

## Beyond the Theoretical Dichotomy in Islamic Finance: Analytical Reflections on *Murābahah* Contracts and Islamic Debt Securities\*

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### 1. Introduction

Islamic finance had been originally considered as the financial system based on the notion of profit-sharing and participatory finance due to the fact that *ribā* (interest) is forbidden in Islam. However, since the rise in the practice of Islamic finance in the 1970s, mainly two discussions relating to the legitimacy of the modes of financing have been raised: one pertains to *murābahah* contracts and the other, to Islamic debt securities. These discussions have led to divergence in the practice of Islamic finance.

Existing literatures on the historical overview in Islamic economics and financial studies appear to opine that these discussions have roots in the dichotomy between those who attach greater importance to the ideal of Islamic finance and those who deem it desirable to respond to the practical demands of Islamic finance. Subsequently, each discussion tends to result in convergence after many arguments. This paper primarily aims to trace several arguments in each discussion and summarize them into a framework of theoretical divergence and convergence, which is premised by many works, regardless of whether the framework is described explicitly or implicitly.

However, the divergence/convergence framework reviewed in this paper appears to lack certain crucial points pertaining to the relationship among theoretical standpoints and the structure of discussions. Therefore, this paper examines these points by using as examples the discussions on *murābahah* contracts and Islamic debt securities and aims to present an advanced picture of the framework beyond mere dichotomy. Furthermore, based on the overview, this paper also attempts to explore the underlying and essential features of Islamic finance that have been commonly shared by the scholars who participated in each discussion.

The following two chapters deal with the overviews of the discussions on *murābahah* and Islamic debt securities. The fourth chapters discusses the divergence/convergence framework within which the theoretical discussions on Islamic finance can be located and it also presents an advanced picture of the framework beyond mere dichotomy. Then, the underlying features of Islamic finance are outlined.

### 2. Overview of Discussion on *Murābahah* Contracts

#### 2.1 Background

Before the rise of the practice of Islamic banking in the 1970s, there appeared to be a consensus in Islamic economics regarding preferable financial instruments for Islamic banking operations<sup>1)</sup>.

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Most Islamic economists encouraged profit-sharing-based financial instruments such as *muḍārabah* and *mushārahah* contracts<sup>2)</sup>. One of the early Islamic economists, Anwar Iqbal Qureshi had already mentioned about profit-sharing-based banking systems in his books published in the 1940s. He states “Islam prohibits interest but allows profits and partnership. If the banks, instead of allowing loans to the industry, become its partners, share the loss and profit with it, there is no objection against such banks in the Islamic system [Qureshi 1945: 158-159].” In addition to Qureshi, Mahmud Ahmad had also mentioned the preference of profit-sharing-based systems in the 1940s [Ahmad 1947]<sup>3)</sup>.

According to the early overview by Muhammad Nejatullah Siddiqi, one of the economists of the first generation of Islamic economics, this consensus on preferable financial instruments had been widely shared both by experts in Islamic law and scholars specializing in economics, until the end of the 1960s [Siddiqi 1981: 29-37]. For example, Muḥammad Bāqir al-Ṣadr formulated the profit-sharing-based banking system as a preferable Islamic system from the viewpoint of Islamic law [al-Ṣadr 1977 (1969)]. Meanwhile, Muhammad Uzair presented the core mechanism of the profit-sharing-based banking system from the viewpoint of economics [Uzair 1955], and Siddiqi himself promoted such a system in his book [Siddiqi 1983a (1969)].

However, from the 1970s onward, the practice of Islamic banks did not necessarily reflect the theoretical suggestions made by Islamic economists prior to that period. Most Islamic banks mainly adopted *murābahah* contracts on their asset side as an alternative financial instrument for interest-based loans<sup>4)</sup>. Originally, a *murābahah* contract is a form of contract wherein a seller sells a product to a buyer at a price comprising its wholesale cost and the seller’s margin, as agreed by both parties. The settlement is generally paid in installments or in the form of deferred payments. In modern Islamic banking, an Islamic bank buys a product specified by its customer on his behalf from the market and sells it to him at a price that includes the product’s cost and the bank’s profit (markup)<sup>5)</sup>.

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- 1) Muhammad Nejatullah Siddiqi presents this in his comprehensive overview of Islamic economics up to the 1970s [Siddiqi 1981].
  - 2) *Muḍārabah* contract is a form of a business contract in which one party offers capital and another party undertakes some business with this capital; the former is termed *rabb al-māl* and the latter *muḍārib*. Any resulting profit is distributed between both parties based on a previously agreed ratio, while the entire loss would be borne by *rabb al-māl* unless *muḍārib* is proved to be negligent. *Mushārahah* contract is a form of business partnership in which multiple parties invest. In Islamic finance, *sharikah al-‘inān* uses a variation of *mushārahah*. Any profit is distributed between both parties in a previously agreed ratio according to the Ḥanafī and Ḥanbalī schools of Islamic law, and shared depending on the amount invested, according to the Mālikī and Shāfi‘ī schools. Each school also consents to any loss being borne, depending on the amount invested. Investors have the right to participate in managing their business partnership, but this right is entrusted to each investor.
  - 3) He states in his early book, “The *shirakat* banks would lend money to industry and commerce on the basis of *shirakat*, that is, they would share the profit with their debtors rather than burden industry and commerce with a fixed rate of interest [Ahmad 1947: 170].” There “*shirakat*” indicates the principle of *mushārahah* contracts. However, Ahmad appears to change his opinion in the 1990s. In his book published in 1992, he propounds the new financial instrument named TMCL (Time-Multiple Counter-Loan) which is based on *qard ḥasan* as a substitute for profit-sharing-based systems [Ahmad 1992: 57-59].
  - 4) On their liability side, profit-sharing-based instruments have been mainly used as a substitute for the term deposit account.
  - 5) According to the works of Monzer Kahf and Rodney Wilson, *murābahah* contracts were discovered and strongly promoted by Sami Homoud [Kahf 2001: 8; Wilson 2004: 211].

## 2.2 *Murābahah* Contracts in Practice

With regard to the share of *murābahah* contracts, the majority of Islamic banks in both the Middle East and Malaysia have shown a widespread preference for *murābahah* contracts. Such a preference can be observed almost throughout the period beginning from the 1980s until now. For example, in Al-Baraka Islamic Investment Bank in Bahrain (established in 1984), the use of *muḍārabah* contracts occupied shares of 5.4% and 2.8% in the first two years of the bank's operation, while the *murābahah* contracts garnered the rest of the share [Presley 1988: 105]. In Bank Islam Malaysia, established in 1983 as the first Islamic commercial bank in Malaysia, *murābahah* contracts (including *bay' bi-thaman 'ajil* contracts that are similar to *murābahah* contracts) have also occupied the highest share of total financing on its asset side every year (see Table 1). To present another example, in Dubai Islamic Bank, which on its establishment in 1975 became the world's first Islamic bank, *murābahah* contracts have occupied higher shares, even if the annual shares in the 2000s are smaller than those in the 1990s (see Table 2).

According to al-Harran's aggregate calculation, it is estimated that 80-90% of financial instruments on the asset side of Islamic banks were *murābahah* contracts from the 1970s through the first half of the 1990s, which implies that the share of profit-sharing-based instruments was meager [al-Harran 1995: xi].

## 2.3 Criticisms against *Murābahah* Contracts

In response to this situation, many criticisms and arguments against this type of contract were advanced in Islamic economics not only because profit-sharing-based financial instruments were rarely used on the asset side of Islamic banks but also because *murābahah* contracts involved certain contentious issues from the viewpoint of Islamic jurisprudence.

With regard to the contentious issues of *murābahah* contracts, the following points are mainly raised: (1) two transactions in one contract, (2) possession of a specified product before agreement, (3) similarity between markup rate in *murābahah* contracts and interest rate in conventional loans, (4) binding effect of *murābahah* contracts and risk bearing, (5) time required to transfer ownership, and (6) penalty for delay in payment<sup>6</sup>.

The third point from among those mentioned above is particularly important and controversial with respect to the principle of the prohibition of *ribā*, which is equivalent to a bank's interest and is the *raison d'être* of Islamic banks. Many scholars who emphasized their ideal of the Islamic economic system where a profit-sharing-based system achieves desirable economic performance from the aspect of Islam are skeptical about the legitimacy of *murābahah* contracts from the viewpoint of its similarity to transactions such as interest-based loans where *ribā* (interest) is charged. For example, Siddiqi is critical and mentions *murābahah* contracts in a negative context with saying that *bay' mu'ajjal* contract (which is a contract similar to *murābahah*) is removed from the list of permissible methods altogether in order to save interest-free banking from being sabotaged

6) For more theoretical overview of each point except the third point that is examined in this paper, see [Ray 1995] and [Sairally 2002].

from within [Siddiqi 1983b: 139].

To present another example, Muhammad Taqi Usmani, who is one of the scholars in Islamic jurisprudence and holds a number of positions on the *shari'ah* boards of Islamic financial institutions in the Middle East, South Asia, and the USA, propounds the restrictive use of *murābahah* contracts with saying that *murābahah* is only a device to escape from interest and not an ideal instrument for carrying out the real economic objective of Islam, therefore, its use should be restricted only to those cases where *muḍārabah* or *mushārahah* are not practicable [Usmani 2000: 104-105].

The reason for the criticism of *murābahah* contracts is essentially as follows. In interest-based loans, the customer uses the bank loan to purchase a specified product from the market and ultimately repays the debt by its maturity date to the bank along with interest that amounts to the bank's profit. In contrast, in *murābahah* contracts, an Islamic bank purchases a specified product from the market on behalf of its customer and resells it to the customer at cost plus markup. Subsequently, by maturity date, the customer repays the debt to the bank along with the markup amount that constitutes the bank's profit. In both cases, the financial instruments function as a provider of liquidity to customers requiring financial assistance, and the validity of the bank's profit can be based on the logic that it is a counter value for providing liquidities. Therefore, this line of reasoning leads to the conclusion that there are no differences between interest and markup; therefore, *murābahah* contracts are merely an alternative form of interest-based loans. Thus, those who criticize *murābahah* contracts consider it unlawful because of the fact that *murābahah* contracts include a factor (markup rate) that is similar to *ribā*. Also, often Islamic banks have made use of the conventional bench mark such as LIBOR (London Inter-Bank Offer-Rate) to determine the profit rate or markup on the *murābahah* transactions [Usmani 2000: 118-120]. This has further likened *murābahah* contracts to interest-based loans and has added to the skepticism towards *murābahah* contracts.

#### 2.4 Advocacy of *Murābahah* Contracts

Therefore, how do the promoters of *murābahah* contracts explain their legitimacy? One of the more notable explanations is found in the legal opinion (*fatwā*) issued at the Al-Baraka seminar (*Nadwah al-Barakah*) held under the auspices of the Dallah Albaraka Group (*Majmū'ah Dallah al-Barakah*), which is not only known as one of the largest investment and development companies in the Middle East but also manages many Islamic financial institutions. At its first seminar held in 1983, the following *fatwā* was issued regarding the uncertainty surrounding the similarity between *murābahah* contracts and interest-based loans. In one part of the question, this *fatwā* states the following [ABS 1983: 8]<sup>7)</sup>:

**Question:** Some people cast doubts on the legitimacy of *murābahah* contracts because this form of contracts appears to include some elements of *ribā*. They are also skeptical about the following points in the procedure of *murābahah* contracts:

1. Possession of a specified product before agreement

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7) Translated from Arabic by the author [ABS 1983: 8].

2. Deferred payment of the sale
3. Sales involving exchange of money for money, which is similar to currency exchange
4. Binding contracts (stipulating a promise to buy), which are prohibited by the Mālikī school of thought
5. Involving fabrication, which is unlawful

The third point from among these questions is related to the topic of this paper. The answer to this question is as follows:

**Answer:** In *ribā*-based loans, transaction is conducted in the form of exchange of similar goods. In such a transaction, the lender stipulates that the payment of interest (for example, 10 riyals) be made on the maturity date by a borrower who takes a loan of 100 riyals. In *murābahah* contracts, with deferred payment, a transaction is conducted in the form of exchange of different goods, particularly the exchange of commodities for money. A specific feature of *murābahah* contracts comparable to *ribā*-based loans is that even if the markup amount (which is the seller's profit) is predetermined, the seller's profit (and similarly, the buyer's gain) will be influenced by the market price of the relevant commodity. Therefore, any profits in *murābahah* contracts are expressed as a function of supply and demand in the commodity market rather than the monetary market.

The essence of the resolution is as follows. The *fatwā* states that although a transaction involving *ribā* occurs when similar products (particularly monetary products) are unequally exchanged, with interest-based loans falling into the category of such unlawful transactions, *murābahah* contracts do not qualify as such transactions. This is because they involve transactions of different goods, which implies that bank profits can be directly influenced by market prices that are the true projection of the real domain of the economic system. In the case of a *murābahah* transaction, there is an exchange of a physical good for a monetary exchange, while in the case of an interest-based loan, an exchange of money for money takes place. Thus, *murābahah* contracts are completely different from interest-based loans and therefore are permissible. Such an explanation is supported by those who prioritize the competitiveness of the Islamic banking system against the conventional financial system.

### 3. Controversy in Islamic Debt Securities: Lessons from Malaysian Case

#### 3.1 Background

After the launch of the *murābahah*-based Islamic banking system, the introduction of an advanced financial system was demanded in order to ensure the smooth operation and expansion of the Islamic financial market. Malaysia has played a leading part in the introduction of such an advanced system, among countries where Islamic finance has been implemented.

Therefore, Malaysia is known as the representative country that has been proactively promoting

the development of Islamic finance since the 1980s. In 1983, the first commercial Islamic bank in Malaysia, Bank Islam Malaysia Berhad, was established under the *Islamic Banking Act* (Act 276). Subsequently, Malaysia introduced the Interest-Free Banking Scheme in 1993 that allowed the then existing conventional financial institutions to offer Islamic financial products in their separating branches. In recent years, Malaysia has accelerated the open-door policy for Islamic finance. In 2003, conventional financial institutions were allowed to establish subsidiary companies for Islamic financial operations. In 2005, foreign Islamic financial institutions were allowed to obtain licenses to establish Islamic financial institutions in Malaysia [Abdul Rahman 2007].

In parallel with these initiatives for the establishment of Islamic financial institutions, Malaysia has provided several subordinate infrastructures for the smooth practice of Islamic finance and for the expansion of Islamic financial markets. For example, the Islamic Interbank Money Market (IIMM) and Islamic Interbank Cheque Clearing System (IICCS) were developed with this objective in the early 1990s.

With regard to financial instruments, alternative Islamic securities to short-term interest-bearing securities, such as treasury bills, were required in order to ensure the liquidity of Islamic financial institutions with the expanding secondary market and to provide portfolios to customers. Since the early 1980s, several types of Islamic securities have been introduced. In 1983, under the *Government Investment Act* (Act 275), Bank Negara Malaysia issued non-interest-bearing securities (Governmental Investment Certificate, GIC) based on *qardḥasan* contracts<sup>8)</sup>. In 1993, *muḍārabah* Interbank Investments (MIIs) based on *muḍārabah* contracts were issued for the IIMM. However, both securities based on *qardḥasan* contracts and *muḍārabah* contracts were used for specific purposes and were not able to gain popularity because it is difficult to trade GICs in secondary markets, and MIIs are plagued by the asymmetric information problem related to the profit between investor's bank and investee's [Wilson 2002: 36]<sup>9)</sup>.

For more general use, Islamic debt securities based on *murābahah* contracts attracted considerable attention from both Islamic banks and customers<sup>10)</sup>. As for Islamic banks, Islamic debt securities were useful for trading accounting receivables (one of the basic resources of debt

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8) *Qardḥasan* contract is a loan in which only the principal is paid back without any additional amount, i.e., an interest-free loan.

9) Many works examine the asymmetric information problem in *muḍārabah* contracts. One of the pioneering works was conducted by Waqar Masood Khan [Khan 1985].

10) Although such securities are generally referred to as Islamic bonds or *sukūk al-murābahah*, in this paper, the author adopts the term Islamic debt securities because of the following reasons: (1) the term bond involves the concept of interest-bearing securities, for which it is inaccurate for it to be modified by the word Islam, which is unfamiliar with the concept of interest, (2) The term *sukūk* historically and theoretically covers many types of Islamic securities and checks, but in the context of Islamic financial studies, it was not until the 2000s that this term emerged. Thus, from the need to examine the relationships between *murābahah*-based securities in the 1990s and what is referred to as *sukūk* (including *sukūk al-murābahah*) in the 2000s, the author distinguishes Islamic debt securities from *sukūk*. Regarding the second point, both Shamsun Hussain, who is the director of Debt Capital Market & Corporate Finance at CIMB Islamic Bank Berhad in Malaysia, and Zarinah Anwar, who is the Chairman of the Securities Commission of Malaysia, state that the first *sukūk al-murābahah* was issued by Shell MDS in 1990 [Hussain 2007; Anwar 2007]. However, Angelo M. Venardos mentions in his book that by then, Islamic debt securities based on *murābahah* contracts had started being traded in the securities markets in Malaysia [Venardos 2005: 165].

securities) in the secondary market. With regard to customers, Islamic debt securities diversified the financing method. In accordance with these practical demands, Islamic debt securities acted as instruments that justified the issuance and trade of debt securities through Islamic methods developed by Malaysian scholars. In the process of the development of such instruments, Malaysian scholars encountered legal problems pertaining to both *bay' al-ṭinah* and *bay' al-dayn* in Islamic jurisprudence. *Bay' al-ṭinah* is related to the problem that arises during the process of the issuance of Islamic debt securities, whereas *bay' al-dayn* is related to the problem cropping up during the process of trade of debt securities.

### 3.2 Discussion on *Bay' al-ṭinah*

*Bay' al-ṭinah* literally implies double sales and is basically an alternative financial arrangement for a customer who needs immediate cash. Instead of direct interest-based loans that are prohibited in Islam, an Islamic bank uses *bay' al-ṭinah* as a means of lending through which it is able to earn profits. The complete procedure is outlined as follows. First, an Islamic bank (prospective creditor) buys some asset from a customer (prospective debtor) who needs immediate cash, and then, the customer immediately buys back his asset from the Islamic bank by means of a *murābahah* contract. The initial trade is a spot transaction, while the subsequent trade is a deferred transaction with a higher price than that in the initial trade. Herein, an Islamic bank provides the customer with financial liquidity and earns profit from the price gap between the initial and subsequent trades. When an Islamic bank faces a liquidity constraint before the maturity date of the subsequent trade and sells the accounting receivables to a third party, its receivables based on *bay' al-ṭinah* convert into debt securities.

Regarding the legitimacy of *bay' al-ṭinah* in Islamic jurisprudence, there are some disagreements on the matter of double sales intended to cash finance with excess repayment that is equivalent to charging *ribā*. Zuḥaylī reviews the classical literature of *bay' al-ṭinah* in Islamic jurisprudence and explains that the Ḥanafī school of jurisprudence prohibits double sales except in the case where a third party intermediates in the trade<sup>11)</sup>, whereas the Mālikī and Ḥanbalī schools prohibit them when the parties involved implement the sales with the consideration that such trades are unlawful [Zuḥaylī 2002: 45]. Meanwhile, Nik Norzrul, Thani, Mohamed Ridza Mohamed Abdullah and Megat Hizaini Hassan introduce the view of the Shāfi'ī school with the explanation that it allows double sales based on al-Shāfi'ī's interpretation. Al-Shāfi'ī, who was the eponym of the Shāfi'ī school, allowed double sales because the validity of contracts is based on the external evidence that they have been properly concluded and that the unlawful intention of parties involved is immaterial unless expressed in their act [Norzrul Thani et al. 2003: 68]. In modern literature, Muslim scholars who do not support al-Shāfi'ī's interpretation have cast doubts on the concept of double sales because such an instrument is considered a mere legal stratagem (*hiyal*) in order to superficially circumvent the prohibition of *ribā*. For example, Usmani states as follows [Usmani 2001: 113]:

11) Abū Ḥanīfah, who was the eponym of the Ḥanafī school, also permits double sales in the case where the interval between the initial and subsequent trades is sufficiently long or the market price of the relevant asset increases.

In some cases, this technique (*bay' al-ṭinah*, annotated by author) ... is nothing but to make fun of the original concept. In many cases it is done merely on papers without a genuine commodity to be sold and purchased. Moreover, this technique is applied indiscriminately to all the banking transactions having no regard whether or not they involve a commodity. The procedure is being applied to all the types of finances including financing overhead expenses, payment bills etc. ... This system cannot be held as immune from being declared as repugnant to the Holy Qur'ān and Sunnah.

Meanwhile, Malaysian scholars who engage in practical judgments tend to allow double sales by adopting the general interpretations of the Shāfi'ī school. One crucial statement was issued by the Sharī'ah Advisory Council of Securities Commission in Malaysia. At its 5th meeting (held on January 29, 1997), the resolution that permitted double sales was issued with the following statement [SC 2002: 22]:

From the study done on the opinions of past Islamic jurists on the issues of *bay' al-ṭinah*, the SAC (Sharī'ah Advisory Council) decided to accept the opinions of the Shāfi'ī and *Zāhirī madhhab* in permitting *bay' al-ṭinah*. Therefore, it can be developed into a product for the Islamic capital market in Malaysia.

A similar statement was issued by the Sharī'ah Advisory Council of Bank Negara Malaysia. At its 8th meeting (held on December 23, 1998), the following resolution was issued [BNM 2007: 26]:

The Council ... resolved that *bay' al-ṭinah* transaction in the Islamic Interbank Money Market is permissible based on the following conditions: (1) *bay' al-ṭinah* transaction must strictly follow the mechanism which is accepted by the Shāfi'ī school; and (2) the transacted asset is not a *ribāwī* item.

It is clear that both resolutions strongly depend on the view of the Shāfi'ī school. However, recent works by Rosly and Sanusi raise doubts on the validity of al-Shāfi'ī's interpretation, which is the main source of the above two resolutions. They point out that there is hardly any satisfactory evidence that can enable one to say that al-Shāfi'ī has expressly declared that double sales are allowed [Rosly and Sanusi 2001: 276]. In reaction to such an academic trend, the following resolutions issued by the Council in the Regional Sharī'ah Dialogue were added to its original resolutions (held in June 28–29, 2006) [BNM 2007: 27]:

The Council ... resolved that: (1) the permissibility of *bay' al-ṭinah* ... is still a matter of juristic disagreement among the Sharī'ah scholars backed by their own basis of justifications; ... (3) *Bay' al-ṭinah* is still necessary in the context of local Islamic finance development. However, the market players are required to strengthen and enhance the operational processes and documentation to comply with the features of *bay' al-ṭinah* as permitted; and (4) Since



*bay' al-ṭinah* concepts is still regarded as a matter of juristic disagreement among the Sharī'ah scholars, it is more desirable that Islamic financial institutions to limit its use in products which face difficulty in structuring them based on other consensually accepted contracts.

This resolution implies that Malaysia attempted to change its own position on *bay' al-ṭinah*, that is, double sales for financial liquidity and issuance of securities were used as a second-best instrument; in order to satisfy these financial needs, it is mandatory to develop alternatives to *bay' al-ṭinah*. This change in Malaysia's position appears to be connected with the movement aiming to standardize the theory of Islamic finance, which is initiated by Malaysia.

### 3.3 Discussion on *Bay' al-Dayn*

In a simple *murābahah* contract between an Islamic bank (first party) and a customer (second party), the former holds accounting receivables for cash that the latter agrees to pay for his product. When there is a need for immediate cash, an Islamic bank sells its receivables to the third party. *Bay' al-dayn* implies such a trade of debt securities or receivables between the first and third parties. By the maturity date, the third party receives cash from the second party. This financial method is considerably convenient for those who hold debt securities but face liquidity constraints.

However, there are some disagreements on the matter of the trade of debt securities in Islamic jurisprudence<sup>12)</sup>. In particular, as Rosly and Sanusi indicate, the problem pertaining to debt securities occurs when they are traded between the first and third parties at discounted prices [Rosly and Sanusi 1999]. In the literature on classical Islamic jurisprudence, trade of debt securities between the first and third parties at discounted prices is unanimously prohibited [Zuḥaylī 1998: 24-25]<sup>13)</sup>, and in modern literature, a majority of Muslim scholars in the Middle East support the classical interpretation. For example, the Islamic Fiqh Academy, one of the most influential associations in Islamic jurisprudence, does not permit the trade of debt securities between the first and third parties at discounted prices. At the 11th Session of the Council of the Islamic Fiqh Academy (held in Manama, November 14-19, 1998), the following resolution was issued [IFA 2000: 234-235]<sup>14)</sup>:

It is not permissible to sell a deferred debt by the non debtor for a prompt cash, from its type or otherwise, because this results in *ribā* (usury). Likewise, it is not permissible to sell it for a deferred cash, from its type or otherwise, because it is similar to the sale of a debt for a debt, which is prohibited in Islam. There is no difference whether the debt is the result of a loan or whether it is a deferred sale<sup>15)</sup>.

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12) Trading receivables between the first and second parties at any price is permissible [Rosly and Sanusi 1999; Rosly 2005: 437-439].

13) Trade between the first and third parties at par prices is also permissible with some conditions [Rosly and Sanusi 1999; Rosly 2005: 437-439].

14) This quoted passage is a part of Resolution No. 101 (4/11) on *Debt Sale and Loan Debentures and Their Islamic Substitutes in Public and Private Sectors*.

15) In this resolution, "sell a deferred debt" implies the trade of debt securities at a discounted price because immediately after the quoted passage, this resolution emphasizes the previous resolution regarding the prohibition

Further, as is the case with *bay' al-ṭinah*, it is widely considered that some Malaysian scholars tend to allow the trade of debt securities between the first and third parties at discounted prices and that their “moderate” interpretations of such transactions support and enhance broader Islamic finance practices in Malaysia. There are three explanations offered for legitimate *bay' al-dayn* between the first and third parties at discounted prices in the following points: (1) authenticity of the prohibition of trade of debt securities, (2) uncertainty over delivery, and (3) type of trade. Mohammad Hashim Kamali, who taught Islamic law and jurisprudence at the International Islamic University, Malaysia, explains the legitimacy of *bay' al-dayn* with regard to every point [Kamali 2000: 128-129]. On the first point, he argues by quoting Siddīq al-Ḍarīr’s statement that there is no textual injunction that declares such a trade as forbidden. On the second point, he also quotes al-Ḍarīr in saying that claims of uncertainty over delivery are unwarranted if the debt is not disputed by the first party who clearly admits his obligation and shows a readiness to discharge it. On the third point, by referring to many Ḥanafī and Mālikī jurists as well as to Ibn Taymīya, he validates such a trade on the grounds that the debt is as good as a tangible asset, which implies that the trade of debt securities between the first and third parties at discounted prices amounts not to monetary but goods exchange.

In Malaysia, some official statements that permit the trade of debt securities between the first and third parties at discounted prices were issued on the advice of academic scholars such as Kamali. One crucial statement was issued by the Sharī’ah Advisory Council of Securities Commission. At its 2nd meeting (held on August 21, 1996), the resolution that permits such a trade was issued with the following statement [SC 2002: 19]:

The argument of the Islamic jurists that prohibited *bay' al-dayn* to a third party for fear that the buyer will have to bear great risk (Ḥanafī *madhhab*) has some truth in it. This is especially true if there is an absence of supervision and control. ... In Malaysian context, the debt securities instruments based on the principle of *bay' al-dayn* are regulated by Bank Negara Malaysia and the Commission to safeguard the right of the parties involved in the contract. Therefore, the conditions set by Mālikī *madhhab* and the fears of risks by Ḥanafī *madhhab* can be overcome by regulation and surveillance.

This statement is based on the second explanation (uncertainty over delivery) for legitimacy. Although the Sharī’ah Advisory Council clearly mentions the first and third points, it places considerable importance on the second point in the context of capital markets. Another crucial statement was made by Othman Hj Ishak, who was the Chairman of the Sharī’ah Advisory Council of Bank Negara Malaysia, 1997-1999. At the International Capital Market Conference (held in Kuala Lumpur, July 15–16, 1997), he stated as follows [Ishak 1997]<sup>16)</sup>:

Can *haqq al-dayn* (be) sold at a lower price? The answer is yes, because it is not a currency and

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of the trade of discounted commercial papers. For the previous resolution, see [IFA 2000: 135].

16) Ishak’s statement is quoted from [Siddiqi 2005: 115-116].

the attributes transferred when bought consist of *ḥaqq al-māl* not currency. ... Based on the above, if the initial seller is willing to reduce his right and give the third party the full right, it is not at all against *sharī'ah* principles. The same with share certificates traded, it is an ownership right in a company and when sold in the secondary market the price is essentially different from the initial price.

His statement is based on the third point (type of the trade). He considers the trade of debt securities between the first and third parties at discounted prices as not monetary but goods exchange that is separate from the initial trade between the first and second parties. Thus, he permits such a trade by legitimating discount selling by the second party.

#### **4. Divergence/Convergence Framework and Analytical Reflections**

##### **4.1 Divergence/Convergence Framework on Theoretical Discussions in Islamic Finance**

This section discusses the divergence/convergence framework within which the theoretical discussions examined above can be located. Such a framework is premised by many works on the historical overview of Islamic finance, irrespective of whether the framework is described explicitly or implicitly.

In the case of *murābahah* contracts, the discussion arises between those who emphasize the ideal of the Islamic economic system wherein profit-sharing-based instruments achieve desirable economic performance from the aspect of Islam and those who prioritize the competitiveness of the Islamic financial system over that of the conventional financial system. Furthermore, the former group criticizes *murābahah* contracts, whereas the latter permits and promotes them. Regarding regional differences, the critics and promoters are observed both in the Middle East and Malaysia. Along with the critics mentioned above (Siddiqi and Usmani who mainly play an active role in the Middle East), some Malaysian scholars, who emphasize the profit-sharing-based system as an ideal of the Islamic economic system, also raise questions pertaining to the leading practice of *murābahah* contracts by Islamic finance in Malaysia [Man 1988; Sum 1995]. With regard to the promoters, Abdul Halim Ismail [Ismail 1987], who was the managing director of the Bank Islam Malaysia Berhad and is currently a member of the Sharī'ah Advisory Council of Bank Negara Malaysia, strongly supports the use of *murābahah* contracts, as revealed in the Al-Baraka seminar's *fatwā* mentioned above. Therefore, the discussion on *murābahah* contracts does not reflect regional differences.

It is reasonable to suggest that the permissive view supported by the promoters almost constitutes the mainstream view among a majority of practitioners of Islamic finance and scholars who, in particular, served as legal advisors [Rosly 2005: 93]. Many papers and books in the practical field began providing explanations for Islamic finance since by then *murābahah* contracts had already been accorded the status of financial instruments. The widespread acceptance of the permissive view on *murābahah* contracts was influenced by the practices in Pakistan and Iran where although profit-sharing-based financial instruments were strongly advocated, the 1980s witnessed

unsatisfactory performances of these financial instruments. Accordingly, they lost practical interest in profit-sharing-based banking as a feasible system and instead showed interest in the more advanced financial system based on fundamental Islamic instruments, including *murābahah* contracts. For example, a book that compiles the *Sharī'ah* resolutions issued by the Sharī'ah Advisory Council of Bank Negara Malaysia since 1997 has not mentioned anything about *murābahah* contracts till date [BNM 2007]<sup>17)</sup>. To sum up, it can be said that the discussion on *murābahah* contracts converged on a practical ground as far as commercial banking practices are concerned<sup>18)</sup>.

With regard to the discussion on Islamic debt securities, the division between the critics and the promoters directly overlaps with the regional differences in the 1990s. On the one hand, a majority of scholars and practitioners in Islamic countries (mainly in the Middle East), except Malaysia, adopt a restrictive attitude toward Islamic debt securities based on *bay' al-ṭinah* and *bay' al-dayn*; on the other hand, those in Malaysia—the active promoters of Islamic finance and Islamic debt securities—exhibit a permissive attitude. It was revealed that such a division stems from the difference in the interpretation of Islamic jurisprudence. It is well said that since the Malaysian interpretation is a more “moderate” view catering to practical demand, these instruments are permitted. In contrast, it is said that the interpretation by scholars in the Middle East is rather “rigid,” leading them to prohibit the use of such instruments.

In the 2000s, as observed in the case of *bay' al-ṭinah*, Malaysia began to transform its policy toward the adoption of other financial instruments as an alternative to Islamic debt securities, based on *bay' al-ṭinah* and *bay' al-dayn*. Table 3 shows that in 2006, the type of Islamic securities issued in Malaysia majorly changed from *murābahah*-based securities (Islamic debt securities) to *muḍārabah* and *mushārahah*-based securities (commonly called *sukūk al-muḍārabah* and *sukūk al-mushārahah*), implying the breakaway from the dependence on *bay' al-ṭinah* and *bay' al-dayn* instruments. One practical reason for such a shift was that the considerable and widespread development of Islamic finance initiated by Malaysia needed to attract more funds from outside Malaysia, particularly from the Gulf countries where the majority of Muslim scholars strictly prohibited *bay' al-ṭinah* and *bay' al-dayn*. Moreover, the theoretical maintenance of *sukūk*, particularly the development and diversification of *sukūk* products, influenced this change. *Sukūk al-muḍārabah* and *sukūk al-mushārahah* serve as tradable securities by ensuring adequate liquidity; further, they adequately ensure the legitimacy of financial instruments without using the scheme of either *bay' al-ṭinah* or *bay' al-dayn*. Considering such a practical transformation that was supported by theoretical evolutions in the field of Islamic securities, it can be regarded that the discussion on Islamic debt securities in the overall scenario appears to converge on an “integrated” or “standardized” point with the Malaysian and Middle Eastern viewpoints.

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17) The Sharī'ah Advisory Council of Bank Negara Malaysia was established on May 1, 1997.

18) Recently the arguments on the application of profit-sharing-based instruments are studied in the context of rural development and poverty reduction (see al-Harran [1995] and the special issue on *mushārahah* contracts in *Arab Law Quarterly* 14(3), 1999).

#### 4.2 Reflections from the Divergence/Convergence Framework

Based on the divergence/convergence framework shown above, this section considers the following two points to be examined in order to present an advanced picture of the framework beyond mere dichotomy: (1) a relationship between the two theoretical standpoints and (2) setting a theoretical dichotomy. The first point is examined in the case of the discussion on *murābahah* contracts, whereas the second is studied in the case of the discussion on Islamic debt securities.

According to the framework, the permissive view on *murābahah* contracts is a convergent point at least in the practical field. Given this, do the critics of *murābahah* contracts not support any of its implications pertaining to the practice of Islamic finance? The answer to this is “yes.” As Rodney Wilson points out, *murābahah* contracts were arguably one of the driving forces that enabled Islamic banking to take off in the 1970s and that proved to be a viable alternative to conventional banking. However, many Islamic banks did not ignore the critics of *murābahah* contracts; instead, they were prepared to offer alternative instruments (*ijārah*, *ijārah wa iqtinā'*, and *istiṣnā'*) to *murābahah* contracts in order to counter criticism [Wilson 2004: 212-213]. In addition, Ibrahim Warde mentions that as a result of the criticism of *murābahah* contracts, many Islamic banks started phasing out elements of *murābahah* contracts that had been subject to criticism [Warde 2000: 134]. In the practical field, there are also proponents of a mode of financing that involves profit-sharing instruments. For example, Saeed al-Ghamdi, who is the Deputy General Manager at Al-Rajhi Bank in Saudi Arabia, argues that the present emphasis on *murābahah* contracts is allowable; however, this system should be phased out once Islamic banking evolves into a much bigger and more developed system<sup>19</sup>. As pointed out by Tag El-Din, quoting from the 1997 report published by the International Association of Islamic Banks, there is evidence that the use of variable return modes of financing by Islamic banks and financial institutions has increased over time: 255 of total financing of Islamic banks and financial institutions represented either *muḍārabah* (6%) or *mushārahah* (19%) [Tag El-Din 2002: 11]. This compares with the 80-90% share of financing that *murābahah* contracts represented between the 1970s-1990s.

Therefore, it can be considered that although most Islamic banks mainly use *murābahah* contracts as a practical tool for financing, they are always driven toward the profit-sharing-based banking system by the critics. Simultaneously, it can be also said that the critics play an important role in preventing Islamic banks from deviating from the principle of Islamic banking; this is because *murābahah* contracts, as already mentioned in this paper, are said to closely correspond to interest-based loans that are prohibited in Islam. Consequently, the relation between the critics and the promoters of *murābahah* contracts is not incompatible but complementary in the current situation.

Regarding the second point to be examined, the setting of a theoretical dichotomy in the discussion on Islamic debt securities needs to be reconsidered. As already mentioned, it was revealed that the Malaysian interpretations for *bay' al-ṭinah* and *bay' al-dayn* are more “moderate” and suitable for practical demand, whereas the interpretation by the Middle Eastern scholars is rather “rigid”. In these literatures, the words of “moderate” and “rigid” reflect some extent of interpretations

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19) Al-Ghamdi's argument is quoted from [Sum 1995: 95].

in Islamic jurisprudence. However, the criterion of the classifications is not necessarily clear. For example, if the degree of rigidity is measured by the extent of allegiance to textual injunction (*Qur'ān* and *Hadīth*), it can be said that Kamali's first explanation to legitimate *bay' al-dayn* (authenticity of the prohibition of the trade of debt securities) is dependent on the more "rigid" (not "moderate") interpretation. Thus, the division between the critics and the promoters of Islamic debt securities does not appear to stem from the dichotomy between the moderate and rigid interpretations; it emerges from the interpretational diversity instead, which implies that both standpoints are not conflicting with each other from the interpretational aspect but from the aspect of the relation to only practical demand. This is why the new phase of Islamic securities that were initiated in the 2000s cannot be termed a "middle" point between the two standpoints but as an "integrated" or "standardized" point.

#### **4.3 Beyond the Divergence/Convergence Framework: Exploring the Underlying Feature of Islamic Finance**

Finally, the discussions mentioned above are explored from a standpoint beyond that of the divergence/convergence framework. To this end, a reexamination of each discussion highlights that all the scholars who participated in these discussions almost shared one common perception on Islamic finance, related to the nature and the categorization of transactions.

In the discussion on *murābahah* contracts, while the critics describe them as money transactions, the promoters describe them as product sales for cash. Similarly, in the discussion on Islamic debt securities, the critics explain that such a form of transaction is already separated by the original product sales, which implies that they do not describe the trade of debt securities as an asset-based transaction, but only as a transaction involving monetary exchange. On the other hand, the promoters emphasize the strong association between the product sold by the second and third parties based on Ishak's [1997] abovementioned argument.

From such a brief review of each discussion from the aspect of the form of trade, we can gain awareness on clear contrasts between the critics and promoters of the instruments. While these instruments are disapproved by the critics because they are unbalanced money exchanges, they are approved by the promoters on account of being good trades. This indicates that whether or not a certain transaction is allowed depends on whether or not it is considered or categorized an unbalanced monetary exchange or a good trade. In other words, the principle that unbalanced monetary exchanges are not permissible whereas good trades are, is a common perception among the discussants. Hence, disputes stem from a difference in the interpretation of the classification of transactions. The argument by Chapra and Khan [2000] appears to reinforce the persuasiveness of this statement because they changed their opinion on the trade of debt securities on a case-by-case basis. In their argument, on one hand, they do not allow the trade of debt securities in the classical era because it constitutes unbalanced monetary exchange; on the other hand, they permit the trade of debt securities operated by modern Islamic banks because it is based on *murābahah* contracts, which is considered good trade [Chapra and Khan 2000: 77].

Considering the above standpoint of analyzing the underlying features of Islamic finance,

it can be said that the accumulation of wealth through money-chained transactions is considered highly unacceptable in Islamic finance. Meanwhile, Islamic finance strongly adheres to financial transactions that involve real assets or those that can be retrieved from the assets. This indicates that Islamic finance is highly involved in the real domain of the economic system. Speaking ambitiously, Islamic finance does not confine itself to only the monetary domain of the economic system, but includes the entire economy. This should certainly be the underlying and essential feature of Islamic finance. In this sense, such a feature might remind us of the pre-modern economic system in the Islamic world where financial sectors were embedded in the real domain of the economic system<sup>20)</sup>.

With regard to the current trend of Islamic finance, even if *sukūk* products (*sukūk al-muḍārabah*, *sukūk al-mushārah* and *sukūk al-'ijārah*), which are alternatively known as ABSs (asset-backed securities), are considered very modern and specific financial instruments, they share the underlying feature of Islamic finance mentioned above. Thus, in this sense, it can be said that *sukūk* products are not subdivisions of the Islamic financial or the Islamic economic system but that they are orthodox successors of the system.

## 5. Conclusion

This paper outlined two theoretical discussions on the financial instruments used in Islamic finance (*murābahah* contracts, Islamic debt securities), and aimed to summarize them into a framework of theoretical divergence and convergence, which is premised by many works, regardless of whether the framework is described explicitly or implicitly. In the case of *murābahah* contracts, the discussion arises between those who emphasize the ideal of the Islamic economic system wherein profit-sharing-based instruments achieve desirable economic performance from the aspect of Islam, then criticizes *murābahah* contracts, and those who prioritize the practical competitiveness of the Islamic financial system over that of the conventional financial system, then permits and promotes them. In the end, the permissive view supported by the promoters almost constitutes the mainstream view among a majority of practitioners of Islamic finance and scholars. With regard to the discussion on Islamic debt securities, the division between the critics and the promoters directly overlaps with the regional differences in the 1990s. On the one hand, a majority of scholars and practitioners in the Middle East adopt a restrictive attitude toward Islamic debt securities based on *bay' al-'inah* and *bay' al-dayn*; on the other hand, those in Malaysia exhibit a permissive attitude. It was revealed that such a division stems from the difference in the interpretation of Islamic jurisprudence. However, in the 2000s Malaysia began to transform its policy toward the adoption of other financial instruments (*sukūk al-muḍārabah* and *sukūk al-mushārah*) as an alternative to Islamic debt securities, based on *bay' al-'inah* and *bay' al-dayn*. Therefore, it can be concluded that the discussion on Islamic debt securities in the overall scenario appears to converge on an “integrated” or “standardized” point with the Malaysian and Middle Eastern viewpoints.

Based on the divergence/convergence framework shown above, this paper considered three

20) Udovitch describes such a situation in the pre-modern Islamic economic system as “bankers without banks” [Udovitch 1979: 255].

points pertaining to (1) the relationship among theoretical standpoints and (2) the dichotomic structure of discussions (3) the underlying feature of Islamic finance in order to present an advanced picture beyond the existing framework. As for the first point, it can be said that in the case of *murābahah* contracts the relation between the critics and the promoters is not incompatible but complementary in the current situation. That is because the critics play an important role in preventing Islamic banks from deviating from the principle of Islamic finance, then the promoters are always driven toward the profit-sharing-based banking system by the critics. Regarding the second point, it can be considered that in the case of Islamic debt securities the division between the critics and the promoters does not appear to stem from the dichotomy between the moderate and rigid interpretations; it emerges from the interpretational diversity instead, which implies that both standpoints are not conflicting with each other from the interpretational aspect but from the aspect of the relation to only practical demand. That is because in the existing literatures the criterion of the classifications between “moderate” and “rigid” is not necessarily clear, therefore, if the degree of rigidity is measured by the extent of allegiance to textual injunction (*Qurʾān* and *Ḥadīth*), for example, it can be said that Kamali’s explanation to legitimate *bayʿ al-dayn* that is said to represent the “moderate” view in the practical criterion is dependent on the more “rigid” (not “moderate”) interpretation. With regard to the third point, it is discovered that all the scholars who participated in these discussions almost shared one common perception that whether or not a certain transaction is allowed depends on whether or not it is considered or categorized an unbalanced monetary exchange or a good trade. This insight can lead the following implication related to the underlying feature of Islamic finance; Islamic finance strongly adheres to the financial transactions that involve real assets or those that can be retrieved from the assets while the accumulation of wealth by money-chained transactions is considered highly unacceptable in Islamic finance.

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Table 1  
Bank Islam Malaysia Berhad: Mode of Financing (% to Total Financing)

Year	<i>murābahah</i> *	<i>muḍārabah</i> + <i>mushārah</i>	<i>ijārah</i>	others	total
1984	86.3	4.3	9.3	0.1	100
1985	91.2	2.9	5.9	0.0	100
1986	92.5	2.5	4.8	0.2	100
1987	93.7	2.4	3.4	0.5	100
1988	94.3	0.1	3.1	2.5	100
1989	94.3	0.1	3.0	2.6	100
1990	86.7	0.1	10.9	2.3	100
1991	85.0	0.1	12.4	2.5	100
1992	86.9	0.6	10.3	2.2	100
1993	86.0	1.9	9.7	2.4	100
1994	86.6	2.0	8.5	2.9	100
1995	89.1	1.9	6.5	2.5	100
1996	89.4	1.9	7.0	1.7	100
1997	90.6	1.5	5.2	2.7	100
1998	90.1	1.0	4.2	4.7	100
1999	90.5	1.1	3.9	4.5	100
2000	91.3	0.7	2.3	5.7	100
2001	85.3	3.6	2.1	9.0	100
2002	82.8	4.1	4.7	8.4	100
2003	83.1	3.6	3.5	9.8	100
2004	89.1	1.1	1.8	8.0	100
2005	84.1	0.7	3.4	11.8	100
2006	77.5	0.7	3.1	18.7	100
Ave.	88.1	1.7	5.6	4.6	100

\*1: *murābahah* includes *bay' bi-thaman ājil*

Sources: Calculated from *BIMB Annual Reports*, 1984-2006 (Data from 1984 to 1987 are cited from [Sum 1995: 95]).

Table 2  
Dubai Islamic Bank: Mode of Financing (% to Total Financing)

Year	<i>murābahah</i>	<i>muḍārabah</i> + <i>mushārahah</i>	<i>ijārah</i>	others	total
1988	90.4	2.0	7.6	0.0	100
1989	92.4	1.9	5.7	0.0	100
1990	91.7	2.3	6.0	0.0	100
1991	92.8	1.9	5.3	0.0	100
1992	73.4	3.5	7.1	16.0	100
1993	75.9	4.9	6.3	12.9	100
1994	69.5	5.7	6.6	18.2	100
1995	60.2	5.1	8.1	26.6	100
2001	51.7	14.0	2.6	31.7	100
2002	50.4	14.6	6.6	28.4	100
2003	46.6	15.4	17.4	20.6	100
2004	48.3	15.2	23.5	13.0	100
2005	46.7	26.5	17.3	9.5	100
2006	51.9	16.9	17.4	13.8	100
Ave.	67.3	9.3	9.8	13.6	100

Sources: Calculated from *DIB Annual Reports*, 1988-1995, 2001-2006 (Data from 1988 to 1995 are cited from [Dawābah 2003: 22]).

Table 3  
Type of Islamic Securities in Malaysia (% to Total Issuance)

Year	<i>murābahah</i> *	<i>muḍārabah</i> + <i>mushārahah</i>	<i>ijārah</i>	<i>istiṣnā'</i>	total
2001	87.0	0.0	0.0	13.0	100
2002	100.0	0.0	0.0	0.0	100
2003	53.5	0.0	0.0	46.5	100
2004	95.2	0.0	2.0	2.8	100
2005	69.8	12.8	2.9	14.5	100
2006	15.6	77.5	4.9	2.1	100

\*1: *murābahah* includes *bay' bi-thaman ājil*

Sources: Calculated from *Securities Commission Annual Reports*, 2000-2006.