1-1-2001

Innovative Financial Securities In The Middle East: Surmounting The Ban On Interest In Islamic Law

Ariel Berschadsky

INNOVATIVE FINANCIAL SECURITIES IN THE MIDDLE EAST: SURMOUNTING THE BAN ON INTEREST IN ISLAMIC LAW

ARIEL BERSCHADSKY*

I. INTRODUCTION

The Koran's proscription against borrowing or lending with interest has taken on greater significance in recent years with the expansion of Islamic fundamentalism in many parts of the world. Since the mid-1970s, in an effort to tap into a potentially huge capital market, Islamic banks and financial houses have structured several basic securities designed to bypass the ban on interest. Until recently, these securities have met the needs of both users and suppliers of capital, but it has become increasingly apparent that the Islamic capital markets are insufficiently developed to meet the demand for medium- and long-term capital in the coming years. Without a mechanism to tap into and lend such capital, many financing needs, particularly in the area of infrastructure finance, will go unmet. In an effort to satisfy this need while accessing and profiting from potentially huge pools of capital, both Islamic

* Ariel Berschadsky received a B.S.F.S. in Development Economics from the Georgetown University School of Foreign Service, an M.B.A. in Finance and Operations Research from the University of Chicago Graduate School of Business, and a J.D. from the Georgetown University Law Center. He is an associate in the corporate division of White & Case, L.L.P., in New York.

financial institutions and the Islamic branches of western institutions have begun developing new financial structures.

This article will discuss Islam's prohibition against interest, the development of modern Islamic finance, the standard financial instruments that have been in use for the past three decades, and several innovative financial structures that have already begun to transform modern Islamic finance by increasing the size and extending the maturity structure of Islamic loans.

II. THE PROHIBITION OF USURY IN ISLAMIC LAW

In the early part of the seventh century, in the small oasis town of Mecca off the main trade route from Yemen to Syria, the Prophet Muhammad began campaigning against the local idols and converting the populace to his new monotheistic religion, Islam.[1] The revelations he claimed to have received from God were later transcribed into what became the Koran, which gave adherents to Islam a comprehensive code of conduct encompassing all aspects of their lives.[2]

One of the Koran's strongest rules forbids lending and borrowing for interest, *riba*, stating that "[t]hose that live on Riba . . . shall rise up before God like men whom Satan has demented by his touch . . . ."[3] Several additional verses, or *Sura,* in the Koran also ban *riba*,[4] including one that commands "[n]o profit without toil and no money without labor. Man hath only that for which he has put forth effort."[5] Finally, there are several narrations of the sayings and behavior of Muhammad, the *Hadith*, that deal with interest.[6] In two of these, it is reported that Muhammad equated the taking and giving of interest to committing adultery thirty-six times or committing incest with one's mother.[7]

Despite the prohibition of *riba*, the term was never clearly defined and no examples were provided in the Koran.[8] To this day, it remains unclear whether the term *riba*, which is derived from the Arabic root meaning "to

---

1 *See* PETER W. WILSON, A QUESTION OF INTEREST: THE PARALYSIS OF SAUDI BANKING 13 (1991).

2 *See id.*

3 KORAN 2:275.

4 *See* BANKING TRAINING CENTRE, CENTRAL BANK OF THE ISLAMIC REPUBLIC OF IRAN, ISLAMIC BANKING 7-9 (Habib Shirazi ed. & trans., Butterworths 1990).

5 J.W. WRIGHT, JR., UNIVERSITY OF DURHAM CENTRE FOR MIDDLE EASTERN AND ISLAMIC STUDIES, ISLAMIC BANKING IN PRACTICE: PROBLEMS IN JORDAN AND SAUDI ARABIA 7 (1995) (quoting SURA 53:39-40).

6 *See* WILSON, *supra* note 1, at 14.

7 *See id.* at 13 (quoting ABDALLA BIN HANZALLAH & HADITH ABU HURAYA, HADITH).

8 *See id.* at 13-14.

grow" or "to be in excess," covers all forms of interest or refers only to exorbitant usury.[9] During this century, a variety of interpretations of the prohibition against *riba* have emerged under Islamic Law, or *Shariah*.[10] The Modernist interpretation, which is the least restrictive, maintains that *riba* is equivalent to the English term "usury," which is the charging of *excessive* interest, and not just the charging of *any* interest.[11] This is based on the belief that the true spirit of the ban on *riba* is the goal of preventing exploitation of the weak.[12] The interpretation of the Zahiris school also tries to narrow the scope of the ban on *riba* by limiting its application to the six commodities specifically mentioned in the Koran — gold, silver, wheat, barley, dates, and salt.[13] Other interpretations, offered by Hanafis, Ja'firi, and some Sh'ia jurists, maintain that a Muslim may engage in interest-bearing transactions but only in non-Islamic countries and only with a non-Muslim.[14] Finally, the Fundamentalist interpretation of *riba* is that all interest-bearing transactions are forbidden in all circumstances.[15] The paying of interest on money is believed to lead to selfishness, violating the Islamic injunction of brotherhood.[16] The Fundamentalist interpretation, because it is the most widely followed approach in the Middle East today, will serve as the backdrop for this article.[17]

III. DEVELOPMENT OF MODERN ISLAMIC FINANCE

Islamic finance has its roots in the camel caravans that used to traverse the Arabian deserts.[18] Wealthy merchants would provide money for traders

---

9 *See id.* at 14.

10 *See* Chibli Mallat, *The Debate on Riba and Interest in Twentieth Century Jurisprudence*, *in* ISLAMIC LAW AND FINANCE 69, 69 (Chibli Mallat ed., 1988).

11 *See* David A. Suratgar, *The Impact of Islamic Banking on World Financial and Commercial Relations*, 16 LAW & POL'Y INT'L BUS. 1089, 1102 n.31 (1984).

12 *See* ABDULLAH SAEED, ISLAMIC BANKING AND INTEREST: A STUDY OF THE PROHIBITION OF RIBA AND ITS CONTEMPORARY INTERPRETATION 41 (1996).

13 *See* NABIL A. SALEH, UNLAWFUL GAIN AND LEGITIMATE PROFIT IN ISLAMIC LAW: RIBA, GHARAR AND ISLAMIC BANKING 15 (2nd ed. 1992); *see also* FUAD AL-OMAR & MOHAMMED ABDEL-HAQ, ISLAMIC BANKING: THEORY, PRACTICE, AND CHALLENGES 9 (1996).

14 *See* SALEH, *supra* note 13, at 40-41.

15 *See* AL-OMAR & ABDEL-HAQ, *supra* note 13, at 7. This interpretation is also known as the "neo-Revivalist view." *See* SAEED, *supra* note 12, at 41.

16 ELIAS G. KAZARIAN, ISLAMIC VERSUS TRADITIONAL BANKING: FINANCIAL INNOVATION IN EGYPT 51 (1993). Some Islamic scholars have tried to give a modern justification for the ban on interest-based lending, claiming that it tends to concentrate wealth in the hands of a few. *See id.*

17 *See id.*

18 *See Banks Find Niche in Islamic World Interest is Barred in Those Countries, but Banks Still Turn Profits*, CHARLESTON GAZETTE & DAILY MAIL, Dec. 8, 1997, at 4D, *available at* 1997 WL 7137507.

to buy and transport goods, profiting from a successful caravan or losing if the caravan got lost or robbed during its journey.[19] Partnerships such as these were acceptable because *Shariah*, though prohibiting payment or receipt of any interest on loans of money, permits and actually encourages the allocation of risks and rewards and sharing in the resulting profits or losses.[20] Such partnerships are seen as a means to facilitate an entrepreneur's ability to transform unproductive resources into productive ones.[21]

Islamic finance developed rapidly during the 1970s.[22] Until then, the average Muslim held few liquid assets and those he did hold, if he entrusted them to a bank at all, were placed there for safekeeping only — no interest or other financial return was paid.[23] The wealthy few, on the other hand, discreetly directed their investable funds to conventional banks paying interest.[24] The oil boom of the 1970s changed this situation, as higher oil prices led to a huge influx of capital into the oil-producing countries of the Middle East.[25] Suddenly much more money was in many more hands, and the average depositor with surplus savings began to demand something in return while still conforming to *Shariah*.[26] Under *Shariah*, the only method to accomplish these dual objectives was to make lenders share in the risk of the venture to which they lent their capital.[27] To attract more of these new investors, banks began offering profit sharing, and developed a variety of Islamically acceptable financial instruments to channel these new funds into activities requiring capital.[28]

---

19 *See id.*

20 *See* Nicholas B. Angell & Emad H. Khalil, *Project Financing: Infrastructure Offers Opportunities to Combine Conventional and Islamic Finance*, 21 MIDDLE E. EXECUTIVE REP. 9 (1998), *available at* WL 21 No. 7 MEEXREP 9.

21 *See* WRIGHT, *supra* note 5, at 9.

22 *See* Kirk Albrecht, *Turning the Prophet's Words into Profits*, BUS. WK., Mar. 16, 1998, at 46.

23 *See Banks Find Niche in Islamic World Interest is Barred in Those Countries, but Banks Still Turn Profits*, *supra* note 18. There had been some previous attempts to provide returns to depositors in Islamic banks — a Malaysian savings plan in the 1940s to finance the pilgrimage to Mecca; a bank established in Pakistan in the late 1950s; and the Mitr Ghams Savings Bank chartered in Egypt in 1963 — but all these attempts ended in failure. *See* WRIGHT, *supra* note 5, at 7-8.

24 *See* FRANK E. VOGEL & SAMUEL L. HAYES, III, ISLAMIC LAW AND FINANCE: RELIGION, RISK, AND RETURN 5 (Arab and Islamic Laws Series, 1998).

25 *See id.*; Albrecht, *supra* note 22, at 46.

26 *See* VOGEL & HAYES, *supra* note 24, at 5. The first wave of successful Islamic banks was established in: Saudi Arabia (Islamic Development Bank in 1974); Dubai (Dubai Islamic Bank in 1975); Sudan (Faisal Islamic Bank in 1977); Egypt (Faisal Bank of Egypt in 1977); Kuwait (Kuwait Finance House in 1977); Jordan (Jordanian Islamic Bank in 1978); and Bahrain (Bahrain Islamic Bank in 1979). *See* WRIGHT, *supra* note 5, at 8.

27 *See* WRIGHT, *supra* note 5, at 9.

28 *See Islamic Banking - A Promising Market for Conventional Banks*, DRESDNER BANK TRENDS, Apr. 1, 1996, at 11, *available at* 1996 WL 9663140.

Today, there is a large amount of capital invested according to *Shariah* — by one estimate nearly $70 billion.[29] With over a billion Muslims throughout the world, greater capital mobility,[30] and Islamic fundamentalism on the rise,[31] there is an ever-larger supply of untapped Islamic assets.[32] Countries such as Iran, Sudan, and Pakistan have actually banned traditional commercial banking altogether and imposed Islamic banking models on their people, further increasing the supply of Islamic capital.[33] Institutional investors represent yet another source of capital that is increasingly being channeled into the Islamic markets in search of higher returns.[34]

To tap into this capital, the next stage of growth in the Islamic financial markets will be the continued development of financial securities designed to comport with *Shariah*. Traditional *Shariah*-based retail commercial banking activity has relied on a limited array of financial instruments, yet it is difficult to profitably engage in retail commercial banking in a religiously acceptable manner.[35] Islamic commercial banking as it has been practiced over the last two decades will be increasingly unable to intermediate between the growing pool of capital on the one hand and the increased need for financing in Middle Eastern countries on the other. The answer for Islamic commercial banks is to diversify away from their traditional retail mode and engage in more flexible forms of financial intermediation.[36]

IV. STANDARD *SHARIAH*-BASED FINANCIAL INSTRUMENTS

A. *The Murabaha*

The most common *Shariah*-based financial instrument for short-term financing is the *murabaha*, also known as cost plus financing, which accounts for about 75% of Islamic finance transactions.[37] Under *murabaha*, the Islamic bank buys goods or commodities based on the client's specifications and then resells them with transfer of title to the client at a predetermined markup on

---

29 *See Islamic Finance, Islamic Windows of Opportunity*, PROJECT & TRADE FIN., Nov. 10, 1998, at 16, *available at* 1998 WL 10129419.

30 *See* Zamir Iqbal, *Islamic Banking Gains Momentum, Expands Markets and Competes With Conventional Banking in Arab States*, 21 MIDDLE E. EXEC. REPORTS 9 (1998), *available at* WL 21 No.1 MEEXREP 9.

31 *See* Albrecht, *supra* note 22, at 46.

32 *See Islamic Finance, Islamic Windows of Opportunity*, *supra* note 29, at 16.

33 *See* Albrecht, *supra* note 22, at 46.

34 *See Islamic Finance, Islamic Windows of Opportunity*, *supra* note 29, at 16.

35 *See* VOGEL & HAYES, *supra* note 24, at 292.

36 *See id.* at 293.

37 *See Islamic Finance, Islamic Windows of Opportunity*, *supra* note 29, at 17.

the purchase cost.[38] The payment can be done in installments,[39] on a deferred basis (*bay mu ajjal*),[40] or through pre-payment with deferred delivery (*bay salam*).[41] The *murabaha* is essentially identical to Western-style interest-bearing securities because financing on the basis of a price mark-up is no different than charging interest.[42] An additional benefit to banks is that returns are short-term and highly predictable.[43]

There are several misconceptions about the *murabaha* contract as it actually operates. First, according to *Shariah*, in the *murabaha* it is the financier's responsibility to locate and purchase the required goods at the best price and if the client is not pleased with the quality or price of the goods he can void the contract.[44] But the ability of the client to void the contract in practice is a fiction. Islamic financiers phrase their contracts in such a way that they avoid any risk related to the goods.[45] For example, the client must assume responsibility for stating the correct specifications so that a financier who has purchased the correct goods is protected.[46] The client, in many cases, even has to provide the suppliers' names.[47] Furthermore, the client's ability to renege is decreased by forfeitable security deposits, advance payments, and third party guarantees.[48] The second ostensible difference between *murabaha* and Western-style interest bearing securities is that in the *murabaha*, the financier assumes the initial risk of storage and transit of the product from the supplier to the client.[49] Again, this risk in practice is nonexistent because financiers simply purchase insurance and pass the cost on to the client.[50] Third, the financier supposedly bears the risk of untimely repayment because the amount of the mark-up remains unchanged even though the financier loses the time value of the money he has lent.[51] Yet this

---

38 *See* Angell & Khalil, *supra* note 20, at 9. The mark-up generally reflects the London Interbank Offered Rate (LIBOR). *See* Moin A. Siddiqi, *Banking on Principles*, THE MIDDLE EAST, May 1, 1997, at 26, *available at* 1997 WL 9741931.

39 *See* Richard Freeland, *Ways to Lend Without Interest Many Moslems are Proud of Their Approach to Finance but are Bemused by Western Criticism*, EUROMONEY, May 1998, at 118.

40 *See* Iqbal, *supra* note 30, at 9.

41 *See id.*

42 *See* SAEED, *supra* note 12, at 93. But note that *murabaha* cannot be used to finance services, only goods. *See id.*

43 *See id.* at 87.

44 *See* AL-OMAR & ABDEL-HAQ, *supra* note 13, at 16.

45 *See* SAEED, *supra* note 12, at 85-86.

46 *See id.* at 85.

47 *See id.*

48 *See id.* at 86.

49 *See* AL-OMAR & ABDEL-HAQ, *supra* note 13, at 15-16.

50 *See* SAEED, *supra* note 12, at 85.

51 *See* AL-OMAR & ABDEL-HAQ, *supra* note 13, at 15-16.

too presents no problem for financiers because they simply impose fines based on the opportunity cost of capital onto procrastinating debtors.[52] Thus it is apparent that "in their investment operations, Islamic banks seem to regard an outward conformity to Islamic legal injunctions as the most important determinant of the islamicity of their operations . . . ."[53]

B. *The Ijara*

The next most common financial instrument, accounting for about 10% of Islamic finance transactions, is the *ijara*.[54] The *ijara* is a medium to long-term leasing structure in which the Islamic bank purchases the asset, generally equipment or real estate, and leases it back to the investor for an agreed period of time and rental payment.[55] The *ijara* differs little from the standard Western lease[56] except for the requirement that the lessor be responsible for maintenance and insurance, which in a standard Western lease is generally the lessee's responsibility.[57] At the end of the term, the asset either reverts back to the bank, the basic *ijara*, or the lessee exercises his option to acquire it, the *ijara wa-iktina*.[58]

C. *Others*

The *mudaraba* and *musharaka* are the remaining Shariah-based financial instruments of significance.[59] The *mudaraba* is a partnership agreement in which the investor, the *rab al-maal*, entrusts capital to an agent, the *mudarib*, who then uses the money to purchase, store, insure, market, and sell goods.[60] The principal is subsequently returned to the investor, usually within a year.[61] The investor supplies the capital but takes no part in the operation of

---

52 *See* SAEED, *supra* note 12, at 87.

53 *Id.* at 92.

54 *See Islamic Finance, Islamic Windows of Opportunity*, *supra* note 29, at 17.

55 *See* VOGEL & HAYES, *supra* note 24, at 190.

56 *See* NICHOLAS DYLAN RAY, ARAB ISLAMIC BANKING AND THE RENEWAL OF ISLAMIC LAW 37 n.84 (Arab and Islamic Laws Series, 1995).

57 *See* VOGEL & HAYES, *supra* note 24, at 191.

58 *See* Angell & Khalil, *supra* note 20, at 9. The risks to the financier of owning the asset are offset by making it the owner of the asset without actually having title to it. A blind trust is created in which a special purpose vehicle (SPV) holds title to the asset while the financier has the beneficial interest. The financier puts in 60-70% of the funds and the investor puts in the remaining 30-40%. *See* Sara Khalili, *Unlocking Islamic Finance*, INFRASTRUCTURE FIN., Apr. 1, 1997, at 19; William G. Shepherd, Jr., *Integrating Islamic & Western Finance*, GLOBAL FIN., May 1996, at 50.

59 *See* RAY, *supra* note 56, at 37 n.84.

60 *See* SAEED, *supra* note 12, at 56.

61 *See* Siddiqi, *supra* note 38, at 26.

the venture.[62] The agent invests only his human capital and does not obtain any wage for conducting the business.[63] Profit sharing is predetermined,[64] but fixed amounts of profits to any party are prohibited.[65] Losses are borne solely by the investor.[66] Banks use the *mudaraba* structure as the primary way to obtain assets from depositors.[67]

The *musharaka* is similar to the *mudaraba* in that both financier and client contribute capital and share the profits on a predetermined basis.[68] However, in the *musharaka*, losses are borne in proportion to the investment.[69] Although there are three varieties of *musharaka*,[70] the commercial *musharaka* is the most common.[71] The commercial *musharaka* is generally used for a specific, short-term purpose, such as the purchase and sale of a machine or a commodity.[72]

The *mudaraba* and *musharaka* structures, however, are not well suited to modern economies.[73] First, the increased costs to bankers of having to exercise constant vigilance over the utilization of funds makes these forms of lending the least profitable.[74] Second, particularly in the case of *mudaraba*, the bank's profits are uncertain given their dependence on the venture's success.[75] Third, even the entrepreneurs who need financing find these structures undesirable because they do not want to give up any of their anticipated profits.[76]

---

[62] *See* BANKING TRAINING CENTRE, *supra* note 4, at 32. Actually, because the *mudaraba* is for the purchase of specified goods, the bank itself often makes the payment directly to the seller. *See* SAEED, *supra* note 12, at 56.

[63] *See* AL-OMAR & ABDEL-HAQ, *supra* note 13, at 12.

[64] Often this determination is based on conventional interest-rate tables. *See* Freeland, *supra* note 39, at 118.

[65] *See* Iqbal, *supra* note 30, at 9.

[66] *See Islamic Finance, Islamic Windows of Opportunity*, *supra* note 29, at 26. Losses sustained due to the negligence of the *mudarib*, however, are borne by him. *See* Siddiqi, *supra* note 38, at 26.

[67] *See, e.g.*, RAY, *supra* note 56, at 35; SAEED, *supra* note 12, at 101.

[68] *See Islamic Finance, Islamic Windows of Opportunity*, *supra* note 29, at 26.

[69] *See id.*

[70] *See* SAEED, *supra* note 12, at 62. They are commercial, decreasing participation, and permanent participation. *See id.*

[71] *See id.* at 65.

[72] *See id.* at 63.

[73] *See id.* at 72.

[74] *See id.*

[75] *See* AL-OMAR & ABDEL-HAQ, *supra* note 13, at 13-14. *See also* RAY, *supra* note 56, at 35 (using the *mudaraba* structure to lend their capital is risky for banks because they bear all the risk, giving the agent the incentive to make high-risk, high-return investments).

[76] *See* AL-OMAR & ABDEL-HAQ, *supra* note 13, at 14; *see also* SAEED, *supra* note 12, at 72 (noting heightened bank involvement discourages entrepreneurs who seek maximum freedom of maneuver in the use of borrowed funds).

V. TRADITIONAL ISLAMIC SECURITIES INCAPABLE OF CHANNELING SUFFICIENT LONG-TERM CAPITAL TO MEET GROWING DEMAND

Despite progress over the last few decades, *Shariah*-based commercial bank lending remains short-term in nature and is generally directed to activities such as trade and commodity financing.[77] This phenomenon is driven by several factors. First, Islamic banks obtain the bulk of their assets through deposits, which are typically short-term given the depositors' natural risk aversion in less developed economies.[78] The short-term nature of investor deposits is reinforced by the *Shariah* requirement that depositors essentially become equity investors in their banks, something they are understandably reluctant to do.[79] The consequence of short-term deposits is the inability of banks to engage in longer-term lending given the need to maintain balance between the maturity structure of assets and liabilities. Second, the pressure on Islamic commercial banks to remain liquid by making primarily short-term loans is compounded by their inability to borrow on interest from a central bank, leaving them without a lender of last resort during liquidity crunches.[80] The need to remain liquid is reinforced by an absence of deposit insurance programs in Islamic countries that would reassure savers and help prevent runs on bank deposits.[81] Third, the absence of an interbank market in the Islamic countries prevents banks from swapping short-term deposits in favor of longer-term assets, as is done routinely in the west.[82] Fourth, most small business owners try to avoid taking out long-term loans from Islamic banks because this would require management participation by the bank and a consequent loss of control to the owners.[83]

---

77 *See* Angell & Khalil, *supra* note 20, at 9; *see also Islamic Finance, Islamic Windows of Opportunity*, *supra* note 29, at 12.

78 *See* Angell & Khalil, *supra* note 20, at 9; *see also* VOGEL & HAYES, *supra* note 24, at 8.

79 *See* WRIGHT, *supra* note 5, at 8.

80 *See* RAY, *supra* note 56, at 22.

81 *See* VOGEL & HAYES, *supra* note 24, at 8.

82 Malaysia is the only Muslim country with an interbank market. It was developed in 1994 with substantial government support. *See* Khalili, *supra* note 58, at 19.

83 In one study, only 13% of small and medium-sized business owners in Saudi Arabia were amenable to the idea of bank participative financing. *See* WRIGHT, *supra* note 5, at 27 (citing Bandar Al-Hajjar & John R. Presley, *Islamic Finance: Attitudes in Small Manufacturing Businesses in Saudi Arabia*, Address to the 1992 International Conference on Islamic Economics, International Institute for Islamic Thought, Kuala Lumpur).

Shariah-based commercial bank lending is thus inherently unable to become a significant source of long-term capital,[84] and, as it stands today, will be unable to meet the Middle East's growing financing needs in coming years. Though some demand for capital is being met by the growth of Islamic units of western banks,[85] which are better able to match assets and liabilities through their ability to participate in offshore interbank markets, the most effective mechanism to raise Shariah-conforming long-term capital in the coming years will be innovative techniques in the securitization and pooling of capital.

VI. RECENT INNOVATIONS IN *SHARIAH*-BASED FINANCIAL SECURITIES

In response to the growing need for longer-term capital, the investment banking arms of Western and Islamic banks have increasingly tried to fill the void left by commercial banking activity by developing innovative financial instruments[86] that are better able to attract Islamic capital than the more traditional plain vanilla financing structures.[87] The major examples of these new financial instruments are the *istisna* structure, *mudaraba* funds, and the *muqarada* bond.

A. *The Istisna Structure*

The *istisna* is a longer-term and larger credit vehicle than the previously discussed *ijara*.[88] In the *istisna*, the financier pays the supplier, who then manufactures the plant or equipment, or purchases the commodities.[89] The client owes the bank the purchase price plus a predetermined markup, and frequently a fee.[90] The typical structure is known as the "back-to-back *istisna*," which finances the purchase of major manufactured goods such as

---

84 *See* VOGEL & HAYES, *supra* note 24, at 8.

85 *See* Albrecht, *supra* note 22, at 46. For example, Citicorp established Citi Islamic Investment Bank in Bahrain in 1996 and ABN-AMRO opened its Global Islamic Financial Services unit in Bahrain in 1997. J.P. Morgan & Co., Deutsche Bank, American Express, and ANZ Investment Bank have also established Islamic units. *See* Iqbal, *supra* note 30, at 9; Stephen Timewell, *A Market in the Making*, THE BANKER, Feb. 1, 1998, at 57.

86 *See Islamic Finance, Islamic Windows of Opportunity*, *supra* note 29, at 16.

87 *See* Khalili, *supra* note 58, at 19.

88 *See* Angell & Khalil, *supra* note 20, at 9.

89 *See id.*

90 *See id.* One example is the $92 million *istisna* bridge facility in the 1993, $1.8 billion Hub River power project in Pakistan. Saudi Arabia's Al-Rajhi Bank bought the rights to the yet-to-be-produced turbines and sold these rights to the project company on a markup basis. *See id.*

ships or airplanes.[91] In the first *istisna*, the bank acts as a seller, accepting a long-term schedule of payments from its customer, while in the second *istisna*, the bank acts as a buyer, paying the manufacturer over a shorter period with progress payments.[92] "The difference between the present value of payments under the two contracts is the bank's compensation for the finance."[93]

Initially used as a vehicle to finance short-term working capital, the *istisna* has expanded its role in recent years and is now the instrument of choice in the growing field of Middle Eastern project finance. The *istisna* structure is able to meet the need of typical project finance deals for long-term capital, typically for eight to ten years.[94] The *istisna* is also well suited to the needs of project finance because like most project finance deals, the *istisna* requires lenders to take a stake in the project's cash flows and successful completion.[95]

It should be noted, given the limited breadth of the Islamic capital markets and the large size of most infrastructure projects, that most *Shariah*-based project finance deals are generally tranches of larger conventional finance structures.[96] In the past, this produced inter-creditor problems because the Islamic tranches, in *istisna* or other form, by not receiving interest, might potentially receive principal repayment prior to the conventional tranches in the deal.[97] This issue has been resolved by ensuring that an inter-creditor agreement clearly identifies different income streams and establishes entitlements under each of them.[98] Most inter-creditor agreements now require all senior lenders to be treated on a *pari passu* basis.[99]

---

[91] *See* VOGEL & HAYES, *supra* note 24, at 147.

[92] *See id.*

[93] *Id.*

[94] *See* Angell & Kahlil, *supra* note 20, at 9.

[95] *See Islamic Finance, Islamic Windows of Opportunity*, *supra* note 29, at 12. In most limited recourse infrastructure projects, lenders require that at least 20-30% of a project's overall financing be in the form of straight equity. *See* Angell & Khalil, *supra* note 20, at 9.

[96] *See Islamic Finance, Islamic Windows of Opportunity*, *supra* note 29, at 12. For example, the Equate project in Kuwait, funded in 1996 and refinanced in 1997, had a five-tranche structure that included two Islamic syndicated loans. It was a joint venture of Union Carbide in the United States and two Kuwaiti corporations, Petrochemicals Industries and Bubiyan Petrochemical. The Islamic syndicated loans totaled $200 million in *ijara* financing arranged by KFH and International Investor with maturities of eight and ten years. The total capital borrowed for this project was $1.2 billion. *See* Angell & Khalil, *supra* note 20, at 9; Khalili, *supra* note 58, at 19.

[97] *See* Angell & Khalil, *supra* note 20, at 9.

[98] *See id.*

[99] *See id.* One notable recent example is the Rousch Power Project in Pakistan, in which the three Islamic facilities totaling $65 million were treated on a *pari passu* basis with the remaining $522 million in conventional financing. *See id.*

B. *Mudaraba Funds*

Another method of adhering to *Shariah* principles, while obtaining sufficient funds to finance large-scale investments, is the *mudaraba* fund,[100] a project-specific pool of funds similar to a mutual fund.[101] Also known as the two-tier *mudaraba,*[102] the *mudaraba* fund is an extension of the standard *mudaraba*[103] because the "[b]ank organizes investors' money into a mutual or unit trust fund, and channels these funds into a *mudaraba* contract with a fund manager."[104] "Most *mudaraba* funds operate as either closed or open-ended investment funds, with tradeable units."[105] *Mudaraba* "[f]unds have been used as a vehicle for bank syndications of large financings and to engage in ventures too risky or too large for any single institution to take on alone, such as holdings in oil tankers or real estate projects."[106]

C. *The Muqarada Bond*

The last innovative Islamic financial structure to be examined in this article is the *muqarada* bond, which is similar to the Western revenue bond.[107] The *muqarada* is "[i]ssued by an existing company (which acts as *mudarib*) to investors (who act as silent partners, or *rabb al-mal*) for the purpose of financing a specific money-making project separable from the company's general activities."[108] The profits of this separate activity are split according to predetermined percentages.[109] An example of the *muqarada* is a bond financing a bridge or tunnel project, whose toll revenues are then paid out to the bondholders as their participation in the profits.[110] Though the *muqarada* is religiously acceptable, to date it has been rarely used.[111] Nevertheless, the *muqarada* could be a viable candidate to expand the range of Islamic investment instruments in any instance where one could carve out a discrete

---

100 *See* VOGEL & HAYES, *supra* note 24, at 166.

101 *See* Angell & Khalil, *supra* note 20, at 9.

102 *See* Siddiqi, *supra* note 38, at 26.

103 The *mudaraba* fund can also be comprised of any standard Islamic contracts, such as *ijara*, *murabaha*, or *istisna*. *See* VOGEL & HAYES, *supra* note 24, at 167.

104 Siddiqi, *supra* note 38, at 26.

105 *Id.*

106 VOGEL & HAYES, *supra* note 26, at 167.

107 *See id.* at 169, 191.

108 *Id.* at 169.

109 *See id.*

110 *See id.* at 191.

111 *See id.* at 192.

activity with its own revenue stream.[112] In the opinion of some Islamic scholars, the *muqarada* could even be used when the organization surrounding the discrete activity does not conform to Islamic principles — just the activity itself would need to conform to *Shariah*.[113]

VII. CONCLUSION

The Islamic financial markets currently provide an array of financial instruments that conform to the Koranic prohibition of interest-based lending. Though the first generation of securities served their purposes well during the 1970s and 1980s, the 1990s saw a much greater need than before for large amounts of long-term capital. This is particularly the case in the area of project finance.

Both Western and Islamic financial institutions have responded by creating several innovative financial structures, billions of dollars of which have already been issued to either partially or fully fund several Middle Eastern transactions and projects. Though even continued development of Islamic securities is unlikely to ever satisfy all of the Middle East's future capital requirements, this development has the potential to make accessible vast amounts of untapped Islamic capital that has been awaiting appropriate investment vehicles.

---

112 *See id.*

113 *See id.* at 192-93.