INNOVATION AND RISKS IN ISLAMIC FINANCE: ARE THEY CLOSER TO REAL LIFE EXERCISES?

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Introduction

The last two decades witnessed fast growth of Islamic finance and introduction of several new products from sukuk to tawarruq and commodity murabahah. Professional bankers and shari'ah specialists have been breathlessly racing to invent new Islamic financial products to mimic or replace every single interest-based contract. Thanks to the big financial crisis of 2008 which allowed us to rethink the fundamentals of Islamic finance that made Islamic banks more resilient to the crash than conventional banks and to reconsider the unique characteristics of Islamic finance especially in the area of risks to which Islamic financial institutions are exposed to.

This paper intends to study the risks to which Islamic finance products are exposed to especially those that are unique to the providers of these products and to make a few comments or propositions on risk management arrangements and tools in Islamic finance as may be derived from the shari'ah axioms and rulings, especially in relation to new products. It has two sections; section one which deals with the fundamentals of Islamic finance as became emphasized after the financial fall down of 2008 and section two will discuss the risk of Islamic financial institutions and their management.

Section One
Fundamentals of Islamic Finance

A few fundamental axioms define Islamic finance as follows:

1. Expanding the meaning and scope finance,
2. Making real market contracts the core of finance provision,
3. Moral screen,
4. Sticking to reality or realism,
5. Integration of financial asset with real assets,
6. Earning by ownership,

7. Partnership with depositors.

All these seven fundamentals have their foundations in shari'ah tenets and maxims. They are inter-related and all bounce to the fact fundamental principle of ownership as declared in shari'ah and six methodologies of acquiring additional properties which are discussed outside the present paper in basic classical fiqh literature.

1. Expanding the meaning and scope finance

Finance is usually associated with the provision of banking credit through a loan contract often called a finance facility or simply credit.[1] This understanding has been developed with the rise of independent institutions which undertake the function of financial intermediations. Is finance really confined to banks' credit?

Inter-personal practices in all societies and the historical experience of human association tell us otherwise. When businesses acquire inventories of goods for sale or raw materials for manufacturing without having to pay for them at the time of acquisition, they are been enabled by suppliers to command more properties than they actually own. This credit offered by suppliers is a form of finance. By the same token, when a business receives services from its employees hour after hour and day after day and doesn't have to pay for these services until the end of the month it is also having command over services for which it is paying at a later date. This is also a form of finance. also when two or more persons put their properties, physical and/or monetary, together in order to create a business or when a shareholding company is established with founders pledging, and actually depositing their founding contributions and when a company announces a public offering to issue new stocks against more contributions it invites from the public, all these are also finance. Additionally, when a good wisher gives a gift to a friend or relative on a happy occasion whether in the form of cash or goods or when a donor gives a charity to a poor person or to a charitable organization, these are also kinds of finance. Of course giving loans in cash or in kind is also a kind of finance.

In other words, it is not only rational but also practical and realistic to understand finance in its general meaning and redefine it in such a way that includes all these kinds or forms of finance. This will provide us with an inclusive as well as exclusive definition of finance whether it is practiced by specialized intermediary institutions, in specialized markets or by any

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[1]Finance is defined in general and business dictionaries as provision of fund, money or capital. The term credit is used in professional banking. Books of intermediate courses of finance define it as provision (of obtaining) funds, or credit for purchases or for enterprises.

economic unit in the society at large. Accordingly, finance can be set as: **Provision of goods, services and means of payments while a counterpart is not required to be rendered at the same time.**

This definition includes all forms of finance whether it is offered by banks and other financial intermediaries, investors in the capital market, individual economic units or parties to sale contracts of goods and services. It also covers all forms of finance whether there is a condition of a delayed-payment counterpart -such as in sale on credit and loan or there is no such counterpart as in gifts, donations and charities. And it also covers the provision of funding when it takes the form of ownership of a company's share of rights to future dividends and payment at liquidation.

2. Making real market contracts the core of finance provision

Islamic finance does not bring any unfamiliar financial ideas. Its innovation is by making contracts of real markets which are sale, leasing and pooling resources together the core of activities of the finance institutions. These ideas and contracts are known in all commercial laws but they have always been thought of as contract which do not serve the finance sector and considered non-suitable for conducting financial transactions. Islamic finance is founded on the belief that only the use of these real market contracts makes finance stick to the real market transactions and does not allow any financing outside the arena of supporting the activities of production, distribution and consumption.

3. Moral screen

Ethical screening is an important feature of Islamic finance. Moral standards enter into Islamic finance contracts from two angles: The first angle relates to the object of the contract whereby all substances which are scientifically proven harmful cannot be contracts' objects, they are also not permissible in shari'ah. The moral criteria are applied in a genuine and integrated way because all Islamic finance contracts have to pass through ownership and any harmful/immoral thing or service cannot be owned, bought or sold. This principle applies to any object that is determined as harmful to human beings or to the environment because "corruption on the Earth الفساد في الأرض" of any kind is not acceptable or permissible in shari'ah as repeatedly stated in the Qur'an.

The second angle of incorporating morality in finance contracts relates to the HOW. This means that a contract must itself observe moral standard of being truthful and clean of misinformation, cheating, doubt or ambiguity. In other words, the morality condition in Islamic finance is concerned with both the form and substance of the relationship which a contract establishes.

4. Sticking to reality or realism

Realism refers to the object of a finance contract as well as its outcome. It requires that objects of contracts should be real assets and that any outcome, gain or loss, must arise from factual change in the wealth in reality. Unfortunately, the contemporary world of finance has a great deal of lack of realism both in traded objects and it contracts' outcome. Indexes as objects of trade, options, futures, contracts for the difference, betting on currency prices and all similar invented objects and market-traded rights are examples of lack of realism.

The finance sector created options and other derivatives simply to trade them in the market. They are only notions, in contrast to real properties. These notional or virtual financial assets are priced in the market because we consider them tradable and ownable. Their pricing is derived from prices of other assets on whom we choose to hang them. Options, as well as other derivatives, do not stand on their own because they do not represent a property of their own. In other words, owning options does not make you owner of a real property; they are tantamount to owning nothing but still being able to speculate and have actual real wealth be transferred from one hand to another, just as in gambling. What is the moral ground for gaining or losing real wealth if only it comes by making an owner of another property richer or poorer?

Lack of realism also applies to interest/Riba as an outcome of lending relationships. Unlike other properties, debts do not create added

value or wealth because they do not have intrinsic utility of their own. Attributing an increment to acts of lending does not stand a realism test; it is pure assumptive!

5. Integration of financial asset with real assets

Islamic finance removes from the basket of objects of finance contracts all virtual assets which are unfortunately traded in several regulated markets around the word. It requires that in order for any asset or commodity to be an object of a finance contract it must pass a two-fold screen or fulfil two conditions. The first condition is that the goods/assets must be real, whether tangible such as fruits and machines or intangible such as publication rights, patents or usufructs. By asserting this condition, objects of Islamic finance contracts must be either physical goods/assets such as producer's and consumer's goods or rights and utilities which can be quantified such as a passage right of a landlocked property or use of an apartment for a given period of time. The second condition is that the asset must, by its own nature, be able to create or generate increments or utilities. No assumptions (e.g., let us assume it generates …) are tolerated in this regards. All the examples given in this paragraph are of assets or goods which generate increments. Any object which is not able by its own nature to create incremental wealth is removed from the basket of goods/assets that may be accommodated in Islamic finance.[2] Of course, increments are addition to wealth; they come in the form of physical increments such as milk from a cow or a flow of utility such as usufruct in a rental exchange contract.

Accordingly, financial assets are only acceptable to the extent they represent real assets in the markets of real goods and services. A whole bunch of assets and transactions are excluded from the Islamic finance market. These include all virtual financial assets such as options about which the OIC Fiqh Academy resolved that they are not acceptable according to shari'ah to be purchased, owned, sold or traded.[3] They also include commodity and currency futures as well as indexes and their likes.[4]

6. Earning by ownership

Owning an asset is a necessary condition without which the shari'ah does not recognize any entitlement to the finance provider. This is also

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[2] Monzer Kahf, Islamic Finance Contracts, ebook published by Monzer Kahf on Amazon Kindle, Jan 2013, Ch. Three and Notes on Islamic Economics: Islamic Finance and Banking, ebook on Amazon Kindle, June 2014, Ch. Five, Also "Objectives of the prohibitions of Riba" paper presented at the international University of on Objectives of Shari'ah, International Islamic University, Aug. 2006.

[3] Resolution 63/1/7, OIC Fiqh Academy, 7th session held in Jeddah, Saudi Arabia, 9-14 May 1992.

[4] Ibid.

derived from fundamental human rationale that an owner of a thing is one who owns all increment generated by the owned property. Ownership is the most important axiom for justification of return in Islamic finance. Without ownership there is no entitlement for the finance provider. This is manifested in all three groups of constructed relationships of Islamic finance; sale, leasing and sharing. In sale-based finance, the finance provider has to own goods in the full sense including taking possession of them in order to be entitled to a profit which is only affected by selling what is already owned for a price that is higher than the cost. Same applies in lease-based finance whereby the finance provider must own a long-lasting asset and earn the price of its usufruct. Also in sharing-based principle the finance provider owns assets consisting of a part of the whole enterprise in musharakah or goods purchased by the mudarib with the mudarabah funds. This ownership is the axiom which justifies entitlement to profit that is generated by a series of activities of the manager/mudarib in either of the two sharing methodologies.

Same also applies in wakalah and revenue sharing methodologies of finance. Ownership by the principal/muwakkil of assets obtained by the agent/wakil is the justifier of the former's entitlement to the profit which may be generated by actions of the wakil when he/she sells the assets. By the same token, ownership of assets is the justifier of the return in revenue-sharing finance.

Same axiom is confirmed in regard to loan-based finance in a negative manner. Because the loan contract transfers ownership of contracted object that is often money and transforms the property of lender from cash on hand into a debt on the borrower, the debt owner does not deserve any return because the assets she/he owns do not generate any increment as they do not carry any intrinsic utility.

It is worth noticing that ownership risk is the other facet which is associated with entitlement right. This means that ownership exposes owners to property risk so that they are liable for whatever may happen to the owned property.

7. Partnership with depositors

The relationship between Islamic financial intermediary institutions and their depositors is one that is based on partnership because this is the only way depositors may be given any return according to the axiomatic principles of Islamic finance as mentioned earlier in this paper. This has two important implications: 1) return distributed to depositors depends on performance of the Islamic bank; a matter which allow for competition to be essential in survival selection.

2) the Islamic bank can lean on depositors during bad times instead of having pre-determined fixed interest which has to be paid to depositors.

Section Two

Risk of Islamic financial institutions and their management

In a book on Risk Management in Islamic Banks,[5] Khan and Ahmad argued that Islamic banks not only face the type of risks that conventional banks face but they are also confronted with "new and unique risks as a result of their unique asset and liability structures." According to Khan and Ahmad, this new type of risks is an immediate outcome of their compliance with the shari'ah requirement. They added that even in regard to common or conventional risks, the nature of risks that Islamic banks face is different from those risks faced by conventional banks. The obvious implication of this argument is that Islamic banks need variant "risk identification processes" and different risk management approaches and techniques and require different kind of supervision and regulations as well. Similar argument appeared a few years earlier in an IMF publication by Luca Errico and Mitra Farahbaksh.[6] Although they conceded that capital minimum requirement should take into consideration assets composition, i.e., the PLS investments versus non-PLS investment, they argued that the capital minimum requirement needed to for risks coverage should be higher in Islamic banks that in conventional banks because their PLS assets are not collaterized. [7]

The focus of these two writings and their likes is especially on supervisory and minimum capital requirement issues in Islamic banks. Whether Islamic finance poses different kinds of risk and challenges depends of whether we look at Islamic financial intermediaries as they are actually or as they were visualized by theoreticians back in the middle of the 20th century. To understand the nature and relative significance of risks in Islamic financial products we need to look at the main characteristics of financial contracts as applied in Islamic banks and then study the risk profile of each of these contract/products.

Accordingly, in this section we will discuss the basic characteristics of Islamic finance products as stipulated in shari'ah and practiced in

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[5] IRTI publication 2003.

[6] Luca Errico and Mitra Farahbaksh, "Islamic Banking: issues in Prudential Regulation and Supervision," IMF Working Paper No. WP/98/30, 1998.

[7] Ibid., p 17.

Islamic financial institutions, their risk profile and their risk mitigation approaches.

a. Characteristics of financial products in shari'ah and practice

Islamic financial products are contracts that abide by the tenets and rulings of shari'ah. There are general principles and requirements for contracting that must be satisfied in all contracts, financial contracts are not different. In this sub-section we will discuss only the special characteristics of Islamic finance contracts, not the general ones.

Not withstanding the several attempts to encode the shari'ah, the fact is that its bulk remains not coded in the form of articles of law but its rulings are found in the writings of shari'ah specialists through the centuries as Islam does not establish a religious hierarchy that is authorized to give the law. We will study the characteristics of financing contracts in an attempt to understand their implications and the rationale of the prohibition of interest. It has become known over the last four decades of theorization and practice that the shari'ah financing contracts are of three major kinds: Sharing-based, sale based and lease based. It has also became known that most of the actual transactions of Islamic banks are either Murabahah or Ijarah as these two modes of finance allow the bank of create debt with definite amounts and due dates of cash inflow and outflow. Sale, lease and sharing contracts whether as described in the classical fiqh or as constructed as hybrids by contemporary fuqaha, fiqh academies and practitioners have the following characteristics:

1. **Debt-creating finance is an acceptable and rewarding business activity at the same time that debt-based interest-bearing finance is prohibited.**
   This is apparent in the Qur'an itself which permitted sale that looks like interest transactions. Verse 2: 275 begins: ". . . They [Riba takers] say: 'Sale is just like Riba,' but God has permitted sale and forbidden Riba." it is also apparent in the sayings of the Prophet, pbuh and the practice of the Muslim society at the time of revelation. This permissibility applies regardless of whether the return of finance is pre-fixed or not as this matter depends on the methodology or contract vehicle used in finance provision.
   Claiming that any sale is just like interest lending is logically incorrect and exposes the claimant to be ridiculed and accused of ignorance of real market functioning, insanity or loss of rationale because cash sale is very remote from interest lending and has no similarity to it. What is, obviously, similar to interest lending is deferred payment sale at a

price that is higher than the cash price. Here the similarity is obvious.[8] Interestingly, the Qur'an did not ridicule this claim or accused it of irrationality; this is in spite of the fact that in many instances/occasions the Qur'an invokes the rationality argument by statements such as: "will they not understand?" "you may understand," "Do you not understand?" "in order that you may rationalize'" all such phrases came in chapter two itself; and "have you no rationale?" "if you have reason," "don't you reason," "so that they may have mind to rationalize with!" and many like phrases throughout the entire Holy Book. This implicitly means that some similarity is acknowledged but yet the Qur'an quickly directs the attention to the permissibility of the sale that is similar to interest lending and the prohibition of the latter; as if it says; while certain similarity is acknowledged there are differences that warrant the permissibility of deferred payment sale-based finance and the prohibition of interest/lending-based finance. This is why the overwhelming majority of shari'ah scholars argue that the permitted sale in this verse is the deferred payment financing sale. This is also supported by bringing in a verse (2: 282) about debts confirmation and documentation immediately after the Verses that deal with the prohibition of interest and permissibility of deferred-payment sale financing (2: 275-281) because deferring the payment creates debts that need to be documented.

The unavoidable immediate implication of the Verse 2: 275 is that debt-creating financing is permissible and recognized in shari'ah. While the verses condemn Interest-based lending and prohibits any increment on it, thus rendering loan giving a non-profitable activity and shifting it from business arena to personal spheres; it approves a kind of sale that fulfills the same objectives including giving a reward for the time value of the sold commodity rather than time value of lent money.

2. The asset base of financing must be the kind that has intrinsic ability to produce utilities or increments.

Understanding the differences between interest lending and debt-creating sale finance is extremely essential to comprehend the objectives of the prohibition of Riba (interest) because it deals with the crucial point of the distinction between seemingly similar processes. The difference between interest financing and Islamic financing is that interest financing is done in a loan contract presuming that a debt may be assigned increment while in reality a debt can't produce any increment. The implications of assumption that a debt generates increments are: 1) you need another untrue assumption

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[8] The general expression of permissibility of sale in the verse 2:275 or course includes cash-paid sale although it intends to addresses sale which includes an element of finance.

about the valuation of the increment, i.e., the rate of interest. This has been done by creating an artificial market for exchanging debts that is built in fact on pure speculation. Unlike markets of assets, goods and services, a purely speculative market is very volatile by its nature; 2) once you allow debts to have a presumed increment you will have to allow it to be rescheduled with increment and you will have to allow discounting with reduction; both these two kinds of transactions do not create or add value in the economy; and, 3) you will have to allow other transactions on debts, pure, including exchanging them through inter-bank transactions and a whole set of pure financial or monetary transactions that do not essentially add value but only transfer wealth from one person to another. The shari'ah takes a close look at these transactions and finds them done in isolation from real production and exchange; they do not affect inventories on the shelves or goods and services reaching consumers; they only enrich some individuals and impoverish others; they are like a zero-sum game; and finally 4) withholding finance from activities other than producing or exchanging goods and services and preventing finance that is provided solely on the credit worthiness of the user of funds regardless of the purpose of their use.

3. **Banning debts trading and discounting, speculative transactions and other exchanges which do not create real value added.**

   Additionally, the objective of shari'ah in the finance sector includes disallowing debts trading and exchanging and similar unrealistic purely speculative transactions that are not based on real production or exchange because these activities do not create value; they only transfer wealth between individuals. This means redirecting the human and other resources used in trading debts toward real production of goods and services as will be seen in the next paragraph. The shari'ah aims at preventing debt discounting and rescheduling for increment because these are non-productive activities and only transfer wealth from one person to another. The alternative the shari'ah provides for rescheduling is interestingly mentioned in the Qur'an within the same sequence of Verses that is: giving time to pay or even forsaking the principal of the debt itself. On the other hand, the shari'ah permits discounting for early payment provided it does not become a business practice (not made as a condition in the contract and only performed between the two parties).

4. **Finance must always pass through real assets which are handed-over to a manager/entrepreneur, retained for leasing or obtained for resale.**

The alternatives shari'ah provides for finance activities are contracts that fall under sale, lease or sharing. This re-channels all business finance toward the production and exchange of goods and services or toward value creation. At the same time, it closes all uses of finance that unnecessarily inflate its size/quantity in the society relative to the size of the real sectors of production and exchange.

Preventing the use of business finances for what can be tagged as 'Abath عبث (nothingness or redundancy) and sending personal finance to where it belongs as a personal service based on direct contact, care and involvement between the finance provider and user. The answer to the question "who will give you a loan?" becomes "your mother or a person who knows and loves you." This does not mean that a personal loan is not useful; it rather means that it must remain personal not transformed into a profit-making business. Giving a loan is even rewardable by God as it is known in the shari'ah.

b. Risk profile of Islamic finance Contracts

The risk profile of Islamic finance products is derived from their fundamentals and characteristics, more precisely from their intrinsic attachment to real market. As the investor earns by virtue of ownership of an increment-generating asset, risks to which it is exposed relate to ownership and what contracts are available within the realm of real life.

Islamic financial intermediary institutions, IFII, deal with the real risk of owning goods, services and productive assets. Hence, we have a combination of **property risk, price risk, liquidity risk and opportunity cost risk**. The latter is usually expressed as interest rate risk because IFII are not price setters but rather price takers in the finance sector which is dominated by interest-based conventional institutions. Same risks also apply to sukuk as much as they apply to other financial products. The **credit risk or risk of default** always exists whenever a contract creates a debt and the **moral hazard** risk crops up in any inter-personal relationship such as sharing contracts.

Of course the liquidity and price risks are important but the IFII have gained sufficient experience and smartness in dealing with them to an extent which renders them practically nil. Price and liquidity risks are mitigated through a series of undertakings/promises obtained from customers before the IFII starts any process of purchase so that it is assured of the sale price and the date of payment before it actually buys the goods or services. This applies in murabahah, musawamah, ijarah, compound salam and compound istisna' and all IFII avoid financing through musharakah and mudarabah unless in exceptional cases and when whey use these vehicles they load with conditions and

undertakings which make them similar to sale in securing definite future cash inflow at definite maturities.

Property risk is a unique shari'ah-addition to the risk profile in finance as it is not known at all in conventional institutions when it comes to activities of finance provision. It is the kind of risk which is a fundamental requirement to legitimize earning a return IIFI. IFII reduce this risk to a minimum by reducing the time span of ownership to a minimum split second through appointing the customer as an agent and securing the second sale immediately after delivery. But with all such measure the risk of invisible defects in the object of sale cannot be avoided and need to be mitigated through insurance of appropriate provisions.

c. Risk mitigation in Islamic financial products

In this sub-section, we will discuss a few arrangements of risk mitigation that are intrinsic to the classical shari'ah literature and go on to imply that these arrangements provide a variety of potential applications that may reduce the need to using risk mitigation tools that raise shari'ah's clouds that are dared sometimes by some products thrown in what is called "the Islamic capital market." Before I conclude this subsection I should also discuss the importance of compliance with the three pillars of the Basel II Accord and their expansion in the Basel III for investors with Islamic banks.

To minimize the investors' risk in new Islamic financial products, especially Sukuk and corporate investments, a handful of arrangements can be used, namely: revenue sharing, service and usufruct-based finance, principal insurance, collaterals, third party guarantee and reversed and line-or-credit murabahah.

Revenue sharing and revenue sharing sukuk

The idea of revenue sharing is based on applying the muzara'ah methodology to fund provision in mudharabah. While mudharabah assigns a share of net profit to the fund provider (rabb al mal), revenue sharing financing assigns a share of the gross revenue to the provider of assets that are used in the production process. Revenue sharing financing is thus a combination of wakalah to purchase or build fixed assets and a muzara'ah based partnership between assets owner and assets operator.

In a Sukuk-type application, a trust (that represents the pool of investors) provides funds on wakalah basis to an SPV that constructs (through an istisna' contract that may be concluded with the operator itself) the required airport, toll road or corporate factory and hands it

over to the operator (the management) on revenue sharing. The airport is thus owned by the trust and investors receive a percentage of the total revenues of the airport. Revenue sharing may be applied to finance infrastructures as well as corporate productive projects.

This arrangement allows investors to get a practically guaranteed positive (above zero) returns because total revenues are always positive. Consequently compared to mudharabah, revenue sharing provides returns to investors even when the operator/management is loosing. An element that reduces the need to worry about investors' return or to seek approaches to guarantee returns that may be dubious from shari'ah point of view such as issuing debt-based tradable sukuk. On the other hand, revenue sharing arrangements do not provide protection against variations in the return of the investors so it is still classified in the area pf sharing tools like mudharabah and musharakah. Stability of projects and strength of their feasibility studies will be crucial for assuring smaller variations in return.

However, similar to mudharabah and musharakah, revenue sharing arrangements can be supplemented by either or both of the two following additions: 1) a condition that imposes a cap on the net profit of the operator/management or on the return to investors whereby surpluses above the cap are either rendered to the other party or scaled at different proportion; and, 2) creating a fund, contributed to by deductions from investors' distributions and any concerned third party, for equalizing the investor's return over distribution periods.

Service and usufruct-based finance

In an economy of ever increasing inflation and rising cost of labor (improving level of living), service and usufruct based financing and Sukuk provide a good shelter against erosion of returns. The reason is: payment of returns is in kind, i.e., in terms of either service units or units of usufructs. This is another shari'ah compatible hedge against inflation without resorting to doubtful vehicles that may involve a form or another of indirect interest.

Principal insurance and collaterals

The shari'ah rule on collateral taking is well known. It applies to debts. This means that any debt-creating finance or debt-representing Sukuk may be supported by collaterals. Collaterals provide a tool to guarantee not only the debt of a principal but also the debt of rentals as well as the in-kind debt of services and usufructs. Consequently, while services and usufructs financing hedge against inflation they can also be supported by collaterals that guarantee both principal and return. This is

simply because services and usufructs financing are based on the sale contract.

Third party guarantee: deposit guarantee

Third party guarantee can be offered by any entity/person that has interest in the financing without being a party to it. It may cover the principal as well as a return. For instance a government, based on its own resources may offer a third party guarantee for financiers who provide funds, on mudharabah or musharakah basis, to certain strategic or infant industries so that a minimum return is guaranteed to investors in addition to guaranteeing their principals. The only requirement is that the guarantor must be financially and legally independent from the managing partner because mudharabah and musharakah are amanah hand contracts in which the manager can only be charged in case of neglect, abuse or violation of the contract conditions but can't be charged for commercial losses. Consequently, we can always create an interested outsider-of-the-contract guarantor who can provide a third party guarantee such as a real SPV that is not owned by the managing partner.

The practice of a third party guarantee is applied to Islamic bank investment deposits when the government provides such a guarantee with no charge to the depository banks or at least for the contributions of the government or central banks to a public deposit guarantee corporation as it is done in Sudan. However, the same principle is also invoked by deposit guarantee funds nourished by deductions from arbab al mall's profits before their distribution. Such funds can also be created for sukuk and the guarantee can be extended to cover the principal and a return on it.

Reversed murabahah and murabahah line of credit

The way of applying reversed murabahah is simple. IFII's needs for funding rely on their own resources and on deposits that are solicited either on loan basis or mudharabah basis. More funds can be obtained on the basis of reversed murabahah in which the Islamic bank is the purchase orderer. Obviously applying reversed murabahah to the purchases of the bank for its own use will limit financing through this methodology to a small amount. But if we apply it to the purchases of the Islamic bank that are part of its own murabahah finance offered to customers it may extend to be a source of funding for a major part of its operation.

This extension can be done by adding a line of credit and a wakalah contract whereby for every murabahah financing the Islamic

bank can transact a reversed murabahah for purchasing goods and services it provides to its customers. Hence, reversed murabahah arrangement can be used with the central bank, as a final resort funds provider. It can also be used with large corporation deposits and as an alternative for inter-bank transactions-cum-financing.

The advantage of reversed murabahah is that it provided definite maturity and cash flow and creates an intimate correction between the inflow and outflow of the bank. This facilitates the liquidity management as well as it profit distribution

The only condition that is needed for this transaction is that it must be true. In other words, there must be real goods/services that will be purchased by the Islamic bank for the purpose of selling them to its customers. Otherwise, it will be a form of Tawarruq or Buy-back ('Inah). This condition can be satisfied by always linking the reversed-Murabahah to the Islamic bank's provision of Murabahah contracts to it customers.

Bundles/packages financing: applying the majority rule

The simple form of a bundle is common stocks. They represent a group of assets, tangible and intangible, including cash and receivables. Yet, they can be traded at a market price that may be different from the vace value because of the rule of majority. Consequently, the recognized ruling of shari'ah is that common stocks may not be traded at a market price if the majority of the companies assets are in receivables and cash although this is a theoretical case or at least very rare in real life as long as we include the market capitalization as an intangible asset.

Creating bundles of goods, services, receivables and may be cash and securitizing them is not restricted to common stocks, it can be done by Islamic banks and other financing and refinancing institutions. The IDB has been doing the same in transferring contracts to the Islamic Unit Investment Fund for two decades and it's been used as a means to discounting (securitizing) its investments at the IUIF.

Bundling lays the ground for a series of financial products that can respond to all personal financing needs and consequently rendered baseless the argument for "a genuine need" for Tawarruq. If there is a need for a certain form of "personal financing" it can be satisfied by means that do not allow themselves to be abused as what actually happens in the case of Tawarruq that is often used to overcome the barriers placed by the prohibition of interest on rescheduling for increment and on abusing the financing for "'Abath" or objectives that can't otherwise be financed according to the shari'ah criteria.

Hedging through options (not trading options)

Finally, hedging existing positions may be differentiated from trading options.

While buying options for the purpose of price speculation may be argued as fictitious and profiteering without owning a real asset that may have an independent demand and supply for its own intrinsic utility/productivity, covering an existing position through buying or selling an option may be looked at as a means to reduce potential variations in prices and then tame price speculation.

Accordingly, one way hedging through options can be found useful and permissible, a matter that can also be used in Islamic financial innovation.

Before concluding this section it should be noted that the rules stipulated in the Basel II accord provide a reasonably adequate basis for reducing credit risk, market risks and default and moral hazard risks and Islamic banks should really look at the Basel II requirement in a positive manner.

Conclusion

A word is needed for conclusion: We have within the limits of shari'ah a variety of means that makes the risk management in innovative Islamic financial engineering a challenging arena that does not leave room to resort to dubious and counterproductive tools of financing that very often contradict the essence and basic objectives "Maqasid" of the prohibition of interest and other regulations of Islamic financing.

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