba*, doubled and multiplied, but fear Allah that you may be successful” [3:130]. This is the first instance in the Quran where the practice of *Riba* is mentioned and prohibited.²¹⁵ Moreover, another verse asserts:

“And [for] their taking of *Riba* while they had been forbidden from it, and their consuming of the people's wealth unjustly. And we have prepared for the disbelievers among them a painful punishment” [4:161].

The above verse indicates that even if people deal with usury, it is still unlawful. This is supported by the following statement from the Quran:

“And whatever you give for *Riba* to increase within the wealth of people will not increase with Allah. But what you give in *Zakat*, desiring the countenance of Allah - those are the multipliers” [30, 39].

In the above verse, life is linked to the hereafter, stating that a good person should live their life as prescribed by God explaining that any unlawful means of gaining money

²¹² Elmelki Anas and Ben Arab Mounira, 'Ethical Investment and the Social Responsibilities of the Islamic Banks' (2009) 2 International Business Research 223.

²¹³ Ibid.

²¹⁴ S Ali Nazim and Naseem N Ali, *Information Sources on Islamic Banking and Economics 1980-1990* (1st edn, Routledge 1994) 12.

²¹⁵ Muhammad Ayub, *Understanding Islamic Finance* (Wiley 2013) 44.

will not help them in the hereafter. Moreover, other verses from the Quran further explain that *Riba* is prohibited and unlawful:

“Those who consume *Riba* cannot stand [on the Day of Resurrection] except as one stands who is being beaten by Satan into insanity. That is because they say; trade is [just] like interest. But Allah has permitted trade and has forbidden interest. So whoever has received an admonition from his Lord and desists may have what is past, and his affair rests with Allah. But whoever returns to [dealing in interest or usury] - those are the companions of the Fire; they will abide eternally therein”. [2:275]

“Allah destroys *Riba* and gives increase for charities. And Allah does not like every sinning disbeliever” [2:276].

“O you, who have believed, fear Allah and give up what remains [due to you] of *Riba*, if you should be believers”. [2:278]

“And if you do not, then be informed of a war [against you] from Allah and His Messenger. But if you repent, you may have your principal - [thus] you do no wrong, nor are you wronged” [2:279]

“And if someone is in hardship, then [let there be] postponement until [a time of] ease. But if you give [from your right as] charity, then it is better for you, if you only knew” [2:280]

“And be fearful of the Day when you shall be returned to the Allah, then everybody shall be paid in full what he has earned and they shall not be wronged”. [2:281]

In the above verses it is clearly stated that Muslims have to stay away from *Riba*. These verses explain that *Riba* is not like trade, even if both of parties in the agreement involving *Riba* agree to accept it, it will not be lawful.

However, the above verses clearly mention the difference between trade and *Riba* that trade is lawful, while *Riba* is not, and that money made from *Riba* will be destroyed. It is said that money must not be taken from *Riba*, with God declaring war on those still dealing with *Riba* in the next verse. It was suggested that when a person

has difficulties in paying his or her debt, extra time should be given for the debt to be paid without charging any extra money for dealing.

While *Riba* is cited in different places in the Quran, almost all of the verses explicitly show that it is unlawful. However, the Quran does not explain the real meaning of *Riba* or why it is wrongful. The term *Riba* in the Arabic language was known before Islam as any increase on a loan and further explanation is provided in the Sunna, whereby more specific types of *Riba* were explained.

In the *Hadith*, *Riba* has been mentioned several times whereby some of the sayings of Prophet Mohammed reiterated the Quranic meanings while others provided additional details and highlighted different types of *Riba*. Thus, certain *Hadiths* are presented below in order to identify the implications and important rules regarding this principle with respect to modern transactions.

The first *Hadith* stated that it is not only the two parties involved in the *Riba* transaction who are blamed and commit a sin, but also all those involved in this transaction. Jabir, a companion of the Prophet, reported that “the Prophet cursed the receiver and the payer of interest, the one who records it and the witnesses to the transaction and said: ‘They are all alike [in guilt]’.”²¹⁶ In another *Hadith*, the Prophet during his last pilgrimage stated:

“Every form of *Riba* is cancelled; capital indeed is yours which you shall have; wrong not and you shall not be wronged. Allah has given His Commandment totally prohibiting *Riba*. I start with the amount of *Riba* which people owe to my uncle Abbas and declare it all cancelled”.²¹⁷

The above *Hadith* mentioned that there is more than one kind of *Riba* that can be recognized as the prophet said, “I start with the *Riba* of Abbas”, which means that there are other types of *Riba*. However, the well-known form of *Riba* among the Arabs of the pre-Islamic era was known as (*Riba Al-Jahiliha*) which has been defined by one of companions of the Prophet as when a person borrows money for a certain period of time and when that period expires, the creditor would ask for his or her money to be

²¹⁶ Abu Al-Husayn Muslim Ibn Al-Hajjaj, صحيح مسلم (*Sahih Muslim*) (Turath for Solutions 2013) Book No. 10, Hadith No. 3880 <<https://sunnah.com/muslim/22>> accessed on 22/5/2014.

²¹⁷ Abu Bakr Ahmad Bayhaqi, سنن البيهقي (*Sunan Al-Bayhaqi Al-Kubra*). 106/9, book of syra, chapter 72, No.17993.

paid or the loan would be increased and extended the period for payment again.²¹⁸ It might be surprising to affirm that this kind of *Riba* is the only type mentioned in the Quran. However, the *Sunna* later introduced other types of *Riba*. For instance, there is a *Hadith* that explains the possible products in which *Riba* can be found:

“Gold for gold, silver for silver, wheat for wheat, barley for barley, dates for dates and salt for salt – like for like, equal for equal, and hand to hand; if the commodities differ, then you may sell as you wish, provided that the exchange is hand to hand.”²¹⁹

This *Hadith* shows how *Riba* can happen and highlights new types of *Riba* other than the one related to loans or debts, which is also known as *Riba An-Nasi'a* (*Riba* of delay), referring to the increase in the amount of a debt because of a delay or deferment in its payment.²²⁰ Furthermore, there is also *Riba* in sale and exchange, which is known as *Riba Al-Fadl* (*Riba* of excess), describing a predetermined return or compensation for the renting or lending of money, or selling money for money.²²¹ The main type of *Riba* on which Muslim scholars focus is *Riba* in sales rather than the interest on loans. Therefore, the sales containing excess or delay in exchanges of certain kinds of property as currency and foodstuffs are now explored in more detail.

The above *Hadith* mentioning “gold for gold” highlighted almost all of the products with which *Riba* can exist and which can be traded on the assumption that the exchange has to be at the same time of the barter. When exchanging goods of the same type, such as wheat for wheat, the exchange is acceptable only in equal amounts. The permissions therefore involve two bans: (1) any sale within a single kind with inequality, with or without delay, is called *Riba Al-Fadl* and (2) any exchange with delay among the goods listed in the *Hadith*, with or without identifying type or quality, is called *Riba An-Nasi'a*. With respect to *Riba Al-Fadl*, according to the rules of Islamic finance, it is not acceptable to sell high quality dates for poor quality dates of a larger

²¹⁸ Abdul Al-Azim Abu Zayd, *فقه الربا دراسة مقارنة وشاملة للتطبيقات المعاصرة* (*Jurisprudence of Usury, a Comprehensive Study for All Practices*) (1st edn, ktab INC 2004) 39.

²¹⁹ Abu Al-Husayn Muslim Ibn Al-Hajjaj, *صحيح مسلم* (*Sahih Muslim*) (Turath for Solutions 2013) Book 10, Hadith No. 3861 <<https://sunnah.com/muslim/22/112>> accessed on 22/5/2014.

²²⁰ Brian Kettell, *The Islamic Banking and Finance* (John Wiley 2011) 37.

²²¹ Hjh Siti Jabbar, 'Islamic Finance: Fundamental Principles and Key Financial Institutions' (2009) 30 Company Lawyer 24.

amount. To make this sale acceptable, one has to sell the first kind for cash, and then buy the other dates with that money.

The solution to this issue has been mentioned in another *Hadith* by a person delegated by the Prophet to collect the *Zakat*, one of the five pillars of Islam and an obligatory payment to be made once a year for charity,²²² from Khyber and he bought dates of a high quality. The Prophet then inquired whether all the dates of that city were like this; to this, that person answered that the dates were not of the same quality but that he had exchanged a *Sa'a* (a unit of measurement) of high quality dates for two or three *Sa'as* of the other kind.

As a result, the Prophet asked him not to do so and to sell the poorer quality dates for Dirhams (the currency used at that time) and then use the money to buy the high-quality ones. The *Hadith* clearly stipulates that when dates are exchanged with dates they have to be of equal weight.²²³ This means that in this *Hadith*, the *Riba* was explained and the solution proposed. From this point, it can be seen that *Riba* can also be divided into two other types: (1) *Riba* in loans or debts and (2) *Riba* in sales in addition to the above classification into (1) *Riba Al-Fadl* and (2) *Riba An-Nasi'a*.

Therefore, based on these premises, as conventional finance transactions allow interest-bearing loans, it seems clear that conventional banking is incompatible with Islamic principles. These transactions are prohibited under Islamic finance, which asserts that a pure return or rent on money is both unfair and immoral.

To be eligible for an allowed return, money can be financed over the buying and selling of tangible assets, after which the revenue streams can be derived from the financial use of those assets. In other words, interest income can be replaced with money streams from productive sources, like the returns from wealth-making investment activities and operations. In this case, money comes from profits from trading in actual assets and cash flows from the transfer of usufruct (the right to use an asset), such as rental revenue.²²⁴

²²² Hartley Dean and Zafar Khan, 'Muslim Perspectives on Welfare' (1997) 26 *Journal of Social Policy* 203.

²²³ Abu Al-Husayn Muslim Ibn Al-Hajjaj, *صحيح مسلم (Sahih Muslim)* (Turath for Solutions 2013) Book 10, Hadith 3869 < <https://sunnah.com/muslim/22> > accessed 14 July 2017.

²²⁴ Michael Ainley and others, 'Islamic Finance in the UK: Regulation and Challenges' (Financial Services Authority 2007) 4 <http://www.fsa.gov.uk/pubs/other/islamic_finance.pdf> accessed 26 March 2015

Furthermore, an important point is that the prohibition of *Riba* should not be confused with the return or profit on capital as Islam encourages finance, which is why almost half of the jurisprudence refers to commerce. However, Islam encourages making justified profit, through earning and sharing profits, because profit means positive entrepreneurship and is the reason for the creation of additional wealth. Profit, in Islamic finance, is to be determined *ex post* while in *Riba* transactions, it is determined *ex ante* irrespective of the result of the business operations.²²⁵ Furthermore, *Riba* is a lazy gain which results in profit without actual trading and financing in goods and services thereby creating more debt and less movement in real investment. This is mentioned in the Quran as follows: “O you who have believed, do not consume *Riba*, doubled and multiplied.”²²⁶

2.7.2 *Gharar*

It is generally assumed that a bank operating without interest can be called an Islamic bank; however, to be considered a true Islamic financial institution, there are other factors which should be considered as well, to achieve all the requirements and responsibilities: to carry out business grounded on the concept of honesty, equity and justice, the ban on overspending and wastage, dealing with the wealth in an appropriate and orderly manner, to afford help and support the needy.²²⁷ One of the acts that should be avoided as well is *Gharar*.

Gharar is an Arabic word that means to tempt, cheat and cause uncertainty. In Islamic jurisprudence, this refers to a contract which involves certain risks to “the compensation of one of the parties and this risk relates to the actual ingredients of the contract.”²²⁸ El-Gamal has defined *Gharar* as “the sale of probable items whose existence or characteristics are not certain, due to the risky nature which makes the trade similar to gambling.”²²⁹ *Gharar* can be found in two ways in a contract: (1) in terms of the subject matter and (2) the price. It is known that businesses deal with

²²⁵ Hjh Siti Jabbar, 'Islamic Finance: Fundamental Principles and Key Financial Institutions' (2009) 30 Company Lawyer 124.

²²⁶ Sami Al-Suwailem, *الأزمات المالية في ضوء الاقتصاد الإسلامي (Financial Crises in The Light of the Islamic Economy)* (SABIC Chair for IFMS 2012) 25.

²²⁷ Ibid 45.

²²⁸ Maulana Ejaz Samadani, *Islamic Banking and Uncertainty* (Darul Ishaat 2007) 15.

²²⁹ Mahmoud A Gamal, *A Basic Guide to Contemporary Islamic Banking and Finance* (Rice University 2000) 7.

uncertainty, known as risk-taking, so sharia scholars distinguish between excessive *Gharar* and minor uncertainty and declared that only excessive uncertainty should be prohibited.²³⁰

For example, *Gharar* in financial contracts, when there are open-ended terms, relates to any contractual term that is intentionally worded to convey more than one meaning or cause ambiguity that may lead to speculation or cause misunderstanding between the parties, which is why it has been prohibited.²³¹ *Gharar* also occurs when a good that is not present at hand is being sold, when the consequences of selling the good is not known. For instance, the sale of a bird in the air would be called *Gharar*, as it is unknown whether it can be caught or not.

So, *Gharar* can occur for three basic reasons: (1) ambiguity in the existence of the sold item, (2) ambiguity in the possession of the sold item and (3) ambiguity in the price of the sold item.²³² The first one applies to a situation when a sold item is not available in the possession of the trader, as there is a risk that the trader cannot possess this item in order to pass it to the original buyer. Example for this is selling goods that do not yet exist, such as selling fruit from a farm when the fruit has not yet appeared. This has been explained in a *Hadith* whereby “the prophet forbade the sale of grapes until they become black, and the sale of grain until it is strong.”²³³

There is also a unanimous agreement among the four schools that this kind of sale is illegal because of the uncertainty involved. However, two kinds of sales are exempted from this rule: the commissioned manufacture (*Istisna*) and the advanced purchase (*Salam*), as discussed later in this chapter. The second form of *Gharar* relates to selling an item that is not the property of the seller, as explained in the *Hadith*: “do not sell what is not in your possession.”²³⁴

Finally, the third situation whereby *Gharar* can occur is when a good is sold after it had been bought, but not taken into one’s possession. One hadith applies for this case:

²³⁰ Alsadek H. Gait and Andrew C. Worthington, 'A Primer on Islamic Finance: Definitions, Sources, Principles and Methods' (University of Wollongong 2007) 10.

²³¹ Camille Paldi, 'Understanding Riba and Gharar in Islamic Finance' (2014) 2 Journal of Islamic Banking and Finance 255.

²³² Ibid.

²³³ Frank E Vogel and Samuel L Hayes, *Islamic Law and Finance: Religion, Risk, and Return* (Koninklijke Brill 2006) 89.

²³⁴ Maulana Ejaz Samadani, *Islamic Banking and Uncertainty* (Darul Ishaat 2007) 18.

“whoever buys foodstuffs let him not sell them until he has possession of them.”²³⁵ This relates to a fundamental principle in sharia: no risk, no gain. Therefore, a good that has been purchased has to be held, physically or any way that traditionally recognised that it is under the new buyer’s possession even if it still at the same place, before being resold. Purchasing can be done by the buyer itself or through an agent such as a bank, so it is enough for the goods to be in the bank’s possession before it can be sold. This is what usually happens in *Murabaha* transactions (trade with mark-up), as discussed later in the thesis.

Owing to that, as mentioned by Habib Ahmed, the prohibition of *Gharar* is one of the reasons which could prevent economic crises to hit the sector of Islamic finance. For example derivative products such as credit default swaps which were part of the problem which caused the last financial crisis are not allowed in Islamic finance.²³⁶ In addition, Brewster supported the idea that the reason behind the survival of Islamic financial institutions from the crisis was because they were not exposed to the toxic securities that involve prohibited acts in Islam.²³⁷ In this regard, a well-known medieval jurist, Ibn Taymiyyah,²³⁸ stated that “two prohibitions can explain all distinctions between contracts that are deemed valid or invalid: *Riba* and *Gharar*.”²³⁹ When *Ghara* is identified in court it could void the transaction which may result voiding its consequences in the contract too. The Board of Grievances court in Saudi Arabia, voided a contract because it contains a prohibited transaction *Ghara* in a case²⁴⁰ that were seen by the Board of Grievances when the *Ghara* was identified, the contract was voided.²⁴¹

2.7.3 Maisir

Maisir is one of the acts prohibited under Islamic finance; this term refers to gambling. The reason for its prohibition is that it is similar to betting which is receiving a gain by

²³⁵ Frank E Vogel and Samuel L Hayes, *Islamic Law and Finance: Religion, Risk, and Return* (Koninklijke Brill 2006) 90.

²³⁶ Habib Ahmed, 'Financial Crisis: Risks and Lessons for Islamic Finance' (2009) 1 ISRA International Journal of Islamic Finance 18.

²³⁷ Ibid.

²³⁸ Famous sharia scholar died 1328 AD.

²³⁹ Mahmoud A El-Gamal, *Islamic Finance: Law, Economics, and Practice* (Cambridge University Press 2009) 8.

²⁴⁰ Case No. 5534/1/G/Year 2008.

²⁴¹ Abdullah Alshowish, 'An Evaluation of the Current Rules and Regulatory Framework of Corporate Governance in Saudi Arabia: A Critical Study in Order to Promote an Attractive Business Environment' (PhD, The Law School, Lancaster University 2016) 152.

chance rather than by productive efforts. Therefore, *Maisir* occurs when one party is making gains through mere expectations while the other party is making losses due to the same reason.²⁴² The Quran provides the following guidance in this matter:

“They ask you about wine and *Maisir*. Say, in them is great sin and [yet, some] benefit for people. But their sin is greater than their benefit” [2: 219].

“O you who have believed, indeed, intoxicants, *Maisir*, [sacrificing on] stone alters [to other than Allah], and divining arrows are but defilement from the work of Satan, so avoid it that you may be successful. Satan only wants to cause between your animosity and hatred through intoxicants and gambling and to avert you from the remembrance of Allah and from prayer. So, will you not desist?” [5: 90, 91]

Maisir and *Gharar* have certain similarities; for instance, a gambler is uncertain of the result of an activity. With respect to Islamic finance, *Maisir* can be seen in the terms of insurance contracts that are widely used in conventional finance, which means that insurance is not sharia compliant. However, an alternative to insurance exists in Islamic finance, which is called *Takaful* (cooperative insurance).

2.8 The Freedom of Contract in Islamic Finance

Islam agrees with the idea of freedom of contract, as long as certain criteria are met, as discussed earlier.²⁴³ Ibn Taymiyyah has attempted to address this issue and stated that the fundamental principles in contracts and stipulations are validity and permissibility. Any contract or stipulation is deemed forbidden or void only if there is an obvious ban stated in the main sources of sharia whether primary or secondary sources.²⁴⁴

Almost all four schools of thought agree with this principle, to some degree, although it can be difficult to find new financial contracts during the period of the development in the four schools of thoughts; even so early scholars agree that a new contract can be created as long as it does not contain unlawful acts such as *Riba* or *Gharar*. The

²⁴² Ali Al-Shamrani, 'Islamic Financial Contracting Forms in Saudi Arabia: Law and Practice' (Phd, Brunel University 2014) 44.

²⁴³ Karen Hunt-Ahmed, *Contemporary Islamic Finance: Innovations, Applications and Best Practices* (John Wiley & Sons 2013) 50.

²⁴⁴ Frank E. Vogel & Samuel L. Hayes, *Islamic Law and Finance: Religion, Risk, and Return* (Koninklijke Brill 2006) 98.

reason might be that the prescribed contracts types totally met their needs at that time, so there was no necessity to discuss new types.²⁴⁵

In addition, the freedom of contract is not the only issue that should be highlighted. The debate usually happens regarding terms and stipulations of a contract because some *Hadiths* restricted certain stipulations. For instance, the Prophet in a *Hadith* prohibited a sale and a stipulation. Also, an important *Hadith* in this area is the story of Aisha, the wife of the Prophet, who wanted to buy and then free a slave woman named Barira. However, the masters of Barira said that they would not agree to this unless they reserved the right to inherit from her, which is known as *Walla*.

In Islam, the right to inheritance in this case should be accorded to the person who frees the slave, as Islam encouraged masters to free their slaves, in this case Aisha. Aisha sought advice from the Prophet who suggested that she buy Barira and manumits her. Then the Prophet stood among the people and addressed them in the following words:

“What about those people who stipulate things that are not present in the book of God, any stipulation not in God’s law is void. Even if there a hundred conditions, the decision of God is more just and the stipulation of God more reliable. The right of walla is only his who manumits.”²⁴⁶

This *Hadith* show that the stipulations have to be agreed with the provisions laid out in the Quran and that this might limit the freedom of contract stated above. However, scholars have clarified those *Hadiths* and compared them with other *Hadiths*, after which they divided the stipulations into two categories: (1) accepted or binding stipulations and (2) invalid stipulations. Accepted stipulations are the conditions inherent in the nature of the contract, such as the way in which the payment will be paid. This means that when a stipulation specifies a certain aspect in a product, such as the fact that a cow has to have milk so it can be milked, it is accepted and valid. This was supported by a *Hadith* where the Prophet declared: “The Muslims are bound by their provisions or stipulations.”²⁴⁷

²⁴⁵ Ibid.

²⁴⁶ Ibid 67.

²⁴⁷ Muhammad Hashim, 'Islamic Perception of Business Ethics and the Impact of Secular Thoughts on Islamic Business Ethics' (2012) 2 International Journal of Academic Research in Business and Social Sciences 114.

The other type of stipulations, the invalid stipulations, can be further divided into two types. The first type are stipulations that make the whole contract invalid, meaning that the contract is not accepted if this stipulation remains: for instance, if a seller conditions the sale of a good to the purchase of another good or a money loan from the buyer. The second type of invalid stipulations are those that do not invalidate the whole contract, but when the condition itself is void, such as, for example, in the above-mentioned example of the slave woman Barira.²⁴⁸

Therefore, in examining the issue of whether a new Islamic financial contract can be created in the modern era, it can be said that the freedom of contract is guaranteed in Islam. This enables Islamic scholars in our modern life to develop their products and to try to create new types of contracts to attract more investors. This issue has become more important after many Islamic countries have opened up to conventional finance, which brought more opportunities and types of finance that were not available in Muslim countries. This therefore encouraged sharia scholars to study such financial contracts in terms of their compatibility with the sharia principles and the possibility of their conversion into sharia-compliant products, bearing in mind the avoidance of invalid stipulations that may conflict with the main point of a contract under Islamic law.

2.9 Different Types of Contracts in Islamic Finance

Islamic finance approves several ways of doing commerce, with different contracts available for each approach. The Islamic system is basically guided by the belief that investment based on the doctrine of profit and loss sharing leads to a healthier financing portfolio, increases rates of return to depositors, and leads to optimal allocation of resources for overall economic growth.²⁴⁹ Profit and loss sharing can be done in some Islamic banks in the way that the assets and liabilities of the banks are combined so that borrowers share profits and losses with the banks, which leads to sharing profits and losses with the depositors.

From this perspective, many studies consider “that Islamic banks are theoretically better poised than the conventional banks to absorb external shocks because the

²⁴⁸ Al-Hussen Showt and Abdulalhq Himish, *فقه العقود المالية (Jurisprudence of Financial Contracts)* (Dar ibn Hazm 2012) 128.

²⁴⁹ Kabir Hassan and Mervyn Lewis, *The Handbook of Islamic Banking* (Edward Elgar 2007) 50.

banks' financing losses are partially absorbed by the depositors."²⁵⁰ Profit and loss sharing contracts are part of Islamic finance. This section briefly highlights the different forms of contracts available in Islamic banking, as well as the way in which they become sharia-compliant and the purpose of each type of contract.

2.9.1 *Mudaraba* (Trustee Profit-Sharing)

Mudaraba is a contract which was found during the pre-Islamic era at a time when most financing activities were utilising interest. Prophet Mohammed himself practised this contract before revelation when he was working as an agent (*Mudarib*) for a wealthy businesswoman who later became his spouse.²⁵¹ Islam approved such contracts as an alternative to finance involving interest or other prohibited acts. Also, the second caliph, Umar ibn Al-Khattab, used this form of contract by investing the wealth of orphans with merchants' ventures who engaged in trade between Medina and Iraq.²⁵² The word *Mudaraba* in Arabic is derived from *Darab fi Al-Ard* which means journeying through the land seeking the bounty of God. Because of the travel and the work involved, the *Mudarib*, or agent, becomes eligible to part of the profit of the venture. This kind of business sustained and remained almost unchanged for centuries until the recent development in Islamic finance and banking whereby it has become the typical profit-sharing instrument in use.²⁵³

Mudaraba is an investment and profit-sharing partnership that is part of an arrangement where one of the partners pays money to the other partner to invest and takes an agreed percentage from the profit. In case of loss, the investor (*Mudarib*) will not pay anything but will also not receive any gain for the work that has been done, unless the loss was caused by his negligence, in which case, he or she would be liable for the loss.²⁵⁴ Therefore, the owner of the capital is liable to the financial risks of the venture and the profit cannot be fixed in advance, which makes it a non-interest economic system.²⁵⁵ An Islamic bank can be part of a *Mudaraba* agreement, as the *Mudarib* (agent) in relation to its depositors, by investing the deposits in many

²⁵⁰ Beng Soon Chong and Ming-Hua Liu, 'Islamic Banking: Interest-Free or Interest-Based?' (2005) SSRN Electronic Journal 126.

²⁵¹ Patricia Crone, *Meccan Trade and the Rise of Islam* (Gorgias Press 2004).

²⁵² Muhammad Ayub, *Understanding Islamic Finance* (Wiley 2013) 320.

²⁵³ M. Shaghil, *Islamic Economics a Global Perspective* (1st ed, SB Nangia 1989) 98.

²⁵⁴ *Ibid* 100.

²⁵⁵ Frank E. Vogel & Samuel L. Hayes, *Islamic Law and Finance: Religion, Risk, and Return* (Koninklijke Brill 2006) 131.

schemes;²⁵⁶ as the supplier of capitals on behalf of itself to a *Mudarib* or as a fund provider on behalf of its depositors by having a two tier *Mudaraba* where the Islamic financial institution acts as a first tier *Mudarib* while it invests funds with entrepreneurs as a second tier *Mudaraba*.²⁵⁷

This may put the Islamic institution in a better position compared to the conventional institution as the former may face fewer liquidity problems than the latter as it does not guarantee the capital of its depositors.²⁵⁸ In order for *Mudaraba* to be accepted, certain conditions have to be met. First, the party who is going to pay the fund has to have the legal capability for becoming a principal in a contract of agency, whereas the *Mudarib* has to have the capacity to be an agent. Second, the profit must be expressed as a ratio or as a part of the total profit. In other words, the profit cannot be expressed as a percentage of capital invested. Third, the authority of the *Mudarib* has to be specified: whether it is absolute in any permissible act or limited to a certain kind of business. If the *Mudarib* exceeds his or her lawful authority, he or she will be liable for the loss or the debt if found.²⁵⁹

2.9.2 Murabaha (Trade with Mark-up)

Murabaha is a well-known form of sale contract, where a price is determined by the initial price plus a stated percentage of profit. Simply put, it is basically a resale with a fixed profit. The purpose of such a contract is to grant individuals and institutions the possibility to get the goods and production tools they need while making the payment of value on the basis of monthly instalments.²⁶⁰ Two elements have to be considered in order for a *Murabaha* contract to be acceptable in Islamic finance: (1) the buyer has to know the starting price of the product, including additional costs such as delivery, (2) the profit to be added to the original cost has to be known.

The way a *Murabaha* contract is usually practised in Islamic financial institutions is when a person wishes to buy a product, such as a machine or a car, but cannot afford to do so. So this person turns to a financial institution providing all the details of the

²⁵⁶ Ismail Ahmad El- Shenawy, 'دور المصرف الإسلامى فى النشاط الاقتصادى' (The Role of the Islamic Banks in Economic Activities)' (Postgraduate, Alexandria University, Egypt 1982).

²⁵⁷ Frank E. Vogel & Samuel L. Hayes, *Islamic Law and Finance: Religion, Risk, and Return* (Koninklijke Brill 2006) 131.

²⁵⁸ Ibid.

²⁵⁹ Ismail Ahmad El- Shenawy, 'دور المصرف الإسلامى فى النشاط الاقتصادى' (The Role of the Islamic Banks in Economic Activities)' (Postgraduate, Alexandria University in Egypt 1982) 138.

²⁶⁰ Ibid.

product, such as the full description and the quantity. A promise should be given by this person (the client) to the financial institution that when the product is owned and possessed by the institution, the client will buy it; this promise is considered as a non-binding contract. When the product comes into the financial institution's possession, it can be resold to the client by *Murabaha*.

The second sale is usually in instalments or with delayed payment, which would include additional costs agreed between the two parties. This kind of contract has certain similarities to the conventional banks' transactions based on interest-based lending. However, there are significant differences between the two types of contracts. For example, the mark-up in *Murabaha* is for the services that the financial institution offers such as searching and purchasing the requested goods at the best price.

Also, during the time the product was under the financial institution's possession it bears the risk that the good may be destroyed or harmed, which could cause a rejection of the product by the client. This is the reason for adding the mark-up cost, while in a loan agreement the profit is stipulated in terms of a time period.²⁶¹ Therefore, if the client could not make a deferred payment on time, the mark-up does not increase from the agreed price owing to delay. Meanwhile, none of these situations impinge on a loan (See *Figure 2*).²⁶²

Murabaha is a sale contract while the conventional loan is an interest-based lending agreement and transaction. Also, the mark-up in *Murabaha* is fixed at the beginning of the contract, while with loan interest; the profit usually can be changed during the contract depending on the benchmark interest rate.²⁶³

²⁶¹ Kabir Hassan and Mervyn Lewis, *The Handbook of Islamic Banking* (Edward Elgar 2007) 119.

²⁶² Frank E Vogel and Samuel L Hayes, *Islamic Law and Finance: Religion, Risk, and Return* (Koninklike Brill 2006) 212.

²⁶³ Hamed Merah, *عقود التمويل المستجدة في المصارف الإسلامية: دراسة تأصيلية تطبيقية* (*Emerging Financing Products in the Islamic Banks; A Theoretical and Practical Study*) (1st edn, al-Miman Publisher 2011) 73.

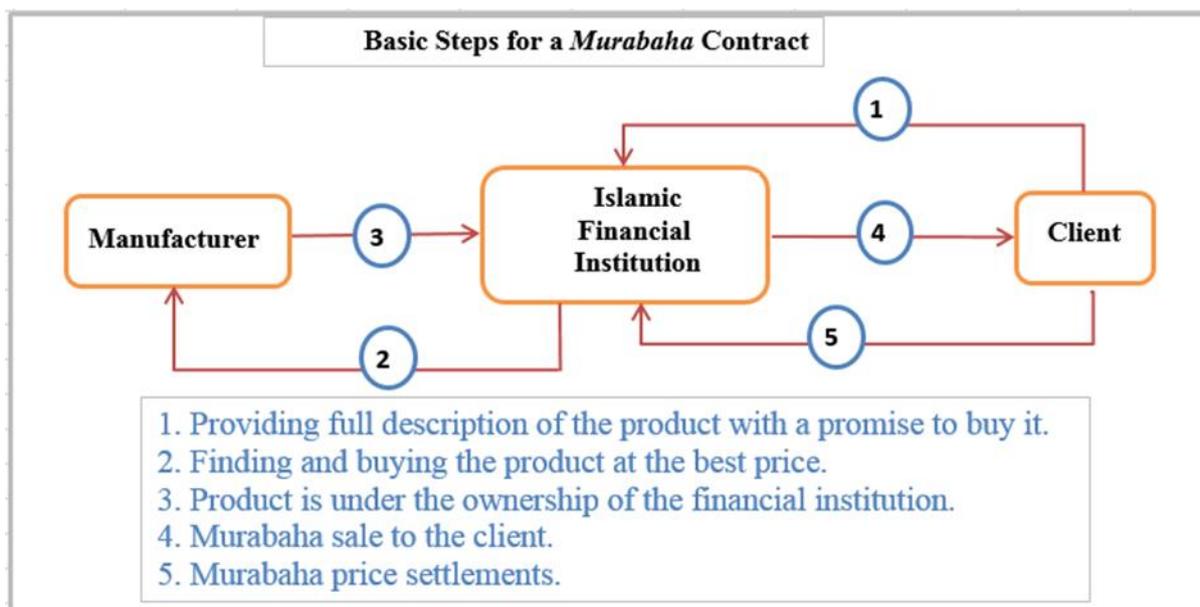


Figure 2: Basic steps for a Murabaha contract

Source: made by the researcher

2.9.3 Salam (Forward Selling) and Istisna (Order to Manufacture)

Salam and *Istisna* are two very similar types of contract. *Salam* refers to an advance purchase, when the full amount is paid in advance for described goods to be delivered at a specific time, whereas an *Istisna* contract is used in a commissioned manufacture, when a party purchases something that the other party agrees to manufacture, following specific descriptions stated in the contract.²⁶⁴ The payment in *Istisna* can be paid either in full in advance, partially in advance or at the time of delivering the goods. These two types of contracts are very important in Islamic finance for agriculture and the manufacturing industry, as well as in large commercial activities, such as building airports, schools and hospitals.²⁶⁵

As mentioned earlier those two contracts are not included in the *Ghara* prohibition: for example, the ambiguity in the existence of the sold item, and the ambiguity in the possession of the sold item. The reason is that when *Salam* and *Istisna* contracts are

²⁶⁴ Ibid 481.

²⁶⁵ Andreas A. Jobst and Juan Sole, 'The Governance of Derivatives in Islamic Finance' (2009) *Journal of International Banking Law and Regulation*.

performed, it is not a sale on specific items, goods or fruit. The sale is on a specification of any product that has the same specifications.

In other words, it is prohibited to sell certain fruits as the *Hadith* forbid the sale of grapes until they become black, and the sale of grain until it is strong. The prohibition is on selling specific grapes from a specific farm, as there might be a problem that these grapes will not continue growing while in a *Salam* contract; there is no prohibition on the sale of any grapes that have the specifications included in the contract.²⁶⁶

2.10 Conclusion

This chapter introduced Islamic finance in general, highlighting the main basics that differentiate such finance from conventional finance. This includes the history of this finance, and some of the popularity it has gained after the 2007 crisis. Then an overview of the sources of Islamic law is introduced including the main four Sunni schools of thought. Also, the major prohibited acts in Islamic finance are discussed to clarify the aspect that has to be considered when approving a financial contract which will be looked at more closely in Chapter Four.²⁶⁷

Then, the freedom of contract in Islamic finance is highlighted to show that the new Islamic financial contracts can be created when certain rules are followed. Finally, some examples of Islamic financial contracts are provided to give more understanding to Islamic finance. As mentioned previously, Saudi Arabia chose to be governed by Islamic law in all its aspects of governance, and this fact will be emphasised in the next chapter. As a result, this chapter is essential to the work because it is not appropriate to discuss the challenges that face Islamic financial contracts in Saudi Arabia in the next chapters without discussing the context of what is meant by Islamic finance.

²⁶⁶ Mahmoud A El-Gamal, *Islamic Finance: Law, Economics, and Practice* (Cambridge University Press 2009).

²⁶⁷ See 4.6 below.

Chapter Three: The Legal System and Islamic Finance in the Kingdom of Saudi Arabia

3.1 Introduction

As Saudi Arabia is the case study for this thesis, there are some essential points which need to be addressed and discussed with regards to the background of the country. This is done by providing specific contextual factors of the history of Saudi Arabia to show the link between Islam which was introduced in the previous Chapter,²⁶⁸ and Saudi Arabia by demonstrating the relevant parts of the history of Saudi Arabia, its legal system and how Islamic finance, including its contracting forms, operates and is supervised.

This chapter will be the foundation for the main arguments which will be developed during this thesis, which is whether the current legal system in Saudi Arabia, which chose to be governed by Islamic law, is helping Islamic finance to develop, or whether it needs further changes. Therefore, this chapter starts with a general overview of Saudi Arabia and then shows how this country has been and is being governed, introducing the structure of its legal system in general and the regulations that control and supervise the financial sector in particular, including the judicial power and how some of the financial disputes in Islamic and conventional financial institutions are seen by special committees or quasi- Judicial committees that may fall within the executive purview and may give judgments that could contradict with sharia. Finally, the chapter ends with the development of Islamic banking in the country.

3.2 An Overview of Saudi Arabia

3.2.1 Historical Background

There is a strong relationship between the Islamic faith and Saudi Arabia not least because Islam as a religion originated from the Arabian Peninsula, in Mecca and Madinah.²⁶⁹ As a result, Islam has become the predominant religion of this geographical area and these two holy cities are located in what is known today as the Kingdom of Saudi Arabia (KSA).

²⁶⁸ See 2.3 and 2.2 above.

²⁶⁹ Frank E Vogel, *Islamic Law and Legal System of Saudi: Studies of Saudi Arabia* (Brill 2000) 88.

Islam is a part of, and a reason for, the existence of Saudi Arabia since its establishment in the eighteenth century. This was when Mohammed bin Saud, a local ruler of a town called Ad-Diriyah, part of Riyadh the capital city of Saudi Arabia now, agreed to form an alliance with Mohammed bin Abdul-Wahab, a religious scholar, with the aim of establishing a State ruled by Islamic law, with the former as ruler and the latter as religious scholar.²⁷⁰

In 1744 the State was established and became what is known as the First Saudi State.²⁷¹ This State expanded to cover not only the centre of the Arabian Peninsula but it covered the east of the Peninsula and the west as well, including the two holy cities Mecca and Madinah. It also expanded south to cover the Asir Mountains and even some parts of Yemen and Oman; while in the north it reached to Iraq and Alshan (Jordan and Syria). However, in 1818 Ottoman troops invaded the Arabian Peninsula to end the first Saudi State.²⁷²

Then, a couple of years after the fall of the first Saudi State, some attempts were made to re-establish the Saudi rule and in 1824 Turki bin Abdullah bin Saud succeeded in starting the second Saudi State.²⁷³ This State adopted the same foundations and pillars of the previous Saudi State which was based on its reliance on Islam, and the application of Islamic law including the finance sector.²⁷⁴

However, this State only controlled the centre and some parts of the east of the Arabian Peninsula while the west (Hejaz), including the two holy cities, were still under the control of the Ottoman Empire before the local Hashemite rulers in Hejaz threw off their allegiance to Ottoman rule to be liberated under Hashemite rule,²⁷⁵ while other parts of the previous State came under the rule of different tribes. The second Saudi State lasted about 67 years; it suffered from many external interventions and battles

²⁷⁰ Abdullah S Al-Uthaymeen, *تاريخ المملكة العربية السعودية (History of Saudi Arabia)* (Vol I, Riyadh 1999) 86.

²⁷¹ Ibid.

²⁷² Mofid Al-Zidy, *موسوعة تاريخ المملكة العربية السعودية: الحديثة والمعاصرة (Encyclopaedia of the history of Saudi Arabia: Modern and Contemporary)* (Dar Osama for Publishing & Distribution 2004) 12.

²⁷³ Ibid.

²⁷⁴ 'History of the Kingdom | Kingdom of Saudi Arabia - Ministry of Foreign Affairs' (*Mofa.gov.sa*, 2017) <<http://www.mofa.gov.sa/sites/mofaen/aboutKingDom/Pages/CountryDevelopment36143.aspx>> accessed 7 October 2017.

²⁷⁵ Ahmed Banafe and Rory Macleod, *The Saudi Arabian Monetary Agency, 1952-2016* (Springer International Publishing 2017) 20.

and at the same time some internal disputes caused by the sons of Faisal bin Turki who ruled the State and this caused the fall of the State in 1891.²⁷⁶

In 1902 Abdul Aziz bin Abdul Rhaman Al Saud, father of the current King Salman, succeeded in recapturing Riyadh; then in 1926 he managed to recapture the west and unify most of the Arabian Peninsula. In September 1932 King Abdul Aziz declared the establishment of the Kingdom of Saudi Arabia with a system of governance based on an absolute monarchy and governed by Islamic law.²⁷⁷ King Abdul Aziz continued the same alliance that was made by the first Saudi State as he appointed Muhammed ibn Ibrahim Al ash-Sheikh, a descendant of Mohammed bin Abdul-Wahab, to be the *mufti* (a scholar who provides a sharia answer) of Saudi Arabia.²⁷⁸ King Abdul Aziz assigned Abdullah Al-Suleyman to be in charge of the finances of the kingdom and to be the first finance minister of the kingdom and he stayed in that position until the founding of the Saudi Arabian Monetary Agency²⁷⁹ (SAMA) in 1952.²⁸⁰

King Abdul Aziz died in 1953 and the Kingdom was ruled after him by his sons: Saud, Faisal, Khaled, Fahad, Abdullah and Salman. Each son, on becoming King, declares that the kingdom is to be governed by Islamic law and is to contribute in the construction and development of the Kingdom in all sectors of life.²⁸¹ This shows that, since its existence, Saudi Arabia has derived its strength by taking on and maintaining the responsibility to govern the country by sharia law.

3.2.2 Legal Background

Administratively Saudi Arabia contains thirteen districts and each one is administered by one of the Royal Family al-Saud.²⁸² Arabic is the official language and Islam is the

²⁷⁶ Abdullah S Al-Uthaymeen, *البحوث والتعليقات في تاريخ المملكة العربية السعودية* (*Comments and Studies in the History of the Kingdom of Saudi Arabia*) (2nd edn, Altwba 1990).

²⁷⁷ Ibid.

²⁷⁸ As'Ad Abu khalil, *the Battle for Saudi Arabia: Royalty, Fundamentalism, and Global Power* (Seven Stories Press 2004).

²⁷⁹ It should be mentioned that SAMA announced in 4th December 2016 that the name of the Saudi Arabian Monetary Agency has been changed to the Saudi Arabian Monetary Authority. Please see SAMA official website of SAMA, 'Sama's Statement on Change of its Name from "Agency" to "Authority"' (2016) <<http://www.sama.gov.sa/en-US/News/Pages/news04122016.aspx>> accessed 30 November 2017.

²⁸⁰ Ahmed Banafe and Rory Macleod, *The Saudi Arabian Monetary Agency, 1952-2016* (Springer International Publishing 2017) 20.

²⁸¹ 'History of the Kingdom | Kingdom of Saudi Arabia - Ministry of Foreign Affairs' (*Mofa.gov.sa*, 2017) <<http://www.mofa.gov.sa/sites/mofaen/aboutKingDom/Pages/CountryDevelopment36143.aspx>> accessed 7 October 2017.

²⁸² Ibid.

official religion; the KSA can be described as a sovereign Islamic nation and Riyadh is the capital city.²⁸³ The country is ruled by a monarchy where the *Custodian of the Two Holy Mosques* is the official title given to the ruler,²⁸⁴ including the current King, Salman bin Abdul Aziz, who was proclaimed the seventh King of the Kingdom of Saudi Arabia in 23 January 2015.²⁸⁵

Since the founding of the country, the KSA legal system has been built on the premise that the law of God should act as the main legal structure of the country.²⁸⁶ In contrast with its neighbouring countries which have varied position on the role of sharia in their respective constitutions.²⁸⁷ While Saudi Arabia hold sharia to be the principal source of law. Other countries either have held it as a principal source of legislation which means that sharia does not necessarily represent the embodiment of the state, though it constitutes the principal source of legislation,²⁸⁸ while some other Arab countries have limited the role of Islam as to being the religion of the state, without making any reference to sharia as being a legislative source.²⁸⁹ For example it is stated in Omani Basic Law that "The religion of the State is Islam and Islamic sharia is the basis for legislation".²⁹⁰

So, sharia doesn't represent the embodiment of the state, as is the case in Saudi Arabia but it displays strong commitment to sharia as it designates it as the main legislative source.²⁹¹ In addition, some other neighbouring countries accepting sharia as a source of law, such as Bahrain, Kuwait and Qatar.²⁹² It is stated in their Constitutions that "The religion of the State is Islam. The Islamic Sharia is a principal

²⁸³ Basic Law of Governance 1992, Art 1.

²⁸⁴ Basic Law of Governance 1992, Art. 1, 5 (A) and 5 (B).

²⁸⁵ 'History of the Kingdom | Kingdom of Saudi Arabia - Ministry of Foreign Affairs' (*Mofa.gov.sa*, 2017) <<http://www.mofa.gov.sa/sites/mofaen/aboutKingDom/Pages/CountryDevelopment36143.aspx>> accessed 7 October 2017.

²⁸⁶ Abdullah S Al-Uthaymeen, *البحوث والتعليقات في تاريخ المملكة العربية السعودية (Comments and Studies in the History of the Kingdom of Saudi Arabia)* (2nd edn, Altwba 1990). See 3.2.3 below.

²⁸⁷ Mohammad Al-Moqatei, 'Introducing Islamic Law in the Arab Gulf States: A Case Study of Kuwait' (1989) 4 Arab Law Quarterly 140.

²⁸⁸ Lu'ayy Al-Rimawi, 'Relevance of Sharia as a Legislative Source in a Modern Arab Legal Context: A Brief Constitutional Synopsis with Emphasis on Selected Commercial Aspects' (2011) 32 Company Lawyer 58.

²⁸⁹ *Ibid.*

²⁹⁰ Omani Basic Law 1996 Article 2.

²⁹¹ Lu'ayy Al-Rimawi, 'Relevance of Sharia as a Legislative Source in a Modern Arab Legal Context: A Brief Constitutional Synopsis with Emphasis on Selected Commercial Aspects' (2011) 32 Company Lawyer 59.

²⁹² *Ibid.*

source for legislation..."²⁹³ On the other hand, some Arab countries accepting that Islam is the religion of the state but "the people" or "the nation" is the source of all powers.²⁹⁴ For example the Constitution Jordan stated that that Islam is the religion of the State.²⁹⁵ But it does not state that sharia is a source of legislation. However, it stated that the nation is the source of all powers.²⁹⁶

So, In Saudi Arabia laws should be directly drawn from the Quran and the *Sunna*. Nevertheless, a number of man-made regulations or transplanted Acts and Codes, identified as *Nizam*, have been introduced, such as Royal Decrees and other ministerial, judicial and administrative regulations.²⁹⁷ To avoid conflict between *Nizam* and the law of God, all laws should be based on sharia law and *Nizam* has to be carefully examined before being implemented to ensure these do not oppose or disagree with sharia. However, few *Nizams* do contradict sharia principles, and it is important, especially in the financial sector, that the distinction is made when there is a contradiction between them.²⁹⁸

As Saudi Arabia is a country that chose to follow religious law, that is, Islam, Muslims believe that Islam is a complete religion that covers all aspects of life.²⁹⁹ Based on this principle, Saudi Arabia should only implement laws that are based on sharia or at least are not in conflict with it.³⁰⁰

Sharia is the constitution of the Kingdom and is derived from primary and secondary sources of sharia and this was introduced in Chapter Two.³⁰¹ Any religious legal opinion, or *Fatwa*, has to come from sharia, which means that all courts decisions have

²⁹³ Bahraini Constitution 2002 Article 2. Also, See Kuwaiti Constitution 1962 Article 2. Also, See Qatari constitution 2003 Article 1.

²⁹⁴ Lu'ayy Al-Rimawi, 'Relevance of Sharia as a Legislative Source in a Modern Arab Legal Context: A Brief Constitutional Synopsis with Emphasis on Selected Commercial Aspects' (2011) 32 Company Lawyer 60.

²⁹⁵ Jordan's Constitution of 1952 with Amendments through 2016, Article 2.

²⁹⁶ Jordan's Constitution of 1952 with Amendments through 2016, Article 24.

²⁹⁷ Ammar Aljaser, 'Is Islamic Insurance Ready to Take the Lead? A Case Study of Saudi Arabia Insurance Law' (PhD, Georgetown University Law Center 2014) 1.

²⁹⁸ Abdulrahman Yahya Baamir, *Sharia Law in Commercial and Banking Arbitration Law and Practice in Saudi Arabia* (Routledge 2016) 5.

²⁹⁹ Munawar Iqbal and David T Llewellyn, *Islamic Banking and Finance: New Perspectives on Profit Sharing and Risk* (E Elgar 2002) xii.

³⁰⁰ Abdulrahman Yahya Baamir, *Sharia Law in Commercial and Banking Arbitration Law and Practice in Saudi Arabia* (Routledge 2016) 150.

³⁰¹ See 2.3 above.

to comply with sharia.³⁰² Therefore, this indicates that all laws should be derived from at least one of the sources of sharia.³⁰³

Although the KSA was established in 1932, it remained without a written constitution for about seventy years, apart from a collection of constitutional documents dealing with certain aspects of government prerogatives such as the Council of Ministers Law.³⁰⁴ The reason behind this absence of a constitution is rooted in the belief that no one has the power to legislate except God.³⁰⁵

However, following the 1991 Gulf War, King Fahd understood the importance of establishing a system based on a constitution in order to regulate the State authority and protect fundamental human rights in accordance with sharia in addition to determining the way to transfer power between the descendants of King Abdul Aziz, the founder of the modern Saudi State.³⁰⁶ Therefore, in 1992, by Royal Order, King Fahd filled the legal gap by approving the Basic Law of Governance.³⁰⁷

Along with this piece of legislation, other laws were adopted, such as the Regions Promulgated Law, the Consultative Law, *Majlis Ash-Shura* Law (Consultation Council law) and the Council of Ministers Law.³⁰⁸ It should be indicated that the Basic Law of Governance, which can be considered as a modern written constitution, do not conflict with the principal sources of sharia – the Quran and the *Sunna*.³⁰⁹

3.2.3 The Basic Law of Governance

As briefly explained above, the Basic Law of Governance was approved in 1992 to modernise all major laws regulating the country.³¹⁰ The Basic Law of Governance consists of nine chapters containing eighty-three Articles illustrating the relationship between the ruler and the citizens in addition to identifying the nature, responsibilities

³⁰² Frank E Vogel, *Islamic Law and Legal System: Studies of Saudi Arabia* (Brill 2000) 10.

³⁰³ Basic Law of Governance 1992, Art 48. Please see 3.3.3 below.

³⁰⁴ Rashed Aba-Namay, 'The Recent Constitutional Reforms in Saudi Arabia' (1993) 42 *International and Comparative Law Quarterly* 295.

³⁰⁵ Ammar Aljaser, 'Is Islamic Insurance Ready to Take the Lead? A Case Study of Saudi Arabia Insurance Law' (PhD, Georgetown University Law Center 2014) 4.

³⁰⁶ Abdullah S Al-Uthaymeen, *تاريخ المملكة العربية السعودية (History of Saudi Arabia)* (Vol I, Riyadh 1999).

³⁰⁷ Royal Order No: A/90 in 1 March 1992.

³⁰⁸ The Regional Law, Royal Order, no. A-92 dated 1 March 1992. The Consultative Council Law, Royal Order, no. A-91 dated 1 March 1992. Shura Council Law, Royal Order, no. A-91 dated 1 March 1992. The Council of Ministers Law, Royal Order, no. A/13, dated 20 August 1993.

³⁰⁹ Faleh Al-Kahtani, 'Current Practices of Saudi Corporate Governance: A Case for Reform' (PhD, Brunel University 2013) 14-15.

³¹⁰ Royal Order No: A/90 in 1 March 1992.

and objectives of the Kingdom.³¹¹ The Basic Law of Governance is considered as the main constitutional document for the Council of Ministers Law, the Regional Law and the Consultative Council Law. The first Article of The Basic Law of Governance emphasises the religion of the country:

Article 1: "The Kingdom of Saudi Arabia is a fully sovereign Arab Islamic State. Its religion shall be Islam and its constitution shall be the Book of God and the *Sunna* (Traditions) of His Messenger, may God's blessings and peace be upon him (PBUH). Its language shall be Arabic...."³¹²

This idea is stressed again in Article 7 whereby "governance in the KSA derives its authority from the Book of God and the Sunna, both of which govern this Law and all laws of the State,"³¹³ and the law did not specify a particular Islamic school of law whose rules are binding. In practice, the Saudi Arabian courts usually apply Hanbali law, although they have some discretion in this respect.³¹⁴ The reason of applying this particular school is that as stated earlier in this chapter,³¹⁵ that Saudi was established by alliance between bin Saud a ruler and Mohammed bin Abdul-Wahab as a religious scholar who was following Hanbali School of legal thought.³¹⁶ Then a Royal edict of 1928 stated that judges should apply the principles set out in specified Islamic Law texts of the Hanbali school.³¹⁷ Generally, Saudi judges adhere to this school, but they theoretically have the ability to apply their own conscience in determining the will of God.³¹⁸ Especially as the Basic Law of Governance has not specified a particular school of thought.

Again in Article 8 "governance in the KSA shall be based on justice, *Shura* (consultation) and equality in accordance with the Islamic sharia."³¹⁹ Also, Article 23 stipulates that the role of the State is to protect the principles of Islam and to enforce sharia.³²⁰ Additionally, it is also mentioned in Article 26 that the country must protect

³¹¹ Basic Law of Governance 1992.

³¹² Basic Law of Governance 1992, Art 1.

³¹³ Basic Law of Governance 1992, Art 7.

³¹⁴ Andreas Haberbeck, 'Succession in Saudi Arabia' (2010) 16 *Trusts & Trustees* 28.

³¹⁵ See 3.2.1 above.

³¹⁶ See **Error! Reference source not found.** above.

³¹⁷ John A Shoup and Sebastian Maisel, *Saudi Arabia and the Gulf Arab States Today: An Encyclopedia of Life in the Arab States* (Greenwood Publishing Group 2009) 404.

³¹⁸ *Ibid.*

³¹⁹ Basic Law of Governance 1992, Art 8.

³²⁰ Basic Law of Governance 1992, Art 23.

human rights in accordance with sharia.³²¹ Furthermore, Article 55 affirms that “The King shall run the affairs of the nation in accordance with the dictates of Islam. He shall supervise the implementation of Islamic sharia and the general policies of the State, and the protection and defense of the country”.³²²

As the focus of this thesis is on Islamic financial contracts, which have to be in harmony with sharia, most of the Articles are chosen to illustrate that the laws of Saudi are based on sharia and all financial activities should be handled according to sharia, which means financial contracts containing prohibited activities such as *Riba*, which have already been discussed in Chapter Two,³²³ should not exist or be approved of by the courts.

As the legal system is derived from the principles of sharia, the Basic Law of Governance assigns to authority bodies the right to give *Fatwas* (religious legal opinions) about what can be called sharia or not and this is going to be developed later in this chapter;³²⁴ therefore, Article 45 of the Basic Law of Governance highlights again that the Book of God and the *Sunna* of his Messenger are the source of *fatwas* and the Board of Senior *Ulema* (sharia scholars) and the Department of Religious Research and *Fatwa* should have the authority to provide the *Fatwas*.³²⁵

The Basic Law of Governance covers the economic principles in nine Articles.³²⁶ Also it obliges the State to collect a tax called *zakat* from the rich and redistribute its revenues to the legitimate recipients.³²⁷

Furthermore, the Basic Law of Governance describes in detail the authorities of the State and emphasises the fact that separation of powers is one of the key principles to be upheld, as stipulated in Chapter Six of the Basic Law of Governance. Article 44 defines the authorities of the State as “(1) the judicial authority (2) the executive authority and (3) the regulatory authority. These authorities shall cooperate in the discharge of their functions in accordance with this law and other laws. The King shall be their final authority.”³²⁸ Each authority will be discussed and explained more fully

³²¹ Basic Law of Governance 1992, Art 26.

³²² Basic Law of Governance 1992, Art 55.

³²³ See 2.7.1 above.

³²⁴ See 3.3.1.3 below.

³²⁵ Basic Law of Governance 1992, Art 45.

³²⁶ Ibid from Art 14 to Art 22.

³²⁷ Ibid Art 21.

³²⁸ Ibid Art 44.

later in this chapter.³²⁹ This suggests there is an absence of separation between the State and religion, as Islamic Law grants the King ultimate authority as a supreme ruler whose judgment is limited only by Islamic law.³³⁰

Having presented some of the Articles of the Basic Law of Governance which illustrate the relationship between the ruler and the citizens in addition to identifying the nature, responsibilities and objectives of the Kingdom, it should be clear that the Basic Law of Governance always indicates that the Kingdom of Saudi Arabia should be run in accordance with sharia. It is also necessary to introduce and present the structure of the legal system and the authorities of the country in general and the financing system in particular. This will help the reader to have sufficient knowledge about the legal system in Saudi Arabia, which will make it easier to identify the legal challenges that may face the Islamic finance in the Kingdom and understand the suggested solutions. This proves that there is a strong link between the religion of Islam and the Saudi legal system; because Islamic finance forms a part of Islamic law, the Saudi Arabian legal system should always support Islamic finance.

3.3 Structure of the Saudi Legal System

The structure of the Saudi legal system is presented by the Basic Law of Governance in terms of three different authorities: (1) the legislative authority, (2) the executive authority and (3) the judicial authority. These three authorities will be examined in detail and in addition, the interrelationships among them addressed.³³¹

3.3.1 The Legislative (Regulatory) Authority

The legislative authority, and all bodies which are responsible to make laws, consist of the *Shura* Council, the Council of Ministers and the Council of Senior Scholars. Article 67 of the Basic Law of Governance stipulates that the drafting of laws and regulations is the responsibility of this regulatory authority stressing that laws and regulations shall be in accordance with sharia, safeguarding all interests, and warding off harm to State affairs. Furthermore, the power of this authority shall be exercised

³²⁹ See 3.3 below.

³³⁰ Ammar Aljaser, 'Is Islamic Insurance Ready to Take the Lead? A Case Study of Saudi Arabia Insurance Law' (PhD, Georgetown University Law Center 2014) 5.

³³¹ Basic Law of Governance 1992, Art 44.

according to the provisions of the Law of Governance, the Law of the Council of Ministers and the Law of the *Shura* Council.³³²

As explained above, the Basic Law of Governance emphasises that sharia is the basis of legislation, which means that any law in the Kingdom has to be under the umbrella of sharia,³³³ and that should be run by the King who shall supervise the implementation of sharia and the general policies of the State.³³⁴

So, the ruler can implement certain regulations (*Nizams*) to deal with the comprehensive development of the country on condition that it does not contradict with sharia.³³⁵ As the system of governance is an absolute monarchy³³⁶ this grants the King the power to endorse laws by Royal Order without consulting any other authority.³³⁷ This can be done through the *Diwan Al Malaki* (Royal Court) which is the primary executive office of the King. Despite the fact that the King can enact laws by his own will, in practice, the *Shura* Council and the Council of Ministers share the legislative power in making laws. In addition, the Board of the Senior Council of Scholars (the religious authority) has legislative power by offering religious opinions (*Fatwas*) and interpreting the texts of the Quran and the *Sunna* to ensure that laws do not contradict with sharia.³³⁸

In this regard, it is worth bearing in mind that the notions of legislative authority or legislation are not mentioned in the Basic Law of Governance; instead, the term regulatory *authority* is used. This stems from the idea that, from an Islamic point of view, only God has the right to legislate.³³⁹

³³² Ibid Art 67. Please see 3.3.1.1.

³³³ Basic Law of Governance 1992, Art 1.

³³⁴ Ibid Art 55.

³³⁵ Basic Law of Governance 1992, Art 7, 8, 23, 26, 46, 48, 55, 57B, 67.

³³⁶ Ibid Art 5A.

³³⁷ Faleh Al-Kahtani, 'Current Practices of Saudi Corporate Governance: A Case for Reform' (PhD, Brunel University 2013) 16.

³³⁸ Basic Law of Governance 1992, Art 45 and Faleh Al-Kahtani, 'Current Practices of Saudi Corporate Governance: A Case for Reform' (PhD, Brunel University 2013) 17.

³³⁹ Abdullah F Ansary, 'A Brief Overview of the Saudi Arabian Legal System' (New York University School of Law 2015).

3.3.1.1 The *Shura* Council

The *Shura* Council was founded in 1992.³⁴⁰ It consists of a speaker and one hundred and fifty members with at least 20% women members, all of whom are appointed by the King. Their rights, duties and affairs are determined by a Royal Order.³⁴¹

The main purpose of the Council is consultation upon the King's request in matters pertaining to the State's general policy.³⁴² It also discusses and provides views on the subjects of social and economic development planning.³⁴³

Moreover, the Council may investigate the possible discrepancies in the government agencies' annual reports and offer an opinion when required.³⁴⁴ In addition, the Council exercises the power of legislation and the power to interpret laws in addition to reviewing international agreements, concession agreements and treaties that are to be enacted and amended by Royal Decree.³⁴⁵ Furthermore, the Council has the authority to suggest new laws or propose amendments to existing laws which should be submitted to the King.³⁴⁶

All the resolutions of the *Shura* Council have to be reviewed by the King who then takes the decision to have them reviewed by the Council of Ministers. At this point, if the Council of Ministers agrees with the resolution made by the *Shura* Council, the King merely approves and signs it. On the other hand, if the Council of Ministers disagrees, the King returns the law to the *Shura* Council for a final review before the decision is ultimately taken by the King.³⁴⁷

3.3.1.2 The Council of Ministers

The Council of Ministers was established in 1953.³⁴⁸ It is presided over by the King who acts as a Prime Minister and leads the Cabinet.³⁴⁹ Ministers are appointed,

³⁴⁰ 'Majlis Ash-Shura - Historical Background' (*Shura.gov.sa*, 2017) <<https://www.shura.gov.sa/wps/wcm/connect/ShuraEn/internet/Historical+BG/>> accessed 16 November 2017.

³⁴¹ Shura Council Law 1992, Act 3 with amendments by the Royal Order No A/44 dated 11 January 2013.

³⁴² Shura Council Law 1992, Act 15.

³⁴³ Shura Council Law 1992, Act 15 B.

³⁴⁴ Shura Council Law 1992, Act 15.

³⁴⁵ *Ibid.*

³⁴⁶ *Ibid* Act 23.

³⁴⁷ *Ibid* Act 17.

³⁴⁸ Charles W Harrington, 'The Saudi Arabian Council of Ministers' (1858) 12 Middle East Journal <<http://www.jstor.org/stable/4322975>> accessed 19 April 2016.

³⁴⁹ Basic Law of Governance 1992, Art 56.

relieved of their posts and their resignations accepted by Royal Order.³⁵⁰ The functions of the Council of Ministers are as follows:

“While deferring to provisions of the Basic Law of Governance and the *Shura* Council Law, the cabinet shall draw up the internal, external, financial, economic, educational and defense policies as well as general affairs of the State and shall supervise their implementation. It shall also review the resolutions of the *Shura* Council. It has the executive power and is the final authority in financial and administrative affairs of all ministries and other government institutions”.³⁵¹

The Council of Ministers Law states that the bylaws, laws, treaties, international agreements and concession agreements shall be enacted and amended by Royal Decree upon review of the Council.³⁵² The role of the Council of Ministers as an executive branch will be mentioned soon in the section on executive power.

3.3.1.3 The Religious Authority: Council of Senior Scholars

The Council of Senior Scholars was officially established in 1971.³⁵³ It is a religious legal body which consists of a president, called a *Mufti*, and twenty religious scholars all of whom are nominated by the King.³⁵⁴ The Council's legislative power lies in their issuing of religious opinions (*Fatwas*).³⁵⁵ According to the Basic Law of Governance, the main references for a *Fatwa* are both the Qur'an and the *Sunna*.³⁵⁶ More specifically, Article 3 of the Council of Senior Scholars Law highlights their responsibilities in terms of offering religious opinions upon the King's request and advising him in respect to public law from a religious point of view.³⁵⁷ However, the Council's *fatwas* hold an advisory nature and are not legally binding on to the King or individuals, unless the opinions have been approved by the former.³⁵⁸

In addition, in 2010 a Royal Decree granted the Council an exclusive jurisdiction over the issuing of *Fatwas* so as to prevent erroneous *Fatwas* which could put human lives

³⁵⁰ Council of Ministers 1992, Act 8.

³⁵¹ Ibid Act 19.

³⁵² Ibid Art 20.

³⁵³ Royal Oder No. 1/137 Dated in 30 Aug 1971.

³⁵⁴ Faleh Al-Kahtani, 'Current Practices of Saudi Corporate Governance: A Case for Reform' (PhD, Brunel University 2013) 18.

³⁵⁵ Ibid.

³⁵⁶ Basic Law of Governance 1992, Art 45.

³⁵⁷ Council of Senior Scholars Law, Royal Decree no 1/137 dated 29 August 1971.

³⁵⁸ Council of Senior Scholars Law 1992, Art 3B.

at risk and cause confusion to the public.³⁵⁹ Moreover, since the establishment of the Council, all the members appointed have belonged to the Hanbali school of thought, as it is the popular school in Saudi, especially since the establishment of Saudi Arabia as mentioned earlier.³⁶⁰

However, since 2009 scholars from other Sunni *Madhabs* like the Hanafi, Maliki and Shafi schools have been appointed in the Council.³⁶¹ The researcher sees this as a good step to have sharia scholars from different school of thoughts at the highest council for sharia scholars. This will help the *Fatwas* from the council to consider different school of thoughts before providing a *Fatwa*. This will include *Fatwas* in financial and commercial cases.

Thus, this will have a good impact on the development of Islamic finance in Saudi, in particular the sharia boards at the financial institutions who can be as well from different *Madhabs* and the Central Sharia Board that this thesis is going to suggest.

It should be highlighted that based on what has been mentioned above in relation to the legislative authority,³⁶² it can be seen that all members of the three councils, the *Shura* Council, the Ministers Council and the Council of Senior Scholars, are appointed and can be relieved of their posts by Royal Order. In addition, all the decisions of these councils are not final until approved by the King. Therefore, these councils depend on the King to practise their role in the legislative authority.

3.3.2 The Executive Power

The second component of the legal structure in the Kingdom is the executive power which is held jointly between the King, who acts as Prime Minister, and the Council of Ministers, in addition to being shared by local governments, different Ministry branches quasi-independent public agencies.³⁶³ As the King is the Prime Minister, he supervises

³⁵⁹ Royal Decree no. 13876/B. Date: 11/8/2010 Royal Decree Restricting the Right to Issue Fatwas to Members of the Council of Senior Scholars. However, the Royal Decree exempts from the restriction the individual *fatwas* on personal matters, such as matters of worship, transactions, and personal status, on condition that such *fatwas* should be private: between the questioner and the scholar.

³⁶⁰ See 3.2.23.2.3 above.

³⁶¹ Muhammad al-Atawneh, 'Wahhabi Legal Theory as Reflected in Modern Official Saudi Fatwas: Ijtihad, Taqlid, Sources, and Methodology' (2011) 18 Islamic Law and Society 340.

³⁶² See 3.3.1 above.

³⁶³ Abdullah F Ansary, 'A Brief Overview of the Saudi Arabian Legal System' (New York University School of Law 2015).

the overall policy-making of the State, the Council of Ministers, all government agencies as well as the implementation of laws.³⁶⁴ Moreover, he has the authority to appoint or dismiss vice-presidents, ministers or any other council member.³⁶⁵ He also has the power to dissolve the Council of Ministers and reconstitute it by Royal Decree.³⁶⁶

In addition, Article 55 states that “he shall supervise the implementation of Islamic sharia and the general policies of the State.”³⁶⁷ So, he is, therefore, the focal point of all authority. The Council of Ministers led by the King as Prime Minister is in charge of the executive and administrative affairs and its prerogatives include: (1) handling matters of public interest, (2) observing the implementation of laws, resolutions and regulations, (3) following up on general development planning, (4) forming committees in charge of the review of ministries’ and other governmental agencies’ conduct of business.³⁶⁸

The Regional Law states that the purpose of dividing the country into several regions is “to improve the standard of the administrative work and the development in the provinces of the Kingdom. It is also aimed at maintaining security and order, and guaranteeing citizens' rights and freedom within the framework of the sharia.”³⁶⁹

In addition, a number of independent and quasi-independent administrative agencies have been founded to help fill certain gaps in terms of the social, economic and administrative challenges which have been facing the Saudi Arabia since its formation.³⁷⁰ For example the Jubail and Yanbu Royal Commission and the Petroleum and Minerals Administration are economic agencies. With regard to investment and financial agencies there are for example the Saudi Arabian Monetary Authority (SAMA), the Capital Market Authority, the Real Estate Development Bank, and the

³⁶⁴ Faleh Al-Kahtani, 'Current Practices of Saudi Corporate Governance: A Case for Reform' (PhD, Brunel University 2013) 15.

³⁶⁵ Basic Law of Governance 1992, Art 57A.

³⁶⁶ Ibid Art 57C.

³⁶⁷ Ibid Art 55.

³⁶⁸ Council of Ministers 1992, Art 24.

³⁶⁹ Law of Provinces 1992, Art 1.

³⁷⁰ Abdullah F Ansary, 'A Brief Overview of the Saudi Arabian Legal System' (New York University School of Law 2015) 16.

Saudi Industrial Development Fund.³⁷¹ Most of these agencies are under the direct supervision of particular ministries or government agencies.³⁷²

3.3.3 The Judicial Power

It should be noted that in Saudi Arabia the king has the authority over judiciary by being able to appoint and terminate judges by Royal Order, at the recommendation of the Supreme Judicial Council.³⁷³ However, the Basic Law of Governance enshrines the principle of judicial independence as it states that "the judiciary shall be an independent authority. There shall be no power over judges in their judicial function other than the power of sharia".³⁷⁴ Also it emphasizes that all court judgments have to be based on sharia directly or on other laws that the authorities may promulgate on condition that it does not conflict with sharia.³⁷⁵ In addition, the Judiciary Act 1975 already stated that a number of Article for the independency of a judge such as "Judges are independent and, in the administration of justice, they shall be subject to no authority other than the provisions of sharia and laws in force. No one may interfere with the judiciary."³⁷⁶

Also, "Judges are not subject to removal from office except in the cases set forth in this Law."³⁷⁷ Furthermore, "judges may not be transferred to other positions except with their consent or by reason of promotion."³⁷⁸ Article four stated that judges cannot be prosecuted except according to their disciplinary regulations.³⁷⁹

According to the Basic Law of Governance, the judicial system is divided into two judicial orders serving different sorts of dispute resolutions depending on the subject matter.³⁸⁰ However in practice there is one more which will be explained shortly. The judicial orders are: (1) the General Courts, also known as Sharia Courts, (2) the Board

³⁷¹ Corporate Author, *Saudi Arabia Commercial and Trade Laws* (International Business Publications 2016) 11.

³⁷² Ibid.

³⁷³ Basic Law of Governance 1992, Art 52.

³⁷⁴ Basic Law of Governance 1992, Art 46

³⁷⁵ Ibid Art 48.

³⁷⁶ The Judiciary Act 1975 Article 1.

³⁷⁷ Ibid Article 2.

³⁷⁸ Ibid Article 3.

³⁷⁹ Ibid Article 4.

³⁸⁰ Basic Law of Governance 1992, Art 49 and 53.

of Grievances or Administrative Court and (3) the Limited Courts or Quasi-Judicial Committees.³⁸¹

The first judiciary law was issued in 1975,³⁸² and then in 2007 a new law³⁸³ was introduced changing and amending many laws and regulations that had been applied before,³⁸⁴ and introducing the commercial court which will be suggested to be in charge of the disputes of Islamic finance. The transition between laws moved slowly.³⁸⁵ Some of the new law is already being implemented and certain new courts that brought in the new law are now hearing disputes that had previously been brought before special administrative committees.³⁸⁶ The judiciary of the Kingdom is currently in a transitional period: more time is needed before it can fully implement the new judicial system.³⁸⁷

3.3.3.1 Sharia Courts

Sharia Courts have general jurisdiction over all disputes and crimes. There are three levels of courts in the Sharia Court system, as presented below in a decreasing order in terms of the judicial process.³⁸⁸

First, there is the Supreme Court, headed by the Chief Justice of the Supreme Court and a number of judges who should be appointed by Royal Decree.³⁸⁹ The new Supreme Court should assume the previous Supreme Judicial Council's main function to be the highest authority in the judicial system.³⁹⁰ Secondly, there are the Appellate Courts, located in each province, where each circuit is made up of a three-judge panel, except the criminal circuit that contains a five-judge panel.³⁹¹ The role of such courts

³⁸¹ Abdullah F Ansary, 'A Brief Overview of the Saudi Arabian Legal System' (New York University School of Law 2015).

³⁸² Royal Decree No. M/64 dated in 22 July 1975.

³⁸³ The Law of the Judiciary, Royal Decree No. M/78, in 1 October 2007.

³⁸⁴ Abdulrahman Yahya Baamir, *Sharia Law in Commercial and Banking Arbitration Law and Practice in Saudi Arabia* (Routledge 2016) 20.

³⁸⁵ Ibid.

³⁸⁶ Abdullah F Ansary, 'A Brief Overview of the Saudi Arabian Legal System' (New York University School of Law 2015).

³⁸⁷ Up until the time of writing this thesis there are new courts being established and judges are provided with special educational courses to work in the new courts.

³⁸⁸ The Law of the Judiciary 2007 Art 9.

³⁸⁹ Ibid Art 10.

³⁹⁰ Corporate Author, *Saudi Arabia: Company Laws and Regulations Handbook: Strategic Information and Important Regulations* (USA International Business Publications 2008).

³⁹¹ The Law of the Judiciary 2007 Art 15.

is to act as safeguards as they can overturn lower courts' decisions by hearing appealable judgments from lower courts. These courts are divided into five departments: Civil, Criminal, Personal Status, Commercial and Labour Divisions.³⁹² Thirdly, there are the Courts of First Instance or Trial Courts which are also located in every province and region of the Kingdom. These courts can be classified into five different types depending on the subject matter of the dispute and one of them is Commercial Courts,³⁹³

Finally, the Supreme Judiciary Council is at the top of the court system for supervision and administration;³⁹⁴ it is responsible for handling internal judiciary affairs, but should not interfere in the analysis of the outcomes reached by the courts in the cases they handle. Furthermore, if needed, the Council has the power to create other specialised courts after gaining the King's approval.³⁹⁵ It should be pointed out that most of the Islamic finance disputes, especially those in the banking sector, are not resolved by any one of these court as will be explained shortly.³⁹⁶

3.3.3.2 The Board of Grievances

The Board of Grievances was created in 1955 as a department of the Council of Ministers, then it became independent to serve as a general clearing house for complaints in the public domain.³⁹⁷ In other words, it is an administrative judicial body whose decisions are final and enforceable and directly linked to the King, for example, to deal with complaints of citizens against administrators.³⁹⁸ The Board is only competent to hear cases based on regulations that do not conflict with sharia.³⁹⁹

3.3.3.3 Special Committees or Quasi-Judicial Committees

As the KSA is rapidly evolving and engaging with the world in different aspects, social, economic or educational, in some cases the government issues different laws and regulations which would cause some disputes that needed urgent solutions as well as

³⁹² Abdulrahman Yahya Baamir, *Sharia Law in Commercial and Banking Arbitration Law and Practice in Saudi Arabia* (Routledge 2016) 21.

³⁹³ The Law of the Judiciary 2007 Art 10 sets up the five Courts. The Commercial Courts moved from The Board of Grievances to the General Sharia Court in 17/10/2017.

³⁹⁴ The Law of the Judiciary 2007 Art 6.

³⁹⁵ Ibid Art 9.

³⁹⁶ See 3.3.3.3 below.

³⁹⁷ Abdulrahman Yahya Baamir, *Sharia Law in Commercial and Banking Arbitration Law and Practice in Saudi Arabia* (Routledge 2016) 32.

³⁹⁸ Ahmed Al-Ghadyan, 'The Judiciary in Saudi Arabia' (1998) 13 Arab Law Quarterly 242.

³⁹⁹ Ibid.

needed specialised people with certain expertise to look at cases. This might make it difficult for courts to deal with the new cases, especially with the huge number of cases that judges have to solve every day.⁴⁰⁰

In addition, in some other cases the government issues some laws and regulations that may not comply with sharia.⁴⁰¹ This resulted to a number of disputes that may include activities that are not in strictly compliance with sharia, such as disputes on financial contracts that contains prohibited acts such as *Riba* that might be practiced in conventional banks.⁴⁰²

So, Sharia Courts have taken a dismissive attitude toward enacted laws that has sharia- complaint issues, they decide cases according to sharia jurisprudence, not according to laws.⁴⁰³ Which mean that judges in Sharia Courts are not willing to accept such cases.⁴⁰⁴

As a result, different laws and regulations have granted adjudication of disputes and crimes that would normally fall within the jurisdiction of the Sharia Courts to either the Board of Grievances or to administrative committees.⁴⁰⁵

Thus, the King may issue a decree to set up temporary special committees to have jurisdiction over specific areas of the law; some of these committees fall under the supervision of the judiciary while others fall within the executive purview.⁴⁰⁶ This results in a diversity of quasi-judicial committees founded by the Saudi regulator. For example, the Committee for Settlement of Banking Disputes solves disputes between banks and their customers for conventional banks that deal with *Riba* as an example, also the Islamic banks.⁴⁰⁷

⁴⁰⁰ Abdulaziz Al-Dugaither, 'تسوية المنازعات المصرفية: دراسة فقهية قانونية مقارنة' (Banking Disputes Settlement: Comparative Legal Study)' (Postgraduate, Al- Imam Mohammed Ibn Saud Islamic University 2008) 23.

⁴⁰¹ Ayoub M. Al-Jarbou, 'Judicial Independence: Case Study of Saudi Arabia' (2004) 19 Arab Law Quarterly 23.

⁴⁰² See 3.3.3.3.1 below.

⁴⁰³ Ayoub M. Al-Jarbou, 'Judicial Independence: Case Study of Saudi Arabia' (2004) 19 Arab Law Quarterly 24.

⁴⁰⁴ Ahmed Al-Ghadyan, 'The Judiciary in Saudi Arabia' (1998) 13 Arab Law Quarterly

⁴⁰⁵ Ayoub M. Al-Jarbou, 'Judicial Independence: Case Study of Saudi Arabia' (2004) 19 Arab Law Quarterly 23.

⁴⁰⁶ Ibid.

⁴⁰⁷ 'Historical Preview' (*Sama.gov.sa*, 2017) <<http://www.sama.gov.sa/en-us/about/pages/samahistory.aspx>> accessed 28 November 2017.

Furthermore, the Customs Committee deals with cases related to smuggling or attempts to smuggle.⁴⁰⁸ The new judicial system issued in 2007 mentions that most of the special committees will be transferred to be part of the Sharia Courts as the disputes will be presented in one of the five different types of courts.⁴⁰⁹

Thus recently, some committees have moved and others are in the process of moving, to be under the General Courts; for example the Commercial Papers Disputes is moving mid-February 2018 from the Ministry of Commerce and Industry to be under the General Court.⁴¹⁰ Furthermore, the Labour Dispute Settlement Committees are in the process of moving as well.⁴¹¹ It should be mentioned that members of such committees are not judges and have only administrative powers to look into such cases,⁴¹² and as mentioned earlier,⁴¹³ the judiciary shall be an independent authority and there shall be no power over judges in their judicial function other than the power of sharia.⁴¹⁴ While the independence of such committees is questionable, they are created to be under a particular ministry supervision to carry out their judicial functions. However, they belong to the executive branch rather than the judicial branch. Therefore, these committees are not sufficiently independent.⁴¹⁵ It can be seen that such committees were established as a temporary solution, as going to be explained soon,⁴¹⁶ until judges in the judicial system became familiar with the new regulations or the government can develop its system to keep the development of the country running without infringing its main laws that the “governance in the kingdom of Saudi Arabia derives its authority from the Book of God and the Sunna, both of which govern this Law and all laws of the State.”⁴¹⁷ Yet some of these committees are still in position

⁴⁰⁸ Royal Decree No. 425 dated 23 November 1952.

⁴⁰⁹ The Law of the Judiciary 2007.

⁴¹⁰ Al-jazirah Newspaper, 'نقل مكاتب منازعات الأوراق التجارية إلى المحاكم الجزائية بداية جمادى الآخرة' (Transferring the Commercial Paper Disputes Offices to Criminal Courts)' (2017) <<http://www.al-jazirah.com/2017/20171114/ec7.htm>> accessed 28 November 2017.

⁴¹¹ It should move to be under the Labour Court in the middle of 2018, and currently there are more than 60 judges under training at the current bodies for Settlement of Labour Disputes. Please see Adnan Al-Shabrawi, 'تطرق أبواب المحاكم' «المادة ٧٧» و «العمالية» على «العمالية» تدريب ٦٠ قاضياً على «العمالية» (Judges Under Training For «Labour Court» and «Article 77» Would Be The First Issue To Be Discussed Courts)' Okaz (17/2/2017) <<http://bit.ly/2zdaSRn>> accessed 22 November 2017.

⁴¹² Faleh Al-Kahtani, 'Current Practices of Saudi Corporate Governance: A Case for Reform' (PhD, Brunel University 2013) 21.

⁴¹³ See 3.3.3.1 above.

⁴¹⁴ Basic Law of Governance 1992, Art 46, 48, 52. Also see the Board of Grievances Statute 1982, Art. 1. Also See The Judiciary Act 1975 Article 1, 2, 3, 4. See 3.3.3 above.

⁴¹⁵ Meshal Faraj, *Toward New Corporate Governance Standards in the Kingdom of Saudi Arabia* (SABIC 2014) 41.

⁴¹⁶ See 3.3.3.3.1 below.

⁴¹⁷ Basic Law of Governance 1992, Art 7.

after more than three decades. It is only recently that some of them have moved to be under the judicial authority to gain their independence.⁴¹⁸

In addition, the plan for the Implementation of the Judicial System Act and the Board of Grievances Act,⁴¹⁹ show that the jobs of the Quasi-Judicial Committees shall be transferred to courts under the job title “judge” and members of the existing committees shall be encouraged to occupy those jobs to work as judges in these courts, provided that they meet the requirements to be a judge which would enhance the independence of the judicial system in the Kingdom.⁴²⁰

Even though, Islamic banking and finance has developed and become a well recognise in many countries, but most of the disputes in Islamic finance, including banking disputes, are not seen by courts but by Special Committees such as the Committees for Banking and Financial Disputes and Violations, because the regulators treat Islamic finance under the umbrella of conventional finance as there are no especial regulations for Islamic banking and finance,⁴²¹ which will be discussed later.⁴²²

However, Participant E and C of the interviews believe that the new commercial courts should have the authority to look at disputes in Islamic finance, since all activities of such finance should be in accordance with sharia.⁴²³ It was perhaps necessary, before the new courts were established, that these disputes be handled by the committees to avoid the long process of resolving disputes in the General Courts as there were no specialised courts; but with the new courts ,such as commercial courts, the situation is different. It would be better for cases to be seen by judges who have a strong background in sharia as well as commerce and also the independence of the judgments are guaranteed by the law as stated earlier.⁴²⁴ While most of the members of committees have only a commercial background with no independence guaranteed.

⁴¹⁸ Abdullah F Ansary, 'A Brief Overview of The Saudi Arabian Legal System' (New York University School of Law 2015).

⁴¹⁹ The Law of the Judiciary, Royal Decree No. M/78, in 1 October 2007.

⁴²⁰ Royal Decree 78/M Dated 30 September 2007 the implementation plan for the new judicial law in Saudi Arabia.

⁴²¹ Ali Al-Shamrani, 'Islamic Financial Contracting Forms in Saudi Arabia: Law and Practice' (Phd, Brunel University 2014) 190.

⁴²² See **Error! Reference source not found.** below.

⁴²³ A personal interview with participant C on 3 March 2015. Also, a personal interview with participant E on 24 February 2015.

⁴²⁴ Basic Law of Governance 1992, Art 46, 48, 52. Also see the Board of Grievances Statute 1982, Art. 1.

Islamic finance may be handled by four committees and these are (1) the Banking Disputes Committee, (2) the Financing Disputes and Violations Settlement Committee, and (3) the Committee to Consider Violations and Dispose on Credit Information Disputes Relevant to Credit Information (4) Committee for the Resolution of Securities Disputes.

3.3.3.3.1 Banking Disputes Committee

As mentioned earlier, the Kingdom of Saudi Arabia chose to be governed by Islamic Law in all areas of life. As Saudi Arabia is by far the biggest producer and exporter of oil in the Gulf Cooperation Council and that was one of the reasons for its fast development since the discovery of oil in King Abdul Aziz time.⁴²⁵ The Kingdom at that time needed banks to keep pace with its developments. However, Islamic banks were not at that time in existence; the Islamic banking system at that time was seen as immature and lacking experience, at least in the leaders' eyes, and that led to allowing conventional banks to work in the Kingdom providing its services and charging interest (*Riba*).⁴²⁶ When banks needed, for example, a judicial enforcement against defaulting customers, the sharia court would not be a sensible option especially when the contract contained a prohibited transaction such as *Riba*, as a sharia court, or the Board of Grievances, which used to have the authority on commercial disputes, would annul the part which contradicted with sharia in the contract.⁴²⁷

Another option was to use arbitration but the same problem appeared. Although, arbitration is an independent dispute resolution method, it still attaches to the domestic legal system and the public order of the place of the issuance and the place of enforcement; this means the awards of the arbitral authority have to be approved by the Board of Grievances or by the enforcement court to be enforceable.⁴²⁸ This will

⁴²⁵ The Gulf Cooperation Council (GCC) was established in 1981 to promote stability and economic cooperation among six Gulf countries: Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates; Ahmed Banafe and Rory Macleod, *The Saudi Arabian Monetary Agency, 1952-2016* (Springer International Publishing 2017).

⁴²⁶ John R Presley and Rodney Wilson, *Banking in the Arab Gulf* (MacMillan Academic and Professional 1991) 34.

⁴²⁷ Abdulrahman Yahya Baamir, *Sharia Law in Commercial and Banking Arbitration Law and Practice in Saudi Arabia* (Routledge 2016) 189.

⁴²⁸ The Law of Arbitration Royal Decree No. M/34 Dated 16/4/2012.

lead again to rejecting the enforcement of the part contradicting with sharia and offering the bank approval for executing the award in the part compliant with sharia.⁴²⁹

By the early 1980s, a number of complaints had been made by conventional banks to the authorities, claiming that they were losing too much when they go to courts and that the risk was too high,⁴³⁰ and that resulted in a Royal Decree in 1987 which authorised the Banking Disputed Settlement Committee to operate under the aegis of the Saudi Arabian Monetary Authority (SAMA).⁴³¹

The Committee was established to consider and study cases between banks and their clients for settlement of disputes, and to find proper solutions between the two parties according to the agreement signed between them.⁴³² It should be highlighted here that the committee will approve *Riba* to be paid if it included in the agreement even it's prohibited by Islam to do so as discussed earlier.⁴³³ By doing such a thing the committee violate Basic Law of Governance, the judicial power that work under sharia law and even violates article 6 of the Charter SAMA⁴³⁴ that this committee works under its supervision.⁴³⁵

The Committee used to be consisted of only a one-stage litigation procedure.⁴³⁶ In 1988 another Royal Decree was issued to limit the jurisdiction of the Committee to only the pure banking cases and claims,⁴³⁷ such as opening bank credits, accounts of every kind and loans.⁴³⁸ So, this Committee was established with its jurisdiction over banking disputes and the application of its own particular principles to disputes, which consisted of approving a transaction or contract as agreed between both parties.

⁴²⁹ Abdulrahman Yahya Baamir, *Sharia Law in Commercial and Banking Arbitration Law and Practice in Saudi Arabia* (Routledge 2016) 167.

⁴³⁰ Ibid 169.

⁴³¹ Royal Decree number 8/729 dated 10 March 1987.

⁴³² Ibid.

⁴³³ See 2.7.1 above.

⁴³⁴ See 3.4.2 below.

⁴³⁵ Abdulrahman Yahya Baamir, *Sharia Law in Commercial and Banking Arbitration Law and Practice in Saudi Arabia* (Routledge 2016) 162.

⁴³⁶ Hassan Al Faioumy, 'Forming an Appeal Committee for Banking Disputes in Saudi Arabia' (*HG.org*, 2015) <<https://www.hg.org/article.asp?id=37627>> accessed 29 November 2016.

⁴³⁷ Royal Decree number 110/b/4 dated 14 August 1988.

⁴³⁸ Hassan Al Faioumy, 'Forming Appeal Committee for Banking Disputes in Saudi Arabia' (*HG.org*, 2015) <<https://www.hg.org/article.asp?id=37627>> accessed 29 November 2016.

The Committee can enforce the banking claims in ways that would not be possible to be heard in the general court system of the Kingdom.⁴³⁹

However, there were some aspects of uncertainty regarding the authority of the Committee and the exact status and the parameters of its mandate appeared to be challenged from time to time.⁴⁴⁰ The debate is whether the decisions of this Committee are considered final and enforceable and whether it is to be counted as a court, or only to be a mediator between the parties. This question had been asked and debated among legal professionals and even in the media.⁴⁴¹

In 2011 this ambiguously came under the microscope when the Board of Grievances was petitioned by a bank customer trying to avoid a judgment being enforced against him that was given by the Committee. He claimed that the judgments of the Committee were not those of a court and as a result the judgments should not be enforced by the relevant executive authorities.⁴⁴² After a short time a Royal Decree was made to clear up the status of the Committee along with its powers and processes.⁴⁴³ The Royal Decree discussed and introduced different aspects which improved this Committee in the following ways:

- It amended the name of the Committee, from the Banking Disputes Settlement Committee to the Committee for Banking Disputes and that was a signpost that the Committee is not only seen as a mediation forum but a real court.⁴⁴⁴
- It expanded its jurisdiction to settling original and affiliated banking disputes.⁴⁴⁵ Based on this, Islamic banks have been included under the Committee and cannot be heard in Sharia Courts even though the Islamic banks should be sharia-compliant.

⁴³⁹ Tim Plews and others, 'SAMA Committee Restructuring' (*Cliffordchance.com*, 2012) <https://www.cliffordchance.com/briefings/2012/07/sama_committee_restructuring.html> accessed 29 November 2016.

⁴⁴⁰ Ibid.

⁴⁴¹ Ibid.

⁴⁴² Ibid.

⁴⁴³ Royal Decree number 37441 dated 1 July 2012.

⁴⁴⁴ Tim Plews and others, 'SAMA Committee Restructuring' (*Cliffordchance.com*, 2012) <https://www.cliffordchance.com/briefings/2012/07/sama_committee_restructuring.html> accessed 29 November 2016.

⁴⁴⁵ Royal Decree number 37441 dated 1st July 2012.

- The Royal Decree introduced the establishment of Appeal Committees for Banking Disputes and Violations. It should reconsider the appellate authority in the Committee for Banking Disputes.⁴⁴⁶

In addition, members of this committee are not judges and the Royal Decree only stated that members of the committee should be specialised in banking activities.⁴⁴⁷ So no sharia qualifications are required. However, Muhammed ibn Ibrahim Al ash-Sheikh the Grand *mufti* (a scholar who provides a sharia answer) of Saudi Arabia⁴⁴⁸ denounced the existence of members who are not sharia experts to share decisions with other sharia expert members in solving disputes in this committee. As he stated that this may lead to preferring secular law over sharia law, which is prohibited.⁴⁴⁹ This concern also shared by many Muslims including Saudis that accepting to be governed by laws other than sharia law is prohibited, and the debated only whether it is still prohibited even under the necessity.⁴⁵⁰ This is why the Basic Law of Governance stated in more than one place that the government is governed by Islamic law in more than one place.⁴⁵¹ One of the reasons of the existence of Islamic Banks is that people want to live their life in accordance with sharia.

Islamic banks in Saudi Arabia have hugely developed since the past few decades, but still governed by SAMA under the regulations of conventional banks. Thus, the researcher will point out some suggestions to solve the problem after discussing the Islamic banking activities in Saudi Arabia.⁴⁵²

3.3.3.3.2 Financing Disputes and Violations Settlement Committee

As the previous committee is set to be in control of disputes of banks including Islamic banks, while this committee is for financial institutions, including Islamic finance institutions that is provided by financial companies not banks. This Committee was formed in 2012, with primary and appeal stages, to look at cases resulting from the

⁴⁴⁶ Ibid.

⁴⁴⁷ Royal Decree number 8/729 dated 10 March 1987 Article 2.

⁴⁴⁸ Died 1969.

⁴⁴⁹ Mohammed Bin Qussem, *فتاوى ورسائل سماحة الشيخ محمد بن ابراهيم (Fatwas and Messages of Sheikh Muhammad Bin Ibrahim)* (Vol 12 Government publisher in Makkah Al- Mukarama 1979) 262.

⁴⁵⁰ Abdulaziz Al-Dugaither, 'تسوية المنازعات المصرفية: دراسة فقهية قانونية مقارنة' (Banking Disputes Settlement: Comparative Legal Study)' (Postgraduate, Al- Imam Mohammed Ibn Saud Islamic University 2008) 109.

⁴⁵¹ 3.2.3 and 3.3.3 above.

⁴⁵² See 3.4 also 3.4.2 and 4.6 below.

application of the Finance Companies Control Law,⁴⁵³ which includes Islamic financial institutions especially *Ijara* financing (rental solutions with ownership promise).

It should be mentioned that the Company Control Law stated that finance companies shall engage in finance activities in a manner not conflicting with principles of sharia as defined by Sharia Committees required in such companies.⁴⁵⁴ This should give an indication all activities should be based on sharia so disputes can be seen by judges in Sharia Courts. In addition, the Royal Decree stated that this Committee and its appeal committee shall be from those committees that are temporarily exempt from being seen by the judicial body until there is a specialised court.⁴⁵⁵

3.3.3.3.3 Committee to Consider Violations and Disputes on Credit Information Disputes Relevant to Credit Information

This committee is another example of a committee that has the authority to review violations of provisions of Credit Information Law and to decide on disputes and disagreements arising between consumers and members and companies.⁴⁵⁶ This committee was formed in 2008. However, its decisions can be appealed before the Board of Grievances which makes it not totally independent from the judicial power. (See *Table 1*) for some brief points from the Royal Decrees for the three committees.

⁴⁵³ The Law on Supervision of Finance Companies Royal Decree M/ 51 dates 2nd July 2012.

⁴⁵⁴ Ibid Art 3.

⁴⁵⁵ Ibid order 3.10.

⁴⁵⁶ Credit Information Law 2008, Art 14.

The committee	Banking Disputed Committee	Appeal Committee for Banking Disputes and Violations	Financing Disputes and Violations Settlement Committee	Appeal Committee for Financing Disputes and Violations Settlement	Committee to Consider Violations of Credit Information Law
Members of the committee	Three members	Three members	Three members, one of them hold a sharia degree	Three members, one of them holds a sharia degree	Three members, one of them should be a legal counsellor
Possibility of creating more than 1 circuits	As many circuits as needed	As many circuits as needed	As many circuits as needed	As many circuits as needed	As many circuits as needed
Jurisdiction	To settle original and affiliated banking disputes	Reconsider the decisions of the Committee for Banking Disputes	Cases resulting from applying the Finance Companies Control Law	Reconsider the decisions of primary committee	To review violations of the provision of Credit Information Law
Type of decision	Decisions are made by majority and considered final and non-appealable before any other authority after 30 days	Decisions considered final and non-appealable before any other authority	Decisions are made by majority and considered final and non-appealable before any other authority after 30 days	Decisions are made by majority and considered final and non-appealable before any other authority	Decisions are made by majority and may be appealed before the Board of Grievances within 60 days

Table 1: A comparative Summary between the Committees: Brief points from the Royal Decrees for the three committees made by the researcher.

3.3.3.3.4 Committee for the Resolution of Securities Disputes (CRSD)

This committee engages with part of Islamic finance as going to be illustrated soon and further discussed in chapter six.⁴⁵⁷ The committee was formed pursuant to Article (25) of the Capital Market Law.⁴⁵⁸ The CRSD have jurisdiction over the disputes falling under the provisions of the Capital Market Law and its implementing regulations, as well as the regulations of the Capital Market Authority (CMA) and the Exchange, in addition to their rules and instructions in terms of public and private rights.⁴⁵⁹ This includes cases of disputes that arise among traders of securities. Thus, *Sukuk* are included here as it is kind of securities.⁴⁶⁰

The members of CRSD are specialized in the doctrine of financial transactions and stock markets, as well as being experts in commercial and financial matters along with securities issues.⁴⁶¹ However, no sharia qualifications are needed and those members of the CRSD are not judges.

Thus, the independency that is guaranteed by the law for the judiciary authority and for the judges⁴⁶² might not be guaranteed for such committee.⁴⁶³ As CRSD and its Appeal Panel fall within the executive purview, the decisions of Appeal Panel of the CRSD are final and cannot be reviewable by ordinary courts or higher judicial authorities.⁴⁶⁴

It should be mentioned that, while proceedings should be in open court as Law of Procedure before Sharia Courts stated “proceedings shall be in open court unless the judge on his own or at the request of an litigant closes the hearing in order to maintain order, observe public morality, or for the privacy of the family”.⁴⁶⁵ The CRSD are not

⁴⁵⁷ Capital Market Law, Royal Decree No. (M/30) dated 31/7/2003. See 6.4 below.

⁴⁵⁸ See 3.4.3 below.

⁴⁵⁹ 'Committee for Resolution of Securities Disputes' (*Cma.org.sa*, 2016) < <https://goo.gl/wFbTk3> > accessed 19 February 2018.

⁴⁶⁰ *Ibid.*

⁴⁶¹ Capital Market Law dated 2003 Article 25 b.

⁴⁶² Basic Law of Governance 1992, Art 46. Also, See 3.3.3 above.

⁴⁶³ Tariq Sadiq, *الحماية القانونية لعمليات التداول في أسواق المال وفقاً للنظام السعودي (The Legal Protection of Transactions in the Financial Markets According to the Saudi System)* (Al Manhal 2015) 265.

⁴⁶⁴ Bushra Ali Gouda, 'The Saudi Securities Law: Regulation of The Tadawul Stock Market, Issuers, and Securities Professionals Under the Saudi Capital Market Law of 2003' (2012) 18 Annual Survey of International & Comparative Law 119.

⁴⁶⁵ Law of Procedure before Sharia Courts, Article 64 Dated 25 November 2013.

open for public or even independent researchers or inquiries regarding decisions issued by the committee.⁴⁶⁶ The CRSD has disposed of many cases, but no one outside the circle of litigants knows how things go inside the CRSD.⁴⁶⁷ As Bushra Ali Gouda stated that “few know the facts of the cases that come in the media in the form of news releases”.⁴⁶⁸ Such lack of disclosure from the CRSD raised concerns of such committee and its appeal panel, as it makes it difficult to know how the members of the committee think or how they interpret the law, how they reason their decisions or under what section of the law the CMA prosecutes violators of the CML.⁴⁶⁹

In addition, judgment of the committee might not be sharia compliant as no member of the committee is required to be a sharia expert as the committee looks at cases that may contain prohibited trades such as *Riba* in bonds and such trade would be approved from the committee.

As mentioned earlier⁴⁷⁰ the Basic Law of Governance in the country explicitly vested judicial authority in two branches: the Sharia Court and the Board of Grievances.⁴⁷¹ The Sharia Court used to be organized in a hierarchical system: the Supreme Judicial Council, the Court of Cassation, and the Court of First Instance.⁴⁷² This was more or less the situation until the beginning of 2017 when a new specialised court started to be established in fulfilment of the new judicial system which had been announced in 2007.⁴⁷³ From the researcher point of view after introducing the current development in the judicial power and underlining the new specialised courts that have just been established, such as the commercial courts. Also, highlighting that the existence of most of special Committees or Quasi-Judicial Committees was a temporary solution to keep up with the development of the country which might be difficult for courts to

⁴⁶⁶ Bushra Ali Gouda, 'The Saudi Securities Law: Regulation of The Tadawul Stock Market, Issuers, and Securities Professionals Under the Saudi Capital Market Law of 2003' (2012) 18 Annual Survey of International & Comparative Law 126.

⁴⁶⁷ Ibid.

⁴⁶⁸ Bushra Ali Gouda, 'The Saudi Securities Law: Regulation of The Tadawul Stock Market, Issuers, and Securities Professionals Under the Saudi Capital Market Law of 2003' (2012) 18 Annual Survey of International & Comparative Law 126.

⁴⁶⁹ Ibid.

⁴⁷⁰ See 3.3.3 below.

⁴⁷¹ Basic Law of Governance 1992.

⁴⁷² Ayoub M. Al-Jarbou, 'Judicial Independence: Case Study of Saudi Arabia' (2004) 19 Arab Law Quarterly 21.

⁴⁷³ The Law of the Judiciary 2007.

deal with. Thus, the new specialised courts can replace most of the special Committees to move their tasks to courts in order to guarantee independence which is assured for judges by law. In addition, disputes which do not comprise acts that conflict with the principle of Islam such as Islamic finance institutions disputes should be easy to be moved under the judicial power, especially the Financing Disputes and Violations Settlement Committee, as financing companies are required by law to have Sharia Committees helping the company not to engage with prohibited acts.

So, only committees that were created to solve disputes that conflict with sharia such as conventional banks should stay exempt from moving back to courts but Islamic banking should be moved to commercial court in a procedure that will be suggested later when other important parts of the thesis in covered.⁴⁷⁴

Following a general introduction of Saudi Arabian history and an outline of the legal structure of the country, this chapter moves on to focus on the financial activities in the country to concentrate on the main point of this research which is to identify the legal challenges that may face Islamic finance in the Kingdom and to try to suggest solutions. Therefore, the next section examines the financial situation in the country and the laws that control the finance sector.

3.4 Activities related to Finance in Saudi Arabia

Most of the Kingdom's economy used to rely on the annual influx of pilgrims to the Holy Cities of Mecca and Madinah.⁴⁷⁵ Jeddah, being the nearest port to Mecca, used to hold most of the commercial activities: for instance, currency exchange.⁴⁷⁶ In 1925, the first modern bank was introduced to Saudi Arabia, when a Dutch bank, known as *Aemene Bank Nederland*, opened an office in Jeddah to serve the needs of Muslim pilgrims from the Dutch East Indies (Indonesia).⁴⁷⁷ This bank was not active in taking deposits or grants and its main focus was on money-changing facilities. At that time, the Kingdom did not have conventional commercial banks except the small community of foreign residents in Jeddah who took the opportunity of the lack of banks. However most of the financial activities were with the trading concern Gellatly Hankey. This

⁴⁷⁴ See 7.2.

⁴⁷⁵ Rodney Wilson, *Banking and Finance in the Middle East* (Springer, 1984) 87.

⁴⁷⁶ Ibid.

⁴⁷⁷ Ibid.

company was mostly involved in shipping and it slowly built up its financial activities to provide more and more services to foreign residents in Jeddah,⁴⁷⁸ at the same time it was careful not to get involved in any trade which contained interest payments to, or receipts from, local citizens.⁴⁷⁹

Later, in 1938, the National Commercial Bank was established and within two years it became the sole commercial bank operating in the KSA and it also acted as bankers for the Kingdom's rulers until 1952 when the Saudi Arabian Monetary Agency (SAMA) was founded. In its early years the Agency was mainly concerned with managing the issue of currency notes.⁴⁸⁰

In 1950, the British Bank of the Middle East started to operate offices in Al Khobar, on the East Coast, and in Jeddah. Then, in 1957, Riyad Bank was the second local bank to be established. These two local banks accounted for almost all the bank branches in the Kingdom while foreign banks were only limited to the offices already opened in Al Khobar and Jeddah since they were not allowed to expand their network, until 1975 when they became "saudicized" ensuring that 60% of foreign owned shares were sold to local Saudi nationals.⁴⁸¹ By 1985, eleven commercial banks were operating and covering most of the Kingdom with about 570 branches.⁴⁸²

Since the establishment of SAMA it has licensed twelve Saudi banks and thirteen foreign banks that offer retail and corporate banking, investments services, brokerage facilities and derivative transactions.⁴⁸³

Four of these twelve Saudi banks are considered Islamic banks, that is, banks that offer all their finance services according to sharia principles.⁴⁸⁴ While the other are conventional banks providing full-service banking to individuals, and to private and public enterprises.⁴⁸⁵

⁴⁷⁸ Ibid.

⁴⁷⁹ Ibid.

⁴⁸⁰ Ahmed A. M. S Al-Suwaidi, *Finance of International Trade in The Gulf* (Graham & Trotman 1994) 14.

⁴⁸¹ John R Presley and Rodney Wilson, *Banking in the Arab Gulf* (MacMillan Academic and Professional 1991) 19.

⁴⁸² Ahmed A. M. S Al-Suwaidi, *Finance of International Trade in The Gulf* (Graham & Trotman 1994) 14.

⁴⁸³ 'Banking Control Licensed Banks' (*Sama.gov.sa*, 2016) <<http://www.sama.gov.sa/en-US/BankingControl/Pages/LicensedBanks.aspx>> accessed 29 November 2016.

⁴⁸⁴ Fayaz Ahmad Lone and Salim Alshehri, 'Growth and Potential of Islamic Banking in GCC: The Saudi Arabia Experience' (2015) 3 *Journal of Islamic Banking and Finance* 36.

⁴⁸⁵ Ibid.

Furthermore, the Saudi Stock Exchange (*Tadawul*) is also part of the Kingdom's financial system; it is well recognised as one of the largest capitalised stock exchange markets in the Arab world.⁴⁸⁶ The issuance of *Sukuk* (Islamic bonds) in the Kingdom is operated on the Saudi stock exchange, which is regulated and supervised by the Offer of Securities Regulations issued by the CMA.⁴⁸⁷

It is worth mentioning that the Islamic finance services sector in Saudi Arabia is one of the main players in the international sharia-compliant industry which showed its strength by continuing to grow even during the global economic crisis. According to Ernst & Young, the total Islamic financial assets in Saudi Arabia grew by 19% annually between 2007 and 2012.⁴⁸⁸

3.4.1 The Law of Banking Control

Almost all banking and financial activities including Islamic financial institutions or Islamic banks in Saudi Arabia are regulated by the Banking Control Law (BCL).⁴⁸⁹ The BCL regulates the banking and financial sector after a massive capital outflow in 1965, which caused many of the banks to go bankrupt and threatened the financial stability of the country.⁴⁹⁰

The BCL granted the SAMA the authority to license and regulate banks.⁴⁹¹ The BCL contains twenty-six Articles covering many prerogatives such as defining the banking business, determining capital adequacy and conferring licensing powers, opening letters of credit, opening current accounts, issuing letters of guarantee. However, although the Saudi legal system is based on Islamic law, no Article makes mention of Islamic banking or Islamic finance; in fact, there are no separate Islamic banking laws in the country.⁴⁹²

⁴⁸⁶ Michael Ovaska and Asa Fitch, 'Saudi Arabia in the Spotlight as Market Opens to Foreigners' *The Wall Street Journal* (2015) <<http://graphics.wsj.com/saudi-stock-market-to-open/>> accessed 29 November 2016

⁴⁸⁷ 'Capital Market Authority' (*Cma.org.sa*, 2016) <<https://cma.org.sa/Pages/default.aspx>> accessed 29 November 2016.

⁴⁸⁸ The Report Saudi Arabia 2014, *Oxford business Group*.

⁴⁸⁹ Royal Decree no. M/5 dated 11 June 1966.

⁴⁹⁰ Ahmed A. M. S Al-Suwaidi, *Finance of International Trade in The Gulf* (Graham & Trotman 1994)

⁴⁹¹ Saudi Arabia Banking control law 1965, Art 3.

⁴⁹² Zulkifli Hasan, 'Regulatory Framework of Sharia Governance System in Malaysia, GCC Countries and The UK' (2010) 3 *Kyoto Bulletin of Islamic Area Studies* <<https://ssrn.com/abstract=2196825>> accessed 30 July 2015.

3.4.2 SAMA

As mentioned earlier the Saudi economy has been boosted since the discovery of oil in 1938;⁴⁹³ for example the total income of the country was \$113 million in 1950 while payments received for the petroleum products totalled \$100 million in 1951.⁴⁹⁴ Even though, there was a huge increase in the income of the country the spending on the infrastructure was increasing faster than the income.⁴⁹⁵ The Minister of Finance at that time, Al-Suleyman, tried and failed to cut spending. This caused the postponing of some development projects, which indicated that some type of national body was needed to control the situation.⁴⁹⁶

Later in 1951 Arthur Young from the USA, an economist and financial expert from the USA, proposed a plan of setting up a central bank. The plan was to set up a national bank with capital from the government, the aims of this bank were for it (1) to be responsible for operating a stable monetary system, (2) to regulate the local banks, (3) to be responsible for receiving the income of the government and making payment to it which means being a government's bank, and (4) to advise the government on financial problems.⁴⁹⁷

The plan was presented to the King but his advisers told him that setting up a bank would lead to engagement with *Riba* which is against the principles of Islam. After a few months Al-Suleyman contacted Young again and he suggested that if the plan ensured that no *Riba* would be practised inside the country, he would be able to meet the objections of the king's advisers, as they were only concerned about what was happening inside Saudi Arabia.⁴⁹⁸

In April 1952 SAMA was established to be the Saudi Arabia Central Bank.⁴⁹⁹ a board of directors were chosen by the King to govern SAMA, this board consists of a Governor, a Vice-Governor and three members.⁵⁰⁰ SAMA developed its supervisory

⁴⁹³ See 3.4 above.

⁴⁹⁴ Ahmed Banafe and Rory Macleod, *The Saudi Arabian Monetary Agency, 1952-2016* (Springer International Publishing 2017) 24.

⁴⁹⁵ *Ibid.*

⁴⁹⁶ *Ibid.*

⁴⁹⁷ *Ibid.*

⁴⁹⁸ *Ibid.*

⁴⁹⁹ Royal Decree no. 30/4/1/1046 dated 19 April 1952.

⁵⁰⁰ Charter of the Saudi Arabian Monetary Agency, Royal Decree No. 23 dated 19 April 1952.

system in 1980 to become more suitable in terms of corporate governance and infrastructure.⁵⁰¹

SAMA was introduced to perform many duties pursuant to a number of laws and regulations. Some of its duties and responsibilities include dealing with the banking affairs of the government, maintaining and printing the national currency (the SAR) in addition to strengthening and stabilising its internal and external value and strengthening the cover of the currency.⁵⁰²

Other tasks include managing the foreign exchange reserves of the Kingdom and supporting the growth of the financial system and safeguarding its soundness. In addition, a point of particular interest for this thesis pertains to Article 1 Section C of the SAMA Charter which regulates commercial banks and exchange dealers, and supervises financial companies, cooperative insurance companies and the self-employment profession relating to cooperative insurance activity.⁵⁰³

Moreover, it is worth pointing out that the Islamic finance industry came into being as a formal institution in the Kingdom after the approval of the SAMA Charter which, to this date, has not been modified. This explains why there is no mention of Islamic banking or Islamic finance in the Charter of SAMA. However, upon its approval, it was assumed that the SAMA Charter was deemed sharia-compliant, as stated, for instance, in Article 6 (a) and (d) it says:

"The Agency shall not undertake any of the following functions: (a) acting in any manner which conflicts with the teachings of the Islamic Law; the Agency shall not charge any interest on its receipts and payments; (b) engaging in trade or having an interest in any commercial, industrial, or agricultural enterprise".⁵⁰⁴

In addition to the above Article, Article 2 states that "the Saudi Arabian Monetary Agency shall not pay nor receive interest."⁵⁰⁵

⁵⁰¹ Tahreem Noor Khan, 'A Study of Customers' Perception and Attitude to Islamic Banking: Products, Services, Staff, Sharia Board and Marketing in Five Countries: Pakistan, Malaysia, Saudi Arabia, UAE and UK' (PhD, University of Aberdeen 2011).

⁵⁰² 'SAMA Functions' (*Sama.gov.sa*, 2017) <<http://www.sama.gov.sa/en-us/about/pages/samafunction.aspx>> accessed 30 November 2015.

⁵⁰³ Charter of the Saudi Arabian Monetary Agency 1952.

⁵⁰⁴ *Ibid* Art. 6.

⁵⁰⁵ Charter of the Saudi Arabian Monetary Agency 1952.

However, in reality, it seems that certain issues of sharia-compliance have not been truly addressed by SAMA,⁵⁰⁶ or at least, not implemented in practice as it should have been, as mentioned in its Charter. For example, Article 6 above prevents acting in any manner which conflicts with the teachings of the Islamic law, while it supervises and approves transactions of conventional banks that are based on interest. Participant A of the interview said that SAMA contradicts itself as it prohibits itself from engaging with activities that do not comply with Islamic principles, while it allows banks to conduct their business on the basis of interest. It is also uses the repo rate and the reverse repo rate to influence the daily liquidity in the financial system and the overnight interest rate in a conventional way with all banks including Islamic banks. In addition, he said SAMA as a central bank put some obstacles in the path of Islamic banks such as their being prevented from trading or being in ownership of real estate which minimizes the option for Islamic banks to follow the conventional banks to focus more on debt contracts.⁵⁰⁷

Also, Participant C highlighted that SAMA is doing a great work with regards to supervising banks and keeping them safe from large economic shocks. However, there is a noticeable need for Islamic banks as an example to have special regulations to operate better.⁵⁰⁸ This will be discussed in detail in the next chapter.

3.4.3 Capital Market Law and Capital Market Authority

In 2003, while the international stock markets were doing well, The Saudi capital markets faced difficulties in attracting more funds and regulating capital markets including *Sukuk* as Saudi stock market was operating under three masters Ministry of Commerce, Ministry of Finance and SAMA.⁵⁰⁹ Thus, a Royal Decree Number M/3 was issued promulgating the constitutive law of the securities industry,⁵¹⁰ which helps to develop the securities laws and regulations in the Kingdom.⁵¹¹ The Capital Market Law

⁵⁰⁶ Rodney Wilson, 'The Development of Islamic Finance in the Gulf Cooperation Council States', *The Transformation of the Gulf: politics, economics and the global order* (1st edn, Routledge 2012).

⁵⁰⁷ Interview with participant A on 16 March 2015, Riyadh Saudi Arabia.

⁵⁰⁸ Interview with C on 3 March 2015, Manama Bahrain

⁵⁰⁹ Mohammed Ramady, *The Saudi Arabian Economy: Policies, Achievements, and Challenges* (Springer 2010) 148.

⁵¹⁰ Capital Market Law, Royal Decree No. (M/30) dated 31/7/2003.

⁵¹¹ Bushra Ali Gouda, 'The Saudi Securities Law: Regulation of The Tadawul Stock Market, Issuers, and Securities Professionals Under the Saudi Capital Market Law of 2003' (2012) 18 Annual Survey of International & Comparative Law 117.

(CML) stated the establishment of Capital Market Authority (CMA).⁵¹² Illustrating the duties and authorities of the CMA are as follows:

- Regulating and developing the capital market and promoting appropriate standards and techniques for all sections and entities involved in Securities Trade Operations.
- Enhancing investors' and the public's protection from unfair and unsound practices involving fraud, deceit, cheating, manipulation, and inside information trading.
- Maintaining fairness, transparency and efficiency in the transactions of securities.
- Developing suitable measures that can limit the risks associated with the transactions of securities.
- Improving, regulating and supervising the issuance of securities including the issuance of sukuk and under-trading transactions.
- Regulating and monitoring the activities of entities working under the CMA.
- Regulating market operations and public offerings.⁵¹³

However, as going to be revealed in Chapter Six,⁵¹⁴ that the CML never mentioned sharia-compliant bonds or Islamic bond or *Sukuk* in its laws. Thus, CMA regulate it as debt securities to be the same of bonds,⁵¹⁵ even though there are some differences that should be concede when looking at *sukuk* as going to be discussed in other chapters.⁵¹⁶

3.5 Islamic Banks in Saudi Arabia

The relationship between Islam and Saudi Arabia holds a special significance in the KSA, unlike in any other country in the world, as it is the heartland of Islam, its historical birthplace, home of the Two Holy Mosques and the focus of Islamic devotion and prayer.⁵¹⁷ Since the establishment of Islam and the early days of Islamic history, Muslims were able to create an interest-free system to mobilise resources for consumers' needs and to finance productive activities, which worked successfully for

⁵¹² The Capital Market Law 2003, Art 4.

⁵¹³ The Capital Market Law 2003, Art 5 A.

⁵¹⁴ See 6.4 below.

⁵¹⁵ Abdullah Al Elsheikh and Joseph Tanega, 'Sukuk Structure and its Regulatory Environment in the Kingdom of Saudi Arabia' (2011) 5 Law and Financial Markets Review 190.

⁵¹⁶ See 5.4.1 and 6.4 below.

⁵¹⁷ Rodney Wilson, 'The Development of Islamic Finance in the Gulf Cooperation Council States', *The Transformation of the Gulf: politics, economics and the global order* (1st edn, Routledge 2012).

many centuries.⁵¹⁸ For example, instead of interest-based borrowing and lending, partnership and profit- and loss sharing structures constituted the basis of commerce and industry during the twelfth and the thirteenth centuries in the Mediterranean region.⁵¹⁹

Yet, as the centre of economic gravity moved with time towards the West, especially after the direct or indirect colonisation of most of the Muslim counties, this had an impact on local laws particularly with regards to the commercial and civil spheres, Western financial institutions, including banks, took the lead and developed gradually while the Islamic financial system almost froze.⁵²⁰

When Saudi Arabia was founded, there was no clear vision to have an Islamic banking system and the only available option to engage with the world and meet the demands of the country's growth was through a conventional system. That is why the Kingdom opted for a conventional banking system, starting with the Dutch Commercial Company in 1925.⁵²¹

As a result, the Saudi banking sector grew significantly, as explained earlier.⁵²² In 1976, the First World Conference on Islamic Economics took place in Mecca and this opened the door for debates and discussions regarding the introduction of an Islamic economics discipline.⁵²³ The conference resulted in the approval of a draft agreement supporting the establishment of the Islamic Development Bank.⁵²⁴ The aim of this Islamic bank is to foster economic development and social progress, individually and collectively, among country members and Muslim communities in accordance with the principles of sharia law.⁵²⁵ The KSA is considered to be the bank's most important funding contributor with a capital of nearly 25% of the total subscribed capital and is also home to its headquarters in Jeddah.⁵²⁶

⁵¹⁸ Munwar Iqbal and Philip Molyneux, *Thirty Years of Islamic Banking: History, Performance and Prospects* (Palgrave Macmillan UK 2005).

⁵¹⁹ Ibid.

⁵²⁰ Frank E Vogel, *Islamic Law and Legal System: Studies of Saudi Arabia* (Brill 2000) 18.

⁵²¹ Ahmed A. M. S Al-Suwaidi, *Finance of International Trade in The Gulf* (Graham & Trotman 1994) 14.

⁵²² See 2.4 above.

⁵²³ Tahreem Noor Khan, 'A Study of Customers' Perception and Attitude to Islamic Banking: Products, Services, Staff, Sharia Board and Marketing in Five Countries: Pakistan, Malaysia, Saudi Arabia, UAE and UK' (PhD, University of Aberdeen 2011).

⁵²⁴ Ibid.

⁵²⁵ Ibid.

⁵²⁶ S. A Meenai, *The Islamic Development Bank: A Case Study of Islamic Co-Operation* (Routledge 2009).

Furthermore, a number of Islamic banks are partly owned by Saudi nationals outside Saudi Arabia, such as, the Faisal Islamic Bank, established in Egypt and Sudan in 1977, with an ownership of 49% of Faisal Islamic Bank in Egypt and 40% of Faisal Islamic Bank in Sudan owned by Saudis.⁵²⁷ Another example was the Bahrain Islamic Bank, established in 1979, with about 35% of its capital subscribed by Saudi citizens.⁵²⁸

The KSA banking sector is one of the world's most stable and fastest growing banking markets. Indeed, within the last decade, the Saudi banking industry has witnessed a noticeable progression in terms of organisational structure, outreach and utilisation of technology and financial health and size.⁵²⁹ The Saudi banking industry performed well and recorded a good growth in assets and deposits. Even in the midst of the world financial crisis and the subsequent global adverse economic conditions, it is worth emphasising that the industry grew remarkably and expanded its lending activities.⁵³⁰

At present, there are thirteen foreign banks and twelve domestic banks in the Kingdom.⁵³¹ In 2004, a number of amendments were made to the regulation of the SAMA to enable foreign banks to operate in the Kingdom. Among the twelve domestic banks, eight are entirely Saudi-owned, whereas four are joint-ventures with foreign international banks. With regards to the domestic commercial banks, four are full-fledged Islamic banks⁵³² and the rest are counted as conventional banks while also serving an Islamic banking clientele by establishing their own Islamic window or subsidiary.⁵³³

⁵²⁷ Ahmed A. Al-Suwaidi, *Finance of International Trade in The Gulf* (Graham & Trotman 1994) 18.

⁵²⁸ Ibid.

⁵²⁹ Bukhari M. S. Sillah, Imran Khokhar and Muhammad Nauman Khan, 'The Performance of Saudi Banking Industry 2000 -2011: Have the Banks Distinguished Themselves from one Another?' (2014) 5 *International Journal of Financial Research* 122.

⁵³⁰ Ibid.

⁵³¹ The foreign banks that operate in the Kingdom of Saudi Arabia are: Gulf International Bank (GIB), Emirates NBD, National Bank of Bahrain (NBB), National Bank of Kuwait (NBK), Muscat Bank, Deutsche Bank, BNB Paribas, J.P. Morgan Chase N. A, National Bank of Pakistan (NBP), State Bank of India (SBI), T.C. ZIRAAT BANKASI A.S., Industrial and Commercial Bank of China (ICBC), the QNB and Bank of Tokyo – Mitsubishi UFJ (Licensed - has not started yet). See official website of Saudi Arabia Monetary Authority please see 'Banking Control Foreign Banks' (Sama.gov.sa, 2017) <<http://www.sama.gov.sa/en-US/BankingControl/Pages/ForeignBanks.aspx>> accessed 18 December 2017.

⁵³² Bukhari M. S. Sillah, Imran Khokhar and Muhammad Nauman Khan, 'The Performance of Saudi Banking Industry 2000 -2011: Have the Banks Distinguished Themselves from one Another?' (2014) 5 *International Journal of Financial Research* 122.

⁵³³ M. Mansoor Khan and M. Ishaq Bhatti, 'Islamic Banking and Finance: on its Way to Globalization' (2008) 34 *Managerial Finance*.

There is a new movement from SAMA towards Islamic banks even it is not much yet but it shows that there is some interest. Participant B said SAMA has not interested in Islamic finance but the current situation force SAMA to deal with Islamic banks. Thus, SAMA established an Islamic Banking Committee, its members are representative from every bank, and a representative from SAMA should attend the meeting. The meetings organized and paid for by the banks.⁵³⁴ Participant B said SAMA does not approve any result or recommendations of the meetings. Even though he said SAMA take other committees more serious such as Finance committee, Treasury committee and transaction operation committee as he said that he is close to some of those committees. The meetings only to help banks to sit together and discuss some challenges facing them and try to come up with solutions. However, the committee has no ability to commit to anything; it is only discussing common issues and trying to unite effort.⁵³⁵ In some cases when a problem between two or three banks caused by different point of view, this meeting would be good to make them set to together to discuss the problem. He said that one of the achievements of this committee is publishing a brochure on the legal quality and regulatory guide in Islamic banks. Because in Saudi Arabia there are no standards have been set by central bank or any governmental authority, banks have different standards for their sharia boards, some of them work hard to develop their product. While others unfortunately do not achieve the minimum requirement for a proper sharia board.⁵³⁶ Thus, the purpose of this brochure is to indicate the level required to be achieved by sharia boards and there is no obligation to follow this guide. It is only to measure the extent of seriousness or negligence of the board.⁵³⁷

3.5.1 Full-Fledged Islamic Banks

Islamic banks are those banks which are supposed to offer instruments and products consistent with the religious beliefs via the sharia board that is part of the bank.⁵³⁸

⁵³⁴ Interview with participant B on 9 March 2015, Riyadh Saudi Arabia.

⁵³⁵ Ibid.

⁵³⁶ See 4.8 below.

⁵³⁷ Interview with participant B on 9 March 2015, Riyadh Saudi Arabia.

⁵³⁸ Interview with participant B on 9 March 2015, Riyadh Saudi Arabia.

3.5.1.1 Al-Rajhi Bank

The year following the emergence of the Islamic Development Bank, a new Islamic bank appeared in the arena: Al-Rajhi Bank. It was founded in 1978 and became the first bank to apply and specialise in Islamic banking in the KSA. At the beginning Al-Rajhi provided Islamic financial services like currency exchange, and then in 1987, it became Al-Rajhi Banking & Investment Corporation which was formed as a joint-stock holding company. At first, SAMA refused to grant Al-Rajhi Bank a licence to operate while licences had already been given to other conventional banks that were basically dealing with interest although the SAMA should only have accepted banks which worked according to the teaching of Islamic Law. For example, Article 2 stated that SAMA shall not pay nor receive interest and Article 6 (a) and (d) that was introduced earlier also has this restriction.⁵³⁹

Despite this, Al-Rajhi Bank was only dealing with Islamic transactions and this is still the case today. In other words, giving the licence to Al-Rajhi Bank would imply that the other financial institutions were non-Islamic. However, in 1987 after much lobbying and because Al-Rajhi Bank already had significant deposits, it was felt necessary and preferable to have it regulated by SAMA⁵⁴⁰ and the bank received its licence on the condition not to use the term Islamic in its title.⁵⁴¹

In 2002, Al-Rajhi Banking and Investment Corporation became the largest Islamic bank in the world with \$15.8 billion in assets⁵⁴² and by the end of 2013; its total assets were \$74.6 billion.⁵⁴³ It is now the largest provider of Islamic banking products in the Arab world and has the largest retail banking franchise in Saudi Arabia with a market share of 39% in domestic consumer financing.⁵⁴⁴

⁵³⁹ Charter of the Saudi Arabian Monetary Agency, Royal Decree No. 23 dated 19 April 1952.

⁵⁴⁰ Rodney Wilson, 'The Development of Islamic Finance in the Gulf Cooperation Council States', *The Transformation of the Gulf: politics, economics and the global order* (1st edn, Routledge 2012).

⁵⁴¹ Barbara A Roberson, *Shaping the Current Islamic Reformation* (Routledge, Taylor et Francis Group 2003)

⁵⁴² Munwar Iqbal and Philip Molyneux, *Thirty Years of Islamic Banking: History, Performance and Prospects* (Palgrave Macmillan UK 2005).

⁵⁴³ Oxford Business Group, 'The Report Saudi Arabia 2014' (Oxford Business Group 2014)

<<http://www.oxfordbusinessgroup.com/saudi-arabia-2014>> accessed 3 December 2015.

⁵⁴⁴ Ibid.

3.5.1.2 Albilad Bank

Albilad Bank is a Saudi joint-stock company established in 2004. Its mission is to strive, through initiatives and innovation, to provide banking services on a genuine Islamic basis and meet the ambitions of all stakeholders including clients, employees and shareholders.⁵⁴⁵ The bank is developing gradually; for example, its total assets increased by 22% from December 2012 to the end of 2013 to reach \$ 9.685 billion; its assets then reached \$12.05 billion in 2014 and \$13.104 billion in June 2015.⁵⁴⁶

3.5.1.3 Al-Jazira Bank

Al-Jazira Bank is a joint-stock company incorporated in the KSA and formed by Royal Decree no. 46/M, dated 21 June 1975. The bank was operating as a conventional bank until 1998 when its board of directors took the strategic decision to convert from conventional to sharia-compliant banking. To ensure compliance with sharia principles, the bank established a sharia department within its organisational structure and formed a Sharia Advisory Board which count a number of scholars specialised in Islamic banking to screen, monitor and endorse the bank's operations and extend the sharia principles throughout its working environment. By 2002, the bank succeeded in changing all its branches to operate as per sharia rules and principles and since its conversion, the bank started to post the highest growth in earnings, registering a 140% compound annual growth rate from 2002–2006.⁵⁴⁷ Then in 2007, the bank was fully converted to a sharia-compliant institution and simultaneously increased its paid-up capital to reach \$ 0.8 billion which were entirely derived from the bank's profits.⁵⁴⁸ The total assets of the bank by the end of 2013 were about \$ 16 billion.⁵⁴⁹

3.5.1.4 Alinma Bank

Alinma Bank was licensed in 2006 to operate in the Saudi financial services sector. It is trying to show its competitive advantages in the following areas. The Bank seeks to become an integrated financial institution that is in complete accordance with sharia-

⁵⁴⁵ 'Albilad|Bank Albilad - About the Bank' (*Bankalbilad.com*, 2015)

<<http://www.bankalbilad.com/sites/en/Albilad1/Pages/About.aspx>> accessed 3 March 2016.

⁵⁴⁶ Bank Albilad, 'Unaudited Interim Consolidated Financial Statements for the Six-Months Period Ended June 30, 2015' (Bank Albilad 2015).

⁵⁴⁷ Oxford Business Group, 'the Report: Emerging Saudi Arabia 2007' (Oxford Business Group 2007).

⁵⁴⁸ 'Bank Aljazira | About-Us' (*Baj.com.sa*, 2015) <<http://www.baj.com.sa/about-us.aspx?page=corporate-profile&id=139&AspxAutoDetectCookieSupport=1>> accessed 3 December 2015.

⁵⁴⁹ Oxford Business Group, 'The Report Saudi Arabia 2014' (Oxford Business Group 2014).

compliant banking standards in all services and transactions.⁵⁵⁰ Its total assets were \$ 16.8 billion by the end of year 2013⁵⁵¹ while in 2012, they reached \$ 14.4 billion and \$ 9.786 billion in 2011, which shows a gradual increase every year.⁵⁵²

3.5.2 Banks in the Process of Being Converted to Islamic Bank

3.5.2.1 The National Commercial Bank

The bank was established in 1953 by Royal Decree as a general partnership, resulting from the merger of Saudi Arabia's largest currency houses: Saleh and Abdul Aziz Kaki and the Salem bin Mahfouz Company. The two businesses joined to form the first officially-recognised Saudi bank⁵⁵³ and is now the largest bank by assets in the Arab world.⁵⁵⁴ In 1990, the bank decided to convert into a fully dedicated Islamic bank.⁵⁵⁵ All of its branches are now offering Islamic services and it has already banned interest payments and pure monetary speculation in its operations. However, some of its businesses are still based on conventional banking rules. The bank announced in 2014 that it would transform into a full-fledged Islamic bank within about five years.⁵⁵⁶ In 2013, their total assets exceeded \$ 100.53 billion,⁵⁵⁷ while it reached \$ 119.946 billion in 2017.⁵⁵⁸

All other banks in the Kingdom are considered as conventional banks but also serve their Islamic banking clientele by establishing their own Islamic window or subsidiary

⁵⁵⁰ 'About- Alinma Bank' (*Alinma.com*, 2015) <<http://bit.ly/2iJTURB>> accessed 3 December 2015.

⁵⁵¹ Oxford Business Group, 'The Report Saudi Arabia 2014' (Oxford Business Group 2014).

⁵⁵² Alinma Bank, 'Consolidated Financial Statements (Audited) for the Year Ended December 31, 2012' (*Alinma Bank* 2013) <[Http://Bit.Ly/2zjgaq6](http://bit.ly/2zjgaq6)> Accessed 3 December 2015.

⁵⁵³ 'Our History' (*Alahli.com*, 2015) <<https://www.alahli.com/en-us/about-us/corporate-profile/Pages/AIAhli-History.aspx>> accessed 3 December 2015.

⁵⁵⁴ Fayaz Ahmad Lone and Salim Alshehri, 'Growth and Potential of Islamic Banking in GCC: The Saudi Arabia Experience' (2015) 3 *Journal of Islamic Banking and Finance* <http://jibfnet.com/journals/jibf/Vol_3_No_1_June_2015/4.pdf> accessed 2 May 2017.

⁵⁵⁵ M. Mansoor Khan and M. Ishaq Bhatti, 'Development in Islamic Banking: A Financial Risk-Allocation Approach' (2008) 9 *The Journal of Risk Finance*.

⁵⁵⁶ Marwa Rashad, 'Saudi Bank's \$6 Billion IPO Ignites Religious Controversy' (*UK.reuters*, 2014) <<http://uk.reuters.com/article/us-national-comm-l-bk-ipo-islam/saudi-banks-6-billion-ipo-ignites-religious-controversy-idUSKCN0I31QG20141014>> accessed 6 June 2017.

⁵⁵⁷ Fayaz Ahmad Lone and Salim Alshehri, 'Growth and Potential of Islamic Banking in GCC: The Saudi Arabia Experience' (2015) 3 *Journal of Islamic Banking and Finance*.

⁵⁵⁸ NCB Group Investor Relations, 'NCB Reports 1H 2017 Net Income of SAR 5.2 Billion' (NCB 2017) <https://www.alahli.com/en-us/Investor_Relation/Documents/NCB%20Q%202017%20Earnings%20Release.pdf> accessed 10 December 2017.

and most of them have their own Sharia Committee to develop and supervise the Islamic contracts which are made available to their clients.

3.5.3 Conventional Banks

3.5.3.1 The Saudi Hollandi Bank

The Saudi Hollandi Bank, founded in 1926 and first known as the Netherlands Trading Society, was the first bank to operate in the Kingdom and acted as the *de facto* central bank, holding the Kingdom's gold reserves and receiving oil revenues on behalf of the Saudi government. The bank started its Islamic banking and finance department in 1995 offering Shariah-compliant products to both individuals and corporations.⁵⁵⁹

3.5.3.2 Riyad Bank

Riyad Bank was established in 1957 and started to provide Islamic finance options in 2000, and in 2003 it opened its first Islamic branch. With respect to its total assets, the bank was \$ 57675.2 million in 2017,⁵⁶⁰ while it was \$ 58031 million for the period 2016 ended September.⁵⁶¹ However, regarding the Islamic development of the bank, it can be said that there is a continued increase in terms of, for instance, loans and advances. The bank's net Islamic products amounted to \$ 18188 million in 2014,⁵⁶² while they were \$ 17043.4 million in 2013 and \$ 15151.4 million in 2012.⁵⁶³ The bank's Islamic banking department is making efforts to educate its employees in matters of Islamic financing contracts. For example, it provided special training workshops to 350 bank employees to explain and introduce Islamic banking products, as well as how to best

⁵⁵⁹ 'Personal Banking' (Alawwalbank.com, 2015) <<https://www.alawwalbank.com/en/personal>> accessed 3 December 2015.

⁵⁶⁰ 'Who We Are - Leading Saudi Bank | Riyad Bank' (*Riyad Bank*, 2017) <<https://www.riyadbank.com/en/about-us/who-we-are>> accessed 10 December 2017

⁵⁶¹ 'Islamic Business Finance | Riyad Bank' (*Riyad Bank*, 2015) <<https://www.riyadbank.com/en/business-banking/finance/islamic-finance#success>> accessed 9 November 2015.

⁵⁶² Riyad Bank, 'Annual Report 2014' (*Riyad Bank* 2015) <https://www.riyadbank.com/en/Images/1Annual%20Report%202014-En_tcm8-6367.pdf> accessed 29 January 2015.

⁵⁶³ Riyad Bank, 'Annual Report 2013' (*Riyad Bank* 2014) <https://www.riyadbank.com/en/Images/Annual%20Report%202013%20En_tcm8-3299.pdf> accessed 5 February 2017.

present those products to customers and answer their questions accurately.⁵⁶⁴ The following sections present the conventional banks.

3.5.3.3 Samba Bank

The Samba bank was first established in 1955 under Citibank; then in 1980, following a Royal Decree, the bank became the Saudi American Bank. In 1996, an Islamic banking division was created as an independent entity with a separate account and the bank now has its own Sharia Committee which counts five sharia scholars.⁵⁶⁵ In 2004, Citibank sold their last remaining shareholding to local investors.⁵⁶⁶ In March 2014, the total assets of the bank were \$ 55671030.66 then it increased to reach \$59355127.2 in March 2015,⁵⁶⁷ while it reached \$ 61849424.26 in March 2017.⁵⁶⁸

3.5.3.4 The Saudi Arabia British Bank (SAAB)

The SAAB, an associate company of the HSBC group, was established in 1978 and started to offer sharia-compliant products in 2000 through its separate Amanah Islamic banking services division.⁵⁶⁹ The bank recorded a net profit of \$ 297.3 million for the quarter ending March, 2015, which represents an increase of about \$ 9 million or 3.2%, compared to \$ 288.2 million for the same period in 2014.⁵⁷⁰ While the Total assets reach SAR 179.5 billion at 30 September 2017.⁵⁷¹

⁵⁶⁴ Ibid.

⁵⁶⁵ 'Samba | Personal and Business Banking' (*Dxb.samba.com*, 2016)

<<https://dxb.samba.com/en/personal-banking/>> accessed 18 December 2016.

⁵⁶⁶ Ibid also see Jeffreys, A. (2011) *The Report: Saudi Arabia*. 2010, Oxford Business Group.

⁵⁶⁷ Official website of SAMBA Bank, SAMBA financial Group Financial Statements and Auditors' Review Report March 2015, [Online]available at https://www.samba.com/en/pdf/financial-reports/Financial_Statement_Q1_2015_En.pdf Accessed 25 September 2016.

⁵⁶⁸ Samba Financial Group, 'Interim Condensed Consolidated Financial Statements for the Three Month Period Ended March 31, 2017' (*SAMBA* 2017) <https://www.samba.com/en/pdf/financial-reports/Financial_Statement_Q1_2017_En.pdf> accessed 10 December 2017.

⁵⁶⁹ About SABB and Shariah Committee, 'Shariah Committee' (*Sabb.com*, 2017)

<<http://www.sabb.com/en/about-sabb/about/shariah-committee/>> accessed 10 December 2017.

⁵⁷⁰ 'News Room' (*Sabb.com*, 2017) <<https://www.sabb.com/en/about-sabb/news-room/>> accessed 18 December 2017.

⁵⁷¹ 'SABB Reports Profit of SAR 3,248 Million for the Nine Month Period Ended September 2017' (*Sabb.com*, 2017) <<https://www.sabb.com/en/about-sabb/news-room/news-year-2017/SABB-reports-profit-of-SAR-3-248-million-for-the-nine-month-period-ended-September-30-2017/>> accessed 10 December 2017.

3.5.3.5 Banque Saudi Fransi

The Banque Saudi Fransi is a Saudi Arabian joint-stock company established by Royal Decree No. M/23 dated 4 June 1977. The bank has made huge progress regarding the development of its products and services including enhancements of its branches to meet the terms and provisions of sharia as well as to deliver alternative products to companies and individuals including investment and global market services.⁵⁷² The bank offers Islamic personal financing as well as sharia-compliant investment instruments⁵⁷³ and total assets \$ 54495482.4 in 2017.⁵⁷⁴

3.5.3.6 The Arab National Bank

The bank was established in 1979 by Royal Decree no. M/38 and has made tremendous efforts to comply with Islamic finance. It created an Islamic banking division and one of the most important duties of this division is to develop products and services that are sharia-compliant that provide sharia-based financial solutions to cater for the needs and expectations of all its customers. The Islamic banking division supports branch conversions from conventional to dedicated Islamic branches.⁵⁷⁵

3.5.3.7 The Saudi Investment Bank

This bank was established by Royal Decree no. M/31 in 1976; it offers sharia-compliant products and a branch network that is largely designated as Islamic. The bank offers traditional wholesale, retail and commercial banking products. For example, they provide financing of private industrial sectors and trade finance products to facilitate imports and increase the country's exports. As far as the retail side is concerned, they offer a variety of sharia-compliant products and services and also

⁵⁷² Bank Alfransi, 'Profile - Banque Saudi Fransi' (*Alfransi.com.sa*, 2015) <<http://www.alfransi.com.sa/en/article/about-us/profile.html>> accessed 4 December 2016.

⁵⁷³ Ibid.

⁵⁷⁴ Banque Saudi Fransi, 'Interim Condensed Consolidated Statement of Financial Position 2017' (*BANQUE SAUDI FRANSI* 2017) <http://www.alfransi.com.sa/en/media/get/20170523_bsf-financial-q1-2017-english-signed-1.pdf> accessed 10 December 2017.

⁵⁷⁵ Arab National Bank, 'Finance Program' (*Anb.com.sa*, 2015) <<https://www.anb.com.sa/Default.aspx?tabid=124&language=en-US>> accessed 7 October 2016.

provide a comprehensive series of treasury and institutional banking products and services.⁵⁷⁶

A study, generated by Al-Jazira Capital during the period 2007-2012 for the compound annual growth rate (CAGR), showed that lending by sharia-compliant institutions were 16.3% of the total lending in the kingdom while it was 9.8% for conventional banks.⁵⁷⁷ The study also revealed that the sharia-compliant sector is doing better in comparison to the non-Islamic lenders. For instance, in 2012 the aggregate net interest margin of Islamic banks reached 4.1% while it was only 2.9% for the conventional lenders.⁵⁷⁸

After briefly highlighting the different banks in Saudi Arabia in terms of their being Islamic banks or conventional banks, it should be mentioned that the popularity of Islamic finance among Saudi Arabians persuaded all banks including the conventional ones, offer financial products that are marketed as sharia-compliant. This will be referred to in the later chapters when discussing the legal requirements needed to ensure that any financial products that are marketed or sold as sharia-compliant products to end users, that is to the clients of financial institutions, really are sharia-compliant.

3.6 Saudi Vision 2030

At the time of writing this thesis, Saudi Arabia in all its sectors, ministries and individuals are eager to be equipped to meet the 2030 Vision that was announced on 25th April 2016 and every person tries to understand and cooperate with this Vision. The Vision is mainly about reducing the dependence on oil and government funding. Also, the Vision intends to provide additional support to the private sector to participate in the development of the country.⁵⁷⁹ Despite the fact that statements regarding diversifying the sources of income have repeatedly been made in the past, every time the price of oil dropped down, this time the Cabinet under the chairmanship of the King have approved this Vision.⁵⁸⁰

⁵⁷⁶ The Saudi Investment Bank, 'SAIB Overview' (*Saib.com.sa*, 2015)

<https://www.saib.com.sa/en/content/saib-overview#mmenu_left> accessed 10 December 2016.

⁵⁷⁷ Oxford Business Group, 'The Report Saudi Arabia 2014' (Oxford Business Group 2014).

⁵⁷⁸ *Ibid.*

⁵⁷⁹ The Vision 2030 of the Kingdom of Saudi Arabia, 'Cabinet Approves Kingdom of Saudi Arabia's Vision 2030' (2016) <<http://vision2030.gov.sa/en/node/161#>> accessed 4 June 2017.

⁵⁸⁰ *Ibid.*

The Vision could be a tool to help solving the obstacles that Saudi Arabia is encountering. It intends to develop the law to give more opportunity for the private sector to play a vital role in the Saudi economy: for instance, it is stated in the Vision that “over the past year, we reviewed many current laws and enacted new laws that have been years overdue. These include the company law, the non-governmental organizations’ law.”⁵⁸¹ Also, it states:

“We believe strongly in the important role of the private sector, it currently contributes less than 40 percent of the GDP (Gross Domestic Product). To increase its long-term contribution to our economy, we will open up new investment opportunities, facilitate investment, encourage innovation and competition and remove all obstacles preventing the private sector from playing a larger role in development. We will continue to improve and reform our regulations, paving the way for investors and the private sector to acquire and deliver services”⁵⁸²

The researcher is optimistic that this Vision might enhance the Islamic financial sector and provide it with the better regulations in order to make it more powerful; as the Vision stated the first of the three themes that the Vision is built on: a strong foundation for economic prosperity for members of this society who live in accordance with the Islamic principle of moderation.⁵⁸³ Also the Vision started with the indication that one of the powerful points of the country is its location as it is in the heart of the Arab and Islamic world,⁵⁸⁴ and this again will enhance the position of Islamic finance in the country. In addition, the Vision stated that it is planning to reach the highest level of transparency and governance in all sectors,⁵⁸⁵ and this is what Islamic finance in Saudi Arabia is in need of as will be discussed in the next chapter.

There are some positive signs showing that this Vision can contribute to the development of Islamic finance. This can be seen from a number of actions that have recently happened and others that are still in the process of happening and will be announced soon. For example, in October 2016, the CMA became a member of the

⁵⁸¹ Saudi Vision 2030, 'Saudi Vision 2030 the Council of Economic Affairs and Development Issued the Decision No. (3-31/37) dated 19 April 2016' (Saudi Vision 2016) 81 <<http://vision2030.gov.sa/en/media-center>> accessed 4 June 2017.

⁵⁸² Ibid 45.

⁵⁸³ Ibid 13.

⁵⁸⁴ Ibid 9.

⁵⁸⁵ Ibid 65.

Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) which is counted as one of the most vital organisations that aims to develop Islamic financial activities. The CMA stated in a recent announcement that “Membership in AAOIFI is in line with CMA’s efforts to achieve Saudi Arabia’s 2030 Vision, through continued development of the Saudi capital market while looking to enhance performance and elevate efficiency of control and audit, through standards of accounting, auditing, business ethics and corporate governance”.⁵⁸⁶

The CMA becoming a member in the AAOIFI means that Saudi Arabia is paying more attention to Islamic finance. This sends an indirect message to the local market in the Kingdom that Islamic finance will be looked after and will be better organised.⁵⁸⁷ Also, this constitutes an indirect message to financial institutions that provide Islamic finance products without paying undue attention to the level of its consent to sharia to be more careful. In addition, it may help to encourage Islamic financial institutions to adopt the AAOIFI sharia standards which would help standardise this market.

Furthermore, in March 2017, the Institute of Finance, which is part of SAMA, signed an agreement with the AAOIFI for the professional development of Islamic finance including sharing expertise, laying the basis for joint cooperation in the professional development of Islamic finance activities in the banking sector and in the capital and insurance markets, enhancing professional levels of human resources and raising awareness of sharia-compliant financial products and instruments.⁵⁸⁸ Then, SAMA as well became a new institutional member of AAOIFI.⁵⁸⁹ The Vision 2030 will be discussed in more detail in Chapter Six with the researcher’s own perspective on how the Vision could contribute to the development of Islamic finance, after discussing all the challenges that may face the development of Islamic finance.

⁵⁸⁶ Capital Market Authority, 'CMA Joins AAOIFI Membership' (2016) <<https://cma.org.sa/en/MediaCenter/PR/Pages/AAOIFI.aspx>> accessed 4 July 2017.

⁵⁸⁷ Interview with participant C on 3 March 2015, Manama Bahrain.

⁵⁸⁸ AAOIFI, 'AAOIFI Celebrates Admission of SAMA as Institutional Member at Official Ceremony Held in Riyadh' (2017) <<http://aaoifi.com/announcement/aaoifi-celebrates-admission-of-sama-as-institutional-member-at-official-ceremony-held-in-riyadh/?lang=en>> accessed 4 November 2017.

⁵⁸⁹ Ibid.

3.7 Conclusion

The chapter is part of several chapters whose main aim is to clarify the legal challenges and difficulties that may face Islamic finance in Saudi Arabia and so may prevent the Kingdom of Saudi Arabia from being the leading country for developing Islamic finance. This thesis will discuss some of the challenges, such as not having sharia governance as part of the corporate governance of financial institutions which provide financial products advertised as being compliant with sharia law; and also the challenges of not having a Central Sharia Board to ensure the conformity of financial products to sharia law. The thesis will suggest some recommendations that could help to overcome the challenges. However, in order to do that the thesis had to define Islamic finance first,⁵⁹⁰ and then illustrate the sources that Islamic law depends on and the major rules that Islamic finance has to deal with, in order to differentiate this finance from conventional finance.⁵⁹¹

This Chapter was presented to show the relationship between Islamic finance and Saudi Arabia in order to develop the themes of this thesis and find out the challenges that may face such finance in Saudi Arabia. This chapter started by giving the relevant historical background about Saudi Arabia including the legal background. After that, the structure of the Saudi legal system was provided including the regulatory, the executive and the judicial authorities in the Kingdom to show where the position of Islamic finance in the country is. This was followed by illustrating the financial activities in Saudi Arabia which include introducing the Banking Control Law and the Saudi Arabian Monetary Authority (SAMA) showing their links to Islamic Banks in Saudi Arabia.

Finally, the 2030 Saudi Vision was presented to show the recent development in the country which may benefit Islamic finance in Saudi Arabia. This Chapter is vital to the thesis as it set the basics that Saudi Arabia for example committed its self by law to follow sharia in all its aspects while in practice there are some breaches to the laws,⁵⁹² which can be justified as a necessity in some cases but that should be for certain time.

⁵⁹⁰ See 2.2 above

⁵⁹¹ See 2.7 above.

⁵⁹² See 3.3.3.3.3 and **Error! Reference source not found.** above.

Chapter Four: The Importance of Sharia Boards for Financial Activities in Saudi Arabia

4.1 Introduction

This chapter focuses on sharia boards in financial institutions including banks in Saudi Arabia. Some of the challenges that are highlighted related to sharia boards and show the need for a special governance framework that is sharia governance. Such governance is needed to minimise the bad practices by some financial institutions who market some of their products as sharia-compliant when they are not.

Thus, this chapter will show some of the challenges facing Islamic finance and these will be then shown in practice in the next two chapters when discussing *Sukuk*.⁵⁹³ This chapter will begin by showing the meaning of sharia compliance, which is what sharia boards in financial institutions should guarantee in all the financial products they approve. As Chapter Two already discussed the essential basics of Islamic finance, such as sharia sources,⁵⁹⁴ and the fundamental principles of Islamic finance.⁵⁹⁵ This chapter should become easy to follow and understand which would be needed to develop the thesis by discussing the challenges that face Islamic finance when some of its financial contracts are accepted in certain countries and void in other showing the reasons for having different *Fatwas* on a certain financial product depending on the Islamic schools of thought, that already introduced;⁵⁹⁶ and their position with regards to *Hilah* (a legal trick) will be presented in this chapter.

This chapter will also highlight the situation of sharia boards in Islamic financial institutions in Saudi Arabia from a legal perspective and how corporate governance of Islamic financial institutions compares with the current situation of some other countries including the neighbouring countries in the GCC countries. This part of the chapter is linked to chapter three which discussed the legal system and Islamic finance in Saudi Arabia. Lastly, the chapter will discuss the idea of creating a Central Sharia Board to supervise individual sharia boards in financial institutions.

4.2 An Overview of Sharia Compliance

⁵⁹³ See 6.4 below.

⁵⁹⁴ See 2.3 above.

⁵⁹⁵ See 2.7 above.

⁵⁹⁶ See **Error! Reference source not found.** above.

Islamic finance started with the establishment of Islam. Most of the principles of Islamic finance can be found in the Holy Quran and *Hadith* (prophetic traditions),⁵⁹⁷ some verses were revealed to prohibit some activities that people used to do when trading. For example, 'Oh who you who believe fear Allah and give up what remains of *Riba*; if you do it not, take notice of war from Allah and His Apostle'. [2:278]

Since then, Muslims started to engage in finance and trade according to the teaching of Islam. However, as discussed earlier,⁵⁹⁸ after both direct and indirect pressure from western colonists which affected the law in most of the Muslim countries, especially in the commercial and civil sphere.⁵⁹⁹ In 1971 the first modern Islamic bank opened after several attempts;⁶⁰⁰ one of the problems facing Islamic banks since then was that the *Fatwa* (an Islamic legal opinion) for certain financial products may differ from one sharia scholar to another and from one sharia board to another, one of the reason of the different in *Fatwa* is related to the use of *Hila* and the excessive use of it which going to be discussed soon.

Many conventional financial products have been studied by sharia scholars to determine their compatibility with sharia, and if found not to be compatible, some reverse engineering might be done to make them sharia compliant.⁶⁰¹ However, authors have used the term sharia-compliant in different ways. Some authors use this term only for financial products that were found in conventional finance and were then modified in order to be used in Islamic finance, whereas products that do not have a conventional finance background were identified as sharia based.⁶⁰² In contrast, other authors use the term sharia-compliant for financial products that can meet the substance and form of sharia but not the social needs of the community, which Islam usually cares about,⁶⁰³ while using the term sharia based for products that meet both

⁵⁹⁷ Hjh Siti Jabbar, 'Islamic Finance: Fundamental Principles and Key Financial Institutions' (2009) 30 Company Lawyer 24.

⁵⁹⁸ See 2.4 and 3.5 above.

⁵⁹⁹ Wael B. Hallaq, *An Introduction to Islamic Law* (1st edn, Cambridge University Press 2009) 141.

⁶⁰⁰ Hamed Merah, *عقود التمويل المستجدة في المصارف الإسلامية: دراسة تأصيلية تطبيقية (Emerging Financing Products in the Islamic Banks; A Theoretical a Practical Study)* (1st edn, al-Miman Publisher 2011) 41.

⁶⁰¹ Abbas Mirakhor, Zamir Iqbal and Hossein Askari, *Globalization and Islamic Finance: Convergence, Prospects and Challenges* (Wiley 2013) 166.

⁶⁰² Said Mikail and Mahamad Arifin, 'A Critical Study on Sharia Compliant and Sharia Based Products in Islamic' (2013) 3 Journal of Islamic and Human Advanced Research.

⁶⁰³ Habib Ahmed, 'Maqasid al-Sharia and Islamic Financial Products: a Framework for Assessment' (2011) 3 ISRA International journal of Islamic finance.

goals.⁶⁰⁴ In this thesis all products that are accepted by sharia boards will be called sharia-compliant including the sharia based ones.

4.3 The Definition of *Hila*

Hila can be defined in classical Islamic jurisprudence as an artifice, device or stratagem. While in practice, it is “the use of legal means for achieving extra-legal ends, ends that could not be achieved directly with the mean provided by the sharia, whether such end might or might not be in themselves illegal.”⁶⁰⁵ It is basically known as a legal trick.⁶⁰⁶ *Hila* is the singular and the plural is *Hiyal*. A famous example of a financial contract that uses *Hila* and has caused a huge debate among sharia scholars is *Bay al Inah* which can be called a buy-back contract or double selling. One of the ways *Bay al Inah* is performed is when a bank sells a commodity to a customer on a deferred payment basis and then buys it back immediately for cash at a lower price. The difference in price is the bank's profit which is determined in advance.⁶⁰⁷ So, it can be seen that, there were two separate transactions, each one having no contradiction with sharia, but the completed process of the two transactions achieves an illegitimate end, which is charging interest on a loan and this is considered to be a type of *Riba*. In practice the debtor does not intend to purchase the commodity, and the bank usually uses the same commodity to complete this procedure with other customers.⁶⁰⁸

In addition, *Hila* can have a slightly different meaning to describe a clever way of using the law to achieve a legitimate end.⁶⁰⁹ For example Ibn Qayyim al-Jawziyya⁶¹⁰ differentiated between two kinds of *Hiyal*, one he considered lawful, when “a lawful end was to be achieved by lawful means”,⁶¹¹ others are forbidden, when unlawful ends would be achieved. Other scholars having similar views such as Ibn Taymiyah and al-Shatibi⁶¹² mentioned that *Hila* can be reprehensible when it is used to achieve

⁶⁰⁴ Ibid.

⁶⁰⁵ Majid Khadduri and Herbert J Liebesny, *Origin and Development of Islamic Law* (Lawbook Exchange 2008) 78.

⁶⁰⁶ Abdulazeem Abozaid and Asyraf Dusuki, 'The Challenges of Realizing Maqasid Al-Sharia in Islamic Banking and Finance', *Islamic Banking and Finance: Research and Development: The Bridge between Ideals and Realities Conference* (IIUM Institute of Islamic Banking and Finance 2007).

⁶⁰⁷ Ibid.

⁶⁰⁸ Ibid.

⁶⁰⁹ Joseph Schacht, *An Introduction to Islamic Law* (Clarendon Press 1964) 79.

⁶¹⁰ Famous sharia scholar died 1350 AD.

⁶¹¹ Joseph Schacht, *An Introduction to Islamic Law* (Clarendon Press 1964) 81.

⁶¹² Famous sharia scholar died 1388 AD.

illegitimate ends while it is commendable when it is used to achieve a result that does not contradict the spirit of the law.⁶¹³ Recently some scholars started naming the permissible *Hila* as *Makhraj Fiqhia* (a legal existence from a hardship).⁶¹⁴

Furthermore, legal tricks are not the only discussed in sharia law, Joseph stated that evasions and other devices are practised in other legal systems including Jewish and Canon law, and legal fictions in particular played a considerable part in Roman law and elsewhere.⁶¹⁵

The concept of *Hiyal* is an important element to be discussed as most of the differences among sharia boards in financial institutions around the world are caused by *Hiyal*, and how scholars and *Madhahib* (Islamic schools of thought) look at them.⁶¹⁶ Agha stated that the excessive use of *Hiyal* would make Islamic financial products Islamic in form only and not in substance, where principles in Islam should be put before profit; so succeeding in this world is important, but such success must not be at the cost of the means to success.⁶¹⁷

4.4 Islamic Schools of Thought and *Hila*

After introducing *Madhahib* in Chapter Two,⁶¹⁸ it should be easier to link them to their positions with regards to *Hila*. Highlighting the issue of *Hila* is important as it is one of the main causes for debate on financial contracts in some sharia boards at different financial institutions all around the world and this has its effect on Saudi Arabia as well.⁶¹⁹ Ibn Taymiyah links the origin of *Hila* with the promotion of *Al-ra'y* (opinion).⁶²⁰ In his view, most *Hiyal* were validated by jurists who belonged to the school of *Ashab al-ray* (people of opinion) as they use more human reasoning in solving legal problems,⁶²¹ or relied much more on the use of legal reasoning and sound judgment

⁶¹³ Ibrahim Ibn Al Shatibi, *Reconciliation of The Fundamentals of Islamic Law* (Garnet Press 2014) 180, also Muammed Ismail, 'Legal Stratagems (*Hiyal*) and Usury in Islamic Commercial Law' (PhD, The University of Birmingham 2010) 112.

⁶¹⁴ Habib Ahmed, 'Maqasid al-Sharia and Islamic Financial Products: a Framework for Assessment' (2011) 3 ISRA International journal of Islamic finance.

⁶¹⁵ Joseph Schacht, *An Introduction to Islamic Law* (Clarendon Press 1964) 79.

⁶¹⁶ Oliver Agha, 'Islamic Finance: Principle before Profit' (2009) 2 Berkeley J. Middle E. & Islamic 182 <<http://scholarship.law.berkeley.edu/jmeil/vol2/iss1/4/>> accessed 20 July 2016.

⁶¹⁷ Ibid.

⁶¹⁸ See **Error! Reference source not found.** above.

⁶¹⁹ Muhammad Tahir Mansoori, 'Is "Islamic Banking" Islamic? Analysis of Current Debate on Sharia Legitimacy of Islamic Banking and Finance' (2011) 50 Islamic Studies 392.

⁶²⁰ Already discussed in Chapter Two

⁶²¹ Ahmad Alkhamees, *A Critique of Creative Sharia Compliance in the Islamic Finance Industry* (Brill Nijhoff 2017)

than on *hadith*.⁶²² As *Ashab al-ray* apply *Hiyal* more, it can be indicated from what has been discussed in Chapter Two⁶²³ that two *Madhahib* who were influenced by *Ashab al-ray* would use it as well, that is the Hanafis and Shafis, whereas the other two *Madhahib* are influenced by *Ashab Al-Hadith* (people of hadith) who always try to base their legal opinions entirely or at least primarily on literal hadith reports, keeping human reasoning to a minimum.⁶²⁴ It should be pointed out that the founders of the four schools did not specify, discuss or approve *Hila* directly, but by investigating their rulings on different contracts *Hila* was identified and then was presented by some of the later scholars of those *Madhahib*.⁶²⁵ *Hiyal* can be found in different parts of the law: financial, criminal, inheritance law, taxation law and others.⁶²⁶ To serve the purpose of this thesis the focus will be only on the financial part. The *Madhahib* will be listed depending on their view on *Hila*: the Hanafi, Shafi, Maliki and Hanbali.

4.4.1 Hanafi *Madhab*

Hila can come in different forms and examples can be found in some books of the Hanafis.⁶²⁷ For example Abu -Haniifa was asked about selling grapes to a winemaker and he validated the transaction as the winemaker might not use these grapes to make wine.⁶²⁸ However, it is not always the case that a transaction or a contract that contains *Hila* is valid, meaning it is permissible. Scholars may validate a transaction but they believe that it might not be permissible to do so if the parties did it with intention to achieve a prohibited result, as only the God knows the intentions.⁶²⁹ In other words, the transaction may be valid from a judicial perspective, but is not permissible from a religious perspective; for the religious side it would be dependent on the intention of the person who made the transaction and that between the person

⁶²² Frank E Vogel, *Islamic Law and Legal System: Studies of Saudi Arabia* (Brill 2000) 40.

⁶²³ See **Error! Reference source not found.** above.

⁶²⁴ Frank E Vogel, *Islamic Law and Legal System: Studies of Saudi Arabia* (Brill 2000) 40.

⁶²⁵ Abd al-Razzaq al-Sanhuri, *مصادر الحق في الفقه الإسلامي دراسة مقارنة بالفقه الغربي* (*Sources of the Right in Islamic Jurisprudence a Comparative Study of Western Jurisprudence*) (Vol 3 Dar Ihya al-Turath al-Arabi 1997) 139.

⁶²⁶ *Ibid.*

⁶²⁷ Abdullah Saeed, *Islamic Banking and Interest: A Study of the Prohibition of Riba and its Contemporary Interpretation* (Brill 1996) 38.

⁶²⁸ Muhammad Ibn Abidin al-Shami, *حاشية رد المحتار على الدر المختار شرح تنوير الأبصار* (*Hashiyat Radd Al-Muhtar 'Ala Ad-Durr Al-Mukhtar*) (Vol 9 Dar al-Alamiyyah 2012) 559.

⁶²⁹ Muammed Ismail, 'Legal Stratagems (Hiyal) and Usury in Islamic Commercial Law' (PhD, The University of Birmingham 2010)125.

and the God.⁶³⁰ So, the Hanafis disregard the motives of parties behind contracts as it is difficult to know the intention of the parties when performing the sale contract. Many scholars in this *Mathab*, including the early jurists such as al-Shaybani, and al-Khassaf, also the founder of this school, see the prohibition of *hila* when it is applied to *haram* (a forbidden action) or to deny the rights of other people.⁶³¹

4.4.2 Shafi Madhab

It should be noted that some of the countries that are interested in developing Islamic financial contracts and becoming a hub of Islamic finance are countries that follow the Shafi *Madhab*, such as Malaysia, and that has meant some of their products are not accepted in other countries which follow a stricter view about *hila* such as Saudi Arabia which follows the Hanbali school.⁶³²

So the Shafi School's view regarding *hila* will be discussed here in more detail. This school is also known to accept the legality of *Hiyal*,⁶³³ even though the early scholars of this *Madhab* did not state that they supported the use of it, but it can be found in some legal opinions especially in cases relating to trade,⁶³⁴ with examples to this, allowing the sale of grapes to a wine maker as the Hanafi *Madhab*, and another example, the *Bay al Inah* transactions, described as the king of *Hiyal*.⁶³⁵ The founder of the school was known for his opposition to the *Hiyal*.⁶³⁶ However, he explained the way he follows when examining the validity of a contract: he does not void a contract that appears valid, just because there is suspicion about the parties' illegal intention or their practice, as he validates it on the ground of its form. On the other hand, he stated that if an illegal intention was made explicit he would invalidate the sale.⁶³⁷ Also, he believed that a contract can only be invalidated on the ground of the terms explicitly

⁶³⁰ Muhammad Ibn Abidin al-Shami, *حاشية رد المختار على الدر المختار شرح تنوير الأبصار* (*Hashiyat Radd Al-Muhtar 'Ala Ad-Durr Al-Mukhtar*) (Vol 9 Dar al-Alamiyyah 2012) 559.

⁶³¹ Ibn Hajar al-Asqalani, *فتح الباري بشرح صحيح البخاري* [*A Book That Expound True Hadiths that Were Chosen by Al-Bukhari*] Vol 4 (al-Risalah al-Alamiyyah publisher 2013)

⁶³² Muammed Ismail, 'Legal Stratagems (Hiyal) and Usury in Islamic Commercial Law' (Doctor of Philosophy in Law, The University of Birmingham 2010) 100.

⁶³³ Abdullah Saeed, *Islamic Banking and Interest: a Study of the Prohibition of Riba and its Contemporary Interpretation* (Brill 1996)

⁶³⁴ Ahmad Alkhamees, *A Critique of Creative Sharia Compliance in the Islamic Finance Industry* (Brill Nijhoff 2017)

⁶³⁵ Abd al-Ghani Maydani, Abd al-Fattah Abuu Ghuddah and Abd al-Majid Mahmud Abd al-Majid, *كشف الإلتباس عما أورده الإمام البخاري على بعض الناس* [*Clarification on Some of Imam Al-Bukhari Opinions*] (Maktab al-Matbuat al-Islamiyah 1993) 35

⁶³⁶ Muammed Ismail, 'Legal Stratagems (Hiyal) and Usury in Islamic Commercial Law' (Doctor of Philosophy in Law, The University of Birmingham 2010) 165

⁶³⁷ Paul R Powers, *Intent in Islamic Law: Motive and Meaning in Medieval Sunni Fiqh* (Brill 2006) 114

stated in the contract. So, pre-contract or post-contract arrangements will not make the contract void; also, it will not be voided because an illegal motive, such as practicing usury, is suspected or because it can lead to an impermissible action.⁶³⁸

As with the Hanafi *Madhab*, al-Shafi and many scholars in his school may validate some contracts that contain *hila*, but such validation may only be seen from the judicial side while they might be prohibited to do so from a religious side especially when bad intention was established. Al-Shafi stated that he sees this intention as *Makruh* from a religious side. The word *Makruh* originally meant dislike but al-Shafi uses this word in different places in his book *al-Umm*⁶³⁹ to mean forbidden.

However some scholars believe that al-Shafi meant that he dislikes the action but it is not prohibited, while the majority understand that it means prohibited.⁶⁴⁰ The researcher sees that this is an important point, as sharia boards, who choose to follow the Shafi school in related cases, should be not allowed to approve a contracts that contains *hila* that leads to illegal ends even if the form of the contract is accepted judicially, because it is prohibited religiously and they should not expose their client to commit a sin. In particular, approving a contract for a financial institution would mean that such a contract will be used as a form and used over and over again with the same *Hila* giving an unlawful result at the end of the contract every time. Thus, this will give the same result as implicating the illegal intention when forming the contract which is seen as prohibited in all the *Madhahib* because the illegal result would be achieved every time when such contract practice. Besides, large numbers of Shafi jurists prohibit scholars from teaching or drawing people's attention to such legal ruses to avoid obligation or to breach the prohibition.⁶⁴¹

In relation to this, Ibn Al-Qayyim said that some of the sharia scholars in his time talk about some forms of *Hiyal* that were never mentioned by the earlier scholars in the *Madhahib*, and some of those scholars wrongly assumed that those *Hiyal* were in

⁶³⁸ Abd al-Ghani Maydani, Abd al-Fattah Abuu Ghuddah and Abd al-Majid Mahmud Abd al-Majid, *كشوف الإلتباس عما أورده الإمام البخاري على بعض الناس [Clarification on Some of Imam Al-Bukhari Opinions]* (Maktab al-Matbuat al-Islamiyah 1993) 35

⁶³⁹ Muhammad Ibn-Idris al-Shafi, *كتاب الأم (Al- Umm)* [Al-Shafi's Book of Law] (Maktabat al-Kulliyat al-Azhariya 1988)

⁶⁴⁰ Abd al-Ghani Maydani, Abd al-Fattah Abuu Ghuddah and Abd al-Majid Mahmud Abd al-Majid, *كشوف الإلتباس عما أورده الإمام البخاري على بعض الناس [Clarification on Some of Imam Al-Bukhari Opinions]* (Maktab al-Matbuat al-Islamiyah 1993) 35.

⁶⁴¹ Ahmad Alkhomees, *A Critique of Creative Sharia Compliance in the Islamic Finance Industry* (Brill Nijhoff 2017). And Muhyi al-Din Nawawi, *المجموع شرح المذهب [al-Majmu sharh al-Muhadhdhab]* (vol. 9 Dar al-Irshad 1971)79.

existence and accepted by the earlier scholars, especially *Hiyal* which have been linked to Al-Shafi; Whereas those *Hiyal* were not really discussed or accepted by Al-Shafi, and most of them were made up or wrongly attributed by orientalists (Western Artists in Arabia).⁶⁴² Even so, al-Shafi usually legalises a contract based on its form, without concentrating on the intention of the two parties when forming the contract, but there is no doubt that he would not encourage and show people how to deceive and mislead others in their financial contracts.⁶⁴³

In addition, some of the early prominent scholars in the Shafi School, such as al-Juwayni and Isfariyani, forbid *Bay al Inah* transactions from a sharia perspective. They also void a sale contract if one of the parties involved makes a habit of using the *Bay al Inah* transaction.⁶⁴⁴ So, the Shafi *Madhab* has different opinions as to when *hila* is included in a financial contract but most of the early and current scholars including the founder of the school may validate some cases that include *hila* but they prohibit it when being used intentionally to achieve an unlawful end.

4.4.3 Maliki *Madhab*

The Maliki school is influenced by *Ashab Al-Hadith* who keeps human reasoning to a minimum, while it tries to base its advisory opinions on *hadith* as possible as possible. As explained in Chapter Two.⁶⁴⁵ Maliki used in his *Fiqh* (doctrine) *Al-masalih Al-mursalah* (public interest if not leading to prohibition) and *Sadd Al-dharai* (precautionary legal prohibition).⁶⁴⁶ The latter approach has given *hila* a very small chance of existing in any financial contract as *hila* may lead to unlawful ends so it is forbidden.⁶⁴⁷ This school uses the verses of the Quran and the *Hadiths* that warn people against manipulating with his rules to achieve unlawful ends to prohibit and

⁶⁴² Abd al-Ghani Maydani, Abd al-Fattah Abuu Ghuddah and Abd al-Majid Mahmud Abd al-Majid, كشف الإلتباس عما أورده الإمام البخاري على بعض الناس [Clarification on Some of Imam Al-Bukhari Opinions] (Maktab al-Matbuat al-Islamiyah 1993) 34.

⁶⁴³ Ibid.

⁶⁴⁴ Ahmad Alkhamees, *A Critique of Creative Sharia Compliance in the Islamic Finance Industry* (Brill Nijhoff 2017) 49.

⁶⁴⁵ See **Error! Reference source not found.** above.

⁶⁴⁶ Hans Visser, *Islamic Finance: Principles and Practice: Principles and Practice* (2nd edn, Edward Elgar 2013)17.

⁶⁴⁷ Abd al-Ghani Maydani, Abd al-Fattah Abuu Ghuddah and Abd al-Majid Mahmud Abd al-Majid, كشف الإلتباس عما أورده الإمام البخاري على بعض الناس [Clarification on Some of Imam Al-Bukhari Opinions] (Maktab al-Matbuat al-Islamiyah 1993) 34.

void *Hiya*. For example, the Quran⁶⁴⁸ tells a story of people who were commanded by God to not catch fish on Saturday. But those people noticed that on Saturday more fish comes around so some of them decided to circumvent this command by leaving the fishing nets out on the day before Saturday and collecting them on the day after Saturday: thus, those people were punished.⁶⁴⁹

Alshatibi a great scholar in the Maliki *Madhab* listed many *Hiyal* in his time showing the reasons for prohibition.⁶⁵⁰ He also accepted other *Hiyal* and stated that the *Hiyal* that were illegal were revoked and prohibited because they worked against the principles of sharia. However, assuming a *Hila* does not contravene an established legal principle or a principle of public good, it would not be seen to be void or prohibited.⁶⁵¹ Also he stated that on the one side, it is difficult to give proof from sharia to invalidate every *Hila* which appears.

On the other side, there is no proof to validate every *Hila*. So, any *Hila* that conflicts with the values of Islam should be invalidated in all Muslim schools and the debate should be only on cases that have supporting proofs on both sides.⁶⁵² So, Alshatibi sees *Hiyal* as one of the issues that jurists can have disputes on; each jurist would be able to give his legal opinion on a *Hila* depending on whether it achieves an unlawful end or not.

Al Muqry said that money in Islamic jurisprudence can be found in two places, one is related to worship finance which mean money is spend in this life to get reward in the hereafter, such as *Zakat* and *Hajj*; here God gives all the instructions and details needed so there is no need for a jurist to make *Ijtihad* (Self-exertion to give *Fatwa*).⁶⁵³ The other part is commercial jurisprudence; here there are fewer details in the sharia primary sources, and more fundamental rules and guides. The reason is that people use different methods to do finance and perform contracts at different times and

⁶⁴⁸ See Quran [7:163].

⁶⁴⁹ Muhammad Hisham Burhani, *سد النزاع في الشريعة الإسلامية (Precautionary Legal Prohibition in Islam)* (Dar Alfiker 1995).

⁶⁵⁰ Ahmad Alkhamees, *A Critique of Creative Sharia Compliance in the Islamic Finance Industry* (Brill Nijhoff 2017) 40.

⁶⁵¹ Ibrahim Ibn Al Shatibi, *Reconciliation of The Fundamentals of Islamic Law* (vol 2 Garnet Press 2014) 281

⁶⁵² Ibrahim Ibn Al Shatibi, *Reconciliation of The Fundamentals of Islamic Law* (vol 2 Garnet Press 2014) 285.

⁶⁵³ Abdullah Almuqry, 'البيوع أنموذجاً: المذهب المالكي: البيوع أنموذجاً' [Jurisprudence of Transactions in the Maliki Doctrine: Sales as a Model] (Postgraduate, Sudan University of Science and Technology 2014) 42.

different places so the door of *Ijtihad* is opened for the jurist, making Islam a total way of life which is applicable to all times and places.⁶⁵⁴

4.4.4 Hanbali *Madhab*

This *Madhab* is influenced by *Ashab Al-Hadith* as well, so their view about *Hiyal* is not far from the view of the Maliki School. The founder of this school, Ibn Hanbal, rejected *Hiyal* stating that they cannot be a solution.⁶⁵⁵ Most of the scholars in this school share the same view.⁶⁵⁶ Ibn Taymiyah and his disciple Ibn al-Qayyim, who played a significant role in the development of the Hanbali *Madhab*, argued against many *Hiyal* that were presented at the time. They criticised *Hiyal* as contrary to textual sources on the grounds of deception and deceit.⁶⁵⁷ For example, Ibn Qayyim believed that it was inconceivable that an act prohibited by one law could be permitted by another law under the same legal system.⁶⁵⁸

However, Ibn Taymiyah and Ibn Qayyim agreed with the Hanafi and Shafi schools in the sense that lawful *Hiyal*, which gives a result that does not conflict with the purposes of the law, is not void which was given name as *Makharij* (Exits). Ibn Al-Qayyim advised jurists to discover such *Hiyal*, which they called *Makharij*, and recommended jurists to re-examine them to make sure that they did not give an unlawful result.⁶⁵⁹ An example of a *hila* that is accepted by some current Hanbali jurists, but was not accepted by Ibn Taymiyah, is *Tawarruq* which is basically when a person needs to obtain liquidity: for example a person buys a commodity by deferred payment then re-sells it again to a third party, not to the first seller, for cash at a price lower than the original cost usually.⁶⁶⁰ Ibn Taymiyah stated that a contract would only be void if the illegal intention was stated or there is clear circumstantial evidence indicating the illegal intention when forming the contract that is intended to achieve an illegal result,

⁶⁵⁴ Ibid.

⁶⁵⁵ Satoe Horii, 'Reconsideration of Legal Devices (*Hiyal*) in Islamic Jurisprudence: The Hanafis and their "Exits" (*Makharij*)' (2002) 9 *Islamic Law and Society*

⁶⁵⁶ Ahmad Alkhamees, *A Critique of Creative Sharia Compliance in the Islamic Finance Industry* (Brill Nijhoff 2017) 54.

⁶⁵⁷ Majid Khadduri, *the Islamic Conception of Justice* (Johns Hopkins University Press 1984) 154.

⁶⁵⁸ Ibid.

⁶⁵⁹ Satoe Horii, 'Reconsideration of Legal Devices (*Hiyal*) in Islamic Jurisprudence: The Hanafis and their "Exits" (*Makharij*)' (2002) 9 *Islamic Law and Society*.

⁶⁶⁰ Mahmoud A El-Gamal, *Islamic Finance: Law, Economics, and Practice* (Cambridge University Press 2009).

such as involving in *Bay al Inah* sale just to have the same result of a lone with interest.⁶⁶¹

However, investigating motives behind contracts is beyond the powers of the judge who may validate the contract; but this does not mean that it is permissible religiously, as God knows the real motive. Then Ibn Taymiyah stated the *hadith* of the prophet “The reward of deeds depends upon the intentions and every person will get the reward according to what he has intended.”⁶⁶²

So, from the above it can be seen that all *Madhabs* agree with *Hiyal* that give a result which does not conflict with the purposes of the law, as they are not leading to any manipulation with God’s law; such *Hiyal* have been called *Makhraj fiqhia* (a legal existence from a hardship) to be distinguished from the unlawful *Hiyal*. Whereas in the case of *Hiyal* that could result in an unlawful outcome, two of the *Madhabs*, the Hanafi and the Shafi, would validate contracts that contains such *Hiyal* if no intention or invalid terms are stated in the contract from a judicial perspective; while from the religious perspective almost all *Madahibs* are not agreed about them: the Hanafis and Shafis, at worst, view them as *Makruh* (dislike, immoral), while the Malikis and even more so the Hanbalis forbid them altogether.⁶⁶³

Merah highlighted the difference between the *Hila* that leads to *Riba* and *Makhraj Fiqhia*. The first one is the use of legal means in a way to achieve a different result from what it was meant to be, but achieves an illegal end by leading to *Riba*. The latter can be defined as tricky solutions to difficult problems without frustrating the purpose of law. They are clever uses of law to achieve legitimate ends.⁶⁶⁴ He added that a number of sharia scholars interpret the Quran’s verse “whoever fears Allah - He will make for him a way out” [65:2] as saying that God would give a way out from prohibition to permissibility to any person who fears him. Merah believes that a *Hila* that leads to *Riba* is prohibited, while *Makhraj Fiqhia* is permissible and most of the debate among sharia scholars relates to cases that are not giving a clear result: whether the case should be counted as a prohibited *Hila* that leads to *Riba* or counted

⁶⁶¹ Ahmad Ibn Taymiyyah, *بيان الدليل على بطلان التحليل* [Giving Proof to Void Some Permitted Cases] (1st edn, al-Maktab al-Islami 1998).

⁶⁶² Ibid 282.

⁶⁶³ Alexander Pock, *Strategic Management in Islamic Finance* (Deutscher Universitäts-Verlag 2007) 25.

⁶⁶⁴ Hamed Merah, *عقود التمويل المستجدة في المصارف الإسلامية: دراسة تأصيلية تطبيقية* (Emerging Financing Products in the Islamic Banks; A Theoretical a Practical Study) (1st edn, al-Miman Publisher 2011) 52.

as a *Makhraj fiqhia*.⁶⁶⁵ Merah assumed that whoever bans *Hiyal* would mean they were referring to the *Hiyal* that leads to *Riba*. On the other hand, whoever allows *Hiyal* would mean they were referring to *Makhraj Fiqhia*.

4.5 *Hiyal* in Saudi Law

The word *Hiyal* is mentioned in Saudi Law. It is found in its Commercial Court Law⁶⁶⁶ and this law introduces a punishment to anyone who practises financial *hila* to circumvent the prohibited *Riba*. The article gave an example which is one of the forms of *Bay al Inah* as stated “selling a commodity for a deferred price, then buying the same commodity by the merchant himself, agent, or another person for a mount less than its sale in cash or lending something to a person who sells it in a great increase in value, shall be considered usurer”⁶⁶⁷ The article states that the creditor who uses a *Hila* “shall only get his capital with no interest, and shall be liable to imprisonment from Three months to a year and shall be defamed”.⁶⁶⁸

As discussed in Chapter Three,⁶⁶⁹ the commercial courts in Saudi Arabia were repealed in 1955 distributing their jurisdiction to the Board of Grievances and specialised tribunals such as the committees for Banking and Financial Disputes and Violations,⁶⁷⁰ whereas the Commercial Court Law which was issued in 1931 is still valid with some amendments or has sometimes being superseded by recent laws that address specific areas such as companies.⁶⁷¹ The new judicial law of 2007 brought in new commercial courts and appellate bodies, including a Supreme Court.⁶⁷² The reforms and transfer of the commercial courts away from the Board of Grievances just has been implemented October 2017.⁶⁷³ However, the committees for Banking and Financial Disputes and Violations are still exempt from referring cases back to the court.⁶⁷⁴ Many Articles of the 1931 Commercial Court Law including Article 149 concerning *hila* is still recognised while some other Articles were changed or

⁶⁶⁵ Ibid.

⁶⁶⁶ Commercial Court Law 1931 Article 149.

⁶⁶⁷ Ibid.

⁶⁶⁸ Ibid.

⁶⁶⁹ See 3.3.3.2 above.

⁶⁷⁰ See 3.3.3.3 above.

⁶⁷¹ Michael O'Kane, *Doing Business in Saudi Arabia* (1st edn, Andalus Publishing 2013).

⁶⁷² Royal Decree No. M/78, dated 1 October 2007.

⁶⁷³ Ministry of Justice, 'Justice Minister to Inaugurate Specialized Commercial Courts' (21 October 2017) <<https://www.moj.gov.sa/en/MediaCenter/Pages/NewsDetails.aspx?itemId=12>> accessed 24 October 2017.

⁶⁷⁴ Royal Decree No. 37441 dated 1 July 2012.

amended.⁶⁷⁵ Article 149 of the Commercial Court Law discussed *Hiyal* that would lead to *Riba* but did not state the punishment when *Riba* is practiced directly, it can be said that *Riba* is included in this article in the first place as lawyer Khalid Othman argued.⁶⁷⁶ However Article 5 of this law stated that

“A merchant must practice the commercial activities honestly and in good faith according to Islamic principles, therefore, he must not be engaged in any form of fraud, deceit, deception, injustice, betrayal, violation, or any other behaviour breaching the principles of honesty and religion. In case of committing any of the stated actions, the merchant shall subject to the deterrent penalty set forth in this Law.”⁶⁷⁷

So practising *Riba* can be included in this Article as it is against to Islamic principles which were discussed in chapter two.⁶⁷⁸ Then Article 147 stated that

“A merchant who violates the provisions of Article (5) shall be punished by imprisonment for a period ranging between 10 days and 3 months or a fine in accordance with the nature of his crime and his cases.”⁶⁷⁹

Thus, from the researcher point of view, practising *Hila* to achieve *Riba* or practise *Riba* is illegal under the Law Commercial Court in Saudi Arabia and this is one of the reasons of the existence of some Quasi-Judicial Committees such as Banking Disputes Committee which has been discussed earlier.⁶⁸⁰ To enable conventional financial institutions to work in Saudi Arabia without exposing to the risk of losing the interest that would be gained by practising contracts that contains *Riba*.

A case ⁶⁸¹ was presented to the Board of Grievances in which the appellant claimed that the consequence of the contract was sale on credit. While the defendant said that the contract was a fictitious, sham contract. The evidence showed that there was an intention to practise *Riba* by *Hila* and also the contract contained *Gharar*. The decision

⁶⁷⁵ Abdurahman Dahish, 'الاختصاص القضائي للمحاكم التجارية السعودية وإجراءات التقاضي أمامها' (Jurisdiction of The Saudi Commercial Courts and The Procedures of Litigation)' (Postgraduate, Naif Arab University for Security Sciences, Law college 2014).

⁶⁷⁶ Khalid Othman, 'عقوبة التعامل بالربا في القانون التجاري السعودي' (The Penalty of Dealing in Usury in the Saudi Commercial Law) Issue N. 5353' Okaz newspaper 7 May 2008.

⁶⁷⁷ Commercial Court Law 1931 Article 5.

⁶⁷⁸ See 2.7 above.

⁶⁷⁹ Commercial Court Law 1931 Article 147.

⁶⁸⁰ See 3.3.3.3 above.

⁶⁸¹ Case no 167/3/G/Year 2006.

of the Board of Grievances was that the contract was void and its consequences were void.⁶⁸²

4.6 Sharia Boards in Financial Institutions in Saudi Arabia

Saudi Arabia is attached very closely to Islam, as it is the birth place of Islam, and from there Islam spread to cover the whole of the Arab peninsula and moved beyond to many places in different continents.⁶⁸³ As mentioned in the previous chapter the link between Saudi Arabia and Islam is very close as almost all the population of Saudi Arabia are Muslims⁶⁸⁴ and the government of Saudi Arabia itself declared Islam as the religion of the country.⁶⁸⁵

But as most of the global banking and financial activities are built on conventional financial systems which include dealings with some activities that conflict with Islamic teachings such as *Riba*, and *Gharar*, Muslims have to find a way to avoid being involved in *haram* (a forbidden action) but still investing their money and doing finance in a permissible way. In the case of Saudi Arabia, as has been discussed earlier,⁶⁸⁶ that Saudi Arabia at the beginning of its development especially with the huge income which was coming from the oil which resulted to the need of banks to keep pace with its developments and Islamic banks were not at that ready at that time.⁶⁸⁷ This caused the establishment of SAMA as a Central Bank in 1952,⁶⁸⁸ being responsible to regulate commercial banks and exchange dealers as stated on its Charter,⁶⁸⁹ SAMA was expected as it stated in its Charter to allow only financial activities that do not conflict with the teachings of Islamic law,⁶⁹⁰ and to not engage in trade or have an interest in any commercial, industrial, or agricultural enterprise.⁶⁹¹ As the government was just engaging with banking activities and needed experts in this field to have a strong start,

⁶⁸² Abdullah Alshowish, 'An Evaluation of the Current Rules and Regulatory Framework of Corporate Governance in Saudi Arabia: A Critical Study in Order to Promote an Attractive Business Environment' (PhD, The Law School, Lancaster University 2016) 152.

⁶⁸³ See 3.2 above.

⁶⁸⁴ Oxford Business Group, 'The Report: Saudi Arabia 2008' (Oxford Business Group 2008) 12.

⁶⁸⁵ Article 1 The Basic Law of Governance.

⁶⁸⁶ See 3.3.3.1 above.

⁶⁸⁷ Ibid.

⁶⁸⁸ Royal Decrees number 30/4/1/1046 (20/4/1952).

⁶⁸⁹ Art. 1 Charter of SAMA 1957.

⁶⁹⁰ See 3.4.2 above.

⁶⁹¹ Art. 6 (a and d) Charter of SAMA 1957.

the United States of America provided technical assistance.⁶⁹² Mr. George A. Blowers (a U.S. citizen) was the first governor of SAMA.⁶⁹³ Also as there was no strong and successful role model for Islamic finance at that time this made SAMA work and supervise the financial activities on a conventional financial base and that included accepting financial institutions and banks to deal with *Riba*. This was justified at that time as a necessity, and in Islam necessity permits a prohibited matter.⁶⁹⁴

However, after 1970 Islamic finance started to gain some popularity, and some countries and organisations started to regulate such finance.⁶⁹⁵ But Saudi Arabia preferred to stand by and continue adopting and practising the same regulations as before. Then, as discussed in Chapter Three,⁶⁹⁶ the Al-Rajhi Bank got a licence from SAMA⁶⁹⁷ after being refused before on condition that it did not use the word Islamic in its title.⁶⁹⁸ Then the development in the Islamic finance sector increased which reduced the need for SAMA to engage with *Riba*.

4.7 Importance of Sharia Board

The existence of sharia boards in financial institutions appear together with the establishment of Islamic banks as there is no Islamic financial institution without a sharia board or sharia committee.⁶⁹⁹ There is no standard definition for the sharia board; it can be seen as a group of scholars or a panel of sharia scholars who ensure that all the conduct of the financial institution complies with sharia.⁷⁰⁰ These groups of

⁶⁹² Fayaz Ahmad Lone and Salim Alshehri, 'Growth and Potential of Islamic Banking in GCC: The Saudi Arabia Experience' (2015) 3 Journal of Islamic Banking and Finance <http://jibfnet.com/journals/jibf/Vol_3_No_1_June_2015/4.pdf> accessed 2 May 2017

⁶⁹³ 'Historical Preview' (*Sama.gov.sa*, 2017) <<http://www.sama.gov.sa/en-US/About/Pages/SAMAHistory.aspx>> accessed 10 December 2017.

⁶⁹⁴ Yasmin Safian, 'Necessity (Darura) in Islamic Law: A Study with Special Reference to the Harm Reduction Programme in Malaysia' (PhD, the University of Exeter 2010).

⁶⁹⁵ Kabir Hassan and Mervyn Lewis, *Handbook of Islamic Banking* (Edward Elgar 2007).

⁶⁹⁶ See 3.5.1.1 above.

⁶⁹⁷ Barbara A Roberson, *Shaping the Current Islamic Reformation* (Routledge, Taylor et Francis Group 2003) 159

⁶⁹⁸ Rodney Wilson, 'Arab Government Responses to Islamic Finance: The Cases of Egypt and Saudi Arabia' (2002) 7 Mediterranean Politics <<http://www.tandfonline.com/doi/pdf/10.1080/13629390207030010>> accessed 3 April 2016.

⁶⁹⁹ Samy Garas and Chris Pierce, 'Sharia Supervision of Islamic Financial Institutions' (2010) Vol. 18 Journal of Financial Regulation and Compliance <<https://doi.org/10.1108/13581981011093695>> accessed 13 May 2017.

⁷⁰⁰ Hichem Hamza, 'Sharia Governance in Islamic Banks: Effectiveness and Supervision Model' (2013) 6 International Journal of Islamic and Middle Eastern Finance and Management <<http://www.emeraldinsight.com/doi/pdfplus/10.1108/IMEFM-02-2013-0021>> accessed 2 May 2017.

respected scholars provide stakeholders with crucial confidence and assurance that a financial institution does not violate Islamic principles in its business.⁷⁰¹ De Lorenzo describes the important role of a sharia board in Islamic financial institutions, as it should be involved in all steps of establishing a financial product. It should start assisting from the pre-certification stage while the product is under development and structuring.⁷⁰² If the sharia board is satisfied with the product from the sharia side, it should certify the finished product or service by issuing a *Fatwa* before introducing the product to the market. Afterwards, the board should follow the progress of the product by finding and mitigating all possible risks, especially the sharia compliance risk. The board should work closely with management all the way through the process of product development and its lifecycle in order to have a successful management of sharia compliance risk.⁷⁰³

From the researcher's point of view, it is important to have sharia boards in Islamic financial institutions. However, it is more important to have an effective sharia board that contains qualified members who can give their time and effort to study and monitor each product in order to give the right *Fatwa* and make sure that what is provided to the clients is the same product approved. As going to be discussed soon that some sharia boards may become one of the reasons to make clients lose confidence of the effectiveness of such boards.

So, a sharia board should have sufficient time and should be provided with enough knowledge of the reality of a product that is going to be approved, to avoid the risk of approving a product then revising and reversing the decision after it has been presented to the public, as this could deeply harm the reputation and the financial position of the institution. Such an incident did happen when the sharia scholar Abdullah Al-Mani withdrew his authorisation of a *Sukuk* that was issued by the Bahraini government after realising that there was an issue with the underlying assets of the *Alijara* (leasing) *Sukuk* when he found out that the possession of the underlying assets

⁷⁰¹ Hussain G. Rammal, 'The Importance of Sharia Supervision in Islamic Financial Institutions' (2006) 3 Corporate Ownership and Control.

⁷⁰² Hichem Hamza, 'Sharia Governance in Islamic Banks: Effectiveness and Supervision Model' (2013) 6 International Journal of Islamic and Middle Eastern Finance and Management 228 <<http://www.emeraldinsight.com/doi/pdfplus/10.1108/IMEFM-02-2013-0021>> accessed 2 May 2017.

⁷⁰³ Ibid.

was not entirely conveyed to the lessor in the manner stated in the leasing contracts according to Islamic commercial law.⁷⁰⁴

4.8 Sharia Board Requirements

It is important that the board has to have a real authority and independence in the financial institution to make sure that all products approved by the board are really compliant with sharia. This is crucial, as any negligence or manipulation of the credibility of sharia compliance could cause a severe risk to the financial institution or even to the whole Islamic financial services industry.⁷⁰⁵ Any ambiguity in the role of the sharia board can cause a problem; when there are no clear standards defining how a sharia board should perform its tasks, the work of sharia boards can be different from one financial institution to another.⁷⁰⁶

A study was made to find out the reaction of depositors in Islamic banks in both Bahrain and Sudan if they had discovered that their Islamic banks were found not to be complying with Islamic law. The result was that 86% of Bahraini depositors and nearly 95% of Sudanese depositors would be prepared to withdraw their money from their banks.⁷⁰⁷ This is why Islamic financial institutions have to be serious about this issue; also the government itself should make sure that customers of financial institutions will not be sold products as sharia-compliant when they are not to stop financial institutions of using “sharia compliant” as label for a marketing tool while they are not different than conventional finance that may offer better price. This can only be done by an authority that has the power over all financial institutions to implement regulations for this matter; this is usually a government authority such as a central bank or a Ministry of Finance or any other appropriate body in the country assigned to ensure sharia supervision according to defined standards.⁷⁰⁸

⁷⁰⁴ Ahmad Alkhamees, *A Critique of Creative Sharia Compliance in the Islamic Finance Industry* (Brill Nijhoff 2017) 191.

⁷⁰⁵ M. Fahim Khan, 'Setting Standards for Sharia Application in the Islamic Financial Industry' (2007) 49 Thunderbird International Business Review.

⁷⁰⁶ Mohammed Ali Ahmed, ' دور السلطات الرقابية فى الرقابة على المؤسسات المالية الإسلامية ' (The Role of The Supervisory Authorities in The Supervision of Islamic Financial Institutions)', The 2nd Conference of Islamic financial Services (2010).

⁷⁰⁷ Ahmad Alkhamees, *A Critique of Creative Sharia Compliance in the Islamic Finance Industry* (Brill Nijhoff 2017).

⁷⁰⁸ M. Fahim Khan, 'Setting Standards for Sharia Application in the Islamic Financial Industry' (2007) 49 Thunderbird International Business Review.

When a question was asked of interviewees as to whether Islamic financial institutions were taking advantage of not being supervised by SAMA or any government organisation with regards to sharia boards, most of those responding agreed that it was a disadvantage not to have specific regulations for Islamic finance; also, most of the interviewees agreed that SAMA or the Ministry of Finance has to bring in some laws and set standards for the sharia boards and its independence. Some of the interviewees gave more details.

For example, participant C in the interview said it was possible that in the short term some institutions may take advantage of having no extra controls over them, especially with regard to sharia governance, as in the meantime as there is no control on financial institutions regarding to sharia compliant, every financial institution could call any financial contract sharia-compliant whether it was really sharia-compliant or not. In this regard, some financial institutions may benefit from this aspect by using the word Islamic or sharia-compliant as a marketing tool without having any onus to prove this fact. Meanwhile when looking to the medium and long term, there is no doubt that financial institutions are affected, as their need for central bank intervention is essential to regulate and apply suitable sharia governance framework. He added that the current situation could affect customer confidence and this could affect the financial sector and the whole market.⁷⁰⁹

In this regard of the importance of customer confidence in the financial sector, Chris Gill stated that Customer confidence is paramount which could be damaged by miss-selling of financial products.⁷¹⁰ Trust plays a central role in the way in which financial services organisations present themselves to their customers.⁷¹¹ A study shows that the issue of trust in Islamic banking are compliant with sharia requirements, customer level of trust is be partly based on whether they believe that Islamic banks will fulfil its promises and guarantees of being sharia compliant.⁷¹²

⁷⁰⁹ Interview with participant C on 3 March 2015, Manama Bahrain.

⁷¹⁰ Chris Gill, 'Restoring Consumer Confidence in Financial Services' (2008) 26 *International Journal of Bank Marketing* 148.

⁷¹¹ Christine Ennew and Harjit Sekhon, 'Measuring Trust in Financial Services: The Trust Index' (2007) 17 *Consumer Policy Review* 62.

⁷¹² Mohammad Ziaul Hoq, Muslim Amin and Nigar Sultana Sultana, 'The Effect of Trust, Customer Satisfaction and Image on Customers' Loyalty in Islamic Banking Sector' [2011] *SSRN Electronic Journal* 84.

Customer confidence and the credibility of what is provided to customers is an area which faces very real risks of manipulation.⁷¹³ Those affected by this issue are the financial institutions including banks, the financial market, the customers and the Saudi economy as a whole which is affected by the lack of legislation, regulations and special instructions to govern the work of the Islamic financial institutions.⁷¹⁴

Participant A in the interview clarifies this in his answer: Islamic finance, especially Islamic banks, are regulated by SAMA by regulations that made for conventional banks, some of those rules actually harm the Islamic financial industry instead of being useful to it. In other words, SAMA applies the same rules that were made for conventional banks to Islamic financial institutions, even though in many cases the spirit and the uniqueness of Islamic finance would be spoiled. While there are no rules and standards in this area, which needs to be tackled in Islamic finance institutions.⁷¹⁵

He goes further that, in a way, with the current situation that Islamic finance is under regulations that made for conventional bank, less control from SAMA on Islamic finance could be an advantage for Islamic finance. This can be seen in the following scenario: if SAMA intervened and set regulations without consulting experts in this field, it may prevent sharia scholars and developers in Islamic finance from expanding their products to be closer to sharia. Sharia scholars might be affected by being put in a corner which could limit their creativity.

So, each time they come up with a new and alternative idea which can be more appropriate to sharia, they will be stopped as this may interfere with some of those regulations, and that will leave the sharia scholars with no choice and make them believe that all alternative ways to provide a financial product that is truly sharia-compliant are blocked. So, they may validate financial contracts that have great suspicion of not being sharia-compliant and very close to the conventional banks just because of the needs of people, as customers need to borrow and finance their money; this is indicated in the jurisprudential rule, that the general need can be counted as a necessity.⁷¹⁶

⁷¹³ Interview with participant C on 3 March 2015, Manama Bahrain.

⁷¹⁴ Ibid.

⁷¹⁵ Interview with participant A on 16 March 2015, Riyadh Saudi Arabia.

⁷¹⁶ Ibid.

Participant A, gave an example to show that regulations may limit the creativity in Islamic financial product such as charging fees on bank guarantees, as all sharia scholars, he said, agree that it is prohibited to do so; however people need to have a bank guarantees as it is required by the government in its tenders.⁷¹⁷ The bank guarantee contains a risk to the banks and the guarantee would transfer to the loan and the charging fee at the beginning is something extra to the loan, so it is *Riba*. He said there are alternative ways to make the bank guarantee letter sharia compliant: for instance, the bank can have a share in the project by a percentage, and then the bank can issue a letter of guarantee and take a profit on its share.

However Islamic financial institutions are prevented from doing this by SAMA as well as by conventional banks. So, some of the sharia boards have authorized the letter of guarantee if it does not lead to a loan, while other sharia boards have approved the letter of guarantee as it comes under the rule of necessity. Such regulations from SAMA made sharia boards approve things that should not have been approved where there is an alternative way of doing it.⁷¹⁸

Participant E in the interview also adds in his answer that as the financial institutions can choose the members of the sharia board and there are no standards or rules to be taken into account when electing the sharia members or even the number of members on a sharia board, it made it possible to find two financial institutions in the same street where one offers a financial contract as sharia-compliant while the other sees it as non-sharia compliant. This could reduce customer confidence in all Islamic financial products. Also, because there is no sharia governance, financial institutions may have an approved financial contract as sharia-compliant while what is provided to customers are different products that may contain sharia issues. Where as in some countries the financial institution has to provide an observer to review every financial contract made, to make sure that it is the same as the sharia board's approved version, this is called sharia audit. He added that in Saudi Arabia some sharia boards in financial institutions only meet once a month or less and there are no sharia observers. It is dependent on the financial institution, which leaves clients doubtful of the credibility of the products from the sharia point of view.⁷¹⁹

⁷¹⁷ Ibid.

⁷¹⁸ Ibid.

⁷¹⁹ Interview with participant E on 24 February 2015.

Also, participant B said with regard to this point that in the current situation, any financial institution can claim that all or some of its financial contracts are sharia-compliant and sharia approved, once one person, with no qualification needed, is appointed as a consultant or a member of a sharia board. However, no one has the right to question or intervene to verify his credibility and how and who has approved the products. This causes a problem and affects customer confidence in all the financial institutions that offer sharia-compliant products.⁷²⁰

On the other hand, SAMA deals with the same question, as it cares about the quality of the product and its conformity to the banking regulations such as stability, risk and liquidity, regardless of whether it is sharia-compliant or not, as this issue is a matter for the financial institution and their sharia bodies.⁷²¹

From the above, it can be seen that there is a gap between SAMA and the Islamic finance institutions regarding the use of sharia compliance as a label for a marketing tool. The problem is that there is no other governmental entity authorized to deal with this issue, as SAMA is in charge of everything related to financial institutions and if SAMA does not offer a solution, no one else can do so.

Again, the researcher can see the gap between the authority in SAMA, and the specialists in finance in general, and Islamic finance in particular, when SAMA answered another question that was asked about the reason why SAMA has no special regulations or standards for financial institutions that offer Islamic financial products, or why it should not at least adopt some of the standards and regulations that have already been made by international organisations that specialise in Islamic finance.

SAMA answered that its job is to provide a competitive environment according to free market mechanisms, so there is no discrimination in dealing with conventional banks, and financial institutions that comply with sharia.⁷²² Since SAMA has left the door open for the development of the financial contracts to the institutions, the responsibility of finding a financial contract that is sharia-compliant is on the financial institution.⁷²³ From this answer it can be seen that SAMA thinks that applying some standards to

⁷²⁰ Interview with participant B on 9 March 2015.

⁷²¹ Interview with participant D on 2 September 2015.

⁷²² Ibid.

⁷²³ Ibid.

ensure that financial institutions will not use Islam as a label to sell their products to customers, who might be willing to pay extra money for the sake of avoiding engaging in *haram* (prohibited action), is not important. However, leaving the door open for the financial institutions to call any financial contract sharia-compliant without control may allow some financial institutions to manipulate the *Fatwa* or at least its application that practise at the financial institution. It should not be forgotten that the majority of the population in Saudi Arabia are Muslims, as has been said before, and they believe that *Riba* is prohibited. Also, the government itself and SAMA as well prohibit *Riba* and any act that conflict with sharia.

Participant C said that SAMA is convinced that it should not interfere in this matter, and I support that; it should not interfere in this issue unless it has a qualified cadre of people who know enough about Islamic finance and are able to keep up to date the in this market, as this is not an easy job and it is a new job that SAMA need to do. But this does not mean that SAMA should stay as it is now; it can achieve some of its duties by cooperating with an external consultant to supervise sharia boards and other related issues until SAMA becomes ready to take over.⁷²⁴

In relation to this issue, participant B mentioned an event that happened in one of the meetings at the Islamic Banking Committee meeting, already mentioned in Chapter Three.⁷²⁵ One of the full-fledged Islamic banks presented a paper about a new financial product that was being studied before being introduced to its customers, but there were some sharia compliance issues and the sharia board and the development management sector in the bank could not find a way to make it Islamic compliant; this prevented the bank from introducing it yet.

So, the bank mentioned the financial product, through his member at the Islamic Banking Committee meeting, to get some advice from other banks on how to overcome this challenge.⁷²⁶ Participant B said that after a few months, one of the conventional banks introduced exactly the same product with the same issue to its customers and was marketing it as a sharia-compliant product! The problem is that everyone at the meeting agreed that there were problems in the financial contract with regard to sharia but no one had the ability to stop that bank from marketing this product

⁷²⁴ Interview with participant C on 3 March 2015, Manama Bahrain.

⁷²⁵ See **Error! Reference source not found.** above.

⁷²⁶ Interview with participant B on 9 March 2015, Riyadh Saudi Arabia.

as a sharia-compliant one.⁷²⁷ The researcher sees that such an incident shows that some financial institutions can destroy customer trust by marketing some products as sharia-compliant when they are not, just to get access to more customers which would have bad consequences for the whole Islamic finance market.

The lack of regulations governing sharia boards in financial institutions has caused a lack of credibility in Islamic financial products.⁷²⁸ For example Al-Osaimi said that he used to support the idea that SAMA allows conventional financial institutions to offer Islamic financial products even through some of its branches being modified to offer only sharia-compliant products. He said that he used to support the decision of allowing conventional institutions to offer Islamic financial products. However, after observing the results for more than 10 years, and the absence of regulations from SAMA for Islamic financial institutions, he was able to tell that the corruption came from the ability of the conventional institution to provide products that contained *Riba*, at the same time they called it in somehow sharia compliant.

As the Islamic financial products in conventional banks have not been used in a proper way giving Islamic finance a bad image and causing confusion to the customer,⁷²⁹ he said that he supported the view that SAMA should only approve Islamic banks, or at least segregate Islamic banks from conventional banks, so the latter could not provide Islamic finance products, and this has been done recently by some neighbouring countries such as Qatar and Kuwait.⁷³⁰

4.9 Challenges Facing Sharia Boards

From what have been discussed earlier, sharia boards have to have authority and independence in order to provide better financial contracts that can be called sharia-

⁷²⁷ Ibid.

⁷²⁸ Mohammad Ziaul Hoq, Muslim Amin and Nigar Sultana Sultana, 'The Effect of Trust, Customer Satisfaction and Image on Customers' Loyalty in Islamic Banking Sector' [2011] SSRN Electronic Journal 84.

⁷²⁹ Dr Muhammad Al Osaimi is an expert in Islamic banking who is a sharia board member in a number of financial institutions.

⁷³⁰ Fahad Al Sunaidy, Interview with Mohammad Al Osimi, 'The Difference between Islamic and Conventional Financial Institution' (26 October 2014). Available at <https://www.youtube.com/watch?v=_Y3mILMfZec> accessed 4 May 2017.

compliant. Al-Hussein,⁷³¹ explained how sharia boards in financial institutions can be pushed to provide doubtful sharia-compliant contracts.⁷³² Al-Hussein said that banks in general are only looking for profit and this is unfortunately what happens even to Islamic financial institutions.

The Islamic financial institutions derive their strength, which is the foundation of their survival, from sharia boards in their institutions. So, the sharia boards in the financial institutions have the power to correct their path to be real Islamic institutions if they have real independence. However, financial institutions are pushing sharia boards so hard to give *Fatwas* on financial contracts that are no different than the financial contracts in conventional financial institutions, which are mainly based on *Riba*, instead of putting the effort to provide real Islamic finance.⁷³³

Al-Hussein said that at the beginning when the government of Saudi Arabia allowed Islamic financial institutions especially Islamic banks to work, huge waves of liquidity were deposited by customers who were running away from *Riba* that were provided by conventional financial institutions. Islamic financial institutions were not prepared with suitable products to use with the huge influx of liquidity at that time, so the institutions resorted to their sharia boards to seek a way out of the impasse. So, sharia boards had to offer practical solutions, such as models based on the guarantee of capital and return. This was made on the basis of temporary solutions, as it was looked at as a necessity.⁷³⁴

Islamic banks have admired those products as they are not far from the ones practised in conventional banks and they were welcomed by SAMA, so Islamic financial institutions made such products the backbone of their work. Then Islamic banks began to develop similar products until they came to have a distinctive character.⁷³⁵ This situation became an effective factor in the reluctance of Islamic banks to completely experience and develop real Islamic transactions that take the banks far away from

⁷³¹ Sheikh Saleh al-Hussein was the President-General of the Affairs of the Two Holy Mosques, a member of the Council of Senior Scholars and Secretary-General of the King Abdulaziz Center for National Dialogue, who died in May 2013.

⁷³² Saleh Al-Hussein, 'الهيئات الشرعية الواقعية وطريق التحول لمستقبل أفضل' (Sharia Boards the Reality and a Way of Transition for a Better Future)' (2004) Islamic Business Researches Centre <<http://bit.ly/2nMfYTE> > accessed 4 June 2016.

⁷³³ Saleh Al-Hussein, 'الهيئات الشرعية الواقعية وطريق التحول لمستقبل أفضل' (Sharia Boards the Reality and a Way of Transition for a Better Future)' (2004) Islamic Business Researches Centre <<http://bit.ly/2nMfYTE> > accessed 4 June 2016.

⁷³⁴ Ibid.

⁷³⁵ Ibid.

the model of guaranteeing capital and return, to make an alternative finance to avoid the devastating result of being dependent on usury.⁷³⁶ Some banks take further steps to try to convince sharia boards to approve financial contracts that are close to the interest-bearing system and eliminate as much as possible the practical and sharia constraints that restrict them from the use of the interest system. Financial institutions will spare no effort to keep pushing their sharia boards to approve financial contracts that are similar to their conventional peers if there is no law or central sharia board that can direct the Islamic finance in the right way.⁷³⁷

This supports the argument of the researcher that Islamic finance, especially sharia boards, should have special laws and standards that control the number of members in sharia boards and the standard and qualifications which should be followed when electing them, then regulators have to insure the independency of the board and make more governance standards needed. Also, a Central Sharia Board, which will be further discussed soon,⁷³⁸ would be very helpful to reduce the irregularity in *Fatwas* among Islamic financial products in financial institutions, and also to provide more corporate governance in the Islamic financial institutions

4.10 Corporate Governance

Corporate governance has become an important concept in the past few decades due to the economic crises and financial declines which have been witnessed by many countries in their money markets and corporations.⁷³⁹ The global financial crisis has heightened interest in the relationship between the governance and performance of banks.⁷⁴⁰ Corporate governance can be defined as the structures and processes by which companies are directed and controlled.⁷⁴¹

Also it can be seen as a process of monitoring performance by applying appropriate counter-measures to deal with transparency, integrity and accountability.⁷⁴² Grassa

⁷³⁶ Ibid.

⁷³⁷ Ibid.

⁷³⁸ See 4.12 below.

⁷³⁹ Mohamed Alotaibi, 'The Importance of Corporate Governance in Saudi Arabia Economy' (2015) 4 Journal of WEI Business and Economics

⁷⁴⁰ Sabur Mollah and Mahbub Zaman, 'Shari'ah Supervision, Corporate Governance and Performance: Conventional vs. Islamic Banks' (2015) 58 Journal of Banking & Finance 418.

⁷⁴¹ 'Corporate Governance, an Overview' (*ifc.org*, 2017)

<http://www.ifc.org/wps/wcm/connect/Topics_Ext_Content/IFC_External_Corporate_Site/IFC+CG> accessed 22 March 2017.

⁷⁴² Hussein Elasrag, *Corporate Governance in Islamic Finance Basic Concepts and Issues* (Lap Lambert Academic Publishing 2014).

considers the corporate governance of Islamic financial institutions as a mechanism that provide all stakeholders with the credibility through greater transparency and accountability toward Islamic principles⁷⁴³ For businesses that offer sharia-compliant products, the corporate governance would look first at the structure of a transaction to find out whether the transaction contains elements that invalidate gains or profits, as sharia is not only concerned with the substance but also with the form of the transaction.⁷⁴⁴ Hussein Elasrage explained the important of corporate governance especially after the last financial crisis. He argued that all of the complex factors that are involved in balancing the power between the CEO (chief executive officer), the board of directors and shareholders became part of the corporate governance framework.⁷⁴⁵ He believes that Islamic financial institutions need corporate governance more than conventional banks as the former rely on depositors rather than inter-bank borrowing for their funding. Thus, need to have more credibility with their clients in order to gain their trust.⁷⁴⁶

In addition, sharia board in Islamic financial institutions is sharing the responsibility with the regular boards of directors and routine executive and other operational committees. Sharia boards in Islamic banks changes their governance to add additional layer which can be call “multi-layer” governance. Instead of the “single-layer” governance structure, which normally comprises of the board of directors and executive/ board subcommittees, in conventional banks.⁷⁴⁷

As has been mentioned in the earlier chapters ⁷⁴⁸ Islamic finance offers a different paradigm from conventional banking; it embodies a number of interesting features since equity participation, risk and profit-and-loss sharing arrangements form the basis of Islamic financing. These differences would imply different stakeholder relationships as stakeholder interests in Islamic financial institutions differ from those in the more

⁷⁴³ Rihab Grassa and Hamadi Matoussi, 'Corporate Governance of Islamic Banks: a Comparative Study between GCC and Southeast Asia Countries' (2014) 7 International Journal of Islamic and Middle Eastern Finance and Management.

⁷⁴⁴ Ibid.

⁷⁴⁵ Hussein Elasrag, *Corporate Governance in Islamic Finance Basic Concepts and Issues* (LAP LAMBERT Academic Publishing 2014) 56.

⁷⁴⁶ Ibid.

⁷⁴⁷ Sabur Mollah and Mahbub Zaman, 'Shari'ah Supervision, Corporate Governance and Performance: Conventional vs. Islamic Banks' (2015) 58 Journal of Banking & Finance 419.

⁷⁴⁸ See 2.2 also 2.9 and 3.5 and 4.7 above.

conventional ones.⁷⁴⁹ So, Islamic financial institutions are subject to an additional layer of governance as investment and financing suitability in Islamic financial institutions depend on the conformity with Islamic law and the expectations of the Muslim community.⁷⁵⁰

The IFSB define sharia governance system as a “set of institutional and organisational arrangements through which an Islamic financial institution ensures that there is effective independent oversight of sharia compliance over each of the following structures and processes”:⁷⁵¹ issuance of relevant sharia pronouncements, then dissemination of information on such sharia pronouncement. An internal sharia compliance review/audit for verifying that sharia compliance has been satisfied, which any incident of non-compliance will be recorded and reported, and as far as possible, addressed and rectified. Finally, an annual sharia compliance review/audit for verifying that the internal sharia compliance review/audit has been appropriately carried out and its findings have been duly noted by the Sharia board.⁷⁵²

Different countries and international organisations have set standards for corporate governance for Islamic businesses. For example, AAOIFI has set seven standards for Islamic Financial Institutions,⁷⁵³ Such as Sharia Supervisory Board: appointment, composition and report. Audit and governance committee for Islamic financial institutions, and corporate social responsibility conduct and disclosure for Islamic financial institutions.⁷⁵⁴ The IFSB issued four standards as well,⁷⁵⁵ such as Competence, independence and Confidentiality.⁷⁵⁶

Countries deal with sharia governance in different ways; some countries adopt a centralised model, where the Central Bank itself has its own sharia supervisory board which is the top of the sharia boards in the financial institutions. For instance, Malaysia and Pakistan are good examples of this type.

⁷⁴⁹ Sohail Jaffer, *Islamic Wealth Management: A Catalyst for Global Change and Innovation* (Euromoney Books 2009).

⁷⁵⁰ Ibid.

⁷⁵¹ 'Guiding Principles on Sharia Governance Systems for Institutions Offering Islamic Financial Services' (IFSB, 2009) <<http://www.ifsb.org/published.php>> accessed 30 September 2017.

⁷⁵² Ibid.

⁷⁵³ 'Accounting and Auditing Organization for Islamic Financial Institutions' (AAOIFI, 2017) <<http://aaoifi.com/standard/shariah-standards/?lang=en>> accessed 30 September 2017.

⁷⁵⁴ Ibid.

⁷⁵⁵ 'Guiding Principles on Sharia Governance Systems for Institutions Offering Islamic Financial Services' (IFSB, 2009) <<http://www.ifsb.org/published.php>> accessed 30 September 2017.

⁷⁵⁶ Ibid.

On the other hand, a decentralized model is where the financial institution is in charge of the whole sharia governance. This type used to be the model in the GCC countries;⁷⁵⁷ however, the researcher would draw the attention that with new development the majority of the GCC countries are moving to the centralised model to have better sharia governance. A number of countries would be introduced to show the way used to achieve the best result to reach better sharia governance.

4.11 Recent Developments in the UK and the GCC Countries towards Sharia Governance

This section will introduce examples of some countries that have interest in Islamic finance showing the way used to achieve the best result to reach better sharia governance. Some of those examples could be the remedy to the current situation in Saudi Arabia. First country would be introduced is considered the hub of Islamic finance in Europe while the other countries are the neighbouring countries to Saudi Arabia which share many common principles such as religion and level of economy. Those examples would be used for ideas for reform to the current practise in Saudi Arabia.

4.11.1 The United Kingdom

As mentioned earlier, Islamic finance has recently undergone tremendous growth worldwide, including the UK, gaining an important recognition from international financial centres.⁷⁵⁸ This success can be viewed as the gateway for Islamic finance to enter the whole of Europe.⁷⁵⁹ Thus the UK is chosen to show the way sharia governance is applied. Islamic finance has been accepted in the UK for several reasons including the need for the large domestic Muslim minority in the UK to have access to financial services and marketplaces that are compliant with their religious beliefs, as there was a noticeable absence of Muslim citizens in financial institutions.

⁷⁵⁷ Nor Razinah Binti Mohd Zain, Izyan Farhana Binti Zulkarnain and Prof. Dr. Rusni Hassan, 'Sharia Corporate Governance Structure of Malaysian Islamic Banking and Finance: The Traces of Shura' (2015) 3 Journal of Islamic Banking and Finance.

⁷⁵⁸ Rodney Wilson, '*Islamic Finance in Europe*' (European University Institute 2007).

⁷⁵⁹ Ibid.

Studies show that two out of ten of the minority groups in the UK do not engage in any financial institutions. Most of these citizens are of Pakistani or Bangladeshi origin.⁷⁶⁰

In addition, London has always accommodated and responded flexibly to any new ideas of finance since the seventeenth century.⁷⁶¹ A number of international institutions, like Deutsche Bank, ABC International Bank and Citi Bank already have branches in Muslim countries, which is also helping them to gain an insight into the functioning of the Islamic market.⁷⁶²

In addition to that, some of these institutions have accepted some of the Islamic finance contracts and opened Islamic windows.⁷⁶³ This could contribute to develop Islamic products because the UK is a major global provider of the specialist legal expertise which can be used to improve the Islamic products.⁷⁶⁴ Six fully sharia-compliant banks have been licensed in the UK,⁷⁶⁵ with total assets of \$3.6 billion at the end of 2014 while about twenty banks offer Islamic finance services, thereby making the UK the leader in Islamic banking in the West.⁷⁶⁶ A number of rich Muslim countries including the Gulf Cooperation Council (GCC) countries have enormous liquidity surpluses needing to be financed, and that has encouraged conventional institutions including the UK institutions to adopt contracts which comply with sharia to attract this large share of capital. An example of this is the acquisition of Aston Martin by two Kuwaiti financial institutions via sharia-compliant financing.⁷⁶⁷

In the 1990s, retail Islamic products started to appear in the UK on a very small scale, with simple products like home finance being offered by a small number of banks from South-East Asia and the Middle East, although these could not be compared with the

⁷⁶⁰ Jonathan Ercanbrack, 'The Regulation of Islamic Finance in the United Kingdom' (2011) 13 Ecclesiastical Law Journal.

⁷⁶¹ Michael Ainley and others, 'Islamic Finance in the UK: Regulation and Challenges' (Financial Services Authority 2007) <http://www.fsa.gov.uk/pubs/other/islamic_finance.pdf> accessed 2 April 2015

⁷⁶² World Islamic Economic Forum (WIEF), 'Leading Western Centre for Islamic Finance' (DDCAP Limited 2015) <<https://www.thecityuk.com/assets/2015/Reports-PDF/The-UK-Leading-Western-Centre-for-Islamic-Finance.pdf>> accessed 25 April 2016.

⁷⁶³ Ahmed Belouafi and Abdelkader Chachi, 'Islamic Finance in the United Kingdom: Factors Behind its Development and Growth' (2014) 22 Islamic Economic Studies 53.

⁷⁶⁴ Ibid.

⁷⁶⁵ Ibid.

⁷⁶⁶ World Islamic Economic Forum (WIEF), 'Leading Western Centre for Islamic Finance' (DDCAP Limited 2015) <<https://www.thecityuk.com/assets/2015/Reports-PDF/The-UK-Leading-Western-Centre-for-Islamic-Finance.pdf>> accessed 25 April 2016.

⁷⁶⁷ Michael Ainley and others, 'Islamic Finance in the UK: Regulation and Challenges' (Financial Services Authority 2007) 8 <http://www.fsa.gov.uk/pubs/other/islamic_finance.pdf> accessed 2 April 2015.

products available from conventional banks at that time. During that period, the majority of the products offered by Islamic finance did not fit the regulatory frameworks, which resulted in less protection being offered to their consumers.⁷⁶⁸ In 1995, the Governor of the Bank of England, Lord Edward George, recognized the importance of Islamic banking and “the need to put Islamic banking in the context of London’s tradition of competitive innovation.”⁷⁶⁹ This limited range of Islamic products remained unchanged for approximately five more years, and then in 2000s a noticeable improvement could be observed in the availability of both wholesale and retail products. This was because the UK government has taken major steps to help grow different kinds of finance, including Islamic finance, such as through the removal of important barriers to trade. This began with certain tax and legislative changes being implemented to help Islamic finance in the first decade of the 21st century. For example, the Finance Act 2003 offered a way to avoid multiple payments of Stamp Duty and Land Tax on Islamic mortgages, which was almost destroying the business at that time. The Finance Acts 2005 and 2006 then equalised the tax owed by certain Islamic products compared to their conventional counterparts. The Finance Act 2007 provided a tax framework for *Sukuk*, a key product of Islamic finance.⁷⁷⁰

This resulted to various kinds of products became available, with a higher level of quality, attracting new customers to join the market and making London an important global centre for Islamic finance.⁷⁷¹

It should be noted that because of the absence of a predetermined return called interest in Islamic banking, it were treated as “alternative financial investments” and was regulated under the Financial Services Authority (FSA)⁷⁷² which was replaced in 2013 by the Financial Conduct Authority (FCA).⁷⁷³ Some Islamic banks are already

⁷⁶⁸ Ibid 6.

⁷⁶⁹ Ibid 8.

⁷⁷⁰ Michael Ainley and others, 'Islamic Finance in the UK: Regulation and Challenges' (Financial Services Authority 2007) 10 <http://www.fsa.gov.uk/pubs/other/islamic_finance.pdf> accessed 26 March 2015.

⁷⁷¹ Ahmed Belouafi and Abderrazak Belabes, 'Islamic Finance in Europe: The Regulatory Challenge' (2010) 17 *Islamic Economic Studies* 43.

⁷⁷² Jonathan Ercanbrack, 'The Regulation of Islamic Finance in the United Kingdom' (2011) 13 *Ecclesiastical Law Journal*.

⁷⁷³ Ahmad Alkhamees, *A Critique of Creative Sharia Compliance in the Islamic Finance Industry* (Brill Nijhoff 2017).

established in the UK, such as the Islamic Bank of Britain which was authorised in 2004, as well as the Bank of London and the Middle East authorised in 2007.⁷⁷⁴

In addition, Her Majesty's Treasury (HM Treasury) the Islamic Expert Group and HM Revenue and Customs (HMRC) were able to advise the government on how to best support the development of Islamic finance in the UK.⁷⁷⁵ The FSA was the body in charge of the regulation and authorisation of all financial services in the UK; this includes authorising Islamic financial institutions. The FSA applied conventional regulatory criteria and product definitions; while, Islamic banks are different from their conventional counterparts as they are supervised by sharia supervisory boards which have been developed over centuries of Islamic jurisprudence.⁷⁷⁶ This raised some certain legal concerns, such as *Mudaraba* agreement. In Islamic bank, clients can deposit their money to the bank in different ways, it can be only for saving, current accounts, or can be as *Mudaraba* agreement⁷⁷⁷ which entails sharing the losses and profits. In this agreement the client has to accept the loss in order to gain the possible return.⁷⁷⁸ Under UK law, an Islamic bank is legally obliged to repay the amount deposited in full, which is against the sharia law as the parties are regarded as sharing the risk.⁷⁷⁹ Thus Islamic Bank of Britain, which provide that if the pooled funds referable to the deposit return a loss, the bank will offer to make good the amount of any shortfall in the depositor's capital.⁷⁸⁰

The current FCA is not much different from the FSA with regard to Islamic finance.⁷⁸¹ Therefore, all contracts and products in Islamic banks are created by merging a series of classical Islamic contracts together so as to comply with the conventional regulatory system and to be highly competitive in global financial markets.⁷⁸² However, it is

⁷⁷⁴ Yusuf Karbhari, Kamal Naser and Zerrin Shahin, 'Problems and Challenges Facing the Islamic Banking System in the West: the Case of the UK' (2004) 46 *Thunderbird International Business Review*.

⁷⁷⁵ Jonathan Ercanbrack, 'The Regulation of Islamic Finance in the United Kingdom' (2011) 13 *Ecclesiastical Law Journal* 70.

⁷⁷⁶ *Ibid.*

⁷⁷⁷ See 2.9.1 above.

⁷⁷⁸ Abdul Karim Aldohni, *The Legal and Regulatory aspects of Islamic Banking: A Comparative Look at the United Kingdom and Malaysia* (Routledge 2011) 158.

⁷⁷⁹ Sir William Blair, 'Publication Review the Legal and Regulatory Aspects of Islamic Banking * By Abdul Karim Aldohni' (2013) 2 *Journal of Business Law* 263.

⁷⁸⁰ *Ibid.*

⁷⁸¹ Ahmad Alkhomees, *A Critique of Creative Sharia Compliance in the Islamic Finance Industry* (Brill Nijhoff 2017) 193.

⁷⁸² Jonathan Ercanbrack, 'The Regulation of Islamic Finance in the United Kingdom' (2011) 13 *Ecclesiastical Law Journal* 70.

difficult to apply conventional regulatory criteria to Islamic banks because the latter cannot accept or take *ghara* and interest in their transactions. For example, derivatives are not accepted as they contain both of the forbidden acts in Islam while attempting to make value from real tangible assets. For that reason, Islamic finance is treated by the UK government as “alternative financial investments”.⁷⁸³ The FSA stated that all authorised financial institutions or those seeking to operate in the UK are subject to the same standards and no financial system can earn special treatment to the detriment of others. Thus, “the government espouses a religiously ‘neutral’ position predicated on the establishment of a ‘level playing field’ for Islamic finance that is not distorted by tax and regulatory laws originally conceived for the conventional, interest-based system.”⁷⁸⁴

Therefore, since 2003 “alternative financial instruments” have been used to refer to general Islamic financial products in all legislative amendments to Acts of Parliament containing both finance and regulatory provisions. Also, “alternative investment bonds” refer to Islamic bonds known as *Sukuk*.⁷⁸⁵

Furthermore, the FSA and FCA have not set special regulations to ensure that the Islamic finance contracts which would be regulated under the alternative financing instruments are really sharia compliant. This relates to interpretations of sharia law, which can be done by the Sharia Supervisory Board who can examine products and transactions. Indeed, as the FCA is a secular, not a religious regulator, it cannot judge between different interpretations of sharia. Thus, the role of the FCA is merely to ensure that these kinds of products can be regulated under its regulations. Whereas, Alkhamees stated that the Muslim Council of Britain (MCB) complained about some Islamic financial institutions which provide products that claimed to be sharia-compliant without reassuring its clients that such products are really sharia-compliant.⁷⁸⁶ In the UK regulators are not concerned at all about sharia compliance and matter is completely delegated to the Islamic finance institution to select the

⁷⁸³ Jonathan Ercanbrack, 'The Regulation of Islamic Finance in the United Kingdom' (2011) 13 Ecclesiastical Law Journal.

⁷⁸⁴ Ibid.

⁷⁸⁵ Ibid.

⁷⁸⁶ Ahmad Alkhamees, *A Critique of Creative Sharia Compliance in the Islamic Finance Industry* (Brill Nijhoff 2017).

framework suitable for them.⁷⁸⁷ Also the corporate governance standards which are set for conventional industry is also followed by Islamic banks which means again that the sharia board is under complete control of the financial institution.⁷⁸⁸

The MCB suggested that Islamic finance transparency standards should be made by regulators to Islamic financial institutions to give more assurance to that customers are provided genuine sharia-compliant. Alkhamees suggests that the FCA should enforce sharia governance on Islamic financial institutions to ensure the products are sharia compliant.⁷⁸⁹

As a result, nowadays Islamic finance does not exist only in Muslim countries, but has spread all over the world, so that many countries are now trying to understand and regulate such finance and use these financing tools to help their economy grow.

4.11.2 Oman

Oman recently engaged with Islamic finance through its Central Bank after a Royal Decree amended the Banking Law of 2000.⁷⁹⁰ It is considered the latest Arab county to enter the field of Islamic banks.⁷⁹¹ The Central Bank made a special Regulatory framework for Islamic banking. This framework was divided into ten titles. This framework applies the standards of international financial institution AAOIFI (the Accounting and Auditing Organization for Islamic Financial Institutions) in many respects such as on the accounting and auditing standards and the way financial reporting is prepared.⁷⁹² In addition for the matters where there are no relevant standards in existence, the International Financial Reporting Standards (IFRS) are applied.⁷⁹³

In Oman no Islamic products or services shall be offered through conventional branches.⁷⁹⁴ An Islamic window shall only operate through separate Islamic banking

⁷⁸⁷ Asad Khan and others, 'Comparative Analysis of Regulatory and Supervisory System of Islamic Banks: Evidence from Pakistan, Malaysia, Bahrain And United Kingdom' (2015) 6 Mediterranean Journal of Social Sciences 636.

⁷⁸⁸ Ibid.

⁷⁸⁹ Ahmad Alkhamees, *A Critique of Creative Sharia Compliance in the Islamic Finance Industry* (Brill Nijhoff 2017).

⁷⁹⁰ Royal Decree 69/2012 issued on 6th December 2012 Oman.

⁷⁹¹ Amel Kamel Abdallah, 'البنوك الإسلامية في سلطنة عمان بين دعم ورقابة البنك المركزي' (Islamic Banks in Sultanate of Oman, Support and Supervision of Central Bank)' (2016) 13 Revue Elmofaker, Mohamed Khaidar University, Biskra, Algeria 27 <<https://ssrn.com/abstract=2777123>> accessed 20 January 2018.

⁷⁹² Central Bank of Oman, 'Islamic Banking Regulatory Framework' (Central Bank of Oman 2012).

⁷⁹³ Central Bank of Oman, 'Islamic Banking Regulatory Framework' (Central Bank of Oman 2012).

⁷⁹⁴ Ibid No. 3.13.9.

branches and they shall be dedicated to offering Islamic products and services only. Foreign licensees shall also comply with this.⁷⁹⁵ In addition, the Central Bank announced the formation of the High Sharia Supervisory Authority and its structure,⁷⁹⁶ and the first meeting was in 2015.⁷⁹⁷

With regards to corporate governance for Islamic banks and Islamic “windows” in Oman, they must follow the Corporate Governance rules given in the Islamic Banking Regulatory framework; also, they should follow the Code of Corporate Governance by the Omani-Capital Market Authority.⁷⁹⁸ So, an Omani Islamic bank has extra especial Corporate Governance to ensure there is transparency and protection of the rights of all parties engaged with such finance.

The Islamic banking framework states that the minimum number of members in a sharia supervisory board is to be three.⁷⁹⁹ These members have to be specialised in Islamic commercial jurisprudence. However, one or more non-voting members may be included if they have expertise in related areas to Islamic banking such as finance, economy accounting, law, etc. with the condition that they have a basic knowledge of Islamic commercial jurisprudence.⁸⁰⁰

Also the Regulatory framework states that the sharia supervisory board has to be independent, objective, competent and appropriately empowered to carry out its responsibilities.⁸⁰¹ It also states that essential measures shall be taken to guarantee that the sharia supervisory board not only works independently, but is also seen to be independent by the stakeholders including the general public.⁸⁰² The researcher believes this is an important matter that Saudi Arabia needs to do, to make sure the independence of the sharia supervisory board is achieved and can be recognised as such by the public as going to be discussed soon.⁸⁰³

⁷⁹⁵ Ibid No. 3.13.7.

⁷⁹⁶ Oman Central Bank, 'Establishing and Organizing the High Sharia Supervisory Authority in the Central Bank of Oman Regulation No. BM/54/12/2013' (Central Bank 2013).

⁷⁹⁷ Central Bank of Oman Press Release, 'High Sharia Supervisory Authority Holds Its First Meeting' (16/3/2015) <<http://www.cbo-oman.org/Year2015NewsArchive.htm>> accessed 30 September 2017.

⁷⁹⁸ Central Bank of Oman, 'Islamic Banking Regulatory Framework' (Central Bank of Oman 2012) No 3.1.1.

⁷⁹⁹ Ibid No 2.2.1.3.

⁸⁰⁰ Ibid No 2.2.1.2.

⁸⁰¹ Ibid No 2.2.4.2.

⁸⁰² Ibid.

⁸⁰³ See 4.12 below.

Banking sector analysts say that, even with the recent establishment of Islamic banks in Oman and the problems that usually faces new finance when first starting, the market share of Islamic banking has jumped from 5.1 per cent of the banking system's overall assets in 2015 to 10.8 per cent by February 2017.⁸⁰⁴

4.11.3 Kuwait

In December 2016 the Kuwait Central Bank issued instructions on sharia supervisory governance for Kuwait Islamic Banks. The new instructions replace the Rules and Conditions for the Appointment and Responsibilities of the Sharia Supervisory Board in Islamic Banks issued on June 2003 and they complement the instructions relating to the Rules & Standards of Corporate Governance in Kuwaiti Banks issued in 2012.⁸⁰⁵ The new instructions are guided by the IFSB and the AAOIFI and some instructions issued by other Central Banks relating to Islamic finance.⁸⁰⁶

The Sharia Board has to submit its report to the General Assembly to ensure the implementation of the decisions issued by them and the activities of the executive management.⁸⁰⁷ The minimum number for a sharia board is three members; those members are nominated by the General Assembly after a recommendation from the Board of Directors.⁸⁰⁸ A member of the sharia board has to have at least a degree in sharia with a specialty in Islamic commercial jurisprudence, or he or she is to be a well-known sharia scholar in Islamic commercial jurisprudence.⁸⁰⁹ In addition, there are eleven clauses related to the nomination and the terms of references of the sharia board. One of them is that a sharia scholar can only be a member of three sharia

⁸⁰⁴ Staff Report, 'Islamic Banking Gains Significant Market Share in Oman' (*GulfNews*, 2017) <<http://gulfnews.com/business/sectors/banking/islamic-banking-gains-significant-market-share-in-oman-1.2041880>> accessed 28 July 2017.

⁸⁰⁵ Central Bank of Kuwait, 'Press Release: CBK Issues Instructions on Sharia Supervisory Governance for Kuwaiti Islamic Banks' (2016) <<http://www.cbk.gov.kw/en/cbk-news/announcements-and-press-releases/press-releases.jsp?kcp=o8QTtSFuP5lx5WoYWwE74iHAhdgkIQ==>> accessed 25 October 2017 also see Danah Al-Doaig, 'أول دراسة: حوكمة الرقابة الشرعية: نعم أو لا' (A Study about Governance of Sharia Supervision: Yes or No) *Alqabas* (15 January 2017) <<http://alqabas.com/346167/>> accessed 29 October 2017.

⁸⁰⁶ Central Bank, 'Instructions on Sharia Supervisory Governance for Kuwaiti Islamic Banks' (Central Bank of Kuwait 2016).

⁸⁰⁷ *Ibid* 2.5.

⁸⁰⁸ *Ibid* 3.1.1A.3.

⁸⁰⁹ *Ibid* 3.3.

boards in Kuwait. Also, no one from the board of directors, executive management or a shareholder with effective influence can be a member of the sharia board.

The minimum number of meetings of the sharia board is four a year. Decisions of the sharia board are binding and must be adhered to by the bank. A member of the sharia board cannot be dismissed until the decision has consulted with the sharia board and has been provided with the reasons for dismissal, and then has asked the General Assembly to have the final word.⁸¹⁰ Also, for more independence of the sharia board, six further instructions have been stated such as: there must be no close family member or partner relationship with any of the board of directors or executive management; a member of the sharia board cannot be a permanent employee in the bank; and the member shall not accept any reward from the bank or affiliated company except the official reward for his job.⁸¹¹

An internal sharia audit department should be working under the supervision of the sharia board, the former should periodically submit a report and observations to the sharia board including all activities in the financial institutions, as the sharia board is required to disclose sufficient information about the bank's compliance with the provision of sharia in the annual report of the bank.⁸¹² (See *Figure 3*) In addition, an external sharia audit office is required to be assigned by the general assembly.⁸¹³

⁸¹⁰ Ibid 3.1.3.3.

⁸¹¹ Ibid 3.2.3.

⁸¹² Ibid 3.1.3.2.

⁸¹³ Ibid 4.1.

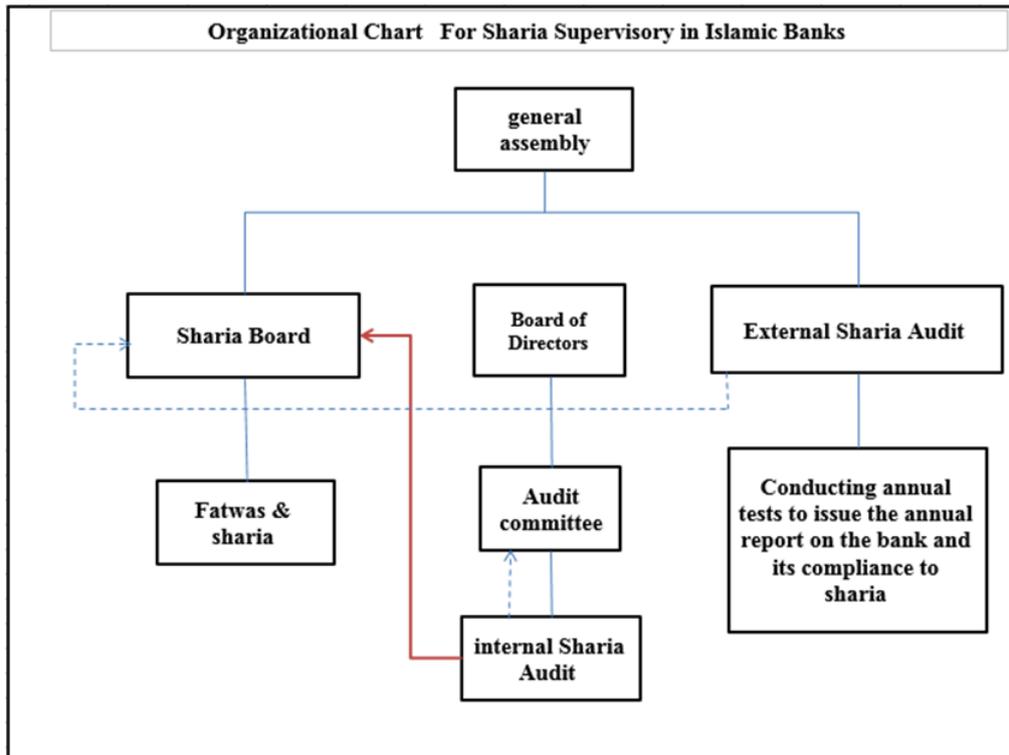


Figure 3: Kuwait Organizational Chart for Sharia Supervisory in Islamic Banks ⁸¹⁴

4.11.4 United Arab Emirates

A recent development in the UAE towards a better Islamic finance environment and better corporate governance took place on 31st of May 2017 when the Cabinet approved the formation of the Higher Sharia Board for Banking and Finance. The Higher Sharia Board is to strengthen the consistency of the Islamic financial industry across the UAE.⁸¹⁵ The Board will have the authority for setting rules, standards and general principles for banking and financial activities that comply with Islamic laws, alongside setting a general framework for Islamic governance and *Fatwa* issuance on matters highlighted by the Central Bank or other financial institutions in the country.⁸¹⁶ The Higher Sharia Board is already stated in the Federal Law No- 6 of 1985 that the

⁸¹⁴ Central Bank of Kuwait, 'Governance Instruction for Islamic Banks' (Central Bank of Kuwait 2016). <<http://www.cbk.gov.kw/en/images/Governance-Instruction-Islamic-Banks---AR-11-122719-1-10-122719-3.pdf>> accessed on 12/08/2017.

⁸¹⁵ 'News of The UAE Cabinet' (*United Arab Emirates the cabinet*, 2017) <<https://uaecabinet.ae/en/details/news/uae-cabinet-convenes-in-ramadan-and-approves-the-establishment-of-both-uae-council-for-fatwa-and-sharia-board-for-banking-and-finance>> accessed 31 May 2017.

⁸¹⁶ 'News of The UAE Cabinet' (*United Arab Emirates the cabinet*, 2017) <<https://uaecabinet.ae/en/details/news/uae-cabinet-convenes-in-ramadan-and-approves-the-establishment-of-both-uae-council-for-fatwa-and-sharia-board-for-banking-and-finance>> accessed 31 May 2017.

Higher Sharia Authority shall be formed by cabinet decision.⁸¹⁷ Even though this Higher Sharia Authority has been part of the law for more than 30 years it has only just been approved, after the increase in the number of financial institutions that offer Islamic finance and the challenges that this sector is facing, such as less governance control, and the conflict concerning *fatwas* among the different financial institutions causing confusion for customers.

4.11.5 Qatar

In 2011 the Central Bank of Qatar placed a ban on conventional banks offering Islamic financial products, even though their Islamic branches, so Islamic finance was only offered by Islamic financial institutions.⁸¹⁸

The Central Bank provided some reasons for this action: applying oversight instruments and prudent ratios and indexes for risk management is complicated when you have such different banking systems; also, there was the complexity of applying unified capital adequacy standards; and the prejudice emerging from the nature of competition between the banks and their transparency levels and the different level of governance needed to be applied for each one.⁸¹⁹

This was followed by an updating of the law of the Central Bank in 2012; the new Qatar Central Bank Law and the Regulation of Financial Institutions replaced the previous QCB Law No 33 of 2006. The new law provides a chapter for Islamic financial institutions, as the previous law did not differentiate between Islamic and conventional financial institutions.⁸²⁰ The new law states that a sharia board has to be created in every Islamic financial institution. The minimum number of members in a sharia board is three and they have to be nominated by the General Assembly of the financial institution. Each member of the sharia board is prohibited from performing any function in the Islamic financial institution or rendering services or being a contributor to it, nor

⁸¹⁷ Article 5 of the UAE Federal Law No- 6 of 1985 Regarding Islamic Banks, Financial Institutions and Investment Companies 1985.

⁸¹⁸ Central Bank of Qatar, 'Islamic Branches of Conventional ("Commercial") Banks' (2011) <http://www.qcb.gov.qa/english/news/pages/islamicbranchesofcommercialbank_pr.aspx> accessed 11 September 2017.

⁸¹⁹ Karim Shiyab, 'Closing Islamic Branches of Qatari Commercial Banks' (Tamimi.com, 2011) <<http://www.tamimi.com/en/magazine/law-update/section-7/april-6/closing-islamic-branches-of-qatari-commercial-banks.html>> accessed 11 September 2017.

⁸²⁰ Chapter 3 of Qatar Central Bank Law and Regulation of Financial Institutions 2012.

may he or his relatives to the fourth degree have any personal interest in the Islamic financial institution.⁸²¹

4.11.6 Bahrain

Recently, towards the end of 2016, the government of Bahrain set up a Centralised Sharia Supervisory Board. The Central Bank of Bahrain carried out extensive consultation with the industry and the Centralised Sharia Supervisory Board released a new Sharia Governance Module which will be effective from 30th June 2018.⁸²² The new Sharia Governance Module states that independent external sharia compliance audit will become mandatory for financial institutions that offer sharia-compliant products.⁸²³

Also the new Sharia Governance Module declares that the sharia governance structure of Islamic banks must consist of four important elements: a sharia board, a sharia coordination and implementation function, an internal sharia audit function and an external independent sharia-compliant audit.⁸²⁴ The new sharia governance shows the relationship between a sharia board in a financial institution and the Centralised Sharia Supervisory Board as: 1- In all cases, Bahraini Islamic bank licensees must comply with the sharia pronouncements and opinions issued by the Centralised Sharia Supervisory Board. 2- In case of a conflict between the opinion or interpretation of the Centralised Sharia Supervisory Board and the sharia board of the Bahraini Islamic bank licensee with respect to any sharia matter, the opinion of the Centralised Sharia Supervisory Board shall prevail.⁸²⁵

⁸²¹ Article 107 of Qatar Central Bank Law and Regulation of Financial Institutions 2012.

⁸²² Bahrain issues Landmark Regulations of Sharia Governance 9 September 2017.

⁸²³ 'Central Bank of Bahrain - Bahrain Issues Landmark Regulations on Sharia Governance' (*Central Bank*, 2017) <http://www.cbb.gov.bh/sv/page-p-bahrain_issues_landmark_regulations_on_sharia_governance.htm> accessed 9 September 2017.

⁸²⁴ Bahrain issues Landmark Regulations of Sharia Governance 9 September 2017.

⁸²⁵ Central Bank of Bahrain, 'Volume 2: Islamic Banks Sharia Governance Module' (Central Bank 2017) SG-2.10.

4.11.7 Saudi Arabia

The recent Principles of Corporate Governance for Banks Operating in Saudi Arabia was issued by SAMA on March 2014.⁸²⁶ It has not mentioned anything in its principles that relates to sharia compliance or a sharia board, and how to guarantee the compliant of the product in the Islamic banks to sharia. The Saudi Corporate Governance for Banks gives guide for the boards of directors including their qualifications, composition and appointment, and their responsibilities also for setting up Board of Directors' Committees⁸²⁷ but it has not mentioned anything about the sharia board, for example its independence or at least some principles or guidance to distinguish between Islamic financial products and others if it claimed to be sharia compliant.

Even the Audit Committee that is mentioned in this guide gives in detail the instructions for monitoring and reviewing the effectiveness of the internal audit activities, making recommendations to the board of directors on the appointment, reappointment and changing of the external auditors and ensuring their independence, studying accounting policies and reviewing the external auditors' plan related to financial statements, safeguarding the bank's assets, reviewing related parties' transactions and ensuring that such transactions are recorded and disclosed appropriately.⁸²⁸ But it does not highlight the need to review the transaction from the sharia-compliant side. This is very important as it is one of the major characteristics of Islamic financial institutions. The claim that products of a financial institution are sharia-compliant is an important reason for their huge success and popularity, especially in Saudi, as Islam is the religion of the country.

Thus, failing to regulate and apply an extra layer of corporate governance for Islamic financial institutions, would open the door for some of the financial institutions to manipulate this issue which would rock the shareholders' and customers' confidence in all the Islamic financial institutions. This may lead to what is called an Islamic bank run as depositors in Islamic banks might withdraw their money not mainly out of fear of losing their money, but out of concern of being tricked by being offered non- sharia-

⁸²⁶ The Principles of Corporate Governance for Banks Operating in Saudi Arabia 2014.

⁸²⁷ Principle 1,2 and 3 of the Principles of Corporate Governance for Banks Operating in Saudi Arabia issued on 19th March 2014.

⁸²⁸ Principle 4 (Audit Committee) of the Principles of Corporate Governance for Banks Operating in Saudi Arabia issued on 19th March 2014.

compliant products. Sharia compliance is one of the key motivations for dealing with an Islamic bank in the first place.⁸²⁹

In this regard basic rules such as the minimum number of members on sharia boards are not discussed in the Principles of Corporate Governance for Banks Operating in Saudi Arabia or anywhere else. As Grassa said, the number of members in a sharia board in Malaysia has to be at least five sharia scholars. However, the Bahraini law and other GCC countries require at least three sharia scholars; nevertheless, there are no specific requirements in Saudi Arabia.⁸³⁰ Also the qualification needed before electing a member of sharia board is not mentioned, whereas it is required for other board such as the members of the board of directors as mentioned earlier.⁸³¹

It can be seen that there is a recent fast movement to achieve better Islamic finance markets in many countries in the GCC who share a more or less similar environment with regards to religion, society, the economy and the type of customer requirements and needs. Almost all the GCC countries adopted an additional layer of governance to the one provided for conventional finance which is the special governance for Islamic financial institutions; also, the Central Sharia Supervisory Boards are issued or are in the process of being issued in some of the GCC countries.

However, even though Saudi Arabia is also moving fast and updating its regulations for its finance in general, not much progress can be seen towards Islamic finance. The ignorance from SAMA towards Islamic banks still existed. As discussed earlier in Chapter Three⁸³² that at the beginning of the establishment of the banking activates in Saudi Arabia and the establishment of SAMA, Islamic law was not followed by SAMA even though it should be followed as its Charter stated.⁸³³ That might be justified at that time as there was no strong example of Islamic banks. Thus, SAMA regulates banks based on conventional banks. But this situation has changed and Islamic banks

⁸²⁹ Ahmad Alkhamees, *A Critique of Creative Sharia Compliance in the Islamic Finance Industry* (Brill Nijhoff 2017).

⁸³⁰ Rihab Grassa and Hamadi Matoussi, 'Corporate Governance of Islamic Banks: a Comparative Study between GCC and Southeast Asia Countries' (2014) 7 *International Journal of Islamic and Middle Eastern Finance and Management*.

⁸³¹ Principle 1,2 and 3 of the Principles of Corporate Governance for Banks Operating in Saudi Arabia issued on 19 March 2014.

⁸³² See 3.5 above.

⁸³³ See 3.4.2 above.

do exist and regulate in many countries. Also, they show strength to face financial challenges such as the 2007 financial crisis.⁸³⁴ So, they reach a stand to be looked differently from the conventional banks to have their suitable Regulatory Framework. In this regards, Regulators in Saudi have not yet tackled the issue of sharia governance, it is kept for the financial institutions themselves to make their own sharia governance as has been discussed before when the central bank, SAMA, responded to one of the researcher's questions by saying that they work to provide a competitive environment according to the free market mechanisms,⁸³⁵ so there is no discrimination in dealing with conventional banks and financial institutions that comply with sharia.

So the door is left open for the development of financial contracts to the institutions, the responsibility of finding a financial contract that is sharia-compliant is on the financial institution.⁸³⁶ SAMA have not set regulations concerning sharia boards in financial institutions, for example, ensuring its independency, the qualifications of its members, minimum number of members, the need for sharia audit or anything regarding sharia governance, as any aspect related to sharia compliance is handed to the financial institutions themselves to do whatever they want. This would cause some uncertainty, and harm the trust of customers and shareholders, about the products that are being offered as sharia-compliant by financial institutions. In addition, comparing the Saudi situation with the neighbouring countries in the GCC, it can be seen that most of the countries realised the importance of setting up specific regulations for Islamic finance to strengthen the trust of shareholders and the market in general.

In this regard, the example of the National Commercial Bank (NCB) in Saudi Arabia and its initial public offering (IPO) can show how the inconsistency in *Fatwas* could breach a customer's trust, when inconsistency is caused by a lack of sharia governance and the absence of a central sharia board to give its final word when a conflict has appeared between sharia scholars. The NCB announced that it was converting to a full- fledged Islamic bank in 2004, and the plan was to take 2 years to

⁸³⁴ See 2.5 above

⁸³⁵ See 4.8 above.

⁸³⁶ Response from the Head of Financial Sectors Division at SAMA on 2 September 2015.

do this.⁸³⁷ But since that time until now the bank has not converted, while it has managed to make the retail branches offer sharia-compliant products but not the Corporate Banking group and the Treasury Group which are still offering conventional and some sharia-compliant products.⁸³⁸ The bank gets support from sharia scholars who are hoping that the bank will be a full-fledged Islamic bank. The same message is passed to the public at every opportunity to get more clients. As said before, the majority of Saudis are Muslims believing in the prohibition of *Riba*, and this excuse was used again to market the IPO in 2014.

The sharia board of the bank, including its Chairman Sheikh Abdullah Al-Manea who is also the chair of most sharia boards in Saudi, legalized the IPO from a sharia perspective, although the bank was dealing with huge non-Islamic businesses at that time. However, many sharia scholars including members of the highest religious body in Saudi Arabia, the Council of Senior Scholars, indicated that subscribing to the IPO of this bank was not permissible as the bank had too many forbidden dealings on its balance sheet.⁸³⁹ This caused much confusion in the media. On the other hand, the sharia board of the bank insisted that it was permissible to do so, arguing that the bank was planning to become an Islamic bank.⁸⁴⁰

Al-Osimi said regarding the IPO of the NCB, when Al-Manea was consulted by the Albilad bank, as he is the head of the sharia board as well, about accepting the receiving subscriptions to the IPO, he said that with the current situation of the NCB it was not permissible to do so.

Thus, the Albilad bank and all the other full-fledged Islamic banks in Saudi refused to receive the subscriptions to the IPO of the NCB, while the NCB sharia board insisted that it was permissible. This has created much public confusion.⁸⁴¹ Such an incident would not happen or at least could be solved if there was a central sharia board that could have the final word in such dissension.

⁸³⁷ Prospectus initial public offering for the National Commercial Bank 2014.

⁸³⁸ Ibid.

⁸³⁹ Marwa Rashad, 'Saudi Bank's \$6 Billion IPO Ignites Religious Controversy' (UK.reuters, 2014) <<http://uk.reuters.com/article/us-national-comm-l-bk-ipo-islam/saudi-banks-6-billion-ipo-ignites-religious-controversy-idUSKCN0I31QG20141014>> accessed 6 June 2017.

⁸⁴⁰ Tahreem Noor Khan, 'Enhancing Islamic Financial Brand: Sharia Board Theoretical Conceptual Framework' (2015) 3 Journal of Islamic Banking and Finance.

⁸⁴¹ Fahad Al Sunaidy, Interview with Mohammad Al Osimi, 'The Difference between Islamic and Conventional Financial Institution' (26 October 2014). Available at <https://www.youtube.com/watch?v=_Y3mILMfZec> accessed 4 May 2017.

In addition, as there is a lack of standards for Islamic banks and as SAMA is only targeting conventional financial institutions on its laws and standards, some of the well-known sharia scholars may accept work for, and provide *Fatwas* that are not 100% sharia-compliant to some conventional financial institutions hoping to bring them more closely to Islamic finance. Those scholars believe this would take conventional finance closer towards being Islamic finance, as they are aiming to motivate conventional finance to be Islamic.

However, the researcher believes that in an environment like Saudi, there is no need to do so, as the market itself is thirsty for real Islamic finance; and being tolerant with financial institutions to provide doubtful sharia-compliant products under the name of sharia compliance, could confuse the market. Also, this would give regulators the impression that Islamic and conventional finance are the same and there is no need for special regulations.

Almutairi and Quttainah said that the markets in Saudi are still in need of Islamic financial institutions.⁸⁴² An example of a conventional bank which successfully converted to an Islamic bank without delaying is the al-Jazira bank. The bank has earned huge profits after the decision to convert to a wholly sharia-compliant financial institution in 2002. The bank started changing all its branches to operate as per sharia rules and principles to cultivate the results of its strategic conversion into sharia-compliant banking and achieve progressive growth;⁸⁴³ and it has achieved the highest growth in earnings rate from 2002-2006 with 140% compound annual growth.⁸⁴⁴ In 2007, the bank witnessed its full conversion into a sharia-compliant institution and simultaneously increased its paid-up capital to SR 3 billion which came entirely from the bank's profits.⁸⁴⁵ This example is brought to show that the Saudi market is in need of Islamic finance, and giving questionable *Fatwas* by some sharia supervisory boards could damage the customer confidence in all sharia boards.

⁸⁴² Ali Almutairi and Majid Quttainah, 'Corporate Governance: Evidence from Islamic Banks' (2017) 13 *Social Responsibility Journal*.

⁸⁴³ 'Aljazira Bank | About-Us' (Baj.com.sa, 2017) <<http://www.baj.com.sa/ar/about-us.aspx?page=corporate-profile&id=139&AspxAutoDetectCookieSupport=1>> accessed 22 May 2017.

⁸⁴⁴ The Report: Emerging Saudi Arabia 2007, 85.

⁸⁴⁵ 'Aljazira Bank | About-Us' (Baj.com.sa, 2017) <<http://www.baj.com.sa/ar/about-us.aspx?page=corporate-profile&id=139&AspxAutoDetectCookieSupport=1>> accessed 22 May 2017.

The researcher believes that sharia governance for the institutions offering Islamic financial services, including different aspects such as the rights of investment account holders, compliance with sharia rules and principles, sharia board independence, the disclosure and transparency of both the sharia board and the financial reporting in respect of investment accounts, is a fundamental issue.

However, it is not fair to say that institutions that offer Islamic finance in Saudi Arabia do not show concern about this issue. Some of the financial institutions work hard to adopt the best corporate governance standards that suit Islamic finance as they can. But the issue is that as there is no special corporate governance for Islamic finance applied by the regulators, financial institutions apply different sharia governance principles, and others can only adopt the principles of corporate governance that are required by the Central Bank which does not really meet the Islamic financial needs, such as compliance with sharia rules and principles.⁸⁴⁶

Participant B said that there is a lack of disclosure with regards to the sharia board activities. He stated that some sharia boards only meet once or twice a year and there are some doubtful financial contracts practised in such institutions as sharia-compliant products that might not be approved by the board, as there is no sharia audit to spot such doubtful contracts and report them to the sharia boards; yet huge remuneration is paid to the sharia board members even though they do not do much, while there are some Islamic banks that work very hard and try their best to present products that are sharia-compliant as much as they can: for instance, meeting at least 30 times a year with special preparation before each meeting, while the sharia board members receive less remuneration than expected. Some of the latter banks disclose some of their information regarding the sharia boards' activities in their annual reports to reassure comfort the public, while other banks disclose virtually nothing. He suggests that SAMA should oblige Islamic financial institutions to provide high levels of disclosure with regards to the sharia board activities, to be the same as the directors and management boards in their annual reports.⁸⁴⁷

So, the researcher believes that an additional layer of corporate governance needs to be added onto the current corporate governance that already existed for conventional financial institution in Saudi Arabia; the new layer should be about sharia governance

⁸⁴⁶ Interview with participant B on 9 March 2015, Riyadh Saudi Arabia.

⁸⁴⁷ Interview with participant B on 9 March 2015, Riyadh Saudi Arabia.

which should be enforced by SAMA where many customers may choose the Islamic finance from a religious point of view. [See figure 4]

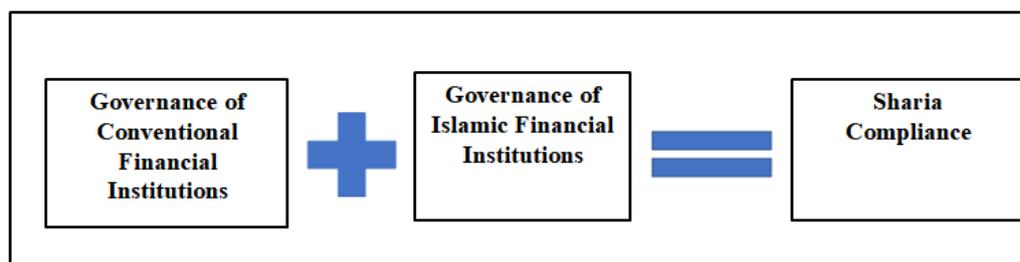


Figure 4: Relation between Governance in Conventional Banks and Islamic Banks

Examples of information that should be disclosed for better sharia governance include: the number of meetings that the sharia board made; the number of meetings attended by each member of the sharia board; decisions that have been taken; the sharia board remuneration and the sharia board endorsement on the conformity of the operations of the Islamic financial institution in accordance with sharia principles.⁸⁴⁸

Also, the researcher sees that the number of boards a sharia scholar can be on should be limited. Currently some scholars are members of more than 80 sharia boards;⁸⁴⁹ the repeated names of sharia scholars appear in different sharia boards, because of the limited number of sharia scholars who specialised in finance, it is difficult to cut such big numbers suddenly, but a gradual plan can be made, for example a member cannot be in more than 20 sharia boards for the next five years, then the number should be reduced to 10 and then to 5. This would offer the opportunity for the production of new generations of scholars to be members of boards.

Furthermore, the non-sharia income should be disclosed and where it is distributed, as this is an important issue among shareholders and customers.⁸⁵⁰ Alkhamees compared sharia supervision disclosure in twelve Saudi banks with nine UK banks that offer Islamic financial services. The comparative includes the number of areas, such as the professional background of members in sharia boards, the sharia board

⁸⁴⁸ Tadashi Mizushima, 'Corporate Governance and Sharia Governance at Islamic Financial Institutions: Assessing from Current Practice in Malaysia' (2014) 22 Reitaku Journal of Interdisciplinary Studies

⁸⁴⁹ Ahmad Alkhamees, *a Critique of Creative Sharia Compliance in the Islamic Finance Industry* (Brill Nijhoff 2017)

⁸⁵⁰ Mohammed Ali Ahmed, ' دور السلطات الرقابية في الرقابة على المؤسسات المالية الإسلامية ' (The Role of The Supervisory Authorities in The Supervision of Islamic Financial Institutions)', The 2nd Conference of Islamic financial Services (2010).

annual report to shareholder, the publication of *Fatwas* or decisions, their duties, the power of their decisions (binding or advisory), the financial rewards of the members, the supervision processes and finally the selection procedures of the members of the sharia board. The result shows that the transparency culture in Islamic financial institutions in the UK is more prevalent than in Saudi; also, the UK is in a better position comparing the disclosing of sharia scholars' membership on other sharia boards.⁸⁵¹

With regard to the comparisons among the twelve Saudi Banks, two banks published their *Fatwas*. With regards to the type of power the sharia boards have over its decisions, five banks revealed such information. For the supervision processes half of the banks disclosed such information. Finally, only two banks disclosed the selection procedure of the sharia board.⁸⁵²

In addition, the independence of sharia boards has still not been solved. Participant C answers a question about the role of SAMA if the financial institution does not comply with the decisions of its sharia board. He said that in some banks the board of directors assume a higher level of authority than the sharia board and this may cause problems when a member of sharia is pushed by the board of directors to give *Fatwas* that may contain some issues, or basically the bank does not comply with the decisions of the sharia board.

Obviously sharia scholars should maintain their integrity by avoiding dubious activities. But as no rules are set by regulators about the qualifications and the requirements that members of sharia board have to have in order to be elected in this position, some financial institutions may use this gap to elect members who are not qualified to be true sharia scholars with regards to the ethical, educational, and technical requirements, or to elect members who may turn a blind eye when sharia compliance is infringed by the financial institution. Even if such cases may not happen, it opens the door for questioning the integrity of the sharia board and its independence which can create a huge lack of trust among shareholders, customers and the financial institutions.⁸⁵³ Some Islamic financial institutions try to overcome this challenge by making their own regulations to commit to sharia, in order to gain the trust of their

⁸⁵¹ Ahmad Alkhamees, *A Critique of Creative Sharia Compliance in the Islamic Finance Industry* (Brill Nijhoff 2017).

⁸⁵² Ibid.

⁸⁵³ A personal interview with participant C on 3 March 2015, Manama Bahrain.

shareholders. One of them is to link the sharia board directly to the general assembly, which puts the sharia board on an equal level to the board of directors, and sharia member nomination comes from the general assembly. As have been said some of the financial institutions do that while others leave this issue to the board of directors. However, even those who obligate themselves with regulations to commit to sharia, still such rules are considered as internal rules. Thus, if the board of directors violated such rules, no external authority would interfere and stop such practice, as there is no external audit who would report it and the regulators do not concern themselves about this issue.

On the other hand, when the bank for example violates one of SAMA's instructions such as an accounting standard, it will intervene directly and punish the bank and oblige it to amend. While if the bank contravenes the sharia board's decisions, SAMA will not intervene. In such a situation the general assembly may vote against it and even this has many practical difficulties. So, there is no real obligation on the bank when ignoring the sharia board's decisions.⁸⁵⁴

Al-Khalif defines the independent authority of sharia boards as a way of exercising their purposes neutrally and in complete freedom. No kind of pressure should be asserted by the financial institutions management or shareholders to influence the sharia board.⁸⁵⁵ Al-Shabli stated three important elements to ensure the independence of sharia boards. First, members of sharia boards should not be selected from the staff of the financial institution and the sharia audit department in the financial institution should report directly to the sharia board. Secondly, the fee payable to a sharia board member should not be made dependent upon the contracts or products that the member has approved, it should be either a reward paid annually or determined according to the effort a member has made in carrying out such a job.

Finally, appointing and dismissing sharia board members should be done by the general assembly as it is the highest authority in the institution, while the sharia auditors can be appointed and dismissed by an administrative decision with the

⁸⁵⁴ A personal interview with participant C on 3 March 2015, Manama Bahrain.

⁸⁵⁵ Riyadh Al-Khalifi, 'النظرية العامة للهيئات الشرعية' [The General Theory of Sharia Boards]', *3rd Conference of Sharia Boards of Islamic Financial Institutions* (2003).

condition of it being approved by the sharia board.⁸⁵⁶ Unfortunately none of what has been mentioned is discussed by SAMA or any government authority to ensure all sharia boards in financial institutions have any level of independence.

In addition, as mentioned earlier, recently some central banks in the GCC countries have gone for better governance for sharia by adopting a centralised model, where the Central Bank itself has its own sharia supervisory board at the top of the sharia boards in the financial institutions, instead of a decentralized model which they used to have and still practise in Saudi Arabia. The importance of a central sharia board is going to be discussed here.

4.12 Central Sharia Board in the Central Bank

As has been discussed earlier, regulators in Saudi Arabia have not been giving Islamic financial institutions the appropriate attention, with no special regulations for such finance, even though the two types of finance, the Islamic and the conventional, have some differences, which require sometimes different regulations or standards that suit the nature of each type of finance; Meanwhile, many countries, including the neighbouring countries of Saudi Arabia, are updating their laws to give Islamic finance special rules, whereas Saudi Arabia itself is still ignoring this issue, and this has become one of the major challenges.

As Al-Hussein highlighted earlier the key pillar for Islamic finance institutions is the sharia board.⁸⁵⁷ There are no Islamic financial institutions without a sharia board or sharia committee.⁸⁵⁸ It is not always easy to ensure that all financial institutions would respect the rights of customers and shareholders to provide the best practices to develop financial products that comply with Islamic principles.

⁸⁵⁶ Yusuf Al-Shabili, ' الرقابة الشرعية على المصارف ضوابطها وأحكامها ودورها في ضبط عمل المصارف [Sharia Supervision of Banks and their Rules and Role in Controlling the Work of Banks]', *the 19th session of the Islamic Fiqh Academy* (the Islamic Fiqh Academy 2009). AL-Shabili is a well know sharia scholar who is a member of many sharia boards inside and outside of Saudi Arabia.

⁸⁵⁷ Saleh Al-Hussein, ' الهيئات الشرعية الواقع وطريق التحول لمستقبل أفضل ' (Sharia Boards the Reality and a Way of Transition for a Better Future)' [2004] Islamic Business Researches Centre <<http://bit.ly/2nMfYTE> > accessed 4 June 2016.

⁸⁵⁸ Samy Garas and Chris Pierce, 'Sharia Supervision of Islamic Financial Institutions' (2010) 18 *Journal of Financial Regulation and Compliance* <<https://doi.org/10.1108/13581981011093695>> accessed 13 May 2017.

Giving *Fatwas* in commercial jurisprudence is tricky, especially when *Hila* is applied. As discussed earlier in this chapter *Hila* can be used excessively by a member of a sharia board even outside of the limit that all schools would approve, just to permit a prohibited transaction such as *Riba* to be marketed as sharia compliant; and no one can object in this situation, as this might destroy the whole market. As there are no rules regarding the number or qualifications of members needed in a sharia board, and also no rules to ensure the independence of the sharia board or even its decisions, undesirable conflict in *Fatwas* among financial institutions could happen. Examples were provided earlier with the IPO of NCB, and the other example that happened in the Islamic Banking Committee meeting, when a conventional bank picked a financial contract that was agreed to have sharia problems from the meeting, and advertised it to its customers with the label “sharia compliant”. Applying sharia governance by the regulators could help to strengthen the Islamic finance in some parts of sharia governance as already mentioned earlier; but there is the other part that the researcher believes would help the Islamic finance to obtain a better position, which is creating a central sharia board.

Sheikh Abdullah Al-Manea, the most senior Saudi sharia scholar in Islamic finance who is a member of more than 84 financial institutions, complained that the Saudi central bank had not done enough to promote Islamic banking products and services. Most products were developed by individual scholars rather than through official channels.⁸⁵⁹ He also believes that the Saudi central bank is the main obstacle that prevents Saudi being the central hub of Islamic banking around the world.⁸⁶⁰

The importance of a central sharia board is to avoid strange and irregular *Fatwas* that approve financial contracts which have noticeable sharia issues. When obvious conflicts in *fatwas* among financial institutions are dealt with by the central sharia board, the stability and confidence in such finance would increase in the market and among shareholders and customers.

Also, this would create a pattern which can be found in the approved contracts, which could help to standardise many Islamic finance contracts in Saudi Arabia especially

⁸⁵⁹ Tahreem Noor Khan, 'Enhancing Islamic Financial Brand: Sharia Board Theoretical Conceptual Framework' (2015) 3 Journal of Islamic Banking and Finance.

⁸⁶⁰ Ahmad Alkhamees, *A Critique of Creative Sharia Compliance in the Islamic Finance Industry* (Brill Nijhoff 2017).

the basic sharia-compliant contracts that are offered by many financial institutions. When basic contracts are standardised, finance institutions and its sharia boards would be encouraged to introduce new products and services in order to compete with other players in the market. As Ozgur Tanrikulu⁸⁶¹ said, innovation in Islamic finance will occur only when the essentials are standardised, otherwise growth will be impeded.⁸⁶² Once the basics of the contracts are standardised nationally it would be a huge step to have international standardisation for the financial contracts that are agreed among most of the sharia boards in the world, so products can be approved in Saudi Arabia and marketed in Malaysia or vice versa, while products that have conflict about their compliance to sharia law, with regards to the Islamic school of thought that a country belongs to, would be traded at national level or with other markets that share the same jurisprudence.⁸⁶³

This will help the economy in Saudi and the whole Islamic finance market in the world considering that Saudi Arabia is one of the largest countries in Islamic banking assets and market share.⁸⁶⁴ In addition, this can make the Islamic finance more stable and avoid affecting the efficiency of the Islamic finance industry as the confusion will not only damage the public, but also the practitioners in the industry. For example, as said in an earlier chapter that the statement of Taqi Usmani⁸⁶⁵ was one of the main causes of the shrinking in the value of the international *sukuk* market from about \$50 billion in 2007 to about \$15 billion in 2008 when he stated that “many structures presenting themselves as Islamic did not meet the definition of true sharia compliance.”⁸⁶⁶

Hasan indicated in his study on sharia governance that it is not expected from institutions that provide Islamic finance to voluntarily develop and portray strong sharia governance practices without proper supervision. So, less interference and the lack of a regulatory framework for sharia governance is one of the factors that impedes the extent of sharia governance practices. He concluded that having an appropriate legal

⁸⁶¹ The head of Islamic finance at McKinsey, a global management consulting firm

⁸⁶² Ahmad Alkhamees, *A Critique of Creative Sharia Compliance in the Islamic Finance Industry* (Brill Nijhoff 2017) 103

⁸⁶³ Ibid 102.

⁸⁶⁴ Islamic Financial Services Board, 'Islamic Financial Services Industry Stability Report 2016' (IFSB 2016).

⁸⁶⁵ A leading Sharia scholar in Islamic finance and Sharia Board Chairman of State Bank of Pakistan and the chairman of the AAOIFI Sharia board.

⁸⁶⁶ Ahmad Alkhamees, *a Critique of Creative Sharia Compliance in the Islamic Finance Industry* (Brill Nijhoff 2017) 101.

framework without proper supervision and enforcement will not guarantee the improvement of sharia governance practices.⁸⁶⁷ This shows the importance of the intervention of SAMA to set proper regulations and also the need for a central sharia board to be at the top of the sharia boards.

In addition, having a central sharia board will encourage financial institutions to focus on recruiting developers of Islamic financial products and Islamic financial engineers who should enjoy with their knowledge of finance a good knowledge of sharia principles, instead of concentrating on attracting well-known sharia scholars to be on their sharia boards whose main roles are giving *Fatwas*, while they receive high remuneration, as the central board will give the final *Fatwa* to approve a financial contract. So, such high remuneration can be spent on the developers who would produce a variety of financial products and increase the competition among financial institutions.

Also, because of the limited number of famous sharia scholars who are specialised in Islamic commercial jurisprudence along with a good knowledge of the economy, many financial institutions as mentioned before seek the same scholars to be on their sharia board. Some of the members were offered executive positions inside the financial institution,⁸⁶⁸ which could generate conflicts of interest when a scholar sits on several sharia boards and takes advantage of the information from the different institutions, as it is hard to express an independent opinion for different institutions during the release of new products.⁸⁶⁹

With the limited number of proper sharia scholars who can be on sharia boards, the researcher suggests that a central sharia board should be established to regulate and supervise all financial institutions that provide sharia-compliant products. Members of this central board should be scholars who are skilled in sharia with all the different *Madhahib* in Islamic commercial jurisprudence, law and finance.

⁸⁶⁷ Zulkifli Hasan, 'Sharia Governance in Islamic Financial Institutions in Malaysia, GCC Countries and the UK' (PhD, Durham 2011).

⁸⁶⁸ Samy Nathan Garas, 'The Conflicts of Interest Inside the Sharia Supervisory Board' (2012) 5 International Journal of Islamic and Middle Eastern Finance and Management.

⁸⁶⁹ Ibid.

The central board is not for uniting financial contracts and leaving no place for innovation, but it should approve any product that is not conflicting with sharia, and it should send back products that contain sharia-compliant issues to the financial institution to be modified until it becomes sharia compliant.

So, the job of this central board is not to create financial products to be adopted by financial institutions, but to confidentially study proposed financial products that are submitted by financial institutions, and then give its comments on the products.

Doing this will overcome the challenge of a conflict of interest as the sharia scholars in the central board will only study and give *Fatwas* on products that have been developed by someone else. In the current situation with the lack of specialised sharia scholars, most of them are members of many financial institutions and that may affect the confidentiality of some financial institution as the sharia scholar might pass some confidential information regarding a new product from one institution to another one unintentionally while they were trying to develop new financial products: this would be considered as bad as treason.

Also having almost the same sharia board in different financial institutions could slow down the development of this sector as the products would be almost all the same, as they are developed by the same people: this would kill the creativity. On the other hand, when financial institutions start to focus on financial developers, this would help the Islamic financial sector to develop faster.

In addition, a central sharia board will raise the level of governance by cutting the way for financial institutions that may enrol unqualified sharia board members or pressure its members to allow questionable financial contracts. So financial institutions will focus when recruiting sharia boards or financial developers to select qualified cadre as their decisions will be verified by the central board.

4.13 Conclusion

This chapter is continuing what has been discussed in previous chapters: defining Islamic finance and Islamic banking, showing the principles that such finance hold in Chapter Two;⁸⁷⁰ then, discussing how Saudi Arabia is handling Islamic banking and finance, illustrating the laws that specifying that the country should be ruled under the

⁸⁷⁰ See 2.7 above.

Islamic principles and that includes finance;⁸⁷¹ also, showing the different in law and practise with regards to Islamic finance and how SAMA is dealing with this issue.

⁸⁷²This chapter discuss the importance of sharia boards in financial institutions in Saudi Arabia; it started by revealing the reasons for the different *Fatwas* in the sharia boards which are affected by the level of acceptance of *Hila*. A briefing on the position of different *Madhabs* towards *Hila* was presented. Then sharia boards in financial institutions were defined, showing via interviews the challenges that Islamic finance in Saudi Arabia is facing because of issues related to sharia boards. The chapter indicated that most of the challenges that are facing sharia boards in Saudi Arabia were related to the lack of sharia governance. The chapter discussed the position and the recent development of different countries towards better sharia governance as ideas for reform to the current practise in Saudi Arabia. This included standards required when establishing a sharia board and the level of disclosure and independence. Finally, the idea of having a central sharia board in Saudi Arabia is discussed. More details of sharia governance and the role of the central sharia board and the position will be highlighted in the last chapter in the recommendation section. Meanwhile the next two chapters will focus on a particular financial product in Islamic finance, *Sukuk*, which will be used as a case study to show how such challenges appear in practice. *Sukuk* is used because of the increase in the popularity of such products in Saudi Arabia, and in many other countries, and the researcher will evaluate how Saudi Arabia deals with this product.

⁸⁷¹ See 3.2.3 above.

⁸⁷² See 3.4.2 and **Error! Reference source not found.** above.

Chapter Five: *Sukuk* in Islamic Finance

5.1 Introduction

As the thesis started with illustrating the meaning of Islamic finance and the principles that a financial contract has to acknowledge when creating a financial product.⁸⁷³ Also, some examples of Islamic financial contracts, which already existed from an early stage of establishment of Islam, were introduced.⁸⁷⁴ Then the thesis discussed the relation between the legal system in Saudi Arabia and Islamic finance law and practice.⁸⁷⁵ Besides, discussing the importance of sharia boards in Islamic financial institutions in Saudi Arabia from a legal point view and the need for better corporate governance for Islamic financial institutions which could have its impacts on *Sukuk* and its compliant to sharia. This chapter and the next chapter will take *Sukuk*, an Islamic financial product that can be performed by one or more of the different Islamic financial contracts, as a case study to show the difficulties and challenges that are facing Islamic finance in Saudi Arabia. This Chapter will define *Sukuk* and briefly highlight the development history of this product in the recent time. Also, the chapter will show how *Sukuk* differ from other types of finances particularly bonds that used in conventional finance. In addition, this chapter will discuss different types of contracts that are used in *Sukuk* to show when it can be traded in a secondary market.⁸⁷⁶ This chapter is closely linked to the next chapter which will discuss *Sukuk* in Saudi Arabia examining the validity of the current laws and regulations that have their effects on *Sukuk*. Thus next chapter will highlight the challenges and difficulties that might face *Sukuk* in Saudi Arabia.

5.2 Defining *Sukuk*

The term *Sukuk* is the plural of the Arabic word *Sakk*. For hundreds of years Islamic commercial transactions have involved the use of *Sukuk* but within a slightly different context than its current meaning.⁸⁷⁷ Originally, the term *Sukuk* meant 'papers' or 'documentation' which relate to financial obligations originating from trade and other

⁸⁷³ See 2.2 and 2.7 above.

⁸⁷⁴ See 2.9 above.

⁸⁷⁵ See 3.2 also 3.3 and 3.4 above.

⁸⁷⁶ See 5.7 below.

⁸⁷⁷ Muhammad Ayub, *Understanding Islamic Finance* (Wiley 2013) 204.

commercial activities,⁸⁷⁸ legal instruments, Cheques or deeds.⁸⁷⁹ In this respect, a verse from the Holy Quran encourages the writing of contracts:

O you, who have believed, when you contract a debt for a specified term, write it down. And let a scribe write [it] between you in justice...It is more just in the sight of God, more suitable as evidence and more convenient to prevent doubts among yourselves.⁸⁸⁰

Therefore, a *Sakk* can be a written vow to pay for goods when they are delivered. In addition, one of the reasons for the use of *Sakk*, was to avoid transporting money across dangerous territories within the Islamic world. Gradually the use of *Sukuk* spread throughout the world.⁸⁸¹ It is believed that it was introduced by Muslims in the 13th century,⁸⁸² during the flourishing period of the Islamic world, and is the origin of the European cheque system which was transmitted by Jewish merchants from the Muslim world to Europe.⁸⁸³ A *Sakk* referred to any certificate representing a contract or conveyance of financial rights, money transactions or obligations which are sharia compliant.⁸⁸⁴ Yet, the use of the term *Sukuk* has undergone significant changes in reflects to the need of the financial market as is going to show soon.⁸⁸⁵

One of the biggest challenges that Islamic financial institutions faced when they were first established was the risk of high liquidity. In Islamic banks almost every financing contract should be tied with real asset which makes it different compared with the conventional banks.⁸⁸⁶ Thus, liquidity risk might arise in Islamic banks when business (real sector) is in downturn causing a failure to conduct a proper liquidity management (a balance asset and liability).⁸⁸⁷ In addition, Islamic banking can be financial intermediaries, supporter and facilitator all together. They can be as well a trusted

⁸⁷⁸ Ibid.

⁸⁷⁹ Khalid Alsaeed, 'Sukuk Issuance in Saudi Arabia: Recent Trends and Positive Expectations' (PhD, University of Durham 2012) 9.

⁸⁸⁰ Holy Qur'an verse 2:282.

⁸⁸¹ A Saeed and O Salah, 'Development of Sukuk: Pragmatic and Idealist Approaches to Sukuk Structures' [2013] 1 Journal of International Banking Law and Regulation 46.

⁸⁸² Mohamed Ariff, Shamsheer Mohamad and Meysam Safari, *Sukuk Securities: New Ways of Debt Contracting* (John Wiley & Sons Singapore Pte Ltd 2014) 42.

⁸⁸³ Ibid.

⁸⁸⁴ Khalid Alsaeed, 'Sukuk Issuance in Saudi Arabia: Recent Trends and Positive Expectations' (PhD, University of Durham 2012) 9.

⁸⁸⁵ Ibid.

⁸⁸⁶ Rifki Ismal, 'Assessment of Liquidity Management in Islamic Banking Industry' (2010) 3 International Journal of Islamic and Middle Eastern Finance and Management 148.

⁸⁸⁷ Ibid.

body for the investors and business partners by becoming business partner, advisor, consultant and source of information.⁸⁸⁸ So, they would be fully responsible to provide liquidity when demanded by the third party, Islamic banks manage liquidity demanded through coordination with all the counterparties. Thus, there is a need for an instrument that manages liquidity.⁸⁸⁹

In order to overcome this challenge, liquidity management in Islamic institutions had to come up with effective financial instruments that combined profitability and diversity while responding to different maturities.⁸⁹⁰ This is can be found as going to be explain soon in *Sukuk* as they have a maturity date and holders are entitled to a regular stream of income over the life of the *Sukuk* along with a final payment at maturity. It also provides liquidity since *Sukuk* can be traded in secondary market.⁸⁹¹

By looking at the conventional financial institutions and banks, a way to overcome such a challenge was to either invest in bond issuing and trading or use the excess cash in bank deposits for cash benefits. However, both ways are incompatible with sharia and involve the charging of interest, *Riba* in Arabic, which is prohibited in Islam. Indeed, as was pointed out before,⁸⁹² in Islamic law, money is a means of exchange rather than an asset in itself, which is why it is prohibited in Islam to make money from money alone without it being invested.⁸⁹³ Therefore, considering such a prohibition, financial institutions have to make their profit on the basis of actual economic activities.

In *Sukuk* asset securitization is the essence, as a *Sakk* (bond) must assume the role of an object with value or property to qualify as an object of sale. An object of sale in sharia law of contract has to be a property of value.⁸⁹⁴ When a bond certificate is backed by an asset (supported by an asset) as evidence via securitization process, it is moved from just being money into an object value and therefore qualifies to become

⁸⁸⁸ Ibid.

⁸⁸⁹ Ibid.

⁸⁹⁰ Fahad Al-marshadi, *الصكوك - أحكامها ووضوابطها وإشكالاتها: دراسة شرعية نقدية (The Provisions of Sukuk, Its Controls and Problems: A Critical Study)* (Dar Kpnoz Ashbilia 2014).

⁸⁹¹ Nursilah Ahmad, Siti Nurazira Mohd Daud and Zurina Kefeli, 'Economic Forces and the Sukuk Market' (2012) 65 *Procedia - Social and Behavioral Sciences* 127.

⁸⁹² See 2.7.1 above.

⁸⁹³ Harris Irfan, *Heaven's Bankers: Inside the Hidden World of Islamic Finance* (2nd edn, The Overlook Press 2015).

⁸⁹⁴ Karmila Hanim Kamil and others, 'The Subprime Mortgages Crisis and Islamic Securitization' (2010) 3 *International Journal of Islamic and Middle Eastern Finance and Management* 392.

an object of trade, then it can be traded purchased in both the primary and secondary market.⁸⁹⁵

Furthermore, Islamic financial institutions are prohibited from investing in a number of sectors including gambling, excessively risky trade contracts, *Gharar* in Arabic,⁸⁹⁶ trading in alcohol or tobacco, or trading in debt contracts at a discount. Therefore, because of the impossibility of adopting the conventional banks' methods, researchers had to find a new tool which could be used as an alternative to conventional bonds as the prohibition of interest has mostly blocked the way on pure debt security. Yet, an obligation that is associated with the performance of a real asset is acceptable, hence the use of a new instrument called *Sukuk*.⁸⁹⁷

In the early emergence of *Sukuk* as an economic mechanism, it was surrounded by misunderstanding and misinformation regarding the organisational and legislative challenges, and this contributed to the reluctance of many investors and businessmen to use them. After a number of attempts to develop *Sukuk*, a Malaysian attempt showed a degree of success and this aroused the interest of various countries and organisations in this instrument.⁸⁹⁸ The interest in *Sukuk* gradually increased during and after the global financial crisis in 2008.⁸⁹⁹

Sukuk, according to market parlance, are considered to be negotiable financial instruments provided they do not involve any prohibited products or transactions.⁹⁰⁰ According to the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI), *Sukuk* are certificates of equivalent value that represent undivided shares in ownership of either tangible assets, usufruct and services or even (in the ownership of) the assets of certain projects or special investment activities. However, this is true after the receipt of the value of the *Sukuk*, the closing of the subscription and the employment of funds received for the purpose for which the

⁸⁹⁵ Ibid.

⁸⁹⁶ See 2.7.2 above.

⁸⁹⁷ Fahad Al-marshadi, *الصكوك - أحكامها ووضوابطها وإشكالاتها: دراسة شرعية نقدية (The Provisions of Sukuk, Its Controls and Problems: A Critical Study)* (Dar Kpnoz Ashbilia 2014).

⁸⁹⁸ Khalid Talahma, 'Islamic Bonds (Sukuk): Opportunities and Challenges' (2015) 15 *Asper Review of International Business and Trade Law* 393.

⁸⁹⁹ Ibid.

⁹⁰⁰ Ali Alshamrani, 'Sukuk Issuance and Its Regulatory Framework in Saudi Arabia' (2014) 2 *Journal of Islamic Banking and Finance*.

Sukuk were issued.⁹⁰¹ It can be also defined as “a commercial document that proves that the holder has ownership over the underlying asset as well as any profits in accordance with this ownership. In this case, the issuer should identify existing assets to sell to the investors through a special-purpose vehicle (SPV).”⁹⁰² *Sukuk* can be fully understood from the examples of *Sukuk* presented below.⁹⁰³ *Sukuk* can be compared to a trust certificate with a relative or undivided stake in an asset or a pool of assets. This interest grants the right to the corresponding share of cash flows, in addition to the risk and benefits derived from owning the assets.⁹⁰⁴

As it can be seen from the above definitions, *Sukuk* relate to the ownership of an asset or its usufruct, which suggests that the claim embodied in *Sukuk* is not only a claim to cash flow, but also relates to the ownership of the asset or its use over the given period of time or the tenor of the issuance.⁹⁰⁵

5.3 The History of *Sukuk*

The first use of *Sukuk* as a borrowing instrument can be traced back to the end of the 13th century whereby, at the time of the Ottoman Empire, the emperor had to borrow a large amount of money after the devastation of the Turkish Empire which was caused by the crusades. Sharia scholars of that time helped to design and invent a public financing instrument which was different from the Christian practices at that time and was compliant with the Islamic ethics of borrowing, by devoting some of the treasury assets to ownership by the lending public.⁹⁰⁶

Then, in 1978, the Jordan Islamic Bank issued *Muqaradah* bonds after gaining the permission from the government to do so, and in 1981, the *Muqaradah* Bond Act was issued to define this kind of bonds.⁹⁰⁷ At about the same time, in 1980, Pakistan also made a specific law called the *Modaraba* Companies and *Modaraba* (Floatation and

⁹⁰¹ Essia Ahmed, Md. Aminul Islam and Tariq Alabdullah, 'Islamic Sukuk: Pricing Mechanism and Rating' (2014) 4 Journal of Asian Scientific Research Also Dina Elshurafa, 'Project Finance and Sukuk in Saudi Arabia: An On-Going Project?' (2013) 2 Journal of International Banking and Financial Law

⁹⁰² Abdullah Al Elsheikh and Joseph Tanega, 'Sukuk Structure and its Regulatory Environment in the Kingdom of Saudi Arabia' (2011) 5 Law and Financial Markets Review 184.

⁹⁰³ See 5.4 and 5.7 below.

⁹⁰⁴ Safiyah Taoual, 'Sukuk: A Potential for Stability and Development in the GCC' (Economics Discussion Papers, Kingston University London 2016)

⁹⁰⁵ Khalid Alsaeed, 'Sukuk Issuance in Saudi Arabia: Recent Trends and Positive Expectations' (PhD, University of Durham 2012)

⁹⁰⁶ Mohamed Ariff, Shamsheer Mohamad and Meysam Safari, *Sukuk Securities: New Ways of Debt Contracting* (John Wiley & Sons Singapore Pte Ltd 2014) 6.

⁹⁰⁷ Abbas Mirakhor and Zamir Iqbal, *an Introduction to Islamic Finance* (2nd edn, Wiley 2011) 185.

Control) Ordinance. However, because of the lack of powerful infrastructures and transparency in the market, neither of these efforts resulted in any noteworthy activity in the market.⁹⁰⁸ Also, in 1984, Turkey adopted a new type of Islamic bonds, called Participation Bonds, which were issued to fund a project to build the second Bosphorus Bridge and this was quite successful.⁹⁰⁹

After the previous attempts to provide *Sukuk* that to be considered sharia-compliant and there were a number of different *Fatwas* regarding to the complaint of previous attempts. Thus, it became public issue. Therefore, *Sukuk*, as they are known today, were rediscovered and defined in 1988 at the fourth session of the Council of the Islamic *Fiqh* Academy in Jeddah, Saudi Arabia, under the name *Mugarada* bonds.⁹¹⁰

Then in 1990, the current Islamic *Sukuk* funding market in Malaysia started with a small amount of money whereby Shell Malaysia issued a *Sukuk* to raise about US\$ 40 million,⁹¹¹ and again in 1995 for the building of a power station for about US\$ 350 million.⁹¹² In 2000 which marked the boom of the *Sukuk* market when a number of institutions started issuing *Sukuk*: for example, the governments of Bahrain issued *Sukuk* worth US\$250 million in 2001, the Islamic Development Bank issued *Sukuk* worth US\$400million in 2003 and US\$500million in 2005, Qatar issued *Sukuk* worth US\$700 million in 2003.⁹¹³

As *Sukuk* was still considered new to the market and a high level of concern regarding sharia compliance issues and standardisation there were a need for more *Fatwas* and standers for *Sukuk*. Thus, the AAOIFI which were counted as the preminent accounting and auditing authority for the Islamic finance industry,⁹¹⁴ defined approved standards for *Sukuk*,⁹¹⁵ These standards became operative at the beginning of 2004.

⁹⁰⁸ Ibid.

⁹⁰⁹ Ibid 192.

⁹¹⁰ Mohamed Ariff, Munawar Iqbar and Shamsheer Mohamed, *The Islamic Debt Market for Sukuk Securities: The Theory and Practice of Profit Sharing Investment* (Edward Elgar Pub 2012) 51.

⁹¹¹ Ibid.

⁹¹² Khalid Talahma, 'Islamic Bonds (*Sukuk*): Opportunities and Challenges' (2015) 15 *Asper Review of International Business and Trade Law*.

⁹¹³ Tariqullah Khan, Elsayed Elsiefy and Lee EunKyoung, 'Legal and Regulatory Issues in Issuing *Sukuk* in South Korea Lessons from Developed Countries' Experience' (2014) 2 *International Journal of Economics, Commerce and Management* 4.

⁹¹⁴ Michael McMillen, 'Asset Securitization *Sukuk* and Islamic Capital Markets: Structural Issues in these Formative Years' (2008) 25 *Wisconsin International Law Journal* 707.

⁹¹⁵ Ibid.

The standards define fourteen different *Sukuk* structures of Islamic financial contracts.⁹¹⁶

In the same year, 2004, the capital raised through *Sukuk* reached US\$6.7 billion,⁹¹⁷ *Sukuk* was issued even in some western countries such as the German state of Saxony-Anhalt issued *Sukuk* worth US\$136 million in 2004,⁹¹⁸ to be the first European country engaging with *Sukuk*.⁹¹⁹ The regional finance minister outlined:

“On the one hand for economic reason. There are investors out there and it makes sense to provide them with a product. On the other hand, it is a matter of international courtesy. We want to send out a message of respect for other culture who have different regulations on investing.”⁹²⁰

In 2007 the number jumped to US\$39 billion.⁹²¹ *Sukuk* then played a significant part in Islamic finance and now represents about 16% of all Islamic finance transactions,⁹²² with a rapid growth over 20% per year since 2008 to reach US\$310 billion in assets at the end of 2014.⁹²³ Between 2012 and 2013 the market witnessed record *Sukuk* issuances at both international and domestic levels whereas in the years 2014 and 2015 the *Sukuk* market did not maintain the same development.⁹²⁴ This can be explained by a number of reasons such as, the uncertainties in the whole of the global financial system and the severe drop in oil prices.⁹²⁵

Also, the new strategic decision of Bank Negara Malaysia (BNM), one of the key players in the *Sukuk* market, to stop the issuance of its short term *Sukuk* and to shift the issuance focus from providing investment opportunities towards providing liquidity

⁹¹⁶ Michael McMillen, 'Asset Securitization *Sukuk* and Islamic Capital Markets: Structural Issues in these Formative Years' (2008) 25 Wisconsin International Law Journal 707.

⁹¹⁷ Mohamed Ariff, Shamsheer Mohamad and Meysam Safari, *Sukuk Securities: New Ways of Debt Contracting* (John Wiley & Sons Singapore Pte Ltd 2014).

⁹¹⁸ Tariqullah Khan, Elsayed Elsiefy and Lee EunKyoung, 'Legal and Regulatory Issues in Issuing *Sukuk* in South Korea Lessons from Developed Countries' Experience' (2014) 2 International Journal of Economics, Commerce and Management.

⁹¹⁹ Jan Job de Vries Robbé and Paul A. U Ali, *Securitisation of Derivatives and Alternative Asset Classes* (Kluwer Law International 2005) 370.

⁹²⁰ *Ibid* 370.

⁹²¹ Mohamed Ariff, Shamsheer Mohamad and Meysam Safari, *Sukuk Securities: New Ways of Debt Contracting* (John Wiley & Sons Singapore Pte Ltd 2014)

⁹²² Wayne Evans and Philip Jones, 'The UK: Leading Western Centre for Islamic Finance Report' (DDCAP Group 2015) 6.

⁹²³ *Ibid*.

⁹²⁴ Ijlal Ahmed Alvi and others, '*Sukuk* Report: A Comprehensive Study of The Global *Sukuk* Market' (International Islamic Financial Market 2016) < <http://ow.ly/d89e30c4x9y> > accessed on 12/10/2017.

⁹²⁵ *Ibid*.

management for Islamic banks. Can be a reason for the decline in 2015. However, in the beginning of the year 2016 BNM started issuing again short-term *Murabahah Sukuk* with tenors of 9 and 12 months for liquidity management purposes.⁹²⁶ Figure 5 shows the total international *Sukuk* issuances between 2001 and 2015.

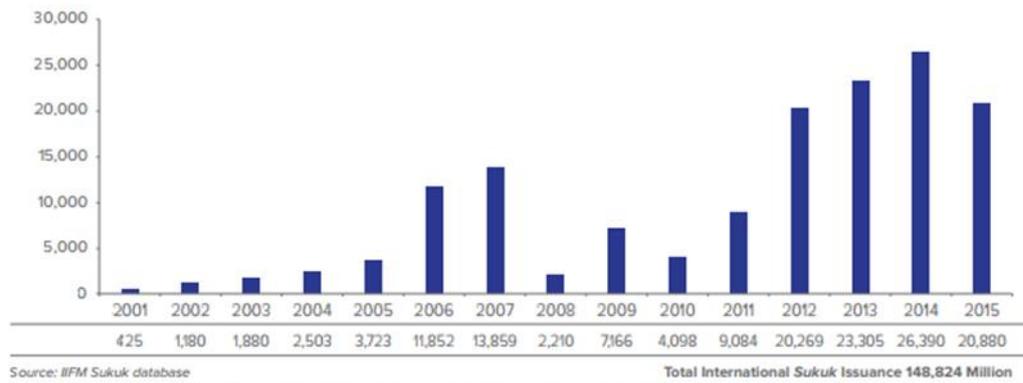


Figure 5: Total International Sukuk Issuances between JAN 2001 and DEC 2015. all tenors, all currencies, in USD millions

(source: <http://ow.ly/d89e30c4x9y>)

However, during the last couple of years, between 2014-2015 long-term *Sukuk* were issued in a record number in new jurisdictions such as the United Kingdom which has a very strong participation in the market of Islamic assets.⁹²⁷ More than twenty banks based in London provide Islamic financing services through *Sukuk*; six of those banks are completely compliant with the provisions of Islamic sharia,⁹²⁸ which make the UK to be the largest Western country in terms of the number of banks issuing *Sukuk*.⁹²⁹ Other countries that have recently been engaged with *Sukuk* include South Africa, Hong Kong, Oman, Ivory Coast, Senegal and Luxembourg.⁹³⁰

Moreover, socially responsible investing has recently engaged with *Sukuk* by means of a socially responsible *Sukuk*, a new category of investment, with the issuance of *Sukuk* by the World Bank linked International Finance Facility for Immunization

⁹²⁶ Ibid.

⁹²⁷ Khalid Talahma, 'Islamic Bonds (*Sukuk*): Opportunities and Challenges' (2015) 15 *Asper Review of International Business and Trade Law* 401.

⁹²⁸ Ibid.

⁹²⁹ Ibid.

⁹³⁰ Ibid 7.

(IFFIm).⁹³¹ In the latter part of 2014 the first Socially Responsible Investing (SRI) *Sukuk* were issued with US\$500 million; then in September 2015, other *Sukuk* worth US\$200 million were issued for the same purpose.⁹³² SRI also called “socially conscious”, “sustainable”, “ethical”, “mission” or “green” investing, shares common principles with Islamic finance in terms of fairness, equality and ethical principles that Islamic finance aims to uphold. Investors in both instances seek to achieve a high return on their investments and, at the same time, they also take into account social returns to society and not only purely economic returns.⁹³³ The total volume of SRI has increased by 30% since 2005.⁹³⁴ Islamic finance, especially *Sukuk*, provides a great opportunity to attract new customers, who share a similar focus on ethics and socially conscious investments, to join the *Sukuk* market; this would be a useful bridge to connect the conventional and Islamic markets.⁹³⁵

Over the last decade, *Sukuk* have been growing fast due to the demand for Islamic financial products and services and the huge number of financial institutions entering the market. The *Sukuk* market is projected to have strong long-term growth prospects.⁹³⁶

Sukuk are financial tools that represent the most important and the main outlet for liquidity management in Islamic financial institutions and banks.⁹³⁷ Issuing *Sukuk* has become one of the most important goals of Islamic banking and financial institutions since it offers an effective way to manage liquidity, whenever they have an excess of liquidity, they can buy these instruments, and when they are short of liquidity, and those *Sukuk* can be sold in the secondary market.⁹³⁸

⁹³¹ Ibid.

⁹³² Ibid.

⁹³³ Malaysia World's Islamic Finance Marketplace, 'Socially Responsible Investing: An Opportunity for Islamic Finance' (Bank Negara Malaysia 2015) <<http://www.mifc.com>> accessed 7 April 2016.

⁹³⁴ Ibid.

⁹³⁵ Michael S. Bennett and Zamir Iqbal, 'How Socially Responsible Investing Can Help Bridge the Gap Between Islamic And Conventional Financial Markets' (2013) 6 International Journal of Islamic and Middle Eastern Finance and Management.

⁹³⁶ Khalid Alsaeed, 'Sukuk Issuance in Saudi Arabia: Recent Trends and Positive Expectations' (PhD, University of Durham 2012) 9.

⁹³⁷ Ahmed Badran, 'الصكوك كأداة للتمويل بين النظرية والتطبيق' (Sukuk as a Tool for Financing: Theory and Practice) (2014) 152 Almuslim Almaser Journal 159.

⁹³⁸ Ibid 162.

5.4 Differences and Similarities between *Sukuk* and other Financing Instruments

5.4.1 Similarities and Differences between Conventional Bonds and *Sukuk*

Before going into the details of the differences and similarities between *Sukuk* and bonds, it seems important to highlight that the idea of the current version of *Sukuk*, which is practised in many places around the world, comes from conventional bonds. Bonds are designed to provide useful mechanisms to the economy, such as controlling excess liquidity and being an effective way for governments and companies to access cash;⁹³⁹ yet bonds are based on interest which should be calculated on their maturity while, as has been discussed earlier, Islam prohibits any act that may cause damage to the individual or society, interest or usury being one of them.⁹⁴⁰ The current Islamic finance sector is eager to adopt the same important features as the bonds while trying to avoid engaging with usury or any act that may contradict with Islamic finance principles.⁹⁴¹ For Investors who want to only engage with investments that do not contreduct with their belive for example Muslims investors who want to only invest in a way that do not contreduct with sharia. They will avoid engaging with bonds for example because it contains riba but they may choose sukuk as an alternative option.

In order to show the differences between *Sukuk* and conventional bonds, it is essential to compare their definitions. Bonds, known as fixed income securities, can be defined as certificates that establish a relationship between the bond-holder (creditor) and the issuer (debtor) whereby the latter gets a certain amount of money in return for the bond, and then the same amount of money has to be paid back plus interest at the end of the lifetime of the bond (maturity) to the bond-holder.⁹⁴²

On the other hand, with respect to *Sukuk*, the relationship between the *Sukuk* holder and the issuer is a relationship between an issuer and a buyer. Indeed, the *Sukuk* holder has the ownership of an asset that represents undivided shares in ownership of either tangible assets, usufruct and services or even (in the ownership of) the assets

⁹³⁹ A Saeed and O Salah, 'Development of *Sukuk*: Pragmatic and Idealist Approaches to *Sukuk* Structures' [2013] *Journal of International Banking Law and Regulation* 42.

⁹⁴⁰ See 2.7.1 above.

⁹⁴¹ Abdullah Al Elsheikh and Joseph Tanega, 'Sukuk Structure and its Regulatory Environment in the Kingdom of Saudi Arabia' (2011) 5 *Law and Financial Markets Review* 184.

⁹⁴² Abdullah Al Elsheikh and Joseph Tanega, 'Sukuk Structure and its Regulatory Environment in the Kingdom of Saudi Arabia' (2011) 5 *Law and Financial Markets Review*.

of certain projects or special investment activities, and the *Sukuk* holder will get the profit based on the revenue made by the performance of the underlying real asset. Therefore, the value of the *Sukuk* and its return should not be guaranteed while in bonds it is a debt plus an interest which has to be paid as agreed.

Cakir and Raei see both bonds and *Sukuk* almost the same with regards to rating, issuance and redemption procedures and default clauses.⁹⁴³

Based on the above, it can be said that *Sukuk* and bonds are:

- Traded securities whose primary purpose is to finance a project.
- Both can be used to manage cash flow and to finance various purposes.

Trading in bonds does not require the transfer of share ownership of those assets, which becomes the prerogative of the issuer, as it is only transferring the debt certificate from one to another for cash, while trading in *Sukuk* is a sale of a share of the ownership in the project to a new holder.⁹⁴⁴

One of the differences between *Sukuk* and conventional bonds is that the *Sukuk*'s return on investment is based on the revenue made by the performance of an underlying real asset whereas in the conventional bonds, the revenue on investment is fixed in the form of interest which is not contingent upon any underlying asset.⁹⁴⁵ Therefore, as far as *Sukuk* are concerned, an investor gets returns on the basis of ownership rather than interest.⁹⁴⁶ As a result, the value of *Sukuk* can increase when the value of assets increases.⁹⁴⁷ Indeed, *Sukuk* are priced in line with the value of the assets that back them, while bond pricing is grounded on credit rating.⁹⁴⁸

Moreover, the sale of *Sukuk*, both in the primary and secondary markets, is a sale of a share of an asset, while selling a bond is basically the sale of a debt to be traded in

⁹⁴³ Faezeh Raei and Selim Cakir, 'Sukuk Vs. Eurobonds: Is There a Difference in Value-At-Risk?' (2007) 7 IMF Working Papers 12.

⁹⁴⁴ Njla AL-Bogomy, *مخاطر الصكوك وآليات التحوط منها: مع دراسة تطبيقية لصكوك شركة متعثرة (Hedging Sukuk Risks: With a Case Study of a Defaulted Sukuk)* (SABIC publisher 2013).

⁹⁴⁵ Siti Faridah Abdul Jabbar, 'Sharia-Compliant Financial Instruments: Principles and Practice' (2009) 30 Company Lawyer.

⁹⁴⁶ Muhammad Ayub, *Understanding Islamic Finance* (Wiley 2013) 193.

⁹⁴⁷ Wahida Ahmad and Rafisah Mat, 'Sustainability of *Sukuk* and Conventional Bond During Financial Crisis: Malaysia's Capital Market' (2011) 4 Global Economy and Finance Journal.

⁹⁴⁸ Ali Alshamrani, '*Sukuk* Issuance and its Regulatory Framework in Saudi Arabia' (2014) 2 Journal of Islamic Banking and Finance.

the secondary market, which is prohibited in Islam.⁹⁴⁹ This suggests that in *Sukuk* what should be traded in the secondary market is an ownership right in a tangible asset and not a pure debt claim.⁹⁵⁰

Furthermore, *Sukuk* can help the economy be accessible to Muslim investors all around the globe who seek opportunities of receiving a decent return in a way that also pleases God, as bonds usually contain interest which is prohibited in Islam.⁹⁵¹

Other differences include the fact that *Sukuk* could be safer than bonds in a way that because the owners of *Sukuk* (*Sukuk* holders) own asset-backing for their funding, while in bonds it is a loan and the lender usually do not own the underlying asset to secure and to recover the principal investment.⁹⁵² However, as the *Sukuk* holders are considered as having an actual ownership in the assets of a project, they can be at risk of losing if the assets or the project were to collapse.⁹⁵³

Both bonds and *Sukuk* can be asset-backed but the difference between *Sukuk* and conventional asset-backed securities is that in the latter, the underlying assets can be financial assets like loans or other receivables, while in *Sukuk* only real assets can be used as collaterals and must not contradict sharia.⁹⁵⁴

In addition, validity of bonds depends on and is measured through credit of its issuer as it represents loan; while in *Sukuk*, the validity should depend on value of the assets backing it.⁹⁵⁵

Even though *Sukuk* and bonds have many similarities, a number of their differences may have significant consequences to the economy.⁹⁵⁶ For example, several problems that hit the world economy in the last decade have been caused by the practice of

⁹⁴⁹ Khalid Talahma, 'Islamic Bonds (*Sukuk*): Opportunities and Challenges' (2015) 15 *Asper Review of International Business and Trade Law*.

⁹⁵⁰ A Saeed and O Salah, 'Development of *Sukuk*: Pragmatic and Idealist Approaches to *Sukuk* Structures' [2013] *Journal of International Banking Law and Regulation*.

⁹⁵¹ Tahmoures A. Afshar, 'Compare and Contrast *Sukuk* (Islamic Bonds) with Conventional Bonds, are they Compatible?' (2013) 9 *The Journal of Global Business Management*.

⁹⁵² Mohamed Ariff, Munawar Iqbar and Shamsheer Mohamed, *The Islamic Debt Market for Sukuk Securities: The Theory and Practice of Profit Sharing Investment* (Edward Elgar Pub 2012) 14.

⁹⁵³ Hamed Merah, *صكوك الإجارة: دراسة فقهيّة* (*Ijara Sukuk: An Empirical Study*) (Dar Al Miman publisher 2008) 367.

⁹⁵⁴ Ali Alshamrani, 'Sukuk Issuance and Its Regulatory Framework in Saudi Arabia' (2014) 2 *Journal of Islamic Banking and Finance*.

⁹⁵⁵ Pegah Zolfaghari, 'An Introduction to Islamic Securities (*Sukuk*)' (Working Paper, Uppsala University 2017) 15.

⁹⁵⁶ Muhammad Ayub, 'Securitization, *Sukuk* and Fund Management Potential to be Realized by Islamic Financial Institutions', *The 6th International Islamic Economic Conference* (2005).

profiting from money alone at the expense of productivity and people.⁹⁵⁷ Interest and artificial inflation of prices based on debt rather than on real value is considered as one of the main reasons why bubbles form, burst and then lead to recessions and depressions.⁹⁵⁸ Such problems should not exist in *Sukuk* as they are priced according to the real market value of the assets that back the *Sukuk* certificate.⁹⁵⁹ The pricing of bonds is based on the credit rating of the issuer, so when an investor sells a bond on the secondary market, the investor is actually selling the debt in the underlying loan relationship. On the other hand, in the case of *Sukuk* the sale in the secondary market is simply the sale of ownership in the asset.⁹⁶⁰

Based on a report by Aljazira Capital, *Sukuk* are preferred over conventional bonds in Saudi Arabia.⁹⁶¹ According to this report, one of the reasons for this preference is that *Sukuk* are backed by physical collaterals and give investors proportionate ownership of the underlying asset for a predefined period while conventional bonds only give a promise by the issuer to repay the loan to investors. The report also mentions that the rising cost of financing due to the tighter lending environment and the volatility in the equity markets has increased the reliance on *Sukuk* financing.⁹⁶² Table 2 below shows a summary of the differences between *Sukuk* and bonds.

#		<i>Sukuk</i>	Bonds
1-	Contract based on	Seller – buyer relationship.	The borrower – lender.
2-	Representation	A claim on ownership of asset and cash flow.	Claim is on the debt instrument.
3-	Return rate	May have fixed (from lease <i>sukuk</i> contract) or variable rates of return.	A fixed rate.

⁹⁵⁷ Ibid.

⁹⁵⁸ Muhammad Ayub, 'Securitization, *Sukuk* and Fund Management Potential to be Realized by Islamic Financial Institutions', *The 6th International Islamic Economic Conference* (2005)

⁹⁵⁹ Aujil Al-Nashmi, 'الصكوك الإسلامية: عرض وتقويم' (Islamic Sukuk: Presentation and Evaluation)' [2010] مركز أبحاث الأعمال الإسلامية.

⁹⁶⁰ Ibid.

⁹⁶¹ Abdullah Alawi, Saleh Al-Quati and Wael Sindi, 'The Financing Role of the Saudi Capital Market Promising Prospects' (AlJazira Capital 2010) 12.

⁹⁶² Ibid.

4-	Return	Expected/estimated from underlying asset.	Pre-determined (interest).
5-	Capital appreciation	Investors may get more return on their invested capital.	Return is fixed and cannot vary with the performance.
6-	Return on invested capital	Invested capital is not guaranteed.	Issuer is obligated to pay at maturity.
7-	Sharia compliant	Underling assets must comply with sharia. For example no interest.	No need to comply with sharia, it is applicable to any transaction either permitted to or not to sharia.
8-	In case of default	The <i>Sukuk</i> holders have recourse to the asset not to a bankrupted individual.	Bond holders have no choice but to have recourse to the issuer for the unpaid amount.
9-	Customer of this product	Suitable to any investor.	Have some issues for example, Muslims should not engage with bonds as they are not sharia-complaint.

Table 2: Comparative between *Sukuk* and bonds⁹⁶³

⁹⁶³ Tahmoures A. Afshar, 'Compare and Contrast *Sukuk* (Islamic Bonds) with Conventional Bonds, are they Compatible?' (2013) 9 The Journal of Global Business Management

5.4.2 Similarities and Differences between *Sukuk* and Stocks or Shares

There are some similarities between *Sukuk* and stocks. For example, they represent ownership claims and that the return on both investments is not guaranteed.⁹⁶⁴ Also, both the owner of stocks and of *Sukuk* is eligible for a share of the net profits of the company and the project is commensurate with the value of the shares owned by the company or instrument which is owned in the project. In addition, a *Sukuk* certificate and a stock certificate are both financial instruments whose face value is not guaranteed by the issuer, so the *Sukuk* and stock holders may or may not get back the entire principal.⁹⁶⁵

On the other hand, *Sukuk* and stocks differ in some aspects; for instance, *Sukuk* usually have lower risks than stocks because the assets usually chosen in *Sukuk* are high value assets to encourage investors to buy the *Sukuk* and to have better rating while the stock certificate is categorised as a high-risk investment.⁹⁶⁶

In addition, stocks are permanent posts in the company and exist as long as the company remains, even when ownership of the company moves from one person to another. As they represent the company's issued share capital, stocks do not have a maturity date by which they have to be sold, which is not the case in *Sukuk* that have a maturity date by which date they will end, as specified at the beginning of the agreement.⁹⁶⁷ Furthermore, *Sukuk* must be related to a specific asset, service or project for a period of time. Equity shares, of course, represent ownership claims on the whole company with no maturity date.⁹⁶⁸

Another difference is that the *Sukuk* certificate owner is a fund provider to the company while the stock holder is a partner in a company.⁹⁶⁹ Also stock differs from *Sukuk* from the perspective that the owner of the stock can contribute to the company's

⁹⁶⁴ Christophe J. Godlewski, Rima Turk-Ariss and Laurent Weill, 'Sukuk vs. Conventional Bonds: A Stock Market Perspective' (2013) 41 Journal of Comparative Economics 747.

⁹⁶⁵ Njla AL-Bogomy, مخاطر الصكوك وآليات التحوط منها: مع دراسة تطبيقية لصكوك شركة متعثرة, (Hedging Sukuk Risks: With a Case Study of a Defaulted Sukuk) (SABIC publisher 2013).

⁹⁶⁶ Ibid.

⁹⁶⁷ Ibid.

⁹⁶⁸ Christophe J. Godlewski, Rima Turk-Ariss and Laurent Weill, 'Sukuk vs. Conventional Bonds: A Stock Market Perspective' (2013) 41 Journal of Comparative Economics 747.

⁹⁶⁹ Fahad Al-marshadi, الصكوك - أحكامها وضوابطها وإشكالاتها: دراسة شرعية نقدية, (The Provisions of the Sukuk, its Controls and Problems: a Critical Study) (Dar Kpnoz Ashbilia 2014) 24.

management through the election of the board of directors while a Sukuk holder cannot.⁹⁷⁰

5.5 How Sukuk Work

Islamic financial contracts are distinctive as they are not only designed to provide the different parties with a practical profit, but also because the whole procedure from starting the financial contract to gaining a profit has to be done in a manner compliant with sharia principles. A number of traditional Islamic financial contracts exist, new contracts have also been made and others can be designed through financial engineering to be sharia compliant. Several of these contracts have been used in the financial market to issue *Sukuk*. They are backed by sharia-compliant sale leasebacks or profit-sharing arrangements. Ayman Alshelfan categorises *Sukuk* contracts into four types: (1) partnership, (2) obligation, (3) quasi-debt contracts and (4) hybrid contracts. Hybrid contracts are a combination of different Islamic contract forms, including the three types that have just been mentioned, packaged together and sold in order to form the underlying basis for issuing *Sukuk*.

Although the procedures differ from contract to contract, the basic idea of *Sukuk* in general can be explained as follows. In order to make a *Sukuk*, the first step is securitisation, known as *Tawaruq*, which consists of transforming assets into financial instruments. Conversion of assets to securities allows investors to buy small parts of the asset without being enforced to pay entire price of the overall asset for its purchase. Securitisation is usually achieved through three stages: (1) the *Sukuk* issuance stage (2) managing the *Sukuk* portfolio stage and (3) the maturity date or the end of the lifetime of the *Sukuk*.

For the *Sukuk* issuance stage, the originator or the issuing entity of the assets (company, individuals or groups or countries) starts to list all the assets that generate cash returns; those varieties that are meant to be securitised into one investment account are called a *Sukuk* portfolio asset.

The next step is to securitise the assets by selling, and transferring the ownership of those assets to a Special Purpose Vehicle (SPV) that will sort out the assets by re-classifying and dividing them into units to fit and meet the needs and desires of

⁹⁷⁰ Njila AL-Bogomy, مخاطر الصكوك وآليات التحوط منها: مع دراسة تطبيقية لصكوك شركة متعثرة (Hedging Sukuk Risks: With a Case Study of a Defaulted Sukuk) (SABIC publisher 2013).

investors and finally to convert them into certificates, each one represents an undivided interest in the securitized assets, to be sold to investors. Therefore, as an issuance agent, the SPV is required to hold underlying tangible assets in order to issue the certificates of *Sukuk*. At the same time, the *Sukuk* holders have to hold some degree of ownership in the underlying tangible assets to avoid falling into *Riba* that indirectly leads to a prohibition on trading in debt receivables (*bay' Al-dayn*) as the majority of sharia scholars consider trading in debt claims to be included in the prohibition of *Riba* as it is similar to the forbidden use of money as a source of profit. This therefore means that pure debt instruments are Islamically prohibited.⁹⁷¹

The *Sukuk* proceeds that paid by the investors should be used for the purpose they have been issued for. This can be considered as one of the *Sukuk*'s significant features, as a *Sukuk* holder is an owner of a share in the capital of the project. Moreover, a single *Sukuk* certificate represents a non-divided percentage in the ownership of an asset, such as an aircraft, a ship or a building, with a right of access to the regular income derived from this asset. The regular revenues of the *Sukuk* can be structured in the form of tradable securities in the stock exchange markets.

After the sale of the instruments via SPV to the investors, the SPV is responsible for managing the portfolio on behalf of the investors for the whole duration of the release, for collecting the frequent revenue that should be generated from the assets and for distributing them to the investors, so providing all the services needed by the portfolio.

Finally, the end of the lifetime of the *Sukuk*, or maturity date, is to repurchase the instruments on the dates specified by the prospectus. Figure 6 below illustrates the basic structure of *Sukuk*.

⁹⁷¹ A Saeed and O Salah, 'Development of *Sukuk*: Pragmatic and Idealist Approaches to *Sukuk* Structures' [2013] *Journal of International Banking Law and Regulation*.

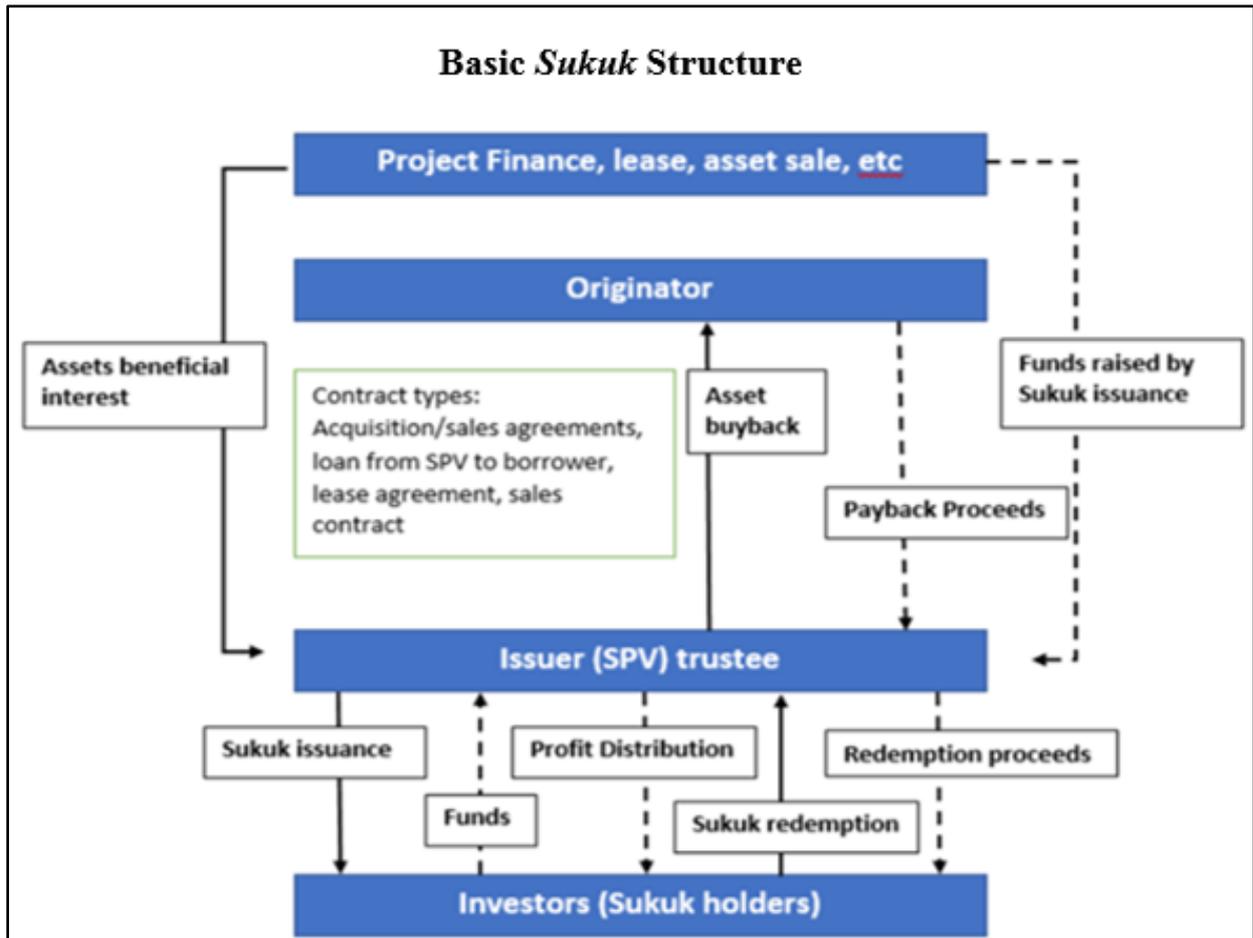


Figure 6: From *Sukuk*: a potential for stability and development in the GCC

Source: http://eprints.kingston.ac.uk/34924/1/2016_007.pdf

5.6 Asset-backed *Sukuk* and Asset-based *Sukuk*

At the beginning of appearance of the *Sukuk* in financial market, there were lack of definitions and categories of the different forms of *Sukuk*. Then after some defaults incidents that happened during the global financial crisis in 2008 most of them were assets based *Sukuk*, that shared a common structure of debt-instruments as Mashiyat Tasnia, Is'haq Muhammad Mustapha and Mohammad Hassan Shakil stated.⁹⁷² They added that such *Sukuk* defaulted in part due to the monetary crisis and the economic downturn that triggered it originators did not earn sufficient revenues to make the promised payments.⁹⁷³ While, almost none of the asset-backed *Sukuk* has defaulted,

⁹⁷² Mashiyat Tasnia, Is'haq Muhammad Mustapha and Mohammad Hassan Shakil, 'Critical Assessment of the Legal Recourse for the Case of *Sukuk* Default for the Asset-Backed and Asset-Based *Sukuk* Structures' (2017) 7 *European Journal of Islamic Finance* 2.

⁹⁷³ *Ibid.*

due to the notion that they follow the structure of profit and loss sharing, hence they do not have any debt instrument.⁹⁷⁴

There has been an attempt to categorise *Sukuk* with the intention of differentiating genuine and non-genuine ones, especially from the perspective of risk factors and sale execution.⁹⁷⁵ Thus, the issue of the ownership in the *Sukuk* asset appeared, resulting in the popularity of categorizing the *Sukuk* into asset-based and asset-backed structures.⁹⁷⁶

The asset-backed can be defined as an Islamic security issued pursuant to a securitization transaction.⁹⁷⁷ The transaction in asset-backed involves true sale and the transfer of legal ownership of the asset from the originator to a third party which is usually the SPV, thus the assets should be removed from the issuer's balance sheet.⁹⁷⁸ The SPV should be an express trustee of the *Sukuk* holders that receives fees as an issuer of the *Sukuk*, whereas the legal part-owners of the underlying asset are the *Sukuk* holders who receive a return on investment based on the performance of the underlying asset.⁹⁷⁹ In the case of default by the *Sukuk* issuer, the *Sukuk* holders have recourse to the *Sukuk* asset, not the issuer.⁹⁸⁰

On the other hand, in asset-based, the underlying asset used to structure the issuance remains on the balance sheet of the originator after the issuance of the *Sukuk*. In this category, the originator only passes beneficial ownership of the asset to *Sukuk* holders, while still keeps its legal ownership.⁹⁸¹

Thus, from legal perspective no true sale is made in asset-based structure. In other word, it is a sale that fall short of true sales which are recognised as valid sales in common law;⁹⁸² As a result, the assets cannot be sold to a third party by the *Sukuk*

⁹⁷⁴ Ibid.

⁹⁷⁵ Ayman Alshelfan, 'Maslaha: A New Approach for Islamic Bonds' (PhD, Victoria University Melbourne 2014) 50.

⁹⁷⁶ Sutan Hidayat, 'A Comparative Analysis between Asset Based and Asset Backed Sukuk: Which One is More Sharia Compliant?' (2013) 1 International SAMANM Journal of Accounting and Finance 26.

⁹⁷⁷ Ibid.

⁹⁷⁸ Ayman Alshelfan, 'Maslaha: A New Approach for Islamic Bonds' (PhD, Victoria University Melbourne 2014)

⁹⁷⁹ Sutan Hidayat, 'A Comparative Analysis between Asset Based and Asset Backed Sukuk: Which One is More Sharia Compliant?' (2013) 1 International SAMANM Journal of Accounting and Finance 25.

⁹⁸⁰ Ibid.

⁹⁸¹ Ibid.

⁹⁸² Sutan Hidayat, 'A Comparative Analysis between Asset Based and Asset Backed Sukuk: Which One is More Sharia Compliant?' (2013) 1 International SAMANM Journal of Accounting and Finance

holders. It also means the *Sukuk* holders only have the recourse to the originator/obligor.⁹⁸³ Thus, Prospective investors, therefore, rely on the creditworthiness of the obligor or sponsor of an asset-based *Sukuk* rather than on the quality of the assets underlying the *Sukuk*.⁹⁸⁴ According to Rating Agency Malaysia, the underlying asset in Asset-based *Sukuk* is not the one to be considered as the fund generator and the capital payments. Rather it is a mechanism to fulfil the requirement of the sharia.⁹⁸⁵ There are some concerns from sharia scholars about some of the assets based structures that may comply with sharia in form but not in substance.⁹⁸⁶ As Asyraf Dusuki stated sharia compliant, should not be only in forms and legal technicalities of the financial contracts.

But, more importantly, in their economic substance, which should be premised on the objectives outlined by the sharia.⁹⁸⁷ The different views on the sharia validity of some of the assets-based *Sukuk* can be understood from the different schools of thought and *Hiyal* that already have been discussed.⁹⁸⁸

Table 3 shows the differences between asset-based and asset-backed *Sukuk*.

Category	Asset-based	Asset-backed
Source of Payment	The source of payment comes from the originator/obligor's cash flows.	The source of payment comes from the revenue generated by underlying asset.
The use of assets	Assets are used as security interest.	Securitisation
Presentation/dis-closure of the asset	The asset stays on the balance sheet of the originator/obligor.	The asset is separated from the originator's book.

⁹⁸³ Ibid 26.

⁹⁸⁴ Inutu Lukonga, 'Islamic Finance, Consumer Protection, and Financial Stability' (2015) 15 IMF Working Papers 15.

⁹⁸⁵ Mashiyat Tasnia, Is'haq Muhammad Mustapha and Mohammad Hassan Shakil, 'Critical Assessment of the Legal Recourse for the Case of Sukuk Default for the Asset-Backed and Asset-Based Sukuk Structures' (2017) 7 European Journal of Islamic Finance 3.

⁹⁸⁶ Ibid.

⁹⁸⁷ Asyraf Wajdi Dusuki, 'Do Equity-Based Sukuk Structures in Islamic Capital Markets Manifest the Objectives of Shariah?' (2010) 15 Journal of Financial Services Marketing 212.

⁹⁸⁸ See 4.4 above.

Type of <i>Sukuk</i> holders' ownership	Beneficial ownership with no right to dispose of the asset.	Legal ownership with right to dispose of the asset.
Recourse	Purchase undertaking at par from obligor is the ultimate recourse. The recourse is only to the obligor and not the asset.	<i>Sukuk</i> holders only have recourse to the asset, thus, the asset plays a genuine role in defaults.
Risk	Risk with originator.	Risk with assets.

Table 3: Differences between asset-based and asset-backed *Sukuk*

(Source: <http://ow.ly/Ja2R30c4CVo>)

5.7 *Sukuk* that can be Traded in the Secondary Market

Sukuk have been issued and traded in the secondary market in various parts of the world; it worth noting that the demand for *Sukuk* has become essential for Islamic banks and Islamic financial institutions as they have fewer financial instruments that can be used to manage the liquidity,⁹⁸⁹ which is an inherent conduct of banking operations.⁹⁹⁰ They can only use instruments which are sharia-compliant, since they are prevented from borrowing or lending in the interbank market or at the central bank's discount window.⁹⁹¹ For instance, Islamic pension funds and Islamic insurance companies can only invest in sharia-compliant instruments.⁹⁹²

As *Sukuk* have become the backbone of the development of a much-needed secondary Islamic capital market, most of these instruments are retained by Islamic banks, Islamic pension funds and Islamic insurance companies, as they are permitted to invest in sharia-compliant instruments. With the high demand for *Sukuk* from Islamic financial institutions, there are limited supplies on the market, which leads to an excess

⁹⁸⁹ See 5.1 above.

⁹⁹⁰ Christophe J. Godlewski, Rima Turk-Ariss and Laurent Weill, 'Sukuk vs. Conventional Bonds: A Stock Market Perspective' (2013) 41 Journal of Comparative Economics 757.

⁹⁹¹ Nathif J Adam and Abdulkader Thomas, *Islamic Bonds: Your Guide to Issuing, Structuring and Investing in Sukuk* (Euromoney Books 2005) 61.

⁹⁹² Ibid.

of demand over supply situation.⁹⁹³ Based on the comparison between conventional and Islamic bonds, it appears that not all kinds of *Sukuk* can be traded in the secondary market as some have several sharia issues with regard to reselling.⁹⁹⁴

The basic idea behind the permissibility of trading *Sukuk* or any instrument in a secondary market is that as *Sukuk* represent undivided shares in ownership of tangible assets, usufruct and services, the decision whether they can be traded in the secondary market depends on the kind of assets.⁹⁹⁵ Thus, the issuance of *Sukuk* has to be against some tangible assets and not against cash or debts.⁹⁹⁶ So the tradability of *Sukuk* at the time of issuance (primary market) as well as in the secondary market has to follow these rules:

1. If *Sukuk* are issued against specific assets (tangible assets) or services, then this issuance implies the sale of these assets to the *Sukuk* holders in return for cash money based on current values of assets or services, and therefore the *Sukuk* becomes tradable.⁹⁹⁷

2. If the issuance of *Sukuk* is made against described assets or services that would be constructed or manufactured in the future, this would mean that the issuance implies the sale of these assets to the *Sukuk* holders in return for cash money, and these *Sukuk* are not tradable until the deliverability of assets or services.⁹⁹⁸

3. If the issuance of *Sukuk* is not against assets or services, but for the purpose of utilising the proceeds to acquire some assets, then *Sukuk* cannot be tradable until the stage at which those assets or services are purchased. This is because the *Sukuk* up to that point represent liquid proceeds, for example, cash money and money only can be sold against money under certain rules of *Sarf* (exchange) are observed.⁹⁹⁹

⁹⁹³ Christophe J. Godlewski, Rima Turk-Ariss and Laurent Weill, 'Sukuk vs. Conventional Bonds: A Stock Market Perspective' (2013) 41 *Journal of Comparative Economics* 757.

⁹⁹⁴ Mohamad Zin and others, 'The Effectiveness of Sukuk in Islamic Finance Market' (2011) 5 *Australian Journal of Basic and Applied Sciences* 473.

⁹⁹⁵ Hamed Merah, *صكوك الإجارة: دراسة فقهيّة (Ijara Sukuk: An Empirical Study)* (Dar Al Miman publisher 2008).

⁹⁹⁶ Mohamad Zin and others, 'The Effectiveness of Sukuk in Islamic Finance Market' (2011) 5 *Australian Journal of Basic and Applied Sciences* 473.

⁹⁹⁷ Mohamad Zin and others, 'The Effectiveness of Sukuk in Islamic Finance Market' (2011) 5 *Australian Journal of Basic and Applied Sciences* 473.

⁹⁹⁸ *Ibid.*

⁹⁹⁹ *Ibid.*

4. If there is any mixture between the three types above then the assets stated in the first type must dominate in sukuk issuance.¹⁰⁰⁰

5.8 The Most Common *Sukuk* Contracts

Sukuk can be created in various forms: for example, partnership, obligation, and quasi-debt contracts. As mentioned earlier AAOIFI defines fourteen different *Sukuk* structures.¹⁰⁰¹ This section will only choose four contracts as they are the most commonly used *Sukuk* that provide sufficient information for the purpose of this study.¹⁰⁰²

5.8.1 *Ijarah Sukuk*

This *Sukuk* is formed based on the *Ijarah* (lease) contract which allows the transfer of the usufruct of an asset in return for rental payment, which makes it similar to a conventional lease contract.¹⁰⁰³

Ijarah Sukuk are based on a sale and leaseback agreement which signifies an ownership of equal shares in rented assets or the usufruct of assets. The holders of such *Sukuk* should obtain the right to own real estate, receive the rent and dispose of their *Sukuk* in a manner that does not affect the right of the lessee (i.e. they are tradable). The owners of *Ijarah Sukuk* should be responsible for all costs of maintenance and damage to the real estate, while maintenance expenses related to its operation should be the lessee's responsibility.¹⁰⁰⁴

Ijarah Sukuk can take different forms depending on the need of the originator. There are usually three parties who engage in this kind of *Sukuk*: (1) the originator, (2) the SPV and (3) investors or *Sukuk* holders.¹⁰⁰⁵ The common form of *Ijarah Sukuk* is a sale and leaseback agreement which starts with an originator or beneficiary who sells

¹⁰⁰⁰ Ibid.

¹⁰⁰¹ See 5.3 above.

¹⁰⁰² Mumtaz Hussain, Asghar Shahmoradi and Rima Turk, 'An Overview of Islamic Finance' (2015) 15 IMF Working Papers 15.

¹⁰⁰³ Muhammad Ab Aziz and Mohd Ibrahim, 'The Structure of Sukuk Ijarah: An Initial Analysis from the Perspective of Maqasid Al-Sharia', *The 5th Islamic Economic System Conference* (iECONS 2013).

¹⁰⁰⁴ 'Central Bank of Bahrain Volume 2—Islamic Banks' (Complinet.com, 2016) <http://www.complinet.com/cbb/display/display.html?rbid=1821&element_id=2317> accessed 8 December 2016.

¹⁰⁰⁵ Khalid Alsaeed, 'Sukuk Issuance in Saudi Arabia: Recent Trends and Positive Expectations' (PhD, University of Durham 2012) 46.

the assets that would be used as *Sukuk* on a specified and defined purchase price to a SPV. The SPV converts those assets to issue certificates that have an equal value and represent undivided shares in the ownership of those assets to be sold to investors who become the *Sukuk* holders.¹⁰⁰⁶ The income derived from selling the *Sukuk* certificates to investors are paid to the originator via the SPV, then a lease agreement is signed between the SPV and the originator for a fixed period of time whereby the originator leases back the assets as lessee and pays a regular rental amount to the SPV which distributes the rental income to the *Sukuk* holders. The *Sukuk* holders can sell the leased asset as long as the sale does not hinder the lessee from receiving a benefit from the asset and the new holder will start to receive the rentals. Finally, at the predefined maturity of the *Sukuk*, the SPV sells the assets back to the originator at a predetermined value.¹⁰⁰⁷

Furthermore, the use of a purchase undertaking in *Ijarah Sukuk* is generally accepted by sharia scholars.¹⁰⁰⁸ Also, the general flexibility of the *Ijarah* contract has led to flexibility in the *Ijarah Sukuk*. These are some of the reasons behind its popularity among other *Sukuk* structures.

However, there are disagreements between sharia scholars on several issues with these *Sukuk*, such as the promise of *Sukuk* managers, partners, or agents to repurchase the *Sukuk* for the same price at its face value. Indeed, a number of sharia scholars prohibit such a promise and consider that the promise of repurchasing should be based on the value of the assets at the time for the repurchase (See Figure 7).¹⁰⁰⁹

¹⁰⁰⁶ Ali Alshamrani, 'Sukuk Issuance and its Regulatory Framework in Saudi Arabia' (2014) 2 Journal of Islamic Banking and Finance 313.

¹⁰⁰⁷ Khalid Alsaeed, 'Sukuk Issuance in Saudi Arabia: Recent Trends and Positive Expectations' (PhD, University of Durham 2012) 46.

¹⁰⁰⁸ Dubai International Financial Centre, 'Dubai International Financial Centre Sukuk Guidebook' (DIFC 2009).

¹⁰⁰⁹ Faisal Al-Shamary, *مسائل فقهية في الصكوك: عرض وتقويم (Fiqhi Issues in Sukuk: Presentation and Assessment)* (SABIC 2016).

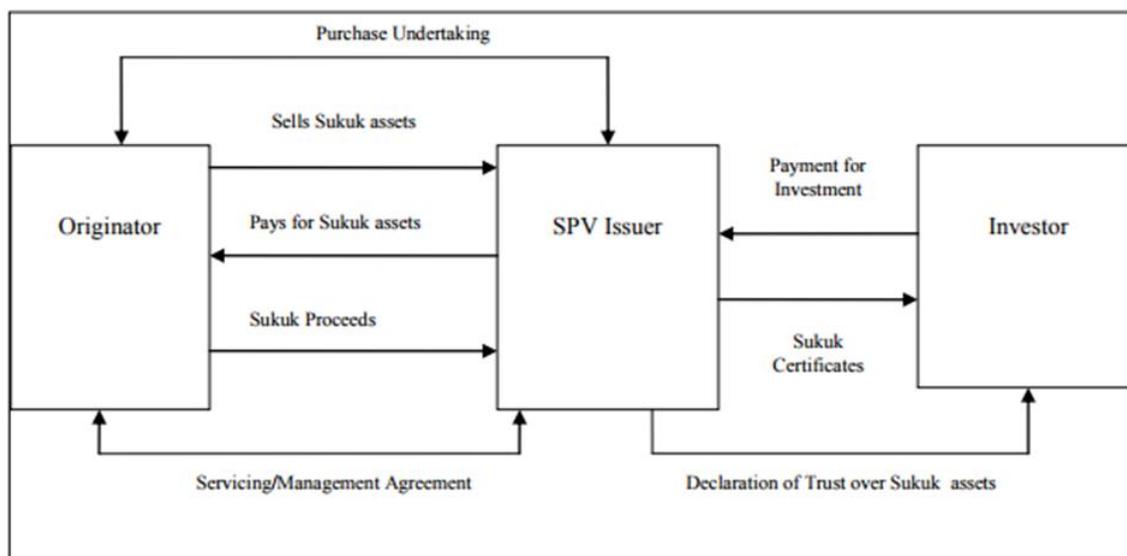


Figure 7: Sukuk Ijara structure Surece: Sukuk Issuance in Saudi Arabia: Recent Trends and Positive Expectations ¹⁰¹⁰

Sarawak Economic Development Corporation (SEDC) can be an example of this kind of Sukuk when SEDC raised US\$350 million in 2004 from the market through a *Sukuk Ijarah* Trust Certificates issuance by its SPV, Sarawak Corporate Sukuk Inc. (SCSI). The maturity of the issued certificates was 5 years and under the proposed structure, the proceeds will be used by the issuer to purchase certain assets from 1st Silicon (Malaysia) Sdn Bhd. Thereafter, the issuer will lease assets procured from 1st Silicon to SEDC for an agreed rental price for an agreed lease period of 5 years.¹⁰¹¹

5.8.2 Sukuk Al-Musharaka

Musharaka is derived from the Arabic word *Shirakah*, which means partnership. The *Musharaka* structure is an agreement between two or more parties to participate in terms of capital, labour and management for the sake of establishing a joint business. All profits and losses generated from the *Musharaka* are shared by the parties on the basis of a prearranged participation ratio, unless the loss is proved to be caused by the negligence of one party.¹⁰¹² With regards to *Musharaka Sukuk*, they are certificates

¹⁰¹⁰ Khalid Alsaeed, 'Sukuk Issuance in Saudi Arabia: Recent Trends and Positive Expectations' (PhD, University of Durham 2012) 46.

¹⁰¹¹ Khalid Alsaeed, 'Sukuk Issuance in Saudi Arabia: Recent Trends and Positive Expectations' (PhD, University of Durham 2012) 49.

¹⁰¹² Abdullah Al Elsheikh and Joseph Tanega, 'Sukuk Structure and its Regulatory Environment in the Kingdom of Saudi Arabia' (2011) 5 Law and Financial Markets Review 187.

of equal value which evidence undivided ownership of the certificate holders in the *Musharaka* venture.¹⁰¹³

The purpose of issuing these *Sukuk* can be for using mobilized funds for establishing a new project or improve and developing an existing one or financing a business activity on the basis of one of the partnership contracts.¹⁰¹⁴ The holders of such *Sukuk* are involved in the partnership and they share profits based on an agreement with an agreed ratio while losses are shared based on the *Sukuk*'s holding.¹⁰¹⁵ These *Sukuk* have to be decided in advance for both, the length of the joint venture agreement and the profit ratio.¹⁰¹⁶

Several types of *Sukuk* are based on *Musharaka* contracts. For example, one type consists of having certain *Sukuk Musharaka* with a fixed ratio for the whole period of the contract. It starts when the investors (*Sukuk*-holders) contribute to the capital with the SPV issuer to establish a joint venture with the originator who is looking for finance. The issuer, in this case, delivers the capital that has been collected from the investors while the originator supplies the assets or capital required to start the business.¹⁰¹⁷ The issuer should provide investors with certificates with equal value, which are considered to be negotiable instruments that can be traded in secondary markets.¹⁰¹⁸ The issuer and originator should share the profits from the business as agreed between them. Also, the issuer is responsible for distributing the profits to the investors and in case of losses; they should be distributed based on each party's proportion of the capital.¹⁰¹⁹

The Emirates *Musharakah Sukuk* can be an example, when Wings FZCO issued *Sukuk* in 2005 at a value of approximately US \$550 million at the rate of 75 basis points on LIBOR, having a maturity of 7 years. The key objective for the *Musharakah* was to establish a new headquarters and engineering centre in Dubai. Regular

¹⁰¹³ Yahia Abdul-Rahman, *The Art of RF (Riba-Free) Islamic Banking and Finance: Tools and Techniques for Community-Based Banking*, (2nd edn, John Wiley & Sons 2014) 416.

¹⁰¹⁴ Takao Moriguchi and others, 'Contemporary Practices of Musharakah in Financial Transactions' (2016) 3 International Journal of Management and Applied Research 70.

¹⁰¹⁵ Ibid.

¹⁰¹⁶ Mohamed Ariff, Shamsheer Mohamad and Meysam Safari, *Sukuk Securities: New Ways of Debt Contracting* (John Wiley & Sons Singapore Pte Ltd 2014).

¹⁰¹⁷ Abdullah Al Elsheikh and Joseph Tanega, 'Sukuk Structure and its Regulatory Environment in the Kingdom of Saudi Arabia' (2011) 5 Law and Financial Markets Review 178.

¹⁰¹⁸ Ibid

¹⁰¹⁹ Ibid.

payments for Sukuk certificates were made from the rental money obtained from the *Musharakah*.¹⁰²⁰

Another version is *Sukuk* based on diminishing *Musharaka*, that is, when both parties establish an SPV to administer the *Sukuk*, the issuer transfers the ownership of an asset to the SPV to enter the partnership agreement while investors enter the agreement by paying cash.

As a result, both the issuer and the investors are equity partners. Then the issuer starts to pay instalments to the investors to repurchase their respective shares in the asset plus the asset's generated income, which constitutes the cash flow stream for *Sukuk* holders to have the investment share in the SPV diminishing over time.¹⁰²¹ The diminishing *Musharaka* is more desirable for investors than the normal *Musharaka* as it allows them to release their capital from the investment by decreasing their equity share annually and to get more of the periodic profits based on the remaining share balance.¹⁰²² Figure 8 shows the basic structure of diminishing *Musharaka Sukuk*.

Diminishing Musharaka Sukuk Structure

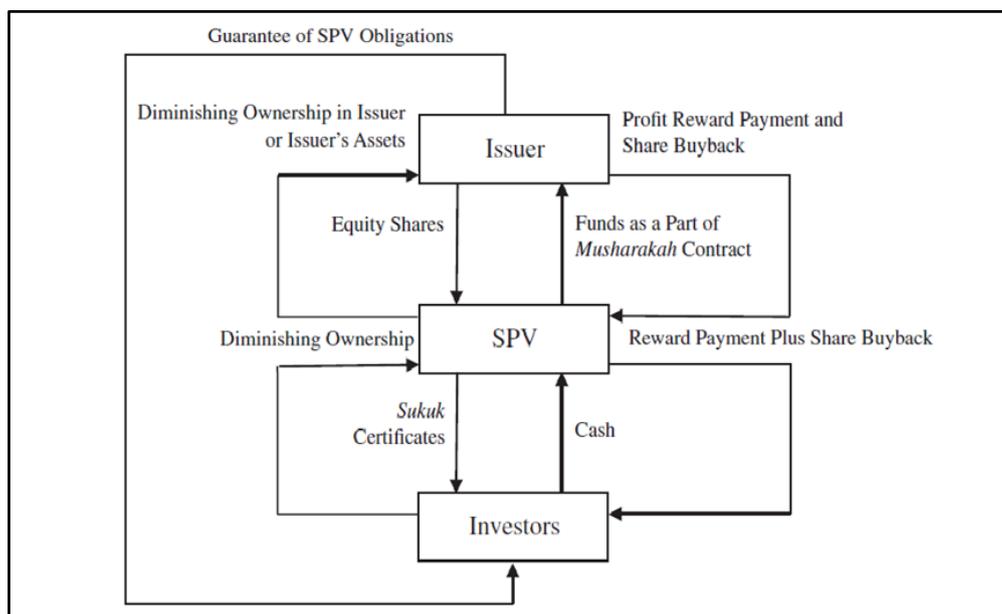


Figure 8: Diminishing Musharaka Sukuk Structure.¹⁰²³

¹⁰²⁰ Ali Alshamrani, 'Sukuk Issuance and its Regulatory Framework in Saudi Arabia' (2014) 2 Journal of Islamic Banking and Finance 315.

¹⁰²¹ Mohamed Ariff, Shamsheer Mohamad and Meysam Safari, *Sukuk Securities: New Ways of Debt Contracting* (John Wiley & Sons Singapore Pte Ltd 2014) 61.

¹⁰²² Ibid.

¹⁰²³ Ibid.

5.8.3 *Mudaraba Sukuk*

Mudaraba can be defined as a partnership in profit whereby one party provides capital who should be *Rab Al-maal* (provider of funds) and the other provides labour (*Mudarib*).¹⁰²⁴ The *Mudaraba Sukuk* are investment *Sukuk* that signify ownership of equal value units in the *Mudaraba* equity. The SPV as *Rab Al-maal* provides the capital for the investment activity that was collected from the *Sukuk* holders. The investment agent, the *Mudarib*, is paid an agreed fee out of any profits derived from the business activity.¹⁰²⁵ Such *Sukuk* can be used for enhancing public participation in mega investment projects.¹⁰²⁶ The framework of these *Sukuk* usually start by establishing an SPV to issue the *Sukuk* and contributing the funds raised from the investors as *Mudaraba* capital, in which case the SPV issuer would be the *Rab Al-maal* and act as the silent partner.¹⁰²⁷

On the other hand, the originator of the *Sukuk*, who should be the party looking for a sharia-compliant financing, would provide labour, expertise and possibly cash. This party, who manages the capital, is called the *Mudarib*. An agreement between the *Rab Al-maal* and the *mudarib* should be established on a profit/loss-sharing basis in order to be compliant with sharia rules. Thus, such *Sukuk* do not allow owners to make claims for any annual interest.¹⁰²⁸

The SPV, as the *Rab Al-maal*, issues *Sukuk* certificates to *Sukuk* holders to contribute the funds that will be passed to the *Mudarib* to be used in the *Mudaraba* investment. The SPV declares a trust over all the units for the *Sukuk* holders that the SPV is holding in the *Mudaraba*. Therefore, this type of *Sukuk* allows the pooling of investors' funds with the *Sukuk* holders to have a common share of the *Mudaraba* capital in addition to giving the *Sukuk* holders the right to returns in proportion to their investment.¹⁰²⁹

¹⁰²⁴ AAOIFI Sharia Standards no13 on *Mudarabah* (2).

¹⁰²⁵ Muhammad al-Bashir and Muhammad Al-Amine, *Global Sukuk and Islamic Securitization Market* (Martinus Nijhoff 2012) 226

¹⁰²⁶ Khalid Alsaheed, 'Sukuk Issuance in Saudi Arabia: Recent Trends and Positive Expectations' (PhD, University of Durham 2012) 40

¹⁰²⁷ A Saeed and O Salah, 'Development of *Sukuk*: Pragmatic and Idealist Approaches to *Sukuk* Structures' [2013] *Journal of International Banking Law and Regulation*.

¹⁰²⁸ Abdullah Al Elsheikh and Joseph Tanega, 'Sukuk Structure and its Regulatory Environment in the Kingdom of Saudi Arabia' (2011) 5 *Law and Financial Markets Review*.

¹⁰²⁹ A Saeed and O Salah, 'Development of *Sukuk*: Pragmatic and Idealist Approaches to *Sukuk* Structures' [2013] *Journal of International Banking Law and Regulation*.

Any profits made via the *Mudaraba* are shared between the *Rab Al-maal* and the *Mudarib* depending on an agreed profit-sharing ratio set out in the *Mudaraba* agreement. Also, in case of losses, each party bears the loss of their contribution to the contract, which means that the financier bears all financial losses and the entrepreneur bears the operating losses such as time and effort.

However, in the case of misconduct or negligence by the *Mudarib*, he or she alone is liable to cover it as he or she works as an agent as well as a trustee of the business.¹⁰³⁰ When the SPV receives profits from the *Mudaraba*, it should make payments of the periodic distribution amounts due under the *Sukuk*.¹⁰³¹

In addition, selling or transferring the ownership of the *Sukuk* in the market can only be permissible for the *Sukuk* holders after the period of the subscription discretion ends.¹⁰³²

Furthermore, certain rules should be followed before trading such *Sukuk*, depending on the stage of the *Sukuk* capital. First, when trading *Sukuk* which involve the transfer of *Mudaraba* capital while the capital is still in the form of money and has not yet been used in the operation of the specific project, the sale has to be done under the rules of exchange of money for money (*Sarf*). Second, when the capital of the *Mudaraba* is in the form of debt, then the trade has to be in compliance with the rules of Islamic debt trading. Finally, when the capital of the *mudaraba* is in mixed forms of debt, money, benefits or assets, the sale has to be based on the market price determined by mutual consent.¹⁰³³

Regarding guaranteeing the price of the *Sukuk* via the originator to the *Rab Al-maal*, *Sukuk Al-mudaraba* are considered as equity-based instruments, which suggests they have the same conclusion as *Sukuk Musharaka* mentioned earlier; this is that, as the AAOIFI has stated, scholars have adopted the view that it is not permissible for the

¹⁰³⁰ Mohamed Ariff, Shamsheer Mohamad and Meysam Safari, *Sukuk Securities: New Ways of Debt Contracting* (John Wiley & Sons Singapore Pte Ltd 2014) 58.

¹⁰³¹ 'The Sukuk Handbook: A Guide to Structuring Sukuk' (Latham & Watkins 2015) <<https://www.lw.com/thoughtLeadership/Latham-guide-to-structuring-sukuk-2015>> accessed 8 August 2016.

¹⁰³¹ A Saeed and O Salah, 'Development of *Sukuk*: Pragmatic and Idealist Approaches to *Sukuk* Structures' [2013] *Journal of International Banking Law and Regulation*.

¹⁰³² Mohamad Zin and others, 'The Effectiveness of *Sukuk* in Islamic Finance Market' (2011) 5 *Australian Journal of Basic and Applied Sciences*.

¹⁰³³ Ali Alshamrani, 'Sukuk Issuance and Its Regulatory Framework in Saudi Arabia' (2014) 2 *Journal of Islamic Banking and Finance*.

originator to grant a purchase undertaking for any amount other than the market value of the *Rab Al-maal's* interest in the *Mudaraba* assets at the time of sale; this is because if the value is determined by reference to the value of the *Sukuk*, it would be a kind of guarantee of profit and principal, which is not permitted under sharia law, unless given by an independent third party.¹⁰³⁴ In addition, a number of sharia scholars and the AAOIFI regulations put restrictions on such contracts insofar as at least 33% of the *Mudaraba* enterprise's capital should be invested in tangible assets at all times.¹⁰³⁵

5.8.4 Hybrid/Pooled Sukuk

This type of *Sukuk* is becoming popular as the underlying pool of assets consists of two or more Islamic finance contracts, where both equity and debt elements do exist. In certain *Sukuk*, such as *Ijarah Sukuk*, the originator has to have sufficient tangible assets in order to issue the *Sukuk*.¹⁰³⁶ Hybrid *Sukuk* exist as an option when there are not enough tangible assets and to allow financing contracts for refinancing means; (See *figure 9*) in other words, they constitute a refinancing tool. Therefore, in this *Sukuk* structure, the underlying pool of assets can consist of *Murabaha* contracts, *Istisna* contracts plus *Ijarah* contracts.

¹⁰³⁴ Ayman Alshelfan, 'Maslaha: A New Approach for Islamic Bonds' (PhD, Victoria University Melbourne 2014) 29.

¹⁰³⁵ Dubai International Financial Centre, 'Dubai International Financial Centre Sukuk Guidebook' (DIFC 2009)

¹⁰³⁶ Ali Alshamrani, 'Sukuk Issuance and Its Regulatory Framework in Saudi Arabia' (2014) 2 Journal of Islamic Banking and Finance.

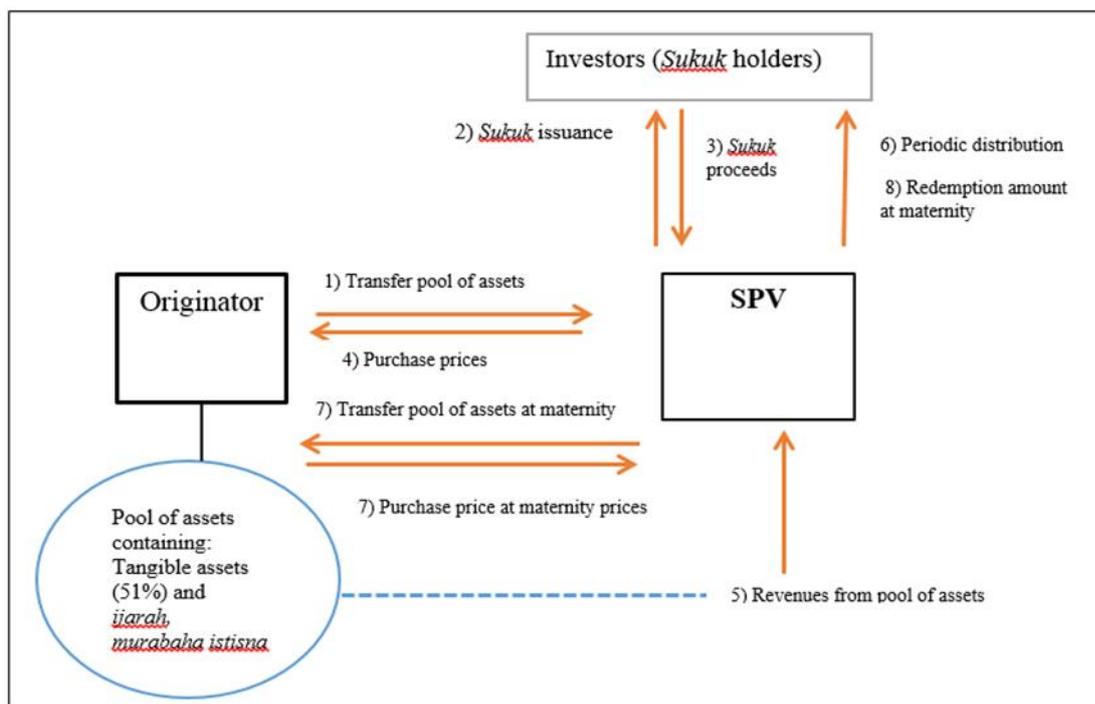


Figure 9: Hybrid Sukuk structure ¹⁰³⁷

As explained here, a number of steps can be followed to create a hybrid *Sukuk*. For instance, tangible assets with underlying *Ijarah*, *Murabaha* and *Istisna* deals are transferred to an SPV via the originator who receives *Sukuk* proceeds from *Sukuk* holders after the issuance of the *Sukuk* via the SPV. The revenues realised with these *Ijarah*, *Istisna* and *Murabaha* contracts are paid to the *Sukuk* holders. At the maturity date, the originator purchases back from the SPV the assets that consist of tangible assets with *Ijarah*, *Murabaha* and *Istisna* contracts.

The *Sukuk* holders receive a fixed payment of return on the assets and the *Sukuk* is redeemed.¹⁰³⁸ The assets of these *Sukuk* should be a mix of different categories with at least 51% of tangible assets in order to be allowed to be traded in the secondary market. This is because *Murabaha* and *Istisna* contracts cannot be traded in the secondary market since they create debt and many sharia scholars do not allow the trade in debt receivables.¹⁰³⁹ Figure 9 shows the basic structure of a hybrid *Sukuk*. This type of *Sukuk* is the closest structure to conventional bonds as they contain debt

¹⁰³⁷ A Saeed and O Salah, 'Development of *Sukuk*: Pragmatic and Idealist Approaches to *Sukuk* Structures' [2013] *Journal of International Banking Law and Regulation*.

¹⁰³⁸ *Ibid.*

¹⁰³⁹ *Ibid.*

assets and can be traded in the secondary market; this is why they have become more popular lately.

Recently, Saudi Arabia announced that it was in the process of issuing US\$10 billion *Sukuk* internationally,¹⁰⁴⁰ and hybrid *Sukuk* were chosen for this deal.¹⁰⁴¹ Although it is believed that this structure may be useful in a way that encourages Muslims who want to engage in finance according to sharia, for the identity of Islamic Finance there is not much benefit in having another version of conventional bonds, when Islamic finance is expected to work differently, because *Sukuk* might be exposed to the same volatility inherent in certain conventional financial vehicles during a financial crisis.

5.9 Conclusion

After introducing Islamic finance discussing the principles that financial contracts have to acknowledge when being created.¹⁰⁴² Then highlighting the link between the legal system in Saudi Arabia towards Islamic finance and the laws that should be applied for such finance.¹⁰⁴³ That was followed by discussing the importance of sharia boards in Islamic financial institutions in Saudi Arabia from a legal point of view and the need for better corporate governance for Islamic financial institutions.¹⁰⁴⁴ Also, the role of *Hiyal* (Legal tricks) that might be applied in some Islamic schools of thoughts more than other on financial products.¹⁰⁴⁵

This chapter introduce *Sukuk* as one of the Islamic financial product that has been recently developed to suit Islamic finance and has attracted the attention of many countries around the world. This product is chosen to be an example of the challenges and difficulties that is facing Islamic finance in Saudi Arabia. This chapter discusses the basic structure of *Sukuk* and shows its importance to Islamic finance that was introduced by giving some history of *Sukuk*; then showed how it is differ from other

¹⁰⁴⁰ 'Strong Demand for First International Saudi Sukuk' (*Mof.gov.sa*, 2017) <https://www.mof.gov.sa/en/DebtManagementOffice/NewsandPressReleases/Pages/news_12042017.aspx> accessed 13 December 2017.

¹⁰⁴¹ Archana Narayanan, 'Saudi Aramco to Price Islamic Bond in \$10 Billion Debt Push' (*Bloomberg.com*, 2017) <<https://www.bloomberg.com/news/articles/2017-03-28/saudi-aramco-said-to-set-final-price-for-debut-riyal-sukuk-bond>> accessed 13 December 2017.

¹⁰⁴² See 2.2 above.

¹⁰⁴³ See 3.4 above.

¹⁰⁴⁴ See 4.6 above.

¹⁰⁴⁵ See 4.4 above.

types of finances particularly the bonds that used in conventional finance. Also, this chapter discussed different types of contracts that are used in *Sukuk* to show what can be traded in a secondary market. This chapter is closely linked to the next chapter which will discuss *Sukuk* in Saudi Arabia examining the validity of the current laws and regulations that have their effects on *Sukuk*. Thus, next chapter will highlight the challenges and difficulties that might face *Sukuk* in Saudi Arabia.

Chapter Six: *Sukuk* and its Regulations in Saudi Arabia

6.1 Introduction

This chapter is part of other chapters that aim to determine the challenges facing Islamic finance in Saudi Arabia in order to suggest some reforms to help developing Islamic finance further.

This chapter will look at the way Saudi Arabia regulates *Sukuk*, one of the products in Islamic finance that has been chosen to be a case study and already defined in the previous chapter,¹⁰⁴⁶ to consider the challenges facing such product. The thesis already provided an overview of Islamic finance indicating the sources of Islamic law and the major rules that should be acknowledge when creating Islamic financial products.¹⁰⁴⁷

Then, the thesis moved to discuss the link between the legal system in Saudi Arabia towards Islamic finance, illustrating the gap between the laws that indicate that Saudi Arabia should be govern by sharia in all its laws¹⁰⁴⁸ and what are already practised.¹⁰⁴⁹ Then the thesis discussed the importance of sharia boards in Islamic financial institutions in Saudi Arabia from a legal point view which can help to develop products which are genuinely complied with sharia law and the need for better corporate governance for Islamic financial institutions.

After that, the thesis takes *Sukuk* an Islamic financial product that can be performed by one or more of the different Islamic financial contracts as a case study for the thesis. In that chapter the basic structure of *Sukuk* was discussed showing its importance to Islamic finance,¹⁰⁵⁰ and how it is differed from other types of finances particularly the bonds that used in conventional finance.¹⁰⁵¹ In this chapter *Sukuk* in Saudi Arabia will be discussed, examining the validity of the current laws and regulations that have their effects on *Sukuk*, highlighting the challenges and difficulties that may face *Sukuk* in Saudi Arabia.

¹⁰⁴⁶ See 4.5 above.

¹⁰⁴⁷ See 2.2 and 2.7 above.

¹⁰⁴⁸ Basic Law of Governance 1992, Art 7. See 3.2.3 above.

¹⁰⁴⁹ See 3.2 also 3.3 and 3.4 above.

¹⁰⁵⁰ See 5.1 above.

¹⁰⁵¹ See 5.3 above.

The chapter will start by describing the growing interest in *Sukuk* in Saudi Arabia. Then the difficulties facing *Sukuk* in Saudi Arabia will be discussed and how the authorities in Saudi Arabia intend to encourage such finance, especially in light of the Saudi Vision 2030. Finally, suggestions will be put forward as to how to enhance the use of *Sukuk* in Saudi Arabia.

6.2 History

It is fair to say that Saudi Arabia has been isolated from the *Sukuk* market for a long time.¹⁰⁵² One of the reasons behind this isolation relates to the fact that there was no need for the country to engage in *Sukuk* or bonds as its oil revenues were high, and *Sukuk* and bonds were only issued to raise money for the government or its quasi-governmental companies.¹⁰⁵³ Nahla Samargandi, Jan Fidrmuc and Sugata Ghosh stated that Saudi Arabia's economy is heavily dependent on oil revenue and this domination may cause the underdevelopment of the financial sector in Saudi.¹⁰⁵⁴ This can be explained as because the country is depending on oil revenue not much industrial projects were made which would need to be finance by *Sukuk* or bonds and when there is a need for financing a project the government usually borrow directly from banks.¹⁰⁵⁵

However, between 1981 and 1991 oil prices dropped to US\$22 per barrel, which forced the government to try to diversify the economy and invest in non-oil industrial projects.¹⁰⁵⁶ As a result, industrial cities started to be established to attract investment in the non-oil industrial sector.¹⁰⁵⁷ However, the government preferred to finance industrial development through a specialised governmental credit institution called the Saudi Industrial Development Fund (SIDF) instead of mobilising the country's wealth

¹⁰⁵² Abdullah Al Elsheikh and Joseph Tanega, 'Sukuk Structure and its Regulatory Environment in the Kingdom of Saudi Arabia' (2011) 5 Law and Financial Markets Review 192.

¹⁰⁵³ Abdullah Alawi, Saleh Al-Quati and Wael Sindi, 'The Financing Role of the Saudi Capital Market Promising Prospects' (AlJazira Capital 2010) 3.

¹⁰⁵⁴ Nahla Samargandi, Jan Fidrmuc and Sugata Ghosh, 'Financial Development and Economic Growth in an Oil-Rich Economy: The Case of Saudi Arabia' (2014) 43 Economic Modelling 268.

¹⁰⁵⁵ Ibid.

¹⁰⁵⁶ Abdullah Alawi, Saleh Al-Quati and Wael Sindi, 'The Financing Role of the Saudi Capital Market Promising Prospects' (AlJazira Capital 2010) 3.

¹⁰⁵⁷ 'Saudi Industrial Development Fund Industrial Development in Saudi Arabia' (*Sidf.gov.sa*, 2017) <<https://www.sidf.gov.sa/en/IndustryinSaudiArabia/Pages/IndustrialDevelopmentinSaudiArabia.aspx>> accessed 29 January 2018.

through capital market development.¹⁰⁵⁸ With time, the pace of industrialisation accelerated, which made it difficult for the SIDF to finance all the industrial projects, so the government started to engage with other national and foreign institutions to take part in financing projects. This was done via the Ministerial Committee set up in 1984 and with the help of the Saudi Arabian Monetary Authority (SAMA).¹⁰⁵⁹

As SAMA is the government's bank,¹⁰⁶⁰ it is prohibited by its Charter from lending directly to the government ¹⁰⁶¹as a fundamental protection of the soundness of the currency and the monetary system.¹⁰⁶² Nonetheless, it acts effectively as a secured agent to issue debt securities or arrange loans to the government or quasi-governmental companies, which is another reason for Saudi Arabia's isolation from the *Sukuk* market as it chose to issue debt securities instead of *Sukuk*.¹⁰⁶³

In 1988, SAMA started to issue Saudi Government Development Bonds (SGDBs) to raise funds to finance the country's mega-projects although, as discussed in Chapter Three,¹⁰⁶⁴ Article 2 of SAMA's Charter bans SAMA from either paying or receiving interest and Article 6 stipulates that the Authority shall not act in any manner which conflicts with the teachings of the Islamic law.¹⁰⁶⁵ It is worth to mention that, as discussed in the previous chapter that bonds do conflict with Islamic law.¹⁰⁶⁶ While *Sukuk* constitute an alternative to bond and sharia compliant, this should encourage SAMA to issue *Sukuk* instead of bonds.¹⁰⁶⁷

In addition, as highlighted in Chapter three,¹⁰⁶⁸ that the Saudi capital markets faced some difficulties in attracting more funds and regulating capital markets including *Sukuk* as Saudi stock market was operating under three masters Ministry of

¹⁰⁵⁸ Abdullah Alawi, Saleh Al-Quati and Wael Sindi, 'The Financing Role of the Saudi Capital Market Promising Prospects' (AlJazira Capital 2010) 3.

¹⁰⁵⁹ Ibid 4.

¹⁰⁶⁰ Charter of the Saudi Arabian Monetary Agency, Royal Decree No. 23 dated 19 April 1952 Article 1 B.

¹⁰⁶¹ Charter of the Saudi Arabian Monetary Agency, Royal Decree No. 23 dated 19 April 1952 Article 6 C.

¹⁰⁶² Anthony Shoult and Habiba Anwar, *Doing Business with Saudi Arabia* (4th edn, Blue Ibx Ltd 2009) 192.

¹⁰⁶³ Anthony Shoult and Habiba Anwar, *Doing Business with Saudi Arabia* (4th edn, Blue Ibx Ltd 2009) 191.

¹⁰⁶⁴ See 3.4.2 above.

¹⁰⁶⁵ Charter of the Saudi Arabian Monetary Agency, Royal Decree No. 23 dated 19 April 1952 Article 2 and 6

¹⁰⁶⁶ See 5.3 and 5.45.4.1 above

¹⁰⁶⁷ See 3.5 above

¹⁰⁶⁸ See 3.4.3 above.

Commerce, Ministry of Finance and SAMA.¹⁰⁶⁹ In order to overcome this challenge, the Capital Market Authority (CMA) was established in 2003 under the aegis of the Capital Market Law (CML) to regulate and supervise the capital market.¹⁰⁷⁰

A number of regulations were issued via CMA tackling different aspects in the market such as market conduct, corporate governance, mergers and acquisitions, and the issuance of financing tools such as IPOs, bonds and mutual funds.¹⁰⁷¹

In 2008, the CML gave its permission to non-banking foreign brokerages, asset managers, and other non-bank financial intermediaries to operate in the Kingdom,¹⁰⁷² which gave a chance for more asset management industry and gave further opportunities to offer more products to investors.¹⁰⁷³

6.3 Growing Interest in *Sukuk*

The Kingdom has witnessed a rapid growth in investment, both in the public and private sector, in large infrastructure projects. Also, amongst all the other GCC countries, the Kingdom enjoys the largest number of investors and there is more demand for long- and short-term finance;¹⁰⁷⁴ *Sukuk* as a capital market tool started to gain some popularity, especially due to their reputation of not being in contradiction with sharia.¹⁰⁷⁵

The first *Sukuk* large scale issuance in Saudi Arabia dates back to 2006 when the CMA gave its approval to the Saudi Arabia Basic Industries Corporation (SABIC) to issue *Sukuk* of a total amount of up to SAR 3 billion.¹⁰⁷⁶ This aroused such a remarkable amount of interest that within ten days, the arranger bank received 4.3

¹⁰⁶⁹ Mohammed Ramady, *The Saudi Arabian Economy: Policies, Achievements, and Challenges* (Springer 2010) 148.

¹⁰⁷⁰ Article 4 of the CML in accordance with Royal Decree No. (M/30) dated 2 July 2003.

¹⁰⁷¹ Abdullah Alawi, Saleh Al-Quati and Wael Sindi, 'The Financing Role of the Saudi Capital Market Promising Prospects' (AlJazira Capital 2010).

¹⁰⁷² Khalid Al-habshan, 'Issues Involving Corporate Transparency in the Saudi Capital Market' (2017) 6 Public Administration Research.

¹⁰⁷³ Abdullah Alawi, Saleh Al-Quati and Wael Sindi, 'The Financing Role of the Saudi Capital Market Promising Prospects' (AlJazira Capital 2010) 6.

¹⁰⁷⁴ Abdullah Al Elsheikh and Joseph Tanega, 'Sukuk Structure and its Regulatory Environment in the Kingdom of Saudi Arabia' (2011) 5 Law and Financial Markets Review 190.

¹⁰⁷⁵ Abdullah Alawi, Saleh Al-Quati and Wael Sindi, 'The Financing Role of the Saudi Capital Market Promising Prospects' (AlJazira Capital 2010).

¹⁰⁷⁶ Oxford Business Group, 'The Report: Emerging Saudi Arabia 2007' (Oxford Business Group 2007) 83.

billion.¹⁰⁷⁷ These *Sukuk* opened the door to other similar *Sukuk* issuance initiatives and in 2007, for instance, the Saudi Electricity Company issued *Sukuk* worth SR 5 billion.¹⁰⁷⁸ Most of the sovereign *Sukuk* in Saudi Arabia are used to fund large-scale infrastructure projects.¹⁰⁷⁹

Furthermore, Basel III¹⁰⁸⁰ contributed to the fostering of the *Sukuk* market. This can be seen as, one of the Basel III requirements regarding liquidity is that banks have to hold sufficient amounts of high quality liquid assets to cover their net cash outflows for a certain period of time in a stress scenario. Usually the regulations for bank capital require institutions to hold a particular amount of capital compared to their risk-weighted assets. The very small percent risk weights make domestic or foreign government bonds very highly rated and other bonds relatively more attractive, as banks do not need to hold capital for holding these bonds.¹⁰⁸¹ Saudi banks already meet the Basel III capital, liquidity and leverage standards that should be applied in 2019.¹⁰⁸² In case of Islamic banks, they are prohibited from holding conventional bonds, thus, Basel III stated that *Sukuk* can be alternative to interest-bearing debt securities to be held as high quality liquid assets.¹⁰⁸³

The researcher identifies another reason for *Sukuk* being popular amongst companies in Saudi Arabia. *Sukuk* gives more chance for companies to be in the Sharia-compliant Companies List. The Sharia-compliant Companies List is a list that made by an Islamic financial institution or individual specialised sharia scholars to rate joint stock companies in the Saudi Stock Exchange with regards to their compliance to sharia.¹⁰⁸⁴

¹⁰⁷⁷ Ibid.

¹⁰⁷⁸ Oxford Business Group, 'The Report: Saudi Arabia 2008' (Oxford Business Group 2008) 59.

¹⁰⁷⁹ Velid Efendić, Fikret Hadžić and Hylmun Izhar, *Critical Issues and Challenges in Islamic Economics and Finance Development* (Springer 2017) 30.

¹⁰⁸⁰ Basel III is an internationally agreed set of measures developed by the Basel Committee on Banking Supervision in response to the financial crisis of 2007-09. The measures aim to strengthen the regulation, supervision and risk management of banks. Please see 'Basel III: International Regulatory Framework for Banks' (*Bis.org*, 2017) <<https://www.bis.org/bcbs/basel3.htm>> accessed 18 December 2017.

¹⁰⁸¹ Basel Committee on Banking Supervision, 'Basel III: The Liquidity Coverage Ratio and Liquidity Risk Monitoring Tools' (Bank for International Settlements 2013) 19 <<https://www.bis.org/>> accessed 11 December 2017.

¹⁰⁸² International Monetary Fund, 'Saudi Arabia Selected Issues' (IMF 2016) 20 <<http://www.imf.org>> accessed 11 October 2017.

¹⁰⁸³ Basel Committee on Banking Supervision, 'Basel III: The Liquidity Coverage Ratio and Liquidity Risk Monitoring Tools' (Bank for International Settlements 2013) 19 <<https://www.bis.org/>> accessed 11 December 2017.

¹⁰⁸⁴ 'Shariah Guidelines for Trading and Investment in Stocks' (*Alrajhi-capital.com*, 2017) <<http://www.alrajhi-capital.com/en/Pages/shariahguide.aspx>> accessed 11 December 2017.

A company would be keen to be in such a list and have access to more investors trading in its stocks. As all providers to the stock market who are counted as Islamic banks, such as Alrajhi, Albilad, and Al Jazira, have the majority of users and investors,¹⁰⁸⁵ this will only give their users access to trade with companies in their Sharia-compliant Companies List. Also, as mentioned earlier, Saudi Arabia is a Muslim country and most local investors prefer to invest their funds in a way that does not conflict with their religious principles.¹⁰⁸⁶

Companies that comply with sharia are divided into two types: the first type are companies with permissible objectives and activities all of whose dealings come from permissible ways. This means that companies with illicit objectives and activities, including trading in tobacco, gambling, pork or interest-bearing banking activities, will not be accepted.¹⁰⁸⁷ The second type is companies with permissible objectives and activities that may have illicit matters in their dealings, such as, for instance, interest-bearing loans or deposits.¹⁰⁸⁸ With respect to this, sharia scholars have ruled on the permissibility of investing and trading in the stocks of these companies, subject to the following controls: (1) Trading in the stocks of these type of companies shall be restricted to exigency. Incidentally, when other companies are found to comply with the prohibition of dealing in usury, they should be favoured over the companies not complying with these principles. (2) Interest-based debt: The collective amount raised as a loan on interest, whether long-term or short-term debt does not exceed 30% of the market capitalization of the corporation.¹⁰⁸⁹ (3) The earnings generated from the

¹⁰⁸⁵ Fayaz Ahmad Lone and Salim Alshehri, 'Growth and Potential of Islamic Banking in GCC: The Saudi Arabia Experience' (2015) 3 Journal of Islamic Banking and Finance 42.

¹⁰⁸⁶ Mabd Al-Jarhi and Abdul Azim Abu-zaid, 'أسواق الصكوك الإسلامية و كيفية الارتقاء بها' (The Market of Islamic Sukuk and How to Improve It)', 24-26 May 2010 (Islamic Development Bank 2010) <<http://www.kantakji.com/media/3738/431.pdf>> accessed 11 December 2017.

¹⁰⁸⁷ 'Shariah Guidelines for Trading and Investment in Stocks' (*Alrajhi-capital.com*, 2017) <<http://www.alrajhi-capital.com/en/Pages/shariahguide.aspx>> accessed 11 December 2017.

¹⁰⁸⁸ Ibid.

¹⁰⁸⁹ Saeed Mahfooz and Habib Ahmed, 'Sharī'ah Investment Screening Criteria: A Critical Review' (2014) 27 JKAU: Islamic Econ 10. However, there are other well-known independent scholars who have their own lists and have views about the second type: Dr Yousef Abdullah Al Shubaily and Dr Abd Al-Aziz Fawzan Al-Fawzan. Sheikh Al Shubaily's fatwa is almost the same as that of Alrajhi capital while Al-Fawzan does not recognise these types of companies in his list, please see Abdul Aziz Al-Fawzan, 'قائمة الشركات المباحة في السوق السعودي لعام ١٤٣٨ هـ' (List of Halal Companies for Investment in Stocks 2016)' (*Main.islammessage.com*, 2016) <<http://main.islammessage.com/newspage.aspx?id=9663>> accessed 11 December 2017.

illicit component shall not exceed 5% of the total earnings of the respective company.¹⁰⁹⁰

Therefore, it appears that not being in the Sharia-compliant Companies List means that fewer investors will buy the shares of these companies. The main reason for removing a company from the above list is related to taking loans or financing a non-sharia-compliant project; this puts *Sukuk* in a better position to be chosen by companies to finance. Another reason for the growing interest in *Sukuk* is the current drop in oil prices, which has forced the government to vary its resources, including the use of *Sukuk* and bonds to finance projects for the government and the private sector.¹⁰⁹¹

Also, *Sukuk* are valued by different potential investors, eager to generate profit by either keeping them until maturity or re-trading them, as some investors prefer short-term *Sukuk*. (Figure 10) below shows the types of investors in the *Sukuk* market. For example, those managing investment funds prefer the long-term investment such as pension funds which are usually government owned and tend to participate in most issues; while others that are keen to benefit from *Sukuk* to manage excess cash tend to participate in *Sukuk* issuances to diversify their investments, for example corporates.¹⁰⁹²

¹⁰⁹⁰ 'Shariah Guidelines for Trading and Investment in Stocks' (*Alrajhi-capital.com*, 2017) <<http://www.alrajhi-capital.com/en/Pages/shariahguide.aspx>> accessed 11 December 2017.

¹⁰⁹¹ Oxford business Group, 'The Report: Saudi Arabia 2016' (Oxford business Group 2016) <<https://oxfordbusinessgroup.com/saudi-arabia-2016>> accessed 11 December 2017

¹⁰⁹² Imran Iqbal and Bayan Bin Zarah, 'Sukuk Market in Saudi Arabia' (Saudi Hollandi Capital Report 2013)

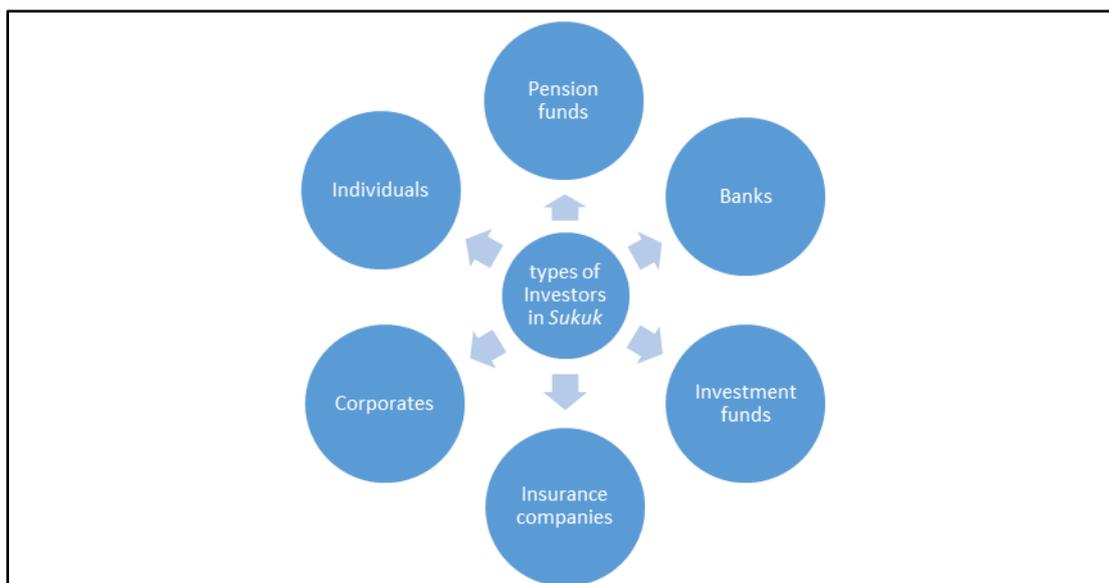


Figure 10: Types of Investors in the Sukuk market in KSA

(Source: Saudi Hollandi Capital)

Finally, the new Vision 2030 for Saudi Arabia might have a positive impact on Islamic finance in general and *Sukuk* in particular, as explained in more detail later.¹⁰⁹³

6.4 Difficulties Facing the Saudi *Sukuk* Market

Despite the popularity of *Sukuk*, especially due to their reputation for being sharia-compliant, a number of challenges still facing Islamic finance in general including this product in Saudi Arabia.¹⁰⁹⁴ Paradoxically, Saudi Arabia enjoys unique elements that should ensure that the financial sector is fully regulated by the sharia which should make it the first country of choice in terms of *Sukuk*. As discussed earlier,¹⁰⁹⁵ the Kingdom is considered to be at the heart of the Muslim countries as it hosts the two Holy Mosques.¹⁰⁹⁶ Its laws stated that the Kingdom should be ruled and governed in all aspects by sharia law and this is also stated in the Charter of SAMA.¹⁰⁹⁷ Also, the majority of its population believe in Islam and there is a strict prohibition of interest

¹⁰⁹³ See 6.6 below.

¹⁰⁹⁴ Ali Al-Shamrani, 'Islamic Financial Contracting Forms in Saudi Arabia: Law and Practice' (PhD, Brunel University 2014) 113.

¹⁰⁹⁵ See 3.2.2 above.

¹⁰⁹⁶ Muncef Guizani, 'The Financial Determinants of Corporate Cash Holdings in an Oil Rich Country: Evidence from Kingdom of Saudi Arabia' (2017) 17 *Borsa Istanbul Review*

¹⁰⁹⁷ See 3.2.3 and 3.4.2 above.

(*Riba*).¹⁰⁹⁸ This is why, despite the underdeveloped *Sukuk* market and the lack of specific regulations to support this market, Saudi borrowers raised up to US\$7.9 billion from the sale of *Sukuk* in 2014,¹⁰⁹⁹ making the Kingdom the second country in the world after Malaysia. The government should take advantage of this popularity of such product due to their compliant to sharia and support the development of Islamic finance, in general and *Sukuk* in particular, to meet the Saudis demand of being able to engage with finance that do not conflict with their believe and their laws. In addition, to take advantage of the rising popularity of this type of finance in many countries around the world including non-Muslim countries.¹¹⁰⁰

Nonetheless, a close look at the local practices suggests that the financial sector in the country is regulated by and built on conventional financial activities.¹¹⁰¹ It can be argued that the reason behind the existence of conventional regulations to govern the financial activities relates to the fact that upon the official founding of modern Saudi Arabia, Islamic finance was not very successful. It did not play a significant role at the time when those regulations were implemented, which led the government to put in place regulations based on conventional finance as it was almost the only choice available internationally.¹¹⁰²

Subsequently, all developments in the financial sector, such as the creation of SAMA and the CMA, followed the same previous regulations, being made to regulate conventional financial activities, except that a provision was added, that is, all activities should be in accordance with sharia and Islamic teachings.¹¹⁰³ With time, Islamic finance started to gain popularity as certain countries and organisations started to regulate this type of finance.

¹⁰⁹⁸ See 3.2 above.

¹⁰⁹⁹ Daria Solovieva and Deema Almashabi, 'Saudi Arabia to Foster Sukuk Market as Stocks Open to Foreigners' (*Bloomberg.com*, 2015) <<https://www.bloomberg.com/news/articles/2015-05-10/saudi-arabia-to-foster-sukuk-market-as-stocks-open-to-foreigners>> accessed 11 August 2017

¹¹⁰⁰ See 5.1 above.

¹¹⁰¹ Zulkifli Hasan, 'Regulatory Framework of Sharia Governance System in Malaysia, GCC Countries and the UK' (2010) 3 *Kyoto Bulletin of Islamic Area Studies* 2 <<https://ssrn.com/abstract=2196825>> accessed 30 July 2015.

¹¹⁰² See 3.5 Also, John R Presley and Rodney Wilson, *Banking in the Arab Gulf* (MacMillan Academic and Professional 1991) 34.

¹¹⁰³ Rodney Wilson, 'Arab Government Responses to Islamic Finance: The Cases of Egypt and Saudi Arabia' (2002) 7 *Mediterranean Politics* 185 <<http://www.tandfonline.com/doi/pdf/10.1080/13629390207030010>> accessed 3 April 2016.

However, Saudi Arabia preferred to stand by and continue adopting and practising the same regulations as before. This is why *Sukuk*, for example, as claimed by the researcher, have never been mentioned or introduced in the CML or in SAMA regulations but were handled under the conventional bonds regulations as a debt instrument in the Securities Regulations.

An interesting study investigating the determinants of the development of the *Sukuk* market in certain countries including Saudi Arabia, Kuwait, UAE, Bahrain, Qatar, Indonesia, Malaysia, Brunei, Pakistan and Gambia for the period 2003-2012 has concluded that the development of the *Sukuk* market is derived from a confluence of many variables and factors.¹¹⁰⁴ Indeed, certain factors, for instance, macroeconomic factors such as the Gross Domestic Product (GDP) per capita, and the size of the economy, the trade openness have a positive influence on the growing of the *Sukuk* market. The study explained that as all factors mentioned above have a positive impact on the economic growth in general which has its positive impact on the development of the *Sukuk* market.¹¹⁰⁵ The study found that the higher the level of natural openness, the greater the level of access to external funding and the greater the development of the local *Sukuk* market.¹¹⁰⁶

In addition, the regulatory quality has a huge influence on the development of the *Sukuk* market. Indeed, according to that study, countries with a higher regulation quality have a greater *Sukuk* market.¹¹⁰⁷ Therefore, more efficiency and reliability in terms of regulations would lead to a better market.¹¹⁰⁸ This point is significant as, in the case of Saudi Arabia, it can be seen that although there are good regulations for finance in general as stated by some of the interviewees,¹¹⁰⁹ more attention regarding Islamic finance, and the *Sukuk* market in particular, is still needed. This was revealed by the Chairman of the CMA during his speech in 2016 stating that the *Sukuk* market in the Kingdom was still below its desired level and that the CMA was working hard to

¹¹⁰⁴ Ali Said and Rihab Grassa, 'The Determinants of *Sukuk* Market Development: Does Macroeconomic Factors Influence the Construction of Certain Structure of *Sukuk*?' (2013) 3 Journal of Applied Finance & Banking 255.

¹¹⁰⁵ Ibid 259.

¹¹⁰⁶ Ali Said and Rihab Grassa, 'The Determinants of *Sukuk* Market Development: Does Macroeconomic Factors Influence the Construction of Certain Structure of *Sukuk*?' (2013) 3 Journal of Applied Finance & Banking

¹¹⁰⁷ Ibid.

¹¹⁰⁸ Ibid.

¹¹⁰⁹ Participants B, C and E.

develop it.¹¹¹⁰ The study concluded that countries who have adopted a legal system with a sharia law origin or a combination of common law and sharia law origins have a more developed *Sukuk* market. In addition, the higher percentage of Muslims in a country has a positive effect on the development of the *Sukuk* market.¹¹¹¹

The above elements should encourage decision-makers in Saudi Arabia to develop this market in order to have more financial players who are keen to invest in a sharia-compliant environment by providing better relevant regulations for Islamic finance including *Sukuk* to take the lead in the *Sukuk* market, since most of the requirements for a well-developed market of *Sukuk* do exist in Saudi Arabia. This only requires courageous decisions from regulators to put in place special regulations for Islamic finance to allow this field to develop in the right environment and then for the investors' trust in this to grow.

Indeed, the lack of suitable regulations for example suitable regulations on issuance of *Sukuk* to ease the issuance of *Sukuk* which is one of the challenges facing the *Sukuk* market in Saudi Arabia.¹¹¹² As a matter of fact, the absence of a special legal framework for *Sukuk*, especially in the GCC countries including Saudi Arabia, caused discouragement among both investors and issuers of *Sukuk*.¹¹¹³ As stated by Rafisah Radzi and Nurul Muhamed, there are shortcomings in terms of the regulatory framework in Saudi Arabia pertaining to Islamic finance.¹¹¹⁴ The long processes to issue *sukuk* and the absence of clear laws for *Sukuk* slow down the process for issuing *Sukuk*, which is against what *Sukuk* issuers need.

Moreover, Al-Jarhi and Abu-zaid believe that monitoring and supervising the issuing, buying and trading of *Sukuk* cannot be done without a suitable environment that contains the following important elements: (1) simplifying the process of sharia-

¹¹¹⁰ Conference Report, 'Islamic Finance Industry – 40 Years since Inception: Evaluation of Experience and the Way Forward', AAOIFI International Conference (AAOIFI 2016) <http://aaoifi.com/wp-content/uploads/2016/06/Madinah-Conference-Report_English-v7-Final-12-6-2016.pdf> accessed 11 December 2017.

¹¹¹¹ Ali Said and Rihab Grassa, 'The Determinants of *Sukuk* Market Development: Does Macroeconomic Factors Influence the Construction of Certain Structure of *Sukuk*?' (2013) 3 *Journal of Applied Finance & Banking* 256.

¹¹¹² Conference Report, 'Islamic Finance Industry – 40 Years since Inception: Evaluation of Experience and the Way Forward', AAOIFI International Conference (AAOIFI 2016) <http://aaoifi.com/wp-content/uploads/2016/06/Madinah-Conference-Report_English-v7-Final-12-6-2016.pdf> accessed 11 December 2017.

¹¹¹³ Rafisah Radzi and Nurul Muhamed, 'An International Comparative Study on Sharia Governance Supervision of *Sukuk* Defaults' (2012) 8 *Journal of Islamic Economics, Banking and Finance*.

¹¹¹⁴ *Ibid.*

compliant *Sukuk* issuance, as complicating the process may lead the issuer to waive some of the sharia principles in order to be accepted by the authorities.(2) regulating *Sukuk* with suitable regulations would give a clear pathway for *Sukuk* and make it easier for regulators to discover and deal with any new challenge that may come in the future regarding this market as the foundation that the regulations are built on is already suitable for such finance which would encourage private individual companies to issue *Sukuk*.¹¹¹⁵

The *Sukuk* market would hugely expand in Saudi Arabia to be the first in the world if the regulators give it more attention, as the financial environment in Saudi Arabia is more to Islamic finance than conventional finance because of the sharia-compliant issue in the conventional finance in general.¹¹¹⁶ The Secretary General of AAOIFI declared that issuers “do not have to waste any time or effort in figuring things out”,¹¹¹⁷ which is one of the reasons why Malaysia remains the top country in the *Sukuk* market as the regulator has set out clear guidelines for Islamic bond sales.¹¹¹⁸ He also stated that “the regulator in Saudi Arabia should set out clear guidelines if it wants to emulate Malaysia, the world’s biggest *Sukuk* market”.¹¹¹⁹

Therefore, there is a great need to put in place specific laws and regulations, which encourage risk sharing for example and Central Sharia Board to approve any financial instrument that claimed to be sharia-complaint in order to gain the investors’ trust as discussed in chapter four.¹¹²⁰ This should be applied to govern Islamic banks and Islamic financial institutions including *Sukuk* and enable regulators such as SAMA and the CMA in Saudi Arabia to supervise and monitor the Islamic financial products based on Islamic principles and not on conventional ones.

Currently, the CMA Listing Rules and the CMA Offer of Securities Regulations regulates *Sukuk* issuance under regulations that made to regulate shares and debt instruments issuance and therefore there is no mention of *Sukuk* or sharia in those

¹¹¹⁵ Mabd Al-Jarhi and Abdul Azim Abu-zaid, 'أسواق الصكوك الإسلامية وكيفية الارتقاء بها' (The Market of Islamic Sukuk and How to Improve It)', 24-26 May 2010 (Islamic Development Bank 2010) <<http://www.kantakji.com/media/3738/431.pdf>> accessed 11 December 2017.

¹¹¹⁶ See 3.5above.

¹¹¹⁷ Daria Solovieva and Deema Almashabi, 'Saudi Arabia to Foster Sukuk Market as Stocks Open to Foreigners' (*Bloomberg.com*, 2015) <<https://www.bloomberg.com/news/articles/2015-05-10/saudi-arabia-to-foster-sukuk-market-as-stocks-open-to-foreigners>> accessed 11 August 2017.

¹¹¹⁸ Ibid.

¹¹¹⁹ Ibid.

¹¹²⁰ See 4.11 above.

rules and regulations.¹¹²¹ Indeed, ignoring the major differences between the two financial systems and not differentiating between them may lead to the issuing of regulation directives that do not comply with Islamic banks and Islamic financial institutions. The researcher can suggest that the regulators should extend current Securities regulations to cover more different financial products such as *Sukuk* by issuing regulations that comply with nature of the product. This can be done by taking advantage from some international Islamic financial organisations that already studied *Sukuk* and issue framework such as AAOIFI. AAOIFI issued standards for investment *Sukuk* in 2004,¹¹²² then in 2008 it reaffirmed its rules on *Sukuk*,¹¹²³ then in 2017 a financial accounting standard “*Sukuk* Issuance” was announce with should be effective for accounting periods beginning on or after 01 January 2019.¹¹²⁴ Thus, regulators in Saudi Arabia should work closely to update their regulations with the help of AAOIFI, especially after current rapprochement between CMA and AAOIFI as CMA became a member of AAOIFI in 2016.¹¹²⁵

Another challenge that the *Sukuk* market, as a sharia-compliant product, is facing relates to the laws govern *Sukuk*. As stated by Hans Visser that the legal system that govern Islamic finance in some judications especially in the GGC countries still underdeveloped.¹¹²⁶ As explained before,¹¹²⁷ that any *Sukuks*' disputes in Saudi Arabia would be seen by the Committee for the Resolution of Securities Disputes (CRSD) which already mentioned some concerned about its independency and the unclarity of the way that members of CRSD and its appellate body would interpret the law,¹¹²⁸ how they reason their decisions or under what section of the law the CMA prosecutes violators of the CML.¹¹²⁹ This is because of close hearing litigant which

¹¹²¹ Ali Alshamrani, 'Sukuk Issuance and Its Regulatory Framework in Saudi Arabia' (2014) 2 Journal of Islamic Banking and Finance 326.

¹¹²² AAOIFI's Shari'a Standard No. 17 – Investment Sukuk 2004.

¹¹²³ AAOIFI reaffirming its rules on Sukuk 2008.

¹¹²⁴ 'AAOIFI Publishes Exposure Draft of The Financial Accounting Standard “Sukuk” and Invites Opinion from Islamic Finance Industry' (AAOIFI.com, 2018) <<http://aaoifi.com/announcement/aaoifi-publishes-exposure-draft-of-the-financial-accounting-standard-sukuk-and-invites-opinion-from-islamic-finance-industry/?lang=en>> accessed 13 April 2018.

¹¹²⁵ Capital Market Authority, 'CMA Joins AAOIFI Membership' (2016)

<<https://cma.org.sa/en/MediaCenter/PR/Pages/AAOIFI.aspx>> accessed 10 April 2018.

¹¹²⁶ Hans Visser, *Islamic Finance: Principles and Practice* (2nd ed, Edward Elgar 2013) 97.

¹¹²⁷ See 3.3.3.3.4 above.

¹¹²⁸ *Ibid.*

¹¹²⁹ Bushra Ali Gouda, 'The Saudi Securities Law: Regulation of The Tadawul Stock Market, Issuers, and Securities Professionals Under the Saudi Capital Market Law of 2003' (2012) 18 Annual Survey of International & Comparative Law 126.

made it difficult even for legal firms outside the circle of litigants to know how things go inside the CRSD.¹¹³⁰ Thus, Saudi Arabia are not encouraging issuers to choose Saudi Arabia as the governing authority; this has meant that some sharia scholars have accepted that the regulations should be construed in accordance with other law such as English law because English law is what stakeholders generally prefer. This is especially true given that most countries, including Saudi Arabia, do not recognise the concept of trust with flexibility, as common law jurisdictions do which is important in a case of default.¹¹³¹ Common law recognizes dual ownership,¹¹³² the two sides of which are legal ownership and beneficial ownership, while many countries including many GCC countries do not.

This is why when Saudi Electricity Company (SEC) for example issued a number of *Sukuk* in the past ten years, it chose English Law to be used as a governing law and enforcement of judgments for the SEC Global *Sukuk* II and III when the type of contract used to structure the *Sukuk* required the use of dual ownership such as *Ijara*.¹¹³³ While in other *Sukuk* of the SEC, the governing law and enforcement of judgments were Saudi law, the CRSD and its appellate committee the ACRSD to be more specific,¹¹³⁴ because the structure of *Sukuk* does not required the use of trust law.¹¹³⁵ By the way sharia has recognized the concept of dual ownership which can be understood from the AAOIFI *Sukuk* standard relating to the sale of usufruct.¹¹³⁶

When the asset is transferred in some of the *Sukuk* structure to the SPV issuer from the originator and moved back, there will be transfer of legal ownership and beneficial ownership of the underlying asset.¹¹³⁷ In Common law systems, only beneficial ownership can be transferred to *Sukuk* holder when the asset moves, and legal

¹¹³⁰ Ibid.

¹¹³¹ Ahmed Belouafi and Abdelkader Chachi, 'Islamic Finance in the United Kingdom: Factors Behind its Development and Growth' (2014) 22 Islamic Economic Studies 60.

¹¹³² Tariqullah Khan, Elsayed Elsiefy and Lee EunKyoung, 'legal and Regulatory Issues in Issuing Sukuk in South Korea Lessons from Developed Countries' Experience' (2014) 2 International Journal of Economics, Commerce and Management 13.

¹¹³³ See prospectus of Saudi Electricity Global Sukuk Company 3 issued in 2014 available at < <https://www.se.com.sa/en-us/invshareholder/Pages/IssanceInCapitalMarket.aspx> > accessed on 8 February 2018.

¹¹³⁴ See Prospectus of Saudi Electricity Company Sukuk issued in 10 May 2010 and 3rd June 2014 available at < <https://www.se.com.sa/en-us/invshareholder/Pages/IssanceInCapitalMarket.aspx> > accessed on 8 February 2018.

¹¹³⁵ Ibid.

¹¹³⁶ AAOIFI Shariah standard no.17.

¹¹³⁷ Tariqullah Khan, Elsayed Elsiefy and Lee EunKyoung, 'legal and Regulatory Issues in Issuing Sukuk in South Korea Lessons from Developed Countries' Experience' (2014) 2 International Journal of Economics, Commerce and Management 13.

ownership is retained by the originator.¹¹³⁸ This can be one reason to make English law popular for some *Sukuk* structure to govern and be used for dispute resolution.¹¹³⁹ Even though, English law is usually chosen to govern *Sukuk* but the final recourse to the underlying asset unavoidably depends on the law of the jurisdiction in which the assets are located.¹¹⁴⁰

Therefore, any agreement made on behalf of a trust by trustees may not be legally recognised in Saudi law, which means that in the case of defaulting *Sukuk*, investors may not be able to claim their rights prescribed in the *Sukuk* documents.¹¹⁴¹ This was stated in Risk Factors Relating to Enforcement of the SEC *Sukuk* that chose to be governed by English law.

“The courts and judicial committees of the Kingdom may not recognise the choice of English law or submission to jurisdiction of English courts at the option of the Certificate holders of a Series. Accordingly, in any proceedings relating to the Certificates in the Kingdom, sharia, as interpreted in the Kingdom, may be applied by the relevant court or judicial committee. The courts and judicial committees of the Kingdom have the discretion to deny the enforcement of any contractual or other obligations, if, in their opinion, the enforcement thereof would be contrary to the principles of sharia”.¹¹⁴²

In addition, when English law is chosen as the law governing the *Sukuk* and a case is presented to the English court, there may be conflicts between the English law and Islamic (sharia) law regarding certain clauses in the contracts. Several recent rulings by the English courts confirm that in case of any contradiction between Islamic law and English law, the latter prevails.¹¹⁴³ This is discouraging for *Sukuk* issuance in Saudi Arabia even though it is the birth place of Islam and has chosen to be governed by sharia and any *Sukuk* issuance here should therefore meet the needs of Islamic finance.

¹¹³⁸ Ibid.

¹¹³⁹ Umar A Oseni and M Kabir Hassan, 'Regulating the Governing Law Clauses in Sukuk Transactions' (2015) 16 Journal of Banking Regulation.

¹¹⁴⁰ Sweder Wijnbergen and Sajjad Zaheer, 'Sukuk Defaults: on Distress Resolution in Islamic Finance' [2013] SSRN Electronic Journal.

¹¹⁴¹ Ibid.

¹¹⁴² See Prospectus of Saudi Electricity Global Sukuk Company II and III 37. Available at <<https://www.se.com.sa/en-us/invshareholder/Pages/IssanceInCapitalMarket.aspx>> accessed on 8 February 2018.

¹¹⁴³ Ibid.

In order to overcome this challenge from the researcher point of view, two aspects could help here. First, the new commercial court can be a solution for this challenge but that would be depend on how the commercial court will work and would this court be supported by well specialised judges who have good knowledge about *Sukuk*, keeping in mind that as mentioned that sharia does recognized the concept of dual ownership. The second aspect is the existence of central sharia board which should give its approval for the *Sukuk* before being issued which would make any dispute afterwards easy to be seen by a court as there will not be any issue regarding to sharia-compliant.

An additional challenge relates to the lack of specific laws for Islamic financial contracts including *Sukuk*, and this lack could require an Islamic financial contract not to be 100% compatible with sharia. As Saudi Arabia treats *Sukuk* as conventional bonds, the laws do not apply to true underlying assets sales, they categorise *Sukuk*, even asset-backed ones, as debts which prejudice this kind of instrument to follow the conventional contract in order to be fit to be govern by Saudi law, trust law and dual ownership can be an example for that.¹¹⁴⁴ Furthermore, as discussed in Chapter Four¹¹⁴⁵ with regards to sharia boards and the lack of regulations that encourage Islamic financial institutions to have effective sharia boards that contains qualified members who can give their time and effort to study and monitor financial product in order to give the right *Fatwa* and to encourage Islamic finance developers to develop financial contracts that present genuine Islamic finance, and not only sharia-compliant, the current laws push issuers and sharia boards to structure *Sukuk* in the form of bonds in order to be accepted by the regulator, which in turn slows up the development of such an important financial instrument. Treating Islamic finance as being under the umbrella of conventional finance has led to a moving away from the spirit of Islamic finance, which should be built on ethical principles to offer only what it is supposed to; instead it makes the developers of Islamic finance to only try to come up with financial contracts that have a very close similarity to the conventional system in order to be accepted under the legal regulation of the country.

¹¹⁴⁴ Ali Alshamrani, 'Sukuk Issuance and Its Regulatory Framework in Saudi Arabia' (2014) 2 Journal of Islamic Banking and Finance 327.

¹¹⁴⁵ See 4.9 above.

In the absence of specific laws regulating Islamic financial contracts, risk-sharing is practised less than what should be the case in the Islamic finance industry. As Mohammad Kamali and Abdullah AK stated that the Islamic financial market has yet to make risk-sharing a major feature of their activities.¹¹⁴⁶ Innovation and development in the Islamic financial market should pass the stage of replication of conventional structures because the regulations put in place to regulate conventional financial contract are usually built on debt. So, Muslim societies will not enjoy the full benefits of financing on a risk-sharing basis, which minimise the need for debt and help in the distribution of wealth.¹¹⁴⁷

As stated before¹¹⁴⁸ that some financial institutions are pushing sharia boards so hard to give *Fatwas* on financial contracts that are no different than the financial contracts in conventional financial institutions, which are mainly based on *Riba*, instead of putting the effort to provide real Islamic finance.¹¹⁴⁹ Thus sharia boards need to have real independence and especial sharia governance regulations to insure that only qualified specialist can be in the sharia board with specific minimum number of members in a sharia board. In addition of giving a limit number of how many sharia boards can a member be which already discussed in Chapter Four.¹¹⁵⁰ As the sharia boards in the financial institutions have the power to correct their path to be real Islamic institutions if they have the supporting regulations.¹¹⁵¹

Additionally, contracts in Islamic finance are drafted by finance experts or legal practitioners depending on the laws of the country, and in the case of Saudi Arabia as explained earlier,¹¹⁵² most financial laws deal with conventional finance as there was no successful example of an Islamic banking system at the establishment of the country and its financial authority organisations such as SAMA and the only available option to engage with the world and meet the demands of the country's growth was

¹¹⁴⁶ Mohammad Hashim Kamali and A.K. Abdullah, *Islamic Finance: Issues in Sukuk and Proposals for Reform* (Kube Publishing Ltd, 2014) vii.

¹¹⁴⁷ Ibid.

¹¹⁴⁸ See 4.9 above.

¹¹⁴⁹ Saleh Al-Hussein, 'الهيئات الشرعية الواقعية وطريق التحول لمستقبل أفضل' (Sharia Boards the Reality and a Way of Transition for a Better Future)' (2004) Islamic Business Researches Centre <<http://bit.ly/2nMfYTE> > accessed 4 June 2016.

¹¹⁵⁰ See 4.11 above.

¹¹⁵¹ Saleh Al-Hussein, 'الهيئات الشرعية الواقعية وطريق التحول لمستقبل أفضل' (Sharia Boards the Reality and a Way of Transition for a Better Future)' (2004) Islamic Business Researches Centre <<http://bit.ly/2nMfYTE> > accessed 4 June 2016.

¹¹⁵² See 3.4.2 above.

through a conventional system.¹¹⁵³ So, Islamic finance contracts are couched in terms that may become difficult for interpretation when presented to the sharia boards for approval. As a result, a sharia board may certify certain products that may not necessarily satisfy the sharia requirements under the state of necessity¹¹⁵⁴ because laws make it hard to create a financial contract that complies %100 with sharia.¹¹⁵⁵ Thus, as argued in previous chapters that Islamic financial contracts including *Sukuk* should be created in a way that do not contradict with Islamic principles,¹¹⁵⁶ and Saudi Arabia should be one of the best countries to develop Islamic finance as there is a strong relationship between the Islamic faith and Saudi Arabia that were introduced before.¹¹⁵⁷

In addition, the Basic Law of Governance of Saudi Arabia stated that its constitution is based on sharia,¹¹⁵⁸ thus, there is an urgent need to develop and improve the legal framework for *Sukuk* and debt market origination to facilitate securitisation and true underlying assets sales for a better asset-backed *Sukuk* structure. Also, as discussed in Chapter Four on the importance of corporate governance regulations, these need to be applied here for additional transparency and to strengthen the rules of disclosure¹¹⁵⁹; both of these are important issues to avoid any possible default in the future.¹¹⁶⁰

Furthermore, an additional challenge facing *Sukuk* in Saudi Arabia is the absence of a central sharia board which can affect in a negative way the confidence of investors. Religion can be used in a bad way to get advantages from investors who seek legitimate contracts, even when they involve exploitation, and gain the Islamic label for financial products that are in conflict with the fundamental principle of Islamic finance. Even if such practices appear acceptable from the outside, they may cause

¹¹⁵³ See **Error! Reference source not found.** above.

¹¹⁵⁴ As discussed in Chapter Four See 4.6 and 4.8**Error! Reference source not found.**, an act maybe not be accepted by sharia but it can be practised if there is a need for it and there is no other choice. In this case sharia scholars may allow such an act under the provision of necessity.

¹¹⁵⁵ Umar A Oseni and M Kabir Hassan, 'Regulating the Governing Law Clauses in Sukuk Transactions' (2015) 16 Journal of Banking Regulation 607.

¹¹⁵⁶ See 2.7 above.

¹¹⁵⁷ See 3.2.1 above.

¹¹⁵⁸ See 3.2.3 above.

¹¹⁵⁹ Khalid Alsaheed, 'Sukuk Issuance in Saudi Arabia: Recent Trends and Positive Expectations' (PhD, University of Durham 2012) 254.

¹¹⁶⁰ Ibid.

distrust for Islamic finance and this could threaten the whole financial market in a country, especially in a Muslim country like Saudi Arabia.¹¹⁶¹

The SEC *Sukuk* can be an example to the importance of central sharia board as the prospectus of the SEC mentioned that their *Sukuk* have been approved by members of sharia committees in Deutsche Bank and HSBC Banks, however the prospectus stated that “there can be no assurance that the transaction documents or the issue and trading of the certificates will be deemed to be sharia-compliant by any other sharia committee or sharia scholars”,¹¹⁶² it also stated that even

“Judicial committees and courts in the Kingdom may form different opinions on identical issues and therefore potential investors should not rely on the pronouncements of the sharia advisors in deciding whether to make an investment in the certificates and should obtain their own independent sharia advice”.¹¹⁶³

It can be seen that, there is no assurance that this *Sukuk* are sharia-compliant as different sharia board or scholars can have different opinion. While if there is a Central Sharia Board, their *Fatwa* will be more powerful and any court would accept such *Fatwa* as it would be the highest sharia board in the country with regard to finance.

As has been pointed out in Chapter Four,¹¹⁶⁴ the AAOIFI has set a whole framework of standards for a central sharia board, setting out some requirements for that board to make the most of it.¹¹⁶⁵ Unfortunately the government of Saudi Arabia has not yet expressed the need to have such a board.

Nonetheless, the researcher suggests that regulators should at least implement laws or standards on corporate governance for sharia boards at the financial institution level to prevent institutions from choosing non-experts as members on their sharia boards so as to obtain their approval for their financial contracts that contradict sharia as this might reduce the confidence of clients and investors in the whole financial system.

¹¹⁶¹ Mabd Al-Jarhi and Abdul Azim Abu-zaid, 'أسواق الصكوك الإسلامية وكيفية الارتقاء بها' (The Market of Islamic Sukuk and How to Improve It)', 24-26 May 2010 (Islamic Development Bank 2010) <<http://www.kantakji.com/media/3738/431.pdf>> accessed 11 December 2017

¹¹⁶² See Prospectus of Saudi Electricity Global Sukuk Company III 40. Available at <<https://www.se.com.sa/en-us/invshareholder/Pages/IssanceInCapitalMarket.aspx>> accessed on 8 February 2018.

¹¹⁶³ Ibid.

¹¹⁶⁴ See 4.11.2 and 4.12 above.

¹¹⁶⁵ AAOIFIO Governance Standard No. 8 for Central Sharia Board.

Currently, if a financial institution manipulates and declares non-sharia products to be sharia compliant, no one can object, not even the other Islamic financial institutions committed to basing all their activities on sharia.¹¹⁶⁶ This example of the sort of risk associated with *Sukuk* illustrates the need for a central sharia board¹¹⁶⁷ as it will reduce cost, organise the work, and unite efforts to solve greater problems together.¹¹⁶⁸

Another challenge is that laws dealing with defaults in *Sukuk* (Bankruptcy) can be a source of problems in Saudi Arabia. *Sukuk* default can show the strength and suitability of regulations in a country. A default in *Sukuk* has exposed the Saudi regulations as *Sukuk* was handled by SAMA at that time as debt, when it was not debt; this was accomplished with less transparency than it should have been, as will be explained now.

Although the number of *Sukuk* defaults at the global level is still in single digits,¹¹⁶⁹ most defaults happened between 2008 and 2009 when there were a number of defaults in different countries around the world and these were considered to be the first ever defaults in *Sukuk*. It started in 2006 when a US oil and gas company called East Cameron Partners (ECP) issued *Sukuk* of US\$165.67 million with a maturity period of thirteen years.¹¹⁷⁰ The company faced financial problems arising from the shortfall in oil and gas production triggered by damage following a hurricane in September 2008; they defaulted in October 2008. The company filed for bankruptcy protection under Chapter 11 of the US Bankruptcy Code, claiming its inability to pay the periodic returns.¹¹⁷¹ The ECP filed 'adversary proceedings' and requested the court to consider the primary *Sukuk* transaction with the purchaser SPV as 'secured loans' and not as a 'true sale' of assets, which would indicate that the assets would be shared between the *Sukuk* holders and the other creditors of the originator in the liquidation process if the transaction was considered a secured loan. However, the

¹¹⁶⁶ Umar A Oseni and M Kabir Hassan, 'Regulating the Governing Law Clauses in *Sukuk* Transactions' (2015) 16 *Journal of Banking Regulation*.

¹¹⁶⁷ Chapter Four has discussed this issue in detail.

¹¹⁶⁸ Mahir Alman, 'Sharia Supervisory Board Composition Effects on Islamic Banks' Risk-Taking Behavior' [2012] *SSRN Electronic Journal*. See also AAOIFIO Governance Standard No. 8 for Central Sharia Board.

¹¹⁶⁹ Umar A Oseni and M Kabir Hassan, 'Regulating the Governing Law Clauses in *Sukuk* Transactions' (2015) 16 *Journal of Banking Regulation*.

¹¹⁷⁰ Najeeb Zada, Ahcene Lahsasna and Muhammad Yusuf Saleem, 'On *Sukuk* Insolvencies: A Case Study of East Cameron Partner', *Islamic Capital Markets: Volatility, Performance and Stability* (Springer 2016) 37.

¹¹⁷¹ *Ibid.*

court rejected that by stating that the *Sukuk* “holders invested in the *Sukuk* certificates in reliance on the characterisation of the transfer of the royalty interest as a true sale”.¹¹⁷² However, the court decision gave leave for ECP to amend its complaint; so the company filed an amended complaint. In the end, the parties agreed to a settlement under which the ECP *Sukuk* was wound up and all the ECP assets excluding cash, records, books and certain litigation claims were sold to the holders of the *Sukuk* for a consideration of the litigation settlement and the cancellation of US\$4 million DIP (debtor-in-possession) financing which the *Sukuk* holders had provided to the ECP during the bankruptcy proceedings¹¹⁷³. This was to avoid the suspension or termination of federal leases held by ECP as a result of its filing under Chapter 11 of the US Bankruptcy Code, which might consequently have resulted in *Sukuk* holders losing all their investment.¹¹⁷⁴ Therefore, the court judgment contributed to the *Sukuk* growth in the US as it set the precedent that asset-backed *Sukuk* are in fact bankruptcy proof and the transfer of assets to the *Sukuk* SPV was shown to be safe from the bankruptcy of the originator company.¹¹⁷⁵

On the other hand, the Saad Group, a Saudi Arabian conglomerate, defaulted in 2009 on the periodic payments of its *Sukuk Ijarah* known as the Golden Belt 1. The *Sukuk* were issued in 2007 and were supposed to mature in 2012. The default of US\$650 million was caused by a liquidity crisis that the company was facing. It then appeared that the originator company had some issues regarding its transparency as proper information was not even provided to the regulators. Most assets were located in Saudi Arabia so SAMA froze the assets of the Group.¹¹⁷⁶

In addition, the *Sukuk* holders were issued with personal promissory notes for extra security, governed by the Saudi law, but the *Sukuk* holders were unable to either execute the personal promissory notes provided to them or gain any access to the physical assets held by the SPV which issued the Golden Belt note.¹¹⁷⁷ As there were legal issues that needed to be resolved before the *Sukuk* investors were given the

¹¹⁷² Ibid.

¹¹⁷³ Nafis Alam and Syed Aun R Rizvi, *Islamic Capital Markets Volatility, Performance And Stability* (Springer International Publishing 2016).

¹¹⁷⁴ Ibid 38.

¹¹⁷⁵ Ibid 37.

¹¹⁷⁶ Inutu Lukonga, 'Islamic Finance, Consumer Protection, and Financial Stability' (2015) 15 IMF Working Papers.

¹¹⁷⁷ Sweder Wijnbergen and Sajjad Zaheer, 'Sukuk Defaults: on Distress Resolution in Islamic Finance' [2013] SSRN Electronic Journal.

status of unsecured creditors of the Saad Group, the rights of *Sukuk* holders were affected via the issuer and the government of Saudi Arabia, as Robert Shapiro stated:

“Much of the criticism of the Saudi performance in these defaults has focused on issues of transparency and equal treatment for foreign creditors. Many aspects of the operations of the Saad and Alghosaibi Groups that affect the defaults remain shrouded in secrecy and unavailable to foreign creditors, and the Saudi Government appears to have abetted this lack of transparency”.¹¹⁷⁸

These *Sukuk* disputes are still not solved and similar cases are being dealt with in the courts, such as *Golden Belt 1 Sukuk Company B.S.C.(c) v BNP Paribas*.¹¹⁷⁹

With respect to the Golden Belt litigation, which still seen in a commercial court in the UK, the problem was caused by paperwork that did not have a “wet ink” signature from the owner of the Saad group, Al-Sanea; it was not properly executed under Saudi law when the transaction was made.¹¹⁸⁰ However, other *Sukuk* have been regulated in Saudi Arabia by the CMA and traded on the Tadawul and enjoy a good reputation, such as the Saudi Arabia Basic Industries Corporation (SABIC) and Saudi Electricity.¹¹⁸¹ One of the reasons behind the Golden Belt *Sukuk* problems is that the arrangement for the *Sukuk* was made offshore, in Bahrain, which provided less regulatory surveillance at that time, as *Sukuk* were still very new to the market.¹¹⁸²

Nonetheless, default may still happen even though strict measures are included in the *Sukuk* contracts and in their risk management, as this is the general nature of commercial transactions, whether Islamic or conventional. It is important, however, to have good regulations to resolve any default case that happens, in order to gain

¹¹⁷⁸ Robert J. Shapiro, 'The Importance of International Standards in Managing Defaults in Islamic Finance: Saudi Arabia and the Saad Group's *Sukuk* Default' (*Sonecon*, 2013) <http://www.sonecon.com/docs/studies/Shapiro_Paper_Sukuk_Default_new.pdf> accessed 12 September 2017.

¹¹⁷⁹ [2017] EWHC 3182 (Comm).

¹¹⁸⁰ Kit Chellel and Samuel Potter, 'BNP Sued Over \$650 Million `Wet Ink' Error in Al-Sanea Deal' (*Bloomberg.com*, 2015) <<https://www.bloomberg.com/news/articles/2015-11-02/bnp-sued-over-650-million-wet-ink-error-in-al-sanea-deal>> accessed 12 May 2017 also Adam Ibrahim and Sohail Ali, 'Members of the Shari'ah Board - Religious Scholars or Lawyers?' (*DLA Piper*, 2017) <<https://www.dlapiper.com/en/uk/insights/publications/2017/03/members-of-the-shariah-board/>> accessed 12 December 2017.

¹¹⁸¹ Umar A Oseni and M Kabir Hassan, 'Regulating the Governing Law Clauses in *Sukuk* Transactions' (2015) 16 *Journal of Banking Regulation*.

¹¹⁸² Rodney Wilson, 'Sukuk Defaults: Islamic Debt Investors Need Better Data' (*World Economics*, 2013) <https://www.worldeconomics.com/Papers/Sukuk%20Defaults%20Islamic%20Debt%20Investors%20Need%20Better%20Data_435d6ca7-d1ab-4ab1-afe1-b108784cc835.paper> accessed 04/09/2017.

investors' confidence.¹¹⁸³ Saudi Arabia needs an updated and better regulations regarding Bankruptcy as the current regulations indicate that there is a need for a more developed framework. The economic market has hugely developed since 1931, when the Commercial Court Law was introduced. Chapter 10 of the Royal Decree was about insolvency¹¹⁸⁴ and the Law of Settlement Preventing Bankruptcy, known as the Preventive Settlement Law, was made law in 1996.¹¹⁸⁵ The Commercial Court Law provides a detailed code for bankruptcy although its relationship to corporate insolvency is unclear.¹¹⁸⁶

Also, the Preventive Settlement Law applies to every trader, person or company who fears the imminence of insolvency on what appears to be a cash flow basis; but this still has some uncertainty, which makes decisions, in practice, heavily dependent on the discretion of the individual judges dealing with any particular matter.¹¹⁸⁷ There are no specialist insolvency judges and the judicial precedent system does not apply, which hinders the will of companies, especially international ones, to invest in Saudi Arabia as they cannot be clear about the laws that might apply if they face default or insolvency.¹¹⁸⁸

Furthermore, as mentioned earlier, Saudi Arabia is working hard to diversify its sources of income instead of being dependent on oil and the government has already taken steps to attract foreign capital by opening its stock market to foreign investors and selling *Sukuk* internationally.

However, investors have expressed hesitancy regarding the clarity of the nation's financial regulations and in today's climate, due to the global environment, foreign investors are attracted by clear and comprehensive laws including insolvency laws.¹¹⁸⁹ This has also been said recently by the Saudi Minister of Commerce during a talk in which he stated that: "one of the most difficult questions I got when I was working as a lawyer was when an international company wanted to invest in Saudi and asked

¹¹⁸³ Umar A Oseni and M Kabir Hassan, 'Regulating the Governing Law Clauses in Sukuk Transactions' (2015) 16 Journal of Banking Regulation.

¹¹⁸⁴ Royal Decree No. 32 in (1931).

¹¹⁸⁵ Royal Decree M/16 (1996).

¹¹⁸⁶ Alex Gross, 'Saudi Arabia to Introduce Revolutionary New Insolvency Law in 2016' (*eSQUIRE Global Crossings*, 2016) <<https://www.esquireglobalcrossings.com/2015/12/saudi-arabia-to-introduce-revolutionary-new-insolvency-law-in-2016/>> accessed 12 October 2017.

¹¹⁸⁷ *Ibid.*

¹¹⁸⁸ *Ibid.*

¹¹⁸⁹ Patrick Venter and James Sprayregen, 'Bankruptcy Reform in Saudi Arabia Bridging Islamic Law and Modern Bankruptcy?' (2016) 34 Law Journal Newsletters.

about Bankruptcy laws here. There was not a clear answer to give, as the law is nebulous and depends on the decision of judges".¹¹⁹⁰ This is why the majority of *Sukuk* issuers in Saudi Arabia choose to have the default law governed by English law owing to its versatile trust law structures.¹¹⁹¹ This suggests that, as explained earlier, one of the difficulties facing *Sukuk* is the lack of suitable regulations to ease their issuance, in addition to the need for updated laws to solve challenges that might occur during or at the end of a transaction.

Finally, the government felt the need to update the laws coinciding with the 2030 Vision and introduced a revolutionary new regulation in 2016 as a draft on Bankruptcy,¹¹⁹² which was approved Royal Decree No. M/05 dated 13/02/2018.¹¹⁹³ The new law effectively replace: The Law of Settlement against Bankruptcy issued pursuant to the Royal Decree No. M/16 dated 24/01/1996, Chapter 10 of the Commercial Courts Laws issued pursuant to the Royal Decree No 32 dated 01/06/1931 and all provisions of any applied laws or regulations that are inconsistent with the Bankruptcy Law shall be voided. This law should not only benefit Islamic finance and *Sukuk*, but also all economic activities whether based on Islamic or conventional rules.

The high cost of a credit rating agency is also one of the challenges; the credit rating agency had to be hired from outside of Saudi Arabia as there were no regulations to allow such credit rating agencies to work in Saudi Arabia until November 2014 when the CMA set regulations authorising credit rating agencies to work in Saudi Arabia; these regulations came into effect on 1st September 2015.¹¹⁹⁴ Six agencies applied for authorisation to carry out credit rating activities in the Kingdom.¹¹⁹⁵ August 31st 2016 was the target for agencies to continue working; then the CMA would issue licences

¹¹⁹⁰ It was said during an open meeting in Asharqia Chamber on 09/04/2017 after a question about the laws on insolvency in Saudi Arabia < <https://www.chamber.org.sa> > accessed 12 November 2017. Ebrahim Al-Shiban, 'غرفة الشرقية: حديث وزير المالية عن نظام الإفلاس اجتزأ من سياقه' (Asharqia Chamber: A Talk of The Minister of Finance about the Bankruptcy System) 21 April 2017' (Riyadh Newspaper, 2017) <<http://www.alriyadh.com/1587543>> accessed 12 December 2017.

¹¹⁹¹ Silke N Kumpf, 'A New Frontier' [2014] New Law Journal

<<https://www.newlawjournal.co.uk/content/new-frontier-0>> accessed 12 December 2017.

¹¹⁹² Alex Gross, 'Saudi Arabia to Introduce Revolutionary New Insolvency Law in 2016' (eSQUIRE Global Crossings, 2016) <<https://www.esquireglobalcrossings.com/2015/12/saudi-arabia-to-introduce-revolutionary-new-insolvency-law-in-2016/>> accessed 12 October 2017.

¹¹⁹³ bankruptcy law approved by Royal Decree No. M/05 dated 13/02/2018.

¹¹⁹⁴ Capital Market Authority, 'Six Agencies Applied for Authorization to Carry Out Credit Rating Activities in the Kingdom' (2015) <https://cma.org.sa/en/MediaCenter/PR/Pages/credit_rating.aspx> accessed 12 December 2017.

¹¹⁹⁵ The six agencies applied are; the Saudi Credit Bureau (SIMAH), Standard & Poor's Credit Market Services Europe Limited, Moody's Investors Services Middle East Limited, Fitch Ratings, The Islamic International Rating Agency and A.M. Best Europe- Rating Services Ltd.

to allow agencies to work officially in the Kingdom. The grace period for the credit rating agencies which applied for authorisation to conduct their activities was then extended to 24th August 2017.¹¹⁹⁶ Two agencies have been issued the licence at the time of writing: SIMAH and Standard & Poor's.¹¹⁹⁷ The researcher believes that this may benefit the Saudi capital market in general including *Sukuk* market, as having a local credit rating agency will reduce the cost of relying on an external agency to rate the efficiency and value of assets, which usually costs more than a local agency. Also, this will increase competition among credit rating agencies in addition to improving performance and lowering costs, which in turn will benefit all *Sukuk* issuers especially small and medium size enterprises.

Another challenge is the secondary *Sukuk* market in Saudi Arabia, as it is suffering from a lack of deals in the market. Indeed, the market started in 2009 but until the mid of March 2018 there have been only limited number of trades. The researcher has identified only seventeen deals in the market during the past four years from March 2014 until March 2018 (see Table 4). All deals in *Sukuk* in the secondary market, since its establishment in 2009 until mid-2017, make up less than a day's trade in the Saudi stock exchange market, Tadawul,¹¹⁹⁸ as the total value of *Sukuk* traded in the market since its establishment reached SAR 3.9 billion (US\$1.04 billion). The secondary debt

¹¹⁹⁶ Capital Market Authority, 'CMA Extends the Grace Period for the Credit Rating Agencies which applied for Authorization Prior to 01/09/2015 To Conduct Rating Activities' (2016) <https://cma.org.sa/en/Market/NEWS/Pages/CMA_N_2100.aspx> accessed 12 December 2017.

¹¹⁹⁷ SIMAH has been licensed on 31/12/2015 please check Capital Market Authority, 'The Capital Market Authority (CMA) Authorises SIMAH Rating Agency – under Formation- to Conduct Credit Rating Activities' (2015) <https://cma.org.sa/en/Market/NEWS/Pages/CMA_N_1894.aspx> accessed 12 December 2017. Standard and Poor's Credit Market Services Europe Limited has been licensed 17/10/2016 please check Capital Market Authority, 'The Capital Market Authority (CMA) License Standard and Poor's Credit Market Services Europe Limited' (2016) <https://cma.org.sa/en/Market/NEWS/Pages/CMA_N_2124.aspx> accessed 12 December 2017.

¹¹⁹⁸ On the 19th of March 2007, the Council of Ministers approved the formation of The Saudi Stock Exchange (Tadawul). This was in accordance with Article 20 of the Capital Market Law establishing Tadawul as a joint stock company. Tadawul is the sole entity authorized in the Kingdom of Saudi Arabia to act as the Securities Exchange (the Exchange). It mainly carries out listing and trading in securities, as well as deposit, transfer, clearing, settlement, and registry of ownership of securities traded on the Exchange. The legal status, duties, and responsibilities of the Exchange and Depository Centre are explicitly defined in the Capital Market Law (CML) issued by Royal Decree Number (M/30), on June 16, 2003. The Exchange is also the official source of all market information.

The capital of Tadawul is SAR 1,200,000,000 divided into (120,000,000) shares of equal value of SAR 10; all of which are cash shares subscribed by the Public Investment Fund. Tadawul is an affiliate member of the International Organization of Securities Commissions (IOSCO), the World Federation of Exchanges (WFE), and the Arab Federation of Exchanges (AFE). Please see 'About Tadawul' (Tadawul.com.sa, 2017) <<https://www.tadawul.com.sa/wps/portal/tadawul/about/company/about-tadawul>> accessed 12 December 2017.

market in general is not active because most bonds and *Sukuk* are bought by autonomous government agencies or banks on the basis of them being held to maturity.¹¹⁹⁹ Also, with a limited supply of instruments, investors prefer to hold them to maturity, which leads to the absence of a vibrant secondary market in *Sukuk*,¹²⁰⁰ although it is important to create an efficient secondary market to encourage the issuance of new corporate debt instruments such as corporate *Sukuk* and bonds.¹²⁰¹ A liquid secondary debt market will help to put in place a mechanism for the redemption payments of the movements of bond pricing. In this regard, the SAMA needs to play an important role to improve issuance mechanisms, such as tap issues, to create a full maturity spectrum for duration management, fixed and floating coupons to diversify price risks and the availability of a repo facility for day-to-day liquidity management.¹²⁰²

All trades in the Sukuk and Bond Market in Saudi Arabia from 24/3/2014 until 28/2/2018

DATE	NUMBER OF TRADES	VALUE TRADED (SAR)	-	DATE	NUMBER OF TRADES	VALUE TRADED (SAR)
24/3/2014	1	25.025.000.00	-	21/01/2016	1	99.750.000.00
21/05/2014	1	997.500.00	-	11/02/2016	1	5.940.000.00
18/09/2014	2	33.500.000.00	-	22/03/2016	1	299.100.000.00
21/9/2014	2	130.050.00	-	20/07/2017	3	15.000.000.00
22/01/2015	1	213.489.750.00	-	13/08/2017	3	9.925.600.00
01/06/2015	1	70.000.000.00	-	11/10/2017	1	1.000.000.00
18/06/2015	3	50.500.000.00	-	28/11/2017	1	2.000.000.00
24/8/2015	1	50.125.000.00	-	28/02/2018	1	8.022.280.00
13/01/2016	1	45.160.650.00	-			

Table 4: All trades in the Sukuk and Bond Market in Saudi Arabia over three years

¹¹⁹⁹ Oxford Business Group, 'The Report: Saudi Arabia 2016' (Oxford Business Group 2016) <<https://oxfordbusinessgroup.com/saudi-arabia-2016>> accessed 11 December 2017.

¹²⁰⁰ Ibid.

¹²⁰¹ Khalid Alsaeed, 'Sukuk Issuance in Saudi Arabia: Recent Trends and Positive Expectations' (PhD, University of Durham 2012) 78.

¹²⁰² Ibid.

(Source: official website of Tadawul, available at <https://www.tadawul.com.sa/wps/portal/tadawul/markets/Sukuk-%26-bonds>)

6.5 *Sukuk* Attract the Authorities' Attention in Saudi Arabia

As discussed above,¹²⁰³ Islamic finance in general and *Sukuk* in particular still need a better legal environment in Saudi Arabia.¹²⁰⁴ This issue has not only been highlighted by economists or researchers, but also by decision-makers, such as the Chairman of the CMA, a governmental organisation which has authority over the financial, legal and administrative independence of the Kingdom.

The CMA is working on accomplishing strategic goals such as supporting the growth of assets, encouraging the issuance of *Sukuk* and improving the financial markets which are not performing as they should.¹²⁰⁵ The Chairman believes that although the CMA of Saudi Arabia is giving *Sukuk* a great deal of attention, the *Sukuk* market in the Kingdom is still below the desired level. The CMA is working hard to develop this market as it is an important instrument to the national economy and a major player in supporting the financing of development projects. The development of this market requires concerted efforts and cooperation between multiple departments in the Kingdom which can affect the inception, continuation and growth of this market and how attractive it is for investors and issuers.

The major challenge in the *Sukuk* and debt instruments market that is contributing to the slow development of this sector is the lack of variety in investment products, which does not meet the requirements of different classes of investors to enable them to diversify their investments and find financing alternatives for public and private projects. In response to that, the CMA is paying a high level of attention to this market through a number of initiatives. One of their foremost initiatives is to develop a national strategy about the importance of such instruments, enhance the efficiency of debt instruments issuance and develop the legal infrastructure to support the development

¹²⁰³ See 6.4 above.

¹²⁰⁴ Abdullah Al Elsheikh and Joseph Tanega, 'Sukuk Structure and its Regulatory Environment in the Kingdom of Saudi Arabia' (2011) 5 Law and Financial Markets Review 184.

¹²⁰⁵ Conference Report, 'Islamic Finance Industry – 40 Years since Inception: Evaluation of Experience and the Way Forward', AAOIFI International Conference (AAOIFI 2016) <http://aaoifi.com/wp-content/uploads/2016/06/Madinah-Conference-Report_English-v7-Final-12-6-2016.pdf> accessed 11 December 2017.

of securitisation by simplifying the procedures of issuance and overcoming organisational and structural difficulties. This, in turn, will give the Saudi capital market the opportunity to attract the issuers and investors in of this market.¹²⁰⁶

Additionally, the Chairman revealed during his talk that the CMA was reviewing the current procedure and requirements to issue *Sukuk* in order to adopt a different review methodology and set different requirements for issuance based on several considerations such as: making it easier and faster to find out the former history of the company who is floating the *Sukuk*; the credit rating history of the issuer; the target categories of investors and the level of complexity involved in the debt restructuring.¹²⁰⁷

Furthermore, the Chairman highlighted that the CMA was in the process of issuing new regulations for SPVs related to the issuance of debt instruments: these were aiming to increase the attractiveness of the financial market as a funding source, to activate the trading of securities issued by asset securitisation store and to protect those assets., He acknowledged the need for establishing more specialised centres to develop Islamic financial products in universities that will, it is hoped, constitute the basis for the formation of qualified professionals in this industry.¹²⁰⁸

There has been new development with regards to the regulations that could help the development of *Sukuk* and its secondary market in Saudi Arabia such as the New Corporate Law that came into effect on 2nd May 2016,¹²⁰⁹ as a replacement to the previous Companies' Law which was enacted in 1965.¹²¹⁰ The Kingdom was in need of this new law due to the huge changes and development that occurred in almost all sectors of the economy in general and to companies in particular. In this regard, the Minister of Commerce and Industry, Tawfiq Al Rabiah, made the following statement:

“This new law comes as one of the most prominent economic regulations for development; issued by the state to provide a regulatory environment, to act as incubator that stimulates initiatives and investment. This is to enhance the role

¹²⁰⁶ Ibid.

¹²⁰⁷ Ibid.

¹²⁰⁸ Ibid.

¹²⁰⁹ Royal Decree No M3 dated 10/11/2015.

¹²¹⁰ Royal Decree No M6 dated 22/04/1965.

and value of companies and to develop their activities and contributions in supporting the National Economy".¹²¹¹

In addition, he added that the new system had laid the legal basis for allowing the joint stock companies to issue debt credits or negotiable financing instruments according to the Capital Market System.¹²¹² This new law eased some of the requirements to establish a new Joint Stock Company (JSC) by reducing the minimum capital from two million Riyals to only five hundred thousand Riyals .¹²¹³ Also, only two partners can establish a JSC instead of five as previously.¹²¹⁴ Even a single person company can be created with a minimum capital of five million Riyals.¹²¹⁵ The new law allows debt instruments and *Sukuk* to be converted into shares. However, such conversion cannot be made if the terms of issuing the instruments or the *Sukuk* do not permit it, or if the instrument certificate holders do not approve of such conversion.¹²¹⁶

Although many challenges are still affecting the *Sukuk* market, at the time of writing, and as the new law needs some time to prove its reliability, the interest shown by some officials as mentioned above, together with the new Saudi Vision 2030 and also the new corporate law, are all positive signs showing the *Sukuk* market might be in a better position in the future. For example, the new corporate law seems favourable to debt instruments and to *Sukuk* as it encourages the creation of companies by reducing the minimum capital and allowing a company to be formed by two parties or even a single one with a higher minimum of capital.¹²¹⁷

In addition, the new legislation aims to boost the creation of new companies by allowing a JSC to issue convertible bonds and debt instruments including *Sukuk* and by allowing a JSC to issue bonds or *Sukuk* that exceed the JSC's capital. As this was not possible under the previous regulations, it will likely be welcomed by participants in debt capital markets, which will place bonds and *Sukuk* in a better position.¹²¹⁸

¹²¹¹ Ministry of Commerce and Investment, 'Approving and Issuing the New Corporate Law Provides an Incubator Environment that Stimulates the Investment in the Kingdom' (2015) <<https://mci.gov.sa/en/MediaCenter/News/Pages/09-11-15-01.aspx>> accessed 12 December 2017.

¹²¹² Ibid.

¹²¹³ New Corporate Law 2015 Article 54.

¹²¹⁴ Ibid Article 2.

¹²¹⁵ Ibid Article 55.

¹²¹⁶ Ibid Article 123.

¹²¹⁷ Oxford Business Group, 'The Report: Saudi Arabia 2016' (Oxford Business Group 2016) 384 <<https://oxfordbusinessgroup.com/saudi-arabia-2016>> accessed 11 December 2017.

¹²¹⁸ Ibid.

Also, the Deputy Minister for Internal Trade, Tarek Al Naeim, stated that the new law can help the private sector by increasing its contribution to boost economic development through facilitating the procedures to set up companies, allowing more flexibility by permitting the announcement of establishing contracts and basic rules using the Ministry's website and finally laying the legal framework for the holding companies.¹²¹⁹ The researcher believes that the *Sukuk* market and its secondary market will benefit from this new law which will greatly increase the number of JSCs that may need to finance their projects via *Sukuk*.

Article 121 of the new law states that the JSCs must observe the principles of sharia when issuing and trading in debt instruments or *Sukuk*.¹²²⁰ although there is no explanation about who is responsible to determine whether *Sukuk* and debt instruments are sharia-compliant or not. Are conventional bonds counted as sharia-compliant so that they can be traded? Further clarification is still needed from the ministry or CMA in this respect.

Furthermore, in May 2016 both the Governor and Vice Governor of the SAMA gave speeches during the First Islamic Banking and Finance Research Conference,¹²²¹ highlighting the importance of Islamic finance; as the Governor of SAMA said:

“Islamic banking has gained growing international attention over several decades due to its large growth and resilience to financial crises as well as the nature of sharia-compliant finance models that focus on the principles of investment in real assets and risk-sharing. The Islamic finance model has contributed to the spread of real-asset-based finance principles and led to their adoption at a G20 summit as an ideal option for the finance of infrastructure projects in many countries”¹²²²

Then the Governor provided information and figures showing the importance of this type of finance such as the fact that there are more than 2,000 financial institutions providing sharia-compliant financial product assets which have reached over US\$2

¹²¹⁹ Ministry of Commerce and Investment, 'Approving and Issuing the New Corporate Law Provides an Incubator Environment that Stimulates the Investment in the Kingdom' (2015) <<https://mci.gov.sa/en/MediaCenter/News/Pages/09-11-15-01.aspx>> accessed 12 December 2017.

¹²²⁰ New corporate law 2015 Article 121.

¹²²¹ 'KFUPM Islamic Banking and Finance Research Conference' (*Cim.kfupm.edu.sa*, 2016) <<http://cim.kfupm.edu.sa/ibf2016/>> accessed 12 December 2017.

¹²²² Saudi Arabian Monetary Authority, 'Speech of H.E. The Governor of SAMA at the First Islamic Banking and Finance Research Conference' (2016) <<http://www.sama.gov.sa/en-US/News/Pages/News14032016.aspx>> accessed 12 December 2017.

trillion internationally. Also, he stated that the *Sukuk* volume had reached US\$300 billion, nearly one-third of which is shared by the GCC countries. Also, the cooperative insurance sector has exceeded US\$20 billion more than 40 percent of which is accounted for by the GCC countries.¹²²³

The Governor concluded his talk by highlighting the need for more studies in this field and stated that “the scarcity of research and studies and the limited number of researchers specialising in Islamic banking legislation are among the impediments to the growth and development of the Islamic finance industry”.¹²²⁴ The Vice Governor also reiterated the importance of Islamic finance and the need for more attention to be paid to this field and to develop this sector.¹²²⁵

In order to show the new strategy that Saudi Arabia is adopting to develop the financial sector in Saudi Arabia, a number of speech extracts were quoted from certain members in authority in different ministries and government organisations in Saudi Arabia, such as the Chairman of the CMA, Mohammed Jadaan who is now the Minister of Finance, the Minister of Commerce and Industry, Tawfiq Al Rabiah, and the Governor and the Vice Governor of the SAMA.

Also, the Saudi authorities seem to have now realised the need to update laws taking into consideration Islamic finance as an important part of the Kingdom of Saudi Arabia. In this respect, the Saudi authorities have recently been attending and holding several meetings and conferences about Islamic finance. Most particularly, *Sukuk* have been targeted by the strategic plan of the CMA covering the period 2015-2019; See Figure 11 regarding the CMA’s plan.¹²²⁶ The Saudi Vision 2030 has also come into line on this with an interest in having more developed laws and regulations and also to make more use of Islamic finance concurrent with the Saudi Vision 2030. This is what is going to be discussed now.

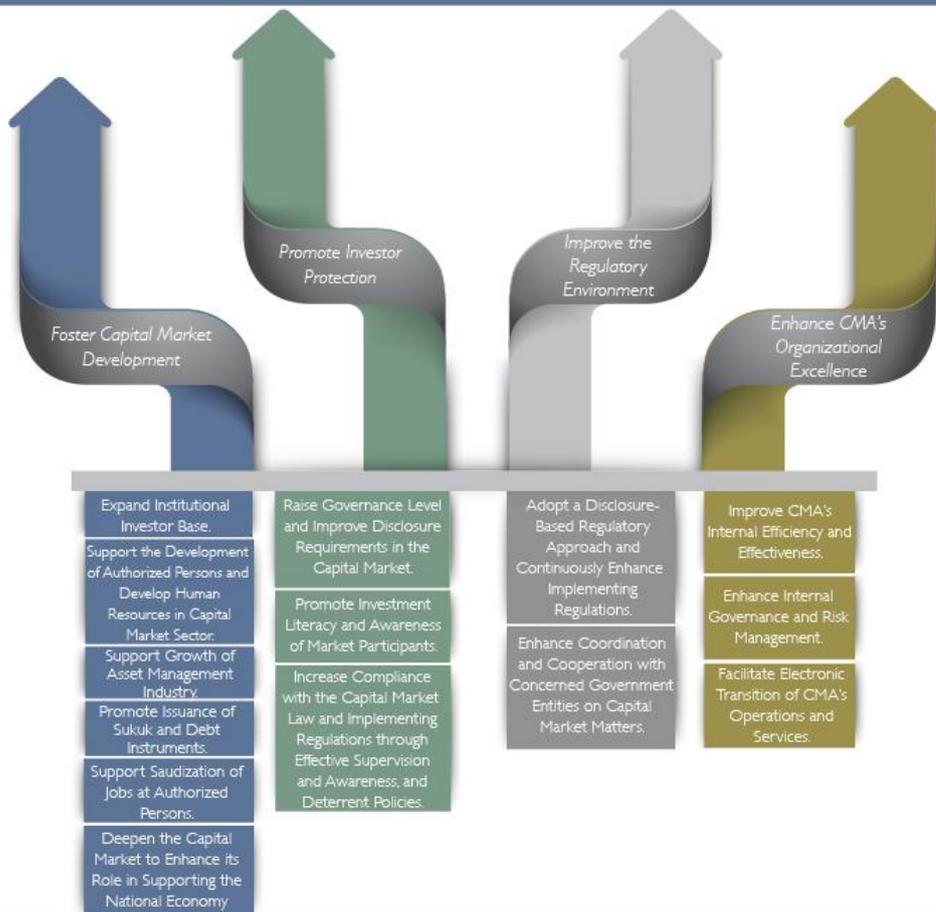
¹²²³ *Ibid.*

¹²²⁴ *Ibid.*

¹²²⁵ *Ibid.*

¹²²⁶ Capital Market Authority, 'Capital Market Authority Annual Report 2015' (CMA 2017) <https://cma.org.sa/en/AboutCMA/AnnualReport/Documents/cma_2015_report.pdf> accessed 12 August 2017.

Vision: To make the Saudi capital market a pioneer market earning the confidence of investors.



Mission: Regulate and develop the capital market to be an investment-conducive environment; promote fairness, efficiency and transparency in protection of market participants.

Figure 11: Strategic Plan Themes and Objectives of the CMA

https://cma.org.sa/en/AboutCMA/AnnualReport/Documents/cma_2015_report.pdf

6.6 Saudi Vision 2030

There has already been mention in Chapter Three of the Saudi Vision 2030 and the optimistic future for the economy of Saudi Arabia, especially the focus on updating the laws and regulations of the country to keep up with the development of the economy in the developed countries.¹²²⁷ The Vision is expected to promote the *Sukuk* market in Saudi Arabia, as stated in the Vision:

¹²²⁷ See 3.6 above.

“Our Vision is to maximize our investment capabilities by participating in large international companies and emerging technologies from around the world. This will ensure that we become market makers in selected sectors, as well as a leader in competitively managing assets, funding and investment. All of this will require the formation of an advanced financial and capital market open to the world, allowing greater funding opportunities and stimulating economic growth. To this end, we will continue facilitating access to investing and trading in the stock markets. We will smooth the process of listing private Saudi companies and state-owned enterprises, including Aramco. This will require deepening liquidity in our capital markets, fortifying the role of the debt market and paving the way for the derivatives market.”¹²²⁸

As there are no special regulations for *Sukuk* in Saudi Arabia yet, they fall under the debt market; however, the researcher is optimistic about the future of *Sukuk* and Islamic finance in Saudi Arabia, especially given that the CMA has recognised that more efforts are needed with regards to *Sukuk* and that they have been included in the strategic plan which should be achieved in the next few years.

The CMA has successfully developed its regulations in some parts of the market through, for instance, easing the listing requirements for companies in the stock market with greater efficiency than before. Indeed, previously, this involved a lengthy and costly process handled by many government agencies like the SAMA, the Ministry of Commerce and Industry, the CMA and a number of other agencies.¹²²⁹ However, the researcher believes that a remaining problem is facing Islamic finance: the CMA and the SAMA, who both have the power to develop the regulations for Islamic finance, still do not seem to acknowledge the differences between conventional and Islamic finance, especially with regard to what can be labelled as Islamic as these regulatory agencies have left this to the financial companies themselves. This, in turn, has been the cause for some exploitation and the loss of customer trust. However, positive signs can be seen with this Vision which can contribute to the development of Islamic finance

¹²²⁸ Saudi Vision 2030, 'Saudi Vision 2030 the Council of Economic Affairs and Development Issued the Decision No. (3-31/37) dated 19 April 2016' (Saudi Vision 2016) 43 <<http://vision2030.gov.sa/en/media-center>> accessed 4 June 2017.

¹²²⁹ Capital Market Authority, 'CMA Joins AAOIFI Membership' (2016) <<https://cma.org.sa/en/MediaCenter/PR/Pages/AAOIFI.aspx>> accessed 4 July 2017.

including *Sukuk*. For example, SAMA¹²³⁰ and CMA both became members of AAOIFI,¹²³¹ as mentioned in Chapter Three. Another positive sign is that, any proposed future legislation or successful development will be reconsidered in 2020 as the Vision 2030 states: “in order to build the institutional capacity and capabilities needed to achieve the ambitious goals of Saudi Arabia’s Vision 2030, the National Transformation Program 2020 was launched across 24 government bodies operating in the economic and development sectors in its first year. It is notable that the program’s strategic objectives are linked to interim targets for the year 2020.”¹²³²

Moreover, for the first time, Saudi Arabia is currently in the process of issuing sovereign *Sukuk* which will have a tremendous impact on the *Sukuk* market in Saudi Arabia.¹²³³ In 2017, *Sukuk* are internationally and locally issued by the Debt Management Office in the Ministry of Finance,¹²³⁴ and Islamic finance can benefit from both the domestic and the international sovereign *Sukuk* which will create a long-term benchmark for others to price against in the country instead of depending on the benchmark from bonds or other conventional finance which is built on the interest rate.¹²³⁵

6.7 Conclusion and Suggestions

This chapter is made to show the need for more attention towards better environment for Islamic finance in Saudi Arabia using *Sukuk* as an example to show the need for more attention regarding to *Sukuk*. As has been shown previously the meaning of Islamic finance and the principles that such finance is built on with the unique

¹²³⁰ AAOIFI, 'AAOIFI Celebrates Admission of SAMA as Institutional Member at Official Ceremony Held in Riyadh' (2017) <<http://aaoifi.com/announcement/aaoifi-celebrates-admission-of-sama-as-institutional-member-at-official-ceremony-held-in-riyadh/?lang=en>> accessed 4 November 2017.

¹²³¹ Capital Market Authority, 'CMA Joins AAOIFI Membership' (2016) <<https://cma.org.sa/en/MediaCenter/PR/Pages/AAOIFI.aspx>> accessed 4 July 2017.

¹²³² 'National Transformation Program | Saudi Vision 2030' (*Vision2030.gov.sa*, 2017) <<http://vision2030.gov.sa/en/ntp>> accessed 18 December 2017.

¹²³³ Archana Narayanan and Arif Sharif, 'Saudi Arabia Raises \$9 Billion with Inaugural Islamic Bond' (*Bloomberg.com*, 2017) <<https://www.bloomberg.com/news/articles/2017-04-12/saudi-arabia-raises-9-billion-in-inaugural-islamic-bond-sale>> accessed 12 November 2017.

¹²³⁴ 'About Debt Management Office' (*Mof.gov.sa*, 2017) <<https://www.mof.gov.sa/en/DebtManagementOffice/AboutDebtManagementOffice/Pages/default.aspx>> accessed 12 November 2017.

¹²³⁵ A personal interview with participant C on 3 March 2015.

characters it has.¹²³⁶ Then, the strong relation between Islam and Saudi Arabia, which should put Saudi on the top of countries to support and support Islamic finance.¹²³⁷

Then, showing the way Islamic finance is regulated in Saudi,¹²³⁸ highlighting some of gap between what the Basic Law of Governance stated with regard to finance and the current practised.¹²³⁹ After that, the thesis defines the phrase sharia-compliant and discussed the reason of the different *Fatwas* from different schools of thought depending of the uses of *Hila*.¹²⁴⁰ Then, the importance of sharia boards in financial institutions and the challenges facing such boards were discussed.¹²⁴¹

Also, the need of special corporate governance for Islamic finance in Saudi Arabia was discussed giving some example of different countries and their practises towards Islamic finance. After that the thesis introduced one product of Islamic finance, *Sukuk*, to be a case study to examine the challenges that may face Islamic finance in Saudi Arabia. *Sukuk* was discussed illustrating its importance to Islamic finance and giving some history of *Sukuk*;¹²⁴² then showed how it is differ from other types of finances particularly the bonds that used in conventional finance.¹²⁴³

Then this Chapter came to demonstrate the need for more attention towards better environment for Islamic finance in Saudi Arabia using *Sukuk* as an example discussing the challenges the country faces and the possible solutions to overcome them. *Sukuk* have been chosen as they play a vital role in Islamic financial institutions, and they are a way of attracting many countries around the world, in both conventional finance and also new customers such as Socially Responsible Investing (SRI) who share a similar focus on ethics and social consciousness.

This chapter has therefore given a brief history of *Sukuk* in Saudi Arabia, highlighting the growing interest of such *Sukuk*. Moreover, the challenges facing Islamic finance and *Sukuk* were presented including the fact that *Sukuk* have been treated as conventional finance products instead of being regulated by specific laws that can protect and help to develop this market. In addition, the chapter has highlighted the

¹²³⁶ See 2.2 also 2.5 and 2.7 above.

¹²³⁷ See 3.2 also 3.2.2 and 3.2.3.

¹²³⁸ 3.4.1Also 3.4.2 and 3.4.3

¹²³⁹ 3.3.3.3 and 3.4 above.

¹²⁴⁰ 4.2 also 4.4 above.

¹²⁴¹ 4.7 and 4.9 above.

¹²⁴² See 5.2 and 5.3 above.

¹²⁴³ See 5.4 above.

recent development in Saudi Arabia in terms of the new laws and regulations that have recently been implemented or that are currently being drafted. They can soon be implemented in accordance with the Saudi Vision 2030, which may have a tremendous impact on *Sukuk* in the near future.

Based on what has been discussed earlier, a number of suggestions may be made that might be important points for the regulators to consider in order to develop this market. Considering such points would benefit the economy of the country and place it ahead of other countries with regard to Islamic finance, as it should be, because it enjoys unique features that it should take advantage of: such as hosting the two Holy Mosques, the fact that the vast majority of its population believe in Islam and in the prohibition of *Riba*, and also the fact that the country is governed by sharia law.

One of the suggestions relates to the importance for the SAMA and the CMA to take advice from other central banks and organisations already working with *Sukuk*, such as the Central Bank of Bahrain, the Dubai International Financial Centre and Bank Negara Malaysia, to learn from their experiences, whether positive or negative, and build on their experiences to achieve a better-performing *Sukuk* market. Furthermore, opening up with other central banks, especially in the GCC countries, is preferable as they already entered into an Agreement on the Execution of Rulings in 1995 (the GCC Convention) for the recognition and enforcement of both court judgments and arbitral awards without re-examination of the merits.¹²⁴⁴

As discussed in this chapter, a central sharia board to supervise the *Fatwas* for the new products created by different financial institutions is needed in order to control products that are covered under the Islamic label just to have access to more investors not keen on investing in products that contradict sharia.

Moreover, in order to encourage the Islamic finance sector to create and develop financial products that reflect Islamic ethics and values, another suggestion may be to have a special rating scale to measure the compatibility of a financial product to sharia. This rating scale could be added to the credit rating for Islamic financial products to encourage banks and financial institutions and their sharia boards to keep developing their financial products to meet the fundamental principle of Islamic standards.

¹²⁴⁴ Khalid Alsaeed, 'Sukuk Issuance in Saudi Arabia: Recent Trends and Positive Expectations' (PhD, University of Durham 2012) 99. Also, Dubai International Financial Centre, 'Guide to Dispute Resolution in the Middle East' (Herbert Smith LLP 2010).

Regulators should give a chance to scholars, lawyers and economists to form a better structure to serve *Sukuk* instead of being tied up with regulations designed to assist the debt market and conventional securities.

Finally, the Saudi Vision 2030, together with the new laws that have just been implemented and those under process, and in addition to the recent growing interest of regulators in Islamic finance, are all good signs that Islamic finance and *Sukuk* will be given more attention and will be served better than before.

However, the new promises which have already been given above to develop the *Sukuk* and Islamic finance do not cover all the challenges that have been mentioned earlier, which indicate that there is more work to be done in order to make the most use of Islamic finance.

Chapter Seven: Conclusion and Recommendations

7.1 Conclusion

People and organisations who engage with, or have an interest in, finance have witnessed the rapid progress of Islamic finance over the past four decades. Such growth has encouraged many major financial institutions to become involved, in one way or another, in this particular form of finance.¹²⁴⁵ This has resulted in an increase in the number of countries allowing such finance to enter their countries. Islamic financial institutions are now operating in more than a hundred countries,¹²⁴⁶ and more countries have introduced, or are considering introducing, legislation that complies with the regulatory framework of this industry.¹²⁴⁷

Islamic finance is not a new discovery; Islamic finance law has been part of Islamic law since its inception more than 1400 years ago and is built on basic principles that are deeply rooted in the teachings of the sharia,¹²⁴⁸ However, the impact and influence of European colonisation in the Muslim world may have lessened both the spirit and the status of this legal framework over a long period of time.¹²⁴⁹ It was only about 40 years ago that Islamic financial law began to regain its importance within the banking sector, as a growing number of Muslim countries decided to adopt this particular financial system with its conformity to Islamic principles.¹²⁵⁰

In the middle of the 19th century Saudi Arabia started to develop rapidly because of the discovery of oil.¹²⁵¹ The country started to need banks, and then regulations to govern those banks. This resulted in the establishment of the Saudi Arabian Monetary Authority (SAMA) as a Central Bank in 1952.¹²⁵² SAMA as a government institution has to work according to the law governing the country, which is Islamic law. Thus, it is stated in its Charter that it would not act in any manner which conflicts with the

¹²⁴⁵ Craig R Nethercott and David M Eisenberg, *Islamic Finance: Law and Practice* (Oxford University Press 2012) 2.

¹²⁴⁶ Ibrahim Warde, *Islamic Finance in the Global Economy* (2nd edn, Edinburgh University Press 2014) 1.

¹²⁴⁷ *Ibid.*

¹²⁴⁸ Samir Alamad, *Financial Innovation and Engineering in Islamic Finance* (Springer International Publishing 2017) 107.

¹²⁴⁹ See 2.2 above.

¹²⁵⁰ *Ibid.*

¹²⁵¹ See 3.2 above.

¹²⁵² See 3.4.2 above.

teachings of the Islamic Law.¹²⁵³ However, it has licensed conventional commercial banks and supervised financial activities on a conventional financial basis, including allowing financial institutions and banks to deal with *Riba*.¹²⁵⁴ This shows that there is difference between law and practice.

The absence of successful examples of central banks that regulated Islamic finance at that time could justify the practice of SAMA to be done under the provision of necessity.¹²⁵⁵ But with the development of Islamic finance and its regulations there leaves a question mark as to why SAMA has still not done enough to develop rules and regulations that are more suitable to Islamic finance, and what legal challenges are now facing Islamic financial products in Saudi Arabia.¹²⁵⁶

In order to answer such questions some basic points need to be clarified and then linked together to give a logical sequence to understanding and then answering these questions. Thus, Chapter Two defined Islamic finance,¹²⁵⁷ and highlighted the main differences between such finance and conventional finance.¹²⁵⁸ This chapter then briefly introduced the historical stages Islamic finance and banking went through from the period just before Islam began up to the present day.¹²⁵⁹ This includes the gap in the period when Islamic finance almost lost its identity in many Muslim countries because of Western colonialism which has had its impact on the development of this type of finance globally, and also on the recent financial crisis in 2007, which contributed to the increase in popularity of Islamic finance.¹²⁶⁰ An Islamic financial system would prohibit debt and risk-shifting in favour of risk-sharing and equity finance, which would give more stability to the market.¹²⁶¹

This then follows an overview of the structures that Islamic law is built on,¹²⁶² including the main four Sunni schools of thought which have a significant influence on *Fatwas* regarding the compliance of financial contracts-with sharia law.¹²⁶³ Then the chapter discussed the major prohibited acts in Islamic finance to clarify the aspect that has to

¹²⁵³ Ibid.

¹²⁵⁴ Ibid.

¹²⁵⁵ See 3.3.3 above.

¹²⁵⁶ See 3.4.2 above.

¹²⁵⁷ See 2.2 above.

¹²⁵⁸ Ibid.

¹²⁵⁹ See 2.4 above.

¹²⁶⁰ See 2.5 above.

¹²⁶¹ Ibid.

¹²⁶² See 2.3 above.

¹²⁶³ See **Error! Reference source not found.** above.

be considered when approving a financial contract;¹²⁶⁴ the fact that those acts have to be avoided when providing a financial contract is crucial for understanding the next chapters. Following on from this, the freedom of contract in Islamic finance was highlighted to show that new Islamic financial contracts can be created when certain rules are followed.¹²⁶⁵ Finally, some examples of Islamic financial contracts were provided to give a better understanding of Islamic finance.¹²⁶⁶ This chapter is essential to the work as it is not appropriate to discuss the challenges that face Islamic finance in Saudi Arabia without discussing the context and what is meant by Islamic finance.

After defining Islamic finance and Islamic principles the thesis went on to introduce Saudi Arabia,¹²⁶⁷ which is the case study of the thesis. Saudi Arabia is a country that has chosen Islamic law to be the law of the country.¹²⁶⁸ Thus, Chapter Three describes Saudi Arabia and its legal system with respect to Islamic finance. After defining Islamic finance in the previous chapter,¹²⁶⁹ this chapter showed the relationship between Islamic finance and Saudi Arabia in order to develop the themes of this thesis and to find out the challenges that may face such financial institutions in Saudi Arabia.¹²⁷⁰ This chapter started by giving the relevant historical background about Saudi Arabia including the legal background to demonstrate the close link between Islam and the law of the country.¹²⁷¹

After that, the structure of the Saudi legal system was provided including the regulatory, the executive and the judicial authorities in the Kingdom to show where the position of Islamic finance in the country is.¹²⁷² Also, the chapter highlighted one of the challenges that Islamic finance may face regarding the judicial sector, as most of the financial disputes, including Islamic finance, are not being referred to courts to be looked at by judges, whom are granted their independence by law; instead disputes are usually handled by special committees whose independence is questionable.¹²⁷³ They are created to be under a particular ministry supervision to carry out their judicial

¹²⁶⁴ See 2.7 above.

¹²⁶⁵ See 2.8 above.

¹²⁶⁶ See 2.9 above.

¹²⁶⁷ See 3.2 above.

¹²⁶⁸ See 3.2.2 above.

¹²⁶⁹ See 2.2 above.2

¹²⁷⁰ See 3.2.1 above.

¹²⁷¹ See 3.2 above.

¹²⁷² See 3.3 above.

¹²⁷³ See 3.3.3.3 above.

functions. However, they belong to the executive branch rather than the judicial branch. Therefore, these committees are not sufficiently independent.¹²⁷⁴

This chapter continued by illustrating the financial activities in Saudi Arabia which include the Banking Control Law,¹²⁷⁵ the Saudi Arabian Monetary Authority (SAMA)¹²⁷⁶ and the Capital Market Authority,¹²⁷⁷ all of which play a vital role in the financial sector in Saudi Arabia; and so it is very important that this is discussed by showing their links to Islamic banking and finance and then categorising different kinds of banks in the country with respect to their relationship with Islamic finance to prove that not all financial institutions are working in accordance of sharia.¹²⁷⁸

Finally, the 2030 Saudi Vision was presented to show the recent development in the country which may benefit Islamic finance in Saudi Arabia. The Vision was introduced here to be part of the chapter that set out most of the important laws, activities and organisations that relate to finance in Saudi Arabia.¹²⁷⁹

However, further links between the Vision and Islamic finance are presented in Chapter Six.¹²⁸⁰ Chapter Three is vital to the thesis as it sets out the basics that Saudi Arabia for example committed itself by law to follow sharia in all respects; whereas in practice there are some breaches or gaps in the law and in the regulations which need remedying to achieve the best practice for such finance;¹²⁸¹ and that is what Chapter Four is trying to show.

Chapter Four is considered one of the most vital chapters to this thesis as it shows most of the challenges relating to Islamic finance in Saudi Arabia. It would be hard to discuss this chapter without understanding the two previous chapters, as this chapter is built on the conclusions of the two previous chapters put together. This can be seen when Chapter Four discussed the importance of sharia boards in Islamic financial institutions.¹²⁸² The sharia boards are required to guarantee that all financial products they approve are sharia compliant. It should be easy to define sharia compliance after

¹²⁷⁴ Ibid.

¹²⁷⁵ See 3.4.1 above.

¹²⁷⁶ See 3.4.2 above.

¹²⁷⁷ See 3.4.3 above.

¹²⁷⁸ See 3.5 above.

¹²⁷⁹ See 3.6 above.

¹²⁸⁰ See 6.6 above.

¹²⁸¹ See 3.3.3.3 and **Error! Reference source not found.** above.

¹²⁸² See 4.7 above.

understanding the essential basics of Islamic finance as discussed in Chapter Two.¹²⁸³ In addition, there is discussion on the major rules of Islamic finance such as the prohibition of *Riba*, *gharar* and *maisir*,¹²⁸⁴ and also the different Islamic schools of thought¹²⁸⁵ with some examples of financial contracts that have been used and still exist in Islamic finance, such as *Mudaraba*, *Murabaha* and *Salam*¹²⁸⁶. These are explained in Chapter Two and help to discuss *Hila* and the position of each school of thought towards it.¹²⁸⁷

In order to answer questions such as, to what extent does Saudi Arabia commit to its own Islamic laws with respect to Islamic financial institutions in the Kingdom and what laws are really being applied to Islamic finance in Saudi Arabia. Chapter Four needs to acquire all the points discussed in Chapter Three: from the legal background of Saudi Arabia,¹²⁸⁸ the link between Islam and sharia law,¹²⁸⁹ to the structure of the country's legal system,¹²⁹⁰ and the financial activities and laws governing the financial sector.¹²⁹¹ All these points need to be kept in mind, to be able to discuss the current practices in Islamic finance and the role of sharia boards in financial institutions to ensure the compliance of their financial products to Islamic principles.

In addition, the chapter stressed the need for the involvement of a legal regulatory body to participate in and to be part of the remedy in order to have a better environment for Islamic finance,¹²⁹² by securing the independence of sharia boards and by removing procedures in some financial institutions that might mislead customers by labelling non-sharia-compliant products as sharia compliant.

Thus, this chapter highlighted the situation of sharia boards in Islamic financial institutions in Saudi Arabia from a legal point view and looked at how the corporate governance of Islamic financial institutions compares with the current situation of some other countries including the neighbouring countries in the GCC countries.¹²⁹³ Therefore, the researcher concluded this point by pointing out the need for sharia

¹²⁸³ See 2.2 and 2.3 above.

¹²⁸⁴ See 2.7 above.

¹²⁸⁵ See **Error! Reference source not found.** above.

¹²⁸⁶ See 2.9 above.

¹²⁸⁷ See 4.3 and 4.4 above.

¹²⁸⁸ See 3.2.2 above

¹²⁸⁹ See 3.2.3 above.

¹²⁹⁰ See 3.3 above.

¹²⁹¹ See 3.4 above.

¹²⁹² See 4.8 above.

¹²⁹³ See 4.6 and 4.11 above.

governance set by the regulators to be part of the corporate governance for financial institutions that provide financial products that are sharia compliant;¹²⁹⁴ and a suggested framework is therefore made at the end of this thesis.¹²⁹⁵

Lastly, the chapter discussed the idea of creating a Central Sharia Board to supervise individual sharia boards in financial institutions, highlighting the advantages of creating one to be at the top of the sharia boards in the financial institutions and to be part of the sharia governance.¹²⁹⁶ The framework and legal requirements to create a Central Sharia Board is made in the last chapter.¹²⁹⁷ Then, the thesis chose one of the Islamic financial instruments as a case study to show some of the challenges facing Islamic finance in Saudi Arabia and to emphasise the need for sharia governance that was discussed in Chapter Four.

Chapter Five introduced *Sukuk*, an Islamic financial instrument, as a case study to show in practice the challenges that may face Islamic finance in Saudi Arabia and the need for more attention from the regulators to develop a market which conforms with Islamic principles. As these principles form the basis of the law governing Saudi Arabia, the country should lead the development of Islamic finance so avoiding contradicting its laws by regulating and working with financial activities that are inconsistent with sharia. *Sukuk* was chosen to be the case study as they can be organised and built on different forms of Islamic financial contracts, and because of their popularity in many countries including Saudi Arabia.¹²⁹⁸

This chapter defined *Sukuk* and gave a brief history of their development and the growing interest of this product.¹²⁹⁹ Then it went on to differentiate this product from other types of financing instruments, particularly bonds that are used in conventional finance.¹³⁰⁰ Also, this chapter explained the basic idea of *Sukuk* in general and how they work showing that *Sukuk* can be assets-backed or assets-based and the differences between them.¹³⁰¹ Also, which *Sukuk* can be traded in the secondary

¹²⁹⁴ See 4.11.7 above.

¹²⁹⁵ See 7.2 below.

¹²⁹⁶ See 4.12 above.

¹²⁹⁷ See 7.2 below.

¹²⁹⁸ Abdullah Al Elsheikh and Joseph Tanega, 'Sukuk Structure and its Regulatory Environment in the Kingdom of Saudi Arabia' (2011) 5 Law and Financial Markets Review 190.

¹²⁹⁹ See 5.2 and 5.3 above.

¹³⁰⁰ See 5.4 above.

¹³⁰¹ See 5.6 above.

market was clarified.¹³⁰² Finally, this chapter discussed different types of contracts that are used in *Sukuk* to show which ones can be traded in a secondary market.¹³⁰³

This chapter is closely linked to the next chapter which discussed *Sukuk* in Saudi Arabia examining the validity of the current laws and regulations that have their effects on *Sukuk*. Thus, the next chapter highlighted the challenges and difficulties that might face *Sukuk* in Saudi Arabia.¹³⁰⁴

Chapter Six is another chapter that aims to determine the challenges facing Islamic finance in Saudi Arabia in order to suggest some reforms to help in developing Islamic finance further. This chapter looked at the way Saudi Arabia regulates *Sukuk*. *Sukuk* are already defined and discussed in detail in the previous chapter to make it easy for this chapter to focus on Saudi Arabia,¹³⁰⁵

In addition, the legal system of Saudi Arabia was described and discussed in Chapter Three,¹³⁰⁶ then some challenges facing Islamic finance were illustrated in Chapter Four.¹³⁰⁷ More challenges related to *Sukuk* were discussed in Chapter Six, such as the absence of regulations that target *Sukuk* in Saudi Arabia with the recommendation to open more links with organisations that focus on making standards and rules that suit Islamic financial products such as *Sukuk*.¹³⁰⁸

In addition, the chapter identified a challenge related to choosing Saudi Arabia as the governing authority. *Sukuk* disputes in Saudi are seen by the Committee for the Resolution of Securities Disputes (CRSD) not by a sharia court. The challenge was debated in detail and the researcher's point of view was presented.¹³⁰⁹

The chapter also highlighted the absence of suitable regulations for Islamic finance in general, and in the example of *Sukuk* this absence might push issuers and sharia boards to structure *Sukuk* in the form of bonds in order to be accepted by the regulator,¹³¹⁰ which in turn slows up the development of such an important financial instrument. This can be more serious with the absence of sharia governance when the

¹³⁰² See 5.7 above.

¹³⁰³ See 5.7 and 5.8 above.

¹³⁰⁴ See 6.4 above.

¹³⁰⁵ See 5.2 above.

¹³⁰⁶ See 3.2.2 above.

¹³⁰⁷ See 4.5 above.

¹³⁰⁸ See 6.4 below.

¹³⁰⁹ Ibid.

¹³¹⁰ Ibid.

independence of sharia boards in financial institutions are questionable. This may make some financial institutions push sharia boards so hard to give *Fatwas* on financial contracts that are no different than the financial contracts in conventional financial institutions, which are mainly based on *Riba*, instead of putting the effort in to provide real Islamic finance.¹³¹¹ The challenge was followed by another challenge which was the absence of a central sharia board. A lack of a central sharia board can affect in a negative way the confidence of investors, as religion can be used in a bad way to get advantages from investors who seek legitimate contracts which could threaten the whole financial market in a country, especially in a Muslim country like Saudi Arabia.¹³¹²

Furthermore, the chapter discussed the challenge relating to *Sukuk* defaults and the bankruptcy law in Saudi Arabia, as the previous default in *Sukuk* gave rise to some concerns regarding insolvency regulations which have some uncertainty to them. Thus, there was a need to update and improve regulations regarding insolvency as the current regulations indicate that there is a need for a more developed framework. Consequently, the government felt the need to update the laws coinciding with the 2030 Vision and introduced a new bankruptcy law in February in 2018.¹³¹³ The new law will not only benefit Islamic finance and *Sukuk*, but also all economic activities whether based on Islamic or conventional rules.

Then the chapter discussed another challenge that may face *Sukuk* and its popularity in Saudi Arabia, which is the high cost of a credit-rating agency as there were no credit-rating agencies in Saudi Arabia. However, in August 2017 two agencies started to work from Saudi and more are going to be licensed soon.

This may benefit the Saudi capital market in general including the *Sukuk* market which should increase competition amongst credit-rating agencies, in addition to improving performance and lowering costs; this in turn will benefit all *Sukuk* issuers especially small and medium size enterprises.¹³¹⁴

The final challenge discussed was the secondary *Sukuk* market in Saudi Arabia, as it suffers from a lack of commercial deals or operations. This was caused by the limited

¹³¹¹ See 4.9 and 6.4 above.

¹³¹² *Ibid.*

¹³¹³ See 6.4 above.

¹³¹⁴ *Ibid.*

supply of instruments, which made investors prefer to hold them to maturity, leading to the absence of a vibrant secondary market in *Sukuk*.¹³¹⁵ The only solution, from the researcher's point of view, is in the hands of regulators to encourage Islamic finance in general and the issuance of *Sukuk* in particular, by creating a suitable legal environment for this kind of market and to respond to the challenges discussed earlier by adopting the best practices.

Then the chapter highlighted the recent development in Saudi Arabia in terms of the new laws and regulations that have recently been implemented or that are currently being drafted.¹³¹⁶ Also, decision-makers, such as the Chairman of the CMA, the Minister of Commerce and Industry, the Deputy Minister for Internal Trade, and also both the Governor and Vice-Governor of the SAMA, all felt the need for new regulations to encourage the economic development of the country.¹³¹⁷ Furthermore, some of them emphasised in particular the need to develop Islamic finance including *Sukuk*. such as the need to adopt a different review methodology and set different requirements for issuance based on several considerations such as: making it easier and faster to find out the former history of the company who is floating the *Sukuk*; the credit-rating history of the issuer; the target categories of investors and the level of complexity involved in the debt restructuring; and also, introducing a New Corporate Law which may contribute to the development of *Sukuk* and its secondary market.¹³¹⁸ Saudi authorities seem to have now realised the need to update laws taking into consideration Islamic finance as an important part of the Kingdom of Saudi Arabia. In this respect, the Saudi authorities have recently been attending and holding several meetings and conferences about Islamic finance. Most particularly, *Sukuk* have been targeted by the strategic plan of the CMA covering the period 2015-2019.¹³¹⁹

Finally, the chapter showed the attention that the Saudi Vision 2030 is giving to developing new laws and regulations that may have a tremendous impact on *Sukuk* and Islamic finance in general in the near future, especially given that the CMA has recognised that more efforts are needed with regards to *Sukuk* and that they have been included in the strategic plan which should be achieved in the next few years.

¹³¹⁵ See 6.4 above.

¹³¹⁶ See 6.5 and 6.6 above.

¹³¹⁷ See 6.5 above.

¹³¹⁸ *Ibid.*

¹³¹⁹ *Ibid.*

However, regulators still do not seem to acknowledge the differences between conventional and Islamic finance, especially with regard to what can be labelled as Islamic, as these regulatory agencies have left this to the financial companies themselves, and it has required economics and researchers and this thesis to draw their attention to this important issue.

On the other hand, positive signs can be seen with this Vision which can contribute to the development of Islamic finance including *Sukuk*. For example, SAMA and CMA both became members of AAOIFI.¹³²⁰ In addition, the Vision brought about the issue of sovereign *Sukuk* which will have a tremendous impact on the *Sukuk* market in Saudi Arabia; the *Sukuk* are internationally and locally issued by the Debt Management Office in the Ministry of Finance,¹³²¹

7.2 Recommendations

After discussing the situation of Islamic finance in Saudi Arabia and the need for the regularity bodies in the country to adopt extra regulations for better Islamic finance, this section will give some recommendations for a better Islamic financial environment.

Based on what has been discussed earlier, a number of suggestions are considered to be important points for the regulators to adopt in order to develop this market. Considering such points would benefit the economy of the whole country and would place it ahead of other countries with regard to Islamic finance; and this is as it should be, because of the unique features that Saudi Arabia enjoys which it should take advantage of, such as hosting the two Holy Mosques, the fact that the vast majority of its population believe in Islam, the prohibition of *riba*, and also the fact that the country is governed by sharia law.¹³²²

It should be noted that it is only 40 years since the engagement of Islamic finance with modern financial activities. The whole Islamic market is still reconfiguring itself again. Islamic finance used to follow its true origins which were a mix of both a profitable and an ethical base, then for a long period of time it lost sight of this and was replaced by conventional finance. Then the Islamic finance started to come back, after losing its identity, on a pathway that did not directly collide with the conventional financial system

¹³²⁰ See 6.6

¹³²¹ See 6.6 above.

¹³²² See 3.2 and 3.2.2 above.

and the modern laws and regulations that govern this type of finance. This pathway led to a slight abdication of sharia scholars and Islamic economists in some cases on some Islamic principles under the umbrella of necessity in order not to deprive Muslim countries and communities from their economic development. This does not mean surrendering to reality but this should be a starting point and development is supposed to continue to evolve; by detecting the problems year after year it is attempting to return to the blueprint of Islamic finance. This means that the current financial products should not stay the same for very long; they should be re-examined and developed to be as close as possible to fulfilling what is true Islamic finance.

This also can be said for Saudi Arabia and its engagement with Islamic finance, as has been discussed earlier, that when Saudi Arabia first engaged with financial organisations, there was no strong position for Islamic finance. Thus, it adopted the available option at that time which was conventional financial system. However, as the country chose to be governed by sharia law, it stated that all laws should be in accordance with sharia law. The researcher can argue that when Saudi chose conventional financial system it was under necessity. However, Islamic finance has developed since that time and Saudi Arabia should be the first country to contribute to the development in Islamic finance. Islamic finance has proven its strength during the past decade and during the last financial crisis.¹³²³ It is now the time for Saudi Arabia to open up its Islamic finance and help such finance until it reaches a point when there will not be a need to regulate financial activities that contradict with sharia law. In order to reach this point, regulators in Saudi Arabia should make every effort to ensure that the Islamic finances that are practised in the country is done in the right way. This is why the thesis will now give some recommendations to regulators in order to develop this market. The suggestions will be categorised into three parts depending on who should be responsible to make it work.

One of them is the Central bank and the CMA should exchange experiences with other central banks and organisations already working in Islamic finance, such as the Central Bank of Bahrain, the Dubai International Financial Centre, the Bank Negara Malaysia, and the AAOIFI to learn from their experiences, whether positive or negative, and to build on their experiences to achieve a better performing Islamic

¹³²³ See 2.5 above.

finance. Furthermore, opening up with other central banks, especially in the GCC countries, is preferable as they have already entered into an Agreement on the Execution of Rulings in 1995 (the GCC Convention) for the recognition and enforcement of both court judgments and arbitral awards without re-examination of the merits.¹³²⁴

Another recommendation is that a legal development committee for Islamic finance should be established (LDCIF) by SAMA which should consist of specialised members in different fields such as law, finance, sharia and the economy, to help SAMA to develop its regulations that supervise Islamic financial institutions to have the best practice in order to develop Islamic finance. Instead of applying the same regulations that are designed for conventional finance, it is time to have regulations that help financial institutions and financial developers to create financial products that are genuinely sharia compliant.

Also, one of the recommendations is activating the role of the Islamic Banking Committee that already exists and is recognised by SAMA but does not have an active role.¹³²⁵ At the moment this committee, which consists of representatives from all banks that offer Islamic financial products whether full-fledged Islamic banks or conventional banks, are hardly known even by people who are interested in the field of Islamic finance. Even SAMA does not approve any result or recommendation of the committee. This committee should submit a report to the suggested committee, LDCIF, pointing out all the legal challenges or suggestions that could contribute in developing the Islamic finance market, to be studied by the LDCIF committee whose goal it is to develop the regulations and laws that govern Islamic financial institutions.

In addition, it is recommended there is established a Central Sharia Board to become the highest authority that specialises in *Fiqh al-Muamalat* (Islamic commercial jurisprudence) to oversee and advise on matters connected with finance and business in respect of sharia matters to regulators and government authorities. The criteria and regulations for creating the Central Sharia Board is left to the regulators. However, the

¹³²⁴ Khalid Alsaeed, 'Sukuk Issuance in Saudi Arabia: Recent Trends and Positive Expectations' (PhD, University of Durham 2012) 99. Also, Dubai International Financial Centre, 'Guide to Dispute Resolution in the Middle East' (Herbert Smith LLP 2010).

¹³²⁵ See **Error! Reference source not found.** also 4.7 and 4.12.

researcher will propose some guidelines for establishing this Central Sharia Board; the relevant standards are inspired by the AAOIFI Governance Standard.¹³²⁶

- The Central Sharia Board should be situated under the Council of Senior Scholars, which is the highest sharia authority in Saudi Arabia for *Fatwa*.¹³²⁷
- Establishing this Board should be made by a Royal decree to set up the Board stating its position and responsibilities.
- Members of this Board should be appointed by the Senior Scholars Council in Saudi Arabia, which would increase the independence as the Senior Scholars Council is not under the pressure of Islamic financial institutions or other authorities as the Council is linked directly to the King.¹³²⁸
- The government should be responsible for paying and fixing the remuneration of the Board's members. It should be treated as part of the Council of Senior Scholars to ensure the independence of individual members.
- Members of the Central Sharia Board should be jurists who are specialised in *Fiqh al-Muamalat* (Islamic commercial jurisprudence) and may include others such as experts in Islamic banking, finance, law and accounting, but who should also be experts in the field of Islamic financial institutions and with knowledge of *Fiqh al-Muamalat*.
- The Board should have the duty of directing, reviewing and supervising the activities of the Islamic financial institutions in order to ensure that they are in compliance with sharia principles and rules. The *Fatwas* and rulings of the board shall be binding on the Islamic financial institution.
- The Central Sharia Board should issue *Fatwas* and decisions in relation to its area of work and also approving *Sukuk* structures and documentation for sovereign and government *Sukuk*, as referred to it by the CMA. In addition, it should validate the product structures, services and tools offered by Islamic financial institutions. Furthermore, it has the task of reviewing and approving regulatory bodies' directives relating to Islamic finance to ensure sharia compliance and also, providing sharia consultation to the regulators,

¹³²⁶ AAOIFI Governance Standard No. 8 issued in 2017.

¹³²⁷ See 3.3.1.3 above.3.3.1.3

¹³²⁸ See 3.3.1.3 above.

government and relevant authorities with regard to various laws, rules and regulations.

- The Board should have an advisory role supporting the Central Bank SAMA and the Capital Market Authority (CMA) in defining broad principles for profit-and-loss calculation and distribution among investment accountholders/similar stakeholders and shareholders for Islamic financial institutions; and in addition, providing sharia advice to the regulators, when drafting regulations that applies to Islamic financial institution.
- Most of the functions of a Central Sharia Board relating to advisory and *Fatwas* are passive (reactive) in nature. It only affords *Fatwa* or advice or guidance when asked for it by the appointing authority or SAMA or CMA. However, the Board can be proactive in nature when it concludes that a major non-compliance of sharia principles and rules has occurred, and regulators have not been taken any action.
- The appointment authority should issue an appointment letter for every member, stating the engagement terms and terms of reference.
- The Board should be made up of a suitable number of members to provide a diversity of members and to enable them to discharge their functions and duties efficiently and effectively. It should include relevant experts to allow the board to have access to accurate and relevant advisory services whenever needed.
- The Board shall include sharia scholar members and expert members; this may include sharia scholars who work as members of sharia boards in Islamic financial institutions on a condition that it does not exceed one-third of the total number of the Central Sharia Boards' members.
- The minimum number of total members of the Central Sharia Board should be 7 members as the Board would be responsible for multiple industry segments.
- The majority of the members should be the sharia scholar members within or outside the Saudi Arabia. They should meet the fit and proper criteria applicable to sharia scholar members.
- In case of removing or terminating the engagement of a member of the Board, it can only be made by the appointing authority with the agreement of the

majority of the Board members when professional misconduct is proven against such member or if he is in breach of a principal term of reference; or the member has not attended the minimum criteria of attending meetings as set out in the terms of reference.

- Both SAMA and CMA should have operational links to the Central Sharia Board, which means that when a bank, for example, develops a financial product to be marketed as sharia-compliant, this product should be passed to the Central Bank for approval. The Central Bank should examine the product from a purely banking point of view and pass the product to the Central Sharia Board to be examined from the sharia side. When a product passes both examinations, the Central Bank can approve this contract for the bank. The same process should be done with the CMA when it receives a request to approve an issuance of financial products such as *Sukuk*.

The benefit of this Board is to ensure that all financial products that are marketed as sharia-compliant by financial institutions are really sharia-compliant which will increase the confidence of clients and shareholders who are interested in engaging with finance activities in a way that does not contradict with sharia.

After recommending establishing a Central Sharia Board, and suggesting its position, responsibilities and some of the main standards of its framework, another important issue that this thesis has argued and concluded is that there is a need for applying sharia governance to Islamic financial institutions. Regulators are recommended to apply such governance to the financial institutions and their sharia boards.

Applying an extra layer of corporate governance for Islamic financial institutions would prevent some financial institutions manipulating this issue which would rock the shareholders' and customers' confidence in all the Islamic financial institutions.¹³²⁹ Thus, regulators are advised not to always deal with Islamic financial institutions and conventional financial institutions as if they are the same but to consider the differences that those institutions have and the need to adopt the proper regulations for each one in order to have the best practices.

¹³²⁹ See 4.11.7 and 6.4 above.

A suggested sharia supervisory governance for Islamic financial institutions in Saudi Arabia which is inspired from the recent Instructions on Sharia Supervisory Governance for Kuwaiti Islamic Banks is stated now.¹³³⁰

- Financial institutions that provide financial products as sharia-compliant shall have a sharia board.
- All Islamic financial products that are offered by a financial institution must be approved by the sharia board.
- Decisions of the sharia board are binding and must be adhered to by the financial institution.
- Sharia board members shall be nominated by the General Assembly based on the recommendation of the Board of Directors.
- A member of the sharia board cannot be dismissed until the decision has been put to consultation with the sharia board and has been provided with the reasons for dismissal, and then the decision approved by the General Assembly.
- Sharia boards shall be linked directly to the General Assembly for nominations.
- No one from the Board of Directors, executive management or a shareholder with effective influence can be a member of the sharia board.
- A sharia board member cannot be a close family member or partner relationship with any of the Board of Directors or executive management.
- A member of the sharia board cannot be a permanent employee in the financial institution; and the member shall not accept any reward from the bank or affiliated company except the official reward for his job.
- The minimum number of members in a sharia board is three.
- The maximum number of sharia boards that a member can be on is 10 sharia boards inside Saudi Arabia.

¹³³⁰ Central Bank, 'Instructions on Sharia Supervisory Governance for Kuwaiti Islamic Banks' (Central Bank of Kuwait 2016).

- It is required that every member of the sharia board obtain at least a degree in sharia with a specialty in Islamic commercial jurisprudence, or be a well-known sharia scholar in Islamic commercial jurisprudence.
- The minimum number of meetings of the sharia board is four a year.
- The attendance of a member of the sharia board shall not be less than 75% of the board meetings.
- The sharia board is responsible for its decisions and *Fatwas*, while the Board of Directors is responsible for all aspects of the financial institution's governance.
- The sharia board is responsible for disclosing sufficient information on the extent of the financial institution's compliance with the provisions of sharia in the annual report of the financial institution.
- In the event that the executive management of the financial institution contravenes the decisions of the sharia board, the sharia board shall give the executive management a warning in writing of the occurrence of the violation and the manner of rectifying it. In case of non-response, the sharia board must prove the matter in the annual report that should be submitted to the General Assembly.
- Financial institutions that provide financial products as sharia-compliant shall have an internal sharia audit to check that all financial contracts and products made as sharia-compliant agree with the *Fatwa* approved by the sharia board.
- The sharia board should play the role of supervising issues related to sharia in the financial institution. This can be done through the sharia audit department which should submit its report periodically to the sharia board.
- The internal sharia audit is linked from the technical aspect of the sharia board while it is linked from an administrative aspect by the chairman of the Board of Directors in order to have its independence.
- As, some sharia boards do not have sufficient time to follow up with the internal audit, and to gain more independence to ensure an honest view of the implementation of sharia compliance, an external sharia audit should be used. An external sharia audit is an independent sharia audit agency that is

competent to supervise and check all transactions in the financial institution to ascertain the extent of its compliance with the resolutions of the sharia board.

- The external sharia audit must be licensed by SAMA or CMA to practise sharia audit in Saudi Arabia.
- The external sharia audit shall submit its reports to the general assembly.
- The external sharia audit shall be assigned by the general assembly.

After the suggestion of a sharia supervisory governance for Islamic financial institutions in Saudi Arabia, there is one more suggestion based on what has been discussed in the thesis which can contribute to the development of Islamic finance. For example, as the Governor of SAMA highlighted, the shortages in the number of researchers specialising in Islamic banking legislation are among the impediments to the growth and development of the Islamic finance industry.¹³³¹ There is a real need for human resources qualified to work in Islamic banking and finance institutions. Saudi Arabia has a very strong and well-developed network of universities and colleges that teach different aspects of Islamic studies and sharia.

Although great scholars have been graduating every year, few colleges are specialised in Islamic finance to study the current financial contracts that have been developing rapidly. Therefore, it seems important to encourage sharia students to study economics and gain a greater awareness of Islamic banking and finance legislation. In addition, more research centres focusing on Islamic banking are needed in order to reduce the need for duplicating conventional contracts, with some amendments to make them sharia complaint, and to be able to create unique financial products built on Islamic principles and yet effective in our modern life.

¹³³¹ Saudi Arabian Monetary Authority, 'Speech of H.E. The Governor of SAMA at the First Islamic Banking and Finance Research Conference' (2016) <<http://www.sama.gov.sa/en-US/News/Pages/News14032016.aspx>> accessed 12 December 2017. See 6.5 above.

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CERTIFICATE OF ETHICAL APPROVAL

Academic Unit: School of Law

Title of Project: Islamic Financing Contracts: Can Islamic Finance contracts be a solution to the economic crisis? Taking Islamic banks in Saudi Arabia as a case study.

Research Team Member(s): Waleed Abdulaziz Abalkhil

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This project has been approved for the period

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(Matt Lobley, Chair, SSIS College Ethics Committee)