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Forward

The "Wednesday Seminar" is annually published book, containing the working papers presented at the Islamic Economics Institute (IEI) weekly seminars. These seminars have been going on since 1985, though the book series started in 2007.

I am pleased to present to the readers the sixth book of the "Wednesday Seminars' that were held during the academic year 2010-2011, which is also electronically available on the IEI website http://ierc.kau.edu.sa/Pages-A-NHiwar.aspx.

In this year, 2011, the Islamic Economics Institute presents this book in a new format. Where a separate section is assigned for papers written in English. These papers are the outcome of the monthly seminar held by the "Chair for Ethics and Financial Norms". This Chair has been created in collaboration between IEI and University Paris 1 Pantheon Sorbonne.

I hope the respected reader of the "Wednesday Seminar" book finds it beneficial and useful.

Dean

Dr. Abdullah Qurban Turkistani

List of Participants in the Seminars

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Variety of Models for Welcoming Islamic Finance into National Law

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Abstract. The present paper highlights the variety of legal models for welcoming Islamic finance in different countries. This modeling breaks the symmetry between the conventional, the dual and the Islamic regimes put forward by the economic literature, and emphasizes some relationships and interactions which sometimes lead to backtracking. Thus, there is no valid universal model for all countries. The welcoming of Islamic finance tends to take place in stages in a concerted manner that best meets the specific characteristics of each country.

Keywords: Islamic finance, regulation, taxation, epistemological modeling, competitiveness.

I. Introduction

This paper proposes an epistemological modeling of welcoming Islamic finance in national law without claiming to be exhaustive. To understand the scope of this modeling, it is important to go beyond the boundaries of the strictly legal considerations and embrace the aspects of organizational and institutional dynamics in all their complexity.

The legal framework adopted at a particular time does not in itself constitute an equilibrium position or advantage gained once and for all. Its flow may vary in one direction upward or downward under conditions of possibility and impossibility.

The variety of these models illustrates the complexity of the relationship between financial practices referring to religious principles and national law and, therefore, the diversity of solutions that provides evidence that the trend in the legal framework for Islamic finance, although far from being the unification, is plurality.

I. Classical Typology

The literature review that looked, in part, on the subject indicates, gradually, the outline of a typology focusing, initially, on the creation of the early Islamic banks by exceptional laws(1) and the Islamic banking regime in some Muslim Countries (Ahmad, 1985:11), the conventional banking regime after the establishment of Islamic banks in Europe (Sundararajan, Errico, 2002:3) and, finally, the dual banking regime (El-Hawary *et al*., 2004:26-27). It should be noted that some jurists do not retain the Islamic banking regime and integrate it into the dual regime (Youala, 1989:197).

The study of Islamic finance in some European countries brings back, after 2004, a new systemic variant limited to the tax law (Belouafi, Belabes, 2011). This regulatory treatment aims to facilitate the development of Islamic financial products in an environment where all financial actors and instruments have a level playing field without discrimination or favor (Davies, 2002:10; Ainleyet *al*., 2007:11); while keeping them in the exclusive field of activities of credit institutions by considering the profit margins as if it were interest. In other words, Islamic finance will be treated at the input level as a conventional finance with the index referring to interest rates and, at the output level as an alternative finance respecting the social, environmental, ethical, or moral consumer beliefs (see Fig. 1).

Fig. 1.Treatment of Islamic finance in terms of regulation

(1) For example, Law No. 48 of 1977 establishing Faisal Islamic Bank of Egypt.

The message of the regulatory authorities is: the institution of an Islamic bank can be done just as easily as a conventional bank and does not require special consideration under the national law, if we move towards economic function or substance of contract rather than their form (Arnaud, 2010:173). It is therefore to decide on the quality of banking products to the criteria of national regulation, but the question of compliance with the *Shari'ah* is not within its mandate. The existence of *Shari'ah* board responsible for reviewing such compliance is, therefore, internal to the discretion of the institution.

In France, for example, the latest tax instructions published in this direction(2) can be interpreted as a subterfuge creating the right and not merely as fact sheet stools of Islamic finance. Thus, changes in the legal system seem to be made via the French General Directorate of Treasury and Economic Policy(3), the Ministry of Economy and Finance, to circumvent, in a certain sense, the reservations of the regulatory authority after an attempt at legislative reform has been censored by the Constitutional Council, on October 14, 2009, seized by the opposition on September 18, 2009(4).

III. Complex and dynamic systemic modeling

The researcher was surprised when he starts a modeling of this type because he found little work done in this area. The only attempt made by Georges Affaki who distinguishes between two models:

1) Bivalent model.
2) Multivalent model.

The first "*took as its premise that, to be hosted by French law, Islamic finance should take one or other of the contracts called in French law. Otherwise, it would be a world of lawlessness and should be rejected*" (Affaki, 2008:146). In the second, French law would receive "*tools and ideas from other legal systems by the effect of globalization*

(2) Official Tax Bulletin No.78 of August 24, 2010, Directorate General of Public Finance 4/FE/S1 /10, 4 FE/S2/10, 4 FE/S3/10, 4 FE/S4/10 (in French).
(3) DGTPE.
(4) Constitutional Council, Decision No. 2009-589 DC of October 14, 2009 (in French).

and trade law" (Affaki, 2008:170). This does not mean that the identity of legal traditions should disappear, but means that normative systems "*are not exclusive of one another, as bridges are built between each other and that ideas are exchanged, while preserving the values and distinguishing features of each system*" (Affaki, 2008:170-171).

Our paper proposes a broader modeling by shedding light on the relationships and interactions between the three legal entities of the traditional typology (see Fig. 2). For now, seven variants were selected as models: PROG model, JUMP model, REV model, Inverse-V model, N model, INTEG model and, finally, ASSIM model.

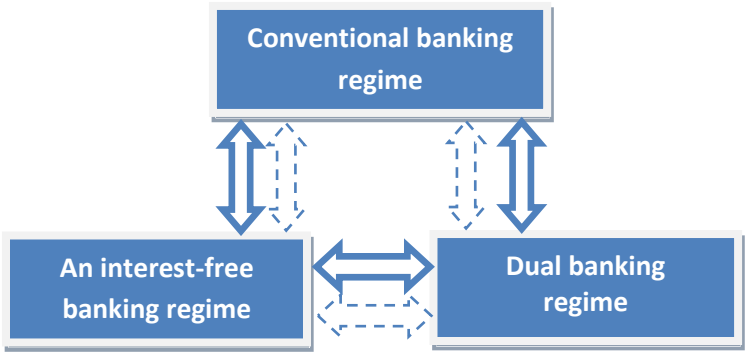


Fig. 2. Relationships and Interactions between the traditional legal entities

III.1. The PROG model (or Progressive model)

This is the case of Lebanon (Belabes, 2009) where the legal framework for Islamic banking has gone through three phases from the Conventional Regime (CR) to the Fiduciary Regime (FR) to the Dual Regime (DR):

CR ⇢ FR ⇢ DR

• 1992-1996: under the Code of Money and Credit No. 13513 of August 1, 1963 covering the currency, the role and function of the central bank and the activities related to the banking industry.

• 1996-2004: Law No. 520 of 6 June 1996 on the development of financial market and fiduciary contracts that offer the possibility of Islamic banking. As noted by Hassan Rifaat Tabet, a law professor at St. Joseph University in Beirut (2000:4), "*it fully meets the concerns of investors who refuse to be remunerated by the interest payment*".

• From 2004: Law 575 of 11 February 2004 on the establishment of Islamic banks in Lebanon. The importance of enacting a specific law for Islamic banks is the need to attract foreign financial flows from Islamic countries, especially the Arabian Gulf countries, and enhance the attractiveness of Beirut financial centre in the region.

This evolution demonstrates that the trust law was not sufficient to enhance the attractiveness of the Beirut financial center in the field of Islamic finance. To avoid a succession of reforms, containing and binding, which distort, ultimately, the Islamic financial instruments, the Lebanese legislature has opted for pragmatism of a specific regime for Islamic finance fed regularly by circulars. It is surprising that France, trying to introduce Islamic banking system via the fiduciary regime(5), did not heed the Lebanese experience which seems advanced in this area! The leadership alone is not enough, other factors seem to play a role in influencing.

III.2. The JUMP model (or by jumps)

This is the case of Syria which was inspired by the Lebanese experience by avoiding the intermediate Fiduciary Regime (FR):

In May 4, 2005 Syria establishes the law No. 35 for Establishing Islamic Banks. Islamic banking activities are subject to a special law because they do not appear in Act No.28 of 2002 on private banks. The latter remains a reference for the exercise of Islamic banking activities.

(5) In France, the fiduciary regime, equivalent to the Anglo-American trust, has been introduced in the Civil Code (articles 2011andfollowing) by the Act of February 19, 2007 following a bill by Senator Philippe Marini.

As stipulated in Article 2 of the Legislative Decree No. 35 of 2005: "*The establishment of Islamic banks in the Syrian Arab Republic shall be subject to the legal basics and rules and to the procedures specified in Law 28/2001 on establishment of private and mixed banks*".

It should be noted that the Law No. 28 of 2001 and Legislative Decree No. 35 of 2005 on the creation of traditional and Islamic banks were amended by the Law No. 3 of 2010 whose two main points are:

1) "*The percentage of ownership by non-Syrians may be raised up to 60%"* when it was previously fixed to 49%(6).

2) "*The authorized capital of an Islamic bank must be stated in the bank charter provided it is not less than 15 billion Syrian pounds*" when it was previously fixed to 10 billion Syrian pounds(7).

Through this pragmatic approach, Syria has started where its referent predecessor, Lebanon, left off. Thus, the leading country seems to show those who follow it the picture of their own future. However, several factors appear to influence the choice of the referent leading country: geography, culture, language, school of jurisprudence(8) and school of law (civil law, Common law). The weight assigned to each factor is determinative and several factors can sometimes converge to the same referent. For example, if Syria feels itself close to Lebanon, Australia will be more with England, Spain with France, and Japan with Singapore. Thus, after noting that the Japanese banks may face legal difficulties in the provision of Islamic financial products, since the existing Banking Act restricts the non-financial activities of a bank, Tadashi Maeda (2007) advocates to learn from experience of "*the Monetary Authority of Singapore, which explicitly approves a bank to buy goods on behalf of its customers under the Murabahah concept*". This does not preclude that a leader country can be inspired by a country less advanced than it, for

(6) Section 3 of Act No. 3 of 2010 amending paragraph c of section 9 of Act No. 28 of 2001.

(7) Section 4 of Act No. 3 of 2010 amending section 4 of Act No. 35 of 2005.

(8) There are four schools of jurisprudence (*Madhabs*) in Sunni Islam: Hanafi, Maliki, Shafi'i and Hanbali.

example, in the legislation that will allow the issuance of *Sukuk*. The geo-law, or the projection of the judicial power in space, however small, is therefore not unidirectional and conducted in both directions. This situation illustrates the limits of a classical analytical frame work "*hard law/soft law*". Some follower countries influence leading countries unintentionally and without knowing it.

III.3. The REV model (or Revolutionary model)

This is the case of Pakistan, where the legal framework for interest-free banking was introduced with the enactment of the Banking and Financial Services through the Ordinance of 1984, although the process itself was initiated in 1979-80, reaching its peak in 1984-85.

Then from Iran through the Law for Usury Free Banking promulgated August 30, 1983 and became effective from March 21, 1984.

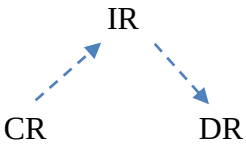
And, finally, the Sudan through the law of October 1984 and the decree of the Central Bank of BC/RAM/11 December 10, 1984, which announced the intention of the authorities to ban interest from all banks in the country.

Does this mean that the practices of the different variants of the REV model are faithful to its injunctional referent (*ahkam*) and purposes (*maqasid*)? The answer to this question does not belong to the lawyer or economist. It is for historians of Islamic finance, with a multidisciplinary background, to explore the evolution of each model by studying its terms of reference and reviewing its practices through a representative sample and a sufficiently long one so that its reliability is properly appreciated.

We should give credit the initiative of the Bank of Sudan which has initiated in recent years an extensive documentation of its long march towards the world of Islamic finance. This initiative will undoubtedly facilitate the work of researchers who will focus rigorously on the history of welcoming Islamic finance in national law.

III.4. The Inverse-V model

This is the case of Pakistan which has moved from the conventional regime (CR) to the Islamic regime (IR) and, finally, to the dual regime (DR) after the death of President Zia ul-Haq, August 17, 1988, while it continues to be ranked among the countries that have fully 'Islamized' their financial system.



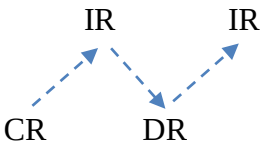
The Inverse-V model highlights that a juridical model, in this instance the REV model, is not necessarily an advantage acquired permanently. Legal organizations can change, for various reasons, from one configuration to another.

It suggests, moreover, that fluctuations in systemic legal entities tend to move toward a dual system; the main factor of success is, perhaps, not to compete with itself. The balance, however, remains a delicate exercise.

It would be useful to consider, in this context, how organizations are structured by examining closely the influence of context variables on the characteristics of organizations.

III.5. The N model

It reflects the evolution of banking legislation of the Sudan until to day:



While in Sudan, a dual banking regime was agreed in 2006, Northern Sudan has Islamic banks while the Southern Sudan has conventional banks. The law that currently regulates banking activity is that of the Central Bank of Sudan issued in 2002 and amended December 17, 2006 after the signing of peace accords between the North and South. Paragraph 1 of Article 2 states that "*the Sudanese banking system*

consists of a dual system: one Islamic northern Sudan and the other conventional Southern Sudan" (Central Bank of Sudan, 2006:2). After the north-south separation, following the referendum of January 2011, the north returned de facto to an Islamic banking regime.

The N model illustrates the importance of geopolitical and political factors in the legal frame work for Islamic banking. This framework is therefore not a purely technical operation that responds to an imperative of financial competitiveness from one side to the other. In other words, the weighting coefficient of the variable economics is lower than that of politics. Some authors consider that the banking policy in Sudan is a hindering to the national unity (El-Hassab, 2011).

III.6. INTEG model (or Integrator model)

This model presents two forms: INTEG 1 model (Integrator model type 1) and INTEG 2 model (Integrator model type 2):

III.6.1. INTEG 1 model

This model applies in Kuwait which joined under Law No. 30 of 2003, Chapter 3 of the Banking Act No. 32 of 1968, a tenth section entitled "Islamic banks". It should be noted that the discussions to develop this law lasted from1996 to 2003.

The Act No. 30 of 2003 has also amended sections of Chapter 4 in sections 101, 102, 103, 104, 105 and 106. This text allows conventional banks to offer Islamic financial products through an independent institution but does not allow them to open Islamic windows.

The Governor of the Central Bank of Kuwait, Sabah al Salem, said that the imposition of a specific chapter to the Islamic banking does not mean the creation of an unlimited number of banks. The balance between the degree of absorption of the national market and the required number will be the basis for the granting of licenses. Thus, from his point of view, although competition is a means to improve economic efficiency, in some areas, particularly the banking sector, the presence of an unlimited number of firm scan induce negative effects on the nature of

this competition(9). This epistemological position seems, at first sight, pragmatic, and appears to be related to socio-economic and political constraints.

III.6.1. INTEG 2 model

This model applies to Jordan, the Palestinian Authority and Qatar that have enacted a new banking law including a section on Islamic banks (Figure 8).

The Jordan Banking Law No. 28 of 2000 includes a section entitled "*Islamic Banks*" of Article 50; and Article 59 refers to the Islamic banking respectively in Article 2, paragraph a, Article 3 paragraph b, Article 90 paragraph b, Article 101 paragraph b.

In the banking law of the Palestinian Authority No. 2 of 2002, Chapter 12 is entitled "*Islamic Banking*", section 70 to section 75. It is, moreover, a reference to Islamic banking respectively in Chapter 1 Article 1, Chapter 3 Section 15, Chapter 4 Article 23 and Chapter 10 Article 65.

In the Decree Law No. 33 of 2003 on the Central Bank of Qatar, Chapter 1 includes a section on "Islamic Banking".

The models INTEG 1 and INTEG 2 reveal that for the same model, there are several paths and adaptation strategies based on established dynamics of the legal system of each country.

In both cases, the legal container remains the conventional regime. In other words, the Islamic banking activity is considered as a complement and not as a substitute to conventional finance. In the spirit of the regulator, the complete 'Islamization' of the banking sector is not feasible and desirable.

(9) Asharq Al-Awsat, June 6, 2003 (in Arabic).

III.7. The ASSIMIL model (or Assimilationist model)

This model is particularly applicable to some countries where the regulators suggest that the prohibition of the interest stems from a conservative interpretation of Islamic law, or at least equates Riba to usury, that is to say, the misuse of Interest (Jouahri, 2008:2). Islamic finance appears, in their point of view, less hostile to the principle of interest as usury. We can find an almost similar reading in a French special report on Islamic finance (Jouini and Pastré, 2008:21). This shows that the leading country can learn from less developed countries or justify its choice through their cases.

In Algeria, for example, the Secretary-General of the Association of Banks and Financial Institutions announced that Commission on Money and Credit of the Central bank seeks to unify the Standard bank interest rates that cannot be equated with Riba, which is to say, from his point of view, the excessive interest (Boukrouh, 2010). In a recent international seminar on "Reality and prospects of Islamic windows in Algeria", he confirms this trend: "*Our country wants to move to wards «midway» solutions, i.e, between conventional finance and Islamic finance*" (Boukrouh, 2011). It is surprising that the association of bankers interferes in matters of Islamic law to determine what Shariah-compliant is and what is not.

Briefly, the interest rates were gradually liberalized in Algeria. First, in 1995, with instruction 07-95, Article 2 paragraphs 2 and 3, on the conditions applicable to banking transactions eliminating the usury rate but allows the definition by the Central Bank a bank margin Max. Then in 2001 with the abolition of the latter, that allows credit institutions the freedom to define their terms in accordance with their commercial policy. The Regulation No. 09-03, May 26, 2009 stipulates in Article 5: "*The rate of interest paid and received as well as rates and levels of fees applicable to banking operations are freely set by banks and financial institutions. The Bank of Algeria, however, may fix the excessive interest rate. The overall effective interest rates on lending by banks and financial institutions should in no case exceed the excessive interest rate*".

Moreover, the regulatory authorities refuse to allow banks offering exclusively *Shari'ah-compliant* products the adjective '*Islamic*'. For them, it would recognize that other banks are '*not Islamic'*. Hence the denomination: '*alternative financial products*'. It should not be forgotten that the primary motivation of the authorities to authorize, in 1991(10), this form of finance was to make visible savings that had aversion to interest rate and prevent it falling into the financing of suspicious activities. In this particular context, Islamic finance was seen as a necessary evil, even, for some, as a threat not an opportunity. This misrepresentation still persists.

IV. Conclusion

At the end, it should be noted that the welcoming of Islamic finance into national law is not a merely technical question or an injunctional procedure where it would just follow some moral or ethical standards issued by a social, environmental or religious beliefs.

The idea that the welcoming of Islamic finance would obey a universal model applicable to all is, paradoxically, the result of confinement, one side in a technicism reducing its interpretation of reality to a purely technical and postulating the linearity of solutions; and the other in reducing dogmatism, in turn, the question to a purely injunctional, ignoring purposes and, consequently, conditions of possibility and impossibility.

Highlighting the variety of models breaks the symmetry between conventional systems, dual and Islamic highlighted by the economic literature and involves complex and dynamic interactions. It draws some interesting lessons that invite deep reflection:

- Each model has its own characteristics.
- The same experience can be used in different models depending on the temporal duration.

(10) Al-Baraka Bank is the first Islamic bank created in Algeria with a mixed capital in May 20, 1991.

- For the same model, the lessons to be learned vary because the process by which the framework of Islamic finance is implemented involves different actors in each country.

These relationships and interactions between legal entities appear systemic, filigree, opportunities and choices. There is no universal model applicable to the Muslim world as a whole, just as there is no magic formula valid for all European or other countries. The welcoming for Islamic finance tends to take place in phases in a concerted manner best suited to the cultural, social and political contexts of each country's level of development of its financial market and its role in financing the real economy. Hence the needs for a typology of the legal framework of Islamic finance which shows the influencing factors and their respective weights.

The legal treatment of Islamic finance is likely, however, to evolve significantly in the global context of legal competitiveness where each country seeks not only to improve the clarity, the comprehensibility and the predictability of it slaw, but to take advantage in terms of adaptation to new and improved alter native markets. Will the European countries address the long-term legal competitiveness in Islamic finance with reference to the traditional postures (Civil Law/Common Law or Romano-Germanic law/Common law), a legal hybrid configuration, or will they position themselves reflexively following the leading country according to the adage '*wait and see*'?

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تعدد نماذج استيعاب التمويل الإسلامي في القانون الوطني

د. عبدالرزاق سعيد بلعباس

باحث – معهد الاقتصاد الإسلامي

جامعة الملك عبدالعزيز – جدة – المملكة العربية السعودية

المستخلص. تسلط هذه الورقة الضوء على تنوع النماذج القانونية لاستيعاب التمويل الإسلامي في دول مختلفة. وتتجاوز النمذجة المقترحة التقسيم التقليدي المتداول في الأدبيات الاقتصادية الذي يفصل بين النظام المصرفي التقليدي والمزدوج والإسلامي وتؤكد على العلاقات والتفاعلات التي تؤدي في بعض الأحيان إلى تراجعات في تأطير النشاط المصرفي الإسلامي؛ وبالتالي، لا يوجد نموذج محدد صالح لجميع البلدان. وفي النهاية يتضح أن استيعاب التمويل الإسلامي في القانون الوطني يمر بمراحل ويتم بطريقة منسقة تتلائم مع خصائص كل بلد.

الكلمات الدالة: التمويل الإسلامي، التنظيم، الضرائب، النمذجة المعرفية، التنافسية.

Hamidullah's Pioneering Contributions to Islamic Economics

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Abstract. Dr. Muhammad Hamidullah (1908-2002), a citizen of the world, was born at Hyderabad (Deccan), lived in Paris and died in Jacksonville (USA). He is widely known across the Islamic world, in the Indian subcontinent and in Europe and North America for his seminal and outstanding contributions to the advancement of Islamic studies and to the dissemination of Islamic teachings. He rediscovered and edited a number of rare manuscripts. He made pioneering contributions to various disciplines of Islamic learning. His inputs to Islamic economics is also remarkable. However, almost all his biographers overlooked this aspect of his contribution. To this forum we present some of his important Islamic economic ideas.

Innovation of the term "Islamic Economics"

It may be recorded that Hamidullah used the term "Islamic Economics" in his paper - *Islam's Solution to the Basic Economic Problems* (p. 217) - as early as in 1936. This is the first use of this term to the extent of finding until this date. It will not be surprising if someday it is discovered that the term occurred much earlier in some of the works authored in the first quarter of the 20th century. In one of his papers Monzer Kahf attributed the first use of the term "Islamic Economics" in 1947 to Manazir Ahsan Gilani (Kahf, M. "Relevance, Definition and Methodology of Islamic Economics" p.16. http://monzer.kahf.com/papers/english/methodology_malaysia.pdf Visited on 15.6.2011).]]

Hamidullah's First Work on Islamic Economics

Perhaps the first paper written by Hamidullah on Islamic economics is "Islam's Solution to the Basic Economic Problems – the Position of Labour", which was published in *Islamic Culture*, Hyderabad (Deccan), in 1936. He starts the paper with a criticism on '*laissez faire'*. He discusses inadequacy of the concept like any skilled professional economist. He shows how Islamic economics is different from *laissez faire* economics (p. 214).

Not only capitalistic *laissez faire*, he also criticizes in this paper the communists, the so-called champions of labourers, for advocating payment of equal amount to all irrespective of quality and quantity of labour because this will kill the incentive to work and loss of efficiency (p. 218).

As against communistic and socialistic slogans, to Hamidullah, "the Islamic formula of distribution seems to be: to the poor according to their needs, to the rich according to their services" (Islam's Solution to the Basic Economic Problems, p. 231). He emphasizes:

> "Economic History has plainly demonstrated that both *laissez-faire* and Socialism are untenable extremes. For efficient and equitable Economics the elimination of their defects and a proper balance of the two, such as Islam offers, seems well worth considering" (p. 233).

Hamidullah on economic crisis

In the opinion of Hamidullah, the most important feature of Islamic economics is that its operation eliminates economic fluctuations altogether (Islam's Solution to the Basic Economic Problems, p.220). These days we are passing through worst kind of financial crisis. One of the most important factors behind this crisis is excess lending. Dr. Hamidullah warned about it some seventy-five years ago. He says:

> "People begin to produce more with borrowed money and to start new concerns, again with borrowed money. For a *time* there are profits. A wave of optimism spreads. Lending institutions become overconfident and lend more and more to the speculators and to

> the less competent enterprisers coming into business. Very soon the credit bubble expands to its full capacity. More money gets involved in production and comparatively little is left with the consumers, so there is a shortage of purchasing-power and pressure on the 'prices to go down" (p.220).

He further shows how borrowing on interest creates conflict of interests and results into financial crisis (p.221). He says:

> "The disease is only of the essence of the institution of lending on interest. Islamic capitalistic economy eliminates lending on interest but retains capitalism and thus gets rid of all crises" (p. 222).

Prohibition of riba needs arrangement for interest-free lending

According to Hamidullah, all religions have prohibited *riba* (usury and interest). However, "It is evident that mere prohibition of interest does not suffice to eradicate it, if provisions are not made to organize institutions for interest-free lending on a nation-wide scale" [Haidarabad's Contribution… p.74]. He observes:

> "The distinctive trait of Islam is that not only has it forbidden this kind of gain, but it has also remedied the causes leading to the existence of this evil institution in human society" [Eco. System of Islam, pp. 130-31] "Public Treasury organized interest-free loans, in addition to and for supplementing the loans offered by charitable men or organizations, to help those who are in need of them. The principle is mutual aid and cooperation". [Eco. System of Islam, p. 131]

He says that Lord Keynes pleaded for 0% interest, but even the economists of his homeland did not take it seriously (pp. 16-17). In his opinion, there are three ways to fight interest: Nationalization of lending, using endowments (*awqaf*) for lending purpose, and establishment of cooperative and mutuality societies for this purpose. To him the last one is more easy and effective in implementation. It can meet the needs of individuals as well as governments (*"Bunuk al-Qard bidun Riba*" p. 21)

Risk-sharing, not the risk-shifting

Today it is much emphasized that the financial crisis may be avoided if instead of shifting risks to others, risk sharing is adopted in financing the projects. It is noteworthy that Hamidullah stressed risk sharing long ago while discussing the reason for prohibition of interest. He argues:

> "The basis of the prohibition of interest is also the unilateral risk. In games of chance and lotteries, there is a great temptation for quick and easy gain, it is possible that circumstances should not have been propitious enough for earning sufficiently to be able to pay the promised interest, the lender not participating in the risks of the exploitation." [Eco. System of Islam, p. 131].

While discussing Islamic banking he says:

> "If the bank participates in the profit of its debtors as well as in their risks, Islam allows such banking activities, otherwise not." [Economic System of Islam, p. 132].

Describing the negative impact of fixed charge on money borrowed for production purpose, he observes:

> "If you have spare money you can become a partner or purchase a share and partake of both positive and negative profits. You are not allowed to give a blow to the entrepreneur in his worst moment and destroy his resisting power and not only ruin him but create social havoc. There is the huge injustice in the institution of interest and the strong tendency to get out of control" (Islam's Solution to the Basic Economic Problems, p. 223). In his opinion there is no argument for interest (ibid.).

Banks should replace interest with unconditional-gifts to attract deposits

Hamidullah feels there is no Shariah prohibition if unconditionally and without predetermined amount, the bank pays certain extra amount to its depositors. He observes:

> "Confidence is born of confidence. If the savings banks of a government declare at the end of the year (and not at its beginning) that they are in a position to pay such and such percentage of profit to the clients, not only would this be lawful

> according to Islam, but the public also would have no hesitation in depositing its savings with governmental banks, in spite of the silence in the beginning with regard to the quantity of the expected profit. For one has confidence in the public administration." [Economic System of Islam, p. 132].

Perhaps he keeps in his mind the report that without prior fixing, the Prophet returned extra amount and said "The best of you is one who is better in repayment". However, the Islamic economists do not agree because once it becomes a custom, it is just like a fixed and conditional. Their view is based on the principle "Something commonly known is just like a condition"

Postponement of Diminishing returns in agriculture

Hamidullah wrote in this paper briefly on agriculture. However, he proposed to write a separate paper on this aspect of the economy (Islam's Solution to the Basic Economic Problems, p. 224). It could not be traced whether he did it. Agriculture which is known for the law of diminishing returns, he predicted:

> "employment of powerful machines and adequate chemical manures may overcome Nature's resistance, and indefinitely postpone the operation of the law of diminishing returns" (p. 225).

First written record of Islamic banking

In 1962, during his stay in Istanbul, Hamidullah published a paper entitled *"Bunuk al-Qard bidun Riba*" (Interest-free Lending Banks), in *al-Muslimun*, (Damascus: vol. 8, no. 3, Dec. 1962, pp. 16-21.) in which Hamidullah gave an account of the modus operandi of the first established interest-free lending society in Hyderabad, Deccan. It is known from his another article that it was established as early as 1891 (Haidarabad's Contribution … p. 74). It was established by a sufi called Sayyid Umar Qadiri. Following is an account of this foundation:

> "His friends and disciples used to deposit with him, for his honesty, their surplus money for safe custody. He obtained their permission to utilize these amounts for lending to those in pressing need, for determined periods, on production of dependable securities (like

> ornaments etc.) He also added to the "capital" the amount he used to receive from his disciples to disburse at his discretion on charitable purposes: particularly the hides of sheep sacrificed during the *`id al-adha* feast every year. The society still continues and thrives." (Haidarabad's Contribution … p. 75).

At the time when he wrote the paper, the society was working and flourishing under the founder's son Muhammad Badshah Qadiri (*"Bunuk al-Qard bidun Riba*" p. 19).

Hamidullah has given account of another organized interest-free society established in 1902 under the name *Mu`in al-Muslimin* society. This society existed until 1914, and transacted in hundreds of thousands of rupees. (Haidarabad's Contribution … p. 75). After the First World War, the Hyderabad state paid attention and following the same model organized a similar society for the government employees.[ibid]

International Monetary Fund for Muslim Governments

On the same pattern, he proposes establishment of an international monetary fund for Muslim governments so that they could be saved from begging "aids" from other countries and falling their prey of interference and meddling in their affairs (*"Bunuk al-Qard bidun Riba*" p. 21).

In one of his earliest papers in Urdu entitled "*Anjumanha-e-Qarzah-e-besoodi*" (Interest-free Loan Societies), which was published in *Ma`arif* (Azamgarh: vol.53, no. 3, March 1944, pp. 211-16.) Hamidullah gives an account of interest free lending societies in Hyderabad. He states that, some people have surplus money, while some others are in deficit. It is humanistic to help one's needy brother. But very few people would be ready to do this 'painful good deed' without charging anything in return. That is the reason that all religions and past civilizations prohibited charging interest (p. 212). Islam not only prohibited interest, but also provided means to abolish it altogether and ordered that a part of government revenue should be allocated to help the indebted. As a proof, he presents the verse which stated the heads of expenditure of zakah: "Surely (the government revenue) zakah (etc.) are meant for the poor, the needy, the collecting officers, reconciliation of hearts, freedom from captivity, and indebted ……" Hamidullah argues that since the poor and

needy have been mentioned in the beginning of the verse, the 'indebted' does not refer to starving poor. Rather it means 'the well-to-do' who is temporarily in need of finance (ibid. p. 213).

According to Hamidullah, "Islam is the first system to lay down the provision of interest-free loans for the needy, even the well-to-do"(p.19). This is so because "Mere prohibition of interest, without providing how to meet the requirements of the needy, has proved useless in all civilizations. Islam was the first to lay down that it is among the first duties of the State to provide interest-free loans for the needy, even for well-to-do; and the Qur'an has earmarked this item among the expenditures of the Muslim State. In the time of the Caliph Umar, the State treasury lent moneys even to the person of the Caliph himself - of course to others also - on providing security of repayment." (*"Bunuk al-Qard bidun Riba*" p. 20)

In *Islamic Quarterly* vol. 2: 142-45, 1955, Hamidullah reviewed DR. J. HAN's work *Homo Economicus Islamicus,* publishers Joh. Sen, Klagenfurt, Wien (Austria), 1952. In his review he says:

> "There is a very important lesson for Muslim countries to learn from the war-torn Western countries, like Germany, France, England, &c., as to how they have adopted intricate and ingenious methods to finance and to cope with their empty hand."
>
> "The interest-free lending was also not wanting, though in more modest proportions. It began in the last century in Hyderabad, and later developed into co-operative lending societies, with affairs running yearly in some cases into six figures. Its members were not exclusively Muslims. One such, the Interest-free Co-operative Lending Society of the Department of Survey and Settlement in Hyderabad, has been revived now after the occupation, by the non-Muslim director of this department!

Mutual and cooperative financing

Hamidullah stressed on micro-financing based on mutuality and cooperation:

> "Islam has ordered that one of the charges on State income is the obligation of helping those who are heavily charged. Hence, the Public Treasury organized interest-free loans, in addition to and for supplementing the loans offered by charitable men or organizations, to help those who are in need of them. The principle is mutual aid and cooperation." [Economic System of Islam, p. 131].

It may be noted that at present some scholars, unsatisfied with the existing state of art of Islamic banking, propose establishment of Islamic banking, especially the microfinance, on the basis of mutuality.

Islam and Communism

An important monograph of Hamidullah is entitled *Islam and Communism: A Study in Comparative Thought*. In this he examines various aspects of communism and Islamic stand towards them.

In the beginning of the paper he makes clear:

> "Although Islam and Communism are not the same thing, it is possible that they do not differ in each and every thing. The object of this short study is to find out how far Islam may tolerate the teachings of Communism." (*Islam and Communism***,** p.3)
>
> "Economic betterment is the common goal, the ways leading thereto may differ. The pros and cons are to be weighed against each other before making the choice." (*Islam and Communism,* P.1)
>
> "The past history of man shows that every advance and every discovery of the means of comfort came into existence through competition and desire for amelioration and also through the existence of grades of wealth or poverty among men one above the other" (Ibid. P. 2).

Various forms of communism

According to Hamidullah there are various forms of communism. "The question, how far Islam accommodates Communism, however, cannot be so easily disposed of. There is Marxism, there is Leninism, there is Stalinism, there is Titoism, there is Maoism of Mao Tse Tung in our times, not to speak of Mazdakism and Abu Dharrism, etc., of the days of yore" (*Islam and Communism*, p.4)

He examines in this paper the Communist State and its attitude towards Religion. " According to Section 124 of the Constitution of the U. S. S. R., "freedom of religious worship and freedom of antireligious propaganda is recognized for all citizens." He further remarks:

> "I do not know the official interpretation, yet it means to me that preaching and propagation is allowed to the anti-religious only. Mere freedom of religious worship without means of religious instructions and apologetical or polemical propaganda for the followers of religious, particularly Islam, does not imply much" (pp.4-5).

After quoting statements from Marx and Lenin, Hamidullah concludes:

> "a true Communist cannot believe in God or His Messengers and His commands, and the Hereafter" (ibid. p. 5). To a communist, man is but "a tool-making animal", a definition extolled by Karl Marx himself in his *The Capital*" (p. 6). He emphatically says: Islam cannot and does not accommodate such a state of things. The profession of Islam begins and ends with the belief in One God and His Messengers, in the finality of this world and the Resurrection of the dead for Divine Judgment" (ibid. P. 6).

Dealing with the political aspect of communism, Hamidullah gives his own political thought. He examines the idea of a single "World State", world political system, world capital, separation of church and state, etc. pp. 6-9. Finally, he concludes that the "Political doctrine of Communism offers no difficu1ty for Islam" (P.9). However, he makes clear that. Statecraft or politics, even when separated from religious office, do not become independent of, but continue to remain subject to the provisions of the Qur’an and the Sunna. It is only a separation of

officers, not separation of authority, which is derived only from God." (ibid). The main difference between Islam and communism is that Islam emphsises more on the moral aspect than on the economic one. pp.10-13

According to Hamidullah, Materialism has been responsible for the degeneration of Capitalism. Similarly, "Communism, that is collective ownership of the means of production, may as such not lead to anything unbearable what I fear for it is its alliance, or rather conspiracy, with materialism" (P. 17). He makes clear that "In normal times, Islamic polity makes least interference in the economic freedom of individuals. Free trade is its motto, though cut-throat and unfair competition is not allowed. …… In abnormal times, in periods of need and emergency, the interference proportionately increases" (p.18).

In the discussion of the etymology of the Western and Islamo-Arabic equivalents *(socialism* and *ishtirakiyah),* it is noteworthy that in 'socialism' the emphasis is merely on the question of belonging to a society, which may be hierarchic; whereas the Arabic word is more expressive, meaning sharing, participating with others. He further says:

> "Capitalism, in its good sense, is allowed in Islam with the condition that the minimum taxes suffice for the dual purpose of the State, namely feeding all the destitute and defending the integrity and independence of the realm. Yet in time of need, Islam goes even beyond Communism, and orders that leaving the just necessary for preserving one's life *(sadd ramq),* all one's property may be confiscated as tax for the purpose of the dual State duty mentioned above. Islam has all along had a moral basis also" (ibid. p. 19).

Social insurance of the community

At the end of this paper he points out that "From the time of the Prophet, we come across a sort of social insurance of the community, insurance against tort entailing payment of damages beyond individual capacities. This insurance was called *Ma'aqil*" (p. 20). However, he does not explain it. This he has explained in his paper "The Economic System of Islam" (p.128). He notes that in the time of the Prophet, 'insurance against captivity and against assassination' had received attention" Thus, in the Constitution of the City-State of Medina of the first year of the

Hijrah, this insurance is called *ma`aqil* and it worked in the following manner:

> If someone was made a prisoner of war by an enemy, payment of ransom was needed to procure his liberation. Similarly, all bodily torts or culpable homicides required payment of damages or blood money. This often exceeded the means of the individual concerned, prisoner or criminal. The Prophet organized an insurance on the basis of mutuality. The members of a tribe could count on the central treasury of their tribe, to which everybody contributed according to his means. And if the treasury of the tribe proved inadequate, other related or neighbouring tribes were under obligation to render aid. A hierarchy was established for organizing the units into a complete whole. At Medina, the tribes of the Ansarites were well known. The Prophet ordered the Meccan refugees there, who belonged originally to the various tribes of Mecca, or were Abyssinians, or Arabs belonging to different regions, to all constitute a new "tribe" of their own, for purposes of the said social insurance." "In the time of the caliph 'Umar, the branches of insurance were organized on the basis of the profession, civil or military administration, to which one belonged (or even of regions). Whenever needed, the central or provincial government came to the succor of the branches"

The idea of insurance based on 'mutuality'.

He presented the idea of insurance based on 'mutuality'. He observes:

> "Insurance signifies essentially the repartition of the burden of an individual on as many as possible, in order to lighten the burden of each. Instead of the capitalistic companies of insurance, Islam preferred organising insurance on the basis of mutuality and cooperation, aided by a pyramidal gradation of the branches culminating in the central government" (ibid, p. 129).

He further writes:

> "Such a branch could engage in commerce with the help of unutilized funds remaining at its disposal, so that the capital is augmented. A time might come, when the members of a branch could be fully exempted from paying further contributions, or might even receive amounts of the profits of commerce. It goes

> without saying that these elements of mutual aid could insure against all kinds of risks, such as accident of traffic, fire, loss in transit, and so on. Also, it goes without saying that the insurance business is capable of being "nationalized" for all or certain kinds of risks (i.e. temporary motives such as the dispatch of parcels, etc.) "(Economic System of Islam, p. 129).

On the same pattern he saw the possibility of establishing banking on mutuality, in which "members paid a small percentage monthly towards expenses of the establishment, like stationery (the staff consisting of honorary workers). The surplus of this was preserved as reserve fund, to cover unforeseen losses. This reserve fund was later put to enhanced utility: a store as organized on commercial basis, where members of the society purchased on credit their requirements in non-perishable goods. The benefit was used to remunerate the workers and also to strengthen the reserve fund further." (Haidarabad's Contribution … p. 75).

Evils of conventional insurance

Dr Hamidullah is against the conventional insurance. To him it "falls under the same prohibition as interest. One sided risk and gain without proportionate responsibility in such a commercial contract are reasons thereof." (Haidarabad's Contribution . p. 76). In his note "Islamic Insurance", *Islamic Review*, London, vol. 39, nos.3-4, March-April 1951, 45-46, Dr. Hamidullah has elaborated how Islamic insurance system can be established on the basis of 'mutual co-operation'.

At another occasion he likens it with the game of chance. He observes: "Without entering into technical details, it may be pointed out that capitalistic insurance, in which the insured person does not participate in the benefits of the company in proportion to his contributions, is not tolerated in Islam as this would constitute a form of game of chance." [Eco. System of Islam, p. 129].

He is in favour of "an insurance company, not on capitalistic but mutuality basis." (Haidarabad's Contribution . p. 76). He presented an example of mutuality based insurance which was practiced by the army in Haidarabad. When number of motor vehicles increased in Haidarabad and more accidents occurred, the *Majlis `Ulama* suggested to mutualize insurance, instead of leaving it to usurious capitalists (ibid.).

International Monetary Fund for Muslim Governments

In his note "A Suggestion for an Interest- free Islamic Fund", *Islamic Review*, London, vol. 43, no.6. june.1955, p.11, Dr. Hamidullah suggests establishment of Islamic Monetary Fund on the pattern of IMF but interest free. He says:

"Today not only private citizens but even governments are in constant need of borrowing money, in millions and billions, to finance programmes of construction and other developments. There is an international monetary fund in America; yet as could be expected, it is not interest-free. An Islamic monetary fund could and should be established, yet not in any spectacular way and not even despising the modesty of its start".

He gave the idea of IDB long ago in 1955 in his note "A Suggestion for an Interest- free Islamic Fund", *Islamic Review*, London, vol. 43, no.6. June. 1955, p. 12. He insisted that in such an institution Muslim Governments of Soviet Union should also be included: "There is no reason why even Turkestan, Azerbaijan, Kazan, etc., should not join this fund (ibid).

The economic policy of Islam with respect to distribution

In Chapter ten of his work *Introduction to Islam* Dr. Hamidullah discusses economic policy of Islam with respect to distribution. He says:

"The economic policy of Islam has also been explained in the Qur'an in the most unequivocal terms: ". . . *so that this (wealth) may not circulate solely among the rich from among you. . . .*" (Q. 59 : 7)

> "Equality of all men in wealth and comfort - even if it is ideal - does not promise to be of unmixed good to humanity. First because natural talents are not equal among different men, so much so that even if one were to start a group of persons with complete equality, the spendthrift will soon fall into difficulties and will again look on the fortune of his comrades with greed and envy. Further, on philosophic and psychological grounds, it seems that in the very interest of human society, it is desirable that there should be grades in wealth, the poorer having the desire and incentive to work

> harder. On the other hand, if everybody is told that even if he works more than what is required of him as his duty, he would get no reward and would remain as those who do not do more than their duty, then one would become lazy and neglectful, and one's talent would be wasted to the great misfortune of humanity" "The Economic System of Islam" p. 121.

Suggestion to use the right of testament to implement Islamic law of inheritance

According to Hamidullah, "Islam has taken two steps: firstly the obligatory distribution of the goods of a deceased person among his close relatives, and secondly a restriction on the freedom of bequest through wills and testaments. The legal heirs do not require any testamentary disposition, and inherit the property of the deceased in the proportions determined by law. A testament is required solely in favour of those who have no right to inherit from a deceased person." …. However, " In countries where the Islamic law of inheritance is not applied by governments, yet the right of testament is recognized, the Muslim inhabitants can (and must) utilize this facility, in order to fulfill their religious duty with regard to the disposition of their property after their death."

> "… the right of testamentary bequests is operative only within the limits of a third of the property, in favour of persons other than creditors and heirs. The aim of this rule seems to be two-fold: (1) To permit an individual to adjust things, in extraordinary cases, when the normal rule causes hardship; and a third of the property is sufficient for fulfilling all such moral duties. (2) Another motive of the law of the will is to prevent the accumulation of wealth in the hands of a few, a thing which would happen if one should give all this property, by will, to a single person excluding totally one's near relatives. Islam desires the circulation of wealth among as large a number of people as possible, taking into account the interests of the family."…

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إسهامات حميدالله الرائدة في الاقتصاد الإسلامي

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باحث بمعهد الاقتصاد الإسلامي

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المستخلص. ولد الدكتور محمد حميدالله (١٩٠٨-٢٠٠٢م)، وهو مواطن "عالمي"، في حيدر آباد (الدكن)، عاش في باريس وتوفي في جاكسونفيل (الولايات المتحدة). وهو معروف على نطاق واسع في أنحاء العالم الإسلامي، في شبه القارة الهندية، وأوروبا وأمريكا الشمالية لإسهاماته البارزة والمؤثرة في تقدم الدراسات الإسلامية ونشر تعاليم الإسلام. لقد استطاع الأستاذ حميدالله اكتشاف وتحرير عدد من المخطوطات النادرة، وقدّم إسهامات رائدة في مختلف التخصصات للتعليم الإسلامي. إن له إسهامات ملحوظة في الاقتصاد الإسلامي أيضا. لكن للأسف كل من كتب عن سيرته الذاتية على وجه التقريب لم يُولِ العناية الكافية لهذا الأمر. في هذا الحوار نقدم بعضًا من أفكاره الاقتصادية الإسلامية الهامة.

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Abstract. This paper attempts to discuss linkages and similarities between economic ideas of Muslim scholars and Scholastics with an objective to find out common ground in the history of our field of interest that may help understand our healthy traditions, boost cooperation and strengthen bonds of our association. To provide background knowledge, it begins with an account of circumstance in which Muslim dialecticians and European Scholastics emerged and the foundation on which the two were based. It traces the links through which they came close to each other. It presents a number of cases in which the two traditions have the similar views. It concludes with a note that ethics and human values were the overriding considerations of both Scholastics and Islamic scholars, and in spite of enormous change in economic principles and practices, this concern of humanity has not changed. If economic science is enriched with those values, they will surely add to efficiency, justice, and stability.

Before we discuss linkages and similarities between Islamic economics and Scholastic ideas, it seems worthwhile to refreshes our knowledge that

the basic sources of Islamic economics are the Qur'an(1) and Sunnah(2) which contain a number of economic teachings and rules. The Qur'an gave clear economic teachings regarding trade, *riba* (usury/interest), *zakah*, inheritance, lending and borrowing, moderate spending, financial penalties, etc. The *Sunnah* or the tradition of the Prophet provided detailed code of conduct about these teachings and added some others.

In matters where the Qur'an and the *Sunnah* are silent, use of reasoning power (*ijtihad*) has been appreciated by the Prophet(3). Thus, *ijtihad* or creative thinking and analogical reasoning based on principles derived from the primary sources of Islam has also been an important source in Islamic economics. In post revelation period, Muslim scholars offered economic solutions in new situations through *ijtihad*. Islam also welcomes local healthy customs and traditions (called *`urf*)(4), helping devices, and wisdom (*hikmah*) of other nations.(5) This encouraged Muslims to have translations of Greek intellectual heritage (1^{st}–5^{th} AH / 7^{th}–11^{th} CE centuries). The translation activity started in the first century Hijrah (7^{th} century C.E.) although it took two more centuries to make its influence felt among Muslim scholars(6). The incorporation of ancient sciences into Arabic gave a fresh lease of life to many important Indian,

(1) The Qur'an (Western sources write as Koran or Coran) is the words of God revealed to the Prophet Muhammad. According to Muslim belief, it is the last Divine Book consisting of guidance in every aspect of life.

(2) The *sunnah* refers to the method of the Prophet. Sometimes used as synonymous of "Tradition" which means sayings, actions and approvals of the Prophet.

(3) This source of rule is based on a tradition of the Prophet. See Abu Dawud (n.d.), *Sunan Abi Dawud*, n.p.: Dar Ihya' al-Sunnah al-Nabawiyah, vol. 3, p.303.

(4) Khallaf, Abd al-Wahhab (1968) *Ilm Usul al-fiqh* (Science of Jurisprudential Rules), Kuwait, al-Dar al-Kuwaitiyah, 8^{th} edition, pp: 89-90.

(5) Ibn Majah, (n.d.), *Sunan*, Beirut, Dar al-Fikr, vol. 2, p. 1395.

(6) The first incidence of translation is reported during the Caliphate of `Umar. It was translation of the tax register (*diwan*), from Persian to Arabic (Ibn Khaldun, n.d., *Muqaddimah*, Beirut, Dar al-Fikr, p. 112.). It was an Umayyad prince Khalid b. Yazid (48-85/668-704) who made a systematic beginning of translation. He sent for scholars from India, Persia, Rome and Greece and arranged the translation of their classical works. In the coming years the political upheavals interrupted this work. Its full-fledged commencement could be traced to the Abbasid Caliph al-Ma'mun (167-218/783-833) who established '*Bayt al-Hikmah*" (the house of wisdom) specially for this purpose. Greek manascripts were brought there from Constantinople and other places for translation purpose.

Persian and Greek works and saved them from oblivion[7]. In coming centuries it facilitated even the transfer of Indian and Persian sciences to Europe.[8]

Emergence of Muslim dialecticians (*mutakallimun*)

As a result of this encounter a new intellectual group emerged called *mutakallimun* and *filasifah* (dialecticians and Muslim philosophers) who critically examined the whole stuff, wrote commentaries, made improvements and additions. Some important names of *mutakallimun* are al-Mawardi,[9] al-Ghazali,[10] Fakhr al-Din al-Razi,[11] etc. and 'Muslim

(7) Many Greek books, such as those of Galen, were saved for the Western World thanks only to Arabic translations'. (Lopez-Baralt, Luce, 1994, "The Legacy of Islam in Spanish Literature", in Jayyusi, Salma Khadra (ed.), *The Legacy of Muslim Spain*, Leiden, E.J. Brill, p. 509). So-called Bryson's Greek original is now lost and survives in Arabic translation (Heffening, W. 1934, "*Tadbir'* in *The Encyclopaedia of Islam*, Old Edition, Leyden E.J. Brill & London, Luzac and Co., Vol. 4, p. 595). Greek version of the Arabic translation of Ptolemy's *Optics* has yet to be found. (Burnett, Charles (1994) "The Translating Activity in Medieval Spain", in Jayyusi, Salma Khadra (ed.), *The Legacy of Muslim Spain*, Leidan, E.J. Brill, p. 1054 n.).

(8) The case of Arab–Indian numerals is a living example of this intellectual exchange. Burnett writes: 'The so-called Arabic numbers without which Europeans would never have been able to develop mathematics, were introduced into the West and the Hindu East by the Arabs'. (Burnett, *op. cit*. pp: 509-10).

(9) Ali b. Muhammad al-Mawardi (364-450/974-1058), the son of a rose water merchant in Baghdad, his work *al-Ahkam al-Sultaniyyah* (the Ordinances of Government, Tr. By Wahba, H. Wafa and published by Garnet publishing Ltd. Reading, U.K., 1996) was commissioned by the Caliph. It contains a wide range of subjects including market supervision, taxation and economic role of government.

(10) Abu Hamid Muhammad b. Muhammad al-Ghazali (450-505/1058-1111), lived during the Saljuq period. His scholarship extended to many diverse fields of learning. Most of his economic ideas are found in his famous work *Ihya 'Ulum al-Din* and *al-Tibr al-Masbuk fi Nasihat al-Muluk*. For a detailed study of his economic ideas please see Ghazanfar, S.M., and Islahi, Abdul Azim, 1990, Economic Thought of an Arab Scholastic: Abu Hamid al-Ghazali", *History of Political Economy*, (Durham), USA, **22**(2), pp. 381-403; Ghazanfar, S.M., and Islahi, Abdul Azim, 1998, *Economic Thought of al- Ghazali*, Jeddah, Scientific Publishing Centre, KAAU. Al-Ghazali criticised philosophy in his work *Tahafut al-Falasifah* (Incoherence of Philosophers). According to Myers, al-Ghazali's works were available in Latin even before 1150 AD. And St. Thomas, directly or indirectly, benefited from those books in his efforts to refute the arguments of philosophers and sophists against faith. (Myers, Eugene A., 1964, *Arabic Thought and Western World*, New York, Fredrick Ungar Publishing Company, Inc. pp. 39, 42-43).

philosophers' are like Ibn Sina (Avicenna),[12] Ibn al-Haytham (Alhazen, Avennathan, Avenetan in Medieval Latin text),[13] Ibn Tufayl,[14] Nasir al-Din al-Tusi,[15] Ibn Rushd (Averroes),[16] etc.

Greek economics or *oikonomia* was translated by Muslims as '*ilm tadbir al-manzil* (the science of household management). It was one of the three branches of Greek philosophy, the other two being ethics (*ilm al-akhlaq*) and politics (*ilm al-siyasah*). Muslim scholars extended this branch of knowledge 'far beyond the household, embracing market,

(11) Fakhr al-Din al-Razi (544-606/1149-1209). Judge, theologian (*mutakallim*) and historian. His commentary on the Qur'an '*Mafatih al-Ghayb'* is characterized by philosophical exposition. It contains some insights which are of great interest to economists.

(12) al-Husayn bin Abdullah Ibn Sina (Avicenna) (370-428/980-1037). Logic, philosophy and medicine were to be his calling in life. His *'al-Qanun'* (the Canon of medicine) and *al-Shifa* (Healing known in the West as the *Sanatio*) remained a basis for teaching medicine in Europe unto the 17th Century.

(13) Al-Hasan b. Husayn Ibn al-Haytham (Alhazen, Avennathan, Avenetan) (354-430/965-1039). Principal Arab mathematician and the best physicist. Born in Basrah and died in Cairo. He devoted to mathematics and physics but he also wrote on philosophical and medical subjects.

(14) Ibn Tufayl (504-581/1110-1186). Ibn Tufayl was the first Andalusi thinker who knew and used Ibn Sina's *al-Shifa*. The thought of Ibn Tufayl represent a late continuation of the philosophy of Ibn Sina and the more Aristotelian line which would later be represented by Latin scholasticism… Ibn Tufayl's work was not directly known to medieval Latin scholastics. Translated into Hebrew in 1349 by Moses b. Narbonne, it was edited in 1671 by E. Pococke, accompanied by a Latin version with the title *Philosopus Autodidactus* and met with surprising success in the Western world. His famous work *Hayy b. Yaqzan* (trnslated by L. E. Goodman 1972, London) is forerunner of English Robinson Cruso.

(15) Nasir al-Din Abu Ja`far al-Tusi (597-672/1201-1274). Born at Tus and died in Baghdad, began his career as astrologer, later became the trusted adviser to Hulagu to the conquest of Baghdad, became vizier and superviser of *waqf* estates and retained his influential position under Abaqa also without interruption until his death. Of an economic interest is his treatise on finance – *Risalah Maliyyah*, and *Akhlaq-e-Nasiri*.

(16) Abu'l-Walid Muhammad b. Ahmad Ibn Rushd (Averroes) (520-595/1126-1198). As a philosopher he had little influence in the East, came at the end of development of Philosophy in Islam and perhaps marking its summit. In Europe he became the great authority on Aristotle's philosophy and a school arose around his commentaries on Aristotle known as 'Latin Averroism' and famous for the theory of the 'Unity of the Intellect'.

price, monetary, supply, demand phenomena, and hinting at some of the macro-economic relations stressed by Lord Keynes.'[17] According to Schumpeter, Greek economic ideas were confined to a few aspects of life such as, 'wants and their satisfactions', 'economy of self sufficient households', 'division of labour', 'barter', and 'money'. 'This – presumably the extract from a large literature that has been lost – constitutes the Greek bequest, so far as economic theory is concerned'.[18] Muslim scholars were not confined to these areas. In addition, they discussed market function and pricing mechanism, production and distribution problems, government economic role and public finance, poverty eradications, and economic development, etc.

Translation activities – An Important Channel of contact

When translation activities started in Europe beginning from $4^{th}/10^{th}$ century,[19] Muslim scholars re-exported the new improved intellectual product to the West along with their own ideas. With the passage of time, volume of retranslation work considerably increased. Hence the period before Western renaissance is termed as the 'translation age'.[20]

(17) Spengler, Joseph J. (1964) "Economic Thought of Islam: Ibn Khaldun", *Comparative Studies in Society and History*, (The Hague), Vol. VI, p. 304.

(18) Schumpeter, Joseph A. (1997) *History of Economic Analysis*, London, Routledge. p. 60.

(19) We have reports regarding translation activities from Arabic to Greek by the end of 4^{th} century Hijrah in the Byzantine capital Constantinople (Sezgin (1984) p. 119). Sezgin, Fuat (1984) *Muhadarat fi Tarikh al-Ulum al-Arabiyyah wa'l- Islamiyyah*, (Lectures on Arabic and Islamic Sciences), Frankfort, IGAIW.

(20) Myers, Eugene A. (1964) *Arabic Thought and Western World*, New York, Fredrick Ungar Publishing Company, Inc. p. 78. Louis Baeck has classified three periods of translation from Arabic. First from the early twelfth century to the beginning of the thirteenth century 'in which most important texts written by Arab and Greek scholars were translated into Castilian Catalan and Langue d'Oc'. In the second period 'from these vernacular languages, they were rendered into Latin'. The third period starts from the middle of thirteenth century - 'returned to the double pass: Arabic – Langue d'Oc – Latin'. "In this process of translation the most important Arabic texts on astronomy, mathematics, medicine, *kalam* and philosophy were transferred to the West". (Baeck, Louis (1994) *The Mediterranean Tradition in Economic Thought*, London and New York, Routledge. p. 119).

Other Channels of contact

The transmission of Muslim scholars' thought was not confined to translation work. A number of European students traveled to the Islamic seats of learning in Iraq, Syria, Egypt and Andalusia where they learnt various sciences from their Muslim teachers and on return to their countries they spread their ideas through their own writings or teaching work.(21) Trade and commerce, pilgrimage, students visits, oral transmission, and diplomatic channels also played important role. This contact, gave the way to various economic instruments and institutions to spread in medieval Europe such as *suftajah* (bill of exchange), *hawalah* (letter of credit), *funduq* (special trading centers), *mo`unah* (a kind of private bank), checque (*sakk*), mathessep (*muhtasib*), etc.

Scholastics the counterpart of Muslim dialecticians

As in the Muslim world, in Europe too, the discovery of this new world of knowledge gave the birth to a generation of scholars known as Scholastics. They were an outgrowth of and having different approach from Christian monastic teaching circles. European scholasticism was outcome of a new type of schools where Roman law and Greek philosophy was also studied. It prevailed during 1100-1500.

Having no significance teachings in their religious sources, Scholastics heavily depended on the newly discovered materials. Starting from almost nothing they expressed considerable opinions on economic issues.(22) It is an accepted historical fact that 'economic thinking' in the Christian world started with the scholastic philosophers. Writing in "*An Essay on Medieval Economic Teaching*" of the West, O'Brien says: "There is not to be found in the writers of the early Middle Ages, that is to say from the eighth to the thirteenth centuries, a trace of any attention given to what we at present day would designate economic questions".(23) According to Jourdain, as quoted by O'Brien, the greatest lights of

(21) Sezgin, *op. cit*. p. 128.

(22) For an account of Scholastics' deviation from early fathers on matters of economic interest refer to Viner, Jacob,1978, *Religious thought and Economic Society*, Durham, N.C., Duke University Press. pp: 106-111

(23) O'Brien, George (1920) *An Essay on Medieval Economic Teaching*, London, Longman. Reprint 1967, p. 13

theology and philosophy in the Middle Ages such as Alcuin, Rabnas, Mauras, Scotus Erigenus, Hincmar, Gerbert, St. Anselm and Abelard, had not 'a single passage to suggest that any of these authors suspected the pursuit of riches, which they despised, occupied a sufficiently large place in national as well as in individual life, to offer to the philosopher a subject fruitful in reflections and results',(24)

O'Brien mentions two causes of 'this almost total lack of interest in economic subject'. 'One was the miserable condition of society', 'almost without industry and commerce', the other was the absence of all economic tradition'. Not only had the writing of the ancients, who deal to some extent with the theory of wealth, been destroyed, but the very traces of their teaching had been long forgotten'.(25)

There is an additional reason for that state of affairs. Christianity traditionally discouraged man's engagement in economic enterprise. Trade and commerce, until the Middle Ages, were considered sinful, the urge to earn more was an expression of mere avarice. Gordon writes: "As late as the year 1078, a church council at Rome issued a canon which affirmed that it was impossible for either merchants or soldiers to carry on their trades without sin."(26) We find some opinions on economic subject like 'believers should sell what they have and give it to poor', or, …. 'They should lend without expecting anything (possibly not even repayment) from it'.(27)

It is self-evident that no economic theory can be built on such idealistic imperatives. Thus, the early Christian scholars did not find any base or incentive for looking into economic problems and formulating theories. This attitude accounts for 'the great gap'(28) from early

(24) (ibid., p. 14).
(25) (ibid., p. 15).
(26) Gordon, Barry (1975) *Economic Analysis Before Adam Smith*, New York, Barnes and Noble. p. 172.
(27) (Schumpeter, *The History of Economic Analysis, op. cit*., p. 71).
(28) Joseph Schumpeter (*The History of Economic Analysis*, pp. 73-74) talked of 'the great gap' in evolution and development of economic thought in his monumental work *History of Economic Analysis* In his *magnum opus, The History of Economic Analysis.* After discussing the Greco-Roman economic thought, he remarks: "so far as

Christianity up to the middle of the Middle Ages. Lamenting this situation, Schumpeter writes: "Whatever our sociological diagnosis of the mundane aspects of early Christianity may be, it is clear that Christian church did not aim social reform in any sense other than that of moral reform of individual behavior. At no time even before its victory, which may have roughly dated from Constantine's Edict of Milan (313 A.D.), did the church attempt a frontal attack on the existing social system or any of its more important institutions. It never promised economic paradise, or for that matter any paradise this side of the grave. The how, and why of economic problem were *then* of no interest either to its leaders or to its writers".(29)

It is therefore surprising that coming to 12th and 13th century A.D., a revolution came and the prohibited tree of economics became part and parcel of the Scholastics. The question naturally arises what were the factors that led to this radical change and how the Scholastics were able to develop a very large body of economic thought without almost any precedent. Very few historians of economic thought have tried to address this question. Even those who answered it, they could not fully substantiate it. The great historian of economic thought, Professor Jacob Viner remarks: "From the thirteenth century on, after the discovery of Aristotle in the Western world, and especially after the absorption of

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= our subject is concerned, we may safely leap over 500 years to the epoch of St. Thomas Aquinas (1225-74), whose *Summa Theologica* in the history of thought was what the south-western spire of the Cathedral of Chartres is in the history of architecture" (ibid. p. 74). In 1987, Mirakhor penned down a well-documented paper in which he questioned the Schumpeterian great gap thesis and pointed out to the 'serious omission in the history of economics of profound contribution made by Muslim scholars'. He showed that 'both motive and opportunity existed for the Medieval European scholars to be influenced by the economic ideas and institutions developed in medieval Islam and that based on the available evidences, they availed themselves of such an opportunity by using some of the available knowledge to advance their ideas'. (Mirakhor (1987) p. 249) The echo of this paper was heard at the History of Economics Society Conference in Toronto, Canada, June 1988 in which Ghazanfar (presented his study on "Scholastic Economics and Arab Scholars: The Great Gap Thesis Reconsidered" (Ghazanfar, S.M. (ed.), (2003) *Medieval Islamic Economic Thought*, London and New York, Routledge Curzon, p. 19, footnote 1).

(29) Schumpeter, *The History of Economic Analysis, op. cit*., p.72.

Aristotelian teaching by Albert the Great and St. Thomas Aquinas, Christian moral theology became a tremendous synthesis of biblical teaching, church tradition, Greek philosophy, Roman and Canon Law, and the wisdom and insights of the scholastics themselves".(30) In this statement "moral theology" refers to Scholasticism, economics was a part of it. One may wonder, what is new or unique in these elements. Bible teachings, church tradition, Roman and Canon Law and even Greek philosophy(31) all existed since long ago. Why such synthesis could not be presented during the Dark Ages? In fact, it was not simply Greek philosophy. But it was Greek philosophy in its improved form - *with the commentary, addition and exposition by Muslim scholars*. Schumpeter is more explicit(32) (though he mentions it 'marginally' only) when he says: "During the twelfth century more complete knowledge of Aristotle's writings filtered slowly into the intellectual world of western Christianity, partly through Semite mediation, Arab and Jewish".(33) "Access to Aristotle's thought immensely facilitated the gigantic task before them, not only in metaphysics, where they had to break new paths, but also in the physical and *social sciences, where they had to start from little or nothing*" (emphasis added).(34)

Schumpeter is correct when he says: "I do not assign to the recovery of Aristotle's writings the role of chief cause of thirteenth century development. Such developments are never induced solely by an influence from outside".(35) True, 'this phenomenon cannot be causally explained by a lucky discovery of a new volume' of the Greek philosophy. There must have been other factors that affected 'the wisdom and insights of the scholastics themselves' and induced them to change

(30) Viner, *Religious thought and Economic Society, op. cit.*, p. 48

(31) Greek philosophy was known to Christian scholars in their early period also. It never died fully among them. Even some translations were made directly from Greek to Latin. The reader may refere to Gordon (Gordon, Barry (1975) *Economic Analysis Before Adam Smith,* New York, Barnes and Noble. pp. 82-110) to see how Christian fathers reacted to Greek ideas in early centuries. It was totally different from what they did after discovering it with Muslim commentaries.

(32) Schumpeter (1997) has mentioned role of Muslim scholars in his encyclopedic work *History of Economic Analysis* at the margin only. See pp. 87-88 footnote.

(33) Schumpeter, *The History of Economic Analysis, op. cit.*, p. 87

(34) ibid., p. 88

(35) ibid.

the traditional Christian outlook towards the realities of life and think the way they thought. Of course this important factor was the contact – negative or positive – on various levels with the Muslim scholars, their work, trade, traveling for education or exploration, war and peace, conquest and defeat, living together and migration, etc.(36)

Karl Pribram is perhaps among the fewest Western economists who have openly accepted it. He says: "All relevant writings of the Greek philosopher Aristotle (384–322 B.C.) were gradually made available in Latin translation along with various treatises in which Arabian philosophers had interpreted Aristotle's work in light of their own reasoning. Of particular importance for subsequent development of Western thought was a translation into Latin of the commentaries of Aristotle's *Ethics* by the Cordoban philosopher Ibn-Rushd, called Averroes (1126-1198)".(37) He mentions two streams that affected the Medieval society. The second and "far more important stream started within the body of Scholastic theologians who derived their intellectual armory from the works of Arabian philosophers".(38)

The preceding account is not to belittle the scholastic contributions to economic thought. It intends to establish that in the wake of various links between the two cultures, it is not wonder to see so many common ideas and similarities between Scholastics and Muslim scholars.

Motivated by identical objectives.

A comparative study would show that both scholastics and Muslim scholars had similar objectives of economic activities. Scholastics stressed on economic justice, preference of the common good, earning for the self reliance and help of the poor, and elimination of exploitation

(36) As Muslim scholars based their ideas on both revealed knowledge and human reason, they were more suited to scholastic scholars. So they benefited from them to a greater extent which is clear from the gap which is found between their voluminous body of thought on economic issues and almost no contribution of their predecessors who could not have access to Arabian sources.

(37) Pribram, Karl (1983) *A History of Economic Reasoning,* Baltimore and Lord, The Johns Hopkins University Press, p. 4.

(38) ibid., p. 2.

and hardship from economic life.[39] These were the objectives emphasized by Muslim scholars as well. For instance, Ibn al-Qayyim calls attention to justice saying that it is the objective of the Shari'ah. "Anything contrary to justice which turn the matter from blessing and welfare into a curse and an evil, and from wisdom into disutility has nothing to do with the Shari`ah."[40] He also puts emphasis on public interest, that is, common good of the majority has a preference over the private interest. This is consistence with the spirit of the Shari'ah[41]. if individual owners use property in a manner that violates social welfare, the state may have the right to intervene and even confiscate such property, with proper compensation, if by so doing the greater good of the society will be served[42]. Al-Ghazali allows additional taxes under certain conditions, chief among them being the need for *maslahah*, or social welfare of the community[43]. Ibn Taimiyah, for example, while aware of the market forces of demand and supply in determining prices, points out the possibilities of market imperfections which could lead to unjust practices on the part of suppliers; under these circumstances he would recommend state intervention to promote the common good.[44]

Thus, both Muslim scholars and Scholastics considered justice, equity, common good, and protection of the weaker as objectives behind various economic teachings and institutions discussed in the two traditions. They mainly talked about prohibition of usury, protection of the poor and needy from charging exploitative rate, adoption of *commenda* or *mudarabah*, acceptance of just price, opposition of administrative price fixation, condemnation of hoarding and monopoly,

(39) For Scholastics' consideration refer to Viner, *Religious thought and Economic Society*, *op. cit*., pp. 50, 51.

(40) Ibn al-Qayyim, *Zad al-Ma`ad*, Cairo: al-Matba`ah al-Misriyah, n.d., p. 15.

(41) Ibn al-Qayyim (1955) *I`lam al-Muwaqqi`in*, Cairo, Maktabah al-Sa`adah Vol. 3, p. l71.

(42) Ibn Qayyim (1953) *al-Turuq al-Hukmiyyah*, Cairo: Matba`ah al-Sunnah al-Muhammadiyyah, pp: 245-46, 254-60.

(43) For details refer to Ghazanfar, S.M., and Islahi, Abdul Azim (1998) *Economic Thought of al- Ghazali*, Jeddah, Scientific Publishing Centre, KAAU., p. 47.

(44) For a detailed analysis of Ibn Taimiyah's views in this regard, see A.A. Islahi, *Economic Concepts of Ibn Taimiyah*, Islamic Foundation, Leicester (1988) pp. 88-102. Also see Islahi, "Ibn Taimiyah's Concept of Market Mechanism," *Journal of Research in Islamic Economics*, **2**(2), Winter 1405/1985; pp. 55-56.

ban on forestalling, respect of human labour in acquisition of landed property, and issues related to the nature and functions of money. In the following sections we intend to show similarities and parallels in the two traditions on these topics. But first we would like to draw the attention to a more interesting object:

Resemblance in contents and style

In many cases, not only thinking of scholastics was similar to the thought of newly discovered savants, the Muslim scholars and jurists. But the contents and style of their works had also very close resemblance. For example St. Thomas Aquinas(45) (d. 1274) devotes two chapters in his famous work *Summa Theologica* on elimination of cheating and usurious practices from buying and selling.(46) Imam al-Ghazali (d. 1111) devotes Chapter 3 of volume 2 of his work *Ihya' Ulum al-Din* to deal with the business ethics (*adab al-ma`ash*).(47) The two works have tremendous similarities in choice of their topics and contents and spirit. It may be noted that Al-Ghazali's influence on Aquinas has been documented by many authors.(48)

(45) St Thamas Aquinas is called the prince of the Scholastics (Haney, L.H. (1949) *History of Economic Thought*, New York: Macmillan, 4th ed. p. 98) whose thought influenced an epoch (Gray, A. and Thompson, A. (1980) *The Development of Economic Doctrine*, New York: Longman, 2nd ed., p. 30)."The teaching of Aquinas upon economic affairs remained the groundwork of all the later writers until the end of the fifteenth century. His opinions on various points were amplified and explained by later authors in more detail than he himself employed" O'Brien, George, 1920, *An Essay on Medieval Economic Teaching*, London, Longman. Reprint 1967.p. 18.

(46) Aquinas, Thomas (1947) *Summa* Theologica, New York, Benziger Brothers, II:II Q77 and Q78).

(47) Al-Ghazali, al-Ghazali, Abu Hamid (n.d.), *Ihya Ulum al-Din*, Beirut, Dar al Nadwah, vol. 2, pp.62-80.

(48) Harris write: "Without the influence of Arabian Peripateticism, the theology of Aquinas is as unthinkable as his philosophy" (Harris, C.R.S. (1959) Duns Scotus, 2 Vols. The Humanities Press, New York, p. 40). Ghazarfar has documented statements of many scholars who admit influence of al-Ghazali on St. Thomas Aquinas. He has also tried to trace parallels and linkages between St. Thomas Aquinas and Abu Hamid al-Ghazali, and has shown how former's *Summa* and latters *Ihya* have parallel commentaries on compatible economic topics. (Ghazanfar (2003) *op. cit.* pp. 193-203).

Usury a sin against justice.

While prohibiting *riba* (usury/interest) the Qur'an at the very outset said that it was unjust. But the Scholastic scholars could perceive this as late as 12th century. This had been considered as a great discovery in the Western circle. O'Brien says: "Alexander III (d. 1181) having given much attention to the subject of usury, had come to the conclusion that it was a sin against justice. This recognition of the essential injustice of usury marked a turning point in the history of the treatment of the subject, and Alexander III seems entitled to be designated the pioneer of its scientific study".(49)

Practice of usury - a robbery or a war

Raymond of Penafort (d.1275) considers usury as an act of robbery.(50) According to Langholm, in *De bono mortis* of St. Ambrose, the following plain statement occurs: "If someone takes usury, he commits robbery, he shall not live."(51) It may be noted that this will be a natural thinking if one could know that God and His Prophet declared war against the usurer.(52)

Reducing the loaned amount to get payment in time.

The Muslim scholars unanimously uphold decreasing the amount to be returned on due date to facilitate payment. The Prophet advised one of his companions to cut his loaned money and get it back at once.(53) Imam Shafi`i went to the extent that it is also permitted to reduce the amount to get it back before the due date.(54) The purpose is to promote common interest. This was made clear so that one may not think that this is tantamount to usury. The Scholastics also thought on the same line. "If a

(49) O'Brien, *op. cit*., p. 175.
(50) Langholm, Odd (1987) "Scholastic Economics", in Lowry, S. Todd (ed.), *Pre-Classical Economic Thought*, Boston, Kluwer Academic Publishers, p. 132
(51) Langholm, Odd (1998) *The Legacy of Scholasticism in Economic Thought*, Cambridge, Cambridge University Press. p. 59.
(52) c.f. The Qur'an 2: 279.
(53) al-Bukhari, 1987 al-Bukhari (1987) al-Jami` al-Sahih, Cairo: Dar Al-Sha`b, vol. 1, p. 124.
(54) Ibn Rushd (1975) *Bidayat al-Mujtahid wa Nihayat al-Muqtasid*, Egypt: Mustafa al-Babi al-Halabi Press, vol. 2, p. 144.

man wishes to allow a rebate on the just price in order that he may have his money sooner, he is not guilty of the sin of usury".[55]

Protection of a needy buyer.

The Prophet prohibited selling goods to a needy person taking the advantage of his need (called as *bay' al-mudtarr*.[56] In another tradition, charging an exorbitant price from an ignorant person has been considered as usury[57] The purpose of these teaching was to protect the needy from exploitation. Perhaps similar intention led St. Aquinas to liken a needy borrower on usury to a buyer in need to whom a thing is sold at an excessive price[58] In the Scholastic tradition also 'it was strictly forbidden to raise the price on account of the individual need of the buyer'.[59]

Commenda, collegantia and risk sharing

According to Viner, 'trade was treated in biblical texts as being peculiarly associated with avarice, riches, and luxury. Here the pagan and biblical traditions had much in common'.[60] But the scholastics accepted trade as a legitimate occupation. In the absence of interest scholastic scholars and Islamic sources, as well as the practice on both parts, approved carrying out businesses and trades on the basis of partnership known as *commenda* in the West, and *mudarabah* in the East. There are many similarities in various provisions of the two. The Western *Commenda* is a counterpart of *Mudarabah* in Islamic word. Under this partnership capital was provided by one party while refraining from taking any direct part in the enterprise, and the other party worked with that capital and they shared the profit with a predetermined ratio. According to Gray and Thompson, 'the medieval doctrine did not condemn investment when investment took the form of a partnership, provided the partner did in fact share the risk of business. *Commenda* the original form of partnership, has always been regarded as entirely

(55) O'Brien, *op. cit*., p.119
(56) Abu Dawud, *op. cit*., Vol. 3, p. 255.
(57) al-Bayhaqi, Abu Bakr Ahmad (1999) *al-Sunan al-Kubra*, Beirut: Dar al-Kutub al-`Ilmiyah, vol. 5, p. 541.
(58) Langholm (1998) *op. cit*., p. 77
(59) O'Brien, *op. cit*., p. 120
(60) Viner, *Religious thought and Economic Society, op. cit.* 35.

legitimate'.[61]

In case both the parties contributed capital and worked together, it was called *Collegantia* or *Societas* by the scholastics.[62] In the Islamic system its name is *Musharakah* or *shirkat al-`inan.* The main characteristic of the two instruments is risk sharing. According to Baldus (d. 1400), when there is no sharing of risk, there is no partnership.[63] And the Islamic rule is also the same. *Al-ghunm bi'l-ghurm wa'l-ribh bi`l-daman* which mean a gain is associated with (the readiness to bear) the loss, and profit entitlement is tied with (bearing) the risk.[64] It may be noted that during the recent financial crisis, many savants saw the cure in risk-sharing.[65]

Just Price

Just price was the main theme of discussion for both Islamic scholars and Scholastics and it is still one of the most discussed topics of scholastic economics with diverse interpretations. However we find a great resemblance between Ibn Taymiyah's (d. 1328) concept of just price and that of Aquinas. For both, the just price must be a competitive market price and there must be no fraud.[66]

Price Control

Peter Olivi (d. 1298), the author of a much copied treatise on economic contracts opposed price control even when there was general scarcity. He states openly that unless one does this, those with supplies in

(61) Gray, A. and Thompson, A. (1980) The Development of Economic Doctrine, New York: Longman, 2nd ed. P. 47.

(62) de Roover, Raymond (1965) "The Origin of Trade" in: *Cambridge Economic History of Europe*, Cambridge: Cambridge University Press, vol. 3, pp: 49-50.

(63) O'Brien, *op. cit*., p. 208.

(64) al-Sindi, Nur al-Din (1986) *Hashiyat al-Sindi `ala al-Nisai*, edited by Abd al-Fattah Abu Ghuddah, Aleppo: Maktab al-Matbu`at al-Islamiyah, vol. 7, p. 255.

(65) Chapra, Mohammad Umer (2009) "The Global Financial Crisis: Can Islamic Finance Help?" in: *Issues in the International Financial Crisis from an Islamic Perspective*, Prepared by: Group of Researchers, Islamic Economic Research Center, Jeddah, King Abdulaziz University, p. 38.

(66) For details see Islahi, Abdul Azim (1988) *Economic Concepts of Ibn Taimiyah*, Leicester, The Islamic Foundation. pp: 76-80.

stock will be less inclined to part with them, to the detriment of all those who need them.(67)

Ibn Qudamah al-Maqdisi (d. 1287), in addition to support his stand on price control with the tradition of the Prophet, says: price fixing must lead to dearth and high price. Outside traders will not bring their goods, while local traders conceal their stocks. The needy buyers and wealthy stockists both will suffer.(68)

It may be noted that the question of administrative price fixation has been very controversial among the Muslim scholars. For example, Ibn Taimiyah, a noted scholar of early fourteenth century, discusses certain circumstances which might warrant price regulation and controls - specifically when there are market imperfections (monopolistic practices) and/or when there are national emergencies (famine, war, etc.).(69)

Hoarding and forestalling

Hoarding and forestalling (i.e. buying from a merchant in route to the market) were condemned by Scholastic Scholars.(70) In Islamic sources we read condemnation of hoarding and prohibition of forestalling known as *ihtikar* and *talaqqi al-jalab* respectively. The Prophet said The hoarder is committing a wrongdoing and one who bring supply is favoured by livelihood.(71)

Prohibition of Town guilds leading to monopolization.

In the interest of common good the schoolmen opposed the attempt by the town guilds of manufacturers and tradesmen who may fix an exploitative price for their goods and services.(72) Long ago Ibn Taymiyah also opposed, on similar grounds, forming a kind of manufacturers guilds. He recommended interference by the authority in such cases.(73)

(67) Langholm (1987) *op. cit*., p. 117.
(68) al-Maqdisi, Ibn Qudamah, Abd al-Rahman (1972) *al-Sharh al-Kabir* (Printed at the foot of *al-Mughni* by Ibn Qudamah), Beirut: Dar al-Kitab al-Arabi, Vol. 4, pp: 44-45).
(69) Ibn Taymiyah (1976) *al-Hisbah fi'l-Islam*, Cairo, Dar al-Sha'b. pp: 24-6).
(70) Gordon, *op. cit*., pp: 219-20
(71) al-Sana`ani, Abd al-Razzaq (1403 H) *Musannaf Abd al-Razzaq*, Beirut: al-Maktab al-Islami, 8: 204.
(72) Gordon, *op. cit*., p. 220.
(73) Ibn Taymiyah, *op. cit*., pp: 25-26.

Revival of Dead land

The Islamic position is that "One who revives a land (i.e. makes it cultivable) has right to own it".(74) St. Aquinas held that "the expenditure of labour in cultivating an area of land, or occupation of it, can give rise to a just claim of ownership."(75) These opinions not only gave a due respect and recognition to labour but also encouraged appropriation of lands and making them cultivable.

Money and related issues

Money is one of the less discussed topics by Scholastics. Nicole Oresme (d.1382) authored a small tract on the subject which is considered as the first treatise entirely devoted to an economic topic authored by a schoolman. He discussed nature and purpose of money, gold and silver as suitable materials for coinage, bad consequences of alteration and debasement of currency, and the idea similar to Gresham's law.(76)

Much before Oresme, Qudamah ibn Jafar (d. 932),(77) Ibn Miskawaih, (d.1030),(78) al-Ghazali (d.1111),(79) al-Dimashqi (lived in 12th century),(80) Ibn Taymiyah (d. 1328),(81) and al-Maqrizi(82) discussed all

(74) al-Tirmidhi, Abu Isa (1976) *al-Jami` al-Sahih*, Egypt, Mustafa al-Babi al-Halabi, Vol. 3, pp: 653, 655.

(75) Gordon, op. cit., p. 182.

(76) For Oresme's thought on money see Monroe, A.E. (1965) *Early Economic Thought*, Cambridge, Harvard University Press, pp: 81-102.

(77) Qudamah ibn Jafar (1981) *al-Kharaj wa Sina`at al-Kitabah*, Baghdad, Dar al-Rashid, p. 434.

(78) Ibn Miskawaih (1964) *Risalah fi Mahiyat al-`Adl*, edited and translated by M. S. Khan, Leiden, Brill, p. 29; idem. (n.d.) *Tahdhib al-Akhlaq*, Cairo, al-Matba`ah al-Misriyyah, p. 110.

(79) al-Ghazali, Abu Hamid (n.d.) *Ihya Ulum al-Din*, Beirut, Dar al Nadwah, Vol. 2, pp. 73, 92; Vol. 4, pp: 114-115.

(80) al-Dimashqi (1977) *al-Isharah ila Mahasin al-Tijarah*, edited by al-Shorabji, Cairo, Maktabah al-Kulliyyat al-Azhariyyah, p. 21.

(81) Ibn Taymiyah (1963) Majmu` Fatawa Shaykh al-Islam Ahmad Ibn Taymiyah, Riyadh, al-Riyad Press, Vol. 29, pp. 469, 472. It may be noted that Ibn Taymiyah does not think that money must be gold or silver; it is a matter of convention, so other material can also be used as money provided it has general acceptance (ibid., Vol. 19, pp: 250, 251, 248-249).

(82) al-Maqrizi (1994) has extensively discussed the monetary issues in his work *Ighathat al-Ummah*, translated and edited by Adel Allouche as *Mamluk Economics*, Salt Lake City, University of Utah Press.

these aspects of money, in context of various socio-economic issues. This similarity was partly because both sides benefitted from Greek ideas and faced similar problems, and partly because of their common concern for commutative justice, facilitation of transactions, and check on cheating and deception in money matters.

Concluding Remarks

Such examples of similarities can be multiplied but the time and space do not allow us to cover all such cases. In fact it is a theme of full-fledged research. In the conclusion it may be emphasized that since the era of Scholastics and early Muslim scholars, economic principles and practices have undergone drastic change. Compositions of production and techniques have enormously developed. But man's nature is the same. His conscious, ethics and human values have not changed. These were the overriding considerations of both scholastics and Islamic scholars and it is this aspect of their thought that has lessons for us. In the end I must reiterate that the purpose of this presentation is not to plead for return to medieval period. But at the same time I must says emphatically that in heavenly religions there are certain rules, ethics and values. If they are brought back to economics, they will enhance this science in efficiency, justice, and stability, especially after learning so many lessons from the recent world financial crises.

Notes and References

1. The Qur'an (Western sources write as Koran or Coran) is the words of God revealed to the Prophet Muhammad. According to Muslim belief, it is the last Divine Book consisting of guidance in every aspect of life.
2. The *sunnah* refers to the method of the Prophet. Sometimes used as synonymous of "Tradition" which means sayings, actions and approvals of the Prophet.
3. This source of rule is based on a tradition of the Prophet. See Abu Dawud (n.d.), *Sunan Abi Dawud*, n.p.: Dar Ihya' al-Sunnah al-Nabawiyah, vol. 3, p. 303.
4. Khallaf, Abd al-Wahhab, 1968, *Ilm Usul al-fiqh* (Science of Jurisprudential Rules), Kuwait, al-Dar al-Kuwaitiyah, 8th edition, pp: 89-90.
5. Ibn Majah, (n.d.), *Sunan*, Beirut, Dar al-Fikr, vol.2, p. 1395.
6. The first incidence of translation is reported during the Caliphate of `Umar. It was translation of the tax register (*diwan*), from Persian to Arabic (Ibn Khaldun, n.d., *Muqaddimah*, Beirut, Dar al-Fikr, p. 112.). It was an Umayyad prince Khalid b. Yazid (48-85/668-704) who made a systematic beginning of translation. He sent for scholars from India, Persia, Rome and Greece and arranged the translation of their classical works. In the coming years the political upheavals interrupted this work. Its full-fledged commencement could be traced to the Abbasid Caliph al-Ma'mun (167-218/783-833) who established '*Bayt al-Hikmah*" (the house of wisdom) specially for this purpose. Greek manascripts were brought there from Constantinople and other places for translation purpose.
7. Many Greek books, such as those of Galen, were saved for the Western World thanks only to Arabic translations'. (Lopez-Baralt, Luce, 1994, "The Legacy of Islam in Spanish Literature", in Jayyusi, Salma Khadra (ed.), *The Legacy of Muslim Spain*, Leiden, E.J. Brill, p. 509). So-called Bryson's Greek original is now lost and survives in Arabic translation (Heffening, W. 1934, "*Tadbir'* in *The Encyclopaedia of Islam*, Old Edition, Leyden E.J. Brill & London, Luzac and Co., Vol. 4, p. 595.). Greek version of the Arabic translation of Ptolemy's *Optics* has yet to be found. (Burnett, Charles, 1994, "The Translating Activity in Medieval Spain", in Jayyusi, Salma Khadra (ed.), *The Legacy of Muslim Spain*, Leidan, E.J. Brill, p. 1054 n.)
8. The case of Arab–Indian numerals is a living example of this intellectual exchange. Burnett writes: 'The so-called Arabic numbers without which Europeans would never have been able to develop mathematics, were introduced into the West and the Hindu East by the Arabs'. (Burnett, *op. cit.* pp: 509-10).

9. Ali b. Muhammad al-Mawardi (364-450/974-1058), the son of a rose water merchant in Baghdad, his work *al-Ahkam al-Sultaniyyah* (the Ordinances of Government, Tr. By Wahba, H. Wafa and published by Garnet publishing Ltd. Reading, U.K. (1996) was commissioned by the Caliph. It contains a wide range of subjects including market supervision, taxation and economic role of government.

10. Abu Hamid Muhammad b. Muhammad al-Ghazali (450-505/1058-1111), lived during the Saljuq period. His scholarship extended to many diverse fields of learning. Most of his economic ideas are found in his famous work *Ihya 'Ulum al-Din* and *al-Tibr al-Masbuk fi Nasihat al-Muluk*. For a detailed study of his economic ideas please see Ghazanfar, S.M., and Islahi, Abdul Azim, 1990, Economic Thought of an Arab Scholastic: Abu Hamid al-Ghazali", *History of Political Economy*, (Durham), USA, Vol. 22, No. 2, pp: 381-403; Ghazanfar, S.M., and Islahi, Abdul Azim, 1998, *Economic Thought of al- Ghazali*, Jeddah, Scientific Publishing Centre, KAAU. Al-Ghazali criticised philosophy in his work *Tahafut al-Falasifah* (Incoherence of Philosophers). According to Myers, al-Ghazali's works were available in Latin even before 1150 AD. And St. Thomas, directly or indirectly, benefited from those books in his efforts to refute the arguments of philosophers and sophists against faith. (Myers, Eugene A., 1964, *Arabic Thought and Western World*, New York, Fredrick Ungar Publishing Company, Inc. pp: 39, 42-43).

11. Fakhr al-Din al-Razi (544-606/1149-1209). Judge, theologian (*mutakallim*) and historian. His commentary on the Qur'an '*Mafatih al-Ghayb'* is characterized by philosophical exposition. It contains some insights which are of great interest to economists.

12. al-Husayn bin Abdullah Ibn Sina (Avicenna) (370-428/980-1037). Logic, philosophy and medicine were to be his calling in life. His *'al-Qanun'* (the Canon of medicine) and *al-Shifa* (Healing known in the West as the *Sanatio*) remained a basis for teaching medicine in Europe unto the 17th Century.

13. Al-Hasan b. Husayn Ibn al-Haytham (Alhazen, Avennathan, Avenetan) (354-430/965-1039). Principal Arab mathematician and the best physicist. Born in Basrah and died in Cairo. He devoted to mathematics and physics but he also wrote on philosophical and medical subjects.

14. Ibn Tufayl (504-581/1110-1186). Ibn Tufayl was the first Andalusi thinker who knew and used Ibn Sina's *al-Shifa*. The thought of Ibn Tufayl represent a late continuation of the philosophy of Ibn Sina and the more Aristotelian line which would later be represented by Latin scholasticism… Ibn Tufayl's work was not directly known to medieval Latin scholastics. Translated into Hebrew in 1349 by Moses b. Narbonne, it was edited in 1671 by E. Pococke, accompanied by a Latin version with the title *Philosopus Autodidactus* and met with surprising success in the Western world. His famous work *Hayy b. Yaqzan* (trnslated by L. E. Goodman 1972, London) is forerunner of English Robinson Cruso.

15. Nasir al-Din Abu Ja`far al-Tusi (597-672/1201-1274). Born at Tus and died in Baghdad, began his career as astrologer, later became the trusted adviser to Hulagu to the conquest of Baghdad, became vizier and superviser of *waqf* estates and retained his influential position under Abaqa also without interruption until his death. Of an economic interest is his treatise on finance – *Risalah Maliyyah*, and *Akhlaq-e-Nasiri*.

16. Abu'l-Walid Muhammad b. Ahmad Ibn Rushd (Averroes) (520-595/1126-1198). As a philosopher he had little influence in the East, came at the end of development of Philosophy in Islam and perhaps marking its summit. In Europe he became the great authority on Aristotle's philosophy and a school arose around his commentaries on Aristotle known as 'Latin Averroism' and famous for the theory of the 'Unity of the Intellect'.

17. Spengler, Joseph J. (1964) "Economic Thought of Islam: Ibn Khaldun", *Comparative Studies in Society and History*, (The Hague), Vol. VI, p. 304.

18. Schumpeter, Joseph A. (1997) *History of Economic Analysis*, London, Routledge. p. 60.

19. We have reports regarding translation activities from Arabic to Greek by the end of 4th century Hijrah in the Byzantine capital Constantinople (Sezgin, 1984, p. 119). Sezgin, Fuat (1984) *Muhadarat fi Tarikh al-Ulum al-Arabiyyah wa'l- Islamiyyah*, (Lectures on Arabic and Islamic Sciences), Frankfort, IGAIW.

20. Myers, Eugene A. (1964) *Arabic Thought and Western World*, New York, Fredrick Ungar Publishing Company, Inc. p. 78. Louis Baeck has classified three periods of translation from Arabic. First from the early twelfth century to the beginning of the thirteenth century 'in which most important texts written by Arab and Greek scholars were translated into Castilian Catalan and Langue d'Oc'. In the second period 'from these vernacular languages, they were rendered into Latin'. The third period starts from the middle of thirteenth century - 'returned to the double pass: Arabic – Langue d'Oc – Latin'. "In this process of translation the most important Arabic texts on astronomy, mathematics, medicine, *kalam* and philosophy were transferred to the West". (Baeck, Louis (1994) *The Mediterranean Tradition in Economic Thought*, London and New York, Routledge. p. 119)

21. Sezgin, *op. cit*. p. 128.

22. For an account of Scholastics' deviation from early fathers on matters of economic interest refer to Viner, Jacob,1978, *Religious thought and Economic Society*, Durham, N.C., Duke University Press. pp: 106-111

23. O'Brien, George (1920) *An Essay on Medieval Economic Teaching*, London, Longman. Reprint 1967, p. 13

24. (ibid., p. 14).

25. (ibid., p. 15).
26. Gordon, Barry (1975) *Economic Analysis Before Adam Smith*, New York, Barnes and Noble. p. 172.
27. (Schumpeter, *The History of Economic Analysis*, *op. cit*., p. 71).
28. Joseph Schumpeter (*The History of Economic Analysis*, pp. 73-74) talked of 'the great gap' in evolution and development of economic thought in his monumental work *History of Economic Analysis* In his *magnum opus, The History of Economic Analysis.* After discussing the Greco-Roman economic thought, he remarks: "so far as our subject is concerned, we may safely leap over 500 years to the epoch of St. Thomas Aquinas (1225-74), whose *Summa Theologica* in the history of thought was what the south-western spire of the Cathedral of Chartres is in the history of architecture" (ibid. p. 74). In 1987, Mirakhor penned down a well-documented paper in which he questioned the Schumpeterian great gap thesis and pointed out to the 'serious omission in the history of economics of profound contribution made by Muslim scholars'. He showed that 'both motive and opportunity existed for the Medieval European scholars to be influenced by the economic ideas and institutions developed in medieval Islam and that based on the available evidences, they availed themselves of such an opportunity by using some of the available knowledge to advance their ideas'. (Mirakhor, 1987, p. 249) The echo of this paper was heard at the History of Economics Society Conference in Toronto, Canada, June 1988 in which Ghazanfar (presented his study on "Scholastic Economics and Arab Scholars: The Great Gap Thesis Reconsidered" (Ghazanfar, S.M. (ed.), 2003, *Medieval Islamic Economic Thought*, London and New York, RoutledgeCurzon, p. 19, footnote 1).
29. Schumpeter, *The History of Economic Analysis*, *op. cit*., p.72.
30. Viner, *Religious thought and Economic Society*, *op. cit*., p. 48
31. Greek philosophy was known to Christian scholars in their early period also. It never died fully among them. Even some translations were made directly from Greek to Latin. The reader may refer to Gordon (Gordon, Barry, 1975, *Economic Analysis Before Adam Smith*, New York, Barnes and Noble. pp. 82-110) to see how Christian fathers reacted to Greek ideas in early centuries. It was totally different from what they did after discovering it with Muslim commentaries.
32. Schumpeter (1997) has mentioned role of Muslim scholars in his encyclopedic work *History of Economic Analysis* at the margin only. See pp. 87-88 footnote.
33. Schumpeter, *The History of Economic Analysis*, *op. cit*., p. 87
34. ibid., p. 88
35. ibid.

36. As Muslim scholars based their ideas on both revealed knowledge and human reason, they were more suited to scholastic scholars. So they benefited from them to a greater extent which is clear from the gap which is found between their voluminous body of thought on economic issues and almost no contribution of their predecessors who could not have access to Arabian sources.

37. Pribram, Karl, 1983, *A History of Economic Reasoning*, Baltimore and Lord, The Johns Hopkins University Press, p. 4.

38. ibid., p. 2.

39. For Scholastics' consideration refer to Viner, *Religious thought and Economic Society*, op.cit. pp: 50, 51.

40. Ibn al-Qayyim, *Zad al-Ma`ad*, Cairo: al-Matba`ah al-Misriyah, n.d., p. 15.

41. Ibn al-Qayyim (1955) *I`lam al-Muwaqqi`in*, Cairo, Maktabah al-Sa`adah Vol. 3, p. l71.

42. Ibn Qayyim (1953) *al-Turuq al-Hukmiyyah*, Cairo: Matba`ah al-Sunnah al-Muhammadiyyah, pp: 245-46, 254-60.

43. For details refer to Ghazanfar, S.M., and Islahi, Abdul Azim (1998), *Economic Thought of al- Ghazali*, Jeddah, Scientific Publishing Centre, KAAU., p. 47.

44. For a detailed analysis of Ibn Taimiyah's views in this regard, see A.A. Islahi, *Economic Concepts of Ibn Taimiyah*, Islamic Foundation, Leicester, 1988. pp. 88-102. Also see Islahi, "Ibn Taimiyah's Concept of Market Mechanism," *Journal of Research in Islamic Economics*, **2**(2), Winter 1405 / 1985; pp: 55-56.

45. St Thamas Aquinas is called the prince of the Scholastics (Haney, L.H., 1949, *History of Economic Thought*, New York: Macmillan, 4th ed. p. 98) whose thought influenced an epoch (Gray, A. and Thompson, A., 1980, *The Development of Economic Doctrine*, New York: Longman, 2nd ed., p. 30)."The teaching of Aquinas upon economic affairs remained the groundwork of all the later writers until the end of the fifteenth century. His opinions on various points were amplified and explained by later authors in more detail than he himself employed" O'Brien, George, 1920, *An Essay on Medieval Economic Teaching*, London, Longman. Reprint 1967. p. 18.

46. Aquinas, Thomas (1947) *Summa* Theologica, New York, Benziger Brothers, II:II Q77 and Q78)

47. Al-Ghazali, al-Ghazali, Abu Hamid (n.d.), *Ihya Ulum al-Din*, Beirut, Dar al Nadwah, vol. 2, pp: 62-80.

48. Harris write: "Without the influence of Arabian Peripateticism, the theology of Aquinas is as unthinkable as his philosophy" (Harris, C.R.S. (1959) Duns

Scotus, 2 Vols. The Humanities Press, New York, p. 40). Ghazarfar has documented statements of many scholars who admit influence of al-Ghazali on St. Thomas Aquinas. He has also tried to trace parallels and linkages between St. Thomas Aquinas and Abu Hamid al-Ghazali, and has shown how former's *Summa* and latters *Ihya* have parallel commentaries on compatible economic topics. (Ghazanfar, 2003, *op. cit.* pp: 193-203).

49. O'Brien, *op. cit*., p. 175
50. Langholm, Odd (1987) "Scholastic Economics", in Lowry, S. Todd (ed.), *Pre-Classical Economic Thought*, Boston, Kluwer Academic Publishers, p. 132
51. Langholm, Odd, 1998, *The Legacy of Scholasticism in Economic Thoug*ht, Cambridge, Cambridge University Press. p. 59.
52. c.f. The Qur'an 2:279
53. al-Bukhari (1987) al-Bukhari (1987) al-Jami` al-Sahih, Cairo: Dar Al-Sha`b, vol. 1, p. 124
54. Ibn Rushd (1975) *Bidayat al-Mujtahid wa Nihayat al-Muqtasid*, Egypt: Mustafa al-Babi al-Halabi Press, vol. 2, p. 144.
55. O'Brien, *op. cit*., p.119
56. Abu Dawud, *op. cit*., Vol. 3, p. 255.
57. al-Bayhaqi, Abu Bakr Ahmad (1999) *al-Sunan al-Kubra*, Beirut: Dar al-Kutub al-`Ilmiyah, vol. 5, p. 541.
58. Langholm (1998) *op. cit*., p. 77
59. O'Brien, *op. cit*., p. 120
60. Viner, *Religious thought and Economic Society, op. cit*. 35.
61. Gray, A. and Thompson, A. (1980) The Development of Economic Doctrine, New York: Longman, 2nd ed. P. 47
62. de Roover, Raymond (1965) "The Origin of Trade" in: *Cambridge Economic History of Europe*, Cambridge: Cambridge University Press, vol. 3, pp: 49-50.
63. O'Brien, *op. cit*., p. 208
64. al-Sindi, Nur al-Din (1986) *Hashiyat al-Sindi `ala al-Nisai*, edited by Abd al-Fattah Abu Ghuddah, Aleppo: Maktab al-Matbu`at al-Islamiyah, vol. 7, p. 255.
65. Chapra, Mohammad Umer (2009) "The Global Financial Crisis: Can Islamic Finance Help?" in: *Issues in the International Financial Crisis from an Islamic Perspective*, Prepared by: Group of Researchers, Islamic Economic Research Center, Jeddah, King Abdulaziz University, p. 38
66. For details see Islahi, Abdul Azim (1988) *Economic Concepts of Ibn Taimiyah*, Leicester, The Islamic Foundation. pp: 76-80

67. Langholm (1987) *op. cit*., p. 117.
68. al-Maqdisi, Ibn Qudamah, Abd al-Rahman (1972) *al-Sharh al-Kabir* (Printed at the foot of *al-Mughni* by Ibn Qudamah), Beirut: Dar al-Kitab al-Arabi, Vol. 4, pp: 44-45).
69. Ibn Taymiyah (1976) *al-Hisbah fi'l-Islam*, Cairo, Dar al-Sha'b. pp. 24-6).
70. Gordon, *op. cit*., pp: 219-20
71. al-Sana`ani, Abd al-Razzaq (1403H) *Musannaf Abd al-Razzaq*, Beirut: al-Maktab al-Islami, 8: 204.
72. Gordon, *op. cit*., p. 220.
73. Ibn Taymiyah, *op. cit*., pp. 25-26.
74. al-Tirmidhi, Abu Isa (1976) *al-Jami` al-Sahih*, Egypt, Mustafa al-Babi al-Halabi, Vol. 3, pp. 653, 655.
75. Gordon, *op. cit*., p. 182.
76. For Oresme's thought on money see Monroe, A. E. (1965), *Early Economic Thought*, Cambridge, Harvard University Press, pp. 81-102.
77. Qudamah ibn Jafar (1981) *al-Kharaj wa Sina`at al-Kitabah*, Baghdad, Dar al-Rashid, p. 434.
78. Ibn Miskawaih (1964) *Risalah fi Mahiyat al-`Adl*, edited and translated by M. S. Khan, Leiden, Brill, p. 29; idem. (n.d.) *Tahdhib al-Akhlaq*, Cairo, al-Matba`ah al-Misriyyah, p. 110.
79. al-Ghazali, Abu Hamid (n.d.) *Ihya Ulum al-Din*, Beirut, Dar al Nadwah, Vol. 2, pp. 73, 92; Vol. 4, pp: 114-115.
80. al-Dimashqi (1977) *al-Isharah ila Mahasin al-Tijarah*, edited by al-Shorabji, Cairo, Maktabah al-Kulliyyat al-Azhariyyah, p. 21.
81. Ibn Taymiyah (1963) Majmu` Fatawa Shaykh al-Islam Ahmad Ibn Taymiyah, Riyadh, al-Riyad Press, Vol. 29, pp. 469, 472. It may be noted that Ibn Taymiyah does not think that money must be gold or silver; it is a matter of convention, so other material can also be used as money provided it has general acceptance (ibid., Vol. 19, pp. 250, 251, 248-249).
82. al-Maqrizi (1994) has extensively discussed the monetary issues in his work *Ighathat al-Ummah*, translated and edited by Adel Allouche as *Mamluk Economics*, Salt Lake City, University of Utah Press.

الروابط وأوجه الشبه بين الأفكار الاقتصادية للعلماء المسلمين والمدرسين المسيحيين

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المستخلص. تحاول هذه الورقة مناقشة أوجه التشابه والتواصل بين الأفكار الاقتصادية للعلماء المسلمين والمدرسيين المسيحيين، وتهدف الى معرفة الأرضية المشتركة بينهما في مجال تاريخ الفكر الاقتصادي.

يتوقع الباحث أنه ومن خلال تحديد التشابه ومعرفة الأرضية المشتركة فإنه يمكننا فهم تقاليدنا الصحيحة وتعزيز التعاون فيما بيننا وتقوية أواصر شراكتنا.

تبدأ الورقة ببيان الوضع الذي نشأ فيه المتكلمون المسلمون والمدرسيون الأوربيون، والأسس التي بنى عليها الاثنان الروابط التي من خلالها تم تقاربهما (من بعضهما البعض) ويقدم الباحث عددًا من الحالات التي كانت فيها وجهات نظرهما متماثلة.

تختتم الورقة نقاشها بملاحظة أن الأخلاق والقيم الإنسانية حظيت باهتمام بالغ عند كل من المدرسيين والعلماء المسلمين. وتبين أنه على الرغم من التغير الهائل في المبادئ والممارسات الاقتصادية فإن هذا القلق للبشرية لم يتغير.

يختتم الباحث ورقته بالتأكيد على أهمية تطبيق ودمج القيم بعلم الاقتصاد مما سيضيف إلى تنامي الكفاءة والعدل والاستقرار.

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Adapting the Demands of the Islamic Moral Order to Project Finance: Prospects for French Law in Connection with an Istisna'a-Ijara(1) Structure

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Introduction

Central Objective of this Study

1. Why utilize project finance? At first glance, it would appear that project finance is consistent with the objectives of Islamic finance. Without going into too much detail about the requirements of Islamic Contract Law–which we will do later in this study–we will succinctly describe the common features of project finance and Islamic finance.

2. Typically in project finance, financial partners form a project company in which the capital is invested and their compensation is a function of how successful the investment project is. Any loans necessary for such funding will be taken out by a special-purpose vehicle(3) (SPV) and are paid back from operating income from the project.
3. As we will see, Islamic Law prohibits the charging or paying of interest, regardless of whether it is usury or not. The charging of a fixed fee that solely is a function of the passage of time and unrelated

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(3) Report from Group of Banks and Financial Institutions that are members of the Insitut de gestion délégué: "*Le financement des PPP en France*," I.G.D., October 1986, pp.20-21.

to the actual profitability of the underlying investment project, goes against Islamic moral principles but it is regarded as unfair.

4. However, the Qur'an does not prohibit the payment of remuneration on money loaned; it only bans the charging of a fixed predetermined interest. That is why financing transactions cannot, in theory, include any fixed remuneration. Only the profits derived from the asset financed can be used to remunerate the money invested. Yet, in project finance transactions, debt servicing relies primarily on future cash flows generated from the project. From this standpoint, debt servicing, unforeseen events, the ability to cover operating costs and a fair rate of return on capital all depend on the profitability of the asset financed(4).

5. Likewise, the Islamic Business Law requires that financial transactions be asset-backed (by a tangible asset) in order share the resulting losses and profits (PLS). So, Islamic banks will give the funds to a businessman and the profits will be shared on a prearranged basis. In project finance, the investment project is necessarily a tangible asset (*i.e.*, airport, electrical power plant, nuclear power plant, desalination plant, university, plant, etc.) and the lenders share the risks along the project developers: the repayment of the loan made to fund the construction of the project depends primarily on cash flows from the project (non-recourse financing). Therefore, there is an underlying asset and a sharing of risks.

6. Furthermore, Qur'anic Law does not allow speculation and risky or hazardous sales (gharar). Gharar is the as a sale of assets "*for which it is not known whether they exist or not, given the risk involved in such probability and which subjects the validity of the transaction to conjecture*.(5)" Qimaars and maysirs are forms of aleatory contracts, such as speculation, standard insurance policies and derivative products. Yet in project finance, each project for new infrastructure requirements huge investments and loans. As a consequent, only an exhaustive analysis of the technical and contractual risks–with a matrix

(4) Sarmet, Marcel, « *Gestion et techniques bancaires*, » RB, no. 392, February 1980.

(5) Karich, Imane (2002) *Le système financier islamique. De la Religion à la Banque*, Larcier, coll. Cahiers financiers, p. 44.

identifying and sharing them–can help optimize the financing terms, i.e. to reduce the cost of the debt, and to eliminate chance which is prohibited under Qur'anic Law.

7. Finally, according to the fundamental tenants of Shari'a Law, the investment project must be legal (halal). Traditionally, some business sectors are excluded. The project must also contribute to social and economic development and play a role in creating jobs. This is hardly ever an issue to the extent that most investment projects are by nature eligible (hospital, airport, nuclear power plant, plant, etc.) for Islamic financing and, because of their size, result in significant economic activity. So project finance fully complies with these requirements.

8. As indicated, the very concept of project finance appears to be consistent with Islamic finance that subjects financing deals to moral, ethical and economic constraints based on Shari'a Law and requires special contractual arrangements. The premises of this study and the contract model test that we propose are based on these focal points.

9. Moreover, given the multiple sources of potential conflict that are associated with it, project finance does not imply that precedents will give rise to the same outcomes. While there is indeed some reliability, there is not however, in theory, a predetermined and efficient method to address the complexity of the topic. Yet, because of its very complexity, project finance offers a very broad field of investigation and shines light on the large number of constraints arising from Islamic moral order. Because it is intricate, project finance combines more moral and business considerations than another form of financing.

10. The syndicated Islamic finance that we call project co-financing refers to the participation of a group of financial institutions in a joint financing deal Shari'a complaint. Islamic banks and the conventional counterparties finance together a project, one or more of the component parts of which are financed by Islamic financing provided that the project observes Shari'a Law in all respects.

11. The primary goal of this study is to analyze the adaptability of the demands of the Islamic moral order to project co-financing transactions under French Law. In other words, the contractual arrangements must

comply with French banking regulations and be consistent with the demands of the Islamic moral order. To this end, this study proposes a model that provides appropriate solutions in French Law that reconcile these conflicting interests.

12. But what does the term Islamic moral order mean? In a broad sense, in Islamic finance law, which has varied sources and schools, there are seven imperative principles: four negative principles (prohibition of *riba*, *gharar*, haram, indebtedness above a certain percentage) and three positive principles (profit and loss sharing, existence of an underlying asset and payment of a *zakāt*). If these principles are observed, it is possible to infer a religious moral order that has as an effect to guarantee a fair contractual balance by subjecting an Islamic contractor to a number of requirements. But this moral order is weighty, as remarked one author, it is not easy to "*break through the wall of a religious moral order built for over a thousand years*"(6) due to the fact that "*the religious moral order that serves as a backdrop to Islamic Law plays a compelling role in contractual activity and in business in general*."(7) The author continues: "*A contract under Islamic Law is an instrument for specific purposes defined by law and which is the equality or the equivalency of reciprocal services. This idea of quid pro quo and fair balance is a moral idea that underlies the entire general theory of Islamic Contract Law and even goes beyond the contractual event since it has as a consequence to restrict the will and freedom to form a contract*."(8)

13. It is of note, therefore, that the paradigms of Islamic finance are based on the principle of the authority of religious rule–Islamic Law is theocratic–and no one can modify the rudiments. The expression of commutative justice, principles of equality and balance in reciprocal services and fair profit refer to a moral system that protects the contractor. These principles, justified by moral rationale, are organized. Order here refers to an organization of a community of individuals

(6) Comar-Obeid (1995) Nayla, *Les contrats en droit musulman des affaires*, Économica, p. 2.
(7) Comar-Obeid, Nayla, *op. cit.*, p. 2.
(8) Comar-Obeid, Nayla, *op. cit.*, p. 5.

(ummah[9]) who share the same norms dictated by the Islamic values that they mean to abide by and make sure they are abided by. This body of rules carries great constraints that must be taken into consideration in financial arrangements. However, the challenge that they bring is less their existence than their dosage. These obligations carry more or less weight depending on their place in the hierarchy of legal norms. For example, a Qur'anic rule such as the prohibition of *riba* has special legal force that is more authoritative than the prescriptions contained in the Sunna, which itself is more authoritative than the *ijmā* or *urf* rules. But, while they apply, they still run counter to classic project finance techniques that sometimes offer tools to satisfy them. However, this often requires using special arrangements that combine several techniques designed to achieve a stated goal while addressing the existing constraints. That is the subject of this study.

14. After a rapid assessment, we see that Islamic finance law is based on a moral order that it is designed to serve. Such that ethical injunctions hit legal rules broadside therefore dictate special structuring of international financial transactions so as to adapt moral rules to conventional contractual arrangements.

15. This analysis shows fairly clearly the complex nature of project co-financing transactions where conventional finance and Islamic finance have to fall into line. As we will see, the distinctiveness of Islamic finance and the strength of its moral rules make for special challenges of putting together a financing deal. This study, which is intended to highlight the challenges of reconciling the conflicting interests of parties, provides an inventory of the challenges of structuring a deal. On the other hand, regardless of the challenges associated with these rules, these tensions are not insurmountable, although they require a certain degree of sophistication.

(9) Arabic word meaning the community of Muslim believers or the world Muslim community.

Benefits and Objectives of this Study

16. What is the relevance of such a study? In a world where there is growing globalization and increasing competition between the global financial centers, a study of the relationship between French Law and Islamic Contract Law has a two-fold benefit. Firstly, an academic benefit in that is related to the emerging faith-based concept in banking law and financial markets and of which Islamic finance is certainly the most significant illustration. What is it? The faith-based concept "*should not be confused with recognizing in France instruments and contracts executed pursuant to and by virtue of the laws of a foreign jurisdiction that has religious law. These are not, either, contracts containing a foreign element governed, under the parties' agreement, by state or non-state religious laws. These are financial instruments governed by French Law but that comply with religious law*."(10) To the best of our knowledge, not much research has focused narrowly on a study of Islamic Shari'a compliant project co-financing in French Law. The work by the Paris-Europlace Islamic Finance Commission, the whitepapers of a number of law firms and the perspective of certain specialists(11) provided us with invaluable insight.

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(10) Le Dolley, Erik (2010) *Les concepts émergents en droit des affaires*, L.G.D.J, Coll. Droit et Économie, p. 163.

(11) Mcmillen J.T. (2001) "Islamic Chari'ah Compliant Project Financing. Collateral Security and Financing Structure Cases Studies," *Fordham International Law Journal*, volume 48, May 2001; Grangereau, Pascal and Haroun, Medhi, «Financements de projets et financements islamiques. Quelques réflexions prospectives pour des financements en pays de droit civil », *Banque et droit* n° 97, September-October 2004, pp. 52-61; Grangereau, Pascal and Haroun, Medhi, «Banques islamiques: la problématique de la mise en place de cofinancements », *RB* n° 657, April 2004, pp. 56-60; Boureghda, Maya and Hamra-Krouha, Mohamed, «Problématiques pratiques des financements de projet islamiques », *RB*, n° 253, December 2007; Boureghda, Maya, « Les structures contractuelles islamiques dans les financements de projet » in Jean-Paul Laramée [dir.], *La finance islamique à la française. Un moteur pour l'économie. Une alternative éthique*, Édition Secure Finance, 2008, Chapter 5; Bourabiat, Foued, « Tifert: acid test for Islamic and conventionnally-financed projects in North Africa », *Infrastructure Journal*, September 2009, pp. 1-6; available on: www.ijonline.com; Bertran de Balanda, Jacques and Bourabiat, Foued, « Financements de projets intégrant une tranche islamique: expérience vécue au Maghreb », Herbert Smith LLP, African Islamic Finance Forum, April 7-8, 2010, Casablanca.

17. As is the case with any objective analysis, the focus of our investigation is to explore in depth a field of knowledge, namely by examining Islamic financial contracts and the Islamic moral order that they are based on. Islamic finance is an ethical form of finance, which means that it asks what to do in a given situation. Yet, only this detailed study can help surpass the challenges of putting together a financing deal: some are inherent in project finance while others stem from the interventionist nature of a moral order that sometimes tends to be constrictive.

18. Secondly, this study presents a practical benefit, which is of the same essence as the first benefit, namely to identify, through a contractual approach, the constraints of project finance in order to propose a legal structure that is consistent with the requirements of the Islamic moral order. Up until now, recommendations have come from parliaments or professional organizations. Our approach, therefore, is not unbiased and isolated. So, it is worth noting that are early as January 2009, a commission was set up by Paris-Europlace to identify the legal and tax obstacles (when Islamic finance is received in France) and the panel proposed to make a number of minor amendments to certain sections of our civil code which gave rise to a number of conformist objections from conservative-minded individuals. From this perspective, our research could shed light on the subject in a way that may be helpful to lawmakers. We believe that there is therefore a clear benefit in taking part in a project focusing on this financial center; the benefit becomes even clearer in light of the financial crisis and efforts to move away from oil dependent economy.

19. Other arguments are also extremely convincing. The flow of capital from the Gulf countries clearly constitutes a competitive advantage for France. Recently, the Islamic Development Bank (IDB) nearly doubled its infrastructure financing to help member countries prepare themselves for the post-crisis world, as stated in the Message from the President, Mr. Ahmed Mohamed Ali, in the 1430H[(12)] (2009[13]) annual report. In 1430 H, the IDB Group approved some 457 project

(12) The letter H refers to the Islamic calendar.
(13) The date in parentheses refers to the Gregorian calendar.

financing transactions[14] for a total of DI4,720 million DI (Islamic dinars) or a $7,253.8 million.

20. The IDB provided DI1,816 million, or $2,805 million in finance for development of transportation, production, electricity generation and transmission, water and sanitation infrastructure and other sectors including Industry[15]. According to the aforementioned report, "*Due to the increased focus on developing infrastructure to help accelerate member countries' economic development and make them more attractive to foreign investors, the Bank's financing for infrastructure in 1430H (2009) was 300 percent more than the ID635 million ($931 million) financed in 1427H (2006)*."[16]

21. When one examines the regional breakdown and the type of financing, it appears that majority of the financing was invested in Asia (Indonesia, Bangladesh, Iran), followed by the CIS[17] and Europe (28%), the Middle East (19%), North Africa (13%), East Africa, Southern Africa and Central Africa (3%). Clearly, Islamic financiers are interested in taking part in project financing in Europe alongside traditional investors such as the European Development Bank (EDB).

22. According to IDB estimates[18], the Islamic co-financing volume rose from $19.6 billion in 1428H (2007) to $27.2 billion in 1429H (2008), which amounts to a 32% increase in the words of the Islamic banking institution: "*The European Investment Bank may be considered as one of IDB's earliest co-financing partners, given that it co-financed IDB's very first transaction, Cameroun's Song-Loulou hydropower scheme, which was approved in 1396H (1976). Since then, cooperation has increased steadily, rising sharply in the past five years. Together, IDB and the European Investment Bank have supported 24 projects worth around $11 billion in 12 countries in Africa and Asia, and*

(14) The Islamic Development Bank's (2009) Annual Report, p. 2.
(15) Energies & IT (40%), Transportation (33%) Urban Development and Services (16%), Others (11%).
(16) The Islamic Development Bank's (2009) Annual Report, p. 41.
(17) The Commonwealth of Independent States (CIS) is a regional organization whose participating countries are 11 out of the 15 former Soviet Republics.
(18) The Islamic Development Bank's (2009) Annual Report, p. 57.

provided $1,145 million and $2,169 million, respectively. Clearly demonstrating a revitalized cooperation, as indicated above, more than 70 percent of co-financing volume was actually registered during the six-year period 1425-1430H (2004-2009) alone."[19]

23. In 2009, the *istisna'a* (construction financing) was the most commonly used forms of contract for project finance in IDB member countries (57%), 19% of transactions were financed using *ijara* agreements (lease-purchase agreement) and 13% using *murabaha* contracts (form of trust sale). *Mudarabah* and *musharakah* equity financing accounted for 5% of the total amount of financing approved. These contracts are most often used to finance Islamic projects and we will see how they can be structured in French Law.

24. After an in-depth examination of project finance and in consideration of experiments carried out by professionals in various places throughout the world, we will now endeavor focus on contrasted figures, their players, in order to identify the challenges of structuring a deal. So, we will try to derive a model, however imperfect, or guidelines to use a term used by practitioners. This is a tall order: a map is not a territory, a flag is not a county, the concept of a dog does not bark, as it was written[20].

25. The investigation will thus concentrate on the possibilities offered by French Law, even if it has to be brought up-to-date, to implement Islamic project finance contractual arrangements. Inventiveness, adaptability and pragmatism–these will guide our reflections. Here, "*a pure contractual imagination*"[21] will be used but isn't that the main purpose of the exercise as it has been suggested: *For a lawyer, project finance is nothing more than a contractual issue. The drafting of the clauses is dictated certainly by financial imperatives but they are not the result of a specific type of contract or a (national or international) standard. It*

(19) The Islamic Development Bank's (2009) Annual Report, p. 72.

(20) « *La constellation du Chien n'aboie pas.* » Spinoza, *Éthique*, I, scolie de la proposition 16.

(21) *Droit financier*, Précis Dalloz, 1e éd., juin 2008, a book containing a collection of articles edited by Professors Alain Couret and Hervé Le Nabasque, p. 1028.

is necessary for legal practitioners to use their full imagination; this assumes that they are truly competent because, until now, project finance has always triggered tensions and conflicts between different legal systems. The major consequence of this is the extreme heterogeneity of the types of contracts used."(22) And it can be added that with respect to co-financing, this is even more the case.

Research Questions

26. In attempting to get as a clear a sense as possible of reality, we need to explore the impact of applying Islamic moral order to co-financing. How can structures be adapted to this new environment? How can ethical injunctions be incorporated into an autonomous set of norms? What are the means of this acculturation? What are the binding obligations between conventional and Islamic financiers?

27. All these questions must be borne in mind while avoiding any certainties. We will see that a modification of legal rules in no way leads to an upheaval of conventional rules and the elasticity of French Law offers a flexibility that makes it possible to provide appropriate solutions to the necessary reconciling of conflicting interests. So, there is hope that the arrangements proposed will create a favorable ground for the development of multi-source financing, of which, it should be recalled, there are no examples currently in France.

Research Methodology

28. The significance of the expansion of Islamic finance in the global marketplace and the great interest that professionals are showing for it has lead us to examine its role in France in connection with project co-financing operations. From the analysis of the stakes associated with it to the need to introduce an appropriate legal framework, the challenge for France is about being a competitive global financial center. First of all, we should highlight an important point related to our method in this research. For the sake of avoiding any risk in this sort of challenge, we intend to limit our analysis to that of a French lawyer and therefore our

(22) *Droit financier, op.cit,* p. 1028.

reflection rejects any pretention to religious analysis of the subject of the study. Thus, we cannot substitute for a sharia scholar, which has exclusive competence over the subject. Although normative references are sometimes identical, the analysis approaches are necessarily different. In this sense, the method retained here, is that of faith-based, which involves the analysis of financial instruments subject to French Law, while complying with religious law. The study of this topic utilizes a two-pronged approach. The first approach is dynamic in that it requires examining the flexibility of French Law when the Islamic moral order is applied to it. The second approach is static because the research is on contractual solutions in project finance that one has to have a clear idea of. This is necessary for the reader to have the means to understand the higher ambitions of Islamic finance. This is often at the expense of the paradox between, on the one hand, absolute contractual freedom and, on the other hand, a constrictive moral order.

Definition of Co-financing

28. Coming up with a definition of Islamic project finance may seem like an ambitious challenge because, as it is understood from the standpoint of French Law, it is, we believe, the result of a double legal acculturation. The concept of legal acculturation can be defined as "*the overall transformation that a legal system undergoes when it is exposed to another legal system–a process that involves implementing binding means varying in nature and degree and that address certain needs of the society that undergoes it*" [(23)].

29. So a first legal acculturation in the French legal system is the Anglo-American concept of project finance[(24)] and a second acculturation the French legal system experienced is the demands of the Islamic moral order. Islamic project co-financing is at the confluence of three different legal cultures: the Common Law, Civil Law and Qur'anic Law systems. If we were to try to theorize this transmutation, we would run

(23) Rouland, Norbert (2005) *L'anthropologie juridique*, 2e éd., Paris, PUF, Que sais-je ?.

(24) Dont la traduction française de (2006) « Financement sur projet », que nous utilisons dans l'ensemble de notre étude, est empruntée à Michel Lyonnet du Moutier dans son ouvrage *Financement sur projet et partenariats public-privé*, éd. Ems.

the risk of devalue the concepts. Even so, we propose the following definition: Islamic project co-financing is a financial arrangement used to undertake major public and private infrastructure initiatives and that is structured in two legally separate contractual components. These components represent a single economic entity, to wit conventional finance without recourse wherein a SPV, used for the construction and development of an investment project, takes on the debt and contracts are entered into finance a part of the project's assets, the title to which to temporarily transferred to Islamic financiers. These two contractual components, to a greater or lesser extent dependent on each other, combine to form a relatively stable whole.

30. Understood in this way, Islamic project co-financing implies a particular organization of various types of contractual arrangements under domestic law so that they are Shari'a compliant. The process of structuring co-financing is fraught with a permanent tension between these two and the challenge is to create between the parties, through financing contracts with varying degrees of complexity, the terms of a partnership revolving around an investment project.

31. How can one make sure that the precepts of the Islamic moral order and French Law coexist smoothly in a project co-financing deal where the former must necessary pledge allegiance to the latter without being altered by them? In terms of how it is structured, we have seen that co-financing is based on two legally separate components. These components represent a single economic entity, to wit conventional finance without recourse wherein a SPV, used for the construction and development of an investment project, takes on the debt and contracts are entered into finance a part of the project's assets, the title to which to temporarily transferred to Islamic financiers who own the SPV. Here, we will focus our analysis on the structuring of the Islamic financing tranche. This engineering plays out in two stages corresponding to the two project finance phases: the construction and development of the underlying asset. Even though the ability to imagine contractual arrangements may be unlimited, we have elected to focus our analysis primarily on *istisna'a-ijara* (construction financing and lease-to-own) structures, which, we believe offer the flexibility to overcome the

challenges and constraints referred to above and highlight the potentials of Islamic finance.

32. From a practical standpoint, we will see how a model of the Islamic tranche can be built based on a sale for future delivery and a lease-purchase agreement. Firstly, via a SPV, the Islamic bank will make payments to the project company so that it can build Islamic assets(25). Once the construction has been completed, the project company transfers title to an Islamic SPV(26). Next, a lease-purchase agreement is entered into and pursuant to which the Islamic SPV (in its capacity as the lessor) makes assets available to the project company (lessee), while at the same time pledging to transfer title after the lease period, in exchange for it making rent payments for the duration of the lease period.

33. The apparent likeness between *istisna'a-ijara* construction financing and lease-to-own arrangements, construction financing agreements and lease-purchase agreements must not serve to deny the difficulty of the exercise. In fact, there are many stumbling blocks because the diversity of schools of Islamic Law thought means that its norms cannot be standardized. So, conscience of these obstacles, our attempt at building a model does not purport to put an end to the debate by proposing turnkey solutions but rather to stimulate debate by raising issues that have not hitherto been discussed.

These models of contracts will cover successively the construction period (I) and the operation of the completed project of investment (II).

(25) In the project, assets will be identified as being Shari'a compliant (example: "lots" 6, 7, 8 and 9 of a project) that will be referred to as the "Project's Islamic Assets".

(26) The Islamic SPV is owned by the Islamic investors who cannot be directly or indirectly shareholders in the project company because of the substantial debt (generally over 33%).

I. Building a Model *Istisna'a* Agreement under French Law

Preliminarily, we will examine the similarities and differences between *istisna* and Sales of Property Not Yet Developed (VEFA) (A). The constraints on the operation through the respective obligations of the parties will be then identified (B), then we will also propose to overcome these constraints by presenting a contractual structure (C). Finally we will analyze the guaranties of the project (D), and the cases of contract termination (E, F).

A. Legal Nature: Similarities and Differences Between *Istisna'a* Agreements and Sales of Property Not Yet Developed

34. An ideal type of agreement for Islamic project finance, an *istisna'a* is similar to the sale of property that is not yet developed under French Law. After an analysis of this agreement, we will see how the sale of property that is not yet developed is a Shari'a compliant contract vehicle used Islamic financiers who own a SPV to finance the construction of what we will refer to here as "Islamic project assets."

35. If you look at its etymology, the word *istisna'a* comes from the word *sanaa*[(27)], which means literally "*to make or build something*."[(28)] *Istisna'a* agreements are commonly used in connection with finance projects in high-tech sectors such as naval aviation, air and space, airport and in real-estate development; they are also used in the financing of intangible assets such as electricity or gas[(29)]. Islamic lawyers define it as

(27) Ibn Manzur, Muhammad Ibn Mukarram, Lisan al-'Arab, Dar Sadir, Beirut, Lubnan, 1955, Vol. 8, pp. 208-212 in Ph.Muhammed Al-Bashir Muhammed Al-Amine dans Comar-Obeid, *op.cit.*, p. 34.

(28) Ibn Yacoub al-Fayrozabadi, al-Qamus al-Muhit, Mua'ssasat al-Risalah, Beirut, 1983, p. 54; also see: E. W. Lane's, Arabic English Lexicon, Islamic Book Centre, Lahore, Pakistan, 1982, Vol. 4, p. 1733 in Ph. Muhammed Al-Bashir Muhammed Al-Amine dans Comar-Obeid, *op.cit.*, p. 34.

(29) Habib Toujkani (Mohamed), « Les contrat Salam et Istisnâ'a: Les Sciences de la Chari'a pour les Économistes, les sources du *Fiqh*, ses principes et ses théories; le *Fiqh* des transactions financières et des sociétés; et son application contemporaine », proceedings from a seminar on "Sciences de la *Chari'a* pour les Économistes" held in Niamey, Niger, April 20-29, 1998, jointly by the Islamic Development Bank's Islamic Research and Training Institute, =

an agreement by which one party (*mustasni*) asks another party (*sani*) to carry out construction or manufacturing work on its behalf. In practice, the Islamic bank, as a profit-making business, will finance its client's purchase of movable or immovable property from a third party and the bank receives a service fee that includes the cost of construction and manufacturing plus a finance charge. Three parties are involved in the transaction: the initial client (the buyer), the Islamic bank (the seller) and the developer.

36. Among the various *Fiqh* Schools of thought, there are differences in the nature of *istisna'a* agreements. The Milikites, *Shafi'i* and *Hanbali* believe this type of agreement is a derivative of *salam* sales. Islamic legal scholars from the *Hanafi* School see it as a pure *ijara* while others say it is an *ijara* at the beginning and a sale at the end of the agreement(30). It is therefore not easy to give an all-embracing approach.

37. To begin, we will present below the main differences between *istisna'a* agreements and *salam*, *ijara* and *mourabaha* agreements. We should point out at this point that *istisna'a* agreements have some points in common with *salam* agreements, in particular the fact that the thing being sold or the service to be provided in the future does not exist when the agreement is entered into. Still, there are ways in which they are different:

- *istisna'a* agreements must always involve a manufactured good unlike *salam* agreements that can pertain to any identifiable good;

- in *salam* agreements, the price must be paid in advance whereas in *istisna'a* agreements payment can be deferred or be made in several installments(31).

= Jeddah, Kingdom of Saudi Arabia and the Islamic University of Niger, Niamey, Niger, 1998, p. 219.

(30) Ibn al-Humam, Muhammad Ibn' Abd al-Wahid, Fath al-Qadir, Maktabat al-Rashidiyyah, Pakistan, 1985, Vol.2, p. 32 in Ph. Muhammed Al-Bashir Muhammed Al-Amine dans Comar-Obeid, *op.cit.*, p. 34.

(31) Al a' al-Din al-Samarkhandi, Tuhfat al-Fuqaha', Mat ba'at Jamiat Dimashq, Damascus, 1983, Vol. 2, p. 538 in Ph. Muhammed Al-Bashir Muhammed Al-Amine dans Comar-Obeid, *op. cit.*, p. 38.

38. It should also be noted that there is a significant difference between *istisna'a* agreements and *ijara* agreements: in the former, the manufacturer of the good has to use its own equipment; in the case where the client supplies the equipment and the labor, the transaction is an *ijara*. There are other differences too: *mourabaha* agreements pertain essentially to the sale of goods for a price that covers the purchase price plus a profit margin agreed to by both parties to the agreement(32) whereas the *istisna'a* is an agreement for some future thing to be built or manufactured. In other words, the thing does not exist when the parties enter into the agreement. Furthermore, in *mourabaha* agreements, for the transaction to be valid the Islamic bank must be in possession of the goods before transferring them to the buyer. During this time, the Islamic bank, as the owner, assumes the risk and peril of any damage or loss of the assets whereas in *istisna'a* agreements the good is only transferred once it is completed. Lastly, the main difference between these two types of agreements the thing that is sold undergoes a transformation: unlike the case of *mourabaha* agreements, the object of the transaction is the delivery and not the goods purchased in their state and condition, but rather finished products that has been through a process of transformation.

39. The result of practice, the source of this type of agreement is not in scriptural texts; it is the result of contractual freedom. There is no explicit text in the Qur'an and in the *Sunna* to establish its legality which is derived from other sources such as need and necessity, which calls for a preliminary remark. In this regard, Islamic legal scholars have differing opinions on whether agreements that are not regulated by law are lawful. The *Milikites*, *Shafi'i* and *Hanbali* claim that all agreements are considered prima facie as prohibited except those authorized by Shari'a Law. However, other legal practitioners, such as the *zahiri* are fairly liberal and accept the creation of new agreements that use craftiness (*qiyās*) and the public interest (*maslaha*).

(32) Haron, Sudin, *Islamic Banking Rules and Regulations*, Pelanduk Publications, Selangor, Malaysia, 1997, p. 75 in Ph. Muhammed Al-Bashir Muhammed Al-Amine dans Comar-Obeid, *op.cit.*, p. 39.

40. In support of their case, the opponents of contractual freedom cite a hadith in which the Prophet is believed to have said this: "*if some comes to an act that we have not commanded, then he will be rejected*." The proponents of contractual freedom in Islamic Law assert that individuals are free to define for themselves the terms of their own agreements. They contend that contractual freedom should be the rule and any restrictions, even minor, should be the exception. They base their argument on the following verses from the Qur'an:

"*O ye who believe! Fulfill the bonds. Lawful for you is the flesh of cattle, save what is mentioned to you, and unlawful hunted game when you are in the state of pilgrim sanctity. Assuredly, God decrees as He wills*."(33)

"*And why should you not eat of that over which God's Name has been pronounced, seeing that He has clearly spelled out to you what He has made unlawful to you unless you are constrained to it by dire necessity? But, indeed many people lead others astray, driven by their lusts and fancies without any knowledge. Indeed your Lord is He Who knows best those who exceed the bounds*."(34)

41. While Islamic legal scholars have attempted to establish the legality of this type of agreement by means of different legal sources, such as the Qur'an, the *Sunna*, the *Ijmā*, the *Qiyās*, the *Istihsan* and the *Maslaha* seem to us, however, to be the most significant legal basis. This is what the Islamic *Fiqh* Academy teaches. Along these lines, the scholar Al-*Kasani* declared:

"*Concerning the legality of istisna'a, in principle it would not be permitted on the basis of Qiyas because it is a sale of what we do not have nor on the basis of Salam and the Prophet had prohibited the sale of what we do not have ... and it is allowed based on Istihsan because people are unanimous about its need. They have used it through the ages and the Prophet has said "My community shall never agree on an error" and "What is good for Muslims is good in the sight of Allah*."

(33) Qur'an, chapter 5, verse 1.
(34) Qur'an, chapter 6, verse 119.

42. Some have also asserted, in particular the *Hanafi* School, that this agreement is based on the *Ijmā* which refers ideally to the consensus of the scholars of Islam on a legal issue. With respect to the basis of the *istisna'a* by virtue of the public interest (*maslaha*), Al-Ashgar considered that "*the use of this agreement, for example, in the construction of buildings, shoes, furniture and other elements, with no objection by researchers, is a matter of general necessity. Consequently, it is lawful when it is based on the public interest*."(35)

43. Under French Law, the *istisna'a* is similar to a business agreement pursuant to which one party (*moustasni*) asks another party (*sani*) to make or build something for a price payable in advance, in installments or over time. In an *istisna'a* sale, the client asks a developer to build a specific building for it or on behalf of a third party. The fundamental point of this agreement, from the standpoint of Qur'anic Law, is that it relates to a future thing and moral order which seeks to protect the contractor prohibits the sale of a thing that one does now possess (hadith prohibiting the sale of fruits still on the tree or a calf still in the cow's stomach). The *istisna'a* is however permitted by Islamic exegetists some of whom take that the divine principle "Do not sell what is not with you" to mean that selling what one does not own is prohibited (the tabi'a ma lais 'indaka) at the time of the sale(36). Other jurists maintain that this hadith applies only to the sale of a personalized object *'al'ayn*) and not to freely exchangeable products like those that are easy replaced.

44. Our research found that an *istisna'a* cannot pertain to natural products such as fruits, vegetables and grains. These products must, we believe, exist when the agreement is entered into. However, there is an exception in the case of industry. Industrially manufactured products (frozen or processed) are not subject to this prohibition(37). As we indicated, an *istisna'a* customarily pertains to the construction of

(35) Habib Toujkani, *op.cit*, p. 222.

(36) Muhammad Ibn Isma'il al-San'ani, Subul al-Salam Sharh Bulugh al-Maram, al-Maktabah al-Tijariyyah, Le Caire, Vol. 3, p. 17 in Ph. Muhammed Al-Bashir Muhammed Al-Amine in Comar-Obeid, *op.cit*., p. 39.

(37) Habib Toujkani, *op.cit*., p. 220.

physical infrastructure (power plants, production facilities, etc.) or movable infrastructures (cars, aircrafts, trains, ships, etc.). That is why is frequently used in project finance in Islamic countries.

B. The Obligations of the Parties

45. The respective obligations of the parties are the construction of infrastructure or the performance of work by one party in exchange for remuneration that the other party agrees to pay it. By the end of the term set forth in the agreement, the manufacturer or contractor must deliver the product free of any defects and the buyer is required to pay it the amount of the price. However, it is not mandatory that for goods to have been made by the manufacturer itself. It can be made by a third party(38) provided that the goods meet all the contractual specifications. To this end, the goods must be precisely specified in terms of quality and quantity. The sale price and the date and place of delivery must be specified in advance.

46. Classical *Hanafi* legal scholars generally divide the obligatory effect of the *istisna'a* into three phases. In the first phase, the construction work has not yet begun and *Hanafi* legal scholars are unanimous in saying that the agreement is not binding (*lazim*) and the developer can choose not to build the building. The two parties to the agreement are therefore discharged of their respective obligations. In the second phase, the manufacturer has completed manufacturing the good, but the good has not yet been delivered. The manufacturer still has the right at that point, we believe, to sell it to another party. In the third and last phase, the building has been completed and delivered to the buyer. In this case, there are differing opinions among Hanafi legal scholars about whether the buyer has the right to refuse to take the building.(39)

(38) Which cannot be the final intended owner of the goods to be manufactured or property to be developed.

(39) Ibn al-Humam, Fath al-Qadir, Vol.8, p.116; Al-Kasani, Badai' al-Sanai', Vol.6, p. 2680 in Ph. Muhammed Al- Bashir Muhammed Al-Amine dans Comar-Obeid, *op. cit.*, p. 40.

47. In business practice, such legal insecurity is an unacceptable situation and that is why it was finally accepted that *istisna'a* agreements have binding force once it is executed. In this sense, Islamic banks base themselves on Article 392 of Islamic jurisprudence (the *Majella* uniformed civil code) which holds that "*Once the istisna'a agreement is entered into, none of the parties to the agreement is entitled to breach it. If the product that is the subject of the agreement does not meet the desired criteria, the buyer has the right to choose between continuing or terminating the agreement*." Therefore, the buyer must pay the price of the thing and the manufacturer or the contractor must supply the product according to the requested criteria.

48. Still, if, once production has been completed, the buyer finds that the good does not meet any of the desired criteria, it has options(40). It can continue the agreement and, if it wants, demand a reduction in the price or it can terminate the agreement. The buyer is also entitled to continue or terminate the agreement if it finds a defect in the product making it unfit for its intended use.

49. In a manner analogous to French Law, professional sellers cannot absolve themselves of responsibility for defects in items sold making them unfit for their intended use. In fact, the obligation of the seller(41), who is assumed to be the manufacturer or the producer of the thing sold, is to supply a product free of defects and that meets standards.

C. Presentation of the Contractual Arrangement

50. In connection with co-financing, *istisna'a* agreements allow Islamic banks or Islamic financiers to advance the funds necessary for the construction of part of the investment project assets, *i.e.*, the Islamic project assets (IPA). To do this, the Islamic SPV will make phased payments to the project company so that it can build the Islamic assets. Once the construction of the Islamic assets has been completed, the project company transfers title thereto to the Islamic SPV, which then

(40) Habib Toujkani, *op.cit*, p. 222.
(41) Habib Toujkani, *op.cit.*, p. 222.

enters into lease-purchase agreement for their transaction. We will see below that *sukuk* bonds can also be issued as part of this.

51. In the financial analysis, there do not seem to be any obstacles to the acceptance of *istisna'a* agreements in French Law. Based on our research, it appears that an *istisna'a* can be structured, under French law, for sales of property to be developed. Through this agreement, the seller agrees to develop property by a given deadline and the sale can be done as a sale for future delivery or as a sale of property that is not yet developed. This sale must comply with the requirements under Sections 1601-1 et seq. of France's Civil Code as well as Sections L.2361-9 et seq. of France's Construction and Housing Code.

52. For sales for future delivery, an agreement is entered into whereby a seller agrees to deliver property once its development has been completed to a buyer who agrees to take delivery of the property and to pay the price on the delivery date. The title to the property is transferred automatically by virtue of a legal instrument entered into through a French *notaire* confirming completion of the development of the property; the legal instruction takes effective retroactively as of date of the sale(42).

53. For sales of property that is not yet developed, an agreement is entered into whereby a seller immediately transfers to a buyer its rights to the land and title to existing buildings. Any future buildings to be built will become the property of the buyer as they are built. The buyer is required to pay the price as the construction work progresses. The seller remains the project owner until the delivery of all property(43). Technically speaking, the seller (reservor) agrees to reserve or set aside for the buyer (reservee) property or part of some property of which the seller is required to specify the nature and state of the property and the deadline for delivery. In exchange, the buyer pays a sum of money that is deposited into a special account.

54. It is common, in practice, for Islamic bank to use a double *istisna'a* arrangement. First, the bank enters into an agreement with it client(s)

(42) Civil Code, Section 1601-2.
(43) Civil Code, Section 1601-3.

(the principals who are instructing the bank) whereby the bank agrees to deliver to them by a given date the property to be developed– the nature, price and payment terms are clearly defined. Then, subsequent to that, a contractor (in our case, it could be the project company) agrees, at the request of the bank, to develop the property in question on the terms and conditions agreed to in the agreement, making sure that the delivery dates are observed. So, there is no legal relationship between the Islamic buyers and the project company: as a financial intermediary, the bank is therefore liable, on the one hand, to the contractor, and on the other hand, to the final buyer, for each or their actions(44).

55. As the seller, the bank is required to give warranties with respect to the property not being occupied and not having any known or latent defect, imperfections or any other flaws. It must also, when necessary, provide an extrinsic guarantee (guarantee facility) or an intrinsic guarantee (funds) to reassure the buyer with regard to completion of the property development. Lastly, the bank is required to deliver the property by the deadline specified in the agreement. In the event of late performance or nonperformance of the agreement by the project company, the bank is ultimately liable.

56. However, given the difficulty of such an arrangement in French Law, it seems to us more reasonable to avoid any intermediation by having the Islamic financiers set up a French company (hereinafter the "SPV") that could in fact be a subsidiary of the Islamic bank. In this type of contractual arrangement, the Islamic SPV would contract directly with the project company both for the construction phased and during the lease period where it would be the lessee, subject to getting authorization from the French Ministry of the Economy, Finance and Industry.

D. Project Guarantees

57. As a business concern, the project company must provide a financial guarantee furnished by one or more banks, guaranteeing completion of the Islamic assets or repayment of all moneys paid by the Islamic

(44) Guéranger, *op. cit*, p. 123.

financiers. This guarantee comes at a considerable cost that is borne by the project company. Pursuant to the requirements of Section R.261-17 of France's Urban Development and Housing Code, the completion bond is a result of either conditions specific to the transaction or the involvement of a bank, a financial institution authorized to provided mortgage lending, an insurance company authorized for this purpose or a mutual guarantor company organized and existing pursuant to the requirements of Act, as amended, of March 13, 1917, that lends to small and medium sized businesses or to small and medium sized industries. In practice, either financing is made available (the institution advances the funds necessary to the seller or pays on its behalf moneys necessary for the completion of the property), or a completion bond (the guarantor makes a promise to the buyer, sharing joint and several liability with the seller, to pay the moneys necessary for the completion of the property development).

58. It should be noted that the guarantor is not required to continue to property development work until its completion. This is the bank's obligation alone as the project owner. The guarantor is only required to provide the financing necessary for completion of the property development. This guarantee benefits only the Islamic financiers as the buyers of the Islamic project assets and it can be enforced only to finance any remaining work to be done. It cannot be used to finance any repairs or defects; those are the responsibility of the project company as the contractor. Lastly, the guarantor cannot be held liable for any late delivery of the assets to the Islamic financiers.

59. Furthermore, it seems that the project company must provide proof of an extrinsic repayment guarantee to protect the Islamic financiers in case of a failure to complete the property development. This is a guarantee by which the guarantor promises, sharing joint and several liability with the seller, to pay back any moneys paid by the Islamic financiers in case of an amicable or court-ordered rescission of the sale as a result of a failure to complete the property development. Since the cost of this guarantee is substantial, we believe it is preferable for the project company to create the conditions necessary to ensure that the construction will be successfully completed by the agreed deadline and the property is delivered by the delivery date defined in the agreement.

60. Five (alternative) situations, and which must exist on the day of the closing on the sale, discharge the seller of its obligation to provide an extrinsic guarantee and allow it to provide only an intrinsic guarantee:

- the property is not flooded and is not encumbered by any mortgage or right of priority;

- the foundations are completed (which is certified by an industry professional) and either
75% of the property financing of the sale price must be provided either sales already made or by loans confirmed by banks (after deducting the value of any loans transferable to the buyers) or 60% of the property financing of the sale price is secured and 30% of it is funds provided by the seller;

- for residential single homes sold but not yet built, there must be an intrinsic guarantee only if the foundations are completed, payments by the buyer as stipulated in the agreement do not exceed 20% upon completion of the foundations, 45% upon the end of any flooding, 85% upon completion of the house, the balance being held in escrow in the event of a dispute regarding conformity. The guarantee covers any unscheduled payments. In the event of a problem, the buyer can have the work completed at no extra cost to it above and beyond the initial price, since the part of the house already completed would be worth more, in such a case, than what was already paid.

- the sale is made either by a public sector construction company or by a company in which a public entity owns at least a 35% stake;

- the sale is made by a public entity that manages government-subsidized housing.

61. The completion or repayment bond ends upon the completion of the property. Legally speaking, the building is deemed to be completed once the work is completed and any equipment necessary is installed so that it is fit for its intended use. Yet, from a technical perspective, the project is divided into several separate and distinct parts, which makes it

possible to isolate the Islamic assets, although from an economic standpoint it constitutes a single economic and industrial entity. So, this raises questions about the notion of completion described above. Does one have to wait until all the project assets have been completed, or just the Islamic assets, for the completion bond to end? Even though it is divided into legally separate parts, the project still constitutes, in our opinion, a single uniform technical entity. While it is perfectly conceivable to declare the completion of the property in the case of the building of a hospital in which the Islamic assets represent, for example, a specific building (A, B, C, D), a hesitation would however be understandable in the case, for instance, of the construction of a power plant or a plant where, we believe, the parts (Islamic assets) can hardly be considered completed separately and independently from the whole of which they form a part.

62. Completion must be certified by an industry professional (an architect) or by a court- appointed expert who attests that the work is in compliance with the building permit. It should be noted, however, that while certification of completion of the work terminates the completion and repayment bonds, it does not imply that the work is in compliance with the initial projections or that the Islamic financiers waive their right to enforce any of the guarantees owed to them separately by the project company. In fact, Section R.264-1 of the Urban Development and Housing Code holds that property sold for future delivery or that is not yet developed is deemed to be completed, as this term is defined in Section 1601-2 of the Civil Code and reproduced in Sections L.261-2 and L.261-11 of the Urban Development and Housing Code, when the work is completed and any equipment necessary is installed so that the contracted property is fit in accordance with its intended use. For purposes of determining completion, no nonconformity to what is stipulated in the agreement is taken into account unless it is material, nor are any defects unless they make the property or any of its parts described above unfit for use.

E. Agreement Termination

64. In Islamic Law, agreements can be terminated, in case of defects, subject to certain requirements:

- the defect has to have existed before the agreement was entered into;

- the defect has to exist when the buyer takes possession of the property;

- the buyer has to be unaware of the defect when the property is delivered;

- the defect has to exist when the buyer demands termination of the agreement;

- the defect cannot be minor.

65. A buyer who discovers the existence of a defect has the option of:

- either terminate or confirm the agreement with the full price stipulated; or

- terminate the agreement or confirm it and demand a reduction of the price.

66. It is commonly known that in French Law, damages and interest are the financial compensation that a person can seek when they have suffered emotional distress or non- economic damage and financial losses. Regardless of whether the damages arise from late performance or nonperformance of an agreement and compensation is the payment of an equivalent amount in capital or an annuity. The amount of damages and interest is a function of the losses sustained and the lost income. How are these dealt with in the Islamic moral order?

In its Resolution 66/3/7, 1992, the Al-Islam Islamic Jurisprudence Academy authorized penalty clauses to be included in *istisna'a* agreements(45). However, this clause cannot be used as a means to apply pressure on the liable party and damages and interest may not be computed on banking products; they have to be placed in a *zakāt*

(45) Al-Ashgar, Bay' al Murabahah, p. 183 in Ph. Muhammed Al-Bashir Muhammed Al-Amine dans Comar-Obeid, *op.cit.*, p. 52.

account and paid to a charity or a charitable organization. In this case, in a sale agreement for future delivery between Islamic financiers and the project company a penalty clause can stipulate that in the event of a late delivery of the Islamic project assets, compensation will have to be paid to a specific institution or foundation named in the agreement. This financial sanction represents less damages and interests than a penalty because ultimately it will not compensate the contractor for the loss.

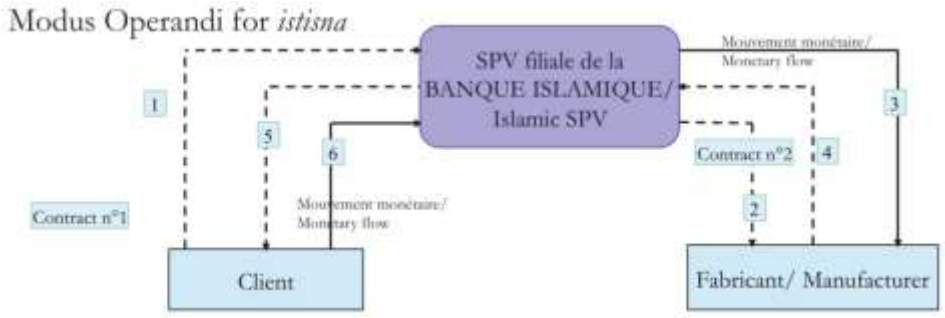
67. There are certain standards for the evaluation of *istisna'a* investment projects. The object of the *istisna'a* must be lawful (halal). In other words, an *istisna'a* cannot be used for investment projects in certain sectors (the construction of infrastructure related to alcohol, pork, gambling clubs, etc.). We will detail them below in the section devoted to lease- purchase agreements. For this reason, extreme care should be used when structuring project co-financing so as not to corrupt the Mulim-financed tranche. The purchase of a hotel, for example, will require a specific structuring in which haram assets (such as the floor on which the bar is located) are isolated and are not part of the part of the project's Islamic assets.

68. What is more, the prime consideration for the acceptability of a project is that there be no interest (*riba*), that is to say an obstacle in connection with the project co-financing where most of the funding is provided by conventional banks through a loan agreement.

69. The second requirement is that the project be economically viable with cash flows sufficient to cover the direct costs and overheads and get a reasonable return for the investor. Understood in that way, the project must also contribute to social and economic development by creating jobs. So, Islamic financiers will be keen to make sure the project is feasible and a panel of experts will determine whether the project company is on sound financial footing. Experts will be called on to advise the project company and the Islamic financiers on the structuring of the construction agreement. Since the sums in question are considerable, it is of paramount importance that the specifications wished by the client be adhered to. In order to avoid any litigation and conflict of interests between the partners, the Islamic financiers will be

responsible for appointing and paying the consultant hired to supervise the performance of the work on the part of the assets that they own.

Simplified Diagram Showing How an Istisna'a Works



(1) Le Client approche la Banque pour lui demander dc fabriquer Ie bien deerit avec des specifications precises/ The Client approaches the Bank for a specific asset to manufactute;

(2) La Banclue approche un fournisseur pour lui demander de fabriquer Ie produit demande par son Client/ The Bank approaches a manufacturer to produce the requested asset from the Client;

(3) Le Fabricant construit Ie bien demande en recevant des paiements periodiques du banquier selon un echeancier convenu d 'avance/ The manufacturer produces the requested asset while receiving periodic payments from the Bank;

(4) Le Fabricant effectuc Ie transfert de propriete en livranr la Bane]ue/ The Manufacturer transfers the ownership by delivering the Bank;

(5) La Banque livre Ie bien au Client/ The Bank delivers the asset to the Client;

(6) Le Client regle le prix du bien en totalite ou en plusieurs echeances/ The Client pays the asset price at once or in several payments.

70. At this juncture, we should briefly discuss the doctrine of frustration in the Islamic moral order. Under this doctrine, a court must restore the balance of the agreement, the terms of performance of which were seriously changed to the detriment of one of the parties as a result of an event that was reasonably unforeseeable when the agreement was

entered into. The event is not necessarily the result of a case of force majeure but it seriously changes the contractual balance, making the performance of the agreement abnormally onerous for one of the parties. This doctrine not recognized by the French courts and in French Law. In Islamic Law, it is possible to find the authority of this doctrine in the following verses of the Qur'an:

"*O ye who believe! Do not dispossess one another of your property by dishonest means. May your trading be based on transactions freely consented to. Do not make attempts on your life for Allah is Full of compassion for you.*"(46)

71. So, when an event making performance of the agreement impossible or fundamentally different from what was contemplated at the outset, the parties can be discharged of their obligations. However, it is possible to suggest a modification of the agreement; if the parties are in agreement, they make the change contractually or, if they are in disagreement, they can take the matter to court. In such a case, the court will become a third party to the agreement. The doctrine of frustration applies only if the event is unexpected, unforeseeable, general in nature, and if it occurs during the performance of the contractual obligation that has become exceptionally onerous. There must also be a direct causal link between the unexpected, unforeseeable and general event and onerous nature of the performance of the obligation. Before modifying the agreement, the court can ask the parties to the agreement to renegotiate the terms of the contact together.

Failing an agreement between the parties, the court will reduce the excessive obligation.

F. Amicable Rescission

72. We are going to explore the validity of arbitration clauses in the Islamic moral order. The significant development Islamic project finance in the Arab World has lead Islamic banks to include arbitration clauses in *istisna'a* agreements. So, we will examine the legality of such clauses

(46) Qur'an, chapter 4, verse 29.

under Qur'anic Law and under French Law. An arbitration clause as typically found in western agreements would be considered *gharar* because of the uncertainty about the occurrence of a dispute. In fact, out of a concern for fairness and social justice, moral order which seeks to protect the parties to an agreement, prohibits, in Islamic Law, any element of uncertainty or risk (*gharar*) in agreements. Therefore, the parties would be entitled to revoke any agreement up to the time an arbitral award is rendered. This opinion was expressed in Article 1847 of the *Majella*. However, these arguments appear to be inapplicable to business practice and this prohibition would be a major obstacle to the development of project co-financing. Certain Islamic Law experts are therefore opposed to this prescription, which, they argue, has no justification in contract law and the freedom-of- contract doctrine that prevail in Islamic Law. It seems, in fact, that any arbitration clause should be considered to be an ordinary contractual undertaking, which is valid and binds the parties by virtue of the general theory of contracts. In this regard, *Malikite* legal scholars argue that arbitration agreements are irrevocable. Actually, it is interesting to compare this prohibition with the public interest rule that requires giving the parties legal security. In this case, it would appear that protecting parties to an agreement requires the enforceability of arbitration clauses. That is why, Islamic scholars agree on the validity of such clauses in *istisna'a* agreements and Article 1941 of the *Majella* now authorizes the appointment of an arbitrator. Below are several prerequisites(47) for the clause to be valid under Shari'a Law:

- the arbitrator must competent(48) to serve as a judge under Shari'a Law;

- the arbitrator must have at least some of the qualifications required of judges;

(47) Conference on binding arbitration and Islamic transactions, a Speech delivered by Salim El Méouchi, on Thursday, December 1, 2005 in Paris, France, at a seminar on Franco-Arab Mediation and Arbitration System organized by Franco-Arab Chamber of Commerce's Mediation and Arbitration Center.

(48) For example: Article 4 Saudi Arabia's Arbitration Code holds that the arbitrator must be experience, have proper conduct and have his/her full legal capacity.

- the arbitrator can be selected from legal practitioners[49] (judges, lawyers and accountants);

- it suffices that the arbitration be entrusted to a Muslim;

- it is considered that only a Muslim can possess knowledge of Shari'a Law so that he can hand down a decision that is in accordance with the principles of Shari'a Law;

- the Hanafi School accepts that a non-Muslim can do justice to a native non-Muslim;

- Shari'a Law must be the applicable law regardless of whether or not it is designated as such in the agreement, even if it is in conflict with the man-made laws of the country of which one of the parties to the agreement is a national;

- the provisions of Shari'a Law are based on notions of justice and fairness, and it is inconceivable that a man-made law is more just and fair than the divine law revealed to man;

- if an arbitral award rendered by an international arbitrator is based on laws that are in conflict with the rules of Shari'a Law, the award will not be able to be enforced in an Islamic country that enforces Islamic law.

- Shari'a Law will apply both to procedural matters and to the substantive issues.

73. There does not seem to be any obstacle to the acceptance of *istisna'a* agreements in French Law and they can be structured for the sale of property to be developed. In that scenario, the seller agrees to build a building by a specific deadline and the sale could be done as a sale for future delivery or as a sale of property that is not yet developed. Lastly, the other companion financial agreements such as *mourabahas* or *moucharakas* can be used to buttress a more complex contractual deal.

(49) See Article 3 Saudi Arabia's Arbitration Code.

II. Building a Model *Ijara* Agreement under French Law

64. Recently, the Crédit Foncier bank participated in the lease-purchase financing for the construction of a new €54 million hospital facility for the Metz Private Hospitals–a 49,000- square-foot facility with a 613-bed capacity(50). The financial arrangements include a loan from the European Investment Bank (EIB)–the first time it has ever financed a private hospital project. The pioneering deal is part of the hospital renovation program that the EIB launched in France in 2010 as part of the 2010 Hospital Plan.

65. There is not at the present time any co-financing of Islamic projects in France. In this study, we are trying to show that such a transaction is possible by arguing that the *istisna'a- ijara* can be structured in French law through a sale agreement for future delivery (construction period) and a purchase-lease agreement (lease period) and the funding necessary for the construction of the asset could be provided via a Shari'a compliant investment fund or by issuing *sukuk* bonds (see my PhD thesis for a further discussion of this). So, by structuring the transaction in this way, Islamic financiers could finance the construction of part of the assets referred to above as Islamic project assets(51) all the while isolating themselves from conventional investors.

66. We believe that there are other benefits(52) that explain why one would opt for this type of arrangement and here are some of the most important:

- the project company retains its funds(53);

(50) Available on: www.bpce.fr/content/.../2637/.../mipim_BPCE_FR_light.pdf.

(51) These are referred to throughout this study alternately as Islamic assets or Islamic project assets.

(52) Duche, R and Penvern, C, « Intérêt financier du crédit-bail immobilier », Document Paris-Commerce 1971, n° 8 spécial, p. 71.

(53) Imbert-Casau (sylvie), « Le financement des investissements immobiliers des entreprises industrielles et commerciales. Le crédit-bail immobilier », *Hommes et Techniques*, 1972, p. 889; Rives-Lange (Jean-Louis), « Financement crédit-bail immobilier », *RD imm*, 1979, p. 234.

- rent payments are deductible (except for the amortizable part relating to the land, contained in the last rent payments);

- the asset will be amortized for the duration of the lease-purchase agreement, *i.e.*, a shorter period than what applies when the asset is held directly;

- the surplus amortization will be booked by the project company in the year in which the purchase option is exercised, which is akin to a free deferred tax. The surplus amortization will be booked over time;

- likewise, the Islamic financiers may not interfere directly or indirectly in the project company's technical management of the construction of the Islamic assets; while, as we have seen in the second half of this study, conventional investors play an active role in project finance, this is not permitted in the case of a lease-purchase agreement where the lease-purchase company is required to be firmly impartial.

67. To illustrate this analysis, we believe that it is conceivable to use Islamic financing to build a private hospital in France. Let us assume that a hospital is built with a central medical and technical unit and three residential units organized by medical specialty (at an average cost of 173 million euros). The 70,000-square-foot facility has 520 beds and 18 operating rooms. It is structured in four major blocks: a central medical and technical unit, a surgery building, a neurology building and a building dedicated to cardiovascular, hematology, oncology and pulmonology medicine. So, for example, the Islamic tranche could serve to finance the cardiovascular medicine building (immovable property) or operating rooms (movable property). These assets would be identified as Islamic project assets and could be the subject of a lease-purchase agreement, or possibly combination with some other contractual arrangement.

68. After analyzing the similarities and differences between Ijara and conventional leasing contract (A), we will propose a contractual structure (B, E) for overcoming the constraints, which relate to both: the nature of contractors (the problem of banking monopoly) (C), and the type of assets financed (D). Then we will illustrate the parties'

obligations (F), the essential clauses in the contract (G), guarantees of the project (H) and the termination of the contract (I).

A. Legal Nature: Similarities and Differences Between *Ijara* Agreements and Lease- purchase agreements

69. Like the *mourabaha*, the *ijara* was not originally a method of financing. It is a lease, which is an agreement by which one party (*ajir* or *mujir*) agrees to pay (rent) another party (*mustajir*) for the use of tangible or intangible property for a specified period of time. However, Islamic financial institutions have over time used the *ijara* as a financial agreement, which enabled them, among other things, to get around the prohibition of interest-bearing loans.

70. From that standpoint, Islamic financial institutions used the same lease-purchase agreement model(54) as the one used by conventional banks(55), even though a certain number of the terms were not Shari'a compliant. This approach failed to take their differences into consideration. Actually, while the division of ownership is common to both these agreements, there are still fundamental differences between present-day lease-purchase agreements and Shari'a authorized *ijara* agreements and we will examine them.

71. Even though the *ijara* was not originally a financial agreement, it can still be used to finance investment projects as we showed in the second part of this study. So, it is worth bearing in mind that the compliance of a project to scriptural texts requires an in-depth contextual examination of the deal by the members of the shari'a board designated in the agreement. This entails the interpretation of religious text and case-based reasoning to determine the adequate solution. That is why it is not enough to replace the word "interest" with "rent."

(54) Birbes, H, « Aspects juridiques du crédit-bail immobilier », *Cah. dr. Entr.*, 1972/3 and 4, p. 1; Cabannes- Buisson, C, « Le crédit-bail immobilier », *Hommes et techniques*, 1970, p. 1012; Boullay, P, « Le *leasing* immobilier, étude de cas », *Nouvelles techniques contractuelles*, Montpellier 1990.

(55) Bourdeaux, Gautier, «Crédits à l'exportation, crédits acheteurs et fournisseurs», *J.-Cl.Dr.Intern.,* Fasc. 566-80.

72. Actually, this difference is the same in French Law[56]. Lease-purchase agreements cannot be used as a disguised loan to buy property, even though they have a financial component to them. Taking a closer look, while the 1985 Banking Services Act describes lease-purchase transactions as "credit transactions" it is only by assimilation; the reservation is significant.

With respect to Islamic assets, the project company pays a *rent paymet*[57] and not *scheduled loan repayments*. In this regard, Act No. 66-1010 of December 28, 1966 on usury loans, money loans and some solicitation and advertising practices, which has since been repealed, did not actually apply at the time to lease-purchase transactions[58]. Let us also add that neither the lease-purchase offer nor the actual agreement can mention the annual equivalent rate[59] (AER), which is used only for loans. Then, let us stress that none of France's Consumer Protection Code provisions[60] relative to protecting borrowers apply. As proof of

(56) Mathély and Charrière, H, « Le crédit-bail immobilier », *Banque*, juin 1969, p. 275.

(57) Attal, André, « Le loyer du contrat de crédit-bail immobilier », *AJPI*, 1976, p. 786.

(58) On this subject see: Doll, Paul-Julien, « L'usure, le démarchage et la publicité en matière de prêts d'argent », *Gaz. Pal*. 1967, 1, doctr. p. 99; Vasseur, Michel, « Usure et prêts d'argent », *Banque* 1967, p. 460; Gavalda, Christian and Stoufflet, Jean, « La limitation des taux d'intérêts conventionnels par la loi n° 66-1010 du 28 December 1966 sur l'usure », *JCP G* 1968, I, 2171, n° 25; Gavalda (Christian): Rép. com. Dalloz, 2e éd., V° Usure, n° 21-22; Chabas, François, « La réforme de la clause pénale, loi n° 75-597, 9 juill. 1975 », *D*. 1976, chron. p. 229; Françoise Furkel, note ss French Supreme Court, Business Section, 30 avr. 1974, *JCP G* 1976, II, 18282; Baudoin, E, « Crédit, usure, justice ou déclin de la clause pénale », Rép. Commaille 15 Nov. 1968, n° 17, p. 565; Dessens, note ss Court of Appeals of Rouen, 3 juill. 1970, *D.* 1971, jurispr. p. 465; Rép.min. Habib Deloncle, séance 30 juin 1966: JO Sénat Q 1er juill. 1966, p. 1157; Rép. min. just. n° 25822: JOAN Q 29 nov. 1972, p. 5730; Court of Appeals of Aix-en-Provence, 3e ch., 10 mars 1969, Sté Méditerranée Mosaïque c/ Locafrance, inédit; Court of Appeals of Toulouse, 8 mai 1970, *JCP G* 1970, II, 16481, note El-Mokhtar Bey; *D.* 1971, somm. p. 96; Court of Appeals of Rouen, 3 juill. 1970, *D.* 1971, jurispr. p. 465, note Dessens; *JCP G* 1971, II, 16581, note Bruno Boccara; Court of Appeals of Caen, 3e ch., 6 mai 1971, Launay c/ Somatrens.

(59) Court of Appeals of Aix-en-Provence, June 7, 1989: *Bull. Aix* févr. 1989, n° 59, p. 24.

(60) See Sections L.312-2 et seq.

this, it should be noted, finally, that Section L.312-3 of said code expressly stipulates that:

"*The following are beyond the scope of this chapter:*

1) Loans granted to legal entities under public law;
2) Those intended, in whatever form this may be, to finance a business activity, in particular, that of natural and legal persons who, even if this is secondary to another activity, or by virtue of their company object, regularly procure, in whatever form this may be, properties or parts of properties, whether built or not, whether finished or not, whether apartments or individual houses, under ownership or possession."

But lease-purchase agreements are, under currently applicable law, for the leasing of immovable property used for business purposes.

73. In law, the question of the legal nature of an agreement raises ipso facto the issue of its legal definition. The legal definition makes its legal classification clear. That also helps determine the specific legal provisions that apply. The approach that we propose is a comparative study of the legal content of *ijara* agreements and lease-purchase agreements used to finance assets. To that end, we will examine the underlying and central question of the permeability of French Law to Islamic moral order rules. This examination does not, in theory, assume the formulation of a positive or negative evaluation but seeks to highlight similarities and differences between these two particular types of agreements. Based on the foregoing, here are three questions: Can the French law provisions that apply to lease- purchase agreements also apply to *ijara* agreements used in connection with transactions to co-finance projects using Islamic financing? What are the obstacles under Shari'a Law and under French Law that could prevent it from being used? What are some of the solutions in both the legal systems?

74. Based on Section L.313-7 of France's Monetary and Financial Code, lease-purchases cover: "*The leasing of capital goods or tools specifically purchased for leasing by companies which retain ownership thereof, when such leases, regardless of their nature, give*

the lessee the possibility of buying some or all of the leased goods at an agreed price which takes account, at least partially, of the installments paid under the lease.

Transactions through which a company leases real property for professional use which it has bought or had built, when such transactions, regardless of their nature, enable the lessees to become the owners of some or all of the leased properties, upon expiry of the lease at the latest, via transfer upon execution of a promise to sell or via direct or indirect acquisition of title to the land on which the leased property is built, or via automatic transfer of title to the buildings standing on the land belonging to the said lessee."

75. So the lease-purchase mechanism "*relies on the distinction between the beneficial owner and the legal owner of an asset*."(61) A lease-purchase arrangement(62) is a transaction to lease movable or immovable property used for business purposes, purchased or built on behalf of the lessor/seller that comes with an exclusive option to later purchase the home, which is fundamental(63), at the discretion of the lessee/buyer, for an agreed price that takes into account, at least in part, the amount paid in rent payments and allowing the lessee/buyer to become the owner. It is noteworthy, in this regard, that immovable property, unlike the case of movable property, is neither technically nor economically depleted.

76. The rent payment is determined based on the financial cost to the lessor of purchasing or building the property. At the end of a fixed lease period determined as a function of the amortization period of the leased asset, the lessee has three options:

- purchase the property for a price agreed at the outset;

(61) Couret, Alain and Rapp, Lucien, *Les 100 mots du droit des affaires*, Paris, PUF, Que sais-je ?, 2010, p. 55.

(62) On the subject see: Cohen-Steiner, Nicolas, « Le contrat de crédit-bail immobilier: six ans d'application de la réforme de 1994 », *Sem. jur.*, Edition N. I, 2001, n° 25, p. 1060; Bergeron, Jean -Yves, Guillemin, Yves, « Le Crédit bail en France: caractéristiques, évolution récente et perspectives », 1979.

(63) French Supreme Court, Business Section, May, 30 1989, *D.*1989, IR 190.

- move out of the property; or

- agree with the lessor to extend the lease period.

77. Similar to a lease-purchase agreement, an *ijara* agreement is used to finance (movable or immovable) assets in the medium term through a lease with an option to purchase. In most cases, it entails three successive transactions: a sales agreement by which a financial institution (*ajir* or *mujir*) purchases an asset from a third party, then leases it to a lessee (*mustajir*) in some cases an option to purchase the asset in the future (*ijara wa iqtina*). It should be noted that an *ijara* agreement is a bilateral agreement even though the *ijara* is a tripartite deal.

78. It is also common to combine the *ijara* with a diminishing *moucharaka*. The Islamic bank's share in the leased asset diminishes with the capital payments that are made by the client in addition to the rent payments, the objective being ultimately to transfer title of the asset to the client. Technically, the Islamic financier finances some building (*i.e.* a turnkey plant) or capital good on behalf of its client bound by a purchase undertaking. In exchange, the client makes rent payments into an investment account which enable it, at the end of a defined period, to become the owner of the leased property or building. In order to limit its exposure in its capacity as the owner, the financer forms a special purpose vehicle (SPV). As we will see, the financier, through an agency agreement, authorizes the client-borrower to maintain and insure the financed asset. The asset is insured by a *takaful*.

79. Based on this initial description, it appears that these two agreements are in a class of their own, complex(64) (sale, lease, construction financing agreement, agency agreement, etc.), officially recorded, so they have to be in a particular form (private agreement); they are bilateral agreements in which the lessor agrees to let a lessee use some property in exchange for rent payments to be made for the duration of the lease; they involve a service provided for valuable consideration; the price of the service is known by both parties when the agreement is entered into; since they are

(64) Carbonnier, Jean, « Le crédit-bail: du bail au crédit », *Defrénois* 1991, p. 1025.

concluded on a private placement basis, the agreements are valid only if the parties give their consent and the parties freely negotiate the terms and conditions of the agreement; they are successive since they are performed only through the passage of time.

80. At this early stage of the examination, there is another point that is worthy of attention.

While French Law permits the sale of property pursuant to a sale undertaking and expressly precludes the purchase of the property being contingent on the lessee's acceptance (considering that the lessor's sale undertaking is exclusive of the lease-purchase agreement), Islamic Contract Law requires the leased asset to remain the private property of the lessor who cannot be unilaterally bound to sell the property that is the subject of the lease. In other words, the opposite! In short, the nature of the transaction(65) requires in one case a sale undertaking and in the other a purchase undertaking. We will see, as a result, how its acceptance in French Law implies certain changes on both sides.

B. Presentation of the Contractual Arrangement

81. The *ijara* can be presented as follows:

- The bank's client makes contact with the seller of the property and prepares all the necessary information.

- The client contacts the bank and asks the bank to prepare an *ijara* agreement; the client promises the bank to lease the property once the bank has purchased it.
- The bank buys the property at the agreed price from the seller and title to the property is transferred to the bank.
- The bank leases the property to the client, transferring to the client its right of *use.*
- The client makes rent payments to the bank for the duration of the lease.
- In the end, the property belongs to the bank.

(65) Not without a certain degree of complexity, see: Bey, El-Mokhtar, « De la symbiotique dans le *leasing* et dans le crédit-bail immobilier », *D.*1970; see also: Coillot, Jacques, *Initiation au leasing ou crédit-bail*, éd. J. Delmas, 1968.

82. An agency agreement can be executed as part of this. In which case, the bank will ask the client to act as its agent. The agency agreement, which is separate from the lease, is prepared and combined with the *ijara* agreement. The client then chooses the property in the name and on behalf of the bank. It must inform the bank in writing of the details of the deal, such as the name of the seller and the purchase price. The seller conveys the property to the client (the agent) on behalf of the bank (principal). After the bank pays for the property, the agency agreement is terminated and the lease is executed in accordance with the initial undertakings. In both the cases that we just described, the Islamic bank or SPV takes back the leased property at the end for the agreement and this has significant and measurable financial implications.

83. In the *ijara wa iqtina* scheme, at the end of the lease period the lessor becomes the owner of the asset. In this case, the right to acquire the asset is based on the purchase and sale undertakings and we will examine their construction. The option to exercise an undertaking is in fact a key component of lease-sale or purchase-lease arrangements, which comply with Shari'a Law. However, as we have indicated, although the sale undertaking is at the discretion of the lessee, the form of the amortization is such the lessor has, in the final analysis, a very compelling economic interest to purchase the asset.

84. Of course, each project is unique. Still, we can give the following example of Islamic project co-financing:

- Phase A: the *istisna'a*(66) (sale agreement for future delivery): *istisna'a* agreements are used by Islamic banks or financiers to advance the funds necessary for the construction of Islamic project assets. They will make various payments to the project company to enable it to build the Islamic assets. The project company has full control of the building construction and the agreement stipulates in careful detail the technical specifications. Once construction is completed, the project company transfers title to the asset to the Islamic bank, or, in the case in point, to the SPV owned by the Islamic financiers.

(66) See below.

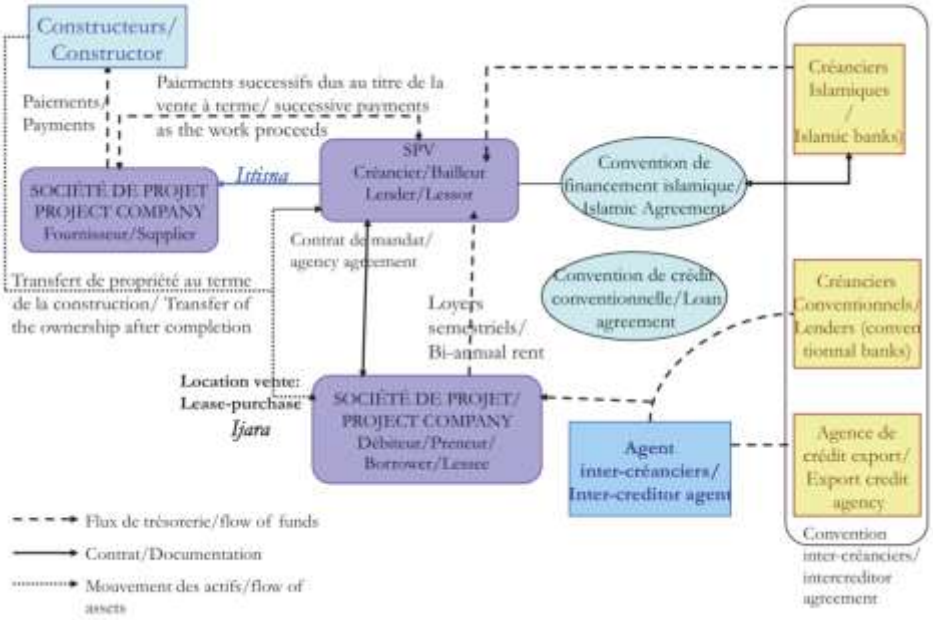
- Phase B: *ijara* agreements (lease-purchase agreement) are entered into between the Islamic SPV (lessor) and the project company (lessee):

- the project company makes rent payments during the period when it has possession (it is possible to make advance rent payments during the construction period);

- the Islamic SPV, which owns the Islamic assets, undertakes to sell them to the project company at the end of the lease;

- the project company undertakes to purchase the assets.

Example of Project Financing Using an *Istisna'a-Ijara*



Source: Hugues Martin-Sisteron, "Shari'a Compliant Project Co-financing Arrangements" in French-Saudi Forum for Dialogue Between Civilizations, March 15 and 16, 2010.

C. The Status of the Parties to the Agreement: Issue of Banking Monopoly

85. We will examine lease-purchase agreements from the standpoint of the Islamic moral order and its constraints. The Act of January 24, 1984 gives banks and financial services companies a monopoly on loans, including lease-purchases which are legally likened to loans. So it is illegal for anyone other than a lending institution to routinely provide banking services and, in particular, lease-purchase services. Section L.313-1 of the Monetary and Financial Code, derived from the Act of January 24, 1984, defines lending(67) as a person who makes or promises to make funds available to another person for valuable consideration and takes, to ensure repayment, collateral or a repayment bond. The law considers that lease-purchases and, more generally, any lease with option to purchase is a form of loan. That is probably due to the fact that, in French law, lease-purchase agreements are regarded as loans and companies that do lease purchases are recognized as lending institutions. In fact: "*a lease-purchase agreement is a complex contract that forms a whole defined by lawmakers, both in 1966 (Act of July 2, 1966) and in 1984 (Act of January 24, 1984) is a substantially a financial service articulated legally around the principal relationship, which gave it its name of lease-purchase, as a service*." Consequently, people who want to enter into lease-purchase agreements to purchase property in France have to get the banking business license provided for in Section L. 511-10 of the Financial and Monetary Code, from France's Prudential Regulatory Authority.

European banking business licenses allow investment firms based in another European country to either provide banking services or open up a branch office in any country in the European Economic Area without having to apply for a license in each country.

86. As we saw above, lease-purchase transactions can be handled only by authorized banks or financial services companies that are subject to regulations applicable to banks or by companies associated with the banking services industry. This is undoubtedly the result of the

(67) Which is classified as a banking service.

transposition in law of the criteria of providing such services on a routine basis, which is used in general business law, to define business practices. However, it seems possible, using a contrario reasoning, for an unauthorized party to handle a lease-purchase transaction on a non-routine basis without facing criminal or civil penalties instituted to protect the banking monopoly and the public interest. It must therefore be determined what frequency constitutes a routine basis.

87. According to France's Supreme Court, routine starts with the second same type of transaction, regardless of the time period between the two. Notwithstanding any criminal penalties that anyone who breaks the law may face, any authorized party who routinely or even occasionally enters into lease-purchase arrangements runs the risk of the agreements being invalidated(68). Pending any future changes in the law, it is conceivable that an Islamic SPV be set up to finance a single project, such as, for example, a hospital.

88. A lessor and a *mustajir* can be either an industrial or a commercial business, regardless of the company's legal form, or a person who is an independent contractor: industrialists, businesspersons, tradespersons, members of the professions, local governments and nonprofit organizations engaging in business. Under French Law, the property has to be used for business purposes and the project company must engage in some business activity. In the case we have been considering, the designation of the property will provide this confirmation.

D. The Nature of Islamic Project Assets

89. What is the nature of Islamic project assets? Things that are immovable by nature are fixed to the ground that cannot move themselves or be removed from one place to another. The criterion is that they be fixed (*i.e.* land or a house). The ground encompasses not only the surface of the Earth but also the subsurface with any deposits

(68) French Supreme Court, Business Section, Nov. 19, 1991, *Bull. civ*. IV, n° 347, *D*. 1992, IR 33, *RJDA* 12/1991, p.885, rapp. P. Leclercq, *Banque* 1992.426, obs. Jean-Louis Rives-Lange; Lagarde, Christine, « Commune et crédit- bail... prudence », *Bull. Cridon* Paris 1988. IX, p. 49.

that it may contain. Lastly, anything that is affixed to the ground or in the ground is by nature immovable: trees, fruits, vegetables and unharvested crops. Immovables by the objects to which they are applied are rights on or to immovables. This category includes rights in rem established on real estate (mortgage, usufruct), real-estate debts and real-estate stocks.

90. Things that are immovable by their destination are ab initio movable by nature and are accessory to an immovable object but they are considered to be immovable in nature because of this connection. For a movable object to become immovable by destination, both must have the same owner. The connection is economic when they are used to operate an immovable object; so, for instance, machinery that belongs to a manufacturer and that are used in a plant become immovable by destination when the manufacturer is the owner of the premises.

91. The connection can be tangible when objects that are movable by nature are attached to an immovable object "as a permanent feature" and cannot be removed from it without being altered (ex: fireplaces) or damaging the part of the immovable object that they are affixed to. Section 524 of the Civil Code specifies certain attachment scenarios making it possible to infer the owner's intent to attach an object as a permanent feature depending on the location of the objects.

92. Section L.307-7 of the Monetary and Financial Code designates practices by which a business leases immovable property used for business purposes that it purchased or had built. On this account, it appears that an asset that is the subject of a lease-purchase agreement must be immovable and must be used in connection with a business activity. It may be immovable by nature, by destination or, as the case may be, by incorporation. It can be an existing building or a building to be built, or, as examined in this study, property that is yet to be developed.

93. The legal requirement that the property be used for business purposes is intended to make sure that it is actually used. In other words, the status of the lessor and the hypothetical or theoretical purpose for

which the property was intended do not affect the classification of the lease-purchase; the only thing that counts is how the property subject to a lease- purchase agreement is used. The business conducted on the property premises will therefore be the only criterion used.

94. In an *ijara*, the lessor must retain legal ownership of the property and transfer beneficial ownership to the lessee. Moreover, *ijara* agreements cannot be for consumptible goods. In the objective sense of the term, it can be considered that consumptible goods(69) are consumed the first time they are used. Furthermore, the agreement cannot involve the lease or rental of property directly or indirectly related to:

- arms industries or services;

- gambling or casinos;

- the making or selling of alcohol, tobacco or pork-based products;

- the entertainment industry (pornography, music, media, movies);

- hotel or restaurant businesses;

- conventional financial services (banks, insurance);

- precious metals (gold or silver).

95. The asset must therefore be first examined by a shari'a board that will rule on the validity of the transaction under Islamic Law. The leased property must be clearly identified in the ijara agreement. In the case in point, the hospital sector is not considered to be a haram and financing the construction of a building dedicated to cardiovascular medicine

(69) A typical example of a consumptible good is money whose traditional function in economic teams is well known; its only use is alineation in the sens that one does not hold on to it. If money were not consumptible *primo usu*, it would not exist; it would have no value. According to the distinction made by Roman legal scholars, property can have three attributes: *jus utendi* (*usus*, the right to use property), *jus abutendi* (*abusus*, the right to alienate property) and *jus fruendi* (*fructus*, the right to profit from the proceeds of property). What makes consumptible good unique is that encompass these categories of property rights. Since they can only be consumed when used, the *fructus* disappears and the *usus* combines to merge with the *abusus*.

seems to the perfectly Shari'a compliant. That is not the case, we believe, of the following elements: the hospital kitchens, hybrid library or a newsstand (like the Relais H newsstands that sell tobacco products).

E. The Typology of Contractual Arrangements

96. In our study, we make the distinction between three more or less complex forms of lease- purchase contractual arrangements: purchase of the land and construction, purchase of property through a lease-purchase agreement as part of a sale of property that is yet to be developed and a lease-purchase agreement entered into for existing property.

97. A lease-purchase agreement can pertain to existing property. This entails a lease-purchase company or, in the case in point, an Islamic SPV, purchasing property (Islamic project assets) chosen by the lessee, *i.e.* the project company, that negotiated all the terms and conditions in advance. The property will be leased and rent payments will be made for a period agreed to by the project company. The project company has the option to acquire ownership of the property(70) at the end by exercising the sale undertaking that must be contained in the agreement.

98. Purchasing property through a lease-purchase agreement can be done as part of a sale of property that is yet to be developed. In that case, the project company can pick the land and is free to define the specifications of the property to be developed. After the building permit has been obtained, filed in the name of the lessee (the project company) and any third-party claims settled, the lessor (the Islamic SPV) replaces the lessee. It will purchase the barren land and finance the construction and development of the property as the construction works advance.

99. As part of the lease-purchase agreement, the parties will execute a construction financing agreement (*istisna'a* as described above) in which the lessor (the Islamic SPV) is the project owner(71) and the lessee (the

(70) Champigny, Daniel, « L'évaluation d'immeubles sous contrats de crédit-bail », *Gaz. Pal.* 1978, 1, doctr. p. 74.

(71) Vallery-Radot, Laurent, « L'immixtion du maître de l'ouvrage dans une opération de construction », *Gaz Pal.* 1982, 2, doctr. p. 572.

project company) is the general contractor or the delegated project administrator. A delegated project administrator agreement is then entered into for the project company to develop the property on behalf of the Islamic investors who are the temporary owners of the property. As we previously saw, the project company, as the general contractor, will undertake for a fee, on behalf of the Islamic SPV, as the project owner, to perform and inspect the construction works with full independence and without any agent.

100. Based on this proposition, the obligations imposed on the project company–whether it is an agent, general contractor or delegated project administrator–are an enforceable duty to use sufficient means so as to bring about the contractually agreed-upon outcome specified, making it ipso facto liable for any defects or imperfections affecting the buildings, regardless, in fact, of how significant they are.

101. The project company, as the contractor, will be under obligation to maintain the property throughout its construction. It must take out appropriate insurance policies(72), in particular those covering risks associated with the worksite, pollution and radioactivity in the grounds, as well as the costs necessary for any decontamination work; it must also deliver the property at the agreed place and by the agreed date (by virtue of Section 1245 of the Civil Code).

102. The delegated project administrator agreement must define the terms of payment and repayment to be made by the SPV and the terms on which the work will be performed by the project company. The Islamic SPV may pay the bills approved by the project company, in its capacity as the SPV's agent (by virtue of Section 1792-6(1) of the Civil Code). It should be noted that during the construction period, outlays by the project company will be the subject of payment of intercalary interest called "rent prepayments." The rent payments under the lease-purchase agreement commence once the property is completed, which is in point of fact a requirement under Shari'a Law. The amount

(72) Zeller, O and Chanteau, O, « Le crédit-bail immobilier exige des assurances sur mesure », *Assur. fr.*, déc. 1996, p. 51, n° 727.

of the lease-purchase is then adjusted in line with the final amount of the investment.

103. In the event of a default by the project company, any unpaid subcontractors will be entitled to bring action directly against the Islamic SPV as the project owner in order to obtain payment. A certificate of delivery and conformity signed by the project owner, the architects and the contractor certifies that the work complies with market standards, the plans, the estimate and the building permit, completes delivery, which puts an end to the contractual relationship.

104. A lease-purchase agreement can also be used to purchase land and develop and construct property. In this particular case, an agreement is entered into by the parties under which the project company undertakes to build buildings on land title to which is transferred to an Islamic SPV and to maintain them in a proper state of repair for the full duration of the lease. The construction is a key feature of the agreement and failure to complete the construction will result in its termination. So, for instance, a simply duty to make improvements is not sufficient to consider that it is a construction lease agreement. The project company will have to pay rent on the leased land. They are payable in kind (completion of sections of buildings by agreed due dates or delivery of completed buildings by the end of the stipulated lease) or, alternatively, in cash. It should be noted that in the event of nonperformance of these obligations, the Islamic SPV will be entitled to demand termination of the agreement before the contractual term.

105. Moreover, construction lease agreements are not subject to laws on business leases(73) because of their distinctiveness. However, the project company has, for the duration of the lease, temporary rights in rem to the buildings that it built on the leased land, which can raise problems under Shari'a Law. When the construction lease agreement expires, the Islamic SPV repossesses full title to the property leased and will acquire, subject to special contractual provisions, title to built without any obligation to pay compensation. However, in practice, title will be transferred to the project company.

(73) French Supreme Court, 3rd Civil Section, May 11, 1988, *Bull. civ*. III, n° 89.

106. A lease-purchase can also be structured through a special purpose vehicle such as a real estate investment company. The real estate investment company is formed by the Islamic investors and the project company. The special purpose company, whose director as designated in the articles of incorporation is the Islamic SPV, will purchase the property or the partners will contribute the property to its assets. Subsequently, a lease-purchase agreement will be entered into with the real estate investment company that will sublease the property to the project company. In such an arrangement, the purchase-lease company agrees to sell its shares in the company if the purchase option is exercised. However, this arrangement is likely to be invalidated by the shari'a board because Islamic investors cannot have an equity investment in an excessively indebted company as is the case with the project company as a result of the financing agreement it entered into with conventional lenders.

F. The Obligations of the Parties

107. In the *ijara* and lease-purchase agreement, the object of the parties' respective obligations is the leasing of Islamic project assets by Islamic investors (or an Islamic bank or lending institution as defined in Monetary and Financial Code) in exchange for periodic payment of contractually predetermined rent payments.

108. As the owner of the leased property, the Islamic SPV remains, for the full duration of the lease-purchase agreement, until closing on the sale of the Islamic assets by the project company, the holder of all the legal ownership rights and is responsible for all its legal obligations. The Islamic SPV is therefore automatically subjected to the provisions of Sections 1719 to 1721 of the Civil Code (delivery, maintenance, guarantee) and must make all repairs necessary to maintain the property in a state of repair and normal upkeep of the leased Islamic assets.

109. However, in the practice of co-financing, it is very common for lessors to transfer their obligations to lessees, a practice that is accepted by jurisprudence(74). In such a case, the Islamic investors are

(74) Court of Appeals of Paris, Oct. 11, 1989, *D.* 1989, IR 275, *Gaz. Pal*. 1990.1. somm.

only under obligation to warranty that the property is not occupied by it or by third parties, but that has no practical implications.

110. The Islamic SPV cannot, however, lease the Islamic assets without agreeing to a delivery obligation. There are no specific formalities(75) required for delivery but delivery must occur. In fact, while some argue that lease-purchase arrangements can be fully released of the delivery obligation, especially if the property subject to the lease-purchase agreement cannot be delivered, according to Mr. El-Mokhtar Bey, "*no one has the power to do away with it altogether; that would destroy the agreement, because in order for there to be a lease, something has to be delivered or made available to the lessee so that it can take possession… the lessee's obligations thereby being without consideration, the penalty for the failure to deliver is the nullity of the agreement or, for certain agreements, termination*(76) *of the lease, resulting in the return of any moneys unjustifiably paid, such as early rent payments, and an award of damages and interest for the losses suffered, unless the plaintiff seeks a specific performance order*."(77)

111. On the same topic, Mr. Guy Duranton considers that: "…*this is an instance where there is no consideration and no immediate reason for the agreement. The selection the property and/or the buildings as well as persons in charge of them and the negotiation of the practical, legal and financial terms and conditions of the transaction are dictated by the lessee to the lease-purchase company. These considerations are valid on to the extent that the obligations are transferred to the lessee and that it has accepted a clause stipulating that it will have no recourse*

(75) On methods of delivery for example: « *ayant constaté que le crédit-preneur avait accompli, après achèvement des travaux, des actes démontrant qu'il était en possession de l'immeuble, la cour d'appel a exactement retenu que la livraison du bien construit ne devait revêtir aucun formalisme, et souverainement constaté qu'elle était effectivement intervenue* » (French Supreme Court, 3rd Civil Section, June 6, 1996: Juris-Data n° 002323).

(76) Cohen, Elie, « Une crise juridique dans le crédit-bail immobilier, la faculté de résiliation unilatérale du crédit- preneur et la nullité du contrat », *Gaz. Pal.* 1996.2, doctr. 975.

(77) Bey, El-Mokhtar, « Crédit-bail immobilier », *fasc.* n° 650, JurisClasseur Banque - Crédit – Bourse, 2000, p. 10.

against its contractual partner for any reason and that all rights and guarantees were transferred to it by the lease-purchase company. Notwithstanding these contractual provisions, the courts are not always inclined to accept the admissibility of 10-year warranty claims brought by the lessee acting alone such that, in practice, a lessee may have to bring a lawsuit jointly with it principal (the lessor) in construction disputes with contractors and design engineers."

112. As the lessee, the project company is subject to the Civil Code provisions relating to leases.

It must therefore manage the leased property carefully and cautiously, make the rent payments on the agreed terms and (in theory) return the leased property at the end of the lease. The project company must thus refrain from any action affecting the Islamic investors' property rights which last at least until the option is exercised. It may not sell the Islamic assets or create any security interest on the assets, especially because the assignment or creation of any such security interest without the agreement of the Islamic SPV would, in all likelihood, be disallowed by a French *notaire*.

113. In practice, it is common practice for a clause to stipulate that the project company waive its right to demand that the Islamic investors have any work or repairs done, either when possession is taken or during the lease period. So, the project company will agree to make sure, at its expense and under its sole responsibility, the property is maintained in proper repair, including any fixtures that it may have installed and to make and pay for any and all repairs, regardless of their nature[(78)], including the major repairs provided for under Section 606 of the Civil Code[(79)] or those that may become necessary as a result of construction defects or imperfections[(80)].

(78) Civil Code, Section 1720(2) and Section 1754(1).

(79) Court of Appeals of Paris, Oct. 11, 1989.

(80) Duranton, Guy, «Crédit-bail immobilier», Recueil, V Crédit-bail, no. 117, 2000, p. 21.

114. In *ijara* agreements, lessees are not allowed to use the leased property for unlawful purposes or for purposes other than those set forth in the agreement and they are required to compensate the lessor for any damage caused to the leased property as a result of any misuse or negligence on its part. So, a single wrongful act entitles the lessor to compensation. The lessee is responsible for damage caused to the leased property for the duration of the lease (lessee's liability arising from the *ijara* agreement).

115. Similarly, upon the expiration of the lease, if the project company has not asked to close on the sale or in case of premature termination, it must prepare along with the Islamic investors an inventory of the state of the premises, at its expense, confirming that the Islamic assets are in a functioning state. If they are not, the project company is liable for the cost of the necessary repair work.

116. In addition, the project company may undertake, at its expense, works to improve or refurbish the premises. Any work that entails the demolishing or opening of walls, beams, floors or roofing, the building of any outward or upward extensions or a change in the inside layout will require prior written authorization from the Islamic investors, who, if they do give such authorization, may require that their architect exercises oversight and the architect's will be paid by the project company.

117. What is more, the project company will be required to undertake any and all works, regardless of the cost, required as a result of any statutory or regulatory provisions or any administrative order, in particular for the purpose of obtaining a certificate of conformity or in terms of health and safety and the project company will not be able to assert the provisions of Section 1755 of the Civil Code(81). So the project company agrees to comply with all statutes and regulations on protection against asbestos and to hold the Islamic investors harmless under such legislation.

(81) Section 1755 (created by Act 1804-03-07 promulgated on March 17, 1804) holds that: "no repairs to leased property should be paid for by lessees when they are required as a result of wear and tear or acts of God."

118. In the event that the Islamic project assets have to be inspected, guarded or undergo work, the project company will generally take on these obligations and will alone pay all expenses associated with them. It will, in fact, have to agree to provide the Islamic investors proof of completion. It is often contractually stipulated that the project company may not claim any reduction in rent payments or terminate the lease on this account, regardless of how much work needs to be done or how long it is expected to last.

119. Separately, anything stationary that is added to the property by the project company will be deemed to be its property during the lease-purchase agreement and will automatically become the property of the Islamic investors, who will not be required to pay any compensation therefor, at the normal expiration of the agreement, if the lessee fails to exercise the purchase option or in case of premature termination. Any performance obligations that the project company incurs pertain only to the Islamic project assets. If the property is part of a building co-operative, with regard to any work to be done on the communal parts that is approved and carried by the building owners association, the project company will only have to refund the Islamic investors for the share of the cost that relates to the leased Islamic assets.

120. As indicated above, all lessees are required to take out rental insurance. The lease-purchase agreement stipulates that the project company must have insurance covering all risks associated with using the Islamic assets. The insurance company must be approved by the Islamic investors who may demand that the project company have the insurer inform them of any irregularities on the part of the project company (late payment, incident, cancellation) with respect to its insurance policy. It is worth noting that traditional insurance, *i.e.* non-Islamic insurance, is permitted in the name of the necessity principle, which means that conventional insurance can be used when there is no adequate system of Islamic insurance.

121. The Islamic SPV may also demand that the project company makes sure that the insurance policy stipulates that any insurance payout and/or reimbursement for damage to all or part of the property be paid directly to it. What makes a lease is not the actual use that the lessee makes of

the leased property but the intended use that parties mutually agree to. That is why it is useful to include a clause which provides that any change in the intended use without the authorization of the Islamic SPV is a cause for rescission. So, any changes in layout as a result of any demolishing or opening of walls, beams or floors will require prior written authorization from the Islamic investors and possibly require a building permit to be obtained. Any work authorized by the Islamic investors must be performed at the sole expense and risk and peril of the project company and under the supervision of an architect or engineering firm approved by the Islamic SPV.

122. Any such work constitutes improvement or refurbishment work and therefore the cost as well as any insurance premiums on any insurance policies the project company has taken out in connection therewith, the fees of architects or engineering firms, will, in theory, be paid in full by the project company with no recourse against or recovery from the Islamic investors and without being permitted to offset such costs against moneys owed to the Islamic investors for any other reason. However, in the event that such work, because of their extent or nature, has to be justified by the Islamic investors for tax or accounting purposes, it is generally agreed that payment of the corresponding expenses by the project company will be in the form of a special supplemental rent payment.

However, Islamic Business Law contains special provisions. In the event of the partial destruction of the property, making it unfit for the use for which it was intended, or in case of the total destruction of the asset, the *ijara* agreement will end on the date the total destruction of the property is certified. However, if the loss or partial destruction of the property is caused by misuse or negligence by the project company, it will be required to indemnify the Islamic investors for the value of all rent payments that have not yet become due and payable. The conventional type of insurance will cover this risk. Indeed, there is currently no efficient system of Islamic insurance (*takaful*), therefore conventional insurance is allowed under the principle of necessity (*dharura*).

123. Unlike Islamic sales agreements, the *ijara* can be entered into for a future date. So, while Shari'a Law does not permit sales for future

delivery, *ijara* for a future date is allowed, provided that rent payments commence only after possession of the property is taken. As a matter of fact, in most conventional lease-purchase agreements, lessors purchase property from lessees. Lessees buy the asset in the name of the lessor who will pay the price to the supplier, either directly or through lessee. This is the case of some financial lease agreements where the lease begins on the same day when the price is paid by the lessor, separately and independently of the fact that the lessee paid the supplier and took possession of the asset; which means that the lessee's is responsible for making rent payments even before it takes possession of the asset. Under Shari'a Law, this practice is akin to a *ribawi* transaction which is not permitted. That is why rent payments can only be payable after the lessee takes possession of the asset and not on the day the price is paid. If the supplier is late delivering the asset after the full price has been paid, the lessee must not be required to during the late delivery period. During the construction period, outlays by the Islamic investors will be treated as rent prepayments. Rent payments under the lease- purchase agreement will only commence upon completion of the construction of the Islamic assets.

124. It must be clearly understood that when lessee was authorized by the lessor to take possession of the lease asset from the supplier or to build the building, the Islamic SPV and the project company have specific obligations. In the first phase, the project company is authorized by the lease-purchase company to purchase the property on its behalf from the supplier. At that point, the parties' relationship is no longer an agency relationship: the agent is required to perform the terms of the agency agreement that it entered into and it must, in the performance of the agency agreement, act with due care and due diligence. In our case, the lessor and the lessee are not contractually bound by a lease. The second phase begins on the date at which the project company takes delivery of the property from the supplier. That is why, in the first phase, the project company cannot be liable for the obligations that would apply to a lessee. During this period, it is responsible for performing its duty of due care and due diligence as an agent. It is not until the date of delivery of the asset that it liable for the lease obligations. In other words, the lease takes effect as of the effective

date of the agreement, which is the date the project company takes delivery of the asset.

125. As the owner of the asset, the lessor is required to pay all sales costs paid by the lessee in its capacity as agent, as well as any expenses incurred to import the asset into the lessor's country. Any agreement otherwise, which are often found in conventional financial leases, are contrary to the Islamic moral order.

126. So, a distinction must be drawn between two situations: one is the building construction is contractually based on the agency agreement as indicated above and the other is a construction financing agreement such as a sale for future delivery (sale of property that is yet to be developed, etc.). In the latter case, the project company is independent and acts without being an agent, which has as a result to reinforce its obligations.

127. The lessee is liable for any loss caused to the asset due to its negligence or misuse.
However, it cannot also be liable for the normal wear and tear that occurs during use. But unlike with conventional lease-purchase arrangements, it cannot be liable for the loss of the asset if it is caused by favors beyond its control.

128. Lastly, under Islamic Law, a lessor cannot sublease the property without the lessor's express authorization. Islamic schools of thought are unanimous that subleasing is lawful if the sublessee rent payments are less than or equal to the rent payments to the original lessor. However, opinions are divided in the case where the sublessee is asked to make rent payments that are higher than the rent payments to the original lessor. Muhammad ibn Idris ash-Shafi'i[82] and a number of other Muslim legal scholars consider that the owner of the lease asset should reap the benefit of any extra amount from payments received from the sublessee. That is also the position favored by the Hanafi School. Separately, Abou Hanifa An-Noù'man Ibn Thabi[83] is of the opinion that any extra amount from payments received from the sublessee should not benefit the sublessor who should donate it to charity.

(82) Founder of the Shafi'i School (150-204 H).

However, it should be noted that if the sublessor has modified the leased property by adding anything to it or if it has leased the property in a currency other than the one in which it makes rent payments to the owner, then it may demand higher rent payments from the sublessee and thereby profit from the extra amount. French Law allows subleasing even though a sublease does not create, in principle, a legal relationship between the sublessee and the lessor. From a legal standpoint, though, there is nothing to prevent a lessor from demanding that a sublessee make rent payments directly to it or from ordering it not to make the rent payments to the lessee if the lessee is in default. These options are available by law and set forth in Section 1753 of the Civil Code.

G. Clauses of Critical Importance in the Agreements

129. This section proposes to examine the clauses that are of critical importance in lease- purchase and *ijara* agreements. In the *ijara* agreement, the amount of the rent payments must be specified when the agreement is entered into for the entire lease period. Incidentally, the agreement can contain rent payments amounts that vary from one period to the next, provided that the amount is clearly stipulated for each period. Example (1): Islamic SPV A leases a capital good to project company B for a 7-year period. The amount of the rent payments for the first 4 years is €20,000.00 a month and it is agreed that each year the rent payments will increase 10%. Under these circumstances, the ijara is legally valid. Example (2): In the example above, Islamic investors A determine the amount of the rent payments (€20,000.00) just for the first year. Under this set of circumstances, the lease is null and void. This same requirement exists under French Law, which prohibits, for example, a clause containing two paragraphs written in convoluted language that pertains only to a brief period and fails to give the benchmark index.

130. Yet, in long-term leases, it is not in lessors' interest to set the amount of the rent payments in stone because market conditions fluctuate. In this case, lessors have two options:

- a) they can stipulate in the lease agreement that the amount of the rent payments will increase by a specific percentage (for example, 5%) after an agreed period (for instance, one year);

- b) they can enter into a lease agreement for a shorter period and later decide to extend it on new terms. In this case, the lessee may refuse to extend the lease, in which case the lessee returns the leased property.

However, some Muslim legal scholars have accepted that the amount of the rent payments be indexed to a variable benchmark index if the index is sufficiently specific. For example, lease agreements can stipulate that in the event of any increase in taxes levied by the government, the rent payments will be adjusted accordingly. Under French Law, rent payments can be indexed based on the INSEE building and construction cost index defined as the difference between the monetary depreciation rate and the increase in productivity in real estate construction(83) provided that this clause is written in plain language(84). Similarly, indexing the annual increase of rent payments based on the inflation rate is allowed. So, if the inflation rate goes up by 5%, this will lead to 5% increase in the amount of the rent payments. In this regard, we note however that today's rents rose faster than inflation, and hence it may be interesting to provide indexation on average rents. Some Islamic banks use a benchmark interest rate to calculate the amount of rent payments in order to earn the same amount of profit on a lease-purchase agreement as conventional banks. That is why, Islamic banks adjust the amount of rent payments using an interest rate and the agreement stipulates that the rent payment will be equal to the interest rate or the interest rate plus some margin. Since the interest rate is variable, it cannot be specified for the entire lease period. As a result of this, it is common practice, for the calculation of the periodical rent payment increases, to use the interest rate of a given country as the benchmark (Libor or Euribor). The objection raised with respect to this is that by

(83) Rép. min. éco. et fin., p. 21856, à M. Louis Courroy: JO Sénat Q 26 avr. 1977, p. 658; Court of Appeals of Paris, 5e ch A, 22 avr. 1985, Sté Hôtelière de la Porte de Sèvres c/ Sté Locabail Immobilier: Juris-Data no. 023067.

(84) Court of Appeals of Paris, 16th Chambre-A, Sept. 24, 1985, Sté Sogebail v. Sté CCN: Juris-Data no. 025587.

applying an interest rate to the rent payments, the transaction is akin to *ribawi* financing like business loans made by conventional banks. This is a surmountable obstacle if the agreement specifies, like in the case of *mourabaha*, that the interest rate is only used as a benchmark. To the extent that all other requirements applicable to lease agreement under Shari'a Law are observed, then the agreement can use any point of reference to calculate the amount of rent payments. In fact, the fundamental difference between an interest rate and a rent payment is not the amount to be paid to the bank or the lessor, but rather the risks taken on by the parties. In the lease agreement, the lessor assumes risks as owner of the leased asset. If the asset is destroyed during the lease period, the lessor will take the loss. Likewise, if the lease property becomes unusable, not as a result of any misuse or negligence on the part of the lessee, then the lessor will not be able to demand the rent payments. In conventional financing, things are different: the borrower will be charged interest and repay part of the capital with no consideration with regard to the actual use of the loaned funds; in other words, the destruction of an asset financed through a loan has no consequence on repayment of the loan. The obligation to repay interest and the capital is not extinguished if the financed asset disappears or is destroyed. It appears clearly that in the event that this difference is maintained (the lessor assumes the risk associated with the leased asset), the transaction cannot be classified as a *ribawi* transaction even if the amount of the rent payment paid by the lessee is equal to the interest rate. Under to this analysis, it follows that the use of an interest rate is a mere benchmark does not make an agreement haram in that it is based on interest being charged as part of the transaction. In practice, however, these obligations are often incurred by the lessees who as agents for a fee factored in the calculation of the amount of rent payments. This transfer of risks deprives the distinction of a part of its content. In our opinion, this issue needs to be addressed with great care in for the members of the shari'a board to officially approve the transaction.

131. Based on a careful reading of the provisions of Section L.313-7 of the Monetary and Financial Code, the lessee becomes the owner of the leased property no later than at the expiration of the lease, either through a sale pursuant to a sale undertaking or by directly or indirectly acquiring the property rights to the land on which leased building(s)

was(were) built or by transferring full title to buildings built on land owned by said lessee. Under a sale undertaking, which carries a term, the Islamic SPV or its representative must undertake to sell the leased Islamic assets to the project company if the project company elects to exercise its purchase option. The sale undertaking starts running at the end of the minimum irrevocable period after the lease-purchase agreement takes effect and it ends at the contractually agreed end of the lease-purchase agreement. The so-called irrevocable period is the period during which the purchase option cannot be exercised(85). While parties are generally free to define this period contractually, a practical objection can be made. For tax purposes, there are deadlines that have to be observed and failure to do so can result in dissuasive monetary penalties making the transaction financially complex(86). The lease-purchase arrangement can in fact be challenged if the irrevocable period is too short or if the purchase option is exercised during this period(87).

132. The project company must give exercise notice, by registered letter with signature confirmation of delivery sent to the Islamic SPV's corporate headquarters, at least six months in advance; within three months after that, the project company must pay the Islamic SPV an amount sufficient to cover the sale price and any costs, duties and taxes associated with the sale. Failure to do so may result in the exercise notice being deemed invalid.

133. The agreement can stipulate that if the project company fails to perform its obligations, the sale undertaking will become null and void. The sale price will be determined on the day of the closing in a sale deed entered into through a French *notaire*. The transfer of title will be conditional upon the contractually agreed stipulation that rent payments must be paid on a regular basis and residual value payment be made. Possession will be taken when the property is actually made available.

(85) Gerber, P, « Levée de l'option dans un contrat de crédit-bail immobilier », *Crédit-bail* avr. 1990, p. 49, n° 10.

(86) See below the tax rules that apply to lease-purchases.

(87) French Supreme Court, 3rd Civil Section, June 10, 1980 and French Supreme Court, Business Section, Jan. 15, 1985.

In validly constructed clauses containing exceptions, the parties can expressly agree that the sale will be made at the risk and peril of the project company with no warranties from the Islamic SPV that the property is unoccupied or regarding the existence of hidden defects. In fact, according to legal scholars "*the validity of contractual clauses pursuant to which, as an exception to Section 1641 of the Civil Code, a lessee exercising a purchase option waives its right to bring action against the former lessor for hidden defects affecting the ground or the underground or any imperfections affecting the buildings, is not, in theory, questionable*."

134. What is more, based on Sections 1627 et seq. of the Civil Code, the parties can, through special agreements, agree that the seller will not be required to give any warranty that property is unoccupied. All costs, duties and fees associated with the sale will be paid by the project company, as the buyer. The sale deed must be notarized and the Islamic investors will be required to file a copy of the sale deed with the Mortgage Registry Office as with any property sale. The statutory filing requirements regarding leases and sale undertakings apply, especially the requirement to file a copy of any lease for over 12 years.

135. Under penalty of nullity, Section 1840-A of France's General Tax Code requires that, in order to be legally valid, sale undertakings relating to property, ongoing businesses or a limited number of other things the tax code lists, they have to be entered into either through a French *notaire* or the parties can enter into a private agreement but provided, in this case, that they be registered within 10 days after they are accepted by the beneficiary. However, France's Supreme Court(88) found that "*a lease-purchase agreement is a complex contract in which the sale undertaking only one part of the legal solution enabling the parties to carry out a complete transaction offering them mutual benefits*, [the Supreme Court ruled] *that the appellate court correctly*

(88) French Supreme Court, 3rd Civil Section, Nov. 3, 1981: *Bull. civ*. III, n° 173; *D.* 1982, inf. rap. p. 76; *JCP G* 1982, II, 19867, note El-Mokhtar Bey, upholding Court of Appeals of Bastia, Jul. 19, 1979: *JCP CI* 1980, II, 13260, note David (C), decision involving a lease-back.

reasoned that such a transaction, by its nature, is not subject to the provisions of Section 1840-A of the General Tax Code."

136. And, according to the High Court(89), "*a sale undertaking included in a lease-purchase agreement is inseparably linked to a set of mutual contractual obligations and is not subject to the filing requirement stipulated in Section 1840-A of the General Tax Code*…."

137.In an opinion dated January 15, 2002, the Business Section of France's Supreme Court overturned an appellate court ruling with the following reasoning:

"*In reversing the decision, the Court of Appeals, after finding that under the terms of Article 2 of the March 28, 1990 Agreement SGA had agreed to sell the property in question, the description and the price were defined and determinable while SI had no contractual obligation to purchase the property, held that the sale undertaking was consequently unilateral, but the Court of Appeals enunciated that the since the sale undertaking was set forth in an agreement containing a number of mutual contractual obligations, the sale undertaking was not subject to the filing requirement prescribed under Section 1840-A of the General Tax Code*.

But, by so reasoning, without seeking to determine whether there existed the necessary dependency connection between these various mutual contractual obligations liable to modify the terms of the sale undertaking, the Court of Appeals failed to give a legal basis to its decision."

Furthermore, it is important that the undertaking be a sale undertaking from a lessor and not a purchase undertaking from a lessee. This is a crucial point it determines how the agreement will be legally classified. A lessor cannot reserve its acceptance. The party providing a sale undertaking (the Islamic SPV) promises to sell Islamic assets to another party called a beneficiary (the project company) upon receipt of an exercise notice from the beneficiary. It cannot be a purchase undertaking in

(89) French Supreme Court, 3rd Civil Section, June 3, 1982: *Gaz. Pal*. 1983, 1, p. 8, note El-Mokhtar Bey.

which the project company agrees to purchase the property whenever the Islamic SPV decides to sell. Such an arrangement is contrary to the very purpose of the lease-purchase agreement.

138. With regard to this, France's Supreme Court a contract cannot be legally classified as a lease-purchase agreement if it stipulates that the lessee had "*…already expressed its intent to acquire the property at the end of the lease, which the lessor duly noted reserving its acceptance…. By finding that such a lease agreement was a lease-purchase agreement, even though it found that the purchase of the property leased by the lessee was contingent upon the lessor's acceptance, such that, far from containing a sale undertaking as required under the aforementioned law, the lessee's expression of intent constituted a purchase undertaking, the Court of Appeals failed to reflect the legal implications of its own findings*."(90)

139. In another precedent-setting case, the Supreme Court(91) also opined that based on the agreement "*the lessor acknowledged the lessee's intent to purchase the property, 'reserving its acceptance'… the purchase of the leased property was contingent upon the lessor's acceptance, such that, far from containing a sale undertaking as required under the aforementioned law, the lessee's expression of intent constituted an exclusive lease- purchase purchase undertaking.*"

140. However, when an agreement contains a purchase option that is subject to a single requirement that the beneficiary inform the lessor of its intent to exercise the option at least one month before the lease expires, the clause in question qualifies as a sale undertaking required in lease-purchase arrangements(92). An agreement that does not contain an option to purchase the leased property is not a lease-purchase agreement(93).

(90) French Supreme Court, Business Section, May 30, 1989, Sté Locavehi c/ Skocic, *Bull. civ*. IV, n° 167; *JCP G* 1989, IV, 283.
(91) French Supreme Court, Business Section, June 15, 1999, *RJDA* 10/1999, n° 1118.
(92) French Supreme Court, Business Section, May 13, 1997, *RJDA* 10/1997, n° 1231.
(93) French Supreme Court, Business Section, Apr. 14, 1972, *JCP G* 1972, II, 7369, note Elie Alfandari; French Supreme Court, 1st Civil Section, Oct. 11, 1989, *Bull. civ*. I, n° 327; *D*. 1991, jurispr. p. 225, note Pascal Ancel; *RTD com*. 1990, p. 244, obs. Bernard Bouloc.

141. Yet, Islamic Contract Law requires the leased asset to remain the exclusive property of the lessor that cannot unilaterally undertake to sell the property leased under the lease agreement. In the final analysis, under French Law in order for a lease-purchase agreement to be legally valid, it must contain a sale undertaking from the lessor whereas under Islamic Law specifically prohibits *ijara* agreements from containing any such undertaking.

142. However, our research has found that in the practice of co-financing, this prohibition under Islamic Law can be gotten around if the sale undertaking is separate from the lease agreement. To do this, the undertaking must be set forth in a document that is separate from the lease-purchase agreement. Muslim legal scholars accept transactions structured in this way. It would have to be determined whether a French court would find that an agreement qualifies as a lease-purchase agreement if the lessor's acceptance is set forth in a separate document. From a tax point of view, the July 23, 2010 tax directive provided clarification on the rules applicable to the *ijara*, which confirms our interpretation: the two agreements must be executed at the same time and they must form part of the same contractual deal.

143. According to the aforementioned directive, the *ijara* "*…here is a contract pursuant to which an entity leases a movable or immovable asset to a client for a specific period of time and in exchange for rent payments. The client can be the original owner of the asset. The ijara agreement can contain a sale undertaking or a purchase option exercisable at the end of or during the agreement. The sale undertaking or the purchase option can be separate from the lease agreement*." Based on this explanation, the directive holds that the tax rules applicable to *ijaras* depends on how the transaction is legally classified, subject to whether or not it is considered to be a lease-purchase transaction as defined in Section L.313-7 of the Monetary and Financial Code or a lease that contains a purchase option (also called a "lease with a sale undertaking"). In point of fact, France's tax authorities consider that, from a legal standpoint, both are loan transactions covered under the second paragraph of Section L.313-1 of the Monetary and Financial Code, which states that: "*Lease-purchasing, and, in general, any leasing transactions that involve a purchase option, are treated as loans*."

According to the French tax authorities, it is now possible for sale undertakings to be set forth in a separate document without preventing it from qualifying as a lease- purchase transaction.

H. Project Security Package

144. At first glance, the Islamic investors are just unsecured creditors for all the moneys owed to them by the project company under the lease-purchase agreement(94). As a result of this, in our opinion, Islamic investors will demand certain guarantees that can be in one of a number of forms. We will examine three of them: pledging a lease-purchase agreement as part of a pledge agreement, assigning sublease rent payments as collateral, a share pledge and a guarantee facility.

145. The project company can pledge and give as security to the Islamic investors the intangible assets arising from the lease-purchase agreement, the right to the lease as well as the benefit of the sale undertaking, with no exceptions or reservations. By means of this pledge, the Islamic investors will have all rights and privileges provided by law to pledge creditor on and to the project assets under the lease-purchase agreement. Under the terms of Section L.313-23 of the Monetary and Financial Code, any loan that a lending institution makes to a private law or public law entity or to an individual for business purposes, may involve the institution being given, by the mere delivery of a written statement, an assignment or pledge by the borrower of any business receivable due and payable by any third party (a private law entity, a public law entity or an individual). Therefore, the project company can, if necessary, assign the receivables in a written statement to guarantee payment of the principal, interest and related costs; if, for example, the receivable is rent payments from a sublease, the statement can reference the name of the sublessee.

(94) French Supreme Court, Business Section, Apr. 9, 1991, *Bull. civ*. IV, n° 124, D. 1991. somm. 329, obs. Adrienne Honorat, *RD imm*. 1991.371, obs. Phillipe Delebecque and Philippe Simler, *RTD civ*. 1992.152, obs. Monique Bandrac; Court of Appeals of Paris, Jan. 17, 1985, *JCP*, éd. E, 1985. II. 14255.

146. The Islamic investors can also authorize the project company to receive sublease rent payments on its behalf. In that case, the agreement will need to contain a number of additional clauses. It will have to mention sublease rent payments received by the project company are received on behalf of the Islamic SPV. The Islamic SPV will have to give its express authorization for either party to modify or terminate(95) the sublease agreement. The project company will, we believe, have to agree to refrain from using the rescission clause contained in the sublease agreement and not to extend the sublease without the express written authorization of the Islamic investors.

147. The shares in the project company can be pledged in a pledge agreement entered into through a French *notaire* or as a private agreement that must be notified to the company or accepted by it in a deed prepared by a French *notaire* of which public notice must be given and the date of such public notice will determine the of the pledge creditors. To do this, the project company can pledge and give as security to the Islamic SPV part of its full-paid-up outstanding shares, forming part of its share capital.

148. The Islamic SPV can also demand that the shareholders of the project company agree to maintain the company's share capital in the same geographic location, under penalty of rescinding the lease-purchase agreement. The shareholders will have to agree not to sell their shares in the company and agree to act as guarantors with joint and several liabilities. The Islamic SPV can demand a guarantee facility from a third party as protection against nonpayment of any moneys owed to it.

I. Termination of the Agreement

149. What about termination of the agreement? If the project company fails to perform any of its contractual obligations, the Islamic SPV has the right to terminate the lease-purchase agreement after serving formal notice to pay or formal notice to perform its obligation, that remain unremedied in full or in part. In such a case, the project company may

(95) Virassamy, Georges, « Les clauses contractuelles aménageant l'après-contrat de crédit-bail résolu ou résilié », *JCP E* 1992, I, 137.

be evicted from property or dispossessed of the asset by order of the superior court, certain terms of which are enforceable notwithstanding any challenge or appeal. The project company will then have to return the Islamic SPV's assets or vacate its property immediately, leaving it in a proper state of repair, and provide proof of payment of all taxes, duties, service fees and insurance premiums. This seems impractical when the Islamic assets form, along with the other project assets, an economic entity that is difficult to separate. It is hard to imagine how Islamic assets such as a hospital building that houses a cardiovascular medicine unit can be returned to the Islamic investors.

150. At the end of the lease-purchase agreement, there are three alternatives possible. The first is the parties can negotiate a second lease-purchase agreement. The second alternative is that the project company vacates the premises or returns the asset without exercising the purchase option. The third option, which is most common, is that the project company exercises the purchase option and purchases the property for the residual value, which is the actual value after deducting amortizations included in the rent payments.

151. In such a situation, the Islamic SPV is under no obligation to give notice to the project company if the agreement ends before its term. If the project company remains the owner of the land, the expiration of the lease-purchase agreement occurs at the same time as the construction lease agreement or the long-term lease conferring a right in rem, so that the project company acquires ownership of the buildings with no payment to be made or any expression of intent to be provided.

152. If the lease-purchase is structured such that the purchase is from a real estate investment company, once the property company exercises its purchase option, it will become the owner of the shares that belonged to the Islamic SPV. The determination of the sale price will be a function of the property's residual book value. The price may be calculated as follows:

"*At the contractually agreed end of the lease-purchase agreement, the price will be one euro (€1). For the previous years, the sale price will*

be calculated as follows: The sale price will be the discounted value, on the effective date of the sale, of all moneys due (rent payments and residual value at the end of the lease-purchase agreement) until the end of the agreement. In any case, this amount may not be less than the outstanding amount due on the date the exercise notice is given, plus three percent (3%). These values will be calculated based on the effective date of the agreement such as, given the base annual rents paid on their due date, the sale price applicable at the end of each calendar year yields an annual rate equal to the transaction's discounted rate. It is expressly agreed that the sale price determined in this way, forms, in the minds of the parties, with the rents paid on their contractually agreed due dates, a whole that constitutes the financial terms of this agreement. Consequently, if, for any reason whatsoever, the Islamic investors that own Company X is forced to reduce the contractual amount of one or more rent payments or the dates by which they must be paid, the sale price will be recalculated taking into account, on the one hand, the moneys actually paid and the payment dates, and, one the other hand, any rent payments that Company X may not have received by the contractually agreed due date, absent any rent reduction or payment due date extension–all such that Company X receives, by means of the recalculated price, the returns arising from the strict application of the terms and conditions of this agreement."

It is worth noting, in passing, that the parties are free to determine the calculation formula, which means that neither party can attempt to rescind the sale ex post facto claiming that the price is unfair or claiming hardship (which is accepted by French courts).

153. After the project company gives exercise notice, the sale is done. The sale must comply with legal rules and be set forth in a sale deed entered into through a French *notaire*. The *notaire* must filing a copy of the sale deed with the Mortgage Registry Office no later than two months after closing, which makes the sale enforceable on third parties. All taxes and fees from the sale are paid by the buyer. It should be noted that the Islamic SPV has an obligation to deliver the property to the extent that the project company is already in the premises.

154. The agreement can be terminated prematurely by court-order by action taken by either party because the other party fails to perform its obligations. The agreement can therefore stipulate that the failure to pay any rent payment on the due date, any part of it or the corresponding value added tax, or the failure to payment any maintenance charges or to perform any of the other terms and conditions of the agreement, the lease-purchase agreement will be terminated automatically, without the requirement to get a declaratory judgment from a court, one month after formal written notice is served by a bailiff and the nonperformance remains unremedied in full or in part. Furthermore, when the Islamic assets under the lease-purchase agreement require an operating license or some other legal authorization in order to be used, it is generally stipulated that if they are not obtained, or if a final operating license or authorization is not given, the agreement will be terminated automatically at the behest of one of the parties. Under Section 1226 of the Civil Code, the project company would be required to pay the Islamic SPV a fixed amount in compensation for termination that is commonly called a penalty clause payment. The penalty can, for example, be equal to the sale price determined on the effective date of termination, plus the amount of tax refunds, plus two years of rent payments calculated based on the last rent payment notice sent to the lessee before the termination. A value added tax may apply to the penalty payment. Therefore, the fixed penalty payment due to the lease-purchase company may be reduced if it is found to be excessive and it fails to consider that the creditor has kept the property and can resell it(96).

155. Yet, as we have already indicated, the Islamic moral order prohibits Islamic financial products from including late payment penalties. A finance charge for late payment is considered a *ribawi*. However, in order to avoid the adverse impact of an abusive use of this prohibition, a clause can be included in the lease agreement. In the clause, the project company can be asked to agree, if it fails to make a rent payment by the due date, pay a certain some of money to a charitable organization that works to promote Islam such as, for example, the Arab World Institute in France. In practice, Islamic SPVs may manage a charity fund into which such moneys are paid and used for charitable purposes.

(96) Court of Appeals of Versailles, Feb. 26, 1999, *BRDA* 9/1999, n° 9.

156. The clause could be worded as follows: "*In the event of a late payment of rent that comes due, the project company hereby agrees to pay an amount calculated as…% of the charity fund maintained by the Islamic SPV or designed by it in the agreement; this amount will be used by the Islamic SPV solely for charitable purposes approved by Shari'a Law and may not be included in its balance sheet as income*." While this clause does not compensate the Islamic SPV for its opportunity cost during the default period, it can serve as a powerful deterrent.

157. In lease-purchase operations under French Law, the lessor has the right to unilaterally terminate a lease(97) and to demand payment of the rent payments outstanding for the initial period of the lease. This is not possible under Islamic Law because it goes against the tenants of fairness and social justice under the Islamic moral order that does not accept as a rationale consequence of the termination of a lease that the lessor can just take its property back. Moreover, if the termination is caused by misuse or negligence by the lessee, the lessor can ask it to pay it compensation for the loss caused by the negligence but the lessee cannot be forced to continue to pay the rent for the remaining period. If the leased property is insured, the insurance premiums should be paid by the lessor who will pass on the cost to the lessee.

158. Under the terms of Section L.313-9 of the Monetary and Financial Code, lease-purchase agreements must stipulate, under penalty of nullity, the circumstances under which the agreement can be terminated by the lessee. The termination cannot be based on an implicit interpretation of other termination clauses(98).

159. The termination clause(99) could be worded as follows(100):

(97) Cohen-Steiner, Nicolas, « La clause de résiliation anticipée dans le contrat de crédit-bail immobilier », *Sem. jur*., éd. N. I, 2001, n° 13, p. 661.

(98) French Supreme Court, 3rd Civil Section, Dec. 19, 1983, *Bull. civ*. III, n° 267, *D.* 1984, IR 133.

(99) Pronier, Dominique, *La clause de résiliation anticipée dans un contrat de crédit-bail immobilier*, Supreme Court Rapport, 1998, p. 123 et seq.

(100) Lamy Formulaire commenté Droit immobilier, 2011.

"*The project company may demand the termination of this agreement effective as of [•], subject to the terms and conditions defined hereinafter. This termination may take place effect each year only on the anniversary of the effective date of the lease. The project company must notify the Islamic SPV of its decision to terminate the agreement no more twelve months and no less than nine months in advance by registered letter with signature confirmation of delivery. The project company must vacate the premises no later than ten days before the effective termination date. The Islamic SPV will have an inventory of the state of the premises prepared, at the expense of the project company. The inventory must confirm that the Islamic assets are in a perfect state of repair, in accordance with the provisions of [•] general terms and conditions and that they can be leased for use consistent with their intended use at no expense to the Islamic SPV. The project company must be in compliance with in all its contractual obligations such that the requirements for the Islamic SPV to enforce the rescission clause stipulated in [•] above are not fulfilled. The certificate of conformity must have been obtained. The project company must have paid to the Islamic SPV the fixed penalty payment agreed, equal to the sale price determined on the effective date of termination, plus the amount of tax refunds referred to in [•]. If any of the abovementioned requirements are not fulfilled ten days before the effective date of termination, the Islamic SPV will be entitled, should it so determine, to consider the project company's notice of termination null and void. The Islamic SPV must inform the project company within ten days after the date scheduled for termination, by registered letter with signature confirmation of delivery, explaining which requirement(s) has(have) not be fulfilled. The project company will not have to pay any penalty if, before the date scheduled for termination, it has a third party purchase the property on the following terms: The price must be at least equal to the sale price defined in [•], determined on the day the sale deed was executed in the offices of the French* notaire, *plus any taxes (in particular capital gains taxes) owed as a result of the sale and any tax refunds referred to in [•]. For the purpose of paying real estate conveyance tax, the property's market value, if it is greater than the sale price, will be represented by the parties in the sale deed to be an estimate.*

The sale must, furthermore, be carried out on the terms and conditions set forth in [•]. The project company must inform the Islamic SPV, by registered letter with signature confirmation of delivery, of the full name and address of the future buyer of the property and take personal responsibility of all actions by the buyer until closing on the sale; the Islamic SPV will have not responsibility vis-à-vis the project company in this regard.

This agreement will end on the date the sale deed is executed. The project company will be a party to the sale deed to terminate this agreement and to give its personal undertaking to the buyer to vacate the premises without delay. All rent payments and maintenance charges due and payable until the date either of the termination or of the execution of the sale deed in the offices of the French notaire. Any surplus payment will go to offset any moneys that may be owed by the project company or refunded. The penalty payment stipulated in [•] below will also be due if termination is the result of a decision by a receiver appointed in a court order to commence receivership or liquidation proceedings (Article 37 of Act No. 85-98 of January 25, 1985)."

Conclusion

In summary, project finance seems structurally compliant with the Islamic moral order, which we believe designates the set of rules or intangible principles. Firstly, financiers can be repaid from the cash flow generated from the project, which is consistent with the *riba* prohibition. Secondly, the project's success is based on the performance of the financed asset, which complies with the *gharar* and asset banking prohibition (speculation). Moreover, the projects involve the construction of physical infrastructure, which meets the requirement that the object be halal (lawful). Lastly, the project risks are borne by the party that is in the best position to evaluate them, which is consistent with the principle of fairness in contractual relations.

However, putting this reasoning into practice is not as easy as it seems and it would be a disservice to suggest that things are set in stone when, in actual fact, they are more flexible and supple. For, as we have seen, while it claims or aims to be unconditional, the Islamic moral order

subjects financing agreements to a set of mandatory rules the binding force of which varies in degree. Here is a brief reminder of the principles: the use of conventional hedging practices such as futures and options is prohibited; late performance or nonperformance penalties are prohibited; ownership of the asset must be transferred to the Islamic financiers; the use of certain conditions precedent is prohibited in contracts.

Co-financing involves a comingling of separate rights and obligations and one of the real challenges is achieving a fair balance through their articulation. That is what makes it complex. While conventional financiers seek to preclude their risks, Islamic financiers will not accept to fund any project that is not compliant with moral order.

In a detailed examination, we therefore sought to highlight the differences, stress the rationales and inventory the constraints in order to propose a contractual model that could surmount them. The challenge here was to effectively meet the requirements of both conventional investors and their Islamic counterparties. Now, France has a tax system that

promotes Shari'a compliant investments. It must be noted that with respect to *mourabahas*, financiers' income is the remuneration from a deferred payment akin, from the tax standpoint, to interest due for the period. This income is taxable, for the duration of the *mourabaha*, as industrial and business income. Profits can be spread out over the duration of the deferred payments, regardless of the payments made, at a frequency identical to that used for withholdings booked in connection with the operation and in accordance with a schedule appended to the contract. Likewise, moneys paid by the client are exempt from the mandatory fixed tax on fixed income investment products when financiers and not resident in France. In addition, financiers' income is exempt from value added tax, as is the only that part of fees paid for financial intermediation services.

With respect to investment *sukuks*, they can be considered for tax purposes akin to bonds or negotiable debt securities depending on the legal status and their maturity. From this standpoint, the income paid to

bearers of *sukuks* is treated from a tax perspective like ordinary interest. Their issuers are allowed to deduct from their taxable income a charge corresponding to the compensation due pursuant to the issue agreement and calculated based on a "desired profit margin."

As for the *ijara*, when the transaction involves and lease-purchase arrangement or a lease with a purchase option, the rules governing lease-purchase agreements apply to them, even when the client's purchase option is set forth in a document separate from the lease agreement, provided that they form part of the same contractual deal.

The *istisna* is regarded as a conventional purchase transaction involving phased payments and/or payment terms. Consequently, financiers' income is the remuneration from a deferred payment akin to interest due for the period considered.

If recent tax directives are a significant move in the right direction, they do not make it possible, in and of themselves alone, to achieve their stated ambitions. Even though we have managed to overcome the constraints identified, there are still many obstacles to the use of co-financing. That is why, as we come to the end of our study, it is fitting to mention a number of the incentives recommended by the Paris-Europlace Islamic Finance Commission.

Firstly, the fact that Islamic SPVs are not lending institutions means that they cannot receive security and collateral under the Dailly Act. It would be helpful to create a mechanism in France's civil code enabling receivables to be assigned as security or collateral, thereby overturning the December 19, 2006 precedent set by the Business Section of France's Supreme Court.

Secondly, given the current state of our legislation, when an Islamic SPV resells Islamic project assets to a buyer, it is required to give the buyer a warranty regarding hidden defects (warranty required as a matter of public policy), which makes no sense in short-term sale/resale transactions. Therefore, there is a need, on the one hand, when the resale of the financed property occurs at the same time as the first sale, for resellers to be exempt from given a hidden defect warranty (which

then bears on the initial seller), and, on the other hand, to clarify the rules applicable to lease-purchase arrangements, which are poorly defined, and expand the rules applicable to trusts.

Thirdly and lastly, it would be helpful for SPVs that are subsidiaries of lending institutions not to be required to obtain a banking business license. In effect, the fact that Islamic SPVs are not lending institutions means that, under normal circumstances, it cannot provide lease-

purchase services. Any subsidiary in which a lending institution has a 90% stake to be authorized as a bank as a part of its parent company (this is the notion of a "banking license loan") which would not be in breach of Directive 2006/48EC.

Glossary of Islamic Banking Terms

The following has been adapted from the SBP Publication, 'Islamic Banking and Finance: Theory and Practice' by Muhammad Ayub, Sr. J.D. IBD, SBP)

Amanah
This refers to deposits in trust. A person can hold a property in trust for another, sometimes by express contract and sometimes by implication of a contract. Amanah entails an absence of liability for loss except in breach of duty. Current Accounts are regarded as Amanah (trust). If the bank gets authority to use Current Account funds in its business, Amanah transforms into a loan. As every loan has to be repaid, banks are liable to repay the full amount of the Current Accounts.

Arbun
Down payment; a non-refundable deposit paid by a buyer retaining a right to confirm or cancel a sale.

Al-'Aariyah
(Gratuitous loan of non-fungible objects) (Al-'Aariyah means the loan of a particular piece of property, the substance of which is not consumed by its use, without anything taken in exchange, In other words, it is the gift of usufruct of a property or commodity that is not consumed on use. It is different from Qard in that it is the loan of fungible objects which are consumed on use and in which the similar and not the same commodity has to be returned. It is also a virtuous act like Qard. The borrowed commodity is treated as liability of the borrower who is bound to return it to its owner.

Bai' Muajjal
Literally this means a credit sale. Technically it is a financing technique adopted by Islamic banks that takes the form of Murabaha Muajjal. It is a contract in which the seller earns a profit margin on his purchase price and allows the buyer to pay the price of the commodity at a future date in a lump sum or in installments. The bank has to expressly mention the cost of the commodity and the margin of profit is mutually agreed. The price fixed for the commodity in such a transaction can be the same as the spot price or higher or lower than the spot price.

Bai' Salam
Salam means a contract in which advance payment is made for goods to be delivered later. The seller undertakes to supply some specific goods to the buyer at a future date in exchange for being paid in advance a price fully paid at the

time of contract. According to the normal rules of the Shariah, no sale can be effected unless the goods are in existence at the time of the bargain, but Salam sale forms an exception given by the Prophet himself to the general rule provided the goods are defined and the date of delivery is fixed. It is necessary that the quality of the commodity intended to be purchased is fully specified leaving no ambiguity leading to potential disputes. The objects of this sale are goods and cannot be gold, silver or currencies because these are regarded as monetary values exchange of which is covered under rules of Bai al Sarf, i.e. mutual exchange which must be hand to hand without delay. Barring this, Bai' Salam covers almost everything which is capable of being definitely described as to quantity, quality and workmanship.

Bai' bil Wafa
Sale with a right in the seller, having the effect of a condition, to repurchase (redeem) the property by refunding the purchase price. According to the majority of Fuqaha this is not permissible.

Daman
1) Contract of guarantee, security or collateral;2) Responsibility of entrepreneur/manager of a business; one of two basic relationships toward property, entailing bearing the risk of its loss.

Dayn
means Debt .A Dayn comes into existence as a result of any contract or credit transaction. It is incurred either by way of rent or sale or purchase or in any other way which leaves it as a debt to another.

Duyun
(debts) ought to be returned without any profit since they are advanced to help the needy and meet their demands and, therefore, the lender should not impose on the borrower more than what he had given on credit.

Falah
Falah means to thrive, to become happy or to have luck and success. Technically it implies success both in this world and in the Akhirah (Hereafter). The Falah presumes belief in one God, the apostlehood of Prophet Muhammad, Akhirah and conformity to the Shariah in behaviour.

Fiqh
Islamic law. The science of the Shariah.

Gharar
This means any element of absolute or excessive uncertainty in any business or a contract about the subject of contract or its price, or mere speculative risk. It has the potential to lead to undue loss to a party and unjustified enrichment of the other, which is prohibited.

Al Ghunm bil Ghurm
This provides the rationale and the principle of profit sharing in Shirkah arrangements. Earning a profit is legitimized only by engaging in an economic venture, applying risk sharing principles and thereby contributing to the economy.

Hadith
(see Sunnah)

Halal
Anything permitted by the Shariah.

Haram
Anything prohibited by the Shariah. Examples are wine and pork.

Hawalah
Literally, this means a transfer.Legally, it is an agreement by which a debtor is freed from a debt by another becoming responsible for it, or the transfer of a claim of a debt by shifting the responsibility from one person to another – contract of assignment of debt. It also refers to the document by which the transfer takes place.

Hibah Gift. Ijara
means letting on a lease. It refers to the sale of a definite usufruct of any asset in exchange for a definite reward. It refers to a contract of land leased at a fixed rent payable in cash and also to a mode of financing adopted by Islamic banks. It is an arrangement under which the Islamic banks lease equipment, buildings or other facilities to a client, against an agreed rental.

Ijarah-wal-Iqtina‘
means a mode of financing, by way of hire-purchase, adopted by Islamic banks. It is a contract under which the Islamic bank finances equipment, building or other facilities for the client against an agreed rental together with a unilateral undertaking by the bank or the client that at the end of the lease period, the ownership in the asset would be transferred to the lessee. The undertaking or the

promise does not become an integral part of the lease contract to make it conditional. The rental as well as the purchase price are fixed in such a manner that the bank gets back its principal sum alongwith with some profit, which is usually determined in advance.

Ijtihad
Refers to the endeavour of a qualified jurist to derive or formulate a rule of law to determine the true ruling of the divine law in a matter on which the revelation is not explicit or certain, on the basis of Nass or evidence found in the Holy Qur'an and the Sunnah. Express injunctions have no room for Ijtihad. Implied injunctions can be interpreted in different ways by way of inference from the accepted principles of the Shariah

'Illah
This is the attribute of an event that entails a particular Divine ruling in all cases possessing that attribute. 'Illah is the basis for applying analogy for determining permissibility or otherwise of any act or transaction.

Ijma'
Consensus of all or a majority of the leading qualified jurists on a certain Shariah matter in a certain age.

'Inah
(A kind of Bai): this is a double sale by which the borrower and the lender sell and then resell an object between them, once for cash and once for a higher price on credit, with the net result being a loan with interest.

'Inan
(A type of Shrikah): this is a form of partnership in which each partner contributes capital and has a right to work for the business, not necessarily in equal shares.

Istihsan
this is a doctrine of Islamic law that allows exception to strict legal reasoning, or guiding choice among possible legal outcomes, when considerations of human welfare so demand.

Israf
This refers to immoderateness, exaggeration and waste and covers spending on lawful objects but exceeding moderation in quantity or quality; spending on superfluous objects while necessities are unmet; spending on objects which are

incompatible with the economic standard of the majority of the population. See also Tabzir.

Istisna'a
This is a contractual agreement for manufacturing goods and commodities, allowing cash payment in advance and future delivery or a future payment and future delivery. A manufacturer or builder agrees to produce or build a well described good or building at a given price on a given date in the future. Price can be paid in installments, step by step as agreed between the parties. Istisna'a can be used for financing the manufacture or construction of houses, plant, projects, and the building of bridges, roads and highways.

Jahala
Ignorance, lack of knowledge; indefiniteness in a contract, sometime leading to Gharar.

Kali bil-Kali
The term Kali refers to something delayed. It appears in a maxim forbidding the sale of al-Kali bil-Kali i.e. the exchange of a delayed counter value for another delayed counter value.

Al-Kafalah
(Suretyship) Literally, Kafalah means responsibility, amenability or suretyship. Legally in Kafalah a third party become surety for the payment of a debt. It is a pledge given to a creditor that the debtor will pay the debt, fine etc. Suretyship in Islamic law is the creation of an additional liability with regard to the claim, not to the debt or assumption only of the liability and not of the debt.

Kharaj bi-al-Daman
Gain accompanies liability for loss. This is a Hadith forming a legal maxim and is a basic principle of Islamic finance– see also Al-Ghunm bil Ghurm.

Khiyar
Means an option or the power to annul or cancel a contract.

Khiyar al-Majlis
Means the power to annul a contract possessed by both contracting parties as long as they do not separate.

Khiyar al-Shart
A right, stipulated by one or both of the parties to a contract, to cancel the contract for any reason for a fixed period of time.

Mal-e-Mutaqawam
Things the use of which is lawful under the Shariah; or wealth that has a commercial value. Legal tender of the modern age that carry monetary value are included in Mal-e-Mutaqawam. It is possible that certain wealth has no commercial value for Muslims. Examples would be pork or wine.

Mithli
(Fungible goods): Goods that can be returned in kind, i.e. gold for gold, silver for silver, US $ for US $, wheat for wheat, etc.

Mubah
Means an object that is lawful (i.e. something which is permissible to use or trade in).

Mudarabah
A form of partnership where one party provides the funds while the other provides expertise and management. The latter is referred to as the Mudarib. Any profits accrued are shared between the two parties on a pre-agreed basis, while loss is borne by the provider(s) of the capital.

Murabaha
Literally this means a sale on mutually agreed profit. Technically, it is a contract of sale in which the seller declares his cost and the profit. Murabaha has been adopted by Islamic banks as a mode of financing. As a financing technique, it can involve a request by the client to the bank to purchase a certain item for him. The bank does that for a definite profit over the cost which is stipulated in advance.

Musawamah
Musawamah is a general kind of sale in which the price of the commodity to be traded is bargained between seller and the purchaser without any reference to the price paid or cost incurred by the former.

Maisir
An ancient Arabian game of chance played with arrows without heads and feathering, for stakes of slaughtered and quartered camels. It came to be identified with all types of hazard and gambling.

Musharakah
Musharakah means a relationship established under a contract by the mutual consent of the parties for sharing of profits and losses in a joint business. It is an agreement under which the Islamic bank provides funds which are mixed with the funds of the business enterprise and others. All providers of capital are entitled to participate in management, but not necessarily required to do so. The profit is distributed among the partners in pre-agreed ratios, while the loss is borne by every partner strictly in proportion to respective capital contributions.

Qimar
Qimar means gambling. Technically, it is an arrangement in which possession of a property is contingent upon the happening of an uncertain event. By implication it applies to a situation in which there is a loss for one party and a gain for the other without specifying which party will lose and which will gain.

Qiyas
Literally this means measure, example, comparison or analogy. Technically, it means a derivation of the law on the analogy of an existing law if the basis (‘illah) of the two is the same. It is one of the sources of Islamic law.

Riba
means an excess or increase. Technically, it means an increase over the principal in a loan transaction or in exchange for a commodity accrued to the owner (lender) without giving an equivalent counter-value or recompense (‘iwad) in return to the other party; every increase which is without an ‘iwad or equal counter-value.

Riba Al-Fadl
Riba Al-Fadl (excess) is the quality premium in exchanging low quality with better quality goods e.g. dates for dates, wheat for wheat, etc. – an excess in the exchange of Ribawi goods within a single genus. The Concept of Riba Al-Fadl refers to sale transactions while Riba Al- Nasiah refers to loan transactions.

Qabul
Acceptance, in a contract; see also Ijab.

Qard
(Loan of fungible objects): The literal meaning of Qard is ‘to cut’. It is so called because the property is really cut off when it is given to the borrower.

Legally, *Qard* means to give anything having value in the ownership of the other by way of virtue so that the latter could avail of the same for his benefit with the condition that same or similar amount of that thing would be paid back on demand or at the settled time. It is a loan which a person gives to another as a help, charity or advance for a certain time. The repayment of the loan is obligatory. The Holy Prophet is reported to have said "…..Every loan must be paid……". But if a debtor is in difficulty, the creditor is expected to extend time or even to voluntarily remit the whole or a part of the principal. *Qard* is, in fact, a particular kind of *Salaf*. Loans under Islamic law can be classified into *Salaf* and *Qard*, the former being loan for a fixed time and the latter payable on demand. (see *Salaf*)

Riba Al-Nasiah

Riba Al-Nasiah or *riba* of delay is due to an exchange not being immediate with or without excess in one of the counter values. It is an increment on principal of a loan or debt payable. It refers to the practice of lending money for any length of time on the understanding that the borrower would return to the lender at the end of the period the amount originally lent together with an increase on it, in consideration of the lender having granted him time to pay. Interest, in all modern banking transactions, falls under the purview of *Riba* Al-Nasiah. As money in the present banking system is exchanged for money with excess and delay, it falls, under the definition of *riba*.

Ribawi

Goods subject to Fiqh rules on Riba in sales, variously defined by the schools of Islamic Law: items sold by weight and by measure, foods, etc.

Al- Rahn

Means pledge or collateral; legally, Rahn means to pledge or lodge a real or corporeal property of material value, in accordance with the law, as security, for a debt or pecuniary obligation so as to make it possible for the creditor to recover the debt or some portion of the goods or property. In the pre-Islamic contracts, Rahn implied a type of earnest money which was lodged as a guarantee and material evidence or proof of a contract, especially when there was no scribe available to put it into writing. Theinstitution of earnest money was not accepted in Islamic law and the common Islamic doctrine recognized Rahn only as a security for the payment of a debt.

Salaf
Means loan/debt .The word Salaf literally means a loan which draws forth no profit for the creditor. In wider sense, it includes loans for specified periods, i.e. short, intermediate and long- term loans. Salaf is another name for Salam as well wherein the price of the commodity is paid in advance while the commodity or the counter value is supplied in future; thus the contract creates a liability for the seller. Amount given as Salaf cannot be called back, unlike Qard, before it is due. (see Qard)

Al-Sarf
Basically, in pre-Islamic times this was the exchange of gold for gold, silver for silver and gold for silver or vice versa. In Islamic law such an exchange is regarded as 'sale of price for price' (Bai al Thaman bil Thaman), and each price is consideration of the other. It also means sale of monetary value for monetary value – currency exchange.

Shariah
The term Shariah refers to divine guidance as given by the Holy Qur'an and the Sunnah of the Prophet Muhammad and embodies all aspects of the Islamic faith, including beliefs and practice.

Shirkah
Means a contract between two or more persons who launch abusiness or financial enterprise to make profits. In the conventional books of Fiqh, the partnership business is discussed under the option of Shirkah and that may include both Musharakah and Mudarabah.

Sunnah
Means custom, habit or way of life. Technically, it refers to the utterances of the Prophet Muhammad other than the Holy Quran. These utterances are known as Hadith, or his personal acts, or sayings of others, tacitly approved by the Prophet.

Tabarru'
Means a donation/gift the purpose of which is not commercial but is done to seek the pleasure of Allah. Any benefit that is given by a person to other without getting anything in exchange is called Tabarru' It is absolutely at the lender's own discretion and without any prior condition or inducement for reward.

Tabzir
Spending wastefully on objects which have been explicitly prohibited by the Shariah irrespective of the quantum of expenditure. See also Israf.

Ujrah
A contract of agency in which one person appoints someone else to perform a certain task on his behalf, usually against a certain fee.

"تكييف متطلبات النظام الأخلاقي الإسلامي حسب قانون تمويل المشاريع وإمكانيات القانون الفرنسي بالنسبة لهيكل الاستصناع – الإجارة التمليكية"

هوج مارتين سيسترون

المستخلص. بينت هذه الدراسة أن عقد تمويل المشاريع ينسجم مع أهداف التمويل الإسلامي، وستصف هذه الورقة القواعد المشتركة بينهما. أن كليهما يشترط: وجود أصول ملموسة، وتقاسم للمخاطر، فكما أن الشريعة لا تسمح للمراهنات والعمليات المحفوفة بالمخاطر أو المبيعات الخطرة (عالية الغرر) فإن عقد تمويل المشاريع يشترط توفر تحليل شامل للمخاطر التقنية والتعاقدية مع مصفوفة تحددها وتبينها مما يساهم في تحسين شروط التمويل. أيضا كليهما يخضع التمويل لمجموعة من القيود الأخلاقية والاجتماعية والاقتصادية القائمة على الشريعة والقانون ويتطلب ترتيبات تعاقدية خاصة. إن الهدف الأساسي من هذه الدراسة هو تحليل القدرة على التكيف لمطالب النظام الأخلاقي الإسلامي في عقد معاملات تمويل المشروع المشترك بموجب القانون الفرنسي. وبعبارة أخرى، يجب أن تمتثل الترتيبات التعاقدية مع الأنظمة المصرفية الفرنسية وتكون متسقة مع متطلبات النظام الأخلاقي الإسلامي. ولهذه الغاية، تقترح هذه الدراسة نموذجا يوفر الحلول المناسبة في القانون الفرنسي والتي تسهم في التوفيق بين هذه المصالح المتضاربة. أن التمويل الإسلامي وقوة نظامه الأخلاقي جعل تنفيذ صفقة التمويل تحديا استثنائياً. تهدف هذه الدراسة إلى تسليط الضوء على هذه التحديات والتوفيق بين المصالح المتضاربة بين اطرافها، وتقدم الدراسة عرضا للتحديات الهيكلية بغض النظر عن التحديات المرتبطة بهذه القواعد والتوترات التي لا يمكن التغلب عليها، لكونها تتطلب درجة معينة من التطور.

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Islamic Project Finance

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Abstract. As Islamic project finance develop in strength and scope, it interacts more frequently with conventional financial structures, governments, multinational enterprises and international organizations. The emerging Islamic project finance and the international system of project finance are reshaping one another at the same time as they are transforming the world economy. This coexistence between systems is not a simple "domestication" of burgeoning Islamic practice by western-dominated structures, but an improved series of reciprocal influences and mental adaptations that could evolve into an international process of collective learning and cooperation(2).

The last decade has witnessed a global surge in private project financing especially in infrastructure development creating major opportunities for Islamic banks and institutions. This growth was as a result of a renewed government focus and a tremendous growing appetite for infrastructure investments. We should not underestimate the importance of liquidity in bringing Islamic finance into the mainstream. The potential to target capital from Islamic countries is enormous. In addition, the pressing infrastructures needs of the Middle East and the North African region are also huge(3). This paper aim to pull together the key elements regarding the road ahead for Islamic project finance.

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(2) **R.R Bianchi** (2007) "Islamic Finance and the International system: Integration without Colonialism", in "Integrating Islamic Finance into the Mainstream: Regulation, standardization and Transparency", *Islamic Finance Project*, Harvard University, p. 133.

(3) **J. Collins** (2007) "The road ahead for Islamic Finance", in: "Integrating Islamic Finance into the Mainstream: Regulation, standardization and Transparency", *Islamic Finance Project*, Harvard University, p. 133.

Introduction

Large scale industrial infrastructure or real estate projects present unique financing challenges. It requires mobilizing necessary resources through equity investors (often the sponsors of the project) and the availability of debt financing usually on a non-recourse or limited recourse bases. The non-recourse party – the lender – will only look to the cash flow of the project for the repayment of his loan. This type of financing is extremely rare. Limited recourse financing, is the general rule, the lenders can look to the profit revenues, to borrowers shares in the project company and to the assets of the project in order to repay their loans if the borrower fails to comply with his financial obligations to the lenders(4).

The structure of a project financing is often rendered rather complex due to the involvement of a multitude of local and international parties such as investors, project companies, lenders, construction and operating companies, users, legal consultants, insurers, and sometimes governments in BOT structures. The complexity of financing structures and the multiplicity of participants are a source of a multitude of risk factors that requires a body of various agreements and documents in order to identify these risks and to allocate them between the concerned partners in the project. Regardless the common desire of all these participants to maximize predictability, stability and success of the project, the nature of their interest is different, sometimes contradictory. Mc Millen is of the view that "*each party will participate in the project financing transaction bound by their existing institutional perceptions and practices with respect to such matters as risk allocation, risk coverage, underwriting criteria and accounting treatment*"(5). Everyone in his specialty and after his viewpoint, examines the project and seeks to detect the slightest risk to not accept and support without having properly assessed(6). Certainly, the success of project financing is based on the interweaving of the skills of project participants, their teamwork and a

(4) **G. Vinter** (1998) *Islamic Project Finance*, Sweet and Maxwell, p. 112.
(5) **M.J.T. MC** Millen (2007) "Islamic Project Finance", in "*Handbook of Islamic Banking*", Edward Elgar Publishing limited, p. 202.
(6) **A.M. Toledo, P. Lignieres** (2002) *Le financement de projet*, Joly, p. 8.

global reflection on the structure of financing, the costs of the project and risks to be taken by the various project participants(7).

Co-financing including Islamic tranche (as opposed to fully funded projects on a sharia-compliant basis) are the most frequently encountered structures capable to reconcile different financial approaches. These structures will allow both investors – Islamic and Western – to operate within a context of predictability, stability and certainty that is acceptable to all parties.

This present paper undertakes evaluating the basic elements in traditional Western project finance and Islamic finance in order to understand the parallels and the similarities between both systems (I). It will also identifies risk factors facing the operation of project finance and analyses these risks allocation and management (II). Finally, it will discuss the coexistence of traditional project finance with Sharia compliant structures (III).

I. Similarities Between Traditional Project Finance and Islamic Finance

Certainly, there are profound differences between Islamic finance and conventional finance from the point of view of origin, architectural and legal and fiscal environment. But in practice, particularly in the field of project finance there are several points of convergence. Historically, we can note striking similarities between project financing and some classical Islamic financing techniques used in the past. These similarities are not coincidental, they arise out of the very nature and conceptual basis of project finance itself(8). While Muslim traders in the Ottoman empire financed their maritime projects using the profit sharing instrument of *Mudaraba*, the Crown of England, in the thirteenth century, was associated with Italian bankers Frescobaldi through a production payment loan – a quasi-equity facility as a structure to finance the silver mines in the area of Devon. Italian bankers

(7) **A.M. Toledo, P. Lignieres** (2002) Le financement de projet, Joly, p. 8.
(8) **M. Khan** (1997) « Designing an Islamic model for project finance », *International Financial Law Review*, p. 16.

exploited the mines for a period of two years and were repaid their loans by the results of mining(9).

In addition, political, economic and cultural ties and exchange between the Muslim world and the West throughout history have meant that the financial structures put in place can be quite similar. One can also cite the reforming efforts of the Islamic doctrine in the field of finance in order to fulfill the contemporary financial needs while respecting the requirements of Islamic law.

A. Conceptual parallels

Islamic finance, which is an important component of Islamic economics, is broadly based on some prohibitions and encouragements. The structure of Islamic finance revolves around the prohibition of any interest or any *ex ante* return derived on a loan/debt (*Riba*). *Gharar* is also prohibited, it involves risk, uncertainty, lack of adequate value-relevant information (*jahl*) and speculation. *Kimar* and *maysir* (gambling and games of chance) are also prohibited. Any trade in *haram* prohibited good is not accepted in Islam. In addition to these major prohibitions, Sharia has enunciated a set of principles that provide a basic framework for the economic activities in general, and for the financial and commercial contracts in particular. These principles are the Profit and Loss Sharing PLS and asset backed business and transactions. Moreover, Islam shares with the Western societies a common moral/behavioral standards such as justice, fair dealing, documentation and transparency, paying liabilities, mutual cooperation and free marketing(10)

It is pertinent to observe that Islam is not alone in prohibiting usury. Over 1400 years Judaism and Christianity have all opposed usury. Any form of interest was prohibited, but gradually with growth of commerce the practice of interests was accepted. What is important here is to understand the rationale for the prohibition of interest, why all these revealed religions have prohibited interest?. According to all relevant texts and principles of Islamic law, Sharia ban all kind of interest to

(9) **R.L. Klarmann** (2003) Islamic project finance, Thesis, University of Lausanne, p. 81.
(10) **M. Ayub** (2007) Understand Islamic Finance, John Wiley & Sons Ltd., p. 64.

prevent injustice, encourage work, and productive efforts, seek equitable form of transaction and block the means that lead to the accumulation of wealth in a few hands.

In Talmudic law, although the interest was only prohibited among the brothers and fellow members of the tribe or the adherents to the common faith, the concept of interest was considered as a practice against the principle of social justice. It creates an imbalance of benefits between the parties. On the one hand, the borrower is forced by need or by circumstances, to borrow with interest. On the other hand, the lender withdrew from just lending a profit without any effort or risk(11). Under Christianity, St Thomas Aquinas, has condemned usury because '*it leads to inequality which is contrary to justice*". Prohibition of usury in biblical sources referred to poor people, widows and orphans and was allied to several ethical notions such as "lend freely to poor hoping for nothing thereby" and justice. To the canonists, interest lead to the inequality between parties, wealthy receives an unearned income from the unfortunate, according to them, usurer is anyone who sells his goods on credit and ask for higher price because of the lapse of time in the transaction(12). These similarities between the attitude of the three revealed religions to interest are striking. They all agree that interest implies gaining profits without giving anything in exchange. Money is not used in a productive manner, it will lead to an ever-increasing share of risk-free capital vis-à-vis risk related capital. These parallel are hardly surprising, since Islam, historically is the third revealed religion. It comprises like the other two religions a set of principles that guide and regulate mankind spiritual and material life. It also builds on, sustains and fulfils the message of its two monotheist antecedents. On top of that, Muslims should believe in Jesus and Moses as messengers of God, and all the prophets(13).

(11) **S. Schwarzfuchs**, « A. weingort. Intérêt et crédit dans le droit talmudique, Revue de l'histoire des religions, tom 199, n°2, 1982, p. 207.)

(12) **R.H. Tawney** (1926) Religion and the Rise of Capitalism, Harcourt Brace, P. 59-61.

(13) **M. Lewis** (2007) "Comparing Islam and Christian attitudes to usury", in "*Handbook of Islamic Banking*", Edward Elgar Publishing limited, p. 69.

If we turn to the forbidden *bay al-gharar* , Professor M. Al-ZARQA says that " *bay al-gharar is the probable sale of items whose existence or characteristics are not certain"*. Ambiguity in the terms of trade can lead to error and to exposure to excessive risk. Ignorance of the nature of the goods traded, price or conditions of sale is likely to cause an imbalance benefiting one party over another. In order to ensure that risk are shared rather than sold, Islamic law has ruled the consumer information and standardized named contracts to ensure a balance of benefits and protect the weaker party - consumer - in the transaction. In the field of Islamic finance, a valid financial contract, should be lawful, its object should be clearly defined at the time of conclusion of contract and Its quantity and its value must be clearly defined. Finally its delivery should be possible, certain and immediate. However, in order to better adapt Islamic law to the needs engendered by modern economic activity, Muslim jurists have allowed two exceptions to the prohibition of the sale of future goods : the sale to be delivered (*Bay al-Salam*) and commission to manufacture(*Istisna*). These two contracts were permitted under certain conditions, they have to specify the term of the contract, the price to be paid and the characteristics of the item.

Similarly, the French consumption law protects the consumer in its contractual relationship with the professional(14). The lack of information on essential characteristics of a product will constitute error on its essential qualities that causes a significant imbalance between the rights and obligations of parties to the contract. Indeed, to protect the consumer's consent, there are a number of legal obligations of information to the consumer. Under the article L. 113-3 of the Code of Consumption, "any vendor of a product or a provider of a service must, by the mean of marking, labeling, displaying or any other suitable method, inform consumers about the price, the limitations of contractual liability and the special conditions of sale ". L. 114-1 also regulates the obligation to provide information on delivery time, in any sale or service contract the vendor must specify the date by which he agrees to deliver the goods or perform the services especially when the delivery is not immediate and if the agreed price exceeds the limit set by regulation. It is so, in terms of readability of terms and conditions of

(14) **Y. Picod *et* H. Davo** (2005) Droit de la consommation, Armand Colin, p. 111.

contracts between professionals and consumers, according to article L. 133-2 of the Code of consumption, they must be presented and written in a clear and understandable manners.

When it comes to the Islamic prohibition of trade in all immoral activities affecting the interests of mankind, disturbing the moral and damaging the economy such as transactions related to alcohol, narcotics, pork, pornography, armaments *etc*... This principle implies that every act must secure in the purpose and usefulness of its subject justice, equity and balanced mutual benefits of the contracting parties. Ethics is an integral part of Islamic law, it guides individuals in their relationships. Under French law, protection of public order and morality "*bonnes mœurs* " are core principles that provide contractors with guidelines and impose certain behaviors, sometimes, mandatory. Indeed, under Article 6 of the French Civil Code "you cannot waive, by private agreement, the laws of public order and morality. "

In addition to its special function, Islamic financial Institutions through project financing, like any other aspects of Islamic society, are expected to "*contribute richly to the achievement of the major socio-economic goals of Islam*"(15). The most important of these goals, are the economic well-being through justice and the equitable distribution of income and wealth, full employment and a high rate of economic growth, stability in the value of money and the mobilization and investment of savings ensuring a fair profit sharing to all parties involved in the project(16). These ethical goals join the requirements and the objectives of the concept of sustainable development which is defined and set by the World Commission on Environment and Development of United Nation. According to the Commission "*humanity has the ability to make development sustainable to ensure that it meets the needs of the present without compromising the of future generations to meet their own needs. The concept of sustainable development does imply limits – not absolute limits but limitations imposed by the present state of*

(15) **U. Chapra** (1985) *Towards a just monetary system ; A discussion of money, banking, and monetary policy in the light of Islamic teaching*, Islamic foundation, p. 55.

(16) **M.K. Hassan** and **M. Lewis** (2007) "Islamic Banking: an Introduction and Overview", in "*Handbook of Islamic Banking*", Edward Elgar Publishing limited, p. 5.

technology and social organization on environmental resources and by the ability of the biosphere to absorb the effects of human activities. But technology and social organizations can be both managed and improved to make way for a new era of economic growth"[17].

The above goals reminds us of the objectives of (*Maqasid*) Sharia. These objectives have been identified by jurists like Ghazali, Shatbi and Ibn Ashour by an inductive survey of the Holy Coran and Sunna. As per Ghazali (1058-1111) in *Al Mustasfa min Ilm Usul Al Fiqh*, the primary objectives of Sharia aim to protect human beings and their environment through five fold tenets of safeguarding and protection of religion (*dyn*) life (*nafs*), progeny (*nasl*), property (*mal*) and intellect (*akl*)[18].

Project finance is conceptually an area conducive to Islamic finance and close to the economic philosophy of Islam, it configures itself as an ideal solution, capable of meeting the economic and financial needs of projects supported by big capital and important economic returns in the medium or long term. "By its very nature, the remuneration of Islamic lender is not based on the lapse of time but based on revenues (cash-flow) generated by the project. He will act as an active partner in the project and not as a conventional creditor, therefore he will take a commercial risk, which tends to resemble the philosophy of project financing.

Project finance uses a variety of contractual and financial arrangements in order to fund specific projects of different sectors in different environments. Project finance must involve a real, useful and beneficial asset. This seems entirely relevant to the principal asset backing in Islamic law. finance structures are used to finance industrial sector (power generation, manufacturing etc..), development of natural resources (oil fields, gas or mining, etc.) and construction and infrastructure development (ports, highways, telecommunications, etc.)[19]. Similarly, Islamic finance contemplates the funding of any

(17) See report Bruntland, 4 August 1987.

(18) **M. Ayub** (2007) Understand Islamic Finance, John Wiley & Sons Ltd., p. 23.

(19) **P. Wood** (1995) Project Finance, Subordinated Debt and State Loans, Sweet and Maxwell, p. 3; P. Lignieres, Partenariat public-privé, 2e édition, Litec, 2005, p.8.

Islamically acceptable project by means of contracts which are in accordance with the Sharia[20].

B. Structural parallels

Islamic financing is generally structured by contracts of partnership based on the profit and loss sharing (*musharaka, mudaraba*), by contracts of sale of an existing commodity based on cost-plus-profit sale (*murabaha*), by contracts of manufacture or asset construction contracts of facilities or goods to be built or manufactured for future delivery (*salam, istisna*), and by leasing contracts (*Ijara*). These techniques seems to be compatible with the conventional modes of project financing, they can be structured as a package and may find interesting applications in designing complex project finance models.

From a structural point of view, setting up of an "ad hoc" project company, known as special purpose vehicle" (SPV) is a major key in any operation of project financing. This separate legal entity is created for a period of time, to isolate the assets financed from other assets of the promoters. It is capitalized through equity and debt funding which is used to cover project capital expenditure, to procure the design and construction of the project, and eventually to operate the project in order to generate the necessary cash flow to repay the investment[21]. The debt is usually provided by a syndicate of limited number of commercial banks, multilateral agencies as the group of the World Bank or the European Investment Bank (EIB)[22], export credit institutions, pension funds, insurance companies and participants in international capital markets, while equity is held by two types of investors (sponsors) in the project company. The first type are long-term investors who will often take little role in the management of the project company, they

(20) **M. Shahid Ebrahim** (1999) "Integrating Islamic and Conventional Project Finance", Thunderbird International Business Review, Vol. **41**, p. 584.

(21) **M. Obaidullah** (1999) "Designing Islamic Contracts for Financing Infrastructure Development", in "Local Challenges, Global Opportunities", Third Harvard University Forum on Islamic Finance, Center for Middle Eastern Studies, Harvard University, Cambridge, Massachusetts, p. 165.

(22) **M. Lyonnet du Moutier**, Financement sur projet et partenariats public-privé, *op. cit.*, p. 200 et s.

are more interested in the investment itself. The second type is project active sponsors whose participation in the project is not restricted to their role as investor, such as a construction company that intends to undertake or participate in the construction of the project, an operating company intending to operate the completed project and a bank providing debt for the project(23).

The project company is responsible of concluding different contracts for the project such as: agreements with governments or governments entities under concession model or a Public-private partnerships PPP, construction and operation contracts with contractors and operators and all various financing agreements(24). Indeed, the independent status of the project company allows the confinement of the project's financial risk and simplify contractual relationships with various project partners. Debt can generally be deconsolidated, and therefore does not increase the sponsors' on-balance sheet leverage or cost of financing. From the perspective of the sponsors, non-recourse debt can also reduce the potential for risk contamination. In fact, even if the project were not productive, this would not jeopardise the financial integrity of the sponsors' main businesses(25).

Meanwhile, the creation of an ad hoc structure is used as well in Islamic project financing. Indeed, this corporate structure is established to carry out operations related to Islamic financial structures, and to uphold the contractual relations with other entities of the projects. Major projects co-financed by conventional banks and Islamic banks, often require the creation of an intermediary company that manages operations related to mounting Islamic confines of the specific risks attached to Islamic financing and make the connection between Islamic lenders and the project company.

The Islamic concept of the proportionality between risk and profit adapts perfectly to the logic of the project finance. It seeks to establish

(23) **M. Obaidullah**, *op. cit*., p. 165.
(24) **M. Nussenbaum** (2002) « Le METP face à la technique de financement de projet appliquée à un projet public », RGCT, No. 22, p. 164.
(25) **Lyonnet du Moutier**, Financement sur projet et partenariats public-privé, *op. cit*., p. 26.

cooperation and justice between partners and helps achieving economic success of the project(26). Mohammad Ayub confirms that "*the assumption of business risk is a precondition for entitlement to any profit over the principal*" he adds that "*The important Sharia maxim: "Al Kharj bi-al-Daman" or "Al Ghunum bil Ghurm" is the criterion of legality of any return on capital, meaning that one has to bear loss, if any, if he wants to get any profit over his investment. Profit has to be earned by sharing risk and reward of ownership through the pricing of goods, services or usufruct of goods*"(27). Similarly, conventional project financing encourages investment and infrastructure development especially in emerging countries, allowing the different project actors to participate actively, and making sure that all risks related to the project were identified, allocated among the participants and properly mitigated.

II. Risk Allocation and Management

Note that major infrastructure projects, whatever its financing mode - conventional or Islamic, are characterized by big risks related to construction and operation of the project. Risk mitigation and management measures in both financial structures will not necessarily be the same. In addition to these risks, there are other risk factors that arise because of the specific contractual mechanisms used in Islamic finance. These two essential types of risks and their allocation and management will be analyzed below.

A) Risks inherent to Project Finance

We can say that in project finance, as in Islamic finance, the risk analysis and risk allocation between the different project's participants are essential elements. It seems very complex to present the risks borne by each participant in a universal classification. Because these risks, assessed and managed differently depending on the party and the sector of his intervention and on the nature and level of risks during life cycle of the project. They are often intertwined and their management techniques are interdependent. A successful financing

(26) **G. Lippa** (2006) "Islamic Project Finance", *Shirkah journal*, p. 10.
(27) **M. Ayub** (2007) *Understanding Islamic Finance*, John Wiley & Sons, Ltd, p. 81.

structure entails a balanced allocation of these risks among the various involved parties. The following is by no means an exhaustive list of project finance-related risks:

1) Structuring-related risks

It must be recognized that the complexity of the contractual structure and the multiplicity of participants in the financial structures can raise some considerable conflicts between the various interests of participants who perform multiple roles. For example, in the case of some BOT models, main contractors appointed for the construction of the project can participate in the capital of the project company and play the role of a majority shareholder(28). The problem here, is that contactors are interested in obtaining payments from the project as early as possible and on a periodic or staged basis. Meanwhile, in their capacity as shareholders (long-term investors) in the project company, who only obtain payments - dividends - after the completion of the project and during its operating phase, would wish to limit the payments to constructors to a lower reasonable level in order to control the overall development cost of the project which they finance through injection of funds into the project company(29).

Similarly, operating partners who act as shareholders would take advantage of their quality of shareholders to have as favorable agreement and conditions as possible.

When it comes to banks, playing the role of lenders and project sponsors at the same time, the probability to cause conflicts of interests and raise moral and ethical problems is very high. Banks in their capacity of lenders would impose their prior approval before distributing any dividends to shareholders and would also require the priority in the repayments of the installments of the debt to any other financial engagements of the project (dividends, construction and operating costs…etc.). Banks may also be a project sponsor, in such situation,

(28) **M. Obaidullah**, *op. cit.*, p. 168.
(29) **M. Obaidullah**, *op. cit.*, p. 168.

there is a conflict of interests, they would require as much divided as possible to be paid out at as earlier as possible(30).

The above risk of conflict of interests require more profound investigation and must be minimized through appropriate stipulations in the shareholders' agreement which regulates the relationship between the participants in the project company.

2) Construction-related risks

In the construction phase of the project, the risks encountered are the risks of cost overruns, missed deadlines and defaults in construction of the facility or its non-conformity to the desired specifications. It is clear that these risks may not only significantly affect the profitability of the operation but degrade the image of the facility or the service to potential customers.

These risks often come from the following different factors:

- Any modifications or changes in the characteristics of the facility, during the construction phase, by the project administrator or by the public partner in BOT structures.

- Poor estimates of costs or construction delays.

- Technical or financial failure of the constructors.

- Application and absorption of a new technology resulting in construction and operational defects.

- Environmental damage and force majeure events. (the discovery of deposits of pollutants or archaeological sites).

The construction phase is the most risky in an infrastructure project. Different operators are outsourcing these risks through turnkey construction contracts, with fixed price and a fixed date of delivery. Generally, manufacturers bear the risks associated with construction.

(30) **M. Lyonnet du Moutier** (2004) « Financement sur projet: élaboration d'un test de la théorie positive de l'agence », *Finance Contrôle Stratégie*, **7**(3), September, p. 154.

Indeed, the sponsors of the project company seek to transfer the risk of delay or poor performance to contractors and incorporate in the construction contract, penalty clauses for delay and damages and interests clauses for any delay or poor performance. As lenders, they can allocate a portion of the risks related to the construction jointly with the sponsors by establishing a line of credit with major additional funding to cover the additional costs or delays encountered during the construction phase.

It is recalled that the construction risks arising from political and regulatory factors are supported by the public partner in BOT structure and covered by insurance companies.

In the Islamic project finance contractual structures, the construction phase of project may be financed through *istisna* (asset construction contract) or *ijara* (asset leasing contract). It is interesting to examine risk allocation among the different parties under these Sharia- compliant structures.

Istisna is a type of contract in which a client mustasne' requiring the manufacturing or construction of an asset, orders from a manufacturer or constructor sane' an asset masnou' meeting certain specifications and to be delivered within a specified period of time(31). usually *istisna* takes a two-tier forms that requires two contracts: first contract is between the Islamic bank as the seller and his client (the project company) as a buyer of the final facility or the product. In order to satisfy the demand of his client, the bank will enter into another contract as a buyer with the manufacturer or constructor to purchase the facility or the product which is the subject of the first contract. A question arises here as to whether these two contracts are binding or merely a promise. In other words, the issue is to know whether the client (project company) is contractually bound as soon as he has ordered the product or if he simply makes a non binding promise to buy it once it has been completed. According to classical Islamic jurists, istisna contract is revocable by either party at any time(32).

(31) Majelle articles 338-92. See also W. Al-Zahayli (2003) *Financial Transactions in Islamic Jurisprudence*, Dar Al Fikr, p. 165-231.

(32) R.L. Klarmann, *op. cit.*, p. 231.

Fortunately, in order to avoid this risk, the modern Islamic scholars view in this regard, was that the *istisna* contract is binding on both parties starting from the moment the contract is concluded by offer and acceptance.

We also note that, as in conventional financing, all risks caused by non-conformity of the facility to specifications will be covered by the manufacturer or the constructor of the project. Risks arising from delay or default in adhering to schedules caused by the financial difficulties (insolvency or bankruptcy) of the construction company will be mitigated by some tools used in both financing systems – conventional and Islamic – such as security on assets refundment bonds, performance guarantees and liquidated damages (damages and interests)(33). One can notice that the penalty clause for the payment of liquidated damages, not allowed in the past, is accepted by the OIC Fiqh Academy in the Islamic contracts(34). In addition, all risks of assets damages during construction caused by accidents, acts of war or vandalism may be covered by Islamic insurance *Takaful*.

In the case of *Ijara* leasing contract, it is a lease of an object or a service involving the transfer of the usufruct *manfa'a* (the use of an object or the services of a person) for a rent consideration(35). The nature of the lease must be precisely defined and the rent must be for a fixed value. This fixed value of rent may cause some financial risks due to fluctuations in market conditions. In order to avoid these risks, the early termination and the renegotiation of a new lease were approved by contemporary Islamic scholars. In order to integrate with the going rate on the financial market, the lease payment can be also linked to indices (LIBOR)(36).

Another issue giving rise of discussion is the classical Ijara practice, since the lessor is the owner of the asset he is supposed to be responsible for structural maintenance and to bear the risk of wear and tear and the

(33) **M. Obaidullah**, *op. cit.*, p. 171.
(34) **M. Obaidullah**, *op. cit.*, p. 171.
(35) Majelle articles 404-11. See also W. Al-Zahayli, *op. cit.*, p. 381-434.
(36) **F. Vogel** and **S. Hayes** (1998) Islamic Law and Finance: Religion, Risk and Return, The Hague: Kluwer Law International, p. 263.

partial or total destruction of the asset. The lessee bears no liability for the rent once the asset is destroyed or severely damaged except when the loss is due to misuse or negligence on the part of the lessee. In order to mitigate these risks and to avoid the Islamic prohibition of the transfer of liabilities from the lessor to the lessee, the lessor can take Islamic insurance *takaful* for the leased assets and include the cost of insurance in the rent. This risk can be mitigated also by transferring some specific liabilities to the lessee (through agency contract) such as damages, theft, loss or destruction of the asset except in the case of force majeure(37). The risk of delays or default of payment of the rent by the lessee can be covered by the advanced rentals as a security deposit against these risks.

Ijara wa iqtina (hire-purchase contract) in this type of *ljara*, the combination of the contracts of lease and the option to buy (understanding to purchase) the asset at the termination of the contract is now allowed under Islamic law, as long as it respects the prohibition of *bayatan fi bay* (two contracts in one), in other words, the lessor's promise to sell the object to the lessee and the lessee's promise to buy the object from the lessor should not be contained in the lease agreement(38).

As in the case of *Istisna, Ijara* involves the risk of non-binding promise, the client may not honor his commitment to rent the asset after it has been acquired by the bank for onward Ijara. To mitigate this risk, banks can shift this risk to the original supplier by using the *khiyar al-shart* framework under which the bank may retain an option for itself at the time of purchase from the supplier. This option will be expired if the bank's client respects his commitment buying the same promised asset, if the client fails to honor his commitment, the bank will exercise his option and rescind the purchase contract(39).

(37) **S.M. Hussain** (1997) "Leasing" and "lease-based Investments", paper presented at the International Capital Market Conference, Kuala Lumpur.
(38) **R.L. Klarmann**, *op. cit.*, p. 265.
(39) **M. Obaidullah**, *op. cit.*, p. 172.

3) Operating-related risks

Regarding operational risks of insufficient income, they arise from a poor estimation of project revenues, of the factors used to calculate the costs of management, maintenance or renewal and major repairs. Moreover, dysfunction or unavailability of assets or equipments of the project are often detected during the operation phase and are normally borne by the operation company(40).

In addition, new regulations and increased taxes, the rate of VAT and corporate tax rates during the phase of operation, can arise high risks affecting the profitability of the project. Such risks, as risks related to construction, is normally covered by the public partner in BOT projects.

In large BOT highway infrastructure projects, there are risks of trafficking. These risks are borne directly by the project company that hires experts and consultants specialized in traffic analysis and assessment of revenues. Main lenders can be concerned by these type of risks, they also control the traffic studies by hiring experts in the field(41).

We remark, however, a project financed by Islamic techniques may encounter the same foregoing risks. As in the construction phase, these risks will be transferred or shared through the mechanism of damages and interest , specific stipulations will be included in *Ijara* agreements. These risks can be passed on to the *takaful* company.

4) Financial and other related risks

Financial risk factors due to inflation, to devaluation or depreciation of local currency of the project and interest rate changes affect significantly the profitability of the project. Also the risk of exchange rate especially when the expenditure is incurred in a currency different from that of borrowing incurred to finance the project. In this case, to

(40) **Delelis** (2008) « Partenariat public-privé », Juris-classeur administratif, Fasc. 670, LexisNexis SA, p. 12.

(41) **M. Lyonnet du Moutier**, Financement sur projet et partenariats public-privé, *op. cit.*, p.126.

cover this risk, the project company will contractually require to be paid in the currency of its expenditures(42).

In a conventional financing, the risk of interest rates changes may be important in the case of a variable rate financing. However, this risk can be hedged by using the technique of interest rate swaps allowing to exchange floating rate against a fixed rate(43).

As discussed earlier, In Islamic finance, even if the operations are not based on interest rates, some measures have been admitted by jurists such as regular adjustments of rents or reference to a market index such as LIBOR (London Interbank Offered Rate) in *Ijara* contract.

In addition to the above, political stability and economic environment of the host state of the project are important for assessing the conditions of the project's success. These risks might be caused by political decisions taken against the project directly or against the foreign investors such as changing tax regimes, nationalization, expropriation, confiscation or not obtaining permits. It can also be a political risk arising from a change in economic or financial rules of the country. Indeed, the host State may impose, in some cases, regulatory constraints directly affecting the profitability of the project It should be noted that changes in the political landscape such that the change of government or administrative policies of the country might affect the project or to redefine the limits and conditions for its realization. Finally, civil wars, conflicts or wars between countries and terrorist acts are serious risks that may materially affect the balance and success of the project.

Insofar as political risks cannot be controlled by the private partners in the case of PPP projects, they are usually borne by the government, which directly or indirectly by state insurance agencies or public partners. In France, the French Insurance Company for Foreign Trade (COFACE) "manages first, on behalf of the State, the public service credit insurance and guarantees all political, monetary and commercial

(42) **M. Lyonnet du Moutier**, *op. cit.*, p. 134.
(43) **M. Lyonnet du Moutier**, *op. cit.*, p. 134.

operations of import and export risks, catastrophe risks that cannot be covered by classical insurance companies(44). "

Note, finally, that there are international financial institutions that guarantee the loans of private banks. Indeed, affiliated institutions with the World Bank and those of regional development banks play a key role in covering political risks.

B) Risks related to Islamic finance contractual mechanisms

Although the risks related to Islamic Finance practice are numerous, we will provide a quick overview of the main risks facing Islamic project finance.

1) Regulatory and legal issues

From a structural point of view, Islamic banking is distinguished mainly by the conventional banks, in that the guidelines are issued by a supervisory board consisting of religious and independent members, called Sharia board scholars or jurists, who are both competent in Islamic law and finance. The Council role is to ensure, using the fatwa, the conformity of products and financial transactions with the principles of Shari'ah. To ensure independence, the freedom of their actions and the objectivity. their fatwas. They are usually appointed by the general assembly's or boards of banks in which they operate and have an odd number of scholars. Indeed, they represent the regulatory authority of the Islamic bank. Generally, some scholars of international reputation operating in several supervisory boards of various banks at a time.

Notwithstanding the efforts of standardization standards, documentation and operations fatwa by professional bodies such as the Accounting and Auditing Organization for Islamic Financial Institutions AAOIFI or Fiqh Academy of the Organization of Islamic Conference, some questions remain about the degree of compliance

(44) **M. Jacquet, P. Delebecque et S. Corneloup** (2007) Droit du commerce international, Dalloz, 1er édition, , p. 585.

with the Shari and the impact of some differences of interpretation of the Shariah by the various Islamic scholars. Some products or services may be approved as being Sharia compliant but some Sharia board scholars but not by others. This situation may arise important risks and constitute, sometimes, barriers to the participation of Islamic banks in the syndicate project financing.

The governing law is one of the important legal issues to be solved. Most large project financings involve multiple and diverse parties and jurisdictions, and the application of multiple legal systems. The choice of law is rather ambiguous, to say the least, and raises a whole set of questions. One is whether and to what extent the parties can validly agree on Islamic law as a governing law of a financial transaction.

Ensure conformity with the principles of Sharia law of contracts subject to a law not inspired by these rules poses to investors or legal advisors of some Western developers the delicate problem of legal security. According to them, Islamic canon law, cannot be considered, in principle and as such, a national law, although in some Muslim countries, national law must be consistent with the principle conveyed by the Shari'a(45). In practice,

Western lenders and developers involved in a project finance operation, will naturally return to their international law firms, who are not entitled to put opinions in Islamic law, in order to build up the necessary contractual and financial structures. The validity of the project documentation under the principles of Sharia law will most often be the responsibility of the members of Sharia board scholars appointed for this mission. According to Kilian Bälz, in the light of the interpretative pluralism in Islamic law, it seems a difficult if not impossible task for any court to come up with an interpretation of Islamic law that will satisfy all circles(46).

(45) **P. Grangereau and M. Haroun** (2004) « Financement de projets et financements islamiques: quelques réflexions prospective pour des financements en pays de droit civil », Banque et droit, p.58.

(46) **K. Balz** (2005) "Islamic Financing Transactions in European Courts", in: "Islamic Finance: Current Legal and Regulatory Issues", *Islamic Project Finance*, Harvard University, p.65.

This issue was taken up in *Shamil Bank of Bahrain v. Beximco Pharmaceutical Ltd. And Others*, both the London High Court and the Court of Appeal declined to attribute any legal effect to the reference to Islamic law contained in the agreement(47).

Mc Millen explains that each participant in the project financing will be bound by his existing institutional perceptions and practices shaped by existing regulatory framework. He adds that "*For a range of reasons, the perceptions of most participants will be based upon project-financing standardized techniques and structures that have been developed in the Western interest-based economic and legal system. Some of those reasons include a) the dominance of the Western economic system over the last few centuries b) the predominance of United States and European financial institutions, lawyers and accountants in the field of project financing, c) the refinement and exportation of Anglo-American law, d) the relative infancy of modern Islamic finance e) the lack of familiarity of with the operation of legal system in most Arab and Muslim countries, f) the general lack of knowledge of, and familiarity with, the Sharia*"(48). According to this analyses, parties will tend to have their contracts governed by either English or New York law, rather than the law of host country.

There are also certain risks related to tax issues, some instruments of Islamic finance such as *Murabaha* or *Ijara* where ownership of the asset is transferred twice (The first when the bank buys the asset from the supplier and the second when the client of the bank buys the same asset from the bank) this situation due to double taxation may involve extra costs due to the increase registration fees, this friction can seriously reduce the attractiveness of Islamic products.

2) Risks related to the role of the Islamic financer

We have discussed earlier in *Istisna* and *Ijara* contracts some of the owner and vendor risks related to the quality of the islamic bank as an owner and a vendor of assets that should be sold to the his client such

(47) January 28, 2004, (2004) Ewca Civ 99.
(48) **M.J.T. Mc Millen**, *op. cit.*, p. 202.

as risk of loss or destruction of the asset, the liabilities and indemnities and the default of payments. We can add to this, that the classical transaction of *murabaha* which is defined as "*the sale of a commodity for the price at which the vendor has purchased it, with the addition of a stated profit known to both the vendor and the purchaser. It is a cost-plus-profit contract*"(49) involves multiple risks due to the fact that an Islamic bank has little or no knowledge of the vendor activities such as the quality and the state of goods, he does not wish to deal and take all extra costs and efforts of packing, storage, transportation, and insurance nor to provide warranty for the goods or to take the risk or not finding a final purchaser(50). For this reason modern murabaha, as practiced by Islamic banks has been adapted to include a binding promise by the client to purchase the commodity once it has been purchased by the Islamic bank. The creation of SPV structure will help mitigating all vendor risks, the SPV will negotiate the selling terms with the supplier. Once these terms are agreed by the parties, the SPV turns to the Islamic bank and requests that he purchase the goods in order to resell it. This way the bank will maintain his role as an intermediary between supplier and purchaser. The Islamic insurance system *takaful* can provide another alternative to manage these type of risks.

3) Intercreditor issues

In case of failure of the project company, calls on collateral security and the right of ownership of Islamic financers on all or part of the assets of the project introduces an imbalance among the different groups of financers giving in certain cases a greater negotiation power for Islamic financers. For example, in *ijara* transaction, the right of ownership of the asset by the lessor (Islamic bank), place him in a more advantageous position than other lenders (conventional banks and others) who can hardly foreclose on the collateral security of this property. To ensure an equal treatment *Pari Passu* of all lenders in projects co-financed by both – islamic and conventional tranches, the intercreditor agreement should

(49) **N. Saleh** (1992) Unlawful Gain, and legitimate profit in Islamic law, 2nd addition, Graham and Trotman, p. 117.

(50) **R.L. Klarmann**, *op. cit.*, p. 224.

determine precisely the terms dealing with prepayment, ranking, termination, voting and payment distributions, etc.

III. Coexistence of Traditional Project Finance With Sharia Compliant Structures

It is important to understand how Sharia-compliant techniques and conventional project finance model can be adapted to one another and coexist in one structure to achieve the same economic efficiency. It is worthwhile to study before the general concepts of each type of financing separately.

A) Conventional Project Finance

As set in figure 1 and 2[(51)], In conventional project finance, sponsors (shareholders) of the project company, are bound together by a shareholders' agreement that defines their responsibilities and duties and limit their project risks. As stated earlier, they are interested in the first degree to the operation of the project funding, they prefer to operate projects without taking the risks on the balance sheet (off balance sheet).

In very rare cases, the construction and the operation activities of the project can be executed directly and personally by the project company. But most often, in practice, the project company subcontracts, as a project administrator, most of its commitments to specialized companies in construction and operation.

In order to secure financing of the project and establish the loan modalities, the project company will sign the financing contracts and related documents with a group of lenders 'banks and other financial institutions'. These documents includes a) loan agreement, b) documents for collateral security structure: mortgage or dead of trust on the project assets, c) security agreements (pledges) on the personal property of the project company, environmental indemnity agreements running to the benefits of the bank, d) different guarantees: completion

(51) **P. Deniau** (2007) Les financements de projet, seminar in banking law, University of Paris 13.

and technology guarantees(52). The conclusion of financing agreements with the project company has a strategic advantage for lenders. Indeed, the project company reinforces the lenders on the project since all the money lent will be devoted to carrying out the project.

In the case of Build-Operate-Transfer BOT structure, the project company will negotiate and sign off-take agreements with the users (host government or utility companies) of the facility, e.g. a power station. These off-take agreements will often be on a "take-and- pay" or "take-or-pay" basis(53).

Finally, the project company shall discharge its risks by insurance policies (liability, risk of interruption of work or loss from operations ... etc.).

(52) **M. J.T. MC Millen**, *op. cit.*, p. 204.
(53) **M. Obaidullah**, *op. cit.*, p. 165.

Conventional Project Finance

Principal project contracts

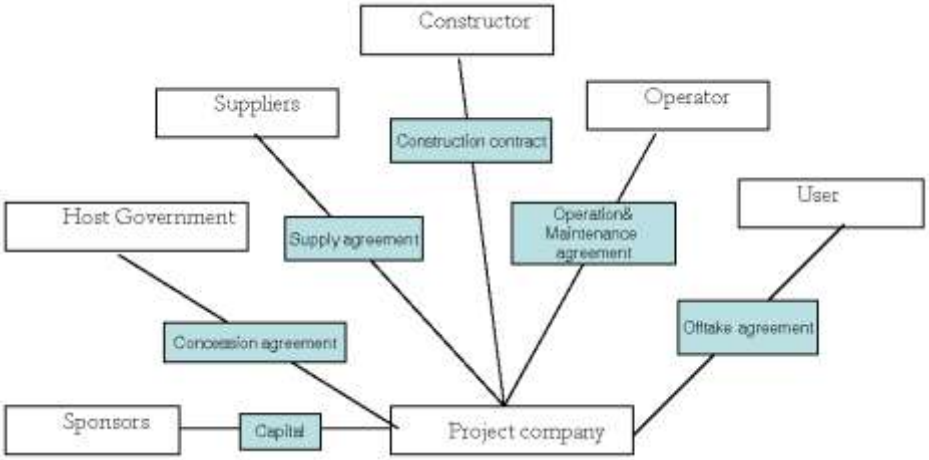

Figure 1

Financing contracts

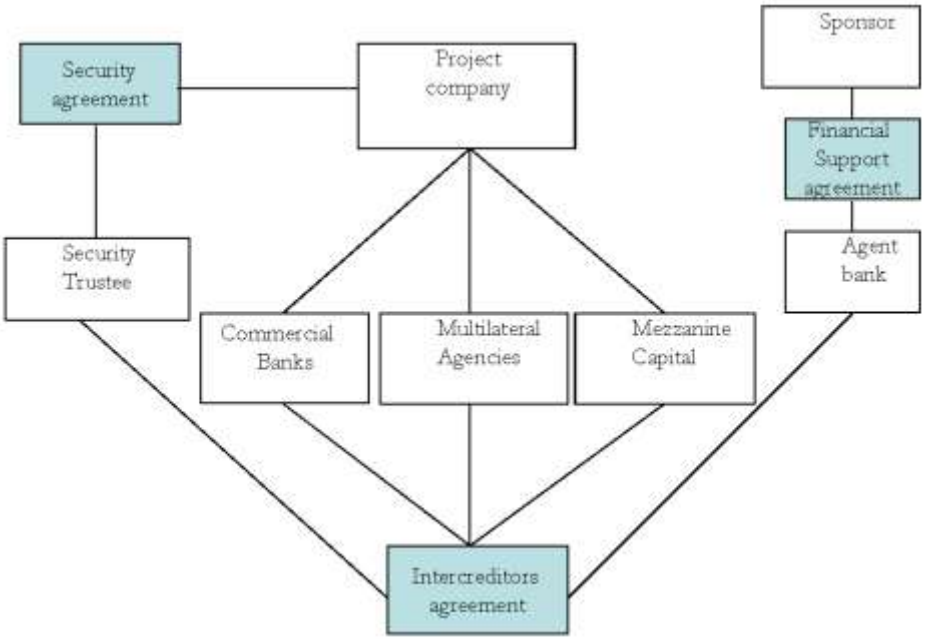

Figure 2

B) Islamic Project Finance

Islamic finance techniques can be modeled in combination to offer various packages in project finance. In the following, we shall turn to analyse how these different contractual techniques can be put to use in order to participate in a project finance model for an independent power plant (IPP). figure 3[(54)].

This figure illustrates the application of four different Islamic contracts: *mudaraba, istisna, salam,* and *wakala* (agency). In this model, there will be 4 main participants: 1) the syndicate of lenders led by the agent, 2) the SPV set up by the agent, 3) the power producer and 4) the power purchaser (the utility).

Independent Power Plant Financing (IPP)

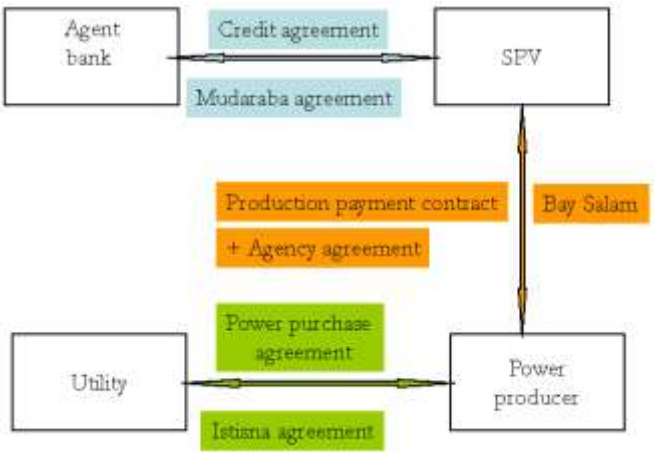

Figure 3

If we study this model, we will note that the agent leading the syndicate of lenders will enters into a credit agreement with the SPV, this transaction can be based on the Islamic contract *mudarabah*, where the lenders will act like sleeping investors *rab el-mal* entrusting money

(54) **M. Khan** (1997) « Designing an Islamic model for project finance », *International Financial Law Review*, p. 15.

to another party called *mudarib* or manager (the SPV in this model)who is to trade with the money in an agreed manner and then return to the investors the principals and the pr-agreed share of the profits, keeping for himself what remains of the profits(55).

The SPV as a manager will then enter into a production payment contract with the producer whereby the SPV will finance the project by making an advanced payment to the producer against a promise under an agreed schedule to the future delivery of electricity. This transaction can be structured by *Bay Salam* technique which is defined as the sale of an article which will be delivered to the purchaser on a future date fixed in advanced(56).

The producer will enter with the utility into a power purchase agreement to purchase the electricity from him. This transaction can be accommodated under the *istisna* contract which is giving an order to manufacture a definite article with agreement to pay a definite price for that article when it is completed. The difference between *istisna* and *salam* that under Salam, the price must be paid in advance, in *Istisna*, payment is flexible, it is to be paid only when the article is ready for delivery.

It is important to note that a valid *istisna* contract should be defined in details, therefore, the power purchase agreement should be very comprehensive including the description of the physical infrastructure, specifications of the required electricity, a description of the fuel and all other technical quantitative and qualitative details of the project. This document should also include risk allocation, the dispute resolution mechanism, and the financial and operational obligations of the producer and the utility(57).

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(55) **N. Saleh** (1992) Unlawful Gain, and legitimate profit in Islamic law, 2nd addition, Graham and Trotman, p. 15.

(56) **S. Rayner** (1991) The Theory of contracts in Islamic law, Graham and Trotman, p. 134.

(57) **M. Khan** (1997) « Designing an Islamic model for project finance », *International Financial Law Review*, p. 15.

The SPV will mandate the producer through an agency contract *wakala* to sell two shares of electricity to the utility. The first share is the production payment electricity which will be sold on behalf of and for the account of the SPV while the second share will be the subject electricity which represents the share of the producer to be sold to the utility on the same basis of the first share. All the revenue from the sale of production payment electricity from the utility will be transferred to the SPV after the deduction of the producer's fixed O&M costs, fixed fuel costs, insurance costs and return on equity investments.

Cofinancing Model

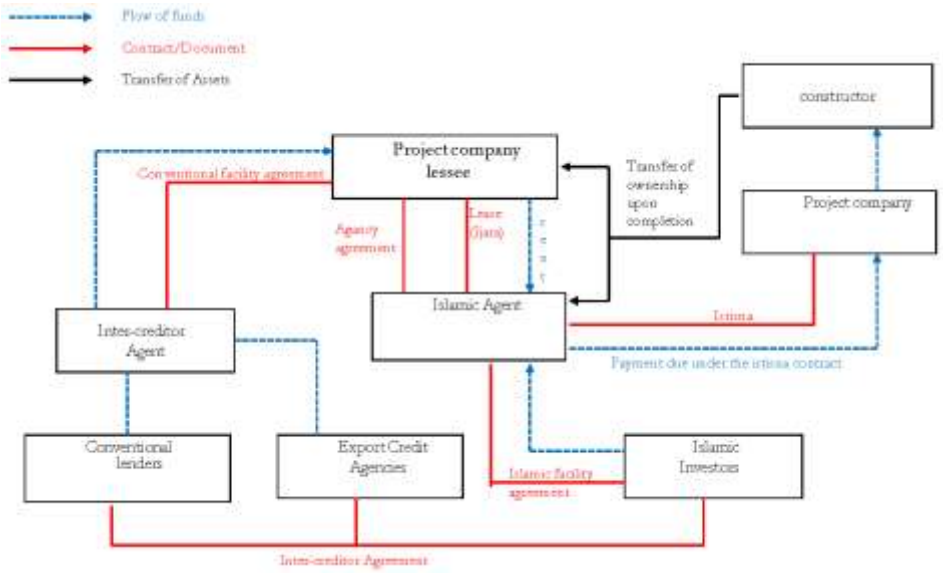

Figure (4)

Source: BOUREGHDA (Maya), Islamic Project Financing: Practical experiences, seminar at ESC-Lille "Ecole Supérieure de Commerce", 2009, p. 6.

Conclusion

It is shown here that the success in the financing of an infrastructure project, by means of project finance techniques, depends on all the parties involved satisfactorily complying with their various contractual obligations under the project finance agreements and documentation. Lenders, as well as the other participants, in accordance with the level of risk being assumed and in proportion to the benefits received from the implementation of the project, will undertake the due diligence needed to adequately measure the risks involved.

The viability of the Project Finance model is based also on the consistency and efficiency of its network of agreements. Such documents must be structured and negotiated in a consistent manner with the respective legislation applicable in the jurisdictions involved, and be constructed in such a way as to allow full implementation of their respective terms and conditions.

Islamic finance has successfully integrated into the legal system of Common law countries who have ensured its compatibility with commercial finance. Moreover, the principles of Islamic finance also appear to be adaptable to the legal constraints of several western countries. In France, huge efforts have been undertaken to adapt the legal, tax and regulatory instruments to the requirements of the rules of Islamic law in finance while complying with French prudential norms.

This paper has emphasized the parallel points between project finance model and the Sharia-compliant financial structures. It focused also on the possibility to finance an important projects with a combination of structures and documentations from both system without compromising any religious principles or financial interests.

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التمويل الإسلامي للمشاريع

مها قباني

المستخلص. إن تطور (صيغة) تمويل المشاريع الإسلامية من حيث المدى والقوة وسعة انتشارها جعلها أكثر تفاعلا وتواصلا مع هياكل المالية التقليدية وعقود الحكومات والشركات المتعددة الجنسيات والمنظمات الدولية.

إن نشأة الصيغة الإسلامية لتمويل المشاريع وتوفر نظام دولي لتمويل المشاريع أدى إلى تفاعلهما في إعادة تشكيل كل منهما للآخر وفي نفس الوقت فقد ساهما في تطور الاقتصاد الدولي. هذا التعايش بين الأنظمة ليس عملية "تفاعل" بسيطة بين تطبيقات تمويلية إسلامية فذة وأنظمة مالية تقليدية مسيطرة ولكنه سلسلة من التحسينات والتأثيرات المتبادلة والتكيفات النفسية التي يمكن أن تتطور إلى عملية دولية من التعلم والتعاون الجماعي.

وقد شهد العقد الأخير طفرة عالمية في مجال تمويل المشاريع الخاصة وخاصة في تطوير البنية التحتية مما خلق فرص كبيرة للمصارف والمؤسسات الإسلامية. وكان هذا النمو نتيجة لتجدد تركيز الحكومة وشهية هائلة متزايدة ركزت على الاستثمار في البنى التحتية (الأساسية).

وينبغي ألا نقلل من أهمية وفرة السيولة المالية في المصارف الإسلامية واشراكها في عمليات النظام التمويلي العالمي لأن إمكانية استقطابها هي فرصة عظيمة (هائلة). بالإضافة إلى الحاجة الماسة لتمويل احتياجات البنى التحتية في منطقة الشرق الأوسط ومنطقة شمال أفريقيا.

تهدف هذه الورقة لجمع كافة العناصر الرئيسية المتعلقة بتمويل المشاريع الإسلامية وبناء إطار واضح لمستقبل ذلك التمويل.