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The Integration of Islamic Finance into the Irish Legal System: Current Issues and Future Challenges

A dissertation submitted to the University of Dublin

for the Degree of Doctor of Philosophy

Edana Richardson

Trinity College Dublin, 2012

School of Law

Trinity College Dublin

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Summary

This thesis examines the accommodation of Islamic finance in the Irish legal system. It considers current issues and future challenges which may arise should Islamic financial products and transactions be offered under Irish law. It explores the theological basis of Islamic finance and the legal framework under which an Irish Islamic finance industry would operate. By analysing the interaction between the structures and concepts found in the contemporary Islamic finance industry and relevant provisions of Irish law, this thesis considers the potential legal treatment of Islamic financial transactions and their participants.

This thesis is divided into three parts. Part I considers the religious basis of Islamic finance. It outlines the nature and roots of Islamic law and highlights the continuing relevance of classical religious doctrine in Islamic legal teachings. Building upon this initial discussion, Part I introduces Islamic finance and the religious dictates around which it is structured. This part serves as a foundation upon which more in-depth discussion in later chapters is built. Part II considers the conceptual basis for the accommodation of contemporary Islamic finance activity. It involves jurisdictional case studies in which the various methodologies for accommodation are presented and analysed; potential lessons for Ireland are highlighted. This part also considers accommodations already introduced by the Irish government and discusses the economic and constitutional justifications for existing and future accommodation. Finally Part III examines the practical interaction between Islamic finance and Irish law. It considers three discrete aspects of contemporary Islamic finance – Islamic real estate finance, *sukūk* and the supervision of Islamic financial activity – analyses how these aspects will be treated under Irish law and discusses the effectiveness of any existing accommodations. It also presents suggestions for further changes to Irish law which may be needed.

This thesis represents the first comprehensive analysis of Islamic finance in the context of the Irish legal system. It approaches the issue from a neutral perspective and critically examines the legal challenges raised by Islamic finance in Ireland. In doing so, it demonstrates that while contemporary Islamic financial products are often similar economically to conventional products, their structural distinctiveness may prevent such

Islamic products from being readily subsumed within Ireland's legal framework. If this industry is to develop and function as a viable segment of Ireland's economy, legislative adjustments and clarifications will be needed. However, accommodation works both ways. If an Islamic finance industry develops in Ireland, it will function under Irish law and within the context of the Irish economy; it may therefore need to adapt to this broader legal and economic framework. While this adaption should not result in a compromise of core Islamic teachings - as an Islamic product which openly violates Islamic law is not "Islamic" - it will require some flexibility on the part of participants in Islamic financial transactions. This thesis finds that if a mutually satisfactory balance can be achieved between the concessions made on both sides, the integration of Islamic finance into the Irish legal system may be possible.

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To my parents

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Glossary

adl —— Justice

ahadith —— Plural of *hadīth* (see below for definition)

al-ghurm bil ghunm —— Islamic legal maxim: Entitlement to gain must be accompanied by risk of loss

al-kharaj bil daman —— Islamic legal maxim: Gain accompanies liability for loss

al-wadiah —— Safekeeping

amanah ——Trust

amin —— Trustee

'aqd —— Lit. knot, tie. In the context of Islamic law, frequently used to describe a contractual obligation

'aqd al-mu'ayyana —— Nominate contract

'ayn —— A tangible thing which is unique and individual (this is the opposite of *'dayn* or fungible)

bay' al-dayn —— Sale of debt

bay' bithaman ajil' —— Sale in which the (higher) sale price is deferred for goods delivered spot (used almost exclusively in Malaysia)

bay' istisnā' —— Sale in which a non-generic good which requires manufacturing/construction. The good is delivered on completion and payment is paid in advance or on an instalment basis (also written simply as *istisnā'*)

bay' mu'ajjal —— Sale on credit

bay' murābaha —— Sale with a specified mark-up (generally written simply as *murābaha*)

bay' salam —— Sale in which payment is made in advance for (fungible) goods to be delivered at a date in the future (also written simply as *salam*)

bay'—— Sale

bi'l-kalām —— Orally

bi'l-kitābah —— In writing

da`if —— Weak

darūra —— Necessity

'dayn —— Generic goods (generally fungibles) (this is the opposite of *'ayn*)

faqih (plural: *fuqaha*) —— Jurist who is an expert in Islamic law

fatwā (plural: *fatāwā*) —— Religious ruling or edict

fiqh —— Lit. understanding. Generally used to describe Islamic jurisprudence through which the classical scholars developed the rules of Islamic law

furū-al-fiqh —— Branches of Islamic law

gharar —— Ambiguity and excessive risk

hadīth —— Account of a saying, action or omission by the Prophet Mohammed.

halāl —— Lawful/permissible under Islamic law

hamish jiddiyah —— Security deposit. Money paid by a promisor to confirm the sincerity of a promise to purchase

Hanafi —— One of four Sunni schools of Islamic law – founded by Abu Hanafia

Hanbali —— One of the four Sunni schools of Islamic law – founded by Ahmad ibn Hanbal

haram —— Forbidden under Islamic law

hasan —— Good

hiba —— Gift

hila (plural: *hiyal*) —— Legal stratagem or device

'ibādāt —— Act of worship. Relates to the relationship between man and God

ijārah —— Leasing or hire contract

ijārah muntahia-bi-tamleek —— Lease ending with ownership

ijārah thumma al-bai' —— Lease with sale

ijārah wa iqtina —— Lease with acquisition

ijmā'—— Consensus. One of the four roots (*usūl*) of Islamic law

ijtihād—— Lit. personal effort, endeavour. Effort by a qualified jurist to derive a ruling on Islamic law in circumstances where the divine roots of that law are not explicit or clear

iktiyar —— Choice

'illah —— Effective cause

'ilm —— Knowledge

istihsān —— Juristic preference in choosing one ruling over another

istinbat —— Extracting

istislāh —— Public opinion which is used when deriving/developing a rule of Islamic law

istisnā' —— Sale of a non-generic good which requires manufacturing/construction. The good is delivered on completion and payment is paid in advance or on an instalment basis

jahiliyya —— Lit. age of ignorance. Refers to the pre-Islamic era

madhab (plural: *madhāhib*) —— School of Islamic law

majlis al'aqd'—— Session of the contract (i.e. the time during which a contract is negotiated and signed)

Maliki —— One of four Sunni schools of Islamic law – founded by Imam Malik

manfa'ah —— Usufruct (use of an asset)

maqasid al Sharī'ah —— The basic goals of Islamic law

maslaha —— Public interest. Used when deriving/developing a rule of Islamic law

maudu —— Fabricated

maysir —— Gambling

mu'āmalāt —— Dealings or transactions between human beings

mudāraba —— Form of partnership in which one partner contributes money while the other partner contributes time, effort and labour. Occasionally referred to as *qirad* or *muqarada*

mudārib —— Partner contributing labour in a *mudāraba*

muftī —— Islamic jurist who issues *fatāwā*

murābaha —— Sale with a specified mark-up

mushāraka —— Form of partnership in which both partners contribute capital and labour

muwakkil —— Principal in an agency contract

qadi —— Judge

qard/qard al-hasan —— Gratuitous loan

qiyās —— Analogy. One of the four roots (*usūl*) of Islamic law

Qur'ān —— The primary religious text in Islam. One of the four roots (*usūl*) of Islamic law

rabb al-mal —— Partner contributing capital in a *mudāraba*

rahn —— Pledge or charge

ribā —— Lit. increase or growth. Unjustified gain resulting from an unfair exchange of counter-values between parties to a contract. Most commonly interpreted in contemporary Islamic finance as a prohibition on interest in financial dealings.

ribā al-buyu'—— *Ribā* in sales

ribā al-fadl —— *Ribā* by excess. Arises in the sale of goods of the same class and kind in different quantities or qualities

ribā al-jahiliyya —— Pre-Islamic ribā. Refers to increase in the amount of a debt

riba al-nasi'āh —— *Ribā* by delay. Refers to delay in the exchange of countervalues, with or without profit and regardless of whether those countervalues are equivalent

ribā al-qarud —— *Ribā* of loans

ribā duyun —— *Ribā* of debts

ribāwī —— Items to which the rules of *ribā* apply

sahih —— Sound

salam —— Sale in which payment is made in advance for (fungible) goods to be delivered at a date in the future

Shafi'i —— One of four Sunni schools of Islamic law – founded by Imam al-Shafi'i

Sharī'ah —— The divide law of Islam based on guidance as given by the *Qur'ān* and *Sunnah*. Frequently used to describe Islamic law generally

shirkah —— Partnership

shirkat-ul-aqd —— Commercial or contractual partnership

shirkat-ul-milk —— Proprietary partnership. Joint ownership of property

shurūt —— Contractual stipulations

sukūk —— Plural of *sakk*. Certificates representing ownership or interest in tangible assets, usufruct, and services or the assets of particular projects or special investment activity (often referred to as Islamic bonds).

Sunnah —— Traditions of the Prophet Mohammed (recorded in the *ahadith*). One of the four roots (*usūl*) of Islamic law

takāful —— Mutual guarantee. Generally used to describe Islamic insurance

takhayyur —— Process of picking and choosing legal rules from a variety of sources

talfiq —— Patching. Used when deriving/developing a rule of Islamic law

taqlīd —— Imitation

tawarruq —— A reverse *murābaha*. Mechanism for raising cash under which an asset is bought on credit and immediately sold for cash.

tawhid —— Unity/oneness of God

ujrah —— Wages

ulamah —— Religious scholars

ummah —— Community of believers

urboun —— Earnest money

urf —— Custom

usūl al-fiqh —— Roots of Islamic law. The interpretative methodology applied by Islamic jurists to the sources of Islamic law in order to elucidate the details of *Sharī'ah*

wa'd —— Promise

wakāla —— Contract of agency

wakeel —— Agent in an agency contract

zann —— Opinion

Abbreviations

AAOIFI —— Accounting and Auditing Organization for Islamic Financial Institutions

AFIB —— Alternative Finance Investment Bonds (UK)

APR —— Annual Percentage Rate

BAFIA —— Banking and Financial Institutions Act 1989 (Malaysia)

BBA —— *Bay' bithaman ajil'*

BIMB —— Bank Islam Malaysia Berhad (Malaysia)

BLME —— Bank of London and the Middle East

BMMB —— Bank Muamalat Malaysia Berhad (Malaysia)

BNM —— Bank Negara Malaysia (Malaysia)

CAT —— Capital acquisitions tax

CCA —— Consumer Credit Act 1995 (Ireland)

CERCLA —— Comprehensive Environmental Response, Compensation and Liability Act 1980 (US)

CGT—— Capital Gains Tax

CMP1 —— Capital Markets Masterplan (1) (Malaysia)

CMP2 —— Capital Markets Masterplan (2) (Malaysia)

CMSA —— Capital Markets and Services Act 2007 (Malaysia)

CTFS —— Commission for Transformation of Financial System (Pakistan)

DIFC —— Dubai International Financial Centre

DJIMI —— Dow Jones Islamic Market Index

ECFR —— European Council for Fatwa and Research

FSA —— Financial Services Authority (UK)

FSC —— Federal Shariat Court (Pakistan)

FSMA —— Financial Services and Markets Act 2000 (UK)

FSMP1 —— Financial Sector Master Plan (1) (Malaysia)

FSMP2 —— Financial Sector Master Plan (2) (Malaysia)

GCC —— Gulf Cooperation Council

GIIS —— FTSE Global Islamic Index Series

HM Treasury—— Her Majesty's Treasury (UK)

HMRC —— Her Majesty's Revenue and Customs (UK)

HPP —— Home Purchase Plan

IBA —— Islamic Banking Act 1983 (Malaysia)

IBI —— Islamic Banking Institution

IBS —— Islamic Banking Scheme (Malaysia)

ICTA —— Income and Corporation Taxes Act 1988 (UK)

IDB —— Islamic Development Bank

IFI —— Islamic Financial Institution

IFSB —— Islamic Financial Services Board

IFSC —— International Financial Services Centre (Ireland)

IIFM —— Islamic International Financial Market

IIFS —— Institution offering Islamic Financial Services

IMF —— International Monetary Fund

IOSCO —— International Organization of Securities Commissions

IRTI —— Islamic Research and Training Institute

ISB —— Islamic Development Bank

ISC —— Islamic Shari'a Council of London

MCOB —— Mortgage Conduct of Business Rules (UK)

MiFID —— Markets in Financial Instruments Directive (EU)

NAMA —— National Asset Management Agency (Ireland)

OCC —— Office of the Comptroller of the Currency (US)

OIC —— Organization of Islamic Countries

PIF —— Professional Investor Fund

PKR —— Pakistani rupee

PLS —— Profit-and-loss sharing

QIF —— Qualifying Investor Fund

RAO —— Regulated Activities Order (UK)

RM —— Malaysian Ringgit

SAB —— Shariat Appellate Bench of the Supreme Court (Pakistan)

SAC —— Shariah Advisory Council (Malaysia)

SBP —— State Bank of Pakistan

SC —— Securities Commission

SCA —— Securities Commission Act 1993 (Malaysia)

SDCA —— Stamp Duties Consolidation Act 1999 (Ireland)

SDLT—— Stamp Duty Land Tax (UK)

SECP —— Securities and Exchange Commission of Pakistan (Pakistan)

SPV —— Special Purpose Vehicle

SRI —— Socially Responsible Investment

SSB —— *Sharī'ah* Supervisory Board

TCA —— Taxes Consolidation Act 1997 (Ireland)

UAE —— United Arab Emirates

UK —— United Kingdom

UKIFS —— United Kingdom Islamic Finance Secretariat (UK)

US —— United States

Chapter 1

Introduction

1.1 Introduction

> Money is the most abstract and 'impersonal' element that exists in human life. The more the world of the modern capitalist economy follows its own immanent laws, the less accessible it is to any imaginable relationship with a religious ethic of brotherliness. The more rational, and thus impersonal, capitalism becomes, the more this is the case. In the past it was possible to regulate ethically the personal relations between master and slave precisely because they were personal relations. But it is not possible to regulate – at least not in the same sense or with the same success – the relations between the shifting holders of mortgages and the shifting debtors of the banks that issue those mortgages: for in this case, no personal bonds of any sort exist.[1]

Islamic finance, or financial activity structured to comply with the dictates of Islamic law, is an approach to economic activity which seeks to distance itself from the perceived religious repugnance of much of the conventional banking and finance system. Over the past forty years, the Islamic finance industry has experienced rapid and substantial growth,

[1] Weber, Max, "Religion", in *From Max Weber: Essays in Sociology*, Hans H. Gerth and C. Wright Mills, (eds.), (Oxford University Press, New York, 1946), at 331.

growth which continues.[2] However, the industry is now maturing from the niche "Golden Child" of unconventional financial activity into an identifiable segment of the global financial market.[3]

For economic and societal reasons, which will be considered in more detail later in this thesis,[4] legal, fiscal and regulatory authorities in Muslim and non-Muslim countries[5] have specifically addressed the position of Islamic financial activity within their economies.[6] In Ireland, official consideration of Islamic finance has only occurred recently. The first step was the publication by the Irish Revenue Commissioners [the Revenue Commissioners] of a Tax Briefing in October 2009 [the Tax Briefing 2009].[7] This non-binding guidance note represented a statement of policy and clarified the taxation of a number of Islamic products without amending any provisions of Irish law. More significantly, sections of the Finance Act 2010[8] altered the way in which Irish tax law will treat a variety of contracts structured in accordance with Islamic legal teachings.

Despite the significance, both of the Islamic finance industry globally and of the accommodation of Islamic finance within Irish law, little academic attention has been given to this financial sector in Ireland. This discursive deficit is particularly acute in legal academic commentary. Rather than analysing the variety of legal issues raised by the integration of Islamic finance into the Irish legal system, commentary on this issue has almost universally been used as an uncritical platform for promoting Ireland as a destination for Islamic finance activity.[9]

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[2] Carvalho, Stanley, "Islamic finance set to cross $1 trillion-Moody's", *Reuters*, June 15, 2010, available at: http://www.reuters.com/article/2010/06/14/islamicfinance-moodys-idUSLDE65D19720100614.

[3] Coughlin, Paul, "Foreword" in *Islamic Finance Outlook 2010*, (Standard & Poors, New York 2010), at 1, available at: http://www2.standardandpoors.com/spf/pdf/media/Islamic_Finance_Outlook_2010.pdf.

[4] *infra.* at 95 et seq.

[5] Islamic countries continue to represent a large market for Islamic financial activity, however Western economies, particularly the United Kingdom and Luxembourg, have emerged as important centres for *Sharī'ah*-compliant transactions. Toan, Robert, "Cross-Border *Ijarah*; A Case study in the US Taxation of Islamic Finance", in *Third Harvard Islamic Proceedings.* (Harvard Islamic Finance Program, Cambridge, 2000), 191-197.

[6] *infra.* at 95 et seq.

[7] Revenue Commissioners, "Islamic Finance", *Tax Briefing Issue 78*, October 2009, available at: http://www.revenue.ie/en/practitioner/tax-briefing/78/index.html#. This Briefing deals with Islamic leasing, Islamic insurance and Islamic funds.

[8] Finance Act 2010, [Number 5 of 2010].

[9] See for example, Madden, Angela, "Ireland: European center for Islamic finance", (2011) 8(31) *Islamic Finance News,* 22-23, Khan, Omer, "Ireland to be Even More Islamic Finance Friendly", (2010) 7(7) *Islamic Finance News*, 19-20.

This thesis therefore represents the first major research project to consider, from a legal perspective, the interaction between Islamic finance and Irish law. As Ireland does not yet have a substantial Islamic finance industry, this thesis is forward-looking in approach and identifies the potential legal issues which may arise if Islamic finance products were to be offered within the ambit of Irish law. On this basis, it then considers the effectiveness of current accommodations of Islamic finance and proposes recommendations for legislative and policy-based adjustments.

1.2 Thesis Questions

A number of questions will be considered over the course of this thesis:

- What are the core teachings of Islamic law in relation to financial activity and how have these teachings shaped the Islamic finance industry today?
- Are there legitimate justifications for Ireland, or indeed any non-Islamic country, to adopt tailored accommodation designed to facilitate the introduction of Islamic finance domestically?
- If accommodation of Islamic finance within Ireland's legal system is justified, how can such accommodation occur, and indeed *can* such accommodation occur, in a manner which upholds the conceptual integrity of Ireland's legal, fiscal and regulatory frameworks while also allowing Islamic finance to function?
- To what extent, if at all, should the Irish Government supervise compliance with Islamic law in Islamic financial activity?

With these questions in mind, this thesis contains three Parts. Part I (Chapters 2 and 3)[10] introduces the theological basis for Islamic finance, looking at the sources of Islamic law and the defining characteristics of Islamic finance. Part II (Chapters 4 and 5)[11] deals with the conceptual basis for the introduction of Islamic finance into contemporary economies. It considers methodologies adopted in other jurisdictions to facilitate Islamic financial activity and addresses the question of whether accommodation in Ireland is justified. Part III (Chapters 6 to 10)[12] takes concepts addressed in Parts I and II and uses them when analysing the practical impact of Ireland's laws on two Islamic financial products, (Islamic

[10] *infra.* at 13 et seq.
[11] *infra.* at 95 et seq.
[12] *infra.* at 199 et seq.

real estate financing and *sukūk* (similar to bonds)), and on the supervision of Islamic financial activity.

This division is not rigid and there are repeated and necessary overlaps between Chapters and between Parts. However, this structure has been adopted as the most suitable means of addressing, in a logical order, the issues raised by the integration of Islamic finance into the Irish legal system.

1.3 Outline of Thesis

1.3.1 Part I: The Theological Basis for Islamic Finance

Part I of this thesis considers the religious elements of Islamic financial activity. Detailed consideration of the theological foundations of Islamic finance is a necessary first step when discussing the integration of that financial sector into Ireland, as it addresses why Islamic finance exists and why it is subject to such unique structural requirements.

Chapter 2 outlines the nature of Islamic law. It considers the concept of divine law (*Sharī'ah*) and Islamic jurisprudence (*fiqh*). It also discusses the "roots" or "sources" of Islamic law (the *Qur'ān*, *Sunnah* (traditions of the Prophet), *ijmā'* (consensus) and *qiyās* (analogy)). Following this introduction to Islamic law, Chapter 2 considers the more divisive issue of whether that law is capable of development through more unofficial mechanisms. Finally, the legal framework developed by classical Islamic scholars is transported to the present day, with a discussion of the spread of Islam (and with it, Islamic legal concepts) around the world. The aim of Chapter 2 is to emphasise the link between religious belief and Islamic law, as well as the broad ambit of that law. This will allow religious legal concepts to be referred to throughout this thesis without the need to re-emphasise their ideological significance.

Chapter 3 flows directly from the discussion in Chapter 2 but narrows the analysis of Islamic law to elements which are relevant to financial activity. This Chapter explores the restrictions which Islamic law has directly or indirectly placed on the financial dealing of Muslims and highlights the influence which these restrictions have had on the contemporary Islamic finance industry. Chapter 3 goes on to consider mechanisms developed by Islamic scholars which allow Muslims to participate in the banking and

finance sector without violating the economic dictates of Islamic law. This Chapter is central to the thesis as it sets out the perimeters within which financial activity must fall before it can be considered to be *Sharī'ah*-compliant. Consequently, the financial structures analysed in Chapter 3 represent the building blocks upon which the more complex products considered in Chapters 6 to 9 are constructed.

1.3.2 Part II: The Conceptual Basis for Islamic Finance in Contemporary Economies

Part II considers the position of Islamic finance in contemporary legal and economic frameworks. Chapter 4 introduces the contemporary Islamic finance industry and deals with three distinct approaches to accommodation of this industry: full-scale islamisation (Pakistan), a dual financial system (Malaysia) and integration (UK). This Chapter considers the rationales behind the different approaches and outlines the measures taken within each country to facilitate domestic Islamic financial activity. While the ideological differences between Pakistan, Malaysia and Ireland are acknowledged, this Chapter serves as a basis for highlighting the different conceptual frameworks for accommodation or integration of Islamic finance. Broad lessons which Ireland could learn from the experiences of other jurisdictions are examined and the approach which Ireland now appears to be adopting is considered.

Looking both at economic rationales for accommodation as well as the constitutional protection of religious free-exercise, Chapter 5 engages with the question of whether the accommodation of Islamic finance in Ireland's legal system is justified. This Chapter acts as a transition from the theoretical nature of Chapters 2 and 3 to the more practical application of Islamic finance discussed in Chapters 6 to 10.

1.3.3 Part III: Practical Interaction between Islamic Finance and Irish Law

Part III discusses how practical examples of Islamic financial activity may be treated under Ireland's law, and whether effective accommodation of such activity is possible. Chapters 6 to 9 deal with two discrete products: Islamic real estate financing and *sukūk* (roughly, Islamic bonds).[13] These two products have been chosen for a number of reasons.

[13] As will be discussed in Chapters 9 and 10, however, *sukūk* are not bonds and, increasingly, are being distinguished from conventional interest bearing bonds.

First, these products are likely to raise particularly complicated legal problems if offered in Ireland. By addressing their legal treatment, a comprehensive view of difficulties faced by Islamic financial activity generally can be presented. Second, these products have received relatively detailed consideration in other jurisdictions, thus allowing more effective analysis and comparisons. Third, while both products have uses from a wholesale and retail perspective, real estate financing may be particularly relevant in retail home financing while *sukūk* may be of more relevance to wholesale market participants.[14] Consideration of these products therefore captures the interaction of a broad spectrum of Ireland's laws and the principles of Islamic finance. Chapters 6 and 8 discuss the nature of these products, Chapters 7 and 9 explore their taxation and their position under Ireland's consumer protection, regulatory and/or property laws. The accommodations already introduced are analysed and proposals for further change are presented.

Chapter 10 represents the final substantive Chapter of this thesis and looks to a hypothetical point in the future in which Islamic finance is offered in Ireland. It considers how compliance with the dictates of Islamic law would be enforced and whether the Irish Government (including the judiciary) has any part to play in the religious supervision of Islamic financial products. Chapter 10 also considers private methods which can be implemented at contractual and institutional levels in order to ensure external *Sharī'ah* supervision.

The concluding Chapter of this thesis draws together the issues raised and discussed in the preceding Chapters. Chapters 6 to 10 have already recommended specific accommodations which may facilitate the development of Islamic finance in Ireland. Rather than reiterating these accommodations, Chapter 11 consolidates these proposals and reflects on the current legal position of Islamic financial structures in Ireland and the future challenges facing the industry. Chapter 11 draws the conclusion that, while accommodation of Islamic financial activity in Ireland may be justified and indeed possible, Islamic finance cannot function within Ireland without some level of compromise by the industry, by the Irish Government, or by both. It is the conclusion of this thesis, therefore, that further, more effective, accommodation of the Islamic financial sector is needed but, subject to the caveat that a degree of pragmatism is required by all parties involved.

[14] In practice, Islamic real estatefinancing is frequently used in commercial activities. Nevertheless, as will be discussed in Chapters 7 and 8, it has uses in retaifinanrovidce. To provide a broad, academic discussion which encapsulates both retail and commercial, it will be dealt with in this thesis primarily in the context of home financing.

1.4 Research Methodology

The integration of Islamic finance into Western legal systems is an underdeveloped but potentially rich area of legal research. As a result of cultural, economic and legal distinctions between countries, it is difficult to establish a single conclusion on how Islamic finance should be integrated into a non-Islamic legal framework.[15] Nevertheless, the Islamic finance industry is evolving rapidly around the world and academic commentary, case law and legislation has had to react to this development.

1.4.1 Doctrinal

The principal research method used in this thesis has been doctrinal in nature. In relation to Irish law, the primary sources relied on are the Constitution, caselaw and most particularly, legislation. These sources reflect the areas of Irish law which will directly influence the development of an Islamic finance industry in Ireland, and the manner in which this industry may be treated (and accommodated) under Irish law. Secondary material on Islamic finance in Ireland has been more difficult to obtain for the simple fact that such material is limited in quantity. Parliamentary debates and speeches are, however, referred to, particularly in Chapter 5.[16] Similarly, media coverage of Ireland's steps to accommodate Islamic finance is relied on when discussing the Tax Briefing 2009 and the Finance Act 2010. More generally, academic and practitioner commentaries found in books, journal articles and conference papers, have been consulted on aspects of Irish law which may be relevant to domestic Islamic finance activity. The concepts and structures found in Islamic finance are then laid over this information in order to project the potential treatment of Islamic finance under Irish law, any difficulties which may arise and possible solutions to these difficulties.

Doctrinal research of Islamic law has relied on translations of the primary sources of this law: the *Qur'ān* and, where available, the *Sunnah*.[17] However, as a result of the nature of Islamic law - as a human estimation of God's will - it could be argued that sources of information on the content of this law will, almost always, be secondary rather than

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[15] Bälz, Kilian, Islamic Finance for European Muslims: The Diversity Management of *Sharī'ah*-Compliant Transactions, (Winter 2007) 7(2) *Chicago Journal of International Law*, 551-567 at 552.

[16] *infra.* at 152.

[17] In a number of instances, a translation of a particular *hadīth* could not be found. In such circumstances, the book or article in which the report was referenced is cited instead.

primary. As a result, commentaries by contemporary scholars, academics and practitioners, as well as translations of classical books of *fiqh*[18] are referred to repeatedly. A similar approach has been adopted in relation to research of Islamic finance; academic and industry commentary, case studies, international best practice standards and religious pronouncements form the principal doctrinal basis of this thesis. This process has been facilitated by the fact that in practice, the rapid development and international character of Islamic finance has resulted in many of the most influential ideas originating in contemporary academic books and articles written in, or translated into, English. As this research has progressed it has become clear that writings on Islamic finance must be approached with a degree of circumspection. Perhaps because of the religious element in Islamic finance, literature on this topic is often polarised into two "camps," one which adamantly extols the virtues of Islamic finance as superior to the interest-based financial system and one which regards the current Islamic finance industry as bordering on fraudulent exploitation of religious belief. Increasingly, however, it is possible to detect the emergence of a "middle ground" amongst some commentators; this literature has proved to be an invaluable source of information and has represented a benchmark against which some of the more extreme views can be considered and dissected.

This thesis also draws on international legal research and examples of accommodation of Islamic finance in other jurisdictions. Considering the approach to the integration of Islamic finance adopted in a number of countries, including Pakistan, Malaysia and the UK, has allowed more informed conclusions regarding Islamic finance in Ireland to be drawn. Foreign precedent, particularly that set by the UK, is used prominently in Chapters 7, 9 and 10 as a source of guidance when discussing the position of Islamic finance in Ireland. This foreign element has relied on legislation and case law from Pakistan, Malaysia, the UK, the US and the UAE, as well as academic commentary and Government policy documents.

Finally, Islamic finance, while based on principles of Islamic law, also raises religious, financial and political issues. The primary focus of this thesis remains legal, however discussion of legal concepts relevant to Islamic finance has also drawn on interdisciplinary sources, largely secondary in nature. Particularly when considering the justifications for

[18] Where a translation of a classical jurist's writings was unavailable, a transliterated citation of the original work is used, together with the English source in which it is referenced.

accommodation in Chapter 5 and the structure of the financial products in Chapters 6 to 9 therefore, reference is made to concepts which are not traditionally legal in nature.

1.4.2 Empirical

A limited amount of empirical research has also been relied on in this thesis, although such research has served largely as a complement to the doctrinal research rather than as a standalone body of data. This research has taken the form of interviews (face to face or through email) conducted with Government bodies such as the Financial Regulator (now the Central Bank),[19] the Revenue Commissioners,[20] lawyers[21] and members of Ireland's Muslim community.[22] An informal survey was also carried out amongst Muslims in Dublin in conjunction with the *History of Islam in Ireland*,[23] a research project at University College Cork.[24] This survey assessed the views of Muslims on the need and viability of a domestic Islamic finance industry. While attempts were made to reach a diverse range of Ireland's Muslims, this survey was primarily handed out in Mosques and Islamic community events; it is acknowledged that the results may not be an entirely representative overview of the Muslim community in Ireland.

The content of two Chapters of this thesis has formed the basis of journal articles. Chapter 3 was used in a *Trinity College Law Review* article "The *Shari'ah* Prohibition of Interest"[25] while Chapter 7 has been used in a modified form in a forthcoming article in the *Journal of Muslim Minority Affairs*. Conference papers in Ireland and Canada have also drawn on research conducted in relation to this thesis.

1.5 Scope of Thesis

The number of legal issues raised by the introduction of novel financial transactions into Ireland's legal system is immense. Space constraints have prevented each one of these

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[19] See appendix 1, *infra.* at 454 and appendix 2, *infra.* at 458.
[20] See appendix 3, *infra.* at.459 and appendix 4, *infra.* at 460.
[21] See appendix 5, *infra.* at 462 and appendix 6, *infra.* at 465.
[22] See appendix 7, *infra.* at 468.
[23] The *History of Islam in Ireland* is an IRCHSS funded project, operating in the College of Arts, Celtic Studies and Social Sciences at University College Cork. The research at University College Cork considers the history of Islam in Ireland rather the current emergence of Islamic finance but highlights a growing interest in the interaction between Islam and Irish society.
[24] See appendix 8, *infra.* at 472.
[25] Richardson, Edana, "The Shari'ah Prohibition of Interest", (2008) 11 *Trinity College Law Review* 78-101.

issues from being dealt with in detail. Consequently, a level of delimitation of this research has been necessary.

This thesis deals with the introduction of Islamic financial transactions into Ireland's legal system, not the introduction of Islamic institutions. Consequently, the institutional aspects of Islamic financial institutions in Ireland[26] have been deliberately omitted. Instead, the legal implications of the products and the supervision of Islamic financial activity have been considered with reference to a "generic" financial institution. This institution may be Islamic in orientation but, at least in the short term, would most likely to be conventional.

Two products are dealt with in Chapters 6 to 9. Even prior to the Tax Briefing 2009 and the Finance Act 2010, Ireland was already witnessing development in the Irish Islamic funds industry. As a result, an expanding number of funds are now domiciled in Ireland following their authorisation by the Central Bank.[27] Though Islamic funds were not dealt with specifically in the Finance Act 2010, the Tax Briefing 2009 confirmed parity of taxation between Islamic and conventional funds.[28] It is, however, precisely because of this existing parity that Islamic funds are not considered in detail in this thesis. The reality is that unlike Islamic real estate financing and *sukūk*, the taxation and regulation of Islamic funds fits relatively seamlessly into the existing legal framework.[29] The integration of such products thus provides limited scope for analysis in the context of an academic thesis.

1.6 Terminology

[26] Although limited reference to Islamic financial institutions in other countries is made in Chapter 5 as a means of establishing the conceptual framework for accommodation undertaken in these other jurisdictions.

[27] For example; Oasis Crescent Global Equity Fund, DWS Noor Islamic Funds plc (which offers an Asia-Pacific equity fund, China equity fund, Global select equity fund, Japan equity fund and a precious metals securities product), SEI Islamic Investments Fund plc, The Concord Islamic US Equities Fund and The SEI Islamic US Equity Fund.

[28] Revenue Commissioners, "Islamic Finance", *Tax Briefing*, note 7. Cross-referencing to sources already cited in full will re-start at the beginning of every chapter.

[29] A conclusion supported by the fact that Ireland's Islamic funds industry had begun to develop prior to any Government clarification or accommodation of Islamic financial activity. A similar situation has occurred in the UK where Islamic funds and their managers have been subject to the same authorisation procedures and requirements as their conventional counterparts. Correspondence with Geraldine Murphy, Revenue Commissioners (as it then was), appendix 2, *infra.* at 458. For more information on Islamic funds in the UK see, Wilson, Rodney, "Why London is so influential," (Summer 2007) 5(2) *Islamic Banking & Finance*, 29, at 30, Walmsley, Gillian, "London – the European hub for Islamic Finance," (2009/2010), *Islamic Finance Review*, 32, at 33.

El-Gamal has suggested that as a means of making "new products identifiable as Islamic,"[30] the contemporary Islamic finance industry has developed a proclivity for using Arabic words liberally when discussing Islamic financial concepts and transactions. While this may be true, the use of Arabic terminology sets Islamic finance apart from conventional financial activity. Similarly, relying on terms found in the sources of Islam and the writings of classical jurists represents an overt indication that Islamic transactions and products were designed specifically to comply with religious belief. The use of Arabic terminology is thus, most certainly, an important public relations device in the Islamic finance industry. Quite apart from this however, relying on Arabic words is often a more straightforward, cleaner way of discussing concepts which either do not translate elegantly into English or for which no unanimously agreed upon English translation yet exists.[31] As a result, this thesis will follow other commentators, scholars and participants in the Islamic finance industry by using transliterations of Arabic terms. A somewhat personalised approach to transliteration has been adopted, although the use of macrons and apostrophes has allowed for a more phonetic transliteration than if fully anglicised versions of Arabic words were used.

There is of course, no single correct means of expressing Arabic words and sounds in the Latin alphabet.[32] Throughout this thesis, quotations and the official names of products and organisations, which contain a transliteration and use of italicisation which are different from that used in this thesis, will be reproduced without adjustment.

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[30] El-Gamal, Mahmoud Amin, *Islamic Finance: Law, Economics, and Practice* (Cambridge University Press, Cambridge, 2006), at 12.

[31] Indeed, the Arabic terms often have connotations that the English terms do not carry and there may be historical meaning and context which is relevant in an industry that is so young. Many thanks to Michael J.T. McMillen for highlighting this.

[32] Dickins, James, Hervey, Sándor G. J. and Higgins, Ian, *Thinking Arabic translation: a course in translation method: Arabic to English*, (Routledge, London, 2002), at 35-36.

PART I

THE THEOLOGICAL BASIS FOR ISLAMIC FINANCE

Chapter 2

Islamic Law – Its Roots and Elaboration

2.1 Introduction

References to "*Sharī'ah*" and "Islamic law" abound in Islamic finance discourse. Financial institutions, Governments and investors involved in this industry often seek promote their Islamic products and activities with overt reliance on religious legal teachings and the views of religious scholars.[1] Such reliance is, in the context of Islamic finance, understandable. Without a connection between the secular and the sacred, Islamic finance becomes disconnected from the ultimate reason for its existence: the provision to Muslims of a financial system which conforms with their religious beliefs.[2] As Vogel and Hayes have noted, Islamic finance "seek[s] to apply the Islamic religious law...to a sector of modern commerce. This law - more than business organization, economics, politics, theology, or history - shapes Islamic banking and finance and differentiates it from its conventional counterparts."[3] A structure which has been specifically designed to comply with religious teachings is not, however, a common feature of Western financial products, services and instruments. Before considering the integration of Islamic finance into Ireland's legal system, it is necessary to contextualise this financial activity by considering its religious underpinnings and the tenets around which it is structured. Only through such reference can the nature, form and development of the Islamic finance industry in the 20th and 21st centuries be properly understood.

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[1] As a practical matter, and as discussed in Chapter 11, Islamic finance products cannot be sold without reliance on the approval of scholars. Many thanks to Michael J.T. McMillen for highlighting this.

[2] Vogel, Frank E. and Hayes, Samuel L., *Islamic Law and Finance, Religion, Risk and Return.* (Kluwer Law International, The Hague, 1998), at 23.

[3] *ibid.*

The following Chapter will provide an outline of Islamic law. First, it will consider the nature of Islamic law (2.2),[4] its sources and scholarly attempts to determine its content (2.3).[5] Second it will address the extent to which Islamic law can, and has, been developed by Islamic scholars (2.4).[6] Finally, it will consider the question of whether "Islamic law" is "law" (2.5).[7] Academic discussion of this area remains divided, particularly in relation to the legitimacy of innovation and the legal content of Islamic law. This debate has been the subject of numerous commentaries[8] and its minutiae are beyond the scope of this Chapter. As a result, areas of contention will be highlighted but not discussed in detail.

2.2 *Sharī'ah* and *Fiqh*

Unlike many judicial systems - in which ancient legal history is often of interest only to a select number of academics and where contemporary innovations are at the centre of attention for jurists and commentators - Islamic law remains overtly connected to its origins. *Sharī'ah*, or the sacred law of Islam, occupies a central place in Muslim society; indeed Schacht referred to *Sharī'ah* as "the core and kernel of Islam itself."[9] Often described simply as "Islamic law," the term *Sharī'ah* stems from the notion of a way or road, leading towards a watering hole.[10] From a religious perspective, it provides a well trodden path towards salvation, an indication of God's will to be respected and followed by believers.[11] *Sharī'ah* is an abstract, somewhat indefinite, concept which refers to the total way of life,[12] and the complete set of norms, which Allah has laid down for man. As the way through which man can attempt to fulfil the Divine Will, *Sharī'ah* regulates both spiritual and temporal activity, conflating secular and sacred into a single, all

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[4] *infra.* at 14.
[5] *infra.* at 17.
[6] *infra.* at 26.
[7] *infra.* at 39.
[8] Discussion can, for example, be found in Schacht, Joseph, *An Introduction to Islamic Law*, (Clarendon Press, Oxford, 1964) and Hallaq, Wael B., *Shari'a; Theory, Practice, Transformations*, (Cambridge University Press, Cambridge, 2009), among many others.
[9] Schacht, Joseph, *An Introduction to Islamic Law*, note 8, at 1. Similarly, Melchert notes that "[a]s in Judasim, the law is the chief expression of Islamic faithfulness." Melchert, Christopher, "Islamic Law", (1998) 23 *Oklahoma University Law Review*, 901-910 at 901.
[10] Nazir-Ali, Michael, "Islamic Law, Fundamental Freedoms, and Social Cohesion: Retrospect and Prospect", in *Shari'a in the West*, Rex Ahdar and Nicholas Aroney, (eds.), (Oxford University Press, Oxford, 2010), 71-89 at 71.
[11] Esposito, John, *Islam the Straight Path*, (2nd ed, Oxford, Oxford University Press, 1998), at 79, Rabbani, Faraz, "The philosophy of Sharia - the Clear Path," *Religion & Ethics – Islam,* BBC, at 2, available at: http://www.bbc.co.uk/religion/religions/Islam/beliefs/sharia_1.shtml
[12] Rahman, Fazlur, *Islam* (2nd ed., University of Chicago Press, Chicago, 1979), at 101.

encompassing "code of behaviour."[13] Dictated by God, *Sharī'ah* is considered to be infallible and immutable, fixed for all time,[14] and revealed to Muslims in the *Qur'ān*, (the holy book of Islam)[15] and the *Sunnah*, (the utterances and actions of the Prophet in light of this revelation).[16]

Notwithstanding the importance of adherence to *Sharī'ah* in a life bound for eternal salvation, *Sharī'ah* has not been handed down to man "ready-made, to be passively received and applied; rather, it is to be actively construed on the basis of those sacred texts which are its acknowledged sources."[17] Though the *Qur'ān* and *Sunnah* indicate God's will,[18] they have not precisely articulated the principles of *Sharī'ah* applicable to every past, present and future situation faced by mankind.[19] Nor do they represent a neatly codified body of law. It has been for man to deduce, extrapolate and apply the principles of *Sharī'ah* through the science of *fiqh*.[20] *Fiqh*, frequently described as an Islamic form of

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[13] Iqbal, Zafar and Lewis, Mervyn, *An Islamic Perspective on Governance*, (Edward Elgar, Cheltenham, 2009), at 21.

[14] Khadduri, Majid, "Nature and Sources of Islamic Law", (1953-1954) 22 *The George Washington Law Review* – A Symposium on Muslim Law, 3-23 at 7.

[15] Al Omar, Fuad and Abdel-Haq, Mohammed, *Islamic Banking Theory, Practice and Challenges*, (New Jersey, Zed Books, 1996), at xvi.

[16] *Qur'ān* 4:80 "He who obeys the Messenger (Muhammad), has indeed obeyed Allah, but he who turns away, then we have not sent you." *Qur'ān* 24:54 "Say: 'Obey Allah and obey the Messenger, but if you turn away, he (Messenger Muhammad) is only responsible for the duty placed on him (i.e. to convey Allah's Message) and you for that placed on you. If you obey him, you shall be on the right guidance. The Messenger's duty is only to convey (the message) in a clear way (i.e. to preach in a plain way),'" *Qur'ān* 33:21 "Indeed in the Messenger of Allah (Muhammad) you have a good example to follow for him who hopes in (the Meeting with) Allah and the Last Day and remembers Allah much." References to *Qur'ānic* verses made throughout this thesis come from *The Noble Qur'an in the English Language*, Muhammad Taqi sl-Hilali and Muhammad Muhsin Khan (trans.), (Maktaba Dar-us-Salam, Riyadh, 1996), Unless stated, all brackets included in these verses are in the original. See also, Kharoufa, Ala Eddin, "Philosophy of Islamic Shari'ah and its Contribution to the Science of Contema at porary Law," *Islamic Development Bank, Eminent Scholars' Lecture Series 19*, (Saudi Arabia, Islamic Institute for Research and Training, 2000), at 25, available at: http://www.theiccm.org/downloads/reads/Philosophy-of-Islamic-Shariah.pdf, Al Omar, Fuad and Abdel-Haq, Mohammed, *Islamic Banking Theory, Practice and Challenges*, note 15, at 1 noting that while the term *hadith* is more frequently that *Sunna*, *Sunna* actually refers to a tradition of the Prophet while *hadith* refers to the rule that is deduced from this tradition.

[17] *Qur'ān* 3:7, Weiss, Bernard, "Interpretation in Islamic Law: The Theory of Ijtihād", (1977-78) 26 *American Journal of Comparative Law*, 199-212 at 199. See also 'Ali ibn Abi Talib; "The *Qur'ān* does not speak; men speak on its behalf" in El-Gamal, Mahmoud, *Islamic Finance; Law, Economics and Practice*, (Cambridge University Press, Cambridge, 2006), at 27.

[18] "... We have neglected nothing in the Book, then unto their Lord they (all) shall be gathered." *Qur'ān*, 6:38.

[19] Vikør notes that "Mankind has only been given glimpses of this divine will through the Revelation, as far as God has willed it." Vikør, Knut S., *Between God and the Sultan: a History of Islamic law*, (C. Hurst & Co. (Publishers) Ltd., London, 2005), at 2. Similarly, Mallat suggests that *Sharī'ah*'s primary sources, "do not manifest – generally – their legal or conceptual content in a clear precise manner" Mallat, Chibli, *The renewal of Islamic Law: Muhammad Baqer as-Sadr: Najaf and the Shi'i Internationa*l, (Cambridge University Press, Cambridge, 1993), at 111.

[20] McMillen, Michael J.T., "*Islamic Shari'ah-Compliant Project Finance: Collateral Security and Financing Structure Case Studies*", (2000) 24(4) *Fordham International Law Journal*, 1184-1263 at 1190. *Sunan Abu Duwud*, Book 24, Number 3575 acknowledges this fallibility when a *hadīth* Narrated Umar ibn al-Khattab states that "Umar said while he was (sitting) on the pulpit: O people, the opinion from the Apostle

jurisprudence, means "comprehension" or "understanding" and refers to the interpretative methodology applied by Islamic jurists to the sources of *Sharī'ah* in order to elucidate the details of *Sharī'ah* (*usūl-al-fiqh* or roots of *fiqh*). It also refers to the deductions made by jurists as a result of that interpretation (*furū-al-fiqh* or branches of *fiqh*).[21] *Fiqh* is the end product of this explanation and collection. For Kamali, it is "the law itself."[22] However, as a human attempt to determine the *Sharī'ah* and, by extension, to apply its injunctions to novel situations, *fiqh* falls short of *Sharī'ah*'s perfection and fixed nature.[23] It is not the direct will of Allah, but is rather an attempt to understand that will and so constitutes opinion (*zann*) rather than knowledge (*'ilm*).[24] Nevertheless, as a form of systematisation of ethical-religious principles, *fiqh* transforms the often undefined dictates of *Sharī'ah* into practical standards.[25] It is within the voluminous *fiqh* literature, created by classical Islamic scholars, that many key details of the Islamic principles relating to financial activity are contained.[26] As will be seen over the course of this thesis, the contractual forms and the procedures found in contemporary Islamic finance, were frequently developed in the *fiqh* literature rather than directly in the primary sources of *Sharī'ah* - it is within these writings that the norms established in the *Qur'ān* and *Sunnah* were discovered and explained. Indeed, Vogel and Hayes note that "when we refer to Islamic law [in the context of Islamic finance] we nearly always mean *fiqh*, not the shari'a."[27]

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of Allah (peace_be_upon_him) was right, because Allah showed (i.e. inspired) him; but from us it is sheer conjecture and artifice." Ahmad Hasan (trans.), available at: http://www.usc.edu/schools/college/crcc/engagement/resources/texts/muslim/hadith/abudawud/024.sat.html.

[21] Baamir, Abdulrahman Yahya, *Shari'a Law in Commercial and Banking Arbitration; Law and Practice in Saudi Arabia*, (Ashgate Publishing Ltd., Surrey, 2010), at 9, Aghnides, Nicolas P., *Mohammedan Theories of Finance*, (The Premier Book House, Lahore, 1961), at 24-29, Weiss, Bernard, "Interpretation in Islamic Law: The Theory of Ijtihād", note 17, at 199, Vesey-Fitzgerald, S. G., "Nature and Sources of the Shari'a" in Majid Khadduri and Herbert J. Liebesny, (eds.) , *Law in the Middle East* (Vol. 1, Middle East Institute, Washington, DC, 1955), at 86.

[22] Kamali, Mohammad Hashim, *Principles of Islamic Jurisprudence*, (Cambridge University Press, Cambridge, 1991), at 12.

[23] Wacek, Jennifer, "The Multivocal Shari'a in History and Literature", (2010) 28 *Wisconsin International Law Journal*, 299-324 at 300.

[24] Coulson, Noel James, *Conflicts and Tensions in Islamic Jurisprudence*, (The University of Chicago Press, Chicago, 1969), at 3, Weiss, Bernard, "Interpretation in Islamic Law: The Theory of Ijtihād", note 17, at 203.

[25] *ibid*, at 205.

[26] Hicks, Stephen C., "The Fuqaha and Islamic Law", (1982) 30 *American Journal of Comparative Law, Supplement*, 1-13 at 3 noting that; "Fiqh ... is a science, an understanding or discernment, which results in the deduction of the path (Shari'ah) or way of being in the world with others through what is required, forbidden, recommended, etc., by sources of law."

[27] Vogel, Frank E. and Hayes, Samuel.L., *Islamic Law and Finance, Religion, Risk and Return*, note 2, at 24. See also, Glenn, H. Patrick, *Legal Traditions of the World*, (3rd ed., Oxford University Press, Oxford, 2007), at 174 noting that "[t]he great part of the shari'a is found in the corpus of fiqh…".

Section 2.3 will discuss the "roots" of Islamic law: the *Qur'ān* (2.3.1),[28] the *Sunnah* (2.3.2),[29] *ijmā'* (2.3.3)[30] and *qiyās* (2.3.4)[31]. Each root will be explained and assessed for its influence over Islamic legal doctrine.

2.3 The "Roots" of Islamic Law: *Usūl-al-fiqh*

Following the initial untrammelled use of personal opinion, (*ra'y*),[32] in the creation of *fiqh*,[33] Shafi'i - the eponymous jurist of one of Sunni Islam's schools of thought[34] - sought to restrict the extent to which individual reason could act as a separate source of Islamic law in addition to the *Qur'ān* and *Sunnah*.[35] In *al-Risala*, Shafi'i standardised the process of deducing rules of *Sharī'ah*,[36] by emphasising the centrality of the divine texts[37] and by establishing four separate but interrelated sources of Islamic law: the *Qur'ān* and the *Sunnah*, *ijmā'* (consensus of jurists) and *qiyās* (analogical reasoning).[38] While Shafi'i acknowledged the need for some level of human reason when determining the rules of *Sharī'ah*, such reasoning could not be independent from the divine revelation, it had to be based on the primary sources.[39] The four "roots" (*usūl*) proposed by Shafi'i are generally presented as a hierarchy of "sources" of Islamic law in which the *Qur'ān* sits at the top.[40] However, whether consensus or analogical reasoning can be sources of religious law is

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[28] *infra.* at 18.
[29] *infra.* at 21.
[30] *infra.* at 24.
[31] *infra.* at 26.
[32] Hallaq, Wael B., *Shari'a; Theory, Practice, Transformations*, note 8, at 48-49.
[33] Coulson, Noel James, *Conflicts and Tensions in Islamic Jurisprudence*, note 24, at 4.
[34] See *infra.* at 37, for further discussion of the schools.
[35] Coulson, Noel James, *Conflicts and Tensions in Islamic Jurisprudence*, note 24, at 6.
[36] Doi, 'Abd ar-Rahman, *Sharī'ah Islamic Law*, revised and expanded by 'Abdassamad Clarke, (Ta-Ha Publishers, London, 2008), at 133.
[37] Hallaq, Wael B., *Shari'a; Theory, Practice, Transformations*, note 8, at 51. As Hasan noted "[t]he concept of *nass* [text] was not dominating in the pre-Shafi'i period. As a result of al-Shafi'i's emphasis on textual evidence, it acquired a dominant position in legal reasoning and became a substitute for the *r'ay-ijma* phenomenon. Unrestricted ra'y was violently attacked by al-Shafi'i, and, therefore, *Qiyās* was naturally narrowed down to *nass*." Hasan, Ahmad, *Early Development of Islamic Jurisprudence*, (Islamic Research Institute, Islamabad, 1970), at 222.
[38] Schacht, Joseph, *The Origins of Mohammadan Jurisprudence*, (Clarendon Press, Oxford, 1950), at 1 notes, "[t]he classical theory of Muhammadan law, as developed by the Muhammadan jurisprudents, traces the whole of the legal system to four principles or sources: the Koran, the sunna of the Prophet, that is, his model behaviour, the consensus of the orthodox community, and the method of analogy. The essentials of this theory were created by Shafi'i..." (internal citation omitted).
[39] Coulson, Noel James, *Conflicts and Tensions in Islamic Jurisprudence*, note 24, at 6, Kamali, Mohammad Hashim, *Principles of Islamic Jurisprudence*, note 22, at 14-15, Hallaq, Wael B., *Shari'a; Theory, Practice, Transformations*, note 8, at 51.
[40] See for example, Coulson, Noel James, *Conflicts and Tensions in Islamic Jurisprudence*, note 24, at 55-56. See Lowry, Joseph E., "Does Shafi'i have a Theory of 'Four Sources' of Law?" in *Studies in Islamic legal theory*, Bernard G. Weiss (ed.), (Brill, Leiden, 2002), 23-50 for a discussion on the correctness of suggestions that Shafi'i created a "four sources" theory.

questionable and the approach proposed by Zweigert and Kötz - under which Islamic law is composed of two sources (the *Qur'ān* and *Sunnah*), a judgment (*ijmā'*) and a method of developing rules (*qiyās*) - has a certain appeal to it.[41]

2.3.1 The *Qur'ān*

Frequently referred to as the *ipsissima verba* or *verbum dei*,[42] the *Qur'ān* is, in Islam, the direct word of Allah[43] set out for man through revelations to the Prophet Mohammad.[44] According to Ibn Khaldoun, it was

> sent from heaven in the Arab tongue, and in a style conformable to that in which the Arabs were wont to express their thoughts...It was revealed phrase by phrase, verse by verse, as it was needed, whether for manifesting the doctrine of the unity of God, or for expounding the obligations to which men ought to submit in this world. In the one case we have the proclamation of the dogmas of faith, in the other the prescriptions which regulate the actions of men.[45]

As an expression of Allah's will,[46] devoid of human inspiration,[47] the *Qur'ān* is considered by Muslims to be free from errors and, theoretically, the primary source of Islamic law.[48]

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[41] Zweigert, Konrad and Kötz,Hein, *An Introduction to Comparative Law*, (3rd ed., Oxford University Press, Oxford, 1998), at 308. Rahman explains the relationship between the four concepts by drawing a parallel with the Aristotelian scheme of analysis: "Pursuing this analogy, the Qur'an and the Sunna are the material principles (or the 'sources'), the activity of analogical reasoning (qiyas) the efficient cause, and the ijma' the formal principle (or the functional power)," Rahman, Fazlur, *Islam*, note 12, at 68.

[42] See for example, Anderson, J. N. D., "Law as a Social Force in Islamic Culture and History", (1957), 20(1/3), *Bulletin of the School of Oriental and African Studies, University of London, Studies in Honour of Sir Ralph Turner*, 13-40 at 15.

[43] Sell, Edward, "Inspiration (Muslim)", in *Encyclopedia of Religion and Ethics, Part 13*, James Hastings and John A. Selbie, (eds.), (Kessinger Publishing, 2003), 354-357 at 354.

[44] *Qur'ān* 53:1-5, "By the star when it goes down. Your companion (Muhammad) has neither gone astray nor has erred. Nor does he speak of (his own) desire. It is only a Revelation revealed. He has been taught (this *Qur'ān*) by one might in power (Gabriel)." Vesey-Fitzgerald, S. G., "Nature and Sources of the Shari'a", at 21, at 87, Doi, 'Abd ar-Rahman, *Sharī'ah Islamic Law*, note 36, at 47, Klein, FA, *The Religion of Islam*, (Taylor & Francis, London, 1985), at 2.

[45] Ibn Khaldoun, quoted in Sell, Edward, *The Faith of Islam*, (2nd ed., Kegal Paul, Trench, Trübner & Co Ltd, London, 1896), at 3.

[46] *Qur'ān* 55:1-2, "The Most Gracious (Allah)! He has taught (you mankind) the Qur'ān."

[47] *Qur'ān* 53:2-4, "Your companion is not misguided or misled, nor does he speak from whim. It is nothing but Revelation revealed." Rahman, Fazlur, *Islam and Modernity: Transformation of an Intellectual Tradition*, (University of Chicago Press, Chicago, 1982), at 30, Doi, 'Abd ar-Rahman, *Sharī'ah Islamic Law*, note 36, at 74.

[48] Coulson, Noel James, "Islamic Law" in *An Introduction to Legal Systems*, John Duncan and Martin Derrett, (eds), (Sweet & Maxwell, London, 1968), 54-79 at 55. See also *Qur'ān* 22:43-6, "Truly, you (Muhammad) are one of the Messengers, On the Straight Path (i.e. *Sharī'ah*). (This is a Revelation) sent

In practice, the position of the *Qur'ān* as a realistic and viable source of legal principles[49] has been heavily debated amongst commentators, a debate which remains unsettled. The *Qur'ān* is not, and does not explicitly profess to be, a book of law.[50] On its face, there are few verses in the *Qur'ān* which are of an overtly legal nature and numerous commentators have suggested that only between 350[51]- 600[52] verses, out of a total of more than 6,200, are legal. Coulson has concluded that of this 600, as little as 80 verses "deal with legal topics in the strict sense of the term."[53] The conclusion has thus gained prominence that the principles of Islamic law are found primarily in its second source, the *Sunnah*. According to Schacht

> [t]he Koran taken by itself, apart from its possible bearing on the problem raised by the traditions of the Prophet [the *Sunnah*], can hardly be called the first and foremost basis of early legal theory.[54]

Goitein has presented a less dismissive view of the *Qur'ān*'s store of legislative provisions. He notes, first, that verses of the *Qur'ān* which relate to legal matters are often lengthier than those dealing with other issues[55] and second, that unlike non-legal concepts, the legal provisions of the *Qur'ān* are generally not repeated multiple times throughout the text.[56] Thus

> ...if one condenses [the *Qur'ān*'s] subject-matter to its mere content, under the five main headings of preaching, polemics, stories, allusions

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down by the All-Mighty, the Most Merciful, In order that you may warn a people whose forefathers were not warned, so they are heedless."

[49] In the Western sense of the term. See *infra.* at 39, for a discussion on whether the term Islamic "law" is correct at all.

[50] Coulson, Noel James, "Islamic Law" in *An Introduction to Legal Systems*, John Duncan and Martin Derrett, (eds), note 48, at 56.

[51] Kamali, Mohammad Hashim, *Principles of Islamic Jurisprudence*, note 22, at 27 suggests that there are 350 such verses.

[52] Ostroróg, Léon, *The Angora Reform*, (University of London Press, London, 1927), at 19, Doi, 'Abd ar-Rahman, *Sharī'ah Islamic Law*, note 36, at 67, who suggests that there are 500, Coulson, Noel James, *A History of Islamic Law*, (Edinburgh University Press, Edinburgh, 1964), at 12, who suggests 600.

[53] *ibid.* at 12. Some of the more overtly legal injunctions related to marriage and family law (particularly *Qur'ān* 4), inheritance (*Qur'ān* 4:176 for example), stipulated punishments for unlawful sexual intercourse (*Qur'ān* 24:2), drinking alcohol (*Qur'ān* 5:90-1), theft (*Qur'ān* 5:38) and highway robbery (*Qur'ān* 5:33-4).

[54] Schacht, Joseph, *The Origins of Mohammadan Jurisprudence*, note 38, at 224.

[55] Goitein, Samuel " The Birth-Hour of Muslim Law", (1960) 50 *The Muslim World*, 23-29 at 24, a conclusion confirmed by Madigan who notes that "the longest sūras [verses of the *Qur'ān*] all contain legislative material..." Madigan, Daniel A., "Themes and topics", in *The Cambridge Companion to the Qur'ān*, Jane Dammen McAuliffe, (ed), (Cambridge University Press, Cambridge, 2006), 79-96 at 93.

[56] Goitein, Samuel " The Birth-Hour of Muslim Law", note 55, at 24, Hallaq notes that "It is common knowledge that the *Qur'ān* repeats itself both literally and thematically, but this tendency of repetition is absent in the legal subject matter." Hallaq, Wael B., *The Origins and Evolution of Islamic Law* (Cambridge University Press, Cambridge, 2005), at 21.

> to the Prophet's life, and legislation, one will reach the conclusion that proportionately the Qur'an does not contain less legal material than the Pentateuch, the Torah, which is known in world literature as "The Law.[57]

Nevertheless Goitein also suggests that "it occurred to Muhammad only at a relatively late period that even strictly legal matters were not religiously irrelevant."[58] However, for modern commentators, the legal character of the *Qur'ān* is, in fact, relatively substantial. Hallaq, for example, has presented a compelling argument that the *Qur'ān* must be approached "on its own terms."[59] As morality and law were conflated concepts in classical Arabia, one cannot read the *Qur'ān* in a manner which searches only for strictly (Western) legal principles. The *Qur'ān* creates a "moral cosmology" and thus a divine law against which every temporal activity must be judged.[60] This "moral blueprint" forms the basis for future Islamic law which will, as a result, be fundamentally rooted in the teachings of the *Qur'ān*.[61]

As will be discussed in detail in Chapter 3, Islamic finance and commercial activity are the explicit subjects of a number of *Qur'ān*ic verses.[62] Indeed, with an emphasis on fair dealing and the avoidance of exploitation, Islamic commercial principles set out in the classical *fiqh* literature - and the contemporary transactions which have developed from these - draw noticeably on specific provisions and the broad moral character of the *Qur'ān*. Consistent with the views of Hallaq, therefore, the *Qur'ān* has played more than a marginal role in the development of Islamic finance and is an important root of Islamic economic teachings. Nevertheless, the *Qur'ān* lacks detail in relation to many of the issues it refers to,[63] including commercial issues.[64] Islamic scholars therefore seek guidance from the second source of Islamic law: the tradition of the Prophet (*Sunnah*) and the narrations

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[57] Goitein, Samuel " The Birth-Hour of Muslim Law", note 55, at 24.

[58] *ibid.* at 26.

[59] Hallaq, Wael B., "Groundwork of the Moral Law: A New Look at the *Qur'ān* and the Genesis of Sharī'a", (2009) 16 *Islamic Law and Society*, 239-279 at 279.

[60] *ibid.* at 259.

[61] *ibid.* at 279.

[62] See for example, *infra.*at 51, 54, 63. Vesey-Fitzgerald, S. G., "Nature and Sources of the Shari'a", note at 21, at 88. For a discussion of the trading activity and market of Medina before and at the time of the Prophet see Lecker, Michael, "On the Markets of Medina (Yathrib) in Pre-Islamic and Early Islamic Times", (1986) 8 *Jerusalem Studies in Arabic and Islam*, 133-147.

[63] Pearl, David and Menski, Werner, *Muslim Family Law*, (Sweet and Maxwell, London, 1988), at 3.

[64] Saeed, Abdullah, *Interpreting the Qur'an: Towards a Contemporary Approach*, (Routledge, London, 2006), at 65.

of the Prophet's sayings and actions (*hadīth*).[65] Through a study of how the Prophet himself applied the teachings of Islam, *Sharī'ah* scholars have been able to establish a wide-ranging collection of religious regulations.

2.3.2 The *Sunnah* and *Hadīth*

For Muslims, Muhammad did not bequeath the power of prophecy to his Companions[66] and so on his death (11 AH/632 AD), revelation ceased.[67] As a written text, the *Qur'ān* does not provide explicit directions (as opposed to broad moral standards) for every conceivable issue which may arise in the life of man. Thus, as Weiss has noted, "even during the lifetime of the Prophet, and much more frequently after his death, pressing problems arose for which the *Qur'ān* provided no explicit answers."[68] Faced with such gaps, *fiqh* scholars, searching for a divine basis for rules of Islamic law, looked to what the Prophet and sometimes his Companions[69] said, did and allowed to be done during their lifetime.[70] While the notion of *Sunnah*, as a mode of life to be followed and emulated, existed prior to the advent of Islam,[71] the Prophet was considered to be divinely guided and God's representative on earth;[72] prophetic *Sunnah* was a logical source of guidance for Muslims attempting to act in accordance with God's will.[73] The *Qur'ān* itself refers to the Prophet's "good example"[74] and calls on Muslims to follow this example noting that "He who obeys the Messenger has indeed obeyed Allah."[75] This Prophetic *Sunnah* came to be

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[65] Hannan, Shah Abdul, *Usul al Fiqh, (Islamic Jurisprudence), at* 8, available at: http://msacalgary.com/advancedbooks/usulalfiqh/usul_al_fiqh.pdf.

[66] The Prophet's close disciples, Akhtar, Shabbir, *Islam as Political Religion: the Future of an Imperial Faith*, (Routledge, Oxford, 2011), at 146.

[67] Burton, John, "Qur'an and Sunnah: A Case of Cultural Disjunction", in *Method and Theory in the Study of Islamic Origins*, Herbert Berg (ed.), (Brill, The Hague, 2003), 137-158 at 140.

[68] Lewis, Bernard, "Islam in History" (1991) 38(20) *The New York Review of Books*, available at: http://www.nybooks.com/articles/archives/1991/dec/05/in-search-of-Islams-past/.

[69] See the saying of Ibn Mas'ud who noted that: "When any man of us learnt ten ayat he would not go beyond them until he knew their meanings and how to practise them. So we learnt the *Qur'ān* and the practice (amal) together," quoted in Doi, 'Abd ar-Rahman, *Sharī'ah Islamic Law*, note 36, at 75.

[70] Anderson, J. N. D., "Law as a Social Force in Islamic Culture and History", note 42, at 15.

[71] Hallaq, Wael B., *Shari'a; Theory, Practice, Transformations*, note 8, at 40.

[72] Kazi, Mazhar, *A Treasury of Ahadith*, (Abul-Qasim Publishing House, Jeddah, 1992), at 1-2.

[73] Ansari, Zafar Ishaq, "The Contribution of the Qur'ān and the Prophet to the Development of Islamic Fiqh", (1992) 3(2) *Journal of Islamic Studies*, 141-171 at 152, Hallaq, Wael B., *Shari'a; Theory, Practice, Transformations*, note 8, at 43. See also Coulson who noted that "...[the Prophet's] authority lay in the fact that he was closest, in time and spirit, to the Qur'ān and as such was the ultimate starting-point of the Sunnah," Coulson, Noel James, *A History of Islamic Law*, note 52, at 43.

[74] *Qur'ān* 33:21, "Indeed in the Messenger of Allah you have a good example to follow for him who hopes in (the Meeting with) Allah and the Last Day and remembers Allah much."

[75] *Qur'ān* 4:80. See also *Qur'ān* 3:32, "Say (O Muhammad): 'Obey Allah and the Messenger.' But if they turn away, then Allah does not like the disbelievers." *Qur'ān* 3:132, "And obey Allah and the Messenger that you may obtain mercy, *Qur'ān* 16:44, "And We have sent down the Reminder to you so that you can make clear to mankind what has been sent down to them so that hopefully they will reflect." *Qur'ān* 24:63, "And

the secondary divine source of *Sharī'ah* and was transmitted through generations in the form of reports of sayings or actions (*hadīth*).[76]

While the *hadīth* are a rich source of Islamic law, the fact that there has been widespread fabrication of these reports has been acknowledged by both Muslim and Western scholars.[77] The *hadīth* give actions, teachings and rules a Prophetic character, even in the absence of explicit references in the *Qur'ān*; establishing a link to the Prophet gives principles an authority in Islamic law which they could not otherwise have attained.[78] In the centuries after the Prophet's death, this link was established in each *hadīth* through the narration of the chain of authority that had transmitted the *hadīth* with that chain ultimately beginning with the Prophet.[79] Through the use of a long line of transmissions from one scholar to the next, a vast corpus of extra-*Qur'ānic* teachings has been attributed back to the Prophet.[80] With little authority other than the strength of each link in the chain of transmission,[81] the potential for pseudepigraphy in the *hadīth* is considerable.[82] As a result, Hurgronje has suggested that

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let those who oppose the Messenger's commandment beware, lest some Fitnah befall them or a painful torment be inflicted on them." *Qur'ān* 59:7, "And whatsoever the Messenger gives you, take it, and whatsoever he forbids you, abstain from it..."

[76] Plural: *ahadith*. The term *hadīth* is derived from the verb hadatha which Doi broadly translates as "to recount a tale" or "make verbal communication of any kind." Doi, 'Abd ar-Rahman I., *Sharī'ah Islamic Law*, note 36, at 82, Weiss, Bernard, "Interpretation in Islamic Law: The Theory of Ijtihād", note 17, at 200. Though *Sunnah* and *hadith* are distinct concepts, the terms have frequently been used interchangeably, particularly by contemporary commentators.

[77] Vesey-Fitzgerald, S. G., "Nature and Sources of the Shari'a", at 21, at 93.

[78] Hallaq, Wael B., *Shari'a; Theory, Practice, Transformations*, note 8, at 45.

[79] Goldziher, Ignác, *Muslim Studies*, Samuel Miklos Stern (ed.), C.R. Barber and Samuel Miklos Stern (trans.), (State University of New York Press, Albany, 1971), at 25, Schacht, Joseph, *The Origins of Mohammadan Jurisprudence*, note 38, at 156.

[80] Ansari, Zafar Ishaq, "The Contribution of the Qur'ān and the Prophet to the development of Islamic fiqh", note 73, at 160.

[81] Hallaq, Wael B., *A history of Islamic legal theories: an introduction to Sunnī uṣūl al-fiqh*, (Cambridge University Press, Cambridge, 1997), at 2. Imam al-Shafi, notes that, "He who relates a tradition must merit confidence in his religion, and be known as reliable in his transmitting,comprehending whaThe Transmits, aware of any pronunciation that might change the meaning of the tradition, capable of transmitting the tradition word for word as he heard it, not merely transmitting [in his own words] its meaning; for if he transmits only the meaning and is unaware of what might alter its sense, he might unknowingly, transmute the lawful into the unlawful and vice-versa.3 So if he transmits word for word there remains no ground for fearing a change of the meaning. [Furthermore], he should have learned the tradition by heart if he relates it from memory, and should have memorized the written text [of traditions] if he relates it in,. its written form; when he participates with others in relating a tradition from memory, that which they relate must agree," Al-Shafi'i, al-Imam Muhammad ibn Idris, *al-Risala fi Usul al-Fiqh*, (Tretise on the Foundations of Islamic Jurisprudence), Majid Khadduri (trans.), (2nd ed., Islamic Texts Society, Cambridge, 2003), at 239-240. See Aghnides, Nicolas P., *Mohammedan Theories of Finance*, note 21, at 47 *et seq*. For a discussion of the different reliance levels of transmitters.

[82] Vesey-Fitzgerald, S. G., "Nature and Sources of the Shari'a", at 21, at 93, Goldziher, Ignác, *Introduction to Islamic Theology and Law*, Andras Hamori and Ruth Hamori (trans.) (Princeton University Press, Princeton, 1981), at 43, noting that "[t]o fabricate hadith was hardly considered dishonorable if the resulting fictions served the cause of the good."

> ...by a gigantic web of fiction, [the Prophet] became after his death the organ of opinions, ideas, and interests, whose lawfulness was recognised by every influential section of the Faithful. All that could not be identified as part of the Prophet's Sunna, received no recognition; on the other hand, all that was accepted had, somehow, to be incorporated into the Sunna.[83]

Nevertheless, from the third century AH/ninth century AD, *hadīth* were progressively classified into those which were sound (*sahih*), good (*hasan*), weak (*da`if*) and fabricated (*maudu`*).[84] With this refinement of the *hadīth* literature, collections of authentic *hadīth* were created with several such as *Sahih al-Bukhari* and Imam Malik's *Muwatta*, gaining prominence as reliable.[85] These collections continue to be referred to in Islamic financial activity and the *hadīth* which they contain have represented an essential source of Islamic finance concepts and principles.

While Islamic finance instruments and activities[86] frequently rest (at least to a certain extent) upon *Qur'ānic* injunctions, considerably more detail on religiously acceptable financial activity, the structures to be used in such activity, and the conduct of parties in a transaction, is found in the *Sunnah*. Evidence that the Prophet himself and his Companions engaged in trading activity is recorded in the *hadīth*, providing *fiqh* writers and contemporary market participants with direct confirmation of transactions which are compatible with Islam (actual *(fi'li) Sunnah*). Equally, numerous trading practices prevalent at the time of the Prophet which were inconsistent with Islam were explicitly prohibited by the Prophet, again establishing the ideological parameters of Islamic financial activity

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[83] Hurgronje, C. Snouck, "Mohammedanism; Lectures on its Origin, its Religious and Political Growth, and its Present State", *American Lectures on the History of Religion Series of 1914-1915*, at Part II, see Hallaq, Wael B., "The Authenticity of Prophetic Ḥadîth: A Pseudo-Problem" (1999) 89 *Studia Islamica*, 75-90, at 88, who considered the debate over *hadīth* authenticity to be exaggerated and "not particularly instructive."

[84] Commenting upon this move to separate true from forged *hadīth*, Schacht noted that, "before the time of the six great collections of traditions in the ninth century A.D., there was deliberate forgery of traditions on such a scale that no purely legal tradition of the Prophet himself can be regarded as above suspicion," Schacht, Joseph, *The Origins of Mohammadan Jurisprudence*, note 38.

[85] Rahman, Fazlur, *Islam*, note 12, at 63, noting that, "[b]y the end of the 3rd [AH]/beginning of the 10th [AD] century several collections had been produced, six of which have since then been regarded as being especially authoritative and are known as "The Six Genuine Ones", Rayner, Susan E., *The Theory of Contracts in Islamic Law: A Comparative Analysis with Particular Reference to the Modern Legislation in Kuwait, Bahrain and the United Arab Emirates*, (Graham & Trotman, London, 1991), at 4-5.

[86] See for example the Islamic real estate structures and *sukūk* discussed *infra.*at 199 et seq. (real estate financing) and 295et seq. (*sukūk*).

(verbal *(qawli) Sunnah)*.[87] Finally, in addition to activity which the Prophet engaged in or openly prohibited, substance has been drawn from situations in which he remained silent. Islamic scholars have relied on the Prophet's tacit or silent approval of financial activity which was prevalent during his lifetime and to which he did not object (tacit (*taqriri*) *Sunnah*).[88] Through the *Sunnah*, the Prophet has effectively been transformed into a source of legal principles.

There is, however, only so much that can be retrospectively attributed to the Prophet. Complex financial transactions and economic activity, for example, are removed not just culturally but epistemologically from 7th century Arabia. The explicit guidance in the revealed sources may not be sufficient to establish comprehensive Islamic law rules for all situations and so the third and fourth roots of Islamic law may be relied on.

2.3.3 *Ijmā'*

Third in the hierarchy of the roots of Islamic law, *ijmā'*, (consensus of the community), acts more as a mechanism for determining what the Islamic law is rather than functioning as a free-standing source of that law. It pre-supposes that the Islamic law already exists, to be discovered by man through, amongst other things, the process of consensus. The *Qur'ān* advocates "mutual consultation"[89] and enjoins Muslims to confer with others when making a decision.[90] Support for the process of *ijmā'* also comes from a *hadīth* where the Prophet is recorded as saying, "[m]y community shall never agree on an error."[91]

While *ijmā'* can relate to consensus of the whole Islamic community,[92] in the context of determining legal doctrine, *ijmā'* generally refers to consensus of Islamic scholars, at a

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[87] Kamali, Mohammad Hashim, *Principles of Islamic Jurisprudence*, note 22, at 52-53. See, for example, the practices prohibited as involving excessive risk, infra. at 59.

[88] Farooq A. Hassan, "The Sources of Islamic Law", (1982) 76 *American Society of International Law Proceedings*, 65-75 at 66, Hallaq, Wael B., *The Origins and Evolution of Islamic Law*, note 56, at 102, Hallaq, Wael B., *Shari'a; Theory, Practice, Transformations*, note 8, at 34.

[89] *Qur'ān* 42:38.

[90] *Qur'ān*, 3:159 notes that, "And by the Mercy of Allah you dealt with them gently. And had you been severe and harsh-hearted, they would have broken away from about you; so pass over (their faults), and ask (Allah's) Forgiveness for them; *and consult them in the affairs*." (emphasis added).

[91] Ibn Abi 'Asim, *as-Sunnah*, quoted in Doi, 'Abd ar-Rahman, *Sharī'ah Islamic Law*, note 36, at 99.

[92] And indeed this is the sense in which al-Shafi'i advocated its use, Al-Shafi'i, al-Imam Muhammad ibn Idris, *al-Risala fi Usul al-Fiqh*, note 81, at 285-287. See also, Kamali, Mohammad Hashim, *Principles of Islamic Jurisprudence*, note 22, at 229-230.

particular period of time, on a specific issue.[93] Doi classifies *ijmā'*, when used as a root of Islamic law, as:

> ...the consensus of juristic opinions of the learned *'ulamā'* of the *Ummah* after the death of the Messenger of Allah and can be defined as the consensus of the Companions of the Prophet and the unanimous agreement reached on the decisions taken by subsequent learned *muftīs* and jurists on various matters[94]

The rationale behind the acceptance of consensus of the jurists as a secondary source of Islamic law is the understanding that Islamic jurists are in a unique position; they possess the necessary knowledge, training and expertise to examine all relevant legal authorities before arriving at a conclusion, something the ordinary members of the community are unable to do.[95] While conclusions on Islamic legal principles which are reached only by a single scholar (often through the process of endeavour (*ijtihād*))[96] represent non-binding conjecture, such judgments become immutable, binding provisions of Islamic law when reached by a consensus of jurists.[97] Judgment reached through consensus could relate to the interpretation and understanding of provisions in the *Qur'ān* and *Sunnah*,[98] or to the manner in which Islamic law should deal with a novel situation and, as Hallaq notes, with consensus, "this judgment, being so irrevocable, acquires a validity tantamount to that of the *Qur'ān* and the highly reliable traditions embodied in the Sunna of the Prophet. Thus, such a case with its established judgment becomes a precedent according to which another new legal question may be solved."[99]

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[93] Coulson, Noel James, *A History of Islamic Law*, note 52, at 77. Al-Amidi described *ijmā'* as "[t]he agreement of all recognised and qualified scholars who belong to the community of Muhammad, in a certain period of time, on a ruling about a certain incident." Al-Amidi, *al-Ihkam*, Vol. 1 at 168 quoted in, Al-Matroudi, Abdul Hakim I., *The Hanbali School of Law and Ibn Taymiyyah, Conflict or Conciliation*, (Routledge, London, 2006), at 57, Zaman, Muhammad Qasim, "Consensus and Religious Authority in Modern Islam: The Discourses of the 'Ulamā'" in *Speaking for Islam: religious authorities in Muslim societies*, Gudrun Krämer and Sabine Schmidtke (eds.), (Brill, Leiden, 2006), 153-180 at 153.

[94] Doi, 'Abd ar-Rahman, *Sharī'ah Islamic Law*, note 36, at 98.

[95] Malik, Akbar Ali, *A Theoretical & Practical Approach to Islamic Law*, (Unique Books, London, 2001), at 76.

[96] See *infra.* at 27 for a discussion on *ijtihād.*

[97] Coulson, Noel James, *A History of Islamic Law*, note 52, at 78.

[98] Rahman, Fazlur, *Islam*, note 12, at 74 noting that "it was ijma that determined what the Sunna of the Prophet had been and indeed what the right interpretation of the Qur'an was. In the final analysis, therefore, both the Qur'an and the Sunna were authenticated through ijma."

[99] Hallaq, Wael, "On the Authoritativeness of Sunni Consensus", (1986) 18 *International Journal of Middle Eastern Studies*, 427-454 at 427. Brown also suggests that "the orthodox schools of law sealed their position, and placed a shield around existing legal doctrine by means of their doctrine of consensus (*ijma*)", Brown, Daniel W., *Rethinking Tradition in Modern Islamic Thought*, (Cambridge University Press, Cambridge, 1999), at 20. Similarly, Weiss has suggested that consensus "may be regarded as sacred to the extent that it is the product of special divine guidance bestowed upon the Community, safeguarding it against error." Weiss, Bernard, "Interpretation in Islamic Law: The Theory of Ijtihād", note 17, at 200.

2.3.4 *Qiyās*

Like *ijmā'*, *qiyās* (analogical reasoning), is not strictly a source of Islamic law. Unlike the *Qur'ān* and *Sunnah* it does not contain God's revelation, but acts as a mechanism to determine how the *Sharī'ah* can be applied to situations not directly covered by the *Qur'ān* or *Sunnah*.[100] Potentially approved by the *Qur'ān* which states, "[t]ake admonition, O you with eyes,"[101] *qiyās* developed out of the practice of *ra'y*.[102] It acts as a means of ensuring that the scope of Islamic legal doctrine can be expanded beyond the issues explicitly referred to in the textual sources of *Sharī'ah*. However, the process of *qiyās* limited the juristic freedom of *ra'y* by maintaining an overt connection with the *Qur'ān*, *Sunnah* and *ijmā'*; analogy can only be drawn from a ruling previously established in one of the other roots of Islamic law.[103] This process can take two forms: either analogy is drawn on the basis of similarities between the external features of a case and those of one already determined in the *Qur'ān*, *Sunnah* or *ijmā'*, or it is drawn through consideration of the underlying reasoning (*illah*) behind the teachings found in the other roots.[104]

Similar to the notions of *stare decisis* and precedent in common law, *qiyās* appears to bring a level of individual reasoning into legal principles. As a result, this interpretative mechanism has not received the same broad support from Islamic scholars as the other roots of Islamic law.[105] Nevertheless, analogical reasoning has provided classical scholars with a means through which Islamic legal provisions can be articulated and applied to innumerable situations, including financial activity.

2.4 Scope for Development in Islamic Law

With the four *usūl-al-fiqh* set out by al-Shafi'i, classical Islamic *fiqh* writers developed the *furu' al-fiqh*, or substantive legal doctrines of Islamic law.[106] Through study of the

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[100] Hallaq, Wael B., *Shari'a; Theory, Practice, Transformations*, note 8, at 51.
[101] *Qur'ān* 59:2.
[102] *ibid*, Rahman, Fazlur, *Islam*, note 12, at 71.
[103] Hallaq, Wael B., *Shari'a; Theory, Practice, Transformations*, note 8, at 51, Doi, 'Abd ar-Rahman, *Sharī'ah Islamic Law*, note 36, at 117.
[104] Lambton, Ann K.S., *State and Government in Medieval Islam: an Introduction to the Study of Islamic Political Theory: the Jurists*, (Routledge, New York, 1981), at 9.
[105] See Aghnides, Nicolas P., *Mohammedan Theories of Finance*, note 21, at 71-73 for a discussion of scholars who oppose the use of *qiyās* and their reasoning for doing so.
[106] Baamir, Abdulrahman Yahya, *Shari'a Law in Commercial and Banking Arbitration; Law and Practice in Saudi Arabia*, note 21, at 14.

Qur'ān and *Sunnah*, use of consensus and analogy, Islamic law was, effectively, drawn from the ether by Islamic scholars and transformed into practical norms.

Islamic scholars, classical and contemporary have also relied on other, less official sources of law and interpretative methodologies when determining Islamic legal principles. In relation to the contemporary Islamic finance industry, "even the strictest theoretical ideals"[107] have been modified in order to allow Islamic finance to maintain its competitiveness with the conventional financial market.[108] Before considering the rules of Islamic law relevant to Islamic finance therefore, a number of additional, secondary influences must be acknowledged. This section will therefore look first at *ijtihād* (2.4.1)[109] and second at other influences on Islamic legal doctrine (2.4.2).[110] It will also introduce the Schools of Islamic law (2.4.3).[111] This section argues that while the roots considered in section 2.3[112] continue to guide contemporary Islamic financial activity, development in that activity has been facilitated through the use of other legal mechanisms.

2.4.1 *Ijtihād*

Hallaq has suggested that out of the practice of *ra'y*, implemented by the earliest Islamic jurists, a number of other intellectual processes have emerged in addition to *qiyās*. Amongst these is the practice of *ijtihād*.[113] Definitions of what exactly *ijtihād* is vary, with commentators generally unsure what the concept covers and its continued vitality within Islamic law.[114] Nevertheless, reference is frequently made to the "total expenditure of effort"[115] made by a *mujtahid* (an Islamic scholar who is qualified to undertake *ijtihād*) who "exerts himself to the utmost"[116] in determining and elaborating rules of Islamic law

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[107] Rayner, Susan E., *The Theory of Contracts in Islamic Law: A Comparative Analysis with Particular Reference to the Modern Legislation in Kuwait, Bahrain and the United Arab Emirates*, note 85, at 22.

[108] Vogel, Frank E. and Hayes, Samuel L., *Islamic Law and Finance, Religion, Risk and Return*, note 2, at 34. These devices are far from new in relation to Islamic jurisprudence, nevertheless, for the purposes of this thesis, they are considered primarily in the context of contemporary usage in Islamic finance.

[109] *infra.* at 27.

[110] *infra.* at 33.

[111] *infra.* at 37.

[112] *supra.*at 17 et seq.

[113] Hallaq, Wael, *The Origins and Evolution of Islamic Law*, note 56, at 114.

[114] Ali-Karamali, Shaista P. and Dunne, Fiona, "The Ijtihad Controversy", (1994) 9(3) *Arab Law Quarterly*, 238-257 at 238.

[115] Kamali, Mohammad Hashim, *Principles of Islamic Jurisprudence*, note 22, at 315. See also Sayf al-Din al-Amidi,.al-Ihkam *.fu.ul al-ahkmm* (Vol. IV, Cairo, Dir al-kutub alkhidiwiya, 1914), at 218, quoted in W eiss, Bernard, "Interpretation in Islamic Law: The Theory of Ijtihād", note 17, at 207.

[116] Anderson, J.N.D., "Modern Trends in Islam: Legal Reform and Modernisation in the Middle East", (1971) 20(1) *The International and Comparative Law Quarterly*, 1-21 at 14.

found in the primary sources.[117] For Weiss, *ijtihād* is "the process of extracting or deriving (*istinbat, istithmar*) legal rules from the sources of the Law"[118] while Doi similarly suggests that "it means the use of human reason in the elaboration and explanation of the *Sharī'ah*."[119] It is, thus, the act of probing the primary sources of *Sharī'ah* in order to discover the rules of Islamic law applicable to a new and unprecedented issue. Some commentators see *ijtihād* as a fifth source of Islamic law.[120] However, it could be argued that *ijtihād* is the intellectual process, the human element, that links *ijmā'* and *qiyās* to the primary sources;[121] the individual reasoning of Islamic scholars which eventually leads to *ijmā'* could be considered to be *ijtihād*,[122] while the process of drawing an analogy between a rule set out in the *Qur'ān* and *Sunnah* and a novel situation using *qiyās* is again individual, human endeavour to discover the *Sharī'ah*.[123] While the process of *ijtihād* inevitably brings human fallibility within the elaboration of Islamic legal doctrine, a frequently referred to *hadīth* acknowledges the validity of individual thought. Here, when sending Muadh to Yemen, the Prophet is recorded as asking, "How wilt thou decide when a question arises?"

> Muadh: "According to the Book of Allah."
>
> Muhammad: "And if thou findest naught therein?"
>
> Muadh: "According to the Sunna of the Messenger of Allah."
>
> Muhammad: "And if thou findest naught therein?"
>
> Muadh: "Then shall I apply my own reasoning."[124]

In the early centuries of *fiqh* development, Islamic scholars had little guidance other than the *Qur'ān* and the *Sunnah* when determining the content of Islamic law.[125] As a

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[117] Doi, 'Abd ar-Rahman, *Sharī'ah Islamic Law*, note 36, at 118.

[118] W eiss, Bernard, "Interpretation in Islamic Law: The Theory of Ijtihād", note 17, at 199-200.

[119] Doi, 'Abd ar-Rahman, *Sharī'ah Islamic Law*, note 36, at 118.

[120] See for example, Farooq A. Hassan, "The Sources of Islamic Law", note 88, at 67.

[121] A view supported by Kamali who notes that "The various sources of Islamic law that feature next to the Qur'an and the Sunnah are all manifestations of ijtihad, albeit with differences that are largely procedural in character," Kamali, Mohammad Hashim, *Principles of Islamic Jurisprudence*, note 22, at 315.

[122] Maududi, Sayyid Abdul A'la, *The Islamic Law and Constitution*, Khurshid Ahmad, (trans. and ed.), (Islamic Publications (Pvt.) Ltd, Lahore, 1960), at 79 discussing how *ijtihād* can attain force of law. *Ijtihād* which does not lead to *Ijmā'* arguably lacks authority representing as it does the unendorsed views of a single jurist.

[123] For al-Shafi'i, *Qiyās* and *ijtihād* were interchangeable concepts, Hallaq, Wael B., *Shari'a; Theory, Practice, Transformations*, note 8, at 51, Usmani, Muhammad Taqi, *An Introduction to Islamic Finance*, (Kluwer Law International, The Hague, 2002), at 112.

[124] *Sunan Abu Dawud*: Book 24, Number 3585, Ahmad Hasan (trans.), available at: http://www.usc.edu/schools/college/crcc/engagement/resources/texts/muslim/hadith/abudawud/024.sat.html. See also, Vogel, Frank E., *Islamic law and legal system: studies of Saudi Arabia*, (Brill, Leiden, 2000), at 38, Hassan, Farooq A., "The Sources of Islamic Law", note 88, at 67.

[125] Weiss, Bernard, "Interpretation in Islamic Law: The Theory of Ijtihād", note 17, at 203 noting that "[w]hen the Law is known, there is no need to interpret it. In such case, the Law need only be passively

result, individual effort was needed in order to interpret those sources. After the 3rd century AH/ 9th century AD, however, emphasis on the divine texts, as well as the developing body of immutable *ijmā'* on issues of Islamic law, reduced the scope for personal endeavour by Islamic scholars. It was believed that all major issues of Islamic law had been discussed and elaborated; the law was seen as being as complete as human beings could make it.[126] At this point, Rahman notes, "the door of *ijtihād* was closed."[127] The view that scholarly interpretation and innovation stopped in the 4thcentury AH /10th century AD and that from that point on, no scholar was capable of attaining the rank of *mujtahid*, has garnered quite considerable support. *Ijtihād* was treated as the prerogative of classical scholars while future generations of Islamic scholars had to rely on the concept of *taqlīd* or imitation.[128] Schacht has been a key proponent of the theory that the gates of *ijtihād* were closed[129] concluding that

> ...the point had been reached when the scholars of all schools felt that all essential questions had been thoroughly discussed and finally settled and a consensus gradually established itself to the effect that from that time onwards no one might be deemed to have the necessary qualifications for independent reasoning in law...This closing of the door of *ijtihād* as it was called, amounted to the demand for taklid, a term which had originally denoted the kind of reference to Companions of the Prophet that had been customary in the ancient schools of law, and which now came to mean the unquestioning acceptance of the doctrines of established schools and authorities.[130]

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acknowledged, rather than actively pursued. If the Law is not known-is not self-evident-the jurist exercises his full interpretive skills to produce as sound an opinion as possible as to what the Law is." Kayadibi, Saim, "Ijtihad by Ra'y: The Main Source of Inspiration behind Istihsan", (2007) 24(1), *The American Journal of Islamic Social Sciences*, 73-95 at 74.

[126] Weiss, Bernard, "Interpretation in Islamic Law: The Theory of Ijtihād", note 17, at 208.

[127] Rahman, Fazlur, *Islam*, note 12, at 77.

[128] Jackson, Sherman A., "*Taqlīd*, Legal Scaffolding and the Scope of Legal Injunctions in Post-Formative Theory Mutlaqand 'Āmm in the Jurisprudence of Shihāb al-Dīn al-Qarāfī", (1996) 3(2) *Islamic Law and Society*, Issues and Problems, 165-192 at 167. Hallaq definestaqlid as "reasoned and highly calculated insistence on abiding by a particular authoritative legal doctrine," Hallaq, Wael B., *Authority, Continuity, and Change in Islamic Law*, (Cambridge University Press, Cambridge, 2001), at ix.

[129] He was not the first to use the expression as Ostroróg, for example, had used it in 1927, Ostroróg Léon, *The Angora Reform*, (University of London Press, London, 1927), at 29.

[130] Schacht, Joseph, *An Introduction to Islamic Law*, note 8, at 71. See also, Coulson, Noel James, *A History of Islamic Law*, note 52, at 80-81, Khadduri, Majid, "From Religious to National Law", in *Modernization in the Arab World*, Jack Howell Thompson, Robert Danton Reischauer (ed), (Van Nostrand, New York, 1966), 37-51at 41.

For Schacht, Islamic law became set and rigid upon this closure, preserved in the Middle Ages.[131] For others, however, Schacht's views are increasingly doubtful, with those such as Hallaq questioning whether the gate was every closed.[132] In relation to the development of Islamic finance, it is suggested that *ijtihād* is now used by scholars to tackle contemporary problems through deductions from, and expansion of, the legal principles laid down by the primary sources.[133] In an attempt to engineer complex products and instruments which are compliant with Islamic economic principles, but which are still competitive with non-Islamic alternatives, contemporary scholars are returning to first principles, re-considering the primary sources in order to provide a textual basis for their activities. Fresh consideration of the *Qur'ān* and *Sunnah* has been made necessary by the fact that issues arising in financial transactions today are simply so novel and so removed from the experiences of the classical scholars that to only apply Islamic law on the basis of *taqlīd* would be artificial and potentially impossible.[134] As a result, *ijtihād* has provided a mechanism through which Islamic legal doctrine applying to unprecedented financial situations can be ascertained.[135] For example, in relation to Islamic funds and their

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[131] Schacht, Joseph, *An Introduction to Islamic Law*, note 8, at 75 noting that, Islamic law became "increasingly rigid and set in its final mould...changes which did take place were concerned more with legal theory and the systematic superstructure than with positive law. Taken as a whole, Islamic law reflects and fits the social and economic conditions of the early 'Abbasid period, but has grown more and more out of touch with later developments of state and society." See Goolman, Nazeem, "Ijtihad and its Significance for Islamic Legal Interpretation", (2006) *Michigan State Law Review*, 1443-1467 for a detailed overview of the development of *ijtihād*.

[132] Hallaq, Wael B., "Was the Gate of Ijtihad Closed?", (1984) 16(1) *International Journal of Middle East Studies*, 3-41. Others have suggested that while "absolute *ijtihād*" (where personal rulings are derived directly from the *Qur'ān*, *Sunnah* and *Ijmā'*) may now be unavailable, *ijtihād fi'l madhhab* or *ijtihād* on the basis of teachings of the imams who founded a madhhab and *ijtihād fi'l masa'il* or *ijtihād* on the basis of existing fatwā within a madhhab remain, Doi, 'Abd ar-Rahman, *Sharī'ah Islamic Law*, note 36, at 123, Watt, Montgomery, "The Closing of the Door of Ijtihād", (1974) 1 *Orientalia Hispanica*, 675-678, at 678. Others such as Jamal al-Din al-Afghani and his disciple Shaikh Muhammad Adbuh have written about the re-opening of the gates of *ijtihād*. Indeed Al-Shawkani put it succinctly when he said, "It is utter nonsense to say that Allah Almightly bestowed the capacity for knowledge and ijtihad on the bygone generations of ulema but denied it to the later generations... [the claim that the gates of *ijtihād* are closed] is the greatest lie and there is no reason in the world to vindicate it," Ali al-Shawkani, *Irshad al-Fuhul ild Tahqiq al-Haqq min 'llm al-Usūl* (Marba'at al-Sa'adah, Cairo, 1909), at 254, quoted in Kamali, Mohammad Hashim, *Principles of Islamic Jurisprudence*, note 22, at 336.

[133] A trend confirmed by Vogel and Hayes who note that *ijtihād* is "increasingly being used in Islamic banking and finance, particularly when a legal instrument or ruling is considered novel, never considered by scholars of the past," Vogel, Frank E. and Hayes, Samuel L., *Islamic Law and Finance, Religion, Risk and Return*, note 2, at 34. See also, Elshayyal, Abdulkhaliq, "A Brief Look at Ikhtilaf - Diversity of Ijtihad in Islamic Finance", (October 2010), Issue 12, *Opalesque Islamic Finance Intelligence*, 14-15, Ahmed, Abdulrahman Yousri, "The Scientific Approach to Islamic Economics: Philosophy, Theoretical Construction and Applicability", in *Theoretical Foundations of Islamic Economics*, Habib Ahmed (ed.), (Islamic Development Bank, Jeddah, 2002), 19-60 at 22-23.

[134] Rayner, Susan E., *The Theory of Contracts in Islamic Law: A Comparative Analysis with Particular Reference to the Modern Legislation in Kuwait, Bahrain and the United Arab Emirates*, note 85, at 47-48, Warde, Ibrahim, *Islamic Finance in the Global Economy*, (1st ed., Edinburgh University Press, Edinburgh, 2000), at 87.

[135] Coulson, Noel James, *Commercial law in the Gulf States: The Islamic legal tradition*, (Graham & Trotman, London, 1984), at 103 noting that a "parallel exists between the activities of contemporary Muslim

investment in institutions whose business activities involve some non-*Sharī'ah*-compliant elements, contemporary scholars looked to a Prophetic *hadīth* in which the Prophet is reported to have said "one third, and one third is plenty"[136] for charitable donations. Based on this *hadīth*, some scholars have set thresholds of non-*Sharī'ah*-compliant income which can be present in an investment.[137] Similarly a provision of the *Qur'ān* was relied on to act as the divine legitimation of *sukūk* instruments[138] which have largely been developed in the last decade.[139] Some commentators have also noted the emergence of "group *ijtihād*" in which groups of scholars meet to discuss the Islamic legal position on new issues.[140] Such resolutions are not 100% consensus, nevertheless, as Islamic finance becomes increasingly internationalised, 100% consensus is an increasingly impossible standard to achieve. Thus debate has arisen as to what now represents consensus with "reasoned and broad agreement" gaining support as a method of developing Islamic financial principles.[141] The rulings issued by the Organisation of Islamic Conferences' [OIC] Islamic Fiqh Academy in Saudi Arabia, as well as the Accounting and Auditing Organisation for Islamic Financial Institutions [AAOIFI], have both been cited evidence of this group *ijtihād*.[142] Of most

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jurispeudents and those of their predecessors in the early years of Islamic legal history. During the 7th and 8th centuries A.D. the first Islamic jurists fashioned the law of contracts by reviewing and assessing the commercial practices of their own day in the light of the norms established by the *Qur'an* and the *sunna*...The right of fresh, independent interpretation, or *ijtihad*, is now central to developing Islamic law in general and commercial law in particular."

[136] Narrated by Sad, *Sahih Bukhari*, Volume 7, Book 70, Number 572, M. Muhsin Khan (trans.), available at: http://www.usc.edu/schools/college/crcc/engagement/resources/texts/muslim/hadith/bukhari/070.sbt.html#007.070.572.

[137] See for example, the FTSE *Sharī'ah* Global Equity Index investment criteria, FTSE, *Ground Rules for the Management of the FTSE Sharī'ah Global Equity Index Series*, available at: http://www.ftse.com/Indices/FTSE_Shariah_Global_Equity_Index_Series/Downloads/FTSE_Shariah_Index_Series_Ground_Rules.pdf, El-Gamal notes that this 33% *Sharī'ah* screen is not a legal proof but rather a rule of thumb, El-Gamal, Mahmoud Amin, *A Basic Guide to Contemporary Islamic Banking and Finance*, (Rice University June 2000), at 21, McMillen, Michael J.T., "Islamic Law Forum", (2008) 42(2) *International Law* 1017-1032, at 1024.

[138] *Sukūk* structures are considered in detail in Chapter 8 – see *infra.*at 301.

[139] Wilson, Rodney, "Innovation in the structuring of Islamic Sukuk securities", Paper given at the 2nd Banking and Finance International Conference, Islamic Banking and Finance, Lebanese American University, Beirut, February 23-24, 2006 noting that "[t]he Islamic scholars have shown their willingness to apply the principles of *ijtihad* or legal adaptation to the *sukuk* now being traded" See also Venardos, Angelo M., *Islamic Banking and Finance in South-East Asia: Its Development and Future*, (2nd ed., World Scientific Publishing Co., Singapore, 2007), at 96.

[140] Baamir, Abdulrahman Yahya, *Shari'a Law in Commercial and Banking Arbitration; Law and Practice in Saudi Arabia*, note 21, at 10.

[141] Many thanks to Michael J.T. McMillen for highlighting this development.

[142] Warde, Ibrahim, *Islamic Finance in the Global Economy*, (2nd ed., Edinburgh University Press, Edinburgh, 2010), at 236-237 noting that "[i]creasingly, the old principle of ijmaa was modified to signify broad consensus or even simple majority." Maurer, Bill, "Form versus substance: AAOIFI projects and Islamic fundamentals in the case of sukuk", (2010) 1(1) *Journal of Islamic Accounting and Business Research*, 32-41 at 33.

relevance in this thesis, the pronouncements of AAOIFI,[143] an Islamic finance standard setting body, have had a noticeable impact on the Islamic finance industry. While the pronouncements remain non-binding best practice standards, they have been adopted in eight jurisdictions[144] and are used as the basis for guidelines issued by the authorities in Australia, Indonesia, Malaysia, the Kingdom of Saudi Arabia and South Africa.[145]

Contemporary Islamic finance is not, however, based solely on re-interpretations of the primary sources of Islam and in practice, the writings of the early scholars on issues of Islamic financial activity remain central to the development of the industry. As will become evident over the course of this thesis, the instruments and structures developed by the classical scholars have formed the building blocks upon which more innovative structural engineering of contemporary Islamic finance has taken place.[146] *Taqlīd* thus remains a prominent element of the Islamic finance industry. As an example of this reliance on *fiqh* writings, AAOIFI cited Ibn Qudama (the Hanbali scholar),[147] Imam Khatib al-Shirbini (the Shafi'i scholar), Sharh al-Saghir of Sidi al-Dardi, (the Maliki scholar) and Ibn al-Humaam (the Hanafi scholar) as authority when considering the Islamic legal position on online financial dealing.[148] While this use of concepts developed in antiquity has been criticised,[149] *taqlīd* provides a mechanism through which contemporary Islamic legal

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[143] The Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) was established in 1991 as an independent body charged with the issuance of standards relating to accounting, auditing, governance and *Sharī'ah* compliance of Islamic financial activities, transactions and instruments. These standards do not only consider economic matters but they must also be vetted for *Sharī'ah* compliance by AAOIFI's *Sharī'ah* supervisory board. This board brings together a cross-section of *Sharī'ah* scholars representing the various schools of Islamic law and as a result, its pronouncements seek to harmonise the potentially contradictory rulings of various national and institutional *Sharī'ah* boards. Providing a series of best practice guidelines, AAOIFI now has over two hundred members including institutions, regulators and central banks. As will be discussed in Chapter 9, despite the lack of official adoption in jurisdictions other than those set out above, AAOIFI standard number 17 and a number of other AAOIFI standards have been adopted by the industry in numerous jurisdictions.

[144] The Kingdom of Bahrain, Dubai International Financial Centre, Jordan, Lebanon, Qatar, Sudan and Syria. Pakistan has recently announced that it too will incorporate AAOIFI standards into its Islamic financial guidelines.

[145] AAOIFI will be referred to throughout this thesis with particular discussion, *infra.*at 108 (in relation to AAOIFI standards in Pakistan), 302 (AAOIFI definition of *sukūk* certificates) and 311 (which involves an extensive discussion of the AAOIFI *sukūk* clarification).

[146] Vogel, Frank E. "Ijtihad in Islamic Finance", Speech given at the Fifth Harvard University Forum on Islamic Finance (April 6-7, 2002) in *Proceedings of the Fifth Harvard University Forum on Islamic Finance - Islamic Finance: Dynamics and Development*; (Harvard Islamic Finance Program, Cambridge, 2003), 121-123 at 122.

[147] The different Schools of Islamic legal thought are discussed in more detail, *infra.* at 37.

[148] AAOIFI, Shari'a Standard No. (38), "Online Financial Dealings", in *Shari'a Standards for Islamic Financial Institutions 1432 H-2010*, (AAOIFI, Bahrain, 2010), 675-692 at 688.

[149] See generally, Hamoudi, Haider, "The Muezzin's Call and the Dow Jones Bell: On the Necessity of Realism in the Study of Islamic Law", (2008) 56 *The American Journal of Comparative Law*, 423-469. See also, Dallal, Ahmad, "Appropriating the past: Twentieth-Century Reconstruction of Pre-Modern Islamic Thought", (2000) 7(3) *Islamic Law and Society*, 325-358, at 326, noting that "[t]o many Muslim reformers as well as students of Islam, ijtihad is the landmark of modern Islamic reform."

provisions can be supported by accepted authority.[150] Reference to a classical scholar as authority adds (even perhaps only superficially) to the legitimacy of a modern development by suggesting that the correct Islamic principles are being applied faithfully.[151] The classical scholars developed certain financial structures precisely because these allowed financial activity to be conducted in a manner which was compliant with the teachings of Islamic law; any dramatic move away from such rulings by modern scholars could raise concern that the teachings of Islamic law are not being adhered to.[152] As Jackson notes, use of classical *fiqh* writings "undergird [contemporary] legal interpretations with some recognizable form of authority."[153] El-Gamal too has suggested that reliance on concepts developed in Islamic jurisprudence maintains "credibility" within the Islamic finance industry.[154]

2.4.2 Other Influences

This tendency to rely on the classical *fiqh* rather than openly "rethinking"[155] Islamic legal doctrine has resulted in contemporary scholars using other "unofficial" methods for developing Islamic legal rules.[156] These include judicial preference (*istihsān*), common good and the public interest (*istislāh* and *maslaha*), necessity (*darūra*), legal stratagem (*hila*) and patching (*talfiq*).[157] These concepts are not strictly roots of Islamic law but are, rather, methods through which the application of that law to a particular situation can be modified.[158] In a type of "quasi-*ijtihād*," contemporary scholars have relied on these devices to adjust the application of Islamic law in novel situations. *Istihsān*, *istislāh* and *maslaha* all provide Islamic scholars with an opportunity to take into account external circumstances and to attempt to achieve a "just" result where the strict application of

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[150] Jackson, Sherman A., "*Taqlīd*, Legal Scaffolding and the Scope of Legal Injunctions in Post-Formative Theory Muṭlaqand 'Āmm in the Jurisprudence of Shihāb al-Dīn al-Qarāfī", note 128, at 169.

[151] *ibid.*

[152] Whether or not this is in fact the case.

[153] Jackson, Sherman A., "Taqlīd, Legal Scaffolding and the Scope of Legal Injunctions in Post-Formative Theory Muṭlaqand 'Āmm in the Jurisprudence of Shihāb al-Dīn al-Qarāfī", note 128, at 169.

[154] El-Gamal, Mahmoud Amin, *A Basic Guide to Contemporary Islamic Banking and Finance*, note 137, at 12.

[155] Rahman, Fazlur, "Post-Formative Developments in Islam", (1962) 1(4) *Islamic Studies* 1-23, at 12.

[156] Vogel, Frank E. and Hayes, Samuel L., *Islamic Law and Finance, Religion, Risk and Return*, note 2, at 35.

[157] These devices are also used in other areas of life in order to ensure the relevance of Islamic legal provisions, however, for the purpose of this thesis, the focus in this Chapter will primarily be on their use in the context of Islamic finance.

[158] Opwis, Felicitas, "Maslaha in Contemporary Islamic Legal Theory", (2005) 12(2) *Islamic Law and Society*, 182-223 at 190, Goolman, Nazeem, "Ijtihad and its Significance for Islamic Legal Interpretation", note 131, at 1466-1467 noting that "[t]he ethical and moral precepts underlying the spirit of the Shari'ah should never be overlooked, since the dignity of Islam and its followers is founded upon its moral and ethical values."

Islamic principles may cause unnecessary hardship.[159] Judicial preference, for example, has been defined as allowing a scholar to choose between competing solutions to a problem when one is more suitable for the particular circumstances,[160] even if the other is doctrinally stronger.[161] This weaker option could be a practice of local custom (*'urf*)[162] or rules based on "that which arises spontaneously in the mind."[163] Through the use of *istislāh*,[164] scholars can achieve the result which was most suitable in the public "well-being, welfare, and social weal"[165] (*maslaha*).[166] Highlighting the usefulness of these principles in the context of Islamic finance,[167] AAOIFI has noted that while the partnership structure developed by classical scholars will apply to all modern forms of corporations, contemporary procedural systems relating to representation of partnership companies and bureaucratic, administrative and accounting procedures "are required by *maslaha*...which is an acceptable source for validating human actions...."[168] These tools allow an Islamic scholar to implement what Opwis has described as "substantive rationality in the law-finding process" without violating the teachings of Islam.[169]

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[159] Schacht, Joseph, *An Introduction to Islamic Law*, note 8, at 204, Rayner, Susan E., *The Theory of Contracts in Islamic Law: A Comparative Analysis with Particular Reference to the Modern Legislation in Kuwait, Bahrain and the United Arab Emirates*, note 85, at 28. Al-Izz Ibn Al-Salam noted that "a thorough study of the objectives of the Shari'ah with regard to the conception of al-maslahah leads to the firm conviction that whatever and whenever al-maslahah exists, it should be considered even in the absence of a specific text. This is the inevitable aim of the Shari'ah," Al-Izz Ibn al-Salam Qawaid Al-Ahkam 11:62 quoted in Ajijola, Alhaji A.D., *The Islamic Conception of Law*, (Adam Publishers & Distributors, New Dehli, 2008), at 88.

[160] Baamir, Abdulrahman Yahya, *Shari'a Law in Commercial and Banking Arbitration; Law and Practice in Saudi Arabia*, note 21, at 12.

[161] Hallaq notes that *istihsān* is a "mode of reasoning that yields reasonable results, unlike strictly logical inference such as *Qiyās* which may lead to an undue hardship." Hallaq, Wael B., *The Origins and Evolution of Islamic Law*, note 56, at 116.

[162] Shabana, Ayman, *Custom in Islamic Law and Legal Theory; The Development of the Concepts of 'Urf and 'Adah in the Islamic Legal Tradition*, (Palgrave Macmillan, New York, 2010), at 89-90.

[163] Abu Hāmed Mohammad ibn Mohammad al-Ghazzālī, *al-Mustasfa min 'ilm al-usūl* (*The Essentials of the Islamic Legal Theory*), (al-Matba'ah al-Amiriyyah, Cairo, 1322 AH/1904 AD), at 274 (5) cited in Makdisi, John, "Legal Logic and Equity in Islamic Law", (1985) 33(1) *The American Journal of Comparative Law*, 63-92 at 74.Weiss, Bernard G., *The Spirit of Islamic Law*, (University of Georgia Press, Georgia, 1998), at 86-87.

[164] Defined as "the building of *Sharī'ah* rules in accordance with the dictates of public interests, namely those interests to which *Sharī'ah* has given no consideration, neither in their individual or collective capacity, but which realize the general objectives of *Sharī'ah* in the social life of Muslims." Zarqa, Muhammad Anas, "Islamization of Economics: The Concept and Methodology", (2003) 16(1) *J.KAU: Islamic Economics*, 3-42 at 29 (internal citation omitted).

[165] Opwis, Felicitas, "Maslaha in Contemporary Islamic Legal Theory", note 158, at 183.

[166] Doi, 'Abd ar-Rahman, *Sharī'ah Islamic Law*, note 36, at 124-125.

[167] Rayner, Susan E., *The Theory of Contracts in Islamic Law: A Comparative Analysis with Particular Reference to the Modern Legislation in Kuwait, Bahrain and the United Arab Emirates*, note 85, at 25.

[168] AAOIFI, Shari'a Standard No. (12), "Sharika (Musharaka) and Modern Corporations", in *Shari'a Standards for Islamic Financial Institutions 1432 H-2010*, (AAOIFI, Bahrain, 2010), 199-230 at 221.

[169] Opwis, Felicitas, "Maṣlaḥa in Contemporary Islamic Legal Theory", note 158, at 192.

Darūra (necessity) has equally (albeit controversially) provided a valid basis for departure from even the clearest injunctions in the *Qur'ān* and *Sunnah*. Justification for the principle of *darūra* comes from the *Qur'ān* which explicitly allows consumption of forbidden food in the case necessity.[170] This necessity must, according to Vogel and Hayes "be of great severity, usually life-or-death."[171] As will be discussed in Chapter 7, *darūra* and the broader concept of *hāja* (need) have been used in contemporary Islamic financial activity, particularly in relation to Muslims living in non-Muslim countries.[172] Thus, non-Islamic mortgages have been permitted where no Islamic alternative is available[173] as "*darūra* in terms of housing relates to the protection of life and honour and *hāja* is connected to stability and peace."[174] Also on the basis of *darūra*, Islamic financial institutions have been able to deposit funds in interest-bearing accounts.[175]

Finally, and controversially, *hila*[176] (legal stratagem) and *talfiq* (the process of patching) have become prevalent means of developing Islamic financial principles without conspicuously departing from the classical *fiqh* doctrine. *Hiyal* are developed through overly formalistic reliance on legal principles to achieve a certain result[177] and are used to "circumvent legal concepts proving too ideal to be practicable."[178] Where the *hila* leads to a *Sharī'ah*-compliant result, classical scholars approved this practice.[179] However,

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[170] *Qur'ān* 2:173, "He has forbidden you only dead animals, and blood, and the flesh of swine, and that which is slaughtered as a sacrifice for others that Allah...But if one is forced by necessity without wilful disobedience nor transgressing due limits, then there is no sin on him. Truly, Allah is Oft-Forgiving, Most Merciful."

[171] Vogel, Frank E. and Hayes, Samuel L., *Islamic Law and Finance, Religion, Risk and Return*, note 2, at 38.

[172] This *fatwā* is referred to *infra.*at 202.

[173] European Council for Fatwa and Research, *Resolution 2/4: Purchasing houses with an usurious loan for Muslims living in non-Muslim countries, i.e. taking up a mortgage to buy a house*, (ECFR, Dublin, 1999), available at: http://www.e-cfr.org/en/index.php?ArticleID=285. Yusuf Al-Qaradawi issued a *fatwā* allowing Muslims in North America to finance their home purchases with conventional mortgages, but only where "there is no Islamic affordable contract" available. He based this ruling on three considerations; the opinion of Abu Hanifa that permitted dealing with interest in non-Muslim lands, the determination that the mortgagor is the primary beneficiary of a home financing and finally, the applicability of the doctrine of necessity, Fatwa issued by the First Fiqh Conference in the US and Canada, held in Detroit, Michegan, November 1999.

[174] Al-Arabi Bichri, referred to by Caeiro, Alexandre, "The Social Construction of Shari'a: Bank Interest, Home Purchase, and Islamic Norms in the West", (2004) *Die Welt des Islams* 44(3) 349-375 at 357.

[175] An example cited by Vogel, Frank E. and Hayes, Samuel L., *Islamic Law and Finance, Religion, Risk and Return*, note 2, at 38.

[176] Plural, *hiyal*.

[177] Vogel, Frank E. and Hayes, Samuel L., *Islamic Law and Finance, Religion, Risk and Return*, note 2, at 39, Schacht, Joseph, *An Introduction to Islamic Law*, note 8, at 210.

[178] Rayner, Susan E., *The Theory of Contracts in Islamic Law: A Comparative Analysis with Particular Reference to the Modern Legislation in Kuwait, Bahrain and the United Arab Emirates*, note 85, at 23.

[179] Khir, Mohamed Fairooz Abdul, "Shari'ah Parameters of Hiyal in Islamic Finance", (2010) 2(2) *ISRA International Journal of Islamic Finance*, 159-167 at 159 who also cites at 162 an example of acceptable hila; the use of financial mechanisms for liquidity management purposes, it is a permissible *hila* because without the usage of such mechanisms, the Islamic banks could not survive.

increasingly this device is being used to produce structures that comply with Islam outwardly but whose substance is little different from non-Islamic financial products.[180] *Talfiq* performs a similar function. The sources of Islamic law have anticipated and acknowledged the validity of differences of opinion; as only God can know the true content of the *Sharī'ah*, no human attempt to determine that law can be treated authoritative over all others.[181] As a result, a contemporary scholar attempting to construct a financial instrument which is *Sharī'ah*-compliant may have a range of opinions from classical scholars on what is and what is not required for that compliance. In addition to this, a scholar also has a range of sources in which legal principles have been set out. Applying the process of *takhayyur*,[182] contemporary scholars have been able to choose legal rules from a variety of different sources and to patch these rules together using *talfiq*.[183] Through this process, scholars have been able to engineer novel instruments while maintaining a connection with classical *fiqh* and the *usūl*.[184] At its extreme, this patching involves a disregard of lines of separation between the different schools of Islamic law and ignores the context and reasoning underpinning the rulings.[185] The rules are simply fused together in a manner which produces a desired result, even if that result is not advocated by any one of the sources.[186] Within contemporary Islamic finance, a instrument which has been cited as evidence of *talfiq* is the introduction of a binding promise to purchase (*wa'd*) in Islamic cost-plus sales (*murābaha* with a purchase order).[187] This promise was introduced in order to maintain competitiveness of the Islamic structure despite the fact that the classical scholars, on whose *fiqh* writings the sales contract is based, did not permit

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[180] An example sometimes cited of *hila* in Islamic finance is the *tawarruq* product in which every element of the sales agreement is compliant with Islam but the overall economic effect of the structure resembles almost exactly an interest based loan. Hegazy, Walid, "Fatwas and the Fate of Islamic Finance: A Critique of the Practice of Fatwa in Contemporary Islamic Financial Markets", in *Islamic Finance, Current Legal and Regulatory Issues*, S. Nazim Ali (ed.), (Harvard Islamic Finance Program, Cambridge, 2005), 133-149 at 143. However, there has not been universal agreement on the use of this prejorative label for *tawarruq*.

[181] See generally, Jackson, Sherman A., *On the Boundaries of Theological Tolerance in Islam: Abu Hamid al-Ghazali's Faysal al-Tafriqa* (Oxford University Press, Oxford, 2002).

[182] "[P]icking and choosing legal rules from a variety of sources," Hallaq, Wael B., "Can the Shariah Be Restored?" in Yvonne Yazbeck Haddad and Barbara Freyer Stowasser, (eds.), *Islamic law and the Challenges of Modernity*, (Rowman & Littlefield Publishers, Inc, Maryland 2004), 21–55 at 24 who defines this process as "picking and choosing legal rules from a variety of sources."

[183] *ibid.*

[184] Anderson, J. N. D., "Modern Trends in Islam: Legal Reform and Modernisation in the Middle East", note 116, at 13 noting that *talfiq* involves the "combination of part of the opinion of one school or jurist with part of the opinion of another school or jurist in such a way as to reach a result which was in fact new, although its component parts could claim the most respectable ancestry."

[185] Hallaq, Wael B., "Can the Shariah Be Restored?" in Yvonne Yazbeck Haddad and Barbara Freyer Stowasser, (eds.), *Islamic law and the Challenges of Modernity*, note 182, at 24.

[186] Nyazee notes that *talfiq* could involve "number of opinions of different schools are considered together and then pieces from each of these are lumped to form a new opinion not held by any of the schools individually," Nyazee, Imran Ahsan, "The Scope of Taqlid in Islamic Law", (1983) 22(4) *Islamic Studies*, 1-29, at 24.

[187] *infra.*at 73and 204.

binding promises within the transaction. By fusing the writings from minority scholars[188] onto Islamic jurisprudence permitting sales contracts, contemporary scholars have thus legitimated a practice which the majority of classical scholars considered to be contrary to *Sharī'ah*.[189]

The process of extrapolating and developing rules of Islamic law is therefore based on a fusion of roots and methods. While the *Qur'ān*, *Sunnah*, *ijmā'* and *qiyās* remain the dominant official roots, more unofficial influences have provided scholars with a measure of flexibility. Use of secondary mechanisms remains, however, controversial and as will be demonstrated over the course of this thesis, the *Qur'ān*, *Sunnah*, *ijmā'* and *qiyās* continue to have a discernable impact on the nature and development of the Islamic finance industry.

2.4.3 Schools of Law

Al-Shafi'i is often referred to as the "father of Islamic jurisprudence."[190] However, numerous scholars made significant contributions to the understanding of Islamic law in the two centuries following the death of the Prophet.[191] Until the systematisation of *usūl-al-fiqh*, independent reasoning limited widespread consistency in rulings. Nevertheless, groups formed around the teachings of prominent scholars.[192] By the 3rd/4th century AH/9th/10th century AD these groupings had crystallised into fully formed schools of Islamic law (*madhāhib*),[193] a development which Hallaq has described as "bringing Islamic

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[188] This purchase undertaking is considered in detail in Chapter 6 (Islamic real estate financing). Ercranbrack notes the willingness of contemporary scholars to extend the scope of the *talfiq* principle "to include any opinion put forward from any Sunni school; or even to doctrines advocated by the early jurists prior to the formulation of the madhahib, or to school doctrines which have since become extinct such as the Zahiris. On some occasions modernisers have even attempted to invoke Shi'i opinions..." Ercanbrack, Jonathan, "Accommodating the dynamism of commerce and trade: the role of custom and jurisprudential principles in commercial Islamic law", Paper presented at Re-Imagining the Shari'a: Theory, Practice And Muslim Pluralism At Play, September 13-16 2009, Warwick in Venice - The Palazzo Pesaro-Papafava, Venice.

[189] Hegazy, Walid, "Fatwas and the Fate of Islamic Finance: A Critique of the Practice of Fatwa in Contemporary Islamic Financial Markets", note 180, at 148, Vogel, Frank E. and Hayes, Samuel L., *Islamic Law and Finance, Religion, Risk and Return*, note 2, at 38, Ercanbrack, Jonathan, "Accommodating the dynamism of commerce and trade: the role of custom and jurisprudential principles in commercial Islamic law", note 188, Hegazy, Walid S., "Contemporary Islamic Finance: From Socioeconomic Idealism to Pure Legalism", (2007) 7(2) *Chicago Journal of International Law*, 581-601 at 600.

[190] See for example, D'Amato, Anthony A., *International Law Anthology, Book 1994*, (3rd ed., Anderson Pub. Co., Ohio,1994), at 134, Janin, Hunt, *The Pursuit of Learning in the Islamic World, 610-2003*, (McFarland & Company, Inc., Publishers, North Carolina, 2005), at 54.

[191] Doi, 'Abd ar-Rahman, *Sharī'ah Islamic Law*, note 36, at 131.

[192] Aghnides, Nicolas P., *Mohammedan Theories of Finance*, note 21, at 127, Hallaq, Wael B., *Shari'a; Theory, Practice, Transformations*, note 8, at 63.

[193] Plural of *madhab*. Melchert, Christopher, *The Formation of the Sunni Schools of Law, 9th-10th Centuries C.E., Studies in Islamic Law and Society* (Brill, Leiden, 1997).

law to full maturity."[194] Within Sunni Islam, four schools have come to pre-dominate and continue to espouse views on Islamic legal doctrine; the Hanafi School (founded on the teachings of Imam Abu Hanifa (d.150 AH/767 AD), the Maliki School (Imam Malik Ibn Anas d. 179 AH/795 AD), the Shafi'i School (Imam Muhammad ibn Idris al-Shafi'i d.204 AH/820 AD) and finally the Hanbali School (Imam Ahmad ibn Muhammad ibn Hanbal d. 241 AH/ 856 AD).[195] The four schools generally agree on the key tenets of Islam but a certain level of divergence is evident, with the Hanafi and Maliki schools tending to adopt a more liberal stance while the Shafi'i and Hanbali schools represent the more traditionalist and strict view of Islamic doctrines.[196]

This *ikhtilaf* (difference of opinion among jurists over legal doctrine)[197] is referred to by the sources of Islamic law in both a pejorative and approving manner. One *hadīth*, for example, notes that, "[u]nity is tantamount to (divine) mercy while dissension is torment"[198] while another, more widely propagated *hadīth* claims that, "dissension among my Companions (or in my community) is (divine) mercy."[199] In practice, and as will be discussed in Chapter 3, the classical scholars varied, along lines of affiliation to a particular *madhab*, on interpretation of economic principles in the sources of Islamic law.[200] Views on the nature and scope of these principles, the structure of compliant financial transactions and the actions of the parties in a transaction therefore fluctuate between Schools, albeit generally only on finer details. Amongst contemporary Islamic finance scholars, however, loyalty to the accumulated doctrine of a particular school appears to be increasingly less pronounced,[201] a reality highlighted by the use of *talfiq*. Differences remain with, for

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[194] Hallaq, Wael B., *Shari'a; Theory, Practice, Transformations*, note 8, at 60. Badr, Gamal Moursi, "Islamic Law: Its relation to other legal systems", (1977-1978) 26 *American Journal of Comparative Law*, 187-198 at 189 suggesting that "[t]his [the establishment of schools of thought] is a situation unprecedented in other legal systems."

[195] A fifth Sunni school, the Zahirite School no longer exists. However, contemporary scholars have at times referred to the writings of Zahiri scholars in order to provide a jurisprudential basis for a particular activity in Islamic banking and finance, Ercanbrack, Jonathan, "Accommodating the dynamism of commerce and trade: the role of custom and jurisprudential principles in commercial Islamic law", note 188.

[196] Reinhard Leopold Klarmann, *Islamic Project Finance, A legal study with particular reference to the laws of Switzerland and the United Arab Emirates*, (Schulthess, Zurich, 2003), at 26.

[197] al-Dihlawī, Walī Allāh, *al-Inṣāf fī bayān sabab al-ikhtilāf* (A rational explanation of difference of opinion in Fiqh), Muhammad Abdul Wahhab (trans.), (Ta-Ha Publishers Ltd., London, 2003), at 94.

[198] *Musnad Ahmad ibn Hanbal,* Vol. IV, Number 278, 375 in Friedmann, Yohanan, "Dissension", in *Encyclopaedia of the Qur'ān*, Volume One; A-D, Jane Dammen McAuliffe (ed), (Brill, Leiden, 2001), at 538.

[199] Quoted in Friedmann, Yohanan, Dissension, in *Encyclopaedia of the Qur'ān*, Volume One; A-D, Jane Dammen McAuliffe (ed), (Brill, Leiden, 2001), at 539, Weiss, Bernard, "Interpretation in Islamic Law: The Theory of Ijtihād", note 17, at 204.

[200] See for example, *infra.* at 70, Foster, Nicholas HD, "'Islamic Commercial Law: An Overview (I)", (2006) *InDret: revista per a analisi del dret* 4. 384, at 11.

[201] Vogel, Frank E. and Hayes, Samuel L., *Islamic Law and Finance, Religion, Risk and Return*, note 2, at 47 noting that "[e]ven the 'schools of law' that once dictated legal thought and action are now important chiefly as vehicles for organizing legal education and for the study of past views."

example, scholars in Malaysia adopting a more liberal interpretation of Islamic finance concepts than scholars in Saudi Arabia.[202] Yet broad agreement in relation to many of the basic aspects of Islamic finance is now more discernable. As a result, the Islamic finance referred to in this thesis will generally be the more standardised Islamic finance that may develop in Ireland.

2.5 Islamic Law and Terminological Correctness

Before concluding this Chapter, it must briefly be considered whether use of the word "law" and other legal terminology when discussing "Islamic law" and "*Sharī'ah*" is, in fact, correct. This Section discusses the extent to which Islamic law conforms with the Western notion of positive law (2.5.1).[203] It then moves on to the more likely classification of Islamic law as similar to natural law (2.5.2).[204]

2.5.1 Islamic Law and Positive Law

Notwithstanding its widespread translation as "Islamic *law*," *Sharī'ah* and the *fiqh* that explains it encompass and direct a far greater sphere of human activity than generally associated with the Western concept of "law."[205] Not only are fields such as crime and punishment, civil, family and commercial law covered but so too are personal acts of worship and private morality, subject not to the coercive force of the state but to the adherent's own conscience and the threat of extemporal reprisals.[206] Concerned with issues which are legal from a Western perspective as well as with morality,[207] *Sharī'ah* and *fiqh* comprise two main types of rules: *'ibādāt*, meaning ritual, and *mu'amalāt*, meaning

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[202] Anderson, Scott R., "Finance [notes]", (2010) 35(1) *Yale Journal of International Law*, 237-264 at 240, El-Gamal, Mahmoud Amin, *A Basic Guide to Contemporary Islamic Banking and Finance*, note 137, at 86-89. See Sloane, Peter D., "The Status of Islamic Law in the Modern Commercial World", (Fall 1988) 22(3) *International Lawyer (ABA)*, 743-766 at 571 for a discussion of Islamic law in Saudi Arabia.

[203] *infra.* at 39.

[204] *infra.* at 41.

[205] Katz, Marion Holmes, "Pragmatic Rule and Personal Sanctification in Islamic Legal Theory", in *Law and the Sacred*, Austin Sarat and Lawrence Douglas (eds.), (Stanford University Press, Stanford, 2007), 91-108 at 91.

[206] Abdel-Wahab, Salah-Eldin, "Meaning and Structure of Law in Islam", (1962-1963) 16 *Vanderbilt Law Review* 115-130 at 118-119, Husam Hourani, "The Three Principles of Islamic finance explained", (2004) *International Financial Law Review*, 46 at 46. Choudhury, Masudul Alam, *Islamic Economics and Finance; An Epistemological Inquiry*, (Emerald Group Publishing Limited, Bingley, 2011), at 5 noting that, "[t]he universality and uniqueness of the divine law is proved by its status of unfailing conception, formalism, and application to "everything."

[207] Coulson, N. J, "Islamic Law" in *An Introduction to Legal Systems*, John Duncan and Martin Derrett, note 48, at 54.

transactions. *'Ibādāt* rules deal with the relationship between man and God and cover purely religious matters while *mu'amalāt* rules govern the relationship between man and man and thus focus on those subjects which comprise the basic content of other legal systems.[208] The result of this dual pronged set of obligations is that Islamic doctrine indicates "not only what the individual is entitled or bound to do in law, but also what he or she ought, in conscience, to do or refrain from doing,"[209] an area with which other legal systems are unconcerned, considering it beyond their purview and more correctly placed in the realm of ethics.[210] These rules are not considered to emanate from any temporal authority; their creator is divine and beyond reproach. Consequently, the rules are often strictly moral in their content and enforcement. Even the Islamic prohibition of *ribā* (generally translated as interest),[211] a cornerstone of the Islamic banking and finance industry, does not provide any punishment for transgression which is enforceable in this life.

This conflation of rules directed both at earthly activities and at concepts of morality, in circumstances in which a higher authority creates and enforces these rules, does not accord neatly with a positivist view of law. Law, in the Islamic context, is ethically charged and transcends State and any sovereign entity in it; neither legislature nor any ruler creates *Sharī'ah* nor do they have any means of ensuring punishment in the afterlife.[212] For positive law theorists on the other hand, the existence of a law is not dependent upon its correctness or merits;[213] a law's validity as a "law" is not contingent on its moral content or conformity to a higher set of norms.[214] Radically simplified versions of early positivists, Austin and Hobbes's theses, would have law strictly so called as a command from a

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[208] Mohammed, Noor, "Principles of Islamic Contract Law", (1988) 6(1) *Journal of Law and Religion*, 115-130 at 115.

[209] Badr, Gamal Moursi "Islamic Law: Its relation to other legal systems", note 194, at 189.

[210] *ibid.*, Anderson, J. N. D., *Islamic law in the Modern World*, (New York University Press, New York, 1959), at 5 noting that "It thus covers every field of law - public and private, national and international - together with an enormous amount of material that we in the West would not regard as law at all."

[211] *Ribā* is discussed in detail, *infra.*at 53et seq.

[212] Weiss, Bernard G., *The Spirit of Islamic Law*, note 163, at 24.

[213] Austin notes that "[t]he existence of law is one thing; its merit and demerit another. Whether it be or be not is one enquiry; whether it be or be not conformable to an assumed standard, is a different enquiry." Austin, John, *The Province of Jurisprudence Determined*, (1832), W.E. Rumble, (ed.), (Cambridge University Press, Cambridge, 1995) quoted in Green, Leslie, "Legal Positivism", *The Stanford Encyclopedia of Philosophy (Fall 2009 Edition)*, Edward N. Zalta (ed.), available at: http://plato.stanford.edu/archives/fall2009/entries/legal-positivism/.

[214] Raz, Joseph, *The Authority of Law: Essays on Law and Morality* (Clarendon Press, Oxford, 1979), at 47-50.

politically superior, sovereign entity coupled with the coercive force of that law.[215] More recent positivists have focused on law as something founded on social conventions.[216] Raz, for example, has suggested that law is an authoritative social institution which has *de facto* authority simply because that law exists.[217] *Sharī'ah*, as the universal rules which only God truly knows, cannot fall within this conception of law as the validity of these Islamic rules ultimately depends on their conformity with a higher will, not social convention; to Muslims, "the Shari'a does most certainly stand outside and above the facts of social life; it unquestionably has an independent validity of its own which is not man-made."[218] As a result, a rule of *Sharī'ah* which is unenforceable on earth, and which no official authority considers to be binding, remains a valid dictate of God, the consequences of which will be felt after death.[219]

2.5.2 Islamic Law and Natural Law

Nevertheless, it is suggested that rules incumbent on Muslims can be described as Islamic "law". As already discussed, Hallaq has suggested that the *Qur'ān* embodies the moral cosmology of *Sharī'ah* and that law and morality cannot be separated.[220] This view that *Sharī'ah* is a moral law could lead to the conclusion that *Sharī'ah* and *fiqh* are similar to the Western jurisprudential concept of natural law. Natural law theories refer to notions of immutable, transcendental norms, to moral doctrine and to the substantive content of rules as elements in the determination of what constitutes a law.[221] This idea that the validity of a law depends not just on its existence but on its conformity with universal values which transcend society shares characteristics with *Sharī'ah*;[222] *Sharī'ah* represents the higher body of norms while *fiqh* is the human attempt to determine the content of those

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[215] Brown, W. Jethro, *The Austinian Theory of Law; Being and edition of lectures B and VI of Austin's "Jurisprudence," and of Austin's "Essay on the Uses of the Study of Jurisprudence" with critical notes and excursus*, (John Murray, London, 1906), at 4.

[216] Marmor, Andrei, "The Nature of Law", *The Stanford Encyclopedia of Philosophy (Spring 2011 Edition)*, Edward N. Zalta (ed.), available at: http://plato.stanford.edu/archives/spr2011/entries/lawphil-nature.

[217] Raz, Joseph, *The Authority of Law: Essays on Law and Morality* (Clarendon Press, Oxford, 1979), at 116-120, Marmor, Andrei, "The Nature of Law", *The Stanford Encyclopedia of Philosophy (Spring 2011 Edition)*, Edward N. Zalta (ed.), available at: http://plato.stanford.edu/archives/spr2011/entries/lawphil-nature.

[218] Anderson, J. N. D., *Islamic law in the Modern World*, note 210, at 8.

[219] *ibid.*

[220] *infra.* at 20.

[221] Murphy, Mark, "The Natural Law Tradition in Ethics", in *The Stanford Encyclopedia of Philosophy (Fall 2008 Edition)*, Edward N. Zalta (ed.), available at: http://plato.stanford.edu/archives/fall2008/entries/natural-law-ethics. See also Byrne, Raymond and McCutcheon, J. Paul, *The Irish Legal System*, (4th ed., Butterworths, Dublin, 2002), at 15-17.

[222] Anderson, J. N. D., *Islamic law in the Modern World*, note 210, at 8.

norms.[223] It is suggested that it is within this category of law that *Sharī'ah* falls.[224] It is not "law" according to the West's general conception of law yet it is, for many Muslims, the divine norms to which they must conform and against which their actions will be judged.[225]

The *fiqh* literature, then, represents elucidation and explanation of this law, transforming it into a more concrete set of rules. Such rules are merely emanations of God's teachings,[226] and so *fiqh* is not positive law because, as Sfeir notes, it shares "with other transcendental laws the attributes of immutability and exclusivity-attributes that stand in contradistinction to those of modern secular laws, which are autonomy and generality."[227] *Fiqh* is simply a temporal expression of the Islamic legal principles found in *Sharī'ah*. Consistent with this, in the absence of a specific decision by a state or other official authority to enforce the views of classical scholars as positive norms, the rules set out in the texts of *fiqh* remain morally coercive only on those who believe; beyond this they have no temporal authority.

Sharī'ah and *fiqh* therefore together form the "Islamic law" referred to by commentators and so the notion of Islamic "law" (albeit natural law) is not incorrect. While *fiqh* generally contains the substantive rules which can be implemented by participants in an Islamic financial transaction, those rules ultimately rely for their

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[223] Anderson has suggested that the fit is not seamless; first, natural law is often treated as inherent in the universe and consisting of principles about the universe that are "logically unavoidable." Such principles deal with what is inherently good and inherently bad and when applied in the context of religion, these principles dictate God's actions; God encourages that which is inherently good and prohibits that which is inherently bad. In Islam however, there are no *a priori* considerations for God; the law emanates entirely from God's will. As a result, what is inherently good under the *Sharī'ah* is such only because God has said so and what is inherently evil is evil because God forbid it. The second problem with natural law concepts is the notion within these theories that man is capable of rationally determining the content of that law. Within Islam however, man is incapable of knowing the true content of the *Sharī'ah* and so, in the absence of divine revelation, cannot know what is right and what is wrong, *ibid.*, Emon, Anver M., "Natural Law and Natural Rights in Islamic Law", (2004-2005) 20 *Journal of Law & Religion*, 351-395 at 351.

[224] Ahmad, Imad-ad-Dean, "On Natural Law and Sharī'ah", Paper presented at the IIIT Summer Institute 2009 on "Contemporary Approaches to Qur'ān and Sunna," August 3 2009, Saleh, Nabil, "The Law Governing Contracts in Arabia", (1989) 38 *International and Comparative Law Quarterly*, 761-787 at 781.

[225] Hallaq suggests that Western commentators cannot judge Islamic law against western notions of "law" and expect it to "measure up against what *we* consider to be 'our' supreme model," Hallaq, Wael B., *Shari'a; Theory, Practice, Transformations*, note 8, at 1-3.

[226] Hallaq notes that, "[l]ike any system of interpretation, usul al-fiqh starts from given or self-evident premises. The decisive fact about these premises is that, while they are humanly conceived, they must strive to express what is thought by the *human mind* to be God's law. In short, they are bound by the unalterable proposition of the divine origins of that law. This basic but crucial fact restricts, on the one hand, the range of possible interpretations, yet allows, on the other, a wide spectrum of interpretative possibilities within the divine limitations of the law. Hallaq, Wael B., "Usul al-Fiqh: Beyond Tradition", (1992) 3(2) *Journal of Islamic Studies*, 172-202 at 178.

[227] Sfeir, George N., "Source of Law and the Issue of Legitimacy and Rights", (1988) 42(3) *Middle East Journal*, 436-446 at 441.

legitimacy on the *Sharī'ah*.[228] Nevertheless, "*Sharī'ah*" and "Islamic law" are now frequently used interchangeably and in preference to *fiqh* by commentators; a similar approach will be relied on throughout this thesis.

2.6 Conclusion to Chapter 2

Islamic law today represents a set of rules which are neither strictly positive in the Western sense of the term nor entirely divine in origin. Instead, Islamic law has developed though a variety of sources (2.3)[229] and interpretative methodologies (2.4)[230] into a comprehensive blueprint for Muslim life. This law stands as the human attempt to elucidate God's law, and its principles which are relevant to financial activity represent the core source of guidance in the contemporary Islamic finance industry.

The impact of Islamic law extends, of course, beyond financial activity and touches on every aspect of a Muslim's life. The teachings which have been deduced by scholars set out how a Muslim should conduct their worldly activities in a manner which upholds, and is in conformity with, God's will. Though a central component of the Islamic religion, Islamic law is of relevance not simply in Muslim countries. Today, there are approximately 1.8 billion Muslims in the world,[231] just under a quarter of the global population. While it could be assumed that the scope of the Islamic law is limited to the Islamic world, or indeed solely to the Middle East, the global Muslim population spans numerous races, nationalities and cultures. In practice, only 20% of Muslims live in Arab countries.[232] The world's largest Muslim community is found in Indonesia,[233] and substantial parts of Asia and much of Africa are Muslim, while significant Muslim minorities are also found in China, Eastern Europe and Russia. The Muslim diaspora has also grown significantly in

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[228] Foster, Nicholas H. D., "Islamic Perspectives on the Law of Business Organisations I: An Overview of the Classical Sharia and a Brief Comparison of the Sharia Regimes with Western-Style Law", (2010) 11(1) *European Business Organization Law Review*, 3-34 at 8.

[229] *supra.*at 17.

[230] *supra.*at 26.

[231] Major religions of the World Ranked by Number of Adherents, available at: http://www.adherents.com/Religions_By_Adherents.html#Islam

[232] Esposito, John L., *What Everyone Needs to Know About Islam*, (2nd ed., Oxford Univertisty Press, Oxford, 2011), at 4.

[233] CIA, The World Factbook 2011, available at: https://www.cia.gov/library/publications/the-world-factbook/geos/id.html, Ariff, Mohamed, "Islamic Banking: A South Asian Perspective", in *Islamic Banking in Southeast Asia*, Mohamed Ariff (ed.), (Institute of Southeast Asian Studies, Singapore, 1992),194-213 at 209.

recent years with large Muslim communities emerging in Western Europe and the Americas.[234]

Because of the all-encompassing nature of Islam, the applicability of its tenets and beliefs is not limited geographically to Islamic nations. Indeed, "to Allah belongs the East and the West. Wherever you turn there is the presence of God,"[235] and so wherever a Muslim is located, he or she must continue to live in accordance with the teachings of Islamic law. Only in the most exceptional circumstances can a Muslim disregard his or her religious beliefs where no other choice is available.[236] Essentially in Islam it is the responsibility of all Muslims to adhere to the religion's teachings whether they are in a non-Islamic state, a state with a majority Muslim population but in which secular law is imposed or in an Islamic state where religion is the principal, if not the sole source of reference.

In practice, many[237] Islamic states do not fully apply Islamic law. They do, however, apply a hybrid *Sharī'ah*/secular set of principles[238] in which some codification has taken

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[234] Michaels, Adrian, "Muslim Europe: the demographic time bomb transforming our continent", *The Telegraph*, August 8, 2009, available at: http://www.telegraph.co.uk/news/worldnews/europe/5994047/Muslim-Europe-the-demographic-time-bomb-transforming-our-continent.html noting that Europe's Muslim population has doubled in the past 30 years and will double again by 2015. The UK Office for National Statistics states that at the last census (2001) the UK Muslim population was over 1.5 million, Office for National Statistics, *Religious Populations*, available at: http://www.statistics.gov.uk/cci/nugget.asp?id=954, Schumann, Christoph, "*A Muslim 'Diaspora' in the United States?*", (2007) 97(1) *The Muslim World* 11-32 in which Schumann details the growth of the Muslim diaspora in the US.

[235] *Qur'ān* 2:115

[236] "When angels take the souls of those who die in sin against their souls, they say: In what plight were you? They replied: Weak and oppressed were we in the earth. They say: Was not the earth of God spacious enough for you to move yourselves away from evil? Such men will find their abode in Hell; what an evil refuge! Except those who are really weak and oppressed - men, women and children, who have no means in their power, nor a guide-post to direct their way. For these, there is hope that God will forgive: For God does blot out sins and forgive again and again." *Qur'ān* 4:97-100

[237] Saudi Arabia represents one of the few states in which Islamic law represents the law of the land. See *infra.*at 412, for a discussion of the implications of this in the context of Islamic finance.

[238] This raises problems as regards the interaction between the two forms of law. For example, in the United Arab Emirates [UAE], art 1(1) of the Civil Code indicates that judges should only pass judgment in relation to civil matters in accordance with the *Sharī'ah* where there is no relevant provision in the Civil Code, although art 2 of the Civil Code states (in translation) that "[t]he rules and principles of Islamic jurisprudence ('fiqh') shall be relied upon in understanding, constructing and interpreting" the provisions of the Civil Code. In Abu Dhabi, a case was referred to the Abu Dhabi Appeal Court regarding the Abu Dhabi Alcoholic Drinks Law 1976. The penalties imposed by the law (i.e. by Abu Dhabi's codified civil law) appeared to be in conflict with those imposed by *Sharī'ah*. The court circumvented this problem by suggesting that while *Sharī'ah* prescribes a punishment for consumption of liquor, the crime of public drunkenness (for which a penality was established by the 1976 Law) was not subject to any specific penalty under *Sharī'ah* and so the Abu Dhabi law was not in violation of Islamic law, 1982 Case 1/Year 8 UAE Gazette No. 100. In a later case published in UAE Gazette 135/2004 the Abu Dhabi Constitutional Division of the Supreme Court emphasised the supremacy of *Sharī'ah* and noted that the 1976 Law penalty was not in conflict with *Sharī'ah* but acted as an additional penalty on top of that prescribed by Islamic law. Both cases

place, yet the principles of Islamic law continue to influence and delimit the content of those codes.[239] In contrast, the requirement to abide by Islamic law may be difficult for Muslims living in non-Muslim countries.[240] A unique legal system, which should be applied regardless of geographical location, is not a feature of most minority groups in Western countries and "whilst Islamic law contains practical guidance on the manner in which Muslims should live, Western courts have been reluctant to recognise the Shariah as an independent system of law capable of governing the relationship between parties."[241] Acceptance of Islamic legal principles in non-Muslim countries therefore has been slow, limited and controversial.[242]

Increasingly however, numerous countries, both Muslim and non-Muslim, have specifically sought to regulate and harmonise the treatment of Islamic financial products within their economies.[243] Islamic finance thus represents one of the few latter-day manifestations of Islamic legal principles which have garnered broad, and growing, recognition across the world. Even in jurisdictions where religion has been largely removed from the public sphere and has taken on a private, voluntary role in the lives of citizens, Islamic finance has at times been openly facilitated and publicly promoted by Government authorities.[244] It could, somewhat flippantly, be said that Islamic finance is one of the "success stories" of Islam in the West. Chapter 3 will consider the principles of

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are discussed in, Ballantyne, W.M., *Commercial Law in the Arab Middle East: The Gulf States*, (Lloyd's of London Press Ltd, London, 1986), at 61.

[239] *ibid.*, at 64.

[240] Traditionally known as *Dar al-Harb* (Place of War) as opposed to *Dar al-Islam* (Place of Islam). The continuing correctness of this distinction has been subject to some controversy, see Visser, Hans, *Islamic finance: Principles and Practice*, (Edward Elgar Publishing Limited, Cheltenham, 2009), at 20-23.

[241] Hainsworth, Antony, "Governance rules for Islamic financial institutions: the new frontier?" (2007) 9 *Journal of International Banking and Finance Law* 515-520 at 515. See for example *Shamil Bank of Bahrain v Beximco Pharmaceuticals Ltd* [2004] 1 Lloyd's Rep 1 where the court noted that "most of the classical Islamic law on financial transactions is not contained as "rules" or "law" in the Qur'an and *Sunnah* but is based on the often divergent views held by established schools of law formed in a period roughly between 700 and 850 CE," [2004] 1 Lloyd's Rep 1 at [30]. This case and the enforceability of *Sharī'ah* in a non-Islamic court are discussed below in more detail *infra.*at 389 et seq.

[242] See for example the attempt in Canada to allow Islamic couples to obtain legally binding decisions from private tribunals applying *Sharī'ah* law. Cheadle, Bruce, "*Protests Set to Oppose Sharia Law*", *The Toronto Star*, September 6, 2005, at A02, Yelaja, Prithi and Benzie, Robert "*McGuinty: No Sharia Law*", *The Toronto Star*, September 12, 2005, at A01.

[243] Islamic countries continue to represent a large market for Islamic financial activity, however Western economies, particularly the United Kingdom and Luxembourg, have emerged as important centres for *Sharī'ah*-compliant transactions. Toan, Robert, "Cross-Border *Ijarah*; A Case study in the US Taxation of Islamic Finance", in *Third Harvard Islamic Proceedings.* Cambridge: Harvard Islamic Finance Program, 2000, 191–197.

[244] France for example has restricted certain overt signs of adherence to Islam (Vaïsse, Justin, "Veiled Meaning: The French Law Banning Religious Symbols in Public Schools", *US-France Analysis Series* (The Brookings Institution, Washington DC, 2004) while concurrently publishing tax rules which clarify the tax treatment of certain Islamic finance products and ensure tax their tax neutrality with conventional financial products, Mahlknecht, Michael, and Hassan, Kabir, *Islamic Capital Markets: Products and Strategies*, (John Wiley & Sons, West Sussex, 2011), 347.

Islamic law which underpin this financial activity. These rules are the theological norms upon which the Islamic finance industry rests and the structural parameters of *Sharī'ah*-compliant financial activity. They distinguish Islamic financial activity from conventional, secular alternatives and are the basic reason why a discrete Islamic finance industry exists.

Chapter 3

Principles of Islamic Finance, Contracts and Development

3.1 Introduction

Islamic finance, as practised today in Muslim and non-Muslim nations, is an industry which actively publicises its adherence to the principles of Islamic law and its connection with the roots of that law discussed in Chapter 2.[1] As one commentator has noted, the industry involves, "modern banking [and finance] based on medieval Islamic legal doctrines as interpreted, modified and implemented by competent Islamic legal authorities."[2]

Though references to economic principles in the *Qur'ān* and *Sunnah* are often obscure and dispersed, the *Qur'ān* contains explicit approval of the interrelationship between economics and religion when it notes that "Allah has permitted trading,"[3] and when it calls on Muslims to "spend their wealth (in Allah's Cause)."[4] However, adherence to doctrine does not arise simply through a change in terminology; a transaction is not *Sharī'ah-*

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[1] HSBC Amanah, to take just one example, notes that "[i]In developing our products and services, we are committed to the highest Shariah standards in the Islamic banking industry," HSBC Amanah, "Our Vision", *Islamic Banking*, available at: http://www.hsbcamanah.com/amanah/about-amanah/islamic-banking/our_vision.html. *Supra.*at 18, 21, 24 at 26 for a discussion of each "official" root of Islamic law.

[2] Ray, Nicholas Dylan, *Arab Islamic Banking and the Renewal of Islamic Law*, (Graham & Trotman, London, 1995), at 3.

[3] *Qur'ān* 2:275, Pervez, Imtiaz, "Islamic Finance", (1990) 5(4) *Arab Law Quarterly*, 259-281. Economic issues are dealt with extensively by the *fiqh* writers who have expanded greatly on application of *Sharī'ah* principles in the commercial world as well as provided commentary on how Islam's basic tenets can be most faithfully applied in commercial dealings.

[4] *Qur'ān* 2:274. See also, *Qur'ān* 4:29, "O ye who believe! Devour not your property among yourselves in vanities; but let there be commerce among you by mutual goodwill," *Qur'ān* 17:26-27.

compliant on the basis solely that it is deemed to be such by market participants. Instead, *Sharī'ah*-compliance (whether substantive or structural) comes through fulfilment of directions set out in the sources of Islamic law and developed in the *fiqh* writing of the classical Islamic scholars. These directions are frequently unique to Islamic financial activity and continued adherence to them today establishes Islamic finance as a distinct segment of the financial market. Effectively, the industry justifies its existence, and separates itself from non-Islamic finance, through the use of rules prescribed directly or indirectly by Islamic law as the touchstone of acceptable behaviour in economic matters.

The primary focus of this compliance occurs at basic contractual level, with contracts conforming with Islamic principles representing the starting point for the development of complex financial instruments which adhere to Islam.[5] A single *Sharī'ah*-compliant contract can therefore be used in a variety of different financial products and services. Because of this, national authorities considering the integration of Islamic financial activity within their legal system have repeatedly focused on the contractual basis for this activity, attempting to determine the interaction between existing legal provisions and the unique characteristics of Islamic contracts. This Chapter considers central elements which define Islamic financial activity. It first introduces the requisite elements of an Islamic contract, (3.2).[6] It considers Islamic law's positive injunctions relating to contractual relationships (3.2.1)[7] and then the negative injunctions of Islamic law which are relevant to Islamic financial activity (3.2.2).[8] Due to the influence which the negative injunctions have on contemporary Islamic finance, discussion in Section 3.2 will focus on these. Building upon this discussion Section 3.3 considers the emergence and growth of the contemporary Islamic finance industry (3.3.1)[9] and the various contracts devised by Islamic scholars, and used by participants in that industry, in order to comply with Islamic law (3.3.2).[10] Chapter 3 thus stands as the link between the all-encompassing Islamic law discussed in Chapter 2[11] and the financial activities considered in Chapters 6 to 9.

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[5] Ainley, Michael, Mashayekhi, Ali, Hicks, Robert, Rahman, Arshadur and Ravalia, Ali, *Islamic Finance in the UK: Regulation and Challenges*, (Financial Services Authority, London, 2007), at 5.

[6] *infra.*at 49.

[7] *infra.*at 49.

[8] *infra.*at 52 et seq.

[9] *infra.*at 65.

[10] *infra.*at 69 et seq.

[11] Hourani, Husam, "The Three Principles of Islamic Finance Explained", (2004) *International Financial Law Review*, 46 at 46.

3.2 Elements of an Islamic Contract

3.2.1 Positive Injunctions

That "Islamic law knows no general theory of contract"[12] is a frequently recited adage in literature on Islamic finance. Attributed by some to "primitiveness"[13] or to the premature closing of the gates of *ijtihād*,[14] Islamic law does not contain a separate category of legal rules applicable to contracts. Neither the *Qur'ān* nor the *Sunnah* contains a single, discernable theory guiding contractual relations; verses relating to contract and commerce are instead scattered throughout the texts.[15] Similarly, the *fiqh* literature generally does not treat the law of contract as an umbrella concept encompassing various different contractual relationships.[16] Instead, contractual issues were dealt with on a casuistic basis[17] through which scholars concerned themselves with specific contract forms rather than exploring a theory of contract in the abstract.[18]

However, as Rayner notes, "[t]he fundamental principles which lie at the root of all commercial operations in any legal system, not excluding Islamic law, are to be found in the principles governing the law of contract and the regulations of obligations arising

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[12] See for example, Rayner, Susan, *The Theory of Contracts in Islamic Law: A Comparative Analysis with Particular Reference to the Modern Legislation in Kuwait, Bahrain and the United Arab Emirates*, (Graham & Trotman, London, 1995), at 86, Vogel, Frank .E. and Hayes, Samuel.L., *Islamic Law and Finance, Religion, Risk and Return*, (The Hague, Kluwer Law International, 1998), at 97, Udovitch, Abraham L., *Partnership and Profit in Medieval Islam*, (Princeton University Press, Princeton, 1970), at 86, Hamoudi, Haider Ala, "The Death of Islamic Law", (2009-2010) 38 *Georgia Journal of International and Comparative Law*, 293-339 at 308.

[13] Hassan, Hussein, "Contracts in Islamic Law: The Principles of Commutative Justice and Liberality", (2002) 13(2) *Journal of Islamic Studies*, 257-297 at 259 discussing the views of Coulson, Noel J., *Commercial law in the Gulf States: The Islamic legal tradition*, note 14, at 17.

[14] de Jonge, Alice, *Islamic Law and the Finance of International Trade*, (Monash University, Working Paper 96/4, 1996), at 6, Coulson, Noel J., *Commercial law in the Gulf States: The Islamic legal tradition*, (Graham & Trotman, London, 1984), at 17.

[15] Hassan, Hussein, "Contracts in Islamic Law: The Principles of Commutative Justice and Liberality", note 13, at 257-258.

[16] Hallaq, Wael B., *Shari'a; Theory, Practice, Transformations*, (Cambridge University Press, Cambridge, 2009), at 239.

[17] Johansen, Baber, "Casuistry: Between Legal Concept and Social Praxis", (1995) 2(2) *Islamic Law and Society*, 135-156, at 155-156 noting that "[t]he classical texts of Muslim law do not lend themselves to speculative logical deductions from legal concepts. The manner in which legal concepts relate to each other and the determination of the limits of the concepts' validity must be studied through the casuistry concerning them."

[18] Saleh, Nabil, "Definition and Formation of Contract under Islamic and Arab Laws", (1990) 5(2) *Arab Law Quarterly*, 101-116, at 101, Habachy, Saba, "Property, Right, and Contract in Muslim Law", (1962) 62(3) *Columbia Law Review*, 450-473 at 459 noting that, "[w]hile the old schools of Islamic law wrote extensive volumes on specific contracts, such as sale, lease, and hire, it might appear that they left little that can be called a systematic exposition of the principles governing contracts generally."

therefrom."[19] Consistent with this, it is suggested that Islamic law is not *devoid* of principles relevant to contracts and contractual relationships.[20] Rather than developing a single theory of contract, Islamic law has been interpreted by scholars as setting out generalised conditions which are present in valid contracts as well as moral injunctions relating to contractual activity. Most significantly, Islamic law also outlines elements which must be avoided in *Sharī'ah*-compliant contracts.[21]

On a basic structural level, pre-requisites have been acknowledged by commentators as necessary for a contract to be valid under Islamic legal principles:[22] the parties must be legally competent to enter into a contract, with such capacity relating to intellectual and physical maturity.[23] There must also be a valid offer and acceptance which can be made either in writing (*bi'l-kitābah*) or orally (*bi'l-kalām*)[24] and which can be express or implied. The offer and acceptance must both take place in the context of a *majlis al'aqd* ("session of the contract")[25] with no unreasonable time lag between the exchange of offer and acceptance.[26] Finally, once the offer is accepted, a contract is created,[27] as long as the

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[19] Rayner, Susan E., *The Theory of Contracts in Islamic Law: A Comparative Analysis with Particular Reference to the Modern Legislation in Kuwait, Bahrain and the United Arab Emirates*, note 12, at 86.

[20] Doi, 'Abd ar-Rahman, *Shari'ah Islamic Law*, revised and expanded by 'Abdassamad Clarke, (Ta-Ha Publishers, London, 2008), at 550 *et seq.*

[21] Foster, Nicholas H.D., "Islamic Perspectives on the Law of Business Organisations I: An Overview of the Classical Sharia and a Brief Comparison of the Sharia Regimes with Western-Style Law", (2010) 11 *European Business Organization Law Review*, 3-34 at 8. While the term '*acq* (plural: '*uqūd*), often used in Islamic law to describe contracts, covers every conceivable type of obligation, both between God and man and amongst men, the relevant principles of Islamic law will be considered in this Chapter in the context of financial activity, a task facilitated by the fact that *fiqh* writers have developed the principles set out in the sources of Islamic law into prescriptive rules which are relevant to the contracts underpinning Islamic financial transactions. Hassan, Hussein, "Contracts in Islamic Law: The Principles of Commutative Justice and Liberality", note 13, at 257, Mohammed, Noor, "Principles of Islamic Contract Law", (1988) 6(1) *Journal of Law and Religion*, 115-130 at 116.

[22] See for example, Schacht, Joseph, *An Introduction to Islamic Law*, (Clarendon Press, Oxford, 1964), at 145.

[23] *Qur'ān* 4:6, "Prove orphans till they reach the marriageable age (physical maturity) then if you find them of sound judgment (intellectual maturity), deliver over unto them their fortune." Doi cites *fiqh* literature in support of this view; ash-Shafi, *Kitab al-umm*, vol. 3 at 194, *al-Mughni*, vol. 4 at 525, al-Kashani, *Bada'i as-sana'i*, vol. 1, at 170, in Doi, 'Abd ar-Rahman, *Shari'ah Islamic Law*, note 20, at 553.

[24] The *Qur'ān* emphases the usefulness of written contracts, yet makes their use optional; 'O ye who believe! When ye deal with each other, in transactions involving future obligations in a fixed period of time, reduce them to writing. Let a scribe write down faithfully as between the parties: let not the scribe refuse to write: as God has taught him, so let him write… But if it be a transaction which ye carry out on the spot among yourselves, there is no blame on you if ye reduce it not to writing.' *Qur'ān* 2:282, this leniency is likely to stem from the fact that such contractual forms were not regularly practiced during the Prophet's time, Saleh, Nabil, "Remedies for Breach of Contract under Islamic and Arab Laws", (1989) 4(4) *Arab Law Quarterly*, 269-290 at 270.

[25] Coulson, Noel J., *Commercial law in the Gulf States: the Islamic legal tradition*, note 14, at ix, Hallaq, Wael B., *Shari'a; Theory, Practice, Transformations*, note 16, at 243.

[26] See Ayub who highlights the fact that the session of the contract does not necessarily have to take place at a single sitting, Ayub, Muhammad, *Understanding Islamic Finance*, (John Wiley & Sons Ltd., West Sussex, 2007), at 107.

[27] Mohammed, Noor, "Principles of Islamic Contract Law", note 21, at 128.

object of the contract and consideration are lawful under Islamic law.[28] While these principles do not constitute a complete law of contract, they offer parties a checklist of essential components of a valid Islamic contract which is relatively similar to that found in Western notions of contractual arrangements.

The religious underpinnings of Islamic financial contracts also result in an emphasis on ethical behaviour amongst participants in a transaction. Referring to the code of moral behaviour which Islamic law sets out for those conducting business and trade,[29] Rayner highlights a number of positive exhortations which, she notes, "can be categorized as those directing meticulous honesty, consideration and delicacy in business relations and, above all, fair dealing."[30] Consistent with this, the *Qur'ān* calls on adherents to "deal justly,"[31] to "give full measure when you measure"[32] and not to "eat up...one another's property unjustly"[33] in trading contracts. Islamic law also enjoins Muslims to "fulfil [all] obligations,"[34] and to display honesty as "[t]he truthful and honest merchant shall be with the prophets."[35] This emphasis on fairness and integrity in financial activity is reflective of the broader position of Islam in relation to justice which the *Qur'ān* describes as being

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[28] Sahnun, al-mudawwanah al-kubra, 15:197, ash-Shatibi, al-Muwafaqat fi *usūl* ash-shariah, vol. 2 at 248-264, al-Kashani, Bada'i as-sana'i at 7, 171, all cited in Doi, 'Abd ar-Rahman, *Shari'ah Islamic Law*, note 20, at 551.

[29] *ibid.*, at 542.

[30] Rayner, Susan E., *The Theory of Contracts in Islamic Law: A Comparative Analysis with Particular Reference to the Modern Legislation in Kuwait, Bahrain and the United Arab Emirates*, note 12, at 80, Ayub, Muhammad, *Understanding Islamic Finance*, note 26, at 43 noting that Islamic law "has prescribed a number of...norms and boundaries in order to avoid inequitable gains and injustice."

[31] *Qur'ān* 5:1.

[32] *Qur'ān* 17:35.

[33] *Qur'ān* 2:188.

[34] *Qur'ān* 5:1. See also; *Qur'ān* 17:34 and *Qur'ān* 6:153, a concept reiterated in the Sunnah, "The Messenger of Allah said 'Reconciliation between Muslims is permissible except a reconciliation which prohibits the permissible [halal] and permits the impermissible [haram]. Muslims are bound to the conditions which they agree to, except for a condition which prohibits the permissible [halal] and permits the impermissible [haram]'" Ibn Hajar: al-Tirmidhi declared it sahih, Reported by al-Tirmidhi and al-Daraqutni, in the *Harvard Law School, Islamic Finance Project Shari'a Database*, available at: http://ifp.law.harvard.edu/databank/hadith_details/?id=510&term=Contract&hid=135,137,139,474,510. See also, *Sahih Bukhari, Volume 3, Book 34, Number 364,* M. Muhsin Khan (trans.), available at: *http://www.usc.edu/schools/college/crcc/engagement/resources/texts/muslim/hadith/bukhari/034.sbt.html#003.034.364.*

[35] *Sahih Tirmidhi*, Number 2796, cited in Iqbal, Zafar, "Contemplating an Islamic Theory of Justice: Situating Tradition Amidst Modernity", (2006) 10(1) *Review of Islamic Economics*, 91-121 at fn 10 and Ayub, Muhammad, *Understanding Islamic Finance*, note 26, at 65.

"nearest to piety"[36] in terms of importance to the Islamic faith.[37] In financial activity, this concept manifests itself in existence of norms which "command good" and "forbid evil."[38]

3.2.2 The Prohibitions of Islamic Finance

Islamic law's positive injunctions are, however, of arguably secondary importance[39] in relation to development of financial contracts which are distinctly Islamic. In practice, the structure of Islamic financial contracts is significantly restricted and dictated *ex ante* by prohibitions outlined in the *Qur'ān* and *Sunnah*, and developed by the *fiqh* writers;[40] Islamic finance is, as El-Gamal noted, "a prohibition-driven industry."[41] These prohibitions relating to *ribā* (unjustified increase)(A),[42] *maysir* (gambling), *gharar* (excessive uncertainty)(B)[43] and *haram* (forbidden) activities (C),[44] identify those elements of commercial activity which are contrary to Islamic law and invalid. This dominance of prohibitions arises, it is suggested, from the *ibādāt/mu'āmalāt* distinction referred to in Chapter 2.[45] Based on the general rule of permissibility, all activities falling under the heading of *mu'āmalāt* - which includes commercial and financial activity[46] - are permitted by Islamic law unless they are prohibited.[47] When dictating the *Qur'ān* and in his daily conduct and sayings, the Prophet made "*ad hoc*"[48] adjustments to established financial practice in circumstances where that practice did not conform to the religious principles he

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[36] *Qur'ān* 5:8, DeLorenzo, Yusuf Talal, "The Religious Foundations of Islamic Finance", (2000), 60 *Jurist*, 137-161 at 140.

[37] Farooq, Mohammad Omar, "Stipulation of Excess in Understanding and Misunderstanding riba: The Al-Jassas Link", (2007) 21 *Arab Law Quarterly*, 285-316 at 286.

[38] Kuran, Timur, "Islamic Economics and the Islamic Subeconomy", (1995) 9(4) *Journal of Economic Perspectives*, 155-173 at 159, *Qur'ān*, 9:71.

[39] A reality which some commentators are unhappy with, see Asutay, Mehmet, "Conceptualisation of the Second Best Solution in Overcoming the Social Failure of Islamic Banking and Finance: Examining the Overpowering of HomoIslamicus by Homoeconomicus", (2007) 15(2) *IIUM Journal of Economics and Management*, 167-195. See also,the form over substance discussion *infra.*at 146et seq.

[40] Ayub, Muhammad, *Understanding Islamic Finance*, note 26, at 43.

[41] El-Gamal, Mahmoud Amin, *A Basic Guide to Contemporary Islamic Banking and Finance*, (Rice University June 2000), at 8. See also, Schacht, Joseph, "Riba," *Encyclopaedia of Islam,* P. Bearman, Th. Bianquis, C.E. Bosworth, E. van Donzel and W.P. Heinrichs, (eds.), (2nd ed., Brill Online, Leiden, n.d.), available at: http://www.brillonline.nl/subscriber/entry?entry=Islam_COM-0918.

[42] *infra.*at 53.

[43] *infra.*at 59.

[44] *infra.*at 62.

[45] *supra.*at 40.

[46] Nasir, Jamal J., *The Islamic Law of Personal Status*, (2nd ed., Graham & Trotman, London, 1990), at 5

[47] *Ibādāt* rules operate on the basis that nothing is permitted unless it is expressly permitted, Noor Mohammed, "Principles of Islamic Contract Law", note 21, at 116 noting that "Sharia becomes of importance when temporal transactions are caught within its prohibitions or come under its disapproval." Ibn Taymiyyah, *Majmu al-Fatwa al-Kubra*, cited in Ayub, Muhammad, *Understanding Islamic Finance*, note 26, at 105.

[48] Anderson, J.N.D., "Recent Developments in Shari'a Law", (1950) 40(4) *The Muslim World*, 244-256 at 245.

was expounding.[49] Where an existing contract, transaction or activity contradicted Islamic law, therefore, it was explicitly condemned. Where it did *not* violate Islam, it remained valid, even where that validity was not specifically approved by the Prophet or his Companions. Today, the prohibitions established in Islamic law represent a, if not the, defining feature of the Islamic finance industry; it is because of these prohibitions that parties engaged in Islamic financial activity may face legal obstacles when conducting that activity in a non-Islamic economy.[50]

A. *Ribā*

The first and most infamous prohibition in Islamic financial activity is that of *ribā*. The activity of taking "*ribā*" is emphatically forbidden by *Sharī'ah*, with both the *Qur'ān* and *Sunnah* classifying it as a grave sin resulting in retribution on death.[51] The *Qur'ān* provides "that they took *ribā*, though they were forbidden; and that they devoured men's substance wrongfully. We have prepared for those among them who reject faith, a grievous punishment."[52] The *Qur'ān* also notes that "those who devour *ribā*... will not stand (on the Day of Resurrection) except as stands a person beaten by Satan leading him to insanity."[53] Similarly, one of numerous *hadīth* condemning *ribā* provides that "[t]he Prophet...said: 'On the night of Ascension I came upon people whose stomachs were like houses with snakes visible from the outside. I asked Gabriel who they were. He replied that they were people who had received *ribā*.'"[54]

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[49] Rayner, Susan E., *The Theory of Contracts in Islamic Law: A Comparative Analysis with Particular Reference to the Modern Legislation in Kuwait, Bahrain and the United Arab Emirates*, note 12, at 83-84.

[50] As Muhammed Al-Jasser, governor of the Saudi Arabian Monetary Agency noted, "[w]e have richness in diversity . . . . Everything is permissible unless it is shown to contravene Islamic tenets. Someone has to tell me if and how it contravenes explicitly. In fact, most conventional financial products are fine . . . . Regulators and supervisors are not religious scholars. They are in charge of financial stability. The safety of the institution is paramount," quoted in Parker, Mushtak, "Islamic Finance is Growing at a Phenomenal Pace: Al-Jasser", *Arab News*, November 30, 2009, available at: http://archive.arabnews.com/?page=6&section=0&article=128946.

[51] Rayner, Susan E., *The Theory of Contracts in Islamic Law: A Comparative Analysis with Particular Reference to the Modern Legislation in Kuwait, Bahrain and the United Arab Emirates*, note 12, at 84.

[52] *Qur'ān* 4:161

[53] *Qur'ān* 2:275

[54] Quoted in Siddiqui, Shahid Hassan, *Islamic Banking: Genesis and Rationale, Evaluation and Review, Prospects and Challenges*, (Royal Book Company, Karachi, 1994), at 14. See also,narration by 'Abd Allah b. Hanzala reported by Ahmad 20951which reports the Prophet as noting that "The single dirham of riba which a person consumes while knowing it as such is worse than thirty six instances of illicit sexual intercourse," in the *Harvard Law School, Islamic Finance Project Shari'a Database*, available at: http://ifp.law.harvard.edu/databank/Hadith_details/?id=500&term=Riba&hid=500.

For commentators on Islamic finance, it is clear that *ribā* is prohibited in *Sharī'ah*-compliant activity; this is uncontroversial.[55] Exactly what type of activity is caught by the *ribā* prohibition and why *ribā* is prohibited by *Sharī'ah* have been the source of significant disagreement for which no universally accepted answers have yet been provided. This lack of unanimity arises from the fact that notwithstanding sweeping denunciation of *ribā*, neither the *Qur'ān* nor the *Sunnah* provides a definition of it.[56] Etymologically, *ribā* signifies increase or growth, yet this description is excessively broad and provides only limited guidance on the *ribā* which is prohibited by *Sharī'ah*.[57] Contemporary commentators have generally translated *ribā* either as "interest" or have adopted a more complex definition similar to that used by Saleh who defines *ribā* as an unjustified gain resulting from an unfair exchange of counter-values between parties to a contract.[58] Classical scholars and exegetes did not provide a single definition of *ribā*, and instead concluded on a casuistical basis that *ribā* may arise in two types of arrangements, loans and sales.[59]

The *Qur'ān* itself has been interpreted as only clearly referring to one form of *ribā*: *ribā al-jahiliyya*.[60] Based on the verse which calls on Muslims to "take not doubled and redoubled *ribā*, and fear Allah that ye may prosper,"[61] the "increase" prohibited by the *Qur'ān* is that which occurred in pre-Islamic Arabia when a creditor would agree to defer a debt in return for an increase in the amount due from the debtor.[62] This form of *ribā* accords with the conventional notion of usury[63] and appears to relate, outwardly at least,

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[55] Ayub, Muhammad, *Understanding Islamic Finance*, note 26, at 44.

[56] Foster, Nicholas H.D., "Islamic Perspectives on the Law of Business Organisations I: An Overview of the Classical Sharia and a Brief Comparison of the Sharia Regimes with Western-Style Law", note 21, at 12.

[57] Fadel, Muhammad H., "Riba, Efficiency, and Prudential Regulation: Preliminary Thoughts", (2007-2008) 25 *Wisconsin International Law Journal*, 655-702 at 656-657 noting that "riba literally means 'increase,' but there is universal agreement that not all increases resulting from trade are subject to the restrictions of riba." See also, Schacht, Joseph, *An Introduction to Islamic Law*, note 22, at 145, Saleh, Nabil A., *Unlawful Gain and Legitimate Profit in Islamic Law*, (2nd ed., Graham & Trotman, London, 1992), at 16.

[58] *ibid.*, at 13

[59] Klarmann, Reinhard Leopold, *Islamic Project Finance, A legal study with particular reference to the laws of Switzerland and the United Arab Emirates*, (Schulthess, Zurich, 2003), at 39.

[60] Ibn Rushd, *Bidayat al-Mujtahid wa Nihayat al-Muqtasid*, (*The Distinguished Jurist's Primer*), Vol. II, Imran Ahsan Khan Nyazee (trans.), (Garnet Publishing Ltd., London, 1996), at 158.

[61] *Qur'ān* 3:130.

[62] Fadel, Muhammad H., "Riba, Efficiency, and Prudential Regulation: Preliminary Thoughts", note 57, at 658. See also, al-Tabari, Muhammad ibn Jarir, *Jami' al-bayan 'an ta 'wil ay al-Quran* – English translation of the abridged version by J. Cooper, W.F. Madelung, A. Jones (eds.), (Oxford University Press, New York, 1987), at 4:49 referred to in Zaman, M. Raquibuz and Movassaghi, Hormoz, "Interest-Free Islamic Banking: Ideals and Reality", (2002) 14(4) *The International Journal of Finance*, 2428-2443, at 2429, Qureshi, Anwar Iqbal, *Islam and the Theory of Interest*, (Sh. Muhammad Ashraf, Lahore, 1991), at 54, Kuran, Timur, "Islamic Economics and the Islamic Subeconomy", note 38, at 156-157.

[63] Usury is defined in the Oxford English Dictionary as "The practice of charging, taking or contracting to receive, excess or illegal rates of interest for money on loan." Indeed, Rayner notes that *ribā* has at times

only to inequitable, *ex post* increases in loans (*ribā duyun* (*ribā* of debts) or *ribā al-qarud* (*ribā* of loans)).[64] Indeed, Ibn Hanbal suggested that the "pay or increase" approach of pre-Islamic lenders was the only form of *ribā* prohibited beyond any doubt.[65]

The *Sunnah* extends the scope of the prohibition in order to eliminate *ribā* in sales contracts, ensuring that increase in a debt cannot be disguised as a commercial sales transaction.[66] *Ribā* in sales (*ribā al-buyu'*) is itself broken down into two categories: *ribā al-fadl* and *ribā al-nasi'ah*. Both forms of *ribā* have been developed in *fiqh* writings on the basis of a *hadīth* in which the Prophet is reported to have said:

> The six elements, gold for gold, silver for silver, wheat for wheat, barley for barley, dates for dates, salt for salt; in equal amounts, the same for the same, hand in hand; and if the types are different, sell however so you may wish, so long as it be hand in hand.[67]

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been translated simply as "usury", "excessive interest" or "usurious interest" and gives the example of Wehr, Hans, *Dictionary of Modern Written Arabic*, J.M. Cowan, (ed.), (3rd ed., Spoken Language Services, Ithaca, N.Y., 1976), at 324, Rayner, Susan.E., *The Theory of Contracts in Islamic Law: A Comparative Analysis with Particular Reference to the Modern Legislation in Kuwait, Bahrain and the United Arab Emirates*, note 12, at 267.

[64] In Egypt, Muhammad Sayyed Atiyya Tantawi, Mufti of the Egyptian Republic legitimated the use of interest-bearing government bonds. In doing so he concluded that "the determination of the profit in advance is for the sake of the owner of the capital and is done to prevent a dispute between him and the bank." Cited by Mallat, Chibli, "Tantawi on Banking" in *Islamic Legal Interpretation: Muftis and their Fatwas*, Muhammad Khalid Masud, Brinkley Messick and David S. Powers (eds.), (Harvard University Press, Cambridge, 1996), 286-296 at 293.

[65] Shams al-Din Muhammad Ibn Qayyim al-Jawziyya, *I'lam al-muwaqqa'in 'ala rabb al-'alamin*, Taha 'Abd al-Ra'uf Sa'd (ed.), (Dar al-Jil, Beirut, 1973) 2:153-4 in Vogel, Frank E. and Hayes, Samuel.L., *Islamic Law and Finance, Religion, Risk and Return*, note 12, at 73. See also, Visser, Hans, *Islamic finance: Principles and Practice*, (Edward Elgar Publishing Limited, Cheltenham, 2009), at 32. Ayub disagrees with this view that only increases which are applied once the loan has been entered into (i.e. swapping one debt for another) are prohibited by the *Qur'ān* noting that "a number of forms of riba were prevalent in the pre-Islamic period, including addition over loans and debts, and all of them were prohibited by Islam," Ayub, Muhammad, *Understanding Islamic Finance*, note 26, at 49.

[66] Vogel, Frank E. and Hayes, Samuel.L., *Islamic Law and Finance, Religion, Risk and Return*, note 12, at 74, Al Zuhayli, Wahba, "The Juridical Meaning of Riba", Iman Abdul Rahim and Abdulkader Thomas (trans.), in *Interest in Islamic Economics; Understanding riba*, Abdulkader Thomas (ed.), (Routledge, London, 2006), 25-52 at 26.

[67] Ibn Qudama, *Al-Mughni*, Vol. 4, at 124, in Zaman, M. Raquibuz and Movassaghi, Hormoz, "Interest-Free Islamic Banking: Ideals and Reality", note 62, at 2430. Also reported in *Sahih Muslim*, *Book 010, Number 3845* on the authority of Abu Sa'id Al-Khudriy, Abdul Hamid Siddiqui (trans.), available at: http://www.usc.edu/schools/college/crcc/engagement/resources/texts/muslim/hadith/muslim/010.smt.html. See also,the *Harvard Law School, Islamic Finance Project Shari'a Database*, available at: http://ifp.law.harvard.edu/databank/Hadith_details/?id=498&term=Riba&hid=305,306,307,308,309,495,496,497,498,499.

Ribā al-fadl (*ribā* by excess) arises in the sale of goods of the same class and type in different quantities or qualities.[68] This prohibition requires that in order for such transactions to be considered legally valid, the obligations arising from the contract of exchange must be performed immediately ("hand to hand"), whereby the exchanged quantities must be equal and so without excess ("same for the same").[69] In circumstances where the goods exchanged are of different class and types, then one may be exchanged for a higher quantity of the other ("sell however so you may wish"). This confirmation that no *ribā* by excess arises in relation to the exchange of heterogeneous goods has been interpreted as facilitating freely negotiated cash sales.[70] The doctrine of *ribā al-nasi'ah* (*ribā* by delay) prohibits delay in the exchange of countervalues in a sale, with or without profit and regardless of whether those countervalues are equivalent.[71]

Gradually, distinctions between the different forms of *ribā* have been weakened and the impact of the prohibition has been expanded beyond the list of six commodities set out in the *hadīth*. Today, many scholars consider all interest-bearing transactions to be forbidden, whether the interest is usurious or not[72] and whether in the form of a loan or disguised sale. As a result, the prohibition of *ribā* in the *Qur'ān* has been expanded to encompass not simply *ex post* usurious increases but *any* increase on a loan, even if that increase is agreed

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[68] El-Gamal, Mahmoud, *Islamic Finance: Law, Economics and Practice*, (Cambridge University Press, Cambridge, 2006), at 50.

[69] Al Zuhayli, Wahba, "The juridical meaning of riba", Iman Abdul Rahim and Abdulkader Thomas (trans.), in *Interest in Islamic Economics; Understanding riba*, note 66, at 28. Khalil, Emad H., "An overview of the Sharia'a prohibition of riba", in *Interest in Islamic Economics; Understanding riba*, Abdulkader Thomas (ed.), (Routledge, London, 2006), 53-68 at 56.

[70] Ibn Rushd, *Bidayat al-Mujtahid wa Nihayat al-Muqtasid*, (*The Distinguished Jurist's Primer*), Vol. II, note 60, at 160. See also,Vogel, Frank .E. and Hayes, Samuel.L., *Islamic Law and Finance, Religion, Risk and Return*, note 12, at 74. The validity of cash sales was confirmed by a *hadīth* in which the Prophet is reported as asking, when dates were brought to him, "'Are all the dates of Khaibar like this?' He replied, 'By Allah, no, O Allah's Apostle! But we barter one Sa of this (type of dates) for two Sas of dates of ours and two Sas of it for three of ours.' Allah's Apostle said, 'Do not do so (as that is a kind of usury) but sell the mixed dates (of inferior quality) for money, and then buy good dates with that money.'" Narrated by Abu Said Al-Khudri and Abu Huraira, *Sahih Bukhari*, Vol. 3, Book 34, Number 405, M. Muhsin Khan (trans.), available at: http://www.usc.edu/schools/college/crcc/engagement/resources/texts/muslim/Hadith/bukhari/034.sbt.html.

[71] Khalil, Emad H., "An overview of the Sharia'a prohibition of riba", in *Interest in Islamic Economics; Understanding riba*, note 69, at 56, Fadel, Muhammad H., "Riba, Efficiency, and Prudential Regulation: Preliminary Thoughts", note 57, at 663, Ibn Rushd, *Bidayat al-Mujtahid wa Nihayat al-Muqtasid*, (*The Distinguished Jurist's Primer*), Vol. II, note 60, at 159.

[72] Islam is not, of course, unique in prohibiting interest as the notion of earning money from the use of money is prohibited both in Christianity and Judaism on the basis of the Biblical statement found in the book of Deuteronomy, which states that, "you must not lend on interest to your brother, whether the loan be of money or food or anything else that may earn interest," Deuteronomy, 23:19-20. This passage is supported by one in Exodus and another in Leviticus which notes that "[i]f your brother who is living with you falls on evil days and is unable to support himself with you, you must support him as you would a stranger or a guest, and he must continue to live with you. Do not make him work for you, do not take interest from him; fear God, and let your brother live with you. You are not to lend him money at interest or give him food to make a profit of it," Leviticus, 25:35-37.

upon *ex ante*[73] and in a form other than money.[74] Similarly, the six commodities attracting *ribā* in the *hadīth* have been widely treated as including modern currency.[75] Thus, most significantly for contemporary financial activity, money cannot be exchanged for money except for equal value and immediately.[76] Referring to the *Qur'ānic* verses prohibiting *ribā*, Saleh suggests that enough Islamic scholars now interpret the *Qur'ān* as prohibiting all forms of interest that *ijmā'* may have been reached on the issue.[77] Indeed the Council of Islamic Ideology in Pakistan indicated in 1983 that there was "complete unanimity among all schools of thought in Islam that the term *ribā* stands for interest in all its types and forms"[78] while the Islamic *Fiqh* Academy in Saudi Arabia has declared that all interest-bearing transactions are prohibited and void.[79]

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[73] Farooq (Farooq, Mohammad Omar, "Stipulation of Excess in Understanding and Misunderstanding riba: The Al-Jassas Link", note 37, at 285), attributes this development to Abu Bakr al-Jassas (d.370 AH/981 AD) who noted that a "stipulated excess was riba in the substance of the wealth, because there was no counter-value available from the side of the lender." Al-Jassas, Abu Bakr, *Excerpt on Riba from Akham al-Qur'ān*, Imran Ahsan Khan Nyazee (trans.), (Advanced Legal Studies Institute, Islamabad, 2000), at 3-4.

[74] The Hanafis consider an advantage to be prohibited only if it is agreed upon at the time the contract is entered into, a reality clearly found in modern loan agreements which have a pre-determined, agreed upon rate of interest that must be paid. If however, the advantage is not agreed upon before the conclusion of the contract, the financier may justifiably receive it as constituting a gift (Al-Kasani, *Bada'i'*, Vol VII at 395, Jaziri, *al-Fiqh 'ala al-madhahib*, Vol. II at 340, in Saleh, Nabil A., *Unlawful Gain and Legitimate Profit in Islamic Law*, at note 57, at 52). The Malikis on the other hand prevent the financer from receiving any gift which he obtained from the borrower solely because of the existence of the loan (Jaziri, *al-Fiqh 'ala al-madhahib*, Vol. II at 343, al-Kashnawi, *Ashal al-madarik*, Vol. II at 318, al-Dardir, *al-Sharh*, Vol. III at 293, in Saleh, Nabil A., *Unlawful Gain and Legitimate Profit in Islamic Law*, note 57, at 53). The Shafis regard an advantage conveyed on the lender by the borrower willingly or based on custom as permissible, so long as such an advantage is not a condition of the loan contract. (al-Shirazi, *al-Muhadhdhab*, Vol 1 at 304, Jaziri, *al-Fiqh, 'ala al-madhahib*, Vol II at 342, in Saleh, Nabil A., *Unlawful Gain and Legitimate Profit in Islamic Law*, note 57, at 54). Finally, the Hanbali school regards the loan as a benevolent gift and therefore oppose any advantage conferred on the lender is prohibited, whether previously agreed upon or not (Ibn Qudama, *al-Mughni*, Vol. IV at 345-6 in Saleh, Nabil A., *Unlawful Gain and Legitimate Profit in Islamic Law*, note 57, at 52).

[75] Saeed, Abdullah, "The Moral Context of the Prohibition of Riba in Islam Revisited", (1995) 12(4) *The American Journal of Islamic Social Sciences*, 496-517 at 410.

[76] Choudhury, Masudul Alam, *Money in Islam: a Study in Islamic Political Economy*, (Routledge, London, 1997), at 76-77, Farooq, Mohammad Omar, "Stipulation of Excess in Understanding and Misunderstanding riba: The Al-Jassas Link", note 37, at 288, Saleh, Nabil A., *Unlawful Gain and Legitimate Profit in Islamic Law*, note 57, at 19-20. See also,Khalil who suggests that loans can be brought within the *hadīth* prohibition of riba in sales, Khalil, Emad H., "An overview of the Sharia'a prohibition of riba", in *Interest in Islamic Economics; Understanding riba*, note 69, at 57.

[77] Saleh, Nabil A., *Unlawful Gain and Legitimate Profit in Islamic Law*, note 57, at 15. Farooq does however suggest that *Ijmā'* has not yet been reached, but does acknowledge that the prohibition of interest as riba as "evolved into an orthodox position." Farooq, Mohammad Omar, "Stipulation of Excess in Understanding and Misunderstanding riba: The Al-Jassas Link", note 37, at 285.

[78] Council of Islamic Ideology, *Consolidated Recommendations on the Islamic Economic System*, (CII, Islamabad, 1983), at 7.

[79] The Council of the Islamic Fiqh Academy, Resolution No10 (10/2), "Concerning Transactions with Banks Dealing with Interest and Transactions with Islamic Banks", 2nd session, December 22-28, 1985, in Council of the Islamic Fiqh Academy (2000) *Resolutions and Recommendations (1985–2000)*, (IRTI, IDB, Jeddah, 2000), at 15. Klein, Daniel, "The Islamic and Jewish Laws of Usury: A Bridge to Commercial Growth and Peace in the Middle East", (1994-1995) 23 *Denver Journal of International Law and Policy*,.535-554, at 538.

Rationalisations for this extension of the *ribā* prohibition to encompass interest repeatedly raise issues of socio-economic justice and the purported unfairness and exploitative nature of interest.[80] For Samiullah, interest "drives away from the heart of a person the feeling of human brotherhood and converts him into a 'Shylock' always insisting on his pound of flesh, no matter how distressed his fellow being may be,"[81] while Abu Zahra suggests that interest is a "destructive convention rejection of which is obligatory."[82] Another reason given for the prohibition of interest is the notion in Islam that money is considered to have no intrinsic value and is, instead, simply a measure of value.[83] In an argument similar to that adopted by critics of usury in non-Islamic systems,[84] commentators suggest that money in Islam should only have value as a medium *of* exchange rather than as a commodity *for* exchange, and as a result, no one should be able to make money merely from the use of money.[85]

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[80] Chapra, M.Umer, "Why has Islam prohibited interest? Rationale behind the prohibition of interest", in *Interest in Islamic Economics; Understanding riba*, Abdulkader Thomas (ed.), (Routledge, London, 2006), 95-110 at 95-98.

[81] Samiullah, Muhammad, "Prohibition of Riba (Interest) & Insurance in the Light of Islam," (1982) 21(2) *Islamic Studies,* 53-76, at 54.

[82] Abu Zahra, Muhammad, *Buhuth fi al-*Riba, (Dar al-Buhuth al-'Ilmiyya, Kuwait 1970), at 21 in Fadel, Muhammad H., "Riba, Efficiency, and Prudential Regulation: Preliminary Thoughts", note 57, at 677. In Pakistan the Council of Islamic Ideology similarly focuses on the injustices caused by interest, "[t]he rationale for prohibition of charging of interest on loans taken for consumption purposes is obvious. Such loans are usually taken by people of small means to meet urgent personal requirements as they have hardly any cushion of savings with which to meet such requirements. Prohibition of interest in so far as loans of this type are concerned rests mainly on humane considerations. The main rationale for prohibition of interest in the case of loans for production purposes stems from the concept of justice between man and man which is the cornerstone of the Islamic philosophy of social life," Council of Islamic Ideology, *Elimination of Riba from the Economy and Islamic Modes of Financing*, (2nd Revised and Enliged Edition, CII, Islamabad, 2002), at 10, [1.3].

[83] Choudhury, Masudul Alam, "Development of Islamic economic and social thought", in *Handbook of Islamic Banking*, M. Kabir Hassan and Mervyn K. Lewis (eds.), (Edward Elgar, Cheltenham, 2007), 21-38 at 31. As one commentator noted; Money "cannot be eaten, provide shelter, or perform any utilitarian physical function." Selwood, Dominic, "Islamic Contracts in a Modern Legal Context", in *The Chancellor Guide to the Legal Shari'a Aspects of Islamic Finance*, Humayon Dar and Umar Moghul, (eds.), (Chancellor Publications, London, 2009), 25-56 at 31.

[84] Aristotle noted that usury is the un-natural breeding money from money, Aristotle, *Politica*, (Politics by Aristotle), William Ellis (trans.), (The Echo Library, Middlesex, 2006), at 1257b-1258b in Kirschenbaum, Aaron, "Jewish and Christian Theories of Usury in the Middle Ages", (1985) 75(3) *The Jewish Quarterly Review*, 270 at 272. See also,Harvey, James, *Usury, the Scourge of Nations*, (Austin & Co., London, 1870), who noted at 2 that, "[n]o commodity can fulfil the function of money, be it diamonds, gold, or silver. That money nature is in its nature a representation of wealth, and not real wealth, as a bill of lading, or a warehouse warrant, are representations of cargo, or of goods warehoused; and like those instruments must be documentary, or paper." See also, Kern, Adam, *Bible vs Usury*, (Wisdom & Lucas, Printers, Iowa, 1884), at 2.

[85] Ibn Rushd, *Bidayat al-Mujtahid wa Nihayat al-Muqtasid*, (*The Distinguished Jurist's Primer*), Vol. II, note 60, at 162. See Imam al-Ghazzali quoted by Maulana Justice Taqi Usmani in *Dr. M. Aslam Khaki v. Syed Muhammad Hashim* PLD 2000 SC 225 at [140], "[a]nd whoever effects the transactions of interest on money is, in fact, discarding the blessing of Allah and is committing injustice, because money is created for some other things, not for itself. So, the one who has started trading in money itself has made it an objective contrary to the original wisdom behind its creation, because it is injustice to use money for a purpose other than what it was created for...If it is allowed for him to trade in money itself, money will become his ultimate goal and will remain detained with him like hoarded money."

These justifications have, occasionally, been countered by arguments against an over-expansive reading of the *ribā* prohibition.[86] Nevertheless, such views are in the minority within the Islamic finance industry.[87] For the purposes of a discussion of Islamic finance within the Irish legal system, debate over the true scope of *ribā* is largely tangential. In practice, Islamic finance today is marked by a staunch disavowal of conventional bank interest. Consistent with this, Ireland's Department of Finance has recently cited "a prohibition on earning interest," as one of the most important principles of Islamic finance.[88] This statement reflects the dominant view of the *ribā* prohibition amongst contemporary scholars.[89]

B. *Gharar* and *Maysir*

Though often considered separately, *maysir* (speculation) and *gharar* (uncertainty) will be addressed together in this Chapter, as it is suggested that *maysir* arises as a result of excessive *gharar*. *Gharar* is frequently translated as simply meaning uncertainty and risk in commerce. Such a definition is unsatisfactory; all contracts and business transactions present *some* element of risk or uncertainty[90] and if this definition was applied strictly, Islamic law would prevent Muslims from engaging in any business or commercial activity. The fact that the Prophet and his Companions engaged in trade and business suggests that "risk" is not subject to a wholesale prohibition under *Sharī'ah*.[91] In practice, only certain types of risk, which take the form of endogenous uncertainty within a contract, are to be avoided.

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[86] In Egypt, Muhammad Sayyed Atiyya Tantawi, Mufti of the Egyptian Republic legitimated the use of interest-bearing government bonds. In doing so he concluded that "the determination of the profit in advance is for the sake of the owner of the capital and is done to prevent a dispute between him and the bank." Cited by Mallat, Chibli, "Tantawi on Banking" in *Islamic Legal Interpretation: Muftis and their Fatwas*, note 64, at 293.

[87] Kuran, Timur, "Islamic Economics and the Islamic Subeconomy", note 38, at 157.

[88] Irish Department of Finance, *Islamic Finance in Ireland; An Information Note*, (Department of Finance, Dublin, 2010), at 3.

[89] Saeed, Abdullah. "Riba," in *Encyclopaedia of Islam,* P. Bearman; , Th. Bianquis; , C.E. Bosworth; , E. van Donzel; and W.P. Heinrichs. (eds.), (2nd ed., Brill Online, Leiden), available at: http://www.brillonline.nl/subscriber/entry?entry=Islam_COM-1443.

[90] Visser, Hans, *Islamic Finance; Principles and Practice, (*Edward Elgar, Cheltenham, 2009), at 45, Ibn Taymiah makes this reality clear when he notes that; "it is well known that Allah and his Messenger did not prohibit every kind of risk. Not all kinds of transactions that involve the possibility of gain or loss or neutrality are prohibited. What is prohibited among such kinds is eating wealth for nothing, even if there were no risk, not that risk as such is prohibited," Ibn Taymiyya, Taqi al-Din Ahmad, *al-Qawa'id al-nuraniyya al-fiqhiyya*, (Dar al-Ma'rifa, Beirut, 1399AH, 1979A.D), at 116, in Al-Suwailem, Sami, "Towards and Objective Measure of *Gharar* in exchange", (1999-2000) 7(1 and 2) *Islamic Economic Studies*, 61-102 at 65.

[91] Warde, Ibrahim, *Islamic Finance in the Global Economy*, (2nd ed., Edinburgh University Press, Edinburgh, 2010), at 56.

At its most extreme this uncertainty can take the form of *maysir* (gambling).[92] Like the prohibition of *ribā*, the proscription of *maysir* is referred to in the *Qur'ān*, "O, you who believe! Intoxicants and gambling...are an abomination of Satan's handiwork. So avoid that (abomination) in order that you may be successful."[93] Gambling is based purely on chance, any gains made have not been earned and any losses suffered are a result of simple bad luck; short of cheating, no one (but God) can determine the outcome of a gamble. As al-Qaradawi noted, "gambling...makes a person dependent on chance, 'luck' and empty wishes, taking him away from honest labor, serious work and productive effort. The person who depends on gambling loses respect for the laws of causation which Allah has established and commanded people to use."[94] Such reliance on chance is considered to be excessively speculative and inherently unfair.[95]

At the other end of the risk spectrum in Islamic law there is permissible, indeed openly endorsed, risk. Based on the Islamic legal maxim "gain accompanies liability for loss,"[96] the assumption of *legitimate commercial* risk which is extraneous to the transaction is sufficient consideration, under Islamic economic principles, to justify payment of a profit.[97] Such profit is not *ribā* because the participant has not made idle gain but has instead contributed something of value to the transaction, that is, the risk that they could lose everything. Equally, the transaction does not involve excessive risk because the uncertainty is not internal to the transaction itself but rather unavoidable and inherent in productive business activity.

Gharar, then, falls within this continuum. The point at which legitimate risk becomes prohibited has not yet been precisely defined by Islamic scholars.[98] *Gharar* itself is not mentioned in the *Qur'ān* directly although it is referred to in numerous *hadīth* in which

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[92] Saati, Abdul-Rahim, "The Permissible Gharar (Risk) in Classical Islamic Jurisprudence", (2003) 16(2) *Islamic Economics*, 3-19 at 8.

[93] *Qur'ān*, 5:90-91

[94] al-Qardawi, Yusuf, *The Lawful and the Prohibited in Islam*, Kamal al-Hilbawi, Moinuddin Siddiqui, and Syed Skukry (trans.), (2nd ed., Al-Falah Foundation for Translation, Publication & Distribution, Cairo, 2001), at 233 at 301.

[95] Rayner, Susan, *The Theory of Contracts in Islamic Law: A Comparative Analysis with Particular Reference to the Modern Legislation in Kuwait, Bahrain and the United Arab Emirates*, note 12, at 293.

[96] "*Al-kharaj bil daman*", *Sunan Abu Dawud*, Book 23, No. 3501, Ahmad Hasan (trans.), available at: http://www.usc.edu/schools/college/crcc/engagement/resources/texts/muslim/hadith/abudawud/023.sat.html, Ibn Qayyim al-Jawziyyah, *I'lam al-Muwaqi'in*, (Dar al-Kutub al-Hadithah, Medina, 1969) in Moghul, Umar F., "No Pain, No Gain: The State of the Industry in Light of an American Islamic Private Equity Transaction", (2007) 7(2) *Chicago Journal of International Law*, 469-494 at 470.

[97] Saati, Abdul-Rahim, "The Permissible Gharar (Risk) in Classical Islamic Jurisprudence", note 92, at 14, DeLorenzo, Yusuf, "The Religious Foundations of Islamic Finance", note 36, at 144.

[98] Vogel, Frank .E. and Hayes, Samuel.L., *Islamic Law and Finance, Religion, Risk and Return*, note 12, at 64.

specific transactions, deemed to be excessively risky, are prohibited. One *hadīth* notes that the Prophet forbade the "sale by means of pebbles"(*Bay' al-Hast*) and the *gharar* sale (*Bay' al-Gharar*);[99] others prohibit the sale of weighable goods without knowing exactly how much those goods weighed,[100] the sale of a foetus in the womb[101] and the sale of fruit before it has begun to ripen.[102] On the basis of these *ahadīth*,[103] scholars and commentators have generally treated risk as becoming excessive when there is an uncertainty or unknown element within a contract or arrangement itself.[104] Such intrinsic uncertainty would arise where there is ambiguity or ignorance as regards the existence, quantity or quality of the contract's subject matter,[105] uncertainty surrounding the price to be paid[106] or uncertainty over the rights and obligations of the parties.[107] It also arises in arrangements where there is uncertainty as to whether a transaction will occur at all.[108] These risks are distinct from commercial risk. They represent, instead, risks which are legal and contractual and which approach the level of uncertainty found in gambling.[109] They go to the very heart of the transaction, jeopardising the foundation upon which the parties have agreed to transact.

Within contemporary financial activity, *gharar*, unlike *ribā*, is to a certain extent manageable. So long as uncertainty within the transaction is reduced to only legitimate

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[99] *Sahih Muslim*, Book 10, Introduction, *Hamid Siddiqui* (trans.), available at: http://www.usc.edu/schools/college/crcc/engagement/resources/texts/muslim/hadith/muslim/010.smt.html. See also, Vogel, Frank .E. and Hayes, Samuel.L., *Islamic Law and Finance, Religion, Risk and Return*, note 12, at 87.

[100] *Sahih Ibn Maja*, Book 31, Number 31.13.25 on the authority of Malik, translation available at: http://getintoislam.com/Sunan_Majah_Book_31_-_61.html.

[101] Ibn Malik, *Muwatta*, Book 31 Number 31.1.1 on the authority of Malik, translation available at http://www.iium.edu.my/deed/hadith/malik/031_mmt.html, Bulugh al-Maram, Book 7, Number 662, narrated by Ibn 'Umar, *Attainment of the Objective according to Evidence of Ordinances*, Compiled by al-Hafiz Ibn Hajar al-Asqalani, (Dar us Salam Publications, Riyad, 1996).

[102] *Sahih Ibn Maja*, Book 31, Number 31.8.10, Number 31.8.11 and Number 31.8.12, *on the authority of Malik,* translation available at: http://getintoislam.com/Sunan_Majah_Book_31_-_61.html.

[103] Plural of *hadīth*

[104] Saleh, Nabil A., *Unlawful Gain and Legitimate Profit in Islamic Law*, note 57, at 63-65, Schacht, Joseph *An Introduction to Islamic Law*, note 22, at 147.

[105] Al-Kasani notes that "there are several conditions for the contract of sale to be validly concluded, the first of these is that the subject matter must be in existence. The sale of non-existent [goods] and the sale of anything, which is susceptible to the hazard of non-existence, is void. Examples can be found in the sale of offspring or a future-born animal and the sale of a foetus of an animal before its birth, of which the former is considered the sale of a non-existence [object] whilst the latter involves the hazard of non-existence," Al-Kasani, 'Ala' al-Din, *Badi' al-Sanai'*, (2nd ed., Dar al-Hadith, Beirut, 1986, Vol. 5), at 138 in Zahraa, Mahdi and Mahmor, Shafaai M., "The Validity of Contracts When the Goods Are Not Yet in Existence in the Islamic Law of Sale of Goods", (2002) 17(4) *Arab Law Quarterly*, 379-397 at 380.

[106] Housby, Elaine, *Islamic Financial Services in the United Kingdom*, (Edinburgh University Press, Edinburgh, 2011), at 15.

[107] Ayub, Muhammad, *Understanding Islamic Finance*, note 26, at 61.

[108] Ahmed, Habib, *Product Development in Islamic Banks*, (Edinburgh University Press, Edinburgh, 2011), at 35-38.

[109] Saati, Abdul-Rahim, "The Permissible *Gharar* (Risk) in Classical Islamic Jurisprudence", note 92, at 10.

commercial risk, then an operation can generally be accorded the *Sharī'ah*-compliant seal of approval.[110] However, the very nature of a number of conventional transactions is considered to be disproportionately risky. As a result, traditional insurance,[111] futures and derivatives trading have been widely rejected within the Islamic finance market as such transactions are contingent on the occurrence of a future event which is unpredictable.[112] This unpredictability gives rise to intrinsic uncertainty within the transaction and unlawful risk.

C. *Haram* activities

The final major restriction on Islamic financial contracts is less focussed on the structure of Islamic financial transactions, and instead places limits on the nature of activity in which Muslims can be involved. Islam imposes a religious filter on financial activity which manifests itself as different levels of screening. As Islamic doctrine restricts market participants' ability to associate with certain sectors and businesses, the notion of screening is relevant across the Islamic finance industry.[113] The restriction has become a particularly dominant consideration for Islamic funds activity as the suitability of investments must be judged not simply on the basis of economic viability, but also for compatibility with Islamic doctrine.[114] As a means of streamlining and homogenising this screening, Islamic indexes such as the FTSE Global Islamic Index Series [GIIS] and the Dow Jones Islamic Market Index [DJIMI], have been established.[115] These indices implement both activity-based and financial ratio screening which allows them to track the performance of listed companies whose activities conform with the principles of

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[110] See Chapter 6 for a discussion of potential *gharar* arising in relation to *Sharī'ah*-compliant real estate financing, *infra.*at 207.

[111] Wilson, Rodney, "Concerns and Misconceptions in the Provision of Takaful", in *Islamic insurance: trends, opportunities and the future of takaful*, Sohail Jaffer (ed.), (Euromoney Books, London, 2007), 72-86 at 73. Wilson notes that the view that insurance is prohibited under Islamic law is highly controversial, nevertheless, it does seem to benefit from broad acceptance.

[112] Ayub, Muhammad, *Understanding Islamic Finance*, note 26, at 75. The opposite of *haram* is *halal* (permissible).

[113] Mahlknecht, Michael and Hassan, Kabir, *Islamic Capital Markets: Products and Strategies*, (Wiley & Sons Ltd., West Sussex, 2011), at 83.

[114] Housby, Elaine, *Islamic Financial Services in the United Kingdom*, note 106, at 121.

[115] The FTSE Islamic Index "is designed to identify and track a global Islamic compatible universe of publicly traded equities in a manner analogous to indices which identify and track the relevant universe of publicly traded equities, that have no restrictions imposed by Islamic *Shari'ah* precepts in the selection process. In essence, it is an Islamic stock market indicator." Section 1.2, *Ground Rules for the Management of the FTSE Global Islamic Index Series*, (Version 2.3 October 2001), Hussein, Kabir "Islamic Investment: Evidence from Dow Jones and FTSE Indices," Paper presented at the 6th International Conference on Islamic Banking and Finance, Jakarta, Indonesia, November 14-21, 2005.

Sharī'ah.[116] This activity-based and financial screening is most clearly encapsulated by the Dow Jones *fatwā*, pertaining to equity investments, which was laid down in 1998 and amended in 2003.[117] This *fatwā* continues to represent a benchmark for the Islamic finance industry generally.[118]

The first level of screening, acknowledged by the Dow Jones *fatwā*, is sectoral and prohibits the investment in, or association with, *haram* (forbidden) industries "considered to promote Islamic vices."[119] Key among these industries are those prohibited by the *Qur'ān* or the *Sunnah*, including: making or selling alcohol, pornography, interest-based financial products, anything involving gambling, idolatry and human consumption of pork products.[120] Further prohibited areas have been highlighted by scholars through the use of *qiyās*. Areas such as tobacco, weaponry and insurance industries, while not explicitly prohibited by *Sharī'ah*, are thus often excluded from permissible Islamic financial investment activity.[121] Earning money through involvement in prohibited industries is forbidden and Muslims must refrain from connection with such activities.[122] The principle of *haram* also prohibits investment through "fixed income securities", "preferred shares"

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[116] *Proceedings of the Second Oxford Islamic Finance Round Table*, "The Frontiers of Innovation in Islamic Finance," Oxford, April 15, 2009, (International Shari'ah Research Academy for Islamic Finance (ISRA), Kuala Lumpur, 2010), at 17, Housby, Elaine, *The development of the Islamic financial tradition in contemporary Britain*, PhD Thesis submitted in the Department of Religious Studies of the Open University (2005), at 204.

[117] The Dow Jones Islamic Market Index, Statement by the Shari`ah Supervisory Board, Released 1998, amended 2003, on file with the author.

[118] McMillen, Michael J.T., "Shari'a Compliant Project Finance: A Structural Overview", in *The Chancellor Guide to the Legal and Shari'a Aspects of Islamic Finance*, Humayon A. Dar and Umar F. Moghul (eds.), (Chancellor Publications, London, 2010), 175-228 at 196, describing the *fatwā* as "monumental".

[119] Richardson, Christopher, "Islamic Finance Opportunities in the Oil and Gas Sector: An Introduction to an Emerging Field", (2006) 42 *Texas International Law Journal, 119-153 at 127.* al-Qardawi, Yusuf, *The Lawful and the Prohibited in Islam*, note 94, at 233.

[120] For example, the *Qur'ānic* prohibition of pork, "He hath forbidden you only carrion, and blood, and swineflesh, and that which hath been immolated to (the name of) any other than Allah. But he who is driven by necessity, neither craving nor transgressing, it is no sin for him. Lo! Allah is Forgiving, Merciful," *Qur'ān* 2:173. See also, *Sahih Muslim, Book 010, Number 3840:* "Jabir b. 'Abdullah reported Allah's Messenger as saying in the Year of Victory while he was in Mecca: Verily Allah and His Messenger have forbidden the sale of wine, carcass, swine and idols," Abdul Hamid Siddiqui (trans.), available at: http://www.usc.edu/schools/college/crcc/engagement/resources/texts/muslim/hadith/muslim/010.smt.html.

[121] Though tobacco and weaponry are acknowledged as widely prohibited, the Dow Jones fatwa does accept that prohibition of these industries is not universal amongst shariah boards. Nevertheless, McMillen has highlighted the *makruh* (offensive) nature of tobacco and the fact that the exclusion of weaponry in the context of weapons of mass destruction (as opposed to weapons in general), has garnered near universal acceptance, McMillen, Michael J.T., comments on this thesis. Wilson, Rodney, "Screening criteria for Islamic equity funds", in *Islamic asset management: Forming the Future for Shari'a-Compliant Investment Strategies*, Sohail Jaffer (ed.), (Euromoney Books, London, 2004), 35-45 at 38.

[122] "When Allah prohibits a thing, He prohibits [giving and receiving] the price of it as well", *Musnad Ahmad ibn Hanbal,* Number 2546, in Al-Qardawi, Yusuf *The lawful and the prohibited in Islam*, note 94, at 252.

and "convertible notes".[123] This is an extension of the proscriptions of *ribā* and *gharar*, as, even if the primary business of a company may be *Sharī'ah*-compliant, investment in this business through non-*Sharī'ah*-compliant financial structures renders income produced *haram* and contrary to Islamic law.[124]

Level two screening involves "scrutiny of the financial ratios of companies passing level one screening".[125] This screening is relevant in circumstances where a company's primary business is *halal* (permissible), but some of its income is generated from non-*Sharī'ah*-compliant activity. Rather than prohibiting investment in companies other than those whose activities are rigorously and exclusively compatible with Islamic law, scholars have provided some flexibility, allowing Muslims to own shares of companies or investment vehicles "whose primary business is consistent with Shari`ah precepts, even when a small part of their revenues include, within certain limits, haram income."[126] Where a company earns some *haram* income, investment is still permissible based on the premise that, first, the Islamic investor, is, as a shareholder in the company, not in fact a direct party to the *haram* or prohibited activities, second, the board of directors of the company owes a fiduciary duty to act in the best interests of the company and to maximise shareholder value, and third, investment is encouraged in companies that benefit the shareholder and society at large, even if some activities of the company are *haram*. In relation to the level of a company's income which can be generated from one of the *haram* sectors, such as alcohol and gambling, the Dow Jones fatwa provides that this income must be "negligible" and the investor must be prepared to give to charity an amount proportionate to that negligible income.[127] The FTSE Shariah Global Equity Index Series sets a more specific threshold for secondary, non-*Sharī'ah*-compliant income and provides that "[t]otal interest and non compliant activities income should not exceed 5% of total revenue".[128]

For companies passing the first level of screening, specific financial thresholds have also been set by the Dow Jones *fatwā* in relation to the level of a company's interest-bearing debt, accounts receivable and interest-bearing securities. Acknowledging the

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[123] Richardson, Christopher, "Islamic Finance Opportunities in the Oil and Gas Sector: An Introduction to an Emerging Field", note 119, at 126.

[124] The Dow Jones Islamic Market Index, note 117.

[125] *ibid.*

[126] *ibid.*

[127] *ibid.*

[128] FTSE Shariah Global Equity Index Series, *Fact Sheet*, available at;
http://www.ftse.com/Indices/FTSE_Shariah_Global_Equity_Index_Series/Downloads/FTSE_Shariah_Global_Equity_Index_Series_Factsheet.pdf.

practical reality that companies borrow money on interest and invest excess capital in instruments producing assured interest payments (whether deposit accounts or fixed income securities, amongst others), the fatwa provides that neither total interest-bearing debt to market capitalisation, nor cash-plus-interest bearing securities to market capitalisation, of a company can exceed 33%.[129] Consequently, while paying and receiving interest is religiously "dubious" generally, when kept to a level below 33% of a company's market capitalisation, the *haram* element of the activity is considered to be "minor" and thus not sufficient to prevent investment in such a company by a Muslim investor.[130] Finally, a company's accounts receivable to total assets must also be kept below 45%.

Representing what Siddiqui has described as "interim tolerance",[131] the contemporary application of Islam's sectoral and financial filters involves slightly more flexibility than the prohibition of *ribā*.

3.3 The Islamic Finance Industry and the Contracts Underpinning It

3.3.1 The Re-emergence of Islamic finance

Islamic finance contracts and transactions, unlike conventional financial activity, are constrained by suprasocial, non-temporal principles to which they must conform. The prohibitions of *ribā*, *maysir*, *gharar* and *haram* activities require Islamic market participants to consider issues other than maximum economic success when developing and using financial instruments. In the early 20th century, the restrictions placed on financial activity by Islamic doctrine were considered so onerous, and so inconsistent with established financial practice, that they were dismissed as unrealistic. According to Coulson

> ...the twin basic prohibitions of riba...and gharar had been developed to a degree of systematic rigour which eliminated any form of speculative

[129] Gassner, Michael Saleh, "Islamic Finance: Short in Gambling, Long in Trade", (2004) 5 *Swiss Derivatives Review*, 26-27 at 27. Wilson, Rodney, "Screening criteria for Islamic equity funds", in *Islamic asset management: Forming the Future for Shari'a-Compliant Investment Strategies*, note 121, at 38-39.

[130] The Dow Jones Islamic Market Index, Statement by the Shari`ah Supervisory Board, note 117.

[131] Siddiqui, Rushdi, "Shari'ah Compliance, Performance, and Conversion: The Case of the Dow Jones Islamic Market Index", (2006-2007) 7 *Chicago Journal of International Law* 495-520 at 501.

> risk in contracts and which postulated standards totally unrealistic in the light of the practical demands of commercial and economic life.[132]

Similarly, Anderson suggests that "the Sharī'a had been developed as an ideal law, largely divorced from practice, with a rigidity...in the absolute prohibition of 'usury'...which would effectively have prevented...the prosecution of commerce by the merchants."[133] Islamic economic principles appear to be extensive, difficult to implement and unviable. They restrict the freedom of parties to choose how they pursue profits and, while the punishments imposed for engaging in *ribā*, speculation or *haram* activities are not exacted in this life, they nevertheless impose a significant burden on a believer's conscience.

The religious framework within which Islamic finance must function was therefore established over a century ago in an environment which is almost incomparable with contemporary financial sectors. The disjoint between the economic principles of Islamic law and the practical reality of modern banking and finance was heightened by the fact that developments in Islamic finance slowed during the colonial era.[134] It is suggested that this marginalisation of Islamic economic principles arose not simply because established practices of colonised Islamic countries were superseded or at least supplemented by Western structures,[135] but because of the hegemony of the West in international trade and financial activities;[136] in order to avoid financial isolation, Islamic countries had to conform. As Foster states, "[o]n the commercial side, the sharia was jettisoned nearly

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[132] Coulson, Noel James, "Islamic Law", in *An Introduction to Legal Systems*, John Duncan and Martin Derrett, (eds), (Sweet & Maxwell, London, 1968), 54-79 at 69.

[133] Anderson, J. N. D., "Law as a Social Force in Islamic Culture and History", (1957), 20(1/3), *Bulletin of the School of Oriental and African Studies, University of London, Studies in Honour of Sir Ralph Turner,* 13-40 at 21. See also, Hallaq, Wael B., "Usul al-Fiqh: Beyond Tradition", (1992), 3(2) *Journal of Islamic Studies*, 172-202 at 182 who suggests that "Muslim commercial law [was] a law that has until recently been supposed to have little relevance to actual practice."

[134] Vogel, Frank .E. and Hayes, Samuel.L., *Islamic Law and Finance, Religion, Risk and Return*, note 12, at 4, Hegazy, Walid S., "Contemporary Islamic Finance: From Socioeconomic Idealism to Pure Legalism", (2007) 7(2) *Chicago Journal of International Law*, 581-601 at 581.

[135] Warde, Ibrahim, *Islamic Finance in the Global Economy*, (2nd ed.), note 91, at 46, Issawi, Charles, "General Introduction" in *The Economic History of the Middle East 1800-1914*, Charles Issawi (ed.), (University of Chicago Press, Chicago, 1966), at 10-11 discussing the establishment of Western financial institutions in Islamic countries at the end of the 19th century.

[136] In *Petroleum Development Ltd v Sheikh of Abu Dhabi* [1951] 18 ILR 144, Lord Asquith noted in reference to the municipal legal system of Abu Dhabi that "[n]o such law could reasonably be said to exist...it is fanciful to suggest that in this very primitive region there is any settled body of legal principles applicable to the construction of modern commercial instruments and that the Sheikh of Abu Dhabi administers a purely discretionary justice with the assistance of the Koran." Although note Kuran who suggests that blame placed on Western imperialism may be overstated; Kuran, Timur, *The Long Divergence: How Islamic Law Held Back the Middle East*, (Princeton University Press, Princeton, 2011), at (amongst others) 18.

everywhere, so Islamic commercial law was little studied until recently."[137] This prominence of Western finance, combined with reluctance amongst Islamic scholars to openly depart from classical *fiqh* literature, restricted the extent to which Islamic finance could progress.

With the upsurge of Islamic revivalist views in the aftermath of colonialism, however, came growing calls for the Islamisation of Muslim societies;[138] a development which would include the reassertion of Islamic law's economic principles.[139] It is at this point that contemporary Islamic finance began and so, notwithstanding its medieval underpinnings, the "Islamic financial movement...happens to be one of the unique features of twentieth and twenty-first century Islam."[140] The first attempt to establish a bank that complied with some of the economic principles of Islam occurred in the mid-1940s in Malaysia, a country that has since emerged as a major hub for Islamic finance.[141] Both this bank and one created in Pakistan in the 1950s were ultimately unsuccessful.[142] Nevertheless they are important for having introduced the idea that there are alternatives for Muslims to traditional interest-based banking. Bolstered by the ever increasing independence of Muslims, the first successful and innovative development in contemporary Islamic banking began in rural Egypt in Mit Ghamr and Dondait in 1963.[143] "This brief success was the spark that ignited the Islamic banking movement,"[144] and the 1970s and 1980s saw a dramatic increase in the number of Islamic banks emerging within Islamic countries such

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[137] Foster, Nicholas H.D., "Islamic Perspectives on the Law of Business Organisations I: An Overview of the Classical Sharia and a Brief Comparison of the Sharia Regimes with Western-Style Law", note 21, at 5.

[138] See *infra.*at 89 for a discussion of the notion of "Islamic economics."

[139] Khan, Shahrukh Rafi, *Profit and Loss Sharing: An Islamic Experiment in Finance and Banking*, (Oxford University Press, Oxford, 1987), at 7notes that, "[t]he resurgence in interest in Islamic conservatism is a result of a long prevailing identity crisis being experienced by Muslims. The self-pride of Muslims that came from having been conquerors and rulers for over a millennium was battered by the shocking reality of Western military and technological superiority." See also, Saeed, Abdullah, *Islamic banking and Interest, A Study of the Prohibition of Riba and its Contemporary Interpretation*, (Brill, Leiden, 1996), at 6-14.

[140] Siddiqi, M. Nejatullah, "The Comparative Advantage of Islamic Banking and Finance", Paper presented at the Fifth Harvard University Forum on Islamic Finance; *Islamic Finance: Dynamics and Development*, Cambridge, Massachusetts, April 6, 2002.

[141] *infra.*114 et seq. for a discussion of the Islamic finance industry in Malaysia.

[142] Siddiqi, Muhammad Nejatullah, *Muslim Economic Thinking*, (The Islamic Foundation, Leicester, 1988), at 29-30.

[143] Ready, R.K., "The Egyptian Municipal Saving Bank Project", (1967) 9(2) *International Development Review*, at 2-5, Hegazy, Walid S., "Contemporary Islamic Finance: From Socioeconomic Idealism to Pure Legalism", note 134, at 585-587.

[144] Nienhaus, Volker, "Islamic Economics, Finance and Banking: Theory and Practice", (1986) 3(2) *Journal of Islamic Banking and Finance*, 36-54.

as the intergovernmental Islamic Development Bank (IDB)(1972), the Dubai Islamic Bank (1975), the Faisal Islamic Bank of Egypt (1977) and the Bahrain Islamic Bank (1979).[145]

It was not until very recently that the rest of the financial world took any interest in Islamic finance.[146] Because of the explicit association between religious principles established centuries ago and *Sharī'ah*-compliant finance, Western states and banks approached the area with some reluctance and "a tinge of mockery."[147] As Siddiqi remarked, "alone in an age marked by its scepticism and uncertainty, the Islamic financial movement commits itself to a sacred text. To do so in matters economic leaves many gasping for breath."[148] Yet, despite this hesitation, the continued assertion of Muslim identity,[149] global economic upheaval and disillusionment with some conventional financial products, has led to a realisation that Islamic finance is a legitimate sector of the financial market.[150] Large Western banks, as well as non-banking market participants in Western markets, have entered the industry, applying the principles established by the roots of Islamic law to financial transactions.[151] With global assets now worth over $1 trillion,[152] Islamic finance has assumed mainstream relevance with *Sharī'ah*-compliant financial products available for both wholesale, sophisticated financial activity and retail-level transactions.[153]

This emergence of a financial industry which is designed to fulfil the unique dictates of Islamic law required the development of bespoke contracts which allow participation in

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[145] Ray, Nicholas Dylan, *Arab Islamic Banking and the Renewal of Islamic law*, note 2, at 8, Warde, Ibrahim, *Islamic Finance in the Global Economy*, (1st ed., Edinburgh University Press, Edinburgh, 2000), at 75.

[146] Anonymous, Editorial, "The Call of Profit", (2001) *Company Lawyer*, 1 at 1.

[147] Jabbar, Hjh Siti Faridah Adb, "Addressing Outstanding Issues in Islamic Finance: Malaysia's Initiatives", (2007) 28 (11) *Company Lawyer* 350-352 at 350.

[148] Siddiqi, M. Nejatullah, "The Comparative Advantage of Islamic Banking and Finance", note 140.

[149] Khan, Shahrukh Rafi, *Profit and Loss Sharing: An Islamic Experiment in Finance and Banking*, note 139, at 7.

[150] Even the Vatican voiced support for Islamic finance when it noted that the '[e]thical principles on which Islamic finance is based may bring banks closer to their clients and to the true spirit which should mark every financial service.' Napoleoni, L. and Segre, C., "Dalla finanza Islamica proposte e idee per l'Occidente in crisis," (4th March 2009), *l'Osservatore Romano*, available at: http://rassegnastampa.mef.gov.it/mefnazionale/PDF/2009/2009-03-04/2009030412006886.pdf. Original Italian text translation into English, Adrienne Strubb. See *infra.* at 154 a discussion of the potential economic benefits of Islamic finance.

[151] Citigroup's Bahrain-based Citi Islamic subsidiary was the first into the market in 1996 with others such as HSBC,[151] Standard Chartered and numerous other international banks following suit, Matthews, Owen, "How the West Came to Run Islamic Banks", (October 21, 2005) *Newsweek*, available at: http://www.newsweek.com/id/50875.

[152] Richter, Frederik "Islamic finance assets seen at $1.6 trln by 2012", (April 8 2009), *Reuters*, available at: http://www.reuters.com/article/2009/04/08/Islamicfinance-growth-idUSL894329020090408.

[153] Warde, Ibrahim, *Islamic Finance in the Global Economy*, (1st ed.), note 145, at 86 noting that "[t]oday, Islamic banks exist in virtually all parts of the world."

financial activity while still allowing compliance with Islamic law's various restrictions. Islamic law does not prevent Muslims from making profit or from engaging in financial activity; it simply seeks to eliminate unjustified gain.[154] Those seeking to develop Islamic finance have however been faced with the reality that the economic principles of Islamic law which prevent unjustified gain are often inconsistent with existing conventional contracts.[155] As a result, beginning with classical *fiqh* writers and continuing with contemporary scholars, the principles of Islamic law have been incorporated into Islamic contracts which provide a mechanism for *Sharī'ah*-compliant profit.

3.3.2 The Nominate Contracts and their Contemporary Manifestations

An economically viable Islamic finance industry exists today because profits in financial activity can be made without such profits amounting to *ribā*. This dichotomy in Islam between illicit profit derived from *ribā* transactions and legitimate gain is highlighted by the frequently cited *Qur'ānic* verse in which the Prophet noted that "Allah permitted *bay'* (sale / trade)[156] and prohibited *ribā*;"[157] while profits from trade and *ribā* may be ostensibly similar, only the latter is prohibited. As long as profits are made from an acceptable method of exchange and do not involve the exchange of homogenous goods with delay or excess, then Islamic law takes no position on the nature or level of profits earned.[158] Similarly, risk can be taken which is not *gharar*. As already noted, legitimate commercial risk is not prohibited by Islamic economic principles and is, in fact, a justification for payment of profit.[159] These elements of Islamic law were relied on by classical scholars when developing *Sharī'ah*-compliant mechanisms for conducting profitable financial activity. Using devices such as *hiyal*, *darūra* and *ijtihād*, both classical and contemporary scholars have further expanded the range of Islamic financial contracts available.

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[154] DeLorenzo, Yusuf Tala, "The Religious Foundations of Islamic Finance", note 36, at 145.

[155] As DeLorenzo notes, "it is not enough to find a nice, secure interest-bearing instrument or investment (like a bond, or a treasury bill, or an annuity), and then to sit back and wait for the profits to come to you because you have placed your capital in that investment," *ibid.*, at 146.

[156] Literally sale, but interpreted as trade.

[157] *Qur'ān* 2:275.

[158] See for example the *hadīth* recorded by al-Bukhari which notes that when a transaction does not involve ribā "sell however so you may wish", narrated Abu Bakra Imam al-Bukhari, *Sahih al-Bukhari*, Vol. 3, Book 34, Number 383, M. Muhsin Khan (trans.), available at: http://www.usc.edu/schools/college/crcc/engagement/resources/texts/muslim/hadith/bukhari/034.sbt.html. See also, Farooq, Mohammad Omar, "Stipulation of Excess in Understanding and Misunderstanding riba: The Al-Jassas Link", note 37, at 303.

[159] *supra.* at 60.

Without a general theory of contract in Islamic law, classical scholars developed a series of unique contracts, each self-contained and subject to its own specific set of rules.[160] These contracts, collectively referred to as the nominate contracts (*al-'aqd al-mu'ayyana*), were structures through which economic activity could take place in a *Sharī'ah*-compliant manner.[161] The number of nominate contracts which early scholars are considered to have developed varies amongst contemporary commentators,[162] nevertheless, several core contracts have been traced back to medieval Arabia such as *bay'* (sale), *qard* (loan), *sharikah* (partnership), *ijārah* (hire), *wakāla* (agency) and *hiba* (gift). For the more traditional schools of thought, such as the now non-existent Zahiris, the contracts which are valid under Islamic law were fixed with the original nominate contracts.[163] Commenting on contractual obligations, Schacht similarly concluded that "Islamic law does not recognize the liberty of contract, but it provides an appreciable measure of freedom within certain fixed types."[164] According to the more liberal Hanbali approach, commercial transactions and contracts are permissible unless they involve some element which is prohibited by *Sharī'ah*.[165] Parties are free to enter into any contract, engage in any form of business operation or add any condition (*shurūt*) to a nominate contract, even if there is no precedent for it, so long as it is *Sharī'ah*-compliant.[166] A number of textual

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[160] Hassan, Hussein, "Contracts in Islamic Law: The Principles of Commutative Justice and Liberality", note 13, at 258. Indeed, some commentators have suggested that Islam has a law of *contracts* rather than a single law of contract, Coulson, Noel James, *Commercial Law in the Gulf States: the Islamic Legal Tradition*, note 14, at 17, 27–31, Schacht, Joseph, *Introduction to Islamic Law*, note 22, at 144.

[161] Amin, S. H., *Remedies for Breach of Contract in Islamic Law and Iranian Law*, (Royston, Glasgow, 1984), at 11.

[162] Vogel and Hayes outline three mutually onerous contracts, five gratuitous contracts and three accessory contracts, Vogel, Frank E. and Hayes, Samuel.L., *Islamic Law and Finance, Religion, Risk and Return*, note 12, at 102-110, Hassan notes that the classical manuals set out four while Abd al-Razzaāq al-Sanhūrī set out six, Hassan, Hussein, "Contracts in Islamic Law: The Principles of Commutative Justice and Liberality", note 13, at 258.

[163] Rayner, Susan, *The Theory of Contracts in Islamic Law: A Comparative Analysis with Particular Reference to the Modern Legislation in Kuwait, Bahrain and the United Arab Emirates*, note 12, at 92.

[164] Schacht, Joseph, *An Introduction to Islamic Law*, note 22, at 144. See also,*Sahih Bukhari,* Volume 3, Book 34, Number 364 which provides that: "Whoever imposes such a condition as is not in Allah's Laws, then that condition is invalid even if he imposes one hundred conditions, for Allah's conditions are more binding and reliable," M. Muhsin Khan (trans.), available at: http://www.usc.edu/schools/college/crcc/engagement/resources/texts/muslim/hadith/bukhari/034.sbt.html#003.034.364.

[165] Kamali, Mohammad Hashim, *Islamic Commercial Law; An Analysis of Futures and Options*, (Islamic Texts Society, Cambridge, 2000), at 66, Coulson, Noel James, *Commercial law in the Gulf States: The Islamic legal tradition*, note 14, at 100.

[166] Hallaq, Wael B., *Shari'a; Theory, Practice, Transformations*, note 16, at 246-247, Ibn Qayyim al-Jawziyyah, *I'lam al-Muwaqqi'in 'an Rabb al-'Alamin*, (Vol. 1, Maktabah al-Kulliyyat al-Azhariyyah, Cairo, 1968), at 344, in Kamali, Mohammad Hashim, *Islamic Commercial Law; An Analysis of Futures and Options*, note 165, at 76. Ibn Taymiyyah, the Hanbali scholar, thus claimed that within the parameters set by Islamic law, man is best placed to know what is good for him and "if proper fulfilment of obligations and due respect for covenants are prescribed by the Lawgiver, it follows that the general rule is that contracts are valid," Ibn Taymiyyah, *Fatawa of Taqī ad-Dīn Abu 'l Abbās Ahmad ibn 'Abd al-Halīm ibn 'Abd as-Salām Ibn Taymiya al-Harrānī, Mabhath al-'Uqud*, (Chapter on Contracts), Vol. 3 (Cairo, 1326-1329AH), at 387ff in

sources can be found in support of a permissive stance to freedom of contract. The *Qur'ān*, for example, notes that "God has explained to you in detail what is forbidden to you, except under compulsion of necessity"[167] and "Allah will never lead a people astray after He has guided them until He makes clear to them as to what they should avoid."[168] Such references, though not directly related to contracts, nevertheless suggest that the proscriptions set out in Islamic law represent outer limits within which Muslims are accorded a measure of freedom. While the other schools of Islamic law have tended to adopt a middle ground as regards freedom of contract,[169] contemporary Islamic financial activity has favoured the more liberal Hanbali view thus allowing parties to depart from the original nominate contracts so long as they maintain compliance with Islamic law.[170]

Notwithstanding this relative contractual freedom, in practice contemporary scholars have been reluctant to openly depart from the nominate contracts.[171] Rather than developing wholly novel contracts for contemporary Islamic finance, scholars have relied heavily on existing structures, which they have "revived, modified and combined"[172] so that Islamic financial products can be produced for the contemporary Islamic financial market.[173] As a result, while the nominate contracts are now rarely applied in modern Islamic finance as complete products in and of themselves, the Islamic finance industry

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Kamali, Mohammad Hashim, *Islamic Commercial Law; An Analysis of Futures and Options*, note 165, at 95, Islahi, Abdul Azim, *Economic Concepts of Ibn Taimiyah*, (The Islamic Foundation, Leicester, 1988), at 15.

[167] *Qur'ān* 6:119

[168] *Qur'ān* 9:115. Equally, a *hadīth* notes that "those who were before you were desroyed because of excessive questioning, and their opposition to their apostles. So when I command you to do anything, do it as much as it lies in your power and when I forbid you to do anything, then abandon it."*Sahih Muslim*, Book 007, Number 3095, Abdul Hamid Siddiqui (trans.), available at: http://www.usc.edu/schools/college/crcc/engagement/resources/texts/muslim/hadith/muslim/007.smt.html#007.3095. See also, the *hadīth* that notes that: "he has, out of mercy, but not forgetfulness, chosen to remain silent over certain matters, so try not to be [too] inquisitive about them." al-Nawawi, "Arba'in Hadith", in al-Qaradawi, *Bay' al-Murabah*ah at 13ff quoted in Kamali, Mohammad Hashim, *Islamic Commercial Law; An Analysis of Futures and Options*, note 165, at 66.

[169] Hanafi, Shafi'i and Maliki schools have been more reluctant to embrace the liberal Hanbali stance preferring a more rigid approach but also acknowledging the need for departure in certain circumstances, Muhammad Abu Zaharah, *Usūl al-Faqh*, (Dar al-Fikhr al-'Arabi Cairo, 1377AH (1958AD)), at 219, 'Abd al-Rahman al-Sabuni, *al-Madkhal al-Fiqhi wa'l-Tarikh al-Tashri'al-Islami*, (Maktabah Wahbah, Cairo, 1402AH (1982AD)), at 145.

[170] Mohammed, Noor, "Principles of Islamic Contract Law", note 21, at 126, Coulson, Noel James, *Commercial law in the Gulf States: The Islamic legal tradition*, note 14, at 28-29 noting that a number of "exceptional" transactions not subsumed by the original contracts were "regarded by the consensus as vital and integral parts of the total system" and thus permissible notwithstanding the fact that they may not be underpinned by clear approval in the *Qur'ān* or *Sunnah*.

[171] Hamoudi, Haider Ala, "The Muezzin's Call and the Dow Jones Bell: On the Necessity of Realism in the Study of Islamic Law", (2008) 56 *American Journal of Comparative Law*, 423-469 at 426. Hamoudi criticises this reliance on the writings of the classical scholars.

[172] Ray, Nicholas Dylan, *Arab Islamic Banking and the Renewal of Islamic Law*, note 2, at 31.

[173] Ahmed, Habib, *Product Development in Islamic Banks*, note 108, at 48 discussing the various ways in which the nominate contracts are now modified in order to facilitate development of modern Islamic financial products that function within the contemporary market.

continues to use them as the contractual basis and building blocks around which more complex Islamic finance transactions are structured. [174] Over the course of this thesis, repeated references will thus be made to the contracts used today in Islamic financial products and their position within Ireland's legal framework. This subsection will introduce sale-based contracts (A),[175] partnership contracts (B)[176] and lease contracts (C).[177] For each it will discuss contract forms which are used in the contemporary Islamic finance industry considering their origin, current structure and some of the modifications introduced by market participants. It will not discuss in detail the financial products which have developed on the basis of such contracts as these will be discussed - in the context of real estate finance and *sukūk* - in Chapters 6 and 8 respectively.

A. *Bay'* – Sale-Based Contracts

Explicitly sanctioned by the *Qur'ān* as the *Sharī'ah*-compliant means of earning a profit without taking *ribā*, sale has been categorised as the prototype Islamic contract.[178] As a synallagmatic arrangement, in which the parties can exchange heterogeneous goods immediately (generally money exchanged for an item), a sales contract avoids *ribā*. Hallaq has also highlighted a number of elements in valid *bay'* contracts, many of which go towards avoiding *gharar*: the object of sale must be known by the parties, it must be in existence, it must have monetary value and be capable of lawful use, it must be owned by the party selling it and be capable of delivery.[179] Perhaps because of the explicit endorsement of *bay'* in the primary textual source of *Sharī'ah*, the sale contract has been repeatedly developed by scholars, both classical and contemporary, to produce specific types of sales, some of which are now used as methods of financing. Three types of sales are widely used in contemporary Islamic banking and finance; the *murābaha* (1),[180] *salam* (2)[181] and *istisnā'* (3).[182]

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[174] Selwood, Dominic, "Islamic Contracts in a Modern Legal Context", in *The Chancellor Guide to the Legal Shari'a Aspects of Islamic Finance*, note, 83, at 33, HM Treasury, *The Development of Islamic Finance in the UK: The Government's Perspective*, (HM Treasury, London, 2008), at 18.

[175] *infra.*at 72.

[176] *infra.*at 79

[177] *infra.*at 87

[178] Schacht, Joseph *An Introduction to Islamic Law*, note 22, at 151.

[179] Hallaq, Wael B., *Shari'a; Theory, Practice, Transformations*, note 16, at 248.

[180] *infra.*at 73.

[181] *infra.*at 75.

[182] *infra.*at 77.

1. *Bay' Murābaha*

Bay' murābaha is a cost-plus-profit economic arrangement[183] in which a seller appends a defined profit margin to the price it originally pays for an object, disclosing both the cost price[184] and any mark-up to the purchaser.[185] This mark-up, which must be specified,[186] can take the form of a fixed lump sum added to the cost price or a percentage of that cost price.[187] The purchaser pays this cost price plus mark-up in exchange for the object, thus providing a seller with a specified margin of profit.[188] Described by Ibn Qudama as "the sale at capital cost plus a known profit,"[189] *bay' murābaha* was originally conceived as a spot transaction in which a purchaser instructed a trader to purchase an object and then paid the trader the marked-up price immediately on receipt of the object.[190] The profit element of the transaction was considered to be legitimate because the seller had acquired ownership of the object and the risks associated with this ownership; this was legitimate commercial risk and consideration for earning a profit.[191] Such profit was not *ribā* because

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[183] Saleh, Nabil A., *Unlawful Gain and Legitimate Profit in Islamic Law*, note 57, at 117, Ayub, Muhammad, *Understanding Islamic Finance*, note 26, at 213.

[184] See Ibn Rushd, *Bidayat al-Mujtahid wa Nihayat al-Muqtasid*, (*The Distinguished Jurist's Primer*), Vol. II, note 60, at 256-257 for a discussion of the views of scholars relating to what can and what cannot be included as costs.

[185] Vogel and Hayes note that *murābaha* is now most commonly used in a composite form identified as "*al-murābaha lil-amir bi-al-shira*" which translates as "the *murābaha* of the one who orders or commissions another to purchase" Vogel, Frank E. and Hayes, Samuel.L., *Islamic Law and Finance, Religion, Risk and Return*, note 12, at 140, Ayub, Muhammad, Understanding Islamic Finance, note 26, at 213, Usmani, Muhammad Taqi, "Methods of House Building Finance According to *Shari'ah*", in *Islamic Banking Modes for Building Financing*, Proceedings of a Workshop organized in Khartoum by the Islamic Research and Training Institute of the Islamic Development Bank, October 27-29, 1991, Seminar Proceedings Series No. 28, Mahmoud Ahmad Mahdi (ed.), (Islamic Research and Training Institute, Jeddah, 1995), 61-74 at 63.

[186] Al-Zuhayli, Wahbah, *Financial Transactions in Islamic Jurisprudence*, Mahmoud el-Gamal (trans.), (Vol. 2, Dar al-Fikr, Damascus, 2003), at 355-357 noting that, "[t]he second buyer must know the price at which the seller obtained the object of sale, since knowledge of the price is a fundamental condition for the validity of sale."

[187] Yanagihashi, Hiroyuki, *A History of the Early Islamic Law of Property: Reconstructing the Legal Development, 7th-9th Centuries*, (Brill, Leiden, 2004), at 134.

[188] Ahmad, Abu Umar, *Theory and Practice of Modern Islamic Finance; The Case Analysis from Australia*, (BrownWalker Press, Florida, 2010), at 193.

[189] Ibn Qudama, Abu Muhammad Abdullah bin Ahmad, Al-Mughni, (Vol. 4, Dar-ul Manar, Egypt, 1367AH), at 179 in Ayub, Muhammad, *Understanding Islamic Finance*, note 26, at 216.

[190] Warde, Ibrahim, *Islamic Finance in the Global Economy*, (2nd ed.), note 91, at 140, Usmani, Muhammad Taqi, *An Introduction to Islamic Finance*, (Kluwer Law International, The Hague, 2002), at 37 noting that '*Murabaha* is, in fact, a term of Islamic *Fiqh* and it refers to a particular kind of sale having nothing to do with financing in its original sense.' Hegazy, Walid S., "Contemporary Islamic Finance: From Socioeconomic Idealism to Pure Legalism", note 134, at 598.

[191] *supra.*at 60. See also, Yanagihashi, Hiroyuki, *A history of the Early Islamic Law of Property: Reconstructing the Legal Development, 7th-9th Centuries*, note 187, at 143 who suggests that scholars such as Ibn 'Umar prohibited *murābaha* agreements from being entered into before the seller had acquired the object because any profit made would be unlawful gain since it was made without assuming risk, Hegazy, Walid S., "Contemporary Islamic Finance: From Socioeconomic Idealism to Pure Legalism", note 134, at 598.

it took place in the context of a trading arrangement which was settled immediately thereby allowing the seller to "seek the bounty of [the] Lord"[192] and negotiate a sale price.

A second form of sale, the *bay' mu'ajjal* (credit sale) was also approved by classical scholars. The notion of credit in financial arrangements appears to contradict the prohibition of *ribā al-nasi'ah*, as an object is purchased but not paid for until a future date and so there is a delay. However, *fiqh* writers approved credit sales on the basis of the heterogeneous nature of the goods, established practice[193] and a *hadīth* in which the Prophet is recorded as having participated in such a sale when purchasing clothes from a tailor.[194] Credit price may be higher than the original cost price,[195] although the higher price must be fixed at the outset together with the date on which payment will be made.[196] Precisely because of the acceptability under Islamic economic principles of charging a higher credit price, *bay' mu'ajjal* arrangements have, according to Vogel and Hayes, "been universally employed as a vehicle of finance throughout Islamic history."[197]

Contemporary scholars have combined these two approved sales contracts (*bay' murābaha* and *bay' mu'ajjal*) in order to produce a "*murābaha* with a purchase order" contract,[198] something Saleh has classified as "a good example of the sometimes thin line which separates legitimate trade from illegal *ribā*.[199] Though both *murābaha* and *bay'*

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[192] *Qur'ān* 2:198 cited by AAOIFI as a basis for the legitimacy of *murābaha* arrangements, AAOIFI, Shari'a Standard No. (8), "Murabaha to the Purchase Orderer", in *Shari'a Standards for Islamic Financial Institutions 1432 H-2010*, (AAOIFI, Bahrain, 2010), 111-136 at 129.

[193] Udovitch suggests that "...credit transactions and institutions of credit assumed a major role in the trade and economic life of medieval Christian Europe as well as of that of the medieval Islamic Near East," Udovitch, Abraham L., "Reflections on the Institution of Credit and Banking in the Medieval Islamic Near East", (1975) 41 *Studia Islamica*, 5-21 at 5.

[194] Reported by 'A'isha and cited in Vogel, Frank E. and Hayes, Samuel.L., *Islamic Law and Finance, Religion, Risk and Return*, note 12, at 74.

[195] Al Sarakhsi notes that "[a]n object is sold on credit for a larger sum than it would be sold for in cash," Sarakhsi, *Kitab al-Mabsut,* (Vol. 22, Cairo 1324-1331 AH/ 1906-1913 AD), at 45 in Udovitch, Abraham L., "Reflections on the Institution of Credit and Banking in the Medieval Islamic Near East", note 193, at 5-21

[196] Usmani, Taqi Muhammad, *An Introduction to Islamic Finance*, note 190, at 70-71.

[197] Vogel, Frank E. and Hayes, Samuel.L., *Islamic Law and Finance, Religion, Risk and Return*, note 12, at 139.

[198] Hegazy, Walid S., "Contemporary Islamic Finance: From Socioeconomic Idealism to Pure Legalism", note 134, at 598 noting that "[t]he introduction of murabahah, in its modern form, took place in the mid-1970s when Sami Hamoud, a well-known Jordanian economist and banker, proposed it as an Islamic substitute for conventional interest-bearing loans." (internal citation omitted). See also,Al-Zuhayli, Wahbah, *Financial Transactions in Islamic Jurisprudence*, note 186, at 361.

[199] Saleh, Nabil A., *Unlawful Gain and Legitimate Profit in Islamic Law*, note 57, at 117. Thomas characterised *murābaha* used today as a legal stratagem or hiyal, Thomson, Judith, "Developing Financial Law in Conformity with Islamic Principles: Strict interpretation, Formalism or Innovation?", (1997-2000), 4 *Deakin Law Review* 77-91 at 85. But see however al-Shari'i who notes, "If a person shows a commodity to a person and says, 'Purchase it for me, and I will give you such and such profit,' and the person purchases it, the transaction is lawful," al-Shafi'i, *Kitab al-Umm*, (Vol. 3, Dar al-Maᶜrifah liltibāᶜah wa al-Nashr, Beirut), at

mu'ajjal were original conceived of as sales, together they function as a method of financing.[200] Under such arrangements, a customer will instruct a financier to purchase a particular asset; that asset is then sold to the customer by the financier at a mark up price with that price paid on a deferred basis.[201] Like a conventional loan, *murābaha* with a purchase order, (now generally referred to simply as *murābaha*), provides a customer with the opportunity to purchase an object which he or she wants, without having to pay the full purchase price immediately.[202] At the same time, the seller of the object adds their mark-up in line with the *murābaha* portion of the arrangement. This profit is not *ribā* because it is not (in theory at least) payable as a result of the deferred payment of the purchase price but rather because the seller of the object assumes ownership of the object before the sale and so bears the risks of that ownership. Nevertheless, the combination of a credit sale, mark-up and the ability of the seller to set the level of that mark-up have resulted in the contemporary use of *murābaha* arrangements as alternatives to interest-based loans.[203]

2. *Bay' Salam*

Salam sales are the inverse of *bay' mu'ajjal* and involve payment in advance for an object which is not yet available.[204] Such sales involve a delay in the exchange of countervalues, the sale of a non-existent item[205] and appear to violate the *hadīth* in which the Prophet is reported to have said "do not sell what you do not own."[206] Nevertheless,

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33 in Saeed, Abdullah *Islamic Banking and Interest: A Study of the Prohibition of Riba and Its Contemporary Interpretation*, (Brill, Leiden, 1996), at 77.

[200] Dar, Humayon A., " House Financing in the United Kingdom: Problems, Challenges and Prospects", (2002) 12 *Review of Islamic Economics*, 47-71 at 49. Meera, Ahamed Kameel Mydin, and Razak, Dzuljastri Abdul, "Islamic Home Financing through *Musharakah Mutanaqisah* and *al-Bay' Bithaman Ajil* Contracts: A Comparative Analysis", (2009) 22(1) *Journal of King Abdulaziz University: Islamic Economics*, 121-143at 7.

[201] Vogel, Frank E. and Hayes, Samuel.L., *Islamic Law and Finance, Religion, Risk and Return*, note 12, at 140, Al-Zuhayli, Wahbah, *Financial Transactions in Islamic Jurisprudence*, note 186, at 361, referring to approval of this type of transaction by Al-Shafi'i, who noted that, "[i]f an individual shows another a good and says: buy this, and I will give you this much profit in it; and then the second man buys it, then the purchase is valid. If the first party said 'I will give you this much profit in it, but I retain an option', then he may conclude the sale or leave it," al-Shafi'i, *Kitab al-Umm*, (Vol. 3, Dar al-Maᶜrifah liltibāᶜah wa al-Nashr, Beirut), at 33.

[202] Ahmad, Abu Umar, *Theory and Practice of Modern Islamic Finance; The Case Analysis from Australia*, note 188, at 193.

[203] *infra.*at 204 which discusses the various devices implemented in comtemporary *murābaha* arrangements so that they emulate the risk and rewards of interest-based debt.

[204] Mohammed, Noor, "Principles of Islamic Contract Law", note 21, at 124.

[205] Al-Kasani, amongst many other scholars, denounced the sale of items not yet in existence , Al-Kasani, 'Ala' al-Din, *Badai' al-Sandi'*, (2nd ed, Beirut: Dir al-Hadith, 1986, Vol. 5), at 138, in Zahraa, Mahdi and Mahmor, Shafaai M,. "The Validity of Contracts When the Goods Are Not Yet in Existence in the Islamic Law of Sale of Goods", note 105, at 380.

[206] *Sunan Abu-Dawud*, Book 23, Number 3496, Prof. Ahmad Hasan (trans.), available at: http://www.usc.edu/schools/college/crcc/engagement/resources/texts/muslim/hadith/abudawud/023.sat.html.

approval of *salam* contracts is found in the *Qur'ān*, *Sunnah* and potentially *ijmā'*.[207] In acknowledging the legitimacy of forward sales, both the *Qur'ān* and *Sunnah* set out characteristics which must be present if such contracts are to be valid; the *Qur'ān* notes "O ye who believe! When you deal with each other, in transactions involving future obligations in a fixed period of time, reduce them to writing"[208] while a *hadīth* records the Prophet as noting, in reference to the customary practice of *salam*,[209] "whosoever pays money in advance should pay it for a known quality, specific measure and weight of course along with the price and time of delivery."[210] AAOIFI also states that "[t]he scholars are unanimous on the legitimacy of a Salam contract,"[211] and suggests that the justification for permitting *salam* agreements is that "[s]alam facilitates a type of financing for people in need of it."[212] *Darūra* and *maslaha* therefore appear to have influenced the legitimation of *salam* within Islamic law.[213]

In light of the potential for *salam* arrangements to involve *ribā* and *gharar*, these contracts are subject to prescriptive criteria.[214] The agreement for future delivery can only be made in relation to fungible objects whose quantity and quality have been specified at the time of contracting.[215] Such objects are sold on the basis of that quantity and quality in circumstances where any objects displaying the requisite attributes would be sufficient; the risk that the seller will not be able to deliver the goods at the future date is therefore

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See also, Rayner, Susan, *The Theory of Contracts in Islamic Law: A Comparative Analysis with Particular Reference to the Modern Legislation in Kuwait, Bahrain and the United Arab Emirates*, note 12, at 133.

[207] AAOIFI, Shari'a Standard No. (10), "Salam and Parallel Salam", in *Shari'a Standards for Islamic Financial Institutions 1432 H-2010*, (AAOIFI, Bahrain, 2010), 161-176 at 173, Zahraa, Mahdi and Mahmor, Shafaai M,. "The Validity of Contracts When the Goods Are Not Yet in Existence in the Islamic Law of Sale of Goods", note 105, at 382. Mahmassani, Subhi, *al Mujibat wa al Uqud fi al Fiqh al Islami*, (Dar al Ilm Ii al Malayin, Beirut, 1983), at 327 noting that *salam* and *istisnā'* are exceptions to general Islamic financial concepts, in Obaidullah, Mohammed, "Financial Options in Islamic Contracts: Potential Tools for Risk Management", (1999) 11 *Journal of King Abdulaziz University: Islamic Economics*, 3-26 at 5.

[208] *Qur'ān* 2:282.

[209] Shabana, Ayman, *Custom in Islamic Law and Legal Theory; The Development of the Concepts of 'Urf and 'Adah in the Islamic Legal Tradition*, (Palgrave Macmillan, New York, 2010), at 55.

[210] On the authority of 'Ibn Abbās; *Sahih Bukhari*, Volume 3, Book 35, Number 443, M. Muhsin Khan (trans.), available at: http://www.usc.edu/schools/college/crcc/engagement/resources/texts/muslim/hadith/bukhari/035.sbt.html. See also, Al-Zuhayli, Wahbah, *Financial Transactions in Islamic Jurisprudence*, note 186, at 237-238.

[211] AAOIFI, Shari'a Standard No. (10), "Salam and Parallel Salam", note 207, at 173.

[212] *ibid.*

[213] A conclusion also reached by Hasanuz Zaman, S.M., "Bai' Salam: Principles and Practical Application", (1991) 30(4) *Islamic Studies*, 443–461at 443, Schacht suggests that *salam* is "valid only in so far as it is customary," Schacht, Joseph, *An Introduction to Islamic Law*, note 22, at 155.

[214] El-Gamal, Mahmoud Amin, *A Basic Guide to Contemporary Islamic Banking and Finance*, note 41, at 82, Yanagihashi, Hiroyuki, *A history of the Early Islamic Law of Property: Reconstructing the Legal Development, 7th-9th Centuries*, note 187, at 163 noting that, "[t]he positive rules governing *salam* are often complicated."

[215] Al-Zuhayli, Wahbah, *Financial Transactions in Islamic Jurisprudence*, note 186, at 239 noting that scholars are in agreement that salam is "permissible for all commodities measured by volume, weight, length, or number of similar items (e.g. nuts, eggs, etc.)"

reduced.[216] In contrast, objects sold according to their individual, particularised characteristics, such as a house, cannot be the subject of a *salam* sale as there is no certainty that the seller will be able to acquire the exact object requested at the time specified. Such an arrangement would thus involve *gharar*.[217] At conclusion of the agreement, the fixed price must be paid immediately, while the date and place of delivery must have been agreed by the parties.[218]

In conventional financial activity, a parallel *salam* structure has been devised in which forward sales can be used as a method of financing.[219] Under such arrangements, an institution enters into an initial *salam* contract with a seller and then enters into a separate *salam*, usually with a third party, for the same class and quantity of goods at a higher price;[220] the customer thereby obtains cash without having to take physical delivery of the underlying goods.[221] This arrangement also acts as an Islamic means of hedging price risk as the initial purchaser in the first *salam* can ensure that there is a market for the goods that will pay a fixed price for those goods.[222]

3. Bay' Istisnā

A final sales contract elaborated by the classical scholars that is used in contemporary Islamic banking and finance transactions is *istisnā'* or "a contract with a manufacturer to make something."[223] *Istisnā'* contracts allow a customer to enter into a financial transaction in relation to a good which is not yet in existence[224] and represent a sales contract under which one party undertakes to manufacture or construct a good and deliver

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[216] AAOIFI, Shari'a Standard No. (10), "Salam and Parallel Salam", note 207, at 174-175.

[217] Ibn Rushd, *Bidayat al-Mujtahid wa Nihayat al-Muqtasid*, (*The Distinguished Jurist's Primer*), Vol. II, note 60, at 240, Ayub, Muhammad, *Understanding Islamic Finance*, note 26, at 244-245. See also, Hallaq, Wael B., *Shari'a; Theory, Practice, Transformations*, note 16, at 250-251.

[218] Ibn Rushd, *Bidayat al-Mujtahid wa Nihayat al-Muqtasid*, (*The Distinguished Jurist's Primer*), Vol. II, note 60, at 242, Ayub, Muhammad, *Understanding Islamic Finance*, note 26, at 244-247, AAOIFI, Shari'a Standard No. (10), "Salam and Parallel Salam", note 207, at 174 citing Ibn Qudama, al-Mughni 6/408 as authority.

[219] El-Gamal, Mahmoud Amin, *A Basic Guide to Contemporary Islamic Banking and Finance*, note 41, at 83.

[220] Because of the shorter delivery time.

[221] Iqbal, Munawar and Molyneux, Philip, *Thirty Years of Islamic Banking; History, Performance and Prospects*, (Palgrave, Macmillan, 2005), at 25.

[222] Dar, Humayon A., "Incentive compatibility of Islamic financing", in *Handbook of Islamic Banking*, Kabir Hassan and Mervyn Lewis (eds.), (Edward Elgar Publishing, Cheltenham, 2007), 85-95 at 87.

[223] Al-Samarkhandi, 'Ala' al-Din, *Tuhfat al-Fuqaha, Mat ba'at Jamiat Dimaq*, (Damascus 1983, Vol. 2), at 538 quoted in; al-Amine, Muhammad al-Bashir, "Istisna", in *Islamic Banking and Finance; Law & Practice*, (A.S. Noordeen, Kuala Lumpur, 2006), at 7.

[224] El-Gamal, Mahmoud Amin, *A Basic Guide to Contemporary Islamic Banking and Finance*, note 41, at 90.

that good to the other at a future date.[225] Payment for the property can be on an instalment basis during the construction of the good or once the completed project has been transferred to the customer.[226] While similar in function to *salam*, *istisnā'* contracts are not used for fungibles, but for individual goods whose attributes are specifically agreed upon;[227] effectively, such goods would not exist if the *istisnā'* agreement had not been entered into.[228] In order to be a valid *istisnā'* the contract must include all necessary asset specifications as well as the price to be paid although a specific date for delivery is not essential.[229]

Istisnā' contracts have not been approved in the *Qur'ān*. Nevertheless, a *hadīth* indicates that the Prophet had a ring and pulpit manufactured,[230] while Visser and Aghnides respectively suggest that *istisnā'* have been accepted by Islamic scholars on the basis of *qiyās* with *salam* contracts[231] and through *ijmā'*.[232] Several commentators have also concluded that the presence of *istisnā'* as an Islamic contract is as a result of the application of *istihsān* and *darūra*.[233]

Through the use of back-to-back or parallel *istisnā'* contracts, this manufacturing arrangement has been transformed into a contemporary method of financing. This two-tier

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[225] Warde, Ibrahim, *Islamic Finance in the Global Economy*, (2nd ed.), note 91, at 143.

[226] Muhammad Taqi Usmani, *An Introduction to Islamic Finance*, note 190, at 138, AAOIFI, Shari'a Standard No. (11), "Istisna'a and Parallel Istisna'a", in *Shari'a Standards for Islamic Financial Institutions 1432 H-2010*, (AAOIFI, Bahrain, 2010), 177-198 at 184.

[227] Elfakhani, Said M., Zbib, Imad J. and Ahmed, Zafar U., "Marketing of Islamic financial products", in *Handbook of Islamic banking*, Kabir Hassan and Mervyn Lewis (eds.), (Edward Elgar Publishing, Cheltenham, 2007), 116-127 at 120.

[228] Comair-Obeid, Nayla, "Particularity of the Contract's Subject-Matter in the Laws of the Arab Middle East", (1996) 11 *Arab Law Quarterly*, 331-349 at 343, El-Gamal, Mahmoud Amin, *A Basic Guide to Contemporary Islamic Banking and Finance*, note 41, at 90.

[229] Muhammad Taqi Usmani, *An Introduction to Islamic Finance*, (Kluwer Law International, The Netherlands, 2002), at 88-89, Klarmann, Reinhard Leopold, *Islamic Project Finance, A legal study with particular reference to the laws of Switzerland and the United Arab Emirates*, note 59 at 233. See also, Al-Zuhayli, Wahbah, *Financial Transactions in Islamic Jurisprudence*, note 186, at 273.

[230] Reported in *Sahih al-Bukhari* 5/220 and *Sahih Muslim* 3/1655 (ring), in AAOIFI, Shari'a Standard No. (11), "Istisna'a and Parallel Istisna'a", note 226, at 193. see also, *Sahih al-Bukhari* Volume 3, Book 34, Number 308 (relating to the manufacture of a pulpit), M. Muhsin Khan (trans.), available at: http://www.usc.edu/schools/college/crcc/engagement/resources/texts/muslim/hadith/bukhari/034.sbt.html.

[231] Visser, Hans, *Islamic finance: Principles and Practice*, note 65, at 62.

[232] Aghnides, Nicolas P., *Mohammedan Theories of Finance*, (The Premier Book House , Lahore, 1961), at 95.

[233] See for example, Comair-Obeid, Nayla, "Particularity of the Contract's Subject-Matter in the Laws of the Arab Middle East", note 228, at 343, Ayub, Muhammad, *Understanding Islamic Finance*, note 26, at 263. See Al-Bashir, Muhammad and Al-Amine, Muhammad, "Istisna and Its Application in Islamic Banking", (2001) 16 *Arab Law Quarterly*, 22-48 at 29 for a discussion of the different bases proposed to justify the validity of istisnā'. See also,Al-Zuhayli, Wahbah, *Financial Transactions in Islamic Jurisprudence*, note 186, at 271 noting that, ""[t]he Hanafī jurists,...permitted commissioning to manufacture based on juristic approbation [*istihsān*], due to its common usage in various times without any objections, thus constituting a consensus [*ijmā'*]."

contractual framework involves a customer entering into an initial contract with the financier (acting as manufacturer) to supply the requested good, the financier (as buyer) then enters into a second contract with a manufacturer to construct the same good. The conditions and asset specifications in the first contract will be replicated in the second, as the financier will use the good constructed under the second *istisnā'* to fulfil its liabilities to the customer in the first *istisnā'*. The two parallel structures must be independent of each other such that the fulfilment of the first is not be made contingent on the contractor delivering the property to the financier under the second *istisnā'*; contingency would represent *gharar* since the effectiveness of one *istisnā'* is dependent on the other, thereby creating inherent uncertainty in the arrangement .[234] The effect of such a parallel *istisnā'* is that the financier funds the manufacture while the customer pays the financier on a deferred payment basis, generally at an increased price.[235]

Because Islamic sales contracts resemble interest-bearing transactions and can be modified so that they function like financing arrangements, these contracts have dominated the contemporary Islamic finance industry. *Murābaha* contracts in particular have been used widely by Islamic financial institutions as the contractual basis for Islamic products.[236] The prevalence of some sales contracts in financing transactions (most notably *murābaha*) has, however, been the subject of disquiet amongst some commentators, with many calling on the industry to focus on other contracts perceived to be more consistent with Islamic law.[237]

B. *Sharikah* - Partnership Contracts

The emphasis in Islamic law on trade and the assumption of commercial risk has led to a stress by Islamic scholars on an equity-based system of profit-and-loss sharing [PLS] as

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[234] Haron, Abdullah and Hock, John Lee Hin, "Inherent Risk: Credit and Market Risks", in *Islamic Finance: The Regulatory Challenge*, Simon Archer and Rifaat Ahmed Abdel Karim (eds.), (John Wiley & Sons (Asia) Ptd Ltd., Singapore, 2007), 94-120 at 107.

[235] Khan, Mansoor H., "Designing an Islamic Model for Project Finance", (1997) 16 *International Financial Law Review*, 13-16 at 16.

[236] Iqbal, Muawar and Ahmad, Ausaf, *Islamic Finance and Economic Development*, (Palgrave, Macmillan, New York, 2005), at 12. Some commentators place the figure of profit-and-loss financing as low as 5% of the Islamic financing industry, see for example the Annual Report of Malaysia's Bank Negara (2001), Table 4.18 and (2002), Table 4.17, in Hasan, Zubair, "Islamic Banking at a crossroads: Theory versus Practice", (2005) *Munich Personal RePEe Archive* (MPRA), at 19, available at: http://mpra.ub.uni-muenchen.de/2921.

[237] See, for example, Ali, Jawad I. and Salah, Omar, "Pyrrhic Victory for Islamic Finance: The Further Growth of the Islamic Finance Industry", in *Taking Stock and Moving Forward: The State of Islamic Finance and Prospects for the Future*, (Hawkamah White Paper, Dubai, 2010), at 4, Shafique, Mohammad, "Murabaha Revisited", (June 2006) *NewHorizon Magazine*, available at: http://www.newhorizon-islamicbanking.com/index.cfm?section=features&action=view&id=10991.

the alternative "of choice"[238] to fixed or variable interest-based lending.[239] The profits made from involvement in these partnership structures are neither pre-determined nor fixed. Instead the financier and the customer come together as business partners, contributing financial support or technical know-how to the venture in the hopes of receiving a share of the final profits. Relying on the maxim which confirms that "gain accompanies liability for loss," the philosophical underpinning of partnership financing rests on the idea that a financier looking to make a profit must be prepared to share the risks and rewards with the entrepreneur.[240] PLS requires that returns are linked to the profitability of an underlying business, activity or asset and so whether the partners receive any profit on the investment depends on the ultimate success of the underlying business, activity or asset. This system joins a number of parties in a mutually beneficial relationship and can be used as a financing technique to provide a customer with funds without contravening the prohibitions of *ribā* and *gharar*.[241] Drawing on the thoughts of early Islamic scholars, two broad categories of partnership have emerged:[242] *mudāraba* (1)[243] and *mushāraka* (2).[244]

1. Mudāraba

Mudāraba, frequently described as a "sleeping,"[245] or "limited"[246] partnership, is a form of participatory contract between at least two parties, a finance partner (*rabb al-mal*) and a management partner (*mudārib*).[247] Under *mudāraba* contracts, financial institutions supply

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[238] Warde, Ibrahim, "The Revitalisation of Islamic Profit-and-loss Sharing", Paper presented at Third Harvard University Forum on Islamic Finance; *Local Challenges, Global Opportunities*, Cambridge, Massachusetts, October 1, 1999.

[239] Wilson, Rodney, "The Issue of Interest and the Islamic Financing Alternatives", (1997) 13(1) *Journal of International Banking Law*, 23-29 at 25.

[240] Warde, Ibrahim, "The Revitalisation of Islamic Profit-and-loss Sharing", note 238.

[241] Ray, Nicholas Dylan, *Arab Islamic Banking and the Renewal of Islamic Law*, note 2, at 70, Lewis, Mervyn. and Algaoud, Latifa M., *Islamic Banking*, (Edward Elgar, Cheltenham, 2001), at 43.

[242] Saleh, Nabil A., *Unlawful Gain and Legitimate Profit in Islamic Law*, note 57, at 113. See also, Iqbal, Munawar and Molyneux, Philip, *Thirty Years of Islamic Banking; History, Performance and Prospects*, note 221, at 20, El-Gamal, Mahmoud, *Islamic Economics, Law, Economics and Practice*, note 68, at 117.

[243] *infra.*at 80.

[244] *infra.*at 83.

[245] Saleh, Nabil, "Arab International Corporations: The Impact of the Shari'a", (1993) 8(3) *Arab Law Quarterly*, 179-183 at 182.

[246] Thomson, Judith, "Developing Financial Law in Conformity with Islamic Principles: Strict interpretation, Formalism or Innovation?", note 199, at 89

[247] Iqbal, Munawar and Molyneux, Philip, *Thirty Years of Islamic Banking; History, Performance and Prospects*, note 221, at 21. Udovitch defines *mudāraba* as follows; 'The commenda (*mudāraba*) is an arrangement in which an investor or group of investors (generally an Islamic bank known as a rabb al-mal) entrusts capital or merchandise to an agent manager (the borrower referred to as a *Mudārib*), who is to trade with it and then return to the investors the principal and a previously agreed upon share of the profits. Any loss resulting from…an unsuccessful business venture is borne exclusively by the investors; the agent is in no

the entirety of the capital needs of a venture.[248] The customer (that is, the *mudārib*) on the other hand, is not required to make any financial contribution to the partnership.[249] Instead, the *mudārib* assumes the role of manager, providing the technical know-how, expertise and management needed to ensure the ultimate success of the investment,[250] a contribution known as "sweat" equity.[251] On generation of income in a successful *mudāraba*, the *mudārib* returns, to the *rabb al-mal*, the principal sum invested plus an agreed-upon *share* of the venture's profits rather than a pre-arranged fixed lump sum.[252] Any kind of fixed or guaranteed distribution of profit will be invalid under Islamic legal principles;[253] by fixing a specific return at the outset of the financing, the parties are speculating that the project will be sufficiently successful to cover that pre-determined sum. Given the risks inherent in business, no party can be certain of project success and so an attempt to do so involves *maysir* and *gharar*. Equally, a guaranteed return in a *mudāraba* contract violates the prohibition of *ribā* as the financier has contributed nothing but money to the transaction and so would be making money from the use of money alone.[254] If the enterprise is unsuccessful, any pecuniary losses are borne by the financing partner who may not be able to recover all or any of his initial investment while the management partner will lose the time and effort he or she expended in the venture.[255] This selective monetary responsibility arises as a result of the fact that loss in Islamic economics relates exclusively to that part of the capital which is destroyed.[256] Consequently, loss in *mudāraba* is "distributed in proportion to the invested capital and will be borne by the owners of that capital."[257]

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way liable for a loss of this nature, losing only his expended time and effort.' Udovitch, Abraham L., *Partnership and Profit in Medieval Islam*, note 12, at 170.

[248] El-Ashker, Ahmed Abdel-Fattah, *The Islamic Business Enterprise*, (Taylor & Francis, London, 1987), at 76 in Klein, Daniel, "The Islamic and Jewish Laws of Usury: A Bridge to Commercial Growth and Peace in the Middle East", note 79, at 539.

[249] AAOIFI, Shari'a Standard No. (13), "Mudaraba", in *Shari'a Standards for Islamic Financial Institutions 1432 H-2010*, (AAOIFI, Bahrain, 2010), 231-250 at 235.

[250] El-Gamal, Mahmoud, *Islamic Finance; Law, Economics and Practice*, note 68, at 120. See also,Al-Zuhayli, Wahbah, *Financial Transactions in Islamic Jurisprudence*, note 186, at 487.

[251] Ebrahim, Muhammed-Shahid, *Integrating Islamic and Conventional Project Finance*, (Educational Technology Centre, Universiti Brunei Darus*salam*, 1998), at 14.

[252] Khan, Mansoor H., "Designing an Islamic model for project finance", note 235, at 15.

[253] Al-Zuhayli, Wahbah, *Financial Transactions in Islamic Jurisprudence*, note 186, at 498. *Sunan Ibn Maja*, Book 32, Number 32.4.6: "the stipulation of guarantees in qirad (*mudaraba*) is null and void," translation available at: http://getintoislam.com/Sunan_Majah_Book_31_-_61.html.

[254] Saleh, Nabil A., *Unlawful Gain and Legitimate Profit in Islamic Law*, note 57, at 136. See also, El-Gamal, *Islamic Finance; Law, Economics and Practice*, note 68, at 123.

[255] Usmani, Muhammad Taqi, *An Introduction to Islamic Finance*, note 190, at 13.

[256] Siddiqi, Muhammad Nejatullah, *Partnership and Profit-Sharing in Islamic Law*, (Islamic Economics Series; 9) (The Islamic Foundation, Leicester, UK, 1985), at 16.

[257] *ibid.*, al-Khafif also notes, "If there is a loss in business, it would be deemed reduction of capital and borne by the owner of capital alone." 'Ali al-Khafif, *Al-Shirkal fi'l-Fique al-Islami*, (Dar al-Nashir li'l-Jami'at al-Misriuah (n.d.)), in Siddiqi, Muhammad Nejatullah, *Partnership and Profit-Sharing in Islamic Law*, note 256, at 19.

Because the *mudārib* has made no capital contribution to the *mudāraba*,[258] it cannot be held financially liable for any loss which occurs in the ordinary course of business.[259]

Partnership business associations, where one party contributes capital, while the other labour, were a feature of pre-Islamic Arabian tribes in the form of *qirad* and perhaps *commenda* partnership.[260] While the *Qur'ān* does not explicitly sanction the use of *mudāraba* or *qirad* contracts, the Prophetic traditions refer to *mudāraba* transactions using the term "*qirad*"[261] and "*muqarada*."[262] As a result, "this was one of the forms of business which was found free of the evils of the era of ignorance (*jahiliyya*) and, therefore, retained in the Islamic system."[263] *Mudāraba*-like contracts have subsequently been approved by scholars from the four *madhāhib*.[264]

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[258] It has instead invested the *rabb al mal*'s capital on a trust basis, AAOIFI, Shari'a Standard No. (13), "Mudaraba", note 249, at 236.

[259] As the Hanbali scholar Ibn Qudama al-Maqdisi comments; "...under mudaraba loss would occur in the capital specifically and will not be borne by the party engaged in business because loss means a reduction in capital which is owned by the capitalist and is not at all shared by the party doing business. Loss will therefore accrue only to the party investing capital and not to the other party", Ahmad Ibn Qudama al Maqdisi, *Al-Shar'r al-Kabir 'ala al-Mughni*, (printed along with al-Mughni by Ibn Qudama), (Matba'ah al-Manar, Egypt, 1347 AH, Vol. 5), at 119, AAOIFI, Shari'a Standard No. (13), "Mudaraba", note 249, at 236.

[260] Udovitch has argued, quite persuasively, that the pre-Islamic contract of *qirad* is the pre-cursor to the Western European commenda (or limited) partnership (Udovitch, Abraham. L., "At the Origins of the Western Commenda: Islam, Israel, Byzantium?", (1962) 37(2) *Speculum*, 198-207, Udovitch, Abraham. L., *Partnership and Profit in Medieval Islam*, note 12, at 172, Udovitch, Abraham. L., "Theory and Practice of Islamic Law: Some Evidence from the Geniza", (1970) 32 *Studia Islamica*, 289-303). However, the issue is not settled with some commentators questioning the accuracy of Udovitch's claim, see for example; Pryor, John H., "The Origins of the Commenda Contract", (1977) 52(1) *Speculum*, 5-37, Hillman, Robert W., "Limited Liability in Historical Perspective", (1997) *Washington and Lee Law Review*, 615-628.

[261] *Malik's Muwatta,* Book 32 deals entirely with qirad transactions, `A'isha `Abdarahman at-Tarjumana and Ya`qub Johnson (trans.), available at: http://www.usc.edu/schools/college/crcc/engagement/resources/texts/muslim/hadith/muwatta/032.mmt.html#032.32.1.1.

[262] "[t]he Messenger of God said: 'Three things have blessing: sale (with payment deferred) to a term, *al-muqaradah*, and mixing wheat and barley for home (use) but not for sale'" *Sunan Ibn Majah*, in Shafaat, Ahmad, "Riba in the Qur`an: A Detailed Examination of Relevant Verses", (August 2005), at 36, available at: www.islamicperspectives.com/Riba3.pdf. See also,Al-Zuhayli, Wahbah, *Financial Transactions in Islamic Jurisprudence*, note 186, at 489.

[263] Rahman, Afzalur, *Banking and Insurance*, (The Muslim Schools Trust, London, 1979), at 307. See also, AAOIFI, Shari'a Standard No. (13), "Mudaraba", note 249, at 244-245. Al-Sarakhsī noted that, "[t]he mudārabah is authorized because of the popular need for such contracts. For the possessor of capital may not always find it possible to engage in profitable trade activity, and those who can engage in it may not possess the capital. Yet profit cannot be obtained except by both capital and trading. Through this contract, both objectives are attained," Al-Sarakhsī, *Kitāb al-Mabsūt*', (Beirut 1986 vol. 22), at 19 in Heck, Gene W., *Charlemagne, Muhammad, and the Arab Roots of Capitalism*, (Walter de Gruyter GmbH & Co., Berlin, 2006), at 302.

[264] Muhammad ash-Shawkani, a salafi scholar for example, noted that there was almost unanimity on the legitimacy of these *qirad* contracts, Al-Shawkani, Nayl al-Awtar, (Dar al-Jeel, Beirut), Vol. 6 at 394, in Abu-Saud, Mahmud, "Money, Interest and Qirad", in *Studies in Islamic Economics*, (Khurshid Ahmad ed., International Centre for Research in Islamic Economics, Jeddah, 1976), 59 at 66. See also, Ibn Rushd, *Bidayat al-Mujtahid wa Nihayat al-Muqtasid*, (*The Distinguished Jurist's Primer*), Vol. II, note 60, at 205 in Rahman, Afzalur, *Banking and Insurance*, (The Muslim Schools Trust, London, 1979), at 307 where he notes that "there is no difference of opinion among the Muslims with regard to the legality of *qirad* (*mudāraba*). It was in vogue in the pre-Islamic period and Islam adopted it. There is a consensus of opinion that it consists in

2. *Mushāraka*

Mushāraka is a term often used to describe equity-oriented commercial relationships in which two or more parties contribute to a venture and share in any profits or losses which result.[265] The Arabic term *mushāraka* means sharing,[266] a concept which is fundamental to the validity of a *mushāraka* partnership. In *mushāraka* contracts, all parties contribute to the partnership in the form of capital, labour or goods.[267] In modern *mushāraka* transactions such contributions do not need to be equal[268] and may take a variety of forms.[269] Once the partner has contributed to a *mushāraka* venture, all parties have equal rights of participation in the partnership.[270] It is possible, however, for a partner to elect not to be an active participant in the venture.[271] The partners will then agree to confer on one or more of the remaining partners the power to manage the *mushāraka*.[272] Within the limits set by the *mushāraka* contract[273] as well as those established by Islam,[274] partners (all or

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giving some capital by one person to another for business. The user of capital receives some agreed proportion of the profit, i.e. any proportion they may agree, one-third, one-fourth or even one-half." Hanafi jurists have considered these contracts in detail with both Shaybani in the *Asl* and Tahawi in *Kitab ash-shurut as-saghir*, providing suggested outlines for written *mudāraba* contracts, Abraham L. Udovitch, *Partnership and Profit in Medieval Islam*, note 12, at 196.

[265] Warde, Ibrahim *Islamic Finance in the Global Economy*, (1st ed.), note 145, at 136, Venardos, Angelo M., *Islamic Banking and Finance in South-East Asia. Its development and future*, (2nd ed., World Scientific Publishing Co., Singapore, 2007), at 72.

[266] Usmani, Muhammad Taqi, *An Introduction to Islamic Finance*, note 190, at 1

[267] Abdul-Basser, Taha bin Hasan, "The Centrality of Fiqh, An Introduction to Shari'ah-Compliant Finance", Paper presented at the Fifth Harvard University Forum on Islamic Finance; *Islamic Finance: Dynamics and Development*, Cambridge, Massachusetts, April 6, 2003. There also exist partnerships in creditworthiness and service partnerships.

[268] Al-Quduri, *Mukhtasar*, (Istanbul, 1319/1901), at 53 when he notes that "it (the '*inan* partnership) is valid in the case of a disparity between each partner's investment..." see also; Ibn Qudammah in *al-Mughni* Vol 5, "[e]quality in the amount of wealth is not stipulated", in ur-Rahman, Habib, "The Laws of Partnership (Companies) in Islam", (9 Jumaad al-Oola 1424 Hijri / 8 July 2003) *Khilafah.com Journal*, available at: http://www.muslimtents.com/aminahsworld/Partnership.html.

[269] The Shafi'i school represents the strictest position in relation to acceptable contributions as they insist that capital is the only possible form of investment in a partnership (Jaziri, *al-Fiqh 'ala al-madhahib*, Vol. III at 76, in Saleh, Nabil A., *Unlawful Gain and Legitimate Profit in Islamic Law*, note 57, at 115). The Hanafis and Hanbalis have adopted a more liberal approach to investment, accepting contributions in the form of cash, labour or a combination of these even if the contribution involves mixing of unlike currencies (Ibn Qudama, *al-mughni*, (Riyadh), at 130 in Ray, Nicholas Dylan, *Arab Islamic Banking and the Renewal of Islamic Law*, note 241, at 60). Finally the Maliki School has adopted a midway approach by permitting investments in cash and labour but insisting that the currencies be of the same type (Ibn Rushd, *Bidayat al-Mujtahid wa Nihayat al-Muqtasid*, (*The Distinguished Jurist's Primer*), Vol. II, note 60, at 302-304).

[270] Al-Harran, Saad, "Musharakah Financing Model", in *Iqtisad al Islamy*, (Islamic Economics), available at: http://www.Islamic-world.net/economics/musharakah.htm.

[271] AAOIFI, Shari'a Standard No. (12), "Sharika (Musharaka) and Modern Corporations", in *Shari'a Standards for Islamic Financial Institutions 1432 H-2010*, (AAOIFI, Bahrain, 2010), 199-230 at 205.

[272] Tamer, Sami, *The Islamic Financial System, A Critical Analysis and Suggestions for Improving its Efficiency*, (Peter Lang GmbH, Frankfurt, 2005), at 83. See also, Usmani, Muhammad Taqi, *An Introduction to Islamic Finance,* note 190, at 10.

[273] Ray notes that the *mushāraka* contract may specify that all sales are to be for cash and not credit or that only foodstuff is traded by the partnership, Ray, Nicholas Dylan, *Arab Islamic Banking and the Renewal of Islamic Law*, note 241, at 61.

those appointed to manage the partnership) may then engage in any activity which they feel is beneficial to the partnership venture.[275]

The common pool of contributions is then invested in a venture by the partners or partner appointed to manage the arrangement. Any profits generated by the enterprise are shared between the parties. For scholars adhering to the Hanbali and Hanafi schools of thought, partners are free to decide, by mutual agreement, the ratios according to which profit will be distributed.[276] Maliki and Shafi'i scholars have rejected this view, advocating instead that profit shares must correspond strictly to the amount of capital invested at the commencement of the *mushāraka*.[277] As well as sharing profits, every partner must bear the risk of the venture's failure in proportion to their capital contribution. As a result, they may all lose some or all of their initial investment.[278] The parties to a *mushāraka* therefore interact as partners to a transaction, both contributing and both enjoying similar rights, benefits and liabilities.[279] It is perhaps because of the greater equality between the parties that *mushāraka* contracts have been described as "the most desirable form of financing in Islamic economies."[280]

Traditional Islamic legal doctrine divides partnership into two general categories: proprietary partnerships (*sharikat-ul-milk*), and commercial or contractual partnerships (*sharikat-ul-aqd*).[281] As partnerships which are concerned "exclusively with joint

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[274] Trading in any form of illegal commodity is forbidden, for example no partner may deal in alcoholic beverages, gambling, pork products or interest-based debt.

[275] Siddiqi notes that "by the shirkah agreement each partner is made an agent for each and all of the other partners. He is thereby empowered to exercise such rights on the joint capital as are meant to benefit all the partners, that do not harm the interests of any party and that are current practice." Siddiqi, Muhammad Nejatullah, *Partnership and Profit-Sharing in Islamic law*, note 256, at 40.

[276] Hasan, Zubair, "Determination of Profit and Loss Sharing Ratios in Interest-Free Business Finance", (1985) 3(1) *Journal of Research in Islamic Economics*, 13-29 at 14.

[277] Siddiqi, Muhammad Nejatullah, *Partnership and Profit-Sharing in Islamic law*, note 256, at 24, AAOIFI appears to have adopted a middle ground. They note that "[i]n principle, the shares of profit must be in proportion to the percentage of each partner's contribution to the Sharika capital." However they then go on to suggest that "the partners may agree to make profit-sharing not proportionate to their contributions to capital, provided the additional percentage of profit over the percentage of contribution to the capital is not in favour of a sleeping partner." AAOIFI, Shari'a Standard No. (12), "Sharika (Musharaka) and Modern Corporations", note 271, at 207.

[278] Iqbal, Munawar and Molyneux, Philip, *Thirty Years of Islamic Banking; History, Performance and Prospects*, note 221, at 20, Ibn Qudamah, *Al-Mughni*, (Dar-al-ktab-al-'arabi, Beirut, 1972), Vol. 5 at 147, in Usmani, Muhammad Taqi, *An Introduction to Islamic Finance*, note 190, at 8.

[279] Al-Harran, Saad, "Musharakah Financing Model", note 270.

[280] Al-Suwailem, Sami, "Towards and Objective Measure of Gharar in exchange", note 90, at 87. It has also been described as "the best financing methods of Islamic banks." I*IBID* (International Islamic Bank for Investment), *alTamwil bi al-Musharaka,* (ITBID, Cairo, n.d.), at 6 in Abdullah Saeed, *Islamic Banking and Interest: A Study of the Prohibition of Riba and Its Contemporary Interpretation*, note 199, at 62.

[281] Yasseri, Ali, "The Experience of the Islamic Republic of Iran in *Musharakah* Financing", (1999) 14 *Arab Law Quarterly*, 231-244 at 232.

ownership of property,"[282] the central focus of *sharikat-ul-milk* is the shared ownership, rather than any coordinated exploitation, of an asset.[283] The *sharikat-ul-aqd* commercial relationship has been referred to by all four major *madhāhib*, with each indicating the consensual nature of the arrangement and the intention of the parties to earn a profit.[284] In contrast to *sharikat ul-milk*, joint ownership is a possible consequence of a commercial partnership but it is not a precondition.[285] Instead, the primary emphasis in *sharikat-ul-aqd* is on the joint exploitation of the common pool of contributions as well as the joint allocation of profits and losses from the venture.[286]

The *Qur'ān* does not explicitly approve of *mushāraka* or *sharikah* (the term used by *fiqh* writers)[287] in the context of business relationships[288] although it refers in passing to the

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[282] Udovitch, Abraham L., *Partnership and Profit in Medieval Islam*, note 12, at 17.

[283] *ibid.* The proprietary partnership is summarised by the Hanafi jurist Ahmad b. Muhammad al-Quduri in *Al-mukhtasar* when he noted that; 'A proprietary partnership can occur when two people inherit or purchase anything together. Neither of them is permitted to dispose of the other's portion, except with his permission. Each of them is as a stranger in regard to the portion of his colleague.' Ahmad b. Al-Quduri, *Al-Makhtasar*, (Istanbul, 1319/1910), at 53 in *ibid.*, at 18. Sarakhsi later provided a more extensive definition when he noted that; 'Proprietary partnership occurs when two people are partners in the possession of property. This can be of two types: (1) A partnership which becomes effective without any action on their part, as, for instance, in the case of inheritance; (2) a partnership which becomes effective through their own actions. This comes about through the acceptance of a purchase or a gift or a bequest. The rule governing both types is the same; namely, whatever increase or profit accrues is shared by them in proportion to the extent of their ownership. Each of them is in the category of a stranger in regard to any action in the portion of his colleague.' Sarakhsi, *Al-mabsut*, (Cairo 1324/1906 – 1331/1912) Volume 11 at 151, in Udovitch, Abraham L., *Partnership and Profit in Medieval Islam*, note 12 at 24.

[284] The Hanafis definition of *sharikat al-'aqd* refers to 'an agreement between two or more persons for common participation in capital and profits.' Majella, section 1329, Chapter 6, *Partnerships*, This clear reference to partnership and profit sharing in the Majella suggests that the principles of shirkah set out by Hanafi jurists were not simply theoretical concepts but were actually applied in commercial situations. The Malikis highlight the importance of a joint exploitation of resources by the parties when they note that such partnerships are 'a permission [granted by] each...participant to the others...to transact in [such granting participant's] wealth and on their own behalf, while retaining the right to transact personally [in such wealth].' Abd al-'Aziz al-Khayyat, *al-Sharikat* (Wizaear al-Awqaf, Ammam, 1971), at 42 in Nyazee, Imran Ahsan Khan, *Islamic Law of Business Organisations: Partnerships*, (Kitab Bhavan, India, 1999), at 19. Finally, the *Shafi'is* and Hanbalis definitions stress the need ensure participation between the parties. The Shafi'is described *sharikah al-'aqd* as "in its literal meaning [a] mixing and technically...an established[,] undivided right in a single thing or...a contract implying this," al-Imām Shams al-Dīn Muhammad ibn Ahmad *ibn Hamzah* al-Ramlī, *Nihayat al-Muhtaj li-Shah al-Minhaj* (Cairo, 1967), at 3 in Nyazee, Imran Ahsan Khan, *Islamic Law of Business Organisations: Partnerships*, note 284, at 19 and the Hanbalis articulate the contract simply as a "participation of two or more persons in transactions." Ibn Qudamah, *al-Mughni fi Fiqh Imam al-Sunnag Ahmad ibn Hanbal al-Shaybani* (Cairo: al-Matba'ah al-Salafiya wa Maktubatuha, 1962), at 3 in Moghul, Umar F., "No Pain, No Gain: The State of the Industry in Light of an American Islamic Private Equity Transaction", note 96, at 482.

[285] Saleh, Nabil A., *Unlawful Gain and Legitimate Profit in Islamic Law*, note 57, at 113.

[286] *ibid.*, Nyazee, Imran Ahsan Khan, *Islamic Law of Business Organisations: Partnerships*, note 284, at 20, defining a *sharikat al-'aqd* as "a contract between two or more people for participation in capital and its profits, or participation in transactions in someone else's capital and its profits, or participation in profit without participation in capital or transactions."

[287] Moghul, Umar F., "No Pain, No Gain: The State of the Industry in Light of an American Islamic Private Equity Transaction", note 96, at 470, Shaikh Taqiuddin an-Nabhani states in *Nidaam ul Iqtisaad fil Islam* (Economic System in Islam) that linguistically *sharikah* means mixing two or more shares together

notions of equitable sharing and partnership.[289] The *Sunnah* on the other hand contains several references to partnership with one *hadīth* suggesting that Muhammad was himself involved in a cooperative business relationship; Mujahid reports from Sa'ib that he (Sa'ib) entered with the Prophet into trade partnership before the coming of Islam. "On the day Makkah was conquered (by the Muslims), Sa'ib came to the Prophet...and he welcomed him saying, 'Welcome to my brother and partner who did not use to hide and who did not use to argue in vain...'."[290] This *hadīth*, together with one which reports the Prophet as saying, "Allah the Supreme said 'I am the third of the two partners as long as one of them does not betray his companion'"[291] indicate that Muhammad may have approved, if not used, partnership arrangements.[292]

These traditional *mushāraka* structures were developed as permanent partnership models rather than short-to-medium term methods of financing.[293] As a means of developing partnership arrangements into financing structures, a diminishing *mushāraka* has been developed by the contemporary Islamic finance industry. This neo-nominate contract allows one party (generally the customer) to periodically buy the equity share of the other party (the financier) in the *mushāraka* venture until the customer is left with full ownership of the underlying business or good and the financier is no longer associated with the venture.[294] As will be discussed in Chapter 6, through a combination of a *mushāraka*, a

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such that neither can be distinguished from the other in ur-Rahman, Habib, "The Laws of Partnership (Companies), note 268.

[288] Saeed, Abdullah, *Islamic Banking and Interest, A Study of the Prohibition of Riba and its Contemporary Interpretations*, note 139, at 59.

[289] *Qur'ān* 38:24 for example notes that, "truly many are the partners who wrong each other: Not so do those who believe and work deeds of righteousness." Equally, the *Qur'ān*, in a *sura* relating to *an-nisa* (women) and inheritance, speaks of sharing, equitable division and allocation in property (*Qur'ān* 4:12). This *sura* actually uses the word شُرَكَآءُ (*shoroka'*) which is translated as 'sharers' and is very similar to the word شَرِكَة (*sharika*) meaning partnership

[290] Mujahid reports from Sa'ib, reported by al-Hakim 2/61 cited in AAOIFI, Shari'a Standard No. (12), "Sharika (Musharaka) and Modern Corporations", note 271, at 221.

[291] Narrated Abu Hurairah, *Sunan Abu-Duwud*, Book 22, Number 3377, Ahmad Hasan (trans.), available at:
http://www.usc.edu/schools/college/crcc/engagement/resources/texts/muslim/hadith/abudawud/022.sat.html. See also, an-Nabhani, Taqiuddin, *The Economic System in Islam*, (Al-Khilafah Publications, London, 2000), at 137.

[292] This is a view supported by a number of contemporary commentators, see for example, Irfani, A. M., "Musharakah and its Modern Applications", Paper presented at the Seminar on Islamic Financing Techniques, Islamabad, December 1984, at 2, al-Harran, Saad Abdul Sattar, *Islamic Finance, Partnership Financing*, (Pelanduk Publications (M) Sdn Bhd, Petaling Jaya, Malaysia, 1993), at 75.

[293] Obaidullah, Mohammed, *Islamic Financial Services*, (Islamic Economics Research Center, Jeddah, 2005), at 61.

[294] Meera, Ahamed Kameel Mydin, and Razak, Dzuljastri Abdul, "Islamic Home Financing through *Musharakah Mutanaqisah* and *al-Bay' Bithaman Ajil* Contracts: A Comparative Analysis", note 200, at 123.

simple sale and frequently a lease, diminishing *mushāraka* structures use traditional Islamic contracts to meet the financing needs of the Islamic finance market.[295]

Regularly described as being "at the core of Islamic financing and in tune with the Shari'ah's injunctions against interest-based financing,"[296] partnership arrangements were designed to act as mechanisms for financing rather than sales contracts. However, the risk and reward sharing inherent in these arrangements has dampened the contemporary Islamic finance industry's enthusiasm for *mudāraba* and *mushāraka*. While these structures feature in Islamic finance contracts used today, they do not represent the mainstay of Islamic financial activity. Rather, they exist as methods of Islamic finance alongside other structures, such as sales and leases.[297]

C. *Ijārah* – Lease Contracts

The final broad category of Islamic finance contract to be considered is *ijārah* or leasing contracts. These contracts are similar in structure and function to conventional leases and are used in a variety of contemporary Islamic finance products.[298] *Ijārah* used in the context of assets involve the sale[299] of an asset's usufruct (*manfa'ah*) (the use of an asset)[300] to the lessee, who may then use the asset for islamically acceptable purposes.[301] Title and ownership remain with the lessor who charges the lessee rent for the right to use and benefit from the underlying tangible asset.[302] *Ijārah* contracts may also relate to services where they facilitate the hire of labour and the payment of wages (*ujrah*) in exchange for that labour.[303]

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[295] *infra.*at 215.

[296] Ismath, Bacha Obiyathulla, "Adapting Mudarabah Financing to Contemporary Realities: A Proposed Financial Structure", Paper presented at the Conference on SPTF/Islamic Banking Products, IKIM Kuala Lumpur, 1996.

[297] Bilal, Gohar, "Islamic Finance: Alternatives to the Western Model", (1999) 23 *Fletcher Forum of World Affairs*, 145-159 at 157.

[298] Warde, Ibrahim, *Islamic Finance in the Global Economy*, (2nd ed.), note 91, at 144.

[299] Though *ijārah* represent leasing contracts, in Islamic finance, the lease of a good is considered to be the sale of the good's use, Vogel, Frank E. and Hayes, Samuel.L., *Islamic Law and Finance, Religion, Risk and Return*, note 12, at 143.

[300] The usufruct of the asset is continuously produced rather than something which the customer can purchase in one go and then "own." Instead, periodic consideration must be paid as the usufruct is continuously being "sold." Warde, Ibrahim, *Islamic Finance in the Global Economy*, ((2nd ed.), note 91, at 144 notes that "usufruct is not something existent and tangible, but a stream of use extending into the future..."

[301] Usmani, Muhammad Taqi, *An Introduction to Islamic Finance*, note 190, at 69.

[302] Vogel, Frank E. and Hayes, Samuel.L., *Islamic Law and Finance, Religion, Risk and Return*, note 12, at 103, Al-Zuhayli, Wahbah, *Financial Transactions in Islamic Jurisprudence*, note 186, at 424.

[303] Ayub, Muhammad, *Understanding Islamic Finance*, note 26, at 279, Al-Zuhayli, Wahbah, *Financial Transactions in Islamic Jurisprudence*, note 186, at 413.

While the asset *ijārah* is now the form of *ijārah* most widely implemented in the Islamic finance industry, approval of hiring contracts in the *Qur'ān* and *Sunnah* relates primarily to the hire of labour: the *Qur'ān*, for example, states in relation to the someone who had repaired a wall, "if you had wished, surely, you could have taken wages for it,"[304] while *Sunan Abu-Duwud*, Book 23 is entitled "*Kitab al-Ijārah*" and deals largely with labour and the payment of wages.[305] However Ibn Rushd cites a *hadīth* in which rental of land was approved by the Prophet.[306] The expansion of the *ijārah* structure approved by the *Qur'ān* and *Sunnah* to include the lease of assets other than labour and land has been justified on the basis of consensus and *ijtihād*, as AAOIFI noted

> [t]he legitimacy of ijarah...generated consensus among the legal community. The ijarah is also acceptable by reasoning because it is a convenient means for people to acquire [the] right to use assets that they do not own since not all people may be able to own tangible assets.[307]

In relation to asset *ijārah*, classical scholars established a number of essential characteristics which ensure that any profit made by the lessor is consistent with Islamic law. Central amongst these is the requirement that the lessor owns the asset, with that ownership continuing for the duration of the lease transaction.[308] This condition is underpinned by two *Sharī'ah* maxims; first, "gain accompanies liability for loss," and so in order for the lessor to profit from the rented asset, that lessor must bear the risks associated with ownership of that asset.[309] Second, "do not sell what you do not own"[310]; as *ijārah* contracts are considered to be sales of the usufruct of an asset, the lessor must own that

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[304] *Qur'ān* 18:77. It also provides that "[v]erily, the best of men for you to hire is the strong, the trustworthy."*Qur'ān* 28:26.

[305] *Sunan Abu-Duwud*, Book 23, Ahmad Hasan (trans.), available at: http://www.usc.edu/schools/college/crcc/engagement/resources/texts/muslim/hadith/abudawud/023.sat.html. See also, AAOIFI, Shari'a Standard No. (9), "Ijarah and Ijarah muntahia bittamleek", in *Shari'a Standards for Islamic Financial Institutions 1432 H-2010*, (AAOIFI, Bahrain, 2010), 137-160 at 153

[306] "Three persons cultivate the land: a man who owns the land and cultivates it himself; a man who has been granted the land, and cultivates what he has been granted; and a man who rents it with gold and silver." Ibn Rushd, *Bidayat al-Mujtahid wa Nihayat al-Muqtasid*, (*The Distinguished Jurist's Primer*), Vol. II, note 60, at 266.

[307] AAOIFI, Shari'a Standard No. (9), "Ijarah and Ijarah muntahia bittamleek", note 305, at 153. Ibn Rushd noted that, "ijāra is permissible according to jurists of all the regions and those of the first period." Ibn Rushd, *Bidayat al-Mujtahid wa Nihayat al-Muqtasid*, (*The Distinguished Jurist's Primer*), Vol. II, note 60, at 264.

[308] Warde, Ibrahim, *Islamic Finance in the Global Economy*, (2nd ed.), note 91, at 144.

[309] Ayub, Muhammad, *Understanding Islamic Finance*, note 26, at 280.

[310] *Sunan Abu-Dawud*, Book 23, Number 3496, Prof. Ahmad Hasan (trans.), available at: http://www.usc.edu/schools/college/crcc/engagement/resources/texts/muslim/hadith/abudawud/023.sat.html

asset before he or she can sell its usufruct to the lessee.[311] Thus, while the lessee will be responsible for expenses and costs incurred in the day-to-day operation of the property and any loss caused by the lessee's negligence or misuse, the lessor must retain full ownership of the property together with any responsibilities of ownership.[312] Finally, as the lessee is paying for the purchase of the usufruct of the asset, rent only officially becomes due from the day the property is delivered to the lessee[313] and must be agreed upon and clearly specified.[314]

In a modernisation similar to diminishing *mushāraka* arrangements, *ijārah* too have been modified in order to facilitate *Sharī'ah*-compliant financing. A lease ending in ownership, which is variously referred to as *ijārah wa iqtina* (lease with acquisition), *ijārah muntahia-bi-tamleek* (lease ending with ownership), or *ijārah thumma al-bai'* (lease with sale), allows a customer to rent an asset and then to acquire title to that asset at the end of the lease.[315] Such transactions function as leases, and are subject to the same rules and restrictions as leases. Over the course of the lease term, however, the lessor places (theoretically or literally) a portion of the rental into a reserve account. When that reserve account is sufficiently large to cover the purchase price of the asset, the lessor liquidates the fund and sells the asset to the customer, often for a nominal amount.[316] Using such structures, the lessor will recover the cost price of the asset, plus profit, while the customer will ultimately acquire title.[317]

3.4 Conclusion to Chapter 3

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[311] AAOIFI, Shari'a Standard No. (9), "Ijarah and Ijarah muntahia bittamleek", note 305, at 154, Vogel, Frank E. and Hayes, Samuel L., *Islamic Law and Finance, Religion, Risk and Return.*, note 12, at 143.

[312] Recommendations of the Workshop, Proceedings of a Workshop organized in Khartoum by the Islamic Research and Training Institute of the Islamic Development Bank, 27-29 October 1991, Seminar Proceedings Series No. 28, Mahmoud Ahmad Mahdi (ed.), (Islamic Research and Training Institute, Jeddah, 1995), at 275. Issa , Nabil A., and Campos, Patrick, "Challenges in Structuring Non-Recourse Islamic Financing for Energy Projects in Saudi Arabia", (2007) 2 *Texas Journal of Oil, Gas and Energy Law*, 452-469 at 454. Ayub, Muhammad, *Understanding Islamic Finance*, note 26, at 285. See also,a *fatwā* issued by the Arab Banking Corporation Islamic Bank, which notes that, "[i]t is compulsory for the lessor to bear the cost of insuring the leased item. This is because the cost of insurance is the responsibility of the owner, i.e., the lessor, for the continued [unimpaired] existence of the leased asset is primarily of benefit to the lessor. However, the lessor can factor in the cost of insurance in the rental fee agreed upon with the lessee," available at: http://www.isra.my/fatwas/commercial-banking/financing/ijarah/79-insurance-expenses-paid-by-lessee.html.

[313] Vogel, Frank E. and Hayes, Samuel.L., *Islamic Law and Finance, Religion, Risk and Return*, note 12, at 103, Al-Zuhayli, Wahbah, *Financial Transactions in Islamic Jurisprudence*, note 186, at 415.

[314] Warde, Ibrahim, *Islamic Finance in the Global Economy*, (2nd ed.), note 91, at 144.

[315] Barry, John, "Islamic property financing", (2007) 15 *Australian Property Law Journal* 66.

[316] Zaher,Tarek, and Hassan, Kabir, "A Comparative Literature Survey of Islamic Finance", (2001) 10(4) *Financial Markets, Institutions and Instruments*, 155-199 at 160.

[317] See *infra.*at 210 for a more detailed discussion of *ijārah wa-iqtina* in the context of real estate finance.

The contemporary Islamic finance industry is based on unique structural restrictions which represent the outer limits of acceptable activity in the context of business and commerce. The prohibitions of *ribā*, *maysir*, *gharar* and *haram* activities separate Islamic from conventional finance and represent the primary considerations when determining the religious validity of Islamic financial activity. As these principles are inconsistent with the approach to profit generation found in many non-Islamic financial products, adhering Muslims have been restricted in their ability to fully participate in such conventional financial activity. In order to allow adherents to comply with Islamic legal doctrine while engaging in the financial sector, a series of Islamic finance contracts have been developed or adopted into Islamic law. Originally approved by the classical scholars, contracts such as sale, lease and partnership remain the contractual basis for much of the contemporary Islamic finance industry.

Particularly in the initial stages of Islamic finance's modern emergence,[318] considerable energy has been dedicated by commentators to the establishment of a distinctly Islamic economic discipline.[319] Rather than an addendum to existing financial activity, Islamic economics formed part of a worldview in which the whole of society was free from *ribā* and *gharar* and in which socio-economic justice was fostered.[320] In doing so, these commentators sought to distinguish Islamic economics from the perceived evils of capitalism and socialism.[321] Islamic law was presented as establishing the perfect economic framework "in which solutions to the problems of economic backwardness can be found."[322] The separation of ethics and economics was blamed for the "unhindered pursuit of self-interest by individuals...[and] other insoluble social evils"[323] resulting from

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[318] Kuran, Timur, "Islamic Economics and the Islamic Subeconomy", note 38, at 155-156.

[319] Vogel, Frank E. and Hayes, Samuel.L., *Islamic Law and Finance, Religion, Risk and Return*, note 12, at 30.

[320] Chapra, Umer, "What is Islamic Economics?", *IDB Prize Winners' Lecture Series No. 9*, (2nd ed., Islamic Development Bank, Jeddah, 2001), at 25 referring to *Qur'ān* 57:25 which notes, "We sent aforetime our apostles with Clear Signs and sent down with them the Book and the Balance (of Right and Wrong), that men may stand forth in justice; and We sent down Iron, in which is (material for) mighty war, as well as many benefits for mankind, that God may test who it is that will help, Unseen, Him and His apostles: For God is Full of Strength, Exalted in Might (and able to enforce His Will)."

[321] See for example Mohammad Baqir as-Sadr's Iqtisaduna which spends 300 of its 700 pages denouncing capitalism and communism, as-Sadr, Muhammad Baqir, *Iqtisaduna*, (Baghdad, 1961), referred to in Philipp, Thomas, "The Idea of Islamic Economics", (1990) 30(1/4) Die Welt des Islams, 117-139 at 120, Chapra, Umer, "What is Islamic Economics?", note 320, at 20-21 criticising the prevailing "value-neutral" economic system.

[322] as-Sadr, Muhammad Baqir, *Iqtisaduna*, (Baghdad, 1961), at alif and ba in Tripp, Charles, *Islam and the Moral Economy*; *The Challenge of Capitalism*, (Cambridge University Press, Cambridge, 2006), at 114.

[323] Chapra, M. Umer, Islam and the Economic Challenge, Islamic Economics Series – 17, The Islamic Foundation, Markfield, 2003 at 59.

capitalism as well as the "dialectics, indiscriminate liquidation and expropriation"[324] of socialism. By way of contrast, Islamic economics was venerated as promoting equity, communal justice, the prevention of exploitation, the protection of private property and the elimination of greed.[325] The centrality of religion and ethics within Islamic economics led to an emphasis by commentators on a value-oriented economic framework,[326] in which the moral precepts established by the sources of Islamic law represent the socio-economic ideal to which an Islamic economy must conform.[327] As Kuran has suggested, the aim of Islamic economics was "to transform selfish and acquisitive *homo economicus* into a paragon of virtue, *homo Islamicus*."[328]

Islamic banking and finance, as the practical and institutional manifestation of Islamic economics, is presented as part of this Islamic worldview.[329] As such, commentators continue to suggest that Islamic financial activity must uphold the *maqāsid-al-Sharī'ah* (the broader goals of Islamic law such as brotherhood, equity and fairness).[330] In reality, a

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[324] *ibid.*, at 75.

[325] Philipp, Thomas, "The Idea of Islamic Economics", note 321, at 124 who notes that, "[t]he negative definition of what Islamic economics is not serves a very concrete purpose, namely, the attack on and the denouncement of secular, especially socialist and communist, forms of social and economic order. It is the first step toward asserting an own identity and toward developing a positive content for a specifically Islamic economic order."

[326] Asutay, Mehmet, "Conceptualisation of the Second Best Solution in Overcoming the Social Failure of Islamic Banking and Finance: Examining the Overpowering of Homoislamicus by Homoeconomicus", note 39, at 168.

[327] Rodinson, Maxime, *Islam and Capitalism*, Brian Pearce, (trans.), (Allen Lane, London, 1974), at 19. Ariff, Mohamed, "Economics and Ethics in Islam", in *Readings in the Concept and Methodology of Islamic Economics*, Aidit Ghazali and Syed Omar (eds.), (Pelanduk Publications, Petaling Jaya, 1989), 96-119 at 97, Asutay, Mehmet, "Conceptualisation of the Second Best Solution in Overcoming the Social Failure of Islamic Banking and Finance: Examining the Overpowering of Homoislamicus by Homoeconomicus", note 39, at 169. This connection with religion was regarded as distinguishing Muslims from all other people and serves as a protection from Western influence, as-Sadr, Muhammad Baqir, *Iqtisaduna*, (Baghdad, 1961), at nun and sad in Tripp, Charles, *Islam and the Moral Economy*; *The Challenge of Capitalism*, note 322, at 122.

[328] Kuran, Timur, *Islam and Mammon: the economic predicaments of Islamism*, (Princeton University Press, Princeton, 2004), at 42.

[329] Asutay, Mehmet, "Conceptualisation of the Second Best Solution in Overcoming the Social Failure of Islamic Banking and Finance: Examining the Overpowering of Homoislamicus by Homoeconomicus", note 39, at 172.

[330] Siddiqi, M. N, noting that the *maqasid* encompasses enhancing commonweal, justice and equity, *Round table on: Islamic Economics: Current State of Knowledge and Development of the Discipline*, held at Jeddah, Saudi Arabia on May 26-27, 2004, under joint auspices of the Islamic Research and Training Institute, Jeddah and the Arab Planning Institute, Kuwait, available at: http://www.siddiqi.com/mns/Keynote_May2004_Jeddah.html. As Maududi, a fervent supporter of a morally guided economic system noted, "[f]or establishing economic justice Islam does not rely on law alone. Great importance is attached for this purpose to reforming the inner man through faith, prayers and moral training, to changing his preference and ways of thinking and inculcating in him a strong moral sense that keeps him just," *Maʿāshiyyat-e Islām*,(Lahore 1969), quoted in Philipp, Thomas, "The Idea of Islamic Economics", note 321, at 128 and McDaniel, Charles, "Sergei Bulgakov's 'Philosophy of Economy': a Resource for Economic Bridge-Building between Islam and the West", (2008) 36(4) *Religion, State and Society*, 451-467 at 458, Zahid, Anowar, "Corporate Social Responsibility from a Shari'ah Perspective", (2010) 8 *International Journal of Civil Society Law*, 79-93 at 83.

successful, fully Islamic economy based on PLS has yet to be achieved anywhere[331] and - as indicated by the growth of Islamic finance in Europe, the US and Australia - the Islamic finance industry currently operates in economies founded on non-Islamic ideals.[332] In addition to this conclusion, and perhaps more significantly, the Islamic finance industry operating in both Muslim and non-Muslim countries today is not quite the Islamic finance envisaged by the early commentators. As was noted in subection 3.3.2 above,[333] while contemporary scholars continue to rely on the nominate contracts, these contracts are now being used in a modified form.[334] A range of modern Islamic finance products - which are *Sharī'ah*-compliant but also capable of functioning within contemporary financial markets - has therefore been engineered.[335] Indeed, through the use of devices, stratagems and structural engineering of the nominate contracts,[336] contemporary Islamic finance transactions often produce the same economic effect as non-Islamic alternatives, but they do so in a manner which adhers to the dictates of Islamic law. It can be concluded, therefore, that the aspects of Islamic law, which are relevant to financial activity, continue to influence and shape the contemporary Islamic finance industry. However, that industry is not entirely distinct from one involving interest and is at times, substantively similar.

With this conclusion in mind, Part II of this thesis will consider the conceptual basis for Islamic finance in a modern economy. Chapter 4 will thus consider how (contemporary) Islamic finance has been accommodated in three countries and will focus on the methodologies for accommodation which have been adopted. These methodologies range from the full-scale Islamisation of the economy, (as undertaken in Pakistan)(4.2),[337] the creation of a parallel system under which Islamic and conventional finance exist independently of one another within the same economic framework, (an approach used in

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[331] Asutay, Mehmet, "Conceptualisation of the Second Best Solution in Overcoming the Social Failure of Islamic Banking and Finance: Examining the Overpowering of HomoIslamicus by Homoeconomicus", note 39, Kuran suggests that Islamic economics was more a political tool than a real attempt to implement a viable economy based on Islamic doctrine, as he notes;" at least initially, the economics of Islamic economics was merely incidental to its Islamic character," Kuran, Timur, "The Genesis of Islamic Economics: A Chapter in the Politics of Muslim Identity", (1997) 64(2) *Social Research*,) 301-338 at 302.

[332] Tripp, Charles, *Islam and the Moral Economy, The Challenge of Capitalism*, note 322, at 141-142. See also, Vahed, Goolam and Vawda, Shahid, "The Viability of Islamic Banking and Finance in a Capitalist Economy: A South African Case Study", (2008) 28(3) *Journal of Muslim Minority Affairs*, 453-472.

[333] *supra.*at 71.

[334] Ahmed, Habib, *Product Development in Islamic Banks*, note 108, at 48.

[335] Iqbal, Zumir, "Islamic Financial Systems", (2007) 24(2) *Journal of Islamic Banking and Finance*, 113-122 in *Islamic Banking and Finance; Critical Concepts in Economics*, Amer Al-Roubaie and Shafiq Alvi (eds.), (Routledge, London, 2010, Vol. III), 18-25 at 22 referring to the emergence of more complex and innovative Islamic financial structures.

[336] See *infra.*at 204 the use of *taqlīd* in contemporary Islamic real estate financing in order to replicate the substance of interest-based debt activity.

[337] *infra.*at 97.

Malaysia)(4.3)[338] and finally, the integration of Islamic finance accompanied by modifications to the existing regulatory and institutional framework, (as adopted in the UK)(4.4).[339] These three countries have been chosen as comparators as they have each adopted a distinct approach to dealing with the Islamic finance industry. By discussing how individual countries have dealt with Islamic finance and the problems which have arisen, comparisons and guidance can be drawn in relation to Ireland's approach to integration of a financial sector which is guided by religious dictates.

[338] *infra.*at 114.
[339] *infra.*at 130.

PART II

THE CONCEPTUAL BASIS FOR ISLAMIC FINANCE IN CONTEMPORARY ECONOMIES

Chapter 4

Variations in Methodology: A Jurisdictional Case Study

4.1 Introduction

Part I of this thesis set out the theological basis for the contemporary Islamic finance industry. Part II builds on that discussion to explore the conceptual aspects of fostering Islamic finance within a national framework.

The bifurcated nature of contemporary Islamic finance has allowed those using Islamic financial products to comply with their religious beliefs, while ensuring that the products they use are comparable to the conventional structures they are substituting. However, it has raised difficulties in terms of the treatment of such products within the context of an established legal system. As will be demonstrated in Chapters 7 and 9,[1] the distinctive structure of Islamic finance products sits uneasily within tax, regulatory and other legislative provisions, which were developed for interest-based financing. The structure of Islamic finance products may thus result in legal treatment of such products that is inconsistent with their substance and, by implication, with the treatment of economically comparable conventional structures. As the Islamic finance industry has grown and matured, and as a direct result of this potentially anomalous treatment of Islamic finance activity, national authorities have had to consider whether they will actively seek to facilitate the industry within their economies. With multinational realisation that existing

[1] *infra.* at 222 (Islamic real estate financing) and 325 (*sukūk*).

financial infrastructure is often insufficient to sustain the structures and concepts inherent in Islamic finance, Governments, both Muslim and non-Muslim, have amended, expanded and at times completely overhauled domestic legal instruments in order to enable the supply of Islamic financial services.

This Chapter will consider three dominant methods for Governments dealing with Islamic finance: full-scale islamisation (4.2),[2] the creation of a parallel system for Islamic finance (4.3)[3] and integration of Islamic finance activity into established laws (4.4).[4] As a source of comparison and at times guidance for future development of Islamic finance in Ireland, these three conceptual frameworks will be discussed in the context of the country in which each has been implemented (or in which attempts have been made to so implement) with most determination. This jurisdictional case study approach allows for a more effective analysis of how each method of integration works in practice than if each method was considered in the abstract. Pakistan (full-scale islamisation) and Malaysia (parallel system), as Muslim countries, clearly represent a societal paradigm which is distinct from that found in Ireland. Nevertheless, as will be highlighted in subsections 4.2.5[5] and 4.3.4[6], there are still lessons to be learnt from the method and experience of accommodation in both of these countries. Islamic finance in the UK (integration), represents an example of accommodation which is highly relevant to Ireland and is likely to stand as a key source of direction for the Irish authorities. The similarities between the legal systems of the two countries are strong and many of the hurdles faced by Islamic finance in the UK are likely to be experienced by this industry in Ireland. As a result, Chapters 6 to 10 of this thesis, while referring to other jurisdictions, will rely heavily on the example set by the accommodation of Islamic finance in the UK.

This Chapter will discuss the various approaches to accommodation and the implications of each. While several products are referenced briefly, the focus of discussion will be on the broader mechanism for accommodation adopted in Pakistan, Malaysia and the UK, and their general approach to Islamic banking and non-banking financial activities. Following an outline of each distinct approach, observations will be made on the lessons

[2] *infra.*at 97.
[3] *infra.*at 114.
[4] *infra.*at 130.
[5] *infra.*at 111.
[6] *infra.*at 129.

which Ireland may take from the experiences of these jurisdictions (4.2.5 (Pakistan),[7] 4.3.4 (Malaysia),[8] 4.4.4 (UK)[9]). Section 4.5 will then introduce the measures which Ireland has already adopted in order to accommodate Islamic finance. It will be argued in section 4.5 that, like the UK, Ireland is now adopting an integrationist approach to facilitating an Islamic finance industry domestically.[10]

4.2 Full-scale islamisation: The case of Pakistan

The experience of Islamification and Islamic finance in Pakistan has been a surprisingly arduous and turbulent one. Along with Iran[11] and Sudan,[12] Pakistan represents one of the few examples of attempted full-scale islamisation - politically, socially and economically.[13] The reality of Islamification has been less successful than early utopian visions of a wholly Islamic country discussed in Chapter 3.[14] Like Pakistan, Iran and Sudan have struggled to reconcile religious teachings with contemporary economic realities[15] and, as a result, to bring about a wide scale, successful move towards an economy guided by religious belief.[16] Though discussing Iran, Khan and Mirakhor's suggestion that "external and internal developments...did not allow the policymakers to develop a coherent plan for islamisation of the banking system"[17] could equally apply to the attempts by all three countries to bring about islamisation. While politically Islam served as a unifying tool,[18]

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[7] *infra.*at 111.
[8] *infra.*at 129.
[9] *infra.*at 140.
[10] *infra.*at 143.
[11] Amin, Sayed Hassan, *Islamic Banking and Finance: The Experience of Iran*, (Vahid Publications, Tehran, 1986), Binder, Leonard, "Islam, Ethnicity, and the State in Pakistan: An Overview", in *The State, Religion and Ethnic Politics; Afghanistan, Iran and Pakistan*, A. Banuazizi and M. Weiner (eds.), (Syracuse University Press, Syracuse, 1986), 259-266, Rahnema, Ali and Nomani, Farhad, *The Secular Miracle – Religion, Politics and Economic Policy in Iran*, (Zed Books Ltd., London, 1990), at 236 – 292, Amuzegar, Jahangir, *Iran's Economy under the Islamic Republic*, (I.B. Tauris Publishers, London, 1993), at 15-18, Khan, Mohsin S. and Mirakhor, Abbas, "Islamic Banking, Experiences in the Islamic Republic of Iran and in Pakistan", (1990) 38(2) *Economic Development and Cultural Change*, 353-375 particularly 358 *et seq.*
[12] Tripp, Charles, *Islam and the Moral Economy, The Challenge of Capitalism*, (Cambridge University Press, Cambridge, 2006), at 140, Iqbal, Munawar and Molyneux, Philip, *Thirty Years of Islamic Banking, History, Performance and Prospects*, (Palgrave Macmillan, New York, 2005), at 43-44 noting that "[t]he process of the economy-wide Islamization of the banking system in Sudan has not been smooth and steady."
[13] Binder, Leonard; "Islam, Ethnicity and the State in Pakistan; An Overview", note 11, at 263.
[14] *supra.*at 89.
[15] Raja, Salman Akram, "Islamisation of Laws in Pakistan", (2003) 1(2) *South Asian Journal*, 94-109, available at: http://www.southasianmedia.net/Magazine/Journal/islamisation_laws.htm.
[16] Tripp, Charles, *Islam and the Moral Economy, The Challenge of Capitalism*, note 12, at 140-141 noting that following the "Islamisation" of Iran's banking sector created "a thriving black economy in which interest was charged and other practices forbidden in the formal economy proliferated."
[17] Khan, Mohsin S. and Mirakhor, Abbas, "Islamic Banking, Experiences in the Islamic Republic of Iran and in Pakistan", note 11, at 358.
[18] According to Canetti, Islam serves to unite the just in opposition to the unjust, the saved against the damned, the believer against the unbeliever, Canetti, Elias, *Crowds and Power*, Carol Stewart, (trans.),

the absence of consistent and supportive legislation, regulation and institutions hindered the growth of Islamic finance and may have encouraged isolation of these countries.[19] The concept of a pure Islamic economy has, it seems, largely failed in practice.

However, the case of Pakistan is of particular interest and serves as a source of guidance for any country contemplating the development of an Islamic finance market. After the public failure of full-scale islamisation of the economy, Pakistan has re-launched its Islamic finance industry with a renewed sense of pragmatism. Rather than focusing exclusively on spiritual as opposed to practical economic considerations, the Pakistani Government is seeking to ensure that the Islamic finance industry develops upon a solid and internationally recognised legislative, regulatory and educational basis. Islamic finance in Pakistan now exists alongside conventional structures, and under the same legal and regulatory frameworks as those interest-based arrangements.[20] A policy of full-scale islamisation has thus been replaced by one which shares similarities with an integrationist model.

This section will discuss the development of Islamic finance in Pakistan. It will look first at the Islamic banking sector and the unsuccessful attempt by Pakistan's religious, financial and judicial authorities to bring about islamisation of the economy (4.2.2).[21] It will then discuss the new approach to accommodation which has been adopted, both in the context of Islamic banking (4.2.3),[22] and Islamic non-banking economic activity (4.2.4).[23]

4.2.1 The Islamic Nature of Pakistan

In theory, if Islamic finance were to thrive anywhere it would be Pakistan.[24] The Islamic orientation of Pakistan is emphasised numerous times in its 1973 Constitution.[25] Not only

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(Seabury Press, New York, 1978), at 141 in Cohen, Stephen P., "State Building in Pakistan", in *The State, Religion and Ethnic Politics; Afghanistan, Iran and Pakistan*, Ali Banuazizi and Myron Weiner (ed.) (Syracuse University Press, Syracuse, 1986), 299-332 at 301.

[19] Tripp, Charles, *Islam and the Moral Economy, The Challenge of Capitalism*, note 12, at 140, el-Gamal, Mahmoud A., "'Interest' and the Paradox of Contemporary Islamic Law and Finance", (2003) 27(1) *Fordham International Law Journal* 108-149 at 112.

[20] State Bank of Pakistan, Islamic Banking Department, *Strategic Plan for Islamic Banking Industry of Pakistan*, (SPB, Karachi, 2009), at 1.

[21] *infra.*at 99.

[22] *infra.*at 104.

[23] *infra.*at 109.

[24] Rasul, Bilal, "Lessons from Pakistan's Model in Current Issues", in *Islamic Banking and Finance; Resilience and Stability in the Present System*, Angelo M Venardos (ed.), (World Scientific Publishing Co. Pte. Ltd., Singapore, 2010) 167-188.

does Article 2 declare that "Islam shall be the State religion of Pakistan,"[26] but Article 227 establishes that no law shall be enacted which is repugnant to the injunctions of Islam as laid down in the *Qur'ān* and *Sunnah*.[27] Significantly, it also calls on the State to "eliminate riba as early as possible."[28] Such a specific economic injunction places the Pakistani Government under a direct obligation and suggests that the state shall take an active interest in all fiscal transactions within the country. By stating that the Government "shall" eliminate *ribā* as opposed to simply using its best efforts to eradicate it, this constitutional provision appears to envisage a period in which Pakistan will be an entirely *ribā*-free society.[29]

4.2.2 Islamic Banking and Finance in Pakistan: Legislative and Judicial Developments

A. Islamic Banking: Initial Legislation

The attempted islamisation of Pakistan's economy has been referred to as being gradual in nature.[30] The fact that Pakistan is not now an Islamic economy, thirty years after it was first proposed, is not because a carefully designed, long-term plan was initially implemented but rather because early attempts at rapid islamisation simply failed to work.

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[25] As well as in its two previous Constitutions in 1956 and in 1962, Memon, Noor Ahmed, "Overview of Islamic Banking in Pakistan", (2007) 24(2) *Journal of Islamic Banking & Finance*, 106-112 at 108.

[26] Art. 2, The Constitution of the Islamic Republic of Pakistan, 1973.

[27] Art 227, The Constitution of the Islamic Republic of Pakistan, 1973, a similar provision appears in previous Constitutions of Pakistan; Art 198(1) 1956 Constitution, and Art 8(1) of the 1962 Constitution.

[28] Art 38(f) The Constitution of the Islamic Republic of Pakistan, 1973, Art 29(f) The Constitution of Pakistan 1956, Art 8(18) The Constitution of Pakistan 1962, see generally; Hassan, Parvez and Azfar, Azim, "Moving Toward and Islamic Financial Regime in Pakistan", *Occasional Publications 2*, (Islamic Legal Studies Program, Harvard Law School, Cambridge, 2001), at 4-6.

[29] The Objectives Resolution, incorporated into the Preamble of the 1973 Constitution provided that "...Muslims shall be enabled to order their lives in the individual and collective spheres in accordance with the teachings and requirements of Islam as set out in the Holy Quran and Sunnah," (Preamble, The Constitution of the Islamic Republic of Pakistan 1973). Pursuant to this, Presidential Order 1 of 1980 (PLD 1980 Central Statutes 89) of General Zia-ul-Haq amended the Constitution to provide for the creation of the Federal Shariat Court (FSC) whose sole objective was to determine legislative *Sharī'ah*-compliance and to strike down any law repugnant to Islam (Art 203D Constitution of the Islamic Republic of Pakistan 1975). Equally significant was President's Order No. 14 of 1985 in which General Zia transformed the Preamble into a substantive, and therefore justiciable, part of the Constitution (Kazmi, Shabbir H., "Islamization of Financial System in Pakistan", *Pakistan Economist*, December 23-29, 2002, available at: http://www.pakistaneconomist.com/pagesearch/Search-Engine2002/S.E152.asp). As a result, not only were these new courts empowered to ensure the personal religious rights of citizens were being upheld, but they were granted the authority to strike down any law which failed to fulfil the Islamic ideal. Kennedy, Charles, H., "Repugnancy to Islam - Who Decides?: Islam and Legal Reform in Pakistan", (1992) 41(4), *International and Comparative Law Quarterly*, 796-818 at 772, Hassan, Parvez and Azfar, Azim, "Moving Toward and Islamic Financial Regime in Pakistan", note 28, at 8.

[30] Khan, Mohsin S. and Mirakhor, Abbas, "Islamic Banking: Experiences in the Islamic Republic of Iran and in Pakistan", note 11, at 365.

In 1980 the Council of Islamic Ideology [CII] proposed extensive reforms for the Pakistani economy,[31] culminating in the total elimination of *ribā*[32] from the financial system by 1982.[33] Such recommendations were advisory in nature. Nevertheless a series of legislative amendments took place following both this report and the State Bank of Pakistan's [SBP] 1984 Circular, which also called for the elimination of *ribā* in Pakistan's banking sector.[34] As part of the initial stage towards interest-free banking, key adjustments to existing Pakistani banking laws saw the scope of deposits in the Banking Companies Ordinance 1962[35] islamised[36] and the definition of finance enlarged to include "an accommodation or facility under a system which is not based in interest but provided on the basis of" one of the acceptable modes of Islamic financing.[37]

In theory, by the time the second stage of development was reached (July 1985), all deposits, other than those in current accounts, were accepted only on a *mudāraba* PLS

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[31] Council of Islamic Ideology, *Elimination of Riba from the Economy and Islamic Modes of Financing*, (CII, Islamabad, 1980), page numbers referred to here are from the 2nd revised and enlarged edition published in 2006, available at: http://www.cii.gov.pk/publication.asp.

[32] This would, of course, be what the CII itself considered to be ribā as, following the discussion in Chapter 3, it is clear that what *ribā* actually entails is still subject to some dispute.

[33] Council of Islamic Ideology, *Elimination of Riba from the Economy and Islamic Modes of Financing*, note 31, at 42. See also at 10 where the CII suggested that the PLS system as a key alternative to interest-based banking, available at: http://www.cii.gov.pk/publication.asp, Khan, Mohammad Mansoor and Bhatti, M. Ishaq, *Developments in Islamic Banking, The Case of Pakistan*, (Palgrave MacMillan, Hampshire, 2008), at 81.

[34] State Bank of Pakistan, Banking Control Department, "Elimination of 'Riba' from the Banking System", *BCD Circular No. 13 of 1984*, 30th June 1984, available at: http://www.sbp.org.pk/departments/pdf/IBD-OldCircular/BCD-cir13-1984.pdf.

[35] Banking Companies Ordinance 1962, (LVII of 1962)

[36] Banking Companies (Third Amendment) Ordinance, 1980 (Ord. LVIII of 1980), (The Gazette of Pakistan Extra, Part-I, December 24, 1980), at 550, Section 26A Banking Companies Ordinance 1962, (LVII of 1962), the Amendment narrowed acceptable deposits to those taken

i. on participation in profit and loss of the banking company and
ii. free of interest or return in any form.

Current accounts continued to be accepted but on a *qard-hasan* basis under which no interest was paid. This is a clear articulation of the state's intention that banks should actively participate in partnership financing with depositors. In addition section 26A also provides that banks were able to accept deposits on the basis of interest until such time as the government declared the operations of the banks to be interest-free. This amendment was further supported in 1984 by the State Bank of Pakistan, Banking Control Department, "Elimination of 'Riba' from the Banking System", note 34, which declared that effective as of the 1st April 1985, banks were to be interest-free with no interest bearing deposits accepted after July 1st 1985, State Bank of Pakistan, *Annual Report of the SBP, 2001-2002*, (SBP, Karachi, 2002), at 189.

[37] Section 5(gg) Banking Companies Ordinance 1962 under which defines " loans, advances, and credit" as including "finance" as defined in the Banking Tribunals Ordinance, 1984, inserted by Banking and Financial Services (Amendment of Laws) Ordinance, 1984 (Ordinance No. LVII of 1984) (The Gazette of Pakistan Extra, Part-I, December 24, 1980), at 681 to 695. The range of acceptable options for banks was confirmed by the State Bank of Pakistan's Circular No. 13 in 1984 which approved twelve modes of financing which could be used by banks, State Bank of Pakistan, *Circular No. 13 of 1984*, (SBP, Karachi, June 20th 1984).

basis.[38] The rapid modification of the concept of a deposit, while cosmetically effective, did not provide financial institutions with adequate time to prepare and restructure. Indicative of the mismatch in planning and implementation, it was not until late 1984 that the SBP provided directions on how profits earned through PLS investments were to be shared between the bank and its depositors.[39] Concurrently, while aiming at total inclusiveness, the legislation contained loopholes allowing foreign currency deposits in Pakistan and on-lending of foreign loans to continue on the basis of interest.[40] Ultimately the system served as a facade for Islamic banking; in reality, interest-based transactions continued in force.[41]

B. Judicial Transformation of the Pakistani Economy

While initial measures towards the islamisation of Pakistan's economy were somewhat haphazard, they did at least indicate a general movement towards *Sharī'ah*-compliance. Nevertheless, the practical impact of the islamisation drive on the financial sector was marginal[42] and post-1985, developments in the islamification of Pakistan's economy tapered off.[43] Khan suggests that the principal reasons for the failure of Islamic finance to flourish in Pakistan were the lack of commitment by successive Governments to further islamise the economy, an inadequate judicial system and the absence of institutional *Sharī'ah*-compliance monitoring.[44] The unmanaged nature of the financial sector's transformation quickly resulted in a failure to apply the system faithfully. Unwillingness of financial sector participants to become involved in risky, though religiously preferable, PLS transactions also led to an almost total reliance by financial institutions on mark-up

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[38] Section 26A(3) and (4) Banking Companies Ordinance 1962, Gafoor, A.L.M. Abdul, *Mudaraba-based Investment and Finance*, (Groningen, the Netherlands, January 2001), at 5, available at: http://www.Islamicbanking.nl/article2.html.

[39] State Bank of Pakistan, Banking Control Department, "Determination of rate of profit on various types of PLS liabilities of the banks and DFIs", *Circular No. 34 of 1984*, (SBP, Karachi, November 26, 1984), available at: http://www.sbp.org.pk/departments/pdf/IBD-OldCircular/BCD-cir34-1984.pdf.

[40] State Bank of Pakistan, *Annual Report of the SBP, 2001-2002*, Chapter 10, "*Islamization of Financial System in Pakistan*", (SBP, Karachi, 2002), at 189, State Bank of Pakistan, Banking Control Department, BCD Circular *Circular No. 13 of 1984*, (SBP, Karachi, June 20th 1984), Warde, Ibrahim, *Islamic Finance in the Global Economy*, (1st ed., Edinburgh University Press, Edinburgh, 2000), at 115.

[41] Memon, Noor Ahmed, "Overview of Islamic Banking in Pakistan", note 25, at 110.

[42] Khan, Mohammad Mansoor and Bhatti, M. Ishaq, *Developments in Islamic Banking, The Case of Pakistan*, note 33, at 122 noting that "neither the government of Pakistan nor the SBP was serious about implementing the CII's recommendations in either the spirit or the letter."

[43] Khan, Feisal, "Islamic Banking by Judiciary: The 'Backdoor' for Islamism in Pakistan?", (2008) 31(3) *South Asia: Journal of South Asian Studies*, 535–555 at 543, ul-Hassan, Mehboob, "The Islamization of the Economy and the Development of Islamic Banking in Pakistan", (2007)1-2, *Kyoto Bulletin of Islamic Area Studies*, 92-109 at 100.

[44] Mansur-ur-Rehman Khan interviewed in Kazmi, Shabbir H., "Islamization of Financial System in Pakistan", note 29.

modes of financing (primarily *murābaha*) as *Sharī'ah*-compliant mechanisms for replicating interest-based financing.[45]

The inadequacies of the system were brought to the fore by two cases. In the *Faisal* case[46] in 1991, the Federal Shariat Court [FSC] heard challenges to twenty separate laws as being contrary to the constitutional prohibition of *ribā*.[47] Taking a strict *Sharī'ah* line, the FSC held that *ribā* included not only exorbitant or excessive rates of interest but *any* percentage over the principal since "[t]he word riba as used in the Quran is absolute in terms, and no attribute or qualification as to its quantity is to govern it..."[48] The court was critical of the current state of Islamic finance in Pakistan and noted that PLS accounts introduced by banks fell short of the kind of substantial changes advocated by the Council of Ideology in its 1980 report.[49] The decision was appealed by the Government[50] to the Shariat Appellate Bench of the Supreme Court [SAB][51] and in the 1999 *Aslam Khaki*[52] decision the SAB upheld *Faisal*. Evident in the judgment are overtones of a broader attempt to reinvigorate the now stalled islamification of the country. In his judgment, Muhammad Taqi Usmani recounted the "evil consequences of interest[53] [which] were

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[45] Lobo, Isobel and Bonello, Frank, "Islamic Banking meets 'Conventional' Banking: A survey of recent developments in Banking in Pakistan", Paper presented at the Academy of International Business-South East (USA), 2005 Annual Meeting, Charleston, South Carolina, 234 at 234. This is despite the Council of Islamic Ideology Report which called for banks to "replace interest by a system of profit/loss sharing." Council of Islamic Ideology, *Elimination of Riba from the Economy and Islamic Modes of Financing*, note 31, at 11. See also, Council of Islamic Ideology, *Elimination of Riba from the Economy and Islamic Modes of Financing*, (2nd Revised and Enliged Edition, CII, Islamabad, 2002), at ii. See also, Warde, Ibrahim, *Islamic Finance in the Global Economy*, (2nd ed., Edinburgh University Press, Edinburgh, 2010), at 118 noting that "PLS was shunned by banks, where 90 percent of transactions consisted of mark-up schemes."

[46] *Mahmood-ur-Rehman Faisal v Secretary*, PLD *1992 FSC* 1.

[47] Kennedy, Charles H., "Pakistan's Superior Courts and the Prohibition of Ribai", in *Islamization and the Pakistani Economy*, Robert M. Hathaway and Wilson Lee (ed.), (Woodrow Wilson International Center for Scholars, Washington DC, 2004), 101-117, at 106, and Lobo, Isobel and Bonello, Frank, "Islamic Banking meets 'Conventional' Banking: A survey of recent developments in Banking in Pakistan", note 45, at 234, Hassan, Parvez and Azfar, Azim, "Moving Toward and Islamic Financial Regime in Pakistan", note 28, at 19.

[48] *Mahmood-ur-Rehman Faisal v Secretary*, PLD *1992 FSC* 1 at 73.

[49] *ibid.*, at 144.

[50] Notwithstanding the fact that in 1991 the Government passed the Enforcement of Shariah Act, 1991, (Act X of 1991) which provided that the "State shall take steps to ensure that the economic system of Pakistan is constructed on the basis of Islamic economic objectives, principles, and priorities," at section 8(1). However, like so much of Pakistan's official Islamisation efforts it merely called for Islamisation rather than set out a concrete strategy to be followed in order to ensure this Islamisation was actually possible.

[51] Kennedy, Charles H., "Pakistan's Superior Courts and the Prohibition of Ribai", in *Islamization and the Pakistani Economy*, note 47, at 108.

[52] *Dr. M. Aslam Khaki v. Syed Muhammad Hashim* PLD 2000 SC 225.

[53] The court adopted a contemporary understanding of *ribā* which includes all interest when it noted that "any amount, big or small, over the principal, in a contract of loan or debt is "riba" prohibited by the Holy Quran, regardless of whether the loan is taken for the purpose of consumption or for some production activity," *Dr. M. Aslam Khaki v. Syed Muhammad Hashim* PLD 2000 SC 225 at [468] quoted in McMillen, Michael J.T., "Asset Securitization *Sukuk* and Islamic Capital Markets: Structural Issues in these Formative Years", (2007-2008) 25 *Wisconsin International Law Journal*, 703-772 at 711 and Khan, Mohammad Mansoor and Bhatti, M. Ishaq, *Developments in Islamic Banking, The Case of Pakistan*, note 33, at 160.

never so evident in the past than they are today"[54] and called for a system based on PLS.[55] The court then gave the Government only two years, until June 2001, to fully islamise Pakistan's economy.[56] To provide the necessary surrounding support, the court called for the creation of a Commission for Transformation of Financial System [CTFS] and two task forces, one at the Ministry of Finance and another at the Ministry of Law, to be established.[57] It also called for wide scale training of personnel in financial institutions as well as auditing of certain institutions.[58] The court did not venture to lay out instructions for the development of a regulatory or supervisory framework within which Islamic institutions could operate.

Following *Aslam Khaki*, steps were undertaken by the Government to implement the decision.[59] The CTFS was established and the task forces began work; indeed the Ministry of Law task force produced a draft law for the prohibition of *ribā*, but this was never promulgated.[60] In 2002, *United Bank*,[61] a review petition of *Aslam Khaki* was heard by the SAB.[62] The subsequent reversal by the SAB of its own decision in *Aslam Khaki* was a *volte face*[63] which ended the reign of the strict judicially mandated Islamic economy. The court acknowledged the Government's contention that the implementation of the court's previous directions "is not practical or feasible and if attempted will pose high degree of risk to the economic stability and security of Pakistan."[64] Significantly, in referring the case to the FSC, the SAB recommended that thorough and elaborate research and comparative studies of other Muslim financial systems should be conducted.[65]

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[54] *Dr. M. Aslam Khaki v. Syed Muhammad Hashim* PLD 2000 SC 225, Judgment of Maulana Justice Taqi Usmani at [133].

[55] *ibid.*, at [204].

[56] Iqbal, Munawar and Molyneux, Philip, *Thirty Years of Islamic Banking, History, Performance and Prospects*, note 12, at 40.

[57] *Dr. M. Aslam Khaki v. Syed Muhammad Hashim* PLD 2000 SC 225 at [619] discussed in Khan, Mohammad Mansoor and Bhatti, M. Ishaq, *Developments in Islamic Banking, The Case of Pakistan*, note 33, at 165.

[58] *Dr. M. Aslam Khaki v. Syed Muhammad Hashim* PLD 2000 SC 225, Judgment of Maulana Justice Taqi Usmani at [216]-[217].

[59] Khan, Mohammad Mansoor and Bhatti, M. Ishaq, *Developments in Islamic Banking, The Case of Pakistan*, note 33, at 165-166.

[60] Kennedy, Charles H., "Pakistan's Superior Courts and the Prohibition of Ribai", in *Islamization and the Pakistani Economy*, note 47, at 112, Mehboob, "The Islamization of the Economy and the Development of Islamic Banking in Pakistan", note 43, at 101.

[61] *United Bank Limited v Farooq Brothers and Others* PLD 2002 SC 800.

[62] *ibid.*

[63] The unexpectedness of the United Bank decision can be seen in the fact that Hassan and Azfar, writing just a few months before the case was heard noted that 'not much could be expected from the review petition.' Hassan, Parvez and Azfar, Azim, "Moving Toward and Islamic Financial Regime in Pakistan", note 28, at 51.

[64] *United Bank Limited v Farooq Brothers and Others* PLD 2002 SC 800 at [7].

[65] *ibid.*, at [18].

4.2.3 The Current State of Islamic Banking in Pakistan

With the reversal of *Aslam Khaki*, the timetable imposed by the court was correspondingly removed. However, as the SBP noted in its 2002 Annual Report, in spite of the SAB's ruling, the development of Islamic finance would continue.[66] Even before *United Bank*, Islamic finance in Pakistan was being re-launched with a greater appreciation of the need for regulation, supervision, training and infrastructure.[67] The focus rests now on the facilitation of Islamic financial activity as a *segment* of Pakistan's economy which will operate alongside conventional structures.[68] The new approach also appears to recognise the economic similarities between conventional financial activity and much of the contemporary Islamic products available. This system is being implemented gradually and with greater emphasis on structure, flexibility and long term feasibility.[69] What emerges from the approach of Pakistan now is that the Islamic finance sector will no longer be foisted upon unwilling participants nor is the conventional system being eliminated. Instead the industry will be supported to ensure that it develops into a viable alternative to conventional financing, thereby becoming the system of choice for the finance community.[70]

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[66] State Bank of Pakistan, *Annual Report of the SBP, 2001-2002*, (SBP, Karachi, 2002), at 194.

[67] ul-Hassan, Mehboob, "Islamic Banking in Pakistan from account holders' perspective (Case study on Meezan Islamic Bank)", (2008) 25(1) *Journal of Islamic Banking & Finance*, 79 at 79. Khan and Bhatti note that at an inter-ministerial meeting in September 2001, the Pakistani government had already decided that it could not meet the demands of the FSC and so the government should follow "a 'gradual and evolutionary' process to eliminate interest from the economy of Pakistan." However, "the resolution of this meeting was kept secret for the time being", Khan, Mohammad Mansoor and Bhatti, M. Ishaq, *Developments in Islamic Banking, The Case of Pakistan*, note 33, at 167.

[68] As an affidavit filed by the Deputy Governor of the State Bank noted in the course of the *United Bank case*; "considering all other practical problems associated with the complete transformation of the financial system...it is SBP's considered judgment that a parallel approach will be in the best interests of the country." Lobo, Isobel and Bonello, Frank, "Islamic Banking meets 'Conventional' Banking: A survey of recent developments in Banking in Pakistan", note 45, at 235, Deputy Governor of the State Bank, cited in the State Bank of Pakistan, *Annual Report of the SBP, 2001-2002*, (SBP, Karachi, 2002), at 194. In practice, and as will be discussed below, Pakistan is currently implementing an approach to accommodation which bears similarities with the integrationist approach of the UK, although the SBP has issued a number of guidelines specifically for Islamic financial institutions.

[69] The decision to proceed in this gradual and phased manner was made in a meeting on September 4, 2001, under the Chairmanship of the President of Pakistan, in attendance of representatives of the Ministries of Finance and Law, Governor of the SBP, the Chairman and members of the Council of Islamic Ideology and the Chairman of the CTFS and the two task forces, State Bank of Pakistan, *Annual Report of the SBP, 2001-2002*, (SBP, Karachi, 2002), at 193, footnote 5, State Bank of Pakistan, Islamic Banking Department, *Strategic Plan for Islamic Banking Industry of Pakistan*, note 20, at 1, Akhtar, Shamshad, "Pakistan Islamic Banking – Past, Present and Future Outlook", (2009) 26(2) *Journal of Islamic Banking and Finance*, 53 at 56.

[70] State Bank of Pakistan, *Islamic Banking Sector Review 2003-2007*, (SPB, Karachi, 2007) available at: http://www.sbp.org.pk/ibd/Islamic-Bkg-Review-03-07.pdf, at vi.

As part of the phased reinvigoration of the Islamic finance sector, the SBP implemented a three-pronged institutional strategy. The first step was to encourage the establishment of fully Islamic banks by the private sector, a move which resulted in Al Meezan Investment Limited converting into Pakistan's first Islamic commercial bank in 2002.[71] The second stage saw the amendment of the Banking Companies Ordinance 1962,[72] which expanded the acceptable forms of bank subsidiaries to include those created for "the carrying on of banking business strictly in conformity with the Injunctions of Islam as laid down in the Holy Quran and Sunnah."[73] Finally, the opening of stand-alone branches of Islamic banks by existing commercial banks was addressed and Islamic banking windows *within* conventional financial institutions were also permitted.[74] Complementing each of these institutional expansions, the SBP has also published detailed criteria which act as guidelines to establishing Islamic banks,[75] subsidiaries,[76] Islamic windows[77] or stand alone branches.[78] Relying on these guidelines, applicants must not only demonstrate that they have an adequate framework in place to ensure *Sharī'ah*-compliance, but must also meet conventional institutional criteria relating to licensing, accounts, disclosure and liquidity and cash reserve requirements.

The basic structures of Islamic financial institutions in Pakistan were therefore established early in the rejuvenation process. What has helped to promote greater success within the industry has been the surrounding framework gradually created within Pakistan's economy. In an outline of its strategy for promoting the Islamic financial sector, the SBP noted that development must be directed at four key areas: formulating offerings

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[71] State Bank of Pakistan, Islamic Banking Department, *Strategic Plan for Islamic Banking Industry of Pakistan*, note 20, at 4, Akhtar, Shamshad, "Pakistan Islamic Banking – Past, Present and Future Outlook", note 69, at 53 for a discussion on the performance of Meezan Bank see, Lobo, Isobel and Bonello, Frank, "Islamic Banking meets 'Conventional' Banking: A survey of recent developments in Banking in Pakistan note 45, at 239, ul-Hassan, Mehboob, "Islamic Banking in Pakistan from account holders' perspective (Case study on Meezan Islamic Bank)", note 67, at 79.

[72] Banking Companies Ordinance 1962, (LVII of 1962).

[73] Section 23(1)(aa) Banking Companies Ordinance 1962, Inserted by The Banking Companies (Amendment) Ordinance, 2002 (Ordinance No. CXI of 2002), dated 4-11-2002.

[74] State Bank of Pakistan, "Guidelines for Opening of Stand Alone Branches for Islamic Banking by Existing Banks", *Annexure-III to BPD Circular No. 01 of 2003*, available at: http://www.sbp.org.pk/bpd/2003/annexC1_III.pdf, Kuwait News Agency, "Pakistan Banks allowed to set up Islamic windows", *KUNA*, December 19, 2002, available at: http://www.kuna.net.kw/NewsAgencyPublicSite/ArticleDetails.aspx?Language=en&id=1305818.

[75] Contained in Annexure 1 of the SBP Annual Report 2001-2002, amended by State Bank of Pakistan, *Annexure-I to IBD Circular No. 02 of 2004*, (SBP, Karachi, 2004).

[76] State Bank of Pakistan, "Minimum *Sharī'ah* Regulatory Standards", *BPD Circular No. 1 of 1st January, 2003 amended* by Annexure-III to IBD Circular No. 02 of 2004, (SBP, Karachi, 2004).

[77] State Bank of Pakistan, "Information about Islamic Banking Windows", *IBD Circular No.06 of 2007*, (SBP, Karachi, November 10, 2007), available at: http://www.sbp.org.pk/ibd/2007/C6.htm.

[78] State Bank of Pakistan, "Minimum *Sharī'ah* Regulatory Standards", *BPD Circular No. 1 of 1st January, 2003 amended by* Annexure-III to IBD Circular No. 02 of 2004, (SBP, Karachi, 2004).

that are comparable and compatible with conventional banking but still *Sharī'ah*-compliant, expanding the existing regulatory framework to accommodate Islamic banking transactions,[79] strengthening *Sharī'ah*-compliance mechanisms and coordination with other regulators and agencies so as to establish a global regulatory framework for the Islamic financial services industry.[80] By outlining its approach to fostering the Islamic finance industry, the SBP has been able to focus and organise the development of an Islamic finance sector within Pakistan's existing system.

Concurrently with this development of an increasingly solid regulatory basis for Islamic banking institutions and instruments, more inconspicuous developments have taken place in relation to taxation. Adopting a policy of equality of taxation between Islamic and conventional products, Pakistani authorities have made several adjustments to existing tax laws such as the Income Tax Ordinance 2001 with Schedule 7 noting that "[a]ny special treatment for 'Shariah Compliant Banking' approved by the State Bank of Pakistan shall not be provided for any reduction or addition to income and tax liability for the said 'Shariah Compliant Banking'..."[81] Tailored provisions dealing specifically with Islamic contracts have been adopted in order to facilitate greater parity of taxation as between comparable products. Like interest payments, "any amount incurred by a scheduled bank in the tax year to a person maintaining a profit or loss sharing account"[82] and "any amount incurred by a person in the tax year to a banking company under a scheme of musharika representing the bank's share in the profits of the musharika" can be deducted when computing tax liability.[83] Equality of taxation is also facilitated through indirect references to Islamic finance as tax provisions frequently refer to "profit" rather than "interest." By using the term profit, the application of tax provisions is extended to include returns other than in the form of interest. This allows both interest-based and interest-free products to be

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[79] The SBP, in its Strategic Plan noted that "without a doubt a robust Regulatory framework that is compatible with [the] conventional banking regulatory framework and at the same time recognises the uniqueness of [the] Islamic financial system and caters for this uniqueness, is the fundamental requirement for promoting and establishing Islamic financing as the financial system that can meet the challenges of the dynamic financial markets and customer needs," State Bank of Pakistan, Islamic Banking Department, *Strategic Plan for Islamic Banking Industry of Pakistan*, note 20, at 18.

[80] *ibid.*, at 9. By applying the regulatory standards already in place for conventional institutions, Pakistan will be able to ensure that Islamic firms are held up to the same standards as conventional institutions. Modification and addition to this framework would therefore only be necessary when the unique characteristics of the Islamic finance instrument prevents it from falling within the existing legal structures. Such additional directions have, for example, been issued regarding the essential structures and guidance for *Sharī'ah*-compliance.

[81] Section 3(1) Seventh Schedule, Income Tax Ordinance 2001.

[82] Section 28(d) Income Tax Ordinance 2001.A provision which extends the tax law to mudaraba transactions.

[83] Section 28(h) Income Tax Ordinance 2001, which applies to musharaka arrangements.

taxed under the same laws.[84] The accommodation of Islamic structures within existing taxation provisions is not, however, entirely comprehensive and the remaining uncertainties surrounding tax liability on transfer of goods "put the providers of sharia-compliant financial products at a commercial disadvantage."[85]

Finally, as part of its renewed strategy, Pakistan has also given consideration to ensuring conformity with Islamic law.[86] In doing so, it has adopted a multi-layered approach to *Sharī'ah* supervision which includes institutional supervisors, compliance auditors and a national board within the SPB.[87] For each tier of the *Sharī'ah* supervisory framework, instructions have been set out by the SBP relating to the structure, competence and role of the religious supervisors. At an institutional level, "Shariah Advisors" must be appointed by every banking institution undertaking Islamic banking activity.[88] These advisers, who issue binding *fatāwā*[89] and rulings, must fulfil the Fit and Proper test established by the SBP.[90] In addition to Shariah Advisors, Islamic financial institutions in Pakistan may also establish Shariah Committees or boards which do not have to fulfil the SBPs requirements.[91] At the next tier of *Sharī'ah* governance, an "Internal Shariah Audit" of an institution's activities determines whether or not the institution has conducted its business in a *Sharī'ah*-compliant manner.[92] This Internal Shariah Audit inspects the contracts, *fatāwā* and transactions entered into by the institution to ensure that "the system of internal control for Shariah Compliance is conceptually sound and effective in implementation..."[93] Finally, at the top of Pakistan's *Sharī'ah* supervisory framework, the SBP's *Sharī'ah* board, "the Shariah Board," guides the Pakistani Islamic financial sector and the SBP on

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[84] See for example, the Income Tax Ordinance 2001 which refers to "profit on debt" as (a) any profit, yield, interest, discount, premium or other amount, owing under a debt, other than a return of capital." Section 46(a) Income Tax Ordinance 2001.

[85] Bukhari, Huzaima and Haq, Ikramul, "Pakistan", *World Tax*, (Euromoney), available at: http://www.itrworldtax.com/Guide/308/Pakistan.html.

[86] State Bank of Pakistan, Islamic Banking Department, *Strategic Plan for Islamic Banking Industry of Pakistan*, note 20, at 15-17.

[87] *ibid.*, at 15-17.

[88] State Bank of Pakistan, Islamic Banking Department, "Instructions for Shariah Compliance in Islamic Banking Institutions", *Annexure 1 of IBD Circular No: 02 of 2008*, (SBP, Karachi, 2008), at 1, [A] available at: http://www.sbp.org.pk/ibd/2008/Annex-c2-1.pdf.

[89] *ibid.*, at 1, [A(ix)].

[90] *ibid.*, at 1, [A(iii)].

[91] Although the extent to which this board could contradict the officially approved Shariah Advisors appears to be limited in light of the fact that the SBP confers on Shariah Advisors the power to monitor and review for *Sharī'ah*-compliance all relevant activities and products of the supervised institution and to order the rectification of any breach of Islam's teachings. State Bank of Pakistan, Islamic Banking Department, "Guidelines for Shariah Compliance in Islamic Banking Institutions", *Annexure 2 of IBD Circular No: 02 of 2008* (SBP, Karachi, 2008), at I, available at: http://www.sbp.org.pk/ibd/2008/Annex-c2-2.pdf.

[92] *ibid.*

[93] *ibid.*

issues of Islamic banking and finance.[94] This national board is responsible for reviewing and approving as *Sharī'ah*-compliant, any products or instruments developed for the Islamic banking industry by the SBP. [95] It also advises the SBP on prudential regulations imposed on Islamic financial institutions, the Fit and Proper test for *Sharī'ah* advisers and in relation to conflicting *Sharī'ah* opinions in relation to Islamic banking products.[96] While the *Sharī'ah* Board may advise the SBP in relation to Islamic finance and the decisions of the SBP which are based on the rulings of the *Sharī'ah* Board are binding on Islamic banking institutions, guidelines issued by the SBP acknowledge that individual Islamic banks may develop new Islamic products and vary the instruments approved by the *Sharī'ah* Board with the approval of their *Sharī'ah* advisor.[97]

Consistent with this broad emphasis on *Sharī'ah*-compliance and active, state-level intervention, the SBP has also published a set of *Sharī'ah* standards which outline the "essentials of Islamic modes of financing."[98] In setting out the structures and uses of modern Islamic contracts, such as *murābaha* with a purchase order, *ijārah* and partnership structures, these standards outline the "minimum requirements for Shariah compliance in respect of products developed on the basis of such modes,"[99] encouraging consistent adherence to the religious dictates underpinning Islamic financial activity.[100] In 2010, the SBP announced that it would begin to gradually replace its existing *Sharī'ah* standards with standards established by AAOIFI to "harmonize and standardize the Shariah practices and procedures of IBIs [Islamic banking institutions] as per internationally recognized

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[94] Habib, Ahmed, *Product Development in Islamic Banks*, (Edinburgh University Press, Edinburgh, 2011), at 66.

[95] State Bank of Pakistan, Islamic Banking Department, *Strategic Plan for Islamic Banking Industry of Pakistan*, note 20, Appendix-C Shariah Compliance at 6.

[96] *ibid.*

[97] State Bank of Pakistan, Islamic Banking Department, "Instructions for Shariah Compliance in Islamic Banking Institutions", note 88.

[98] *ibid.*, at 6.

[99] *ibid.*, at 4.

[100] Although Khan and Bhatti suggest that; "[t]he SBP's act of prescribing the terms of *Musharakah* [and the other Islamic contracts] agreements may be regarded as an interference with efficient market mechanisms and free consent of the bank as well as of the client," Khan, Mohammad Mansoor and Bhatti, M. Ishaq, *Developments in Islamic Banking, The Case of Pakistan*, note 33, at 113.

standards."[101] AAOIFI standards will, subject to minor refinements,[102] form the basis upon which Islamic financial activity in Pakistan is developed in the future.[103]

Tailored regulation, taxation and supervision of Islamic banking have facilitated the development of a growing choice of products for Islamic customers in Pakistan. Islamic banking products such as *Sharī'ah*-compliant current and savings accounts, consumer financing, Islamic insurance and *Sharī'ah*-compliant real estate finance are all now available.[104] These products have been accommodated within tax and banking laws but have been the subject of specific guidelines and best practice standards. As a result of a primarily integrationist approach therefore, Islamic banking now represents one, rather than the only, mechanism for banking in Pakistan, without the elimination of conventional financial structures.

4.2.4 Islamic Non-Banking Financial Instruments in Pakistan

Developments in Pakistan's Islamic finance industry have mainly focused on growth at retail-level of Islamic banking products. However, as the former Governor of the SBP noted, "further development of Islamic banking itself depends on concurrent development of [an] Islamic capital market."[105] As the Islamic banking sector has begun to take shape, increased attention has been directed at Pakistan's approach to Islamic non-bank instruments.

Non-bank institutions in Pakistan are brought under a single regulatory authority with the Securities and Exchange Commission of Pakistan [SECP] providing oversight of *modarabas*, Islamic equity funds and the Islamic capital markets.[106] While the SBP has

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[101] State Bank of Pakistan, Islamic Banking Department, "Adoption of Shariah Standards Issued by Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI)", *IBD Circular No. 01 of 2010*, available at: http://www.sbp.org.pk/ibd/2010/C1.htm.

[102] See for example the adjustments which have been made to AAOIFI standards for *murabaha*, *ijārah* and *mudaraba* and those applying on default, State Bank of Pakistan, "Adoption of AAOIFI Shariah Standards Nos. 3, 8, 9 &13", Appendix-A, "Adoption of Shariah Standards Issued by Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI)", note 101.

[103] State Bank of Pakistan, Islamic Banking Department, *Strategic Plan for Islamic Banking Industry of Pakistan*, note 20, at 17.

[104] See for example Dubai Islamic Bank Pakistan Ltd offers Islamic deposit accounts, Al-Islami Saving & Takaful Plan the principle of *Ta'awun* (mutual assistance) and *Tabarru* (voluntary contribution) "where risk is shared collectively by a group of participants" (http://www.dibpak.com/takaful.html) and Islamic real estate finance based on a diminishing musharaka structure. See generally, http://www.dibpak.com/Default.aspx.

[105] Akhtar, Shamshad, "Islamic Finance: Emerging challenges of Supervision", (2007) 24(4) *Journal of Islamic Banking & Finance*, 9-15 at 10.

[106] *ibid.*, at 13.

been active in facilitating interest-free banking, the SECP has taken a more subdued approach to Islamic non-banking activities. *Modaraba* companies constitute partnerships which function on a *mudāraba* basis and have formed the subject of early measures by Pakistani authorities to establish an Islamic non-banking sector.[107] Their establishment under the Modaraba Companies and Modaraba Floatation and Control Ordinance of 1980[108] has been an important step towards mobilising funds within Pakistan in a *Sharī'ah*-compliant manner. However, despite *Modaraba* transaction being the subject of customised legislation and tax incentives,[109] the expansion of these funds and management companies has been disappointing, with only 36 *modaraba* companies active in 2006.[110]

More successful in Pakistan's Islamic non-banking sector has been the *sukūk* market. When compared to other jurisdictions, such as the UAE and Malaysia, the level of *sukūk* activity in Pakistan has been small. Nevertheless, Pakistan represented the fastest growing *sukūk* market in 2007 with twenty *sukūk* issuances, up from four in 2006.[111] 2010/2011 has also seen a significant growth[112] in the issuances of *sukūk* with the Pakistani Government undertaking a number of *sukūk* issuances between July 2010 and June 2011.[113]

Legislative and regulatory amendments supporting *sukūk* in Pakistan have been less extensive than those applicable to Islamic banking activity. No specific provision is made for *sukūk* in Pakistani legislation and so the issuer must be registered under existing companies legislation. Equally, the legal status of the products is governed by untailored legislation relating to the issue of securities, debentures and redeemable capital. For

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[107] These structures created by the Modaraba Companies and Modaraba Floatation and Control Ordinance of 1980.

[108] Modaraba Companies and Modaraba Floatation and Control Ordinance of 1980 (Ordinance 31 of 1980).

[109] Section 37, Modaraba Companies and Modaraba Floatation and Control Ordinance of 1980; Exemption from tax.- The income of a modaraba shall be exempt from tax under the Income-Tax Ordinance, 1979 (XXXI of 1979), if not less than 90 percent of its profits in year is distributed to the holders of the Modaraba Certificates.

[110] Alvi, Ijlal, "Prospects Of Islamic Finance In Pakistan", Paper presented at the 3rd Annual Asian Islamic Banking and Finance Summit, Euromoney Seminars, September 2006 available at: http://www.iifm.net/LinkClick.aspx?fileticket=nc4ZaAU8XX8%3D&tabid=100&mid=393.

[111] Ahmad, Moussa, "*Sukuk* issuance slowing down despite record year, says IFIS", *Business Intelligence Middle East*, February 11, 2008, available at: http://www.bi-me.com/main.php?id=17237&t=1&c=36&cg=4.

[112] Estimated at 13 percent, Khalid, Qayum, and Haris, Anwar, "Pakistan Funds Push for More *Sukuk* Sales to Invest Cash: Islamic Finance", *Bloomberg*, January 18, 2011, available at: http://www.bloomberg.com/news/2011-01-17/pakistan-funds-push-for-*sukuk*-to-invest-cash-Islamic-finance.html.

[113] Bokhari, Farhan, "Islamic banks snap up Pakistan *sukuk* bonds", *Financial Times*, February 27, 2011, available at: http://www.ft.com/cms/s/0/0836bff4-4112-11e0-bf62-00144feabdc0.html#axzz1PHSgDbcd, Nasir, Mobin, "State Bank raises T-bill, PIB auction targets to cover budget deficit", *The Express Tribune*, April 1, 2011, available at: http://tribune.com.pk/story/140692/state-bank-raises-t-bill-pib-auction-targets-to-cover-budget-deficit/.

example, in the Government of Pakistan's three-year PKR6.525 billion (US$84 million) *ijārah sukūk* launched in September 2008, conventional securities, registration and company legislation is referred to throughout the information documents[114] as forming the underlying legal framework for the *sukūk*.[115] While this Government of Pakistan *sukūk* did provide for recourse to the Shariah Advisory Board of the SBP, the absence of legislation which addresses the unique characteristics of *sukūk* results in the situation whereby *sukūk* issued by a corporate body do not have to be vetted by a dedicated *Sharī'ah* supervisory body.[116] Finally, although the income received by non-residents from the WAPDA Energy *sukūk* certificates was exempted from Income Tax,[117] few legislative adjustments have been made to Pakistan's tax laws in relation to *sukūk*, their holders and issuers. This potentially adds a lack of clarity to the *sukūk* market in Pakistan and a sense of uncertainty in terms of tax liability.

4.2.5 Conclusion to Section 4.2

Thirty years after Islamification of the financial system was seriously contemplated in Pakistan, a totally *Sharī'ah*-compliant economy remains elusive. Following an ill-planned approach to transformation of the financial sector,[118] inconsistent Government attitudes and judicial condemnations,[119] Islamic finance has been relaunched in Pakistan with a more practical and pragmatic attitude to the place of Islamic finance *within* the established

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[114] See for example, Statutory Notifications, (S.R.O. 893(I)/2008, Government of Pakistan, Finance Division (Budget Wing) Notification, (Islamabad August 27 2008), at [11] which notes that; "[t]he Sukuk shall be a Government security for the purpose of the Public Debt Act, 1944 (XVIII of 1944) and the payments under the Sukuk shall represent the payment obligations of the Government of Pakistan..."and at [12] "[t]he Federal Government shall declare the Sukuk as approved security for the purpose of sub-section (1) of section 29 of the Banking Companies Ordinance, 1962 (LVII of 1962)."

[115] Procedure Relating to Issue, Management, Repayment etc. State Bank of Pakistan, Financial Markets Strategy & Conduct Department, *GOP Ijara Sukuk*, (SBP, Karachi, September 12, 2008) available at: http://www.sbp.org.pk/FSCD/2008/C13-GOPIjara*Sukuk*.pdf.

[116] In practice however, while there is no legal requirement for issuers of *sukuk* to establish *Sharī'ah* boards, such issuers may appoint an Islamic bank as adviser to the issue. Since all Islamic banks in Pakistan must establish a *Sharī'ah* governance framework it is this bank's *Sharī'ah* advisory board that could provide the oversight necessary to assure that Pakistani *sukuk* do comply with religious principles. See for example Meezan Bank which was appointed as *Sharī'ah* Structuring Advisor to the Government of Pakistan's *Sukūk* issue, Meezan Bank, *Annual Report 2004*, at 7, available at: http://www.meezanbank.com/docs/annualReport2004.pdf.

[117] Section 87, Schedule 2, Income Tax Ordinance 2001.

[118] Ray notes that the process of islamisation of Pakistan's economy was based on the flawed assumption "that the simple statement by a Muslim government that its banking system is Islamic suffices to make it so," Ray, Nicholas Dylan, *Arab Islamic Banking and the Renewal of Islamic Law*, (Graham & Trotman, London, 1995), at 81.

[119] As el-Gamal noted, the Pakistani financial system was "politically mandated to operate on an interest-free basis despite the lack of a coherent demarcation between what is 'interest-based' and what is 'interest-free,'" el-Gamal, Mahmoud A., "'Interest' and the Paradox of Contemporary Islamic Law and Finance", note 19, at 112.

framework both for tax and regulatory purposes. The integrationist approach to Islamic finance now dominates with only *Modaraba* companies being the subject of separate legislation. Early indications of the success of this approach are positive with six fully fledged Islamic banks and twelve conventional banks operating Islamic banking branches.[120] Equally, the SBP's Strategic Plan, which sets a target market share for Islamic banking at 12% by 2012, highlights the continued commitment to fostering the industry. This deadline has recently been extended by the SBP to 2013.[121] However Islamic banking's share of the Pakistani market has already increased to 6.4%,[122] growth which is supported by an increase in the assets held by Pakistan's Islamic banks.[123] The recent increase in *sukūk* issuances may further stimulate the domestic Islamic finance market, although it is suggested that tailoring of Pakistan's existing infrastructure may be required in order to clarify the legal and taxation implications of Pakistani *sukūk* issuances.

Despite this generally successful overhaul of the Pakistani Islamic finance industry, the failure to bring about total islamisation of the Pakistani economy remains a problem when juxtaposed alongside the continuing constitutional obligation imposed on the Pakistani Government to rid Pakistan of *ribā*.[124] Until this goal is fulfilled, the Pakistani Government appears to stand in violation of its constitutional duties. This fact fundamentally distinguishes the position of Islamic finance in Pakistan from that which might possibly apply either now or in the future in Ireland; neither the Irish Constitution nor any other aspect of Irish law contains a similar obligation on the Irish State. Separately, as Pakistan is a Muslim country with a large domestic retail market for Islamic finance, there are major systemic differences between Pakistan and Ireland which limit the extent to which Ireland can directly adopt measures implemented by the Pakistani authorities. Nevertheless, Pakistan's experience of full-scale islamisation of its financial system, and its subsequent

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[120] Ayub, Muhammad, "Islamic Banking in Pakistan: Time to assess the achievement", (2009) 26(1) *Journal of Islamic Banking and Finance*, 20 at 24. Khan, Mohammad Mansoor and Bhatti, M. Ishaq, *Developments in Islamic Banking, The Case of Pakistan*, note 33, at 178.

[121] Anonymous, "SBP plans to increase Islamic banking share to 12 percent", *The International News*, May 5, 2011, available at: http://www.thenews.com.pk/TodaysPrintDetail.aspx?ID=45084&Cat=3&dt=5/5/2011, quoting Saleem Ullah, Director of Islamic Banking Department, SBP, speaking on May 4, 2011.

[122] Up from 5.4% in 2007, State Bank of Pakistan, Islamic Banking Department, "Islamic banking (Balance Sheet) Market Share", *Strategic Plan for Islamic Banking Industry of Pakistan*, note 20, Appendix A, available at: http://www.sbp.org.pk/departments/pdf/StrategicPlanPDF/Appendix-A Existing Position and Growth Forecasts.pdf.

[123] State Bank of Pakistan, Banking Surveillance Department, *Quarterly Performance Review of the Banking System*, (September 2010), at 36, available at: http://www.sbp.org.pk/publications/q_reviews/Q_Review_Sep_10.pdf.

[124] Raja, Salman Akram, "Islamisation of Laws in Pakistan", note 15, noting that; "[w]hile a reprieve had been achieved by the government, the fundamental fault at the heart of [Pakistan's financial] system remains. The status quo cannot continue indefinitely."

use of the integration approach, stand as an example to Ireland of the difficulties which may emerge if Islamic finance is introduced without the surrounding institutional and legal support structures needed to allow Islamic finance to function as a viable economic sector.[125] While the Irish Government will clearly not attempt to Islamise Ireland's economy, it may promote Ireland as a jurisdiction which is amenable to Islamic finance without ensuring that Irish law is capable of addressing the structural attributes of Islamic finance products;[126] this would exacerbate the problems likely to face the industry in Ireland[127] and result in a disconnect between the products which the Irish authorities claim can be offered in Ireland and those products which can actually be offered, in a economically viable manner, within the environment created by the Irish legal system.[128]

The Pakistani experience of Islamic finance also serves as an example of the somewhat obvious point that the introduction of Islamic finance into an established economy does not need to be undertaken in a single sweeping reform. Due to the fact that established legal, tax and regulatory frameworks were designed for conventional financial structures, each is calibrated to the particular legal implications of interest-based arrangements. The novel structures of Islamic financial products will thus almost certainly give rise to unanticipated anomalies in the legal treatment of these products and each legislative accommodation will need to be tested against all other relevant laws to ensure the effectiveness of that accommodation within the legal system as a whole. The most efficient way of achieving

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[125] Rasul, Bilal, "Lessons from Pakistan's Model in Current Issues", note 24, at 179 noting that; "Pakistan's experience with Islamic finance advocates a strong regulatory environment that encompasses the Shariah and the supervisory aspects *en bloc*." Warde, Ibrahim, *Islamic Finance in the Global Economy*, (2nd ed.), note 45, at 118.

[126] Indeed, it appears as though this may already be happening. the Taoiseach, Enda Kenny gave a speech in June 2011 in which he appeared to suggest that Ireland's tax and regulatory law was amenable to Islamic finance, something which this thesis disputes, Kenny, Enda, Speech given at the IFIA Annual Conference, Dublin, June 2, 2011, available at: http://www.merrionstreet.ie/index.php/2011/06/speech-by-the-taoiseach-mr-enda-kenny-t-d-to-the-ifia-annual-conference/?cat=11. See also the statement Angela Madden in a recent article when she suggested (without considering the regulatory issues and remaining tax hurdles) that "almost all Shariah compliant products and structures can now be accommodated in Ireland," Madden, Angela, "Ireland: European center for Islamic finance", (2011) 8(31) *Islamic Finance News,* 22-23 at 23.

[127] Considered *infra.*in Chapters 7, 9 and 10.

[128] The South African case of *Registrar of Banks v Islamic Bank of South Africa Ltd* (in liquidation) (Case No 25286/97) highlights further the need for appropriate supporting legislative infrastructure for Islamic finance before this financial activity is permitted within a jurisdiction. Here, the *Islamic Bank of South Africa Ltd* was granted a banking licence to a bank operating in accordance with *Sharī'ah* principles without any attempt to accommodate that bank within the legal system. Oversight of the bank's activities was therefore insufficient to deal with the unique characteristics of the bank and, when the bank failed, the depositor's claims under Sharī'ah were ignored and conventional banking laws applied, this case is discussed in detail in Nathie, Mahmood, "Islamic Bank Failure: A Case Study", (2010) 2(1) *ISRA International Journal of Islamic Finance*, 7-34.

this is, it is suggested, by introducing amendments, infrastructure and policy adjustments on a phased basis as is currently being undertaken in Pakistan.[129]

4.3 A Dual Financial System: Islamic Finance in Malaysia

Like Pakistan, Islam is the dominant religion in Malaysia with over 60% of the population classified as Muslim.[130] Indeed, in a similar fashion to Pakistan, the Malaysian Constitution specifies that "Islam is the religion of the Federation."[131] However, while Islam is highlighted as the religion of the Federation, the Government is under no specific constitutional duties to promote and protect the principles of Islam.[132] The impact of Islamic law in Malaysia is restricted to issues which are explicitly defined as Islamic.[133] The narrow scope of Islam within the Constitution is highlighted by the fact that the jurisdiction of the *Syariah* [*Sharī'ah*] Courts is limited to "Islamic law and personal and family law of persons professing the religion of Islam" and only where such jurisdiction is conferred by legislation.[134]

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[129] Rasul, Bilal, "Lessons from Pakistan's Model in Current Issues", note 24, at 180 noting that; "[t]he SBP and SECP collaborate in preparing roll-out plans for guidelines and standards issued by international Islamic financial institutions," with the aim of this collaboration to ensure a "common stance to ensure complete harmony in the regulatory approach of the two regulators."

[130] This average is divided into 53.5% in urban areas and 72.9% in rural areas, Population and Housing Census Division , *Population & Housing Census of Malaysia 2000*, (Population and Housing Census Division, Kuala Lumpur, 2000), Population Distribution & Basic Demographic Characteristics.

[131] Article 3, Constitution of the Federation of Malaya 1957, Warde, Ibrahim, *Islamic Finance in the Global Economy*, (1st ed.), note 40, at 123.

[132] Connors, Jane, "Towards a System of Islamic Finance in Malaysia", in *Islamic Law and Finance*, Chibli Mallat (ed.), (Graham & Trotman, London, 1988), 57–68 at 57. Any contention that the Malaysian legislature is required to act under a general *Sharī'ah* ethos was rejected by Malaysia's Supreme Court in 1988 when it refused to acknowledge that since Islam was the religion of the Federation, all laws enacted by Parliament must conform with *Sharī'ah*, *Che Omar bin Che Soh v Public Prosecutor* [1988] 2 M.L.J. 55, Abdullah, Nurjaanah, "Legislating Faith in Malaysia", (2007) *Singapore Journal of Legal Studies*, 264-289 at 266.

[133] This limits the scope of *Sharī'ah* generally to issues of Muslim personal law such as family law, inheritance etc, Federation of Malaya Constitutional Commission, Report of the Federation of Malaya Constitutional Commission (Government Press, Kuala Lumpur, 1957), at para 169 (The Reid Commissions Report), Abdullah, Nurjaanah, "Legislating Faith in Malaysia", note 132, at 267, Roff, William R., "Patterns of Islamization in Malaysia, 1890s-1990s: Exemplars, Institutions and Vectors", (1998) 9(2) *Journal of Islamic Studies*, 210-228 at 216.

[134] Article 121(1A) of the Federal Constitution 1957 provides civil courts with residual jurisdiction over those matters not within the jurisdiction of the *Sharī'ah* courts (Art 121(1A), Federal Constitution 1957, added by Constitution (Amendment) Act 1988 (Act A704)). As the competence of the *Sharī'ah* courts includes family and inheritance issues relating to Muslims, religious offences and charitable matters (List II, Ninth Schedule, Federal Constitution 1957), the jurisdiction of the civil courts extends to all those areas set out in List I of the Constitution's Ninth Schedule, including finance, trade, commerce and industry ([7] and [8], List I, Ninth Schedule, Federal Constitution 1957). While List I does not specifically refer to Islamic finance as being within the competence of the civil courts, disputes relating to *Sharī'ah* compliant financial activity have been treated by commentators, and judges, as within the authority of the civil, secular Malaysian courts. See for example, *Bank Islam Malaysia Bhd. v Adnan Bin Omar* [1994] 3 CLJ 735 in which the court noted that Bank Islam Malaysia Berhad was a corporate body which has no religion, and consequently it is not within the jurisdiction of *Sharī'ah* Courts, Zuryati, Zainal A., Yusoff, Mohamed and

While Islam is a central feature of Malaysian society, its application is less doctrinaire and more pragmatic than in many other Muslim states, as retired Prime Minister Mahathir bin Mohamad commented, "only when Islam is interpreted so as to be relevant in a world which is different from what it was 1,400 years ago can Islam be regarded as a religion for all ages."[135] In practice, the more modern, and frequently more flexible, approach to Islamic law (and by extension, Islamic finance) assumed in Malaysia has caused some difficulties for the Malaysian Islamic financial industry, as a number of products marketed in Malaysia as *Sharī'ah*-compliant have been rejected by scholars in more conservative jurisdictions, most notably the Middle East.[136] Reflective of the *ikhtilaf* prevalent in Islamic legal interpretation,[137] the difference between *Sharī'ah* interpretations adopted in Malaysia and other Muslim states has limited the cross-border transferability of some products developed by Malaysian scholars.[138]

The section will examine the experience of a dual financial system adopted in Malaysia (4.3.1).[139] It will consider banking (4.3.2)[140] and non-banking Islamic finance (4.3.3)[141] in the Malaysian economy and highlight lessons which Ireland can apply in the context of its own accommodation of Islamic finance (4.3.4)[142].

Azrae, Ahmad N., "Separate legal entity under Syariah law and its application on Islamic banking in Malaysia: A note," (2009) 6(2) *International Journal of Banking and Finance*, 139-154 at 150. See also *Yong Fuat Meng v Chin Yoon Kew* [2008] 5 MLJ 226 in which the civil court considered extensively the requirements of Islam in relation to personal laws. The court also discussed the right of the civil court to determine *Sharī'ah* matters as well as the different schools of thought. See also Proctor, Charles, *The Law and Practice of International Banking*, (Oxford University Press, Oxford, 2010), at 795, discussing these cases. See also, the Malaysian Bar, "Legal and Regulatory Framework of Islamic Banking and Finance in Malaysia", September 30, 2008, available at: http://Islamicbanking-malaysia.com/legal-regulations/170-legal-and-regulatory-framework-of-Islamic-banking-and-finance-in-malaysia.

[135] Mahathir bin Mohamad quoted in Sciolino, Elaine, "The Many Faces of Islamic Law", *The New York Times, The Week in Review*, Sunday, October 13, 1996, available at: http://www.nytimes.com/1996/10/13/weekinreview/the-many-faces-of-Islamic-law.html

[136] Oxford Business Group, "No Substitute for Experience", (2007) *The Report: Malaysia 2007*, 81-86 at 84. Despite these difference, however, Malaysia has ultimately prevailed on many of its Islamic finance products and structes.

[137] *supra.* at 38.

[138] See for example the *murābaha sukūk*. Because such certificates are backed by receivables rather than tangible assets, scholars in the Gulf have rejected *murābaha sukūk* an instrument for secondary trading at anything but par value. Malaysian scholars have, however, adopted a more liberal interpretation and allow the trading of murābaha sukūk, even if that trade occurs above or below par, *infra.* at 309 for a discussion of *murābaha sukūk*.

[139] *infra.*at 116.

[140] *infra.*at 117.

[141] *infra.*at 124.

[142] *infra.*at 129.

4.3.1 Dual Financial Market

The Central Bank of Malaysia Act 2009 notes that "[t]he financial system in Malaysia shall consist of the conventional financial system and the Islamic financial system."[143] This legislative enactment confirms Malaysia's standing as a dual financial system in which conventional and Islamic principles co-exist. The dual approach has been a hallmark of Malaysian finance for over twenty years and represents an alternative approach to the implementation of *Sharī'ah* principles within an economy. Like other Islamic finance centres such as Bahrain,[144] Malaysia has developed two distinguishable financial systems which function *in parallel* with each other, both operating tailored institutions, products and, where necessary, legal frameworks.[145] This approach does not seek to "impose Islamic values...on the non-Muslim population,"[146] but rather to develop Islamic finance as a viable alternative for Muslims and non-Muslims[147] and then to let those in the market decide which system is the most suitable for their needs.[148] In doing so, the Malaysian authorities have taken an interventionist and active role in order to "provide a level playing field" for Islamic and conventional finance in the Malaysian market.[149] In order to achieve this, the unique characteristics of Islamic financial activity are accounted for through bespoke legislation and guidelines.[150] At the same time, disadvantages faced by Islamic financial institutions when competing with more established, conventional institutions are overcome through the removal of legal barriers, the creation of incentives for Islamic

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[143] Art 27, Central Bank of Malaysia Act 2009

[144] El Qorchi, Mohammed, "Islamic Finance Gears Up", (December 2005) 42(4), *Finance & Development*, available at: http://www.imf.org/external/pubs/ft/fandd/2005/12/qorchi.htm.

[145] Iqbal, Munawar and Molyneux, Philip, *Thirty Years of Islamic Banking; History, Performance and Prospects*, note 12, at 45, Baba, Ricardo, "Islamic Financial Centres", in *Handbook of Islamic Banking*, M. Kabir Hassan and Mervyn K Lewis, (ed.), (Edward Elgar, Cheltenham, 2007), 384-400 at 392.

[146] Wilson, Rodney, "Islam and Malaysia's Economic Development", (1998) 9(2) *Journal of Islamic Studies*, 259-276, at 263.

[147] Warde, Ibrahim, *Islamic Finance in the Global Economy*, (1st ed.), note 40, at 127.

[148] Hassan, Hj Nik Mustapha Bin Nik and Musa, Mazilan, "An Evaluation of Islamic Banking Development in Malaysia", in *Islamic Banking: An International Perspective*, Bala Shanmugam, Vignesen Perumal and Alfieya Hanuum Ridzwa, (ed.) (Universiti Putra Malaysia Press, Serdang, 2004), 95 at 99.

[149] Aziz, Zeti Akhtar, "Approaches to Regulation of Islamic Financial Services Industry", Speech given at the IFSB Summit - Islamic Financial Services Industry and The Global Regulatory Environment, London, May 18 2004, available at: http://www.bnm.gov.my/index.php?ch=9&pg=15&ac=151&print=1.

[150] For example, the Capital Adequacy Framework for Islamic Banks sets out the unique capital adequacy issues faced by Islamic banks and outlines the implications for Islamic banks involved in various different Islamic contracts, Bank Negara Malaysia, Islamic Banking and Takaful Department, "Capital Adequacy Framework for Islamic Banks", *BNM/RH/GL 002-14*, available at: http://www.bnm.gov.my/guidelines/01_banking/01_capital_adequacy/05_cafib_20110110.pdf, as discussed *infra.*at 118, an entirely bespoke law, the Islamic Banking Act 1983 has been designed for Islamic banks in Malaysia.

finance[151] and the adoption of an overtly supportive Government attitude.[152] The dual system is particularly evident in the Islamic banking sector. Islamic non-banking financial activity has more frequently been integrated into Malaysia's existing legal and institutional framework.

In its attempt to develop the Islamic financial sector in parallel with the conventional sector, Malaysia has adopted a step-by-step approach[153] which has focused on establishing a solid foundation for Islamic finance and includes a comprehensive legal, institutional and regulatory framework designed specifically for Islamic finance activity.[154] Inevitably, failings within the parallel arrangement have emerged. However, the active involvement of Malaysian legal and regulatory bodies has ensured that many of the inequalities between the systems are been addressed on rolling basis.

4.3.2 The Legal and Regulatory Framework for Islamic Banking in Malaysia

Many of the Islamic finance initiatives and guidelines currently implemented by Malaysia's Central Bank (Bank Negara Malaysia [BNM])[155] have formed part of a wider ten year Master Plan [FSMP1] which the Government laid down for the Malaysian economy.[156] While a Second Financial Sector Master Plan [FSMP2] is expected in late 2011,[157] the 2001 blueprint provided for the long-term development of the financial sector

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[151] These incentives are primarily in relation to tax. For example, the Budget 2007, created a 10-year tax exemption for Islamic banks and Islamic banking units licensed under the Islamic Banking Act 1983 on income derived from Islamic banking business conducted in international currencies. The 2007 Budget also announced an exemption from stamp duty for three years for Islamic financial products, Badawi, Abdullah bin Hj Ahmad, "2007 Budget Speech", September 2, 2006, at 2, available at: http://www.treasury.gov.my/pdf/budget/bs07.pdf.

[152] Aziz, Zeti Akhtar, "Approaches to Regulation of Islamic Financial Services Industry", note 149.

[153] Iqbal, Munawar and Molyneux, Philip, *Thirty Years of Islamic Banking; History, Performance and Prospects*, note 12, at 46. The importance of a supportive system within which Islamic finance can develop was emphasised by Zeti Akhtar Aziz, the Governor of the Central Bank of Malaysia when she noted that; "[t]he hallmark of a well-developed financial infrastructure is an effective legal, regulatory and supervisory framework which would underpin the stability of the financial system...For the Islamic financial system, this framework also needs to be consistent with the requirements of the Shariah principles...." Aziz, Zeti Akhtar, "Ensuring Stability In The Islamic Financial System", Speech given at the 3rd Annual Islamic Finance Summit, London, available at: http://www.bnm.gov.my/index.php?ch=9&pg=15&ac=145.

[154] Aziz, Zeti Akhtar, "Legal & Shariah issues in the Islamic financial services industry", Speech given at the Third IFSB Seminar on Legal Issues: Surveys on Legal & Shariah Issues in the Islamic Financial Services Industry, Kuala Lumpur, March 28, 2007, available at: http://www.bis.org/review/r070413c.pdf.

[155] The Central Bank of Malaysia Act 2009 confirmed that one of BNM's roles was to "promote Malaysia as an international Islamic financial centre," (section 60 Central Bank of Malaysia Act 2009).

[156] Bank Negara Malaysia, *Malaysian Financial Sector Master Plan*, (BNM, Kuala Lumpur, 2001), available at: http://www.bnm.gov.my/index.php?ch=20.

[157] Raj, Adeline Paul, "Blueprint to put Malaysia banks on global stage", *Business Times*, March 2, 2011, available at: http://www.btimes.com.my/Current_News/BTIMES/articles/finse/finse.pdf. BNM has highlighted one of the goals of FSMP2 will be ensure Malaysia maintains its "[s]ustained position as a

and dedicated a whole chapter to Islamic banking and *takāful* (an Islamic alternative to insurance).[158] FSMP1 notes that one of its objectives "is to create an efficient, progressive and comprehensive Islamic financial system that contributes significantly to the effectiveness and efficiency of the Malaysian financial sector while meeting the economic needs of the nation."[159] The goal of enabling the Islamic banking industry to "evolve in parallel with conventional banking"[160] is underpinned by both a religious and legal framework. Among the recommendations made, FSMP1 suggests the strengthening of the governing legislation,[161] harmonising *Sharī'ah* rulings,[162] establishing an effective legal structure which can deal with the secular and *Sharī'ah* aspects of Islamic financial disputes[163] and establishing a favourable tax regime for Islamic banking and *takāful* products. As FSMP1 comes to an end, it is possible to identify developments which clearly represent the Government's attempt to implement these recommendations.

A. The Islamic Banking Act 1983 and Malaysia's Islamic Banks

The history of Islamic banking in Malaysia is longer than in most other countries with the establishment of the *Lembaga Tabung Haji Malaysia* (Pilgrims Management Fund Board) in 1969.[164] It was not until thirteen years later that positive steps were taken to create an Islamic banking system. The report of the National Steering Committee on Islamic Banking in 1982 recommended the establishment of an Islamic bank under *Sharī'ah* principles[165] and, following eleven months of research, studying the operation of

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vibrant international Islamic financial hub and the centre for thought leadership in Islamic finance," Ghafur, Abdul Rasheed, "Understanding the Existing & Oncoming Financial Sector Masterplan", Paper presented at the Financial Sector Talent Enrichment Programme, April 18, 2011, available at: http://www.fstep.org.my/media/File/Overview%20Week%20Notes/FSTEP-Understanding%20the%20Existing%20&%20Oncoming%20Financial%20Sector%20Masterplan.pdf.

[158] Bank Negara Malaysia, *Malaysian Financial Sector Master Plan*, note 156, at 76.

[159] *ibid.*, at 79.

[160] *ibid.*, at 79.

[161] *ibid.* Recommendation 5.8.

[162] *ibid.* Recommendation 5.8.

[163] *ibid.* Recommendation 5.10.

[164] Islamic Development Bank, "Tabung haji as an Islamic Financial Institution, The Mobilization of Investment Resources in an Islamic Way and the Management of Hajj", (IDB Prize Winners' Lecture Series, No. 4, Islamic Research and Training Institute, Jeddah, 1995), at 9-14, Thani, Nik Norzrul, Abdullah, Mohamed Ridza Mohamed and Hassan, Megat Hizaini, *Law and Practice of Islamic Banking and Finance*, (Sweet & Maxwell, Malaysia, 2003), at 11.

[165] Ariff, Mohamed, *Islamic banking in Southeast Asia: Islam and the economic development of Southeast Asia*, (Institute of Southeast Asian Studies, Singapore, 1988), at 71.

Islamic banks in Egypt and Sudan,[166] Malaysia passed the Islamic Banking Act 1983 [IBA].[167]

The IBA has been central to the development of the Islamic banking industry in Malaysia and remains in force today. As an Act of Parliament dealing exclusively with the institutional aspect of Islamic banking, it highlights the dual and parallel nature of Malaysia's banking sector. While the IBA stands as a legislative acknowledgement that Islamic banks display unique qualities which must be provided for, the close resemblance which the Act bears to the conventional Banking Act 1973 (and its replacement, the Banking and Financial Institutions Act 1989 [BAFIA][168]) also suggests a wider intention that Islamic and interest-based banks should be subject to comparable treatment.[169] Based on this enactment, Bank Islam Malaysia Berhad [BIMB], Malaysia's first Islamic bank was established in 1983.[170] Bank Muamalat Malaysia Berhad [BMMB] became the country's second wholly Islamic bank in 1999.[171]

An aspect of the IBA which has been subject to criticism is its failure to list and explain the primary *Sharī'ah*-compliant contracts which underpin Islamic financial products.[172] However, as a more appropriate, flexible means of guiding the actions of all Islamic financial institutions (not just those structured as Islamic banks), BNM has consistently issued guidelines on various forms of acceptable Islamic contracts. Most recently, a series

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[166] Connors, Jane, "Towards a System of Islamic Finance in Malaysia", in *Islamic Law and Finance*, note 132, at 58.

[167] Malaysian Banking Act 1983, (Act 276).

[168] Banking and Financial Institutions Act 1989, (Act 372).

[169] Wilson, Rodney, "Islam and Malaysia's Economic Development", note 146, at 269. Like other banking institutions, Islamic banks are subject to requirements concerning their capital reserve fund (section 15 Islamic Banking Act 1983), auditor's reports (section 17 Islamic Banking Act 1983), loans to directors, officers and employees (section 24 Islamic Banking Act 1983) and disclosure of director's interests (section 28 Islamic Banking Act 1983).

[170] Iqbal, Munawar and Molyneux, Philip, *Thirty Years of Islamic Banking, History, Performance and Prospects*, note 12, at 45, Wilson, Rodney, "The Evolution of the Islamic financial system", in Simon Archer and Rifat Ahmad Abdul Karim, (eds), *Islamic Finance: Innovation and Growth*, (Euromoney Books, London, 2002), 29-41.

[171] Iqbal, Munawar and Molyneux, Philip, *Thirty Years of Islamic Banking; History, Performance and Prospects*, note 12, at 45. This extended delay is in line with the recommendations of the National Steering Committee on Islamic Banking which suggested that only one Islamic bank should be established initially so that it can develop and operate smoothly before competition is introduced, Thani, Nik Norzrul, Abdullah, Mohamed Ridza Mohamed and Hassan, Megat Hizaini, *Law and Practice of Islamic Banking and Finance*, note 164, at 78.

[172] Adawiah, Engku Rabiah, *National Symposium on Islamic Banking and Finance in Sabah, 23-24 July 2009 (Day two)*, available at: http://www.malaysianbar.org.my/bar_news/berita_badan_peguam/national_symposium_on_islamic_banking_and_finance_in_sabah_23_to_24_july_2009_day_two.html noting that the current legal framework for Islamic banking was regulatory in nature and lacked substantive law and legal definitions of Islamic concepts. See also, Thani, Nik Norzrul, Abdullah, Mohamed Ridza Mohamed and Hassan, Megat Hizaini, *Law and Practice of Islamic Banking and Finance*, note 164, at 90.

of six "Shariah Parameters" were issued.[173] These guidelines, dealing with *murābaha* (SPR1),[174] *ijārah* (SPR2),[175] *mudāraba* (SPR3),[176] *mushāraka* (SPR4),[177] *istisnā'* (SPR5),[178] and *wadiah,*[179] have been released on a rolling basis following consultation with market participants.[180] Intended to "clarify the concepts, principles and conditions of *Sharī'ah* contracts"[181] and to highlight the "essential features of Islamic financial products based on the underlying Shariah contracts,"[182] the Shariah Parameters set out the legitimacy within Islamic law of each contract, the elements of the contract and the activities of the parties. This could facilitate consistency in the application of Islamic contracts and greater transparency in *Sharī'ah*-compliance.[183] Such guidelines represent a positive step for BNM. Setting out the core components of Islam's principal contracts in self-contained guidelines may ensure that all Islamic products offered by financial institutions start with a common basic definition and could allow greater transparency and consistency in the industry.

B. Interest-Free Banking Scheme

The existence of wholly Islamic banks, while allowing a parallel system to develop, limited the impact that Islamic banking could have on the Malaysian economy in light of the fact that existing conventional banks were not given the opportunity to enter into the

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[173] Parker, Mushtak, "Bank Negara pressing ahead with Shariah parameters", *Arab News*, January 18, 2010, available at: http://archive.arabnews.com/?page=6&section=0&article=131413&d=18&m=1&y=2010.

[174] Bank Negara Malaysia, Islamic Banking &Takaful Department, *Shariah Parameter Reference 1 Murabahah*, (2009), available at: http://www.bnm.gov.my/guidelines/05_shariah/01_murabahah_02.pdf.

[175] Bank Negara Malaysia, Islamic Banking &Takaful Department, "Concept Paper on Shariah Parameter Reference 2: Ijarah Contract (SPR2)", *BNM/RH/CP/012-3*, (2009) available at: http://www.bnm.gov.my/documents/conceptpaper/ijarah_contract_20090715.pdf

[176] Bank Negara Malaysia, Islamic Banking &Takaful Department, "Concept Paper on Shariah Parameter Reference 3: Mudarabah Contract (SPR2)", (2009) available at: http://www.bnm.gov.my/documents/conceptpaper/attachment_mudarabah_contract.pdf

[177] Bank Negara Malaysia, Islamic Banking &Takaful Department, Draft Shariah Parameter Reference 4: Musharakah Contract (SPR4), (2010), available at: http://www.bnm.gov.my/guidelines/05_shariah/04_draft_shariah%20parameter_spr4.pdf

[178] Bank Negara Malaysia, Islamic Banking &Takaful Department, Draft Shariah Parameter Reference 5: Istisna' Contract (SPR5), (2010), available at: http://www.bnm.gov.my/guidelines/05_shariah/06_concept_paper_shariah_para_ref_5_draft.pdf

[179] No draft or completed Parameters have yet been released by BNM for *Wadiah* (safe keeping) contracts.

[180] BNM has most recently opened the consultation on the istisnā' parameters, Parker, Mushtak, "BNM consults market on Shariah parameter for Istisna contracts", *Arab News*, January 3, 2011, available at: http://arabnews.com/economy/Islamicfinance/article228421.ece.

[181] Bank Negara Malaysia, "The Issuance of Shari'ah Parameter Reference 1 (Murabahah Parameter) to Promote Harmonisation of Practice", *Press Release*, August 28, 2009, available at: http://www.bnm.gov.my/index.php?ch=8&pg=14&ac=1907.

[182] Parker, Mushtak, "Bank Negara pressing ahead with Shariah parameters", note 173.

[183] Bank Negara Malaysia, "The Issuance of *Sharī'ah* Parameter Reference 1 (Murabahah Parameter) to Promote Harmonisation of Practice", note 181.

Islamic finance market. As part of their plan to create a comprehensive Islamic finance system, the Government introduced the Interest-Free Banking Scheme in 1993.[184] This scheme, which has since been renamed the Islamic Banking Scheme [IBS],[185] encouraged conventional banks to offer Islamic banking services within their existing institutional framework[186] and was viewed as the "most effective and efficient mode of increasing the number of institutions offering Islamic banking services at the lowest cost and within the shortest time frame."[187]

Unlike the fully fledged Islamic banks, IBS banking does not benefit from its own, tailored piece of legislation and instead has been regulated by the provisions of BAFIA 1989.[188] Following an amendment to s.124 of the Act,[189] a conventional bank can now carry on Islamic banking business or Islamic financial business, in addition to its existing licensed business[190] thus providing legislative footing for conventional banks to participate in Malaysia's Islamic banking industry.

C. *Sharī'ah*-Compliance

Like Pakistan, Malaysia has established a regulated, multi-layered approach to *Sharī'ah* governance. Initially focused only on institutional supervision, the IBA 1983 made it compulsory for Islamic banks to establish their own "Shariah Advisory Body".[191] This body was charged with advising the bank "on the operations of its banking business in order to ensure that they do not involve any element which is not approved by the Religion of Islam."[192] Governance of these boards in *all* financial institutions offering Islamic financial transactions was established in 2005 by the Guidelines on the Governance of

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[184] Wilson, Rodney and Yusoff, Remali, "An Econometric Analysis of Conventional and Islamic bank Deposits in Malaysia", (2005) 9(1) *Review of Islamic Economics*, 31-52 at 32.

[185] Thani, Nik Norzrul, Abdullah, Mohamed Ridza Mohamed and Hassan, Megat Hizaini, *Law and Practice of Islamic Banking and Finance*, note 164, at 18, Wilson, Rodney, "Islam and Malaysia's Economic Development", note 146, at 273.

[186] Chong, Beng Soon and Liu, Ming-Hua, "Islamic Banking: Interest-Free or Interest-Based?" (2009) 17(1) *Pacific-Basin Finance Journal*, 125-144 at 130, Rosly, Saiful Azhar and Abu Bakar, Mohd Afandi, "Performance of Islamic and mainstream banks in Malaysia", (2003) 30(12) *International Journal of Social Economics*, 1249-1265 at 1254, Bank Negara Malaysia, Islamic Banking and Takaful Department, "Guidelines on *Skim Perbankan Islam*", *BNM/RH/GL 001-27*, at [1.1].

[187] Iqbal, Munawar and Molyneux, Philip, *Thirty Years of Islamic Banking; History, Performance and Prospects*, note 12, at 46.

[188] Yasin, Norhashimah Mohd., "Legal Aspects of Islamic Banking: Malaysian Experience", in *Islamic Banking and Finance: Fundamentals and Contemporary Issues*, (IDB, Saudi Arabia, 2007), 215-238 at 221.

[189] BAFIA (Amendment) Act 1996, Act A954.

[190] Section 124(1) BAFIA 1989.

[191] Section 3(5)(b) IBA 1983, Venardos, Angelo M., *Islamic Banking & Finance in South-East Asia: its Development & Future*, (2nd ed., World Scientific, Singapore, 2006), at 148-149.

[192] Section 3(5)(b) IBA 1983.

Shariah Committee for the Islamic Financial Institutions[193] which were superseded in 2011 by the Shariah Governance Framework for Islamic Financial Institutions.[194] The 2011 framework sets out detailed characteristics which the Shariah Advisory Body (now referred to as the "Shariah Committee") and its members must display.[195] As in Pakistan, the Shariah Committee members must fulfil a Fit and Proper test and demonstrate the competences and education necessary to advise on issues of *Sharī'ah*-compliance. However, the 2011 Malaysian framework provides for a "Shariah governance framework"[196] which is considerably more extensive than that operating in Pakistan. This framework includes not only the Shariah Committee on whom the board of directors of an institution is "expected to rely [in relation to] all Shariah decisions, views and opinions relating to the business"[197] of the financial institution, but also an internal "Shariah research capacity", a "Shariah review",[198] "Shariah audit"[199] and "Shariah risk management process".[200]

Notwithstanding the enhanced nature of institutional *Sharī'ah* supervision in Malaysia, such supervision is subsidiary to the authority of BNM's own Shariah Advisory Council [SAC]. Established as the "sole authority" on issues of Islamic banking and *takāful* in Malaysia,[201] the SAC has, since its formation in 1997, grown in prominence in the Islamic banking industry and is authorised to ascertain the Islamic law, issue *fatāwā*, advise the

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[193] Bank Negara Malaysia, "Guidelines on the Governance of Shariah Committee for the Islamic Financial Institutions", *BNM/RH/GL/012-1*.

[194] Bank Negara Malaysia, "Shariah Governance Framework for Islamic Financial Institutions", *BNM/RH/GL_012_3*, available at: http://www.bnm.gov.my/guidelines/05_shariah/02_Shariah_Governance_Framework_20101026.pdf.

[195] The Guidelines apply to *Sharī'ah* committees established in an Islamic bank licensed under the IBA, a financial institution licensed under the BAFIA which participates in the Islamic Banking Scheme, a development financial institution prescribed under the DFIA which carries on Islamic Banking Scheme; and a takaful operator registered under the Takaful Act 1984 Bank Negara Malaysia, Guidelines on the Governance of *Shariah* Committee for the Islamic Financial Institutions, note 193, at [6].

[196] Bank Negara Malaysia, "Shariah Governance Framework for Islamic Financial Institutions", note 194, at [1.2] and [1.3].

[197] *ibid.*, at [2.7].

[198] *ibid.*, at [7.7], which notes that; "[t]he Shariah review function refers to regular assessment on Shariah compliance in the activities and operations of the IFI by qualified Shariah officer(s), with the objective o f ensuring that the activities and operations carried out by the IFI do not contravene with the Shariah."

[199] *ibid.*, at [7.7], which notes that; "Shariah audit refers to the periodical assessment conducted from time to time, to provide an independent assessment and objective assurance designed to add value and improve the degree of compliance in relation to the IFI's business operations, with the main objective of ensuring a sound and effective internal control system for Shariah compliance."

[200] *ibid.*, at [7.15], which notes that; "Shariah risk management is a function to systematically identify, measure, monitor and control of Shariah non-compliance risks to mitigate any possible of non-compliance events." Although the Guidelines acknowledge that less complex financial institutions, notably Islamic windows, may not be obliged to establish full-scale *Sharī'ah*-compliance and research functions within the organisation, the Guidelines nevertheless suggest that such activities should be obtained by other means such as outsourcing.

[201] Section 51, Central Bank of Malaysia Act 2009.

BNM and Islamic financial institutions on *Sharī'ah* issues and any other function that BNM deems necessary.[202] The BNM is now obliged to consult the SAC on all *Sharī'ah* matters[203] while Islamic financial institutions may consult this national board.[204] Even in circumstances where no reference has been made to the SAC, members of institutional Shariah Committees must act in a manner which is consistent with the "rulings and decisions made by the SAC"[205] and must "respect and observe the published Shariah rulings issued by the SAC."[206] Finally, in yet a further attempt to establish consistency in *Sharī'ah* ruling, the Central Bank Act 2009 now provides that courts and arbitrators in Malaysia must take into consideration the rulings of the SAC and must refer any question on Islamic finance to the SAC for determination.[207] The practical effect of the new Guidelines on *Sharī'ah* governance, together with the reinforced position of BNM's SAC provided for in the Central Bank Act 2009, has been the development of a highly centralised system of *Sharī'ah* governance in which the opportunity for cavalier activity by individual *Sharī'ah* scholars or other *Sharī'ah* board members is limited.[208]

With the introduction of conventional banks into the *Sharī'ah* banking business, Islamic banking in Malaysia has developed into a viable financial system rather than a niche segment of the existing conventional framework.[209] Supported by concurrent and widespread amendments to Malaysian tax provisions,[210] a bespoke regulatory regime which provides specifically for financial reporting, capital adequacy, liquidity requirements, risk management and corporate governance of institutions involved in Islamic banking as well as *Sharī'ah* standards for the Islamic instruments themselves, the Islamic banking system now stands as an alternative to conventional financial arrangements. The success of this facilitative dual system is evident from the continued growth of Islamic finance within Malaysia with, for example, *Sharī'ah*-compliant

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[202] Section 52(a) and (b), Central Bank of Malaysia Act 2009.

[203] Section 55, Central Bank of Malaysia Act 2009.

[204] Any decision of the SAC will be binding on the institution that sought the advice, section 57 Central Bank Act 2009.

[205] Bank Negara Malaysia, "Shariah Governance Framework for Islamic Financial Institutions", note 194, [6.2].

[206] *ibid.*, at [6.2].

[207] Section 56, Central Bank of Malaysia Act 2009.

[208] See generally Hasan, Zulkifli, "Sharia governance in Islamic financial institutions and the effect of the Central Bank of Malaysia Act 2009", (2010) 25(3), *Journal of International Banking Law and Regulation*, 105-108, particularly 106-107.

[209] This sentiment was reiterated by the Central Bank in its 1993 Annual Report which noted that; "[w]ith the implementation of the interest free banking scheme, Malaysia has emerged as the first country to implement a dual banking system, whereby an Islamic banking system functions on a parallel basis with the conventional banking system." Bank Negara Malaysia, *Annual Report 1993*, (BNM, Kuala Lumpur, 1994), at 57.

[210] Section 2(8) of the Income Tax Act for example, provides tax neutrality of Islamic financing.

transactions constituting in excess of 12% of total housing loans outstanding in Malaysia.[211] There are now 17 Islamic banks in Malaysia, representing around 34% of the total number of banks in Malaysia[212] while virtually all conventional banks operate interest-free banking operations.[213]

4.3.3 Islamic Non-Banking Financial Instruments in Malaysia

BNM's Governor noted in 2007 that "equally important to the development of Islamic finance is not only the financial intermediaries but also the Islamic financial markets"[214] and, like the Islamic banking sector, the Islamic financial markets have received significant attention from the Malaysian Government. Following an initially slow start,[215] the Malaysian Islamic financial markets, most particularly the capital markets, have experienced rapid and impressive development, boosting Malaysia to the centre stage of Islamic financial market innovation. Expanding into Islamic non-banking financial activity may present Malaysia as a destination for investors from around the world seeking alternative investment opportunities.[216] As such, Islamic financial markets are the next step in Malaysia's goal of becoming a "one-stop shop" for Islamic finance.[217]

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[211] Ismail, Noor Ashikin, "Islamic Mortgages in Malaysia", *Malaysian Islamic Finance Issuers and Investors Forum 2006*, available at: http://www.malaysianIslamicfinance.com/monthly/mifsupplement/article4.html.

[212] Bank Negara Malaysia, *Annual Report 2008*, (BNM, Kuala Lumpur, 2009), at 18.

[213] PriceWaterhouseCoopers, "International Islamic Banking", (2009), at 2, available at: http://www.pwc.com/en_MY/my/assets/issues/international-Islamic-banking.pdf

[214] Aziz, Zeti Akhtar, "Legal & Shariah issues in the Islamic financial services industry", note 154.

[215] Such markets were initially used to meet pressing liquidity needs of Islamic financial institutions. Government Investment Certificates and Issues introduced by the Government Investment Act 1983. These certificates were acquired by Islamic banks as an alternative to interest-bearing government securities or treasury bonds and represented a beneficial loan (*qard hasan*) to the government under which a discretionary dividend was paid. See Wilson, Rodney, "Regulatory challenges posed by Islamic capital market products and services", (2007) 24(2) *Journal of Islamic Banking & Finance*, 18-36, at 31, and Thani, Nik Norzrul, Abdullah, Mohamed Ridza Mohamed and Hassan, Megat Hizaini, *Law and Practice of Islamic Banking and Finance*, note 164, at 21.

[216] As discussed below – participants in the Islamic capital markets in Malaysia are now attempting to formulate transactions which are acceptable not just to Malaysian Muslims but to Muslims in other jurisdictions, *infra.* at 125.

[217] Andreasyan, Tanya, "Country Focus – Malaysia – Leading the Way", (July-September 2007) 165 *New Horizon*, 24-30 at 28, Anwar, Muhammad, "An Islamic Perspective on Capital Markets and 'Islamic' Securities in Malaysia", (1995), 34(4) (Part II), *The Pakistan Development Review*, 865-878 at 865. The Islamic financial markets represent for Malaysia a means of addressing the liquidity requirements of Malaysian banks and companies, an opportunity to bring capital into the country and a vehicle for developing Malaysia's reputation as an international centre for Islamic finance, International Organization of Securities Commissions, *Fact Finding Report of the Islamic Capital Market Task Force of the International Organization of Securities Commissions*, (IOSCO, July 2004), available at: http://www.iosco.org/library/pubdocs/pdf/IOSCOPD170.pdf.

A. Islamic Capital Markets

Comprising an equity and bond market, the Islamic capital markets have been a key focus of attention by the Malaysian Government and regulators.[218] Brought under the sole regulatory oversight of the Malaysian Securities Commission [SC],[219] the "establishment of Malaysia as an international Islamic capital market centre" has been firmly placed on the agenda as one of the six key objectives of the Capital Markets Masterplan [CMP1].[220] Pursuant to this goal, CMP1 highlights the need to facilitate development of a wide range of products and services, to create a viable market, to ensure that an appropriate and comprehensive accounting, tax and regulatory framework exists and to enhance value recognition of the Malaysian Islamic capital market.[221] In the ten years since CMP1, the Malaysian capital market's growth of 13.6%[222] has outpaced the conventional sector with more than half of Malaysia's capital market assets now *Sharī'ah*-compliant.[223] Following the success of CMP1,[224] CMP2 was launched in April 2011. In relation to Islamic finance, the focus of CMP2 is on widening the Islamic capital market's international base[225] by strengthening the market to deal with international transactions and by encouraging the use of Malaysia's capital markets and products by international investors. In order to achieve this latter goal, CMP2 suggests greater use of *mudāraba* and *mushāraka* structures, a move which reflects the difficulties previously caused by the more relaxed and flexible *Sharī'ah* standards which have operated in Malaysia. Focusing on financial structures which benefit from more universal acceptance is highlighted as "further facilitat[ing] internationalisation" and establishing a convergence of *Sharī'ah* activity between the Middle East and Malaysia.[226]

B. Legal Framework

Unlike the banking sector, Malaysia does not have tailored legislation dealing exclusively with its Islamic capital markets. Instead, equity and bond transactions are

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[218] Sukor, Mohd. Edil Abd., Muhamad, Rusnah, and Gunawa, Alwin Yogaswara, "Malaysian *Sukuk*: Issues in Accounting standard", (2008) 16 (1), *Jurnal Syariah*, 63-74 at 65.

[219] Section 15(1) Securities Act 1993 (Act 498).

[220] Securities Commission, *Capital Market Masterplan 1*, (SC, Kuala Lumpur, 2001), at 57.

[221] *ibid.*, at 58.

[222] Securities Commission, *Capital Market Masterplan 2, Growth with Governance*, (SC, Kuala Lumpur, 2011), at 3.

[223] *ibid.*, at 5.

[224] The Securities Commission has noted that "[b]y the end of 2010, 95% of the recommendations in CMP1 had been completed" *ibid.*, at 2.

[225] *ibid.*, at 46.

[226] *ibid.*, at 48.

brought within the same regulatory framework as conventional securities, the Securities Commission Act 1993 [SCA][227] and the Capital Markets and Services Act 2007 [CMSA].[228] Indeed, there is little in either instrument which is distinctly Islamic, indicating that rather than creating a separate parallel system, the SC is seeking to integrate the Islamic capital markets into the existing legislative framework.[229]

Nevertheless, as regulator of the capital markets, the SC has established a dedicated Islamic Capital Market Department within its institutional framework.[230] Relying on the power to issue guidance conferred by s.158 of the SCA, the SC has issued numerous guidelines, many of which apply exclusively to Islamic products. Two areas of the capital market in which Malaysia has been particularly pioneering are funds and *sukūk*. The SC's Guidelines on Islamic Fund Management[231] establish specific directions related to the management of *Sharī'ah*-compliant funds. These directions are heavily *Sharī'ah* focused and introduce governance,[232] disclosure[233] and management[234] obligations intended to promote religious conformity. Equally, Islamic funds and fund management in Malaysia have been supported by some very favourable legal and tax incentives which aim to create an environment conducive to the continued growth of this sector. For example, local and foreign-owned companies managing Islamic funds now benefit from an income tax exemption on all fees received from managing the funds until 2016, Islamic fund management companies are allowed to have 100% foreign ownership and they are permitted to invest 100% of their assets abroad.[235]

The growth of Malaysia's *sukūk* market has been particularly impressive and has been the source of numerous innovative structures. The country was host to the world's first

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[227] Securities Commission Act 1993 (Act 498).

[228] Capital Markets and Services Act 2007 (Act A1305).

[229] International Organization of Securities Commissions, *Objectives and Principles of Securities Regulation*, (IOSCO, May 2003), at 2, available at: http://www.iosco.org/library/pubdocs/pdf/IOSCOPD154.pdf . See also, International Organization of Securities Commissions, *Fact Finding Report of the Islamic Capital Market Task Force of the International Organization of Securities Commissions*, note 217, at 52.

[230] *ibid.*, at 52.

[231] Securities Commission, Malaysia, *Guidelines on Islamic Fund Management*, (December 2007), available at: http://www.mifc.com/index.php?tpt=&tpl=th008_viewpdf.tsl&filelink=/index.php?ch=36>pg=90>ac=9>bb=176.

[232] Section 4 and Section 5 Guidelines on Islamic Fund Management, December 2007.

[233] Section 3.0 Guidelines on Islamic Fund Management, December 2007.

[234] Section 6.01(c) Guidelines on Islamic Fund Management, December 2007.

[235] Income Tax (Exemption)(No. 6) Order 2008; July 24, 2008. See, Securities Commission, Malaysia, "Malaysian ICM", (November 2008), 3(4) *Quarterly Bulletin of Malaysian Islamic Capital Market*, at 9 for a discussion of various tax incentives provided to Islamic capital market participants in Malaysia.

sukūk issued by Shell MDS in 1990,[236] the world's first global sovereign *sukūk* in 2002[237] and the world's first hybrid *sukūk* in 2007.[238] In line with product development, the regulation, *Sharī'ah* governance and taxation of *sukūk* have been strengthened.[239] The Securities Guidelines (Sukuk Guidelines)"[240] which became effective on August 12, 2011,[241] are regulatory guidance for Islamic securities, including the issuance of *sukūk*.[242] These guidelines clarify issues particular to Islamic securities and apply in addition to the existing securities regulations.[243] Complementing the creation of bespoke guidelines which cater to the specific characteristics of Islamic securities, development has also been undertaken in relation to taxation of *sukūk*. These modifications of the *sukūk* taxation regime has served a dual function: first to achieve tax neutrality with conventional products[244] and second to establish certain tax incentives for *sukūk* issues and the holders of *sukūk* certificates.[245]

As part of the broader national governance structure the SC has its own *Sharī'ah* Advisory Council which was established in May 1996.[246] This Advisory Council was only

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[236] Valued at RM125 million (US$33 million).

[237] Issued by the Government of Malaysia and valued at $600 million.

[238] Issued by Nucleus Avenue (Malakoff Corporation) and valued at RM8 billion (US$2.5 billion), De Ramos, Rita Raagas, "Strong Growth for Malaysia's Islamic Bond Market", *Business Week*, March 20, 2008, available at: http://www.businessweek.com/globalbiz/content/mar2008/gb20080320_897719.htm?chan=top+news_top+news+index_global+business.

[239] Aziz, Zeti Akhtar, "The Challenge for a Global Islamic Capital Market – Strategic Developments in Malaysia", Speech give at the Sukuk Summit 2007, London, June 20, 2007, at 3, available at: http://www.bis.org/review/r070702d.pdf.

[240] Securities Commission, Malaysia, Islamic Securities Guidelines (Sukuk Guidelines), (August 2011), available at: http://www.sc.com.my/eng/html/resources/guidelines/bondmkt/sukukGuidelines_110812.pdf, Parker, Mushtak, "Malaysia securities regulator revises sukuk guidelines", *Arab News*, July 17, 2011, available at: http://www.arabnews.com/economy/islamicfinance/article473657.ece.

[241] These Guidelines replaced the Guidelines on the Offering of Islamic Securities issued in July 2004

[242] Section 1.02 Malaysia, Islamic Securities Guidelines (Sukuk Guidelines).

[243] For example, section 1.15 which states that for Islamic securities issued pursuant to an asset-backed securitisation transaction, the Guidelines on the Offering of Asset-Backed Securities will also apply, section 8.02 requires that when the investors purchase the underlying assets, the purchase price must comply with the following SAC pricing guidelines, section 15.05 requires the same disclosures to be made if *sukūk* is listed as would be made for a conventional listed security. See also, Mannix, Rob, "How Malaysia plans to dominate Islamic markets", (2004) 23(9) *International Financial Law Review*, 60-63 at 61.

[244] Such as the removal of additional tax or duty on capital market products approved by the SC's SAC, Income Tax Act 1967, Section 2(8), this was proposed by Malaysia's Treasury in the Budget 2005, at [60(ii)], available at: http://www.treasury.gov.my/pdf/budget/bs05.pdf

[245] Securities Commission, Malaysia, "Malaysian ICM", note 235, at 9. For example, the extension of an existing incentive so as to allow deduction of issuing expenses for *mushāraka*, *mudāraba*, *ijārah* and *istisnā' sukūk* until 2010, Income Tax (Deduction for the Expenditure on Issuance of Islamic Securities) Rules 2007, issued on January 11, 2007.

[246] Securities Commission, Malaysia, "Malaysian ICM", note 235, at 17. In the 2011 Budget, the Malaysian Prime Minister noted that in order to further strengthen Malaysia's *sukuk* market, "expenses for the issuance of Islamic securities which adopt the principles of *Murabahah* and *Bai' Bithaman Ajil* based on *taqarru'* be given tax deduction," Razak, Mohd. Najib Tun Abdul, *The 2011 Budget Speech, Transformation*

provided for in legislation in 2010 by an amendment to the SMCA 2007.[247] Charged with advising the SC on Islamic issues, the Advisory Council also acts as a final arbiter on issues of Islamic finance.[248] Based on the Advisory Council rulings, the SC periodically publishes lists of approved *sukūk* and *Sharī'ah* based funds.[249] The SC has also released a comprehensive collection of resolutions of the Advisory Council.[250] At institutional level, both Islamic funds and persons issuing Islamic securities must appoint an independent *Sharī'ah* adviser.[251] These advisers must be approved and registered by the SC and are entitled to advise the supervised institution on all matters relating to Islamic finance, to provide expertise and to ensure that aspects of the institution which are marketed as *Sharī'ah*-compliant are compatible with the rulings issued by the SC's Advisory Council.[252] The 2009 Registration of Sharia Advisers Guidelines also set out minimum levels of qualification and a Fit and Proper test which must be complied with by *Sharī'ah* advisers before their approval and registration by the SC.

The combined effects of a supportive legal regime, *Sharī'ah* oversight, both tax neutrality and incentives, as well as a focused approach by the government and its agencies have helped to establish Malaysia as the world's largest *sukūk* market[253] and an international hub for *Sharī'ah*-compliant funds. Domestically, Islamic *sukūk* issuances

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Towards a Developed and High-Income Nation, (Kuala Lumpur, October 15, 2010), at [26], available at: http://www.treasury.gov.my/pdf/budget/bs11.pdf

[247] Section316A Capital Markets and Services Act 2007 as introduced by section 7 Capital Markets and Services Act (Amendment) Act 2010 (Act A1370). Prior to 2010, its creation was indirectly permitted pursuant to section 16 of the SCA 1993 (which confers on the SC full jurisdiction in the carrying out of its duties) and section 18 (which empowers the SC to form a committee to help it carry out these duties). Securities Commission, Malaysia, *Resolutions of the Securities Commission Shariah Advisory Council*, (2nd ed., SC, Kuala Lumpur, 2007), at 5.

[248] Section 316B Capital Markets and Services Act 2007 as introduced by section 7 Capital Markets and Services Act (Amendment) Act 2010 (Act A1370).

[249] Nathie, Mahmood, "Embracing Islamic investment in Australia using the Malaysian model: challenges and opportunities", Paper presented at The Challenges and Opportunities of Islam in the West: The Case of Australia Conference, March 3-5, 2008, Brisbane, Queensland, Australia, at 17.

[250] Securities Commission, Malaysia, *Resolutions of the Securities Commission Shari'ah Advisory Council*, (2nd ed., SC, Kuala Lumpur, 2007), available at: http://www.sc.com.my/eng/html/icm/Resolutions_SAC_2ndedition.pdf.

[251] Securities Commission, Malaysia, *Guidelines on Islamic Fund Management*, (SC, Kuala Lumpur, December 2007), at [4], Securities Commission, Malaysia, *Islamic Securities Guidelines*, (Sukuk Guidelines), at [7.0].

[252] Securities Commission, Malaysia, *Guidelines on Islamic Fund Management*, (SC, Kuala Lumpur, December 2007), at [5], Securities Commission, Malaysia, *Islamic Securities Guidelines*, (Sukuk Guidelines), at [1.08] and [1.09].

[253] In 2008, approximately 60% of the world's *sukuk* outstanding was originated from Malaysia, Securities Commission, Malaysia, "Malaysian ICM", (2009) 4(2) *Quarterly Bulletin of Malaysian Islamic Capital Market*, at 11. See also, Oxford Business Group, "No Substitute for Experience", note 136, at 89.

represented 63.3% of bonds approved by the SC in 2010[254] while Islamic funds also dominate with 88% of companies listed in Malaysia being *Sharī'ah*-compliant.[255]

4.3.4 Conclusion to Section 4.3

The progress made by Malaysia in developing a workable Islamic finance system is impressive. Unlike Pakistan, the country has not been plagued by hard-line religious obstacles and has instead sought to establish equality between Islamic finance and the conventional system from the beginning. As a result, the growth of Islamic finance has not resulted in an attempt to replace the interest-based system as initially took place in Pakistan.[256] Instead the development of Islamic finance in Malaysia has simply expanded the economy to provide for both religious and non-religious financial choices. While gaps remain, the dual financial system provides market-participants with two financial options and as such, caters for the needs of Muslims and non-Muslims. Increasingly evident in the Malaysian approach to Islamic banking and finance is also a desire to harmonise Malaysian Islamic finance standards and practices with those of other countries. The change in nomenclature used by Malaysian authorities from "syariah"[257] to *Sharī'ah*, the development of products which have been specifically designed to appeal to both domestic and Middle Eastern investors,[258] and the most recent confirmation by the SC that greater internationalisation is needed within Malaysian Islamic finance, all suggest a movement towards participation in a global Islamic finance market.[259]

As in the case of Pakistan and full-scale islamisation of the economy, the experience of a dual Islamic/conventional financial market in Malaysia is unlikely to be of direct precedential value for Ireland. The enactment of bespoke legislative instruments and Government agencies in Ireland which are dedicated solely to a financial sector underpinned by religious teachings is not necessitated by the size of Ireland's Muslim

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[254] Parker, Mushtak, "Malaysia securities regulator revises sukuk guidelines", note 240.

[255] Bursa Malaysia, *Islamic markets*, (Bursa Malaysia, Kuala Lumpur, 2011), at 10, available at: www.bursamalaysia.com/website/bm/.../Islamic_Markets_brochure.pdf.

[256] *supra.* at 99 et seq.

[257] The Islamic Banking Act 1983 uses the term Syariah Advisory Council (section 13A) where as the Central Bank of Malaysia Act 2009 uses Shariah Advisory Council (section 51).

[258] A *sukuk* recently issued used the *Sukuk al-Amanah Li al-Istithmar* structure and was designed to "meet the most discerning investors' Shariah requirements," Koon, Chong Pooi and Porter, Barry, "Cagamas Designs $1.6 Billion Islamic Bonds to Appeal to Middle East Buyers", *Bloomberg*, July 13, 2010, available at: http://www.bloomberg.com/news/2010-07-13/cagamas-designs-1-6-billion-Islamic-bonds-to-appeal-to-middle-east-buyers.html. This *sukuk* structure is discussed in more detail in Chapter 6.

[259] Parker, Mushtak, "Malaysia securities regulator revises sukuk guidelines", note 240.

population, and may be difficult to justify politically or in practice. Equally, as will be discussed in Chapter 10, it is unlikely that the Irish Government would (or indeed should) make an official determination on what is and what is not *Sharī'ah*-compliant.[260] In contrast, the Islamic nature of Malaysia has allowed such developments without these measures being legally or politically questionable. While a dual financial system may allow the specific and unique needs of Islamic transactions and their participants to be met by supporting legislation and institutions, Ireland will almost certainly not develop the parallel economic framework found in Malaysia. Nevertheless, the Malaysian experience highlights once again the importance of underpinning Islamic transactions with an effective, rather than token, legal framework which is equipped to deal logically and consistently with Islamic financial structures.

The approach to Islamic finance adopted in Malaysia also indicates that while an effective support structure is needed domestically, the Islamic finance industry is global in nature. Ireland should strive to facilitate Islamic transactions and products that are widely used and accepted amongst the international Islamic finance community. Unanimous agreement in Islamic finance is difficult to obtain.[261] Nevertheless, the fact that Malaysia is now trying to foster convergence between its own Islamic financial market and that of more conservative Gulf States suggests that products which contain too many jurisdictional idiosyncrasies may not be attractive to international investors. It is suggested that any Irish accommodations introduced by the Government should be capable of facilitating some of the more conservatively structured Islamic products. This will ensure that Islamic products subject to Irish law can be marketed to a broad spectrum of international market participants.

4.4 The Integration of Islamic Finance into the Established Legal Framework: Islamic Finance and the United Kingdom

The rise and growing prominence of Islamic finance in Muslim countries such as Pakistan and Malaysia has emerged as a result of numerous interrelated factors. The underlying religious duty of Muslims to adhere to the precepts of Islamic law, constitutional and judicial impetus and political encouragement have combined to foster

[260] *infra.* at 383.
[261] *supra.* at 37.

economic environments in which the emergence of a religiously guided financial industry does not appear out of place. The budding Islamic financial industry in the UK can be distinguished by an alteration of emphasis with a focus largely on economic and social considerations and less on religious obligations. Nevertheless, similar to the refocused integration policy adopted in Pakistan and to a certain degree in Malaysia, the UK approach to accommodation has sought to expand its existing financial system so as to incorporate within the interest-based economy, structures compatible with the teachings of Islam.[262]

As noted in Chapter 3, finance guided by religious dictates initially met with both cynicism and apathy in many non-Muslim nations.[263] *Fatāwā* legitimising the use of interest-based products by European and American Muslims, and uncertainties relating to the applicability of Islamic financial concepts in non-Islamic economies, potentially contributed to this early lack of interest.[264] Despite this, the British Government has sought to position the UK as the pre-eminent gateway for Islamic finance.[265] Rather than avoiding this divisive area, UK regulatory and financial authorities have actively supported the integration of the Islamic finance industry within the UK financial market.[266] The commitment of the UK to Islamic finance has been motivated by clearly articulated goals. Domestically, a policy of non-exclusion from the financial system has warranted Government consideration of how the economic needs of Muslims - who would otherwise not be able to participate in the conventional system - can be met through the provision of retail products which comply with Islamic law. As a previous chairman of the UK's Financial Services Authority [FSA] noted in relation to the regulation of Islamic finance

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[262] Aldohni, Abdul Karim, "The Emergence of Islamic Banking in the UK: A Comparative Study with Muslim Countries", (2008) 22 *Arab Law Quarterly*, 180-198 at 189-190.

[263] Wilson, Rodney, "Islamic Finance in Europe", *RSCAS Policy Papers 2007/02 Musmine-Muslim Minorities in Europe*, (European University Institute, Robert Schuman Centre for Advanced Studies, Florence, 2007), at 1, Dixon notes that "the West has failed to adopt a positive attitude towards the needs of Islamic banks. Along with fundamental conceptual difficulties, this attitude has caused problems for Islamic banks operating in Western industrialized countries," Dixon, Rob, "Islamic banking", (1992) 10(6) *The International Journal of Bank Marketing*, 32-37 at 34.

[264] See generally the Qaradawi *fatwā* issued in 1999 by the European Council for Fatwa and Research discussed in Caeiro, Alexandre, "The Social Construction of Sharia: Bank Interest, Home Purchase and Islamic Norms in the West", (2004) 44 *Die Welt des Islams*, 351-375.

[265] UK Government, "UK Minister Reiterates Government's Commitment to Islamic Finance", *Press Release*, July 7, 2009, available at: http://www.zawya.com/Story.cfm/sidZAWYA20090710064848/UK%20Minister%20Reiterates%20Government%27s%20Commitment%20to%20Islamic%20Finance, Williams, David, "The Last Word", (2009) 7(1)(21) *Islamic Banking & Finance*, 30 at 30, Briault, Clive, "London: Centre of Islamic Finance?" Paper presented at the FSA Industry Forum, London, October 17, 2007, available at: http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2007/1018_cb.shtml.

[266] Hajdukovic, Darko, "London Acts as Global Gateway for Islamic Finance", (January 2008) *The 2008 guide to Opportunities & Trends in Islamic Finance*, 6 at 6.

> [i]t would have been an invidious form of social exclusion [of Muslims] for regulation to have prevented the development of financial products which conformed with their religious beliefs, and therefore to have condemned them to a position where their religious beliefs prevented them from accessing financial services.[267]

More broadly, the provision of alternative financial products in the wholesale sector aims at reinforcing London's place as a leading international financial centre.[268]

Building upon legislative and regulatory arrangements already in place, rather than developing a parallel legal framework for Islamic finance (as has occurred in Malaysia), UK government policy has endeavoured "to create the right conditions in the UK for Islamic finance to grow"[269] and ultimately to position the UK as a hub for Islamic finance.[270] However, the application of established laws and guidelines to *Sharī'ah*-compliant structures is not a straightforward exercise. As noted in Chapter 3[271] and in the introduction to this Chapter,[272] contemporary Islamic financial transactions are often structured to replicate the economic outcomes of conventional products, but in a manner which uses classical Islamic contracts and *Sharī'ah*-compliant techniques.[273] Established laws were not designed to cope with the distinctive structure of Islamic finance products. By subjecting Islamic products and services to the untailored legal provisions applying to conventional products, the structure of Islamic finance instruments may result in legal treatment of such products which is distinct from the treatment of economically comparable conventional structures.[274] This would place Islamic products in a distinct,

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[267] McCarthy, Callum "Regulation and Islamic Finance", Speech given at the Muslim Council of Britain Islamic Finance and Trade Conference, June 13, 2006, available at: http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2006/0613_cm.shtml.

[268] HM Treasury, *The Development of Islamic Finance in the UK: The Government's Perspective*, (HM Treasury, London, 2008), at 13.

[269] Davies, Howard, "Islamic Finance in the United Kingdom: Current Initiatives And Challenges", Speech given at the LSE-Harvard Public Lecture on Islamic Finance, London School of Economics, London, UK - February 26, 2009.

[270] Williams, David, "The Last Word", note 265, at 30, Briault, Clive "London: Centre of Islamic Finance?", note 265.

[271] *infra.*at 89.

[272] *infra.*at 95.

[273] Ercanbrack, Jonathan "The Regulation of Islamic Finance in the United Kingdom", (2011) 13 *Ecclesiastical Law Journal*, 69-77 at 70.

[274] Ali, Yasmin, *Impact Assessment for Stamp Duty Land Tax, Capital Gains Tax & Capital Allowance tax reliefs for Alternative Finance Investment Bonds*, (HMRC, London, 2009), at 1, available at: http://www.hmrc.gov.uk/budget2009/afi-bonds-100.pdf.

often disadvantageous position, hindering the development of an Islamic finance market sector.[275]

To overcome this potentially anomalous treatment, UK authorities have supported methods of integrating Islamic finance products which are tailored to accommodate the unique structural characteristics of these products without creating a dual financial system.[276] In relation to both regulation and taxation of Islamic finance, the UK has adopted an approach which seeks to encourage Islamic finance through the establishment of a "level playing field" between Islamic and economically similar conventional financial structures.[277] In order to achieve this level playing field, UK authorities have worked to clarify and even adjust the treatment of Islamic financial products and services under established legal provisions. This has involved conscious modifications to a number of laws and regulatory provisions in order to ensure that where Islamic finance instruments are economically comparable to conventional structures, both will be taxed and regulated in a similar manner notwithstanding differences in structure.[278]

Unlike the Malaysian approach, under which incentives have been offered to the Islamic financial market in order to facilitate more equal competition between sectors, the UK Government has confirmed that "no obstacles, no special favours" will be applied to Islamic finance arrangements.[279] Like the level playing field approach implemented in other non-Islamic countries such as Australia,[280] Hong Kong,[281] France,[282] and the US,[283]

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[275] *ibid.*, Ali, Yasmin, *Impact Assessment of Sukuk (Islamic Bonds) Legislation*, (HMRC, London, 2008), at 1, available at: http://www.hmrc.gov.uk/ria/ia-sukuk-legislation.pdf.

[276] Darko. Hajdukovic, "London acts as global gateway for Islamic Finance", in *The 2008 guide to Opportunities & Trends in Islamic Finance*, note 266, at 6.

[277] Ainley, Michael, Mashayekhi, Ali, Hicks, Robert, Rahman, Arshadur and Ravalia, Ali, *Islamic Finance in the UK: Regulation and Challenges*, (Financial Services Authority, London, 2007), at 11.

[278] Ercanbrack, Jonathan, "The Regulation of Islamic Finance in the United Kingdom", note 273, at 70-71.

[279] Financial Services Authority, "Islamic Banking in the UK", *Briefing Note BN016/06*, (FSA, London, March 9, 2006), available at: http://www.fsa.gov.uk/pages/About/Media/notes/bn016.shtml. See also Amin, Mohammed, "The Taxation of Islamic Finance in Major Western Countries", (2007) 1st Quarter *Arab Banking Review* 129.

[280] Sherry, Nick "The Future of Islamic Finance in Australia", speech given at the Islamic Finance Conference Rendezvous Hotel, Melbourne, June 8 2010. See also, Bowen, Chris, "Interview with Alex Symonds", *Sky Business*, January 15, 2010, available at: http://www.treasurer.gov.au/DisplayDocs.aspx?doc=transcripts/2010/003.htm&pageID=004&min=ceba&Year=&DocType=2. See the Report by the Australian Financial Centre Forum, *Australia as a Financial Centre Building on our Strengths*, (Commonwealth of Australia, Barton, 2009), at 70-71 where it was noted that "it is appropriate for Australia to adopt an approach to taxation and regulation of Islamic financial products that should present 'no obstacles, but no special treatment': in other words, a 'level playing field'."

[281] Chan, Ka Keung, "Islamic Finance", Speech given at the Islamic Banking and Finance Forum: The Way Forward for the Hong Kong SAR, The Hong Kong Polytechnic University, Hong Kong, May 19, 2008, available at: http://www.fstb.gov.hk/eng/sfst/speeches/2008/sp20080519_e.pdf.

the UK authorities' aim has been to put Islamic finance on an equal footing with conventional structures in terms of legal treatment. Intervention only occurs where necessary in order to remove comparative burdens faced by the Islamic finance sector without conferring on this sector any additional advantages; in effect, Islamic finance is allowed to function simply as another part of the UK market.[284]

In pursuit of these objectives, a working group was established in 2000 at which the financial community, the Government, Muslims in the UK, and the FSA were represented.[285] This group acknowledged a number of existing hindrances to the mainstream application of Islamic finance in the UK including taxation and regulatory inequalities, issues of standardisation, and a lack of awareness and skills related to Islamic finance.[286] Since then, support for Islamic finance in the UK has been provided by a number of Government agencies, particularly the FSA, Her Majesty's Treasury [HM Treasury] and Her Majesty's Revenue and Customs [HMRC], with all three authorities establishing dedicated Islamic finance groups.[287] Similarly, the UK Trade and Investment agency has been involved in the promotion of the UK as a destination for Islamic finance services.[288] On the industry side, the UK Islamic Finance Secretariat [UKIFS] was established in 2010 as an Islamic finance trade body charged to "represent the industry to UK authorities in legislative, fiscal, regulatory and political environment matters and will assist Islamic finance by looking to remove obstacles to equal treatment."[289] Guided by a general Government policy of establishing equality between Islamic and conventional transactions and broad official support of the industry, a steady stream of legislative

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[282] See for example, *Bulletin Officiel des Impôts* No 78 (2010), 4 FE/S1/10 (dealing with *murabaha*), 4 FE/S2/10 (*sukuk*), 4 FE/S3/10 (*ijarah*) and 4 FE/S4/10 (*istisna*).

[283] Schmith, Scott "Trends in Islamic-Finance Regulation", International Trade Administration, US Department of Commerce, 2008, available at: http://www.ita.doc.gov/td/finance/publications/Islamic_Regulatory_2008.pdf.

[284] Davies, Howard, "Islamic Finance in the United Kingdom: Current Initiatives And Challenges", note 269.

[285] Ainley, Michael, Mashayekhi, Ali, Hicks, Robert, Rahman, Arshadur and Ravalia, Ali, *Islamic Finance in the UK: Regulation and Challenges*, note 277, at 8.

[286] HM Treasury, *The Development of Islamic Finance in the UK: The Government's Perspective*, note 268, at 15.

[287] The FSA has an Islamic Finance Committee, HM Treasury the HM Treasury Islamic Experts Group and HMRC, the HM Revenue and Customs Islamic Finance Group, Anonymous, "Country Focus: United Kingdom – Open Door Policy", (2007) 164 (April–June) *New Horizon*, 24–28 at 25.

[288] HM Treasury, *The Development of Islamic FInance in the UK: The Government's Perspective*, note 268, at 10 for a discussion of the various measures taken by UK authorities. Ercanbrack, Jonathan, "The Regulation of Islamic Finance in the United Kingdom", note 273, at 70.

[289] UK Islamic Finance Secretariat, *Homepage*, available at http://www.secinst.co.uk/bookmark/genericform.aspx?form=29848780&URL=ukifshomepage.

measures concerning the regulation (4.4.1)[290] and taxation (4.4.2)[291] of both Islamic retail and Islamic wholesale financial products has been developed for the UK market.

4.4.1 Regulation

Oversight of the financial system in the UK has focused on regulating the institutions which provide financial services, outlining the activities and investments which will trigger authorisation of institutional providers by the FSA.[292] Anyone who offers a regulated activity without the necessary authorisation or exemption commits a criminal offence.[293] In line with the treatment of conventional products, the FSA's regulation of Islamic finance products arises within the context of regulating financial institutions. Initially, all Islamic financial products were classified according to existing definitions of conventional activities and investments within the Regulated Activities Order [RAO].[294] As a result, there were no tailored legislative enactments which dealt with the unique features of products approved by religious authorities.[295] Such an approach, while minimising pressure on the regulator to establish a bespoke national framework for the Islamic financial industry raised clear issues which jeopardised the goal of comparable regulatory treatment. As the structure and operation of Islamic products sometimes did not conform with the conventional categorisations set out in the RAO,[296] these products could simply fall outside the regulatory oversight of the FSA or be subject to consequences intended only for products aimed at sophisticated investors.[297] Neither of these implications of a strictly non-interventionist approach by the authorities would be conducive to the creation of viable

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[290] *infra.*at 135.

[291] *infra.*at 138.

[292] Section 19 Financial Services and Markets Act 2000 (c. 8). See also section 22 Financial Services and Markets Act 2000.

[293] Section 23 Financial Services and Markets Act 2000 (c. 8). See also; Ainley, Michael, Mashayekhi, Ali, Hicks, Robert, Rahman, Arshadur and Ravalia, Ali, *Islamic Finance in the UK: Regulation and Challenges*, note 277, at 10.

[294] Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (SI 2001/544).

[295] Smith, Duncan, "Islamic Financing and Investments in Britain: The Growing Potential", (2004) 8(2) *Review of Islamic Economics*, 83-90 at 83.

[296] As the FSA acknowledged "[t]he definition of products offered by Islamic firms is a key factor that firms and the FSA need to consider as part of the authorisation process. As explained earlier, the structure of Islamic products is based on a set of contracts acceptable under Sharia. So, while their economic effect is similar to or the same as conventional products, their underlying structure may be significantly different. This means the definition of these products under the Regulated Activities Order may not be the same as the conventional equivalent," Ainley, Michael, Mashayekhi, Ali, Hicks, Robert, Rahman, Arshadur and Ravalia, Ali, *Islamic Finance in the UK: Regulation and Challenges*, note 277, at 12-13.

[297] Briault, Clive, "London: Centre of Islamic Finance?" note 265, HM Treasury, *The Development of Islamic Finance in the UK: The Government's Perspective*, note 268, at 18, Butterworths, "Islamic Financial Institutions and Islamic Finance", *Encyclopaedia of Banking Law, Division F1*, Antony Hainsworth, (ed). (Butterworths, London, 2008), at [77].

Sharī'ah-compliant sector.[298] The British authorities thus acknowledged that specific regulatory amendments may be necessary to ensure comparable treatment between market participants.

As will be discussed in Chapter 6, the classification of Islamic mortgage-alternatives has received the most extensive regulatory consideration of Islamic retail products in the UK.[299] The structural distinctiveness of Islamic real estate financing, which is frequently based on *murābaha*, diminishing *mushāraka* or *ijārah wa-iqtina* structures, prevented these transactions from being subject to the same regulatory framework as conventional mortgages. This inequality of regulation arose despite the fact that the Islamic and conventional products were designed to produce the same economic result.[300] Following the tailored accommodation of these products within the RAO, Islamic mortgage-alternatives, classified now as "Home Purchase Plans" [HPPs], have been brought into the existing regulatory system.[301] Customers taking out a HPP benefit from the same level of regulatory oversight as those with a conventional mortgage, while HPP providers now have similar obligations and duties as institutions offering mortgages.[302]

UK authorities have increasingly focused on accommodating wholesale structures. As the single regulator for the whole UK financial system,[303] the FSA also regulates and oversees non-banking and wholesale financial activity. Islamic funds and their management have not required any tailored legislative adjustments as *Sharī'ah*-compliant funds and the activities of Islamic fund managers are treated by the existing regulatory and

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[298] Briault, Clive, "London: Centre of Islamic Finance?" note 265, Jensen, Nickolas C. "Avoiding Another Subprime Mortgage Bust through Greater Risk and Profit Sharing and Social Equity in Home Financing: An Analysis of Islamic Finance and Its Potential as a Successful Alternative to Traditional Mortgages in the United States", (2008) 25 *Arizona Journal of International and Comparative Law*, 825-856 at 837.

[299] *infra.*at 254, *Sharī'ah*-compliant bank accounts have also been a source of difficulty in the UK, see Wilson, Rodney, "Regulatory challenges facing the Islamic finance industry", (2005) 14 *Journal of Financial Transformation*, 140-143 at 140-141.

[300] That is, the purchase of the house by a customer with the financial support of a financial institution as well as a profit for that institution.

[301] The FSA extended secondary legislation (primarily the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (RAO) but also the Terrorism Act 2000, (UK), the Proceeds of Crime Act 2002 (UK), and The Financial Services and Markets Act 2000 (Financial Promotions) Order 2005 (UK), a new category of regulated activity was created relating to "Home Purchase Plans."

[302] In order to ensure a more comparable playing field the FSA's "Mortgage and Home Finance: Conduct of Business Sourcebook" (MCOB) has also been amended to provide guiding rules relating to the provision of Islamic mortgage-alternatives.

[303] The FSA was established by the Financial Services and Markets Act 2000 (c. 8) to oversee the whole of the financial market. See in particular sections 3-6 of FSMA 2000 which outline the duties of the FSA. For a general discussion of the FSA as a single regulator see, Briault, Clive, "Revisiting the Rationale for a Single National Financial Services Regulator", *Occasional Paper Series No. 16*, (FSA, London, February 2002), available at: http://www.fsa.gov.uk/pubs/occpapers/op16.pdf.

tax framework in a manner comparable with conventional funds.[304] In contrast, *sukūk* structures have been the primary subject of regulatory accommodations in the UK's Islamic non-banking sector. Despite the economic similarities between some *sukūk* and conventional debt securities, the UK authorities have struggled to find a consistent classification for *sukūk*. Until recently, regulation of these structures had been dealt with on a case-by-case basis with *sukūk* variously falling under two potential categories for regulatory purposes: either a conventional bond or a Collective Investment Scheme [CIS] (which was subject to strict requirements regarding financial promotions and potential investors).[305] In light of this ambiguous regulatory position, a review conducted by the FSA and the HM Treasury sought to establish the legislative changes needed to "align the regulatory treatment of AFIBs [Alternative Financial Investment Bonds or *sukūk*] with conventional debt securities"[306] and to ensure equality of treatment between most types of *sukūk* and interest-based bonds.[307] Following this consultation, the Financial Services and Markets Act 2000 (Regulated Activities)(Amendment) Order 2010[308] now harmonises the regulation of *sukūk* with debt securities by creating a new specified investment under the Regulated Activities Order (RAO)[309] and explicitly exempting *sukūk* from the CIS regime.[310]

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[304] Funds themselves, whether Islamic or secular, are regulated in the UK as Collective Investment Schemes defined under section 235 of FSMA 2000. Like conventional funds, Islamic Collective Investment Schemes can be regulated or unregulated and can be structured to fall within or outside the scope of the *UCITS Directive scheme.* Islamic fund managers operating in or from the UK are also subject to the same regulatory oversight as those managing conventional fund schemes. Under section 51 of the RAO, anyone "establishing, operating or winding up a collective investment scheme" will require authorisation by the FSA. No amendments to the tax regimes have been made specifically for Islamic funds or fund managers.

[305] Financial Services Authority and HM Treasury, "Consultation on the legislative framework for the regulation of alternative finance investment bonds (Sukuk)," (FSA, London, 2008), at 19, available at: http://www.fsa.gov.uk/pubs/cp/sukuk.pdf. These issues are confounded by the fact that AAOIFI has identified 14 *sukūk* structures with the possibility of further developments in the future, Ainley, Michael, Mashayekhi, Ali, Hicks, Robert, Rahman, Arshadur and Ravalia, Ali, *Islamic Finance in the UK: Regulation and Challenges*, note 277, at 25. The UK's response to sukūk regulation is considered in more detail *infra.*at 355.

[306] Financial Services Authority and HM Treasury, "Consultation on the legislative framework for the regulation of alternative finance investment bonds (*Sukuk*)," note 305, at 3.

[307] Bi, Farmida, "The future of UK sukuk", (2011) 30(2) *International Financial Law Review*, 33-34, at 34.

[308] Financial Services and Markets Act 2000 (Regulated Activities)(Amendment) Order 2010, No. 86 of 2010.

[309] This amendment results in the creation of section 77A in the specified investments of the RAO 2001 which has now been extended to include "Alternative Finance Investments".

[310] Article 3, Financial Services and Markets Act 2000 (Regulated Activities)(Amendment) Order 2010, No. 86 of 2010. The British Exchequer Secretary to the Treasury Sarah McCarthy-Fry MP confirmed this continued commitment to Islamic finance when she noted that "[t]his measure is another important step in the development of the Islamic finance sector in the UK and will help to provide a level playing field for Islamic financial products in this country. It is good news for the UK economy and for our Islamic finance industry," HM Treasury, "Government moves to support UK Islamic finance industry," *Press Release*, (21st January 2010), available at: http://www.hm-treasury.gov.uk/press_04_10.htm. Fournier, Elizabeth, "Regulatory reform pushes UK corporate *sukuk*", (2010) 29(8) *International Financial Law Review*, 2 at 2.

4.4.2 Taxation

Relevant to virtually all Islamic financial transactions within the UK, taxation has been one of the core areas of accommodation considered by UK authorities.[311] Tax liability in the UK is generally determined more by a financial instrument's legal form than by its internal substance and so, as Islamic financial products are structurally distinct from their conventional counterparts, they could be subject to distinct taxation.[312] Acknowledging the potentially anomalous taxation of Islamic finance market participants in the UK, HMRC has noted that, "[t]he Government is keen to promote the growth of the alternative finance market in the UK. In order to achieve this it is necessary to deal with certain tax barriers preventing the development of the industry."[313] Commencing with the Finance Act 2003 and continuing in successive Finance Acts since 2005, the Government has outlined specific tax measures aimed at establishing equality of taxation between Islamic and conventional structures.[314] These measures, which apply across different tax statutes, seek to ensure that certain features - such as the multiple transfers of assets, which often take place in Islamic transactions,[315] the profit generation through leasing or mark-up, and the absence of interest payments - do not place Islamic finance transaction participants in a worse, or indeed a better, tax position than their conventional counterparts. Unlike the approach in Pakistan and Malaysia, the adjustments made to established tax laws in the UK do not refer to Islam, *Sharī'ah* or Islamic finance. Instead, they adopt *Sharī'ah*-neutral

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[311] Ercanbrack, Jonathan, "The Regulation of Islamic Finance in the United Kingdom", note 273, at 70.

[312] Amin, Mohammed, "The tax treatment of Islamic Finance in Western countries and Muslim Majority Countries", in *Euromoney Encyclopedia of Islamic Finance*, Aly Khorshid (ed.), 367-376 at 369-370 citing *(CIR) v Plummer* 54 Tax Cases 1, as evidence of the UK's general form over substance approach to taxation. See also, Cape, Jeremy, "Tax and Islamic trade finance", (2010) 13(7) *Trade & Forfaiting Review*, available at: http://www.tfreview.com/xq/asp/txtSearch.Commercial+risk/exactphrase.1/sid.0/articleid.B6806E8F-605F-4CA9-9B08-F8DD055CDF2E/qx/display.htm, Conway, Kevin and Feese, Suzanne, "The tax dilemma in Islamic finance", (July/August 2007) *International Tax Review*, 20-22 at 20.

[313] Ali, Yasmin, HMRC, *Impact Assessment of Sukuk (Islamic Bonds) Legislation*, note 275. See also Foot, Michael, "The Future of Islamic Banking in Europe", Speech given at the Second International Islamic Finance Conference Dubai, September 22, 2003, available at: http://www.fsa.gov.uk/Pages/Library/Communication/Speeches/2003/sp150.shtml, citing excessive taxation of Islamic real estate finance transactions as "the main hurdle in the UK."

[314] HM Treasury, *The Development of Islamic Finance in the UK: The Government's Perspective*, note 268, at 16.

[315] Such as, for example, in diminishing *mushāraka* arrangements where the customer and financier share ownership of an asset/property with the customer progressively purchasing the asset/proeprty until they have total ownership and the financier has none. As will be discussed in more detail *infra.*at 241, the multiple transfers of the underlying property could give rise to stamp duty issues. In order to overcome the excessive taxation which would arise as a result of the diminishing *mushāraka* structure, Section 72 of the Finance Act 2003 eliminated double Stamp Duty Land Tax (SDLT) in relation to *murābaha* transactions in 2003 (s73 Finance Act 2003 (c. 14)).

language which refers to "alternative finance arrangements."[316] Nevertheless, while the relevant provisions are not immediately identifiable as applying to Islamic finance, the instruments whose tax position they concern are consistent with the structure of a number of Islamic contracts. Consolidated and expressly integrated into the various Tax Acts by the Corporation Tax Act 2009[317] and the Taxation (International and Other Provisions) Act 2010,[318] these accommodating tax provisions seek to consciously bring Islamic products into the existing Tax Acts in a manner which will facilitate parity of taxation between economically similar products.

4.4.3 *Sharī'ah*-Compliance

Unsurprisingly, the UK has taken a radically different approach to *Sharī'ah* supervision from that implemented in both Pakistan and Malaysia. Notwithstanding strong political support for Islamic finance in the UK, the FSA has repeatedly stated that it is "a secular and not a religious regulator."[319] Noting that "[i]t would not be appropriate, even if it were possible, for the FSA to judge between different interpretations of Sharia law,"[320] British regulatory authorities have adopted no particular interpretation of *Sharī'ah*.[321] Equally, the FSA has not appointed its own *Sharī'ah* board to act as the ultimate arbiter of *Sharī'ah*-compliance nor has it published guidelines or regulations on the religious compatibility of Islamic financial instruments. Indeed, there is no legal requirement whatsoever that institutions engaged in Islamic finance in the UK establish their own *Sharī'ah* governance structure.[322] Any institutions which have appointed *Sharī'ah* boards or advisers have done so on a voluntary basis with those boards subject to no tailored corporate governance framework.[323]

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[316] See for example, Part 10A Income Tax Act 2007 which is headed as "Alternative Finance Arrangements" with such arrangements defined as meaning (a)purchase and resale arrangements, (b)diminishing shared ownership arrangements, (c)deposit arrangements, (d)profit share agency arrangements, and (e)investment bond arrangements, inserted by Part 1 Schedule 2 Taxation (International and Other Provisions) Act 2010 (c. 8).

[317] Chapter 6, Corporation Tax Act 2009 (c.4).

[318] Schedule 2, Taxation (International and Other Provisions) Act 2010 (c. 8).

[319] Ainley, Michael, Mashayekhi, Ali, Hicks, Robert, Rahman, Arshadur and Ravalia, Ali, *Islamic Finance in the UK: Regulation and Challenges*, note 277, at 13.

[320] *ibid.*

[321] Foot, Michael, "The Future of Islamic Banking in Europe", note 313, noting that "we shall have neither the ability nor the desire to monitor a bank's actual *Sharī'ah*-compliance. That has to be something for the *Sharī'ah* board and for the institution itself."

[322] Hasan, Zulkifli, "Regulatory Framework of *Sharī'ah* Governance System in Malaysia, GCC Countries and the UK", (March 2010) 3-2 *Kyoto Bulletin of Islamic Area Studies*, 82–115 at 103.

[323] Hainsworth, Antony, "Governance rules for Islamic financial institutions: the new frontier?", (2007) 9 *Journal of International Banking and Financial Law*, 515-520 at 515.

The UK view on *Sharī'ah* supervision is in line with similar approaches adopted in other non-Islamic jurisdictions. Governments in Europe, the US and Australia have preferred to assume no role in screening for *Sharī'ah*-compliance and have instead maintained a distributed approach, whereby questions of Islamic interpretation remain entirely a matter for private actors; it has been for the industry itself in these countries to determine the extent to which overt *Sharī'ah*-compliance is a condition precedent to marketing a product or service as Islamic. Within the UK, the absence of a legal obligation to establish a *Sharī'ah* board has not, however, prevented Islamic banks and other bodies involved in Islamic finance from establishing their own *Sharī'ah* advisory process. Gatehouse Bank, for example, has a "Shariah Advisory & Shariah Compliance Department" and a separate Shariah Supervisory Board composed of four Islamic scholars.[324] The Islamic Bank of Britain has established a four person "Sharia Supervisory Committee," one of whom acts as an internal "Sharia-compliance officer"[325] while Ahli United Bank has a *Sharī'ah* board of three scholars.[326] In non-banking Islamic institutions a similar preference for *Sharī'ah* supervision is evident with the Children's Mutual Shariah Baby Bond Child Trust Fund establishing a four person *Sharī'ah* supervisory board.[327] The UK's approach to *Sharī'ah* supervision has not therefore stifled this supervision although it has reduced the extent to which the FSA can supervise directly the activities of *Sharī'ah* boards.[328]

4.4.4 Conclusion to Section 4.4

Islamic banking and finance in the UK has expanded considerably in the last decade, buoyed by a healthy level of governmental support. Acknowledging the still developing nature of the industry and the importance of maintaining economic equality, s.156 of the Finance Act 2008 confers on HM Treasury the power to amend existing tax legislation and to introduce new tax provisions by secondary legislation.[329] This authority has allowed the

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[324] Gatehouse Bank, *Shariah Supervisory Board*, available at: http://www.gatehousebank.com/contact-us/sharia-supervisory-board-2/

[325] Islamic Bank of Britain, *Sharia Supervisory Committee*, available at: http://www.Islamic-bank.com/sharia-finance/sharia-supervisory-committee/

[326] Ahli United Bank, *Our Sharī'ah Board*, available at: http://www.iibu.com/shariaa_board/sboard.aspx

[327] The Children's Mutual, *Shariah Baby Bond Child Trust Fund*, available at: http://www.thechildrensmutual.co.uk/child-trust-funds/our-child-trust-funds/shariah-baby-bond.aspx

[328] Ahmad, Abu Umar Faruq and Hassan, M. Kabir, "The Adoption of the UK Finance Bill Proposals on Islamic Finance into Islamic Banking in Australia", (2006) 10(1) *Review of Islamic Economics*, 41-57 at 53-54.

[329] Section 156 of the Finance Act 2008

Government to respond to changes in the industry without having to wait for the next Finance Act.[330]

By adopting an official policy of parity of treatment between economically similar financial structures, UK authorities have made adjustments to a number of existing laws and guidelines dealing with regulation and taxation of financial activity generally. To the extent that an Islamic product is economically similar to a conventional alternative, such products will generally be subject to comparable legal treatment despite structural differences. However, while the UK's approach may appear logical for a non-Islamic country, the development of the UK Islamic finance market has not been entirely smooth. The Islamic finance sector, like its conventional counterpart, has been negatively affected by the global financial crisis[331] and some UK banks have reduced their Islamic finance services.[332] Equally, a proposed Government *sukūk* was shelved in 2011 in order to allow the UK Government to focus on the country's economic recovery.[333]

Nevertheless, it is suggested that the UK Government has not failed in the objectives it initially set itself in relation to Islamic finance. Without creating a bespoke legal regime for Islamic finance or prioritising Islamic financial activitiy the UK has provided a relatively comprehensive fiscal, legal and regulatory basis for the development of a financial sector which is compatible with Islamic teachings. It has also removed many of the obstacles which previously hindered the growth of this sector. Since 2003, the FSA has authorised nine Islamic fund managers, an Islamic hedge fund, a *takāful* operator, four wholesale Islamic banks[334] and one retail Islamic bank - the Islamic Bank of Britain - which was the first wholly Islamic retail bank in a non-Muslim country.[335] Equally, numerous non-Islamic

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[330] Goddard, Charles, "Finance Act notes: Alternative Finance Arrangements – sections 154-157 and Schedule 46", (2008) 5 *British Tax Review*, 530-533 at 532.

[331] International Financial Services London, *Islamic Finance 2010*, (IFSL Research, London, 2010), at 3, available at: http://www.thecityuk.com/assets/Uploads/Islamic-finance-2010.pdf

[332] A number of banking institutions such as Bank of Ireland and Lloyds TSB have withdrawn or scaled back their activities in the sector, Qayum, Khalid, "U.K. Shariah Asset Growth Curbed by Recession: Islamic Finance", *Bloomberg Businessweek*, July 21 2010, available at: http://www.businessweek.com/news/2010-07-21/u-k-shariah-asset-growth-curbed-by-recession-islamic-finance.html.

[333] HM Treasury, *Pre-Budget Report 2008: Facing global challenges supporting people through difficult times*, [4.3.4] at 74, available at: http://www.hm-treasury.gov.uk/d/pbr08_completereport_1721.pdf

[334] Naumowicz, Dean and Khan, Uzma, "Islamic Finance: Rising above the downturn?", (January 2009) *Practical Law Company*, available at: http://construction.practicallaw.com/0-384-7915. These banks are the Bank of London and The Middle East, European Finance House, European Islamic Investment Bank, Gatehouse Bank.

[335] Ainley, Michael, Mashayekhi, Ali, Hicks, Robert, Rahman, Arshadur and Ravalia, Ali, *Islamic Finance in the UK: Regulation and Challenges*, note 277, at 14.

banks offer Islamic financial services.[336] Complementing this, the UK remains in ninth place globally in terms of *Sharī'ah*-compliant assets with more than any other non-Islamic country[337] while *sukūk* and Islamic funds continue to list on the London exchanges.[338] The core achievement of the UK Government, in relation to Islamic finance, has been to develop the existing financial market into one which is conducive to Islamic finance activity and which will ensure that those who choose to conduct their financial affairs in accordance with Islamic law not only have the ability to do so but will also have many of the same rights and obligations as other market participants, something which would have been difficult to achieve prior to accommodation.

With the UK's Islamic finance industry now approaching the ten year mark, it is suggested that Ireland has much which it can learn from the UK experience. For both retail and wholesale transactions, the UK authorities have been willing to consider the specific structures of Islamic products, while also accounting for their economic substance. Based on this dual-level analysis, reforms have been introduced across UK legislative instruments to ensure that accommodations are consistent and effective. The thoroughness of this accommodation must be borne in mind by the Irish authorities as it arguably sets a benchmark for the level of accommodation which is possible in a non-Islamic country. For geographical and political reasons, Ireland's attempts at accommodation will always be judged against those introduced in the UK (particularly at wholesale level) and so ultimately, if legislative adjustments in Ireland were sloppy or ineffective, they may appear even more unsatisfactory when compared with those found in the UK.[339]

On a more practical level, in the areas relevant to Islamic finance activity, English and Irish law share many similarities.[340] The UK accommodations now act as a blueprint for Irish authorities who are attempting to determine the legal implications of Islamic finance.

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[336] International Financial Services London lists 17 banks as operating Islamic banking windows in the UK; Ahli United Bank, Alburaq, Bank of Ireland, Barclays, BNP Paribas, Bristol & West, Citi Group, Deutsche Bank, Europe Arab Bank, HSBC Amanah, IBJ International London, J Aron & Co., Lloyds Banking Group, Royal Bank of Scotland, Standard Chartered, UBS, United National Bank. International Financial Services London Research, *Islamic Finance 2010*, note 331, at 3. Bank of Ireland has however recently withdrawn from the Islamic finance industry and Lloyds TSB has reduced its Islamic financial services.

[337] The City UK, "Islamic Finance", *Financial Markets Series*, (The City UK, London, May 2011), at 1, available at: http://www.thecityuk.com/media/223683/Islamic finance 2011.pdf.

[338] *ibid.*

[339] See for example the continuing stamp duty issue which exists in Ireland in relation to Islamic real estate financing activity, *infra.*at 242. This stamp duty issue has been addressed under UK accommodations.

[340] That is, for example, in relation to tax and financial regulatory law. There are differences between the two jurisdictions, yet as will be discussed in Chapters 7, 9 and 10, there are also numerous similarities.

4.5 The Accommodation of Islamic finance in Ireland – Initial steps

What emerges from the development of Islamic finance under all three methodologies discussed above is quite simply the need for a comprehensive and planned approach to accommodation.[341] As a result of the diverse structures and the extensive prohibitions underpinning Islamic financial activity, its *successful* integration into the financial market is not ensured simply because Islamic finance exists in other (particularly non-Islamic) economies.[342] It must be accommodated within the specific legal regime in which it is to operate. The impact of Islamic finance extends far beyond simply eliminating interest and affects the relationship between financial institutions and their customers, the manner in which Islamic transactions interact with legal provisions, the mechanisms through which profit is generated and, fundamentally, the way in which a financial institution operates.[343]

The extent to which the Islamic finance industry can operate in a country is, therefore, largely dependent on the amenability of that country's legal and regulatory framework to Islamic finance's structures. Where the development of Islamic finance is a Government priority, as it has explicitly been made in Ireland,[344] conscious determination of how Islamic finance principles will operate and the extent to which established laws and policies could interfere with such operation is necessary. However, as Howladar suggested, "[p]arallel systems are not the way, integration is the key"[345] to the accommodation of the Islamic finance industry - within non-Islamic countries, and even now within Pakistan, the integration approach dominates. This is the direction in which Ireland is moving.

The Revenue Commissioners' Tax Briefing in 2009 was the first prominent attempt to address the distinctive nature of Islamic finance in Ireland. The Tax Briefing, being neither an Act of the Oireachtas nor a Ministerial Regulation, cannot modify

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[341] Ahmad, Abu Umar Faruq and Hassan, M. Kabir, "The Adoption of the UK Finance Bill Proposals on Islamic Finance into Islamic Banking in Australia", note 328, at 51 noting that "in order to support operational soundness, Islamic banking and finance should be equipped with a proper set of regulatory and supervisory instruments that fit its operational activities, and the elimination of a multiplicity of stamp duty and other transfer taxes," Freudenberg, Brett and Nathie, Mahmood, "The Constitution and Islam: Are Tax Reforms Possible To Facilitate Islamic Finance?", (2010) 20(1) *Revenue Law Journal*, Article 5, at 34, available at: http://epublications.bond.edu.au/rlj/vol20/iss1/5.

[342] Bälz, Kilian, "Islamic Finance for European Muslims: The Diversity Management of *Sharī'ah*-compliant Transactions", (2007) 8 *Chicago Journal of International Law*, 569-567 at 552.

[343] *Registrar of Banks v Islamic Bank of South Africa Ltd* (in liquidation) (Case No 25286/97) in October 1997 discussed in Nathie, Mahmood, "Islamic Bank Failure: A Case Study", note 128, 7-34.

[344] O'Carroll, Lisa, "Ireland aims to be home of Islamic finance in Europe", *The Guardian*, June 2 2011, available at: http://www.guardian.co.uk/business/2011/jun/02/ireland-Islamic-finance.

[345] Howladar, Khalid "A Template for Averting Disaster? Roundtable", (January 2009) *The Banker*, 52-53 at 52.

legislation[346] but notes that *takaful*, *ijārah* and Islamic funds will be subject to the same tax regime as their non-Islamic counterparts.[347] In practice, the Tax Briefing 2009 simply confirmed the existing position. Due to the fact that *takaful*, *ijārah* and Islamic funds are often substantively *and* structurally similar to the conventional insurance, leasing and funds they substitute, it is suggested that even in the absence of the Revenue Commissioners' statement, these products would fit into the existing tax framework.[348] Rather than removing legal hurdles faced by these products, the Tax Briefing 2009 is a public acknowledgment that Ireland is amenable to Islamic finance activity domestically.

Following the clarifications outlined in the Tax Briefing 2009, the Finance Act 2010 and subsequent "Guidance Notes on the Tax Treatment of Islamic Financial Transactions" [Guidance Notes][349] represented an important opportunity for those wanting to develop an Islamic finance industry in Ireland. Like the UK, tax liability in Ireland is determined on the basis of a transaction's form rather than its substance.[350] In the absence of legislative amendment to neutralise the differential impact of Irish tax law as between Islamic and conventional financial products, Islamic products which are legally distinct from their conventional alternatives would be subject to tax treatment which is unreflective of their economic effect.[351] There would thus be disparity of substantive treatment between Islamic and conventional activity occurring within Ireland's financial system,[352] something which

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[346] *Pigs Marketing Board vDonnelly* [1939] IR 413, *Cityview Press v An Chomhairle Oiliuna* [1980] IR381, *Sorin Laurentiu v Minister for Justice, Equality and Law Reform, Ireland and the Attorney General*, [2000] 1 ILRM 1 noting that; "[t]he statutory delegation of power to make regulations or orders amounts to an unconstitutional delegation of legislative power where the power so delegated is more than a mere giving effect to principles and policies which are contained in the statute itself."

[347] Revenue Commissioners, "Islamic Finance", *Tax Briefing, Issue 78*, October 2009, available at: http://www.revenue.ie/en/practitioner/tax-briefing/78/index.html#.

[348] A similar position has been adopted in the UK where these three products have not been the subject of tailored accommodation and have, rather, been incorporated into existing legal provisions, see generally, Housby, Elaine, *Islamic Financial Services in the United Kingdom*, (Edinburgh University Press, Edinburgh, 2011), at, Chapter 6, particularly at 118-119, and Chapter 7. See also, Walker, Eloise and Rowbotham, Matthew, "Shari'a Finance," (27 April 2009) *The Tax Journal*, 17, at 17, as Andrew Baird noted; "Leasing in Islamic finance is a quiet revolution and hasn't required much assistance from the government, and is also easily done within the framework of UK law and UK tax law," Baird, Andrew, "Islamic financing: Hitting the big time," (October 2007) 169 *Leasing Life*, available at: http://www.leasinglife.com/articles/article.asp?x=3289&mid=3&smid=.

[349] Revenue Commissioners, "Guidance Notes on the Tax Treatment of Islamic Financial Transactions", (Revenue, Dublin, October 2010), available at: www.revenue.ie/en/practitioner/tech.../guidance-notes-islamic-finance.pdf.

[350] *McGrath v McDermott* [1988] IR 258 at 276 per Finlay CJ, at 277 per McCarthy J who noted that the substance over form approach to determining tax liability was "attractive in equity but it is wrong in law." See also, *Inspector of Taxes v Kiernan* [1981] IR 117, *O'Sullivan v P. Ltd.* (1962) 3 IRC 355, *Revenue Commissioners v Doorley* [1933] IR 750.

[351] Revenue Commissioners, *Guidance Notes on the Tax Treatment of Islamic Financial Transactions*, note 349, at 6.

[352] Department of Finance, "Section 1 of Finance Act 2010, Report on Tax Expenditures", *PRN A10/0776*, July 2010, at [9.3], available at: www.finance.gov.ie/documents/.../reports/2010/taxexpenditure.pdf.

would, according to the Department of Finance, act as a "disincentive to such Islamic transactions occurring or being sited in Ireland."[353] Amending the taxation of certain structured products therefore, s.39 and s.137 of the Act insert into the Taxes Consolidation Act [TCA] 1997 two new provisions, Part 8A[354] and s.85A[355] respectively, which deal with "Specified Financial Transactions."[356] In line with the British model of accommodation, these new provisions do not specifically refer to Islamic finance. *Any* financial transaction structured in a manner which falls within the ambit of the legislation will be taxed accordingly.[357] However, the inclusion of a mandatory "opt-in" clause would suggest that in practice, the likelihood that these provisions will be relevant in non-Islamic structures is minimal.[358] Indeed, the Government has acknowledged that the measures have been designed to accommodate Islamic structures.[359]

With the intention of creating greater consistency in the taxation of Islamic and conventional financial activity,[360] this "first step"[361] with regard to facilitating Islamic finance domestically provides details on the tax position of "deposit transactions" (Islamic deposits), "credit transactions" (financing transactions), and "investment transactions" (*sukūk*).[362] As in the UK, Ireland's accommodating provisions apply to Islamic structures only to the extent that those structures are "the same in substance as conventional financial products."[363] In line with the Revenue Commissioners' policy that tax should be collected fairly,[364] the relevant provisions of the Finance Act endeavour to ensure that market participants that are in a similar position will be subject to similar tax treatment notwithstanding the religious motivations for their activity. The intended aim of the

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[353] *ibid.*

[354] Introduced by section 39 Finance Act 2010. See also, Finance Act 2010, *Explanatory Memorandum*, at 10.

[355] Inserted by section 137 Finance Act 2010.

[356] Defined in Part 8A as meaning a "credit transaction," a "deposit transaction" or an "investment transaction."

[357] See comments in the Dáil made by Deputy Mary Hanafin who noted that; "[o]nce this legislation is enacted, it will apply to any transaction coming within its terms, irrespective of whether it has been entered into by a member of the Muslim community or whether it is Sharia compliant," Hanifin, Mary, Dáil Éireann Debates, Official Report – Unrevised, March 10, 2010, Vol. 704, No. 4, at 692, available at: http://debates.oireachtas.ie/dail/2010/03/10/unrevised1.pdf.

[358] Section 267U Taxes Consolidation Act as introduced by the section 39 Finance Act 2010.

[359] Department of Finance, "Publication of Finance Act," Press Release, (4th February 2010), available at: http://www.finance.gov.ie/viewdoc.asp?DocID=6189.

[360] Department of Finance, *Islamic Finance in Ireland; An Information Note*, (Department of Finance, Dublin, March 2010), at 3.

[361] O'Halloran, Barry, "Changes to attract Islamic investment 'a first step'," *The Irish Times*, February 5, 2010, available at: http://www.irishtimes.com/newspaper/finance/2010/0205/1224263813184.html.

[362] Department of Finance, "Publication of Finance Act," Press Release, note 359, noting that the aim of the provisions was to increase the "attraction of Ireland for the development of Islamic finance."

[363] Department of Finance, *Islamic Finance in Ireland; An Information Note*, note 360, at 3.

[364] The Irish Revenue, *Role of the Revenue*, available at: http://www.revenue.ie/en/about/index.html.

provisions appears to be one of enabling Islamic finance to develop within the existing system by establishing greater equality in the legal treatment of financial products.

In reality, while a decisive step towards accommodation, the Irish provisions are not wholly satisfactory.[365] Inelegantly drafted[366] and lacking in some important details,[367] the amendments to the TCA fall short of the changes needed to ensure a genuinely level playing field between Islamic and conventional products. The October 2010 Guidance Notes brought some clarity to the area, but they too are modest in impact and at times, contradictory.[368] Compounding the problems faced by Islamic finance within Ireland's legal system, the regulation of Islamic finance products continues to remain unclear and potentially discriminatory.[369] Though Ireland has already begun to accommodate Islamic finance therefore, lessons can still be learnt from the experiences of other jurisdictions and other modes of accommodation.

4.6 Conclusion to Chapter 4

With growing global interest in Islamic finance and the lucrative nature of the industry, Ireland's accommodation of certain Islamic transactions is not a surprising development. The Tax Briefing 2009 and the Finance Act 2010 do not represent a leap in financial innovation but are rather in line with a global movement towards accommodation of *Sharī'ah*-compliant financial structures. Ireland's approach to accommodation, one of integration and the development of a level playing field, has been a widely used methodology in other countries and seeks to provide for equality of tax treatment of Islamic financial products to the extent that they are substantively comparable to conventional alternatives. This latter feature of Ireland's accommodations reflects the contemporary nature of the Islamic finance industry - noted in Chapter 3 and in the introduction to this Chapter - in which interest-based and interest-free products frequently perform the same function and produce comparable results.

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[365] Chapters 6 and 7 consider in detail the impact of these provisions.

[366] See for example, the discussion *infra.*at 236 over the extent to which ijārah wa-iqtina arrangements fall within the definitions provided for in the new provisions and *infra.*at 364and 369 highlighting the difficulties produced by the poorly defined requirement that investment certificates be "offered to the public generally."

[367] See for example, the discussion *infra.*at 242 noting the failure of the legislation to deal with stamp duty issues arising in Islamic financial activity.

[368] See for example, the discussion *infra.*at 236 in which the contradiction between what the Irish authorities state in the Guidance Notes and what is contained in the Tax Briefing 2009.

[369] Despite the Irish Prime Minister's suggestion that "Irish tax laws and financial regulations are now sharia-compliant," Edna Kenny quoted in O'Carroll, Lisa, "Ireland aims to be home of Islamic finance in Europe", note 344.

However, as the modern Islamic finance industry attempts to innovate in line with conventional finance and to emulate conventional products, the gap between the dictates of Islamic law and the economic substance of Islamic financial activity is viewed by some as increasingly problematic.[370] As noted in Chapter 3, while PLS transactions are widely venerated as the ideal form of Islamic finance, the industry has shown a preference for (though not a total dependence on) modified sale and lease-based products,[371] and transactions which only implement partial PLS.[372] Discussing the Islamic finance industry, El-Gamal noted that it consists of "various contracts [which] are bundled or unbundled, possibly using multiple steps, to synthesize the ostensibly forbidden practice"[373] and suggests that "[w]hen Islamic finance is truly Islamic, rather than profit-driven Shari'a arbitrage, it should be good finance at a good price. At that point, the industry can proudly abandon the 'Islamic' brand-name, to everyone's benefit."[374] Similarly Homoudi has criticised contemporary Islamic finance as an industry which involves "artifice."[375] Critics of the industry often suggest that genuine Islamic finance should promote justice and equity, something which they consider is difficult to do when replicating the substance of conventional, interest-based products.[376]

The resolution of this debate is beyond the scope of this thesis, particularly as the Islamic finance industry which Ireland is now moving to accommodate largely prioritises formal compliance with the dictates of Islamic law while replicating the substance of interest-based products. In addition to this, while El-Gamal and Hamoudi make valid arguments, the industry's focus on form is understandable. First, the industry is attempting

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[370] Commenting on contemporary Islamic banking and finance Khan asks "[h]ow then can these institutions certify that these practices are "Islamic" when they do nothing more than replicate, using Islamic terminology, standard, interest-based banking products?", Khan, Feisal, "How 'Islamic' is Islamic Banking?", (2010) 76, *Journal of Economic Behavior & Organization*, 805–820 at 817-818.

[371] *supra.*at 83.

[372] See for example, the diminishing *mushāraka* transaction used in Islamic real estate financing, *infra.*at 215.

[373] El-Gamal, Mahmoud, "Incoherence of Contract-Based Islamic Financial Jurisprudence in the Age of Financial Engineering", (2008) 25(4) *Wisconsin International Law Journal*, 605-623, at 616-617.

[374] El-Gamal, Mahmoud,, "Limits and Dangers of Shari'a Arbitrage," Paper presented at the Sixth Harvard University Forum on Islamic Finance; *Islamic Finance: Current Legal and Regulatory Issues*, Cambridge, Massachusetts, May 8-9, 2004. As Hassan and Lewis have noted, organisations like AAOIFI had tended to "start with objectives established in contemporary accounting thought, test them against Islamic shari'a," and "accept those that are consistent with shari'a and reject those that are not" Hassan, M.K. and Lewis, M.K., "Islamic banking: an introduction and overview", in Hassan, M.K. and Lewis, M.K. (eds.), *Handbook of Islamic Banking*, (Edward Elgar, Cheltenham, 2007), 1-17 at 11.

[375] Hamoudi, Haider Ala, "Jurisprudential Schizophrenia: On Form and Function in Islamic Finance", (2006-2007) 7 *Chicago Journal of International Law*, 605-622 at 612 and 620.

[376] Asutay, Mehmet, "Conceptualisation of the Second Best Solution in Overcoming the Social Failure of Islamic Banking and Finance: Examining the Overpowering of HomoIslamicus by Homoeconomicus", (2007) 15(2) *IIUM Journal of Economics and Management*, 167-195.

to develop products which Muslims can use as alternatives to those which involve interest, speculation and *haram* activities; both sets of products are ultimately being used to achieve the same result whether that result is the purchase of a house, the investment of funds in the financial markets or the establishment of a bank account. With the same end point, it is inevitable that the impact of the transaction on the parties will be similar both in Islamic and conventional activities. Compounding this similarity, both Islamic and conventional products must frequently function and compete within the same economic framework. Even where Islamic products are accommodated within that framework, in the absence of a fully Islamic economy, Islamic finance will still be part of a broader financial system and may need to adjust to the requirements of that system. As noted at the Second Oxford Islamic Finance Round Table, "it is a very difficult and challenging task to merge the two paradigms of conventional and Islamic finance at a time when the world is dominated by the interest-based financial system."[377] The key difficulty with Islamic structures is the unwillingness of contemporary scholars to depart from the classical contracts, with the result that Islamic products now involve complicated structures in which contracts never intended to function at such a level of complexity are being engineered into multi-layered arrangements. To move away from such structures, while still ensuring that Islamic customers are given the same financial opportunities as their conventional counterparts, would involve an overhaul of Islamic legal interpretation, something with which the industry and it is suggested, the Muslim community, may not be entirely comfortable.[378]

Second, while contemporary Islamic finance may not be striving purposefully to propagate broader social goals of Islam or the equitable distribution of wealth in society as a whole, the industry displays a noticeable (and growing) focus on ethical, morally justifiable activity. Islamic finance is undeniably profit-driven, yet it generally avoids excessive involvement in *haram* activities, it focuses on tangible assets rather than speculative and indefinable investments and it advocates a less mercenary approach to finance than has perhaps been adopted in the conventional industry.[379] These attributes alone will not create the Islamic economy discussed in Chapter 3 but they indicate that

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[377] Proceedings of the Second Oxford Islamic Finance Round Table "The Frontiers of Innovation in Islamic Finance," Oxford, April 15, 2009, (International Shari'ah Research Academy for Islamic Finance (ISRA), Kuala Lumpur, 2010), at 7.

[378] Maurer, Bill, "Form versus substance: AAOIFI projects and Islamic fundamentals in the case of sukuk", (2010) 1(1) *Journal of Islamic Accounting and Business Research*, 32-41 at 37 noting that; "if there are potential buyers, if there is a market interested in purchasing the "Islamic brand," no matter how it is couched or whether it even is in compliance with standards set by AAOIFI, such investment products will be purchased and will likely be profitable."

[379] Proceedings of the Second Oxford Islamic Finance Round Table "The Frontiers of Innovation in Islamic Finance," note 377, at 45-46.

Islamic finance today has not become disconnected from its religious underpinnings. Consistent with this conclusion, the industry has increasingly distanced itself from products which are considered by scholars to represent an abuse of the rule of permissibility.[380] The organised *tawarruq*, for example, has fallen out of favour as a product for obtaining capital due to the increasingly tenuous link between profits generated and the underlying asset on which those profits were ostensibly based.[381] As discussed in Chapter 8, a similar issue has arisen in relation to certain types of *sukūk*.[382]

The substance over form debate continues. Nevertheless, the remainder of this thesis will generally not focus on this issue and will, instead, look at the structure of Islamic finance transaction which have been developed. Consideration will be given to the extent to which certain activity may conflict with the core Islamic financial principles but such discussion will not focus on the broader social goals of Islam.

Following discussion in this Chapter of the basic methodology to accommodation Ireland is now adopting, Chapter 5 will consider whether Islamic finance *should* be provided with the legal framework needed to function in Ireland. Chapter 5 will look at economic and ideological reasons which may justify the Irish Government's recent attempts to accommodate certain Islamic finance contracts. The Chapter represents an attempt to determine the relevance, for the Irish Government and Irish market participants, of the concepts discussed in Chapters 2 and 3.

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[380] *ibid.* at 46 noting that even in contemporary Islamic finance "the additional level of *Sharī'ah* governance/control means that many of the ills of the conventional financial system, such as debt trading, naked and speculative derivatives and short selling, are avoided."

[381] The International Council of Fiqh Academy, *Resolution 179 (19/5), In Relation to Tawarruq : Its Meaning and Types (Classical Applications and Organized Tawarruq)*, in its 19th session, Sharjah, United Arab Emirates, April 26-30, 2009, Translation into English by the International Shari'ah Research Academy for Islamic Finance available at: http://www.isra.my/fatwas/topics/commercial-banking/financing/tawarruq/item/342-oic-fiqh-academy-ruled-organised-tawarruq-impermissible-in-2009.html.

[382] *infra.* at 311.

Chapter 5

Justifications for Accommodation of Islamic Finance in Ireland

5.1 Introduction

Islamic banking and finance, as the practical materialisation of *Sharī'ah* economic principles, represents a distinct aspect of the Muslim way of life.[1] Prohibitions of interest, *haram* activities, speculation and ambiguous financial dealing are discernable in the sources of Islam and, like other rules prescribed by Islamic law, have the potential to shape and guide temporal behaviour.[2] The impact of these rules has been the development of products and financial services which not only operate under a set of normative principles which is distinct from that directing conventional transactions,[3] but which are also

[1] The Muslims of Europe Charter of Values highlights the importance of Muslim's right to "practise the rites of their religion... in day-to-day affairs." (Article 18, Charter of Values, 2008). Emphasising the importance of constant adherence to Islamic principles, Sheikh Abdullah noted that "[a]s Muslims, we have a duty to live according to the *Qur'an* and *Sunnah* even though we may have chosen to live in non-Muslim countries. I think it is incumbent upon us to live up to this responsibility because of the effect of western influences upon our children and ourselves," in Bano, Samia, "In pursuit of religious and legal diversity – a response to the Archbishop of Canterbury and the 'Sharia debate' in Britain", (2008) *Ecclesiastical Law Journal*, 10(3), 283-309 at 297, Menski has noted that Islamic law has now "turned into an integral part of the lived experience and the unofficial law prevalent among Muslims," Menski, Werner F., "Muslim Law in Britain", (2001) 62 *Journal of Asian and African Studies*, 127-163 at 127. As an identifiable aspect of Islamic law, interest in which is growing internationally, Shari'ah compliant banking and finance principles should, it is proposed, be included within this statement. See also the comments of Shahzad Ahmed, Appendix 7, *infra.* at 468, noting that: "I do not however believe that economics and religion should be kept separate. A Muslim's entire life revolves around his faith i.e. his religion i.e., his deen: his way of life. Islam...is a complete code of life which includes all aspects of a Muslim individual's life: politics, economics, society etc"

[2] Wehrey, Karaski, Theodore, Strom, Steven, "*Islamic Finance in a Global Context*: *Opportunities and Challenges*", (2006-2007) 7(2) *Chicago Journal of International Law,* 379–396 at 381.

[3] Vogel, Frank E., "Islamic Finance; Personal and Enterprise Banking", in *La Banca Islamica e la Disciplina Bancairia Europea*, Gabriella Gimigliano and Gennaro Rotondo (eds.), (Giuffre Editore, Naples, 2006), 53-77 at 75.

structurally distinct in order to comply with those principles. This presents Governments with the task of determining how Islamic products should be treated by the legal system of their country. As discussed in Chapter 4, different methodologies have been implemented by national authorities to facilitate the development or functioning of national Islamic finance industries. The Tax Briefing 2009 and the relevant provisions of the Finance Act 2010 represent Ireland's (potentially initial) attempts to address the legal treatment of Islamic financial activity under Irish law. Ireland, like the UK, has adopted the integrationist approach in which legislative adjustments are made to draw Islamic products into the existing legal framework and to create a level playing field between the legal treatment of conventional and economically comparable Islamic transactions.

Adopting a particular methodology to accommodation does not answer the question raised in the introduction to this thesis as to *why* Ireland should attempt to facilitate Islamic finance. The publication of guidelines, the reform of legislation and the modification of existing infrastructure specifically[4] to accommodate financial transactions structured to ensure religious compliance could be interpreted as privileging one sector of the market and prioritising one religion.[5] Indeed, in the US case of *Murray v Geithner*,[6] the provision of a Government credit facility to the insurance company, AIG, was challenged as establishing religion (Islam) on the basis that AIG was involved in Islamic financial transactions.[7] This Chapter will consider potential justifications for the Irish Government's recent interest in the Islamic finance industry, current and any future measures adopted to facilitate Islamic finance activity in Ireland. Building upon statements made by the Irish Government itself (5.2),[8] this Chapter will look at two distinct rationales for accommodation: first, the economic benefits for Ireland which may result from the

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[4] As noted in Chapter 4, *supra.*at 143, the Irish Government has explicitly acknowledged that section 39 of the Finance Act 2010 was introduced to facilitate Islamic finance in Ireland, Department of Finance, "Publication of Finance Act," Press Release, (4th February 2010), available at: http://www.finance.gov.ie/viewdoc.asp?DocID=6189.

[5] Freudenberg, Brett and Nathie, Mahmood, "The Constitution and Islam: Are Tax Reforms Possible To Facilitate Islamic Finance?", (2010) 20(1) *Revenue Law Journal*, Article 5, at 2, available at: http://epublications.bond.edu.au/rlj/vol20/iss1/5 who raise a similar question in relation to Islamic finance in Australia, Ilias, Shayerah, *Islamic Finance: Overview and Policy Concerns*, (CRS Report for Congress, Washington DC, 2010), at 7, available at: http://www.fas.org/sgp/crs/misc/RS22931.pdf

[6] *Murray v. Geithner* et al., Civil Action No. 08-15147, United States District Court for the Eastern District of. Michigan, slip op., (January 14, 2011).

[7] *Murray v Geithner* et al., 624 F.Supp.2d 667 (2009), at 675 in which the plaintiff suggested that "appropriated funds [to AIG] are being used to finance Sharia-based Islamic religious activities in violation of the Establishment Clause." See also *Murray v. Geithner* et al., Civil Action No. 08-15147, United States District Court for the Eastern District of. Michigan, slip op.(January 14, 2011). The court rejected the plaintiff's claim.

[8] *infra.*at 152.

development of an Irish Islamic finance industry (5.3)[9] and second, the constitutional protection of religious free-practice (5.4).[10] It will be demonstrated in this Chapter that there are legitimate reasons for accommodating wholesale and retail Islamic finance in Ireland although it is unlikely that the Government will be legally obliged to undertake such accommodation. This Chapter will also address the appropriateness of Ireland's "integrationist" approach to accommodation (5.5).[11]

5.2 Potential Justifications Articulated by the Irish Government

The rationale relied on by the Irish Government to justify facilitation of Islamic finance is not clear from the Tax Briefing 2009[12] or the Finance Act 2010.[13] Government discussion of Islamic finance in Ireland has also frequently focused on the fact that modifications were justified in order to provide a level playing field between conventional and Islamic structures[14] without outlining why such equality is needed in the first place.

The Department of Finance has outlined "opportunities" for Ireland which may arise as a result of integrating Islamic finance into the Irish legal system: first, encouraging investment into Ireland in the form of wholesale Islamic financial activity and the establishment of Islamic finance institutions, second, the provision of ethical investment opportunities for Irish investors, and finally, the opportunity for Muslims to participate in the financial sector in a manner which is consistent with their religious beliefs.[15] These perceived benefits for Ireland, which can be broken down into to economic benefits associated primarily with wholesale products and the social benefit of Islamic finance, are comparable to the rationales outlined in some other non-Islamic jurisdictions as the basis for integrating Islamic finance. As will be demonstrated in the following paragraphs, the extent to which a State prioritises between these benefits will determine the kind of Islamic financial products which that State decides to facilitate.

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[9] *infra.*at 154.
[10] *infra.*at 173.
[11] *infra.*at 195.
[12] Revenue Commissioners, "Islamic Finance", *Tax Briefing, Issue 78*, October 2009, available at: http://www.revenue.ie/en/practitioner/tax-briefing/78/index.html#.
[13] Finance Act 2010 (Number 5 of 2010).
[14] Revenue Commissioners, "Guidance Notes on the Tax Treatment of Islamic Financial Transactions", (Revenue, Dublin, October 2010), at 6, available at: www.revenue.ie/en/practitioner/tech.../guidance-notes-islamic-finance.pdf.
[15] Department of Finance, *Islamic Finance in Ireland; An Information Note*, (Department of Finance, Dublin, March 2010), at 4.

As was discussed in Chapter 4,[16] the UK Government has suggested both social inclusion and attracting investment into the UK economy, as key motivations behind official support for Islamic finance.[17] Similarly, the Australian Government has noted that the accommodation of Islamic finance within Australian laws could provide a mechanism for encouraging wholesale, international investment into the Australian economy and for enabling Muslims in Australia to "access products that may be more consistent with their principles and beliefs," potentially fostering greater social inclusion.[18] Like the UK, Australia has sought to balance its focus in relation to Islamic finance between the wholesale and the retail sectors, despite the fact that Muslims make up just over 1.7% of Australia's total population.[19] Dutch financial authorities have also indicated both external economic and internal social justifications for integrating Islamic finance into the Netherlands' established financial system, while also stressing the need to ensure satisfactory Government oversight of financial activity.[20] In order to facilitate meaningful integration of *Sharī'ah*-compliant transactions, the Dutch Central Bank has published a report highlighting the regulatory issues which would be faced by retail and wholesale Islamic finance offered in the Netherlands.[21]

Despite wide reliance by Government authorities on this twofold justification for facilitating Islamic finance, a number of countries have focused more overtly on the wholesale Islamic finance sector and the economic benefits which are associated with it. The Singapore Monetary Authority and the Luxembourg Government, for example, have explicitly noted that their primary motivation for developing an Islamic finance industry is

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[16] *supra.* at 131.

[17] See for example McCarthy, Callum "Regulation and Islamic Finance", Speech given at the Muslim Council of Britain Islamic Finance and Trade Conference, June 13, 2006, available at: http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2006/0613_cm.shtml, HM Treasury, *The Development of Islamic Finance in the UK: The Government's Perspective*, (HM Treasury, London, 2008), at 13.

[18] Sherry, Nick, "The Future of Islamic Finance in Australia", Speech given at the Islamic Finance Conference Rendezvous Hotel, Melbourne, June 8, 2010. See also, Bowen, Chris, "Interview with Alex Symonds", *Sky Business*, January 15, 2010, available at: http://www.treasurer.gov.au/DisplayDocs.aspx?doc=transcripts/2010/003.htm&pageID=004&min=ceba&Year=&DocType=2.

[19] *Census of Population and Housing 2006*, (Australian Bureau of Statistics, Australia, 2006). See also, Department of Immigration and Citizenship, *The People of Australia, Statistics from the 2006 Census*, (Commonwealth Copyright Administration, Australia, 2008), Table 12, at 46, Freudenberg, Brett and Nathie, Mahmood, "The Constitution and Islam: Are Tax Reforms Possible To Facilitate Islamic Finance?", note 5, at 5.

[20] Wouter Bos quoted in Anonymous, "Finance Minister to Encourage Islamic Banking", *NIS News Bulletin*, July 17 2007, available at: http://www.nisnews.nl/public/170707_1.htm.

[21] Schoon, Natalie, "Islamic Finance in Continental Europe", (2009) 6(9) *Islamic Finance News*, 14-15, at 15. There remain however certain taxation hurdles for Islamic finance in the Netherlands, Muller, see, Niels and Hooft, Kees, "Cross Border Islamic Finance in The Netherlands", (2010) 7(47) *Islamic Finance News*, 14-15.

to attract international investment into their respective economies, not to provide *Sharī'ah*-compliant finance to their domestic Muslim populations.[22] Consistent with this aim, both countries have concentrated their accommodation efforts on wholesale products such as investment funds and *sukūk*.

In Ireland, the actual effect of the Government's accommodation of Islamic finance will be more one-sided than the range of products outlined in the Tax Briefing 2009 and Finance Act 2010 would suggest. In reality, most commentators have taken the view that the real ambition of the Irish Government, when accommodating Islamic finance transactions, is economic and based on the facilitation of wholesale Islamic finance in Ireland's International Financial Services Centre [IFSC].[23] Consistent with this, Ireland's Taoiseach, Enda Kenny, recently noted that "[w]e [the Irish Government] are determined to ensure that the IFSC is a Centre of Excellence for Islamic Finance and the changes in recent Finance Acts will support its development."[24] Although the provisions of the Tax Briefing 2009 and Finance Act 2010 do not restrict their application solely to wholesale Islamic finance, their immediate effect will certainly be limited to the wholesale market. This arises because no financial institution offers Islamic retail financing to customers in Ireland, Ireland's modified tax law still does not address some of the key tax problems faced by Islamic retail products[25] and Ireland has not yet dealt with the regulation of Islamic financial activity or issues of consumer protection.[26]

5.3 The Economic Benefits of Islamic Finance for Ireland

In light of the development of Islamic revivalist sentiment globally,[27] continuing dependence on oil and instability in the interest-based financial market, there are strong indications that Islamic finance may continue to strengthen both in Muslim and non-

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[22] Tee, Ong Chong, "Singapore's Perspective on Islamic Finance", Speech given at the Asian Banker Summit 2005, March 16, 2005. Luxembourg for Finance, "Luxembourg Vehicles for Islamic Finance Structures", Luxembourg: Agency for the Development of the Financial Centre, 2010, available at: www.lff.lu/fileadmin/redaction/.../Islamic_Finance_brochure_Apr10.pdf.

[23] See for example, Owens, Ken, Faughnan, Enda Thompson, Yvonne and Khan, Omer, "Ireland's new Finance Bill", (PriceWaterhouseCoopers, Dublin, 2010). See also, comments made at The Irish Banking Federation, *Islamic Finance Seminar*, Clarion Hotel, IFSC, Dublin 1, June 10, 2010.

[24] Kenny, Enda, "Speech given at the IFIA Annual Conference", Dublin, June 2, 2011, available at: http://www.merrionstreet.ie/index.php/2011/06/speech-by-the-taoiseach-mr-enda-kenny-t-d-to-the-ifia-annual-conference/?cat=11.

[25] *infra.*at 241

[26] *infra.*at 246. Department of Finance, "Section 1 of Finance Act 2010, Report on Tax Expenditures", *PRN A10/0776*, (July 2010), available at: www.finance.gov.ie/documents/.../reports/2010/taxexpenditure.pdf.

[27] *supra.*at 65.

Muslim countries.[28] Despite remaining a niche segment of the global financial market,[29] Islamic finance could offer economic benefits for Ireland's economy by attracting investment from abroad and by mobilising funds internally. This former aspect appears to be the primary basis for the Irish Government's interest in the sector and explains the focus of the accommodation on wholesale Islamic products; as former Minister of Finance Brian Lenihan noted, it is "common sense for us to [accommodate] Sharia financial transactions in our financial arrangements as an incentive to attract investment into the country" with such accommodation applying "in the context of the attraction of investment in the IFSC."[30] This section will consider a number of potential economic effects of Islamic finance in Ireland. It will look first at the potential for international Islamic investment and wholesale Islamic finance activity in the Irish economy (5.3.1).[31] It will then outline benefits which may arise from the Islamic finance industry as an ethical alternative to conventional financing (5.3.2).[32] Finally it will consider the economic aspects of retail-level Islamic finance in Ireland (5.3.3).[33] This section concludes that the Islamic finance industry may bring a variety of economic benefits to Ireland. Particularly in light of Ireland's current economic difficulties, these benefits could justify accommodation of Islamic finance activity in Irish law (5.3.4).[34]

Analysis of statistical data concerning the growth and economics of Islamic finance is beyond the scope of this thesis and so economic issues will be considered from a more general perspective.

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[28] Chapra, Muhammad Umer, "The Global Financial Crisis: Can Islamic Finance help Minimize the Severity and Frequency of such a Crisis in the Future?", Paper presented at the Forum on the Global Financial Crisis, Islamic Development Bank, Jeddah, Saudi Arabia, October 25, 2008, available at: http://www.isdbforum.org/presentationPapers/5-M_Umer_Chapra.pdf, Solé, Juan, "Introducing Islamic Banks into Conventional Banking Systems", IMF Working Paper WP/07/175 at 3, Wilson, Scott B., "Islamic Finance – Origins, Emergence, and Future", (September 18, 2007) *The Illinois Business Law Journal*, available at: http://iblsjournal.typepad.com/illinois_business_law_soc/2007/09/islamic-finance.html, Power, Carly, "Faith in the Market", (January/February 2009) 170 *Foreign Policy*, 70-75 at 72.

[29] Townsend, Mark, "Gulf and Asian Centers Battle Over Islamic Finance", (July 13, 2010) *Institutional Investor*, available at: http://www.institutionalinvestor.com/Article/2629757/Asset-Management/Gulf-and-Asian-Centers-Battle-Over-Islamic-Finance.html?ArticleId=2629757.

[30] Lenihan, Brian, *Dáil Éireann Debates*, "Official Report – Unrevised", March 10, 2010, Vol. 704, No. 4, at 716-717, available at: http://debates.oireachtas.ie/dail/2010/03/10/unrevised1.pdf. See also, Department of Finance, *Islamic Finance in Ireland; An Information Note*, note 15, at 4.

[31] *infra.* at 156.

[32] *infra.* at 161.

[33] *infra.* at 168.

[34] *infra.* at 172.

5.3.1 International Involvement and Wholesale Activity in the Irish Economy

Internationally, the contemporary Islamic financial sector has seen rapid growth both in terms of size and complexity and now offers investors an additional asset class in which they can invest.[35] Supporting this growth, continued liquidity in Muslim States,[36] particularly in the MENA region,[37] and an expectation that many of these economies will remain strong,[38] provides a pool of investors who may wish to invest in line with their faith.[39] However, within Muslim countries, domestic investment opportunities and sophisticated financial services are often limited, particularly in light of the still-developing nature of these markets[40] and turbulent political situations.[41] As a result, Islamic investors have looked to the West in order to channel excess liquidity in the context of established

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[35] Al-Salem, Faoud, "Size and Scope of the Islamic Finance Industry: An Analysis", (2008) 25(1) *The International Journal of Management*, 124-130 at 124. The Irish Times reports that 'Islamic equity funds alone run to about €3.5 billion worldwide,' O'Halloran, Barry, "Changes to attract Islamic investment 'a first step'", *The Irish Times*, February 5, 2010, available at: http://www.irishtimes.com/newspaper/finance/2010/0205/1224263813184.html.

[36] Freudenberg, Brett and Nathie, Mahmood, "The Constitution and Islam: Are Tax Reforms Possible To Facilitate Islamic Finance?", note 5, at 4.

[37] Casey, Michael, "Springing to Life", *The Irish Times*, June 24, 2011, available at: http://www.irishtimes.com/newspaper/innovation/2011/0624/1224299201853.html. The former Australian Minister of Trade referred to this as "petrodollar liquidity," Crean, Simon, "Landmark Islamic finance publication", Speech given at the launch of the Australian Government's booklet on *Islamic Finance*, February 12, 2010, available at: http://www.trademinister.gov.au/releases/2010/sc_100212.html.

[38] SHUAA Capital, suggests that the UAE markets will record gains of 20-25% in 2010, SHUAA Capital, *UAE Vision 2010*, (Dubai, 2010), available at: http://www.shuaacapital.ae/shuaa/Uploads/UAE%20Vision%20Book%20email%20NEW.pdf. The UAE economy is predicated to grow by 3-3.5 percent in 2011while the Minister of Economy is quoted as saying; "[w]e now feel much more optimistic about the economy," Staff Reporter, "UAE economy growth expected to reach 3.5%", *Gulf News*, May 16, 2011, available at: http://gulfnews.com/business/economy/uae-economy-growth-expected-to-reach-3-5-1.808522. Though unconfirmed, the Abu Dhabi Investment Authority, is reported to have between $500 and $800 billion worth of assets, Critchlow, Andrew, "Adia's Wounded Pride Over Citi", *Wall Street Journal*, December 18, 2009, available at: http://online.wsJcom/article/SB10001424052748704541004574599782018215974.html,

Thornton, Emily and Reed, Stanley, "Inside the Abu Dhabi Investment Authority", *Business Week*, June 6, 2008, available at: http://www.businessweek.com/globalbiz/content/jun2008/gb2008065_742165.htm, "Asset-backed insecurity - Sovereign-wealth funds", (January 19, 2008) 386(8563) *The Economist*, 71 at 71.

[39] Department of Finance, "Section 1 of Finance Act 2010, Report on Tax Expenditures", note 26, at [9.12], noting that the Gulf region in particular "is...home to large numbers of Sovereign Wealth Funds, large Regional Banks and finance houses with access to significant investment capital."

[40] Chailloux, Alexandre and Hakura, Dalia, "Systemic Liquidity Management in the UAE: Issues and Options", *IMF Working Paper, WP/09/261*, (IMF, Washington DC., 2009), available at: http://www.imf.org/external/pubs/ft/wp/2009/wp09261.pdf, Freudenberg, Brett and Nathie, Mahmood, "The Constitution and Islam: Are Tax Reforms Possible To Facilitate Islamic Finance?", note 5, at 4.

[41] See for example, Kerr, Simeon, "Banks ponder Bahrain exodus", *Financial Times*, June 8, 2011, available at: http://www.ft.com.elib.tcd.ie/cms/s/0/2e64d634-91df-11e0-b4a3-00144feab49a.html#axzz1PucPb0AX, Oakley, David, "Good Omens amid Turbulence", *Islamic Finance*, (Financial Times Special Report, London, May 12, 2011), 1-2 at 1, Hammond, Ed, "Construction: Investors transform UK horizon", *Islamic Finance*, (Financial Times Special Report, London, May 12, 2011), 6 at 6.

legal and financial frameworks.[42] A withdrawal of Muslim investment in the US following the US Patriot Act and the difficulty which this Act imposed on foreign investment now provides European jurisdictions with an opportunity to attract such funds into their economies.[43] The UK has already been successful in attracting international Islamic investments into projects funded in a *Sharī'ah*-compliant manner,[44] with the role played by Islamic finance described as "not only supporting, but defining a new era in the UK construction and property industry."[45] As an English speaking, eurozone country, Ireland could benefit from the continuing expansion of the Islamic finance market. Commenting on this potential for wholesale Islamic finance activity in Ireland, the Irish Government has noted the "significant opportunities for investment"[46] which are now available "provided the necessary framework is in place for Islamic financial products."[47]

One commentator has suggested that Ireland's recent legislative adjustments in relation to Islamic finance may give Ireland "first-mover advantage"[48] in attracting international Islamic investment. Such a statement is somewhat exaggerated. First, while the scope of Ireland's accommodations is relatively ambitious in theory, it is not entirely comprehensive and fails to deal with a number of tax and regulatory issues.[49] Second, Ireland is not the first, or even one of the first, Western jurisdiction to address the unique characteristics of Islamic finance. Simply as a means of maintaining economic competitiveness with other jurisdictions, the accommodation of Islamic finance appears legitimate. As Western countries move to facilitate Islamic finance within their economies, the ineffective accommodation of this sector within Ireland's regulatory and tax systems could result in

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[42] Between 1998 and 2006, Middle East based equity funds invested $6.5 billion globally, while Moody's Investors Service has predicted that the global Islamic finance industry could reach $4 trillion by 2014, Power, Carly, "Faith in the Market", note 28, at 72.

[43] Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 (USA Patriot Act), Pub L No 107-56, 115 Stat 272, Abdel-Khaleq, Ayman H. and Richardson, Christopher F., "New Horizons for Islamic Securities: Emerging Trends in *Sukuk* Offerings", (2007) 7(2), *Chicago Journal of International Law*, 409-425, at 419, Buchanan, Emily and Solanki, Bhasker, "The Steady rise of Islamic Finance", *BBC News*, September 23, 2009, available at: http://news.bbc.co.uk/2/hi/uk_news/8270490.stm, Power, Carly, Faith in the Market, "Faith in the Market", note 28, at 72, Buiter, Willem, "The intrinsic unimportance of Dubai World and the important wider message it conveys", *Financial Times*, November 29, 2009, available at: http://blogs.ft.com/maverecon/2009/11/the-intrinsic-unimportance-of-dubai-world-and-the-important-wider-message-it-conveys/.

[44] The Shard in London for example, which will be the tallest building in the EU, has been partially funded by Qatari funds using *Sharī'ah*-compliant financial structures. Hammond, Ed, "Construction: Investors transform UK horizon", note 41, at 6.

[45] *ibid.*, at 6.

[46] Irish Department of Finance, *Islamic Finance in Ireland; An Information Note*, note 15, at 4.

[47] *ibid.*, at 4.

[48] Ken Owens, quoted in O'Carroll, Lisa, "Ireland aims to be home of Islamic finance in Europe", *The Guardian*, June 2, 2011, available at: http://www.guardian.co.uk/business/2011/jun/02/ireland-Islamic-finance.

[49] Both of which will be considered *infra.* in Chapters 7 and 9.

Ireland being left behind in terms of innovation and availability of financial services. By moving to eliminate obstacles faced by Islamic finance therefore, Ireland is attempting to diversify its financial system in line with measures already adopted in other countries and a growing global interest in Islamic finance.

While Ireland may not have "first-mover advantage" by accommodating Islamic finance, legislative reform already implemented and accommodations introduced in the future may nevertheless allow the Irish economy to compete for Muslim capital on a more equal footing with those countries that have already established a regulatory and fiscal regime tailored to include Islamic finance transactions. Such accommodation would also allow Ireland to differentiate itself from remaining countries which have not yet taken such positive measures. Accommodation of Islamic finance and the development of an amenable and level playing field for financial products could open up Ireland's economy as an available and viable investment destination for international market participants, both individual and institutional, who are interested in diversifying their financial portfolios in a manner which is compatible with the principles of Islamic law. [50] It may also encourage the establishment in Ireland of financial institutions offering financial services which are promoted internationally to Islamic market participants.[51] Indeed, in amending the tax legislation to accommodate some Islamic financial products, the Department of Finance noted that such a move was designed "to boost the Republic's attractiveness to Islamic financial services."[52]

Indicative of the country's potential as a destination for Islamic investment and financial activity, Ireland is already the jurisdiction of domicile or management for 20% of the

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[50] Kettell, Brian, "The Last Word", (2008) 6(2) Number 17, *Islamic Banking & Finance*, 29-30 at 29, Williams, David, "Islamic Bonds (Sukuk); Ireland is well positioned to emerge as a prime hub for Islamic finance in Europe", *LK Shields Publications*, (Dublin, September 2008), available at: http://www.lkshields.ie/htmdocs/publications/pub283.htm. A similar justification was given for the introduction of accommodating legislation in the state of New York where State Senator Kevin Parker has proposed a Bill to accommodate *sukūk*. One of the justifications for the accommodation presented to the New York Senate was that "[c]reating more inclusive forms of state financial opportunities would also broaden the streams of capital available to the state, lowering the cost of financing and once again involving the world's investors in the development of our state's economy," A5836-2011: Relates to alternative investment bonds, March 2, 2011, available at: http://open.nysenate.gov/legislation/bill/A5836-2011.

[51] This basis was explicitly acknowledged by the Department of Finance, Irish Department of Finance, *Islamic Finance in Ireland; An Information Note*, note 15, at 4, Ainley, Michael, Mashayekhi, Ali, Hicks, Robert, Rahman, Arshadur and Ravalia, Ali, *Islamic Finance in the UK: Regulation and Challenges*, (Financial Services Authority, London, 2007), at 24.

[52] O'Halloran, Barry, "Changes to attract Islamic investment 'a first step'", note 35, Parker, Mushtak, "Ireland presses on with Islamic finance tax neutrality laws", *Arab News*, November 21, 2010, available at: http://arabnews.com/economy/article197574.ece.

Islamic funds marketed outside the Middle East.[53] Ireland's favourable taxation environment for financial services has no doubt been a key catalyst in the growth of the domestic Islamic funds industry.[54] As noted in Chapter 1,[55] such funds have required no tailored legislative accommodation in order to operate within Ireland and so the issuers and investors in these Islamic funds have been able to take advantage of the same tax regime as their conventional counterparts. For those Islamic products which *do* require positive accommodation within Ireland's laws, tailored legislative reform would allow such products to be regulated and taxed in a manner comparable to conventional structures; Ireland would be able to compete for Islamic investments on the same basis that it currently competes for those which are non-Islamic. In light of Ireland's low corporation tax, certain fiscal advantages offered to non-resident companies carrying out business in Ireland and the growing number of double tax treaties which Ireland has concluded with Muslim states,[56] the removal of legal burdens faced by Islamic finance could eliminate a disadvantageous aspect of Ireland's laws and present the country as a financially viable destination for international Islamic transactions and investment.[57]

Finally, positive steps by the Irish authorities to remove obstacles faced by Islamic financial activity may provide Irish companies, and even the Irish State, with an alternative means of raising capital.[58] In 2008, Dublin-based Blue Ocean Wireless obtained a $25

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[53] For example; The Islamic Euro Liquidity Fund, The Islamic Sterling Liquidity Fund and The Islamic US Dollar Liquidity Fund were authorised by the Central Bank in September 2010 while numerous other funds such as Oasis Crescent Global Equity Fund, DWS Noor Islamic Funds plc, SEI Islamic Investments Fund plc, The Concord Islamic US Equities Fund and The SEI Islamic US Equity Fund have all already been authorised.

[54] Owens, Ken and Khan, Omer, *Shariah-compliant Funds in Ireland*, (Dublin, PriceWaterhouseCoopers, 2008), at 11, available at: http://download.pwc.com/ie/pubs/shariah_funds_march09.pdf, Wong, Raphael, "At the end of the rainbow lies … Islamic finance", (2009) 6(43) *Islamic Finance News*, 15 at 15. The Revenue has confirmed that Islamic funds will be subject to the same tax regime as their conventional equivalents. As a result, as long as Islamic funds are structured so that they fall within Chapter 1A, Part 27 of the TCA a gross-roll-up taxation regime will be applied eliminating annual tax on the profits of the fund but requiring the fund to deduct and account for tax when unit holders are paid (Chapter 1A Part 27, Taxes Consolidation Act 1997, 2008 version). This regime is nevertheless particularly advantageous for Islamic funds as no tax will need to be deducted if the unit holder is a non-Irish resident or if they are classified as one of the exempt Irish domiciled entities. Though domiciled in Ireland, Islamic funds are frequently marketed to investors abroad. As a result, the existence of a straightforward and favourable tax regime represents a significant advantage for Irish Islamic funds, Revenue Technical Guidelines, "Investment Undertakings, General Guidelines for Calculating Tax Due and for Completing Declaration Forms", at 7-8, available at: www.revenue.ie/en/tax/it/forms/funds1.doc.

[55] *supra.*at 9.

[56] Kenny, Enda, "Speech given at the IFIA Annual Conference", note 24. Ireland has signed double tax treaties with 63 countries (55 are in effect), including Malaysia, Bahrain, Kuwait and the UAE (all brought into force February 2011). Treaties have also been signed with Pakistan and Turkey and a treaty Saudi Arabia is "expected to be signed shortly," Revenue Commissioners, Tax Treaties, available at: http://www.revenue.ie/en/practitioner/law/tax-treaties.html.

[57] Wong, Raphael, "At the end of the rainbow lies … Islamic finance", note 54, at 15.

[58] Parker, Mushtak, "Ireland presses on with Islamic finance tax neutrality laws", note 52.

million *Sharī'ah*-compliant credit facility from Bank of London and the Middle East [BLME].[59] Funded by Gulf investors through the UK regulated bank, the facility was provided under English rather than Irish law. Nevertheless, this transaction could highlight a broader interest within Ireland for alternative sources of finance.[60] While these companies may of course use Islamic finance as a mechanism for upholding a religious ethos, Islamic finance may be used simply as a new source of capital (regardless of its religious underpinnings).[61] In such circumstances Islamic finance could be particularly useful in difficult economic times when smaller or start-up companies fail to obtain funding through more conventional channels.[62] In relation to the Irish Government and Islamic finance, Owens and Thompson have suggested that the issue of a sovereign *sukūk* in Ireland may not only make a contribution "to Ireland's fiscal position in the future", but that Islamic finance generally "could also play a part in renewing growth in Ireland's investment management and securitisation industries."[63] As will be discussed in Chapter 7, the current accommodations made in relation to *sukūk* in Ireland are unlikely to be sufficient to facilitate a thriving *sukūk* industry domestically.[64] Nevertheless, further accommodation of *sukūk* structures and the issue of a sovereign *sukūk* may provide the Government with a source of funding and contribute to the Government's goal of fostering Islamic finance. An Irish Government *sukūk* may also establish a benchmark for Islamic debt issuances thereby providing a pricing guide for future *sukūk* issues in Ireland.[65] Following the UK Government's decision not to issue a sovereign *sukūk* and instead to

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[59] Details on this facility are limited, however it is discussed in Grose, Thomas K., "The Rise of Islamic Banking in a Time of Economic Crisis", *US News*, December 10, 2008, available at: http://www.usnews.com/news/world/articles/2008/12/10/the-rise-of-Islamic-banking-in-a-time-of-economic-crisis.

[60] Parker suggests that Islamic finance in a non-Islamic country may be an "attractive and competitive alternative way of raising funds and therefore a tool to diversify sources of funding." Parker, Mushtak, "Fragile sukuk market clamors for sovereign issuances", *Arab News*, May 22, 2011, available at: http://arabnews.com/economy/Islamicfinance/article422352.ece.

[61] In the UK, Peterborough Garden Park, used Islamic finance (through BLME) to develop one of its garden centres. The company was "attracted by the competitive financing on offer rather than for religious reasons," Oakley, David, "System popular with steel makers, garden centres and luxury gift groups", *Financial Times*, November 10, 2008, available at: http://www.ft.com/intl/cms/s/0/5200958a-aec8-11dd-b621-000077b07658.html#axzz1UNcjojn4, Edible Arrangements International, a US company also obtained Islamic working capital facility provided by Bank of London and The Middle East. McMillen, notes the use of *Shari'ah*-compliant structure involved the Maconda Park Apartments, a residential housing development in the Austin, Texas, McMillen, Michael JT., "Special US Report: Briefing: Islamic Finance: Breaking the Mould", (2000) 44(38) *Middle East Economic Digest*, 28-29.

[62] Wong, Raphael, "At the end of the rainbow lies … Islamic finance", note 54, at 15.

[63] Owens, Kevin and Thompson, Yvonne, "Sovereign Sukuk - A Way to Revive the Celtic Tiger?", (2011) 43(2) *Accountancy Ireland*, 34-36 at 36.

[64] *infra.* at 349(taxation) and 373 (regulation) noting hurdles which face the *sukūk* industry in Ireland.

[65] Wilson, Rodney, "Islamic Finance in Europe", *RSCAS Policy Papers 2007/02 Musmine-Muslim Minorities in Europe*, (European University Institute, Robert Schuman Centre for Advanced Studies, Florence, 2007), at 7.

"focus on economic growth,"[66] other Governments may now be reluctant to issue *sukūk*. On the other hand, the decision may also give a non-Islamic country, such as Ireland, an opportunity to consider the viability of a sovereign *sukūk* and, perhaps, to break new ground in the international Islamic financial market.

Global economic and political factors now present Ireland with an opportunity to attract international Islamic investment from those who may otherwise have been reluctant to participate in Ireland's interest-based economy. Facilitating a regime conducive to Islamic finance activity in Ireland may bring capital into the country through Islamic transactions and institutions, while also providing Irish companies with a source of financing in addition to, or instead of, conventional means of securing capital. This deepening of Ireland's financial market would be in line with the objectives of Financial Services Ireland, which acknowledge the need to support the international marketing efforts affirming Ireland as a "premier location for international financial service."[67] It would also be consistent with the Government's goal of establishing Ireland as a "leader in innovation."[68]

5.3.2 Islamic Finance as an Ethical Alternative to Conventional Financial Activity

Attracting international, wholesale Islamic finance activity is undoubtedly the primary focus of the Irish Government when accommodating Islamic finance within Ireland's tax laws. Secondary economic benefits have also been highlighted by Irish authorities as potentially flowing from this accommodation. The first is the opportunity that Islamic finance presents as a source of ethical financial activity for Islamic and non-Islamic investors.[69]

Transactions and institutions within the Islamic financial system are often said to be guided by principles of justice, equity and fair dealing, characteristics of importance not

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[66] El Baltaji, Dana and Hall, Camilla, "U.K. Cancels Sukuk, Focus on Economic Growth: Islamic Finance", *Bloomberg*, January 17, 2011, available at: http://www.bloomberg.com/news/2011-01-16/u-k-cancels-sukuk-focus-on-economic-growth-Islamic-finance.html.

[67] Financial Services Ireland, *Objectives*, available at: http://www.fsi.ie/sectors/fsia/fsiDoclib3.nsf/vLookupHTML/About_Us_Objectives?OpenDocument.

[68] Department of Enterprise, Trade and Employment, *Innovation in Ireland 2008*, at 1, available at: http://www.entemp.ie/publications/science/innovationpolicystatement.pdf.

[69] Department of Finance, *Islamic Finance in Ireland; An Information Note*, note 15, at 4.

simply to Muslims.[70] These qualities of the Islamic finance industry may be beneficial to the Irish economy for two reasons. First, Islamic transactions and Islamic funds could represent an alternative investment opportunity for Irish investors (Muslim and non-Muslim) (A).[71] Second, Islamic finance could function as an ethical standard for the Irish financial market generally (B).[72]

A. Islamic Finance as a Responsible Investment

Directed by this moral value system of Islam, *Sharī'ah*-compliant finance encourages prudence, avoidance of certain industries and of excessive risk.[73] Increasingly, such attributes are appealing to non-Islamic investors, both as an ethical alternative to the conventional system and as a further source of portfolio diversification.[74] Inglehart has suggested that in an increasingly post-materialist society, "economic accumulation for the sake of economic stability"[75] is no longer the primary guiding factor of social activity.[76] Instead, extra-financial goals, such as environmental protection and ethics, are gaining prominence in modern societies.[77] As conventional investors become aware of their wider social responsibility, financial activities that incorporate principled criteria offer an alternative to conventional banking and finance.[78]

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[70] Ayub, Muhammad, *Understanding Islamic Finance*, (John Wiley & Sons, Ltd., West Sussex, 2007), at 12.

[71] *infra.*at 162.

[72] *infra.*at 165.

[73] Iqbal, Munawar and Molyneux, Philip, *Thirty Years of Islamic Banking; History, Performance and Prospects*, (Palgrave Macmillan, Hampshire, 2005), at 28, Novethic, *Islamic Finance and SRI: Any crossover?*, July 20, 2009, at 3, available at: http://www.responsible-investor.com/images/uploads/resources/research/11248094270Working_paper_on_Islamic_finance_and_SRI.pdf, Khorshid, Aly, "Principles win in the end", (April-May 2009) 7(2) Number 22 *Islamic Banking & Finance*, 27-29 at 27.

[74] Kettell, Brian, "The Last Word", note 50, at 29.

[75] Inglehart, Ronald F., "Changing Values among Western Publics from 1970-2006", (2008) 31(1) *West European Politics* 130-146 at 140.

[76] *ibid.*, at 140-141.

[77] *ibid.*, at 142. Berry also notes a rise in post-materialism and a growing emphasis on social issues such as environmental protection and greater social responsibility, Berry, Jeffrey M., *The new liberalism: the rising power of citizen groups*, (The Brookings Institution, Washington, DC., 1999), at 34-35. Meier acknowledges a similar growth and suggests that "[s]tandard economic theory cannot explain pro-social behaviour in a satisfying way, neither its level nor its variance", Meier, Stephan, *The Economics of Non-Selfish Behaviour: Decisions to contribute money to Public Goods*, (Edward Elgar Publishing Limited, Cheltenham, 2006), at 3.

[78] Menzies, Robin, "Sustainability Agenda – Challenges and How to Address them", (December 2008) 40(6), *Accountancy Ireland*, 39-41 at 41 noting that "companies are recognizing that their ability to generate profits may hinge in part 'upon their responses to the challenges of a carbon-constrained world and an array of other issues on the sustainability agenda…' corporate leaders now see these initiatives as investments in opportunities to operate more efficiently and secure a dependable supply chain."

While countries such as Malaysia have seen a significant interest in Islamic real estate financing by non-Muslims,[79] it is suggested that Islamic finance could particularly appeal to non-Islamic parties in Ireland in the context of ethical investing.[80] Socially responsible investment [SRI] is already a notable part of Ireland's financial system[81] and *Sharī'ah*-compliant activities can be included within this framework, providing investors with an additional ethical investment opportunity.[82] Representing more than 12% of the asset management industry in the US[83] and 17.5% of the industry in Europe,[84] SRI incorporates non-financial criteria into economic activity by considering not just the monetary implications of an investment, but also its broader social impact.[85] This investment strategy screens investments for compliance with an ethical outlook and frequently avoids involvement in "vice" industries such as alcohol, tobacco, gambling, pornography, weapons and nuclear technology.[86] SRI funds may also adopt a positive screening process by actively seeking out investments which promote environmental protection, sustainable development and human rights.[87] Whether adopting negative or positive selection

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[79] Shameen, Assif, "Islamic Banks: A Novelty No Longer", *Bloomberg Businessweek*, August 8, 2005, available at: http://www.businessweek.com/magazine/content/05_32/b3946141_mz035.htm. A similar situation has also been highlighted in a number of Gulf states, most notably Bahrain and the UAE, Mushtak, Parker, "Saudi mortgage law: Potential model for GCC", *Arab News*, May 23, 2010, available at: http://arabnews.com/economy/Islamicfinance/article56955.ece.

[80] Department of Finance, *Islamic Finance in Ireland; An Information Note*, note 15, at 4.

[81] Within Ireland there are a number of "morally aware" products and institutions such as the AIB Investment Managers, Friends First, Aviva Investors (Hibernian), KBC Asset Management, New Ireland, Merrion (Oppenheim) First Active Stewardship Fund, EBS Indexed Ethical Global Equity Fund and Bank of Ireland/New Ireland Smart Funds Ethical Equity Fund. These companies avoid investments dealing with alcohol, armaments, animal testing or pornography. Burgess, Brendan, "Ethical Investment Options for Irish investors", *Green Effects*, February 2007, available at: http://www.greeneffects.ie/Ethical%20Investment%20Accountancy%20Ireland%20Feb%2007.pdf, Leahy, John, "Socially Responsible Investing – The quest for financial return and social good", (December 2008) 40(6) *Accountancy Ireland*, 47-50, for detailed information about socially responsible investment in Ireland see, The Green Effects Fund, http://www.greeneffects.ie/press.html.

[82] Kettell, Brian, "The Last Word", note 50, at 29, Hayat, Usman, "Islamic or Ethical Finance: Where is its Future in European Retail Markets?", (2010) 177 *New Horizon Magazine*, 27-29 at 29.

[83] Bauer, Rob, Koedijk, Kees and Otten, Roger, "International evidence on ethical mutual fund performance and investment style", (2005) 29(7), *Journal of Banking and Finance* 1751-1767 at 1752.

[84] *European SRI Study 2008*, Matt Christensen and Sarah Clawson, (eds.), (Eurosif, Paris, 2008), at 10, this market has reached more than €2.5 trillion.

[85] Owens, Ken, O'Callaghan, Andy and Murphy, Declan, *Assurance Asset Management; Socially Responsible Investment (SRI) Lets think long-term*, (PriceWaterhouseCoopers, Dublin, 2009), at 1, available at: http://download.pwc.com/ie/pubs/socially_responsible_investment_lets_think_long_term.pdf, Novethic, *Islamic Finance and SRI: Any crossover?*, note 73, at 3, Lobe, Sebastian, Roithmeier, Stefan and Walkshäusl, "Christian, Vice vs. Virtue Investing", (August 7, 2009), at 1, available at SSRN: http://ssrn.com/abstract=1089827, Hylton, Maria O'Brien, "Socially Responsible Investing in an Inefficient Market: Doing Good Versus Doing Well", (1992-1993) 42 *American University Law Review* 1-52 at 5 referring to Bruyn, Severyn T., *The Field of Social Investment*, (Cambridge University Press, Cambridge, 1987), at 1, World Economic Forum Global Corporate Citizenship Initiative, *Mainstreaming Responsible Investment*, (Geneva, World Economic Forum, 2005), at 7.

[86] Statman, Meir, "Socially responsible mutual funds", (2000) 56(3), *Financial Analysts Journal,* 30-39 at 31, Lobe, Sebastian, Roithmeier, Stefan and Walkshäusl, "Christian, Vice vs. Virtue Investing", note 85 at 7.

[87] Leahy, John, "Socially Responsible Investing – The quest for financial return and social good", note 81, at 47, DiVanna, Joseph A., *Understanding Islamic Banking, The Value Proposition that Transcends Cultures*,

standards or a combination of the two, SRI ultimately aims to foster broader social good while still ensuring satisfactory monetary gain for investors.[88]

Islamic finance provides a parallel with these ethical investment products[89] and is ideally positioned to offer investors investment opportunities complying with strict moral standards.[90] The development of an Islamic financial sector within Ireland may, thus, have a dual impact on Ireland's SRI industry: not only could it facilitate the development of a range of ethically sound projects, companies and transactions in which *conventional* SRI funds can invest but it could also encourage further growth in Ireland of explicitly Islamic investment funds which manage capital in a *Sharī'ah*-compliant manner.[91] These Islamic funds would then invest in companies and activities which are compatible with Islamic law. It is suggested that the standards applied by Islamic financial funds do not necessarily have to be so overtly religious as to disenfranchise non-Islamic investors. Islam is value-oriented and avoids activities regarded as exploitative. As a result, Islamic funds may

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(Leonardo and Francis Press, Ltd, Cambridge, 2006), at 95, Mufti Barkatulla, "Ethical Fusion", (June-July 2009) 7(3) Number 23, *Islamic Banking & Finance*, 18-19 at 19.

[88] Peifer, Jared, *Socially Responsible Investing: Morality, Religion and the Market from a Sociological Perspective*, A Dissertation Presented to the Faculty of the Graduate School of Cornell University In Partial Fulfilment of the Requirements for the Degree of Doctor of Philosophy, (May 2011), at 1 in which Peifer notes that "[t]he individuals that work for religious mutual funds (whom I will call fund producers) and the individuals who invest in them, intentionally marry their financial profit motives with their religious sensibilities of purity and how the world ought to be." Peifer suggests that as many as a third of SRI funds in the US are religious. Within Ireland there are already a number of SRI funds such as the First Active Stewardship Fund, EBS Indexed Ethical Global Equity Fund and Bank of Ireland/New Ireland Smart Funds Ethical Equity Fund. Burgess, Brendan, "Ethical Investment Options for Irish investors", note 81.

[89] Kettell, Brian, "The Last Word", note 50, at 29.

[90] Like SRI, Islam screens financial activity and prohibits involvement in categories of activity regarded as immoral with most of the traditional vice stocks repeated in the context of Islamic economic activity. Novethic, *Islamic Finance and SRI: Any crossover?*, note 73, at 3. While Islam does not explicitly compel involvement in positive activities, Islamic finance is nevertheless value-oriented and avoids activities regarded as exploitative. As a result, Islamic transactions and activities may protect socially responsible concerns while avoiding irresponsible and environmentally destructive activity. Ayub, Muhammad, *Understanding Islamic Finance,* note 70, at 12-13, Warde, Ibrahim, *Islamic Finance in the Global Economy*, (Edinburgh University Press, Edinburgh, 2000), at 5, *Qur'ān* 2:188, "And do not eat up your property among yourselves for vanities, nor use it as bait for the judges, with intent that ye may eat up wrongfully and knowingly a little of (other) people's property," *Qur'ān* 4:135 "O ye who believe! stand out firmly for justice, as witnesses to God, even as against yourselves, or your parents, or your kin, and whether it be (against) rich or poor: for God can best protect both. Follow not the lusts (of your hearts), lest ye swerve, and if ye distort (justice) or decline to do justice, verily God is well-acquainted with all that ye do." The *Qur'ān* places man as vicegerent over divine creation on earth thereby preventing waste, destruction or superfluous consumption of the earth's resources and the environment which is merely held on trust for God, *Qur'ān*, 10:14, "Then We made you heirs in the land after them, to see how you would behave!" *Qur'ān*, 16:14, "It is He who has made the sea subject, that you may eat thereof flesh that is fresh and tender, and that you may extract there from ornaments to wear; and you see the ships therein that plough the waves, that you may seek (thus) of the bounty of God and that you may be grateful." The Sunnah also contains indications that wastefulness of the earth's resources is immoral; "He who cuts a lote-tree (without justification), God will send him to Hellfire," Narrated by Al-Tirmidhi, Sunan Al-Tirmidhi, Number 5239 in Islam, Muhammad Muinul, "Towards a Green Earth: An Islamic Perspective", (2004) 26(4) *Asian Affairs*, 44-89, at 85.

[91] Wilson, Rodney, "Islamic finance and ethical investment", (1997) 24(11) *International Journal of Social Economics*, 1325-1342 at 1131.

invest in a manner which protects socially responsible concerns while avoiding irresponsible and environmentally destructive activity.[92] Consequently, while investment strategies based on promoting sustainability or environmental protection may be desirable for Islamic funds as consistent with the Islamic worldview generally, they could also be of interest to non-Islamic investors as valid investment goals.[93]

Islamic financial activity may also represent an investment opportunity for conventional investors who are risk-averse, even if those investors are not investing with a view to supporting specific social goals.[94] By eschewing speculative financial behaviour and instead relying on tangible assets as a source of income, Islamic financial transactions and Islamic investment funds could stand out in the Irish financial system as a more conservative mechanism for profit generation than what has hitherto been available. As the Department of Finance has noted

> [c]onventional equity backed assets have fallen out of favour for some investors. The ethical approach and the physical nature of the traded asset in Islamic finance is an opportunity that the Irish Financial Services industry would be in a strong position to promote to Muslim and Non-Muslim clients.[95]

B. Islamic Finance as an Ethical Standard for the Financial Market

Prioritising equity, tangible assets as an underlying source of income and the avoidance of passive gain, Islamic finance has been highlighted by some commentators as offering a

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[92] Jacobs, Jennifer, "Islamic Funds Go Green", (2009) 6(19) *Islamic Finance News* 16 at 16, citing Sustainable Asset Management (SAM) as an example of an Islamic fund which could appeal to Islamic and non-Islamic investors. The fund adopted a *Sharī'ah*-compliant water-focused investment strategy.

[93] Alam, Niaz, "Islamic Finance - Issues and Opportunities", *Client Briefing Note*, (Ethical Investment Research Services, 2004), at 7, Smith, Emmanuelle, "Islamic finance: Investment strategy about more than faith", *Financial Times*, June 21, 2010, available at: http://www.ft.com/intl/cms/s/2/718145ee-7a6e-11df-9cd7-00144feabdc0.html, quoting Jo Divanna "Islamic finance is undergoing a rebranding towards western markets by reducing the use of the term Islamic or sharia and focusing instead on the concepts of ethical and green....This is not to say they are lowering their standards," he adds, but "simply redefining their image," Rahim, Haliza Abd, "Adherence to socially responsible investing within Islamic finance products", IIBI Lecture, July 1, 2010, London, available at: http://www.newhorizon-Islamicbanking.com/index.cfm?section=lectures&action=view&id=10904, noting that SRI and Islamic finance are "in fact compatible and complementary."

[94] Hoepner, Andreas G. F., Rammal, Hussain G. and Rezec, Michael, "By the Numbers: Comprehensive Study Sheds Light On Islamic Mutual Fund Performance", (2010) *Business Islamica Magazine*, available at: http://www.Islamica-me.com/article.asp?cntnt=436.

[95] Irish Department of Finance, *Islamic Finance in Ireland; An Information Note*, note 15, at 4.

more stable approach to financial activity.[96] Numerous conventional economists have also suggested that the existing capitalist regime of overreliance on risky debt and interest is unsustainable and have proposed a move towards more equitable risk allocation and distribution in economic activity.[97] Indeed a financial system notably similar to that advocated by Islamic finance's proponents was proposed by Tomlinson as a preferable model to a debt-based economy.[98] Highlighting the importance of a discernable correlation between money created and the level of assets upon which it can validly claim, Tomlinson suggests that by converting debt to equity, money handled within the banking and financial system would be based on tangible substance rather than insubstantial speculation.[99] This, Tomlinson suggests, would encourage stability within the banking and monetary system and reduce the likelihood of bank collapse.[100]

Contemporary Islamic finance methodology by itself does not represent a panacea for the perceived "evils" of capitalism[101] and integration of religiously guided principles into the Irish legal framework will not eliminate self-serving commercial activity, particularly

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[96] Hesse, Jobst and Solé note that while PLS financing may increase risk for banks and an absence of secondary markets could impact on Islamic banks' liquidity, "there are features of Islamic banks that could render them less vulnerable than conventional banks" such as the economic shock protection offered by risk-sharing, the need for Islamic banks to be more conservative and the tendency of such banks to hold larger proportions of their assets than conventional banks, Hesse, Heiko, Jobst, Andreas A., and Solé, Juan, "Trends and Challenges in Islamic Finance", (2008) 9(2) *World Economics*, 175-193 at 180-181. See also Aglionby who quoted the participants of the fifth World Islamic Economic Forum (WIEF) in Jakarta noting that virtually every speaker "lambasted the excesses of 'irresponsible, unregulated western financial markets' for triggering the crisis, and touted sharia banking as a framework for a more stable global financial system."Aglionby, John, "Islamic Banks urged to show the west the sharia way forward", *Financial Times*, March 3, 2009, available at: http://www.ft.com/intl/cms/s/0/12acd7ea-0792-11de-9294-000077b07658.html#axzz1Pzqd2kyb.

[97] Fisher, Irving, "The Debt-Deflation Theory of Great Depressions", (1933) 1, *Econometrica*, 337-357 at 341 onwards, Bernanke, Ben and Gertler, Mark, "Financial Fragility and Economic Performance", (1990) 105(1), *The Quarterly Journal of Economics*, 87-114 at 88 arguing that "[w]hen the borrower has superior information about his project, or the ability to take unobserved actions that affect the distribution of project returns, a greater incompatibility of interests increases the agency costs associated with the investment process." Stiglitz, Joseph, "The Current Economic Crisis and Lessons for Economic Theory", Presidential Lecture to the Eastern Economic Association, (2009) 35(3), *Eastern Economic Journal*, 281-296. Noting that prior to the US sub-prime crisis, "[t]here were conflicts of interest, incentives to provide distorted information, and incentives to engage in short sighted and excessively risky behavior," at 294. See also 295-296, Rogoff, Kenneth, "International Institutions for Reducing Global Financial Instability", (1999) 4(13), *Journal of Economic Perspectives*, 21-46 at 40 noting that "[i]n an ideal world equity lending and direct investment would play a much bigger role...with a better balance between debt and equity, risk-sharing would be greatly enhanced and financial crises sharply muted."

[98] Tomlinson, John, *Honest Money: A Challenge to Banking*, (Helix Editions Ltd., Oxfordshire, 1993).

[99] *ibid.*, at 100.

[100] *ibid.*, at 115.

[101] Hersh, Emily Sarah, "Islamic Finance and International Financial Regulation", (2011) *Journal of International Service*, 51-64 at 51 suggests that "[t]he need for change is undeniable, but whether Islamic finance should replace the current system is dubious."

in light of frequent substantive similarities between Islamic and conventional finance.[102] Nevertheless, there are certain aspects of the Islamic finance industry which could positively influence other financial institutions operating in Ireland. Existing as it does as the operational manifestation of extra-temporal teachings, Islamic finance should display a level of conscientiousness, imposing strict requirements of transparency, fair practice and integrity on its participants.[103] As a result of this, Kettell has noted that integrating Islamic finance into a conventional system may set an example of institutional reliability for secular market participants[104] and it is suggested that by accommodating Islamic financial principles in Ireland, a benchmark of market integrity could be established. This could have long-term benefits for Ireland, presenting it both as a secure destination for investment and as a jurisdiction adhering to best practice standards of market discipline. Indeed, even the Vatican has voiced support for the Islamic finance sector when it noted that the "[e]thical principles on which Islamic finance is based may bring banks closer to their clients and to the true spirit which should mark every financial service."[105] As the conventional financial system goes through a "process of soul searching"[106] following the global financial crisis, the accommodation of Islamic finance could also facilitate the

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[102] Despite what some commentators suggest. Chapra, Muhammad Umer, "The Global Financial Crisis: Can Islamic Finance help Minimize the Severity and Frequency of such a Crisis in the Future?", note 28.

[103] Proceedings of the Second Oxford Islamic Finance Round Table "The Frontiers of Innovation in Islamic Finance," Oxford, April 15, 2009, (International *Sharī'ah* Research Academy for Islamic Finance (ISRA), Kuala Lumpur, 2010), at 47-48. Deriving from the religious underpinning of the industry and the contemporary application of the prohibitions of *gharar* and *maysir*, precedence has been given to honesty and transparent dealing. There should therefore be no ambiguity in the nature of the transaction nor the existence and quality of the underlying asset. Condemning any uncertainty regarding the central aspects of a transaction the Prophet is reported to have passed a man selling grain. See, *Sahih Bukhari*, Volume 3, Book 50, Number 887, Narrated Abu Huraira: "Allah's Apostle forbade (1) the meeting of the caravan (of goods) on the way, (2) and that a residing person buys for a bedouin, (3) and that a woman stipulates the divorce of the wife of the would-be husband, (4) and that a man tries to cause the cancellation of a bargain concluded by another. He also forbade An-Najsh and *that one withholds the milk in the udder of the animal so that he may deceive people on selling it*." (emphasis added). See also: *Sahih Bukhari*, Volume 3, Book 34, Number 360, M. Muhsin Khan (trans.), available at: http://www.usc.edu/schools/college/crcc/engagement/resources/texts/muslim/hadith/bukhari/. See also, Ayub, Muhammad, *Understanding Islamic Finance*, note 70, at 67. When applied to *Sharī'ah*-compliant transactions, this tradition imposes a requirement that all parties give full disclosure; any transaction in which one party fails to divulge relevant information involves *gharar* and falls short of the ethical paradigm set by the Prophet. The Prophet is also reported to have said that "The truthful and honest merchant shall be with the prophets," Narrated by Abu Issa Muhammad bin Issa, *Sahih Tirmidhi*, Number 2796, cited in Iqbal, Zafar, "Contemplating an Islamic Theory of Justice: Situating Tradition Amidst Modernity", (2006) 10(1) *Review of Islamic Economics*, 91-121 at fn 10, Ayub, Muhammad, *Understanding Islamic Finance*, note 70, at 65. *Supra.* at 49.

[104] Kettell, Brian, "The Last Word", note 50, at 30.

[105] Napoleoni, Loretta and Segre, Claudia, "Dalla finanza Islamica proposte e idee per l'Occidente in crisis," (4th March 2009), l'Osservatore Romano, available at: http://rassegnastampa.mef.gov.it/mefnazionale/PDF/2009/2009-03-04/2009030412006886.pdf. Original Italian text translation into English, Adrienne Strubb.

[106] Proceedings of the Second Oxford Islamic Finance Round Table "The Frontiers of Innovation in Islamic Finance," note 103, at 47.

Department of Finance's strategy of restructuring Ireland's banking market into one which is consistent with "prudent and responsible banking practice."[107]

5.3.3 Mobilisation of Muslim Funds within Ireland

The final economic impact which Islamic finance may have on the Irish economy is at retail-level through the mobilisation of savings of Ireland's domestic Muslim population.[108] The mobilisation of Muslim funds within Ireland is considered last in the economic justification section of this Chapter because in and of itself, the economic benefits of facilitating retail-level Islamic finance in Ireland may not be sufficient to encourage the accommodation of this financial sector.[109] However, when considered in conjunction with the constitutional justifications for accommodation (discussed in the Section 5.4),[110] the additional income which may be generated for the State through retail Islamic finance in Ireland could justify reconsideration by Irish taxation and regulatory authorities of the current lack of access to retail-level *Sharī'ah*-compliant financial instruments.[111]

There were 32,539 Muslims living in the Republic according to the 2006 Census, an increase of almost 70% since 2002.[112] However, a mixed message emerges as regards the potential size of an Islamic retail market in Ireland. In a report on the Finance Act 2010, Ireland's Department of Finance noted that "while there have been some indications that [Ireland's Muslim community] would like to see Islamic mortgages offered by banks, there is no evidence of any strong demand for retail financial products as yet."[113] A subsequent

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[107] Steering Group on Financial Inclusion, *Strategy for Financial Inclusion Final Report,* (Department of Finance, Dublin, 2011), at [1.2] available at: http://www.finance.gov.ie/documents/publications/reports/2011/Fininclusreport2011.pdf.

[108] Kettell, Brian, "The Last Word", note 50, at 29.

[109] Visser notes that "[o]bviously, there is a demand for Islamic financial products, otherwise there would be no Islamic financial institutions, at least not in countries where people have a choice between Islamic and conventional banks," however, while he acknowledges the difficulty faced when trying to obtain reliable information on retail-level Islamic financial activity, he suggests that; "Surveys on the demand for Islamic financial instruments do not always give the impression that the Muslim population can't wait a day longer for Islamic finance to become available," Visser, Hans, *Islamic finance: Principles and Practice*, (Edward Elgar Publishing Limited, Cheltenham, 2009), at 141-142.

[110] *infra.*at 173.

[111] An argument also used by New York where State Senator Kevin Parker when seeking accommodation for Islamic financial activity in New York law, A5836-2011: Relates to alternative investment bonds, note 50.

[112] "Census 2006 (Ireland), A Census of Population was taken on the night of Sunday, 23 April 2006", *Principal Demographic Results*, Irish Central Statistics Office, available at: http://www.cso.ie/census/documents/Amended%20Final%20Principal%20Demographic%20Results%202006.pdf. Informal estimates now place the domestic Muslim population at approximately 50,000 or 1% of the population of the Republic of Ireland. Appendix 8 *infra.* at 472.

[113] Department of Finance, "Section 1 of Finance Act 2010, Report on Tax Expenditures", note 26, at [9.15].

information note also published by the Department of Finance adopted a somewhat more positive tone, stating that the Muslim community in Ireland has "indicated a demand for Shari'a compliant finance."[114] It is suggested that there is, in fact, a greater interest in Islamic retail finance than the Government has acknowledged. Anecdotal evidence suggests that Muslims in Ireland are interested in using retail-level Islamic products, particularly in order to meet their real property needs,[115] while an informal study indicates a strong awareness amongst Muslims of the lack of such products in Irish financial institutions.[116] At small business level too, there appears to be support amongst Muslims for the introduction of Islamic finance with one survey indicating that of the Muslim entrepreneurs in Ireland that were interviewed, 90% saw a domestic need for *Sharī'ah*-compliant financial products.[117] Finally, in 2011, the Irish Islamic Chamber of Commerce began functioning in Dublin. While the first objective of this group is to "[p]romote bilateral trade and cross investments between Ireland and Muslim countries," suggesting that the goals of the group are in line with the objectives of the Irish Government when facilitating Islamic finance, its second and third goals are to "[p]romote and enhance compliance with Islamic business and financial practices in Ireland"[118] and to "[p]romote and develop [the] contribution of [the] Muslim community in the Irish economy."[119] Both of these latter goals suggest active moves by the Irish Muslim community to foster domestic, and even retail-level, Islamic finance activity.

Expressions of interest in Islamic finance and the establishment of groups to promote Irish Islamic finance do not automatically translate into a market for such financial

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[114] Department of Finance, *Islamic Finance in Ireland; An Information Note*, note 15, at 4. Lenihan, Brian, *Dáil Éireann Debates*, "Official Report – Unrevised", note 30, at 717, noted a similar uncertainty as regards the needs of Ireland's Muslims when he noted that; "I have discussed this matter with many of my Islamic constituents. Quite a few of them are quite content with the arrangements they are in a position to enter into with various Irish financial institutions, or at least as satisfied as any of us can be with such institutions these days. They have a preference for the arrangements they choose and do not feel conscientiously constrained. Some, however, do feel conscientiously constrained and it is important to address their concerns."

[115] Correspondence with Shahzad Ahmed (Appendix 7, infra. at 468). Interview with Ali Selim, Former Secretary of the Irish Council of Imams, conducted at Clonskeagh Mosque, March 20th 2010. See also, Fitzgerald, Mary "Call for sharia-compliant finance services in Ireland", *The Irish Time*, May 30, 2008, Consultative Consumer Panel for the Central Bank, Minutes of meeting of the 14th January` 2008,at [7] noting the lack of Islamic mortgage equivalents in Ireland limits migrants access to financial services.

[116] Ibrahim, Vivian and Richardson, Edana, UCC Project Survey, conducted as part of "The history of Islam in Ireland" project at University College Cork, April 2010. Appendix 8, *infra.* at 472.

[117] Gartland, Fiona, "Muslim entrepreneurs need access to Sharia-friendly financial products", *The Irish Times*, October 7 2010. See also, Cooney, Thomas M., Manning, Jennifer, Arisha, Amr and Smyth, Peter, *Muslim Entrepreneurship in Ireland*, (DIT, Dublin, May 2011), at [1.3.3].

[118] ICC Press Release, April 6, 2011, at 1, available at: http://Islamic-chamber.org/wp-content/uploads/2011/04/IICC-Formation-06_04_2011.pdf.

[119] *ibid.*

services.[120] However, they represent an increasingly strong body of evidence that if such services were made available in Ireland they would not go unused. International evidence suggests that there is a retail market for Islamic banking and financial services, even in non-Muslim countries.[121] Financial institutions in the US have responded to demands by Muslims for Islamic finance products with numerous institutions now offering *Sharī'ah*-compliant choices for home and car purchase, business financing and insurance.[122] In the UK, high street banks offer a range of Islamic products to Britain's Muslims with one commentator even suggesting that, "[t]he reality is that the demand for Islamic finance products has always been there but the supply has not."[123] In 2004 a survey suggested that only 5% of UK Muslims were seriously interested in Islamic finance while another 23% would be interested in Islamic financial services if these were comparable in price with conventional products.[124] Notwithstanding this finding, since 2004, the Islamic finance services available to UK Muslims have increased noticeably, suggesting that there is a retail market for Islamic finance, at least in the UK.[125] The fact that the 2010 termination by Lloyds TSB of its Islamic mortgage-alternative offerings[126] has been attributed to the withdrawal of its foreign underwriter, rather than any distinct lack of demand for these products,[127] would also appear to support this argument.[128] Indeed, for Wilson, Islamic

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[120] Dar, Humayon A, "Islamic House Financing in the United Kingdom: Problems, Challenges and Prospects", (2002) 12 *Review of Islamic Economics*, 47-71 at 48 suggesting that "[a]rguably, the Muslim population in the UK has shown strong *desire* for Islamic banking and finance, but it is not a simple matter to infer from that an *effective demand* for any Islamic financial product," (emphasis in original).

[121] Peters, Hans, "Islamic finance needs retail push: Ernst & Young", *Reuters*, February 18, 2010, available at: http://www.reuters.com/article/2010/02/18/us-Islamicbanking-summit-retail-idUSTRE61H3JY20100218

[122] Goud, Blake, *Islamic Finance in North America 2009*, (Yasaar Media, Dubai, 2009), at 23-25.

[123] Ibrahim Thompson quoted in Zafar, Aamina, "Sharia finance strengthens its presence in Britain", *FT Adviser*, December 10, 2010.

[124] Dar, Humayon A., *Demand for Islamic Financial Services in the UK: Chasing a Mirage?*, (Loughborough University, 2004), at 14-15, available at: https://dspace.lboro.ac.uk/dspace-jspui/bitstream/2134/335/3/TSIJ.pdf.

[125] See also, Macfarlane, Ben, "Takaful in the UK: Ripe for Development", (February 2008), *Middle East Insurance Review*, 62-63 at 63. See also, Jouini, Elyès and Pastré, Olivier, "Rapport Jouini et Pastre, Enjeux et Opportunités du Développement de la Finance Islamique pour la Place de Paris", *Rapport remis à Paris Europlace*, (Europlace, Paris, 8th December 2008), at 47. In 2010 the Islamic Bank of Britain announced that it would be extending its Islamic real estate financing services so that its Islamic retail products would be provided through two new intermediaries.

[126] Although not its other Islamic retail financial services.

[127] In 2007, Lloyds TSB noted that "demand [for Islamic real estate products] really has gone through the roof." Abu-Shakra, Emile, quoted in Anonymous, "Lloyds TSB: Islamic mortgage demands 'through the roof,'" *The Money Stop*, October 12, 2007, available at: http://www.themoneystop.co.uk/102007/lloyds-tsb-Islamic-mortgage-demands-through-the-roof.html.

[128] see also Anonymous, "Muslims demand Sharia student loans because paying interest goes against Islamic law", *Daily Mail*, August, 22, 2011, available at: http://www.dailymail.co.uk/news/article-2028782/Muslims-demand-Sharia-student-loans-paying-goes-Islamic-law.html.

retail finance will be the key area of future growth for the Islamic finance industry in the UK.[129]

Ireland's Muslim population remains small, particularly when compared with the larger and more established Muslim communities in the UK, France and Germany. Nevertheless, by establishing a regime amenable to providing a broad complement of Islamic financial services, the Irish Government could provide those Muslims in Ireland who want to bank according to their faith with meaningful access to the financial system. The Department of Finance has explicitly acknowledged a high level of financial exclusion within Ireland (generally rather than specifically amongst Muslims) and defines this form of exclusion as "a process whereby people encounter difficulties accessing and/or using financial services or products in the mainstream market that are appropriate to their needs and enable them to lead a normal social life in the society in which they belong."[130] In line with the Department of Finance's 2011 goal of achieving "a substantial reduction in financial exclusion over a 3-5 year period,"[131] accommodation of Islamic finance could encourage previously unbanked Muslim capital into the banking sector.[132]

In the absence of consumer-level Islamic finance in Ireland, some members of the Muslim community are now participating in informal financial arrangements in order to avoid conventional banking products which involve prohibited *ribā*, *gharar*, *maysir* and *haram* sectors.[133] One method currently being implemented is an informal co-operative model of financing in which each member of the group contributes money to a pool on a periodical basis. At the end of a defined period of time, the pool is paid over to one member of the group, with each member eventually being paid.[134] This structure allows

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[129] Wilson, Rodney, "Islamic banking in the United Kingdom", in M Fahim Khan and Mario Porzio (eds), *Islamic Banking and Finance in the European Union* (Edward Elgar, Cheltenham, 2010), 212-221 at 219-220.

[130] Steering Group on Financial Inclusion, *Strategy for Financial Inclusion Final Report,* note 107, at [1.5].

[131] *ibid.*, at [1.2].

[132] Matuschka, Albrecht, "Islamic Sustainable Finance; Creating Faith-Based Value," (December 2007) *Business Islamica*, 78-80 at 79. In relation to Islamic finance in Australia, the Australian Treasury noted that "[w]e also recognise that there are almost 400,000 Muslims in Australia who may use Islamic financial services if they are more accessible. Offering retail Islamic finance products may foster social inclusion, enabling Australian Muslims to access products that may be more consistent with their principles and beliefs" Sherry, Nick, "Official Launch of' Demystifying Islamic Finance" Speech made at the Four Seasons Hotel, Sydney, May 27, 2010, available at: http://www.treasurer.gov.au/DisplayDocs.aspx?doc=speeches/2010/018.htm&pageID=005&min=njsa&Year=&DocType=.

[133] Correspondence with Shahzad Ahmed, Appendix 7, *infra.*, at 468.

[134] *ibid.*

some of Ireland's Muslims to obtain financing without the payment of interest.[135] It is, however, a problematic development as it indicates that financial activity is being conducted outside the regulated financial system and outside the direct control of the State. Not only could this jeopardise consumer protection, but it could marginalise some Muslims, excluding them from a formal economy which is not reconciled to their needs. The absence of regulation over such activities may also facilitate financial irregularities and a reduction in Government tax revenue. This concern has been raised in a number of countries with the Dutch Finance Minister, for example, noting that "[d]enial of an actual need [for Islamic finance in the Netherlands] can lead to money-flows running via alternative channels out of sight of the Government."[136] The development of retail-level Islamic finance in Ireland could therefore increase official oversight of this financial activity.[137]

5.3.4 Conclusion to Section 5.3

The economic justification for accommodating Islamic finance in Ireland has been considered first in this Chapter due to the fact that economic benefits are the primary factor motivating the Government's recent accommodation of Islamic finance contracts. While economic benefits which Islamic finance may bring to Ireland do not legally oblige the Irish Government to accommodate this sector, they nevertheless appear to be legitimate reasons why such accommodation can take, and has taken, place. As the impact of such accommodations will largely be felt in the wholesale sector, the Tax Briefing 2009 and the relevant provisions of the Finance Act 2010 represent Ireland's first official steps to attract Islamic investment into the Irish economy. Such accommodations could place Ireland in a better position to attract Muslim capital by presenting Islamic institutions and investors with a legal regime which aims to remove tax burdens arising in relation to Islamic finance activity. As Ireland faces unprecedented economic difficulties, the emphasis on international economic benefits is unsurprising; continuing growth in the industry, support from prosperous nations and the additional element of moral suasion over Muslims who wish to transact in accordance with their faith, all place Islamic finance as a lucrative industry.

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[135] *ibid.*
[136] Wouter Bos quoted in Anonymous, "Finance Minister to Encourage Islamic Banking", note 20 .
[137] Matuschka, Albrecht, "Islamic Sustainable Finance; Creating Faith-Based Value", note 132, at 79.

Economic aspects of accommodating *Sharī'ah*-compliant financial activity extend beyond the inflow of liquidity into the Irish economy from international investors and could also include the mobilisation of Muslim and non-Muslim savings within Ireland. As economists and Governments call for greater integrity and accountability in financial dealings,[138] *Sharī'ah*-compliant finance could represent not just an ethical form of financing, but a source of guidance for conventional activity. Similarly, by representing an ethical alternative to conventional interest-based banking, Islamic finance could provide a mechanism for drawing Muslims in Ireland out of the informal financial sector and into the regulated market. While such features are perhaps more long-term in nature, they could nevertheless justify current and further accommodation of Islamic finance in Ireland.

5.4 Constitutional Justifications for Accommodation

Notwithstanding economic rationales for Islamic finance in Ireland, the accommodation of this sector may be justifiable on the basis of Ireland's constitutional protection of religious adherents. In the context of Islamic finance, such protection gives rise to two levels of enquiry: first, whether legislative measures to facilitate Islamic finance in Ireland are constitutionally justified in order to facilitate the free-practice of religion (5.4.1)[139] and second, whether such measures are, in fact, mandatory in order to prevent discrimination on the basis of religious belief (5.4.2).[140] As will be discussed below, while the former may be a valid basis for accommodation, the latter is unlikely to be.

Ireland's Constitution (*Bunreacht na hÉireann*), like many international human rights treaties[141] and most other Constitutions, enshrines and protects certain basic rights of the population, including freedom of conscience, the free profession and practice of religion[142] and equality between human persons.[143] Of particular relevance to the accommodation of Islamic finance, Article 44 of the Constitution covers the extent and limits of protection for

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[138] Masters, Brooke, "Push for greater integrity may help sector's image", *Financial Times*, June 15, 2011, http://www.ft.com/intl/cms/s/0/8595f9da-964c-11e0-afc5-00144feab49a.html#axzz1Pzqd2kyb.

[139] *infra.*at 175.

[140] *infra.*at 190.

[141] Article 18, Universal Declaration of Human Rights, G.A. res. 217 (A(III), December 10, 1948, U.N. Doc. A/810 (1948), International Covenant on Civil and Political Rights, Article 18, G.A. Res. 2200A, U.N. GAOR, 21st Sess., Supp. No. 16, U.N. Doc. A/6316 (1966), 999 U.N.T.S. 171 (1976), European Convention on Human Rights, Article 9, November 4th 1950, 213 U.N.T.S 222 (entered into force September 3rd 1953, American Convention on Human Rights, O.A.S. Treaty Series No. 36, 1144 U.N.T.S. 123 entered into force July 18, 1978, reprinted in Basic Documents Pertaining to Human Rights in the Inter-American System, OEA/Ser.L.V/II.82 doc.6 rev.1 at 25 (1992).

[142] Article 44.2.1°, *Bunreacht na hÉireann*, 1937.

[143] Article 40.3.1°, *Bunreacht na hÉireann*, 1937.

religious adherents. Adopting an approach which leans heavily in favour of avoiding undue hindrance of religious freedom, the relevant sections of Article 44, as amended, state that

44.1.° The State acknowledges that the homage of public worship is due to Almighty God. It shall hold His Name in reverence, and shall respect and honour religion.

44.2.1.° Freedom of conscience and the free profession and practice of religion are, subject to public order and morality, guaranteed to every citizen.

44.2.2.° The State guarantees not to endow any religion.

44.2.3.° The State shall not impose any disabilities or make any discrimination on the ground of religious profession, belief or status.

44.2.5.° Every religious denomination shall have the right to manage its own affairs, own, acquire and administer property, movable and immovable, and maintain institutions for religious or charitable purposes.

In light of such constitutional protections, State action which aims to unjustifiably and purposely restrict religious freedom or adversely differentiates on the basis of religion is unlikely to survive judicial scrutiny.[144] More uncertain is the legal status of "neutral and generally applicable"[145] laws. These laws apply to everyone, without explicitly burdening any particular religion, yet their effect is to incidentally restrict religious belief or practice or to discriminate on the basis of religion.[146] Disregarding the potentially significant detriment caused to religious adherents by generally applicable laws may undermine the constitutional protection of religious liberty. However, deferring as it does to unproven spiritual claims, the positive legislative accommodation of religious idiosyncrasies could be condemned as prioritising religion and allowing the legislative and judicial processes to

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[144] *O'Dálaigh C.J* in the *State (Quinn) v Ryan* [1965] IR 70 at 122 affirmed the Courts right to protect Constitutionally enshrined freedoms from unjust legislative attack; "It was not the intention of the Constitution in guaranteeing the fundamental rights of the citizen that these rights should be set at nought or circumvented. The intention was that rights of substance were being assured to the individual and the courts were the custodians of these rights." A similar view was expressed by Gavan Duffy J, who noted in *The State (Burke) v Lennon* [1940] IR 136 at 143 that; "the People...enshrined the guiding principles [of the Constitution] in language simple and direct; and they entrusted to the Judiciary the tremendous responsibility of maintaining their Constitutional monument against legislative attack."

[145] This phrase is used consistently in academic and judicial commentary of the matter although has yet to be satisfactorily defined in case law. For further discussion on the judicial consideration of the definition see; Stavros, Stephanos, "Freedom of religion and claims for exemption from generally applicable, neutral laws: lessons from across the pond?", (1997) 6 *European Human Rights Law Review*, 607-627 at 609-611.

[146] As Jézéquel notes, "[e]ven if there is no intention to exclude, where in practice [generally applicable laws] result in exclusion that is judged to be discriminatory this is sufficient for them to be considered a source of injustice," Jézéquel, Myriam, "The Reasonable Accommodation Requirement: Potential and Limits", in *Institutional accommodation and the citizen: legal and political interaction in a pluralist society*, Council of Europe, (Council of Europe Publishing, France, 2009), 21-36 at 25. Evans, Carolyn, *Freedom of religion under the European Convention on Human Rights*, (Oxford University Press, Oxford; New York, 2001), at 168.

be hijacked by the whims of a minority. The notion of religious accommodation has thus provoked considerable judicial and academic comment although few consistent principles have been agreed.[147]

5.4.1 Islamic Finance and Religious Free-Practice in Ireland

Islamic finance principles and their interaction with conventional legal and financial norms is an area where, under the semblance of neutral and generally applicable laws, the religious autonomy of Muslims could be undermined.[148] The Irish economy has emerged in the context of a culture which is predominantly non-Muslim. Legal principles and enactments concerning the financial services industry were implemented with an intention of directing and regulating activities of a non-Islamic nature. As a result, these established laws offer "insufficient space for diversity."[149] Without tailored modifications, Ireland's secular legal framework would be incapable of adequately sustaining the distinctive characteristics of many Islamic financial activities. This could cause a number of Islamic products to fall within legal *lacunae*[150] which may result in such products being unregulated, falling outside the remit of consumer protection legislation or simply being unavailable to Muslims in Ireland. It could also subject Islamic finance market participants to excessive financial and documentation burdens.[151] The accommodation of Islamic finance is designed precisely to remove these *lacunae* and to facilitate the Islamic finance industry. In effect, accommodation in the context of laws which are facially neutral attempts to remove burdens which would otherwise have restricted or prevented financial activity which is compliant with religious belief. This subsection will consider the approach of the Irish courts (A)[152] and legislature (B)[153] towards generally applicable laws which infringe religious practice. With this analysis in mind, it will then narrow discussion to consider the more complex question of whether engaging in financial activity which

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[147] *ibid.*, at 168-169.

[148] In his speech delivered at the Royal Courts of Justice, the Archbishop of Canterbury, Dr. Rowan Williams noted that in seeking to accommodate the increased plurality of the UK, the British Government should consider working with the Islamic community to facilitate freedom of religious practices in a number of areas, including the regulation of financial transactions, Williams, Rowan, "Civil and Religious law in England – a religious perspective", (2008) *Ecclesiastical Law Journal*, 10(3), 262-282 at 274.

[149] Menski, Werner F., "Muslim Law in Britain", note 1, at 138.

[150] Solé, Juan A., "Introducing Islamic Banks into Conventional Banking Systems", note 28, at 16, noting that before Islamic finance is effectively accommodated "some Islamic transactions will fall into legal voids and thus may not be permitted by the existing legal framework, or may be viewed with reticence by the general public."

[151] See Chapters 5 to 7 for more detailed discussions regarding the impact of current legislation on the provision of Islamic real estate finance, sukuk and governance.

[152] *infra.*at 176.

[153] *infra.*at 179.

complies with Islamic law may be considered to be a "religious practice," subject to constitutional protection (C).[154] This subsection will argue that while Islamic finance is not a religious practice, the act of adhering to Islamic law's economic principles is. It is this adherence which may justifiably be subject to Article 44 protection.

A. Religious Free-Practice and the Irish Courts

The decision of the Supreme Court in *Quinn's Supermarket v Attorney General*[155] represents the high water mark of judicial support in Ireland for religious free-exercise in the context of religiously neutral laws. This case involved a ministerial order which provided an exemption for shops selling kosher meat from otherwise restrictive opening hours.[156] The plaintiff (non-kosher) supermarket sought a declaration that the order constituted unlawful discrimination contrary to Article 44.2.3°. Noting that the "discrimination" prohibited by Article 44.2.3° should be read as encompassing both positive and negative discrimination, Walsh J acknowledged that the order was *prima facie* unconstitutional as it appeared to privilege Judaism.[157] However, Walsh J, with whom the entire Supreme Court agreed,[158] indicated that this positive discrimination would not necessarily invalidate the order. Instead, the Court looked to the "primary object and aim"[159] of Article 44. This it found to be a guarantee

> [t]hat the practice of religion...shall not subject the person so practising...to any disabilities on that account, or permit distinctions on the ground of religious profession, belief or status between persons in the State...[160]

Discrimination which was necessary to ensure free profession and practice of religion would therefore not be unconstitutional.[161] As the court noted

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[154] *infra.*at 182.

[155] *Quinn's Supermarket v. Attorney General* [1972] IR 1.

[156] *ibid.*, at 11-12, section 2 Victuallers' Shops (Hours of Trading on Weekdays)(Dublin, Dun Laoghaire and Bray) Order 1948 as amended by the Victuallers' Shops (Hours of Trading on Weekdays)(Dublin, Dun Laoghaire and Bray) Order 1948 (Amendment) Order 1968.

[157] *Quinn's Supermarket v. Attorney General* [1972] IR 1at16.

[158] While Kenny J disagreed with the ultimate decision to find the order unconstitutional he nevertheless agreed that the order represented 'justifiable discrimination' *ibid.*, at 34.

[159] *ibid.*, at 24.

[160] *ibid.*.

[161] *ibid.*. See also, Casey, James, *Constitutional Law in Ireland*, (3rd ed., Round Hall, Dublin, 2000), at 692-3.

> [a]ny law which by virtue of the generality of its application would by its effect restrict or prevent the free profession and practice of religion by any person...would be invalid having regard to the provisions of the Constitution, unless it contained provisions which saved from such restriction or prevention the practice of religion or persons who would otherwise be so restricted or prevented.[162]

This statement comes down firmly in favour of constitutionally mandated accommodation of religious practices. Essentially the court concluded that the State was under a positive obligation to uphold the free profession and practice of religion, even if this requires accommodation of religious differences in the context of neutral laws.[163]

Despite the fact that *Quinn's Supermarket* was decided over thirty years ago, the "great solicitude for free-exercise rights"[164] has been affirmed in numerous Irish cases. However, while repeatedly acknowledging the triumph of religious practice over non-discrimination, progressive judicial consideration of Article 44 has moved towards a more relaxed albeit broader interpretation of the State's constitutional duties. From an initial analysis of Article 44 in *Quinn's Supermarket* as mandating religious accommodation of specific religious practices, the courts have increasingly adopted an approach which acknowledges that it is constitutionally permissible (though not necessarily obligatory) for the State to differentiate where necessary to allow freedom of both identifiable religious practices and a broader moral "ethos" of religious organisations.[165] In *Re Article 26 and the Employment Equality Bill 1996*,[166] Hamilton CJ noted that

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[162] *Quinn's Supermarket v. Attorney General* [1972] IR 1 at 24-25, Kenny J in the High Court also noted that positive state action may be necessary in light of the Constitutional protection of religious freedom, "[w]e are in religion a pluralist society made up of people of many persuasions and beliefs and so it is likely that parts of legislation will occasionally indirectly affect the practice of some religion. If the State has to abstain from law-making on matters which indirectly affect the practice of religion by some of its citizens, the scope of legislation will be seriously reduced. Yet this will be the result if the State cannot exempt from the application of some of its legislation those whose practice of their religion will be affected by it."

[163] This interpretation of the court's decision has been acknowledged by Hogan and Whyte (Hogan, Gerard and Whyte, Gerard, *JM. Kelly, The Irish Constitution*, (4th ed., Butterworths, Dublin, 2003), at 2048), Doyle (Doyle, Oran, "Article 44: Privileging the Rights of the Religious," in *The Irish Constitution: Governance and Values*, edited by Oran Doyle and Eoin Carolan, (Thomson Round Hall, Dublin, 2008), 476-489 p.478) and Daly (Daly, Eoin "Religious Discrimination under the Irish Constitution: A Critique of the Supreme Court Jurisprudence," (2008) 8 *Cork Online Law Review*, 28-44, at 31.

[164] Whyte, Gerard, "Religion and the Irish Constitution", (1996-1997) 30 *The John Marshall Law Review*, 725-746 at 733.

[165] This was reiterated by Mac Menamin J in *McNally & Anor v Ireland & Ors* [2009] IEHC 573 at [150].

[166] *Re Article 26 and the Employment Equality Bill 1996* [1997] 2 IR 321.

> [i]t is constitutionally *permissible* to make distinctions or discriminations on grounds of religious profession, belief or status insofar – but only insofar – as this may be necessary to give life and reality to the guarantee of the free profession and practice of religion in the Constitution.[167]

Referring to the earlier case of *McGrath and O Ruairc v Trustees of Maynooth College*,[168] the Supreme Court confirmed that the State could legitimately differentiate between religions in order to protect "the freedom and independence given by the Constitution to the doctrinal and organisational requirements and proscriptions which are inherent in all organised religions."[169] Most recently, Mac Menamin J in *McNally & Anor v Ireland & Ors*[170] reaffirmed the precedence of free-exercise and the importance of religious autonomy but stopped short of reinvigorating the mandatory accommodation of *Quinn's Supermarket*.[171] The Court, however, stressed the significance of denominational autonomy concluding that Article 44, "far from eschewing internal disabilities and discriminations which flow from the tenets of a particular religion, *may on occasion actually allow for support subject to other constitutional rights guarantees*."[172] Consequently, while there now appears to be no judicially dictated accommodation of religious diversity, the Irish courts continue to permit and encourage such accommodation as a legitimate means of

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[167] *ibid.*, at 358 (emphasis added).

[168] *McGrath and O Ruairc v Trustees of Maynooth College* [1979] ILRM 166.

[169] *Re Article 26 and the Employment Equality Bill 1996,* [1997] 2 IR 321, at 358 citing Henchy J in *McGrath v Maynooth College* [1979] I.L.R.M. 166, p.187. See also *Mulloy v. Minister for Education* in which Walsh J confirmed his earlier ruling, noting that discrimination on the basis of religion is impermissible 'save where it is necessary to do so for the implementation of the Constitutional right to the full and free-practice of religion.' *Mulloy v. Minister for Education* [1975] IR 88, at 96.

[170] *McNally & Anor v Ireland & Ors* [2009] IEHC 573

[171] *ibid.*, at [141-142] and [150].

[172] *ibid.*, at [142]. (emphasis added)

protecting the overarching aim of Article 44.[173] It has been left to the legislature to introduce accommodations where these are needed to facilitate free-practice.[174]

B. Religious Free-Practice – The Importance of Legislative Initiative

A suggestion that infringement of religious practice justifies positive State action could be criticised as opening the floodgates to a surge of innumerable religious petitioners.[175] In practice, neither case law permitting such positive discrimination, nor numerous accommodations of religious practices which have been introduced into Irish law through the exercise of legislative power, indicate any paralysis of the legal system. There are, in fact, indications that the Oireachtas is comfortable with the notion of accounting for religious diversity in circumstances where the free-exercise of religious devotees is burdened. Amongst the legislative accommodations of religious activity are s.15(2)(b) and (c) of the Slaughter of Animals Act 1935[176] which relieve Muslims and Jews from the requirements of the Act regarding methods of slaughter. Exemptions are also provided specifically for Jews in s.39 of the Local Elections Order 1925[177] and in s.52 of the Juries Act 1927[178] which removes the obligation of a juror to swear on the Bible. More generally, s.4(2) of the Health Act 1953[179] permits a public health service patient to refuse to submit to a medical examination or treatment for religious reasons and s.23 of the Prison Rules 2007 requires the provision of food which is needed to allow a "prisoner to observe dietary

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[173] Indicative perhaps of a respect for legislative autonomy, the Irish courts have not, since *Quinn's Supermarket*, struck down neutral legislation on the basis that it failed to accommodate religious diversity. The Irish courts are also likely to be unwilling to instruct the Oireachtas on how best an accommodation of religious practice should be worded (*Somjee v the Minister for Justice* [1981] ILRM 324, at 327, in which the court noted that "The courts have no jurisdiction to substitute for impugned legislation a form of enactment which it considers desirable or to indicate to the Oireachtas the appropriate form of enactment which should be substituted for the condemned legislation," approved in *Mhic Mhathúna v Ireland* [1995] 1 ILRM 69), significantly however, this may simply be because no such case has appeared before the courts. By contrast the courts have upheld legislation which already made the necessary distinction indicating that if a suitable case were to raise the issue of non-accommodation, the weight of precedent supporting free-exercise may result in a declaration of unconstitutionality.

[174] The US courts have reached a similar conclusion in *Employment Division, Department of Human Resources of Oregon v. Smith*, per Scalia J, 494 U.S. 872, at 888 when they concluded that a State could not be forced to accommodate religious practices within neutral laws but could do so if it wished without violating the Constitution. The US courts do, however, appear to have been slightly more hostile towards accommodation than their Irish colleagues when they noted that requiring the State to accommodate religious diversity in the context of neutral laws would be "courting anarchy."

[175] Such fear was amply demonstrated at a conference at University College Cork at which a number of attendees criticised the provisions of the Finance Act 2010 accommodating Islamic finance contracts as the beginning of a "slippery slope" towards the accommodation of every religious whim. Richardson, Edana, "Islamic Finance: Why Ireland Should Pay Attention", History of Islam in Ireland Seminar Series, Study of Religions Department, University College Cork, Cork, March 2, 2010.

[176] Slaughter of Animals Act 1935 (No. 45 of 1935).

[177] Local Elections Order 1925 (No. 19 of 1925).

[178] Juries Act 1927 (No. 23 of 1927).

[179] Health Act 1953 (No. 26 of 1953).

practices of a religion or culture of which he or she professes to be a follower."[180] Both of these instruments provide for wide accommodation for religious principles without limiting their application to a specific religious denomination.[181]

While it is not ideal that fundamental rights be subject only to the caprice of the legislature, the fact that the general view of the courts in Ireland towards accommodation of religious exercise is one of permissibility rather than obligation has not prevented such accommodations arising out of Government initiative. In reality, even if the courts are reluctant to mandate accommodation, this neither undercuts the authenticity of religious interference by neutral laws nor prevents positive Government action, a reality which has emerged in the US.[182] After nearly thirty years of judicial support for mandatory accommodation of religious practice,[183] the US courts have now adopted a restrictive interpretation of religious free-exercise.[184] In the Employment *Division, Department of Human Resources of Oregon v. Smith*,[185] the US Supreme Court concluded that while religious accommodation was both desirable and constitutionally permissible, it was not obligatory and should instead be left to the legislature.[186] Assuming this role, the US

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[180] Section 23(2) Prison Rules, 2007S.I. No. 252/2007. See also section 9(3) of the Criminal Justice Act 1960 prevents detention of a young person in an institution conducted in a manner which contradicts their religion, Criminal Justice Act 1960 (Act No. 27/1960), section 101 of the Criminal Justice Act 2006 requires that as far as practicable, a restriction on movement of a person does not interfere with the practice by the offender of his or her religion.

[181] Sandberg has noted a similar development in the UK with some legislative accommodations designed for the religious activity of a specific religion while the majority deal with accommodation on the grounds of religion generally, Sandberg, Russell, *Law and Religion*, (Cambridge University Press, Cambridge, 2011), at 31-32.

[182] McConnell noted that "[e]ven before Smith, legislative accommodations were far more important to the protection of religious exercise than the First Amendment. This fact is even more true today." McConnell, Michael W., "The Problem of Singling out Religion", (2000-2001) 50 *DePaul Law Review*, 1-48 at 5.

[183] *Shervert v. Verner*, 374 U.S. 398 (1963) in which the court introduced the compelling interest test under which no law could be passed or enforced by the Government which burdened religious free-exercise unless that law was the least restrictive means of achieving a compelling social objective. *Wisconsin v. Yoder* 406 U.S. 205 (1972), at 220-221, per Burger CJ; "[t]he *Court must not ignore the danger that an exception from a general obligation of citizenship on religious grounds may run afoul of the Establishment Clause, but that danger cannot be allowed to prevent* any *exception no matter how vital it may be to the protection* of values promoted by the right of free-exercise (emphasis added). Similar views were endorsed in *Thomas v. Review Board* [*Thomas v Review Board* 450 US 707 (1981), at 720] to ensure that a Jehovah's Witness who refused to continue working in a munitions factory would receive unemployment compensation and in *Sherbert v. Verner* [374 US 398 (1963), at 410] to justify payment of such compensation to a Seventh Day Adventist who would not work on a Saturday, as Brennan J noted that, "[the State] may not Constitutionally apply the [religiously neutral] eligibility provisions so as to constrain a worker to abandon his religious convictions respecting the day of rest."

[184] McConnell, Michael, "The Problem of Singling out Religion", note 182, at 2.

[185] *Employment Division, Department of Human Resources of Oregon v. Smith* 494 U.S. 872 (1990).

[186] *ibid.*, at 890, Per Scalia J, "To say that a nondiscriminatory religious-practice exemption is permitted, or even that it is desirable, is not to say that it is Constitutionally required." Stavros, Stephanos, "Freedom of religion and claims for exemption from generally applicable, neutral laws: lessons from across the pond?", note 145, at 624.

Government[187] and States[188] have continued to uphold and accommodate religious diversity.[189]

Bolstered by a constitutionally protected right, the appropriateness of the Irish Government's protection of freedom of religious practice is evident. In a country where "religious beliefs and practices are interwoven through the fabric of...society,"[190] the State should not uphold the basic rights only of the majority, and where legislation unjustifiably interferes with a fundamental constitutional guarantee, there is strong impetus on the authorities to remedy that legislative defect. Positive state action in the context of Article 44 guarantees is crucial, not to elevate any particular faith, but to ensure that general laws do not form an obstacle to the free-exercise of religious activities. A religiously blind approach to non-mainstream religious practices underestimates the genuine moral dilemma faced by adherents when secular and religious norms are inconsistent with each other.[191] *Every* religious belief cannot be accommodated and some sort of religiously neutral mechanism must determine what sort of religious norms will be allowed to oust the civil law.[192] Nevertheless, rigidly emphasising the positivist prerogative of conventional law could force an individual to consider their divided loyalty between the State and their

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[187] Following Smith Congress enacted the Religious Freedom Restoration Act 2000, 42 U.S.C. §2000bb (RFRA) which sought to prevent laws substantially burdening the free-practice of religion – This Act was partially overturned in relation to state and local activity; however, it still applies to the federal Government. In City of Boerne v. Flores, 521 U.S. 507, 511-513 (1997) in which it was held that the RFRA 2000 overstepped Congress's ability to enforce the 14th amendment the Court explicitly acknowledged that the RFRA was a direct response to the Supreme Court's ruling in Smith, Serr, Brian J, "A Not-So-Neutral "Neutrality:" An Essay on the State of the Religion Clauses on the Brink of the Third Millennium", (1999) 51 Baylor Law Review 319-338 at 321. In response to the Boerne ruling, Congress passed the Religious Land Use and Institutionalized Persons Act 2000, Pub. L 106-274, 42 U.S.C. § 2000cc-1, (RLUIPA) which grants special privileges to religious land owners

[188] In 1992, Ryan noted that religious exemptions appeared in over two thousand US statutes. As he noted; "[i]n the United States Code... exemptions exist in food inspection laws for the ritual slaughter of animals, and for the preparation of food in accordance with religious practices. The tax laws contain numerous exemptions for religious groups and allow deductions for contributions to religious organizations... Antidiscrimination laws, including Title VII, the Fair Housing Act, and the Aid to the Disabled Act, contain exemptions for religious organizations...Aliens seeking asylum can do so on the grounds that they will suffer religious persecution if returned to their home countries and gambling laws contain an exemption for religious organizations. Those in the military may wear religious apparel while wearing their uniforms... And last, but certainly not least for purposes of this Note, federal drug laws contain an exemption for the religious use of peyote by members of the Native American Church," Ryan, James E., Note, "Smith and the Religious Freedom Restoration Act: An Iconoclastic Assessment", (1992) 78(6) *Virginia Law Review*, 1407-1462 at 1445-1446, (footnotes omitted).

[189] Conkle, Daniel O., "The Path of American Religious Liberty: From the Original Theology to Formal Neutrality and an Uncertain Future", (2000) 75 *Indiana Law Journal*, 1-36 at 13.

[190] *Campaign to Separate Church and State v The Minister for Education* [1998] 3 I.R. 321 at 359.

[191] Brantz, Dorothee, "Stunning Bodies: Animal Slaughter, Judaism, and the Meaning of Humanity in Imperial Germany", (2002) 35 *Central European History*, 167-193, at 180.

[192] The limitations on religious belief are discussed in more detail below, *infra.*at 188.

faith,[193] pitting the immediate effects of non-adherence to majority law against the eternal implications of defiance of a higher religious duty.[194] With two conflicting normative systems claiming jurisdiction over the adherent's actions, strict indifference in the application of the *lex loci* undermines respect for minority faiths, relegating their legitimately held beliefs to the realm of private cultural idiosyncrasies.[195]

C. Religious Practice – The Place of Islamic Finance

Irish authorities, both legislative and judicial, have supported, and continue to support, a broadly favourable attitude to accommodating religious practices. If the constitutional protection of religious activity against religiously blind legislation is to justify accommodation of Islamic financial activity, it is necessary to consider whether participation in such ethically guided transactions represents a religious practice.

Adherence to Islam, as a religion which prescribes a comprehensive code of correct behaviour, necessarily manifests itself in various practical activities.[196] Admittedly, Islamic financial activity falls short of the wholly religious nature of practices such as worship and attendance at religious ceremonies.[197] Nevertheless, it is suggested that in the case of Islam, the ambit of "practice" extends beyond such a narrow range of activity. With increased religious diversity, legal authorities should be prepared to adopt an understanding of religious activity wider than the traditional concepts of Christian practice. Ostensibly considering the legal position of different faith groups will provide only limited protection of religious practices if the criteria against which those practices are judged are rigidly traditional in their scope. Consequently, in order to ensure that the constitutional protection of religious freedom is actually effective, the State should not refuse to protect manifestation of religious beliefs simply because the manner in which those beliefs are

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[193] As the US Supreme Court noted in *Texas Monthly v. Bullock* 489 U.S. 1, 18 fn.8 (1989), per Brennan J, The accommodation must be "designed to alleviate Government intrusions that might significantly deter adherents of a particular faith from conduct protected by the free-exercise clause."

[194] Menski, Werner, "Muslim Law in Britain", note 1, at 139, Yilmaz, Ihsan, "Muslim law in Britain: Reflections in the Socio-legal Sphere and Differential Legal Treatment", (2000) 20(2), *Journal of Muslim Minority Affairs*, 353-360 at 354.

[195] As Rowan Williams, Archbishop of Canterbury noted; "[t]here is a recognition that our social identities are not constituted by one exclusive set of relations or mode of belonging..." Williams, Rowan, "Civil and Religious law in England – a religious perspective", note 148, at 263.

[196] Rippin, Andrew, *Muslims; Their Religious Beliefs and Practices*, (3rd ed., Routledge, London, 2005), at 88.

[197] El-Fadl, Abou, "Islamic Law and Muslim Minorities: The Juristic Discourse on Muslim Minorities from the Second/Eighth to the Eleventh/Seventeenth Centuries.", (1994) 1(2) *Islamic Law and Society*, 141-187 at 158.

practised does not fit neatly into an accepted category of pious activity. As will be argued, a broad application by the Irish courts of the notion of what religious practice entails, combined with the responsibility of Muslims to conduct their financial activity in accordance with the dictates of Islamic law, support the suggestion that the accommodation of Islamic finance in Ireland is justified in order to allow Muslims to fully and freely practise their religion.

While noting that the State is not an "arbiter of religious truth"[198] the Irish courts have not adopted an explicit test of acceptable religious practice. This position can be contrasted with the approach taken in the UK where the issue of diverse religious practices has received quite significant judicial consideration. Adopting a sympathetic approach to claims of legitimate religious activity,[199] the UK courts have stressed that not every action claiming divine inspiration will be protected. In *R(Williamson) v Secretary of State for Education and Employment*,[200] Lord Nicholls noted that, while everyone is entitled to believe whatever they want, there are basic minimum requirements necessary for legitimate religious manifestation

> [t]he belief must be consistent with basic standards of human dignity or integrity...The belief must relate to matters more than merely trivial. It must possess an adequate degree of seriousness and importance...The belief must also be coherent in the sense of being intelligible and capable of being understood. But, again, too much should not be demanded in this regard. Typically, religion involves belief in the

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[198] Walsh J noted in *Quinn's Supermarket* that; "[t]he effect of these various guarantees is that the State acknowledges that the homage of public worship is due to Almighty God...At the same time it guarantees freedom of conscience, the free profession and practice of religion and equality before the law to all citizens, be they Roman Catholics, Protestants, Jews, Muslims, agnostics or atheists. But Article 44.1 goes further and places the duty on the State to respect and honour religion as such. At the same time the State is not placed in the position of an arbiter of religious truth. Its only function is to protect public order and morality", (*Quinn's Supermarket v. Attorney General* [1972] IR 1 at 23-24). See also *Conway v Independent Newspapers (Ireland) Ltd* [1999] 4 IR 484. This reluctance of the State to question the legitimacy of religious practice is highlighted by the provision in the Prison Rules 2007 which requires the provision of food which is needed to allow a "prisoner to observe dietary practices of a religion or culture *of which he or she professes to be a follower*" the legitimacy of this profession does not appear to be open to question, section 23(2) Prison Rules, 2007S.I. No. 252/2007 (emphasis added).

[199] In *R(Williamson) v Secretary of State for Education and Employment*, Baroness Hale of Richmond accepted that the practice of corporal punishment in certain schools represented a manifestation of the parents' and teachers' beliefs, *R(Williamson) v Secretary of State for Education and Employment* [2005] 2 AC 246 at [78].

[200] *ibid.*

> supernatural. It is not always susceptible to lucid exposition or, still less, rational justification.[201]

This test, which has been applied in subsequent caselaw,[202] presents a logical checklist to be applied by the court when a religious practice is at issue. Avoiding judicial consideration of the religious merits of an activity while still requiring that objective standards are adhered to regardless of their spiritual affiliation, the *Williamson* threshold of religious manifestation represents a balance between respect for norms which are beyond the scope of positive law and the continued integrity of that positive law for the rest of society.[203]

In general, the Irish judiciary has adopted an unarticulated but benevolent attitude towards the legitimacy of religious activities, with Hogan and Whyte noting an acceptance by the courts of "religiously *motivated* action"[204] as warranting consideration for protection. In line with this, the courts have accepted the authenticity of Jewish dietary requirements and observance of the Sabbath,[205] a claim that malicious damage of a religious statue was motivated by divine commands[206] and the refusal by an adult Jehovah's Witness to receive a blood transfusion.[207] Indeed, as the courts have moved from a policy of mandatory accommodation of religious diversity and towards one which simply permits such accommodation, an increasingly broad view of religious practice has been adopted. The Supreme Court in *Quinn's Supermarket* indicated that, in order for religious

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[201] *ibid.*, at [23].

[202] See for example the recent cases; *Regina (Ghai) v Newcastle City Council (Ramgharia Gurdwara, Hitchin and others intervening)* [2010] P.T.S.R. 1003 at 1038, *Grainger plc and others v Nicholson* [2010] I.C.R. 360 at 369.

[203] Per Sachs J in the Constitutional Court of South Africa, who noted that; "[t]he underlying problem in any open and democratic society based on human dignity, equality and freedom in which conscientious and religious freedom has to be regarded with appropriate seriousness, is how far such democracy can and must go in allowing members of religious communities to define for themselves which laws they will obey and which not. Such a society can cohere only if all its participants accept that certain basic norms and standards are binding. Accordingly, believers cannot claim an automatic right to be exempted by their beliefs from the laws of the land. At the same time, the state should, wherever reasonably possible, seek to avoid putting believers to extremely painful and intensely burdensome choices of either being true to their faith or else respectful of the law," *Christian Education South Africa v Minister of Education* (2000) 9 BHRC 53 at [35].

[204] Hogan, Gerard and Whyte, Gerard, *JM. Kelly, The Irish Constitution*, note 163, at 7.8.46 (emphasis added).

[205] *Quinn's Supermarket v. Attorney General* [1972] IR 1.

[206] *The People (Director of Public Prosecutions) v. Draper*, Irish Times, March 24, 1988 – The infringement of the freedom of religious manifestation was however upheld due to considerations of public order.

[207] *Fitzpatrick and Ryan v. F.K and the Attorney General* [2008] IEHC 104 – Laffoy J determined that due to an insufficient level of capacity, the patient could not be regarded as being sufficiently competent to refuse the blood transfusion. However, she went on to note that "a regrettable feature of this case is that...the intervention of the court probably could have been avoided if Ms. K had not misrepresented the facts as to her religion when booking into the Hospital" indicating that had sufficient informed consent been given at the outset, the religious convictions of the patient may have been protected.

accommodations to be mandatory, the religious practice in question must be "an essential element"[208] and "binding part"[209] of the religion. This requirement, which is more restrictive than that adopted in the UK[210] and the US,[211] has been moderated by subsequent caselaw. The court in *Re Article 26 and the Employment Equality Bill 1996*[212] acknowledged that specific provision may be made for discriminatory hiring practices by religious communities despite the fact that such activities are merely in furtherance of the community's mission as opposed to being explicitly and uncontentiously mandated by the teachings of that religion.[213] In *McNally & Anor v Ireland & Ors*[214] Mac Menamin J rejected a claim that the sale of Mass cards represented a religious practice and noted that as the Plaintiff had failed to mention his own religious profession or any denominational belief, the "sole interest that may be placed at risk is a commercial activity, albeit with a religious dimension."[215] With this conclusion the High Court seems to be falling into line with the UK approach by requiring an identifiable religious interest to be at stake that is more than marginally relevant to the activity in question.[216] Most recently, Hogan J noted that it is not for the court to decide what was "orthodox or conventional" in matters of faith and was satisfied that a Jehovah's Witness's refusal of blood transfusions was "scripturally ordained" and a "test of faith" when such a situation arises.[217] In light of this caselaw, where religious activity is one which is more than peripheral to the religion and has an identifiable connection with religious faith, then the Government may, justifiably,

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[208] *Quinn's Supermarket v. Attorney General* [1972] IR 1, at 16.

[209] *ibid.*, at 25, noting that "so long as the present dietary laws remain a binding part of the Jewish religion, then a sufficient exemption...would be necessary."

[210] *Amicus* case, [2004] IRLR 430, 438 at [44] where the court noted that; "the weight to be given to religious rights may depend upon how close the subject-matter is to the core of the religion's values or organisation." This concept of how close the subject matter is to the core of the religion's values appears to have been applied with a certain flexibility by the English courts, see for example; *R (on the application of Ghai) v Newcastle City Council,* [2009] EWHC 978 (Admin) (2009) 159 N.L.J 713; [2009] N.P.C. 68; Times, May 18, 2009; Official Transcript; QBD (Admin), at [100] where the court noted that; "all the law demands of me is that I be persuaded, as I am, that the claimant's belief in open air funeral pyres is sufficiently close to the core of one strand of orthodox Hinduism." See generally; Arlow, Ruth and Adam, Will, "Case Note. R (on the application of Ghai) v Newcastle City Council", (2009) 11 *Ecclesiastical Law Journal*, 367-369.

[211] See for example *Sherbert v. Verner* 374 US 398 (1963), at 411 in which Douglas J refers only to religious 'scruples' rather than binding dictates. The courts have however been willing to draw the line when "a claim is so bizarre, so clearly non-religious in motivation, as not to be entitled to protection under the Free-exercise Clause." *Thomas v. Review Board of the Indiana Employment Security Division*, 67 L. Ed. 2d 624 at 632. See also, *Employment Division, Department of Human Resources of Oregon v. Smith*, 494 US 872, 888, footnote 4, Scalia J noted that; ". . . dispensing with a 'centrality' inquiry is utterly unworkable. It would require, for example, the same degree of 'compelling state interest' to impede the practice of throwing rice at church weddings as to impede the practice of getting married in church."

[212] *Re Article 26 and the Employment Equality Bill 1996* [1997] 2 I.R. 321.

[213] *ibid.*, at 356-358.

[214] *McNally & Anor v Ireland & Ors* [2009] IEHC 573.

[215] *ibid.*, at [156].

[216] *ibid.*, at [140]-[171].

[217] *Temple Street v D. & Anor* [2011] IEHC 1 at [28].

accommodate it, even if it is not a universally acknowledged manifestation of core religious tenets.

It is suggested that the accommodation of Islamic financial activity within Ireland's laws is justifiable under Article 44.2.1°'s protection of religious free-exercise. However it is not the Islamic financial transactions and contracts themselves, but rather the act of adhering to Islamic law's financial teachings, which represents the legitimate religious practice to be protected. Though participation in economically beneficial activity is required of Muslims[218] and hoarding of wealth is forbidden,[219] Islamic law has not set down a fully formed financial system or financial transactions which it explicitly obliges Muslims to follow. It has, rather, established specific rules which are relevant in financial activity.[220] The prohibitions of *ribā*, uncertainty, speculation and forbidden industries are based on specific, textual, references in the *Qur'ān* and *Sunnah*. These teachings do not simply catalogue undesirable activity but repeatedly refer to practices which, if engaged in, would result in punishment in the hereafter.[221] The fact that these practices are prohibited by Islamic law is widely acknowledged and uncontroversial. How these prohibitions are to be interpreted and applied in contemporary financial activity is, however, subject to some variations in opinion. Like much of Islam, there is not unwavering unanimity over the contemporary meaning of the financial prohibitions or the finer details of Islamic financial transactions. Islam is itself "internally plural"[222] and it is not for the Irish State to determine which interpretation of Islamic law is correct. In the absence of a central *Sharī'ah* body or a definitive indication of what is and is not required by Islam in relation to financial activity, there may never be unanimous agreement on how the prohibitions of

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[218] *Qur'ān* 62:10, "Then when the (prayer) is ended, you may disperse through the land, and seek of the Bounty of Allah and remember Allah much: that ye may be successful."

[219] *Qur'ān* 9:34, "And those who hoard up gold and silver and spend them not in the Way of Allah, announce unto them a painful torment."

[220] *supra.*at 52 et seq.

[221] Not only are many of these financial principles enshrined in the *Qur'ān* thereby placing them beyond reproach, but the reports in the *Sunnah* that the Prophet Mohammad himself engaged in financial activity similar to contemporary Islamic banking and finance and condemned conventional finance further support the argument that *Sharī'ah*-compliant finance constitutes a recognised aspect of adherence to Islam. Rippin notes that "if something is felt by Muslims to be a denigration of one aspect of the life of Mohammad, then by implication such may be seen as an attack on the whole way of life of each and every Muslim." Consequently, the absence of a financial sector which complies with religious teachings undermines the ability of Muslims to follow the example set by Mohammad and prevents them from putting into practice explicit teachings of their religion, Rippin, Andrew, Muslims; *Their Religious Beliefs and Practices*, note 196, at 55.

[222] Menski, Werner, "Accommodating religious needs in relation to marriage: Flying kites and navigating state law and other forms of law", Paper presented for Diritto & Religione. Prima giornata di studio "Edoardo Dieni", Il riconoscimento civile dei matrimoni religiosi: conflitto di leggi o di culture?, Università degli Studi dell'Insubria, Facoltà di Giurisprudenza, Como, Novembre 28-29, 2008 at 8.

ribā, *gharar*, *maysir* and *haram* activities can be adhered to faithfully. Consequently, for those Muslims who do not interpret these financial concepts as applicable in the context of contemporary finance,[223] involvement in the interest-based finance sector would not be violating any religious doctrine; such an interpretation of Islamic law would require no tailored contracts and transactions to be developed and accommodated.[224] However, for those Muslims who ascribe to the widely espoused view that conventional banking and finance *is* contrary to the economic teachings of Islamic law, the contemporary Islamic banking and finance industry represents a mechanism for these Muslims to fulfil what they consider to be the financial dictates of Islam. Effectively, the Islamic banking and finance industry, as it exists today, is simply a contemporary attempt to comply with fundamental religious dictates by those Muslims who do not consider conventional financial activity to be a religiously-acceptable option.[225] Presenting these adherents with no practical alternative but to participate in the conventional, interest-based and debt-focused financial system could infringe upon the activity of complying with rules which Islamic law suggests will have a genuine impact beyond the present material world.

In light of this, Article 44 does not require the State to accommodate any specific interpretation of Islamic banking and finance or to establish an Islamic finance industry. It justifies, however, existing and future accommodation of Islamic financial structures which are excessively burdened by existing laws since it is directly through the use of these structures that Muslims can fulfil their religious duties. Such accommodations would, of course, be relevant only to those Muslims who view the conventional financial system as contrary to their religious beliefs. This is not because the Irish State would be agreeing

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[223] For example, those Muslims that view *ribā* as applying only to usury would not consider ordinary interest to be covered by the prohibition in the *Qur'ān* and *Sunnah*. As a result, for these Muslims, complying with their religious belief requires that they avoid usury, not interest as such.

[224] Nazir-Ali, Michael, "Islamic Law, Fundamental Freedoms, and Social Cohesion: Retrospect and Prospect", in *Shari'a in the West*, Rex Ahdar and Nicholas Aroney (eds.), (Oxford University Press, Oxford, 2010), 71-90 at 84 noting that if, according to an interpretation of Islamic law, legitimate interest is not *ribā* "there would be no need for the elaborate products and accompanying super-structure to avoid interest in all forms."

[225] Muslims can simply choose to remove themselves from the formal financial system; however, as has been discussed above, this is not a viable option in contemporary society. The existence of an alternative does not in itself indicate that religious freedom is being upheld since an alternative which is considerably less favourable cannot be said to represent a valid option. A similar view was held by the UK courts in *R(Williamson) v Secretary of State for Education and Employment* [2005] 2 AC 246 at [40]-[41] and by the German Constitutional court who acknowledged that the eating of halal meat was a practice motivated by religious beliefs and that when Muslims eat meat that meat must be halal. To expect that Muslims should forgo meat was not reasonable and therefore the general laws which prevented halal slaughter infringed the right of Muslims to practice their religion; *BVerfg NJW 2002*, 663 at 664, which notes that "[t]o essentially demand that the consumption of meat is renounced, fails to account for the eating habits of German society. Meat is a popular food, being forced to abandon it therefore can hardly be considered reasonable," Translation by Ah-young Koo.

with this interpretation of Islamic law but simply because of the fact that Muslims who do not believe conventional finance is in violation of Islamic law need no specific accommodation in order to practice this aspect of their religion.

D. Limitations on Religious Freedom

While explicitly protecting religious freedom, the Constitution itself imposes limits on untamed religious thought and activity, with the protection offered in Article 44.2.1° "subject to public order and morality." The State is provided with a legitimate reason to restrict religious beliefs or practices even where these would otherwise benefit from Article 44 protection.[226] Neither religious conscience nor practice is absolute, although it is difficult to envisage a successful mechanism for determining and restricting personal thoughts. As a result, the restrictions on the basis of "public order and morality" may be of most tangible impact in relation to religious practice and expression.

Rarely applied by the courts,[227] the concepts of both public order and morality are nebulous, giving rise to uncertainty as regards the standard to be applied. "Public morality," in particular, raises concerns over the possibility that ingrained intolerance may be used as a means of restricting religious freedoms.[228] In *Conlan v Mohamed,*[229] the Supreme Court refused to accept the validity of a foreign Islamic marriage as it was potentially polygamous. Noting that "[i]t has not been contested that a polygamous marriage cannot be recognised in our law as a valid marriage,"[230] the Supreme Court appeared to assume that as a polygamous marriage fell outside of the common law

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[226] The Constitutional Review Group have criticised the failure of the Constitution to offer inviolable protection to religious conscience. The current absence of a thought-action dichotomy in the Irish Constitution does present the perplexing reality that the Constitution allows the Government to restrict individuals' thoughts unlike international human rights treaties which provide that religious conscience is simply outside the purview of State regulation. *The People (Director of Public Prosecutions) v. Draper*, Irish Times, March 24, 1988. The court was willing to restrict untrammelled religious activity due to considerations of public order.

[227] Most recently Senator David Norris, quoting the former Attorney General, John Rogers, in relation to section 96 of the Charities Bill 2007 noted that; "The proposed legislation goes further than is reasonably required to address these evils, in that it renders a sale unlawful simply because it is unauthorised, the matter of unauthorised sales may well be a matter of concern to the Catholic Church, but does not appear to constitute an issue of public order or morality which would justify limiting religious freedom in the manner contemplated." Norris, David, Senate Debate, Vol. 193, No. 15, February 17, 2009, available at: http://debates.oireachtas.ie/DDebate.aspx?F=SEN20090217.xml&Page=1&Ex=663#N663.

[228] UN Human Rights Committee, General Comment No. 22 on Article 18 of the ICCPR, (Forty-eighth session, 1993), states that "limitations on the right to manifest a religion or belief for the purposes of protecting morals must be based on principles not deriving exclusively from a single tradition," [8], http://www1.umn.edu/humanrts/gencomm/hrcom22.htm, accessed January 24 2011.

[229] *Conlan v Mohamed* [1987] I.L.R.M. 172 (HC); [1989] I.L.R.M. 523 (SC).

[230] *ibid.*, at 525 per Finlay CJ in the Supreme Court.

definition of a marriage, such a union was not legally valid in Ireland. While Ní Shúilleabháin has noted that the case is suggestive of a public policy objection to such marriages, the court's conclusion avoided the issue and was not expressly based on public policy issues surrounding non-traditional marriages.[231]

Despite the clear difficulty of balancing competing rights of members of society, it is suggested that no public order or morality concerns arise from protection of Islamic finance as a religious practice. There is nothing morally repugnant about financial transactions which comply with Islam, particularly in light of the fact that such activities may seek to promote fair dealing, equity and integrity.[232] With similarities between Islamic financial doctrine and rules once relevant in Christianity and Judaism,[233] as well as the Vatican's approval of Islamic finance, the extent to which this activity could be challenged as contrary to morality, even Catholic morality, appears to be limited. Equally, religiously guided finance does not raise considerations of public order as it does not constitute any threat to the existing institutions or values of the state.[234] Islamic finance will not usurp the established financial system; the approach of the Irish Government towards this sector is one of establishing neutrality between conventional and Islamic transactions. Rather than privileging Islamic finance, the accommodations extend the range of financial services which may be provided in Ireland, thereby permitting Muslims to participate actively in the Irish financial industry in a manner compatible with their faith.[235] Accommodation would

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[231] Ní Shúilleabháin, Máire, "Accommodating Cultural Diversity under Irish Family Law," (2002) 24 *Dublin University Law Journal*, 175-198 at 183. In *Hamza & Anor v MJELR* [2010] IEHC 427 at [42], Cooke J noted that "a foreign marriage validly solemnised in accordance with the *lex loci* may be recognisable as valid in Irish law, even if it was potentially polygamous according to that law, provided neither party was domiciled in Ireland at the time and neither has also been married to a second spouse, either then or since." The court was therefore once again reluctant to fully recognise a polygamous marriage but as in *Conlan v Mohamed*, did not openly suggest that polygamy as such was contrary to public policy.

[232] *supra.*at 39.

[233] *supra.*at 56, (footnote 72).

[234] Danchin, Peter G., "Suspect Symbols: Value Pluralism as a Theory of Religious Freedom in International Law", (2008) 33(1) *The Yale Journal of International Law* 1-61 at 6-7 quoting Partsch who notes in relation to a similar limitation in the ICCPR, that "limitations on freedom to manifest one's religion cannot be imposed to protect *ordre public* with its general connotations of national public policy, but only where necessary to protect public order narrowly construed ie., to prevent public disorder," Partsch, Karl Josef, "Freedom of Conscience and Expression, and Political Freedoms", in *The International Bill of Rights: The Covenant on Civil and Political Rights*, Louis Henkin ed., (Colombia University Press, New York, 1981) 209 at 212-213 (footnote omitted).

[235] The Irish courts also appear to be implementing the proportionality principle when determining whether a restriction on religious free-exercise is justified. First articulated in Ireland in *Heaney v Ireland* [1994] 3 IR 593 at 607 this principle seeks to determine whether legislative restrictions on Constitutional rights were justified in light of the objective of the legislature. While this principle was recently applied by Mac Menamin J in *McNally v Ireland* to justify restrictions on the sale of mass cards as "minimally intrusive into...Constitutional rights,"(*McNally & Anor v Ireland & Ors* [2009] IEHC 573, at [187]) the notion of proportionality has only tangential relevance to a failure to accommodate Islamic finance in Ireland as the restriction on Muslims' ability to conduct financial activity in a manner consistent with their religious beliefs

simply make Ireland's legal and fiscal frameworks more amenable to diversity and would reduce a cognisable burden on the religious freedom of Muslims.[236]

5.4.2 Non-Discrimination on the Basis of Religion

Accommodation of Islamic finance activities may find justification in the notion of a constitutional protection of religious free-exercise. It could be suggested that modification of legislation and regulations in order to facilitate Islamic finance activity is also defensible under the Article 44 prohibition of disability or discrimination on the basis of religion and the corresponding protection of equality.[237] This ground of justification is weaker than one based on free-exercise, as any disadvantages faced by Islamic finance activity in Ireland are unlikely to be the result of a positive Government policy of religious discrimination. Nevertheless, it will be considered briefly as perhaps a secondary (but unlikely) constitutional rationale for accommodation.

The triumph of religious free-exercise, which has been evident in Irish caselaw and legislation, advocates accommodation of religious diversity where this is necessary to protect the freedom of religious practice. While permitting such positive discrimination, the comments in *Quinn's Supermarket* and subsequent jurisprudence do not undermine the continuing constitutional prohibition of negative discrimination where State activity adversely impacts on religious freedom. Preventing the State from "impos[ing] any disabilities or mak[ing] any discrimination on the ground of religious profession, belief or status," Article 44.2.3° limits the State's power to adversely differentiate on the basis of religion. Prohibiting both discrimination and disabilities, Article 44.2.3° provides a

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arose not out of an identifiable legislative action but rather out of inaction which could not be said to have had a specific purpose in mind.

[236] US authorities have similarly acknowledged that facilitation of Islamic finance may be justified on the basis of religious free-exercise, as Thomas Baxter, General Counsel and Executive Vice President of the Federal Reserve Bank of New York noted; "we [the regulators] are striving for a better understanding of the principles and tenets underlying Islamic finance, so we can accommodate the free-exercise of religion and still carry out our secular mandate," Baxter, Thomas C., "Regulation of Islamic Financial Services in the United States," Remarks Before the Seminar on Legal Issues in Islamic Financial Services Industry, March 2, 2005, available at: http://nubank.com/Islamic/ROIF.pdf. See also Kettell who notes that "[t]he West needs to understand Islamic finance because such an understanding is necessary to implement one of its own core values. The core value is freedom of religion...To foster banking and financial market integrity we need to see whether Western practices may be changed to accommodate and learn from those of the Muslim faith," Kettell, Brian, "The Last Word", note 50, at 29.

[237] Article 44.2.3°, *Bunreacht na hÉireann*, 1937.

constitutional foundation for positive State activity directed towards removing inequality on the basis of religion.[238]

In addition to this Article 44 prohibition of discrimination on the basis of religion, the Article 40.1 equality guarantee reinforces the notion of equality between people.[239] This provision notes that "[a]ll citizens shall, as human persons, be held equal before the law. This shall not be held to mean that the State shall not in its enactments have due regard to differences of capacity, physical and moral, and of social function."[240] Frequently interpreted by the Irish courts in a manner which is consistent with an Aristotelian concept of equality[241] - under which "we treat equals equally and unequals unequally"[242] - Article 40.1 does not guarantee absolute equality amongst people at all times. What it has been interpreted as prohibiting is "arbitrary discrimination"[243] in light of an individual's "human personality,"[244] that is, unjustifiably differentiating between people on the basis of a core attribute of their being, such as race or sex. Religious adherence to various belief structures recurs as a feature in the lives of much of the population and so it is suggested that religion forms an identifiable ground on which the State could seek to classify significant groups of people. While not strictly immutable,[245] religious affiliation nevertheless represents a powerful influence in adherents' lives, shaping their decision making. For many, religious belief forms a central part of their human integrity and part of their "human personality." Unjustifiable differentiation on the basis of religion strikes at a core aspect of a person's individuality separating people as "human persons" in circumstances where such classification may not be relevant.[246]

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[238] This right to non-discrimination on the basis of religion was explained in the context of the US Constitution by the US Commission on Civil Rights who noted that it sought to ensure "the equal protection of the laws, equality of status under the law, equal treatment in the administration of justice, and equality of opportunity and access to employment, education, housing, public services and facilities, and public accommodation because of their exercise of their right to religious freedom." U.S. Commission on Civil Rights, *Religious discrimination. A Neglected Issue*, (A consultation sponsored by the United States Commission on Civil Rights, Washington D.C., April 9-10, 1979).

[239] In *Nicolau v. An Bord Uchtala* [1966] IR 567 at 639, Walsh J referred to Article 40.1 as an acknowledgement of "human equality."

[240] Article 40.1°, *Bunreacht na hÉireann*, 1937.

[241] Doyle, Oran, *Constitutional Equality Law*, (Thomson Round Hall, Dublin, 2004), at 268.

[242] *de Búrca and Anderson v. AG* [1976] IR 38 at 68 per Walsh J.

[243] *ibid.*, Walsh J noting that "...Article 40[.1] does not require identical treatment of all persons without recognition of differences in relevant circumstances but it forbids arvitrary discrimination." See also Hanchy J in *Dillane v AG* [1980] ILRM 167 at 169.

[244] Doyle, Oran, "The Human Personality Doctrine in Constitutional Equality Law," (2001) 9 *Irish Student Law Review*, 101-121 at 103.

[245] *ibid.*, at 120.

[246] The view that religion should be included as a ground upon which equality should be protected has been acknowledged by the courts, as Hamilton CJ noted in *In re Article 26 and the Employment Equality Bill 1996* [1997] 2 IR 321 at 347, "[t]he forms of discrimination which are, presumptively at least, proscribed by

As a result of the structural and ideological disparities between secular and religious financial activity, disregard of these differences by the authorities could impose difficulty on attempts by Muslims to conduct their financial activities in a manner which is consistent with their religious beliefs. The imposition of conventional legal instruments on Islamic financial structures results in ambiguous, inconsistent and discriminatory treatment of individuals participating in this financial sector.[247] While Judaism and Christianity originally supported financial activity similar to contemporary Islamic finance, such practice is no longer strictly required within these religions.[248] For many Muslims on the other hand, the need to conduct their financial activities in compliance with *Sharī'ah* remains an aspect of their religion. As a result, by not acknowledging that the core principles underpinning Islamic banking and finance sit uneasily with the secular framework of Ireland's financial sector, the Irish authorities deny Muslims an equal opportunity to participate in financial activity, as a direct result of their religious beliefs, contrary to Article 44.2.3°.[249] At the same time, the burdens faced by Muslims in attempting to participate fully and freely in the financial sector are not experienced by all religions or all people equally. The effect of an untailored legislative and regulatory framework is the unfavourable treatment of one particular group of people on the basis of their religion, contrary to Article 40.1.

Notwithstanding this conclusion however, the concepts of both negative religious discrimination and equality have been interpreted narrowly by the Irish courts and it is, in practice, unlikely that an absence of Islamic finance in Ireland would be considered to be discriminatory.[250] Discussing a ban on religious advertising, Barrington J in *Murphy v. IRTC*[251] adopted a restrictive conception of unlawful discrimination when he noted that "[t]he ban is directed at material of a particular class and not at people who profess a

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Article 40.1 are not particularised: manifestly, they would extend to classifications based on sex, race, language, religious or political opinions." See also Walsh J in *Quinn's Supermarket* noting that; "[Article 40.1] is...a guarantee against any inequalities grounded upon an assumption, or indeed a belief, that some individual or individuals or classes of individuals, by reason of their human attributes or their ethnic or racial, social or religious background, are to be treated as the inferior or superior of other individuals in the community." *Quinn's Supermarket v. Attorney General* [1972] IR 1 at 13-14.

[247] See for example the anomalous legal treatment of those involved in Islamic real estate financing and *sukūk* under Irish law, *infra.*at Chapter 7 and 9.

[248] *supra.*at 56, (footnote 72).

[249] Justifying their own accommodations, UK authorities reached a similar conclusion noting that "Shari'a compliant finance is an important part of life for this faith group and the UK is committed to removing discrimination and unfair impediments," HMRC, "Shari'a Compliant Financial Products", *Compliance Cost Review*, at [4.3] available at: http://www.hmrc.gov.uk/ccr/sharia-compliant.pdf.

[250] Casey, James, *Constitutional Law in Ireland*, note 161, at 451.

[251] *Murphy v IRTC* [1999] 1 IR 12, [1998] 2 ILRM 360.

particular religion. All people in the same position are treated equally."[252] This statement has been interpreted by Hogan and Whyte as implying that only where State action has a discriminatory motive against a particular religion will it be unlawful.[253] This restrictive interpretation of what constitutes illegitimate differentiation between people has been reinforced by the court's application of Article 40.1. Noting that

> [Article 40.1] is...a guarantee against any inequalities grounded upon *an assumption, or indeed a belief*, that some individual or individuals or classes of individuals, by reason of their human attributes or their ethnic or racial, social or religious background, are to be treated as the inferior or superior of other individuals in the community,[254]

Walsh J in *Quinn's Supermarket* limited illegitimate inequality to circumstances in which there is an assumption or belief that a difference in treatment is justified. This view appears to require an active thought process motivating the selection of a particular group for differential treatment. Both the prohibition of religious discrimination and the right to equality are therefore relevant only when State action is overtly directed by a discriminatory intention. This restricts the relevance of the discrimination and equality provisions in the context of Islamic finance in Ireland, as any hurdles faced by Islamic finance market participants are not the result of conscious Government discrimination.[255] The burdens currently faced by those conducting Islamic finance in Ireland are structural and infrastructural rather than specific legal provisions consciously enacted by the Government to single out Muslims.

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[252] *ibid.*, at 370.

[253] Attributing this restricted conception of discrimination to the court's 'relatively limited understanding of the concept of equality' Hogan and Whyte agree that Barrington J's judgment potentially restricts the guarantee of non-discrimination only to situations of direct discrimination, Hogan, Gerard and Whyte, Gerard, *JM. Kelly, The Irish Constitution*, note 163, at 7.8.97.

[254] *Quinn's Supermarket v. Attorney General* [1972] IR 1 at 13-14, (emphasis added). This narrow interpretation of discrimination to only circumstances where it is direct can be contrasted with the equality guarantee found in the South African Constitution which explicitly prohibits the State from 'unfairly discriminate[ing] directly or indirectly against anyone on one or more grounds, including race, gender, sex, pregnancy, marital status, ethnic or social origin, colour, sexual orientation, age, disability, religion, conscience, belief, culture, language and birth' Article 9, Constitution of the Republic of South Africa (No. 108 of 1996), for more information on the equality guarantee in South Africa, see, O'Regan, Kate, "Cultivating a Constitution: Challenges Facing the Constitutional Court in South Africa", (2000) 7(1) *Dublin University Law Journal* 1-18.

[255] In the Australian case of *Halliday v The Commonwealth of Australia* (2000) 45 ATR 458, Sundberg J reached a similar conclusion, discussed in Freudenberg, Brett and Nathie, Mahmood, "Tax and Religion: Never the twain shall meet?" Paper presented at the 9th International Tax Administration Conference, Sydney, 9 April 2010.

5.4.3 Conclusion to Section 5.4

Religion occupies a complicated position in *Bunreacht na hÉireann*.[256] The history and plain text of the Constitution suggest that it is not simply religious in appearance, but Christian in nature,[257] yet the appreciation by the courts that Ireland is no longer religiously or culturally homogenous has led to an interpretation of the text which is reflective of pluralism. In practice, the application of Article 44 is unlikely to invalidate a law on the basis that such law imposes excessive legal or financial burdens on Islamic finance activity.[258] In light of the courts' retreat from judicially mandated accommodation of religious activities, the task of facilitating free-exercise now appears to rest with the legislature. Similarly, the requirement that discrimination is motivated by a positive intention on the part of the State to segregate a class of people, limits the extent to which ostensibly neutral laws can be challenged as unjustifiably discriminatory. Nevertheless, it is suggested that the constitutional guarantee of freedom of religious practice renders not simply permissible, but eminently justifiable, measures adopted by Irish authorities to identify and counter burdens faced by Muslims in relation to financial activity.

While there is some debate over the practices of conventional Islamic finance, the importance of complying with the financial dictates set out in the roots of Islamic law has received wide acceptance amongst Muslims. Increasing moves in Muslim states to foster their own Islamic finance industries and the development of retail-level *Sharī'ah*-compliant financial structures in Muslim and Western countries highlight the reality that fulfilling the dictates of Islamic law in financial activity represents a discernable and significant element of the Islamic religion. By attempting to remove some of the obstacles and discriminations which undermined the ability to comply with these teachings, Ireland has taken responsive step towards respecting the unique demands of Islamic law.

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[256] Hannon, Patrick, "In God's Name, What Next? Religion, the Constitution and the New Ireland" in *The Irish Constitution: Governance and Values*, Oran Doyle and Eoin Carolan, (eds.), Thomson Round Hall, Dublin, 2008), 463-475.

[257] Barrett, Richard, "Church and State in Light of the Report of the Irish Constitution Review Group" (1998) 20 *Dublin University Law Journal*, 51-72.

[258] *Halliday v The Commonwealth of Australia* (2000) 45 ATR 458.

5.5 Conclusion to Chapter 5

At a time both of financial difficulty and increasing pluralism, the Irish Government's somewhat delayed attempts to facilitate Islamic finance do not come as an unsurprising development. Through such accommodations, Ireland has not recognised Islamic finance as a parallel financial system but has rather attempted to integrate the Islamic finance system into the existing legal framework.[259] As a result, the accommodations already introduced have been a step towards the removal of tax and regulatory burdens faced by Islamic finance activity which would otherwise result in such activity being difficult or legally impossible to conduct under Irish law.[260]

The accommodating approach which Ireland has adopted is appropriate. By integrating Islamic finance into the existing system and extending comparable legal treatment only to the extent that Islamic finance activity is substantively similar to conventional structures, the accommodations will help to maintain the integrity of Ireland's tax and regulatory systems. Any prioritisation of Islamic finance could be interpreted as placing conventional financing at a disadvantage. It could also lead to unbalance in the financial system as it would result in economically comparable products being subject to different legal treatment. Particularly in light of the fact that Ireland's accommodating tax provisions are not limited in their application to products which prove their *Sharī'ah* legitimacy, it is clear that the Irish authorities are unconcerned with religious compliance. They are instead concerned with the substance of the products. Where those products are substantively similar to interest-based structures, it is logical that they should be treated in a similar manner.

Difficulties are likely to arise where Ireland's "level playing field" approach is insufficient to allow the full application of Islam's financial principles. The balance created between the provisions of Article 44 - that is, freedom of religious free-exercise and the prohibition of discrimination, both negative *and positive*, on the basis of religion - justifies

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[259] Nazir-Ali, Michael, "Islamic Law, Fundamental Freedoms, and Social Cohesion: Retrospect and Prospect", in *Shari'a in the West*, note 224, at 84.

[260] Solé, Juan A., "Introducing Islamic Banks into Conventional Banking Systems", note 28, at 16 noting that; "[t]he authorities are also called to play a decisive developmental role, as they can affect the degree of success with which Islamic banking is introduced into a conventional system. In this sense, the role of the supervisor is not only to guarantee financial stability, but also to foster an environment where Islamic banking can offer a suitable response to customers' demands for Islamic products. This is not to say that regulatory advantages should be given to Islamic institutions, but rather that a level playing field should be provided."

accommodation to the extent that that accommodation is necessary to allow free-exercise. The Government's policy of extending equality of legal treatment to substantively similar products may still result in difficulties for Islamic products which are *not* economically comparable to conventional structures or where they contain elements (required by Islamic law) which prevent them from falling within the accommodating legal provisions. The reality remains therefore that the level playing field approach may not allow full freedom to conduct Islamic finance activity. In light of this, it is suggested that the development of an Islamic finance market sector in Ireland will require accommodation both on the part of the Irish authorities and amongst Islamic finance market participants.[261] A policy requiring assimilation of Islamic finance by the Government or unresponsive accommodations which do not take into account unique characteristics of Islamic finance would hinder the development of this sector and restrict both the economic benefits and religious practice it entails. On the other hand, some compromise and adjustments may be needed within the Islamic transactions themselves in order to ensure that they are compatible with the laws of Ireland, as the jurisdiction and legal order under which they will be operating. A process of "mutual acculturation" may be required in which "each system [is] sensitive to the core values of the other."[262] The preponderance of any accommodation may need to be undertaken within Irish laws; an Islamic finance contract which has been modified to such an extent that it no longer complies with Islamic law loses its religious legitimacy. However, in order to avoid conferring benefits on Islamic finance which are unavailable to other market sectors, legal allowances may not be possible for every distinctive element of an Islamic finance transaction.[263]

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[261] As the Organisation for Security and Co-operation in Europe noted in relation to accommodation of religious activities, "*[t]o the extent possible*, the State should attempt to provide reasonable alternatives [within neutral laws] that burden neither those with conscientious beliefs nor the general population," the two interests must be balanced against each other, OSCE/ODIHR Advisory Panel of Experts on Freedom of Religion or Belief, *Guidelines for Review of Legislation Pertaining to Religion or Belief*, June 3, 2004, at 23, available at: http://www.osce.org/odihr/13993, (emphasis added).

[262] Gaudreault-DesBiens, Jean-François, "Religious Courts' Recognition Claims : Two Qualitatively Distinct Narratives", in *Shari'a in the West*, Rex Ahdar and Nicholas Aroney (eds.), (Oxford University Press, Oxford, 2010), 59-70 at 61

[263] See the discussion by Ahdar and Aroney in relation to the accommodation of Islamic practices generally and the similar conflicts which arise in relation to such measures; "[s]tates have invariably been prepared to grant the occasional ad hoc exception [to neutral laws] where these sorts of concessions do not cost the state too much – in terms of both loss of face and derogation from significant societal objects that would otherwise be met by the law," an unbalancing of the financial system through the creation of a playing field which is in fact disproportionately favourable to Islamic finance would arguably be a relevant example of this, Ahdar, Rex and Aroney, Nicholas, "The Topography of Shari'a in the Western Political Landscape", in *Shari'a in the West*, Rex Ahdar and Nicholas Aroney (eds.), (Oxford University Press, Oxford, 2010), 1-32 at 24.

Building upon the ideological underpinnings of Islamic finance and the conceptual basis for Islamic finance in Ireland considered in Parts I and II respectively, Part III of this thesis will consider practical elements of an Irish Islamic finance industry. Chapters 6 and 7 will consider Islamic real estate finance[264] while Chapter 8 and 9 will consider *sukūk*.[265] Chapter 10 will address the supervision of Islamic financial activity.[266]

[264] *infra.* at 199 and 222.
[265] *infra.* at 295 and 325.
[266] *infra.* at 379.

PART III

THE PRACTICAL INTERACTION BETWEEN ISLAMIC FINANCE AND IRISH LAW

Chapter 6

Islamic Real Estate Financing Structures

6.1 Introduction

Chapter 5 demonstrated that while the Irish Government may be under no positive obligation to facilitate an Islamic finance industry domestically, there are a variety of economic and social reasons why such accommodation can be implemented. Part III of this thesis will build upon the theological discussion of Islamic finance undertaken in Part I, and the Part II consideration of the conceptual issues raised by accommodation, and will discuss the practical interaction between Islamic finance and Irish law.

Chapters 6 and 7 will consider the first of two Islamic finance products: Islamic real estate financing. Cumulatively, these Chapters determine how Ireland's laws and supporting infrastructure may impact upon Islamic property financing products. A two chapter format has been adopted for two reasons. First, a variety of different real estate financing structures are available in the Islamic finance industry. Before discussing the legal treatment of each of these structures in Ireland, the structures themselves must be understood and the unique characteristics of each must be considered (Chapter 6). Only then can the focus of discussion be narrowed to the interaction between these structures and national law. Second, Islamic real estate financing in Ireland raises a myriad of legal issues which must be dealt with in detail before conclusions can be reached on the current legal status of these products in Ireland, their likely legal treatment and any reforms which may be necessary (Chapter 7).[1]

[1] *infra.* at 222.

Chapter 6 will thus discuss the various *Sharī'ah*-compliant structures[2] used in Islamic real estate finance activity: *murābaha* (6.2.1),[3] *ijārah wa-iqtina* (6.2.2)[4] and diminishing *mushāraka* (6.2.3)[5].

Real estate transactions are a key component of contemporary Islamic finance, both at retail and commercial level. The "noticeable bias"[6] of the Islamic finance industry towards real estate has arisen for a number of reasons. Real property provides the tangibility and income producing qualities advocated by Islamic law as a means of avoiding speculation and the production of money from money alone.[7] Where a financial transaction is backed by real estate, revenue produced does not take the form of interest but is instead generated from a real asset and is consistent with Islamic law.[8] In addition to this, real estate finance already represents a central aspect of conventional, interest-based financial activity; those using Islamic structures have the same need for property as market participants whose financial activity is not influenced by religious motivations.[9]

Conventional mortgages of real estate present Islamic market participants with a number of ideological difficulties. A conventional mortgage of property involves the use of that property as a guarantee or security designed to ensure that a loan will be repaid or some other obligation performed.[10] When the loan is repaid, generally at a premium, the

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[2] As will be discussed below, these structures are based on the nominate contracts outlined in Chapter 3.

[3] *infra.* at 204.

[4] *infra.* at 210.

[5] *infra.* at 215.

[6] *Proceedings of the Second Oxford Islamic Finance Round Table*, "The Frontiers of Innovation in Islamic Finance," Oxford, April 15, 2009, (International Shari'ah Research Academy for Islamic Finance (ISRA), Kuala Lumpur, 2010), at 20.

[7] Wigglesworth, Robin, "Islamic banks caught between two worlds", *Financial Times*, April 20, 2010, available at: http://www.ft.com/cms/s/0/13061e36-4bde-11df-a217-00144feab49a.html#axzz1QYQmBpsK.

[8] Pollard, Jane, and Samers, Michael, "Islamic banking and finance: postcolonial political economy and the decentring of economic geography", (2007) 32(2) *Transactions of the Institute of British Geographers*, 313-330 at 314.

[9] AbdAllah, Ahmed Ali, "Forms of Investment in Real Estates in Islamic Perspectives, in Islamic Banking Modes for Building Financing", *Proceedings of a Workshop organized in Khartoum by the Islamic Research and Training Institutie of the Islamic Development Bank, October 27-29, 1991, Seminar Proceedings Series No. 28*, Mahmoud Ahmad Mahdi (ed.), (Islamic Research and Training Institute, Jeddah, 1995), 43-54 at 43. See also *Qur'ān* 16:080: "It is God Who made your habitations homes of rest and quiet for you; and made for you, out of the skins of animals, (tents for) dwellings, which ye find so light (and handy) when ye travel and when ye stop (in your travels); and out of their wool, and their soft fibres (between wool and hair), and their hair, rich stuff and articles of convenience (to serve you) for a time." Meera, Ahamed Kameel Mydin, and Razak, Dzuljastri Abdul, "Islamic Home Financing through *Musharakah Mutanaqisah* and *al-Bay' Bithaman Ajil* Contracts: A Comparative Analysis", (2009) 22(1) *Journal of King Abdulaziz University: Islamic Economics*, 121-143, at 5.

[10] Coughlan, Paul, *Property Law*, (2nd ed., Gill & Macmillan Ltd., Dublin, 1998), at 353. See also *Santley v Wilde* [1899] 2 Ch 474 (approved by Lord Halsbury in *Noakes & Co. v. Rice*, [1902] A.C. 24, at 28) where Lindley MR defined a mortgage as "a conveyance of land or an assignment of chattels as a security for the payment of a debt or the discharge of some other obligation for which it is given."

mortgage over the property will be released and the financier's interest in the property will finish.[11] If the borrower fails to repay the loan, the financier may enforce its interest in the property and use that interest to obtain repayment. At its core, secured property lending involves the use of the property to guarantee repayment to the financier of an amount in excess of what was originally loaned.[12] The assured repayment of a higher sum violates the contemporary interpretation of the *ribā* and *gharar* prohibitions;[13] a mortgage loan involves not simply payment of interest to a financier, but it also seeks to guarantee repayment of the loan and profit, regardless of intervening events.[14] As a result of the *Sharī'ah*-incompatible aspects of conventional mortgages, market participants who want to conduct their financial activity in accordance with Islamic dictates may be excluded from participating in the property financing market.[15] This places Muslims in a difficult position as, on the contemporary western model of property acquisition, they could be prevented from acquiring ownership of property unless they can afford to pay the full purchase price immediately.

As of August 2011, neither retail nor wholesale Islamic real estate financing products are offered in Ireland. This is notwithstanding the fact that the Department of Finance has noted that some of the transactions accommodated in the Finance Act 2010 could be used for "mortgages which are structured to comply with Shari'a principles."[16] An absence of *Sharī'ah*-compliant real estate financing in Ireland does not mean that there is no market for such products. At retail-level, there are indications, already discussed in Chapter 5, that Muslims see a need for mortgage-alternatives which are compatible with their interpretation of Islamic law.[17] Perhaps most telling of this gap in Ireland's financial services market, there is anecdotal evidence that money received from informal sources, such as the co-operative model implemented within the Muslim community, is being used

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[11] *Fisher and Lightwood's Law of Mortgage*, Wayne Clark (ed.). (13th ed., LexisNexis Butterworths, London, 2010), at [1.3].

[12] Maurer, Bill, *Pious Property; Islamic Mortgages in the United States*, (Russell Sage Foundation, New York, 2006), at 18-19, Wylie, JC.W., *The Land and Conveyancing Law Reform Act 2009: Annotations and Commentary*, (Bloomsbury Professional, West Sussex, 2009), at 257 discussing the characteristics of a mortgage.

[13] *supra.* at 53(*ribā*) and 59 (*maysir/gharar*)

[14] Gray, Kevin and Gray, Susan Frances, *Land Law*, (Oxford, Oxford University Press, 2007), at 216, Murray, Jennifer, "Of Note: Home Ownership the Islamic Way: Sharia-Compliant Mortgages in the United States", (Summer-Fall 2007) 27(2) *SAIS Review*, 93-94at 93.

[15] Said, Carolyn, "A means to a Home: Islamic Co-ops Create Happy Homecomings", *San Francisco Chronicle*, November 1, 2006 at C1, Mann, Roberta, "Is Sharif's Castle Deductible?: Islam and the Tax Treatment of Mortgage Debt", (2009) 17 *William & Mary Bill of Rights Journal*, 1139-1169 at 1147.

[16] Department of Finance, *Islamic Finance in Ireland; An Information Note*, (Department of Finance, Dublin, March 2010), at 5.

[17] *supra.* at 168.

to pay off conventional mortgage loans, thereby shortening the time these Muslims have a *ribā*-based obligation to a bank.[18] As a result of this simple lack of Islamic real estate financing products in Ireland, Muslims may be able to rely on the 1999 *fatwā* issued by the ECFR which concluded that Muslims living in a non-Muslim country could use a conventional loan to acquire their home where they had no other reasonable choice.[19] However, the legitimacy of this *fatwā* is increasingly uncertain in light of the growing prominence of Islamic finance in the global economy, the availability of these products in the UK[20] and the amendments to Ireland's TCA which are designed to facilitate Islamic structures.[21] In line with the statements made in Chapter 5, the development of retail-level Islamic finance in Ireland may not only add to the range of financial products available domestically, but it could also facilitate the exercise of religious beliefs. The creation of a legal environment which is conducive to such transactions could allow the realisation of these benefits.

At wholesale-level, indications of a need for Islamic real estate financing in Ireland are more limited. Nevertheless, the recent announcement by the National Asset Management Agency [NAMA] that it plans to "boost"[22] Ireland's beleaguered commercial property market[23] by facilitating the sale of commercial property, could indicate an area for the future growth of Islamic real estate financing. The Agency has noted that it expects purchasers of the property to be "sovereign wealth funds, pension funds, insurance companies and private equity firms."[24] With continuing liquidity amongst Middle Eastern and Asian investors,[25] particularly the sovereign wealth funds of Gulf States,[26] the

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[18] Correspondence with Shahzad Ahmed, Appendix 7, *infra.* at 468.

[19] European Council for Fatwa and Research, *Resolution 2/4: Purchasing houses with a usurious loan for Muslims living in non-Muslim countries, i.e. taking up a mortgage to buy a house*, (ECFR, Dublin, 1999), available at: http://www.e-cfr.org/en/index.php?ArticleID=285. See Caeiro, Alexandre, "The Social Construction of Shari'a: Bank Interest, Home Purchase, and Islamic Norms in the West", (2004) 44(3) *Die Welt des Islams*, 349-375 for an extensive discussion of the *fatwā*. Three weeks after the European *fatwā*., a similar one was issued in the US by the League of *Sharī'ah* Scholars of North America.

[20] Housby, Elaine, *Islamic Financial Services in the United Kingdom*, (Edinburgh University Press, Edinburgh, 2011), at 81.

[21] The *fatwā* was itself the subject to considerable backlash. For example, Shaykh Mahmud b. Rida Murad in Saudia Arabia stated that "by allowing usury, [the ECFR] permitting Muslims in the West to fornicate, to consume alcohol and to commit all sorts of sins, since its reasoning allows all difficulties to be removed" Da'wa. 02/12/1999 quoted in Caeiro, Alexandre, "The Social Construction of Shari'a: Bank Interest, Home Purchase, and Islamic Norms in the West", note 19, at 365.

[22] Anonymous, "NAMA chiefs announce plans to boost Irish residential and commercial property markets", *Findfacts Ireland*, May 19, 2011, available at: http://www.finfacts.ie/irishfinancenews/article_1022339.shtml

[23] O'Brien, Sean, "Irish Market in Irish Commercial Property Outlook 2011", *CB Richard Ellis*, (2011) 8 at 8, available at: *www.cbre.co.uk/ukni_en/...ireland.../CBRE_Outlook_2011.pdf.*

[24] Frank Daly and Brendan McDonagh quoted in Anonymous, "NAMA chiefs announce plans to boost Irish residential and commercial property markets", note 22.

[25] *supra.* at 156.

development of *Sharī'ah*-compliant commercial real estate financing could be a means of drawing such investors into Ireland's commercial property market. This could increase capital within the Irish economy while also furthering the Government's aim of facilitating Islamic finance domestically.[27]

6.2 Dominant Contractual Forms used in Islamic Real Estate Financing

The roots of Islamic law have not established a single, complete *Sharī'ah*-compliant product which can be used to fund real property activity. Like many products in the contemporary Islamic finance industry, Islamic real estate transactions involve one or more of the classical nominate contracts, which have been combined, modified or multiplied in a way which is designed to achieve largely the same economic result as a conventional product (in this case, interest-based mortgages of immovable property).[28] Rather than one Islamic real estate financing product, several different legal forms have been developed, each of which professes *Sharī'ah*-compliance, but each of which has been developed to fund the acquisition and/or development of immovable property in a slightly different manner. This section will outline the structure of *murābaha* (6.2.1),[29] *ijārah wa-iqtina* (6.2.2),[30] and diminishing *mushāraka* (6.2.3)[31] products.[32] It will also discuss the techniques implemented in contemporary transactions in order to ensure that they function like mortgage loans. The basic structure of the underlying contractual forms has already been addressed in Chapter 3[33] and so the focus of this section will be on the use of those

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[26] *supra.* at 152.

[27] In relation to commercial Islamic real estate financing in the UK, Investment Week, quoting law firm Trowers & Hamlins notes that "the proportion of international investment in the UK commercial property market from the Middle East has trebled over the last five years and that Gulf investors committed nearly £3bn to the UK commercial property market in the two years following the credit crunch." Denison, Nigel, "Islamic asset allocation in the current environment", *Investment Week*, September 22, 2010, available at: http://www.investmentweek.co.uk/investment-week/feature/1734801/Islamic-asset-allocation-current-environment.

[28] *supra.* at 146.

[29] *infra.* at 204.

[30] *infra.* at 210.

[31] *infra.* at 215.

[32] Other models such as the *istisnā'* (particularly the *istisnā'-ijārah*) will not be considered in this Chapter for a number of reasons. 1. Space constraints limit the number of contracts which can be dealt with in detail. 2. While *istisnā'-ijārah* structures have been used in project financing, the other three structures (*murābaha*, *ijārah wa-iqtina* and diminishing *mushāraka*) have been widely used in both commercial and retail-level arrangements around the world. 3. Because of the *ijārah* element in istisnā'-*ijārah* structures, many of the issues considered below in relation to *ijārah*-based contracts will be relevant in the context of *istisnā'-ijārah*, by addressing these issues therefore, this Chapter is indirectly dealing with issues which may be faced by parties to an *istisnā'-ijārah* structure in Ireland. *Istisnā'* are discussed in detail *supra.* at 77.

[33] *supra.* at 73 (*murābaha*) 83 (*mushāraka*) and 87 (*ijārah*).

contracts in the context of real estate financing. While there is no certainty that *murābaha*, *ijārah wa-iqtina* and diminishing *mushāraka* will be the instruments used in Ireland should Islamic real estate finance ever be offered, it is suggested that in line with international practice, one or more of these three structures will be the contractual form most likely implemented. As a result, while this section may appear overly focused on the detail of each structure, this is because when the legal treatment of Islamic real estate in Ireland is considered in Chapter 7, it is these three instruments, together with their unique structures, which will be discussed.

6.2.1 *Murābaha* with a Purchase Order[34]

Like a conventional mortgage, *murābaha*-based property acquisitions provide a customer with an opportunity to purchase specific real estate, while deferring payment of the asset price over a period of time.[35]

As *Sharī'ah* prohibits a party from selling something which he or she does not own,[36] the financier in a *murābaha* real estate transaction must assume ownership of the property, together with physical or at least constructive possession of it, before selling that property to the customer.[37] In line with the *Sharī'ah* maxim "gain accompanies liability for loss,"[38]

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[34] *supra.* at 74.

[35] Ahmad, Abu Umar, *Theory and Practice of Modern Islamic Finance; The Case Analysis from Australia*, (BrownWalker Press, Florida, 2010), at 193.

[36] See discussion of gharar *supra.* at 59, Narrated Hakim ibn Hizam, "Hakim asked (the Prophet): Apostle of Allah, a man comes to me and wants me to sell him something which is not in my possession. Should I buy it for him from the market? He replied: Do not sell what you do not possess." *Sunan Abu-Dawud*, Book 23, Number 3496, Prof. Ahmad Hasan (trans.), available at: http://www.usc.edu/schools/college/crcc/engagement/resources/texts/muslim/hadith/abudawud/023.sat.html. See also, Rayner, Susan, *The Theory of Contracts in Islamic Law: A Comparative Analysis with Particular Reference to the Modern Legislation in Kuwait, Bahrain and the United Arab Emirates*, (Graham & Trotman, London, 1995), at 133.

[37] AAOIFI, Shari'a Standard No. (8), "Murabaha to the Purchase Orderer", in *Shari'a Standards for Islamic Financial Institutions 1432 H-2010*, (AAOIFI, Bahrain, 2010), 111-136 at 132, McMillen notes that "[d]elivery, for the purposes of the shari'a, relates to the removal of obstacles by the seller between the purchaser and the object of sale (the property), allowing the purchaser to take ownership and control of the object." Physical possession of the property is therefore not strictly necessary for the financier to assert ownership-based control over that asset. McMillen, Michael J.T., "Structuring a Securitized Shari'a-Compliant Real Estate Acquisition Financing: A South Korean Case Study", in *Islamic Finance; Current Legal and Regulatory Issues*, S. Nazim Ali, (ed.), (Islamic Finance Project, Islamic Legal Studies Program, Harvard Law School, Cambridge, Massachusetts, 2005), 77-106 at 93. See also, McMillen, Michael JT., "Trends in Islamic Project and Infrastructure Finance in the Middle East: Re-Emergence of the Murabaha", (February 1, 2011), available at http://ssrn.com/abstract=1753252 in which McMillen notes at 8 that: "[c]onstructive possession here means that the seller has assumed all liabilities and obligations of ownership and possession, including in respect of destruction or "perishing", even though the seller has not taken physical delivery of the object," Usmani, Muhammad Taqi, *An Introduction to Islamic Finance*, (Kluwer Law International, The Hague, 2002), at 42.

the financier must also bear all the risks associated with ownership and so between the time the financier acquires the assets and the point at which ownership is transferred to the customer, the financier should bear the risk that the property may be destroyed or damaged, or that the customer may refuse to purchase the asset from the financier.[39] This assumption of ownership risk - as opposed to credit risk - is uncharacteristic of conventional mortgages, but it ensures that profit received by the financier arises out of the trade in a tangible asset rather than the use of money alone.[40] In practice, the financier generally appoints an agent (*wakeel*),[41] who may be the customer, to purchase and hold the asset on the financier's behalf.[42] In circumstances where the customer is appointed as agent, the customer and not the financier can deal directly with the vendor. This minimises potential for the customer to subsequently reject the property as being unsatisfactory. [43]

Once the financier has assumed ownership of the real estate,[44] it then sells that property to the customer *qua* customer on a deferred basis for a pre-agreed mark-up.[45] Title to the

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[38] *Sunan Abu-Dawud*, Book 23, Number 3501, Prof. Ahmad Hasan (trans.), available at: http://www.usc.edu/schools/college/crcc/engagement/resources/texts/muslim/hadith/abudawud/023.sat.html, Ibn Qayyim, 2 *I.lam al-Muwaqqi.in* 20 (Dar al-Kutub al-Hadithah 1969) in Moghul, Umar F., "No Pain, No Gain: The State of the Industry in Light of an American Islamic Private Equity Transaction", (2007) 7(2) *Chicago Journal of International Law*, 469-494 at 470. See also *supra.* at 60.

[39] *supra.* at 73, AAOIFI, Shari'a Standard No. (8), "Murabaha to the Purchase Orderer", note 37, at 120-121, Moghul, Umar F. and Ahmed, Arshad A., "Contractual Forms in Islamic Finance Law and Islamic Inv. Co. of the Gulf (Bahamas) Ltd. V. Symphony Gems N.V. & Ors.: A First Impression of Islamic Finance", (2003) 27(1) *Fordham International Law Journal*, 150-194 at 180 noting that: "[t]he very substance of a *murabahah* dictates, among other things, that the seller be exposed to the risks normally associated with ownership, such as the risk of loss, damage, and deterioration of the goods prior to delivery. The seller must also accept the buyer's ability to return the good and rescind the sale if the goods are damaged, deficient, do not meet the buyer's preferences, or involve a mistake in pricing."

[40] It is however precisely because of this allocation of responsibility that the Islamic Fiqh Academy has approved *murābaha* contracts as sufficiently distinct from interest-based loans to justify the financier's profit margin, Islamic Fiqh Academy of the OIC, "Decision 3, 2", fifth session (1988) *Fiqh Academy Journal* 2:1599, in Vogel, Frank E. and Hayes, Samuel.L., *Islamic Law and Finance, Religion, Risk and Return*, (The Hague, Kluwer Law International, 1998), at 140. Usmani, Muhammad Taqi, *An Introduction to Islamic Finance*, note 37, at 42, Obaidullah, Mohammed, *Islamic Financial Services*, (Scientific Publishing Centre, King Abdulaziz University, Jeddah, Saudi Arabia, 2005), at 72.

[41] This arrangement must be contained in a *separate* agency agreement (*wakāla*), AAOIFI, Shari'a Standard No. (8), "Murabaha to the Purchase Orderer", note 37, at 132 noting that the agency contract must be separate from the murabaha transaction "to be sure that there is no any [sic] intentional arrangement to connect the two contracts."

[42] Usmani, Muhammad Taqi, *An Introduction to Islamic Finance*, note 37, at 42, Ayub, Muhammad, *Understanding Islamic Finance*, (John Wiley & Sons Ltd., West Sussex, 2007), at 225-226.

[43] Commentators have however stressed the need to maintain a clear delineation between the roles of the parties; when the customer initially purchases the asset from the vendor it does so as agent for the financier and so ownership and liabilities associated with the asset rest with the financier, Thomas, Abdulkader, Qiser, Waheed, Al-Bahar, Bader and Haron, Sudin, "Structuring Islamic mortgage and home finance products", in *Islamic Retail Banking and Finance: global challenges and opportunities*, Sohail Jaffer (ed.), (Euromoney Books Ltd., London, 2005), 75-96 at 79.

[44] The OIC has approved constructive possession of an asset nothing that: "[j]ust as the possession of commodities may be physical, by taking the commodity in one's hand or measuring or weighing the eatables, or by transferring or delivering the commodity to the premises of the buyer, the possession may also be an implied or constructive possession, which takes place by leaving the commodity at one's disposal and

property is transferred to the customer immediately on completion of the second sale, even though payments for the property are spread over a series of instalments.[46] Upon title transfer, the relationship between the parties is no longer one of seller and purchaser but rather one of creditor and debtor, as the customer is now under an obligation to pay the marked-up purchase price for the property.[47] As full legal and beneficial owner of the property, the customer assumes the rights and responsibilities of ownership immediately upon completion of the second sale.[48]At this point, the customer may create a charge (*rahn*)[49] over the property in favour of the financier as security for the debt which is owed.[50]

In theory, *murābaha* real estate financings impose liabilities on a financial institution, which are not normally found in a conventional financing structure, such as a mortgage loan.[51] In practice, financial institutions offering these Islamic products generally seek to minimise the extent to which they are actually burdened by asset, market and counterparty risk.[52] In order to avoid asset risk, the time period during which the financier owns the real estate is often reduced to minutes, or even seconds, with the first and second sale of the property occurring virtually instantaneously.[53] The actual level of asset risk borne by the financier is therefore closely aligned with that present in a conventional mortgage.[54]

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enabling him to deal with it as he wishes. This will be deemed a valid possession, even though the physical possession has not taken place. As for the mode of possession, it may vary from commodity to commodity, according to its nature and pursuant to the different customs prevalent in this behalf." Council of the Islamic Fiqh Academy, *Resolutions and Recommendations (1985–2000)*, (IRTI, IDB, Jeddah, 2000), at 107, Resolution No. (53/4/6), concerning "Possession: Its Different Forms, Especially the Modern Forms and their Rules". In relation to real estate it seems likely that registration of the property in the name of the financier is preferable though not necessarily essential so long as the financier assumes the risks of ownership of that asset, even if indirectly through the agent.

[45] *supra.* at 73, AAOIFI, Shari'a Standard No. (8), "Murabaha to the Purchase Orderer", note 37, at 122.

[46] *supra.* at 74, Zubairi, Sohail, "Home Finance schemes in the UAE: A case study", in *Islamic Retail Banking and Finance: global challenges and opportunities*, Sohail Jaffer (ed.), (Euromoney Books Ltd., London, 2005), 88-97 at 95, Housby, Elaine, *Islamic Financial Services in the United Kingdom*, note 20, at 82.

[47] AAOIFI, Shari'a Standard No. (8), "Murabaha to the Purchase Orderer", note 37, at 122.

[48] Usmani, Muhammad Taqi, *An Introduction to Islamic Finance*, note 37, at 42.

[49] In the sense of a security interests in real property and other immovable property, McMillen, Michael, J.T., "A Rahn-Adl Collateral Security Structure, for Project and Secured Financings", in *Proceedings of the Third Harvard University, Forum on Islamic Finance: Local Challenges, Global Opportunities*, (Center for Middle Eastern Studies, Harvard Islamic Finance Information Program, Harvard University, Boston, 2000), 111-135 at 111.

[50] Usmani, Muhammad Taqi, *An Introduction to Islamic Finance*, note 37, at 53.

[51] El-Gamal, Mahmoud Amin, *Islamic Finance: Law, Economics, and Practice,* (Cambridge University Press, Cambridge, 2006), at 65.

[52] As one commentator notes; banks in particular are financial intermediaries, not traders, Sairally, Beebee Salma, "Murabahah Financing: Some Controversial Issues", (2002) 12 *Review of Islamic Economics*, 73-86 at 80.

[53] El-Gamal, Mahmoud, *Islamic Finance; Law, Economics and Practice*, note 51, at 67. Some *Sharī'ah* boards do require a gap of fifteen minutes between the first and second sale, potentially increasing the financier's asset risks. Nevertheless, market practice has generally followed the rapid sale approach to

Contemporary *murābaha*-based financings also mitigate counter-party and market risk faced by financial institutions by ensuring a captive market out of which predictable and economically viable returns can be generated.[55] As a financier in a *murābaha* transaction may not sell what it does not own, the property must first pass into the ownership of the financier.[56] Unless the financier is certain that the customer will subsequently purchase the asset, there is a risk that the customer may refuse or be unable to complete the second sales transaction.[57] However, Islam does not permit a sales contract in which both the price and delivery are delayed, as such an arrangement contradicts the prohibition of *gharar*.[58] As a result, the financier and customer may not enter into a bilateral contract for the sale of the property to the customer at a defined point in the future as there can be no certainty that the asset will be in existence on that date or that the customer will still want it.[59] This does not prevent the customer from "promising" (*wa'd* (promise)) to purchase the property once the financier obtains possession.[60] The extent to which this promise can be made binding has been, and remains, a source of considerable disagreement amongst commentators and amongst market participants.[61] For the majority of classical scholars, the initial purchase of the property by the financier cannot be dependent upon the customer promising to

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murābaha property financings, Hegazy, Walid S., "Contemporary Islamic Finance: From Socioeconomic Idealism to Pure Legalism", (2007) 7(2) *Chicago Journal of International Law*, 581-603 at 600.

[54] El-Gamal, Mahmoud, *Islamic Finance; Law, Economics and Practice*, note 51, at 67-68, Hegazy, Walid S., "Contemporary Islamic Finance: From Socioeconomic Idealism to Pure Legalism", note 53, at 599, Obaidullah, Mohammed, *Islamic Financial Services*, note 40, at 72, Khan, Mansoor H., "Designing an Islamic Model for Project Finance", (1997) 16 *International Financial Law Review* at 13-16.

[55] Vogel, Frank E. and Hayes, Samuel.L., *Islamic Law and Finance, Religion, Risk and Return*, note 40, at 140.

[56] *supra.* at 75. Ercanbrack, Jonathan, "Accommodating the dynamism of commerce and trade: the role of custom and jurisprudential principles in commercial Islamic law", Paper presented at Re-Imagining the Shari'a: Theory, Practice And Muslim Pluralism At Play, September 13-16, 2009, Warwick in Venice - The Palazzo Pesaro-Papafava, Venice, Vogel, Frank E. and Hayes, Samuel.L., *Islamic Law and Finance, Religion, Risk and Return,* note 40, at 142, noting that in the case of unique goods (*'ayn*), the seller in the second sale must have ownership and possession before a customer can bindingly agree to purchase those goods.

[57] Vogel, Frank E. and Hayes, Samuel.L., *Islamic Law and Finance, Religion, Risk and Return,* note 40, at 141, Haron, Abdullah and Hock, John Lee Hin, "Inherent Risk: Credit and Market Risks", in *Islamic Finance: The Regulatory Challenge*, Simon Archer and Rifaat Ahmed Abdel Karim (eds.), (John Wiley & Sons (Asia) Ptd Ltd., Singapore, 2007), 94-120 at 97-98.

[58] Haneef, Mohamed Rafe Md., "Recent Trends and Innovations in Islamic Debt Securities: Prospects for Islamic Profit and Loss Sharing Securities", in *Islamic Finance, Current Legal and Regulatory Issues*, S. Nazim Ali, (ed.), (Islamic Finance Project, Islamic Legal Studies Program, Harvard Law School, Cambridge, 2005), 29-60 at 37.

[59] Meera, Ahamed Kameel Mydin, and Razak, Dzuljastri Abdul, "Islamic Home Financing through *Musharakah Mutanaqisah* and *al-Bay' Bithaman Ajil* Contracts: A Comparative Analysis", note 9, at 8.

[60] Abdul-Rahman, Yahia, *The Art of Islamic Banking and Finance: Tools and Techniques for Community-Based Banking*, (John Wiley & Sons, New Jersey, 2010), at 208.

[61] See for example the discussion of different views in Laldin, Mohamad Akram, *The Concept of Promise and Bilateral Promise in Financial Contracts: A Fiqhi Perspective*, (International Shari'ah Research Academy for Islamic Finance, Kuala Lumpur, 2011), at 7 *et seq.*

purchase the property;[62] to do so reduces the ownership-related risks borne by the financier and represents speculation on future events. For similar reasons, scholars have been of the view that the purchase undertaking cannot become enforceable once the property has been purchased, although it may be morally binding.[63] Despite this preponderance of views, contemporary scholars have relied on the opinion of minority classical Islamic jurists when concluding that a "promise to purchase" is in fact mandatory, both morally and legally, on the promisor (although not on the promisee).[64] The enforceability of the customer's promise has been confirmed by the Fiqh Academy of the OIC[65] and AAOIFI[66] and now represents market practice.

Notwithstanding these risk-transfer techniques, a persistent difficulty of real estate financing using *murābaha* principles is that on default or early redemption, the customer must pay the financier not only the outstanding principal, but also the entire mark-up price.[67] Unlike an ordinary mortgage in which the interest charged on the loan only

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[62] Hasan, Aznan, "Islamic Structured Products: Issues and Challenges", in *Current Issues in Islamic Banking and Finance; Resilience and Stability in the Present System*, Angelo M. Venardos (ed.), (World Scientific, Publishing Pte., Singapore, 2010), 189-254 at 214.

[63] See for example the comments of al-Nawawi: "There are four [character traits]; anyone who has them all is a pure hypocrite; and anyone who has one of them has one of the attributes of hypocrisy until he rids himself of it. When he is entrusted he betrays the trust; when he speaks he lies; when he binds himself with a pledge he double-crosses; and when he disputes he exceeds [the limits of decency]," al-Nawawi, Sharh Sahih Muslim, (Dar al-Fikr Beirut), 2:47-2:48 in Laldin, Mohamad Akram, *The Concept of Promise and Bilateral Promise in Financial Contracts: A Fiqhi Perspective*, note 61, at 6. See also *ibid.*, at 7-8 in which Laldin notes that the view that fulfilling a promise is morally praiseworthy but not obligatory represents the view of the majority of classical scholars.

[64] Usmani for example refers to the views of Samurah bin Jundub one of the Prophet's companions, 'Umar bin Abdul Aziz, Hasan a-Basri, Sa'id bin al-Ashwa', Imam al-Bukhari and al-Ghazzali as proponents of the view that a promise which is stated in absolute terms may be binding (Usmani, Muhammad Taqi, *An Introduction to Islamic Finance*, note 37, at 50.) Equally, el-Gamal notes the reliance by market participants on the opinion of Maliki jurist, Ibn Shubruma to justify the practice of financial institutions obtaining binding promises of purchase prior to the acquisition of the property by the financier (El-Gamal, Mahmoud, *Islamic Finance; Law, Economics and Practice*, note 51, at 66, Warde, Ibrahim, *Islamic Finance in the Global Economy*, (2nd ed., Edinburgh University Press, Edinburgh, 2010), at 141, Ayub, Muhammad, *Understanding Islamic Finance*, note 42, at 224-225. Effectively, once the property has been purchased by the financier, the promise becomes enforceable against the promisor. See for example the *fatwā* on purchase undertakings issued by the Al-Baraka Banking Group, Al-Baraka Banking Group, *Shariah Opinions (Fatwa)On Murabaha*, Ahmed Mohieddin Ahmed (ed.), (Manama, n.d), Question (3), available at: http://www.albaraka.com/media/pdf/Research-Studies/RSMR-200706201-EN.pdf.

[65] Islamic Fiqh Academy, *Resolutions and Recommendations of the Council of the Islamic Fiqh Academy 1985-2000*, note 44, Resolution No 40-41 (2/5 & 3/5), at 86. In a separate resolution the Fiqh Academy also concluded that where an enforceable unilateral promise has been breached, the promisee may apply to the courts for damages or an order of specific performance, Islamic Fiqh Academy, *Second Resolution of the Fifth Conference of the Islamic Fiqh Academy*, Kuwait, December 10-15 1988. The Fiqh Academy went on to note that damages would be limited to "actual monetary loss suffered by [the promisee], but will not include the opportunity cost," quoted in Ayub, Muhammad, *Understanding Islamic Finance*, note 42, at 115.

[66] AAOIFI, Shari'a Standard No. (8), "Murabaha to the Purchase Orderer", note 37, at 117.

[67] Schoon, Natalie, *Islamic Banking and Finance*, (Spiramus Press Ltd., London, 2009), at 66 citing the fixed nature of the purchase price as a key draw-back of *murābaha* financing. Nyazee, Imran Ahsan Khan, *Murābahah and the Credit Sale*, (Institute of Advanced Legal Studies, Islamabad, 2009), at 75-76 critiquing Usmani's views on the permissibility of discounts.

becomes payable once it has accrued, *murābaha* transactions are sales in which a fixed profit is attached to the capital sum at the outset of the transaction.[68] As a result, both the principal and additional payments are due and payable from the very beginning of the transaction.[69] Similar considerations arise in relation to late payments and the permissibility of a penalty being imposed.[70] Islamic law has been interpreted as prohibiting the imposition of a financial penalty for late payment of money. Such a charge is an increase in the amount due on a debt, contrary to prohibition of *ribā*.[71] However, wthout some form of punishment, there is little to prevent persistent delays in payment by the customer, other than his or her own conscience.[72] In light of this, contemporary scholars have acknowledged that a charge may be imposed[73] "to encourage adherence to a contract"[74] and it should represent a fixed amount rather than one which increases with time.[75]

As a method of asset purchase which is amenable to real estate financing, *murābaha* traditionally represented the most prevalent means of islamically acceptable property acquisition.[76] However, *murābaha*-based agreements have increasingly been criticised by scholars and industry commentators as disconnected from the spirit of Islam and "sidestepping the prohibition of *riba* through simple accounting tricks or linguistic sleights of hand."[77] In light of the structural shortcomings and concerns over the *Sharī'ah*

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[68] AAOIFI, Shari'a Standard No. (8), "Murabaha to the Purchase Orderer note 37, at 122, Vogel, Frank E. and Hayes, Samuel.L., *Islamic Law and Finance, Religion, Risk and Return,* note 40, at 140, noting suggested that in law, "if not economics, there are differences between *murābaha* and loans." See also, Vogel, Frank E., "Islamic Finance: Personal and Enterprise Banking", in *La Banca Islamica e la Disciplina Bancaria Europea*, (Giuffrè Editore, Naples, 2006), 53-80 at 70.

[69] Schoon, Natalie, *Islamic Banking and Finance*, note 67, at 66. Hainsworth, Antony, *Islamic Financial Institutions and Islamic Finance*, (LexisNexis, Butterworths, London, 2009), at [98].

[70] Chapra, Umer M. and Khan, Tariqullah, "Regulation and Supervision of Islamic Banks", *Islamic Development Bank, Islamic Research and Training Institute, Occasional Paper Number 3*, (IRTI, Jeddah, 2000), at 72.

[71] Haron, Abdullah and Hock, John Lee Hin, "Inherent Risk: Credit and Market Risks", in *Islamic Finance: The Regulatory Challenge*, note 57, at 100.

[72] In practice, this fact alone may be sufficient to ensure on time payment, however, a financial institution may not be willing to rely on this without the use of further mechanisms designed to ensure payment.

[73] McMillen, Michael JT., "Trends in Islamic Project and Infrastructure Finance in the Middle East: Re-Emergence of the Murabaha", note 37, at 11.

[74] Issa , Nabil A. and Campos, Patrick, "Challenges in Structuring Non-Recourse Islamic Financing for Energy Projects in Saudi Arabia", (2007) 2 *Texas Journal of Oil, Gas and Energy Law*, 452-469, at 461, Issa and Campos cite a *fatwā* issued by Sheikh Abdulaziz bin Baz (Resolution No. 25) as authority for this.

[75] An alternative approach, and one used frequently in Malaysia, is to specify in an agreement that the late payment costs of the transaction will be the actual costs borne by the financier, but subject to a cap and possibly a floor.

[76] Thomas, Abdulkader, Cox, Stella and Kraty, Bryan, *Structuring Islamic Finance Transactions*, (Euromoney Books, London, 2005), at 128, Lovells, *Shariah-compliant Mortgages*, (September 2004), at 4, available at: http://www.yasaar.org/pubs/20255%20Shariah%20Compliant%20Mortgages%20brochure1.pdf.

[77] Maurer, Bill, "Re-formatting the economy. Islamic banking and finance in world politics", in *Islam in World Politics*, Nelly Lahoud and Anthony H. Johns, (eds.), (Routledge, London, 2005), 54-66 at 56. See also

legitimacy of certain attributes of modern *murābaha*, there has been a growing unwillingness amongst market participants to over (or at least overtly) rely on these structures.[78]

6.2.2 *Ijārah wa-iqtina*[79]

Ijārah arrangements are Islamic leases and involve the transfer of an asset's usufruct to the lessee, who may then use the asset for islamically acceptable purposes.[80] Title and ownership remain with the financier who charges the customer rent for the right to use and benefit from the underlying asset.[81]

As a method of financing the acquisition of real estate, *ijārah* can be structured so that title to the property is ultimately conveyed to the lessee.[82] This structure, the *ijārah wa-iqtina*, shares characteristics with conventional operating and finance leases and involves consideration of the *Sharī'ah* rules relating to leasing which, as discussed in Chapter 3, ultimately rely on the rules relating to sales.[83] *Ijārah wa-iqtina* involves a customer identifying a suitable property and requesting the purchase of that property by a financier. As in *murābaha* transactions, the customer can be appointed as agent to purchase the property on behalf of the financier.[84] Once acquired, title to the property is not immediately

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the views of al-Haddad who has claimed that from the banks perspective, the bank avoids a situation where it owns the property for any length of time. This can be added to the fact that the rate and amount of repayment from the homebuyer to the bank is likely to be strongly linked to interest rates, comments of Sheikh Haitam al-Haddad in Anonymous, "Islamic mortgages: Shari'ah-based or Shari'ah-compliant?", (January-March 2009) 170, *New Horizon Magazine*, 36-39 at 37. El-Gamal defines a *murābaha* real estate financing transaction as one in which "the Islamic bank collects principal plus interest on debt documented as a credit price," El-Gamal, Mahmoud Amin, *Islamic Finance: Law, Economics, and Practice,* note 51, at 64.

[78] Housby, Elaine, *Islamic Financial Services in the United Kingdom*, note 20, at 82.

[79] *supra.* at 87.

[80] Usmani, Muhammad Taqi, *An Introduction to Islamic Finance*, note 37, at 69.

[81] *supra.* at 87. Vogel, Frank E. and Hayes, Samuel.L., *Islamic Law and Finance, Religion, Risk and Return,* note 40, at 103.

[82] Barry, John, "Islamic property financing", (2007) 15 *Australian Property Law Journal* 66.

[83] *supra.* at 87, "Recommendations of the Workshop", Proceedings of a Workshop organized in Khartoum by the Islamic Research and Training Institute of the Islamic Development Bank, 27-29 October 1991, Seminar Proceedings Series No. 28, Mahmoud Ahmad Mahdi (ed.), (Islamic Research and Training Institute, Jeddah, 1995), at 275,Warde, Ibrahim, *Islamic Finance in the Global Economy*, (2nd ed.), note 64, at 144 noting that "ijara or leasing is...technically a sale contract, since it is understood from the standpoint of classical Islamic fiqh as the sale of usufruct...and as such its rules closely follow those of ordinary sales." See also, Tameme, Mohammed Elkhatim Mamoun, *Demand and Supply Conditions of Islamic Housing Finance in the UK: Perceptions of Muslim Clients*; a Thesis submitted to the University of Durham for the Degree of Doctor of Philosophy School of Government and International Affairs, July 2009 at 51.

[84] Although the AAOIFI standard for "Ijarah and Ijarah muntahia bittamleek" has recommended that a third party agent is preferable. Nevertheless, the organization has confirmed the *Sharī'ah* legitimacy of appointing the customer itself as agent for the financier. AAOIFI, Shari'a Standard No. (9), "Ijarah and Ijarah muntahia bittamleek", in *Shari'a Standards for Islamic Financial Institutions 1432 H-2010*, (AAOIFI, Bahrain, 2010), 137-160 at 142.

conveyed to the customer but remains with the financier who leases the property to the customer.[85] Over the course of the lease, the financier places a portion of the periodic rental payments "on-account" in a reserve fund.[86] This fund will increase with each rental period until it corresponds in size with the original consideration paid by the financier for the property. At this point, the reserve fund is released to the financier and title to the property is transferred to the customer as a gift or for a token amount.[87]

While parties to a lease-based finance structure may enter into such a transaction with the intention that the customer will ultimately assume ownership of the property, an *ijārah wa-iqtina* transaction remains, in legal form, a standard lease until that lease comes to an end and ownership is transferred to the customer.[88] As owner of the property for the duration of the lease, the financial institution must assume ownership-level responsibilities.[89] In contemporary practice, the actual servicing of the property is often assigned to the customer under a servicing agency agreement in which the customer carries out the financier's ownership duties in return for a fee.[90] As this activity will be carried out by the customer as the financier's agent, ultimate responsibility remains with the financier, thereby maintaining *Sharī'ah*-compliance.[91] The costs incurred by the financier in relation

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[85] Housby, Elaine, *Islamic Financial Services in the United Kingdom*, note 20, at 83 discussing the *ijārah wa-iqtina* structure implemented in the UK's Ahli United Bank.

[86] As noted in Chapter 2, this reserve fund may be theoretical or real. Newman, Joel S.," Islamic and Jewish Perspectives on Interest", (2000) 89 *Tax Notes* 1311-1318 at 1312. See for example, Al-Manzil Home Purchase Plans, at 4, available at: http://www.iibu.com/pdfs/Al Manzil Brochure.pdf which provides in relation to its *ijārah wa iqtina* product, "[y]ou make monthly payments to us. Your monthly payments include a lease element, known as rent, and an "on account" element towards the purchase of your home in the future."

[87] AAOIFI, Shari'a Standard No. (9), "Ijarah and Ijarah muntahia bittamleek", note 84, at 148, AAOIFI, Accounting, Auditing and Governance Standard No. (8), "Ijarah and Ijarah muntahia bittamleek" in *Accounting, Auditing and Governance Standards for Islamic Financial Institutions 1432 H-2010*, (AAOIFI, Bahrain, 2010), 225-258 at 251, Zaher,Tarek & Hassan, Kabir, "A Comparative Literature Survey of Islamic Finance", (2001) 10(4) *Financial Markets, Institutions and Instruments*,155-199 at 160.

[88] AAOIFI, Shari'a Standard No. (9), "Ijarah and Ijarah muntahia bittamleek", note 84, at 148, AAOIFI, Accounting, Auditing and Governance Standard No. (8), "Ijarah and Ijarah muntahia bittamleek", note 87, at 252.

[89] AAOIFI, Shari'a Standard No. (9), "Ijarah and Ijarah muntahia bittamleek", in note 84, at 144, AAOIFI FinanciL Accounting Standard No. (8), "Ijarah and Ijarah Muntahia Bittamleek", in Accounting, Auditing and Governance Standards for Islamic Financial Institutions 1432H -2010 (AAOIFI, Bahrain, 2010), 225-258 at 249 noting that "[a]ccording to the schools of fiqh [a condition that customer must maintain the asset] renders the ijarah contract void." Recommendations of the Workshop, Proceedings of a Workshop organized in Khartoum by the Islamic Research and Training Institute of the Islamic Development Bank, note 83, at 275, Issa , Nabil A. and Campos, Patrick, "Challenges in Structuring Non-Recourse Islamic Financing for Energy Projects in Saudi Arabia", note 74, at 454.

[90] Dewar, John and Hussain, Mohammad Munib, "Islamic Project Finance", in *International Project Finance: Law and Practice*, John Dewar (ed.), (Oxford University Press, Oxford, 2011), 269-298 at [10.58].

[91] Miller, Neil D. and Morris, Mark, "Application of Islamic finance to project finance", in *Islamic Finance: A Practical Guide*, Rahail Ali (ed.), (Globe Business Publishing Ltd., London, 2008), 67-84 at 82.

to the lease, which include the agent's fees,[92] can be incorporated into the rent charged for the use of the property. Where the customer is appointed as agent, the increase in rent due to the agent's fees and the wage paid to the agent cancel each other out so the financier, though legally responsible, will not be financially liable for the property's upkeep.[93]

Similar to a *murābaha* arrangement, the financial institution offering an *ijārah wa-iqtina* structure will have to acquire ownership of the property before it can lease and subsequently transfer that property to the customer.[94] Unlike a contract of sale, a bilateral agreement to enter into a lease in the future has been viewed by scholars as enforceable, even if the property to be leased has not yet been acquired by the financier.[95] This agreement to lease can then be executed as a full *ijārah* contract once the property has come into the possession of the financier.[96] However, the concept of a binding stipulation in the lease that the lessor will ultimately sell the property to the lessee has been disallowed by Islamic scholars as it would render the future property sale at a pre-agreed price an integral condition of the lease.[97] This would guarantee a captive market and payment of the financier's return, notwithstanding the vicissitudes of property performance.[98] Relying once again on the minority juristic opinion, contemporary *ijārah wa-iqtina* agreements include a *separate and unilateral* agreement, either by the customer to buy the property on

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[92] AAOIFI, Accounting, Auditing and Governance Standard No. (8), "Ijarah and Ijarah muntahia bittamleek", note 87, at 249 noting that: "the lessee is entitled to be paid the equivalent fair wage and expenses incurred in carrying out the work of maintenance if that was done by permission of the lessor."

[93] Abraham, Robin, Long, Shani, Henderson, Steven, "Real estate finance in Dubai", (2007) *IFLR Guide to the UAE*, 15-17 at 17, Miller, Neil D. and Morris, Mark, Application of Islamic finance to project finance, in *Islamic Finance; A Practical Guide*, note 91, at 82.

[94] Haron, Abdullah and Hock, John Lee Hin, "Inherent Risk: Credit and Market Risks", in *Islamic Finance: The Regulatory Challenge*, note 57, at 98 noting that in a non-binding *ijārah* contract, a cancellation by the customer after the financier has acquired the relevant property could result in the financier having to "lease (or sell) the asset at a lease rental (or a selling price) lower than the originally agreed total rentals (or selling price) to the original customer. This represents another form of price risk."

[95] Islamic scholars have justified this difference on the basis that *ijārah* contracts involve the transfer of rights to use an asset rather than an asset itself and as such, this right will be received gradually throughout the term of the lease, (El-Gamal, Mahmoud Amin, *Islamic Finance: Law, Economics, and Practice,* note 51, at 209). It could also be suggested that the more flexible approach adopted towards leases arises because a binding contract for future sale of an asset that has not yet been acquired largely eliminates the ownership risks that the financier must assume whereas in a future lease, the identified assets will remain in the ownership of the financier once the lease is executed.

[96] Haron, Abdullah and Hock, John Lee Hin, "Inherent Risk: Credit and Market Risks", in *Islamic Finance: The Regulatory Challenge*, note 57, at 109.

[97] AAOIFI, Shari'a Standard No. (9), "Ijarah and Ijarah muntahia bittamleek", in note 84, at 148 noting that "in all cases, the separate document evidencing a promise of gift, promise of sale or a promise of gift contingent on a particular event, should be independent of the contract of Ijarah Muntahia Bittamleek and cannot be taken as an integral part of the contract of Ijarah."

[98] Violating as el-Gamal notes, the prohibition of "two contracts in one," El-Gamal, Mahmoud Amin, *Islamic Finance: Law, Economics, and Practice,* note 51, at 99, de Belder, Richard T., "Shari'a related documentary issues in Islamic project finance transactions", (2003) 18(8) *Journal of International Banking Law* and Regulation, 317-325 at 324, al-Omar, Fuad and Abdel-Haq, Mohammed, *Islamic Banking: Theory, Practice and Challenges*, (Zed Books, London, 1996), at 66.

conclusion of the lease or more frequently, by the financier to transfer title to the customer upon the "on-account" fund equalling the initial purchase price.[99] This undertaking must not appear on the face of the lease which must remain a pure leasing agreement in legal form. The customer may, however, be required to pay a deposit to the financier (*hamish jiddiyah* (security deposit) of *urboun* (earnest money)[100]) as a form of assurance that he or she will continue to make rental payments for the duration of the lease.[101]

Ijārah wa-iqtina contracts have provided a mechanism for variable rate financing. To avoid violating the prohibition of *gharar*, the level of rent must be agreed upon and clearly specified at the outset of the lease.[102] In *ijārah wa-iqtina* contracts which ultimately end in the transfer of property ownership, this payment will include not simply the value attributable to the use of the property but also payments which will ultimately be applied towards the acquisition of the property by the customer.[103] As a result, the actual level of the customer's periodic payments may not reflect the market rental value for a comparable property, indeed the rent charged is frequently based on an interest-rate benchmark, such as LIBOR.[104] In order to allow the rental payments to comply with Islamic financial principles while still varying in line with interest rates or some other benchmark, the parties may fix the rent for a "rental period" which could be six months.[105] At the end of the rental period, a new, mutually agreed upon rent is set for the next six months.[106] This allows *ijārah wa-iqtina* lease payments to replicate, in amount and timing, the repayment of principal and interest on conventional mortgage products.[107] Despite such economic similarities, AAOIFI has stated that "profit" is only deemed to arise in Islam within the context of the sale of a commodity for an amount in excess of the costs incurred, not in the

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[99] El-Gamal, Mahmoud Amin, *Islamic Finance: Law, Economics, and Practice,* note 51, at 99.

[100] AAOIFI, Shari'a Standard No. (9), "Ijarah and Ijarah muntahia bittamleek", note 84, at 143

[101] Ayub, Muhammad, *Understanding Islamic Finance*, note 42, at 116.

[102] Vogel, Frank E. and Hayes, Samuel.L., *Islamic Law and Finance, Religion, Risk and Return,* note 40, at 103. The rent only becomes due from the day the property is actually delivered to the customer, Maurer, Bill, *Pious Property; Islamic Mortgages in the United States*, note 12, at 50.

[103] Dewar, John and Hussain, Mohammad Munib, "Islamic Project Finance", in *International Project Finance: Law and Practice*, note 90, at [10.20].

[104] Visser, Hans, *Islamic finance: Principles and Practice*, (Edward Elgar Publishing Limited, Cheltenham, 2009), at 109, Housby, Elaine, *Islamic Financial Services in the United Kingdom*, note 20, at 84, AAOIFI, Shari'a Standard No. (9), "Ijarah and Ijarah muntahia bittamleek", note 84, at 156.

[105] Haron, Abdullah and Hock, John Lee Hin, "Inherent Risk: Credit and Market Risks", in *Islamic Finance: The Regulatory Challenge*, note 57, at 110.

[106] *ibid.*

[107] El-Gamal, Mahmoud, *Islamic Finance; Law, Economics and Practice*, note 51, at 100, Global Trends at 175.

leasing of property.[108] The entirety of payment made in *ijārah wa-iqtina* is deemed to be rent, rather than divided into principal and profit.

Islamic scholars have been reluctant to deem as valid the imposition of penalties for late payment in *ijārah wa-iqtina* structures, although market practice has favoured their use.[109] On default or early redemption of an *ijārah wa-iqtina*, the customer does not have to pay all rental payments which would have been payable if the facility had continued. This is due to the fact that future rental payments have not yet accrued and cannot be a debt which is payable.[110] In such circumstances the financier may rely on its undertaking to sell the property to the customer in an attempt to recover the sum it invested in the property.[111] If the customer cannot purchase the property outright, the financier may choose to determine the lease,[112] potentially resulting in the customer losing the property and the capital which he or she has invested.[113]

The lease ending in ownership structure has been widely used in commercial real estate and project financing.[114] However, retail home financing, particularly in the UK, has relied primarily on a third structure, in which the parties co-own the property and ostensibly share in the risks and returns of that property.

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[108] AAOIFI, Accounting, Auditing and Governance Standard No. (8), "Ijarah and Ijarah muntahia bittamleek", note 87, at 248 noting that: "from the Shari'a point of view, the rent consideration is an indivisible amount which should not be divided into a principal and profit. From a Shari'a perspective, profit is only viewed as the result of a transaction of purchase and sale of a commodity for an amount in excess of its cost."

[109] AAOIFI, Shari'a Standard No. (9), "Ijarah and Ijarah muntahia bittamleek", note 84, at 146, Visser, Hans, *Islamic finance: Principles and Practice*, note 104, at 59.

[110] Kamali, Mohammad Hashim, "A Shari'ah Analysis of Issues in Islamic Leasing", (2007) 20(1) *J.KAU: Islamic Economics*, 3-22 at 9 noting that "rent *after it becomes due* is a debt payable by the lessee." (emphasis added).

[111] *Proceedings of the Second Oxford Islamic Finance Round Table*, "The Frontiers of Innovation in Islamic Finance," note 6, at 49.

[112] Which, according to AAOIFI, requires mutual consent except in the case of force majeure, defect or if one parties obtains an option to terminate. AAOIFI also notes however that "[t]he lessor may stipulate that the ijarah contract be terminated if the lessee does not pay the rent or fails to pay it on time," AAOIFI, Shari'a Standard No. (9), "Ijarah and Ijarah muntahia bittamleek", note 84, 147.

[113] The potential intervention of equity in this situation and the position of the customer on default in an Islamic lease-to-own structure are both discussed in more detail below *infra.* at 259.

[114] Miller, Neil D. and Morris, Mark, Application of Islamic finance to project finance, in *Islamic Finance; A Practical Guide*, note 91.

6.2.3 Diminishing *Mushāraka*

The long-term, permanent nature of *mushāraka* transactions[115] is not particularly amenable to more contemporary real estate financings in which the customer may anticipate a point at which he or she will acquire full ownership of the relevant property without further participation by the financier. Equally, a financier may not wish to retain asset and customer-level risks indefinitely.[116] As a more practical means of providing partnership financing, the concept of *mushāraka muntaqisah* or diminishing *mushāraka* has been introduced into contemporary Islamic finance.[117] This structure[118] allows one partner to progressively buy out the other partner's interest in a venture or asset owned by the partnership.[119] In the context of real estate financing, the parties have joint ownership of property (*sharikat-ul-milk*)[120] rather than interacting as lender and borrower.[121] As co-owners of the property, both parties to a diminishing *mushāraka* may exercise their proprietary right to occupy the property. When this structure is used in contemporary real estate transactions, usufruct rights in the property are conferred on the customer who may occupy the property or lease it to a third party.[122] For the right to act as occupying partner

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[115] *supra.* at 83.

[116] As Bendjilali and Khan note "the non-terminating nature of the bank-firm contractual relationship imposes limitations on the provision of bank finance to new projects and entrepreneurial activities," Bendjilali, Boualem and Khan, Tariqullah, "Economics of Diminishing Musharakah", *Research Paper no. 31*, (Islamic Development Bank, Islamic Research and Training Institute, Jeddah, Saudi Arabia, 1995), at 11, Obaidullah, Mohammed, *Islamic Financial Services*, note 40, at 61.

[117] Diminishing ownership structures were approved by the Islamic finance community in 1979 at the first Islamic Banking conference held in Dubai, May 1979, Abdullah, Ahmed Ali, "Forms of Investment in Real Estates in Islamic Perspectives in Islamic Banking Modes for Building Financing", Proceedings of a Workshop organised in Khartoum, Sudan, October 27-29, 1991, Seminar Proceedings Series No. 28, Mahmoud Ahmad Mahdi, (ed.), (Islamic Research and Training Institute, Jeddah, 1995), 43-54 at 48. Bendjilali, Boualem and Khan, Tariqullah, "Economics of Diminishing Musharakah", note 116, at 66.

[118] *supra.* at 86.

[119] Meera, Ahmed Kameel Mydin and Razak, Dzuljastri Abdul, "Home Financing through the Musharakah Mutanaqisah Contracts: Some Practical Issues", (2009) 22(1) *J.KAU: Islamic Economics*, 121-143 at 123.

[120] *supra.* at 84 for more details on the difference between *sharikat-ul-milk* and *sharikat-ul-aqd.*

[121] This can be contrasted with an *ijārah wa-iqtina* contract in which the financier maintains ownership of the property until payment of the final instalment of rent, Land Registry, *Practice Guide 69: Islamic financing*, (August 2010), available at: http://www1.landregistry.gov.uk/assets/library/documents/pg69.html.

[122] This is more common in commercial properties or properties purchased as investments. Ahmad, Abu Umar Faruq, *Theory and Practice of Modern Islamic Finance; The Case Analysis from Australia*, note 35, at 181. *Sharī'ah* scholars have acknowledged the *Sharī'ah*-compliance of a lease of jointly owned property to the other owning partner (Ibn Qudamah, *al Mughni*, Part 6 at 137 in Usmani, Mohammad Taqi, "Methods of House Building Financing According to *Sharī'ah*" in *Islamic Perspectives in Islamic Banking Modes for Building Financing*, Proceedings of a Workshop organised in Khartoum, Sudan, October 27-29, 1991, note 117, at 68). The *fiqh* texts are more divided on the permissibility of leasing an undivided share to a third party. Some scholars have suggested that leasing of jointly owned property is *only* legitimate between partners, while others have noted that "as a partner is allowed to sell and lease to his partner, he can do the same with a third party." (Ibn Qudamah, *al Mughni*, Part 6 at 137 in Usmani, Mohammad Taqi, "Methods of House Building Financing According to *Sharī'ah*" in *Islamic Perspectives in Islamic Banking Modes for Building Financing*, Proceedings of a Workshop organised in Khartoum, Sudan, October 27-29, 1991, note

and benefit from exclusive use of the property, the customer will enter into an independent *ijārah* agreement with the *mushāraka* partnership, paying a mutually agreed upon sum on a periodic basis.[123] This payment, which is rent, represents the profit of the *mushāraka* partnership, it is thus divided between the partners in accordance with their respective share of the property.[124] As the customer is one of those partners, the portion of the payment to which he or she would have been entitled will be set off against the rent he or she pays as lessee. Only the financier will receive periodic payments with the customer effectively paying the financier for the financier's forbearance in exercising its rights as co-owner.[125]

Concurrently with joint ownership and *ijārah* arrangements, the customer promises (separately and unilaterally) to progressively purchase, and/or the financier promises (separately and unilaterally) to progressively sell, the financier's interest in the property.[126] The customer then purchases the financier's share in units until the financier's equity interest is reduced to zero.[127] As the financier's ownership interest in the property declines, the rental paid to the financier will also reduce until eventually the lease payments

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117, at 68). An inability to lease the acquired property to a third party could raise concerns in relation to a customer, such as a property fund, that intends to use the property as an income generating investment. While the customer may lease the financier's share of the property and then sub-lease the whole property to a third party, *Sharī'ah* concerns over the legitimacy of head and sub leases has meant that the situation remains unresolved (Al Hadaki, *al Dur al Mukhtar Ma'Rad al Muhtar*, Part 6, 47-48 in Usmani, Mohammad Taqi, "Methods of House Building Financing According to *Sharī'ah*" in *Islamic Perspectives in Islamic Banking Modes for Building Financing*, Proceedings of a Workshop organised in Khartoum, Sudan, 27-29 October 1991, note 117, at 68). Nevertheless, Usmani has noted the acceptability of a sub-lease in Islamic finance so long as the rent from the sub-lease is equal or less than that of the head lease and the head landlord has given its consent to the sub-lease, Usmani, Muhammad Taqi, *An Introduction to Islamic Finance*, note 37, at 123.

[123] International Organization of Securities Commissions, *Fact Finding Report of the Islamic Capital Market Task Force of the International Organization of Securities Commissions*, (IOSCO, July 2004), at 11, available at: http://www.iosco.org/library/pubdocs/pdf/IOSCOPD170.pdf.

[124] Gowling Lafleur Henderson LLP, *Report to the Canada Mortgage and Housing Corporation, Islamic Housing Finance in Canada*, (Canada Mortgage and Housing Corporation , January 2010), at 14, available at: http://www.umfinancial.com/uploaded_pic/gallery/CMHC%20islamic%20housing%20report279627.pdf.

[125] Dar, Humayon A., "Islamic House Financing in the United Kingdom: Problems, Challenges and Prospects", (2002) 12 *Review of Islamic Economics*, 47-71 at 52, Meera, Ahamed Kameel Mydin, and Razak, Dzuljastri Abdul, "Islamic Home Financing through *Musharakah Mutanaqisah* and *al-Bay' Bithaman Ajil* Contracts: A Comparative Analysis", note 9, at 11, Matthews, Robin, Tlemsani, Issam and Siddiqui, Aftab, "Islamic Banking and the Mortgage Market in the UK", in *Islamic Banking: An International Perspective*, Bala Shanmugam, Vignesen Perumal and Alfieye Hanuum Ridzwa (eds.), (Universiti Putra Malaysia Press, Serdang, 2004), 149-163 at 160.

[126] Tameme, Mohammed Elkhatim Mamoun, *Demand and Supply Conditions of Islamic Housing Finance in the UK: Perceptions of Muslim Clients*, note 83, at 49.

[127] Aziz, Razi Pahlavi Abdul and Gintzburger, Anne-Sophie, "Equity-Based, Asset-Based and Asset-Backed Transactional Structures in Shari'a-Compliant Financing: Reflections on the Current Financial Crisis", (2009) 28(3) *Economic Papers*, 270-278 at 273 noting that: "[t]he profit and loss in this structure is agreed upon and the exit of this venture is when the bank has realised the targeted profit over a period of time or when the customer redeems the equity of the banks by repurchasing the shares over a period of time."

terminate.[128] At this point there is unity of ownership over the property, the lease ends and the customer obtains full legal title.[129] Unlike *murābaha* and *ijarah* contracts, the sale of the property in diminishing *mushāraka* will be gradual. Consequently, while a promise can be made either to buy or sell the financier's share in the property, each time a unit is transferred to the customer, a separate sales contract must be concluded between the parties.[130] Although structurally diminishing *mushāraka* arrangements contain numerous independent stages, in economic effect, they allow a financier to transfer ownership of property to a customer while recovering its original investment and making a legitimate profit.[131]

Periodic payments in a diminishing *mushāraka*-based real estate transaction are, therefore, comprised of two elements, the lease payment for use of the property and the purchase price for the financier's ownership share.[132] As the lease agreement in shared ownership arrangements is independent and not contingent upon the underlying *mushāraka* partnership, the rent paid may be determined in a manner consistent with the leasing portion of the *ijārah wa-iqtina*.[133] As a result, while this rent may be based upon reasonably determined market values for properties of a similar nature and location, benchmarks such as LIBOR can be used as a means of reproducing the economic characteristics of a floating rate loan.[134] The second aspect of *mushāraka* payments, the

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[128] Ashraf, Muhammad, "Shariah-compliant Financial Products", *Accountancy*, March 3, 2007, available at: http://www.accountancy.com.pk/articles.asp?id=174, Bank Negara Malaysia, "Islamic Banking and Takaful Department Guidelines on Musharakah and Mudharabah Contracts for Islamic Banking Institutions", *BNM/RH/GL/007-9*, at 18, available at: www.bnm.gov.my/guidelines/01_banking/04_prudential.../15_mnm.pdf.

[129] Ahmad, Abu Umar Faruq, *Theory and Practice of Modern Islamic Finance; The Case Analysis from Australia*, note 35, at 181,

[130] Annex, "Shari'ah Related Recommendations" in *Islamic Perspectives in Islamic Banking Modes for Building Financing*, Proceedings of a Workshop organised in Khartoum, Sudan, October 27-29, 1991, Seminar Proceedings Series No. 28, Mahmoud Ahmad Mahdi, (ed.), (Islamic Research and Training Institute, Jeddah, 1995), 271-278 at 275.

[131] Muhammad Taqi Usmani, *An Introduction to Islamic Finance*, note 37, at 31, International Organization of Securities Commissions, *Fact Finding Report of the Islamic Capital Market Task Force of the International Organization of Securities Commissions*, note 123, at 11.

[132] Maurer, echoing the terminology used by some Islamic real estate finance providers, refers to these payments as a return *on* capital and the return *of* capital highlighting perhaps the potential for diminishing *mushāraka* transactions to be used as a viable alternative to an interest-based mortgage. Maurer, Bill, *Pious Property; Islamic Mortgages in the United States*, note 12, at 47.

[133] The Dubai Islamic Bank, for example, pegs the rental payments in its diminishing *mushāraka* property financing to EIBOR (Emirates Interbank Offered Rate), Dubai Islamic Bank, Diminishing Musharaka, available at: http://www.dib.ae/en/realestate_musharika.htm.

[134] Meera, Ahamed Kameel Mydin, and Razak, Dzuljastri Abdul, "Islamic Home Financing through *Musharakah Mutanaqisah* and *al-Bay' Bithaman Ajil* Contracts: A Comparative Analysis", note 9, at 15, Amin, Mohammed, "Applying Islamic Finance to Common Investments in the UK", (April 2008) *Business Islamica*, 32-37 at 34, Maurer, Bill, *Pious Property; Islamic Mortgages in the United States*, note 12, at 50 noting that one financier in the US bases its rental value in declining balance partnerships on an "administrative fee" rather than market rental values.

gradual purchase of the financier's equity in the property, is based on a series of sales contracts concluded over the course of the transaction. AAOIFI has suggested that the purchase of the financier's shares at a price fixed in advance is contrary to the teachings of Islamic law as it minimises the extent to which the financier will be exposed to the profits or losses of the property which it owns.[135] However, Ayub has noted that in relation to *shirkat-ul-milk* partnerships, the shares can be purchased at pre-agreed prices.[136] This fixed, pre-determined acquisition price would reduce *gharar* in the transaction and has emerged as common practice amongst contemporary financial institutions.

6.3 Conclusion to Chapter 6

Within the UK,[137] US[138] and Malaysia,[139] amongst others, Islamic real estate financing is now being offered at both retail and wholesale level. Such financing is frequently

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[135] AAOIFI, Shari'a Standard No. (12), "Sharika (Musharaka) and Modern Corporations", in *Shari'a Standards for Islamic Financial Institutions 1432 H-2010*, (AAOIFI, Bahrain, 2010), 199-230 at 217 noting that "[i]t is permissible for one of the partners to give a binding promise that entitles the other partner to acquire, on the basis of a sale contract, his equity share gradually, according to the market value or a price agreed at the time of acquisition. However, it is not permitted to stipulate that the equity share be acquired at their original or face value, as this would constitute a guarantee of the value of the equity shares of on partner (the institution) by the other partner, which is prohibited by Shari'a."

[136] Ayub, Muhammad, *Understanding Islamic Finance*, note 42, at 338.

[137] The approach of the UK authorities to the classification of Islamic real estate financing products is considered *infra.* at 251, 254 and 264. Retail-level home purchase products which comply with *Shari'ah* are now offered by Ahli United Bank and the Islamic Bank of Britain (IBB). Alburaq, the Islamic division of ABC International Bank, provides a diminishing shared ownership model. Amongst non-Islamic banks, HSBC became the first high street bank to offer *Shari'ah* compliant real estate options through its Amanah Islamic finance section in 2003 and was followed in 2005 by Lloyds TSB who have recently withdrawn its retail Islamic mortgages following the withdrawal of its overseas underwriter. At wholesale level, Gatehouse Bank, a *Shari'ah*-compliant wholesale investment bank has recently noted a "healthy appetite in commercial real estate activity" (Anonymous, "Gatehouse talks up UK real estate", *CPIFinancial Magazine*, May 4, 2010, available at: http://www.cpifinancial.net/v2/news.aspx?v=1&aid=4953&sec=Islamic%20Finance) in the UK. In November 2010 for example, Gatehouse Bank, together with Global Securities House (GSH), a real estate investment advisory firm, acquired the InterContinental Hotels Group headquarters building in London with the InterContinental Hotels Group remaining as tenant until July 2022. In addition to the development of *Shari'ah* compliant real estate portfolios by UK regulated wholesale banks, commercial real estate financing in the UK has also come from overseas investors such as Project Blue (Guernsey) Ltd, a joint venture between Qatari Diar, a sovereign wealth developer, and CPC Group which purchased London's Chelsea Barracks for redevelopment using a diminishing *mushāraka* and *ijārah* structure in 2008. Qatari Diar, together with a consortium of institutional investors including Qatar Islamic Bank, QInvest, and Qatar National Bank financed the development of the "Shard of Glass" in London using a reverse *murābaha/tawarruq* facility.

[138] The approach of the US authorities to the classification of Islamic real estate financing products is considered *infra.* at 251, 256 and 265. Throughout the US, a number of different providers of Islamic retail and commercial property financing now exist with banks, finance houses and community based projects providing some level of Islamic real estate financing. Community based organisations such as Ameen Housing Cooperative in California and Sharika Housing Cooperative in Massachusetts exist but are considerably less prevalent in the US as in other jurisdictions such as Canada where grassroots organisation frequently use a diminishing *mushāraka* model to provide a retail and small business level property financing schemes. Non-bank finance houses such as the American Finance House (LARIBA), Virginia-based Guidance Residential and Zayan Finance offer real estate finance on a diminishing shared ownership model.

structured around one of the contracts discussed above. Built upon the nominate contracts developed by the classical scholars, these contemporary structures rely on *Sharī'ah* principles in order to produce an economic result that is similar to that of a property mortgage loan, without openly violating Islamic law. Structurally, these transactions are distinguishable from conventional mortgages and so, "while the economics are the same, the mechanics are different."[140] Regulatory authorities in a number of countries have specifically considered the place of Islamic real estate financing products within their legal systems and have adopted accommodating measures which have sought to facilitate the provisions of Islamic real estate financing products domestically. Chapter 7 flows directly from Chapter 6 and considers the possible legal treatment of *murābaha*, *ijārah wa-iqtina* and diminishing *mushāraka* under Irish law.

In the UK and particularly in the US, Islamic real estate financing used by commercial customers has adopted numerous structures often involving several layers of single purpose vehicles (SPV)s, the ring-fencing of profits, and very often, the use of a conventional loan.[141] The "bifurcated structures,"[142] which use interest-based financing

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Finally, banking institutions such as University Bank in Michigan and Devon Bank in Chicago now also provide real estate financing services. Devon Bank based in Chicago for example, offers "faith-based financing" in thirty-one US states and provides retail home financing on the basis of either *murābaha*, diminishing *mushāraka* and *ijārah wa-iqtina* (Devon Bank, Buying a Home, available at: http://www.devonbank.com/Islamic/home_buyingahome.html) and commercial real estate acquisition financing on a more limited basis using *murabaha* or *ijarah wa iqtina* structures (Devon Bank, Real Estate Purchase, available at: http://www.devonbank.com/Islamic/bus_realestatepurchase.html).

[139] The approach of the Malaysian authorities to the classification of Islamic real estate financing products is considered *infra.* at 257and 251. Most property financings in Malaysia are based on the '*Bai Bithaman Ajil'* (BBA) model or a deferred payment structure similar to a *murabaha*. A preponderance of BBA-based contracts is particularly evident amongst the products offered by domestic Malay institutions (Ong, Seow Eng, "Mortgage Markets in Asia", Paper presented at the European Real Estate Society Conference 2005, Dublin, available at: www.rics.org/site/download_feed.aspx?fileID=2429&fileExtension). Bank Islam Malaysia for example offers commercial and retail real estate financing using a BBA facility. International banks operating in Malaysia have employed a greater variety of *Sharī'ah*-compliant structures to finance property acquisition. HSBC Amanah's HomeSmart-i and Business Premises Financing-i financings for example, are underpinned by a diminishing *musharaka* contract and Kuwait Finance House (Malaysia) offers both diminishing *mushāraka* and *murābaha* based property finance products. In September 2010, CIMB became the first bank in Malaysia to offer "*Ijarah* Property Financing-i," a financing structure based on the concept of *Ijārah wa-iqtina* (referred to in Malaysia as *ijārah muntahiyah bittamlik*) which is offered to both retail and business customers (CIMB Bank, available at: http://www.cimbbank.com.my/index.php?ch=ci_per_hf&pg=ci_per_hf_buy&ac=26&tpt=cimb_Islamic (Ijarah Property Financing-i (for Home)) and http://www.cimbbank.com.my/index.php?ch=ci_per_hf&pg=ci_per_hf_buy&ac=27&tpt=cimb_Islamic (Ijarah Property Financing-i (for Business))).

[140] DeLorenzo, Shaykh Yusuf Talal, "Shari'ah Compliance Risk Symposium: Islamic Business and Commercial Law", (2006-2007) 7(2) *Chicago Journal of International Law*, 397-408 at 398.

[141] Speight, Rachel, Pascoe, Stephen and Walsh, Stephen, "Explaining leveraged finance for Islamic investors in UK commercial real estate", in *Islamic Finance Review 2005/2006*, Sally Hodgetts (ed.), (Euromoney Yearbooks, London, 2005) 34-39 at 35, Shoon, Natalie, *Islamic Banking and Finance*, (Spiramus Press Ltd, London, 2009), at 100.

within the context of an Islamic transaction, have become an important means of funding very large scale developments as Islamic banks may not have the capital resources necessary to meet the full financing needs of their customers.[143] There are also indications that globally, the use of SPVs in residential Islamic real estate financing has gained popularity as a means of reducing the asset risk borne by individual banks.[144] Under these arrangements, a *Sharī'ah*-compliant contract[145] will exist between a special purpose project company (which may have been established by a financial institution) and a customer who wants to acquire real property. The special purpose project company may then enter into an interest-based loan with a financial institution allowing the SPV to acquire and hold the property for the customer. In order to ensure that the SPV can maintain its loan repayments, the customer's payments under the Islamic facility will be of a similar size and frequency to the interest charged on the loan.[146] Despite the fact that the property transaction is, in reality, being funded with debt, the degree of separation between the loan and the transfer of the property is sufficient to justify this practice as *Sharī'ah*-compliant.[147]

As much of the funding in the bifurcated model is provided on a conventional basis, Chapter 7 will not consider this form of Islamic real estate product in significant detail. Instead, the focus of the next Chapter will be on Islamic real estate financing from a theoretical, academic point of view. As Islamic real estate finance is, as yet, entirely unknown within the Irish real property market, it is difficult to assert with certainty how the Islamic transactions would be structured. Nevertheless, by focusing on theoretical structures, in a similar manner to that adopted by British authorities, some of the more complicated, academically challenging issues surrounding Islamic real estate financing can be addressed.

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[142] McMillen, Michael JT., "Critical Factors For The Development and Growth of Islamic Finance in the West", Paper given at the Berkeley Law Islamic Finance Symposium, Berkeley, California, April 9, 2011.

[143] Latham & Watkins, "Islamic Finance in the United States", *Client Alert, Number 704*, May 19, 2008 at 2.

[144] McMillen, Michael J.T., Comments on this thesis, January 12, 2012, Trinity College Dublin, Ireland.

[145] That is, one of the contracts outlined in this Chapter. See also McMillen Michael J.T., "Asset Securitization Sukuk and Islamic Capital Markets: Structural Issues in these Formative Years", (2008) 25(4) *Wisconsin International Law Journal* 703-772 at 719-720.

[146] McMillen, Michael JT., "Critical Factors For The Development and Growth of Islamic Finance in the West", note 142.

[147] Salah, Isam, "Legal issues arising in Islamic finance transactions in the United States", in *Islamic Finance in North America*, (Yasaar Media, Dubai, 2009), 56-64 at 62.

Chapter 7 will thus focus on structures based on one of three Islamic contract forms already discussed,[148] in circumstances where the financier is directly involved in the Islamic structure. However, acknowledging that in Islamic finance, theory does not always reflect practice, the potential treatment of the bifurcated structure will be considered briefly in the context of both taxation and regulation.

[148] *supra.* at 204, 210 and 215.

Chapter 7

Islamic Real Estate Financing Transactions and Irish Law

7.1 Introduction

Chapter 6 introduced three forms of Islamic real estate financing which may be relevant if Islamic property financing is offered in Ireland.[1] Islamic real estate financing is distinguishable from its conventional alternative not simply because the Islamic arrangements do not involve an interest-bearing loan, but because there is a variety of different structures available. These structures include *murābaha*, *ijārah wa-iqtina* and diminishing *mushāraka*. Chapter 7 will develop this discussion in the context of Irish law. In order to answer the third thesis question presented in Chapter 1,[2] this Chapter will consider how *murābaha*, *ijārah wa-iqtina* and diminishing *mushāraka* may be treated under Irish law. Two broad areas of Irish law are focused on:[3] taxation and property law. Section 7.2 will deal with taxation.[4] It will address the tax clarifications set out in the Revenue Commissioners' Tax Briefing 2009 and the accommodating tax provisions of the Finance Act 2010. Where necessary, it will also suggest areas for further reform. Section 7.3 will consider how the Islamic structures may be classified and treated under Irish property law;[5] problem areas will be highlighted and suggestions for improvement will be

[1] *supra.* at 203.
[2] *supra.* at 3.
[3] Due to space constraints, every legal issue raised by the introduction of Islamic real estate financing products into Ireland cannot be discussed in detail. Taxation and property law issues have been chosen as areas which will cause some of the greatest difficulty.
[4] *infra.* at 223.
[5] *supra.* at 245.

presented. In this Chapter and in Chapter 9 (*sukūk* under Irish law), tax issues will be considered first. This approach has been followed because it is in the area of fiscal accommodation that steps have already been taken by the Irish legislature; it is conceivable that the structures accommodated in the Tax Acts will influence the development of Islamic products should they be offered in Ireland.

In practice, commercial or wholesale Islamic real estate financing will almost certainly be easier to develop within Ireland's current legal system than retail alternatives. This is due to the fact that the retail housing loan market is subject to a prescriptive statutory regime while the wholesale sector benefits from a large degree of freedom to structure the financing contract according to the wishes of the parties.[6] As the legal constraints faced by retail-level real estate finance in Ireland are greater than those faced by the wholesale sector, parts of this Chapter (particularly subsections 7.3.1 and 7.3.2(A)) will focus on Islamic alternatives to home financing. Nevertheless, issues such as taxation (7.2) and lender liability (7.3.2(B)(2)) will be relevant both in wholesale and retail-level transactions.

7.2 Taxation

As already discussed in Chapters 3 and 4, the Tax Briefing 2009 and Finance Act 2010 both include provisions specifically designed to address the tax position of Islamic finance structures in Ireland.[7] The Finance Act 2010 introduced "Specified Financial Transactions" into the TCA,[8] a measure which has been publicly acknowledged as intended to create a level playing field between the taxation of conventional and substantively similar Islamic financial products.[9] The newly inserted Part 8A of the TCA does not refer to real estate finance but, like accommodations introduced in the UK, outlines the underlying structures which form the basis of Islamic transactions, including some of those discussed in Chapter 6.[10]

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[6] *infra.* at 249.
[7] *supra.* at 143.
[8] Part 8A Taxes Consolidation Act 1997 as introduced by section 39 Finance Act 2010.
[9] *supra.* at 143.
[10] "Credit Transactions" (section 267N Taxes Consolidation Act 1997 as introduced by section 39 Finance Act 2010) outlines structures which are similar to diminishing *mushāraka* and *murābaha*. This point is discussed in more detail below.

The taxation of Islamic contracts - like any other financial contract subject to Irish tax law - is determined according to the legal form of the transaction.[11] The existing provisions of Ireland's tax framework relevant to mortgage arrangements have been designed to deal with the structure of conventional secured property loans; the manner in which tax is applied and relieved takes into account the nature of an interest-based mortgage and the ownership of the property over the course of the transaction. Consequently, in a conventional property mortgage, the customer, not the financier, has or acquires ownership of the property subject to the mortgage charge. The financier's role is simply to supply the capital needed to purchase/develop the property while the customer repays the loan, generally with interest. Under Irish tax law, interest payments made on a real estate financing loan will most likely be treated as income in nature. In the context of corporate borrowers these payments are a trading rather than capital expense and may be deductible from the income of the customer which is subject to corporation tax.[12] Similarly, as the mortgagor (retail or commercial) retains ownership of the property for the duration of the mortgage, stamp duty arises only once, on the initial purchase of the property from the vendor.[13]

In place of this loan and interest arrangement, *murābaha* returns take the form of a mark-up on the sale of property[14] while diminishing *mushāraka* and *ijārah wa-iqtina* involve the payment of rent by the customer.[15] These returns, while economically similar to interest,[16] are structurally distinguishable[17] and as a result, sit uneasily within taxation

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[11] Taxation statutes are to be interpreted strictly. See, *Patrick McGrath & Others v McDermott* 111 ITR 683, per Carroll J "It seems to me, therefore, that the principle in the Duke of Westminster's case as approved by Kenny J can be stated thus; in determining whether liability to tax arises, the Court does not look at the substance or financial results of a transaction. It looks at the actual legal effect and legal rights of the parties according to legal ideas and concepts." See also, *The Revenue Commissioners v O'Flynn Construction Co. Ltd, John O'Flynn, Michael O'Flynn* [2006] IEHC 143 (unreported) per Mr. Justice T.C. Smyth, noting that; the "principles of statutory interpretation set out in *McGrath v. McDermott* prohibit us from adopting such a purposive approach."

[12] Section 81(2) Taxes Consolidation Act 1997. See *Sean MacAonghusa v Ringmahon Company* in which Geoghegan J noted that: "...if the respondent had, at all times, financed its business by bank borrowings the interest payable would clearly have been allowable as a trading expense and this could not have been disputed by the Revenue Commissioners." [2001] ITR 117 at 120.

[13] Section100 of the Finance Act 2007 abolished the duty on Mortgages and other security documents, the Act also abolished stamp duty on deeds of release, Quinn, Andrew, "Capital Taxes", in *Taxing Financial Transactions*, (3rd ed., Taxation Series, Irish Taxation Institute, Dublin, 2010), 351-370 at 365.

[14] *supra.* at 204.

[15] *supra.* at 210and 215.

[16] Particularly where they are pegged to an interest rate benchmark such as LIBOR

[17] The US courts noted that interest represents "compensation for the use or forbearance of money." *Deputy v. Dupont*, 308 U.S. 488, 498 (1940), this concept was recently relied on to conclude that fees were not interest as no loan had been extended to a parent company, *Container Corporation v. Commissioner* 134 T.C. No. 5 (2010). See also, Smyth, David and Walsh, Aidan, "Background – Tax Regime for International Financial Business", in *Taxing Financial Transactions*, (1st ed., Irish Taxation Institute, Dublin, 2004), 7-30

legislation designed for interest-based structures.[18] The taxation of the Islamic arrangements, in the absence of accommodation, could therefore be inconsistent with that arising in relation to the secured property loans they are designed to substitute. The unique structural characteristics of the Islamic contracts could also result in a lack of consistent taxation between the various Islamic arrangements themselves. Uncertainties surrounding the taxation of Islamic real estate structures, together with the potential for such structures to be subject to more onerous (or indeed lighter) taxation than similar interest-based structures, represent challenges to the development of Islamic finance in Ireland and the creation of parity between the treatment of financial instruments. This area is highly complex and, in the absence of precedent, unpredictable.

This section will discuss some of the tax implications which may arise in relation to Islamic real estate financing structures in Ireland. It will look first at the tax issues raised by *murābaha* (A),[19] *ijārah wa-iqtina* and diminishing *mushāraka* (B)[20] prior to accommodation (7.2.1).[21] Discussion of corporation and income tax, capital taxes and stamp duty will be used to emphasise the difficulties faced by Islamic finance market participants and to argue that without accommodation, tax issues would have rendered Islamic real estate financing in Ireland unviable. This section will then go on to consider the taxation of *ijārah wa-iqtina* (A),[22] *murābaha* and diminishing *mushāraka* (B)[23] following the 2009 clarification and 2010 accommodation (7.2.2).[24] The effectiveness of these measures will be discussed in relation to each Islamic real estate financing structure. It will be argued in this section that while the accommodations represent an important first step towards the creation of a level playing field between Islamic and conventional structures, more reform is needed. Suggestions for such reform are presented in subsection 7.2.4.[25]

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at 20, [1.7]. Legally the returns in Islamic transactions are not interest; they are neither termed as interest nor do they arise from a loan of money, Mann, Roberta, "Is Sharif's Castle Deductible? Islam and the Tax Treatment of Mortgage Debt", (2009) 17 *William & Mary Bill of Rights Journal*, 1139-1169 at 1152, noting that "[h]olders of Islamic home financing instruments face a possibly insurmountable barrier to deductibility—their payments are not characterized as interest." Shaw, Trevor, "East meets West", (2007) (159)4091, *Taxation*, 68-70 at 68.

[18] Mann, Roberta, "Is Sharif's Castle Deductible? Islam and the Tax Treatment of Mortgage Debt", note 17, at 1152, Shaw, Trevor, "East meets West", note 17, at 69.

[19] *infra.* at 226.

[20] *infra.* at 230.

[21] *infra.* at 226.

[22] *infra.* at 236.

[23] *infra.* at 237.

[24] *infra.* at 235.

[25] *infra.* at 241.

7.2.1 Taxation of Islamic Real Estate Financing Structures: Prior to Accommodation

A. *Murābaha* Real Estate Financing Structures

1. Corporation Tax liability of Financier

Unlike an interest-based mortgage, in which a financier provides a secured loan to a borrower without assuming ownership of the property being purchased or developed, *murābaha* agreements involve the purchase and sale of property by the financier.[26] In the absence of tailored accommodation, the transaction participants in *murābaha* arrangements could be subject to the tax principles relevant to the sale of property with deferred payment.[27]

From the perspective of the financial institution this could result in a higher level of tax liability than would arise in a conventional mortgage transaction. Corporation tax in Ireland is assessed in accordance with a "scheduler system"[28] under which income from different sources is assigned to different Schedules or Cases; the Schedule and Case to which income is allocated will influence the level of corporation tax paid.[29] In *murābaha* transactions in which the financier is a financial institution, the purchase and sale of real estate may be considered to fall outside the scope of that institution's "trade,"[30] that is, banking business (unless it was undertaken on a habitual and systematic basis).[31] This would arguably prevent the return on the transaction from being classified as profit

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[26] *supra.* at 204.

[27] Conway, Kevin and Feese, Suzanne, "The tax dilemma in Islamic finance", (July/August 2007) *International Tax Review*, 20-22 at 20-21.

[28] Smyth, David and Walsh, Aidan, "Background – Tax Regime for International Financial Business", in *Taxing Financial Transactions*, (1st ed.), note 17, at 9. See also, Smyth, David and Walsh, Aidan, "The Fiscal Environment", in *Taxing Financial Transactions*, (3rd ed., Irish Taxation Institute, Dublin, 2010), at 3.

[29] Smyth, David and Walsh, Aidan, "Background – Tax Regime for International Financial Business", (1st ed.), note 17, at 9, Smyth, David and Walsh, Aidan, The Fiscal Environment, in *Taxing Financial Transactions*, (3rd ed.), note 28, at [1.2.1].

[30] In *JA. Browne (Inspector of Taxes) v Bank of Ireland Finance Ltd.* [1991] ILRM 421 the Supreme Court noted that the purchase of government securities by a bank was part of its normal trading activities because such purchases were necessary in order to comply with the directive of the Central Bank. In complying with the order, the purchases became normal trading activity. However, this decision can be distinguished from the purchase and sale of property by a bank as such activity is not essential in order to carry on banking business.

[31] The Central Bank and Financial Services Authority Act 2004 does not actually note that the sale of property is *not* banking business; however it does provide that "receiving money in respect of leasing or selling goods under a hire purchase agreement, a leasing agreement or credit-sale agreement" is not banking business. In *Cooper v Stubbs* 10 TC 29, speculating in cotton futures was outside the "trade" of cotton growers as it was not done on a habitual and systematic basis.

received in the course of trade within Case I of Schedule D of the TCA.[32] The implication of this is that the financial institution's gains may be classified either under Case IV of Schedule D,[33] if the revenue generated is considered to be income in nature,[34] or as gains of a capital nature on the sale of an asset if it is not.[35] Under both classifications, the financier's income may be subject to 25% corporation tax[36] (25% on the whole mark-up payment if classed as income and on the gain if classed as capital) as opposed to the 12.5% corporation tax on profit which would apply if the return was received in the course of the financier's trade and within Case I of Schedule D.[37] For financiers who are *not* financial institutions but entities specifically established to provide financing for Islamic or other real property-based activities, the sale and purchase of the underlying asset could be included in the trading account of the financier and regarded as dealing in land within the course of that financier's trade.[38] This would result in the returns generated by the sale to the customer being brought under Case 1 of Schedule D and so subject to 12.5% corporation tax. In contrast to this relatively unclear tax liability, the Department of Finance has specifically acknowledged that interest payments received by a financial institution or financial services provider will be classified under Case I of Schedule D; the

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[32] Malaysian authorities attempted to deal with this problem very early in the accommodation of Islamic structures with legislative accommodation designed to ensure that gains or profits from Islamic financial instruments were granted the same tax exemptions and the same tax deductibility as interest income and payments, section 2(7) Income Tax Act 1967 (Act 53) which provides that "[a]ny reference in this Act to interest shall apply, *mutatis mutandis*, to gains or profits received and expenses incurred, in lieu of interest, in transactions conducted in accordance with the Syariah." See also, Hegazy, Walid, "Islamic Finance - A Tax Perspective", (1997) 3(10) *Asia-Pacific Tax Bulletin*, 342-348 for a discussion of early Malaysian tax developments.

[33] Section 643 Taxes Consolidation Act 1997 which the Revenue Commissioners has noted "provides for a charge to tax under Case IV of Schedule D on gains from certain disposals of land or property (such as shares) deriving its value from land," Revenue Commissioners, *Notes for Guidance – Taxes Consolidation Act 1997 – 2008 Edition* "Part 22", (tcagpart22_08), at 7, available at: www.revenue.ie/en/practitioner/law/notes/tcagpart22_08.pdf.

[34] Smyth, David and Walsh, Aidan, "The Fiscal Environment", in *Taxing Financial Transactions*, (3rd ed.), note 28, at [1.6.1] citing *Ryall (IoT) v Hoare* 8 TC 521 where Rowlatt J noted that: "'Profits or gains' means something which is in the nature of interest or fruit, as opposed to principal or tree" and "it is quite clear that anything in the nature of a capital accretion is outside the words 'profits or gains'".

[35] Where the sale of the asset occurs outside of the financial institution's usual course of business, the income generated would not be income in nature but rather gains accruing on the sale of a capital asset – if the financier was an individual such gains would be subject to capital gains tax, however, the Taxes Consolidation Act provides that capital gains accruing to a company will be chargeable to Corporation Tax, section 21(3) Taxes Consolidation Act 1997.

[36] The rate of Capital Gains Tax charged was increased to 25% (from 22%) by section 14 Finance Act 2009.

[37] Smyth, David and Walsh, Aidan, "The Fiscal Environment", in *Taxing Financial Transactions*, (3rd ed.), note 28, at [1.2.1]

[38] See *Birth v Delany* [1936] IR 517 at 519-520 where Davitt J notes that "the respondent would be liable to income tax as carrying on a trade in respect of the houses which he sells and the profit to him from such sale…"

financier's return in a conventional mortgage will thus always be subject to 12.5% corporation tax.[39]

2. *Deductibility of Payments made by Customer*

When selling the property to the customer, the financier in a *murābaha* arrangement charges an increased price which is fixed at the outset. In other words, the purchase price of the property includes the original price and the mark-up rather than the price of the property and an additional interest payment as would be found in a conventional mortgage loan.[40] The whole cost of the property would appear to represent a capital payment by the customer towards the acquisition of the property.[41] As the full amount of the *murābaha* payments are being made towards the purchase of property, a customer who is an individual would be unlikely to be able to claim "mortgage interest relief"[42] for "interest paid by the individual"[43] in respect of a "qualifying loan."[44] While this relief is being phased out for conventional mortgages, it nevertheless provides such home owners with tax relief on mortgage payments until at least 2017.[45] A similar issue faces corporate *murābaha* customers who may not be able to deduct payments made under the *murābaha* arrangement from their corporation tax liability as such payments are capital rather than revenue in nature,[46] and are not "wholly and exclusively laid out or expended for the

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[39] Department of Finance, *Trading and Non-Trading Income*, (TSG98/24), available at: http://www.finance.gov.ie/viewdoc.asp?DocID=1463. This conclusion is logical as the extension of credit by a financial institution is likely to be classified as "banking business" under the Central Bank and Financial Services Act 2004 and so will be earned in the course of the banks trade. A similar conclusion could be drawn in relation to other financial services firm whose business includes making loans.

[40] *supra.* at 204.

[41] See the UK case; *I.R.C.* v. *Church Commissioners for England* [1977] A.C. 329 at 343 in which Lord Wilberforce noted that "[d]issection is, at least as a plain case, permissible if the parties who are buying and selling a capital asset, having agreed upon a price, then make provision for payment of that price by instalments, *the amount of which is so calculated and shown to be so calculated as to include an interest element*. Whether there are other possible cases of dissection, i.e., apart from the case where a lump purchase price has been agreed upon, may be a debatable area," (emphasis added).This is not necessarily the case in *murābaha* real estate structures where, legally, the whole amount is the purchase price. See also *Scoble v. Secretary of State for India* [1903] A.C. 299 in which purchase payments on an instalment basis clearly included an interest element in which case dissection into capital and income payments was deemed to be permissible.

[42] Section 244 and 244A Taxes Consolidation Act 1997.

[43] Section 244(a) Taxes Consolidation Act 1997.

[44] Section 244(a) Taxes Consolidation Act, Amin, Mohammed, *A simple introduction to Islamic mortgages*, (March 2011), at 12, available at: http://www.mohammedamin.com/Islamic_finance/A-simple-introduction-to-Islamic-mortgages.pdf noting that "a tax system which looks primarily at the legal form of a contract [like Ireland] will simply analyse the [*murābaha*] transaction as the Islamic bank selling the property to the customer ...as stated in the contract. That means there is no tax deductible finance cost."

[45] Section7 Finance Act 2010 amending Section244 Taxes Consolidation Act 1997.

[46] Smyth, David and Walsh, Aidan, "Background – Tax Regime for International Financial Business", in *Taxing Financial Transactions*, (1st ed.), note 17, at 15-16, [1.4.2] noting that in order for an expense to be

purposes of the trade...".[47] In contrast, a trading company may generally deduct interest payments, including those payable on a real property loan (if wholly and exclusively incurred in the course of trade),[48] thus reducing the level of income on which they are liable to tax.[49]

3. Stamp Duty Liability

Finally, unlike a conventional mortgage which involves a single property transfer between the vendor and borrower, a *murābaha* transaction requires double transfer of the property involving the vendor, the financier and ultimately the customer.[50] Such transactions entered into in relation to Irish property could trigger the double imposition of stamp duty, an *ad valorem* tax which applies to instruments rather than transactions:[51] once when the asset is purchased and again when it is subsequently sold to the customer.[52] In practice, such a double imposition of taxation may be avoided by the use of a sub-sale as provided for in s.46 of the Stamp Duties Consolidation Act [SDCA] 1999.[53] Duty would

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deductible it must be wholly and exclusively laid out or expended for the purposes of the trade and revenue, rather than capital, in nature.

[47] Section 81(2) Taxes Consolidation Act 1997.

[48] Section 81(2) Taxes Consolidation Act, which notes that "in computing the amount of profits or gains to be charged to tax under Case I...no sum shall be deducted in respect of – (a) any disbursement or expense, not being money wholly and exclusively laid out or expended for the purposes of the trade..." Smyth, David and Walsh, Aidan, "The Fiscal Environment", in *Taxing Financial Transactions*, (3rd ed.), note 28, at [1.4]

[49] Amin, Mohammed, "Mortgage based financial products from an Islamic perspective", *PriceWaterhouseCoopers*, (November 11, 2008), available at: http://pwc.blogs.com/files/Islamic_mortages_111108.pdf , who reaches a similar conclusion in relation to conventional mortgages in the UK.

[50] Amin, Mohammed, "Islamic financial products and their challenge to taxation systems", in *The Chancellor Guide to the Legal Shari'a Aspects of Islamic Finance*, Humayon Dar and Umar Moghul (ed.), (Chancellor Publications, London, 2009), 75-104 at 80.

[51] Section 2 Stamp Duties Consolidation Act 1999, Donegan, David, *Irish Stamp Duty Law*, (Tottel, Dublin, 2006), at [3.28-9] quoting Lord Esher in *IRC v Augus* [1889] 23 QB 579 at 589 who noted that "...the thing which is made liable to duty is an instrument. If a contract of purchase and sale...can be or is carried out without an instrument the case is not within the section and no tax is imposed. It is not the transaction of purchase and sale which is struck at; it is the instrument whereby the purchase and sale is effected which is struck at." Recently quoted with approval by the Indian High Court in *Greaves Cotton And Co. Ltd. v State Of Maharashtra*, (24 August, 2004) 2005 57 SCL 19 Bom at [11].

[52] This fact has been confirmed by the Revenue Commissioners in correspondence with Pat O'Connell at the Dublin Stamp Duty Office, Appendix 3, *infra.* at 459.

[53] The financier would thus agree to purchase the property from the vendor and before taking conveyance of the property, direct that the vendor transfers the property to the customer. While this would technically give rise to two stampable events, the legislation provides that duty will be payable only on the consideration paid by the sub-purchaser. Amendments to the stamp duty legislation brought in by the Finance Act 2007 (Section 110, Finance Act 2007 inserting Section 31A into Stamp Duty Consolidation Act 99) limit the relief to situations where less than 25% of the consideration is paid to the original vendor before the subsequent transfer. In a *murābaha* agreement the financier would generally pay the whole purchase price to the original vendor. This would appear to exclude *murābaha* from the scope of the sub sale relief, however, no double tax will occur where the conveyance or transfer of the lands concerned has been presented for stamping within 30 days. This arguably captures the subsequent transfer of the property to the customer as being in conformity with the first purchase agreement. Goodman, Aoife, "Stamp Duty Update", (2007) *Tax Ireland*,

then be charged only when the consideration passes from the customer and would be charged at a rate of 1% for residential property up to €1 million (2% on the remainder)[54] and varying rates between 0% and 6% for other property.[55]

B. *Ijārah wa-iqtina* and Diminishing *Mushāraka*

Without accommodation in Ireland's fiscal regime, *ijārah wa-iqtina* and diminishing *mushāraka* transactions are likely to result in the taxation of the parties which is unwieldy, inconsistent with, and generally less favourable than, that imposed on loan arrangements. Both *ijārah wa-iqtina* and diminishing *mushāraka* arrangements contain fully functioning and enforceable leases in which no mention is made of any undertakings to purchase/sell, any "on-account" funds or any progressive purchase of equity.[56] The tax treatment applicable in the case of leases may therefore be relevant. In a structure similar to that adopted in subsection A relating to *murābaha*, this subsection will consider the corporation/income tax (1),[57] capital tax (2)[58] and stamp duty tax (3)[59] issues raised by *ijārah wa-iqtina* and diminishing *mushāraka* prior to accommodation.

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available at:
http://www.taxireland.ie/taxfind/ContentHTML/ParsedHTML/sacp_HTMLFILES%5C04sacp%5C_infobase00037.htm%5C_h100079.htm%5Ch200086.htm.

[54] This rate was cut drastically from the previous rate which could be as high as 9% by section 66(1) Finance Act 2011 amending Schedule 1 Stamp Duty Consolidation Act 1999.

[55] Revenue Commissioners, *Current Rates of Duty on Non-Residential Property for instruments executed after 15 October 2008*, available at: http://www.revenue.ie/en/tax/stamp-duty/non-residential-rates.htmlRevenue, Revenue Commissioners, *Stamp Duty Consolidation Act 1999, Notes of Guidance*, discussing Section 46 at 55, available at: www.revenue.ie/en/practitioner/law/stamp-duty-guidance-notes.pdf. As the UK has already dealt with the stamp duty liability in Islamic real estate transactions, sub-sale relief is not available to these transactions in the UK, see Douglas, Jane, *Property Transactions: Stamp Duty Land Tax*, (Sweet & Maxwell, London, 2005), at [3.18].

[56] *O'Sullivan v. P. Ltd.* (1962) 3 I.T.C. 355 at 360 per Kenny J referring to a case involving a lease in which a premium was paid: "The case thus raises the difficult and vexed question as to 'form and substance' in taxation matters. When a transaction is contained in a document, the liability to tax arising out of the transaction depends upon the meaning and effect of the document ascertained in accordance with the principles of construction which have been laid down by the Courts." Prior to the decision in *Inland Revenue Commissioners v The Duke of Westminster* [1936] A.C. 1 there was some judicial support for the view that in determining liability to tax, the substance of the transaction was to be looked at: this was assumed to mean that the financial result and not the legal effect of a transaction determined liability for tax purposes. This view was rejected in *the Duke of Westminster's* case." Kenny J therefore concluded that taxation in a lease arrangement will follow the form of the instruments.

[57] *infra.* at 231.

[58] *infra.* at 233.

[59] *infra.* at 234.

1. *Corporation Tax Liability and Deductibility of Payments*

The first area of potential tax liability is in relation to the *hamish jiddiyah* (deposit)/*urboun* (earnest money) in *ijārah wa-iqtina* arrangements. This payment is not used to purchase the customer's equity in the property until the end of the lease and so it may be considered to be a premium paid for the grant of the lease. As *ijārah wa-iqtina* real estate financing transactions are likely to be less than fifty years, the financier (as lessor) will be treated as entitled under Case V of Schedule D to an amount as rent "equal to the amount of the premium reduced by 2 per cent of that amount for each complete period of 12 months, other than the first, comprised in the term of the lease,"[60] any part of the premium paid over this amount may be subject to capital gains tax at 25%.[61]

Once the lease has begun, the status of the rental payments will be relevant. Where a financier is deemed to be carrying out a trade, and the purchase and leasing of real properties is treated by that financier as part of their trading activity, then the rental income may fall within Case 1 of Schedule D giving rise to corporation tax liability of 12.5% on profit. However, due to the long-term nature of the financier's property ownership and the probable lack of volume of such financial activity (at least in the short term), the property purchased under an *ijārah wa-iqtina* arrangement may be treated by the financier as a long-term investment rather than property acquired with the intention of trading at a profit.[62] The fact that equity in the property is progressively sold in diminishing *mushāraka* arrangements may result in such property being treated as having been acquired in the course of trade. Nevertheless, on its face, a diminishing *mushāraka* arrangement includes a *bona fide* lease of the whole property. As such, it may still be treated as an investment. As the financier would be a lessor of the property (under both *ijārah wa-iqtina* and diminishing *mushāraka*) returns generated by the lease may be subject to 25% taxation

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[60] Revenue Commissioners, *Notes for Guidance – Taxes Consolidation Act 1997 – 2008 Edition*, "Part 4" at 76, available at: www.revenue.ie/en/practitioner/law/notes/tcagpart04_08.pdf.

[61] Section 98 Taxes Consolidation Act 1997. See also, Revenue Commissioners, *Notes for Guidance – Taxes Consolidation Act 1997 – 2008 Edition*, "Part 4" at 76. The capital gains tax payable on the balance is dealt with in Schedule 14, Taxes Consolidation Act 1997.

[62] Commenting on aircraft leasing, A&L Goodbody notes that "[t]o be considered to be trading, the company must be carrying on a business activity from which the income derives, as opposed to merely owning an asset that produces income, e.g. an aircraft lease. In addition, it is the view of the Irish Revenue that the control of the trading activities at operational level must be located in Ireland and be carried out by employees or directors of the lessor, present in Ireland and having the requisite skill and expertise," A&L Goodbody, *In Focus; Ireland - a hub for aircraft leasing*, (March 2011), at 1, available at: http://www.algoodbody.com/GetAttachment.aspx?id=73ee9368-5d78-4e2d-bfe1-d3ba2133eff3.

under Case V of Schedule D which deals with charges to tax arising on rent received in respect of land or premises in the State.[63]

Income chargeable to tax under Case V is calculated on the basis of the gross rental payments made by a lessee.[64] In relation to a diminishing *mushāraka*, the customer and financier share the rental proceeds (as co-owners) and so would be subject to tax on the rental payments, less rental expenses, in accordance with their respective shares of the property.[65] In practice, as the customer will be paying rent to occupy the property, the rental income which he or she would receive as co-owner may simply be set off against the rental payments. In addition to this, a corporate customer (as lessee) may be able to deduct the rental payments from its corporation tax liability where such rent is a revenue expense incurred for the purposes of trade.[66] While a customer who is a private individual would traditionally have been able to claim some rent relief[67] for the rental payments made on residential property, such relief is now being phased out.[68]

In an *ijārah wa-iqtina*, the financier is exclusively entitled to receive rent from the property, with the whole amount of the payments made by the customer classified for *Sharī'ah* purposes as rent, even though a portion of that payment is allocated by the financier to the "on-account" fund.[69] This lack of differentiation in an *ijārah wa-iqtina* between the rent paid for occupation of the property and that rent which will eventually go towards the acquisition of the property could result in the financier being subject to Case V taxation (of 25%) on *all* sums paid by the customer over the course of the lease.[70] Adding to this, if the rental payments made by a corporate customer are deemed to be revenue in nature and incurred for the purposes of trade, that customer may be able to deduct the full

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[63] Section 18(2) Taxes Consolidation Act which covers "[t]ax in respect of any rent in respect of any premises or any receipts in respect of any easement." A&L Goodbody, *In Focus; Ireland - a hub for aircraft leasing*, note 62, at 1. See also, Daly, Brian, "Changing finance in changing times - Islamic finance and Irish tax", (September 2007) *Finance Magazine*, available at: http://www.finance-magazine.com/display_article.php?i=7802&pi=274.

[64] Section 97(1)(a) Taxes Consolidation Act, "the amount of the profits or gains arising in any year shall for the purposes of Case V of Schedule D be...the amount of any rent shall be taken to be the gross amount of that rent before any deduction for income tax."

[65] 25% corporation tax on rental income for a corporate customer and 20% income tax for an individual.

[66] Section 81(2) Taxes Consolidation Act 1997. See also Revenue Commissioners, *Taxation Treatment of Finance Leases - IT 52*, available at: http://www.revenue.ie/en/tax/it/leaflets/it52.html.

[67] Although the interest which the customer is acquiring in the property gradually may restrict their ability to claim rent relief.

[68] Section 14, Finance Act 2011, amending section 473 of the Taxes Consolidation Act 1997.

[69] *supra.* at 211.

[70] Section 97(1)(a) Taxes Consolidation Act 1997.

amount of the rental from their corporation tax liability, despite the fact that a portion of their payments will ultimately be used in the purchase of the property.

2. *Tax Liability on Disposal of Property*

The disposal of the property at the end of the *ijārah wa-iqtina* and progressively in a diminishing *mushāraka* could raise anomalous tax liability in retail-level transactions. In both of these transactions, the agreement between the parties is an independent lease over the whole property. In an *ijārah wa-iqtina* arrangement, the financier will ultimately transfer the property to the customer either as a gift or for a token amount. This could be treated for tax purposes as a capital loss for the bank while subjecting the customer to gift tax liability (a form of capital acquisitions tax [CAT]). This latter tax does not exist in the UK and could expose customers in *ijārah wa-iqtina* offered in Ireland to considerable taxation. From a legal perspective, the customer has received the entire property free or at the token consideration, not at its full market value. While a tax free threshold exists in relation to gift tax liability, the lack of any familial relationship between the customer and financier will reduce this threshold substantially (to €16,604).[71] An exemption from gift tax also applies to certain gifts of dwelling houses.[72] However, the wording of this exemption appears to be aimed at situations in which the disponer and donee are in a family relationship, not a commercial, arms-length one.[73] Consequently, the customer in an *ijārah wa-iqtina* could be liable to 25% CAT on the market value of the property over €16,604. For diminishing *mushāraka* arrangements, the sale of the property is gradual and so, each purchase of the financier's equity in the property by the customer could be treated as a part-disposal. However, as the customer generally purchases the financier's equity at the original purchase price, there may be no capital gain or loss for tax purposes.

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[71] Revenue Commissioners, "Indexed Thresholds for Capital Acquisitions Tax - 2009, 2010 & 2011", *Thresholds for Capital Acquisitions Tax*, available at: www.revenue.ie/en/tax/cat/thresholds.html.

[72] Contained in section 86 of the Capital Acquisitions Tax Consolidation Act 2003

[73] For example, section 86(3)(A)(a) Capital Acquisitions Tax Consolidation Act 2003 provides that any period during which a donee occupied a dwelling house that was, during that period, the disponer's only or main residence, shall be treated as not being a period during which the donee occupied the dwelling house unless the disponer is compelled, by reason of old age or infirmity, to depend on the services of the donee for that period, section 86(3)(A)(a) Capital Acquisitions Tax Consolidation Act 2003 as introduced by section 116(1) Finance Act 2007 (Number 11 of 2007).

3. *Stamp Duty Liability*

Finally, *ijārah wa-iqtina* and diminishing *mushāraka*, like *murābaha*, involve multiple transfers of the property.[74] As a result, they will be subject to more than one charge to stamp duty.[75] Indeed, these transactions may give rise to three or more stampable documents under Irish law. *Ijārah wa-iqtina* arrangements involve two property conveyances, once when the financier purchases the property and again when title is transferred to the customer. It also includes a lease.[76] All three of these steps could be subject to stamp duty.[77] Similarly, diminishing *mushāraka* arrangements include an initial purchase by the financier, the lease of the asset and the sale to the customer. The second sale does not occur in one transaction but rather over a series of independent sale and purchase agreements; each one of these agreements could be stampable.[78] The imposition of stamp duty on Islamic real estate transactions would therefore be substantial. While *murābaha* agreements may be able to rely on the sub-sale relief in the SDCA,[79] the fact that the financier in *ijārah wa-iqtina* and diminishing *mushāraka* must assume the role of owner of the property for the duration of the lease would make it difficult to avail of the sub-sale procedure. With the abolition of all existing stamp duty reliefs and exemptions on residential properties,[80] property transactions based on Islamic principles would be subject to considerably more taxation than conventional mortgages in which stamp duty liability arises only once.[81]

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[74] Daly, Brian, "Changing finance in changing times - Islamic finance and Irish tax", note 63.

[75] Tameme, Mohammed Elkhatim Mamoun, *Demand and Supply Conditions of Islamic Housing Finance in the United Kingdom: Perceptions of Muslim Clients*, A Thesis submitted to the University of Durham for the Degree of Doctor of Philosophy, (July 2009), at 88.

[76] *supra.* at 216.

[77] While the final conveyance to the customer may be for a nominal amount, stamp duty will be charged on the market value of the property. Section 30, Stamp Duties Consolidation Act 1999.

[78] Section 31(1) SDCA 1999 provides that Contracts for the sale of an equitable estate or interest are not stampable. However in *Peter Bone Ltd v IRC* [1995] STC 921 Vinelott J noted that "[i]n the case of an agreement for the sale of a legal estate in land the agreement is said to merge with the conveyance of the land, although of course some contractual obligations may remain …[in this case the vendors did] not have the right, which a vendor under an uncompleted contract has, to require the purchaser to take a conveyance and so relieve him of a potentially burdensome legal title. I think that, strictly, the agreement operated as a transfer of the equitable estate in the freehold property, and not as an agreement for the sale of the equitable estate." The agreement was not executory and had the effect of transferring the equitable interest, not merely agreeing to do so. It was therefore a stampable conveyance. Donegan, David, *Irish stamp duty law*, note 51, at 4.38-4.44.

[79] *supra.* at 229.

[80] Section 60 Finance Bill 2011. These reliefs include: first time buyer's relief; reliefs and exemptions for new residential property; consanguinity relief for residential property transfers; and site to child relief, Department of Finance, "Appendix to Press Release", *Finance Bill 2011, List of Items*, at 9, available at: http://www.finance.gov.ie/documents/publications/financebill2011/Listofitemsfinbilll2011.pdf

[81] As noted *supra.* at 224, [footnote 13], Section 100 of the Finance Act 2007 abolished the duty on Mortgages and other security documents, the Act also abolished stamp duty on deeds of release.

In the absence of accommodating legal provisions tailored to the structural characteristics of Islamic real estate transactions, the taxation of these transactions and their participants is not only opaque but at times considerable in size. When compared with the taxation of conventional mortgages, the Islamic alternatives frequently appear to be more expensive, notwithstanding the fact that they are designed to substitute conventional mortgages. The Irish Government could, of course, have chosen to do nothing to address this inequality. However, such an approach would, as the UK's HMRC noted "do nothing to address the underlying tax problems...[and would] therefore be of no benefit to the financial institutions who offer alternative financial products nor to customers and businesses that require them."[82] It is suggested that it would also result in the tax treatment of Islamic products which is so complicated that it would have discouraged financiers from offering these transactions. With the Government's recent interest in attracting Islamic finance activity to Ireland, some level of fiscal accommodation was foreseeable.

7.2.2 Taxation of Islamic Real Estate Financing Structures: Following the 2009 Clarification and the 2010 Statutory Modification

In light of the anomalous and potentially high levels of tax (and an absence of reliefs) faced by participants in Islamic contracts in Ireland, the Tax Briefing 2009 seeks to clarify, while the Finance Act 2010 has overridden, the tax implications which would arise due the legal form of Islamic products. Most notably in relation to real estate transactions, the provisions of the Briefing and Act deal *ijārah wa-iqtina*, *murābaha* and diminishing *mushāraka* structures and seek to align the taxation of these structures with conventional interest-based products. In an approach similar to that adopted in the UK and other countries which have introduced tailored taxation of Islamic structures, the Irish provisions have adopted a "deeming" method of accommodation by treating certain returns as interest and specific transactions as loan arrangements, even though legally they are not.[83]

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[82] HM Revenue & Customs, *Budget 2007: Regulatory Impact Assessment, Alternative Finance Products*, (HMRC, London, 2005), at 4, available at: http://www.hmrc.gov.uk/ria/4-alternative-finance-products.pdf. See also; Daly, Brian, "Changing finance in changing times - Islamic finance and Irish tax", note 63.

[83] Woods, Tom and Jahanjiri, Kashif, "Islamic Financial Transactions", in *Taxing Financial Transactions*, Kenneth Byrne (ed.), (3rd ed., Irish Taxation Institute, 2010), 209-241 at [9.1.1]. Amin, Mohammed, "Taxation of conventional and Shariah compliant mortgages", *PricewaterhouseCoopers*, (November 2008) available at: pwc.blogs.com/files/taxation_rules_for_mortgages.pdf.

A. *Ijārah wa-iqtina* and the Tax Briefing 2009

The Tax Briefing 2009[84] sets out the Revenue Commissioners' policy towards the taxation of certain Islamic products. While only addressing the tax position of a limited number of products, this Briefing outlines the treatment of *ijārah* leasing arrangements and specifically identifies three separate forms of these transactions. First, the Briefing provides for plain *ijārah* leases which are described as being akin to operating leases. This is uncontroversial and is in line with developments in other jurisdictions. The Briefing then goes on to describe two other types of *ijārah*: *ijārah muntahia bittamleek* representing an Islamic finance lease, and *ijārah* products used in the context of hire purchase transactions.[85] The UK Government has acknowledged only two forms of Islamic lease, simple *ijārah* leases in which the asset is returned to the owner at the end of the lease term and *ijārah wa-iqtina*, under which the asset is rented with an understanding that title, and ownership, will eventually transfer from the lessor to the lessee.[86] It is not entirely clear why Ireland chose to split lease-to-own transactions into two separate categories.[87]

Within the *ijārah* arrangements outlined in the Tax Briefing 2009, the *ijārah muntahia bittamleek* structure bears clear similarities to an *ijārah wa-iqtina* structure applied in Islamic real estate financing. Describing the structure of these "Ijarah used for a finance lease,"[88] the Briefing notes that under such leases, the financier makes a separate promise to transfer asset title to the lessee on the occurrence of a pre-determined event, such as the payment of all remaining rental.[89] For reasons which are far from clear, the subsequent

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[84] Revenue Commissioners, "Islamic Finance", *Tax Briefing, Issue 78*, October 2009, available at: http://www.revenue.ie/en/practitioner/tax-briefing/78/index.html#.

[85] *ibid.*

[86] *Ijārah* arrangements are not defined in UK legislation, nevertheless, see; HM Revenue & Customs, "Islamic products: Lease and lease plus purchase," *VATFIN8300*, available at: http://www.hmrc.gov.uk/manuals/vatfinmanual/VATFIN8300.htm. See also; HM Revenue & Customs, "Islamic products: Lease and lease plus purchase: Lease and purchase (*ljara-wa-lqtina*)," *VATFIN8360*, available at: http://www.hmrc.gov.uk/manuals/vatfinmanual/VATFIN8360.htm, which defines *Ijārah wa-iqtina* as: "[T]he same as the *Ijarah* described above except that title to the asset is expected to pass to the customer at some time, usually at the end of the contract period."

[87] It could be speculated that in drafting this Briefing, the Revenue Commissioners received assistance from a Malaysian authority due to the terminology used and the recognition of three types of *ijārah*. A similar situation appears to have happened at the International Financial Reporting Standards Foundation where, after meeting with the Malaysian Accounting Standards Board, the Foundation referred to a similar three way division of *ijārah*, see, IFRS, "Shariah-compliant leases – Lessor issues", *IASB/FASB Meeting Week* ,Commencing May 16, 2011 at 2, available at: http://www.ifrs.org/NR/rdonlyres/64C83556-762F-4A0A-9449-026F24A7500B/0/Leases0511b02Aobs.pdf . This point is, admittedly, relatively minor and the fact that Ireland's Revenue Commissioners have chosen to acknowledge three rather than two *ijārah* structures would not necessarily undermine the impact of the clarification.

[88] Revenue Commissioners, "Islamic Finance", *Tax Briefing*, note 84.

[89] *ibid.*

Revenue Commissioners' Guidance Notes on the Tax Treatment of Islamic Financial Transactions in Ireland use this definition and the term *ijarah muntahia bittamleek* when explaining Islamic hire purchase agreements, not Islamic finance leases, with Islamic finance leases subject to a different definition.[90] Terminological carelessness aside, reference to a structure similar to that used in *ijārah wa-iqtina* real estate financing is important, as it represents an official recognition of Islamic lease-to-own products.

However, this is the extent of the Tax Briefing's usefulness in relation to Islamic real estate financing as the Briefing and subsequent Guidance Notes limit the application of their *ijārah* provisions to "the leasing of plant and machinery and other chattels" rather than leases of immovable property.[91]

B. "Credit Transactions" in the Finance Act 2010

Clarifying the tax position of "credit transactions," the Part 8A TCA, as introduced by the Finance Act 2010, outlines a number of contracts which, though ostensibly *Shari'ah* neutral, encapsulate the structures of *murābaha* and diminishing *mushāraka* transactions. The basic *murābaha* contract provided for in the TCA[92] arises when the financier disposes of the full interest of the asset to the customer in return for a higher than cost-price payment, all or part of which may be deferred.[93] Classified in the TCA as "credit return,"[94] the bank's profit arising out of a *murābaha* transaction must be "equivalent"[95] to the return generated by an interest-bearing loan.[96] Paragraph (c) of the "credit transaction" definition refers to a transaction which resembles diminishing *mushāraka*.[97] Under this arrangement, the financier and another person jointly acquire an asset[98] or the financier purchases an asset owned by the customer in circumstances where the customer retains an interest in that

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[90] Revenue Commissioners, "Guidance Notes on the Tax Treatment of Islamic Financial Transactions", (Revenue, Dublin, October 2010), at 11, available at: www.revenue.ie/en/practitioner/tech.../guidance-notes-islamic-finance.pdf.

[91] Revenue Commissioners, "Islamic Finance", *Tax Briefing*, note 84, Revenue Commissioners, "Guidance Notes on the Tax Treatment of Islamic Financial Transactions", note 90, at 13.

[92] Section 267N(a) Taxes Consolidation Act 1997 introduced by section 39 Finance Act 2010, definition of "credit transaction" .

[93] *ibid.*

[94] *ibid.*

[95] Section 267N(a)(iii)Taxes Consolidation Act introduced by section 39 Finance Act 2010, definition of "credit transaction" .

[96] *ibid.*

[97] Section 267N(c)(i) and (ii) Taxes Consolidation Act introduced by section 39 Finance Act 2010, definition of "credit transaction" .

[98] Section 267N(c)(i) Taxes Consolidation Act introduced by section 39 Finance Act 2010, definition of "credit transaction" .

asset (refinancings).[99] The customer then agrees to make payments to the financier which equal the amount paid by the financier for the asset as well as payments for the use of the asset (i.e. rent).[100] This rent is the financier's "credit return" and must be "equivalent" to the return on a loan of money at interest.[101] The financier's interest in the asset then passes to the customer immediately or by the end of a specified period.[102] This structure has been specifically presented by the Revenue Commissioners in its Guidance Notes as covering "mortgage or hire purchase transactions"[103] and indicates that the Revenue Commissioners is attempting to achieve equality of taxation between some forms of Islamic real estate finance activity and conventional mortgages. The Guidance Notes go on to suggest that *ijārah* hire purchase agreements may be brought under this form of credit transaction.[104] Such a contention is problematic as the new TCA provisions provide that the financier and customer must acquire the asset "jointly," suggesting a level of co-ownership. There is no co-ownership in an *ijārah wa-iqtina* as the financier retains full legal and beneficial interest in the property until it is transferred to the customer or a third party. As a result, the definition of credit transactions would appear to exclude *ijārah wa-iqtina* products from the ambit of the accommodations.

Following the definition of credit transactions, Part 8A TCA goes on to provide for their tax treatment. In order to establish parity of taxation between conventional financial contracts and Islamic structures which are economically similar, the TCA treats credit transactions as if they establish a loan relationship between the financier and the customer.[105] s.267O TCA provides that the credit return arising out of the different forms of credit transaction is, for the purpose of the Tax Acts, treated as if it were interest on a loan.[106] Effectively the new provisions seek to bring "credit transactions" within the scope of the existing rules applying to loans and interest and to tax and relieve returns arising from *murābaha* and diminishing *mushāraka* products as if they were conventional interest

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[99] Section 267N(c)(ii)Taxes Consolidation Act introduced by section 39 Finance Act 2010, definition of "credit transaction".

[100] Section 267N(c)(I)(C) Taxes Consolidation Act introduced by section 39 Finance Act 2010, definition of "credit transaction" .

[101] Section 267N(c)(II), definition of "credit transaction," Taxes Consolidation Act 1997 as introduced by section 39 Finance Act 2010.

[102] Section 267N(c)(III), definition of "credit transaction,""Taxes Consolidation Act 1997 as introduced by section 39 Finance Act 2010.

[103] Revenue Commissioners, "Guidance Notes on the Tax Treatment of Islamic Financial Transactions", note 90, at 24.

[104] *ibid.*

[105] Woods, Tom and Jahanjiri, Kashif, "Islamic Financial Transactions", in *Taxing Financial Transactions*, note 83, at [9.7.2].

[106] Section 267O(1) Taxes Consolidation Act 1997 as introduced by section 39 Finance Act 2010.

payments.[107] In line with this, whether or not the financier is a bank or a company established specifically to provide Islamic financial services,[108] the acquisition of the property by the financier will be considered to have occurred in the course of the financier's trade, if that trade "consists of or includes specified financial transactions."[109] The accommodating provisions also provide that the customer in a credit transaction will only be able to deduct, from their taxable income under Schedule D, an amount equal to the financier's profit.[110] In doing so, newly inserted s.267P(8) TCA dissects the payments made pursuant to the *murābaha* and diminishing *mushāraka* transaction into capital payments and those which are functionally similar to interest.

The relevant provisions of the TCA also try to address some of the taxation implications of the financier's ownership of the property in Islamic transactions.[111] As the underlying property is considered by the Revenue Commissioners to have been acquired for the purposes of trading, not investment, any profit made by the financier would be treated as income rather than capital in nature.[112] Consistent with this, the TCA provides that the customer and not the financer is entitled to claim relief for capital expenditure incurred in relation to the property[113] and that, for the purpose of claiming such relief, the customer in a diminishing *mushāraka* is deemed to have acquired full interest in the property at the date the transaction is entered into.[114] However, s.267O(3) TCA prevents the credit return (i.e. the financier's profit element) from being regarded as capital expenditure by the customer for the purposes of these reliefs and for the purposes of s.552 TCA (acquisition,

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[107] Feeney, Michael, *The Taxation of Companies*, (Bloomsbury Professional, West Sussex, 2010), at [3.215.3].

[108] The definition of "credit transaction" requires that one party is a "finance undertaking" which means a "finance company or a financial institution." "finance company" means a "company whose income consists of either or both of (a) income from the leasing of plant and machinery, and (b) income from the carrying on of specified financial transactions" while a "financial institution" includes banks and investment funds (Section 891B Taxes Consolidation Act). Section 267N Taxes Consolidation Act introduced by section 39 Finance Act 2010, definition of "finance undertaking."

[109] Section 267P(2) Taxes Consolidation Act introduced by section 39 Finance Act 2010. Where the transactions do not occur in the course of the financier's trade, then they will not be treated as such by the accommodating legislation, Woods, Tom and Jahanjiri, Kashif, "Islamic Financial Transactions", in *Taxing Financial Transactions*, note 83, at [9.7.2] who note that: "[w]hether such income is on trading account or otherwise will depend on the overall activities of the financial undertaking. Where a finance undertaking carries out the transaction as part of its trading activities, income from the transaction should be treated as arising on [the] trading account."

[110] Section 267P(8) Taxes Consolidation Act introduced by section 39 Finance Act 2010.

[111] Revenue Commissioners, "Guidance Notes on the Tax Treatment of Islamic Financial Transactions", note 90, at 28.

[112] Section 267P(2) Taxes Consolidation Act introduced by section 39 Finance Act 2010.

[113] Section 267P(4) Taxes Consolidation Act introduced by section 39 Finance Act 2010.

[114] Section 267P(5) Taxes Consolidation Act introduced by section 39 Finance Act 2010. See also, Woods, Tom and Jahanjiri, Kashif, "Islamic Financial Transactions", in *Taxing Financial Transactions*, note 83, at [9.7.2].

enhancement and disposal costs).[115] Similar to interest payments in a conventional mortgage therefore, the mark-up or rental payments made by the customer cannot be deducted by the customer when calculating chargeable gain made on the disposal of the property.[116]

7.2.3 Taxation and the use of a bifurcated structure

The accommodating provisions of Ireland's tax law apply to transactions entered into between a "borrower" and a "finance undertaking",[117] with the latter party defined as a "finance company or a financial institution". The broad definition of finance undertaking is particularly relevant for Islamic real estate financing in which an SPV is used as "finance company", in the context of the Finance Act 2010, means a company whose income consists of either or both of the following "(a) income from the leasing of plant and machinery, and (b) income from the carrying on of specified financial transactions".[118] This, it is suggested, ensures that to the extent that accommodations are available in Islamic transactions between a borrower and a bank, they will also be available where the relevant property is acquired and held by an SPV. At the same time, the conventional loan entered into between the financial institution and the SPV (in order to allow the SPV to acquire the property) will be treated simply as a loan for the purposes of Irish tax law. This favourable tax position for Islamic real estate transactions using SPVs can be contrasted with the situation in the UK, where accommodations are limited to those transactions involving a "financial institution".[119]

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[115] Section 267O(3) Taxes Consolidation Act 1997 as introduced by section 39 Finance Act 2010, Revenue Commissioners, "Guidance Notes on the Tax Treatment of Islamic Financial Transactions", note 90, at 28.

[116] *ibid.*

[117] Definition of "Credit Transaction", Section 267(N) Taxes Consolidation Act 1997, as introduced by section 39 Finance Act 2010.

[118] Definition of "Finance Company", Section 267(N) Taxes Consolidation Act 1997, as introduced by section 39 Finance Act 2010.

[119] See, for example, Part 10A Income Tax Act 2007 as amended by Schedule 2, Part 1(1) Taxation (International and Other Provisions_ Act 2010 which defines financial institution as: (1) a bank, as defined by section 991, (b) a building society, (c) a wholly-owned subsidiary – (i) of a bank within paragraph (a) or (ii) of a building society, (d) a person authorised by a licence under Part 3 of the Consumer Credit Act 1974 to carry on a consumer credit business or consumer hire business within the meaning of that Act, (e) a bond-issuer, within the meaning of section 564G, but only in relation to any bond assets which are rights under purchaser and resale arrangements, diminishing shared ownership arrangements or profit share agency arrangements, (f) a person authorised in a jurisdiction outside the United Kingdom – (i) to receive deposits or other repayable funds from the public, and (ii) to grant credits for its own account, (g) an insurance company as defined in section 431(2) of ICTA or (h) a person who is authorised in a jurisdiction outside the United Kingdom to carry on a business which consists of effecting or carrying out contracts of insurance or substantially similar business but not an insurance special purpose vehicle as defined in section 431(2) of ICTA.

Notwithstanding the broad definition of "finance undertaking", however, there remain areas where Ireland's newly introduced tax accommodations fail to provide a level playing field between conventional and Islamic real estate financing structures. These short comings, which are discussed in the next subsection, arise both in circumstances where a financial institution owns the underlying property directly, and those where the property is held by a separately incorporated SPV.

7.2.4 Areas for Further Reform

The introduction of taxation policies which are tailored to accommodate the unique structure of Islamic contracts represents the most prominent measure so far adopted by Ireland in relation to Islamic real estate finance. However, the provisions of Part 8A are not flawless. Three important tax issues remain unresolved: the level of "equivalence" which the Islamic products must display, stamp duty issues and the status of *ijārah wa-iqtina* arrangements under Irish tax law.

The provisions inserted into the TCA extend to the returns generated by the Islamic products which are "equivalent" to interest.[120] This requirement of similarity is rigid and prevents comparable tax treatment from extending to diminishing *mushāraka* transactions which operate on a PLS basis. In contrast, UK tax rules permit some level of PLS by allowing a financial institution to share in losses generated by diminishing shared ownership products without falling outside the accommodating tax provisions.[121] Any loss or gain generated by an Islamic structure offered in Ireland will be subject to the existing tax rules[122] and will not be treated as comparable to the return on a loan at interest. While this may result in some additional taxation and may, as a result, restrict the ability of Islamic market participants to structure contracts in accordance with Islamic legal dictates, it ensures that the integrity of the tax system is maintained by only deeming and taxing as

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[120] Section 267N(a)(iii) Taxes Consolidation Act 1997 introduced by section 39 Finance Act 2010 definition of "credit transaction," and Section 267N(c)(II), definition of "credit transaction," Taxes Consolidation Act 1997 as introduced by section 39 Finance Act 2010.

[121] For the UK provision see Section 504(5) Corporation Tax Act 2009 (c.4).Stating that the financier's interest in the asset will only pass to the borrower "for a consideration which exceeds the consideration paid by the finance undertaking for the asset," the provisions of Ireland's Finance Bill would seem to prevent the financier from sharing in any loss in value of the asset. Section 267N(c)(III), definition of 'credit transaction,' Taxes Consolidation Act 1997 as amended.

[122] I.e., they will *not* be deemed to be interest on a loan. Where the party making the payments (the customer) is a corporate entity, it seems likely that payments made on the basis of profit-and-loss sharing will be treated as distributions under the Tax Acts thus preventing such payments from being deducted from corporation tax liability, (Sections 129-130 Taxes Consolidation Act 1997). This issue is considered in detail in Chapter 6.

interest, returns which are comparable to interest. However, while it is important that the Islamic structures accommodated by the Part 8A are economically comparable to conventional arrangements, an overly strict application of the "equivalence" requirement by Irish authorities could be problematic in the future. While the "alternative finance returns" in the UK accommodations must "equate in substance" to interest,[123] the same returns in Ireland will fall within Part 8A only if they are "equivalent" to a return on an interest-based loan. By giving no explanation of what is required for equivalence or whether this equivalence is considered in light of the payments as a whole or on each instalment, the standard set by the Irish legislation may be too high. Due to their differing structure and form, Islamic financial returns simply cannot be "equivalent" to interest in every respect; any divergence from the form of conventional interest could prevent a transaction from benefitting from the accommodations. Tailored legislative treatment of Islamic financial transactions is needed precisely *because* the products and their returns are structurally distinguishable from conventional financing. Limiting this treatment only to those contracts whose returns are wholly "equivalent" to interest undermines its effectiveness in practice. As a result, specific clarification is needed from the Revenue Commissioners on the standard of equivalence which must be met by the Islamic arrangements.

The extent to which Irish tax law now creates a level playing field for Islamic and conventional structures is also jeopardised by the fact that no attempt has been made to address the additional stamp duty liability of participants in all forms of Islamic real estate financing.[124] In the recent Guidance Notes, the Revenue Commissioners confirmed that "stamp duty will arise under normal rules on the documentation executed in connection with [credit] transactions."[125] In contrast, stamp duty liability was the first taxation inequality addressed by HMRC in the UK in 2003. Under these UK accommodations the points at which the first and second transactions take place in Islamic arrangements were

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[123] See for example, Section 503(1)(v) Corporation Tax Act 2009 which provides in relation to "purchase and resale arrangements" that "the excess equates, in substance, to the return on an investment of money at interest." See also Section 366(3) Taxation (International and OtherProvisions) Act 2010 (c.8) which notes that "alternative finance arrangements" means arrangementswhich in the Treasury's opinion

a) *equate in substance* to a loan, deposit or other transaction of a kind thatgenerally involves the payment of interest, but

b) achieve a similar effect without including provision for the payment ofinterest. (emphasis added).

[124] Woods, Tom and Jahanjiri, Kashif, "Islamic Financial Transactions", in *Taxing Financial Transactions*, note 83, at [9.7.3].

[125] Revenue Commissioners, "Guidance Notes on the Tax Treatment of Islamic Financial Transactions", note 90, at 29.

identified and the imposition of stamp duty was limited to only one.[126] The multiple impositions of duty which Islamic transactions still face under Irish law could make Ireland an uncompetitive jurisdiction for Islamic financial activity which involves real property. However, as the modifications needed to ensure equality of stamp duty liability between Islamic and conventional products require the tax authorities to "ignore" one or more instances where tax would otherwise be payable, such an accommodation may be open to exploitation.[127] In the UK, for example, a loophole in the stamp duty land tax regime was created by the removal of the double duty for Islamic property transactions. Used primarily in commercial property acquisitions, the loophole allowed a customer to purchase property without paying any stamp duty by using existing stamp duty land tax principles[128] and the relief from double liability for products structured along *Shari'ah* lines.[129] This loophole was subsequently closed in 2008 (while another was addressed in 2011)[130] but it serves to highlight the reality that any relief from taxation could be used as a means of tax avoidance, if not evasion. The Revenue Commissioners may be reluctant to open up any possible taxation ambiguities which could be used to avoid or diminish tax liabilities in a manner which was not intended by the legislation. Nevertheless, the multiple stamp duty liability which will be faced by Islamic real estate structures in Ireland is a large tax hurdle for these arrangements and could undermine the level playing field which Part 8A is trying[131] to achieve.

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[126] Section 72 of the Finance Act 2003 eliminated double Stamp Duty Land Tax (SDLT) in relation to *murābaha* transactions in 2003 (s73 Finance Act 2003 (c. 14)) while a similar carve-out was inserted for diminishing *mushārakah* in 2005 (s71A inserted by the Finance Act 2005, s 94, Sch 8, paras 1, 2). These exemptions were subsequently extended to include corporate borrowing by replacing references to the "individual" by a requirement that one party should be a "person." (Section 168 Finance Act 2006 (Section 25)).

[127] Powley, Tanya, "Search is on for stamp duty loopholes", *Financial Times*, March 23, 2011, available at: http://www.ft.com/intl/cms/s/2/b91eabb8-5582-11e0-a00c-00144feab49a.html#axzz1TFPl908J. In order to avoid companies from exploiting this relief, SDLT relief for alternative property financing in the UK is available only to individuals, Thomas, Michael, *Stamp Duty Land Tax*, (2nd ed., Cambridge University Press, Cambridge, 2006), at [5.127].

[128] These existing exemptions inculde the £15,000 threshold and the fact that no stamp duty is payable where the purchase of the property is not substantially performed.

[129] For a more detailed explanation of the loophole, see Rossiter, James, "Chancellor Alistair Darling to close loophole in finance deals based on Sharia", *The Times*, March 5, 2008, available at: http://www.timesonline.co.uk/tol/money/property_and_mortgages/article3486248.ece, Anonymous, "Sharia SDLT loophole closes", (March 12, 2008),*Taxation*, available at: http://www.taxation.co.uk/taxation/articles/2008/03/12/6165/sharia-sdlt-loophole-closes.

[130] Powley, Tanya, "Search is on for stamp duty loopholes", note 127.

[131] The Department of Finance noted in an impact assessment of Part 8A that; the "parity of treatment [created by the Part] will remove a tax barrier to a business based on Islamic principles setting up in Ireland." Department of Finance, "Section 1 of Finance Act 2010, Report on Tax Expenditures", *PRN A10/0776*, July 2010, at [9.10], available at: www.finance.gov.ie/documents/.../reports/2010/taxexpenditure.pdf .

Finally, the taxation of *ijārah wa-iqtina* structures remains unclear under Irish law. It is suggested that by expanding paragraph (c) in the Part 8A TCA definition of credit transaction to include not just transactions where the parties jointly acquire property, but also transactions where the financier alone obtains title, fiscal accommodations could be extended to *ijārah wa-iqtina* structures. In light of the fact that the Revenue Commissioners itself has suggested that *ijārah wa-iqtina* could fall under the existing paragraph (c)(i) credit transaction, modification of the definition would simply permit what the Irish Government appears to think is already happening. If *ijārah wa-iqtina* arrangements were incorporated in the new Part 8A provisions, clarification of the gift tax liability of the customer would also be needed in order to determine whether the Revenue Commissioners intends to treat the transfer of ownership to the customer at the end of the lease as disposal of an asset below market value.

7.2.5 Conclusion to Section 7.2

The provisions of the Finance Act 2010 create some level of parity between Islamic and conventional real estate financing structures where previously the legal form of the Islamic arrangements would have been so complex and distorted as to be almost unworkable. By looking to the economic substance of various Islamic structures, the Irish Government has modified statutory provisions in order to ensure that, though the novel structures will still be taxed according to their legal form, that legal form will no longer result in tax treatment which is noticeably different from that imposed on conventional interest-based loans. While parity of tax treatment has not yet been achieved in practice, a clear legislative structure now exists in Irish law which could be the basis for further fiscal accommodation.

Taxation is only one aspect of Islamic real estate financing in Ireland and particularly for retail-level structures, the classification and treatment of these arrangements under property law provisions may also raise difficulties. This treatment will be considered in the next Section.

7.3 The Classification of Islamic Real Estate Financing Products under Irish Property-Related Law

Murābaha, *ijārah wa-iqtina* and diminishing *mushāraka* arrangements are not structural replications of conventional property loans. In practice, the Islamic arrangements involve multiple property transfers, the distribution of ownership responsibilities and the financier's direct involvement with real estate in a manner which is distinguishable from the interests and liabilities of the parties in a conventional property financing. They also involve a series of separate contracts rather than a single loan agreement between financier and customer.[132] When accommodating these structures within an established legal framework, attention should be given to the manner in which the legal forms of mark-up, lease-to-own and co-ownership will interact with laws which were designed to support interest-based mortgages. Section 7.2 of this Chapter addressed the first element of this interaction: taxation. This section will explore the treatment of Islamic real estate structures under Irish property-related laws. Relying on the structures presented in Chapter 6, it will consider the likely classification of Islamic structures in Ireland (7.3.1).[133] This section will demonstrate that notwithstanding substantive similarities between conventional mortgages and all forms of Islamic property financing, only *murābaha* arrangements can easily be subsumed under the statutory regime relating to mortgage loans in Ireland (A).[134] *Ijārah wa-iqtina* (B)[135] and diminishing *mushāraka* transactions (C)[136] do not share a sufficient number of structural characteristics with mortgage loans that (in the absence of accommodation), they will be classified and treated as such by Irish law. These conclusions are then developed in subsection 7.3.2.[137] Subsection 7.3.2 will investigate the implications of classification and will highlight areas in which the legal treatment of Islamic property financing products will diverge from the treatment of mortgages. This section will suggest that some legislative adjustment will be needed if Islamic real estate structures are introduced in Ireland. However, it will argue *against* an expansion of the definition of "mortgage" under Irish law. Instead, it will demonstrate that through legislative adjustments, parties using *ijārah wa-iqtina* and diminishing *mushāraka* arrangements can be subject to largely the same rights and responsibilities as those involved in conventional

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[132] Maurer, Bill, *Pious Property; Islamic Mortgages in the United States*, (Russell Sage Foundation, New York, 2006), at 4

[133] *infra.* at 246.

[134] *infra.* at 250.

[135] *infra.* at 254.

[136] *infra.* at 264.

[137] *infra.* at 271.

mortgages without undermining the integrity of Ireland's mortgage regime and without violating the principles of Islamic law. At the same time, this section acknowledges that certain structural aspects of the Islamic products - such as the financier's ownership of the property - cannot be disregarded by the authorities and will influence the treatment of these arrangements under Irish law.

7.3.1 Classification of Islamic Real Estate Financing Products: The Impact of their Unique Structures

This subsection will consider in the likely classification under Irish law (in the absence of accommodation) of the three Islamic contracts: *murābaha* (A),[138] *ijārah wa-iqtina* (B)[139] and diminishing *mushāraka* (C).[140] Determining the correct classification of Islamic property financing products within the Irish legal system provides a basis upon which the broader rights and obligations of the parties can be determined. Integrating Islamic real estate finance into Ireland's economy and into Irish culture,[141] however, faces the difficulty of ascribing established terminology to foreign legal concepts. Reflecting on the suitability of applying the vocabulary of English law to customary practices, Allot suggests that "[t]erminology...is not the last, but the first act of analytical activity in creating a field of study. This is because the choice of terms defines both what one wishes to look at and how one looks at it."[142] When determining how a novel principle will integrate into an existing legal system, and indeed, into an established cultural mindset, the classification of that concept allows authorities to determine which legislative and regulatory principles will apply while also providing the public with a more accurate indication of the nature of the concept and its interaction with existing law.[143]

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[138] *infra.* at 250.
[139] *infra.* at 254.
[140] *infra.* at 264.
[141] Elliot refers to the notion of a "mortgage" "in the lay person's sense of the word" as being an identifiable transaction which possesses particular qualities, Elliot, John, "Housing Loans under the Consumer Credit Act 1995", (1996) 3(8) *Commercial Law Practitioner*, 195-205 at 195.
[142] Allott, Antony, "Popular law making in western society", in *People's Law and State Law: The Bellagio Papers*, Antony Allott and Gordon R. Woodman (eds.), (Foris, Dordrecht, 1985), 21-34 at 22.
[143] Favero, Marc, "Standard Contracts in Financial Law: An Emerging New Legal Order", in *Multijuralism; Manifestations, Causes, and Consequences*, Albert Breton, Anne Des Ormeaux, Katharina Pistor and Pierre Salmon (eds.), (Ashgate Publishing Company, Surrey, 2009), 181-194 at 182 noting that: "it is not enough to understand what [a financial] product is used for and how it is used; it is also important to know under what legal category it can be classified."

Arising from the substantive similarities between Islamic real estate financing products and conventional mortgages, Irish commentators, as well as commentators,[144] and financial authorities[145] in other jurisdictions, have attempted to subsume Islamic structures used for real estate financing under the moniker of "mortgage."[146] This is a cosmetically attractive approach; these products are designed to function as Islamic alternatives to conventional mortgages and their ultimate economic effect is to facilitate the financing of property acquisition or development.[147] Despite this, looking only at substance and abstractly determining that an Islamic product is a mortgage could lead to the understanding that the Islamic structures will also be treated by the law as if they are mortgages. As this subsection will demonstrate, the structural distinctiveness of the Islamic arrangements makes this difficult to achieve in practice. This arises from the fact that, notwithstanding the terminology used by authorities and market participants, such products may not fully conform with existing statutory provisions relating to mortgages[148] and involve, rather, the sale, lease and ownership of real property by the financial institution.

Ireland, like the UK, has a prescriptive mortgage regime in which distinguishing characteristics of mortgages are laid out in legislative provisions and regulatory guidelines. The Land and Conveyancing Law Reform Act 2009 [the 2009 Act][149] has sought to simplify real property-based transactions in Ireland, including the rules applicable to

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[144] See for example, Anonymous, *The 2008 guide to Opportunities & Trends in Islamic Finance*, Sarah Minns (ed.), (Euromoney Institutional Investor, London, 2007), Kadlec, Kit, "Demystifying Muslim Mortgages", *International Business Times*, November 27, 2009, available at: http://au.ibtimes.com/articles/20091127/demystifying-muslim-mortgages_1.htm, Saber, Salam, *Opening Doors for Muslim Families in America*, (Freddie Mac, Virginia, 2002), at 7, available at: www.lariba.com/knowledge.../opening-doors-for-muslims-in-america.pdf, Casciani, Dominic, Case study: Islamic mortgages, November, 29, 2002, available at: http://news.bbc.co.uk/2/hi/business/2525635.stm, Maurer, Bill, *Pious Property; Islamic Mortgages in the United States*, note 132.

[145] See for example, HM Revenue & Customs, "Shari'a Compliant Financial Products", *Compliance Cost Review*, available at: www.hmrc.gov.uk/ccr/sharia-compliant.pdf, Ainley, Michael, Mashayekhi, Ali, Hicks, Robert, Rahman, Arshadur and Ravalia, Ali, *Islamic Finance in the UK: Regulation and Challenges*, (Financial Services Authority, London, 2007), at 20.

[146] See for example the Department of Finance's Information note which notes that Diminishing *Mushāraka* are structures which "cate[r] for a mortgage or other asset finance arrangement," Department of Finance, *Islamic Finance in Ireland; An Information Note*, (Department of Finance, Dublin, March 2010), at 5, Woods, Tom and Jahanjiri, Kashif, "Islamic Financial Transactions", in *Taxing Financial Transactions*, note 83, at [9.7.1], The Irish Catholic, *Islamic mortgages could solve housing glut*, February 12, 2009, available at: http://www.irishcatholic.ie/site/content/islamic-mortgages-could-solve-housing-glut, Financial Regulator (as it then was), *Consultative Consumer Panel*, Minutes of meeting of the 14th January 2008 at the Central Bank, at [7] noting the "lack [in Ireland] of Islamic mortgages."

[147] Financial Services Authority, "Regulation of Home Reversion and Home Purchase Plans Volume 1 – Consultation Proposals", *Consultation Paper 06/8*, (FSA, London, April 2006), at [2.14], available at: http://www.fsa.gov.uk/pubs/cp/cp06_08.pdf.

[148] A reality acknowledged by numerous commentators such as Maurer, Bill, *Pious Property; Islamic Mortgages in the United States*, note 132, at 4,

[149] Land and Conveyancing Law Reform Act 2009 [No 27 of 2009].

mortgages.[150] Reminiscent of the UK's Law of Property Act 1925,[151] the 2009 Act defines a mortgage as including "any charge or lien on any property for securing money or money's worth."[152] It then goes on to restrict legal mortgages over real property in Ireland to those created by means of a charge by deed on the land.[153] The scope of the Act's application is broad and while it specifically provides for legal mortgages, it also notes the continuing permissibility of equitable mortgages over real property that are created where the customer's interest in the land is equitable, the title deeds have been deposited with the financier,[154] or an attempt to create a legal charge has failed.[155] Whether legal or equitable, a "mortgage" over land in Ireland therefore involves an arrangement, in which land[156] is used as collateral for payment which is due (either in the form of cash or as something of value).[157]

The new statutory definition of a mortgage applies to both wholesale and retail security agreements and for those structures which fall within this classification, the provisions of

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[150] Land and Conveyancing Law Reform Act 2009 Explanatory Memorandum, at 35.

[151] Law of Property Act 1925 (c.20).

[152] Section 2, Land and Conveyancing Law Reform Act 2009. Irish courts have defined "money's worth" as not simply "something for which people are willing to pay money but something for which they are able to get money," *The Attorney General (at the Prosecution of Superintendent J P. Hynes) v Casino Amusement Theatres Limited* [1957] 91 ILTR 41 at 49-50, per Kingsmill Moore J.

[153] Section 89(1) Land and Conveyancing Law Reform Act 2009. From a strictly legal point of view a charge and a mortgage remain distinct structures under which a mortgage involves a transfer of estate and a charge merely a transfer of an interest. Mokal has suggested that this difference may have a practical impact in liquidation, Mokal, Riz, "Liquidation Expenses and Floating Charges--the Separate Funds Fallacy" [2004] *Lloyd's Maritime and. Commercial Law Quarterly* 387-404. Nevertheless, the Land and Conveyancing Law Reform Act 2009, amongst others, now establishes a confluence in terminology with mortgage and charge often used interchangeably.

[154] Wylie notes that the deposit of title deeds will cease to be a viable means of creating equitable mortgages following Section 73 of the Registration of Deeds and Title Act 2006 under which the Land Registry "shall cease to issue land certificates and certificates of charge," Wylie, JC.W., *The Land and Conveyancing Law Reform Act 2009: Annotations and Commentary*, (Bloomsbury Professional, Dublin, 2009), at 260.

[155] Section 89(6) Land and Conveyancing Law Reform Act 2009. See also; Wylie, JC.W., *The Land and Conveyancing Law Reform Act 2009: Annotations and Commentary*, note 154, at 260.

[156] Land is given an extensive definition by the Land and Conveyancing Law Reform Act 2009 and includes:

a) any estate or interest in or over land, whether corporeal or incorporeal,

b) mines, minerals and other substances in the substratum below the surface, whether or not owned in horizontal, vertical or other layers apart from the surface of the land,

c) land covered by water,

d) buildings or structures of any kind on land and any part of them, whether the division is made horizontally, vertically or in any other way,

e) the airspace above the surface of land or above any building or structure on land which is capable of being or was previously occupied by a building or structure and any part of such airspace, whether the division is made horizontally, vertically or in any other way,

f) any part of land;

Section 2 Land and Conveyancing Law Reform Act 2009. This definition would cover a consumer mortgage over residential property as well as security granted over a portfolio of property or a project constructed or being constructed.

[157] Coughlan, Paul, *Property Law*, (2nd ed., Gill & Macmillan Ltd., Dublin, 1998), at 353.

Part 10 of the 2009 Act will determine the basic rights and remedies of the parties.[158] While sophisticated participants in commercial transactions are accorded relative freedom to modify the application of the statutory principles in their real estate dealings,[159] the relevant provisions of the 2009 Act nevertheless provide a common statutory basis for secured lending. For retail mortgages, these standards are complimented by the Consumer Credit Act 1995 [the CCA 1995],[160] which provides a consumer protection regime applicable to "housing loans" for residential property.[161] These retail-level transactions are defined as an agreement for the provision of initial or refinancing credit[162] to a consumer[163] on the security of a mortgage[164] of a freehold or leasehold estate or interest in land for the purpose of buying, constructing or improving the secured property.[165] Consistent with the 2009 Act, a mortgage for the purposes of the CCA 1995 is defined as including a charge.[166] The CCA 1995 outlines extensive mortgagor protections, disclosure requirements and best practice standards imposed on institutions providing residential mortgage-related services.[167]

The term "mortgage," particularly when used in relation to consumer property financing, therefore evokes the application of a detailed and specific regime which provides for the rights and remedies of the parties, the duties of retail mortgage providers and supervision of transactions. Describing Islamic products as mortgages may result in Irish market participants drawing the not inconceivable conclusion that the *Sharī'ah*-compliant structures will also benefit from the same legal framework.

When discussing how Islamic real estate structures may be classified in Ireland, three other jurisdictions will be referred to. These countries - the US, Malaysia and UK - have been chosen as they represent three distinct approaches to classification. In the US, the substance of Islamic real estate financing products is focused on, the fact that Islamic

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[158] Land and Conveyancing Law Reform Act 2009 Explanatory Memorandum, at 35.

[159] Section 96(3) Land and Conveyancing Law Reform Act 2009.

[160] Consumer Credit Act 1995 (Number 24 of 1995).

[161] Part IX, Consumer Credit Act 1995.

[162] Includes not simple an initial purchasing loan but also a loan intended to be used to improve residential property, Elliot, John A., "Housing Loans under the Consumer Credit Act 1995", note 141, at 195.

[163] Section 2(1) Consumer Credit Act 1995 as substituted by section 33 of, and Part 12 of Schedule 3 to, the Central Bank and Financial Services Authority of Ireland Act 2004. "'consumer' means—

a) a natural person acting outside the person's business, or

b) any person, or person of a class, declared to be a consumer in an order made under subsection (9)"

[164] Section 2(1) Consumer Credit Act 1995 as substituted by section 33 of, and Part 12 of Schedule 3 to, the Central Bank and Financial Services Authority of Ireland Act 2004.

[165] *ibid.*

[166] *ibid.*

[167] Part IX Consumer Credit Act 1995.

transactions are structurally different from mortgages has been largely ignored by legal and financial authorities. Malaysia has adopted an approach which focuses on form rather than substance. As a result, Islamic real estate arrangements are generally not subsumed under the umbrella definition of a mortgage. As the middle ground, the UK looks at both form and substance and has introduced legislative amendments to ensure that provisions relevant to real estate financing apply equally and consistently to Islamic and conventional structures.[168]

A. *Murābaha*

The simplicity of *murābaha* arrangements,[169] together with their substantive and structural similarities with conventional mortgages, has meant that in countries in which legal authorities have addressed the domestic treatment of Islamic real estate structures, these products have been brought within the legislative or judicial definition of a secured property transaction. This classification has been possible without excessively modifying the structure of (contemporary)[170] *murābaha* arrangements or undermining of the integrity of the established legal regime.

In the US, the Office of the Comptroller of the Currency [OCC] issued Interpretative Letter 867 in which it approved *murābaha* facilities not only for the purchase of residential property in national banking institutions but also for commercial property acquisition, real estate construction and the purchase of commercial equipment.[171] Concluding that the "economic substance of the Murabaha financing transactions is functionally equivalent to either a real estate mortgage transaction or an inventory or equipment loan agreement,"[172] the OCC referred to the fact that while the bank would acquire legal title to the property in

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[168] Modi, Vikram, "Writing the Rules: The Need for Standardized Regulation of Islamic Finance", (Spring 2007) 29(1), *Harvard International Review*, 38-41 at 39 noting that: "recognizing the unique nature of 'Islamic Financial Transactions', the FSA has tailored its regulations to meet the new market." Maurer, Bill, "Articulating Islamic Knowledge to an American Dream: Islamic Home Financing Alternatives after September 11, 2001", (2003) 26(2) *PoLAR,* 196-222 at 206.

[169] Housby, Elaine, *Islamic Financial Services in the United Kingdom*, (Edinburgh University Press, Edinburgh, 2011), at 81, PriceWaterhouseCoopers, "Islamic Finance - UK tax aspects', *An extract from UK real estate insights* Issue 10, October 2008, available at: http://www.pwc.com/gx/en/asset-management/assets/pdf/REI10_11.pdf.

[170] Admittedly, the extent to which such arrangements *genuinely* comply with *Sharī'ah* remains a source of debate.

[171] Zyp, Victoria Lynn, *Islamic Finance in the United States: Product Development and Regulatory Adoption*, A Thesis submitted to the Faculty of the Graduate School of Arts and Sciences of Georgetown University in partial fulfilment of the requirements for the degree of Master of Arts in Arab Studies, Washington DC, April 2009, at 15.

[172] OCC, Interpretive Letter #867, June 1, 1999, available at: http://www.occ.gov/static/interpretations-and-precedents/nov99/int867.pdf at 2.

a *murābaha*, it would do so momentarily,[173] through the customer acting as agent[174] and only if there was a commitment by the customer to ultimately purchase the property.[175] Once the property had been transferred to the customer, the bank would bear no responsibility for the property's maintenance, repair, taxation or insurance, but would secure the balance due under the agreement by way of a first mortgage over the property.[176] This mortgage would allow the financier to foreclose on the property in order to recover the sum outstanding in exactly the same manner as it would in a conventional property loan.[177] In light of this allocation of responsibility, the OCC concluded that a bank offering *murābaha* transactions bore risks which were "identical to the risks in a conventional mortgage or loan transaction."[178] UK authorities have equally concluded that due to the immediate sale of the property to the customer, the debt owed by the customer to the financier and the ability of the customer to charge the property in favour of the financier, *murābaha* arrangements satisfy the structural conditions of a "regulated mortgage" under the RAO.[179] By logical extension, *murābaha* also fulfil the characteristics of a "mortgage" within the terms of the Law of Property Act 1925. The British authorities have therefore been prepared to acknowledge *murābaha* as structurally and substantively consistent with interest-based mortgages and subject to the same legislative regime.[180] Finally in Malaysia, where the *bay' bithaman ajil' [BBA]* model (deferred payment structure similar to a *murābaha*)[181] is the most widely used real estate financing structure,[182] the categorisation

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[173] *ibid.*, at 8.

[174] *ibid.*, at 3 and 5.

[175] This commitment, found in the *Murābaha* agreement will be reinforced by the 25% deposit which the customer must give prior to the bank's initial purchase of the asset.

[176] OCC, Interpretive Letter #867, note 172, at 5.

[177] *ibid.*, at 4.

[178] *ibid.*, at 6, Shayesteh, Abdi, "USA Regulations: American Justice," (July 2007) 20 *Islamic Business and Finance*, available at: http://www.cpifinancial.net/v2/Magazine.aspx?v=1&aid=1091&cat=IBF&in=20, Knoll notes that the OCC recognised that, "in spite of their form, the transactions were in substance lending transactions," Knoll, Michael S., "The Ancient Roots of Modern Financial Innovation: The Early History of Regulatory Arbitrage", (2008) 87 *Oregon Law Review*, 93-116 at 106-107.

[179] Waters, Dan, "Home reversions and Islamic mortgages get new consumer protections", *FSA/PN041/2006*, (FSA, London, 2006), available at: http://www.fsa.gov.uk/pages/Library/Communication/PR/2006/041.shtml, FSA, *Information for Smaller Firms, Home Purchase Plans*, available at: http://www.fsa.gov.uk/smallfirms/your_firm_type/mortgage/home/finance.shtml noting that; *murābaha* "falls within the definition of a regulated mortgage contract and so has been regulated by us since October 2004."

[180] Proctor, Charles, *The Law and Practice of International Banking*, (Oxford University Press, Oxford, 2010), at 809.

[181] Uz Zaman, Fahim, *Shari'ah-compliant Financial Services: A Guide to Products, Markets and Trends*, (VRL KnowledgeBank Ltd., London, 2006), at 50. The primary difference between BBA and the *murābaha* structure which has found greater support in other jurisdictions is that under a BBA, the customer enters into an asset purchase agreement with the seller, transferring the deposit to the seller. The bank then purchases the customers right to acquire the property from the customer and sells it back to the customer at a marked-up price, payable in instalments. In a *murābaha* contract, the bank buys the property directly from the seller and then sells it to the borrower at the marked up price, Adawiah, Engku Rabiah, "Islamic house financing - issues and solutions", (2007) 22(12), *Journal of International Banking Law*, 628-635 at 631. See also,

and legal treatment of these transactions has not been subsumed under an inclusive title of "Islamic mortgage." Instead, the various contractual forms, including *BBA*, have been allowed to develop as discrete products in line with the dictates of *Sharī'ah.*[183] Nevertheless, such products are still subject to existing Malaysian laws and the manner in which those laws apply depends upon the legal form of the transaction. Of particular relevance to Islamic real estate structures, Malaysia's National Land Code 1965[184] does not provide for common law mortgages (or, for that matter, Islamic property transactions) but for security interests based on a charge over property.[185] As the customer in a *BBA/murābaha* grants the financier a charge over the property, the Malaysian courts have confirmed that mark-up financing structures fall within the provisions of s.241(1) of the Code.[186] While the Court of Appeal has recently determined that *BBA* are sales agreements

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International Organization of Securities Commissions, *Fact Finding Report of the Islamic Capital Market Task Force of the International Organization of Securities Commissions*, (IOSCO, July 2004), at 12, available at: http://www.iosco.org/library/pubdocs/pdf/IOSCOPD170.pdf

[182] A preponderance of BBA-based contracts is particularly evident amongst the products offered by domestic Malay institutions, Ong, Seow Eng, "Mortgage Markets in Asia", Paper presented at the European Real Estate Society Conference 2005, Dublin, available at: www.rics.org/site/download_feed.aspx?fileID=2429&fileExtension.

[183] Bank Negara Malaysia (BNM), together with other bodies, have adopted an approach which acknowledges that BBA, *ijārah muntahiyah bittamlik*, diminishing *mushāraka* and *istisna'* are acceptable mechanisms for financing real estate activity without specifically concluding that these products must be the economic equivalent of conventional alternatives.

[184] The National Land Code 1965 applies to peninsular Malaysia, Sabah and Sarawak, two states of Malaysia located on the island of Borneo which use the Land Ordinance (Sabah) [Chapter 68 of the Laws of North Borneo] and the Land Code (Sarawak). Edwin, Clarence, *Malaysia in Security over immovables in selected jurisdictions*, Dennis Campbell (ed.), (Kluwer Law International, The Hague, Netherlands, 2005), 167-215 at 167. Discussion here will be limited to the National Land Code 1965.

[185] In *Perwira Habib Bank Malaysia Bhd v Lum Choon Realty Sdn Bhd*, [2005] 4 CLJ 345, Abdul Hamid Mohamad FCJ (while dissenting on the final decision), noted at [1] that: "The concept of the English mortgage is not consistent with the Torrens System. This is because in a mortgage the title passes from the mortgagor to the mortgagee whereas a duly registered charge under the NLC only creates a legal interest in the land. In a mortgage, the title passes to the mortgagee with the mortgagor retaining the right of redemption, when the mortgagor defaults in the payment of the mortgage debt, the mortgagor "forecloses" *i.e.*, bars the mortgagor from exercising the right of redemption. On the other hand, in a charge, the title remains with the chargor. If the chargor defaults in the payment of the debt, the chargee may apply for an order of sale. As a result, English land law terms are being used interchangeably but erroneously with the terms used in the NLC: "mortgage" for "charge", "foreclosure" for "order for sale", "redemption" for "discharge" etc. leading to confusion as they have different legal meanings." See also the earlier decision (which pre-dates the National Land Code 1965) in which the Privy Council noted that: "It seems to their Lordships that the learned judges... have been too much swayed by the doctrines of English equity, and not paid sufficient attention to the fact that they were dealing with a totally different land law, namely, a system of registration of title contained in a codifying statement. The very phrase 'equity of redemption' is quite inapplicable in the circumstances," *Haji Abdul Rahman v. Mohamad Hassan,* [1917] A.C. 209, at 216, *per* Lord Dunedin. See also; *Mahadevan s/o Mahallingam v Manilal & Sons (M) Sdn Bhd* [1984] 1 MLJ 266 at 270 and *Malayan United Finance Bhd v Tan Lay Soon* [1991] 1 MLJ 504.

[186] See for example, *Bank Islam Malaysia Berhad v Adnan Bin Omar* [1994] 3 CLJ 735 / [1994] MLJU 221, *Bank Islam Malaysia Bhd v Pasaraya Peladang Sdn Bhd*, [2004] 7 MLJ 355, *Arab-Malaysian Merchant Bank Bhd v Silver Concept Sdn Bhd* [2006] 8 CLJ 9, *Bank Islam Malaysia Bhd v Azhar Osman & Others* [2010] 5 CLJ 54 [2010] 1 LNS 251.

not secured loans,[187] the legal form of *BBA/murābaha* is sufficient to place the Islamic transaction in the same statutory position as conventional real estate financing.

In relation to *murābaha* transactions in the context of Irish law, these arrangements share structural characteristics with the 2009 Act's definition of a mortgage, as well as housing loans within the CCA 1995. Like a mortgage,[188] *murābaha* contracts result in title to the property being transferred to the customer almost immediately upon the commencement of the transaction.[189] As the property has been fully conveyed to the customer in return for deferred payment of the price, this creates a debt which the customer owes to the bank; the customer is paying the bank the value of the property acquired on a marked-up basis.[190] The financier retains no ownership interest in the property once it sells it to the customer and so it is the customer rather than the financier who will be fully responsible for the risks and liabilities associated with ownership.[191] This allocation of property-based liability in *murābaha* is distinct from that found in the other Islamic real estate structures and is comparable to the respective liabilities of the parties in a standard mortgage contract. Finally, and significantly, the customer grants the financier a charge (*rahn*) over the land, providing security for the outstanding debt which can be enforced in the event of customer default.[192] Traditionally a *rahn* under Islamic law represented a possessory security,[193] while a legal charge granted over property in a conventional

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[187] *Bank Islam Malaysia Berhad v Lim Kok Hoe & Anor and other Appeals* [2009] 6 CLJ 22 / [2009] 6 MLJ 839 at [24] noting that: "We have no hesitation in accepting that *riba*' or interest is prohibited in Islam. But the issue at hand is whether such comparison between a BBA contract and conventional loan agreement was appropriate. With respect, we do not think so. This is because the two instruments of financing are not alike and have different characteristics. BBA contract is a sale agreement whereas a conventional loan agreement is a money lending transaction. The profit in BBA contract is different from interest arising in a conventional loan transaction. The two transactions are diversely different and indeed diametrically opposed."

[188] Gray, Kevin and Gray, Susan Frances, *Land Law*, (Oxford, Oxford University Press, 2007), at 216.

[189] *supra.* at 206.

[190] *supra.* at 206

[191] *supra.* at 206. Usmani, Muhammad Taqi, *An Introduction to Islamic Finance*, (Kluwer Law International, The Hague, 2002), at 43.

[192] *supra.* at 206. Iqbal, Zamir & Mirakhor, Abbas, *An Introduction to Islamic Finance* (John Wiley & Sons (Asia), Singapore, 2007), at 107.

[193] *Qur'ān* 2:283, "Then a pledge in hand (shall suffice)," Ibn Rushd, *Bidayat al-Mujtahid wa Nihayat al-Muqtasid*, (*The Distinguished Jurist's Primer*), Vol. II, Imran Ahsan Khan Nyazee (trans.), (Garnet Publishing Ltd., London, 1996), at 328, Ali, Jawad and Issa, Nabil A., "Structuring Non-Recourse Islamic Financings in Dubai", (2007) 4(44) *Islamic Finance News*, 12-14 at 12. McMillen has stressed the importance, particularly in commercial project financing transactions that security is perfected and that the creditors are granted priority of security interest, something which is difficult to achieve when perfection requires possession, McMillen, Michael, McMillen, Michael, "A Rahn-Adl Collateral Security Structure for Project and Secured Financings", *Proceedings of the Third Harvard University Forum on Islamic Finance: Local Challenges, Global Opportunities*, (Harvard Islamic Finance Information Program, Massachusetts, 2000), 111-135, at 4 of the transcript, available at: http://www.kslaw.com/library/pdf/mcmillencorporate.pdf.

mortgage confers no automatic right on a mortgagee to possession of that property.[194] Nevertheless, in contemporary practice, perfection of the *rahn* through registration is common,[195] rendering the security enforceable against third parties without the financier having to acquire actual possession of the property.[196]

The structure of contemporary *murābaha* real estate financing products therefore appears to be sufficiently compatible with the basic attributes of a secured property transaction so as to be subsumed within the statutory definition of a mortgage over land in the 2009 Act. Where the contract relates to a consumer's primary residences, *murābaha* transactions may also be classified as housing loans under the CCA 1995.

B. *Ijārah wa-iqtina*

In the English case of *Secretary of State for Work and Pensions v UP*,[197] Mesner J noted that the *ijārah wa-iqtina* structure used to finance the purchase of the defendant's house did not constitute a mortgage but involved two distinct elements: a standalone lease agreement and a subsequent transfer of the property's ownership to the defendant.[198] As there is no extension of credit or a debt which can be charged, the legal form of *ijārah wa-iqtina* has resulted in such arrangements falling outside the definition of a mortgage in the UK. For UK authorities, this was particularly problematic in relation to consumer property finance transactions as it prevented *ijārah wa-iqtina* arrangements - and the institutions offering them - from being regulated by the authorities.[199] In 2008, the FSA decided to regulate *ijārah wa-iqtina* (and diminishing *mushāraka*) as Home Purchase Plans [HPPs] bringing institutions which agree to enter into, administer, advise on, and arrange HPPs within the

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[194] Traditional common law mortgages which operated in Ireland in relation to unregistered land prior to the Land and Conveyancing Law Reform Act 2009 gave a mortgagee the right to go into possession "before the ink is dry on the mortgage unless there is something in the contract, express or by implication, whereby he has contracted himself out of that right" *Four Maid Limited v Dudley-Marshall (Properties) Ltd* [1957] Ch 317 per Harman J. However, following the Land and Conveyancing Law Reform Act 2009, subject to section 98, a mortgagee has no automatic right to possession of the mortgaged property without a court order or written consent of the mortgagor not more than seven days prior to the taking of possession. As an equitable mortgagee has no legal estate in the property, they must obtain a court order prior to taking possession.

[195] McMillen, Michael, McMillen, Michael, "A Rahn-Adl Collateral Security Structure for Project and Secured Financings", note 193, at 18 of the transcript.

[196] Foster has also suggested that in order to overcome the fact that a *rahn* remains a "possession-based security" the pledgee may "lend" the property to the pledgor, thus creating a transaction which is "the closest the *rahn* gets to an English-style charge, as "possession" has become purely theoretical, the true advantage given to the lender being the preference over other creditors." Foster, Nicholas H. D., "The Islamic Law of Real Security", (2000) 15(2) *Arab Law Quarterly*, 131-155 at 137.

[197] *Secretary of State for Work and Pensions v UP* [2010] UKUT 262 (AAC).

[198] *ibid.*, at [14].

[199] Waters, Dan, "Home reversions and Islamic mortgages get new consumer protections", note 179.

regulatory ambit of the FSA.[200] The definition of this new product in the Regulated Activities Order outlines a method of residential real estate finance which is consistent with the structure of *ijārah wa-iqtina* and diminishing *mushāraka* and accommodates the aspects of these products which distinguish them from conventional home mortgages such as the financier's ownership of the property.[201] The FSA has also extended the provisions of the Mortgage Conduct of Business [MCOB] regime to the parties in a HPP arrangement.[202] This extension seeks to ensure comparable protection for all consumers in home purchase arrangements - whether conducted in accordance with Islamic principles or through a conventional mortgage.[203] These accommodations have allowed the FSA[204] and land registry[205] to treat the lease and subsequent conveyance as distinct elements in the *ijārah wa-iqtina* structure while classifying the transaction as a whole as a means of property financing. Essentially, the approach of the UK authorities is that *ijārah wa-iqtina* are financial arrangements which are comparable to mortgages (and should thus be subject to comparable treatment) but which, ultimately, are not legally mortgages.[206]

The OCC in the US has also acknowledged that *ijārah wa-iqtina* real estate arrangements are "functionally equivalent to or a logical outgrowth of secured real estate

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[200] *supra.* at 136.

[201] Section 63F(3) Financial Services and Markets Act 2000 (Regulated Activities) Order 2001/544. See also, Financial Services Authority, *Home Purchase Plans, Factsheet*, (FSA, London, March 2007), at 3-4.

[202] MCOB 1.2.1R. See also Patient, Julie, "Islamic Finance in the UK Consumer Sector", (2008), 23(1), *Journal of International Banking Law and Regulation,* 9-14, Henderson, Andrew, "Islamic Financial Services", in *Financial Services Law*, Michael Blair, George Walker and Robert Purves, (eds), (2nd ed., Oxford University Press, Oxford, 2009), 979-1026 at 1022.

[203] Dan Waters, "[i]t allows us to deliver a level consumer protection playing field with products designed for similar purposes. It also builds on the work that we have already done in the field of Islamic financial services, to improve consumer access to these products." Dan Waters quoted in "Home reversions and Islamic mortgages get new consumer protections", note 179, referring to Financial Services Authority, "Regulation of Home Reversion and Home Purchase Plans Volume 1 – Consultation Proposals", note 147.

[204] FSA describes the process of *ijārah* real estate structures as: "The consumer enters into an agreement with the provider to buy the property at the original purchase price at the end of a specified period. At the same time the provider enters into a lease with the consumer giving him the right to occupy the property for the specified period." Admittedly the FSA uses incorrect Arabic terminology by confusing *ijārah* with *ijārah wa-iqtina*, nevertheless, this quote highlights their acceptance of the fact that these Islamic structures rest on occupation short of full ownership, at least until the conclusion of the lease. Financial Services Authority, "Regulation of Home Reversion and Home Purchase Plans Volume 1 — Consultation Proposals", note 147, at 14.

[205] See for example, the Land Registry discussion of *Ijārah wa-iqtina*: "Ijara is a lease of an item by its owner to a customer and Ijara wa Iqtina is a lease of an item usually followed by the eventual sale of the item to the customer at the end of the lease term." Land Registry, *Practice Guide 69: Islamic financing*, (August 2010), available at: http://www.landreg.gov.uk/assets/library/documents/pg69.html.

[206] As the FSA has noted "we have concluded that it would not be appropriate to adopt the existing mortgage regime. Any requirements we impose must be proportionate in terms of costs and benefits. This market is significantly different from the mortgage market. .. In any event, we could not simply mirror the MCOB regime, as there are other risks related to HPPs that would need to be mitigated by new conduct of business provisions. Financial Services Authority, "Regulation of Home Reversion and Home Purchase Plans Volume 1 – Consultation Proposals", note 147, at [3.20].

lending or mortgage lending activities that are part of the business of banking."[207] In reaching this conclusion, the OCC repeatedly underlined the importance of adopting a substance over form approach to financial regulation.[208] The OCC's conclusion that an *ijārah wa-iqtina* represented a financing arrangement rather than real estate leasing was based on the authority's view that the bank involved in these arrangements would not be assuming any risks outside of those found in ordinary mortgage lending.[209] While the bank may acquire title to the property, it would record its interest in the property in the same manner as it would a traditional mortgage,[210] and the customer's periodic payments would be sufficient to cover capital contributions, the bank's profit, insurance and property taxes.[211] In substance, "the transaction [would] conve[y] the benefits and burdens of ownership to the [customer] Lessee," rather than the bank.[212] Concluding that the bank's legal title in a lease-to-own transaction is largely cosmetic, the OCC considered the relationship between the parties to be equivalent to that of a mortgagor and mortgagee rather than landlord and tenant.[213] Notwithstanding the OCCs conclusion that *ijārah wa-iqtina* are equivalent to mortgages, federal and state authorities in the US have been not modified existing legislation or regulations in order to ensure that these products are

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[207] OCC Interpretive Letter #806, October 17, 1997, available at: http://www.occ.gov/static/interpretations-and-precedents/dec97/int806.pdf, at 4. In drawing this comparison between *ijārah wa-iqtina* transactions and conventional banking activity, the OCC noted that leasing transactions may be considered as incidental to banking business (*M & M Leasing Corp. v. Seattle First Nat'l Bank*, 563 F.2d 1377 (9th Cir. 1977), cert. denied, 436 U.S. 956 (1978), 1380-1382) as some leasings are consistent in economic substance with a loan of money secured on the leased property. See also Dunn, Jeffrey D., "Expansion of National Bank Powers: Regulatory and Judicial Precedent under the National Bank Act, Glass-Steagall Act, and Bank Holding Company Act", 6 (1982-1983) *Southwestern Law Journal*, 765-792 at 777.

[208] OCC Interpretive Letter #806, note 207, at 5-8 in which numerous examples are provided of when substance should trump form.

[209] *ibid.*, at 9, Chiu, Shirley, Newberger, Robin, and Paulson, Anna, "Islamic Finance in the United States", (September-October 2009) *Society*, 64-68 at 67.

[210] The accounting treatment of the transaction would record it as a financing rather than a lease.

[211] OCC Interpretive Letter #806, note 207, at 2. The OCC also noted that the manner in which these lease payments would be determined would replicate the accounting methodology of a conventional mortgage: "Although the two products will have different documentation, the monthly lease payments will be calculated in the same manner. UBK will add its margin to its cost of funds at the beginning of the lease. The London Interbank Offering [sic] Rate will be used to determine UBK's cost of funds. UBK will then allocate lease payments to mirror the principal and interest breakdown of a conventional mortgage." Zyp, Victoria Lynn, *Islamic Finance in the United States: Product Development and Regulatory Adoption*, note 171, at 15, Tacy, Kimberly J, "Islamic Finance: A Growing Industry in the United States", (2006) 10 *North Carolina Banking* Institute, 355- 378 at 371.

[212] OCC Interpretive Letter #806, note 207, at 9.

[213] OCC Interpretive Letter #806, note 207, at 15. This statement contradicts several made by UK authorities that the parties are indeed landlord and tenant; see for example; Financial Services Authority, "Regulation of Home Reversion and Home Purchase Plans Volume 1 – Consultation Proposals", note 147, at 73 [7.22], noting that: "the provider owns the property and the consumer is a tenant. As a tenant, the consumer faces the risk of losing the right to stay in his home if he breaches any of the terms of his agreement with the provider, for example, if he does not keep up the monthly payments, his lease may be forfeited."

actually treated like mortgages.[214] Unlike the UK situation, therefore, no tailored legislative accommodations have accompanied the OCC's recognition of *ijārah wa-iqtina* arrangements.

Finally, the legal position of *ijārah wa-iqtina* has been determined by the Malaysian authorities according to the form of this transaction. Malaysian courts have concluded that a customer cannot charge property in which he or she does not have a chargeable interest[215] and so without a security interest created in compliance with the terms of s.241 of the National Land Code, *ijārah wa-iqtina* real estate financings do not fall within the same statutory provisions as conventional property loans or *BBA/murābaha* arrangements.[216] Rather than a secured property financing, Islamic lease-to-own transactions in Malaysia may be subsumed under the regime applying to leases.[217] This is problematic as the landlord-friendly nature of Malaysia's laws would restrict the rights available to customers using Islamic leases.[218] Malaysian law, for example, does not provide tenants with security of tenure, nor does it require landlords to make any specific disclosures to tenants.[219] This lack of a robust landlord and tenant regime may expose *ijārah wa-iqtina* customers to a level of risk which is distinct from that found in secured property lending.

Both the US and UK authorities have concluded that *ijārah wa-iqtina* arrangements can represent forms of property financing which are comparable in substance to interest-based

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[214] Mann, Roberta, "Is Sharif's Castle Deductible?: Islam and the Tax Treatment of Mortgage Debt", note 17, at 1141.

[215] *Bank Pertanian Malaysia Bhd v Blue Valley Plantation Bhd* [2002] CLJ 100.

[216] *supra.* at 253.

[217] Tag El-Din and Abdullah suggest that *ijārah muntahiyah bittamlik* and conventional hire purchase contracts are both subject to the provisions of the Hire Purchase Act 1967, However, while there are numerous and noteworthy similarities between Islamic lease-to-own structures and conventional hire purchase, the application of the Hire Purchase Act 1967 is of limited use in relation to *ijārah muntahiyah bittamlik* real estate financing as the act is restricted in scope only to consumer goods and certain movables, First Schedule, Hire Purchase Act 1967 (Act 212) Tag El-Din, Seif I. and Abdullah, N. Irwani, "Issues of Implementing Islamic Hire Purchase in Dual Banking Systems: Malaysia's Experience", (March–April 2007) 49(2) *Thunderbird International Business Review*, 225–249 at 231. See also; Abdullah, Nurdiana Wati Irwani and Dusuki, Asyraf Wajdi, "A Critical Appraisal of Al-Ijarah Thumma al-Bay' (AITAB) operation: Issues and Prospects", Paper presented at 4th International Islamic Banking and Finance Conference, Monash University of Malaysia. Kuala Lumpur, November 13-14, 2006.

[218] Malaysia has no specific legislation dealing with landlord and tenant law with the rights of the parties instead outlined broadly in the National Land Code with additional, limited guidance provided in the Specific Relief Act 1930 sections 7 and 8 relate to recovery of specific immovable property.

[219] Keong,Philip Chan Hon and Yean, Sim Miow "Issues Relating to Commercial Leasing, Malaysia" Part IV of *Lex Mundi's Real Estate Survey Series 2009* at question 3, available at: http://www.lexmundi.com/images/lexmundi/PracticeGroups/RealEstate/Survey4/Malaysia.pdf.

mortgages.[220] However, as already noted, in order to be classified as a legal mortgage in Ireland, a transaction must comprise of a charge over land created as security for a debt.[221] Similarly, a housing loan subject to the CCA 1995 involves a mortgage over residential property as security for an extension of credit. Finally, an equitable mortgage requires that land be used as collateral for a debt in circumstances which fall short of a legal charge.[222] If *ijārah wa-iqtina* arrangements are to be classified as mortgages within Irish law, there must be some kind of monetary obligation and a charge or some form of security taken over the property. The following subsections will argue that it is unlikely that these characteristics will be present in *ijārah wa-iqtina* arrangement in Ireland. In doing so it will look first at the customer's interest in the freehold title to the property (1)[223] and second, at the effectiveness of a charge over the customer's leasehold estate (2)[224]

1. The Customer's Interest in the Freehold Title to the Property

In *ACC Bank PLC v Brian Johnston*,[225] Clarke J concluded that a "document clearly is ineffective to create...a charge because [the borrower] does not and never did own the lands so as to entitle him to create a charge over them."[226] This decision is logical; in order for someone to create a charge over property, he or she must have some interest in that property to which the charge can attach. However, in Ahli United Bank's discussion of Islamic lease-to-own transactions, the bank specifically notes that *it* (and not the customer) "own[s] the property and [is]...registered at HM Land Registry as the legal owner of the property throughout the term of the plan."[227] In Ireland too, as the financier in an *ijārah wa-iqtina* would first have to acquire the property from the original seller, this conveyance would need to be registered.[228] Until the property is transferred to the customer, the bank

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[220] *supra.* at 255and 257. See also, Knoll, Michael S., "The Ancient Roots of Modern Financial Innovation: The Early History of Regulatory Arbitrage", note 178, at 105 who notes that *ijārah wa-iqtina* real estate financings are "economically equivalent to making a nonrecourse loan with the house as security."

[221] *supra.* at 248.

[222] Section 89(6) Land and Conveyancing Law Reform Act 2009. See also; Wylie, JC.W., *The Land and Conveyancing Law Reform Act 2009: Annotations and Commentary*, note 154, at 260.

[223] *infra.* at 258.

[224] *infra.* at 262.

[225] *ACC Bank PLC v Brian Johnston, Practising under the Style and Title of Brian Johnston & Co, Solicitors Joseph Traynor & Seamus Mallon*, (unreported) June 1, 2010 High Court [2010] IEHC 236.

[226] *ibid.* Similarly in the UK, the High Court noted that: "a charge would not be duly executed until the [the borrower] had an unconditional transfer of the property to him." See also *Bank of Scotland Plc v Aaron Marcellus King, Samuel Okoronkwo, UZO Onyema Okoronkwo*, [2007] EWHC 2747 (Ch), at [23].

[227] Ahli United Bank, *Risks and Features of this Home Purchase Plan, Ijara plan*, available at: http://www.iibu.com/buy_home/Regulated%20Ijara%20Risks%20Features.pdf. See also Land Registry, *Practice Guide 69: Islamic financing*, note 205.

[228] Section 24, Registration of Title Act 1964, Number 16 of 1964. Coughlan, Paul, *Property Law*, note 157, at 106. From the 1st of June 2011, all counties in the Republic were brought within the compulsory

will be the owner of the property, legally and publically. The implications of this are twofold. First of all, there has been no extension of credit to the customer and no debt owed by the customer as a result of the property purchase; the financier acquired title to the property through use of its own money and not (legally) for the benefit of the customer. Secondly, because the financier has acquired the property, the customer has no legal proprietary interest in that property over which a charge can be granted. Parallels may be drawn with retention of title clauses used in the sale of goods. In such transactions, a sales agreement may provide for the seller's retention of legal and beneficial ownership of the goods supplied subject to the customer making full payment for those goods.[229] Courts and commentators have concluded that such clauses do not create a charge over the property in favour of the seller as ownership does not pass to the customer until the terms of the sales contract are fulfilled.[230] The fact that the financier retains ownership of the property in an *ijārah wa-iqtina* acts to postpone the customer's ability to grant security over that property.[231]

It is also suggested that the customer in an *ijārah wa-iqtina* may not even obtain a beneficial interest[232] in the property through the operation of a trust under Irish law.[233]

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registration regime with the effect that land purchased under an *ijārah wa-iqtina* will result in the registration of the financier as owner of that property. Compulsory registration of title was extended to the counties and cities of Cork and Dublin with effect from 1 June, 2011 by Registration of Title Act 1964 (Compulsory Registration of Ownership) (Cork and Dublin) Order 2010 (S. I. No. 516 of 2010).

[229] The Law Reform Commission, *Report on Debt Collection (2): Retention of Title*, (LRC 28-1989), April 1989, at 7 notes that retention of title clauses were given statutory effect by section 19(1) of the Sale of Goods Act, 1893 which provides: "[w]here there is a contract for the sale of specific goods or where goods are subsequently appropriated to the contract, the seller may, by the terms of the contract or appropriation, reserve the right of disposal of the goods until certain conditions are fulfilled. In such cases, notwithstanding the delivery of the goods to the buyer, or to a carrier or other bailee or custodian for the purpose of transmission to the buyer, the property in the goods does not pass to the buyer until the conditions imposed by the seller are fulfilled".

[230] In *Frigoscandia (Contracting) Ltd v Continental Irish Meat Ltd and Lawrence Crowley* the defendant claimed that the conditions of contract created only an equitable charge on the property sold which was not sufficient to retain the property in the goods and that the property in the goods passed either on delivery or once use commenced (at 397). However, the High Court concluded that the conditions of the contract clearly established that the entire property in the goods was to be retained by the vendor until the purchase price had been paid. *Frigoscandia (Contracting) Ltd v Continental Irish Meat Ltd and Lawrence Crowley* [1982] 2 ILRM 396 at 398 per McWilliams J.

[231] *Clough Mill Ltd. v Martin* where the court noted that no charge could be created until the buyer became the owner of the goods and such a transfer of ownership was precisely what the clause prevented. *C'lough Mill Ltd v Martin* [1984] 3 All ER 982 at 987. See also The Law Reform Commission, *Report on Debt Collection (2): Retention of Title*, note 229, at 14.

[232] That is, whether the financier holds the property on trust for the customer. A trust has been defined as the relationship which arises wherever a person (called the trustee) is compelled in equity to hold property, whether real or personal, and whether by legal or equitable title, for the benefit of some persons (of whom he may be one and who are termed beneficiaries) or for some object permitted by law, in such a way that the real benefit accrues, not to the trustee, but to the beneficiaries or other objects of the trust, Keeton & Sheridan, *The Law of Trusts* (London, 12th ed., 1993), at 3.

[233] The Insolvency Service, *Factors Affecting The Value Of The Bankrupt's Interest In The Property*, Part 3, (May 2008), available at: www.insolvency.gov.uk/freedomofinformation/...36/.../part_3.htm at [33.91] and

While Islam regards the whole amount of the periodic payments made by the customer as rent in exchange for use of the property's usufruct, in practice, the fixed monthly payments are treated by the financier partly as rent for the use of the property and partly as sums ultimately used to purchase the property.[234] The sums representing the acquisition element of the rental payments (together with any deposit) are "on-account" payments which are not used to purchase equity in the property on a recurring basis but are rather maintained[235] until a fund has been created which is equal to the financier's initial payment for the property.[236] The customer is not gradually acquiring the financier's ownership interest but is making payments of rent, part of which will be used at a future date for the purchase of the property.[237] As payments are made pursuant to a lease and in the form of rent, it appears unlikely that a beneficial proprietary interest would arise through a "purchase money resulting trust."[238] Resulting trusts are based on a presumption that a party who contributes to the purchase price of property intended to retain beneficial interest in that property.[239] Rental payments (as the payments are in *ijārah wa-iqtina*) have been rejected by the English courts as a "purchase money" contribution capable of giving rise to the presumption of resulting trust in the first place.[240] Even if the Irish courts were to find that the presumption of a resulting trust does exist in *ijārah wa-iqtina* arrangements, it is suggested that such a presumption is rebutted by the conditionality of the transaction. While the financier may promise to transfer the property on the occurrence of a specified

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Financial Services Authority, "Regulation of Home Reversion and Home Purchase Plans Volume 1 – Consultation Proposals", note 147, at 84 [8.16], both noting the lack of beneficial ownership under English law acquired by the customer in an *ijārah wa-iqtina* arrangement.

[234] The Insolvency Service, *Factors Affecting The Value Of The Bankrupt's Interest In The Property*, Part 3, note 233, at 33.91, Land Registry, *Practice Guide 69: Islamic financing*, note 205, noting that "[t]he customer's monthly 'mortgage' payments will normally comprise both the rental payment as well as an amount held by the bank to act as a guarantee that the customer will be able to pay for the purchase of the property at the end of the lease term."

[235] Albeit theoretically as ownership of the funds should pass to the financial institution in light of the fact that they are legally paid as part of the rent.

[236] *Secretary of State for Work and Pensions v UP* [2010] UKUT 262 (AAC), at [3].

[237] The Insolvency Service, *Factors Affecting The Value Of The Bankrupt's Interest In The Property*, Part 3, note 233, at [33.91].

[238] Delany explains purchase money resulting trusts as those involving direct or indirect contribution to the purchase price of property by one party in circumstances where that party is no legal owner of the property, Delany, Hilary, *Equity and the Law of Trusts in Ireland*, (4th ed., Thomson Round Hall, Dublin, 2007), at 184, 191-192. See also, Mee, John, "The End of the Affair: The Equitable Rights of Cohabitees", (2001) 6(2) *Conveyancing & Property Law Journal* 43-46 at 44 discussing direct and indirect contributions to the purchase price of property, *C v C* [1976] I.R. 254 , *W v W* [1981] ILRM 254, *McC v McC* [1986] ILRM 1.

[239] Chambers, Robert, *Resulting Trusts*, (Oxford University Press, Oxford, 1997), at 2 noting that: "[t]he resulting trust...can only exist when certain requirements are met." See also: *Dublin Corporation v Building and Allied Trade Union* (Unreported), High Court, March 6, 1996, per Budd J., *Twinsectra Ltd v. Yardley* [2002] 2 AC 164, at 190. Delany notes that "[r]esulting trusts can be said to arise by implication and are founded on the unexpressed *but presumed intention of the settlor*." Delany, Hilary, *Equity and the Law of Trusts in Ireland*, note 238, at 135 (emphasis added).

[240] *Savage* v *Dunningham* [1974] Ch 181, Pearce, Robert, Stevens, John and Barr, Warren, *The Law of Trusts and Equitable Obligations*, (Oxford University Press, Oxford, 2010), at 335.

event (i.e. the "on-account" fund reaching a sufficient sum), this promise is unilateral and only becomes relevant once that condition is fulfilled.[241] If the condition is never satisfied the customer will not obtain title.[242] This conditionality may demonstrate that the parties do not intend the customer to acquire a proprietary interest in the property from the outset.

It is also unlikely that the customer in an *ijārah wa-iqtina* could establish a beneficial proprietary interest through proprietary estoppel, as the Islamic arrangement does not contain key elements of this remedy, that is, "a representation, on which the claimant has relied to her detriment, and a subsequent reneging on the representation in circumstances in which it is unconscionable to do so."[243] *Ijārah wa-iqtina* transactions do not involve any representation by the financier other than the conditional promise to sell on fulfilment of certain events; the customer's lack of any legal or beneficial interest *until the condition is met* is exactly what the customer bargained for.[244] Only in circumstances where the financier refuses to sell/transfer property ownership to the customer once the requisite fund level has been reached could a claim based on proprietary estoppel arise. While determination by the Irish courts of the lessee's interest in an *ijārah wa-iqtina* arrangement would be necessary before any more definitive conclusions could be drawn, a view that the customer obtains an interest over the whole property immediately upon obtaining possession contradicts the nature of an *ijārah wa-iqtina* structure.

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[241] The courts may, however, conclude that a Quistclose trust exists over the money in the "on-account" fund as while this money was paid in the form of rent under a lease, it could possibly be argued that it was paid with the intention that it would be used for a specific purpose, where it could not be used for that purpose, the money should result back to the customer. Whether the financier's promise to sell the property to the customer once the "on-account" fund is sufficiently large is clear enough to restrict the use of the "on-account" funds is unclear in light of the fact that caselaw seems to suggests that the party paying the money must specify the purpose for the use of that money in order for a trust to arise, see *Re McKeown* [1987] BCLC 646, *Twinsectra Ltd. v Yardley* [2002] 2 AC 164, see generally, Delany, Hilary, *Equity and the Law of Trusts in Ireland*, note 238, at 146-150.

[242] The Insolvency Service, *Factors Affecting The Value Of The Bankrupt's Interest In The Property*, Part 3, note 233, at [33.91] indeed, the Insolvency Services notes that even if a beneficial interest is found to have been created in favour of the customer, "forfeiture or disclaimer of the lease might defeat any interest the trustee in bankruptcy holds in the property."

[243] Bright, Susan and Hopkins, Nicholas, "Richardson v Midland Heart Ltd - low cost home ownership - legal issue of the shared ownership lease", (2009) 4 *Conveyancer and Property Lawyer*, 337-349 at 348. See also: *Thorner v. Major*, noting that the doctrine of proprietary estoppel is based on three main elements: "a representation or assurance made to the claimant; reliance on it by the claimant; and detriment to the claimant in consequence of his (reasonable) reliance," [2009] 1 WLR 776 at 786, *Re Basham* [1986] 1 WLR 1498, 1503. *Gillett v. Holt* [2001] Ch 210.

[244] Bright, Susan and Hopkins, Nicholas, "Richardson v Midland Heart Ltd - low cost home ownership - legal issue of the shared ownership lease", note 243, at 349.

2. *Customer's Title to the Leasehold*

The customer in *ijārah wa-iqtina* arrangements makes periodic payments to the financier with such payments almost universally translated into English as "rent."[245] Rather than obtaining an interest in the freehold, the customer in an *ijarah* may be considered to have acquired one in the leasehold estate.[246]

As the customer's leasehold interest is distinct from the freehold estate and exists in parallel rather than in contradiction to the superior proprietary rights of the freehold owner,[247] Ayub has suggested that some form of security interest may be possible in an Islamic lease-to-own structure.[248] Such a charge, taken over the customer's leasehold interest in order to secure payment of periodic rental by the customer may fulfil the 2009 Act definition of a mortgage. It does not, however, fulfil the definition of a housing loan under the CCA 1995 as the security would not be taken pursuant to an extension of credit used to purchase/develop property (as required by the Act) but to ensure payment of rent.[249] In addition to this non-fulfilment of the CCA 1995 conditions, the practical effectiveness of taking a charge over the customer's leasehold interest is not entirely clear. A charge over the customer's leasehold estate as security for payment of the periodic rental under the *ijārah* agreement would be effective as a means of recovering debts which have already accrued.[250] As a result, if the customer defaults on his or her rent, the enforcement of the security by the financier would allow recovery of the rent which is due and owing,

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[245] See for example, AAOIFI who classifies the payments made by the lessee as "rental," AAOIFI, Shari'a Standard No. (9), "Ijarah and Ijarah muntahia bittamleek", in *Shari'a Standards for Islamic Financial Institutions 1432 H-2010*, (AAOIFI, Bahrain, 2010), 137-160 at 148-149 discussing *ijārah muntahia bittamleek*.

[246] Irish courts have generally acknowledged that there are certain indicia of lease agreements which distinguish them from licenses; the payment of rent or some other form of consideration, exclusivity of possession and an intention to create a lease. Courtney, Fergus, "Leases v. Licences - An Update", (1998) 3(3) *Conveyancing and Property Law Journal* 59-60 at 60, Ryall, Áine, "Lease or Licence? The Contemporary Significance of the Distinction"", (2001) 6(3) *Conveyancing and Property Law Journal* 56-61 at 56-58 discussing the requisite characteristics of leases.

[247] Gray, Kevin and Gray, Susan Frances, *Elements of Land Law*, (5th ed., Oxford, Oxford University Press, 2009), at 307.

[248] Ayub, Muhammad, *Understanding Islamic Finance*, (John Wiley & Sons Ltd., West Sussex, 2007), at 285.

[249] Section 2(1) Consumer Credit Act 1995 as substituted by section 33 of, and Part 12 of Schedule 3 to, the Central Bank and Financial Services Authority of Ireland Act 2004.

[250] The Insolvency Service, *Factors Affecting The Value Of The Bankrupt's Interest In The Property*, Part 3, note 233, at [33.91] which notes that: "[t]he bank would *not* be a creditor in the bankruptcy estate except in respect of arrears under the lease agreement," (emphasis in original). To take a charge over all accrued and future rents would appear to be inconsistent with the nature of an Islamic lease that rental payments are compensation for use; in the event that the customer is no longer able to use the property (i.e. on termination of the lease), there is little basis in Islamic law for seeking payment for the remainder of the lease instalments.

not the remainder of the rent which has yet to accrue under the lease. In practice it may be more effective for the financier, as registered owner of the property, to simply determine the lease for non-payment of rent.[251]

A mortgage created by way of a charge over the leasehold interest of a property subject to an *ijārah wa-iqtina* may also be rendered invalid as representing a clog on the equity of redemption.[252] Equity prevents a mortgagee from including an option in a mortgage which allows the mortgagee to purchase the property.[253] While such an option may not be explicit in a charge over the customer's interest in an *ijārah* lease, it could be implied. As the financier holds the freehold title to the property, any enforcement of its security would determine the lease resulting in the merger of the leasehold and freehold interests of the property. This would cause the financier to acquire full title to the property unencumbered by the lease (as the lease has been terminated).[254] As payment of the accrued rental payments may not allow the customer to recover the property, a charge over the leasehold interest in *ijārah wa-iqtina* arrangements potentially fetters the customer's redemption.[255]

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[251] Land Registry, *Practice Guide 69: Islamic financing*, note 205.

[252] The traditional common law practice in mortgage transactions involved a conveyance of the fee simple title of the property to the financier as security for the payment of the debt. Upon satisfaction of the debt, the property was re-conveyed to the mortgagor, however, if the mortgagor failed to pay by the appointed date, the property would vest completely in the mortgagee, extinguishing the customer's future interest in it (Willmott, Lindy; Duncan, Bill, "Clogging the Equity of Redemption: An Outmoded Concept", (2002) 2(1) *Queensland University of Technology Law and Justice Journal*, 35-52 at 35, Coughlan, Paul, *Property Law*, note 157, at 352-353). This resulted in the financier obtaining permanent title to the whole property secured, notwithstanding the value of the outstanding debt (Griswold, Scott, "A Redeeming Interest in Religious Freedom: Are Islamic Mortgage Alternatives Clogs on the Equitable Right of Redemption?", (2008) 13 *Fordham Journal of Corporate &Financial Law*, 419-441 at 421). In order to avoid the perceived harshness of this practice, the Courts of Chancery established the equity of redemption doctrine which allowed the mortgagor to recover the secured property on payment of the amount outstanding, even if the originally fixed date for payment had passed. Under this principle therefore, time was not of the essence, giving the mortgagor more time to pay their debt.

[253] Coughlan, Paul, *Property Law*, note 157, at 364, citing *Samuel v Jarrah Timber and Wood Paving Corporation Ltd* [1904] AC 323. As a "jealously guarded" equitable doctrine, any attempt by the mortgagee to frustrate or "clog" this redemption by making it unjustifiably complicated or onerous would be invalid, (Anonymous, Notes, "Clogging the Equity of Redemption", (1900) 13(7) *Harvard Law Review*, 595-596 at 595).

[254] Coughlan, Paul, *Property Law*, note 157, at 325 noting that: "[t]he doctrine of merger is a general principle which proceeds upon the basis that where two estates in the same land become vested in the same person, the estate which is the inferior of the two is subsumed into the estate which is superior in quality and thereby extinguished. In other words, enjoyment of the property is attributed to the greater interest and the lesser is determined because it has become superfluous."

[255] *Dellway Investments Limited, Metrospa Limited, Berkley Properties Limited, Maginotgrange Limited, May Property Holdings Limited, Sci 20 Place Vendome, Directdivide Trading Limited, Submitquest Limited, Belfast Office Properties Limited, the Forge Limited Partnership, Finbrook Investments Limited, Connis Property Services Limited, Formcrest Construction Limited, Chesterfield (the Pavements) Subsidiary Limited, Abbey Developments Limited and Patrick Mckillen v National Asset Management Agency, Ireland and the Attorney General* [2011] IESC 14 Finnegan J noted that "A mortgage may not be made irredeemable, nor can the right to redeem be limited to particular persons or to a particular period: *Re: Wells* [1933] Ch. 29 , *Howard v Harris* [1683] 1 Vern. 190, *Spurgeon v Collier* [1785] 1 Eden. 55 . If the mortgage gives the mortgagee an option to purchase that term is void even if it is not oppressive to the mortgagor: *Samuel v*

Unlike *murābaha* arrangements, *ijārah wa-iqtina* products used in real estate financing do not share a sufficiently large number of structural similarities with conventional mortgages that they can be subsumed easily within the statutory definition of the interest-based structures. As Mesner J noted in *Secretary of State for Work and Pensions v UP*, *ijārah wa-iqtina* arrangements are not mortgages; there is no loan or extension of credit but rather a lease of property. Equally, there is limited scope for granting a charge over the property. It is arguable that such arrangements fall within the legal provisions relevant to leases, not mortgages.

C. Diminishing *Mushāraka*

UK authorities have rejected the idea that diminishing *mushāraka* transactions are mortgages.[256] Instead, they have noted that the "nature of the transaction [is] one of co-partnership, with the right and duty of the purchaser to acquire the bank's beneficial interest in the property."[257] The FSA too has confirmed that diminishing *mushāraka* property financings do not fit within the statutory definitions of a "regulated mortgage."[258] Nevertheless, like *ijārah wa-iqtina* arrangements, diminishing *mushāraka* structures have been incorporated into the HPP provisions of the RAO[259] and the MCOB rules.[260] As a result, diminishing *mushāraka* offered to UK consumers are now subject to largely the same regulatory and legal regime as consumer mortgages.

Diminishing *mushāraka* real estate financings are the most popular form of Islamic residential property financing in the UK.[261] A similarly widespread availability of

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Jarrow Timber and Wood Paving Corp. Limited [1904] A.C. 323," he went on to suggest that some of the statutory rights granted to NAMA in relation to properties it acquires are inconsistent with the equity of redemption (such as the ability to confer the property to any person notwithstanding restrictions on such disposal in law or equity) and "Some of these impinge on the relationship between mortgagor and mortgagee."

[256] *CIS/14483/1996*, The Office of Social Security and Child Support Commissioners, 24 June 1997, decision of Commissioner D G Rice, noting that "the [diminishing *mushāraka*] agreement entered into by the claimant with the bank was *not* by way of a mortgage," (emphasis in original).

[257] *ibid.*, at [8].

[258] Ainley, Michael, Mashayekhi, Ali, Hicks, Robert, Rahman, Arshadur and Ravalia, Ali, *Islamic Finance in the UK: Regulation and Challenges*, note 145, at 21.

[259] Section 88B and accompanying amendments Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (SI 2001/544) as introduced by the Financial Services and Markets Act 2000 (Regulated Activities) (Amendment) (No.2) Order 2006.

[260] See Financial Services Authority, "Regulation of Home Reversion and Home Purchase Plans Feedback on CP06/8 and final rules Volume 2 – Handbook (and non-Handbook) material", *Policy Statement 06/12*, (FSA, London, April 2006), available at: http://www.fsa.gov.uk/pubs/policy/ps06_12_appendix.pdf, for the changes to the MCOB rules made to accommodate HPPs.

[261] Tameme, Mohammed Elkhatim Mamoun, *Demand and Supply Conditions of Islamic Housing Finance in the UK: Perceptions of Muslim Clients*, note 75, at 231, Hameed, Tariq, "Does the Diminishing

diminishing *mushāraka* has not been replicated in other countries in which Islamic finance is available. At US federal level, for example, diminishing *mushāraka* arrangements have not been officially approved by the OCC as permissible activity for national banking institutions.[262] At the moment, only non-bank institutions such as the American Finance House (LARIBA), Guidance Residential and Zayan Finance[263] - which are not directly subject to the US national banking regulations - are able to actively offer shared-ownership products.[264] Despite the fact that Federal authorities have not yet endorsed diminishing *mushāraka* structures, LARIBA's "Shared Home Appreciation in Rent and Equity"[265] structure has been approved by the State of New York Banking Department as sufficiently comparable with a conventional mortgage to require LARIBA to obtain a mortgage banker license before this product could be offered in New York State.[266] However, the arrangement used by LARIBA involves registration of the property ownership in the customer's name with the bank simply taking a lien over that property.[267]

Like *ijārah wa-iqtina* transactions, diminishing *mushāraka* do not immediately fit within a pre-existing category of property acquisition structures available in Ireland; the Islamic structures involve no loan given by the financial institution to the customer but rather shared ownership of property and a coterminous lease.[268] As the Social Security

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Musharakah reflect the spirit of Sharia?", (2006) *Mortgage Finance Gazette*, available at: http://www.mortgagefinancegazette.com/article/Does-the-Diminishing-Musharakah-reflect-the-spirit-of-Sharia-17015.html.

[262] OCC Interpretive Letters #867 and #806 deal with *murābaha* and *ijārah wa-iqtina* respectively, *supra.* at 250 and 257.

[263] Zayan Finance offers real estate financing only to commercial as opposed to retail clients on a diminishing *mushāraka* and ijarah basis, Zayan Finance, *Financing Options*, available at: http://www.zayanfinance.com/financing-options.php.

[264] Ranzini, Stephen Lange, "Islamic Finance (Finally) Taking Root in North America", (June 2007) 4(13) *Islamic Finance News* 11-12 at 11 noting that "[t]he Musharakah structure is also not a legal asset for US banks to hold, which restrains banks from selling this product." Goud, Blake, "The Role of Governments and Regulation", in *Islamic Finance, Islamic Finance in North America 2009*, Blake Goud (ed.), (Yasaar Media, Dubai, 2009), 29-42 at 34, noting that "Islamic financial institutions, however, are often organized as non-deposit-taking institutions either because it is not their core business (e.g. mutual funds) or because they are willing not to have a depository base and are more focused on providing credit, whether for home financing, auto financing, or business. These institutions generally face a lighter regulatory burden than deposit taking institutions. In the case of home, auto and business financing, these institutions are subject to the state regulations of the states in which they do business, primarily enforcement of consumer protection legislation."

[265] LARIBA, *The Lariba Model*, available at: https://www.lariba.com/home-financing.htm.

[266] State Bank of New York, "Re. LARIBA Islamic home financing", *Staff Interpretations*, August 15, 2001, available at: http://www.banking.state.ny.us/legal/lo010815.htm.

[267] LARIBA, *The Lariba Model*, note 265.

[268] Adawiah, Engku Rabiah, "Islamic house financing - issues and solutions", note 181, at 630 noting that: "[i]n a conventional mortgage, the customer is the borrower. However, in an *ijara/musharaka* structure, the customer is the bank's tenant and partner in the property."

Commissioner in the UK noted, the diminishing *mushāraka* entered into between a customer and financier is "*not* by way of a mortgage"[269] nor is it "by way of a loan."[270]

As already discussed, diminishing *mushāraka* transactions in relation to real estate are based on the *shirkat-ul-milk* or joint ownership of property rather than the commercial partnership envisaged by *shirkat-al-aqd*.[271] As a result, if diminishing *mushāraka* real estate financing were introduced in Ireland, the parties are unlikely to be treated as having created a general partnership within the meaning of the Partnership Act 1890[272] or a limited partnership falling under the Limited Partnership Act 1904,[273] both of which require the pursuit of profits.[274] There are still a number of ways in which the co-proprietorship required for *Sharī'ah*-compliance in diminishing *mushāraka* could be achieved under Irish property law: either the bank registers the asset in its own name and then enters into an express trust to hold the property for both the customer and itself as beneficial tenants in common of unequal shares, or the bank and customer are both registered as tenants in common of unequal shares.[275] While each approach would confer on the parties an ownership interest in the same estate, in practice, the former option may be the most practical approach. The Land Registration Rules 1972-2009 require that the share to which each tenant in common is entitled must be reflected in the register.[276] If both the financial institution and customer were registered as tenants in common, it would be possible to indicate the initial unequal shares of the property arising out of the parties' contributions to

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[269]Commissioner D G Rice, *CIS/14483/1996*, The Office of Social Security and Child Support Commissioners, 24 June 1997 at [6] (emphasis in original).

[270] *ibid.*, at [10].

[271] *supra.* at 215.

[272] Partnership Act 1890 (c.39) under which a partnership is defined in Section 1(1) as "he relation which subsists between persons carrying on a business in common with a view of profit."

[273] Limited Partnerships Act 1907 (c.24), while the Limited Partnerships Act 1907 does not explicitly require the pursuit of profit it does note at section 7 that: "[s]ubject to the provisions of this Act, the Partnership Act, 1890, and the rules of equity and of common law applicable to partnerships, except so far as they are inconsistent with the express provisions of the last-mentioned Act, shall apply to limited partnerships," this would appear to suggest that the realisation of profit from a partnership business is an element of limited partnerships as well as general partnerships.

[274] In relation to tax, the Revenue Commissioners has already confirmed that partnership-based (mudaraba) Islamic arrangement will not be classified as partnership; it is suggested that this view should be extended to regulatory treatment, Revenue Commissioners, "Guidance Notes on the Tax Treatment of Islamic Financial Transactions", note 90, at 6.

[275] Coughlan defines "tenancy in common" as a form of co-ownership in which the "share of a tenant in common is distinct and independent from those enjoyed by his fellow co-owners...The shares of tenants in common do not have to be equal...[h]owever, irrespective of whether there is equality as between the interests, it is important to note that as in the case of a joint tenancy they are undivided," Coughlan, Paul, *Property Law*, note 157, at 135. See also, Barry, John, "Islamic property financing", (2007) 15 *Australian Property Law Journal* 66.

[276] Section 48 The Land Registration Rules 1972-2009 which note that: "[w]here it appears to the Authority from an examination of title that two or more persons are entitled to property as tenants in common, it shall ascertain and enter in the register the share of each person in the property."

the purchase price. However, each subsequent transfer to the customer would require an amendment to the registered title of the property.[277] To overcome this difficulty, the British regulatory provisions dealing with diminishing *mushāraka*-based transactions note that the interest acquired in the property is to be "held on trust for the home purchase provider and the individual...as *beneficial* tenants in common"[278] rather than as joint legal owners. As a variation on this approach, HSBC Amanah in the UK transfers legal title of residential property which is the subject of the diminishing *mushāraka* to the HSBC Trust Company which then holds the property on trust in favour of the financier and the customer.[279]

In light of the potential difficulties associated with repeated changes of ownership interests on the register, the joint ownership in diminishing *mushāraka* transactions offered in Ireland may have to exist only in equity. To protect the interests of each party, the financier or trust company involved in a diminishing *mushāraka* in the UK can register the declaration of trust (and thus the customer's beneficial interest) at the Land Registry.[280] In Ireland, s.92 of the Registration of Title Act, 1964 provides that no notice of trust is to be registered against a property's title[281] and the 2009 Act outlines the extensive overreaching rights of purchasers for value of the legal estate, even if they have notice of the equitable interest.[282] However, the 1964 Act permits the registration of a caution[283] or an

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[277] Commenting on a similar problem faced by registration of the parties in diminishing *mushāraka* offered in Australia, one commentator noted that: "[a]ny attempt to do so would lead to an impossible level of ongoing effort and expense to keep the Torrens register synchronised with the growing proprietorship of an intending land owner," Barry, John, "Islamic property financing", note 275.

[278] Section 63F(3)(ii) Financial Services and Markets Act 2000 (Regulated Activities) Order 2001/544, *The Insolvency Service, Factors Affecting The Value Of The Bankrupt's Interest In The Property*, Part 3, note 233, at [33.92]. See also, Gowling Lafleur Henderson LLP, *Report to the Canada Mortgage and Housing Corporation, Islamic Housing Finance in Canada*, (Canada Mortgage and Housing Corporation , January 2010), at 30, available at: http://www.umfinancial.com/uploaded_pic/gallery/CMHC%20islamic%20housing%20report279627.pdf.

[279] HSBC Amanah, Amanah Home Finance, available at: http://www.hsbc.co.uk/1/2/personal/travel-international/hsbc-amanah/amanah-home-finance/how-it-works.

[280] Financial Services Authority, Regulation of Home Reversion and Home Purchase Plans Feedback on CP06/8 and final rules Volume 2 – Handbook (and non-Handbook) material, note 260, at 60, [6.45], noting that: "one way of protecting the consumer's beneficial interest in a property may be to register at HM Land Registry a suitable restriction on the provider's ability to transfer his title to the property."

[281] McAllister, Desmond Laurence, *Registration of Title in Ireland*, (Incorporated Council of Law Reporting for Ireland, Dublin, 1973), at 26, Glover, W.E, *Registration of Ownership of Land in Ireland*, (John Falconer, Dublin, 1933), at 14 who states that: "the register shows the person who is in fact the owner. How that person got on the register is no business of the purchaser; whether the registered owner holds the lands subject to a trust is of no concern of his; the register is a bridge that transports him safely across the morass of trusts and equities through which the purchaser of unregistered land must struggle at his peril; for they do not affect the lands; and on being registered as owner, his ownership is subject only to the registered burdens, and such of the special and limited class of burdens that effect registered land without registration as, in fact, exist over the land he acquires."

[282] Section 21 Land and Conveyancing Law Reform Act 2009, for a criticism of this section see; Mee, John, "The Land and Conveyancing Reform Bill 2006: Observations on the Law Reform Process and A Critique of Selected Provisions—Part 1," (2006) 11(3) *Conveyancing and Property Law Journal* 67-76 at 69.

[283] Section 97 of the Registration of Title Act, 1964.

inhibition,[284] which prevent the legal owner of the property from dealing with that property until the cautioner or person named in the inhibition has been notified.[285] The 2009 Act also provides, as an exception to the general rule of overreaching, that a purchaser of the legal estate for value will not take ahead of an equitable estate in property where the equitable interest is "protected by registration prior to the date of the conveyance"[286] In order to avoid uncertainty and potential future disputes over the respective shares of the parties, the party holding the legal title to the property should give an express declaration that the property is held on trust; this declaration should then be lodged with the Land Registry and a note placed in the folio of the property highlighting the additional interests over the land.[287] The precise altering shares of the parties could then be included in an ancillary document which would record the gradual purchase by the customer.[288] A failure by the parties to provide for a distribution of beneficial interest, which is at variance with the legal title to the property, may result in the courts concluding that the customer has no beneficial interest in the lessor's freehold estate.[289]

Concurrently with the *mushāraka* proprietary partnership, the parties also enter into a separate *ijārah* agreement in which the financier leases its beneficial share of the property

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[284] Section 98 of the Registration of Title Act, 1964.

[285] In noting the possibility of entering a caution or inhibition on the register, the Law Reform Commission has emphasised the need for the party benefitting from the entries to have acquired an equitable interest in the property. The Law Reform Commission, "Interests of Vendor and Purchaser in Land During the Period between Contract and Completion", *LRC 49-1995* (April 1995), at [2.82].

[286] Section 21(3)(b)(iii) Land and Conveyancing Law Reform Act 2009.

[287] This express trust will need to provide not only for the initial unequal shares but also for any future variation in the parties' shares which may occur over the course of the *mushāraka* transaction, Cooke, Elizabeth, "Equitable accounting: some recent decisions in Northern Ireland", [2001] 23 *Dublin University Law Journal*, 188 – 194 noting that an adjustment in the beneficial ownership of property may occur where there has been express agreement.

[288] This could be adjusted with each purchase of a share in the property by the customer. By clearly specifying the respective shares of the parties, the parties could avoid having to decide the interests of each or having to rely on the court to try to make such calculations. See for example, *Redford v Ziff, Court of Appeal, March 15, 1995* where the courts faced difficulties in making calculations over the respective shares of beneficial co-owners. Cooke, Elizabeth, "Equitable accounting: some recent decisions in Northern Ireland", note 287, at 189.

[289] *Stack v Dowden* [2007] UKHL 17; [2007] 2 A.C. 432 (HL) where the court emphasised the importance of specifically declaring each party's beneficial interest. See also; *Anita Carlton v Jerry David Goodman*, [2002] EWCA Civ 545, at [44], per Laws LJ, "I will try one more time: *always try to agree on and then record how the beneficial interest is to be held.* It is not very difficult to do" (emphasis in original). Parallels with diminishing *mushāraka* can be drawn with shared ownership leases (at least those which have been considered by the UK courts) where the absence of an explicit declaration of trust has proved fatal to attempts by a customer to show that they have acquired a beneficial interest in property which has been subject to a shared ownership lease arrangement. Shared ownership leases allow a customer to progressively purchase an interest in property (staircasing) while they rent the unpurchased share. In *Richardson v Midland Heart Ltd (formerly Focus Homes Options)* [2008] L. & T.R. 31 (Ch D)(Birmingham) it was argued that in such leases the freehold is held on trust by the lessor for the lessee. H.H. Judge Gaunt Q.C. rejected this argument noting at [11] that: "[T]he relationship of the housing association and Miss Richardson was that of landlord and tenant, not that of trustee and beneficiary."

to the customer.[290] As joint owners, both the financier and the customer are each entitled to occupy the whole property.[291] The separate leasing contract between the parties will serve to outline the customer's exclusive possession of the property, to the exclusion of the financer. This agreement has been classified in the UK as capable of being a registrable lease.[292] In Ireland, a grant of a lease by the financier, as beneficial owner, could possibly be viewed as a "partition" of the property as it may result in the division of the property into identifiable shares with the customer exercising ownership rights over one portion while the financier acts as landlord of the other. This would terminate the co-ownership and thus the *mushāraka* arrangement between the parties.[293] S.66(2)(b) of the 2009 Act, however, specifically acknowledges the right of co-owners[294] to *jointly* convey property to one amongst them.[295] As a conveyance includes a lease,[296] the customer and financier (in their capacity as beneficiaries) could jointly agree that the financier (as legal owner and trustee) may lease the property to the customer. The financier would then assume the statutory duties of landlord over the whole property.

The structure of diminishing *mushāraka* property transactions is similar to that of *ijārah wa-iqtina* arrangements as the customer in both has no legal title to the property and the relationship of lessor and lessee subsists between the parties. The financier's security arises from its ownership of a portion of the property, not a charge. If the customer fails to pay rent under the lease, the financier, as lessor, can determine the lease and then seek a court order for the sale of the land and distribution of the proceeds in accordance with the parties' respective shares.[297] As in the lease-to-own structure, there is technically no loan of money between the parties.[298] Rather, there is a unilateral promise by the customer to

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[290] *supra.* at 216.

[291] Coughlan, Paul, *Property Law*, note 157, at 135.

[292] Land Registry, *Practice Guide 69: Islamic financing*, note 205.

[293] Coughlan, Paul, *Property Law*, note 157, at 135 notes that' "[w]here co-owners divide the land into individual areas in which each will have the respective right to exclude the others this amounts to a partition which destroys the unity of possession and brings the co-ownership to an end."

[294] Or indeed, any two or more people in which property has been vested.

[295] Section 66(2)(b) of the Land and Conveyancing Law Reform Act 2009, consolidating section 21 of the Law of Property Amendment Act 1859 and section 50 of the Conveyancing Act 1881.

[296] Section 3, Land and Conveyancing Law Reform Act 2009: "'conveyance' includes an appointment, assent, assignment, charge, disclaimer, lease, mortgage, release, surrender, transfer, vesting certificate, vesting declaration, vesting order and every other assurance by way of instrument except a will; and " convey" shall be read accordingly."

[297] Section 31(2)(c) Land and Conveyancing Law Reform Act 2009.

[298] The Insolvency Service, *Factors Affecting The Value Of The Bankrupt's Interest In The Property*, Part 3, note 233, at [33.92], noting that in the event that a customer in a diminishing *mushāraka* transaction goes bankrupt: "[t]he bankrupt's beneficial interest in the property would form part of the bankruptcy estate in the usual way. The bank would not be a creditor in the bankruptcy, although the trustees would have a claim in respect of any arrears under the lease agreement."

gradually acquire the financier's share of the property and a series of sale and purchase agreements as each share is purchased.

However, there are characteristics of diminishing *mushāraka* which could alter the manner in which these arrangements are classified under Irish law. Primary amongst these are the fact that while the financier retains legal and beneficial ownership of the property for the duration of the lease in an *ijārah wa-iqtina*, the customer in a diminishing *mushāraka* is gradually acquiring the financier's share.[299] The payments made for this acquisition do not form part of the tenancy agreement[300] and arise instead as a result of the customer's promise to purchase and the subsequent sales contracts periodically concluded between the co-owners.[301] It could be argued that the financier may take a charge over the customer's share of the co-owned property in order to secure fulfilment of the customer's promise to purchase, although the feasibility of this security would depend on whether the Irish courts would consider the promise to be binding.[302]

Whether this charge would be effective security for "money or money's worth"[303] in practice is unclear in the absence of precedent. There are a number of factors which could mitigate the potential for diminishing *mushāraka* arrangements to include a mortgage-element. First, particularly in circumstances where the customer undertakes to purchase the financier's portion of the property at market value, there is no clearly defined present debt and it would be difficult for the parties to determine the amount of money actually being secured by the charge. Second, as a charge is a "conveyance" under Irish property law,[304] the creation of a charge by one co-owner in favour of the other would partition the property thereby terminating the co-ownership.[305] Finally, a charge created over the customer's share of the partnership property would not fulfil the definition of a "housing loan"[306] in

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[299] *supra.* at 216.

[300] Although in practice, the lease payment and periodic purchase payments may be joined to form a single payment made each month/year by the customer to the financier. See for example, the HSBC Amanah Home Finance product which is based on a diminishing *mushāraka* transaction. Here, a single periodic payment is made by the customer that represents "rent for use of the bank's share of the property and [allows the customer to] acquire an additional share...with each payment made," HSBC Bank, *HSBC Amanah Home Finance*, (HSBC, Hertfordshire, 2010), at 4.

[301] *supra.* at 216-216.

[302] Schmudde, David A., *A practical guide to mortgages and liens* (ALI-ABA, Philadelphia, 2004), at 8 noting that a mortgage to secure a gratuitous promise would be difficult as the "lack of consideration could raise concerns about the viability of the mortgage."

[303] Section 3 Land and Conveyancing Law Reform Act 2009, definition of a mortgage.

[304] Section 3, Land and Conveyancing Law Reform Act 2009

[305] Coughlan, Paul, *Property Law*, note 157, at 135.

[306] Section 2, Consumer Credit Act 1995.

the CCA 1995, as the financier has extended no loan to the customer, the customer has rather promised to do something in the future.

The multiple independent transactions operating in a diminishing *mushāraka* arrangement make it difficult to determine how such transactions will be classified under Irish law. The dominant feature of the parties' relationship is the lease granted over the whole property by the financier; at no point does the financier extend a loan to the customer, nor is there any bilateral contract under which the customer agrees to pay a set amount.[307] There is simply a promise that, at a future date, the customer will purchase something which the financier owns. As such, diminishing *mushāraka* arrangements are unlikely to fit comfortably within Ireland's mortgage regime.

7.3.2 Legal Implications of Classification under Irish Law

Despite the fact that the Islamic real estate financing transactions considered above are often described as Islamic mortgages, it has been demonstrated that such arrangements, if offered in Ireland, would not consistently fall within the mortgage provisions of the 2009 Act and the attendant consumer protection regime established by the CCA 1995. As a result, a number of the Islamic real estate structures could be classified by Irish law as leases, or at least as including a lease, not mortgages. This classification reflects the ownership of the property and the respective rights and responsibilities of the parties under Islamic law. It may also impact on the manner in which these products are treated under Irish law.[308]

Subsection 7.3.2 will consider the legal implications of offering Islamic real estate financing products in Ireland. It will take the conclusions reached in subsection 7.3.1 and use these to determine the likely treatment of the parties in *murābaha*, *ijārah wa-iqtina* and diminishing *mushāraka* transactions. The first area of consideration will be the statutory protections offered to customers using Islamic real estate financing products (A).[309] It will then consider miscellaneous issues (B)[310]: the possible procedure on default in an Islamic

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[307] Commissioner D G Rice, *CIS/14483/1996*, The Office of Social Security and Child Support Commissioners, 24 June 1997 at [10].

[308] Department of Finance, "Section 1 of Finance Act 2010, Report on Tax Expenditures", note 131, at [9.15].

[309] *infra.* at 272.

[310] *infra.* at 284.

structure (1)[311] and the wider liability of the financier due to its ownership of the property (2).[312] This subsection will highlight areas where reforms could be introduced in order to ensure that Islamic market participants are not denied the same legal protections as their conventional counterparts. As noted in the introduction to section 7.3, however, it will be argued that the expansion Ireland's mortgage regime to include Islamic real estate structures is not an effective means of accommodating these products. A more nuanced approach should be implemented which considers the economic substance of these arrangements but does not disregard their formal structure.

A. Statutory Protections Offered to Customers Using Islamic Real Estate Financing Products

1. Murābaha

As *murābaha* real estate transactions involve a debt which can be charged and immediate transfer of ownership of the property to the customer, it is likely that these transactions may be classified in Ireland as mortgages. Thus, the provisions of the 2009 Act will apply to determine the "obligations, powers and rights of [the] mortgagee [finance provider]"[313] and the rights of the mortgagor [*murābaha* customer].[314] In the event that the *murābaha* is used for a residential property financing, the CCA 1995 and Code of Mortgage Conduct[315] will be relevant, directing the conduct of the mortgagee and the protections offered to the mortgagor. Mortgage loans and credit agreements entered into with consumers in Ireland must fulfil certain requirements established to protect those consumers. For example, the mortgage lender or intermediary must disclose to the consumer any insurance commission, introduction fee or other inducement, charge or expense that may be payable to any person[316] and all other fees payable by the potential mortgagee.[317] Information documents, application forms and documents approving a housing loan must display, prominently, a warning that failure to keep up payments under

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[311] *infra.* at 284.
[312] *infra.* at 289.
[313] Chapter 3, Part 10, Land and Conveyancing Law Reform Act 2009.
[314] Chapter 4, Part 10, Land and Conveyancing Law Reform Act 2009.
[315] Central Bank, *Code of Conduct on Mortgage Arrears, 2010*, available at: http://www.centralbank.ie/regulation/processes/consumer-protection-code/documents/code%20of%20conduct%20on%20mortgage%20arrears%20%201%20january%202011.pdf
[316] Section 131 Consumer Credit Act 1995.
[317] Section 132 Consumer Credit Act 1995.

the mortgage could jeopardise the mortgagor's ownership of their home.[318] Regulating the advertisement of housing loans, the Director of Consumer Affairs may prohibit the use of certain information,[319] specify the content of the advertisement[320] or require withdrawal of certain housing loan advertisements.[321] These provisions reflect the fact that the financier is not owner of the property during the loan repayment and has, rather, a charge or some other security over property which is in the ownership of the mortgagor. The increased level of disclosure also reflects the fact that a consumer who purchases property through a secured loan is using their home as collateral.

2. *Financier as Lessor in Ijārah wa-iqtina and Diminishing Musharaka Arrangements*

As *Ijārah wa-iqtina* and diminishing *musharaka* contain *ijārah* leasing arrangements, the provisions of Ireland's mortgage law may not apply and instead, the financier may be considered to be a lessor[322] and, indeed, a landlord.[323] This classification could result in the application of legal provisions to the participants in these transactions which are entirely distinct from those relevant to mortgage transactions. Rather than Part 10 of the 2009 Act and Part IX of the CCA 1995,[324] the provisions of the Landlord and Tenant Acts 1967-1994 and, potentially, the Residential Tenancies Act 2004[325] and Housing (Standards for Rented Houses) Regulations would be the statutory framework for *ijārah wa-iqtina* and diminishing *musharaka* arrangements in Ireland. Particularly for retail leases, the obligations imposed on lessors by Irish law are, in fact, highly consistent with Islamic principles relating to leases. In commercial leases, "responsibility...varies greatly from case to case"[326] and is largely contingent on the terms of the lease thus allowing the parties themselves to determine the allocation of ownership-related responsibilities.[327]

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[318] Section 128 Consumer Credit Act 1995.

[319] Section 135(2)(a) Consumer Credit Act 1995.

[320] Section 135(2)(b) Consumer Credit Act 1995.

[321] Section 135(2)(c) Consumer Credit Act 1995.

[322] Financial Services Authority, "Regulation of Home Reversion and Home Purchase Plans Volume 1 – Consultation Proposals", note 147, at 73 [7.22], noting that "the [HPP] provider owns the property and the consumer is a tenant."

[323] *supra.* at 262.

[324] Relating to mortgages and housing loans, respectively

[325] Residential Tenancies Act 2004 (Number 27 of 2004).

[326] The Law Reform Commission, "Consultation Paper on General Law of Landlord and Tenant", *LRC CP 28-2003*, (December 2003), at 88).

[327] In commercial mortgages, the lease generally establishes the tenant's obligation to carry out full repairs as well as obtain insurance as a condition of the lease (For example the FRI (Full Repair and Insurance) lease). The customer is not appointed as the financier's agent but is directly responsible for maintenance and repair.

In relation to consumer property, the Residential Tenancies Act 2004[328] imposes an obligation on landlords to carry out all necessary structural repairs to the property, as well as to maintain the interior and fittings of the property to the same standard as when the tenancy began.[329] The Act also obliges the financier to obtain and maintain an insurance policy.[330] In addition to these landlord obligations over the course of the letting, residential tenancies in Ireland are also covered by the Housing (Standards for Rented Houses) Regulation 2008[331] and amending Regulation in 2009.[332] These Regulations impose, on landlords of residential property, particularly onerous obligations to ensure that the property meets minimum physical standards.[333] The 2004 Act provides that the landlord can appoint an agent who is "authorised to act on [the landlord's] behalf in relation to the tenancy."[334] While the Act does not actually state that this agent cannot be the tenant, the fact that it repeatedly refers to the tenant and authorised agent as separate entities[335] would suggest that the appointment of the lessee as agent may not be upheld in the absence of further legislative clarification.[336] As a result, a lessor in Islamic residential property transactions which include an *ijārah* element may not be able to appoint the customer as its agent. This would result in the lessor, who would in most cases be a financial institution, assuming direct responsibility for maintenance and repair of the property without being able to rely on the customer to act on its behalf.

Therefore, financiers in an *ijārah*-based structure, which is subject to Irish law, may face ongoing and detailed obligations which cannot be contracted out of, particularly in retail transactions.[337] Such duties are not characteristic of a financier's participation in

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[328] See generally, Ryall, Áine, "Residential Tenancies Act 2004: Review and Assessment," (2006) 6(1) *Judicial Studies Institute Journal*, 60-91.

[329] Section 12(1)(b) Residential Tenancies Act 2004. Ryall, Áine, "Residential Tenancies Act 2004" (2005) 10(1) *Conveyancing and Property Law Journal* 10-15 at 13.

[330] Section 12(1)(c) Residential Tenancies Act 2004.

[331] Housing (Standards for Rented Houses) Regulation 2008, S.I. No. 534 of 2008

[332] Housing (Standards for Rented Houses)(Amendment) Regulation 2009 S.I. No. 462 of 2009

[333] Under these Regulations, the landlord is required to ensure that, amongst other things, the property is maintained in a good state of structural repair, has adequate sanitary, heating, food preparation and laundry facilities, sufficient lighting, ventilation and fire safety, Sections 5-11 Housing (Standards for Rented Houses) Regulation 2008, S.I. No. 534 of 2008.

[334] Section 12(1)(e) Residential Tenancies Act 2004.

[335] See for example section 16(d) Residential Tenancies Act 2004, the tenant has an obligation to "notify the landlord or his or her authorised agent of any defect that arises in the dwelling that requires to be repaired so as to enable the landlord comply with his or her obligations, in relation to the dwelling or the tenancy, under any enactment."

[336] Section 18(1) Residential Tenancies Act 2004. A similar conclusion has been reaching in Canada in relation to Islamic structures. Gowling Lafleur Henderson LLP, *Report to the Canada Mortgage and Housing Corporation, Islamic Housing Finance in Canada*, note 278, at 57.

[337] Tameme notes a similar potential situation in the UK, Tameme, Mohammed Elkhatim Mamoun, *Demand and Supply Conditions of Islamic Housing Finance in the UK: Perceptions of Muslim Clients*, note 75, at 92.

conventional mortgages, where responsibility for the mortgaged property is placed firmly with the customer, as owner. On one hand, it could be argued that the landlord and tenant regime provides customers with considerable protections and recourse to the financier for the duration of the *ijārah* lease. On the other, the types of protections offered under Ireland's landlord and tenant law do not fully reflect the risks faced by customers in an Islamic real estate financing transaction involving a lease.[338] In economic substance, money paid by the customer in an Islamic arrangement - whether in the form of rent in *ijārah wa-iqtina* or under the periodic sales contracts in diminishing *mushāraka* - will ultimately be used to acquire title to the property;[339] where the customer fails to pay the amount agreed upon, he or she could lose the property. Lessors of real estate in Ireland do not need to be regulated, nor are they subject to particularly onerous disclosure and best-practice standards. Mortgage lenders,[340] in contrast, require authorisation by the Central Bank where those lenders provide a mortgage loan to a retail customer.[341] Mortgage intermediaries[342] also need to be authorised.[343] In addition to this direct regulation, residential mortgage lenders are subject to the indirect regulation of the CCA 1995 through its dictates on the conduct of the mortgage lender and the contents of the mortgage loan agreement. It is this direct institutional authorisation and indirect, consumer protection-centred, regulation which could result in a distinction in the protections offered to Islamic and conventional customers using economically comparable products. From a consumer protection and policy perspective, it could be argued that Islamic customers need the same level of information, the same protection from exploitation and the same types of

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[338] Waters, Dan, *Home reversions and Islamic mortgages get new consumer protections*, note 179, noting that the FSA "sees HPPs as presenting similar risks as conventional mortgages."

[339] Financial Services Authority, *Home reversion & home purchase plans - applying for a variation of permission*, (April 2010), available at: http://www.fsa.gov.uk/Pages/Doing/Regulated/Notify/Permissions/home/index.shtml noting that; A home purchase plan serves the same purpose as a regular mortgage – it provides consumers with finances for buying a home – but it is structured in a way that makes it acceptable under Islamic law.

[340] "Mortgage lender" is defined as —

a) a credit institution making housing loans, or

b) any other person of a class prescribed after consultation with the Minister for the Environment, for the purposes of the Act;

c) a person whose business includes the making of housing loans, provided that at least 50 per cent. by number of all business loans outstanding to him, in whole or in part, at any time comprises loans secured by mortgage of residential property, and

d) a local authority (within the meaning of the Local Government Act, 1941).

e) Section 2(1) Consumer Credit Act 1995 as amended by section 3 Consumer Credit Act, 1995 (Section 2) Regulations, 1996 S.I. No. 127/1996.

[341] Either as a credit institution, building society, credit union or retail credit firm. Section 28 Central Bank Act 1997 as amended by section 19 Markets in Financial Instruments and Miscellaneous Provisions Act 2007.

[342] Section 2(1) Consumer Credit Act 1995, defined as "any person, other than a mortgage lender or credit institution, who in return for a commission, payment or consideration of any kind in relation to the credit transaction, arranges or offers to arrange the provision of a housing loan by a mortgage lender."

[343] Section 116(1) Consumer Credit Act 1995.

safeguards as conventional customers who are also acquiring property with the financial support of a bank or other institution.

It is this divergence in regulatory oversight that prompted UK authorities to establish tailored consumer protections for Islamic *ijārah wa-iqtina* and diminishing *mushāraka* products *within* the residential mortgage regime.[344] These protections did not assimilate Islamic arrangements into the definition of mortgage (either under the RAO or the Law of Property Act). Instead, the accommodations in the UK have sought to ensure that Islamic participants are not denied access to the same regulatory and consumer protection regime as other market participants simply because of the structure of the products they are using.[345] If the Irish Government decides to integrate Islamic real estate financing structures into Ireland's legal system, and seeks to do so in a manner which acknowledges the substance of these structures while still respecting the form required for *Sharī'ah*-compliance, then tailored adjustments will need to be made to the scope of established legislative provisions. These adjustments should deal with regulation (a),[346] consumer protection (b)[347] and the classification of the arrangements (c).[348] Each one of these proposed amendments is discussed below. Through these amendments, both the form and substance of Islamic lease-based structures can be accounted for.

a. Regulation

It is suggested first, that the definition of "regulated business" in the Central Bank Act 1997 be expanded to include "Specified Home Purchase Arrangements"[349] in an

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[344] Financial Services Authority, "Regulation of Home Reversion and Home Purchase Plans, Volume 1 – Consultation Proposals", note 147, at 20, [3.18] noting that: "[t]he Treasury is bringing the regulation of these products within our scope to address anomalies in the level of consumer protection available between mortgage products and these unregulated alternatives. If we did nothing (beyond authorising firms), it would mean that HPP consumers would not have the protections available to a consumer buying a regulated mortgage."

[345] House of Commons, "Regulation of Financial Services (Land Transactions) Bill, Bill 7 of 2005 – 06", *Research Paper 05/50*, (House of Commons, London, 2005), at 20-21. See also, Financial Services Authority, "Regulation of Home Reversion and Home Purchase Plans, Volume 1 – Consultation Proposals", note 147, at [1.4] noting that "[t]he Treasury's aim was to enable [the FSA] to address any anomalies in the level of consumer protection between standard and lifetime mortgages, which are already subject to regulation, and their non-regulated counterparts, Ijaras and HRs."

[346] *infra.* at 276.

[347] *infra.* at 277.

[348] *infra.* at 278. This fact was acknowledged by the Department of Finance in a recent impact assessment of the Finance Act 2010 where they noted that "there are regulatory issues related to retail products which will have to be explored with and by the Regulator," Department of Finance, "Section 1 of Finance Act 2010, Report on Tax Expenditures", note 131, at [9.15].

[349] Or some variation on this terminology. Using "specified" in the definition would draw parallels with the tax accommodations and could facilitate consistency in terminology throughout Ireland's legislation. The

accommodation which is similar to that adopted in the UK. "Specified Home Purchase Arrangements" could then be defined in a manner which would cover lease-based real estate financing products – both *ijārah wa-iqtina* and diminishing *mushāraka*.[350] The effect of this amendment would be to bring Islamic real estate financing transactions under the regulatory oversight of the Central Bank and would require the providers of such products to obtain authorisation in circumstances where they are not already authorised.[351] This move would be far from extraordinary; Home Reversion Firms were classified under Irish law as carrying on "regulated business" in 2007.[352] The regulation of Home Reversion Firm activity in Ireland is particularly significant as the UK FSA only began regulating Home Reversion Firms at the same time (and for effectively the same reasons) as providers of HPPs.[353] Ireland has thus already set a precedent for drawing novel financial activity under direct regulatory oversight.

b. Consumer Protection

The next amendment which would be needed would be the expansion of Part IX of the CCA 1995 to cover "Housing Loans *and Specified Home Purchase Arrangements*."[354] This would apply the safeguards available to consumers, who take out a conventional mortgage loan, to consumers using Islamic structures. The remainder of the CCA 1995 would need little adjustment other than terminological modifications[355] as its provisions are relatively consistent with the requirements of Islamic finance.[356] Even the requirement that credit

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UK have done this for *sukūk* and so use the same terminology in tax legislation as in regulatory provisions. The FSA did however decide not to import without modification the definition of Alternative Finance Investment Bonds (sukuk) from the tax legislation into the regulatory provisions, Financial Services Authority, *Consultation on the legislative framework for the regulation of alternative finance investment bonds (sukuk)*, (December 2008), at 16, available at: http://www.fsa.gov.uk/pubs/cp/sukuk.pdf.

[350] This would cover both *ijārah wa-iqtina* and *mushāraka mutanaqisah* products.

[351] In practice, (at least initially) it seems likely that established financial institutions may seek to offer Islamic real estate products in which case, these institutions would already be authorised as a Credit institution or as a credit union and thus regulated by the Cantral Bank.

[352] Section 28, Central Bank Act 1997 as amended by section 19, Markets in Financial Instruments and Miscellaneous Provisions Act 2007.

[353] Financial Services Authority, "Regulation of Home Reversion and Home Purchase Plans, Volume 1 – Consultation Proposals", note 147, at 18-19.

[354] Once again, this is only suggested wording for the amendment.

[355] For example; section 135 Consumer Credit Act 1995 refers to "Advertising of housing loans," more neutral language could be adopted such as housing finance or house purchase and development products.

[356] Even the provision relating to "redemption fees" which the Consumer Credit Act 1995 prohibits in the context of housing loans is disapplied in the context of fixed loans (section 121(2) Consumer Credit Act 1995) thus allowing a financier under a *murābaha* arrangement to charge the full purchase price and mark-up in the event of early payment/late payment/default without such charge representing an illegitimate redemption fee. The remainder of the Housing Loan provisions of the Consumer Credit Act 1995 relate to disclosure by the financier, (sections 128-134 Consumer Credit Act 1995) including a warning that the customer could lose their house if they do not keep up with their mortgage payments. The provisions also

advertisements "contain a clear and prominent statement of the APR [Annual Percentage Rate]"[357] is unlikely to pose significant problems. While APR is defined in the CCA 1995 as the total cost of credit to the consumer[358] and indicates the existence of a loan, UK authorities (discussing a similar requirement in UK law) have stated that this figure can represent an Islamic financier's equivalent of the APR, calculated according to the finance provider's own approach to valuing the transaction.[359] This percentage does not then have to include any reference to interest rates but can include, rather, the financier's anticipated rental charges over the course of the lease.[360] The APR disclosure requirement is an important aspect of the consumer protection offered by the CCA 1995, and allows customers to compare products by different financiers. As such, the Irish Central Bank, like the UK's FSA, is unlikely to permit deviation from this provision. Flexibility in how this value is calculated could allow Islamic financiers to achieve greater overt compliance with Islamic legal principles.

c. Classification

The final area to be addressed is the legal regime underpinning Islamic real estate transactions if offered in Ireland. By amending the CCA 1995 to extend consumer protection to Islamic structures, the Irish authorities would not alter the definition of a mortgage under Irish law, nor would they be suggesting that Islamic *ijārah*-based arrangements are mortgages. They would, instead, acknowledge that the risks faced by Islamic consumers, and the fact that Islamic structures can be used in place of conventional mortgages, justify an extension of disclosure and transparency requirements found in Irish consumer protection law.[361] In the absence of a *sui generis* category of land transaction introduced through the courts or into primary legislation, Islamic transactions will continue to require a legal basis in existing Irish law. The CCA 1995 alone will not provide this

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deal with insurance (section 124) and the practices of the financier (section 127 (prohibition of linking services) and section 135 (advertising housing loans)).

[357] Section 21(1) Consumer Credit Act 1995.

[358] Section 2(1) Consumer Credit Act 1995 definition of APR.

[359] Mortgages and Home Finance: Conduct of Business sourcebook, at [2.2.8A], Financial Services Authority, "Regulation of Home Reversion and Home Purchase Plans Volume 1 – Consultation Proposals", note 147, at [7.28].

[360] Stones, Richard, Fornasier,Victor and Tym, Roger, "Conduct of business update", (2007) 44 *Compliance Officer Bulletin*, 1-40 at 39 noting that: "[a]lthough the APR is not an interest rate, it is often viewed as being related to an interest rate which has no place in Islamic finance. The APR actually is a rate of charge that looks at all of the payments required over the term, and so could be used as a way to compare different offerings. However, if it is only optional, it will not be a useful comparison if not all firms use it."

[361] Waters, Dan, *Home reversions and Islamic mortgages get new consumer protections*, note 179, discussing the UK amendments.

basis as it only lays out consumer-related requirements which must be present in a transaction, rather than establishes a foundation in Irish law for the transaction itself. While it could be argued that Part 10 of the 2009 Act should be amended so as to include Islamic structures in the provisions dealing with mortgages, this, it is suggested, would result in an unjustified extension of the definition of a mortgage to include structures which ultimately are not mortgages.[362] To achieve this, the two defining features of a mortgage in Ireland - an extension of credit and some form of security over the property[363] - would need to be removed or relaxed, in a move which would not so much accommodate Islamic structures in established law as entirely overhaul concepts which have been developed in common law and enshrined in statute. Even applying Part 10 of the 2009 Act to Islamic structures, as distinct products from mortgages, would be of limited use without comprehensive amendments to its provisions. The scope of Part 10 of the 2009 Act is currently limited to mortgages in which property is used as security for a loan or obligation; its provisions provide a statutory regime which is tailored to the particular structure of a conventional mortgage. Such provisions are in parts not relevant to Islamic transactions and indeed, potentially contrary to the teachings of Islam.[364]

Consequently, the preferable option for integrating Islamic real estate structures into Ireland's legal system is to maintain the classification of *ijārah wa-iqtina* and diminishing *mushāraka* as leases, while requiring regulation of participating financiers and the protection of consumers. This would ensure that Islamic consumers are not excluded from consumer protections. At the same time, it would also provide Islamic structures with a basis in Irish law which is largely consistent with Islamic principles and which maintains the integrity of Ireland's mortgage regime.[365] Taking into account the unique structural

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[362] Maddox notes that where security is not granted for a debt, the transaction is not a mortgage and instead, "the lender may sue for the sum as a simple contract debt if the repayment of the loan is defaulted on," Maddox, Neil, *Mortgages Law & Practice*, (Thomson Round Hall, Dublin, 2007), at 1.

[363] Section 3(1) Land And Conveyancing Law Reform Act 2009, ddefinition of mortgage, section 2(1) Consumer Credit Act 1995, definition of mortgage and housing loan, Maddox, Neil, *Mortgages Law & Practice*, note 362, at 1. See as far back as 1871, *Estate of Charles Harold Walker, Owner v Mary Anne Hodgens and others* [1871] 5 I.L.T.R 170, where Flanagan J referred to "mortgage debt," in circumstances where interest was payable on the debt and the principal sum was secured on land, *Re Bernstein* [1925] Ch. 12 at 17 in which Lawrence J noted that a mortgage "is a security upon real or personal property for the payment of a debt…"

[364] For example sections 107(1) and 109 Land and Conveyancing Law Reform Act 2009 which deal with the equity of redemption and acknowledges the customers ownership interest in the property. Section 97 also deals with the need to get a court order for possession which appears contrary to the nature of the *ijārah wa-iqtina* and diminishing *mushāraka* in which the financier legally owns all or at least part of the property.

[365] This approach may raise questions as to whether financial institutions would want to bear the responsibilities of lessor. In practice, such responsibilities arise primarily from the nature of the Islamic transaction itself, the statutory regime simply supports this. UK banks who have entered into these arrangements appear to have accepted the increased responsibilities with the FSA suggesting that the HPP

characteristics of Islamic arrangements, clarifications to Ireland's landlord and tenant laws could then be introduced in order to allow "Specified Home Purchase Arrangements" to function smoothly within that regime. It should, for example, be made explicit in the provisions of the Residential Tenancies Act 2004 and the Housing (Standards for Rented Houses) Regulations that in relation "Specified Home Purchase Arrangements," the landlord may appoint the lessee as its agent to carry out its obligations. The landlord is already able to appoint an agent under these instruments,[366] clarifying the identity of this agent for "Specified Home Purchase Arrangements" is simply ensuring that existing obligations can be fulfilled in *ijārah*-based arrangements. Carve-outs may also be needed from other elements of Ireland's landlord and tenant laws, such as those provisions of the Landlord and Tenant (Ground Rent) Act 1978[367] which prevent residential property lessees from purchasing the leased property.[368] While this approach may appear to be cherry-picking, Ireland's landlord and tenant law is vast and such carve-outs are not unusual.[369] Shared ownership leases[370] under which a customer can progressively purchase an interest

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contract acknowledge that "We [the bank] own the property and you [the customer] are our tenant. As owner of the property, we face the risks associated with property ownership." Financial Services Authority, "Regulation of Home Reversion and Home Purchase Plans, Volume 1 – Consultation Proposals", note 147, at 135. Ultimately this is what *ijārah wa-iqtina* and diminishing *mushāraka* transactions entail.

[366] Section 12(1)(e) Residential Tenancies Act 2004.

[367] Landlord and Tenant (Ground Rents) Act, 1978 (Number 7 of 1978).

[368] Section 2(1) Landlord and Tenant (Ground Rents) Act, 1978.

[369] Cherry-picking has also been a feature of the UK accommodations, for example, HPPs, like regulated mortgages have been excluded from the scope of the UK's Consumer Credit Act 1975, section 16(6C) Consumer Credit Act 1975, Substituted by Financial Services and Markets Act 2000 (Regulated Activities) (Amendment) (No.2) Order 2006/2383 Pt 3 art.25(2)(a) (November 6, 2006 for the purposes of enabling applications as specified in SI 2006/2383 art.1(2)(a), similarly, MCOB 13.4 Arrears: provision of information to the customer of a regulated mortgage contract and MCOB 13.5 Dealing with a customer in arrears or with a sale shortfall on a regulated mortgage contract apply only to regulated mortgages, while HPPs are excluded from their application.

[370] These products are provided for by the Housing (Miscellaneous Provisions) Act 1992 (No. 18/1992). Under a shared ownership lease arrangement, one party, generally a housing authority, conveys a long lease (Section 2(1)(a) The Housing (Miscellaneous Provisions) Act 1992) of suitable property to a purchaser in return for payment of premium (The premium represents a "sum of money being not less than 25 per cent, and not more than 75 per cent, of the market value of the house" Section 2(1)(b) The Housing (Miscellaneous Provisions) Act 1992). This premium is calculated as a portion of the market value of the property and represents the customer's equity share in the property. The customer then leases the property from the housing authority under an arrangement which allows the future purchase of the additional shares in the property (staircasing) (Section 2(1)(c) The Housing (Miscellaneous Provisions) Act 1992). Once the customer has purchased one hundred percent of the lessor's share, the lease terminates and the customer becomes full legal owner of the property. Unless the customer obtains a separate extension of credit in order to pay the initial premium or make subsequent purchases of the lessor's interest, shared ownership leases do not involve a mortgage or loan but rather a lease under which the housing authority can charge the customer rent (Section 3(3) The Housing (Miscellaneous Provisions) Act 1992 as amended by Section 17 of the Planning and Development (Amendment) Act 2002 (No. 32 of 2002), Hogan, Joe, "Housing Initiatives: The Shared Ownership Lease and Affordable Housing", (2007) 12(3) *Conveyancing and Property Law Journal* 83-89 at 85-86). Ireland's shared ownership lease scheme is however being phased out in favour of an equity loan product which is similar to a *murabaha* financing but allows the housing authority to share in any increase in the market value of the property (Section 2 and 3 of the Housing (Miscellaneous Provisions) Act 1992 were repealed by Section 7 and Sch.1 of the Housing (Miscellaneous Provision) Act 2009 (No. 22 of 2009). For a discussion of the Housing (Miscellaneous Provision) Act 2009, including the instalment

in property which he or she is leasing (usually from a housing authority)[371] are explicitly excluded from the Residential Tenancies Act 2004,[372] the Landlord and Tenant (Ground Rents) (No. 2) Act, 1978,[373] Part II of the Landlord and Tenant (Ground Rents) (No. 2) Act, 1978 and the rule against perpetuities, while the application of s.6 of the Landlord and Tenant (Amendment) Act, 1980 is modified for such leases. Wylie justifies these legislative adjustments in the case of shared ownership leases as necessary to "reconcile such leases with landlord and tenant law generally,"[374] and it is suggested that a similar approach could be adopted in relation to "Specified Home Purchase Arrangements." The Residential Tenancies Act, the Housing (Standards for Rented Houses) Regulation and provisions of the Landlord and Tenant Acts restricting tenant purchase are designed to offer protection to customers involved in "normal" landlord and tenant relationships where the customer does not, and does not intend to, acquire an ownership interest in the property. To tailor the application of such instruments in the case of "Specified Home Purchase Arrangements," either through clarification or carve-out, would not constitute a reversal of policy by the Oireachtas. It would simply tighten the legislation to ensure that it applies in the manner the Oireachtas constructively intended.

B. Regulation and the use of a bifurcated structure

Many of the regulatory difficulties faced by Islamic real estate financing structures in which the bank owns the property directly are also raised by the bifurcated structure. However, as will be discussed below, classifying as "mortgages" those arrangements in which an SPV is used may be a slightly more straightforward exercise.

i. Retail-level

a. Housing Loan

At retail-level, real property transactions must fulfil the definition of both a "housing loan" under the CCA 1995 and a "mortgage" under the 2009 Act.[375] Like Islamic real estate financings in which the bank owns the property directly, it is suggested that *ijarah wa*

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purchase scheme, see; Kenna, Padraic, "The Housing (Miscellaneous Provisions) Act 2009", (2010) 15(2) *Conveyancing and Property Law Journal* 26-32 at 29.

[371] Section 2(1) Housing (Miscellaneous Provisions) Act, 1992.

[372] Section 3(1)(e) Residential Tenancies Act 2004, there are, in fact, numerous exemptions to this Act.

[373] Section 3 Housing (Miscellaneous Provisions) Act, 1992.

[374] Wylie, JC.W., *Landlord and Tenant Law*, (2nd ed., Butterworths, Dublin, 1998), at 121.

[375] *supra*. at 246.

iqtina and diminishing *musharaka* structures that use an SPV will not fulfil the definition of a housing loan. As already discussed, a housing loan for residential property requires the provision of credit to a consumer, on security of a mortgage.[376] While the financial institution may provide the SPV with credit to purchase the property *ijarah wa iqtina* and diminishing *musharaka* arrangements, the SPV itself is providing no "credit" to the consumer. Instead, the SPV is either acquiring the property jointly with the consumer (in the diminishing *musharaka*)[377] or it is purchasing the property and then renting it to the consumer (in the *ijarah wa iqtina*).[378] There is, simply, no provision of credit and so the consumer protections of the CCA 1995 are unavailable. This can be contrasted with *murabaha* arrangements. In such transactions there *is* a debt owed by the consumer to the SPV and the SPV can take a mortgage over the property in order to secure this debt. Thus, the customer in such bifurcated *murabaha* contracts should be able to rely on the statutory protections offered to retail consumers.

b. Mortgage

Unlike the Islamic real estate financing products already discussed, it is suggested that those which use an SPV may fall within the definition of a mortgage under Irish law. The 2009 Act sets out a broad definition of a mortgage such that the only requirement is the existence of a charge over property to secure payment of money. Where a financial institution owns property directly, there is limited scope for taking a charge over that property.[379] Where the property is owned by an SPV however, the financial institution would be able to take a charge in order to secure repayment of monies owed. However, McMillen has noted that in a bifurcated structure the leasing transaction (between the SPV and the financial institution) "must be completely independent from the conventional loan transaction", thus preventing the assets of the customer from being used as security for the conventional loan".[380] Instead, the SPV would be able to take security over the property to secure payment under the *ijarah wa iqtina* or diminishing *musharaka* contracts.[381] The SPV could then assign its right to exercise its security on default of the lease to the financial institution.[382] Non-payment under the lease (as opposed to under the conventional

[376] *supra.* at 246.
[377] *supra.* at 264.
[378] *supra.* at 254.
[379] *supra.* at 225 and 257.
[380] McMillen Michael J.T., "Asset Securitization Sukuk and Islamic Capital Markets: Structural Issues in these Formative Years", (2008) 25(4) *Wisconsin International Law Journal* 703-772 at 723-724.
[381] *ibid.*
[382] *ibid.* at 724.

loan) may thus result in the financial institution exercising the charge and using the proceeds of sale of the property to repay any outstanding debt. In practice, this charge may have the effect of ensuring that the provisions of the 2009 Act relating mortgages would apply to Islamic real estate arrangements, thus increasing the protections offered to the mortgagor above those which would otherwise be available if the financial institution owned the property.

Nevertheless, the non-application of Ireland's consumer protections to these structures remains an issue which undermines attempts to create a regulatory level playing field. Thus, it is suggested, that the accommodations already proposed, in relation to regulation and consumer protection for Islamic real estate financings in which the property is owned by a financial institution, would still be needed should an SPV structure be used.[383] This legislative accommodation would extend protections already available to conventional mortgagors to consumers using Islamic arrangements.

ii. Wholesale Level

Ireland's conventional real property mortgage sector remains largely outside the scope of strict regulatory oversight. Thus, while the mortgage provisions of the 2009 Act are, in theory, applicable to commercial mortgages, they can be largely derogated from by the parties to such arrangements.[384] Whether a wholesale-level Islamic arrangement falls within the definition of a mortgage is thus of less practical importance than it is in the context of a retail transaction.

Nevertheless, as discussed in the previous paragraph, where the property in an *ijarah wa iqtina* and diminishing *musharaka* arrangement is held by an SPV rather than by a financial institution, this provides the financial institution with scope to take security over the property,[385] thus potentially bringing the arrangement within the provisions of the 2009 Act. This will facilitate a comparable level of regulation over Islamic real estate structures as already exists over conventional wholesale mortgages.

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[383] These accommodations are discussed in detail *supra.* at 276 - 281.

[384] Section 96(3) Law of Property Act 2009 which provides that: "The provisions relating to the powers and rights conferred by this Chapter apply to any housing loan mortgage notwithstanding any stipulation to the contrary and notwithstanding any powers and rights expressly conferred under such a mortgage, but in relation to any other mortgage, except where this Part provides to the contrary, take effect subject to the terms of the mortgage".

[385] *supra.* at 279.

Thus, the existence of an SPV within an Islamic real property purchase contract may alter the manner in which such structures are regulated under Irish law. However, the bifurcated structure will not automatically create a level playing field between Islamic and conventional structures. Particularly at retail level, noteworthy differences remain. Without accommodation therefore, the level of consumer protection available to Islamic customers will be less than that available to customers in an interest based mortgage.

C. Miscellaneous Implications of Islamic Transactions' Structure

The legislative status of Islamic real estate financing transactions, the effectiveness of regulatory oversight and the relevance of consumer protection in relation to these products have been central factors influencing the accommodations introduced by UK authorities. As discussed in the previous subsection, if these products are offered in Ireland, similar considerations may arise. Two additional but related legal issues may also be of interest, not only to Irish authorities, but to participants in Islamic real estate financing transactions. The final issues considered in this Chapter are the effect which the structure of the Islamic products will have in the event of default (1)[386] and on the potential liability of the financier (2).[387]

1. Default/Non-Payment of Rent

On default by the customer in an Islamic transaction, it follows from the likely classification of these transactions under Irish law that *murābaha* real estate arrangements would be subject to the provisions of the 2009 Act dealing with mortgage default.[388] For retail transactions, the Code of Conduct in Mortgage Arrears[389] introduces guidelines on the behaviour of mortgagees when a housing loan borrower fails to keep up payments under the mortgage.[390] In contrast, *ijārah wa-iqtina* and diminishing *mushāraka* arrangements involve the financier obtaining and holding title to the property.[391] As the financier owns the property rather than holds a security interest in that property, its ability

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[386] *infra.* at 284.
[387] *infra.* at 289.
[388] See generally Chapter 3 of Part 10, Land and Conveyancing Law Reform Act 2009.
[389] Central Bank of Ireland, *Code of Conduct on Mortgage Arrears*, 2010, note 315.
[390] Chapter 1 sets out the scope of the Code as follows: "[t]his Code sets out how mortgage lenders (referred to in this document as "lenders") must treat borrowers in or facing mortgage arrears, with due regard to the fact that each case of mortgage arrears is unique and needs to be considered on its own merits," Central Bank of Ireland, *Code of Conduct on Mortgage Arrears*, 2010, note 315, at 1.
[391] *supra.* at 210 and 215.

(or need) to rely on the enforcement provisions of the 2009 Act is limited.[392] Instead, default in the transaction may be treated by a financier in a manner consistent with non-payment of rent in a lease.[393] This regime is distinct from that relating to mortgages.[394] Nevertheless, particularly in relation to leases of residential property, there remain safeguards in place to prevent the lessor from simply ejecting the lessee without warning. The Residential Tenancies Act 2004 places restrictions on the methods which a lessor can use to determine a residential tenancy, preventing termination "by means of a notice of forfeiture, a re-entry or any other process or procedure" not provided by the Act.[395] Residential tenants who have been in rented accommodation for at least six months may also be able to acquire security of tenure in four year cycles.[396] Landlords of such property are permitted to remove a tenant only through the issue of a notice to quit that complies with the provisions of Part 5 of the 2004 Act.[397] Where the lease is for a fixed term,[398] the landlord must serve twenty eight days notice[399] for breach of an obligation in the lease.[400] Where the violation has been non-payment of rent, the twenty eight days notice must be served after giving fourteen days written notification that the rent is due (giving the lessee a period of a month and a half from non-payment).[401] Business tenants also have security of tenure and may acquire a right to a new tenancy once they have shown continuous occupation for five years.[402] At this point, the business tenant may, as one commentator has suggested, be "entitled to remain in possession effectively forever."[403] Like residential

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[392] *supra.* at 258- 262 and 271.

[393] Damak, Mohamed, *Risk Management for Islamic Financial Institutions: A Rating Perspective*, (Standard & Poor's, January 15, 2008), at 2-3, available at: http://www2.standardandpoors.com/spf/pdf/media/Risk_Management_For_Islamic_Financial_Institutions_15-Jan-08.pdf.

[394] Financial Services Authority, *Regulation of Home Reversion and Home Purchase Plans*, Volume 1 – Consultation Proposals, note 147, at 73, [7.22], Damak, Mohamed, *Risk Management for Islamic Financial Institutions: A Rating Perspective*, note 393, at 2.

[395] Section 58(1) Residential Tenancies Act 2004.

[396] Section 28(1)-(4) Residential Tenancies Act 2004.

[397] Part 5 Residential Tenancies Act 2004, "Tenancy Terminations — Notice Periods and other Procedural Requirements."

[398] Which, in light of the extended period over which an Islamic real estate financing is to last, and the fact that the parties may want the security of a specific leasing term, is likely.

[399] Section 67(2)(b) Residential Tenancies Act 2004.

[400] Section 34 Residential Tenancies Act 2004. See also; Conway, Linda and Wright, Louise, *Security of Tenure in Commercial and Residential Tenancies*, (Dillon Eustace, Dublin, 2009), at 3, available at: http://www.dilloneustace.ie/download/1/Security of Tenure in Commercial and Residential Tenancies.pdf

[401] Section 67(3) Residential Tenancies Act 2004.

[402] Section 3(1), Landlord and Tenant (Amendment) Act 1994 amending section 13(1)(a) of the Landlord and Tenant(Amendment) Act 1980. See also The Law Reform Commission, *Consultation Paper on Business Tenancies* (LRC CP 21-2003) (The Law Reform Commission, Dublin, 2003), at 51, available at: http://www.lawreform.ie/_fileupload/CPOLD/BusinessTenanciescp.pdf

[403] Doyle, Brian T., "Our leasing laws need an overhaul", *Independent*, June 25, 2003, available at: http://www.independent.ie/unsorted/property/our-leasing-laws-need-an-overhaul-218582.html. This statement is of course hyperbole as new business tenancies can be granted for up to twenty years (Section 5 Landlord and Tenant (Amendment) Act 1994, substituting a new subsection (2) in section 23 of the Landlord

leases, a business lease can be terminated by the landlord for breach of a term in the lease, including the tenant's obligation to pay rent.[404]

UK authorities have confirmed that as *ijārah*-based real estate transactions will not function like mortgages on default;[405] the financier may legitimately determine the lease.[406] From a consumer protection perspective, accommodations introduced into UK law have attempted to ensure that consumers in Islamic arrangements who are in arrears will not be treated harshly when compared with consumers in conventional property financings. As the FSA noted, "given the potential for a consumer to lose his home and the relative ease with which a firm may forfeit a lease, we think that it is important to consolidate existing good practice in this case by imposing a framework on firms similar to that imposed on mortgage firms."[407] This has resulted in amendment of the MCOB Rules relating to arrears and repossession so as to incorporate HPPs, to exclude references to mortgage "loans" and "debt" and to replace these with terms which account for the fact that HPPs do not involve indebtedness. The MCOB Rules then sets out how the mortgagee/lessor should act in the event of customer arrears, advocating, fairness and, only as a final resort, repossession of the property.[408] These provisions are largely consistent with Islamic legal principles[409] and can apply to Islamic structures despite the fact that such structures are based on a lease.[410] The only questionable element of these provisions is the requirement that, if the property is

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and Tenant(Amendment) Act 1980), although, the Law Reform Commission has suggested that this is too long and exceeds the length of business leases granted in other jurisdictions, The Law Reform Commission, *Consultation Paper on Business Tenancies*, note 402, at 52.

[404] Business tenancies, unlike residential tenancies can still be terminated by forfeiture (section 14(8) Conveyancing Act 1881) and ejectment (section 52 Deasy's Act), see generally Coughlan, Paul, *Property Law*, note 157, at 328-336 discussing methods of termination and rights on termination.

[405] As the FSA noted, "the provider owns the property and the consumer is a tenant. As a tenant, the consumer faces the risk of losing the right to stay in his home if he breaches any of the terms of his agreement with the provider, for example, if he does not keep up the monthly payments, his lease may be forfeited, Financial Services Authority, "Regulation of Home Reversion and Home Purchase Plans Volume 1 – Consultation Proposals", note 147, at 73, [7.22], Housby, Elaine, *Islamic Financial Services in the United Kingdom*, note 169, at 88.

[406] Land Registry, *Practice Guide 69: Islamic financing*, note 205.

[407] Financial Services Authority, "Regulation of Home Reversion and Home Purchase Plans Volume 1 – Consultation Proposals", note 147, at 78, [7.40]. Housby has however issued a note of warning when she suggests that in relation to diminishing *mushāraka* defaults in the UK, "[t]he precise nature of this joint ownership and partial tenancy arrangement and the implications in the case of default by the buyer have never been tested in English law, Housby, Elaine, *Islamic Financial Services in the United Kingdom*, note 169, at 91.

[408] MCOB 13 Arrears and repossessions.

[409] The FSA prefaced its accommodating rules relating to repossessions and Home Purchase Plans with a statement that: "In line with Islamic law, HPP firms must treat their consumers justly and fairly. Accordingly, they will consider taking possession of a property only as a last resort," Financial Services Authority, "Regulation of Home Reversion and Home Purchase Plans Volume 1 – Consultation Proposals", note 147, at [7.40].

[410] For example, the Rules advocate "Dealing fairly with customers in arrears: policy and procedures" (MCOB 13.3) and MCOB 13.4 dealing with the information to be provided to the customer of a regulated mortgage contract does not apply to HPPs but only to regulated mortgages.

sold at a surplus over the amount "due under the regulated mortgage contract or home purchase plan," reasonable steps are taken to "inform the customer in a durable medium of the surplus and...to pay it to him".[411] This provision suggests that the customer has obtained some interest in the property over the course of the lease, something which contradicts the nature of at least *ijārah wa-iqtina* arrangements.[412]

In Ireland, the absent (*ijārah wa-iqtina*) or limited (diminishing *mushāraka*) ownership interest which an Islamic real estate customer has in the underlying property would make it more straightforward for a financier to enforce their interest in the property than it would be in a conventional mortgage.[413] This does not mean that financial institutions should not be encouraged to treat customers in Islamic transactions fairly. In an accommodation which is similar to that adopted in the UK, and one which is in line with the expansion of the CCA consumer protection regime already advocated (subsection 7.3.2A), amendments could be made to the Code of Conduct on Mortgage Arrears (one such amendment would, of course, be a change of the Code's title). This accommodation could alter the language used in the Code[414] to make it more accessible to "Specified Home Purchase Arrangements" extending the fairness,[415] patience[416] and disclosure[417] advocated by the Code to Islamic real estate financing activities. Only the final section of the Code, relating to repossession,[418] may need substantive - as opposed to cosmetic - modification to accommodate Islamic transactions due to the fact that it deals with court orders for repossession, something which is unlikely to arise in transactions based on a lease.

Finally, in relation to the customer's residual interest in the property and his or her equity of redemption, the UK accommodations suggest on one hand that any surplus on sale of property subject to both a conventional mortgage and a HPP should be given to the

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[411] MCOB 13.6.6.

[412] It also contradicts the FSA's statement that the consumer in an ijarah wa-iqtina has "no formal beneficial interest in the property during the life of the plan." Financial Services Authority, "Regulation of Home Reversion and Home Purchase Plans Volume 1 – Consultation Proposals", note 147, at 84, [8.16].

[413] Although Damak has suggested that in practice, "[a]lthough an Islamic bank is in theory in a position to evict a customer from a property and resell it in the case of a default on the loan backed by the property, this would be unlikely to happen in practice owing to its 'social responsibility'," Damak, Mohamed, *Risk Management for Islamic Financial Institutions: A Rating Perspective*, note 393, at 2-3.

[414] The language in the Code is currently very much based on the notion that a mortgage loan is a conventional extension of credit in which the financier is the lender and the customer is a borrower who must pay back the loan.

[415] Central Bank of Ireland, *Code of Conduct on Mortgage Arrears*, note 315, at 1, which provides that: "[a]ll such cases must be handled sympathetically and positively by the lender, with the objective at all times of assisting the borrower to meet his/her mortgage obligations."

[416] *ibid.*, at [10]-[14].

[417] *ibid.*, at [33]-[41].

[418] *ibid.*, at [46]-[51].

customer.[419] However, on the other hand, the FSA has highlighted the importance of disclosure by the financier in HPP arrangements due to the fact that the customer may not only lose the property, but may lose everything he or she has paid towards the acquisition of that property.[420] As diminishing *mushāraka* involve the progressive purchase by the customer of a beneficial interest in the property, on default and sale of that property, the customer will share in the sale proceeds. While this is not an equity of redemption as such, it would allow the customer to recover the money he or she has invested in the property and to share in any increase in value of the property with the financier. In *ijārah wa-iqtina* arrangements, customers have no residual interest in the property as they have neither obtained ownership at the outset of the transaction nor have they progressively purchased equity in the property. The equity of redemption is a feature of mortgage arrangements, not leases. To confer one on *ijārah wa-iqtina* arrangements would not only contradict the nature of those products under Islamic law, but also the classification of these arrangements as leases under Irish law. Instead, it is suggested that in an *ijārah wa-iqtina* arrangement, the customer could claim that he or she paid above market rental for the property on the basis of the financier's unilateral undertaking to sell the property to the customer at some point in the future. The additional rent which is paid into the "on-account" fund was consideration for this undertaking thereby rendering it enforceable, under Irish law, against the financier. As the future sale cannot occur once the financier has sold the property following determination of the lease, there has been a total failure of consideration justifying the return of the capital held by the financier. While this may not allow the customer to recover the surplus on sale, it would ensure, in line with FSA recommendations, that the customer's "financial [as opposed to equitable] interest in [the] property is properly protected."[421]

2. *Liabilities of Financier as Owner/Occupier of Real Property*

a. *Financier as Owner/Occupier*

In all forms of Islamic real estate financing, the financier assumes ownership of the property either directly or indirectly. A concern in Islamic real estate financing is thus the

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[419] MCOB 13.6.6.

[420] Financial Services Authority, "Regulation of Home Reversion and Home Purchase Plans Volume 1 – Consultation Proposals", note 147, at 84, [8.16].

[421] Financial Services Authority, "Regulation of Home Reversion and Home Purchase Plans Volume 1 – Consultation Proposals", note 147, at 84, [8.16].

potential liability to which financiers may be subject as owners of the underlying property.[422] In *murābaha* arrangements, the financier enters into the chain of title of the property by assuming ownership (albeit momentarily) before selling the property to the customer. In *ijārah wa-iqtina* and diminishing *mushāraka* transactions, the financier remains owner and lessor until the customer purchases the property; their interest and involvement in the property are not peripheral. Such financiers may therefore be regarded as having sufficient control over the property that liability could be imposed for legislative breaches occurring on the property. This liability may be of concern particularly when the customer is involved in industrial or environmentally damaging activity as the financier could be found liable for breaches of environmental or planning legislation.[423]

Lender liability has become a source of uncertainty, even amongst conventional financers that provide capital to a borrower who then breaches the law.[424] In the 1990 *Fleet Factors*[425] decision, the US Eleventh Circuit Court of Appeals held that if a financial institution had the "capacity to influence" the management of a polluting enterprise, this could be sufficient to trigger liability for the enterprise's breaches of the "Superfund" legislation (Comprehensive Environmental Response, Compensation and Liability Act 1980 [CERCLA]).[426] In the UK too, commentators have questioned whether a lender could be held directly responsible for a borrower's breach of the environmental legislation in circumstances where the financier either "caused or knowingly permitted"[427] the contamination[428] or is an "owner or occupier"[429] of contaminated land.[430]

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[422] See for example, Salah, Isam, "Legal issues arising in Islamic finance transactions in the United States", in *Islamic Finance in North America*, Blake Goud (ed.), (Yasaar Media, Dubai, 2009), 56-64 at 59-60, Gowling Lafleur Henderson LLP, *Report to the Canada Mortgage and Housing Corporation, Islamic Housing Finance in Canada*, note 278, at 55.

[423] Nuisance and occupiers liability could also be relevant is injury occurs on the financier's property which is subject to the lease. While principles of *Shari'ah* may prevent involvement in certain *haram* sectors, there is no prohibition on involvement in industrial activity, indeed a review of project financed through Islamic principles around the world indicates that Islamic finance may be used in petrochemical developments, large scale building projects and airport runways, see for example, the Equate Project in Kuwait, Esty, Benjamin C., "The Equate project: An introduction to Islamic Project Finance",(Winter 2000) 5(4), *Journal of Project Finance*, 7-20, the Shard of Glass in London, Qazi, Imam, *Islamic Finance in Real Estate*, (October 23, 2009), available at:http://www.hg.org/article.asp?id=7415.

[424] See for example, Egede, Tamara and Lee, Robert, "Bank lending and the environment: not liability but responsibility", (Nov 2007) *Journal of Business Law*, 868-883, Richardson, Benjamin J., "Environmental liability and banks: recent European developments", (2002) 17(10), *Journal of International Banking Law*, 287-294, Feess, Eberhard, "Lender liability for environmental harm: an argument against negligence based rules", (1999) 8(3), *European Journal of Law & Economics*, 231-250.

[425] *United States v. Fleet Factors Corporation,* 901 F 2d 1550 (1990).

[426] *ibid.*, at 1557-1558 noting that: "[a] secured creditor will be liable if its involvement with the management of the facility is sufficiently broad to support the inference that it could affect hazardous waste disposal decisions if it so chose".

[427] Section 78F(2) Environmental Protection Act 1990.

[428] Class A liability

Ireland's planning and environmental legislation generally focuses liability on the "occupiers" of the property, although some responsibility is imposed on "owners," even if they are not in occupation. Legislation frequently includes a "mortgagee not in possession" exemption from the definition of owner, providing some protection from liability to conventional financial institutions.[431] This carve-out arises from the simple fact that mortgagees are not owners of the property.[432] This can be contrasted with the all Islamic real estate financing transactions in which the financier *is* owner of the property, potentially for several decades. The risks faced by Islamic financiers as property owner are exacerbated in Ireland by the often inconclusive and vague distinction which legislation makes between the owner and the occupier of the property and the allocation of responsibility between these two parties, if they are different. In the Protection of the Environment Act 2003,[433] for example, "occupier" is described as including "the owner, a lessee, any person entitled to occupy the installation and any other person having for the time being, control of the installation or premises."[434] This definition is certainly broad enough to include the owner of property even where they are not in occupation. While it seems probable that liability would be applied against the occupier/*de facto* controller, rather than the owner not in occupation, financial institutions have deep pockets and may be considered to be best placed to meet any remediation and clean up costs associated with environmental issues arising on the property.[435] Other legislation imposes responsibilities on the owner as distinct from those of any occupier. In the Water Services Act 2007,[436] s.70(2) requires the owner of a premises to ensure that all "drains, manholes, gullytraps

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[429] Section 78F(4) Environmental Protection Act 1990.

[430] Class B liability. In 1994 therefore when the Midland Bank took possession of a mortgagor's property it became an "occupier" of that property and was forced to clean up 13,000 car tyres which had been illegally dumped by the mortgagor in contravention to the EPA. The case is referred to in Lee, R., "Contaminated Land and Secured Lending: Midland Bank Clean Up" (1995) 14(1) *International Banking and Financial Law* 1-2 at 1 and Richardson, Benjamin J. Environmental liability and banks: recent European developments, note 424, at 292.

[431] See for example; Section 2 Water Services Act 2007, European Communities (Drinking Water) Regulations 2007 (S.I. No. 106/2007), Section 52 Protection of the Environment Act 2003, Section 2 Planning and Development Act, 2000, and Section 2 Derelict Sites Act, 1990.

[432] In the Scottish case of *Northern Rock Building Society v Wood* 1990 S.L.T. (Sh. Ct.) 109 the Sheriff Court of South Strathclyde, Dumfries and Galloway at Ayr held that a charge holder who assumed possession of property could not be held liable as "owner in possession" as the bank was a charge holder, not owner of the property.

[433] Protection of the Environment Act 2003 (Number 27 of 2003).

[434] Section 2 Protection of the Environment Act 2003.

[435] Hooley, Richard, "Lender liability for environmental damage", (2001) 60(2), *Cambridge Law Journal*, 405-417 at 405.

[436] Water Services Act 2007 (Number 30 of 2007).

and storage and treatment systems for waste water" are maintained.[437] As the duties imposed by s.70(1) of that Act are directed at the occupier of the property, the unambiguous reference to "owner" in s.70(2) could impose liability on an Islamic financier that has retained ownership of the property, even when that property is leased.

On default of the customer in an Islamic transaction, the financier can enforce its security (in *murābaha*) or determine the lease (in lease-to-own structures). If the financier assumes possession of the property it will become not just owner but occupier of the property, in a manner similar to a mortgagee in possession. From this point it will be directly liable, as occupier, for any legislative breaches which it causes and potentially those already existing on the property.[438]

b. Mechanisms for Alleviating (but not excluding) Liability

Lender liability is not an issue which can be easily resolved. Providing an exemption from owner-based liability specifically for financiers in Islamic arrangements could be seen as conferring on Islamic activity, benefits which are not offered to other market participants; conventional mortgagees are excluded from ownership liability because legally they do not own the property whereas the financier in an Islamic arrangement does. In light of the potential policy concerns involved in exempting a particular "type" of legal owner from environmental responsibilities, Ireland should not attempt to makes special provision for property-owning financiers. The increased due diligence which this liability will necessitate is an unavoidable consequence of the Islamic financier's ownership of the property. In order to reduce the economic impact of liability, the financier could obtain indemnities from the customer for the costs incurred as a result of any legislative violation by the customer.[439] While this approach could be criticised as reducing the financier's ownership risks (contrary to the principles of Islamic law), any guarantees given by the customer would act as protection for the financier from the activities of another party, not

[437] Section 70(2) Water Services Act 2007. Section 2(1) of the Act contains an exception from the definition of owner for "mortgagees not in possession."

[438] Egede, Tamara and Lee, Robert, "Bank lending and the environment: not liability but responsibility", note 424, at 876 noting that "where this [polluting] person cannot be found, responsibility will revert to the owner of the land. It follows that banks will not wish to find themselves as a mortgagee in possession of land, once such a company is in insolvency--and hence cannot be 'found'."

[439] Richardson, Benjamin J. "Environmental liability and banks: recent European developments", note 424, at 294 suggesting a similar move in conventional financial institutions as a reaction to the closer scrutiny paid to financial institutions and their influence over the environmentally questionable activities of their borrowers.

its own breaches or its own failure to exercise ownership responsibilities to an adequate standard.

The financier in an Islamic arrangement also must not be exempted from environmental/planning legislation where that financier goes into possession of the property. No such exemption applies to banks in conventional mortgages. Indeed, the exemption from liabilities for "mortgagees not in possession" suggests that mortgagees *in* possession will not be protected from liability by any carve-outs.[440] To exempt only institutions offering Islamic products from occupier-based liability would not only confer a clear benefit on Islamic finance arrangements but would result in gap in the protections offered by Irish law as it would create pockets of immunity around certain types of occupiers.

In practice, the potential liability of Islamic financiers in real estate financing transactions is likely to be less significant than it initially appears. While *murābaha*, *ijārah wa-iqtina* and diminishing *mushāraka* involve ownership of real property by the financier, the vast majority of statutory liability is directed at the party in occupation or in control of the property when a violation of the law occurs.[441] Subject to adequate indemnities being obtained from the customer, where the financier does not cause or does not authorise a violation of Ireland's planning or environmental laws, it seems relatively unlikely that they, rather than the actual violator, would ultimately be held financially responsible.

7.4 Conclusion to Chapter 7

While often garnering less publicity than some other aspects of Islamic finance, such as *Sharī'ah*-compliant funds and *sukūk*,[442] Islamic real estate financing is a key aspect of the Islamic finance sector and is of direct interest to retail customers and wholesale clients. Like many transactions designed to comply with the teachings of Islam, real estate

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[440] *Maguire v Leigh on Sea UDC* (1906) 95 L.T. 319. See also, Egede, Tamara and Lee, Robert, "Bank lending and the environment: not liability but responsibility", note 424, at 876.

[441] Gill, Garrett P., "Environmental Law and its Implications in Property Transactions", (1996) 3(3) *Irish Planning and Environmental Law Journal* 108-113 at 113, noting a trend towards "polluter pays." Discussing conventional lender liability, Egede, Tamara and Lee, Robert, "Bank lending and the environment: not liability but responsibility", note 424, at 883 note that, "[d]irect liability has not proven common and can be avoided with good advice. Indirect impacts in terms of a customer's ability to service obligations or reductions in the anticipated value of security interests are considerably more problematic," this observation could, it is suggested, also be applied to Islamic real estate financings.

[442] *Sukūk* arrangements are considered in detail *infra.* Chatpers 8 and 9.

acquisitions, developments and refinancings which avoid interest must follow a structure which is incompatible with the conventional understanding of a mortgage and the legislative provisions designed specifically for mortgages. While participants in an Islamic real estate financing transaction may be directed by similar motivations to their conventional counterparts and the ultimate effect of these transactions will be the customer's purchase or development of immovable property which would not otherwise have been financially possible, the structure of Islamic contracts prevents them from being seamlessly interchangeable with mortgages in terms of their classification, the rights of the parties and their taxation.

This Chapter has reached a number of conclusions on the likely legal treatment of Islamic real estate financings in Ireland and has proposed amendments to Ireland's taxation and property-related laws. *Murābaha* real estate financing transactions can generally be subsumed into established legislation dealing with secured property lending; it is likely therefore, that such arrangements would be classified as "mortgages" in Ireland. While the taxation of such arrangements may have been more onerous than that applying to conventional mortgages, the 2010 accommodations have gone some way towards alleviating this fiscal hurdle. As a result, *murābaha* arrangements, if offered in Ireland, may be subject to similar legal treatment as conventional mortgages.

Ijārah wa-iqtina and diminishing *mushāraka* arrangements create a conflict between Islamic teachings and the principles of Irish law. Like *murābaha* transactions, *ijārah wa-iqtina* and diminishing *mushāraka* contracts have been the subject of fiscal accommodations. However, these accommodations have not been entirely satisfactory and *ijārah wa-iqtina* arrangements, in particular, continue to be subject to anomalous taxation. It is also unlikely that *ijārah wa-iqtina* and diminishing *mushāraka* will be classified as mortgages under Ireland's property laws and will, instead, be treated as leases. This could raise some consumer protection issues due to the lower level of regulatory oversight in leasing arrangements. This Chapter has proposed tailored amendments to Ireland's existing legal framework which could increase regulation of Islamic real estate financing structures and ensure a comparable level of consumer protection as that available in conventional mortgages. At the same time, these proposed amendments do not disregard the structure of Islamic real estate financing products and conclude that in certain circumstances, the structure of Islamic products will, and should, result in legal treatment which is distinct from that imposed on secured property loans.

Similar taxation and classification problems arise in a range of other Islamic structures such as *sukūk*, considered in Chapters 8 and 9. *Sukūk* transactions could function as a means of developing a secondary market in Islamic real estate transactions and consequently represents an aspect of the Islamic financial system which is complementary to the development of a *Sharī'ah*-compliant real estate sector.

Chapter 8

Introduction to *Sukūk* Structures

8.1 Introduction

As the Islamic banking industry matures internationally, market participants are looking to the capital markets, composed of the debt and equity markets, as an alternative or supplement to more traditional forms of resource mobilisation, such as depositing with, and lending from, a bank.[1] Noting that the

> ...emergence of a distinct Islamic capital market, where investment and financing activities and products are structured in accordance with *Shariah* principles, is...the outcome of a natural progression in the growth of the Islamic financial services industry,[2]

the International Organization of Securities Commissions [IOSCO] has highlighted the potential applicability of traditional *Sharī'ah* principles to more complex, global financial transactions. Islamic capital market activity has the potential to offer Islamic market participants a means of managing resources and mobilising large-scale funding in excess of that available through ordinary bank lending.[3] Equally, these markets may facilitate more effective liquidity management by Islamic financial institutions, by providing an

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[1] Askari, Hossein, Iqbal, Zamir and Mirakhor, Abbas, *Globalization and Islamic Finance; Convergence, Prospects and Challenges*, (John Wiley and Sons (Asia) Ptd. Ltd., Singapore, 2010), at 139.

[2] International Organization of Securities Commissions, *Report of the Islamic Capital Market Task Force of the International Organization of Securities Commissions*, (IOSCO, July 2004), at 27, available at: http://www.iosco.org/library/pubdocs/pdf/IOSCOPD170.pdf.

[3] Ali, Salman Syed, "Islamic Capital Markets: Current State and Developmental Challenges", in *Islamic Capital Markets; Products, Regulation and Development*, Salman Syed Ali (ed.), (IRTI Seminar Proceedings, Jeddah, 2008), 1-22 at 1, Anwar, Muhammad, "An Islamic Perspective on Capital Markets and 'Islamic' Securities in Malaysia, (Winter 1995) 34:4 Part II, *The Pakistan Development Review*, 865-878 at 865.

opportunity to invest excess capital as well as to access funding.[4] Structured around the nominate contracts,[5] the legal form of these *Sharī'ah*-compliant capital market products is often innovative. This presents domestic authorities and international standard setting organisations with the challenge of determining how these financial products interact with existing legal principles.[6] In order to maintain effective legal, taxation and regulatory oversight, financial authorities in both Muslim and non-Muslim countries have taken steps to address the position of *Sharī'ah*-compliant capital market instruments within their legal and financial systems.[7] One such instrument, the *sukūk*, will be considered in this Chapter and in Chapter 9.

As will be discussed in Chapter 9, accommodations introduced by the Finance Act 2010 relating to structures similar to *sukūk* (Islamic trust certificates often referred to as "Islamic bonds"),[8] suggest that Ireland is moving to facilitate not simply the direct lending found in Islamic banking, but also the more multifaceted rights and obligations of *Sharī'ah*-compliant capital market activity.[9] Following global economic uncertainty, to which *sukūk* have been subject,[10] as well as concerns over the *Sharī'ah* legitimacy of certain practices,[11] *sukūk* issuances fell in 2008.[12] However, there are now indications that the market is

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[4] Robbe, Jan Job de Vries, Ali, Paul A. U., *Securitisation of Derivatives and Alternative Asset Classes: Yearbook 2005*, (Kluwer Law International, The Hague, 2005), at 367, Obaidullah, Mohammed, "Securitization in Islam", in *Handbook of Islamic Banking*, M. Kabir Hassan and Mervyn K Lewis, (ed.), (Edward Elgar, Cheltenham, 2007), 191-199 at 193 discussing the importance of liquidity in Islamic financial activity.

[5] AAOIFI, Shari'a Standard No. (17), "Investment Sukuk", in *Shari'a Standards for Islamic Financial Institutions 1432 H-2010*, (AAOIFI, Bahrain, 2010), 303-323 at 321, International Organization of Securities Commissions, *Analysis of the Application of the IOSCO's Objectives and Principles of Securities Regulation for Islamic Securities Products*, (IOSCO, September 2008), at 7, available at:http://www.iosco.org/library/pubdocs/pdf/IOSCOPD280.pdf.

[6] Halawi, Adnan, "Slash Taxes, Spur Sukuk: Countries issuing Sukuk triple between 2005 and 2012 as countries slash taxes", *Zawya*, July 20, 2011, available at: http://www.zawya.com/story.cfm/sidZAWYA20110720052830/Slash-Taxes-Spur-Sukuk.

[7] *supra.* at 125 and 137, and, *infra.* at 327 and 355. Halawi, Adnan, "Slash Taxes, Spur Sukuk: Countries issuing Sukuk triple between 2005 and 2012 as countries slash taxes", note 6, outlining the various accommodating measures adopted in a number of different jurisdictions, Muslim and non-Muslim.

[8] Termed "investment certificates," Part 8A, Taxes Consolidation Act, as amended by s.39 Finance Act 2010. Defined *infra.* at 329

[9] Halawi, Adnan, "Slash Taxes, Spur Sukuk: Countries issuing Sukuk triple between 2005 and 2012 as countries slash taxes", note 6.

[10] Hijazi, Faisal, "Global Sukuk Issuance: 2008 Slowdown Mainly Due to Credit Crisis, But Some Impact from Shari'ah Compliance Issues", *International Structured Finance Special Report*, (Moody's Investors Service, New York, January 21, 2009), at 2.

[11] Maurer, Bill, "Form versus substance: AAOIFI projects and Islamic fundamentals in the case of sukuk", (2010) 1(1) *Journal of Islamic Accounting and Business Research*, 32-41. This issue is discussed in detail *infra.* at 311 et seq.

[12] Standard & Poor's notes that global sukuk issuances fell from a high of $34.3 billion in 2007 to $14.9 billion in 2008, Standard & Poor's, "Sukuk Issuance (2001-2009)", *Islamic Finance Outlook 2010*, (February 2010), at 9, available at: http://www2.standardandpoors.com/spf/pdf/media/Islamic_Finance_Outlook_2010.pdf.

starting to recover,[13] with Moody's suggesting that future growth in the *sukūk* market may not be limited to the traditional centres such as Malaysia and the GCC but will extend to accommodative western jurisdictions.[14] With global *sukūk* issuances now predicted to have reached, if not surpassed, 2007 levels,[15] Ireland's initial steps to facilitate *sukūk* activity are well timed. An emphasis on clarifying the tax position of market participants indicates that Ireland may be seeking to remove obstacles which hinder the origination and issue of Islamic securities domestically.[16]

As with Islamic real estate finance, *sukūk* in Ireland raise numerous legal issues which cannot all be dealt with in this thesis. Nevertheless, areas that have caused difficulty elsewhere will be addressed. Following the same structure used when considering Islamic real estate financings, discussion of *sukūk* in this thesis will take place in two chapters, one introducing *sukūk* structures and the second, considering those structures in the context of Irish law. This two chapter format is necessary due to the complexity and variety of *sukūk* structures available and the detail which is needed when discussing the interaction of those structures with Irish law.

This Chapter will look first to the development and definition of *sukūk* (8.2).[17] It will then explain a variety of *sukūk* structures, starting with a "generic" *sukūk* and progressing to those based on leases, *mudāraba* and *murābaha* contracts (8.3).[18] An explanation of these structures in this Chapter will facilitate discussion of *sukūk* arrangements in Chapter

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[13] KFH Research and NCB Capital, "Soaring Sukuk", (September 2010) 56 *Islamic Business and Finance*, available at: http://www.cpifinancial.net/v2/Magazine.aspx?v=1&aid=2441&cat=IBF&in=56.

[14] Kijazi, Faisal, "Global Sukuk Issuance Poised for Boost from New Legislative and Regulatory Initiatives", Moody's Investors Service, Report Number: SF196842, (April 2010), at 3, available at: http://v2.moodys.com/cust/content/content.ashx?source=StaticContent/Free%20Pages/Products%20and%20Services/Downloadable%20Files/Global%20Sukuk%20Faces%20New%20Legislative%20and%20Regulatory%20Initiatives.pdf, Goud, Blake, (2010) 1(1) *So Far*, 10-17 at 13.

[15] 2009 issuances totalled $23.3 billion, Standard & Poor's, "Sukuk Issuance (2001-2009)", note 12, at 9, 2010 global issuances reached $51.2 billion, Standard & Poor's, *Global Standards To Give Breadth And Depth To The Global Sukuk Market,* (March 1, 2011), available at: http://www2.standardandpoors.com/spf/pdf/media/Global_Sukuk_Market_01_Mar-11.pdf , for comments on 2011 sukuk issuances, see, Zeti Akhtar Aziz quoted in Parker, Mushtak, "Surge in global sukuk issuance revives investors' hopes", *Arab News*, February 27, 2011, available at: http://arabnews.com/economy/Islamicfinance/article289398.ece

[16] Khan, Omer, "Ireland to be Even More Islamic Finance Friendly", (Feb-2010) 7(7) *Islamic Finance News*, 19-20 at 20. The UK has also attempting to remove legal hurdles faced by parties to a *sukūk* issuance, see Ali, Yasmin, *Impact Assessment of Sukuk (Islamic Bonds) Legislation*, (HMRC, London, 2008), at 1, available at: http://www.hmrc.gov.uk/ria/ia-sukuk-legislation.pdf. See also the extended consideration of the issuance of sukuk by the UK Government, HM Treasury, *Government sterling sukuk issuance: a consultation*, (HM Treasury, London, November 2007), available at: http://webarchive.nationalarchives.gov.uk/+/http://www.hm-treasury.gov.uk/d/consult_sukuk141107.pdf.

[17] *infra.* at 298.

[18] *infra.* at 303.

9. Chapter 8 will then go on to consider the controversial issue of asset-backed and asset-based *sukūk* and criticisms of certain practices in the contemporary *sukūk* market (8.4).[19] It will be argued in this Chapter that while criticisms of the *sukūk* industry have not gone unheaded, there continues to be a preference within that industry for structures that replicate the substance of fixed-interest rate debt securities. Building upon this conclusion, Chapter 9 will consider the position of *sukūk* within the Irish legal system. Section 9.2[20] will look at *sukūk* in the context of Irish tax law, focusing specifically on the accommodations introduced by the Finance Act 2010. Section 9.3[21] will look at the potential regulatory status of *sukūk* if these certificates were to be issued and offered in Ireland.

8.2 Development and definition of *Sukūk*

8.2.1 Islam and the Conventional Capital Markets

Bringing together a diverse range of issuers and investors, the capital markets (conventional or otherwise) encourage the allocation of resources from those in surplus to those in deficit and provide a platform for sovereign and corporate entities to access funds without overreliance on the banking industry.[22] At the same time, these markets offer investment opportunities and risk diversification for banks, insurance companies, funds and retail investors.[23] Composed of a primary market, in which debt or equity instruments are issued by borrowers, and a secondary market, on which these products are traded, the capital markets facilitate the allocation of resources while reducing the concentration of risk faced by individual participants.[24] In an increasingly international market place, capital

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[19] *infra.* at 311.

[20] *infra.* at 326.

[21] *infra.* at 352.

[22] Benjamin, Joanna, *Financial Law,* (Oxford University Press, Oxford, 2007), at 172, Vishwanath, S.R. and Azmi, Sabahuddin, "An Overview of Islamic Sukuk Bonds", (2009) *The Journal of Structured Finance*, 58-67 at 58.

[23] Wilson, Rodney, "Innovation in the structuring of Islamic sukuk securities", (2008) 24(3) *Humanomics*, 170-181 at 170, 173, Anwar notes that as a process for channelling funds from surplus units to deficit units which is the major role performed by the capital markets is perfectly Islamic, Anwar, Muhammad, "An Islamic Perspective on Capital Markets and "Islamic" Securities in Malaysia", Part II, note 3, at 868. These borrowers include government and *supra*-national agencies, commercial companies and (in the case of securitisation), SPVs, Benjamin, Joanna, *Financial Law*, note 22, at 173.

[24] Ali, Salman Syed, "Islamic Capital Markets: Current State and Developmental Challenges", in *Islamic Capital Markets; Products, Regulation and Development*, note 3, at 1, Eichengreen, Mussa and Dell'Ariccia note however that informational asymmetries in the conventional capital markets can impact adversely upon the effectiveness of the resource allocation, Eichengreen, Barry J., Mussa, Michael and Dell'Ariccia, Giovanni, "Capital account liberalization: theoretical and practical aspects", *International Monetary Fund, Occasional Paper Number 172*, (IMF, Washington DC, 1998), at 12.

markets may also coordinate domestic and foreign capital and provide issuers with a larger investor base than may otherwise be available domestically.[25]

The contemporary capital markets were not founded with *Sharī'ah* principles in mind. From a regulatory and tax perspective at least, this has been largely unproblematic for the development of an Islamic equity market[26] as the trade in the shares of enterprises, which is found in the conventional equity market, aligns with the participatory nature of Islamic finance.[27] In contrast, several inconsistencies arise between Islamic financial principles and the mainstream debt market.

The very nature of a bond appears contrary to the teachings of Islamic law. Representing a medium to long-term debt obligation under which the issuer of the bond undertakes to pay interest and principle to bondholders on specified dates, conventional bonds are similar in economic effect to interest-based loans.[28] Like a loan, periodic payment of interest and the ultimate repayment of principal will depend more on the creditworthiness of the borrower than the performance of any underlying asset.[29] Indeed

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[25] Ali, Salman Syed, "Islamic Capital Market Products: Developments and Challenges", *Islamic Development Bank Group, Islamic Research and Training Institute, Occasional Paper No. 9*, (IRTI, Jeddah, 2005), at 2.

[26] Gray, Robert and Ismail, Arshad, "Regulating Islamic Capital markets" in *Islamic finance: the regulatory challenge*, Simon Archer and Rifaat Ahmed Abdel Karim (eds.), (John Wiley & Sons (Asia), Singapore, 2007), 282- 292 at 287 noting that; "the concept of shares is in essence not repugnant to the principles of *Shari'ah* and there is therefore no need to establish an independent set of rules and regulations to regulate compliant shares."

[27] Provided those companies are acting in a *Sharī'ah*-compliant manner, discuseed *supra.* at 62. Ayub, Muhammad, *Understanding Islamic Finance*, (John Wiley & Sons Ltd., Chichester, 2007), at 390, Ali, Salman Syed, "Islamic Capital Market Products: Developments and Challenges", note 25, at 24, Askari, Hossein, Iqbal, Zamir and Mirakhor, Abbas, *Globalization and Islamic Finance; Convergence, Prospects and Challenges*, note 1, at 139 noting that the initial focus in the Islamic capital markets was equity-based fund management. See also, Askari, Hossein, Iqbal, Zamir, Krichene, Noureddine and Mirakhor, Abbas, *The Stability of Islamic Finance; Creating a Resilient Financial Environment for a Secure Future*, (John Wiley and Sons (Asia) Ptd. Ltd., Singapore, 2010), at 123 noting that; "[w]ith the prohibition on interest and the preference to share profits and losses, equity markets hold a significant place in an Islamic financial system. Therefore, Islamic scholars have pointed out the necessity, desirability and permissibility of the existence of a stock market in the Islamic financial system..."

[28] Bratton, William, *Corporate Finance: Cases and materials*, (5th ed., Fountain Press, New York, 2003), at 175. The Council of the Islamic Fiqh Academy has described conventional debt securities as 'a certificate by which its issuer undertakes the liability of paying its face value to the bearer on its maturity along with an agreed interest relating to its value or to a pre-determined profit, either in lump-sum or as a discount or in the form of prizes to be distributed on the basis of ballot.' Resolution No. (60/11/6) issued at the sixth session of the Council of the Islamic Fiqh Academy held in Jeddah, Kingdom of Saudi Arabia, March 14th-20th 1990, "Concerning 'Bonds,'" *Resolutions and Recommendations of the Council of the Islamic Fiqh Academy 1985-2000*, (Islamic Development Bank, Jeddah, 2000). See also, Wilson, Rodney, "Overview of the sukuk market", in *Islamic Bonds: Your Guide to Issuing, Structuring and Investing in Sukuk – Overview of the sukuk market*, Nathif J. Adam and Abdulkader Thomas, Nathif J. Adam (eds.), (Euromoney Books, London, 2005) 3-17 at 5.

[29] Hjh Siti Faridah Abd Jabbar, "Sharia-compliant instruments: Principles and practice", (2009) 30(6), *Company Lawyer* 176-188 at 184.

many conventional debt securities do not need to demonstrate a discernable link to any underlying asset, much less a tangible one.[30] Once issued, these securities may be freely traded at a price negotiated by the parties or determined by the market.[31] As the certificates do not confer on the borrower rights of ownership in specified assets, the trade of these instruments on the secondary market simply involves the transfer of an existing debt obligation from one party to another.[32] The price paid for the paper on transfer will vary in line with the perceived ability of the issuer to make payments and speculation on the potential movement of market interest rates, not the value of any related asset.[33]

Resembling unsecured lending, the interest-bearing nature of conventional bonds and their fixed, assured return indicate that investors are being compensated for the money which they have invested, contrary to the prohibition of *ribā*.[34] This *Sharī'ah*-incompatibility is further reinforced by the indistinct and potentially *haram* nature of the assets and activities of the bond issuer. As the ultimate use of the capital raised through the bond issuance is relatively[35] inconsequential to the economic attractiveness of the bond, the activities of the borrower may be subject to less scrutiny and thus not provide Islamic investors with an assurance that their investment will be used in a *halal* manner. Finally, while tradability is an important attribute of many bond issues, Islamic principles dictate that debt can only legitimately be traded at par value since any profit earned by either party

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[30] Wilson, Rodney, "Overview of the sukuk market", in *Islamic Bonds: Your Guide to Issuing, Structuring and Investing in Sukuk – Overview of the sukuk market*, note 28, at 5. This development is however comparatively recent. Contrast Viscount Cave in *Singer v Williams* [1921] 1 AC 41 at 49 who noted that; "[t]he word [securities] denotes a debt or claim the payment *of which is in some way secured*. The security would generally consist of a right to resort to some fund or property for payment; but I am not prepared to say that other forms of security (such as personal guarantee) are excluded. In each case, however, where the word is used in its normal sense, some form of secured liability is postulated,' with the more recent affirmation by the UK courts that no underlying asset was needed; 'the phrase "the debt on a security" is not a synonym for a secured debt." See also, *The Cleveleys Investment Trust Company (Unlimited) v Inland Revenue*, 1971 S.C. 233, per Lord Cameron at 243.

[31] Akkizidis, Ionnis and Khandelwal, Sunil Kumar, *Financial Risk Management for Islamic Banking and Finance*, (Palgrave Macmillan, Hampshire, 2008), at 23.

[32] Benjamin, Joanna, *Financial Law*, note 22, at 173.

[33] Wilson notes that the aim of bond traders is generally to make a capital gain as fixed-interest bond prices rise on the secondary market when variable interest rates fall; bond trading therefore involves little more than interest rate exploitation which is unconnected with the value of any underlying asset. Wilson, Rodney, "Overview of the sukuk market", in *Islamic Bonds: Your Guide to Issuing, Structuring and Investing in Sukuk – Overview of the sukuk market*, note 28, at 5, Askari, Hossein, Iqbal, Zamir, Krichene, Noureddine and Mirakhor, Abbas, *The Stability of Islamic Finance; Creating a Resilient Financial Environment for a Secure Future*, note 27, at 122.

[34] Papazian, Armen V., (2010) 1(1) *So Far*, 19-22 at 21.

[35] Admittedly, the nature of the originator generally could have an influence on the willingness of investors to purchase bonds issued and so, for example, those opposed to armaments for purely secular reasons may choose not to invest in bonds originated by a weapons manufacturer. However, generally, the precise use of the funds raised will have little tangible impact on the economic attractiveness of the bonds issued.

would represent return on the use of money alone.[36] As the secondary bond market relies on the trading of debt obligations, restricting trade to par value transactions would significantly undermine the attractiveness of this market.

These *haram* aspects of interest-based bonds have limited the ability of Islamic finance participants to freely deal with debt securities such as bonds.[37]

8.2.2 *Sukūk* - An Islamic Alternative to Conventional Bonds

As bonds provide a fixed-income means of resource mobilisation in the conventional markets, it is unsurprising that the Islamic financial sector would attempt to replicate these instruments in a manner which complies with *Sharī'ah* dictates.[38] *Sukūk*,[39] while often classified as "Islamic bonds,"[40] are more accurately defined as investment certificates which evidence a holder's ownership interest in an underlying asset, transaction or venture and share characteristics of unsecured debt securities, asset-backed securities and equity investment, but are not easily subsumed under any of these concepts.[41]

Based on the *Qur'ānic* recommendation that contracts be reduced to writing,[42] the Islamic Fiqh Academy has acknowledged the permissibility of evidencing a collection of

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[36] Ayub, Muhammad, *Understanding Islamic Finance*, note 27, at 389.

[37] McMillen, Michael J.T., "Asset Securitization Sukuk and Islamic Capital Markets: Structural Issues in These Formative Years", (2007-2008) 25(4) *Wisconsin International Law Journal* 703-772 at 706 noting that; "Shariah-compliant access to the 'debt' capital markets (as opposed to the equity capital markets) was a more difficult accomplishment." Cox, Stella, "Developing the Islamic Capital Market and Creating Liquidity", (2005) 9(1) *Review of Islamic Economics*, 75-86 at 76, Iqbal, Munawar and Molyneux, Philip, *Thirty Years of Islamic Banking; History, Performance and Prospects*, (Palgrave Macmillan, Hampshire, 2005), at 133-4.

[38] Askari, Hossein, Iqbal, Zamir and Mirakhor, Abbas, *Globalization and Islamic Finance; Convergence, Prospects and Challenges*, note 1, at 139.

[39] *Sukūk* is the plural of *sakk* which has been translated from ancient Arabic as meaning "to strike" or "to hit" and represents today the certificates issued by the issuer, McMillen, Michael J. T., "Islamic capital markets: developments and issues", (2006) 1(2), *Capital Markets Law Journal*, 136-172 at 163.

[40] Owens, Ken and Khan, Omer, *The Sukuk, a catalyst for the growth of Islamic Finance*, (Dublin, PriceWaterhouseCoopers, January 2009), at 1, available at: http://download.pwc.com/ie/pubs/PwC_Sukuk_Flyer_Advisory_Jan09.pdf.

[41] AAOIFI, Shari'a Standard No. (17), "Investment Sukuk", in note 5, at 307, Gassner, Michael Saleh, "Revisiting Islamic Bonds", (March 2008) *Business Islamica*, 22-23 at 23.

[42] *Qur'ān* 2:282 which notes that: "O ye who believe! When ye deal with each other, in transactions involving future obligations in a fixed period of time, reduce them to writing... Disdain not to reduce to writing (your contract) for a future period, whether it be small or big: it is juster in the sight of God, more suitable as evidence, and more convenient to prevent doubts among yourselves. But if it be a transaction which ye carry out on the spot among yourselves, there is no blame on you if ye reduce it not to writing." As Schacht commented; 'Documents (sakk) fulfil no role whatsoever; there are no transactions for which a written format is prescribed.' Schacht, Joseph, G. *Bergsträsser's Grundzüge des Islamischen Rechts*, (Berlin, 1935), at 113, in Udovitch, Abraham L., *Partnership and Profit in Medieval Islam*, (Princeton University Press, Princeton, 1970), at 86.

Sharī'ah-compliant transactions in a written instrument.[43] This ruling has legitimated the concept of a note which represents an interest in an underlying asset. More recently, AAOIFI has defined "investment *sukūk*" as

> ...certificates of equal value representing undivided shares in ownership of tangible assets, usufruct, and services or (in the ownership of) the assets of particular projects or special investment activity.[44]

Unlike conventional (secured or unsecured) bonds, *sukūk* do not denote a debt owed by the issuer,[45] but rather the proportionate ownership rights of the holder in an asset or investment activity.[46] This ownership entitles the holder to receive returns which are, to a greater or lesser extent, based on the revenue generated by the underlying asset.[47] At the same time, the risks associated with that ownership should also be borne by the investors, who share any losses in proportion to their investment.[48] In line with the religious prohibition of uncertainty and *haram* industries, *sukūk* must relate to an identifiable asset or specific activity which complies with the sectoral screening inherent in *Sharī'ah* financial activity.[49]

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[43] The Fiqh Academy noted that the *Qur'ān* encourages documentation of contracts (*Qur'ān* 2:282)which led them to rule in 1988 that any collection of assets can be represented in a written note or bond and that this bond or note can be sold at market price provided that the composition of the groups of assets, represented by the security, consists of a majority of physical assets and financial rights, with only a minority being cash and interpersonal debts, in Wilson, Rodney, "Overview of the sukuk market", in *Islamic Bonds: Your Guide to Issuing, Structuring and Investing in Sukuk – Overview of the sukuk market*, note 28, at 4-5.

[44] AAOIFI, Shari'a Standard No. (17), "Investment Sukuk", note 5, at 307, (bracked comments in original). See also; IFSB, *Capital Adequacy Requirements for sukūk, securitisations and real estate investment*, (Standard No. 7, January 2009), at 3, which defines *sukūk* as *Sukūk* (plural of *sakk*), frequently referred to as "Islamic bonds", are certificates with each *sakk* representing a proportional undivided ownership right in tangible assets, or a pool of predominantly tangible assets, or a business venture ...These assets may be in a specific project or investment activity in accordance with Sharī'ah rules and principles."

[45] AAOIFI, Shari'a Standard No. (17), "Investment Sukuk", note 5, at 309.

[46] See McMillen noting that sukuk are "certificates of equal value put to use as common shares and rights in tangible assets, usufructs, and services, or as equity in a project or investment activity," McMillen, Michael J.T., "Contractual Enforceability Issues: Sukuk and Capital Markets Development", (2007) 7(2) *Chicago Journal of International Law*, 427-467 at 429, Hanif, Atif, "Islamic Finance – an overview," (2008) 1 *International Energy Law Review*, 9-15 at 13, Adam, Nathif J., "Islamic fixed-income securities: Sukuk", in *Islamic Asset Management: Forming the Future for Shari'a-Compliant Investment Strategies*, (Euromoney Books, London, 2006) 72-81 at 72, Al-Amine, Muhammad al-Bashir, "The Islamic Bonds Market: Possibilities and Challenges", (2001) 3(1) *International Journal of Islamic Financial Services* at 5 (when discussing *ijārah sukūk* , at 8 (when discussing *mudāraba sukūk*) available at: http://www.iiibf.org/journals/journal9/albashir.pdf , Jobst, Andreas A., "The Economics of Islamic Finance and Securitization", note 75, at 19.

[47] Hjh Siti Faridah Abd Jabbar, "Sharia-compliant instruments: Principles and practice", note 29, at 184.

[48] Ayub, Muhammad, *Understanding Islamic Finance*, note 27, at 390, AAOIFI, Shari'a Standard No. (17), "Investment Sukuk", note 5, at 310, Schoon, Natalie, *Islamic Asset Management; An Asset Class on its Own?*, (Edinburgh University Press, Edinburgh, 2011), at 43.

[49] McMillen, Michael J.T., "Asset Securitization sukuk and Islamic Capital markets: Structural Issues in these Formative Years", note 37, at 740, Piper, Nathan, "Assessing the Potential for Shari'ah-Compliant Project Finance in India", (2009) 47 *Colombia Journal of Transnational Law*, 418-445 at 433.

8.3 *Sukūk* Structures

8.3.1 The Generic *Sukūk* Structure

The AAOIFI definition of *sukūk*, permutations of which are consistently used by commentators, represents the "ideal" form of Islamic investment certificate. As will be discussed below, concerns have arisen over the extent to which certain types of *sukūk* comply not simply with the letter of Islam, but also with its spirit and underlying objectives.[50]

Without a clear description of *sukūk* in the sources of Islam, the practical application of *Sharī'ah* dictates in the context of a capital market product will inevitably be a matter of some interpretation. Nevertheless, the AAOIFI definition of *sukūk*, together with market practice and the need to develop a viable capital market product, have resulted in certain core characteristics of *sukūk* issuances being largely replicated across *sukūk* structures.[51] An originator, which may be a corporate, sovereign or financial entity,[52] commonly establishes a special purpose vehicle [SPV] as a separately incorporated (and often bankruptcy remote) company or a trust.[53] While an originator could issue *sukūk* directly, by ring-fencing assets or a particular project and then issuing certificates evidencing interest in those assets, the multi-layered approach to *sukūk* issuance has emerged as standard practice[54] in a number of contemporary *sukūk* transactions.[55] Using an SPV as an

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[50] *infra.* at 311, Warde, Ibrahim, *Islamic Finance in the Global Economy*, (2nd ed., Edinburgh University Press, Edinburgh, 2010), at 151.

[51] Shoon, Natalie, *Islamic Asset Management; An Asset Class on its Own?*, note 48, at 44-45 also outlining a "generic" sukuk structure.

[52] Askari, Iqbal and Mirakhor have suggested that corporates, as opposed to sovereign entities have more tangible assets which can underpin the issue of a sukuk. Bloomberg noted in 2010 that yields on sovereign sukuk were higher than those of corporate sukuk (Qayum, Khalid and Yong, David, "Sovereign Sukuk Beating Company Debt First Time Since May: Islamic Finance", Bloomberg, August 25, 2010, available at: http://www.bloomberg.com/news/2010-08-24/sovereign-sukuk-beating-company-debt-first-time-since-may-Islamic-finance.html) and while Parker (quoting Jamil el-Jaroudi) has indicated that the sukuk market is currently dominated by sovereign issuances, "[p]erhaps in 2012, corporate issuances will start equaling origination activity in the sovereign market" Parker, Mushtak, "Fragile sukuk market clamors for sovereign issuances", *Arab News*, May 22, 2011, available at: http://arabnews.com/economy/Islamicfinance/article422352.ece.

[53] Obaidullah suggests that the SPV could also act as an agent (*wakil*) on behalf of all the sukuk investors which are organised as a musharaka company, Obaidullah, Mohammed, "Securitization in Islam", in *Handbook of Islamic Banking*, note 4, at 194, Akhtar, Zia, "Stakeholding in Sharia compliant assets and investor protection", (2011) 26(7) *Journal of International Banking Law and Regulation*, 362-367 at 362.

[54] By establishing a single purpose SPV with no obligations other than those relevant to the sukuk, the risk of insolvency is reduced thus increasing the attractiveness of the sukuk to investors. Richard, Kristel, "A closer look at ijarah sukuk," (March 2005) *Banker Middle East*, 1-5 at 5.

[55] Hassan, Hussein and Irfan, Harris, "Instruments for Islamic Issuers", in *Euromoney Encyclopedia of Debt Finance*, Tony Rhodes, (ed.)(Euromoney Institutional Investor Plc., London, 2006), 124-133 at 126.

intermediary establishes two distinct relationships in *sukūk* transactions, one between the investors and the SPV and another between the SPV and the originator. The interaction between SPV and the investors is, it is suggested, similar[56] to that of a *mudāraba* contract with the investors providing the capital and the SPV using its expertise to invest that capital.[57] The manner in which the SPV interacts with the originator will vary according to the nominate contract used to create the financial obligation.[58] Once established, the SPV issues certificates (the *sukūk*) to investors who purchase those certificates and transfer the purchase price to the SPV. The SPV declares a trust in favour of the investors over those proceeds and any assets purchased with them.[59] The proceeds are used to purchase income generating *Sharī'ah*-compliant assets giving the *sukūk* holders an interest in (or even beneficial ownership of)[60] the underlying assets in proportion to their initial investment.[61] As a result of this interest, the revenue produced by these assets is used to pay the *sukūk* holders.[62] As a single purpose entity, the SPV will generally sub-contract any duties it has to third-party service providers which frequently include the originator.[63] Like a conventional bond, these investment certificates allow investors to contribute fractionally

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See for example the Dana Gas Sukuk which is a *Sukuk al-Mudaraba* due in 2012. Dana Gas (the originator) is a public joint stock company located in Abu Dhabi, the issuer however is a limited liability company established in Jersey (Dana Gas Sukuk Limited), see offering circular of this sukuk, available at: http://www.londonstockexchange.com/specialist-issuers/Islamic/danagas-prospectus.pdf. However, in countries such as Pakistan, SPVs cannot obtain title to tangible assets and so sukuk in Pakistan have been limited to private placements amongst institutional investors and banks, Khan, Afaq, "Development of Sukuk in Pakistan", in *Collaborative Sukuk Report*, Paul McNamara (ed.), (Zawya, Dubai, 2010), 14-15 at 14

[56] Even if the SPV is not actually set up as a *mudāraba* company, the nature of the relationship appears to share characteristics of *mudāraba* arrangements.

[57] Vogel, Frank E. and Hayes, Samuel.L., *Islamic Law and Finance, Religion, Risk and Return.* (The Hague, Kluwer Law International, 1998), at 174-175 noting that "investment securities take the form of interests in companies which in turn own the investment. The natural vehicles for such ownership in Islamic law are mudaraba or musharaka companies." Vogel and Hayes go on to confirm the validity of such an arrangement suggesting that "[scholars] began to see securities representing capital interests in mudaraba partnerships as reflecting not personal partnership interests but shares in the ownership of the enterprise. Ownership of the enterprise is in turn equated with ownership of the company's 'assets.'" See also Suanmugam, Bala and Zahari, Zaha Rina, *A Primer on Islamic Finance*, (Research Foundation of the CFA Institute, 2009), at 48. Obaidullah, Mohammed, "Securitization in Islam", in *Handbook of Islamic Banking*, note 4, at 194.

[58] The nominate contracts are discussed *supra.* at 69. This point will be developed below when each *sukūk* form is discussed separately. However, as an illustration, a Malaysian Sovereign sukuk, issued by an SPV established by the Federal Lands Commissioner of Malaysia, involved the SPV entering into an ijārah contract with the Malaysian government to lease underlying land for the duration of the sukuk, for a more detailed discussion of this sukuk see, Wedderburn-Day, A. Roger, "Sovereign Sukuk: Adaptation and Innovation", (Fall 2010) 73 *Law and Contemporary Problems*, 325-333 at 327.

[59] Duncan, Michael, Desai, Bimal, Rieger, Julie, "Islamic Bankers Take Role on International Projects", (2004) 23 *International Financial Law Review*, 52-54 at 54 also outlining a generic sukuk structure and contrasting this structure from a conventional bond issuance.

[60] This point is discussed below, *infra.* at 311.

[61] Oldridge, David, "Islamic Finance", (2010) 7 *Inter Alia*, 91-95 at 93.

[62] Wilson, Rodney, "Innovation in the structuring of Islamic *Sukuk* securities", Paper presented at the Lebanese American University, 2nd Banking and Finance International Conference, Islamic Banking and Finance, Beirut, February 23-24, 2006.

[63] Abu Jabbar, Hjh Siti Faridah, "Sharia-compliant instruments: Principles and practice", note 29, at 184.

to the funding needs of an originator. However, the connection between the certificate holders and an identifiable asset distinguishes the structure of *sukūk* from pure, interest-based, unsecured debt financing.[64]

Notwithstanding this generalised structure, the practicalities of individual *sukūk* issuances will be determined by the underlying contractual basis on which the assets are transferred and income generated.[65] Unlike a bond, which simply relies on a loan contract to generate indebtedness, *sukūk* transactions impose the generic *sukūk* framework over a variety of *Sharī'ah*-compliant contracts, with the relationship between the parties and the manner of payment varying according to the type of contract used.[66] This structural flexibility is highlighted by the fact that AAOIFI has set out standards for fourteen different types of *sukūk* structures.[67] In line with the contracts available in *Sharī'ah*-compliant financings, three broad categories of *sukūk* are most commonly used: tangible-asset-based (*ijārah*), equity-based (*mushāraka* and *mudāraba*) and debt-based (*murābaha, salaam, istisnā'*).[68]

This section will outline the key characteristics found in each of the three categories - asset based (*ijārah sukūk*)(A),[69] equity-based (*mudāraba sukūk*)(B)[70] and debt-based (*murābaha sukūk*)(C).[71] The aim of this discussion is not to give a comprehensive account of every *sukūk* structure, but rather to give an overview of how the nominate contracts can be used in the issuance of *sukūk*.

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[64] Goldlewski, Christophe J., Turk-Ariss, Rima, Weill, Laurent, *Are Islamic Investment Certificates Special? Evidence on the Post-Announcement Performance of Sukuk Issues*, (Université de Strasbourg, Laboratoire de Recherche en Gestion & Economie, Working Paper 2010-05, April 2010), at 6.

[65] International Organization of Securities Commissions, *Analysis of the Application of the IOSCO's Objectives and Principles of Securities Regulation for Islamic Securities Products*, note 5, at 13.

[66] International Organization of Securities Commissions, *Report of the Islamic Capital Market Task Force of the International Organization of Securities Commissions*, note 2, at 35.

[67] AAOIFI, Shari'a Standard No. (17), "Investment Sukuk", in note 5, at 307-309 sets out rules relating to: *Sukūk* al-*Ijārah*, *Sukūk* al-*Musharaka*, *Sukūk* al-*Mudaraba*, *Sukūk* al-Salam, *Sukūk* al-Istisna'a, *Sukūk* al-Murabaha, *Sukūk* al-Istithmar, *Sukūk* al-Wakala, *Sukūk* al-Manfa'a, *Sukūk* al-Muzara'a, *Sukūk* al-Musaqa, *Sukūk* al-Mugharasa. For a detailed explanation of all of these variations on the *sukūk* framework see; Dubai International Financial Centre, *Sukuk Guidebook*, (DIFC, Dubai, 2009).

[68] Mohammed, Anzal and Kianfar, Sahar, "School of Sharia", (2007) 66 *European Lawyer*, 32-34 at 33.

[69] *infra.* at 306.

[70] *infra.* at 307.

[71] *infra.* at 309.

8.3.2 Variations between *Sukūk* Structures

A. Lease-Based *Sukūk* (*Ijārah Sukūk*)

Based on the *Sharī'ah*-compliant sale and lease structure, *ijārah* has formed the contractual basis for the majority of *sukūk* issued to date.[72] As a transaction revolving around one or a pool of tangible assets which produce a revenue stream, *ijārah* structures are particularly amenable to *sukūk* principles and can be used in situations where an entity wishes to fund the purchase of an asset or raise immediate capital.[73] Under these transactions, the SPV uses the issue proceeds to acquire an interest in identified, *Sharī'ah*-compliant assets.[74] Any interest obtained by the SPV is held on trust for the certificate holders, who are entitled to benefit from income generated by those assets.[75] The assets are leased to the originator itself[76] or to another entity that may or may not be linked to the originator.[77] Rental payments, which can be fixed or pegged to a benchmark such as LIBOR, provide a periodic payment stream which is distributed to the holders of the *sukūk* certificates.[78] Rather than establishing the lender/borrower relationship of conventional bonds, *ijārah sukūk* are underpinned by a lease, with the parties interacting as lessor/lessee. However, like conventional bonds, these *ijārah sukūk* are frequently subject to a repurchase undertaking by the originator who promises to buy the *ijārah* assets at par value on maturity of the *sukūk* or in the event of default.[79]

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[72] Wilson, Rodney, "Innovation in the structuring of Islamic sukuk securities", note 23, at 175.

[73] Chang, Yong-Jae, Kim, Soo-Yup, Jun-Hee, Choi, "Sukuk Tough to Issue", (2008) 27(8), *International Financial Law Review*, 33-35 at 34 noting that the objective of *ijārah sukūk* "to finance the necessary funds through the use of the assets"

[74] Dubai International Financial Centre, *Sukuk Guidebook*, note 67, at 14-15. Depending on the legal system in which the *ijārah sukūk* is being issued, this interest may not be ownership but rather a master lease. Following the AAOIFI clarification considered below and the fact that this Chapter is considering *sukūk* issued in Ireland where SPVs can acquire title to assets, the remainder of the discussion here will relate to SPV's that acquire title to the asset.

[75] Jobst, Andreas A., "The Economics of Islamic Finance and Securitization", *IMF Working Paper, WP/07/117*, (August 2007), at 20 available at: http://www.imf.org/external/pubs/ft/wp/2007/wp07117.pdf.

[76] The Malaysian government's *Sukuk Trust Certificates* employed this form of *ijārah sukūk*. The funds generated by the sukuk issuance were used to purchase parcels of land from a Malaysian state entity. The SPV then leased these parcels of land back to the Malaysian government as lessee with all returns generated being transferred through the SPV to the sukuk holders.

[77] Abdel-Khaleq, Ayman H., "Sukuk products backed by pools of assets located in non-Islamic jurisdictions: Key legal considerations", (2007-8) *Islamic Finance Review*, 75-80 at 76. This form of *sukūk* was recently used in the General Electric Capital aircraft-based *ijārah*. More than $50 million of the proceeds of this *sukūk* issuance were placed in reserve accounts; the remainder was used to purchase a portfolio of existing leases from two wholly-owned subsidiaries of GE Capital. While GE Capital therefore received payment for the purchase of the assets by the SPV, it was not itself actually lessee. The revenue generated by these leases provided the periodic payments to the *sukūk* holders.

[78] Akhtar, Zia, "Stakeholding in Sharia compliant assets and investor protection", note 53, at 362.

[79] Howladar, Khalid, *Shari'ah and Sukuk: A Moody's Primer*, (Moody's Investors Service, New York, 2006), at 8

As *ijārah sukūk* are based on an Islamic leasing arrangement, the contractual nature of trust certificates should, in theory, reflect this lease arrangement.[80] As it is only the usufruct which is handed over to the lessee, the liabilities associated with asset ownership, such as insurance, taxation and maintenance should rest with the SPV (and thus the investors).[81] Liabilities arising from the everyday use of the asset rest with the lessee.[82] In reality, the limited powers of the SPV, and the need to ensure as far as possible its bankruptcy remoteness, frequently result in the establishment of an agency (*wakāla*) agreement between the SPV (as lessor) and the lessee.[83] Under this agreement, the lessor appoints the lessee to carry out these aspects of asset ownership on its behalf.[84]

The liabilities of each party to the transaction can therefore be structured to reflect those found in conventional bonds. Nevertheless, underpinned by a tangible asset, *ijārah sukūk* are distinguishable (under Islamic law) from loans and can be traded in the secondary market at a price agreed upon by the parties to the trade.[85] Any profit made will be the result of a legitimate trade in *halal* (permissible) assets rather than a return on money alone.[86] Once traded, the ownership interest of the original holder is extinguished and transferred to the purchaser, who will then be entitled to receive their share of the rental payments.

B. Equity-Based *Sukūk* (*Mudāraba Sukūk*)

In circumstances where there is no readily available asset which can form the basis of a leasing agreement, financing may instead be provided through a partnership agreement.[87] A *mudāraba sukūk* involves the SPV (*rabb al-mal*) collecting investor subscriptions. The SPV then contributes this capital and the originator (*mudārib* or manager) contributes

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[80] *Ijārah* lease arrangements are discussed *supra.* at 87.

[81] Wilson, Rodney, "Overview of the sukuk market", in *Islamic Bonds: Your Guide to Issuing, Structuring and Investing in Sukuk*, note 28, at 7. See generally, Usmani, Muhammad Taqi, *An Introduction to Islamic Finance*, (Kluwer Law International, The Hague, 2002), at 81, Hassan, Hussein and Irfan, Harris, "Instruments for Islamic Issuers", in *Euromoney Encyclopedia of Debt Finance*, note 55, at 127.

[82] Usmani, Muhammad Taqi, *An Introduction to Islamic Finance*, note 81, at 81.

[83] Wedderburn-Day, A. Roger, "Sovereign Sukuk: Adaptation and Innovation", note 58, at 328.

[84] Hanif, Atif, "Islamic Finance – an overview", note 46, at 13, Burke, Alison, "Banking on Islamic Finance: How Islamic Financing is being used in Project Finance", (Jan-Feb 2004) *Infrastructure Journal*, 37 at 42.

[85] McMillen, Michael J.T., "Asset Securitization Sukuk and Islamic Capital Markets: Structural issues in these formative years", note 37, at 750.

[86] Wilson, Rodney, "Overview of the sukuk market", in *Islamic Bonds: Your Guide to Issuing, Structuring and Investing in Sukuk*, note 28, at 8.

[87] Dubai International Financial Centre, *Sukuk Guidebook*, note 67, at 28.

sweat equity, through its expertise and management of a *mudāraba* venture.[88] The SPV and originator enter into a partnership under which the *mudārib* will deal with the capital invested in accordance with pre-agreed investment guidelines.[89] In line with this, the *sukūk* certificates represent each holder's proportionate ownership of the equity of the *mudāraba* venture, entitling them to a share of any subsequent income generated by the venture.[90] As the originator is also a partner in the venture, it retains a percentage of the profits generated before distribution amongst the investors.[91] At the conclusion of the agreement, the *mudāraba* venture is dissolved and the investor's interests may be purchased by the originator.[92] By purchasing this interest, the *mudārib* will, as far as possible, return to the investors their principal investment plus their portion of any profits generated.[93] In line with the partnership quality of *mudāraba sukūk*, profit distributed should[94] represent a pre-determined *share* of the revenue produced by the partnership.[95]

As long as there is a tangible asset or venture underpinning the equity-based *sukūk*, these certificates can be treated as *halal* commodities and traded on the secondary market at any price agreed upon.[96] As will be discussed below, equity-based *sukūk* in particular

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[88] Ebrahim, Muhammed-Shahid, *Integrating Islamic and Conventional Project Finance*, (Educational Technology Centre, Universiti Brunei Darussalam, 1998), at 14, El-Gamal, Mahmoud, *Islamic Finance; Law, Economics and Practice*, (Cambridge University Press, Cambridge, 2006), at 120, Dubai International Financial Centre, *Sukuk Guidebook*, note 67, at 30.

[89] The primary duty of the *mudārib* is to comply with the trust which the *rabb al-mal* has vested in him while undertaking the business of the *mudāraba*, Saleh, Nabil A., *Unlawful Gain and Legitimate Profit in Islamic Law*, (2nd ed., Graham & Trotman, London, 1992), at 137. Only the *mudārib* is permitted to contribute labour to the arrangement. As a result, the *rabb al-mal* is prevented from taking any kind of active part in the management of the project being financed. Indeed any *mudāraba* contract which is conditional on the full participation of the *rabb al-mal* is invalid as this violates the primary need for a separation between investor and management, Udovitch, Abraham L., *Partnership and Profit in Medieval Islam*, note 42, at 190, Dubai International Financial Centre, *Sukuk Guidebook*, note 67, at 29.

[90] Al-Amine, Muhammad al-Bashir Muhammad, "The Islamic Bonds Market: Possibilities and Challenges", note 46, at 7, Wilson, Rodney, "Innovation in the structuring of Islamic sukuk securities", note 23, at 176, Salah, Omar, "Islamic finance: the impact of the AAOIFI Resolution on equity-based sukuk structures", (2010) 4(5) *Law and Financial Markets Review*, 507-517 at 510.

[91] HM Treasury, *Government sterling sukuk issuance: a consultation*, note 16, at [A8].

[92] Dubai International Financial Centre, *Sukuk Guidebook*, note 67, at 30, HM Treasury, *Government sterling sukuk issuance: a consultation*, note 16, at [A8].

[93] Sarakhsi notes that "[w]e [the hanafis] hold that profit does not arise before the return in full of original capital. Profit means an increment to capital. Unless the original capital is received by the capitalist, no increment to it can take place". Al-Sarakhsi, Muhammad b. Ahmad b. Abi Sahl Abu Bakr, Vol. 22, *Kitab al-Mabsut* at 20 in Siddiqui, Muhammad Nejatullah, *Partnership and Profit Sharing*, (The Islamic Foundation, Leicestershire, 1985), at 32. See *infra.* at 311 for a discussion of the use of a purchase undertaking which was, until 2008, a prominent feature of *mudāraba sukūk*.

[94] *infra.* at 311. See also *supra.* at 80 for a discussion of PLS sharing.

[95] Khan, Mansoor H., "Designing an Islamic model for project finance", (June 1997) 6 *International Financial Law Review*, 13-16 at 15. Classical *fiqh* is quite clear on the unacceptability of predetermined figures, no matter how small they are, as al-Nawawi, the Shafi'i jurists noted, "the share of every party is fixed as a given proportion of the whole…if ten (dirhams) have been settled for one party or, if profit is settled for him out of the gains from some particular merchandise, the agreement shall become void."

[96] Usmani, Muhammad Taqi, *An Introduction to Islamic Finance*, (note 81, at 19.

have been the target of controversy and featured significantly in an AAOIFI "clarification," which sought to re-emphasise the profit-and-loss sharing nature of the *sukūk* holders' ownership rights.[97]

C. Debt-Based *Sukūk* (*Murābaha Sukūk*)

The final broad category of *sukūk* covers those contractual forms which are largely based on financial obligations rather than tangible assets. While *salam* and *istisnā' sukūk* have met with growing acceptance across the Islamic finance market, the permissibility of *murābaha sukūk*, particularly their place on the secondary market, remains controversial. This controversy arises out of the fact that *murābaha sukūk* involve an undivided share in a debt receivable.[98] Using this contractual basis, *murābaha sukūk* involve an SPV that uses the proceeds from the certificate issuance to purchase assets (usually commodities). The SPV then immediately sells these assets to the originator, on a deferred payment basis.[99] The periodic payments made by the originator become the distributions made to *sukūk* holders throughout the term of the *sukūk*. As the SPV immediately relinquishes ownership of the asset to the originator, the *sukūk* certificates represent an undivided ownership share, not in a tangible asset, but in the receivables generated by the *murābaha* payments. Essentially, *murābaha sukūk* evidence a debt owed by the originator to the issuer.[100] As such, the sale of these certificates at a discount or premium is regarded as highly questionable, particularly in the Gulf States, on the basis that it involves profiting from the sale of debt that is not associated with an asset (*bay' al-dayn*).[101] The Shariah Advisory Council of the Malaysian Securities Commission has, however, verified the legitimacy of trading a debt obligation and has permitted the trading of *murābaha* certificates, even at a profit or discount so long as the underlying debt is generated pursuant to a valid *sharī'ah-*

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[97] *infra.* at 316.

[98] Ayub, Muhammad, *Understanding Islamic Finance*, note 27, at 405 who is highly critical of attempts to create *sukūk* certificates solely on the basis of *murābaha* contracts. See also, Usmani, Muhammad Imran, "Fixed Income Securities; Shari'a Perspective", Paper Prepared for the II[nd] SBP International Conference on "Fixed Income Market Development in Emerging Market Economies" on December 18-19, 2006 at State Bank of Pakistan, Karachi.

[99] Dubai International Financial Centre, *Sukuk Guidebook*, note 67, at 47.

[100] Usmani, Muhammad Imran, "Fixed Income Securities; Shari'a Perspective", note 98.

[101] Contrary to the prohibition of *ribā*. The rejection of the sale of debt is based on the Islamic maxim, *bay` al-kali bi-kali* or sale of debt for debt, Vogel, Frank E. and Hayes, Samuel.L., *Islamic Law and Finance, Religion, Risk and Return*, note 57, at 115, Zaman, Fahim Uz, *Shari'ah-Compliant Financial Services: A Guide to Products, markets and Trends*, (VLR KnowledgeBank Ltd, London, 2006), at 121, Mirakhor, Abbas and Zaidi, Iqbal, "Profit-and-loss sharing contracts in Islamic finance", in *Handbook of Islamic Banking*, M. Kabir Hassan and Mervyn K Lewis, (ed.), (Edward Elgar, Cheltenham, 2007), 49-64 at 56, Ayub, Muhammad, *Understanding Islamic Finance*, note 27, at 405.

compliant transaction.[102] Malaysia has therefore developed a liquid *sukūk* market in which *murābaha* and *bay' bithaman ajil* based *sukūk* are negotiable.[103] This more liberal interpretation of what constitutes a *halal* underlying asset has not met with general acceptance outside of Malaysia.[104]

However, the existence of a debt in a *murābaha sukūk* arrangement does not automatically prevent negotiability of a *sukūk* certificate on the secondary market. In a 1988 ruling, the Islamic Fiqh Academy of the OIC noted that Islamic certificates could be sold at market price (as opposed to par value), even where there was a debt obligation in the transaction, as long as the underlying assets consisted of a *majority* of physical assets.[105] The legitimacy of blended-asset *sukūk* was reaffirmed by AAOIFI in a 2008 *sukūk* clarification which notes that, while trade of receivables alone was contrary to the dictates of *Sharī'ah*, such assets could be traded at other than par value when incidental to the physical assets or usufruct included in the portfolio.[106] Applying the maxim "the greater part gets the jurisdiction of the whole,"[107] *sukūk*, even those issued in the Gulf, have been based on asset portfolios that contain a mixture of debt receivables and non-financial assets.[108]

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[102] 2nd meeting of the Shariah Advisory Council of the Securities Commission (SAC) on 21 August 1996 in *Resolutions of the Securities Commission Shariah Advisory Council*, (2nd ed., Securities Commission, Kuala Lumpur, 2006), 16-20. Yean, Tan Wan, "Sukuk: Issues and the Way Forward", (2009) *International Lawyers Network*, at 13, available at: http://iln.com/articles/pub_1674.pdf, Kashoogie, Jhordy, "Shari'a Polemics of Sukuk Trading", (January 20, 2011) 15 *Opalesque Islamic Finance Intelligence*, 5-7 at 6.

[103] Kukor, Mohammad Edil Abd., Muhamad, Rusnah and Gunawa, Alwin Yogaswara, "Malaysian Sukuk: Issues in Accounting Standard", (2008) 16(1) *Shariah Journal*, 63-74 at 66.

[104] Rosly, Saiful Azhar and Sanusi, Mahmood M., "The Application of Bai' Al-'Inah and Bai' Al-Dayn in Malaysian Islamic Bonds: An Islamic Analysis", (1999) 1(2) *International Journal of Islamic Financial Services*, available at: http://www.iiibf.org/journals/journal2/art1.pdf noting that "the trading of Islamic bonds on a discount basis through the *bay' al-dayn* mechanism is too strong to make way for the much needed Islamic capital inflows from the Middle-East countries."

[105] Decision of the Organization of the Islamic Conference's Fiqh Academy (Number 5, Fourth Annual Plenary Session, Jeddah, 1988) noting that "Any collection of assets can be represented in a written note or bond, and the bond or note can be sold at the market price provided that the composition of the group of assets, represented by the security, consists of a majority of physical assets and financial rights, with only a minority being cash and interpersonal debts," quoted in Kamali, Mohammad Hashim, "A Shari'ah Analysis of Issues in Islamic Leasing", (2007) 20(1) *J.KAU: Islamic Economics*, 3-22 at 16.

[106] Accounting and Auditing Organization for Islamic Financial Institutions, *AAOIFI's Shari'a Board Resolutions on Sukuk*, (AAOIFI, Bahrain, 2008), Second clause, available at: http://www.aaoifi.com/aaoifi_sb_sukuk_Feb2008_Eng.pdf.

[107] 'li al-akhtar hukm al-kull, 'Ali Ahmad al-Nadwi (1414/1994) *Al-Qawaid al-fiqhiyya: mafhumuha, nash'atuha, tatawwuruha, dirasat mu'allifatiha, adillatuha, muhimmatuha, tatbiqatuha,* introduction by Mustafa al-Zarqa, (3rd ed., Dar al-Qalam, Damascus, n.d), 32, 349, 353 in Sinanovic, Ermin, "The majority principle in Islamic legal and political thought", (2004) 15(2) *Islam & Christian-Muslim Relations*, 237-256 at 245.

[108] See for example the IDB *sukuk* which combined *ijarah* and murabaha contracts in acceptable ratios. The recent ALIm *sukuk* issued in Malaysia similarly combined tangible and financial assets with fifty percent of the portfolio comprised of real estate properties. For a detailed analysis of the ALIm *sukuk*, see; RAM Ratings, "Landmark Deal Report"; Sukuk al-Amanah Li al-Istithmar, (RAM, Kuala Lumpur, August 2010), available at: http://www.ram.com.my/pubs_commentaries_publications.aspx.

8.4 *Sukūk* Clarification: AAOIFI Criticism of Contemporary *Sukūk* Transactions

An overview of common *sukūk* structures suggests that while these transactions could be used as a *Sharī'ah*-compliant alternative to an issue of conventional bonds, the emphasis on asset proximity and ownership by the *sukūk* holders establishes *sukūk* as distinguishable capital market products. In theory, rather than a guaranteed return of principal and interest, the undivided ownership share of the underlying asset should subject *sukūk* holders to the uncertainties of asset or project performance.[109] However, as the *sukūk* market has grown internationally, investor preference for risk-averse investment and a steady return, has resulted in the development of *sukūk* that replicate the performance and risk profile of conventional, corporate debt securities,[110] a situation described as the "disparity between the 'ideal' and the 'reality' of Sukuk."[111] This section will discuss this "disparity" looking first at the difference between the "ideal" and "reality" of *sukūk* transactions (8.4.1).[112] It will then consider the 2008 AAOIFI criticisms of the contemporary *sukūk* industry (8.4.2)[113] and the reaction of the industry to these criticisms (8.4.3).[114] This section will argue that the current *sukūk* market continues to favour debt-like *sukūk* yet that there are indications that the AAOIFI criticisms are being taken into account. This conclusion will be relevant in Chapter 9 when determining the extent to which *sukūk* can function, effectively, under Irish law.

8.4.1 The Difference between Asset-Backed and Asset-Based: *Sukūk* Prior to 2008

The "ideal" *sukūk* are certificates that are backed by an income producing asset or group of assets such that the returns generated and the rights and liabilities of the parties are

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[109] Dusuki, Asyraf Wajdi and Mokhtar, Shabnam, *Critical Appraisal of Shari'ah Issues on Ownership in Asset-Based Sukuk as Implemented in the Islamic Debt Market*, Research Paper, No. 8/2010, (International *Shari'ah* Research Academy for Islamic Finance (ISRA), Kuala Lumpur, 2010), at 4-5 outlining the characteristics of *sukūk* which should be present, Thomas, Abdulkader, "Islamic securitisations: opportunities with sukuk" in *Asset Securitisation and Synthetic Structures: Innovations in the European Credit Markets*, Rick Watson and Jeremy Carter (eds.), (Euromoney Institutional Investor Plc, London, 2006), 244-261 at 250 noting that; "[s]ukuk ideally have a full asset level risk for total loss..."

[110] Askari, Hossein, Iqbal, Zamir and Mirakhor, Abbas, *Globalization and Islamic Finance; Convergence, Prospects and Challenges* note 1, at 139-140.

[111] Howladar, Khalid, "The future of sukuk: substance over form?", *CPI Financial*, May 31, 2009, available at: available at: http://www.cpifinancial.net/v2/fa.aspx?v=0&aid=260&sec=Islamic%20Finance..

[112] *infra.* at 311.

[113] *infra.* at 316.

[114] *infra.* at 320.

dependent solely on the performance of the underlying asset(s).[115] These *sukūk* are "asset-backed *sukūk*" and involve a sales transaction from the originator to the SPV, which is not only enforceable under *Sharī'ah* but also binding from a conventional perspective.[116] As a result of this sale, all of the risks and rewards associated with asset ownership are transferred to the investors who can then enforce these rights against third parties via the SPV.[117] Separating the assets from the originator will ring-fence the assets ensuring that in the event of the insolvency, the investors will not be treated as unsecured creditors of the originator.[118] It also protects the underlying assets from claw-back by other creditors of the originator. However, as the originator in such a "true sale" arrangement is no longer the owner of the assets, the investors will have no recourse beyond those assets in the event of a short-fall in profits. In light of these characteristics, it could be suggested that the requisite elements of an asset-backed *sukūk* are similar to those relied on when determining whether a conventional securitisation[119] fulfils the characteristics needed for an enforceable asset transfer: "true sale, bankruptcy remoteness and enforceability of security."[120] The comparison between *sukūk* and conventional securitisation is not entirely clean as conventional securitisations are generally backed by a pool of financial assets such as receivables, rather than tangible, *Sharī'ah*-compliant assets.[121] As Thomas noted, *sukūk* "will require a higher connectivity to the underlying asset and operating business" than conventional securitisation.[122] Nevertheless, the basic principle underpinning securitisations that investors are conferred an undivided ownership in underlying assets is

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[115] RAM Rating Services, "Sukuk investors' position amid defaults", *The Star*, October 3, 2009, available at: http://biz.thestar.com.my/news/story.asp?file=/2009/10/3/business/4814754&sec=business noting that; "[a]sset-backed sukuk are characteristically non-recourse sukuk, with the underlying asset(s) forming the lone source of profit and capital payments."

[116] Ayub, Muhammad, *Understanding Islamic Finance*, note 27, at 214, Norman, Trevor, "Sukuk: where next?", (July–September 2009) 172 *NewHorizon Magazine*, 14-15 at 15, Howladar, Khalid, "The future of sukuk: substance over form?", note 111.

[117] The IFSB defines and asset backed sukuk as one that "meets the requirements for being an assetbacked structure as assessed by a recognised external credit assessment institution (ECAI): this structure would leave the holders of sukuk to bear any losses in case of the impairment of the assets. The applicable risks are those of the underlying assets, and these will in principle be reflected in any credit rating issued by a recognised ECAI," Islamic Financial Services Board, *IFSB-7: Capital Adequacy Requirements for Sukuk, Securitisations and Real Estate investment*, (IFSB, Kuala Lumpur, 2009), at 3.

[118] Lotter, Philip and Howladar, Khalid, *Understanding Moody's Approach to Unsecured Corporate Sukūk*, (Moody's Investors Service, Dubai, 2007), at 5.

[119] Defined as "the sale of equity or debt instruments, representing ownership interests in...a segregated, income producing asset or pool of assets, in a transaction structured to reduce or reallocate certain risks inherent in owning or lending against the underlying assets," Shenker, Joseph and Colletta, Anthony, "Asset Securitization: Evolution, Current Issues and New Frontiers", (1991) 69 *Texas Law Review*, 1369-1429 at 1374-1375.

[120] Dusuki, Asyraf Wajdi and Mokhtar, Shabnam, *Critical Appraisal of Shari'ah Issues on Ownership in Asset-Based Sukuk as Implemented in the Islamic Debt Market*, note 109, at 7.

[121] Thomas, Abdulkader, "Islamic securitisations: opportunities with sukuk" in *Asset Securitisation and Synthetic Structures: Innovations in the European Credit Markets*, note 109, at 246.

[122] *ibid.*

highly consistent with the nature of *sukūk*,[123] a reality that has lead some commentators to refer to the "ideal" *sukūk* arrangements as "Islamic securitisations."[124]

The "reality" of contemporary *sukūk* is that such certificates have almost always been "asset-based."[125] Through the use of risk mitigation mechanisms,[126] elements of risk-sharing in *sukūk*, particularly equity-based *sukūk*, have been modified to mimic the risks and returns of fixed-income debt obligations.[127] *Sukūk* have developed into capital market instruments that "loo[k] like a bond, smel[l] like a bond and even wal[k] like a bond,"[128] despite the fact that they profess *Sharī'ah*-compliance. The development of Islamic securities, which are similar *in substance* to corporate bonds, has raised questions over whether the ambition of Islamic finance is to uphold the wider objectives of Islam or simply to replicate the conventional financial sector and, if it is the former, whether contemporary *sukūk* fulfil this goal.[129] The key area of concern for commentators in relation to contemporary *sukūk* structures is the extent to which *sukūk* certificates are actually backed by the underlying assets. In order to avoid being viewed as an interest-bearing loan, the capital transferred from the SPV to the originator generally represents consideration paid for the transfer of an asset or group of assets to the SPV. The trust which the SPV has over the assets confers on the investors an interest in the underlying assets, entitling them to receive payments from the income generated by those assets.[130] Most contemporary *sukūk* fulfil this transfer requirement, with the result that *sukūk* holders enjoy what appears to be an ownership-like interest in specific and identifiable assets.[131]

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[123] Ainley, Michael, Mashayekhi, Ali, Hicks, Robert, Rahman, Arshadur and Ravalia, Ali, *Islamic Finance in the UK: Regulation and Challenges*, (Financial Services Authority, London, 2007), at 25 noting that "[s]tructuring *sukuk* is in many aspects similar to securitisation, one common characteristic being that payouts are based on the performance of the underlying assets."

[124] McMillen, Michael J.T., "Asset Securitization Sukuk and Islamic Capital Markets: Structural Issues in These Formative Years", note 37, at 738 referring to genuinely asset backed sukuk as "Islamic asset securitization structures."

[125] Dusuki, Asyraf Wajdi and Mokhtar, Shabnam, *Critical Appraisal of Shari'ah Issues on Ownership in Asset-Based Sukuk as Implemented in the Islamic Debt Market*, note 109, at 6 noting that; "most of the sukuk structures in the market do not reflect true ownership by the sukuk holders of the underlying asset."

[126] *infra.* at 315.

[127] McMillen, Michael J. T., "Sukuk in Its Infancy: Misstep and Sequel", (May 2008) *Dow Jones Islamic Market Indexes Quarterly Newsletter*, 3-4 at 3.

[128] McNamara, Paul, (March 2010) 1(1) *So Far*, 26-32 at 27.

[129] Goud, Blake, (March 2010) 1(1) *So Far*, 10-17 at 11, Cizakca, Murat, "Comments on 'An Evaluation of Special Finance Houses: A Case Study on Turkey' by Savas Alpay", in *Advances in Islamic Economics and Finance*, Munawar Iqbal, Salman Syed Ali and Dadang Muljawan (eds.), (Vol. 1, Islamic Research and Training Institute, Jeddah, 2007), 407-410 at 409.

[130] Howladar, Khalid, "The future of sukuk: substance over form?", note 111.

[131] Usmani, Muhammad Taqi, *Sukuk and their Contemporary Application*, Yusuf DeLorenzo (trans.), (2007), at 3, available at: http://www.muftitaqiusmani.com/images/stories/downloads/pdf/sukuk.pdf, noting that "[g]enerally, sukuk represent ownership shares in assets that bring profits or revenues, like leased assets, or commercial or industrial enterprises or investment vehicles that may include a number of projects."

Commentators have, however, increasingly raised doubts over the true nature of the *sukūk* holders' interests in the assets.[132] While the *sukūk* assets may be transferred to the SPV, this transfer is not always the result of a "true sale"[133] effected between the originator and the SPV.[134] The implication of this is that there will be no de-linkage between the originator and the assets.[135] While the transfer of physical possession of an asset is not an essential element of a valid sale in *Sharī'ah*, a complete conveyance of an asset will only occur if the purchaser obtains at least constructive possession of the asset and the corresponding right to use and control that asset.[136] Contemporary *sukūk* frequently do not fulfil this second element, the sale of the underlying asset is not, therefore, "true" from an accounting or legal perspective.[137] Such transactions provide investors with contractual entitlement to returns generated by identified assets rather than a proprietary ownership interest in those assets.[138]

Consequently, where *sukūk* are asset-based, the investors have limited or no right to assume control of, or sell, the assets.[139] The assets are thus often of concern to the parties

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[132] Howladar, Khalid, "The future of sukuk: substance over form?", note 111.

[133] True sale is a feature of conventional securitisation arrangements and seeks to ensure that the assets will be removed from the balance sheet of the originator and thus protected from the originator's creditors in the event of originator bankruptcy, Dusuki, Asyraf Wajdi and Mokhtar, Shabnam, *Critical Appraisal of Shari'ah Issues on Ownership in Asset-Based Sukuk as Implemented in the Islamic Debt Market*, note 109, at 10. As Ali has noted in relation to securitisation in Ireland; a "major attraction" of true sale securitisation is that the investors' "investment is secured against the assets owned by the SPV and as a result isolated from the originator's risk of insolvency," Ali, Noman, "Risk of examinership: Ireland's nemesis in whole business securitisation?", (2003) 10(3) *Commercial Law Practitioner*, 78-82 at 78.

[134] Ainley, Michael, Mashayekhi, Ali, Hicks, Robert, Rahman, Arshadur and Ravalia, Ali, *Islamic Finance in the UK: Regulation and Challenges*, note 123, at 25, Askari, Hossein, Iqbal, Zamir and Mirakhor, Abbas, *Globalization and Islamic Finance; Convergence, Prospects and Challenges*, note 1, at 168.

[135] Ainley, Michael, Mashayekhi, Ali, Hicks, Robert, Rahman, Arshadur and Ravalia, Ali, *Islamic Finance in the UK: Regulation and Challenges*, note 123, at 25.

[136] The Islamic Fiqh Academy has ruled that constructive possession in financial transactions is legally valid, Council of the Islamic Fiqh Academy (2000) Resolutions and Recommendations (1985–2000), (IRTI, IDB, Jeddah, 2000), at 107, Resolution No. (53/4/6), concerning "Possession: Its Different Forms, Especially the Modern Forms and their Rules", Ayub, Muhammad, *Understanding Islamic Finance*, note 27, at 214. See *infra.* at 318 for a more detailed discussion of Islamic views on ownership

[137] Ahmed, Habib, "Islamic finance at a crossroads: the dominance of the asset-based sukuk", (2010) 6 *Journal of International Banking and Finance Law*, 366-367, at 367.

[138] As McMillen notes; "many contemporary sukuk were structured as entitlements to returns from entities rather than ownership of entities and others included *murābaha* debt where there was no tangible asset to be owned," McMillen, Michael J.T., "Islamic Capital Markets: Market Developments and Conceptual Evolution in the First Thirteen Years", (April 24, 2011), at 26, available at: http://ssrn.com/abstract=1781112

[139] Dusuki, Asyraf Wajdi and Mokhtar, Shabnam, *Critical Appraisal of Shari'ah Issues on Ownership in Asset-Based Sukuk as Implemented in the Islamic Debt Market*, note 109, at 6-7. See for example the ADIB Sukuk Company Ltd., US$5,000,000,000 Trust Certificate Issuance Programme, Base Prospectus, (1 December 2006), at 10, available at: http://www.londonstockexchange.com/specialist-issuers/islamic/adib-prospectus.pdf, which notes that, "the Certificateholders *will not have any rights of enforcement as against the Trust Assets* and their rights are limited to enforcement against ADIB of its obligation to purchase the Issuer's co-ownership interest in the Co-ownership Assets pursuant to the terms of the Purchase Undertaking Deed. Accordingly, any such restriction on the ability of ADIB to make a "true sale" of the co-ownership

only in so far as those assets are capable of fulfilling the dictates of *Sharī'ah* and have little bearing on the risk assumed by the investors and the ultimate performance of the *sukūk*.[140] In line with this, the originator may give a purchase undertaking to buy back the assets at par value on default or dissolution or at the end of the *sukūk* term, regardless of the actual market value of the asset.[141] This unilateral buy-back undertaking provides capital protection for *sukūk* investors and ensures that, subject to the continued solvency of the originator,[142] their initial investment will be repaid.[143] In the event that the originator is unable to fulfil its payment obligations under the *sukūk* arrangement, the investors have no direct recourse to the assets and will instead, rank *pari passu* with other unsecured creditors.[144] Finally, while *sukūk* assets may be chosen for their ability to generate income, any shortfalls or irregularities in such generation are frequently compensated for by the *sukūk* manager (a role that may be conferred on the originator) who extends an interest-free loan to the SPV; any profits in excess of a pre-agreed rate are paid to the manager as an

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interest in the Co-ownership Assets to the Issuer is likely to be of limited consequence to the rights of the Certificateholders" (emphasis added).

[140] Akhtar, Zia, "Stakeholding in Sharia compliant assets and investor protection", note 53, at 363, Howladar, Khalid, "The future of sukuk: substance over form?", note 111.

[141] Aziz, Razi Pahlavi Abdul and Gintzburger, Anne-Sophie, "Equity-based, Asset-based and Asset-backed Transactional Structures in Shari'a-Compliant Financing: Reflections on the Current Financial Crisis", (2009) 28(3) *The Economic Society of Australia, Economic Papers*, 270-278 at 275-6, Hanif, Atif, "Islamic Finance – an Overview", note 46, at 13, Salah, Omar, "Islamic finance: the impact of the AAOIFI Resolution on equity-based sukuk structures", note 90, at 511, Lotter, Philipp and Howladar, Khalid, *Understanding Moody's Approach to Unsecured Corporate Sukuk*, note 118, at 5 noting that where there is a purchase undertaking; "the true market value of the underlying asset (or asset portfolio) is irrelevant to the Sukuk noteholders, as the amount is defined to be equivalent to the notes." Askari, Hossein, Iqbal, Zamir and Mirakhor, Abbas, *Globalization and Islamic Finance; Convergence, Prospects and Challenges*, note 1, at 168.

[142] This credit (as opposed to asset) risk is also found in conventional bond agreements.

[143] Norman, Trevor, "Sukuk: where next?", note 116, at 14. The presence of this undertaking means that rather than having direct recourse to the assets, the likelihood of sukuk holders recovering the principal investment is dependent upon the originators ability to repurchase the assets, Agha, Oliver, "Islamic Finance: Principle Before Profit", (2009) 2 *Berkeley Journal of Middle East and Islamic Law*, 125-135 at 133, Lotter, Philip and Khalid Howladar, *Understanding Moody's Approach to Unsecured Corporate Sukuk*, note 118, at 5. The IFSB defines an asset-based sukuk structure as one "with a repurchase undertaking (binding promise) by the originator: the issuer purchases the assets, leases them on behalf of the investors and issues the sukuk. Normally, the assets are leased back to the originator in a sale-and leaseback type of transaction. The applicable credit risk is that of the originator, subject to any *Shari`ah*-compliant credit enhancement by the issuer. The recognised ECAI will put weight, in determining the rating, on the payment schedule of the repurchase undertaking and the capability of the originator to make the scheduled payments to the issuer....Such structures are sometimes referred to as "pay-through" structures, since the income from the assets is paid to the investors through the issuer," Islamic Financial Services Board, *IFSB-7: Capital Adequacy Requirements for* Sukuk, *Securitisations and Real Estate investment*, (IFSB, Kuala Lumpur, 2009), at 4. See also, Dusuki, Asyraf Wajdi and Mokhtar, Shabnam, *Critical Appraisal of Shari'ah Issues on Ownership in Asset-Based Sukuk as Implemented in the Islamic Debt Market*, note 109, at 10.

[144] Ahmed, Habib, "Islamic finance at a crossroads: the dominance of the asset-based sukuk", note 137, at 367, Akhtar, Zia, "Stakeholding in Sharia compliant assets and investor protection", note 53, at 363 noting that; "[b]y means of the sale brought about by the undertaking, the credit risk of the investors is transferred to the obligor and the investors do not have recourse to the underlying assets in the event of default and it triggers a claim by the investors against the originator."

"incentive fee."[145] The risks borne by asset-based *sukūk* certificate holders are thus comparable to those of a lender and, by extension, the holder of a conventional interest-based bond.[146]

8.4.2 Usmani and AAOIFI Criticism of Asset-Based *Sukūk*

In response to the growing practice of structuring *sukūk* to provide for capital preservation and fixed returns, Muhammad Taqi Usmani, President of AAOIFI's *Sharī'ah* board suggested, in 2007, that 85% of Gulf *sukūk* were not *Sharī'ah*-compliant as they failed to uphold the spirit of Islam.[147] In 2008, AAOIFI's *Sharī'ah* Board sought to clarify the position of *sukūk* by issuing "clarification" guidelines.[148] These reiterated many of the issues highlighted by Usmani. While the new guidelines deal principally with equity-based *sukūk*,[149] several provisions are of relevance to lease and debt-based certificates.

The guidelines contain six key recommendations on the correct structure for Islamic investment certificates. *Sukūk*, in order to be tradable, must represent the undivided ownership by the *sukūk* holders, of real assets (whether tangible, usufructs or services), which can be possessed and sold in accordance with Islamic law.[150] Such certificates must also confer on the *sukūk* holders all of the rights and obligations that accompany asset ownership.[151] The manager of a *sukūk* issuance must thus establish the transfer of

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[145] Howladar, Khalid, "Rating Islamic Securitisation", (2007) 5(3) Number 14 *Islamic Banking and Finance*, 22-23 at 22.

[146] Howladar, Khalid, "Shari'ah, Sukuk and Credit Risk: A Moody's Primer", (2007) 24(1) *ABANA Review*, 18-20 at 19-20, Thomas, Andulkader and Becic, Muhamed, "Are Sukuk Islamic?", (January 2008) 26 *Islamic Banking & Finance*, available at: http://www.cpifinancial.net/v2/Magazine.aspx?v=1&aid=1341&cat=IBF&in=26, Young, Tom, "Trouble Ahead", (2007) 26(6) *International Financial Law Review,* 14-17 at 15 suggesting a blurring of the lines between Islamic and conventional capital market products.

[147] Usmani, Muhammad Taqi, *Sukuk and their Contemporary Application*, note 131. Oakley, David, "Sukuk Market: Clarification of Rules does Market a Favour", *Financial Times*, June 17, 2008, available at: http://www.ft.com/cms/s/0/57504a52-3c0f-11dd-9cb2-0000779fd2ac.html#axzz1SMG7P2YN noting the fact that guaranteed returns and repurchase arrangements "go against the spirit of Islamic finance where interest is banned and buyers should share risk and profit."

[148] Accounting and Auditing Organization for Islamic Financial Institutions, *AAOIFI's Shari'a Board Resolutions on Sukuk*, note 106.

[149] Mokhtar, Shabnam, *Application of Wa'ad in Equity-based Sukuk; Empirical Evidence*, Research Paper No. 20/2011, (International *Shari'ah* Research Academy for Islamic Finance (ISRA), Kuala Lumpur, 2011), at 2.

[150] Accounting and Auditing Organization for Islamic Financial Institutions, *AAOIFI's Shari'a Board Resolutions on Sukuk*, note 106, First clause.

[151] This requirement applies to all *sukūk* not simply equity-based transactions with the result that *ijārah sukūk* assets must be sold to the SPV rather than simply leased under a head lease as occurred in the Dubai Nakheel Sukuk, see Salah, Omar, "Dubai Debt Crisis: A Legal Analysis of the Nakheel Sukuk", (2010) 4 *Publicist*, 19-32 for a discussion of this sukuk.

ownership of such assets in its books, and must not retain them as its own assets.[152] Further, the clarification attempts to prevent use of techniques which reduce the profit-and-loss sharing nature of equity *sukūk*. First, the manager of *mushāraka*, *mudāraba* or *wakāla*[153] equity-based *sukūk* issuances must not undertake to offer loans to *sukūk* holders when asset earnings fall short of the level expected,[154] although it can use a reserve fund to smooth out shortfalls in returns, distribute profit on account or implement non-recourse project financing.[155] Second, while assets in an *ijārah sukūk* can continue to be purchased at their "nominal value" on extinguishment of the *sukūk*,[156] the guidelines prohibit the assets in equity *sukūk* from being bought by the manager at a pre-agreed price.[157] It is however permissible for the manager to undertake the purchase on the basis of the "net value of assets, its market value, fair value or a price to be agreed, at the time of their actual purchase,"[158] or for the agent in a *wakāla sukūk* to guarantee repurchase in an independent capacity.[159] Described by commentators as having "wrecked the Islamic bond market"[160] and "paralysed the industry,"[161] the comments by Usmani and AAOIFI are a very visible attempt by the Islamic finance industry to affirm the pre-eminence of substantive compliance with the principles of Islamic law.[162]

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[152] Accounting and Auditing Organization for Islamic Financial Institutions, *AAOIFI's Shari'a Board Resolutions on Sukuk*, note 106, First clause, Habbas, Sam and Abdullah, Hossam, "Sukuk issuance: Shariah and the markets", (2008) 28(9) *International Financial Law Review*, 62-65, noting that Musharaka and mudaraba sukuk assets must be off the balance sheets of the issuer and obligor, also available at, http://www.iflr.com/Article/2017789/Channel/193438/Shariah-and-the-markets.html.

[153] Agency agreement – similar in structure to a *mudaraba*.

[154] Accounting and Auditing Organization for Islamic Financial Institutions, *AAOIFI's Shari'a Board Resolutions on Sukuk*, note 106, Third and Fourth clauses.

[155] *ibid.*

[156] McMillen suggests that "nominal value" here means "based upon the financial structuring, would likely be equal to the remaining outstanding principal amount of the *sukuk* from time to time," McMillen, Michael J.T., "Asset Securitization Sukuk and Islamic Capital Markets: Structural Issues in These Formative Years", note 37, at 745 fn 70.

[157] Accounting and Auditing Organization for Islamic Financial Institutions, *AAOIFI's Shari'a Board Resolutions on Sukuk*, note 106, Fourth clause.

[158] *ibid.*, Fourth clause, footnote 6. What these values actually mean is not entirely clear. AAOIFI has, however, subsequently defined "fair value" as "the amount for which an asset could be exchanged or an obligation settled between well informed, willing parties (seller and buyer(in an arm's length transaction." This appears to be similar to market value. Accounting and Auditing Organization for Islamic Financial Institutions, "Financial Accounting Standard No. 25, Investment in sukuk, shares and similar instruments", in *Accounting, Auditing and Governance Standards for Islamic Financial Institutions, 1432 H – 2010*, (AAOIFI, Bahrain, 2010), 573-591 at 586.

[159] Accounting and Auditing Organization for Islamic Financial Institutions, *AAOIFI's Shari'a Board Resolutions on Sukuk*, note 106, Fourth clause, footnote 6.

[160] Benham, Jason, "Islamic Bond Market 'Wrecked' by Critical Remarks", *ArabianBusiness.com*, October 29, 2008, available at: http://www.arabianbusiness.com/536401-Islamic-bond-market-wrecked-by-critical-remarks, quoting a statement by Mohamed Nedal Alchaar, Secretary-General of the AAOIFI.

[161] Kettell, Brian, "The Last Word", (2008) 6(1) Number 16, *Islamic Banking & Finance*, 30 at 30.

[162] McMillen, Michael J.T., "Islamic Capital Markets: Market Developments and Conceptual Evolution in the First Thirteen Years", note 138, at 26, noting that the clarification; "reemphasizes that the *Sharī'ah* principles and precepts applicable to possession and disposition of assets must be at the forefront in structuring any *sukūk* issuance or instrument."

The actual level of ownership transfer that is needed to satisfy AAOIFI's interpretation of *Sharī'ah* compliance, is not, however, entirely clear from the clarification guidelines which were issued. Requiring that *sukūk* holders obtain the "rights and obligations of ownership"[163] which are "capable of being owned and sold legally as well as in accordance with the rules of Shari'ah,"[164] AAOIFI appears to be suggesting that the transfer of asset ownership to *sukūk* holders must be sufficiently robust to extinguish the originator's ownership rights over the assets. Two interpretations of this requirement are possible. First, the rights and obligations of ownership (legal *or* beneficial) must be transferred to the investors and enforceable both under *Sharī'ah* and the national laws of the state in which the assets are located. This interpretation complies with the concept of ownership discussed by a number of Islamic scholars. Ibn Ashat, for example, has noted that ownership is the ability to acquire the lawful right to use something and/or its utility,[165] similarly, Ibn Taymiyya defines ownership as the legal ability to exclusively benefit from something.[166] Effectively, ownership according to Islamic scholars is the right to use something in whatever *Sharī'ah*-compliant manner the owner wishes and to prevent others from using it.[167] This reading of the AAOIFI requirement shares characteristics with the "true sale" requirement found in conventional securitisations and highlights the *Sharī'ah*-compliance of the "asset-backed *sukūk*" outlined above.[168] As a result, commentators have advocated asset-backed securitisation *sukūk* and equity securitisation *sukūk*[169] as mechanisms for upholding the AAOIFI requirements.[170]

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[163] Accounting and Auditing Organization for Islamic Financial Institutions, *AAOIFI's Shari'a Board Resolutions on Sukuk*, note 106, First clause.

[164] *ibid.*

[165] Referred to by Meera, Ahamed Kameel Mydin and Larbani, Moussa, "Ownership effects of fractional reserve banking: an Islamic perspective", (2009) 25(2) *Humanomics*, 101-116 at 103.

[166] Ibn Taymiyya, *Majmu' Fatawa Ibn Taymiyya*, at 347-348 quoted in Gulaid, Mahmoud A., "Land Ownership in Islam (A Survey)", *Research Paper No. 14, Islamic Development Bank; Islamic Research and Training Institute*, (IRTI, Jeddah, 2001), at 12.

[167] *ibid.*, at 12 who discusses in detail the different approaches to ownership (in this case land) held by the various schools of Islamic law. Summarising the different views he notes that; "[t]he strength of these definitions lies in their ability to reflect the legal authority of ownership, and the right to dispose of property in any form and for whatever purpose the owner deems appropriate. To these outstanding attributes of ownership must also be added the ability of the owner to exclude others from posting claims to similar use rights on specific property." More recently, El-Gamal has noted that the "fundamental test of ownership in classical and contemporary Islamic jurisprudence is the risk of loss in case of property destruction," El-Gamal, Mahmoud Amin, *Islamic Finance: Law, Economics, and Practice*, note 88, at 109.

[168] *supra.* at 311.

[169] Terminology used by McMillen in McMillen, Michael J.T., "Islamic Capital Markets: Market Developments and Conceptual Evolution in the First Thirteen Years", note 138, at 29-32.

[170] See for example, *ibid* at 29-32. See also, Goud, Blake, "The rise of istithmar *sukūk*", *Sharing Risk dot Org*, July 5, 2011, available at: http://investhalal.blogspot.com/2011/07/rise-of-istithar-sukuk.html, noting that "the entire area of securitization has largely passed Islamic finance by, although it would be a natural source of new sukuk were Islamic banks to pass on their risk and return to investors."

The alternative interpretation of the AAOIFI recommendation has been presented by Gassner, who suggested that what is now required in *sukūk* is the transfer and registration of *legal* title in the name of the *sukūk* holders.[171] Implementing this interpretation, it is arguable that the transfer of beneficial ownership only would fall short of the standard required. In light of the fact that many Islamic jurisdictions, whose legal systems are based on the Napoleonic Civil Code and the Ottoman *Majella*, have significantly underdeveloped or indeed, non-existent trust law regimes,[172] this narrow conception of ownership may have been what AAOIFI meant by valid transfer of ownership. However, this view does not take into account the strength of the rights and obligations attached to beneficial ownership in common law jurisdictions. Ireland's trust law, for example, is well developed with those possessing the beneficial interest being subject to the benefits and burdens of ownership, notwithstanding the fact that their interest is not publicly registered.[173] While the registration of ownership in favour of the SPV would align both legal and equitable title and ensure complete decoupling of the asset from the originator, the willingness of Irish courts to uphold equitable title suggests that the fact that an interest in an asset is not perfected should not be used as a reason to question the validity of the ownership transfer to the SPV.

In practice, the issue remains unsettled. Nevertheless, it is suggested that, at least in a common law jurisdiction, the AAOIFI standards will be satisfied where there is a true sale of underlying assets to the SPV and the transfer of enforceable ownership interest to the investors with such interests either beneficial or legal.[174] This, together with the stated validity of reserve accounts, on-account payments, third party guarantees and the repurchase of the underlying assets (at nominal value for *ijārah sukūk* and at anything but a

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[171] Gassmer, Michael Saleh, "Revisiting Islamic Bonds; Are 85% of Sukuk haram?", Part 2 (April 2008) *Business Islamica*, 22-24 at 23. See also, Habbas, Sam and Abdullah, Hossam, "Sukuk issuance: Shariah and the markets", note 152, at 62-65.

[172] Howladar gives the example of the UAE where in order for there to be a binding sale it would need to be shown that the sale was "legal, valid, binding and ultimately enforceable on all parties under the laws of the country where the assets and company are based" with "effective registration of the property in the name of the new owner(s)" usually being conclusive evidence of a valid sale, Howladar, Khalid, "The future of sukuk: substance over form?", note 111, Thomas, Abdulkader, "Securitization in Islamic Finance", in *Islamic Finance: The Regulatory Challenge*, Simon Archer and Rifaat Ahmed Abdel Karim, (eds.), (John Wiley & Sons (Asia) Ptr Ltd., Singapore, 2007) 259-270 at 260. For a more detailed discussion of the differences between Islamic and non-Islamic jurisdictions see; Abdel-Khaleq, Ayman H. and Richardson, Christopher F., "New Horizons for Islamic Securities: Emerging Trends in Sukuk Offerings", (2007) 7(2), *Chicago Journal of International Law*, 409-425 at 416-421.

[173] See for example; *West Donegal Land League v Udaras Na Gaeltachta & ors* [2007] 1 ILRM 1 where the Supreme Court acknowledged that the registered owner of land may simply be holding it on trust for the benefit of those with equitable title.

[174] The remainder of this Chapter , and Chapter 9, will proceed on this understanding of the AAOIFI requirements.

pre-agreed amount for equity *sukūk*) arguably still allows even some asset-backed *sukūk* to display some characteristics of fixed-income debt securities.[175]

8.4.3 Impact of the Clarification

The response by the market to the Usmani/AAOIFI criticisms has been mixed. The 2008 standard has not represented the definitive pronouncement on *sukūk* structures, a fact highlighted by the IFBS's 2009 capital adequacy standards for institutions offering *sukūk*[176] and the 2010 Bahrain Financial Exchange Handbook,[177] both of which provide for *sukūk* structures which incorporate some or all of the credit and liquidity enhancements denounced by AAOIFI. Nevertheless, there was a sharp drop in *sukūk* issuances, particularly equity-based transactions, in 2008.[178] This drop was followed by a re-emerging preference for *ijārah sukūk* which can still feature the purchase of the assets by the manager at nominal value and fixed periodic payments to investors.[179] While the global financial crisis has been highlighted by a number of commentators as a primary reason for the fall in *sukūk* issuances,[180] the dominance of *ijārah sukūk* after 2008, and the fact that a number of *sukūk* issued since then have implemented some of the AAOIFI guidelines,[181] suggest that the concern over *Sharī'ah* validity did not go unnoticed by the industry.

The Saudi Hollandia Bank *mudāraba sukūk* issuance in 2009,[182] for example, involved several elements which comply with the AAOIFI guidelines. The returns paid to investors

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[175] Of course, equity-based *sukūk* issuances which use no reserve account, on account payments and which terminates which the market-value sale of the assets may not function as a fixed income security – the point being emphasised here however is that an asset backed *sukūk* does not necessarily lose all its similarities with conventional bonds.

[176] Islamic Financial Services Board, *Capital Adequacy Requirements for sukuk, securitisations and real estate investment, IFSB 7*, (Kuala Lumpur, 2009), at 3-4, available at: http://www.ifsb.org/standard/ifsb7.pdf.

[177] Bahrain Financial Exchange Handbook, *The Exchange Business: An Insight*, (Bahrain, 2010) available at: http://www.bfx.bh/media/downloads/BFX-Handbook-Web.pdf.

[178] Hijazi, Faisal, *Global Sukuk Issuance Poised for Boost from New Legislative and Regulatory Initiatives*, note 14, at 3.

[179] Alvi, Ijlal Ahmed et al., *Sukuk Report*, (International Islamic Financial Market, Bahrain, 2010), at 27, available at: http://www.institutfrancaisdefinanceIslamique.fr/docs/files/14_IIFM_Sukuk__Report_1st_Edition.pdf, Ernst & Young, "The Ijarah structure's widespread acceptability led to its dominance in this period", in *Collaborative Sukuk Report*, Paul McNamara, (ed.), (Zawya, Dubai, 2009), at 116.

[180] Such as Howladar, quoted in Kawach, Nadim, "GCC sukuk recovery in 2011: Moody's", *Emirates 24/7*, June 20, 2010, available at: http://www.zawya.com/story.cfm/sidZAWYA20100620042702/GCC sukuk recovery in 2011. Hijazi, Faisal, "Global Sukuk Issuance Surges as Effects of Credit Crisis Recede: Overview and Trend Analysis", *Moody's Special Report*, (Moody's Investors Services, 2009).

[181] These are discussed in the next paragraph, *infra.* at 320.

[182] Prospectus, Saudi Hollandi Bank, Offer of Mudaraba Sukuk due 2019 callable with step up in 2014, available at: http://www.iefpedia.com/english/wp-content/uploads/2009/12/SHB-2009-Sukuk-Prospectus1.pdf.

under this *sukūk* issuance are fixed,[183] yet such payments are made solely from the money produced by the underlying *mudāraba* assets. Anything in excess of the fixed amount is placed in a reserve account; any shortfall in payment is covered by the money in the reserve account and if necessary, on-account payments by the manager.[184] Equally, there is no undertaking to purchase the assets at par value at *sukūk* maturity and so any shortfall in asset value will need to be covered by the reserve account.[185] If this account is insufficient, the *sukūk* holders may not recover the full value of their *sukūk*. Although noting that this *sukūk* structure appears to be implementing AAOIFI's guidelines, Salah has suggested that it does not fully succeed in doing so.[186] There is, for example, an option for the issuer to redeem the *sukūk* at par value from 2014 until maturity (2019), so long as the value of the assets is equal to or greater than the par value of the *sukūk*.[187] Equally, while the payments made to the *sukūk* holders arise directly out of the *mudāraba* assets, the investors never obtain ownership of those assets, contradicting the first clause of AAOIFI's clarification guidelines.[188] This *sukūk* is asset-based in nature. Another innovative *sukūk* was issued in August 2010 in Malaysia; the *Sukūk al-Amanah Li al-Istithmar* again does not contain a repurchase undertaking.[189] Instead, the underlying assets (and certificates which evidence interest in them) will be disposed of by means of a private auction with the minimum bid being principal and final profit payment.[190] The returns paid to the *sukūk* investors are in

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[183] Prospectus, Saudi Hollandi Bank, Offer of Mudaraba Sukuk due 2019 callable with step up in 2014, at 6, available at: http://www.iefpedia.com/english/wp-content/uploads/2009/12/SHB-2009-Sukuk-Prospectus1.pdf, the "periodic distribution amount" is linked to SIBOR.

[184] Prospectus, Saudi Hollandi Bank, Offer of Mudaraba Sukuk due 2019 callable with step up in 2014, at 4, available at: http://www.iefpedia.com/english/wp-content/uploads/2009/12/SHB-2009-Sukuk-Prospectus1.pdf which notes; "[i]f the Mudaraba Income in any Periodic Distribution Period exceeds the Periodic Distribution Amount, the amount of any surplus shall be retained by the Issuer as a reserve (the —Reserve). The Issuer shall not have the right to use and invest the monies (if any) standing to the credit of the Reserve for its own account. The Issuer shall pay the monies (if any) standing to the credit of the Reserve to the Sukukholders to compensate the Sukukholders for any shortfalls relating to Periodic Distribution Amounts and to compensate the Sukukholders for any loss relating to the Mudaraba Assets as at the Expiry Date, Optional Expiry Date, the Regulatory Dissolution Date or the Event of Default Date (each as defined in the Conditions), with the balance of the monies (if any) standing to the credit of the Reserve to be received by the Issuer as an incentive."

[185] Prospectus, Saudi Hollandi Bank, Offer of Mudaraba Sukuk due 2019 callable with step up in 2014, at 4, available at: http://www.iefpedia.com/english/wp-content/uploads/2009/12/SHB-2009-Sukuk-Prospectus1.pdf.

[186] Salah, Omar, "Islamic finance: the impact of the AAOIFI Resolution on equity-based sukuk structures", note 90, at 514.

[187] Prospectus, Saudi Hollandi Bank, Offer of Mudaraba Sukuk due 2019 callable with step up in 2014, at 7, available at: http://www.iefpedia.com/english/wp-content/uploads/2009/12/SHB-2009-Sukuk-Prospectus1.pdf, Salah, Omar, "Islamic finance: the impact of the AAOIFI Resolution on equity-based sukuk structures", (note 90, at 514.

[188] *ibid.*

[189] A report on the deal notes that "providing a purchase undertaking to buy back the asset or portfolio of assets at par value deviates from the spirit of true risk- and reward-sharing in Islamic finance, where profit generation is only legitimised by engaging in real economic ventures and risk-taking activities." RAM Ratings, "Sukuk al-Amanah Li al-Istithmar", *Landmark Deal Report*, note 108, at 7.

[190] *ibid.*, at 6.

part subject to market forces and could be higher than par value. The deal is, however, still regarded as asset-based, as the originator has undertaken to repurchase the assets at par in the event that no outside bid is received.[191] Genuinely asset-backed *sukūk* thus remain very limited in the *sukūk* market,[192] although such arrangements are not entirely absent; the Sun Finance (Sorouh) *mudāraba sukūk* issued in 2008, involved a true sale of the underlying assets to the SPV and the transfer of beneficial ownership to the *sukūk* investors.[193]

Following the default of Kuwait's Investment Dar Co.'s *sukūk* in April 2009 and the payment standstill under the Nakheel *sukūk* in December 2009, some commentators have suggested that *sukūk* holders may now "seek asset rights"[194] which give them an enforceable claim over the underlying assets. Nevertheless, asset-based *sukūk* - albeit ones which appear to be attempting to comply with some of AAOIFI's guidelines - remain the dominant approach to *sukūk* issuance.[195]

8.5 Conclusion to Chapter 8

Like Islamic real estate financing activity, the *sukūk* market is not composed of one, single, contractual form. Instead, the nominate contracts have been used to produce a variety of transactions which function as *Sharī'ah*-compliant substitutes for conventional bonds. In theory, the rights and responsibilities of the parties to a *sukūk* issuance will vary according to the underlying nominate contract. In practice, *sukūk* are frequently structured so that they function like fixed-income debt instruments, regardless of the nominate contract on which they are based. This feature of the modern *sukūk* issuances has been subject to high profile criticism and reflects the broader tension in the Islamic finance industry between the need to comply with Islamic law in form and/or in substance.

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[191] *ibid.*, at 2, noting that; "[t]he assigned ratings ultimately reflect Cagamas' AAA-rated credit profile. In this transaction, Cagamas assumes various roles including the issuer, agent, purchaser and seller under the respective contracts. From a credit perspective, the Sukuk *ALIm* is viewed to carry the same risk as all of the Company's other unsecured obligations, in spite of the assets attached to the *sukuk*.

[192] McMillen, Michael J.T., "Asset Securitization Sukuk and Islamic Capital Markets: Structural Issues in these Formative Years", note 37, at 739

[193] Prospectus, Sun Finance Limited Sukuk, at 35, available at: http://www.sorouh.com/en/media/get/20091115_01-prospectus.pdf.

[194] El Baltaji, Dana and Permatasari, Soraya, "Dubai Crisis Prompts Sukuk Holders to Seek Asset Rights: Islamic Finance", *Bloomberg*, July 13, 2010, available at: http://www.bloomberg.com/news/2010-07-13/dubai-crisis-prompts-sukuk-holders-to-seek-asset-rights-Islamic-finance.html, quoting Sheikh Yusuf Talal DeLorenzo who suggests that asset-backed debt will become more popular in sukuk issuances.

[195] As Goud noted, this is "the current state of sukuk; they will incorporate limited profit-sharing, but not to the point at which the sukuk has risks that differ from an unsecured bond," Goud, Blake, "Sukuk ALIM - RAM Ratings Report", *Zawya*, August 28, 2010, available at: http://ae.zawya.com/blogs/blakegoud/100828043608/.

This Chapter has concluded that the debt-like, asset-based *sukūk* continue to dominate the *sukūk* industry. However, the current preference amongst market participants for *ijārah sukūk*, and the fact that the issuance of *sukūk* which openly violate the AAOIFI pronouncement has diminished since 2008 are noteworthy developments. It is suggested that the industry is currently undertaking the difficult task of overtly complying with the AAOIFI guidelines while still producing economic substitutes for interest-based bonds.

Ireland's only legislative treatment of *sukūk* has been in relation to the taxation of these transactions and their participants. These accommodations[196] have been promoted by Irish authorities as a mechanism to "enhance Ireland's competitiveness and attractiveness as a domicile for sukuk issuance..."[197] Like the legislative accommodations relevant to Islamic real estate finance,[198] those applicable to *sukūk* are ideologically neutral.[199] Nevertheless, in a March 2010 Information Note, the Irish Department of Finance defined *sukūk* as "the equivalent of a bond or other securitised or structured finance arrangement"[200] and confirmed that the amendments to the Tax Acts introduced by the Finance Act 2010 have sought to ensure "equality of treatment between Islamic financial products and their conventional counterparts [in circumstances where] [t]hese products are the same in substance as conventional financial products."[201] Most recently, the October 2010 Guidance Note, issued by the Irish Revenue Commissioners, envisages *sukūk* as "similar to a securitisation or other structured finance arrangement"[202] and goes on to refer to the *sukūk* holder's share in the ownership of the underlying assets.[203] The accommodations introduced so far in the Irish legal system have therefore acknowledged the asset-linked nature of *sukūk* certificates and indeed, appear to suggest that *sukūk* transactions are more readily comparable to conventional securitisation than to unsecured bonds.[204]

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[196] Discussed in detail in Chapter 9, *infra.* at 326.

[197] Parker, Mushtak, "Ireland presses on with Islamic finance tax neutrality laws", *Arab News*, November 21, 2010, available at: http://arabnews.com/economy/article197574.ece.

[198] *supra.* at 237.

[199] Parker, Mushtak, "Ireland presses on with Islamic finance tax neutrality laws", note 197.

[200] Department of Finance, *Islamic Finance in Ireland; An Information Note*, (Department of Finance, Dublin, March 2010), at 5.

[201] *ibid.*, at 3.

[202] Revenue Commissioners, "Guidance Notes on the Tax Treatment of Islamic Financial Transactions", (Revenue, Dublin, October 2010), at 33.

[203] *ibid.*, at 33, [8.1].

[204] Amin, Mohammed, "The new UK tax law on sukuk", (October-December 2007) 166 *NewHorizon Magazine*, 36-38 at 38 noting that "HM Treasury primarily saw sukuk as an equivalent to conventional securitisation."

With the *sukūk* structures discussed above and the market preference for asset-based, generally *ijārah sukūk* in mind, Chapter 9 will explore the potential treatment of *sukūk* under Irish law. Chapter 9 is divided into two distinct sections: one dealing with the interaction between *sukūk* structures and Irish tax law and the second dealing with *sukūk* and Irish regulatory laws.

Chapter 9

Sukūk and Irish law

9.1 Introduction

No Irish corporate or Government agency has yet issued *sukūk* certificates,[1] although several *sukūk* issuances have been listed on the Irish stock exchange. In fact, the Sorouh Real Estate-Sun Finance Limited *sukūk*, one of the few true securitisation *sukūk* issuances,[2] is listed in Ireland.[3] The Irish financial system has thus already had experience of *sukūk* structures, unlike the Islamic real estate financing transactions considered in Chapter 6 and Chapter 7. In light of the accommodations introduced in Chapter 8, which clarify the tax position of *sukūk* issuers/originators and *sukūk* holders, the Irish authorities are now attempting to encourage more stages of the *sukūk* issuance to take place in Ireland. As jurisdictions such as Luxembourg and the UK develop accommodative legal and tax frameworks in order to develop domestic *sukūk* markets,[4] the 2010 accommodations are Ireland's challenge to the dominance of these jurisdictions in Islamic capital market activity.[5] However, in light of the more advanced legal adjustments made in the UK, and

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[1] Notwithstanding the suggestions of Owens and Thompson that the Irish government should issue a sovereign sukuk, Owens, Ken and Thompson, Yvonne, "Sovereign Sukuk, A Way to Revive the Celtic Tiger?", (2011) 43(2) *Accountancy Ireland*, 34-36.

[2] Howladar, Khalid, "Moody's Assigns Provisional Ratings to Sukuk Certificates issued by Sun Finance Limited", *Moody's Investors Services, Global Credit Research*, (Moody's Investors Services, London, 2008), at 1.

[3] Although the issuer is incorporated in Jersey, Bedell Cristin, *Islamic Finance in Jersey*, (Bedell Cristin Jersey Briefing, Jersey, 2009), at 1, available at: http://www.legal500.com/assets/images/stories/firmdevs/bede4804/Islamic_finance_in_jersey1.pdf.

[4] Parker, Mushtak, "London and Luxembourg battle over sukuk listing domicile", *Arab News*, June 6, 2011, available at: http://www.arabnews.com/economy/Islamicfinance/article448955.ece.

[5] The London Stock Exchange has the most sukuk issuances in Europe, (30 sukuk issuances raising just under $19 billion). London's closest European competitor is Luxembourg, (16 sukuk issues raising $7.3

the fact that Luxembourg's legal framework recognises (rather than overlooks) the asset-ownership of *sukūk* holders[6] and permits effective compliance with AAOIFI standards,[7] further amendments may need to be made to Ireland's laws.

This Chapter will consider the interaction between the *sukūk* transactions discussed in Chapter 8 and Irish law. Section 9.2 will discuss the likely tax issues raised by *sukūk* issued in Ireland.[8] It will look at the effectiveness of the accommodations introduced by the Finance Act 2010 and suggest further reforms which may facilitate the creation of a level playing field in terms of taxation. Section 9.3 will discuss the potential regulation of *sukūk* arrangements under Irish law.[9] Noting the absence of any tailored accommodation dealing with such regulation, this section will highlight the continuing uncertainties faced by parties to *sukūk* issuances. Suggestions for reform will be presented.

9.2 Taxation of *Sukūk* in Ireland

Sukūk, whether asset-based or asset-backed, constitute certificates evidencing some level of *sukūk* holder interest in income-generating assets,[10] a feature reinforced by the market's post-2008 emphasis on greater asset-linkage.[11] In light of the role of tangible assets and productive ventures within *sukūk* transactions, the legal form of these arrangements could be characterised as sharing features with equity-type participatory investments.[12] Such similarities are a consequence of Islamic law's preference for risk-sharing and equity investment in which rewards are generated by active involvement in

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billion), Walmsley, Gillian quoted in Anonymous, "Sukuk - Is the Market Reviving?", (January-March 2011) 178 *NewHorizon Magazine*, 7 at 7.

[6] Le Governement du Grand-Duche de Luxembourg, Administration des Contributions Directes, *Circular of the Tax Director L.G.-A nr 55 of 12 January 2010*, "Islamic Finance", at 4-5, available at:http://www.lff.lu/fileadmin/redaction/News/TaxCirc_2010_12Jan_IslamFin_EN.pdf.

[7] Afakir, Jamal, "The Luxembourg Islamic Finance Package - Direct Tax Aspects", (2010) 7(21) *Islamic Finance News*, 10-11 at 11.

[8] *infra.* at 326.

[9] *infra.* at 352.

[10] *supra.* at 301, Shoon, Natalie, *Islamic Asset Management; An Asset Class on its Own?*, (Edinburgh University Press, Edinburgh, 2011), at 43, De Belder, Richard T and Curtis, James, "Recent Innovations in the Islamic sukuk market", *IIBI lecture*, November 2007, available at: http://www.newhorizon-Islamicbanking.com/index.cfm?action=view&id=10576&section=lectures.

[11] *supra.* at 316.

[12] Shoon, Natalie, *Islamic Asset Management; An Asset Class on its Own?*, note 10, at 43, Jabeen, Zohra and Khan, Memoona Rauf, "An Inquiry into the Usage of Real Assets in Islamic Transactions and their Benchmarking: The Implications for Islamic Capital Markets", in *Islamic Capital Markets: Products, Regulation and Development*, Salman Syed Ali (ed.), (Islamic Development Bank, Islamic Research & Training Institute, Jeddah, 2008), 69-84 at 73.

productive economic activity.[13] This conclusion is supported by AAOIFI's confirmation that *sukūk* do not represent a debt.[14]

Notwithstanding legal form, however, *sukūk* transactions frequently function like debt. They provide the investors with a fixed income stream over the course of the *sukūk*, and, ultimately repayment of principal. Accommodating tax provisions introduced in Ireland and in numerous other jurisdictions have attempted to address the irregular, potentially disproportionate, tax treatment which may arise as a result of this disparity between form and substance. This section will discuss these fiscal accommodations. It will look first to other jurisdictions as a source of guidance (9.2.1).[15] It will consider the purpose of the accommodations introduced by Ireland's Finance Act 2010 and will argue that such accommodations are designed to align the tax treatment of debt-like *sukūk* with debt securities (9.2.2).[16] It will then look in detail at several areas of taxation which are relevant to *sukūk* issuances (9.2.3)[17]: corporation tax (A),[18] stamp duty (B),[19] chargeable gains and capital allowances (C).[20] This section will acknowledge the need for accommodation and will propose further reforms which may be introduced. However, this section concludes that accommodation of *sukūk* – and indeed any Islamic financial transaction – should ensure that economically similar products are subject to similar taxation. Such reforms should not be used to confer tax benefits on Islamic financial transactions which are not also available to economically similar conventional structures (9.2.4).[21] To do so would not create a level playing field and could jeopardise the integrity of Ireland's tax framework.

9.2.1 Fiscal Accommodation of *Sukūk* Transactions in Other Jurisdictions

Focusing only on the legal structure of *sukūk* as a means of determining tax liability would elevate external features of these transactions over their "social and economic reality."[22] The UK authorities have explicitly highlighted the opaque tax position of *sukūk* as a key factor inhibiting the growth of a UK *sukūk* market. Noting that "[t]he tax

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[13] *supra.* at 49 et seq.
[14] AAOIFI, Shari'a Standard No. (17), "Investment Sukuk", in *Shari'a Standards for Islamic Financial Institutions 1432 H-2010*, (AAOIFI, Bahrain, 2010), 303-323 at 309.
[15] *infra.* at 327.
[16] *infra.* at 329.
[17] *infra.* at 333.
[18] *infra.* at 333.
[19] *infra.* at 341.
[20] *infra.* at 348.
[21] *infra.* at 349.
[22] *Commissioner of Taxation v Gloxinia Investments (Trustee)* [2010] FCAFC 46 at [78].

treatment of the issue of a sukuk based on Shari'a compliant financial products is in some areas uncertain and in others produces anomalous results,"[23] HMRC has sought to provide a specific legal basis for *sukūk* within the UK's tax legislation.[24] The gradual accommodations which have been introduced in the UK have attempted to clarify the taxation of *sukūk* and to align their taxation with that imposed on conventional debt securities, in circumstances where the *sukūk* are substantially equivalent in effect to interest-bearing bonds.[25] This development is not exceptional. *Sukūk* have consistently been amongst the first Islamic transactions for which tax authorities have provided clarification, either by issuing guidelines or by amending existing legislation. In countries such as Luxembourg[26] and France,[27] which apply a substance over form approach to taxation, guidance has been published in order to ensure clear and consistent tax treatment of Islamic securities.[28] In doing so, the tax authorities of these countries have, like those in the UK, confirmed that debt-like *sukūk* will be subject to the same tax treatment as conventional bonds.

Malaysia's approach to the Islamic capital markets rests firmly on the promotion of this sector. As noted in Chapter 4, this prioritisation has been used as a mechanism to ensure that *sukūk* issued in Malaysia are not placed in a disadvantageous position due to the still developing nature of the Islamic finance market.[29] Rather than taking steps solely aimed at supplying the necessary infrastructure for *sukūk*, Malaysia has adopted specific measures to strengthen this market. Since 2003, Malaysia has consistently implemented tax exemptions, reductions and an environment conducive to the issuance of *sukūk*.[30] In

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[23] HM Revenue & Customs, *Budget 2007: Regulatory Impact Assessment – Alternative Finance Products*, (HMRC, London, 2007), at [4.14]. See also, HM Revenue & Customs who noted that; "[t]he Government measures enable sukuk to be held, issued and traded in the same way as corporate bonds," HM Revenue & Customs, *Stamp Duty Land Tax: Commercial Sukuk, Consultation Document*, (HMRC, London, June 26, 2008), at [3.5], available at: http://customs.hmrc.gov.uk/channelsPortalWebApp/channelsPortalWebApp.portal?_nfpb=true&_pageLabel=pageLibrary_ConsultationDocuments&propertyType=document&columns=1&id=HMCE_PROD1_028685.

[24] Ali, Yasmin, *Impact Assessment for Stamp Duty Land Tax, Capital Gains Tax & Capital Allowance tax reliefs for Alternative Finance Investment Bonds*, (HMRC, London, April 22, 2009), available at: http://www.hmrc.gov.uk/budget2009/afi-bonds-100.pdf.

[25] Bi, Farmida and Savin, Angela, "Sukuk Issuance: the future", *Practical Law Company*, August 21, 2009.

[26] Luxembourg, Le Governement du Grand-Duche de Luxembourg, Administration des Contributions Directes, *Circular of the Tax Director L.G.-A nr 55 of 12 January 2010*, "Islamic Finance", note 6, at 5.

[27] France; Bulletin Officiel Des Impôts, No 78 du 24 August 2010, Direction Générale des Finances Publiques 4 FE/S2/10, "Régime Applicable aux Sukuk d'investissement".

[28] Delaigue, B and Reillac, A, "France Adopts Tax Measures to Promote Islamic Finance", (2009) 49(5) *European Taxation*, 286-289.

[29] *supra.* at 125.

[30] Shaffaii, Suapi, "Malaysian Budgets 1999-2009: Setting forth the Government's commitment to developing Islamic finance", *Islamic Finance News Portal*, September 15, 2008, available at: http://Islamicfinanceupdates.wordpress.com/malaysian-budgets-1999-2009-setting-forth-the-governments-

contrast, Pakistan's acknowledgement that accommodating treatment of Islamic finance should not result in "any reduction or addition to income and tax liability"[31] highlights that, like their European counterparts, Pakistani authorities are seeking to establish tax parity between Islamic and conventional products. However, as discussed in Chapter 4, few legislative amendments, or guidance, have been published in order to clarify this position.[32] The structural distinctiveness of *sukūk* suggests that the Pakistani approach may be an insufficient means of removing tax burdens and could lead to uncertainty amongst market participants over the tax position of individual Islamic instruments.

9.2.2 The Purpose of Fiscal Accommodation of *Sukūk* under Irish Law

The provisions of Ireland's Finance Act 2010[33] acknowledge the participatory nature of *sukuk*, at least in part. Newly inserted Part 8A of the TCA provides a definition of "investment transaction,"[34] "investment certificate"[35] and "investment return,"[36] outlining structures which are functionally similar to the generic *sukūk* formulation outlined in Chapter 8.[37] Defining "investment certificate" as meaning a security which establishes the "claim of [a] person over the rights and obligations represented by the certificate" and "entitles the owner to an amount equivalent to a share in the profits or losses derived from an asset held by the qualifying company which issued the certificate,"[38] the Irish accommodations acknowledge that the returns in *sukūk*, unlike those of unsecured corporate bonds, are based on the performance of an underlying asset. Indeed, as the definition of "asset" includes "all forms of property," [39] the legislation confirms that this asset may be tangible. It is also noteworthy that the provisions highlight the potential for

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commitment-to-developing-Islamic-finance/ noting that in order to encourage the issuance of non-ringgit *sukūk* in Malaysia, the Government proposed in the 2009 Budget that tax exemption be given for a period of three years for fees and profits earned by institutions undertaking activities relating to the arranging, underwriting, distributing and trading of non-ringgit sukuk issued in Malaysia and distributed outside Malaysia.

[31] Bukhari, Huzaima and Haq, Ikramul, "Pakistan", *World Tax*, available at: http://www.itrworldtax.com/Guide/308/Pakistan.html.

[32] *supra.* at 109

[33] Finance Act 2010, Number 5 of 2010.

[34] Section 267N(1) Taxes Consolidation Act 1997 as introduced by section 39 Finance Act 2010.

[35] *ibid.*

[36] *ibid.*

[37] *supra.* at 306 et seq.

[38] Section 267N Taxes Consolidation Act 1997 as introduced by section 39 Finance Act 2010.

[39] *ibid.*, Section 39 defines "asset" as the same as "asset" under Section 532 Taxes Consolidation Act 1997.

losses to occur over the course of the *sukūk* transaction, a fact which suggests that the Irish provisions do not require the use of liquidity enhancements to ensure fixed returns.[40]

On default or maturity of the *sukūk*, Part 8A requires the redemption of the certificates.[41] Therefore, there must be some form of purchase undertaking in the agreement. However, there does not appear to be a requirement that this repurchase occur at par value.[42] A close reading of the AAOIFI guidelines suggests that the clarification did not prevent certificate repurchase *per se*, simply those agreements which involved a pre-agreed fixed purchase price. As a result, it is possible for the certificates to be redeemed at market value or at a price agreed upon at the time of purchase, a feature which would seem to be supported by the TCA. UK legislation has gone further. Noting that the "amount of the redemption payment may (but need not) be subject to reduction in the event of a fall in the value of the bond assets or in the rate of income generated by them,"[43] UK accommodations have confirmed that unlike conventional bonds, the ultimate redemption of the "alternative finance bond arrangements" (*sukūk*) may not be at the original issue value.

However, elements of Ireland's accommodating provisions suggest that notwithstanding participatory aspects of *sukūk* transactions, for the purposes of Irish tax law these arrangements will be treated as debt, not equity. First, classified by Part 8A as "securities,"[44] the *sukūk* arrangements which fall within the new provisions produce an

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[40] A similarly flexible approach has been adopted in the UK although noting that the amount of the additional payments may be fixed at the beginning of the term, determined wholly or partly by reference to the value of or income generated by the assets, or determined in some other way, the provisions of the Corporation Tax Act 2009 go one step further in explicitly confirming the fact that sukuk returns in the UK do not need to be pre-determined and guaranteed in nature to fall within the accommodations Section 507(2)(f) Corporation Tax Act 2009.

[41] Paragraph (a) of the definition of "investment transaction" states that this is a transaction whereby "a person acquires investment certificates and receives an investment return" with "investment return" relates to the "excess (if any) of the consideration paid by the qualifying company *on redemption f the certificates...*" thus establishing the redemption as a defining feature of the investment certificate arrangements within the accommodating provisions (emphasis added). Section 267N, Taxes Consolidation Act 1997 as introduced by section 39 Finance Act 2010, definition of "investment return"

[42] Investment return is defined as the "excess (*if any*)." Section 267N, Taxes Consolidation Act 1997 as introduced by section 39 Finance Act 2010, definition of "investment return"

[43] Section 507(2)(h) Corporation Tax Act 2009.

[44] In and of itself classifying *sukūk* certificates as "securities" is *not* sufficient to align the taxation of *sukūk* with conventional debt-based bonds. This is due to the fact that Ireland's Taxes Consolidation Act 1997 does not contain a general definition of securities. Instead, there are a number of descriptions of these instruments which vary according to the purpose of the provision. Several provisions in the Taxes Consolidation Act 1997, for example define "security" narrowly as extending only to cover "stocks and shares," (see for example section 748 Taxes Consolidation Act). Others on the other hand, define "security" broadly as "shares, stocks, bonds, debentures and debenture stock and any promissory note or other instrument evidencing indebtedness issued to a loan creditor of the company," (section 892 Taxes

"investment return."[45] Through the process of "deeming" discussed in Chapter 7,[46] the Tax Acts will apply to this investment return as if it "were interest on a security."[47] Although "interest" is not defined fully[48] by the TCA, it is referred to throughout the Act in the context of interest on money[49] as distinct from the "distribution" paid as a result of an equity-type interest in a company/venture/asset.[50] This would suggest that the "interest" which *sukūk* investment returns are "deemed" to represent, is interest on a loan.

Second, for the purposes of the Tax Acts, "the owner of the investment certificate *shall not be regarded as having a legal or beneficial interest in the assets held by the qualifying company.*"[51] Notwithstanding any declaration of trust made by the issuer in favour of the *sukūk* holders, any beneficial ownership is not taken into account by the tax authorities and the parties to the *sukūk* are taxed as if they were parties to a conventional debt.[52] Pursuant to this, "income, profits, gains or losses arising from or attributable to the assets held by the qualifying company shall be income, profits, gains or losses...of the qualifying company and the qualifying company shall be chargeable to corporation tax

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Consolidation Act). While yet others distinguish between "shares" and "securities" with the implication that security is, in this context, largely confined to debt-securities rather than those which are equity in nature (section 135 which defines "security" for the purposes of Chapter 2 dealing with distributions). Thus, by defining *sukūk* as securities, the Finance Act 2010 has confirmed that these certificates are financial instruments but it has not limited the type of securities to those which are debt-based or those which are equity.

[45] Section 267N(1) Taxes Consolidation Act 1997 as introduced by section 39 Finance Act 2010.

[46] *supra.* at 235.

[47] Read in conjunction with existing provisions of the Taxes Consolidation Act 1997, this exemption would appear to apply only to those payments which "represent[t] a reasonable commercial return for the use of [the] principal" (Section 130(2)(d)(iii)(II)) thus ensuring that only those transactions whose economic implications are similar to conventional bonds will actually benefit from parity of treatment. In the UK, a similar caveat is included expressly in the provisions dealing with alternative investment bonds; Section 77A(2)(e) of the RAO 2001 as amended states that "the amount of the additional payments does not exceed an amount which would, at the time at which the bond is issued, be a reasonable commercial return on a loan of the capital"

[48] "Interest" is defined as "both annual or yearly interest and interest other than annual or yearly interest," section 4(1) Taxes Consolidation Act 1997, an identical definition of "interest" in the UK was referred to by a UK Tax Tribunal who then went on to confirm that "the natural and ordinary meaning of interest is that it is a sum of money calculated by reference to an underlying debt which is payment by time for the use of the money borrowed and which accrues from day to day, whether or not it is paid periodically," *Nicholas Pike v The Commissioners for Her Majesty's Revenue and Customs* [2011] UKFTT 289 (TC), at [50] per Mrs B Mosedale (Tribunal Judge).

[49] See for example section 105 Taxes Consolidation Act 1997 which refers to interest on a loan, indeed, for the purposes of Chapter 6 of Part 8, interest is defined as "income from debt-claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in the debtor's profits, and in particular, income from securities and income from bonds or debentures, including premiums and prizes attaching to such securities, bonds or debentures but does not include penalty charges for late payment" clearly highlighting the connection with debt," section 267G(1) Taxes Consolidation Act 1997 as introduced by Schedule 1, Finance Act 2004.

[50] Section 130 Taxes Consolidation Act 1997 which deals with distributions

[51] (emphasis added) Section 267S(1) Taxes Consolidation Act 1997 as introduced by section 39 Finance Act 2010.

[52] A similar approach has been adopted in the UK, see Amin, Mohammed, "The new UK tax law on sukuk", (October-December 2007) 166 *NewHorizon Magazine*, 36-38 at 38.

accordingly."[53] The issuer, rather than the *sukūk* holder, is also the party who can claim capital allowances on the *sukūk* assets.[54] In effect, the Tax Acts treat *sukūk* as loans, returns on which are derived (in whole or part) from underlying assets, rather than as enforceable transfers of ownership of those assets.

Finally, ss.267 R and S, the provisions relevant to *sukūk*, are subject to s.130 TCA (dealing with the definition of a distribution).[55] Under s.130(2)(d)(iii)(II), payments will be treated by the Tax Acts as a distribution (and not interest) unless those payments "represent[t] a reasonable commercial return for the use of [the] principal."[56] Consequently, only those transactions whose economic implications are similar to conventional interest-based lending will be caught by the accommodating provisions for *sukūk*. The Revenue Commissioners subsequently confirmed this conclusion in its Guidance Notes which state that "the investment return equates to the amount which would be equivalent to interest on a conventional bond."[57] Those *sukūk* which are not functionally equivalent to debt, and which are both structurally *and* substantively comparable to equity, will fall outside the provisions of Part 8A and will instead be taxed like equity.[58]

Like accommodations introduced elsewhere, the purpose of Ireland's is to align the taxation of debt-like *sukūk* with the taxation of conventional bonds. The remainder of this section will consider the success of these accommodations. As a source of guidance, more detailed consideration will also be given to the legislative adjustments implemented in the UK.

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[53] Section 267S(2) Taxes Consolidation Act 1997 as introduced by section 39 Finance Act 2010.

[54] Section 267S(3) Taxes Consolidation Act 1997 as introduced by section 39 Finance Act 2010.

[55] Section 267R Taxes Consolidation Act 1997 as introduced by section 39 Finance Act 2010 which notes that; "[s]ubject to section 130, the Tax Acts shall apply to an investment return as if that investment return were interest on a security and the return shall be chargeable to tax accordingly."

[56] Section 130(2)(d)(iii)(II) Taxes Consolidation Act 1997.

[57] Revenue Commissioners, "Guidance Notes on the Tax Treatment of Islamic Financial Transactions", (Revenue, Dublin, October 2010), at 33, available at: www.revenue.ie/en/practitioner/tech.../guidance-notes-islamic-finance.pdf.

[58] Although, in light of AAOIFI's confirmation that *mushāraka*, *mudāraba* and *wakala sukūk* certificates can be purchased at anything but a fixed pre-agreed price as well as the continued permissibility of reserve accounts and on account payments, it is suggested that most *sukūk* could be structured so as to fulfil the basic structure set out in the accommodating provisions.

9.2.3 Taxation of *Sukūk*: the Effectiveness of Ireland's Legislative Accommodations

A. Corporation Tax

1. Trade

In order to qualify as investment certificates, *sukūk* issued in Ireland by a company, do not have to be issued through a separately incorporated entity. However, the issuing company has to be resident in the State.[59] As a result, where the *sukūk* originator is domiciled outside of the State, it will most probably establish an SPV as issuer. Part 8A TCA specifies that the issuer of an investment certificate must be a "qualifying *company*."[60] This restriction draws the initial focus of *sukūk* taxation onto the corporation tax liability of that issuing company. As noted in Chapter 7, s.21 TCA provides the legislative basis for imposing corporation tax on the profits of a company with the level of this corporation tax determined according to a "scheduler system"[61] as set out in s.18 TCA. The Schedules relevant to securities activity are most likely to be Schedule D Case I which relates to profits generated in respect of any trade and Case IV covering any gains not within another Case.[62] In concurrence with this liability to corporation tax, expenses incurred by a company can be deducted in computing the amount of profit subject to tax where these expenses are "wholly and exclusively laid out or expended for the purposes of the trade..."[63] While s.3(1) TCA defines "trade" as including "every trade, manufacture, adventure or concern in the nature of trade,"[64] there is little official clarification outlining what exactly constitutes a trade sufficient to fall within the provisions of Schedule D.[65] Caselaw from both Ireland and the UK suggests that an SPV may struggle to demonstrate

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[59] Definition of "qualifying company" in Part 8A Taxes Consolidation Act 1997 as introduced by section 39 Finance Act 2010.

[60] Definition of qualifying company. Section 267N(1) Taxes Consolidation Act 1997 as introduced by section 39 Finance Act 2010 which notes that 'qualifying company' means a company which—

a) is resident in the State,

b) issues investment certificates to investors,

and

c) redeems the investment certificates after a specified period of time

[61] Smyth, David and Walsh, Aidan, "Background – Tax Regime for International Financial Business", in *Taxing Financial Transactions*, (1st ed., Irish Taxation Institute, Dublin, 2004), 7-30 at 9, *supra.* at 226.

[62] Section 18(2) Taxes Consolidation Act 1997 as amended by the Finance Act 2006, section 15.

[63] Section 18(2) Taxes Consolidation Act 1997 as amended by the Finance Act 2006, section 15.

[64] Section 3(1) Taxes Consolidation Act 1997.

[65] Hickson, John, "Intellectual Property Tax Treatment in Ireland", (March-April 2011) *International Tax Journal*, 19-24, 48-50 at 20 noting that; '[t]here is no precise statutory definition of "trading" or a "trade" and it is therefore necessary to refer to relevant case law in order to determine whether or not a trade exists."

that it is carrying on a trade for tax purposes.[66] In *Cooper v C&J Clark Ltd*[67] for example, the English High Court noted that marketable securities, being income-yielding assets usually capable of appreciating in value, are *prima facie* purchased and sold by way of investment and not by way of trade.[68] Similarly, the Revenue Commissioners' guidance on what it considers to be trading activity provides that "[c]ertain types of activity are more likely to be in the nature of an investment rather than a trade. In general, where a company owns an asset and the mere ownership of that asset produces an income, the company's income from this asset will not be trading income."[69] While the Revenue Commissioners has noted that when determining trading status the "whole picture" must be taken into account,[70] the fact that *sukūk* SPVs generally do no more than hold the assets on trust for the *sukūk* holders and direct revenue to those investors may make it difficult for such entities to demonstrate that their activity is trading in nature.

Recognising the difficulty faced by single purpose entities when attempting to prove that their activities constitute a trade, s.110 TCA was enacted to ensure that conventional SPVs in Ireland would be treated, for corporation tax purposes, as if they were a trading company.[71] S.110 also provides that profits arising out of a qualifying SPV "in relation to activities carried out by it in the course of its business,"[72] shall be chargeable to corporation tax under Case III of Schedule D[73] although the profits or gains earned by the SPV, together with the expenses which could be deducted from corporation tax liability,

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[66] Walsh, Aiden, "Taxation of Interest Bearing and Discount Instruments for non-financial traders", *Tax Ireland*, (January 30, 2003), available at: http://www.taxireland.ie/taxfind/ContentHTML/ParsedHTML/sacp_HTMLFILES%5C04sacp%5C_h200599.htm%5C_h300602%5Ch400603.htm, Feeney, Michael, *The Taxation of Companies*, (Bloomsbury Professional, West Sussex, 2010), at [3.103.3].

[67] *Cooper v C & J Clark* [1982] 54 TC 670

[68] *ibid.*, per Nourse J.

[69] Revenue Commissioners, *Guidance on Revenue Opinions on Classification of Activities as Trading*, (Revenue Commissioners, Dublin, n.d.), at 4, available at: www.revenue.ie/en/practitioner/tech-guide/trade.doc.

[70] *ibid.*, at 10. See also, Ryan, John and Galvin, Catherine, "Ireland's 12.5% corporation tax regime: two years in operation", (2005) *International Tax Review, Supplement – Ireland*, available at: http://www.internationaltaxreview.com/includes/specialfeatures/PRINT.asp?SID=496590&ISS=14555&PUBID=224.

[71] Lawless, David and Houlihan, Conor, "Ireland" in *The International Comparative Legal Guide to: Securitisation 2006*, Penny Smale (ed.), (Global Legal Group Ltd., London, 2006) 137-144 at 141 noting that section 110 "enables the companies to take deductions for all expenditure, in particular interest payments that must be made on debt instruments issued by them. This ensures that there is very little or no Irish tax payable by Section 110 SPVs. This legislative regime has facilitated the development of securitisation in Ireland, and Section 110 SPVs have been used in numerous cross-border securitisations."

[72] Section 110(2) Taxes Consolidation Act 1997 as amended by section 48(1) Finance Act 2003.

[73] Section 110(2) Taxes Consolidation Act 1997 as amended by section 48(1) Finance Act 2003. Case III income is subject to 25% corporation tax, section 21(A) Taxes Consolidation Act 1997.

are computed in accordance with Case I of Schedule D.[74] By confirming that SPVs will be treated as carrying out a trade, s.110 allows these entities to claim deductibility of a range of costs such as interest, and other trading expenses, such that the corporation tax liability of the SPV may effectively be neutralised through deductions.[75] By minimising the number of creditors who will have a claim over the assets of the entity, tax neutrality reduces the bankruptcy risk faced by the SPV and increases the protections offered to investors.[76]

Notwithstanding the development of this regime directed specifically at SPVs issuing securities, when the fiscal accommodations for *sukūk* arrangements were introduced by the Finance Act 2010, an SPV engaged in Islamic financing was unlikely to qualify for s.110 treatment. This arose from the fact that the tax framework established by s.110 TCA is only available to a "qualifying company"[77] which acquires "qualifying assets."[78] While virtually any asset which has a "reasonably predictable cash flow"[79] can theoretically be securitised, s.110 benefits were strictly limited to SPVs holding *financial* rather than tangible assets or usufructs.[80] As *sukūk* are distinguishable from conventional securitisation bonds precisely because they do not evidence ownership of a receivable, SPVs issuing *Sharī'ah*-compliant

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[74] Section 110(2) as amended by section 48(1) Finance Act 2003. Feeney, Michael, *The Taxation of Companies*, note 66, at [12.1102].

[75] Maher, Eleanor, *The Irish Tax Review*, July 2002, available at: http://www.taxireland.ie/taxfind/ContentHTML/ParsedHTML/itr_HTMLFILES%5Citr%5C_group00002%5C_h200455%5C_h300570%5Ch400571.htm, Lawless, David and Houlihan, Conor, "Ireland" in *The International Comparative Legal Guide to: Securitisation 2006*, note 71, at 141, Lawless, David and Houlihan, Conor, *Ireland as a Domicile for Special Purpose Vehicles*, (Dillon Eustace, Dublin, 2010), at 3. As section 110 Taxes Consolidation Act 1997 allows SPVs to be structured so as to be tax neutral, it also establishes Ireland as a jurisdiction which is conducive to the domicile of these entities, Walkers Global, *Locating SPVs in Ireland*, (Walkers, Dublin, 2011), at 1, available at: http://www.walkersglobal.com/files/Publication/1481e177-55b4-4c4c-ac6f-c161aee62514/Presentation/PublicationAttachment/e3ad7443-cabd-4a17-9297-c769f4b858f8/Locating%20SPVs%20in%20Ireland.pdf.

[76] Scott, Hal S., *International Finance: Law and Regulation*, (2nd ed., Sweet & Maxwell, London, 2008), at 449 noting that '[t]he SPV must...be free of tax.'

[77] Section 110(1) Taxes Consolidation Act 1997 as amended by section 48(1) Finance Act 2003

[78] *ibid.*

[79] Prasad, Krishna, "Trends in asset securitisation", in *Asset Securitisation and Synthetic Structures; Innovations in the European Credit Markets*, Rick Watson and Jeremy Carter (eds.), (Euromoney Institutional Investor Plc, London, 2006), 3-10 at 9.

[80] Section 110(1) Taxes Consolidation Act 1997 as amended by section 48(1) Finance Act 2003 defined 'financial asset' as including—

a) shares, bonds and other securities,
b) futures, options, swaps, derivatives and similar instruments,
c) invoices and all types of receivables,
d) obligations evidencing debt (including loans and deposits),
e) leases and loan and lease portfolios,
f) hire purchase contracts,
g) acceptance credits and all other documents of title relating to the movement of goods, and
h) bills of exchange, commercial paper, promissory notes and all other kinds of negotiable or transferable instruments;

certificates were likely to fall outside the definition of a qualifying company in Ireland's tax law.[81]

The Finance Act 2011[82] has now indirectly altered the status of *sukūk* SPVs.[83] In February 2011, the Finance Act extended the range of assets which would be classified by the Tax Acts as "qualifying assets" under s.110.[84] SPVs, *any* SPV, not only one which is involved in *sukūk* arrangements, may now acquire "commodities" and "plant and machinery" while qualifying for the s.110 securitisation regime.[85] This would allow the SPV to hold tangible assets which are dealt with on a "recognised commodity exchange"[86] such as precious metals, as well as assets such as aircraft and equipment.[87] SPVs may now also carry out the business of leasing plant and machinery.[88] Consequently, those *sukūk* SPVs involved in an *ijārah* contract with the originator/third party and those dealing in commodities may benefit from the same tax regime as conventional securitisation SPVs.[89] In practice, while this is a very noteworthy indication of Ireland's future potential as a domicile for *sukūk* issuances, those *sukūk* based on land or property, as well as those based on a business venture, are still unlikely to qualify under s.110, as such SPVs are not holding "qualifying assets." Similarly, a *sukūk* SPV dealing in commodities may be participating in a *murābaha sukūk*. As has been discussed above, such debt-based *sukūk* have limited potential for secondary trading outside of Malaysia.[90]

The classification of *sukūk* SPVs as trading in nature is important, not because of the level of tax imposed on such entities, but because it will allow the SPV to deduct expenses incurred in the course of its trade. This will facilitate the tax neutrality of the *sukūk* issuer. In the 2010 Guidance Notes, the Revenue Commissioners explicitly confirmed that a "qualifying company" involved in Islamic deposit arrangements would be treated as

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[81] Woods, Tom and Jahanjiri, Kashif, "Islamic Financial Transactions" in *Taxing Financial Transactions*, Kenneth Byrne (ed.), (3rd ed., Irish Taxation Institute, 2010), 209-241 at [9.10.2].

[82] Finance Act 2011, Number 6 of 2011.

[83] Owens, Ken and Thompson, Yvonne, "Sovereign Sukuk, A Way to Revive the Celtic Tiger?", note 1.

[84] Section 110(1)(a) Taxes Consolidation Act 1997 as amended by section 40(1)(b) Finance Act 2011.

[85] *ibid.*

[86] *ibid.*

[87] Walkers Global, *Locating SPVs in Ireland*, note 75, at 2.

[88] Section 110(1)(a) Taxes Consolidation Act 1997 as amended by section 40(1)(e) Finance Act 2011.

[89] Woods, Tom and Lynch, Liam, "Financial Services", in *Taxing Times: Finance Act 2011 & Current Tax Developments*, (KPMG, Dublin, 2011), 19 at 19 noting that; "[a]ll of these changes will hopefully enhance the attractiveness of using Ireland as a location to issue Islamic bonds (Sukuk)."

[90] *supra.* at 309.

carrying on a trade; no similar clarification was provided for *sukūk* issuers.[91] In practice it could be suggested that the Revenue Commissioners may simply have assumed that *sukūk* SPVs would be treated as trading companies. This conclusion would explain why the provisions of Part 8A and the subsequent Guidance Notes provide that *sukūk* returns will be treated as interest (and so a deductible trading expense) rather than a distribution.[92] For this reason, the remainder of this Chapter will consider the tax issues raised by *sukūk* on the basis that the SPV is carrying out a trade.

The next step when determining the corporation tax liability arising in *sukūk* issuances is to consider what expenses can be deducted from that liability.

2. Distributions:

The party issuing the *sukūk* receives payment from *sukūk* holders in exchange for the issue of *sukūk* certificates.[93] This is taxable income in the hands of the issuer and any profit is subject to corporation tax.[94] The issuer then makes periodic payments to the *sukūk* holders, arising directly or indirectly out of the performance of the underlying assets. In a conventional bond issue (either by a company carrying out a trade or deemed to be doing so under s.110 TCA), interest payments made by a company pursuant to a loan are deductible expenses which can reduce the company's corporation tax liability.[95] Arising out of an instrument evidencing a debt, conventional bond disbursements are thus generally deductible as expenses incurred prior to the determination of profit.[96] The amendments to the TCA introduced by the Finance Act 2010 appear, at least initially, to encourage *sukūk* returns to be similarly treated with s.267R noting that "the Tax Acts shall apply to an investment return as if that investment return were interest on a security."[97] The accommodating provisions have recharacterised investment transaction returns by deeming

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[91] Revenue Commissioners, "Guidance Notes on the Tax Treatment of Islamic Financial Transactions", note 57, at 32.

[92] See for example; Revenue Commissioners, "Guidance Notes on the Tax Treatment of Islamic Financial Transactions", note 57, at 33.

[93] *supra.* at 303.

[94] Amin, Mohammed, "The new UK tax law on sukuk", note 52.

[95] *Sean MacAongusa v. Ringmahon* Co [2001] ITR 117 where the court confirmed that where a business is financed through borrowing then the interest is a trading expense. See also, Somerville, James, "Section 110 of the new Finance Act will help the Irish securitisation industry play catch-up", (March 2003) *Finance Magazine*, available at: http://www.finance-magazine.com/display_article.php?i=2537&pi=114

[96] Doyle, Mark, "Securitisation in Ireland - Section 110 Companies" (November 2010), *FS Express - Chartered Accountant's Monthly Financial Services Ezine*, available at: http://www.grantthornton.ie/MediaandEvents/Securitisation-in-Ireland.

[97] Section 267R Taxes Consolidation Act 1997, as introduced by section 39 Finance Act 2010.

them to be interest payments; to the extent that conventional interest payments are taxed and relieved, *sukūk* returns should be equally treated.[98] This could allow an issuing company to deduct the periodical *sukūk* payments from net profits subject to corporation tax.[99]

Deductibility (in conventional and Islamic arrangements) does not extend to all payments made by a company.[100] Those characterised as "distributions" under the terms of s.130[101] are treated as appropriations of profits which are paid out *after* profits are ascertained rather than expenses which are incurred in the course of calculating that profit.[102] These distributions are thus taxed in the hands of their recipients rather than the company paying them and so the company will not be entitled to deduct such payments from corporation tax liability.[103] Implemented in order to prevent equity returns being passed off as deductible fixed debt payments, s.130(2)(d)(iii)(I) of the TCA defines as a "distribution" any payment by a company the level of which is "dependent on the results of the company's business or any part of the company's business."[104] The new Part 8A identifies an investment certificate as entitling its holder to share in the "profits or losses derived from an asset held by the qualifying company"[105] and classifies investment return as including "any other payments (if any)"[106] derived from the underlying asset. Since any gains or losses arising from the underlying asset are to be treated as those of the qualifying

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[98] Fox, Jennifer, *Sharia Compliant Funds In Ireland*, (Dillon Eustace, Dublin, 2010), at 4, available at: http://www.dilloneustace.ie/download/1/Sharia%20Compliant%20Funds%20in%20Ireland.pdf, noting that, "in respect of *Sukuk*, the investment return on the *Sukuk* certificate will be treated as interest for the purposes of Irish tax legislation and the *Sukuk* issuer will be entitled to deduction in respect of the coupon paid."

[99] Halawi, Adnan, "Slash Taxes, Spur Sukuk: Countries issuing Sukuk triple between 2005 and 2012 as countries slash taxes", *Zawya*, July 20, 2011, available at: http://www.zawya.com/story.cfm/sidZAWYA20110720052830/Slash-Taxes-Spur-Sukuk.

[100] Revenue Commissioners, "Guidance Notes on the Tax Treatment of Islamic Financial Transactions", note 57, at 34.

[101] Section 130 Taxes Consolidation Act 1997.

[102] Maher, Eleanor, "Banking in Law", in *Taxing Financial Transactions*, (1st ed., Taxation Series, Irish Taxation Institute, Dublin, 2004), 233-264 at 244 [8.8.1], Law, Jonathan, *A dictionary of business and management*, (Oxford University Press, Oxford, 2009), definition of "appropriation of profit."

[103] Maher, Eleanor, "Banking in Law", in *Taxing Financial Transactions*, note 102, at 244 [8.8.1]. This is of course subject to section129 which exempts distributions paid by an Irish resident company to another Irish resident company. Amin, notes (in relation to the UK provisions), "[t]he cost of debt finance is considered a cost to the business and is tax deductible. Conversely the rewards achieved by a provider of equity finance are not deductible to the paying business; they are the investor's participation in the profits of the business. Accordingly, it would be attractive to disguise something that was economically equity finance in the form of debt, to obtain tax relief," Amin, Mohammed, "UK Taxation of Islamic Finance: Where are we now?", (2006) *NewHorizon Magazine*, available at: http://www.newhorizon-Islamicbanking.com/index.cfm?section=features&action=view&id=10954.

[104] Section 130(2)(d)(iii)(I) Taxes Consolidation Act 1997.

[105] Definition of "investment certificate," Section 267N(1) Taxes Consolidation Act 1997 as introduced by section 39 Finance Act 2010.

[106] Definition of "investment return," Section 267N(1) Taxes Consolidation Act 1997 as introduced by section 39 Finance Act 2010.

company,[107] it is arguable that payments made to certificate holders are, at least to some extent, dependent on the results of the issuer's business and thus prevented from being classified as interest under Irish tax law. The internal contradiction in the legislation is evident. *Sukūk*, in order to be *Sharī'ah*-compliant and to fall within the scope of Part 8A, should be based on underlying assets with returns connected with the performance of those assets. Yet this very fact would appear to deny *sukūk* transactions the benefit Part 8A was attempting to provide. In the October 2010 Guidance Notes, the Revenue Commissioners attempted to clarify the incongruity in the legislation: "[i]n general, Revenue will not regard the return [in a *sukūk* transaction] as being dependent on the results of the business"[108] as long as the amount of the return equates in substance to a commercial return on an investment, it is determined at the outset, it is equivalent to the rate of interest and it is not altered during the course of the transaction except where such alteration follows interest rates.[109] These conditions are highly prescriptive and appear to contradict the idea that *sukūk* returns are not *ribā* precisely because they are linked to the performance of the underlying asset. Particularly after the AAOIFI clarification, there is still a risk that only a limited number of *sukūk* could successfully be marketed as *Sharī'ah*-compliant while also complying with these prerequisites.

S.130(2)(d)(iii) contains a carve-out for qualifying companies under the securitisation regime such that a payment made in the course of a securitisation transaction will not be a distribution simply because the payments made to the bond holders are linked to the profitability of the company or exceed the commercial rate of return.[110] For those *sukūk* which fulfil the requirements of a s.110 qualifying company, the internal contradiction of Part 8A could be overcome. However, the inapplicability of s.110 to the remaining *sukūk* transactions would seem to prevent these Islamic investment certificates from benefitting from the carve-out. Without either creating a separate carve-out for *sukūk* in s.130(2)(d)(iii) or bringing all *sukūk* within the s.110 securitisation framework, issues of *sukūk*, particularly those based on *mudāraba* and *mushāraka*, may be restricted in the extent to which they can deduct expenses incurred in the course of the *sukūk* transactions. At the same time, payments, if classed as distributions, will be subject to dividend withholding

[107] Section 267S(2) Taxes Consolidation Act 1997 as introduced by section 39 Finance Act 2010.

[108] Revenue Commissioners, "Guidance Notes on the Tax Treatment of Islamic Financial Transactions", note 57, at 35.

[109] *ibid*,

[110] Section 110(4) Taxes Consolidation Act 1997, Feeney, Michael, *The Taxation of Companies*, note 66, at [12.1103].

tax[111] unless the recipient of that *sukūk* certificate is another Irish company,[112] resident in an EU State or a country with whom Ireland has a double tax treaty.[113]

Recognising the inequalities arising out of a similar disparity of tax treatment in the UK, British authorities have not simply deemed *sukūk* returns as equivalent to interest but have exempted *sukūk* transactions from s.209(2)(e)(iii) Income and Corporation Taxes Act [ICTA] 1988,[114] the British equivalent to s.130(2)(d)(iii).[115] S.1019 Corporation Tax Act 2010 provides that a "[r]elevant alternative finance return is not treated by virtue of s.209(2)(e)(iii) of ICTA 1988 as being a distribution for the purposes of the Corporation Tax Acts"[116] and includes within the definition of alternative finance return, "anything that is [an] alternative finance return for the purposes of Part 6 of Corporation Tax Act 2009 as a result of s.513 of that Act,"[117] or "any part of the redemption payment under arrangements to which s.507 of Corporation Tax Act 2009 applies."[118] The UK has confirmed that for tax purposes at least, all *sukūk* returns which are economically comparable to interest, are deemed not only to be interest but, like the returns of securitisation companies,[119] should be treated as such notwithstanding the discernable link between asset performance and investment return.

As an important anti-avoidance provision in Irish tax law, the application of s.130 cannot simply be excluded for *sukūk*. Yet in their current form, Ireland's tax laws do not establish a level playing field between Islamic and conventional bonds (including securitisation bonds). Specifically amending s.130(2)(d)(iii)(I) to limit its application to transactions other than those falling within Part 8A may successfully counter the tax

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[111] Section 172B(1)(a) Taxes Consolidation Act 1997.

[112] Section 172C(1) Taxes Consolidation Act 1997.

[113] As already noted, Ireland has signed double tax treaties with 63 countries (55 are in effect), including Malaysia, Bahrain, Kuwait and the UAE (all brought into force February 2011). Treaties have also been signed with Pakistan and Turkey and a treaty Saudi Arabia is "expected to be signed shortly," Revenue Commissioners, *Tax Treaties*, available at: http://www.revenue.ie/en/practitioner/law/tax-treaties.html.

[114] Amin, Mohammed, "UK Taxation of Islamic Finance: Where are we now?", note 103, Amin, Mohammed, "British Government Policy on Islamic Finance", Paper presented at Nurturing the Future in Islamic Finance and Thought Leadership, MCB delegation to the 6th World Islamic Economic Forum, Kuala Lumpur, Malaysia, May 18 – 20, 2010, Tariq Hameed, (ed.), (The Muslim Council of Britain, London, 2010), 27-31 at 31. The UK legislation, Income and Corporation Taxes Act (ICTA) 1988 section 209(2) (e) (iii) states that: a distribution constitutes; "any interest or other distribution out of assets of the company in respect of securities of the company where the securities are securities under which the consideration given by the company for the use of the principal secured is to any extent dependent on the results of the company's business or any part of it."

[115] Section 209(2)(e)(iii) Income and Corporation Taxes Act 1988.

[116] Section 1019(1) Corporation Tax Act 2010 c. 4 as introduced by section 54 Finance Act 2005.

[117] Section 1019(1)(a) Corporation Tax Act 2010 c. 4.

[118] Section 1019(1)(b) Corporation Tax Act 2010 c. 4.

[119] Paragraphs (b) to (f) in section 209(2) Income and Corporation Taxes Act 1988.

problem. This amendment would also protect the continuing legitimacy of Ireland's taxation framework since Part 8A itself contains an anti-avoidance provision.[120] In a carve-out which is comparable to that already granted to securitisation SPVs, such an amendment would look to the substance of *sukūk* issuances. It would then extend debt-related tax treatment where justified by the Government's goal of facilitating Islamic finance through equality of taxation.

B. Stamp Duty

The accommodations introduced by the Finance Act 2010 have been only partially effective in aligning the tax treatment of *sukūk* returns with the interest payments in bond transactions and securitisations. The inconsistencies between Islamic securities and the existing tax framework are not limited to the tax status of *sukūk* returns. As discussed above,[121] the debt-like *sukūk* which are envisaged by Part 8A TCA "confer a share in the ownership of the underlying [potentially tangible] asset to the certificate owner."[122] Particularly in *ijārah sukūk*, these assets may be real property such as land and buildings.[123] The transfer of this property over the course of the *sukūk* transaction may raise tax liability which is not present in conventional bonds.[124] Key among these is stamp duty. The compound and unconventional transfers of ownership present in *sukūk* also result in the uncertain assignment of capital gains tax liability and capital allowances.[125]

Property related taxes and their interaction with *sukūk* arrangements have been the focus of recent and comprehensive consultation in the UK.[126] The approach of Ireland's Finance Act 2010 is less consistent; accommodation has been provided in relation to some stamp duty issues (1) while others have been largely ignored (2).

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[120] Section 267V Taxes Consolidation Act 1997 as introduced by section 39 Finance Act 2010.

[121] *supra.* at 329.

[122] Revenue Commissioners, "Guidance Notes on the Tax Treatment of Islamic Financial Transactions", note 57, at 35.

[123] Schoon, Natalie, *Islamic Banking and Finance*, (Spiamus Press Ltd., London, 2009), at 160.

[124] HMRC, *Stamp Duty Land Tax: Commercial Sukuk, Consultation Document*, note 23, at 11.

[125] Revenue Commissioners, "Guidance Notes on the Tax Treatment of Islamic Financial Transactions", note 57, at 35-36.

[126] See for example, HMRC, *Stamp Duty Land Tax: Commercial Sukuk, Consultation Document*, note 23. See also, HMRC, *Stamp Duty Land Tax: Commercial Sukuk, A response to the Consultation*, (HMRC, London, February12, 2009).

1. Stamp Duty on Issue and Redemption of Certificates

Looking first at the stamp duty arising from the issue and transfer of *sukūk*, the provisions introduced by the Finance Act 2010 appear to be relatively effective at aligning the taxation of conventional and Islamic securities. Under schedule 1 of the SDCA1999, stamp duty liability arises in relation to the conveyance or transfer of various forms of property, including stocks and marketable securities.[127] *Sukūk*, classified as securities by Part 8A TCA, would appear to fall within the marketable security category defined as "a security of such a description as to be capable of being sold in any stock market in the State."[128] Marketable securities which fulfil the characteristics of "loan capital" will be exempted from stamp duty charge on issue,[129] transfer and redemption.[130] While loan capital includes debenture stock, bonds or funded debt or any capital raised which is borrowed,[131] the exemption on transfer will only apply if[132]

(i) it does not carry any rights on conversion into stocks or marketable securities (other than loan capital) of a company having its register in the State, or into loan capital carrying such rights;

(ii) it does not carry rights of the same kind as shares in the capital of the company, including rights such as voting rights, a share in the profits or a share in the surplus on liquidation;

(iii) it is redeemable within 30 years of the date of issue and not thereafter;

(iv) it is issued for a price which is not less than 90% of its nominal value; and

(v) it does not carry a right in respect of the repayment or interest related to certain movements in an index or indices specified in any instrument or other document relating to the loan capital.

Condition (ii) excludes *sukūk* from benefitting from the stamp duty relief, particularly *mushāraka* or *mudāraba* structures under which payments to *sukūk* holders are payments out of profit.

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[127] Schedule 1, Stamp Duties Consolidation Act 1999 under the heading "stocks or marketable securities."

[128] Section 1 Stamp Duties Consolidation Act 1999, the Irish Taxation Institute notes that all that is necessary is that the securities are capable of being dealt with on the ISE, not that they actually are, Quinn, Andrew, "Capital Taxes", in *Taxing Financial Transactions*, (3rd ed., Taxation Series, Irish Taxation Institute, Dublin, 2010), 351-370 at 355.

[129] Section 85(2)(a)(ii) Stamp Duties Consolidation Act 1999.

[130] Section 85(2)(b) Stamp Duties Consolidation Act 1999.

[131] Section 85(1) Stamp Duties Consolidation Act 1999.

[132] Section 85(2) Stamp Duties Consolidation Act 1999.

In the UK, the Finance Act 2008 sought to include alternative finance investment bonds within the meaning of "loan capital" in the Finance Act 1986.[133] In doing so, the accommodations allow *sukūk* holders to benefit from stamp duty relief on transfer, just like other debt securities.[134] A similar, and indeed, more straightforward development was included in Ireland's accommodations of investment certificates: s.137 of the Finance Act 2010 has inserted s.85A into the SDCA.[135] This provision specifically states that "[s]tamp duty shall not be chargeable on the issue, transfer or redemption of an investment certificate...."[136] In a similar manner to the exception for securities issued by a s.110 SPV,[137] the Finance Act 2010 has not simply recharacterised investment certificates as loan capital (as has been done by its British counterpart), but has created a new exception from the stamp duty regime specifically for these certificates.[138] The prescriptive nature of the s.85 loan capital provision has been designed, like the UK equivalent, to "capture equity masquerading as debt"[139] and seeks to ensure that the exemption from stamp duty is limited to instruments used in a financing transaction rather than those conferring an equity stake in the issuing entity. The existing carve-out for s.110 companies suggests, however, that Revenue Commissioners is prepared to extend this exemption even in circumstances where returns may be dependent on company performance.[140] In light of this, the provision

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[133] Section154 Finance Act 2008, (c. 9).

[134] Section78 Finance Act 1986, (c. 41).

[135] Section 85A Stamp Duties Consolidation Act 1999 as inserted by section 137 Finance Act 2010.

[136] Section 85A Stamp Duties Consolidation Act 1999 as inserted by section 137 Finance Act 2010.

[137] Consistent with other exceptions made for section 110 securitisation SPV, the transfer of securities issued by such an SPV is exempt from stamp duty. This ensures that despite the underlying securitised assets, bonds issued within a securitisation arrangement are subject to the same tax regime as other debt securities, Clancy, Fintan, Hurley, Conor, Devlin, Caroline and Finnerty, Ailish, "Uses of Ireland for Middle East Investors", *Arthur Cox Tax Group Briefing*, (Autumn 2009), at 4, available at: http://www.arthurcox.com/uploadedFiles/Publications/Publication_List/Briefing_Tax (Middle East), Autumn 2009.pdf.

[138] Revenue Commissioners, "Guidance Notes on the Tax Treatment of Islamic Financial Transactions", note 57, at 36, Owens, Ken, Thompson, Yvonne, Jennings, Caitriona and Ismail, Faisal, "Ireland as a Gateway for Sukuk in Europe", (2010) 7(47) *Islamic Finance News* 10-11 at 11.

[139] Johnson, Ian and Miller, Paul, "How to avoid stamp duty horrors on debt deals", (July-August 2005) *International Tax Review*, 1 at 1.

[140] A similar (and relevant) exemption from stamp duty also exists in relation to repurchase transactions in which legal title to stock/securities is transferred to the "purchaser" at the outset of the arrangement with an agreement that it will be transferred back to the "seller" at the end. Without a carve-out from the existing legislation, such transactions could give rise to two instances of stamp duty. An exemption from stamp duty for repurchase transactions has been introduced into the Stamp Duties Consolidation Act 1999 (section 87A) and the Revenue Commissioners has confirmed that the taxation of repurchase arrangements will be based on the accounting treatment of such arrangements; this follows the economic substance rather than legal form of the transactions. Since repurchase arrangements are economically comparable to loans rather than sales, the Revenue has attempted to tax these arrangements as if they were loans, Revenue Commissioners, *Leaflet*, "Tax Treatment of Stock Lending/Repurchase (REPO) Transactions", available at http://www.revenue.ie/leaflets/stocklen.doc. In this leaflet, the Revenue Commissioners note that, "[a]rrangements have been agreed by the Revenue Commissioners to recognise the substance of these transactions, to tax only the accounting profit earned and, in general, to leave both the borrower and the lender in the same position as if no stock loan had taken place." See also, McQueston, Philip, "Tax Neutrality of Irish Funds and Some Relevant Irish Tax Issues for Funds", (March 2008) *Irish Tax Review*, 55-57 at 56.

introduced by the Finance Act 2010 relating to the stamp duty liability on issue, transfer and redemption of *sukūk* is not only a noteworthy development towards greater tax parity *sukūk* but is in line with similar exceptions which have been made for securities issued in the course of a conventional securitisation.

2. *Stamp Duty on the Transfer of Asset Ownership*

a. *Stamp Duty Liability of Originator and Issuer*

In addition to the stamp duty which arises in relation to the issue and assignment of *sukūk* as marketable securities, the multiple transfers of asset ownership carried out in relation to the issue of Islamic certificates give rise to a disparity of treatment between the Irish stamp duty liability of *sukūk* issuers and those issuing conventional securities. As has already been discussed in the context of real estate financing in Chapter 6, an instrument transferring property which is executed in Ireland or relates to property situated in Ireland is a chargeable asset under the terms of the SDCA.[141] In a conventional bond transaction where an originator issues securities, there is no transfer of a chargeable interest which is capable of being stamped.[142] Equally, if the transaction involves an SPV to whom ownership of financial assets is transferred, this assignment or sale of debt from the originator, though technically stampable,[143] is likely to be exempt either under the debt factoring (in the case where a bank or s.110 SPV is the originator)[144] or loan capital exemption subject to fulfilment of the necessary criteria.[145] This is not the case with *sukūk*. *Sukūk* transactions involve the transfer of an interest in an asset to the SPV who then issues securities representing ownership of that asset.[146] Stamp duty liability may arise if the assets transferred consist of property such as land. A second stamp duty charge applies when the originator ultimately repurchases the asset at the conclusion of the *sukūk*.[147] In light of the *hadīth* in which the Prophet is recorded as prohibiting "two sales in one

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[141] Section 2(1)(a) and (b) and Schedule 1, Stamp Duties Consolidation Act 1999.

[142] HMRC, *Stamp Duty Land Tax: Commercial Sukuk, Consultation Document*, note 23, at 11.

[143] Quinn, Andrew, "Capital Taxes", in *Taxing Financial Transactions*, note 128, at 356.

[144] *ibid.* at 357.

[145] Section 85(2)(b) Stamp Duties Consolidation Act 1999.

[146] Revenue Commissioners, "Guidance Notes on the Tax Treatment of Islamic Financial Transactions", note 57, at 35.

[147] HMRC, *Stamp Duty Land Tax: Commercial Sukuk, Consultation Document*, note 23, at 11, Anonymous, "Impact Assessment of Sukuk Legislation in the UK, Policy", (May/June 2008) 148/149 *Islamic Banker*, 20 at 20.

contract,"[148] both transfers of property ownership must be effected in two separate instruments, both of which are stampable.

Neither the provisions of the Finance Act 2010 nor the subsequent Revenue Commissioners' Guidance Notes have addressed this multiple stamp duty liability.[149] Consequently, when *sukūk* certificates are underpinned by Irish real property, the issue and redemption of the certificates may give rise to at least two,[150] separate impositions of stamp duty. While this may not be a significant problem in the case of a non-Irish originator who sells assets located outside Ireland, it would seem to reduce the attractiveness of a *sukūk* originated by an Irish company or indeed, an Irish sovereign *sukūk*. Concluding that it was "considered desirable that SDLT [Stamp Duty Land Tax] should not be charged when land is sold to the issuer of a *sukūk*, and that no SDLT is charged on the sale back of the building to the originator,"[151] UK authorities enacted Schedule 61 of the Finance Act 2009 which provides for relief from SDLT for land transactions carried out in relation to the issue of *sukūk*, subject to a number of conditions being met.[152] These seven conditions provide a detailed format which the multiple asset transfers must take in order to be able to benefit from SDLT relief. Limited in impact to *ijārah sukūk*,[153] the conditions identify the nature of the first transaction and the subsequent

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[148] Narrated on the authority of Abu Hurayrah in *Sunan Abu-Dawud*, Book 23, Number 3454, Ahmad Hasan (trans.), available at: http://www.usc.edu/schools/college/crcc/engagement/resources/texts/muslim/hadith/abudawud/023.sat.html. See also, El-Gamal, Mahmoud Amin, *Islamic Finance: Law, Economics, and Practice* (Cambridge University Press, Cambridge, 2006), at 99.

[149] Woods, Tom and Jahanjiri, Kashif, "Islamic Financial Transactions", in *Taxing Financial Transactions*, note 81, at [9.10.3] who note that the "normal rules of [the] SDCA would apply in respect of assets acquired or disposed of by the sukuk issuing SPV."

[150] In fact, there may be a third imposition of stamp duty. The potential imputation of liability is relevant to *ijārah* sukuk in particular. The Tax Briefing 2009 confirmed that *ijārah* leases would be subject to the same taxation as conventional leases (Revenue Commissioners, "Islamic Finance", *Tax Briefing, Issue 78*, October 2009, available at: http://www.revenue.ie/en/practitioner/tax-briefing/78/index.html#). This would suggest that they are subject to the same stamp duty liability. UK originators in *ijārah* sukuk that lease sukuk assets back over the course of the transaction may take advantage of the existing sale and lease-back relief from stamp duty land tax (Section 57A (3) Finance Act 2003, see HMRC, *Sale and Leaseback*, available at: http://www.hmrc.gov.uk/so/sale-leaseback.htm for a discussion of this exemption). No similar exemption exists in Ireland where the Revenue Commissioners has confirmed that instruments which relate to distinct matters will be subject to a charge on each matter [Correspondence with Marie Hurley, Revenue Commissioners, Appendix 4, *infra.* at 460]. The initial sale to the SPV and the subsequent lease by the originator and the final repurchase may therefore be stampable, Revenue Commissioners, Part 2, Charging and Stamping of Instruments, Stamp Duties Consolidation Act 1999 (updated to the Finance Act 2009) - Notes for Guidance, section 7, available at: www.revenue.ie/en/.../part2-charging-stamping-of-instruments.pdf.

[151] HMRC, *Stamp Duty Land Tax: Commercial Sukuk, Consultation Document*, note 23, at 11-12.

[152] Schedule 61 Finance Act 2009.

[153] HMRC, *Stamp Duty Land Tax: Commercial Sukuk, A response to the Consultation*, note 126, at 5 noting that; "[t]he relief will be restricted to Ijara sukuk. However, HMRC accepts that in order for the market to develop, the SDLT relief may in the future need to be extended to other sukuk structures."

lease back and *sukūk* issuance (Conditions A to C).[154] In order to "protect Exchequer revenue"[155] and ensure compliance with the conditions, the certificate issuer must grant a charge to HMRC over the *sukūk* assets which is sufficient to cover the SDLT liability and related interest and penalties which would otherwise arise if no relief had been granted (Condition D).[156] The total capital paid to the issuer before conclusion of the *sukūk* must not be less than 60% of the value of the asset acquired (Condition E)[157] and the issuer must hold the asset for the duration of the *sukūk* (Condition F).[158] Finally, at the conclusion of the *sukūk* term (which can be no later than ten years after its commencement), the assets must be re-sold to the originator (Condition G).[159] Only once all of these conditions are met will SDLT relief be available at which point both the first and the second transfer of the property will be exempt from SDLT.[160] Commentators have criticised the highly prescriptive nature of this SDLT relief, suggesting that it may present more obstacles than it seeks to remove.[161] Undoubtedly the provisions of Schedule 61 are narrow; nevertheless the caution of HMRC is reflective of the quite considerable carve-outs to the existing regime which are needed to ensure parity of stamp duty liability between *sukūk* and bonds. Indeed, the modifications introduced by schedule 61 run counter to the traditional approach of the authorities to stamp duty, under which the focus is on the instruments used rather than the attribution of liability to the transaction as a whole. The reliefs appear to be somewhat of a pragmatic compromise; as the HMRC itself noted, doing nothing

> would mean missing opportunities to develop Islamic finance in the UK...and would allow tax inequality of alternative finance products to continue...[t]he clarification of tax rules will [in contrast] encourage the development of the alternative finance industry.[162]

Following the public consultation which the HMRC conducted on the issue of SDLT relief for *sukūk*, it is somewhat surprising that the Finance Act 2010 has failed to address this aspect of *sukūk* issuances. The multiple imposition of stamp duty liability on *sukūk*

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[154] Finance Act 2009, Schedule 61, [5(2)-(4)].
[155] HMRC, *Stamp Duty Land Tax: Commercial Sukuk, A response to the Consultation*, note 126, at 7.
[156] Finance Act 2009, Sched.61, [5(8)(b)].
[157] Finance Act 2009, Sched.61, [5(9)].
[158] Finance Act 2009, Sched.61, [5(10)].
[159] Finance Act 2009, Sched.61, [5(11)].
[160] Finance Act 2009, Sched.61, [6 and 8].
[161] Goddard, Charles, "Finance Act notes: section 123 and Schedule 61 - alternative finance investment bonds - additional sukuk reliefs", (2009) 5 *British Tax Review*, 647-651 at 647 and 650.
[162] Ali, Yasmin, *Impact Assessment of Sukuk (Islamic Bonds) Legislation*, (HMRC, London, 2008), at 1, available at: http://www.hmrc.gov.uk/ria/ia-sukuk-legislation.pdf.

issuances - in circumstances where ordinary debt securities would be free of stamp duty - makes it difficult to see how *sukūk* issued in Ireland could be regarded as existing on a level playing field with bonds. The fact, however, that it has taken the UK so long to address the SDLT problem indicates that this is not a straightforward accommodation. As noted in Chapter 7, as the authorities are ignoring (rather than re-characterising) the existence of asset-transfers, the potential for tax avoidance is a valid concern.[163] Nevertheless, should the Irish Government choose to further accommodate *sukūk* within the established tax laws, the UK provisions stand as a precedent, at least in the context of *ijārah sukūk*. The highly prescriptive nature of the UK conditions is almost inevitable in order to ensure that the accommodations are not exploited. This is not something which is novel to the Revenue Commissioners; outlining conditions which must be fulfilled before stamp duty relief is granted is already a feature of Irish stamp duty provisions applicable to Young Trained Farmers[164] and First Time Buyers of residential property.[165]

b. Stamp Duty Liability of Sukūk Holder:

Uncertainty has arisen in the UK over the stamp duty liability of *sukūk* holders themselves as the *sukūk* certificates represent the holder's ownership interest in the underlying asset. Where this asset involves real property, the *sukūk* certificates could be regarded as documents which transfer an interest in property and thus subject to stamp duty.[166] On receipt of the *sukūk* and, potentially, on each subsequent transfer of the certificates, the *sukūk* holders could be liable to stamp duty. As conventional bonds do not evidence ownership of underlying real property, the issue and sale of these bonds involves no instrument transferring property which is subject to stamp duty.

This discrepancy between the tax liability of *sukūk* and conventional bonds has been addressed by Irish accommodations.[167] Part 8A explicitly provides that "the owner of the investment certificate shall not be regarded as having a legal or beneficial interest in the assets held by the qualifying company."[168] As the *sukūk* holders are deemed, for the

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[163] *supra.* at 243.

[164] Section 81AA Stamp Duties Consolidation Act 1999 and schedule 2A to Stamp Duties Consolidation Act 1999, set out the conditions that must be met before the exemption can be granted.

[165] Section 91, Section 92, Section 92B Stamp Duties Consolidation Act 1999. These exemptions are, as already noted in Chapter 5, gradually being phased out.

[166] HMRC, *Stamp Duty Land Tax: Commercial Sukuk, Consultation Document*, note 23, at 12.

[167] Woods, Tom and Jahanjiri, Kashif, "Islamic Financial Transactions", in *Taxing Financial Transactions*, note 81, at [9.10.2].

[168] Section 267R Taxes Consolidation Act 1997 as introduced by section 39 Finance Act 2010.

purposes of tax, to have no chargeable interest in the assets, it logically follows that the *sukūk* certificates are deemed not to be instruments of sale and are not subject to stamp duty. This provision therefore prevents stamp duty arising on the issue and subsequent transfer of *sukūk* certificates.

C. Capital Gains Tax and Capital Allowances

The final areas of tax liability which will be considered in relation to *sukūk* are CGT and capital allowances. Concurrently with stamp duty liability, both the transfer and re-sale of the tangible asset between the originator and the SPV, and the disposal of the investment certificates by the *sukūk* holders could result in a gain or loss.[169] Such gains or losses could impact on the capital gains liability of the originator, issuer and *sukūk*-holders, while resulting in uncertainty in determining who can benefit from the capital allowances relating to the underlying assets.[170]

The confirmation in Part 8A that the *sukūk* holders have no legal or beneficial interest in the assets, that any "income, profits, gains or losses"[171] attributable to the assets are attributable to the issuer[172] and that capital allowances cannot be claimed by the *sukūk* holders,[173] ensure that like note-holders in conventional bonds, the *sukūk* holders will not be treated as having any interest in the assets for the purposes of CGT or capital allowances.[174] However, CGT and allowances arising as a result of the multiple transfers of *sukūk* assets between the originator and issuer have remained unclarified by Part 8A. In the UK, schedule 61 of the Finance Act 2009 provides that the sale to the SPV in an *ijārah sukūk* will not be a relevant transfer for the purposes of tax on chargeable gains[175] and

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[169] Revenue Commissioners, "Guidance Notes on the Tax Treatment of Islamic Financial Transactions", note 57, at 35.

[170] Amin, Mohammed, "The new UK tax law on sukuk", note 52, Adam, Nathif J. and Thomas, Abdulkader, *Islamic Bonds: Your Guide to Issuing, Structuring and Investing in Sukuk – Overview of the sukuk market*, (Euromoney Books, London, 2005), at 157. Revenue Commissioners, "Guidance Notes on the Tax Treatment of Islamic Financial Transactions", note 57, at 35.

[171] Section 267S(2) Taxes Consolidation Act 1997 as introduced by section 39 Finance Act 2010.

[172] *ibid.*

[173] Section 267S(3) Taxes Consolidation Act 1997 as introduced by section 39 Finance Act 2010, Feeney, Michael, *The Taxation of Companies*, note 66, at [3.215.5].

[174] Unlike the exemption in the UK for corporate bonds into which *sukūk* have been incorporated, Ireland does not have a similar provision for conventional securities and so there is no need to establish one for *sukūk* in order to level the playing field. Section 151T Taxation of Chargeable Gains Act 1992, amended by Schedule 2 Taxation (International and other Provisions) Act 2010. See also, Woods, Tom and Jahanjiri, Kashif, "Islamic Financial Transactions" in *Taxing Financial Transactions*, note 81, at [9.10.2].

[175] Finance Act 2009, Sched.61, at [10].

capital allowances[176] while the sale back to the originator will not be treated for capital gains purposes as an acquisition by the originator or a disposal by the issuer.[177] By deeming the underlying asset to have remained under the control of the originator, that originator can continue claiming capital allowances in relation to the assets where those assets comprise plant and machinery and/or industrial buildings.[178] As a result, the UK accommodations acknowledge the economic reality that in *ijārah sukūk*, the originator (as lessee) will generally be appointed as agent for the issuer and thus responsible (both as agent and financially through payment of rent) for the maintenance of the property. The accommodations also facilitate the creation of a level playing field with conventional bonds under which the issuer would have no right to claim capital allowances in relation to the originators assets. The fact that Ireland's Finance Act 2010 has not made any explicit provision for CGT and capital allowance issues between the originator and SPV could result in a situation where the tax burdens and benefits of ownership of the underlying asset do not rest with the party who retains control of that asset.

9.2.4 Conclusion to Section 9.2

The measures adopted by the British authorities designed to facilitate the origination and issue of Islamic securities have focused largely on the taxation of these instruments.[179] In line with the wider policy of establishing a level playing field between conventional and alternative finance, the measures introduced have sought to replicate the tax regime applicable to interest-bearing debt securities so that Islamic financial transactions and the parties that use them are not subject to tax burdens and reliefs which do not reflect the functional reality of the transaction.

The accommodation of alternative finance investment bonds in the UK has required the explicit carve-out of such structures from anti-avoidance provisions, the disregard of additional stages in transactions and the expansion of the existing tax regime in order to include transactions which, if taxed according to their legal form, would be subject to an anomalous and uncertain tax framework. While these steps have certainly gone some way to ensuring greater tax neutrality of Islamic products they have involved HMRC taking

[176] Finance Act 2009, Sched.61, at [14].
[177] Finance Act 2009, Sched.61, at [12(1)(a) and (b)].
[178] Finance Act 2009, Sched.61, at [14].
[179] Ercanbrack, Jonathan, "The Regulation of Islamic Finance in the United Kingdom", (2011) 13 *Ecclesiastical Law Journal*, 69-77 at 70.

specific steps to circumvent the traditional "form over substance" approach to tax liability. The UK has been pragmatic in its approach to accommodating *sukūk*, acknowledging that without manipulating the existing regime, the tax burdens experienced by *sukūk* participants would exceed those imposed on conventional investors and borrowers.[180]

Ireland has taken a very similar approach to integrating *sukuk*, by deeming debt-like *sukūk* to be comparable to debt securities for the purposes of tax. Nevertheless, the lingering problems arising out of s.130 TCA, the limited applicability of s.110 TCA and stamp duty liability remain stumbling blocks to achieving comparable tax treatment between bonds and *sukūk*. As these issues have been addressed by UK authorities, Ireland may struggle to compete. The proximity between Ireland and the UK, together with the similarities between the legal systems of these countries may result in *sukūk* issuers and participants looking to the UK measures as a benchmark of acceptable accommodation; against this, Ireland's current tax provisions may appear lacking. Ireland's oft publicised "[a]ttractive tax regime"[181] is of limited interest to parties in a *sukūk* transaction if they cannot access the favourable aspects of that regime, such as deductibility. With that said, the extent to which the structural uniqueness of Islamic transactions should be accommodated is a difficult balance to achieve.

Equity, consistency and transparency in a tax system suggest that tax should bear similarly on those engaged in substantively similar activity.[182] Where the relevant asset in an Islamic *sukūk* is not a "qualifying asset," under s.110 TCA, it raises the question of whether those participating in a *sukūk* transaction are, in fact, similarly situated to participants in conventional securitisations. Expanding the securitisation regime to include all debt-like *sukūk* issuers as "qualifying companies," would appear to be the most straightforward mechanism for ensuring comparable tax treatment between *sukūk* and debt securities. However, it could be argued that unless the "qualifying assets" under s.110 were expanded for *all* SPVs to include property and other tangibles, then participants in a *sukūk*

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[180] Ali, Yasmin, *Impact Assessment for Stamp Duty Land Tax, Capital Gains Tax & Capital Allowance tax reliefs for Alternative Finance Investment Bonds*, note 24, at 1.

[181] Owens, Ken, Thompson, Yvonne, Jennings, Caitriona and Ismail, Faisal, "Ireland as a Gateway for Sukuk in Europe", note 138, at 11.

[182] Commission on Taxation Report 2009, Part 2, (Commission on Taxation, Dublin, 2009), at [3.2], http://www.commissionontaxation.ie/downloads/Part 2.pdf, setting out the Principles of Taxation in Ireland as equity, flexibility, neutrality and simplicity and noting that horizontal equity in taxation is well established in the EU context. For a discussion of horizontal equity generally see Elkins, David, "Horizontal Equity as a Principle of Tax Theory", (2008)24(1) *Yale Law & Policy Review* 43-90 at 43who notes that "[t]he principle of horizontal equity demands that similarly situated individuals face similar tax burdens. It is universally accepted as one of the more significant criteria of a 'good tax'."

transaction would be able to benefit from the legislative regime available in securitisation transactions notwithstanding the fact that the Islamic products are backed by assets that are unavailable in functionally similar conventional transactions. The unjustified advantage which such an accommodation would confer on Islamic securities over conventional bonds is highlighted by the fact that despite pressure from the conventional securitisation industry for the inclusion of real property as a qualifying asset in Ireland's securitisation regime, the Revenue Commissioners has refused to expand the s.110 parameters to include real property securitisations.[183] Consequently, the current approach of the Revenue Commissioners as regards the expansion of s.110 is the most equitable; it has expanded the range of "qualifying assets" for all market participants, not just those attempting to comply with Islamic law. While the list of assets remains narrow and will exclude some *sukūk*, it is nevertheless a positive step from a policy perspective as it does not confer on *sukūk* issuers benefits above those granted to their conventional counterparts.

The alternative approach to preventing the re-characterisation of *sukūk* returns as distributions under s.130 TCA is, as already suggested, to carve-out an exception in s.130(2)(d)(iii) for Part 8A transactions. While this would allow *sukūk* which are asset-linked to benefit from the same carve-out as securitisation bonds (which can only be backed by "qualifying assets"), the policy issues of this approach are less difficult to overcome than those which may arise if the Irish authorities simply deemed *sukūk* issuers to be securitisation SPVs under s.110. The "Investment transactions" addressed in Part 8A TCA are separate instruments from securitisation bonds; by excluding both of these products from the operation of s.130(2)(d)(iii), the Irish authorities would not be classifying *sukūk* as securitisation bonds, but would rather be acknowledging a separate category of securities which also produces interest-like returns. As two *distinct* types of security, securitisation bonds and *sukūk* do not have to share structural characteristics with each other. All that is necessary is that they both produce returns which are comparable to interest. Consequently, if *sukūk* returns are economically similar to those found in a conventional debt issuance, then the exclusion of such returns from the operation of s.130(2)(d)(iii) would not be unfairly favouring *sukūk* transactions over securitisations since *sukūk* are a distinct financial instrument.

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[183] Correspondence with Eleanor MacDonagh, McCannFitzgerald Solicitors, Appendix 6, *infra.* at 465.The UK authorities have also refused to allow securitisation SPVs to hold property although it has been contemplated; HMRC, *Securitisation Companies: property securitisations*, (HMRC, London, n.d.), available at: http://www.hmrc.gov.uk/practitioners/securitisation/dregs-property.htm in which the HMRC invested comments. The development of a property securitisation regime has progressed no further than this however.

In practice, the extent to which Ireland is willing to further accommodate *sukūk* may rest on the interest generated by the current legislative amendments. The religious underpinnings of *sukūk* are unlikely to be of sufficient comfort to the Revenue Commissioners to justify opening up loopholes and avenues for tax avoidance for a single category of product, yet if Ireland wants to be capable of providing an environment which is facilitative of Islamic *sukūk* activity then it may have to undertake further legislative adjustments. Going forward, whether Ireland decides to include carve-outs specifically for *sukūk*, amends the entire securitisation regime so as to classify property as a qualifying asset for all issuers, or makes no further amendments to the tax provisions relevant to *sukūk*, could be motivated more by wider economic conditions and precedent set in other countries than a genuine attempt by the Government to achieve tax neutrality between products.

Taxation, though a significant area when considering the viability of Ireland for the issue/origination/distribution of *sukūk*, is not the only concern of potential market participants. Section 9.3 of this Chapter will consider the regulation of *sukūk* in Ireland and any potential hurdles which may exist.

9.3 Regulation of *Sukūk* in Ireland

In line with a wider trend of addressing tax issues raised by *sukūk*, Ireland's accommodations of Islamic finance have so far dealt only with tax. However, as the industry matures globally, greater consideration is now being given to the interaction between Islamic transactions, particularly *sukūk*, and existing regulatory frameworks.[184] If Ireland is to facilitate a competitive Islamic finance framework, the Central Bank (as regulator of Ireland's financial services sector) will have to consider how it will treat *sukūk* for regulatory purposes.

Citing the three core objectives of securities regulation as the protection of investors, the maintenance of a market which is fair, efficient and transparent and the reduction of

[184] Kijazi, Faisal, "Global Sukuk Issuance Poised for Boost from New Legislative and Regulatory Initiatives", *Moody's Investors Service, Report Number: SF196842*, (April 2010), at 3, available at: http://v2.moodys.com/cust/content/content.ashx?source=StaticContent/Free%20Pages/Products%20and%20Services/Downloadable%20Files/Global%20Sukuk%20Faces%20New%20Legislative%20and%20Regulatory%20Initiatives.pdf.

systemic risk,[185] the IOSCO has called on securities regulators to discharge their function in a manner which is consistent, comprehensible, transparent and equitable.[186] It notes that "inappropriate regulation can impose an unjustified burden on the market and inhibit market growth and development."[187] As has already been highlighted throughout this thesis, the disparities between the legal form and economic substance of many Islamic financial products have presented a significant challenge for regulatory authorities seeking to achieve clear and consistent regulation in domestic financial markets.[188] Referring to the regulation of the Islamic finance industry generally, the UK Government noted in 2008 that "Islamic products, which are structured to replicate the function of conventional products, may be categorised differently, or not captured at all, under the existing framework, due to differences in their underlying legal, economic or risk structures."[189] *Sukūk* are no exception to this uncertainty.[190] Just as the consistent and equitable taxation of securities market products requires a substance over form approach to the tax treatment of *sukūk*, fair and transparent regulation of this market also requires a regulatory policy which looks to the economic impact of Islamic securities.[191]

The principal difficulty with the regulation of *sukūk* arises in relation to the classification of these products by the regulator. Where a *sukūk* transaction involves an SPV or trust which receives investor subscriptions before using one of the *Sharī'ah*-compliant contractual structures to invest the accumulated capital in an income producing asset, the relationship between the investors and the SPV or other entity is relatively consistent with that found in investment funds, not debt securities. This equity-like relationship in *sukūk* transactions, in which funds are pooled and invested, with investors sharing (at least in theory) in the profits and losses generated by the asset, has widely been

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[185] International Organization of Securities Commissions, *Objectives and Principles of Securities Regulation*, (IOSCO, May 2003), at 5, available at: http://www.iosco.org/library/pubdocs/pdf/IOSCOPD154.pdf.

[186] *ibid.*, at 10.

[187] *ibid.*, at 8.

[188] Ainley, Michael, Mashayekhi, Ali, Hicks, Robert, Rahman, Arshadur and Ravalia, Ali, *Islamic Finance in the UK: Regulation and Challenges*, (Financial Services Authority, London, 2007), at 25.

[189] HM Treasury, *The Development of Islamic Finance in the UK: The Government's Perspective*, (HM Treasury, London, 2008), at 18.

[190] Ainley, Michael, Mashayekhi, Ali, Hicks, Robert, Rahman, Arshadur and Ravalia, Ali, *Islamic Finance in the UK: Regulation and Challenges*, note 188, at 25.

[191] This move would be in line with broader proposals to apply "principle of economic substance not legal form" to financial market regulation generally, The Turner Review, *A regulatory response to the global banking crisis*, (FSA, London, March 2009), at 7, available at: http://www.fsa.gov.uk/pubs/other/turner_review.pdf.

acknowledged to be closely akin to conventional Collective Investment Schemes [CIS].[192] However, because of the economic impact of, and risks underpinning, *sukūk* transactions, relying only on structure may result in the inappropriate categorisation of these arrangements.[193] Looking beyond this form, the economic effect of the *sukūk* transaction as a whole will vary between debt and equity depending on the nature of the underlying contract and the extent to which liquidity and credit enhancements are applied. Debt-like structures represent the mainstay of the international *sukūk* market yet while most of these *sukūk* transactions share descriptive similarities with CIS, the two products differ in economic function with debt-like *sukūk* offering "a *Sharī'ah*-compliant alternative to conventional fixed-income instruments"[194] rather than a pooled investment vehicle. [195] As will be discussed below, the lack of bespoke classification for *sukūk* in Ireland complicates the regulation of these Islamic products, making their consistent and transparent treatment more difficult.

The remainder of this Chapter will consider the regulation of *sukuk*. It will look first at the regulation of *sukūk* in other jurisdictions noting the preference for regulating *sukūk* as debt securities (9.3.1).[196] It will then consider the potential regulatory classification of *sukūk* in Ireland. This section will argue that *sukūk* - both asset-backed and asset-based - may be classified in Ireland either as units in a CIS or as transferable securities (9.3.2).[197] This is problematic for two reasons (9.3.3).[198] First, it results in a lack of clarity for market participants considering a *sukūk* issuance in Ireland (A).[199] Second, the CIS regime may not be appropriate for debt-like *sukūk* (B).[200] This section proposes measures which the

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[192] International Organization of Securities Commissions, *Analysis of the Application of the IOSCO's Objectives and Principles of Securities Regulation for Islamic Securities Products*, (IOSCO, September 2008), at 11, available at: http://www.iosco.org/library/pubdocs/pdf/IOSCOPD280.pdf.

[193] *ibid.*, at 24.

[194] Islamic Financial Services Board, *Guiding Principles on Governance for Islamic Collective Investment Schemes*, (IFSB, Kuala Lumpur, December 2007), at 3, available at: http://www.ifsb.org/docs/ed_Islamic_collective_investment.pdf , noting that; "[a]lthough, in principle, sukuk schemes fit into the above description, supervisory authorities may wish to prescribe certain economic tests before imposing on them the governance structure and processes under the Guiding Principles, considering that they serve certain economic functions that differ from CIS – that is, fundamentally, they are a *Shari'ah*-compliant alternative to conventional fixed-income instruments."

[195] Lord Myners, "Financial Services and Markets Act 2000 (Regulated Activities)(Amendment) Order 2010", *6th Report from the Joint Committee on Statutory Instruments*, available at: http://services.parliament.uk/hansard/Lords/ByDate/20100210/mainchamberdebates/part006.html.

[196] *infra.* at 355.

[197] *infra.* at 358.

[198] *infra.* at 362.

[199] *infra.* at 362.

[200] *infra.* at 363.

Irish authorities can implement to ensure that debt-like *sukūk* are regulated as transferable debt securities and equity-like *sukūk* are regulated as CIS (9.3.4).[201]

9.3.1 Precedent Set in Other Jurisdictions

In order to facilitate the integration of *sukūk* into domestic markets, Islamic financial centres have taken steps to clarify the regulation of these products and the status of their participants. Following a review and consultation, the UK's FSA acknowledged that some *sukūk* structures, most notably those based on *mudāraba* contracts,[202] could fall within two different regulatory frameworks, the first relevant to CIS while the second dealing with debt-based debentures.[203] Classifying *sukūk* as a CIS under the RAO would result in such arrangements being subject to the more onerous regulatory and disclosure standards than those applying to conventional debt securities.[204] Equally, the certificates would be units in an unregulated CIS unless they were structured as either an Authorised Unit-trust Scheme,[205] an Open-ended Investment Company,[206] or fell within an approved category of CIS operated from outside of the UK.[207] As an unregulated CIS, *sukūk* issuances would be subject to restrictions in the manner in which they could be promoted.[208] The Financial Services and Markets Act 2000 (Regulated Activities) (Amendment) Order 2010[209] thus clarifies the definition and treatment of *sukūk* by harmonising the regulation of Alternative Finance Investment Bonds [AFIBs](*sukūk*) with economically similar debt securities and exempting the Islamic securities from the CIS regime.[210] The special legislative

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[201] *infra.* at 373.

[202] The review only selected *mudāraba sukūk*. However, as will be discussed below in relation to the regulation of sukuk in Ireland, it is suggested that most of the common *sukūk* structures could potentially fall to be regulated either as a debt security or as an investment fund.

[203] Under s.77 RAO, Ainley, Michael, Mashayekhi, Ali, Hicks, Robert, Rahman, Arshadur and Ravalia, Ali, *Islamic Finance in the UK: Regulation and Challenges*, note 188, at 25.

[204] Financial Services Authority and HM Treasury, *Consultation on the legislative framework for the regulation of alternative finance investment bonds (Sukuk)*, (FSA, London, 2008), at 11, [2.10], available at: http://www.fsa.gov.uk/pubs/cp/sukuk.pdf.

[205] Under Chapter III of Part XVII of FSMA.

[206] Under Chapter IV of Part XVII of FSMA.

[207] Three such schemes exist for offer to retail customers in the UK:
Schemes established in another EEA state under the UCITS Directive [Section 264 FSMA]
Schemes authorised in such other countries or territories as the FSA may designate [section 270 FSMA]
Individually recognised overseas schemes [section 272 FSMA]

[208] Section 238(1) FSMA: '[a]n authorised person must not communicate an invitation or inducement to participate in a collective investment scheme. Subject to Article 14(1) CIS Promotions Order

[209] Financial Services and Markets Act 2000 (Regulated Activities)(Amendment) Order 2010, No. 86 of 2010.

[210] Article 3, Financial Services and Markets Act 2000 (Regulated Activities)(Amendment) Order 2010, No. 86 of 2010. The British Exchequer Secretary to the Treasury Sarah McCarthy-Fry MP confirmed this continued commitment to Islamic finance when she noted that "This measure is another important step in the development of the Islamic finance sector in the UK and will help to provide a level playing field for Islamic

dispensation only extends to *sukūk* which are comparable to conventional debt securities,[211] and so *sukūk* which reflect the substance of equity investments, will continue to be treated as CIS.[212] These legislative modifications have been presented by the FSA as a means of reducing the cost of corporate *sukūk* issuances in the UK by around £35,000 for *sukūk* of five years' duration.[213]

Like the UK, the Dubai DFSA has approached the regulation of *sukūk* by considering whether the substance of an Islamic security issued pursuant to a managed fund arrangement is more consistent with debt or equity.[214] Incorporating a highly prescriptive "Sukuk Exclusion" into the Dubai Financial Services Authority Collective Investment Rules, Rule 2.3.9 now provides that

> [a]rrangements do not...amount to a collective investment fund if the arrangements are arrangements under which the rights or interests of the participants are evidenced by sukuk certificates where the holders of the certificates are entitled to rely on the credit worthiness of:
> (a) the issuer of the sukuk certificates; or
> (b) any other persons who has assumed obligations under the sukuk certificates, for obtaining their rights and benefits arising under the certificates.[215]

This carve-out is similar in ambition to that found in the UK legislation and is available only to *sukūk* where the economic effect is comparable to a debt security.[216]

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financial products in this country. It is good news for the UK economy and for our Islamic finance industry," HM Treasury, "Government moves to support UK Islamic finance industry," *Press Release*, (21st January 2010), available at: http://www.hm-treasury.gov.uk/press_04_10.htm. Most recently there have been indications of an interest in issuing *Sukūk* in the UK with a London based hospital looking to issue the UK's first *Sukūk*, C. Valente, "Hospital poised for first UK Sukuk issuance," *Reuters*, February 25, 2010, available at: http://uk.reuters.com/article/idUKTRE61O3NI20100225.

[210] International Organization of Securities Commissions, *Analysis of the Application of the IOSCO's Objectives and Principles of Securities Regulation for Islamic Securities Products*, note 192, at 22.

[211] Despite some potentially misleading comments during the course of the consultation which suggest that the newly inserted regulatory definition of AFIB would result in *all* sukuk being treated as debt instruments, see comments made by Lord Myners, "Financial Services and Markets Act 2000 (Regulated Activities)(Amendment) Order 2010", note 195.

[212] Ainley, Michael, Mashayekhi, Ali, Hicks, Robert, Rahman, Arshadur and Ravalia, Ali, *Islamic Finance in the UK: Regulation and Challenges*, note 188, at 25-26.

[213] Financial Services Authority and HM Treasury, *Consultation on the legislative framework for the regulation of alternative finance investment bonds (Sukuk)*, note 204, at 20.

[214] Dubai Financial Services Authority, Consultation Paper No. 57 Miscellaneous Amendments to the Rulebook, (DFSA, Dubai, July 2008), at 5 (Item 5. CIR 2.3.9 - Certain Sukuk excluded from being a fund), available at: http://dfsa.complinet.com/net_file_store/new_rulebooks/d/f/DFSA_CP57.pdf.

[215] Rule 2.3.9, The DFSA Rulebook; Collective Investment Rules (CIR), available at: http://dfsa.complinet.com/net_file_store/new_rulebooks/d/f/DFSA_CIR_VER10.pdf.

Finally, Malaysia too has clarified the regulatory status of *sukūk*, although Malaysia's distinction between *sukūk* which are comparable to debt and those which are more equity-like in effect is less rigid than the approach adopted in other *sukūk* centres. Replacing the existing sources of regulatory guidance for Islamic securities,[217] the Malaysian Securities Commission's "Islamic Securities Guidelines (Sukuk Guidelines)"[218] become effective in August 2011. These guidelines "regulate any issue, offer or invitation of sukuk"[219] in Malaysia. The Guidelines use the term "Islamic securities" interchangeably with "sukuk" and apply to all *sukūk* forms, not simply debt-like bond alternatives.[220] The Guidelines then go on to apply rules to all *sukūk* which are tailored to the unique characteristics of *sukūk* issuances. Where *sukūk* are asset-backed, the Guidelines require that such *sukūk* must also comply with the Guidelines on the Offering of Asset-Backed Securities.[221] However, the Guidelines specifically extend the application of the Capital Markets and Services Act 2007 provisions relating to debentures to *all* Islamic securities.[222] *Sukūk* issued in Malaysia are therefore subject to a regulatory regime which treats them as similar to debentures, that is a document evidencing a debt. While this could be criticised as failing to acknowledge the diversity of risk allocation found in different *sukūk* structures, the potential for the regulatory arbitrage is minimised by the fact that Malaysia's SC subjects activities relating to all securities (debt and equity) to rigorous authorisation, disclosure and structural requirements.[223]

The authorities in the UK, Dubai and Malaysia have recognised that providing an accommodating tax framework alone will not be sufficient to facilitate the development of a domestic *sukūk* market. These jurisdictions have established regulatory policies which deal specifically with the interaction between existing regulatory frameworks and (primarily) debt-like *sukūk* transactions. In light of the precedent established by these

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[216] Dubai Financial Services Authority, Consultation Paper No. 57 Miscellaneous Amendments to the Rulebook, note 214.

[217] Securities Commission Malaysia, *Guidelines on the Offering of Islamic Securities*, July 26, 2004, at [1.03], available at: http://www.sc.com.my/main.asp?pageid=957&menuid=&newsid=&linkid=&type=.

[218] Securities Commission, Malaysia, *Islamic Securities Guidelines (Sukuk Guidelines)*, (August 2011), available at: http://www.sc.com.my/eng/html/resources/guidelines/bondmkt/sukukGuidelines_110812.pdf

[219] *ibid.*, at [1.03]

[220] *ibid.*, at [2.01].

[221] *ibid.*, at [1.15].

[222] *ibid.*, at [1.12].

[223] See for example the *Guidelines on the Offering of Private Debt Securities* which require approval of documentation involve in the issue of debt securities and declarations by the issuer and advisors involved in the issue (Securities Commission Malaysia, *Guidelines on the Offering of Private Debt Securities*, July 26, 2004, available at: http://www.sc.com.my/eng/html/resources/guidelines/guidelines_privatedebt260704.pdf),this level of direct supervision of debt securities activity is not found in other countries such as Ireland or the UK.

financial centres, as well as the importance of maintaining the integrity of the financial sector generally, it is suggested that any regulatory accommodation of *sukūk* in Ireland should avoid trying to establish an overarching regulatory definition which encompasses *every* form of *sukūk*. Instead, the more pragmatic approach of the UK and Dubai authorities should be adopted. This would allow the Irish Central Bank to consider whether the current framework is capable of regulating both debt-like and equity-like *sukūk* in a logical manner. On foot of this, the authorities could then make the necessary adjustments to that established framework only when needed to ensure a level playing field.

9.3.2 Potential Regulation of *Sukūk* under Irish Law

As has already been discussed in Section 9.2, Part 8A TCA provides a broad definition of *sukuk*-like arrangements for the purposes of tax,[224] yet these products remain undefined for regulatory purposes. The potential classification of these products in Ireland thus rests on construing the existing regulatory framework and determining its compatibility with Islamic capital market instruments. Legal provisions relevant to the definition, regulation and supervision of debt securities and CIS in Ireland are more dispersed and, at times, less detailed than similar provisions in the UK's FSMA and RAO. Nevertheless, it seems likely that when regulating *sukūk*, authorities in Ireland will face a dilemma between classifying the certificates issued as units in a CIS (A)[225] or as debt securities (B).[226]

A. Classification of *Sukūk* as Units in a CIS

One of the few financial products to be specifically regulated under the Irish regulatory framework, CIS are identified under Irish law as schemes which take one of several forms, an Undertaking for Collective Investment in Transferable Securities (UCITS),[227] a unit-

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[224] *supra.* at 329.
[225] *infra.* at 358.
[226] *infra.* at 361.
[227] Despite representing one of the more popular structures for investment funds in Ireland, the open-ended nature of UCITS, under which units must be capable of being redeemed for proportionate net asset value at the request of the unit holder (section 37(1) Directive 85/611/EEC (UCITS Directive) implemented in Ireland by section 3(5)(a) European Communities (Undertakings for Collective Investment in Transferable Securities) Regulations 2003 (S.I. No. 211 of 2003) (revoking the original The European Communities (Undertakings for Collective Investment in Transferable Securities) Regulations 1989 (S.I. No. 78 of 1989))) and the statutory requirement that such funds invest only in specified financial instruments, both limit the extent to which *sukūk* are likely to fall within the European Communities collective investment framework, of which UCITS represent the main focus. This will reduce the ability of *sukūk* regulated as CIS to benefit from the European passport provided for under the UCITS Directive.

trust, a designated investment company, a limited investment partnership[228] or a common contractual fund.[229] Although Irish legislation lacks a single definition of CIS, common characteristics are found in all of these collective financial schemes: a scheme provides an opportunity for investors to subscribe to units or shares in a fund resulting in a pool of investments which is invested in income producing assets. These units or shares - though not conferring on investors the right to manage the underlying assets - evidence a right to share in the profits or losses derived from those assets.[230] While the UK authorities have noted that *mudāraba sukūk* would fulfil the characteristics of a CIS,[231] it is suggested that this conclusion should be extended beyond *mudāraba* arrangements. Most, if not all *sukūk* which are structured to include an independent SPV or a trust, share key cosmetic characteristics with CIS as the relationship between the *sukūk* holders and the SPV resembles that of investors and fund manager.[232] Irish legislation does not readily provide for unregulated schemes[233] and so it is suggested that of the statutory CIS structures available, *sukūk* certificates offered in Ireland would most likely be classified as units in a unit-trust CIS. These trusts involve

> ...any arrangement made for the purpose, or having the effect, of providing facilities for the participation by the public, as beneficiaries under a trust, in profits or income arising from the acquisition, holding, management or disposal of securities or any other property whatsoever.[234]

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[228] Part 11 Central Bank and Financial Services of Ireland Act 2004 amending the Investment Intermediaries Act 1995 section 2(a) so as to provide that "'relevant collective investment scheme instrument' means—

a) units or shares in undertakings for collective investments in transferable securities within the meaning of the European Communities (Undertakings for Collective Investment in Transferable Securities) Regulations 2003 (S.I. No. 211 of 2003), or

b) units in a unit-trust, or

c) shares in an investment company, or

d) capital contributions to an investment limited partnership;"

[229] Part 2, Investment Funds, Companies and Miscellaneous Provisions Act 2005.

[230] While Irish regulatory provisions do not contain a consolidated definition of a CIS, tax legislation does with section16 Taxes Consolidation Act 1997 as amended by Finance Act 2000 defining a CIS as "any scheme or arrangement made for the purpose, or having the effect, of providing facilities for the participation by persons as beneficiaries in profits or income arising from the acquisition, holding, management or disposal of assets."

[231] Ainley, Michael, Mashayekhi, Ali, Hicks, Robert, Rahman, Arshadur and Ravalia, Ali, *Islamic Finance in the UK: Regulation and Challenges*, note 188, at 25.

[232] Hainsworth appears to agree with this conclusion noting that "there is a strong argument to say that most sukuk will not be able to take advantage of...exemption[s]" from the CIS regime, Hainsworth, Antony, *Islamic Financial Institutions and Islamic Finance*, (LexisNexis, Butterworths, London, 2009), at 33.

[233] There are unauthorised unit-trusts but these can only be offered to pension funds and charities.

[234] Section 1(1) Unit-trusts Act 1990 definition of "unit-trust scheme."

Like *sukūk* schemes, a unit-trust involves an interest in the underlying asset being transferred to the SPV, who holds that interest on trust for the investors; each unit in the trust scheme represents the holder's beneficial interest in income producing property.[235] *Sukūk* issuances in Ireland may also be classified as investment limited partnership CIS. Involving at least one general and one limited partner, the aim of investment limited partnerships is to invest funds in property which can be real or personal.[236] The assets of the partnership are then transferred to a custodian for safekeeping. This form of fund structure may be particularly relevant in the case of profit-and-loss sharing *mushāraka sukūk* which are issued directly by the originator rather than through an SPV.[237] The originator would act as the general partner and be personally liable for the debts and obligations of the investment limited partnership, while the investors would be treated as limited partners who are liable only to the extent of their investment.[238] As a result of the partnership nature of these investment funds, all the partnership assets, together with income generated by those assets are owned, proportionately, by all partners.[239]

There exists therefore, an established regulatory framework in Irish law into which many, if not most, *sukūk* issuances could be subsumed. Any straightforward categorisation of *sukūk* for regulatory proposes is, however, complicated by two facts. First, many of the Islamic structures also fall within the definition under Irish law of a transferable security. Second, classifying all *sukūk* as CIS may result in the regulatory treatment of some *sukūk*

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[235] Correspondence with Roy Parker, McCann Fitzgerald McCannFitzgerald Solicitors, Appendix 5, *infra.* at 462.

[236] Irish Funds Industry Association, *Investment Structures*, (IFIA, Dublin, n.d.), at 3, available at: http://www.irishfunds.ie/content/investment structures doc.pdf.

[237] This structure is unlikely to apply to a *sukūk* issued through an SPV because classifying the SPV as a general partner would result in that entity becoming liable for all the debts of the investment. As the SPV itself will not be contributing capital to the investment the relationship between the SPV and the investors is closer to that of a *mudāraba* than a *mushāraka* with the implication that the SPV, save in the case of fraud or negligence, should not be held personally liable for the financial obligations of the partnership.

[238] Mason Hayes and Curran, *Investment Funds in Ireland*, (March 2011), at 21, available at: http://www.mhc.ie/fs/doc/publications/mh-c-investment-funds-ireland-mar2011-email.pdf.

[239] Irish Funds Industry Association, *Investment Limited Partnership*, (IFIA, Dublin, n.d.), available at: http://www.irishfunds.ie/investment_ltd_partnership.htm. The other non-UCITS funds, while similar in form to *sukūk*, include features which make it less likely that *sukūk* will fall within their definition for regulatory purposes. Investment companies established under Part XIII of the Companies Act 1990 for example involve the "collective investment of...funds in property." However, these funds do not confer on investors a legal or beneficial interest in the fund assets and must also fulfil a statutorily imposed requirement of risk diversification. As a *Sharī'ah*-compliant means of raising capital for an originator, the proceeds of a *sukūk* issuance are generally invested in a specific project, business or portfolio of assets connected with the originator. These investments would, it is suggested, be insufficiently diverse to satisfy the requirement of risk spreading. Equally, while the participants in common contractual funds hold an undivided co-ownership interest in the assets of that fund, not only is the category of investors who can invest in these schemes restricted to non-individuals, but the units of the fund are not freely transferable. These features, particularly the one relating to transferability, potentially differentiate common contractual funds from the more common *sukūk* structures.

issuances, and their issuers, which is inconsistent with the economic substance of the transaction.[240]

B. Classification of *Sukūk* as Transferable Securities

The definition for regulatory purposes of "transferable securities" in Ireland is found in the European Communities (Markets in Financial Instruments) Regulations 2007[241] [2007 Regulations], which implement MiFID[242] into Irish domestic law.[243] Defined as those classes of securities which are negotiable on the capital market,[244] the range of instruments classified as transferable securities in Ireland is broad and includes

> (a) shares in companies and other securities equivalent to shares in companies, partnerships or other entities, and depositary receipts in respect of shares;
> (b) bonds or other forms of securitised debt, including depositary receipts in respect of such securities;
> (c) any other securities giving the right to acquire or sell any such transferable securities or giving rise to a cash settlement determined by reference to transferable securities, currencies, interest rates or yields, commodities or other indices or measures.[245]

This definition is wider than that found in ss.77 and 78 of the UK's RAO, which deal only with instruments acknowledging indebtedness.[246] It thus brings *sukūk* certificates within its

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[240] International Organization of Securities Commissions, *Analysis of the Application of the IOSCO's Objectives and Principles of Securities Regulation for Islamic Securities Products*, note 192, at 22.

[241] S.I. No. 60/2007 — European Communities (Markets in Financial Instruments) Regulations 2007.

[242] Markets in Financial Instruments Directive, 2004/39/EC of the European Parliament and of the Council of 21 April 2004.

[243] Bates, Andrew, Kelliher, Brian and O'Connor, Donnacha, *A Guide to MiFID Investment Services in Ireland*, (Dillon Eustace, Dublin, 2009), at 4, available at: http://www.dilloneustace.ie/download/1/A Guide to MiFID Investment Services in Ireland.pdf

[244] Section 3(1) European Communities (Markets in Financial Instruments) Regulations 2007, definition of "transferable securities."

[245] Section 3(1) European Communities (Markets in Financial Instruments) Regulations 2007. The definition of transferable securities in the Investment Intermediaries Act 1995 is more descriptive where such securities are defined as including shares, warrants, debentures including debenture stock, loan stock, bonds, certificates of deposits and other instruments creating or acknowledging indebtedness issued by or on behalf of anybody corporate or mutual body, government and public securities, including loan stock, bonds and other instruments creating or acknowledging indebtedness issued by or on behalf of a government, local authority or public authority, bonds or other instruments creating or acknowledging indebtedness, certificates representing securities, Investment Intermediaries Act 1995 definition of transferable securities as "investment instruments."

[246] S.77 The Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 applies to
a) debentures;
b) debenture stock;

ambit quite easily. Indeed, when considering the specific regulatory definition of *sukūk* in the UK, the FSA acknowledged that "the MiFID definition of transferable securities...already captures sukuk and therefore there is no need to have an explicit provision within the legislation."[247] As a result, in light of their comparability to conventional bonds, the debt-like specified investment certificates accommodated by Part 8A TCA are likely to fall within this definition. Equally, equity-linked *sukūk* which fall outside of the tax provisions may also be treated as transferable securities as "equivalent to shares in companies, partnerships or other entities."[248] As a result, it would appear possible to subsume most forms of *sukūk* under the broad examples of transferable securities. Classified as such, *sukūk* would then fall to be regulated as "financial instruments" within Part 3 of Schedule 1 of the 2007 Regulations.

9.3.3 Difficulties Arising from the Lack of a Clear Regulatory Status of *Sukūk*

A. Uncertainty over Regulatory Regime Applicable in *Sukūk* Issuances

Sukūk transactions share structural similarities with many of the CIS forms approved by the Central Bank. At the same time, the expansive definition of a transferable security contained in the 2007 Regulations may also be sufficiently flexible to accommodate Islamic securities which are, or are at least capable of being, negotiated on the capital markets.[249] Highlighting this overlap as a key problem faced by *sukūk* issuers in the UK, the FSA stated that "sukuk will not...be categorised as a CIS...if the arrangement...is a debt

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c) loan stock;
d) bonds;
e) certificates of deposit;
f) any other instrument creating or acknowledging indebtedness.

[247] HM Treasury and FSA, *Legislative framework for the regulation of alternative finance investment bonds (sukuk): summary of responses*, (October 2009), available at: http://www.fsa.gov.uk/pubs/cp/afibs_sukuk.pdf. See also, Ravalia, Ali, "Proposed amendments to the regulation of "alternative finance investment bonds" (sukuk)", (October 2009), *Financial Services Authority Quarterly Consultation CP09/25*, 7-10 at 9, available at: http://www.fsa.gov.uk/pubs/cp/cp09_25.pdf confirming that "alternative finance investment bonds" come within the list of transferable securities under MIFID.

[248] Section 3(1) European Communities (Markets in Financial Instruments) Regulations 2007.

[249] While the definition in the 2007 Regulations is wide, it is restricted by the requirement that the securities are negotiable. Commentators in the UK have however suggested that negotiability requires only that the securities are *capable* of being negotiated on the capital markets, not that they actually are negotiated. Sheldon, Jeremy, N., Watson, John, Bell, Jeremy and Warburton, Piers, *New UK Prospectus Regulations: Application to private investment funds*, (Ashurst, London, October 2005), at 1, available at: www.ashurst.com/doc.aspx?id_Content=2058, Bates, Andrew, *A Guide to Irish Private Equity Funds*, (Dillon Eustace, Dublin, 2010), at 10, available at: http://www.dilloneustace.ie/download/1/A%20Guide%20to%20Irish%20Private%20Equity%20Funds.pdf.

security within the definition set out in Article 77,"[250] before going on to suggest that notwithstanding the fact that *mudāraba sukūk* could be regulated as either a CIS or a debt security it would (prior to accommodation) more likely to be classified as a CIS.[251]

The wide scope of Ireland's regulatory definitions suggests that a broad range of *sukūk* structures may fall within both regulatory frameworks. This could lead to uncertainty for participants in *sukūk* issuances, as such participants may be unable to anticipate, in advance, to which regulatory regime they may be subject. Concluding that securities regulators should "consider the regulatory classification of Islamic securities products and ensure that they are treated in a fair, transparent and consistent manner,"[252] the IOSCO's report on Islamic capital market products emphasised the need for regulators to establish a clear policy towards the regulation of *sukūk*.[253] As will be discussed below, CIS and transferable securities in Ireland are subject to different degrees of product and participant-level regulation.[254] In light of the fact that within six months of the UK's clarification of the regulatory treatment of *sukūk*, the UK's first domestic *sukūk* was issued,[255] it is suggested that an untailored regulatory framework may be a genuine obstacle to *sukūk* issuances.

B. A Potentially Inappropriate Level of Regulation

The second, and more problematic, implication of the untailored regulation of *sukūk* arises from the fact that it may result in *sukūk* structures and participants being subject to an inappropriate level of regulation with *sukūk* whose "economic characteristics are substantively those of corporate or sovereign bonds"[256] being treated as CIS.

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[250] Ainley, Michael, Mashayekhi, Ali, Hicks, Robert, Rahman, Arshadur and Ravalia, Ali, *Islamic Finance in the UK: Regulation and Challenges*, note 188, at 25.

[251] *ibid.*, at 26.

[252] International Organization of Securities Commissions, *Analysis of the Application of the IOSCO's Objectives and Principles of Securities Regulation for Islamic Securities Products*, note 192, at 4.

[253] *ibid.*, at 20. See also, Khan, Farhaz, "IOSCO principles of regulation and Islamic securities markets", (2009) 24(2) *Journal of International Banking and Financial Law*, 74-75 at 75.

[254] *infra.* at 363.

[255] The *sukūk* was issued by International Innovative Technologies a technology development company based in the North East of England. The *sukūk* itself was a private equity offering with Dubai-based Millennium Private Equity Limited acting as the financier, Anonymous, "Norton Rose advises on UK's first Sukūk", *Lawyers Weekly*, August 18, 2010, available at: http://www.lawyersweekly.com.au/blogs/deals/archive/2010/08/18/norton-rose-advises-on-uk-s-first-sukuk.aspx

[256] International Organization of Securities Commissions, *Analysis of the Application of the IOSCO's Objectives and Principles of Securities Regulation for Islamic Securities Products*, note 192, at 24.

Like the UK, Irish legislation and guidelines impose a high level of regulation on CIS as well as on their promoters and service providers.[257] This product-based oversight arises both at authorisation and throughout the duration of the investment. Such an interventionist level of supervision reflects the fact that the investors in CIS arrangements have limited control over their investments and must instead rely on the proficiency and honesty of the entity which manages the pool (i.e. the fund manager).[258] In contrast, and indicative perhaps of the perceived lower level of risk to investors, regulation of conventional bonds and debentures in Ireland is functional rather than product-based in nature.[259] The Central Bank seeks to minimise the extent to which investors will be unintentionally subjected to undesirable behaviour rather than determining the merits of an investment product itself.[260] Taking a free-market as opposed to a paternalistic attitude therefore, Ireland's securities regulation seeks to provide an environment in which investors in securities can satisfy themselves that they are making the correct investment decisions. As a result, much of the regulation relevant to securities issuances rests on disclosure rather than on authorisation.[261] In ambition and application, the regulations applying to CIS and securities are distinguishable, particularly at retail-level. The next two subsections will consider the implications of regulating *sukūk* in Ireland both as CIS (1)[262] and as transferable securities (2).[263] Following this discussion, conclusions will be drawn on future accommodations which may be needed (9.3.4).[264]

1. Regulation of CIS

Notwithstanding the various different legal forms which CIS can take in Ireland, these funds are subject to a relatively consistent level of regulation and ongoing supervision by

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[257] O'Connor, Benedicte and Dillon, Brian, "PLC Cross-Border Handbooks", *Investment Funds 2010, Country Q&A: Ireland*, (Practical Law Company, London, 2010) 95-103 at 95-96.

[258] Wood, Philip, *The Law and Practice of International Finance*, University Edition, (Sweet & Maxwell, London, 2008), at 336, Wood, Philip, *Regulation of International Finance*, (Sweet & Maxwell, Lonon, 2007), at 357, Moloney, Niamh, *EU Securities Regulation*, (Oxford University Press, Oxford, 2007), at 234-5.

[259] Financial Services Consultative Consumer Panel, *Financial Regulatory Framework Review – An update*, (Central Bank, Dublin, 2010), at 18, available at: http://www.centralbank.ie/consultative-panels/consumer/Documents/May%2009%20Report%20Update.pdf noting that; "the Financial Regulator supervises the actions of the institutions rather than the individual products it offers."

[260] Benjamin, Joanna, *Financial Law* (Oxford University Press, Oxford, 2007), at 231.

[261] Jackson, Howell E., "Regulation in a Multi-Sectored Financial Services Industry: An Exploratory Essay", (1999) 76 *Washington University Law Quarterly*, 319-397 at 352 who notes that disclosure rules "depend upon consumers to absorb and respond rationally to information statements' and contrasts these with more interventionist functional regulations or 'portfolio-shaping rules' which 'entail direct government intervention."

[262] *infra.* at 364.

[263] *infra.* at 369.

[264] *infra.* at 373.

the Central Bank. The regulatory standards applied to CIS are contained in the Acts relevant to each form of fund as well as in the consolidated Non-UCITS Notices published by the Central Bank.[265] These Notices deal both with retail-level funds and with regulated funds which are marketed to professional investors (Professional Investor Funds: PIFs) and qualifying investors (Qualifying Investor Funds: QIFs).[266] While these wholesale funds are not unregulated, they are often exempted from the more stringent disclosure and investment criteria imposed on funds marketed to retail-level investors. The following subsection is highly descriptive; such details serve to highlight the extensive and prolonged regulation of CIS in Ireland.

Retail funds in Ireland are subject to a two-part authorisation process under which the promoter and service providers, as well as the fund itself, must be approved by the Central Bank.[267] Before a fund can be established, the Central Bank must be satisfied with the expertise, experience, reputation, and financial resources of the promoter and investment manager (if different).[268] This initial approval does not directly regulate the promoter and investment manager but seeks to ensure that they meet a level of competence necessary to promote and/or organise the CIS.[269] While there is no requirement that the promoter or the investment manager is resident in the state, firms which are already authorised under MiFID or as a credit institution by another EEA State will be exempt from additional regulation by the Central Bank.[270] A similar reciprocity does not exist where the promoter and investment manager are non-EEA firms.[271] This pre-emptive regulation could be particularly relevant in the case of *sukūk* classified as CIS, as the promoter may be resident

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[265] Central Bank of Ireland, *NU Series of Notices*, Conditions imposed in relation to Collective Investment Schemes Other than UCITS, July 2011, available at: http://www.centralbank.ie/regulation/industry-sectors/funds/non-ucits/Documents/Non UCITS Notices.pdf.

[266] These sophisticated investor funds are discussed in more detail below *infra.* at 367.

[267] NU 4.7; Collective Investment Schemes other than UCITS, Information and document requirements of the Central Bank of Ireland in support of an application for authorisation as a unit-trust, common contractual fund, investment company or investment limited partnership, Central Bank of Ireland, NU Series of Notices, Conditions imposed in relation to Collective Investment Schemes Other than UCITS, July 2011, available at: http://www.centralbank.ie/regulation/industry-sectors/funds/non-ucits/Documents/Non UCITS Notices.pdf.

[268] Unit-trusts Act 1990, Section 4(1)(a), Revenue Commissioners, *Guidance Note 2/96 – Promoters of CIS*, (November 2007), at 2-3, Securities and Exchanges Supervision Department, Central Bank of Ireland, *Collective Investment Schemes in Ireland*, (Dublin, Central Bank, 1996), at 8, available at: http://www.accountingnet.ie/artman2/uploads/collective_invest.pdf. See also, O'Connor, Benedicte and Dillon, Brian, "PLC Cross-Border Handbooks", *Investment Funds 2010, Country Q&A: Ireland*, note 257, at 95-96.

[269] Unit-trusts Act 1990, Section 4(1)(a), Investment Limited Partnership Act 1994 section 8(1), Central Bank, *Guidance Note 2/96; Promoters of collective investment schemes*, (October 2010), at 3, available at: http://www.centralbank.ie/regulation/industry-sectors/funds/Documents/GN 296 Promoters of collective investment schemes.pdf.

[270] *ibid.*, at 4-5

[271] *ibid.*.

in an Islamic (and thus non-EEA) State and so will have to take into account the additional time which such approval may take. Once the promoter has been authorised, the Central Bank must also approve of the fund's Irish domiciled administrator and an Irish trustee (in the case of a unit-trust) or custodian (for investment company, investment limited partnerships or collective contractual funds), charged with safeguarding the assets and ensuring that the fund is managed in accordance with the trust deed, deed of constitution, articles of association or partnership agreement.[272] The only entities which can act as trustee/custodian of an Irish fund are credit institutions authorised in Ireland and their branches, or non-credit institutions authorised as a custodian under MiFID, where that company is incorporated in the State and wholly owned and guaranteed by an EEA domiciled credit institution or equivalent entity.[273] In the case of a custodian safeguarding the assets of a CIS structured as an investment company, the assets are owned by the company itself as a separate legal entity with the custodian merely safeguarding these. However, as unit-trusts have no separate legal personality, the trustee holds legal title to the assets for the benefit of the investors. This could be problematic if the underlying assets on which the fund is based include Irish located real property as a trustee may not wish to hold title to tangible assets.[274] Finally, funds structured other than as an investment company will also need to appoint an Irish domiciled management company which must be independent of the trustee and approved by the Central Bank.[275] Following this approval of the institutions involved in a CIS, requisite documentation must be submitted to the Central Bank. Only once these are deemed to be satisfactory will the fund itself be approved. Without approval of both the parties involved the CIS and the fund itself, no unit/share in the scheme can be sold or purchased under Irish law.[276]

Once authorised, funds are subject to continuing supervision which requires monthly, half-yearly and annual reports from the fund itself,[277] and half-yearly and annual audited

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[272] NU 7.11, Collective Investment Schemes other than UCITS, Trustees - duties and conditions, at [1].

[273] NU 6.5, Collective Investment Schemes other than UCITS, Trustees - eligibility criteria, [3].

[274] For both regulatory capital reasons and because of the potential environmental, nuisance and other property based liabilities discussed in Chapter 7 in relation to Islamic real estate financing.

[275] See for example Unit-trusts Act 1990, Section 4(1)(d), NU 5.11, Collective Investment Schemes other than UCITS, Supervisory conditions for non-UCITS collective investment schemes authorised by the Financial Central Bank and certain firms providing services to such schemes.

[276] See for example, Unit-trusts Act 1990, Section 9(1), Section 256 Companies Act 1990.

[277] NU 10.6, Collective Investment Schemes other than UCITS, Information to be included in the monthly returns and NU 11.8, Collective Investment Schemes other than UCITS, Publication of annual and half-yearly reports.

accounts from the fund manager[278] and any non-credit institution trustee.[279] At the same time, ongoing product-level regulation is applied in the form of extensive investment and borrowing restrictions. These restrictions take the form of prescriptive thresholds, set by the Central Bank, which set out the percentage of the CIS's assets which can be invested in individual schemes, funds or property.[280] Investment restrictions are an attempt by the Central Bank to ensure diversity of investment by the CIS so as to minimise the exposure of investors to a single asset or business; by imposing risk spreading, the Central Bank reduces the likelihood that a single failed investment will cause the collapse of the fund and the loss of investors' money. However, this imposed investment diversification may, in practice, be an obstacle to *sukūk* issued in Ireland. *Sukūk* are generally used as a means of asset, commodity or business financing for an originator; the fact that the Central Bank prohibits a Non-UCITS CIS from investing, for example, "more than 20% of the scheme's net assets...in any single property"[281] or "more than 25% of the scheme's net assets...in properties which are vacant, in the process of development or requiring development,"[282] could limit the extent to which Irish *sukūk* regulated as CIS could be used as a means of meeting the specific funding needs of an originator as it would prevent the *sukūk* SPV investing the investors' capital in a single venture or a single asset.

In light of the fact that such stringent regulatory supervision is not necessary for more sophisticated investors, the Irish authorities have confirmed that funds structured as PIFs and QIFs can be subject to less rigorous disclosure and investment criteria than retail-level funds. Of particular note, the extensive investment restrictions discussed above are potentially waived by the Central Bank where the funds are marketed only to professional investors, and are entirely disapplied to funds marketed to qualifying investors.[283] These exemptions may be the only way in which *sukūk* in Ireland, which are regulated as CIS, could invest in a narrow range of investments.[284] Providing guidance for the establishment of non-retail investment funds, the Central Bank's Non-UCITS Notices provide that to

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[278] NU 5.11, Collective Investment Schemes other than UCITS, Supervisory conditions for non-UCITS collective investment schemes authorised by the Financial Central Bank and certain firms providing services to such schemes at [14].

[279] NU 6.5, Collective Investment Schemes other than UCITS, Trustees - eligibility criteria, at [18].

[280] NU 13.11, Collective Investment Schemes other than UCITS, General investment restrictions.

[281] NU 13.11, Collective Investment Schemes other than UCITS, General investment restrictions, at [7].

[282] NU 13.11, Collective Investment Schemes other than UCITS, General investment restrictions, at [9].

[283] NU 12 and NU 24 Collective Investment Schemes other than UCITS, General investment restrictions (2011).

[284] As an indication of the suitability of these funds for sukuk, the Irish Funds Industry Association has noted that the QIF regime is "an ideal product for" property/real estate funds and infrastructure funds, Irish Funds Industry Association, *The Irish Qualifying Investor Fund (QIF)*, (IFIA, Dublin, n.d.), at 1, available at: http://www.irishfunds.ie/content/marketing_collateral/qif_flyer.pdf.

qualify as a QIF, a fund must have a minimum subscription requirement of €100,000[285] and may *not* raise capital from the public.[286]

This result is unsatisfactory. In the absence of a bespoke regulatory definition of *sukūk*, or at least a clear policy statement by the regulator, it seems probable that most *sukūk* structures could fall to be regulated as CIS, even those fulfilling the criteria set out in the accommodating Part 8A provisions of the TCA. One characteristic of Part 8A, which could be problematic, is the requirement that the specified investment certificates "be offered to the public."[287] This provision may have been included as a means of ensuring that *sukūk* offered in Ireland will always be subject to some level of regulation. This justification was explicitly used by the British authorities when imposing a requirement that AFIBs be listed.[288] However, while the mandatory listing qualification in the UK does not prevent *sukūk* from being offered to a restricted group of sophisticated investors, the Irish equivalent does. Defined unhelpfully by Part 8A as "individuals generally, companies generally, or individuals and companies generally,"[289] the concept of the "public" is difficult to define.[290] S.61 of the Companies Act 1963 notes that an offer to the public includes an offer "to any section of the public," however the requirement in Part 8A that the specified investment certificates be offered to the public *generally* suggests that the offer cannot be narrowed to a particular segment of that public.[291] The concept of "public generally" in the accommodating tax provisions may, therefore, militate against a private

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[285] NU 24.9, Schemes which market solely to Qualifying Investors and which are not bound by the limits relating to Investment Objectives and Policies as set out in these Notices, at 99, available at: http://www.centralbank.ie/regulation/industry-sectors/funds/non-ucits/Documents/Non UCITS Notices.pdf. Up until 2011, this minimum subscription was €125,000, Financial Regulator, Non-UCITS Series of Notices, (April 2008), Section 2 of Notice 12.

[286] Central Bank, "Authorisation of Qualifying Investor Schemes – Application Process", *GN 1/07*, (Central Bank, Dublin, 2011), at [10], available at: http://www.centralbank.ie/regulation/industry-sectors/funds/Documents/GN%20107%20Authorisation%20of%20Qualifying%20Investor%20Schemes%20-%20Application%20Process.pdf.

[287] Paragraph (c) definition of "investment certificate," section 267N Taxes Consolidation Act 1997 as introduced by section 39 Finance Act 2010.

[288] Financial Services Authority and HM Treasury, *Consultation on the legislative framework for the regulation of alternative finance investment bonds (Sukuk)*, note 204, at 15, [3.9].

[289] Part 8A Taxes Consolidation Act 1997 definition of 'public' as introduced by section 39 Finance Act 2010.

[290] Douglas, William O. And Bates, George E., "Some Effects of the Securities Act upon Investment Banking", (1933) 1(2) *University of Chicago Law Review*, 283-306 at 299.

[291] Irish caselaw is minimal in this area. However, the English case of *Nash v Lynde* [1929] AC 158 acknowledges a similar understanding of the public. As Viscount Sumner suggested "[t]he point is that the offer is such as to be open to anyone who brings his money and applies in due form, whether the prospectus was addressed to him on behalf of the company or not." *Nash v. Lynde* [1929] AC 158 at 169 per Viscount Sumner. More recent Australian cases have confirmed that an offer to the public does not necessarily mean that the offer has been addressed to the whole world, only that it is capable of being acted upon by any member of the public, *Lee v Evans* (1964) 112 CLR 276 at 286 recently approved in *Attorney-General v Jillian Wurrabadlumba* (1990) 101 FLR 414 at [12] et seq., *Corporate Affairs Commission (South Australia) and Another v Australian Central Credit Union* [1985] 59 ALJR 785.

placement. This would thus prevent *sukūk* transactions which are subject to Part 8A from being structured as a PIF or a QIF.

In light of the foregoing discussion, it is suggested that classification of *sukūk* as CIS under Irish law will not prevent such *sukūk* from being issued or offered domestically in Ireland. It may, however, force the issuer of *sukūk* which are economically comparable to debt securities to choose between, on one hand, qualifying for taxation under Part 8A but being subject to the stringent and ongoing oversight and investment restrictions imposed on retail CIS, and on the other, being structured as a QIF but excluded from the accommodating tax provisions because the *sukūk* certificates cannot be offered to the "public generally."

2. *Regulation of Securities Issuances*

The level of regulation and ongoing supervision imposed on retail CIS arrangements can be contrasted[292] with the less interventionist approach which the Central Bank applies to debt securities. *Sukūk* classified by the Central Bank as transferable securities rather than as units in a CIS will be subject to a distinct regulatory framework which is more consistent with that imposed on conventional bond issuances.

Unlike CIS, bonds and other securitised debt (and their issuers) are not subject to the dual level, ongoing oversight by the Central Bank. Instead, prior to offering securities, an SPV must be incorporated as a public or private company[293] and comply with the Companies Acts 1963-1990.[294] Where that SPV simply acquires subscriptions and issues securities, it will generally not require specific authorisation by the Central Bank either as

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[292] Although, admittedly, as capital market activities are subject to increased regulation the distinction between the level of regulation imposed on CIS and on debt securities is narrowing slightly.

[293] Section 33(iii) of the Companies Act 1963 defines a private company as one whose articles of association prohibit any invitation or offer to the public to subscribe for any of the company's shares or debentures. Section 7 of the Investment Funds, Companies and Miscellaneous Provisions Act 2006 amends section 33 by specifying that an offer of debentures addressed solely to qualified investors, an offer of debentures whose denomination per unit amounts to at least €50,000, an offer of shares addressed to qualified investors and an offer of shares addressed to 99 or fewer persons do not constitute offers to the public and so can be offered by private companies, McGrann,Seanna, *Investment Funds, Companies and Miscellaneous Provisions Act 2006* , (LK Shields, Dublin, April 2007) available at: http://www.lkshields.ie/htmdocs/publications/pub242.htm.

[294] Breslin, John, "The Central Bank Act 1997: The New Definition of Banking Business", (1997) 4(7) *Commercial Law Practitioner*, 160-163 at 162-163.

a credit institution requiring a banking licence (under Ireland's domestic banking law)[295] or as an investment firm carrying out an investment service (under MiFID) unless it does so on a "professional basis."[296] Confirming this position in the UK, the RAO specifically provides that the issue by a company of its own shares or debentures is not a regulated activity.[297] Within Ireland, no similar safe harbour from regulation under MiFID has been explicitly created for the issue of securities.[298] Nevertheless, such an issue may fall within s.5 of the 2007 Regulation which outlines those activities to which the 2007 Regulation does not apply and which are not caught by the MiFID regulatory regime.[299] Of particular note for companies issuing debt or equity securities, as well as SPVs issuing *sukūk*,[300] is the exclusion from regulation for entities "who do not provide any investment services or activities other than dealing on own account," unless they are market makers or deal outside a regulated market/multi-trade facility on an organised, frequent and systematic basis.[301] In the absence of some further action by the issuer of securities in relation to those

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[295] Under the Central Bank Act 1997, (SI 150/1997), the definition of banking business was extended to include

a) The business of accepting, on own account, sums of money from the public in the form of deposits or other repayable funds whether or not involving the issue of securities or other obligations, howsoever described, or

b) The business aforesaid and any other business normally carried on by a bank, which may include the granting of credits on own account.

This definition is broad enough to potentially include entities which receive subscriptions for the issue of securities. However, the Central Bank Act 1989 amended section 8 of the Central Bank Act 1971 to allow the Central Bank to exempt certain categories from the requirement to hold a licence. In a 2002 notice issued by the Central bank pursuant to section 8(2) specifically exempts Issuers of securities or other paper which an original maturity of one year or more from regulation by the Central Bank. Central Bank of Ireland, Notice by the Central Bank of Ireland of Exemptions granted under section 8(2) of the Central bank Act 1971, as amended, (November 2002) available at: http://www.financialregulator.ie/industry-sectors/credit-institutions/Documents/Commercial%20Paper%20Notice.pdf. Breslin, John, "The Central Bank Act 1997: The New Definition of Banking Business", note 294, at 162-163 noting that the notice "is intended to facilitate companies which might find themselves caught under the CBA definition of banking business by reason of raising money on the capital markets...Where the securities have an original maturity of more than one year, a banking licence is not required if the company issuing the securities complies with the requirements of Irish company law." A similar exemption has been set out in the UK under which money accepted is deemed not to be a deposit within the context of FSMA if it is received for the consideration for the issue of debentures, loan stock, bonds or other similar instruments creating or acknowledging indebtedness.

[296] European Communities (Markets in Financial Instruments) Regulations 2007 definition of "investment firm." The UK's FSA has suggested that when determining if an activity has been carried out on a professional basis it is necessary to look at "the existence or otherwise of a commercial element and the scale of the relevant activity," Financial Services Authority, *Perimeter Guidance relating to MiFID; Feedback on CP06/9 and CP06/14*, (FSA, London, March 2007), at [2.10], available at: http://www.fsa.gov.uk/pubs/policy/ps07_05.pdf.

[297] RAO, article 18(1) which provides that "There is excluded from article 14 (dealing in investments as principal) the issue by a company of its own shares or share warrants and the issue by any person of its own debentures or debenture warrants." See Moloney, Niamh, *EU Securities Regulation*, note 258, at 231-232 for a more detailed discussion of the UK provisions.

[298] Correspondence with Roy Parker, McCann Fitzgerald McCannFitzgerald Solicitors, Appendix 5, *infra.* at 462.

[299] Regulation 5(1)(c) European Communities (Markets in Financial Instruments) Regulations 2007.

[300] Email communication with Roy Parker, McCannFitzgerald Solicitors (Appendix)

[301] Section 5(c) European Communities (Markets in Financial Instruments) Regulations 2007.

securities, that issuer is unlikely to be regulated in Ireland simply as a result of the issuance. In contrast, those market participants that do more than issue securities, such as intermediaries between the issuer and the investors, may be regulated. Financial service providers advising on investment in securities, executing orders as agent or managing a portfolio of securities may thus require approval by the Central Bank.[302] Where these services are offered to retail customers, the authorised firms will be subject to the MiFID Conduct of Business Rules contained in ss.74-111 of the 2007 Regulations.[303]

Unlike CIS funds and the various parties involved in their management,[304] the issue of transferable securities (and *sukūk* regulated as such) gives rise to only limited direct regulation by the Irish authorities. Instead, official oversight of the securities markets in Ireland rests largely on enforcing disclosure requirements so that "[t]he public is not so much protected, as equipped to protect itself."[305] An issue of securities (at least to the public) may therefore be subject to a range of disclosure obligations. The Prospectus Directive[306] imposes an obligation on issuers of securities to publish and obtain approval of a prospectus when securities are offered to the public or admitted to trading on a regulated exchange.[307] This prospectus must contain all the information necessary to enable investors to make an informed decision both regarding the issuer itself and the nature of the security.[308] Where those securities are listed on a regulated exchange they will also have to comply with the Transparency Directive[309] and the Market Abuse Directive.[310]

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[302] Schedule 1, Part 1, Investment Services, European Communities (Markets in Financial Instruments) Regulations 2007. The Financial Central Bank also imposes Minimum Competency Requirements on individuals acting for or on behalf of a regulated firm in relation to financial services offered to consumers. Financial Regulator (as it then was), *Minimum Competency Requirements*, (July 2006), available at: http://www.financialregulator.ie/processes/minimum-competency-req/Documents/Minimum%20Competency%20Requirements.pdf.

[303] Financial Regulator (as it then was), "Markets in Financial Instruments Directive (MiFID)", *Feedback on Discussions of Conduct of Business Industry Working Group*, (Financial Regulator, Dublin, October 2007), available at: http://www.centralbank.ie/regulation/processes/consumer-protection-code/Documents/MiFID%20-%20Feedback%20on%20Discussions%20of%20Conduct%20of%20Business%20Industry%20Working%20Group.pdf.

[304] *supra.* at 364.

[305] Benjamin, Joanna, *Financial Law*, note 260, at 232.

[306] Directive 2003/71/EC Of the European Parliament and of the Council of 4 November 2003 on the prospectus to be published when securities are offered to the public or admitted to trading and amending Directive 2001/34/EC, incorporated into Irish law by S.I. No. 324/2005 — Prospectus (Directive 2003/71/Ec) Regulations 2005.

[307] *ibid.*, at [10]. See also definition of "prospectus" as the 'document or documents required to be published for the purposes of a public offer or admission to trading in accordance with EU prospectus law and includes where the context admits any supplement thereto' in Prospectus (Directive 2003/71/EC) Regulations 2005, S. I. No. 324 of 2005.

[308] Section 19 Prospectus (Directive 2003/71/EC) Regulations 2005, S. I. No. 324 of 2005.

[309] Transparency Directive (2004/109/EC) (the "TD") was implemented into Irish law on 13thJune 2007 by the Transparency (Directive 2004/109/EC) Regulations 2007.

Consequently, issuers of listed securities/*sukūk* categorised as a transferable security will be under an obligation to ensure the necessary transparency for investors through the periodic dissemination of information to the public[311] as well as the *ad hoc* disclosure requirements imposed on issuers in relation to price sensitive information, insiders and own account transactions.[312]

Acknowledging the fact that more sophisticated investors may not need such a high level of information in order to be able to make an investment decision, a number of exemptions exist under which the prescribed disclosure and publication requirements are discharged.[313] These include private offerings and offerings to sophisticated investors,[314] as there is less potential for the "unsophisticated and inexperienced"[315] public to be exploited. The Prospectus Directive also exempts from the need to publish a prospectus, "non-equity securities"[316] where the total consideration is expressly limited to less than €2,500,000[317] so as to avoid placing disproportionate costs on smaller issuers.[318] *Sukūk* which are debt-like in substance and modest in scale may be able to benefit from this exemption.

In practice, the threshold requirement in the accommodating provisions of Part 8A TCA, that an investment transaction must be marketed to the "public," now places *sukūk* in Ireland in a somewhat anomalous position. While conventional bond issuances may be listed or unlisted, offered to the public or subject to a private placement, Irish authorities have explicitly confirmed that *sukūk*, if issued in Ireland, do not need to be listed but must

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[310] EU Market Abuse Directive (2003/6/EC), incorporated into Irish law on July, 1, 2005 by the Market Abuse (Directive 2003/6/EC) Regulations 2005.

[311] Article 5(1) Directive 2004/109/EC of the European Parliament and of the Council on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market and amending Directive 2001/34/EC which requires issuers of debt securities to publish half yearly reports, Article 4(1) requires annual financial report to be published unless the security is a debt security issued by issuers incorporated in a third country. Interim management statements are only required from issuers of shares, Article 6(1). This conclusion was confirmed by the (then) Regulator (now Central Bank), in correspondence with Ryan J. Thomas, Financial Regulator (which is now the Central Bank), Appendix 1, *infra.* at 454.

[312] DIRECTIVE 2003/6/EC of the European Parliament and of the Council of 28 January 2003on insider dealing and market manipulation (market abuse), incorporated into Irish law by S.I. No. 342/2005 — Market Abuse (Directive 2003/6/Ec) Regulations 2005.

[313] Wood, Philip, *Regulation of International Finance*, note 258, at 456.

[314] Exemptions exist, for example in the Transparency Directive are less numerous although an exemption from half-yearly reporting is available to wholesale issues of debt securities in denomination per unit starting at €50,000, Transparency Directive, at [15] and Article 8(1)(b).

[315] Moloney, Niamh, *EU Securities Regulation*, note 258, at 234.

[316] Non-equity securities include any securities other than shares, securities equivalent to shares and securities giving the right to acquire shares that are issued by the issuer of the underlying shares.

[317] Section 8(h) Prospectus (Directive 2003/71/EC) Regulations 2005, S. I. No. 324 of 2005.

[318] Kalderon, Mark, *The Prospectus Directive*, (Freshfields Bruckhaus Deringer, London, 2003), at 2, available at: http://www.freshfields.com/publications/pdfs/practices/4968.pdf.

be offered to the public.[319] This would allow the *sukuk*, which are regulated as transferable securities and structured to comply with the provisions of Part 8A, to fall outside the scope of the Transparency and Market Abuse Directives. It would, however, prevent the *sukūk* issuer from falling within an exemption to the Prospectus Directive. As noted in relation to CIS, debt-like *sukūk* in the UK must be listed but do not need to be offered to the public; requiring a *sukūk* to be listed will ensure that such issuances are not only subject to the Prospectus Directive, the Transparency Directive and the Market Abuse Directive, but it also allows some derogation from the first two Directives in circumstances where the investors are deemed to be sophisticated enough to not require full disclosure. In light of the fact that the first *sukūk* to be issued in the UK involved a private placement, it remains unclear why Ireland's fiscal reforms have prevented such issuances.

9.3.4 Proposals for Change

Classifying *sukūk* as transferable securities does not eliminate regulatory oversight but would transfer the power to impose functional regulation of individual products from the Central Bank to the market itself. Rather than the regulatory authorities determining whether a product and all of its service providers have reached a certain threshold of acceptability, the regulation of the securities market strives to ensure that investors are sufficiently informed so that they themselves can exclude products which are unsatisfactory.[320] The regulation of debt security issuances and CIS are thus two distinct regimes under Irish law. In the absence of a clarification of how *sukūk* will be treated by the Central Bank, *Sharī'ah*-compliant certificates issued in Ireland risk being subject to regulatory oversight which is inconsistent with the nature and level of risk faced by their investors.

In an exposure draft setting out guidelines for the governance and disclosure standards to be applied to Islamic investment funds, the IFSB noted that

> ...although, in principle, *sukūk* schemes fit into the [CIS] description, supervisory authorities may wish to prescribe certain economic tests before imposing on them the governance structure and processes under

[319] Revenue Commissioners, "Guidance Notes on the Tax Treatment of Islamic Financial Transactions", note 57, at 33.

[320] Benjamin, Joanna, *Financial Law*, note 260, at 233.

> the [CIS] Guiding Principles, considering that they serve certain economic functions that differ from CIS – that is, fundamentally, they are a *Sharī'ah*-compliant alternative to conventional fixed-income instruments.[321]

Equally, the IOSCO has concluded that "whilst Sukuk may closely resemble collective investment schemes in terms of legal structure, economically they are usually designed to replicate the function of conventional bonds."[322] These two statements suggest that the regulation of all *sukūk* as CIS is not an appropriate policy. The risks faced by investors in debt-like *sukūk* and the returns paid to investors involved in such *sukūk* issuances are, as a result of purchase undertakings, guarantees and reserve accounts, largely predictable and more readily comparable in substance to those found in bonds. [323] To regulate such *sukūk* as if they were equity instruments would thus overlook the nature of such arrangements and the *actual* risks faced by the parties. In light of the Irish Government policy adopted in Part 8A TCA, which seeks to remove the tax disparities between conventional products and their economically similar Islamic counterparts, imposing the more onerous and stringent CIS regime on debt-like *sukūk* places issuers of these products at a disadvantage when compared with issuers of conventional debt securities.[324] This would seem to undermine the goal of a level playing field for Islamic financial activity.

It must be emphasised, of course, that not all *sukūk* are economically similar to debt. Following AAOIFI's criticism of the industry, it could now be suggested that some future *sukuk* - in which returns and ultimate repayment are unpredictable - may represent true equity investments. Where these transactions are structured so as to involve pooling of investor subscriptions, the management and investment of those in underlying assets without credit or liquidity enhancements, and the assumption of investment as opposed to credit risk by the investors, such arrangements are not economically similar to debt. These *sukūk* should be regulated as CIS in Ireland. By exempting equity *sukūk* from the CIS regime, the Central Bank would be imposing a level of supervision on these instruments

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[321] Islamic Financial Services Board, *IFSB – 6: Guiding Principles on Governance for Islamic*, (IFSB, Kuala Lumpur, December 2009), at 2-3, available at: http://www.ifsb.org/standard/ifsb6.pdf.

[322] International Organization of Securities Commissions, *Analysis of the Application of the IOSCO's Objectives and Principles of Securities Regulation for Islamic Securities Products*, note 192, at 22.

[323] Casey, Peter, "Islamic Finance Series: Inaugural Symposium Sukuk: Theory, Practice and Issues", Paper presented at the DIFC Conference Centre, Dubai, May 3, 2010, available at: http://www.cpifinancial.net/v2/Magazine.aspx?v=1&aid=2357&cat=IBF&in=53.

[324] Financial Services Authority and HM Treasury, *Consultation on the legislative framework for the regulation of alternative finance investment bonds (Sukuk)*, note 204, at 10, [2.10].

which is unreflective of the underlying risks. This could undermine the integrity of the CIS regime and potentially expose investors to an unanticipated (and unsupervised) level of risk.

In line with the transparent policy approach advocated by the IOSCO[325] and implemented by the FSA, it is suggested that if Ireland is to develop a domestic *sukūk* market it should first, clarify the meaning of "public" in the context of Part 8A TCA. Second, it should exclude debt-like *sukūk* from the CIS regime and adopt a consistent regulatory definition of these products. As Ireland does not have a direct counterpart to the UK's FSMA and RAO, introducing a regulatory definition which covers *sukūk* arrangements may be slightly different from the process of accommodation adopted in the UK. Instead, Ireland has two options when clarifying the regulatory status of *sukuk*. First, include a definition of debt-like *sukūk* in the 2007 Regulations and the Central Bank Act 1997, which confirms that such instruments will be treated for regulatory purposes as if they are debt securities. Like the definition of specified investment transactions and certificates outlined in Part 8A TCA, this accommodating regulatory definition should confirm that such instruments must display economic characteristics of debt, such as returns which are economically comparable to interest payments on a loan. Once a definition is established this can then be incorporated into the 2007 Regulations as a form of "transferable security," and into the various CIS Acts in order to exempt such products from the regulatory regime applicable to investment funds. Such an approach would allow debt-like *sukūk* to be regulated as debt while still ensuring that equity *sukūk* are regulated as CIS. The second approach to regulation of *sukūk* in Ireland would be for the Central Bank to simply issue a policy statement. This statement would confirm that *sukūk* transactions, in which certificates are issued that are economically comparable to debt, will be regulated as a debt securities issuance and not as CIS, while those *sukūk* which are equity in nature will be regulated as investment funds (i.e. CIS). This latter approach is arguably the most appropriate in light of the fact that currently debt-based *sukūk* issuances are not *excluded* from being regulated as transferable securities, there is simply a lack of certainty that they will consistently be regulated as such. This situation is distinct from that faced by Islamic real estate financings in Ireland which are excluded from the mortgage regime as they simply do not fulfil the statutory definition of a secured property loan.[326] A

[325] International Organization of Securities Commissions, *Analysis of the Application of the IOSCO's Objectives and Principles of Securities Regulation for Islamic Securities Products*, note 192, at 20.

[326] *supra.* at 254 and 264.

clear policy by the Central Bank as to how such *sukūk* transactions will be treated, rather than any legislative overhaul, should thus be sufficient to provide clarity to market participants and ensure predictable regulation of *sukūk* transactions and their issuers.

9.3.5 Listing

Finally (and briefly), this Chapter will conclude by considering the listing of *sukūk* in Ireland. Many contemporary Islamic securities issues are listed on an exchange with Luxembourg, Dubai, London and Dublin all jurisdictions in which *sukūk* have been listed.[327] Even prior to the accommodation of Islamic finance under Irish tax law, a number of *sukūk* such as the NICBM Ltd *Sukūk*[328] and the Sun Finance Limited *Sukūk*,[329] were approved for listing on the Irish Stock Exchange under the category of debt security. Noting that classification of a *sukūk* for regulatory purposes will not conclusively determine how these certificates will be classified for the purposes of listing, the UK authorities have focused primarily on admitting *sukūk* to trading as debt securities. As Ainley *et. al.* note, classifying *sukūk* as debt securities for the purposes of listing is "better than, say, treating the Sukuk as an 'asset-backed' security since this would detract from the role of the originator as providing what could be said to amount to credit protection for the periodic dividend payments and repayment of principal."[330] That being said, it is suggested that in the case of asset-backed *sukūk* listed in Ireland, such certificates will be classified asset-backed securities[331] while *sukūk* whose economic substance is equity-like, could be listed as CIS.

Only when the *sukūk* has been classified for listing purposes can the level of disclosure required be determined. Those *sukūk* which are asset-based will be subject to disclosure requirements which focus on the issuer, the credit rating of the originator and any

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[327] Alvi, Ijlal A., "Review on Several Sukuk Products Issued Worldwide: Towards Globally Accepted *Sukūk*", *International Islamic Finance Market*, at 2, available at: http://www.iifm.net/media/PDF/presentation/Review-Sukuk-products.pdf. See for example, Salam Bounian Development Company Sukuk Limited, US$137,500,000Trust Certificates (Sukuk Al-Musharaka) due 2018 (listed on the Luxembourg Stock Exchange), Dana Gas Sukuk Limited U.S.$1,000,000,000 Trust Certificates due 2012 (listed on the London Stock Exchange), NICBM Sukuk Limited US$100,000,000 Trust Certificates due 2011 (listed on the Irish Stock Exchange).

[328] Irish Stock Exchange, *Individual Debt Securities Data*, available at: http://www.ise.ie/app/showSecSpecialist.asp?secID=14570.

[329] *ibid.*

[330] Ainley, Michael, Mashayekhi, Ali, Hicks, Robert, Rahman, Arshadur and Ravalia, Ali, *Islamic Finance in the UK: Regulation and Challenges*, note 188, at 26.

[331] Arthur Cox, *Sukuk/Islamic Securitisation, Listing Guide*, (Autumn 2009), at 2, available at: http://www.arthurcox.com/uploadedFiles/Publications/Publication_List/Briefing%20-%20Listing%20Services%20%28Islamic%20Finance%29_Autumn%202009.pdf.

guarantees or credit enhancements.[332] Debt-like asset-backed *sukūk* will detail the assets, liquidity enhancements and guarantees while *sukūk* classified as CIS[333] will need to provide information on the quality of the underlying assets.[334]

9.4 Conclusion to Chapter 9

With an increasing number of countries worldwide seeking to integrate *sukūk* into their domestic markets through the modification and clarification of the tax and regulatory position of these instruments, *sukūk* now occupy a central and conspicuous position in the Islamic capital markets. In line with increasingly accommodating attitudes towards Islamic financial transactions generally, Ireland's recent modifications to the TCA - which introduced legislative provisions aimed at aligning the treatment of some *sukūk* structures with that of conventional debt securities - were an auspicious development and may represent the beginning of a more comprehensive approach to facilitating *sukūk* in Ireland.

Notwithstanding the growth of the Islamic securities market however, *sukūk* transactions remain a difficult product to integrate into an interest-based financial system.[335] Not only can *sukūk* certificates be based on various nominate contracts but there may be considerable differences between their legal structure and their economic impact. While Usmani and AAOIFI criticised *sukūk* which mimic interest-bearing bonds, the terms of the clarification still allow Islamic securities to be structured in a manner which permits economic comparability with conventional bonds. Re-emerging post-2008 into more discernable categories of asset-based and asset-backed, the majority of *sukūk* remain debt-like in economic effect.

With this in mind, Ireland's recent accommodations of "investment certificates" have been structured to apply only to those *sukūk* which are functionally comparable to conventional bonds. While this is in line with international practice, the likely effectiveness of the Irish provisions remains unclear in light of continuing gaps in the tax treatment of

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[332] Sections 19, 20 and 21 Prospectus (Directive 2003/71/EC) Regulations 2005, S. I. No. 324 of 2005.

[333] CIS which are closed-ended are subject to the Prospectus Regulation with only those which are open-ended excluded. As it seems likely that most if not all sukuk classified as CIS will be closed-ended, the provisions of the Prospectus Regulation will be relevant.

[334] Arthur Cox, *Sukuk/Islamic Securitisation, Listing Guide*, (Autumn 2009), note 331, at 2. See also, International Organization of Securities Commissions, *Analysis of the Application of the IOSCO's Objectives and Principles of Securities Regulation for Islamic Securities Products*, note 192, at 14.

[335] HM Treasury and FSA, *Legislative framework for the regulation of alternative finance investment bonds (sukuk): summary of responses*, note 247 at [1.3].

these products. As a result, while Part 8A TCA attempts to align the tax classification of "investment certificates" with that of debt securities, it has not addressed some of the anomalous tax consequences resulting from the underlying asset and the multiple transfers of that asset needed for *Sharī'ah*-compliance.

Regulation of *sukūk* issuances has also raised concerns in other jurisdictions. The unique structure of *sukūk* transactions, their legal similarities with equity and the relationships between the parities, all pose challenges when considering the regulatory classification of these products. While the UK, amongst others, has taken steps to clarify the regulation of *sukūk*, Ireland has yet to address this hurdle. There remains, therefore, uncertainty surrounding the classification of *sukūk* under Irish regulatory laws. If Ireland is to encourage the development of an active *sukūk* market domestically, it is suggested that more accommodations, or at least clarification, will be needed.

In the final clause of AAOIFI's 2008 *sukūk* clarification, the organisation noted that

> Shariah supervisory boards must not consider their responsibility to be over when they issue a fatwa on the structure of Sukuk. Rather, they must review all contracts and documentation related to the actual transaction, and then oversee the ways that these are implemented in order to be certain that the operation complies at every stage with Shariah guidelines and requirements as specified in the Shariah Standards....[336]

This clause highlights, according to McMillen, AAOIFI's intention to "issue a bell-weather call for greater rigor, and greater and continuing oversight, in the industry."[337] Not simply in the context of *sukūk* issuance but in relation of Islamic financial activity as a whole, supervision for compliance with the dictates of Islamic law is a central focus of the contemporary Islamic finance industry. Reflective of this, the final substantive Chapter of this thesis will consider whether such oversight will be possible within Ireland's legal system.

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[336] Accounting and Auditing Organization for Islamic Financial Institutions, *AAOIFI's Shari'a Board Resolutions on Sukuk*, (AAOIFI, Bahrain, 2008), Sixth clause, available at: http://www.aaoifi.com/aaoifi_sb_sukuk_Feb2008_Eng.pdf.

[337] McMillen, Michael J.T., "Islamic Capital Markets: Market Developments and Conceptual Evolution in the First Thirteen Years", (April 24, 2011), at 29, available at: http://ssrn.com/abstract=1781112

Chapter 10

Supervision of *Sharī'ah*-compliance

10.1 Introduction

Over the course of this thesis, it has been demonstrated that compliance with Islamic law, at least outwardly, is a fundamental defining feature of the Islamic finance industry.[1] As a result, stated compliance with the teachings and dictates of Islamic law and persistent reference made by market participants to the sources of this law, ultimately separate Islamic finance from its conventional alternative.[2]

The opaque nature of many of Islamic law's teachings and the absence of a single authoritative interpretation of those teachings may make it difficult for market participants and customers to determine for themselves if financial activity is *Sharī'ah*-compliant.[3] However, with the growing complexity of these transactions and their economic similarities with conventional interest-based products, market participants may not be willing to accept a financial institution's unsubstantiated assurances that an instrument offered faithfully adheres to the economic principles of Islamic law.[4]

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[1] Cunningham, Andrew, "Role of sharia board requires modernization", *Financial Times*, April 22, 2010, available at: www.ft.com/cms/s/0/a5a6e474-4d54-11df-baf3-00144feab49a.html.

[2] Shafique, Mohammad, "Food for thought: role of Shari'ah scholars", (April-June 2010) *NewHorizon*, 24-25 at 24.

[3] Al-Rifai, Tariq, "Development of the Shari'a-compliant fund market and the role Shari'a scholars played," in *Euromoney Encyclopedia of Islamic Finance*, Aly Khorshid, (ed.), (Euromoney Books, London, 2009), 70-78 at 73, Garas, Samy Nathan and Pierce, Chris, "Shari'a supervision of Islamic financial institutions", (2010) 18(4) *Journal of Financial Regulation and Compliance*, 386-407 at 388.

[4] DeLorenzo, Shaykh Yusuf Talal, "Shari'ah-compliance Risk," (2006-2007) 7(2) *Chicago Journal of International Law*, 397-408 at 399, noting that "[p]resent day perceptions of Muslim consumers and investors are such that in order for a financial product or service to be accepted as Shari'ah-compliant, it must first have the approval of a religious authority."

Two mechanisms for religious oversight of an entity's activity have been relied on by the Islamic finance industry. The first is Government-level supervision (10.2)[5] involving centralised, official oversight through the development of *Sharī'ah* standards by the legislature (10.2.1)[6] and use of the courts as an organ for vetting activity for compatibility with Islamic law (10.2.2).[7] It will be demonstrated that such an approach has had only limited success around the world and is not appropriate for Ireland. The second is private *Sharī'ah* supervision (10.3)[8] implemented at contractual level by the parties to the transaction (10.3.1)[9] and at institutional level by *Sharī'ah* Supervisory Boards [SSBs] (10.3.2).[10] It will be argued in this Chapter that private supervision has been a largely effective means of facilitating *Sharī'ah*-compliance supervision within the industry and will almost certainly be the approach adopted in Ireland should an Islamic finance industry develop. Through the use of private mechanisms, parties to an Islamic finance contract can ensure external *Sharī'ah* oversight of their activities, without the need for the Irish Government to adopt a view on what is and what is not *Sharī'ah*-compliant. The following chapter looks to a point in the future in which Islamic financial activity is being offered in Ireland. It will consider both approaches to supervision, discussing the position of each within Ireland's legal order.

10.2 Determination of *Sharī'ah*-Compliance at Government Level

Where a State accommodates Islamic finance within its domestic laws, the organs of that State will need to determine the characteristics which a product must display before it will be accommodated. As one of the defining characteristics of Islamic financial products is adherence to the teachings of Islamic law, it could be suggested that only products which comply with Islam should be treated as such by national law. Without some official requirement of *Sharī'ah*-compliance, restrictions on market participants' ability to brand *any* product or service as Islamic arise primarily in the conscience of those involved, the threat of eternal damnation and rejection of such activity by a market that values adherence to Islamic law. In practice, such restrictions may generally be effective. As a result, disputes of religious compliance and the need to determine whether something genuinely adheres to the teachings of Islam may arise only on limited occasions. Nevertheless,

[5] *infra.* at 380.
[6] *infra.* at 381.
[7] *infra.* at 386.
[8] *infra.* at 411.
[9] *infra.* at 412.
[10] *infra.* at 425.

conscience and market-based supervision leaves the central feature of Islamic financial activity entirely outside the scope of Government oversight. This section will discuss whether the Irish Government should attempt to supervise Islamic finance activity for compliance with Islamic law. It will conclude that such supervision would be inappropriate and potentially damaging to Ireland's potential as a jurisdiction for Islamic finance activity. Such supervision will be considered from two contexts: the establishment of *Sharī'ah* standards by the legislature and regulator (10.2.1),[11] and enforcement of *Sharī'ah* standards by the judiciary (10.2.2).[12]

10.2.1 Legislative and Executive Development of *Sharī'ah* Standards

The *Qur'ān* and *Sunnah* advocate honesty,[13] justice,[14] fair dealing[15] and the equitable distribution of wealth.[16] Institutions operating in accordance with the principles of Islamic law can be guided by the integrated corporate governance principles of Islam when determining the *Sharī'ah*-compliance of their activities.[17] Nevertheless, some commentators have advocated the establishment of an authoritative body which can issue internationally recognised *Sharī'ah* pronouncements and evaluate the Islamic finance activities of institutions across the globe.[18] Indeed, in 2009 AAOIFI suggested that it may begin to "screen products and services offered by the industry for *Shariah* compliance."[19] Calls for industry-wide standardisation are becoming increasingly unsustainable as the

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[11] *infra.* at 381.

[12] *infra.* at 386.

[13] See for example, *Qur'ān*, 8:27, "O ye that believe! Betray not the trust of Allah and the Messenger, nor misappropriate knowingly things entrusted to you."

[14] *Qur'an* 4:30, "If any do that in rancour and injustice, soon shall We cast them into the Fire: And easy it is for God."

[15] Iqbal, Zafar and Lewis, Mervyn K., *An Islamic Perspective on Governance*, (Edward Elgar, Cheltenham, 2009), at 275, Lewis, Mervyn K., "Islamic Corporate Governance", (2005) 9(1) *Review of Islamic Economics*, 5-29 at 20.

[16] See generally, Rice, Gillian, "Islamic Ethics and the Implications for Business", (1999) 18(4) *Journal of Business Ethics*, 345-358.

[17] Ibn al Qayim al-Jawziyyah, *L'lam al-Muwaqqi'in*, (Cairo, 1955) noted that "The basis of the Shari'a is the wisdom and welfare of the people in this world, as well as the hereafter. This welfare lies in complete justice, mercy, well-being and wisdom. Anything that departs from justice to oppression, from mercy to harshness, from welfare to misery and from wisdom to folly, has nothing to do with the Shari'a," quoted in Chapra, Muhammad Umar, "Objectives of the Islamic Economic Order", in *Islam Its Meaning and Message*, Ahmad, Khurshid (ed.), (The Islamic Foundation, Leicester, 1976), 173-195 at 176.

[18] See for example, Ahmed, Elwaleed M., "A Unified Voice: The Role of Shariah Advisory Boards in Islamic Finance", (October, 2007) Business Islamica Magazine, "AAOIFI To Monitor Shariah Products", *Reuters*, October 10, 2009, available at: http://www.business24-7.ae/Articles/2009/8/Pages/09082009/08102009_af046dl da5cd49bb9dOcab506b826ef4.aspx, quoting Mohamed Nedal Alchaar, Secretary-General of the AAOIFI who noted that AAOIFI intends to review "products and services offered by the industry for [*Sharī'ah*] compliance" to help fill the "huge gap in the market relating to credible compliance screening."

[19] AAOIFI, quoted in "Aaoifi to monitor Shariah products", *Emirates 24/7*, August 10 2009, available at: http://www.emirates247.com/2.266/Islamic-finance/aaoifi-to-monitor-shariah-products-2009-08-10-1.29622.

industry grows in size and geographic diversity.[20] The very nature of Islam arguably prevents such global uniformity as to do so would not only undermine geographic variations in interpretation but would restrict the *ijtihād* of individual scholars. Rather than focusing on universal Islamic finance standards, there is now growing interest in the establishment of state-level *Sharī'ah* supervision. This supervision could establish a nation-wide framework of acceptable Islamic contracts and standardised behaviour of individual institutions in relation to Islamic financial activity.[21]

A. Government Endorsed *Sharī'ah* Standards – A Look at the Approach Adopted in Other Jurisdictions

Indicative perhaps of the difficulties involved in developing international *Sharī'ah* standards, national approaches to official *Sharī'ah* governance remain inconsistent between jurisdictions.[22] As discussed in Chapter 4, Malaysia and Pakistan have adopted an interventionist method of supervision.[23] Consequently, the financial authorities in both countries have each established a centralised SSB approach which operates in addition to the institutional *Sharī'ah* boards.[24] These national boards advise their respective Governments and central banks on religious issues relating to Islamic finance, they review and determine the *Sharī'ah*-compliance of products or instruments developed for the Islamic banking industry and they resolve disputes or uncertainties within institutional *Sharī'ah* boards on interpretations of Islam.[25] Simultaneously with this oversight of the market, these boards work with legislative authorities to develop national *Sharī'ah*

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[20] DeLorenzo, Yusuf Talal, "Shari`ah Supervision of Islamic Mutual Funds", Paper presented at the Fourth Harvard University Forum on Islamic Finance; *Islamic Finance: The Task Ahead*, Harvard University, Cambridge, Massachusetts, April 6, 2000, noting that "it is simply impossible for a centralized board to effectively perform all of the tasks required for the Shari'ah supervision of each and every Islamic financial institution. In the early 1980s, when there was only a handful of such institutions, such a notion may have seemed reasonable. But today, when Islamic mutual funds alone number nearly one hundred, the notion is highly impractical." Y-Sing, Liau and Richte, Frederik, "Analysis: Islamic finance seems overwhelmed by scholar reform", *Reuters*, September 28, 2010, available at: http://www.reuters.com/article/2010/09/29/us-Islamic-financial-idUSTRE68S0AL20100929.

[21] Askari, Hossein, Iqbal, Zamir and Mirakhor, Abbas, *New Issues in Islamic Finance and Economics: Progress and Challenges*, (John Wiley & Sons (Asia) Pte. Ltd.,Singapore, 2009), at 68.

[22] Hasan, Zulkifli, "Regulatory Framework of Shari'ah Governance System in Malaysia, GCC Countries and the UK", (2010) 3-2 *Kyoto Bulletin of Islamic Area Studies*, 82–115 at 83-84.

[23] *supra.* at 107, 121, and 128.

[24] *infra.* at 431 for discussion of institutional *Sharī'ah* supervisory boards. Pakistan has established "the Shari'ah Board" that advises the State Bank of Pakistan (Habib, Ahmed, *Product Development in Islamic Banks*, (Edinburgh University Press, Edinburgh, 2011), at 66), while Malaysia's Central Bank has established a national Shariah Advisory Council (SAC) (section 51 et seq. Central Bank of Malaysia Act 2009) and its Securities Commission has also developed its own Shari'ah Advisory Council (SAC) for non-banking Islamic financial activity.

[25] *supra.* at 107 and 128.

standards.[26] These standards - which may be legislative instruments, guidelines, or best practice standards - frequently apply to all domestic institutions offering Islamic banking facilities. They may also extend to regulate the activities of non-banking Islamic finance entities.

In contrast, UK regulatory authorities have explicitly stated that they will make no determination on the *Sharī'ah*-compliance of any activity or product.[27] As noted in Chapter 4, the FSA does not rely on a *Sharī'ah* board when regulating financial activity. It has published no guidelines on the standard of religious compliance which it expects from Islamic products offered in the UK, nor does it require Islamic financial institutions operating in the UK to prove that their activities are *Sharī'ah*-compliant.[28] Within the UK therefore, *Sharī'ah* supervision has been left to parties involved in Islamic financial transactions and the institutions offering them.[29]

B. *Sharī'ah* Standards within the Irish Legislature and Executive

Notwithstanding potential benefits of standardisation and harmonisation which may occur from a centralisation of *Sharī'ah* oversight and mandatory *Sharī'ah* standards, it is suggested that the Irish Government has not, and indeed, should not, adopt an interventionist role in determining the *Sharī'ah*-compatibility of Islamic finance activity. Though Irish financial and legislative authorities have not been quite as explicit as their British counterparts in emphasising their secular nature, Ireland's approach to questions of religious oversight of Islamic financial activity is consistent with that found in the UK. As has already been discussed, the Irish accommodations introduced by the Finance Act 2010 are relatively broad, and ideologically neutral, such that any structures which fall within their terms will be subject to the same tax framework,[30] regardless of whether those transactions comply fully, partially or not at all with the dictates of Islam.[31] As the application of the tax provisions is not contingent on religious compatibility of the

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[26] *supra.* at 107 and 128.

[27] *supra.* at 139.

[28] Hasan, Zulkifli, "Regulatory Framework of Shari'ah Governance System in Malaysia, GCC Countries and the UK", note 22, at 103.

[29] *supra.* at 140.

[30] *supra.* at 145.

[31] Revenue Commissioners, "Guidance Notes on the Tax Treatment of Islamic Financial Transactions", (Revenue, Dublin, October 2010), at 6, available at: www.revenue.ie/en/practitioner/tech.../guidance-notes-islamic-finance.pdf, noting that; "[a]lthough designed to cover certain Shari'a compliant structures, the legislation applies to any financing arrangement falling within the meaning of the term "specified financial transaction" regardless of whether the arrangement is, in fact, Shari'a compliant."

underlying contracts, the manner in which these contracts are used, and the extent to which the overall financial structure adheres to Islamic law, are beyond the purview of the legislation and the concern of the authorities. As the Government has noted, "we are not legislating for the express enactment of Sharia law in Ireland,"[32] it has simply expanded the types of contracts explicitly provided for under Irish tax law. Equally, while no Islamic banks or *takāful* companies have been authorised in Ireland, a precedent of approving and regulating Islamic funds without consideration of religious authenticity has already been established. The Central Bank has confirmed that when authorising these funds, it will "not impose any additional restrictions/conditions in relation to a Shariah fund"[33] over and above those imposed on conventional funds; an Islamic fund which complies with the existing requirements established by the Central Bank will be authorised notwithstanding any doubts as regards its religious legitimacy. Islamic finance is not, therefore, screened by Irish authorities for compliance with a set of religious dictates nor has the Irish Government taken any explicit position on the correctness of any particular interpretation of Islam.

The approach of Irish legislative and executive authorities to the oversight of Islamic finance is justifiable on public policy grounds. As the authoritative bodies on interpretation of Islamic finance issues, the national *Sharī'ah* boards in Pakistan and in Malaysia establish their respective Governments' positions on questions of religious doctrine; they are assuming a view of what is and what is not *Sharī'ah*-compliant. Both Pakistan and Malaysia are explicitly Islamic countries with strong domestic Islamic finance industries and Sunni majority populations. The association of these Governments and legal authorities with a particular interpretation of *Sharī'ah* is not therefore generative of significant legal or political difficulties. In Ireland, neither the Central Bank nor the Oireachtas has a religious mandate nor have they any authority in or in relation to Islam. It is unclear what practical justification these bodies have for adopting any particular position on the interpretation of the roots of Islamic law and the determination of Islamic legal principles. Even if the Central Bank or Oireachtas were to appoint a national *Sharī'ah* board to act as adviser on matters of Islamic finance, there appears to be little legitimate basis for that *Sharī'ah* board, and by extension the Government, choosing between the different views of Islam. By laying down *Sharī'ah* standards and vetting Islamic finance

[32] Lenihan, Brian, *Dáil Eireann Debate*, Vol. 704 No. 4; "Finance Act 2010: Report Stage (Resumed) and Final Stage", March 10 2010.

[33] Correspondence with Geraldine Murphy, Financial Institutions and Funds Authorisation, Appendix 2, *infra.* at 458.

for compatibility with those standards, Irish authorities would implicitly be suggesting that interpretations of Islam other than those of the national *Sharī'ah* board are unsustainable under Irish law. Consistent with this argument against official endorsement of *Sharī'ah* standards, Abdullahi An-Na'im has suggested that;

> [w]hen observed voluntarily, Shari'a plays a fundamental role in shaping and developing ethical norms and values that can be reflected in general legislation and public policy through the democratic political process. But…Shari'a principles cannot be enacted and enforced by the state as public law and public policy solely on the grounds that they are believed to be part of Shari'a. If such enactment is attempted, the outcome will necessarily be the political will of the state and not the religious law of Islam.[34]

For international parties, the determination of *Sharī'ah* standards by the Oireachtas or Central Bank may reduce the viability of Ireland as a jurisdiction for Islamic finance transactions as the official determination of Islamic law may not reflect the views of the parties or those of their customers. At a domestic level, a Government-endorsed interpretation of Islamic doctrine could disenfranchise those Muslims who do not subscribe to officially mandated interpretations. As Ireland is not a Muslim country and its Muslim population does not originate from a single jurisdiction or school of thought,[35] the fact that one view of Islamic doctrine is prioritised over the others would be unsatisfactory. Finally, centralised religious evaluation of financial activity would be inconsistent with the Central Bank's approach to authorisation and supervision of the financial sector, under which the regulator generally eschews consideration of the substantive merits of financial activity,

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[34] An-Na'im, Abdullahi, *Islam and the Secular State: Negotiating the Future of Shari'a,* (Harvard University Press, Cambridge, 2008), at 1.

[35] *supra.* at 168. See for example, the nationality and place of birth results of the Survey contained in Appendix 8, *infra.* at 472. According to the 2006 census, 33.5% of Irish Muslims originated from Asia, 21.7% from Africa and 30.7% were of Irish origin, "Census 2006, A *Census* of Population was taken on the night of Sunday, 23 April *2006*", *Principal Demographic Results*, Irish Central Statistics Office, Table 36, Persons, males and females usually resident and present in the State on Census Night, classified by religion and nationality, available at: http://www.cso.ie/census/documents/Amended%20Final%20Principal%20Demographic%20Results%202006.pdf. This quite even spread across different geographic locations can be contrasted with the Muslim populations in other European countries which are often largely composed of people of a single origin such as the preponderance of North African Muslims in France, Haut Conseil à l'intégration, *l'Islam dans la République* (Haut Conseil à l'intégration, Paris, November 2000), at 26, available at: http://lesrapports.ladocumentationfrancaise.fr/BRP/014000017/0000.pdf, however, even in countries such as France, the Muslim population is not homogenous.

religious or otherwise. Ethical funds are not, for example, vetted by the Central Bank for compliance with their socially responsible investment strategy.[36] Consequently, by accommodating Islamic finance in Irish law, the Government has sought to provide a more even playing field for market participants who wish to comply with their faith; it has not attempted to make any moral determination for them.

Sharī'ah-compliance is thus of direct concern only to the parties in an Islamic financial transaction. However, where there is a dispute between these parties concerning that compliance, the question arises as to whether the dispute should be resolved by the organs of the State or privately between the parties.

10.2.2 *Sharī'ah*-Compliance Before the Irish Judiciary

The Islamic finance sector does not operate in a vacuum. Financial contracts which are structured to be *Sharī'ah*-compliant must be capable of producing legal consequences for participants which will be respected by third parties and upheld by the courts of the country in which the contract is being enforced.[37] It could be argued that even in the absence of *Sharī'ah* standards set by the legislature and executive, those involved in the Islamic finance sector may still want the validity of their contracts and the resolution of disputes to be determined by, and in accordance with, *Sharī'ah*. Consistent with this view, some market participants have reduced religious adherence to writing as a mechanism for overtly emphasising the religious nature of Islamic financial activity and as an attempt to ensure that Islamic financial disputes are resolved by national courts under the principles of *Sharī'ah*.[38] For example, an Islamic financial contract may incorporate *Sharī'ah* into its governing law clause by providing that the contract will be governed solely or partly by Islamic law.[39] Similarly, an Islamic finance contract, whose governing law clause does not mention *Sharī'ah*, could refer to the nominate contracts on which the parties rely or the

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[36] More generally, Chapra has noted the position of capitalist economics which "does not allow the passing of any judgment on individual preferences and relies primarily on choice through the market to determine the individual preferences that may or may not be satisfied," Chapra, Muhammad Umer, "What is Islamic Economics?", *IDB Prize Winners' Lecture Series No. 9*, (2nd ed., Islamic Development Bank, Jeddah, 2001), at 20.

[37] Bälz, Kilian, "Islamic Law as Governing Law under the Rome Convention, Universalist *Lex Mercatoria* v Regional Unification of Law", (2001) 6 *Uniform Law Review*, 37-49 at 40 noting that Islamic banking transactions must "satisfy the requirements of the Nation State's modern law."

[38] Nadar, Aisha, "Islamic Finance and Dispute Resolution: Part I", (2009) 23 *Arab Law Quarterly*, 1-29 at 4, Zulkifli Hasan, "Regulatory Framework of Shari'ah Governance System in Malaysia, GCC Countries and the UK", note 22, at 107.

[39] *Shamil Bank of Bahrain EC v Beximco Pharmaceuticals Ltd* (No.1) [2004] EWCA Civ 19; [2004] 1 W.L.R. 1784 (CA (Civ Div)) *infra.* at 391.

intentions of the parties to transact in compliance with the principles of Islam.[40] The inclusion of these provisions acts as a means of drawing Islamic law directly into financial activity and is an ostensibly attractive approach to reinforcing religious conformity in Islamic finance. It would also appears to grant the courts, rather than the regulator or legislature, the power to determine what is and what is not *Sharī'ah*-compliant.

The enforceability and impact of an Islamic finance contract in Ireland will be relevant primarily[41] in circumstances where the Irish courts have accepted jurisdiction over a dispute arising out of such a contract. Based on common law jurisdiction rules applicable to contracts or the principles of the Brussels Regime[42] where the defendant is domiciled within the EU, the Irish courts would be the forum court for an Islamic finance dispute if the defendant in the dispute was domiciled in Ireland,[43] the underlying contract contained a valid jurisdiction clause in favour of the Irish courts[44] or if the contract was substantially performed in Ireland.[45] Similar considerations would apply to contracts which have no religious affiliation whatsoever.[46] However, while Irish courts may have jurisdiction over a contractual dispute, it does not automatically follow that they must apply Irish law in full or at all when resolving that dispute. International elements can influence the manner in which the court resolves a dispute, for example, where the contract is governed by a foreign law, foreign legal principles are incorporated into the contract or private

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[40] *Islamic Investment Company of the Gulf (Bahamas) Ltd. v. Symphony Gems N.V. & Ors*, The London High Court, 13th February 2002, 2001, 2001 Folio 1226, *infra.* at 416.

[41] If an Islamic finance contract is subject to Irish law but jurisdiction is granted to the courts of another jurisdiction, then those courts may have to consider how Irish courts would interpret the contract. Subject to the mandatory rules of the forum country, the same considerations would apply whether the Irish courts themselves were resolving the dispute or a foreign forum was attempting to determine what conclusion the Irish courts would reach.

[42] Composed of the Brussels Convention, the Lugano Convention, and the Brussels I Regulation ("Council Regulation (EC) No 44/2001 of 22 December 2000 on jurisdiction and the recognition and enforcement of judgments in civil and commercial matters").

[43] Article 2(1) Brussels Regulation, Council Regulation (EC) No 44/2001 of 22 December 2000 on jurisdiction and the recognition and enforcement of judgments in civil and commercial matters, Official Journal L 012 , 16/01/2001 P. 0001 – 0023, which provides that; "[s]ubject to the provisions of this Regulation, persons domiciled in a Contracting State shall, whatever their nationality, be sued in the courts of that State…" *Owusu v N.B. Jackson, trading as 'Villa Holidays Bal-Inn Villas' and Others*, Case C-281/02, (ECJ 1 March 2005), at [31].

[44] Article 23 Brussels Regulation, Council Regulation (EC) No 44/2001 of 22 December 2000 on jurisdiction and the recognition and enforcement of judgments in civil and commercial matters, Official Journal L 012 , 16/01/2001 P. 0001 – 0023, Merrett, Louise, "Article 23 of the Brussels I Regulation: A Comprehensive Code for Jurisdiction Agreements?", (2009) 58 *International and Comparative Law Quarterly*, 545–564 at 545-546.

[45] Article 5(1) Brussels Regulation, Council Regulation (EC) No 44/2001 of 22 December 2000 on jurisdiction and the recognition and enforcement of judgments in civil and commercial matters, Official Journal L 012 , 16/01/2001 P. 0001 – 0023, *Peter Rehder v Air Baltic Corporation, Case C-204/08,* ECJ 9 July 2009 at [37-38].

[46] As a result, the issue of jurisdiction will not be addressed and the remainder of this chapter will apply on the assumption that the Irish courts have been seised

international law rules dictate that a particular aspect of a contract will be determined in accordance with a foreign law.[47] In relation to Islamic finance, whether the judiciary is in a position to resolve a dispute in accordance with the principles of Islamic law has caused substantial controversy in a number of jurisdictions. Unlike their British and Malaysian counterparts, Irish courts have not yet had to consider the validity or terms of an Islamic finance contract.[48] Nevertheless, in a Dáil Debate on the provisions of Ireland's Finance Act 2010, concern was raised over whether the accommodation of Islamic finance in Ireland's tax laws would result in the introduction of Islamic law into Ireland's legal system.[49] Rejecting this concern, then Minster of Finance Brian Lenihan noted that "[a]n Irish court seized of [an Islamic finance dispute] will apply the law as enacted by the Oireachtas, not Sharia law."[50] It is suggested that two issues are likely to restrict the willingness of the Irish courts to adjudicate on matters of Islamic law and by extension, to determine the *Sharī'ah*-compliance of Islamic finance activity. The first issue is the enforceability of such Islamic principles as a governing "law" (A).[51] This subsection will look at two types of Islamic finance contract: one governed by a non-Islamic national law (1)[52] and one governed on its face (in whole or part) by *Sharī'ah* (2).[53] The second issue relates to the unsettled nature of Islamic law and the general unwillingness of the courts to adjudicate on controversial matters of religious doctrine (B).[54]

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[47] As Sir H. Lauterpacht noted in the *Application of 1902 Convention on Guardianship (Netherlands v. Sweden)* [1958] I.C.J Rep. 55 at 94, "[t]he purpose of private international law is to make possible the application within the State of the law of foreign states. This is an object dictated by considerations of justice, convenience, the necessities of international intercourse between individuals and indeed, as has occasionally been said, by an enlightened conception of public policy." Forte, David F., "Islamic Law In American Courts", (1983) 7 *Suffolk Transnational Law Journal*, 1-34 at 2 discussing foreign (notably Islamic law) before US courts.

[48] Indeed, conflict of laws generally and issues relating to international influences in commercial activity have received limited attention in Ireland. The dearth of authority on how the Irish courts will deal with a conflict of laws or other international contractual issue is evident by the fact that the leading textbook in Ireland on conflict of laws was written in 1988 and while a useful source of guidance on the Irish common law position on these questions, it is missing over twenty years of developments, see, Binchy, William, *Irish Conflicts of Law*, (Butterworths (Ireland), Dublin, 1988), Gill, A. V., "Limitations on the choice of the Governing Law in International Contracts", (1987) 5 *Irish Law Times*, 114.

[49] Bruton, Joan, *Dáil Eireann Debate*, Vol. 704 No. 4; "Finance Act 2010: Report Stage (Resumed) and Final Stage", March 10 2010.

[50] Lenihah, Brian, *Dáil Eireann Debate*, Vol. 704 No. 4; "Finance Act 2010: Report Stage (Resumed) and Final Stage", March 10 2010.

[51] *infra.* at 389.

[52] *infra.* at 391.

[53] *infra.* at 396.

[54] *infra.* at 406.

A. Enforceability of Islamic Financial Principles as a Governing "Law"

Irish courts have, like their English counterparts,[55] acknowledged the autonomy of parties to choose the governing law of a contract.[56] In line with the notion of freedom of contract,[57] parties may determine the law to which they wish to submit their contractual activity.[58] While this governing law may be Irish law, it does not have to be and subject to mandatory rules of Irish law and issues of public policy, a contract can validly be governed by law which is entirely distinct from the law of Ireland.[59] This governing law, whether Irish or foreign, will determine the validity and enforceability of the contract, the substantive rules with which the contract must comply, the impact of contractual provisions on the parties and the effect of non-compliance with those provisions.[60] As Irish courts take no judicial notice of foreign law, a non-Irish governing law will be a question of fact and must be proved by expert evidence.[61] Where the contract is governed by a foreign law, the Irish courts will, with the help of experts, identify the relevant provisions of that law and their implications. It may then enforce the contract and resolve disputes between the parties in a manner which is as close as possible to that applied by the courts of the chosen legal system.

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[55] *Vita Food Products v Unus Shipping Co Ltd* [1939] AC 277, *Miller & Partners Ltd v Whitworth Street Estates Ltd* [1970]A.C. 583, 603, per Lord Reid; "Parties are entitled to agree what is to be the proper law of their contract … There have been from time to time suggestions that the parties ought not to be so entitled, but in my view there is no doubt that they are so entitled to make such an agreement, and I see no reason why, subject it may be to some limitations, they should not be so entitled." see also; Harris, Jonathan, "Contractual Freedom in the Conflict of Laws", (2000) 20(2) *Oxford Journal of Legal Studies*, 247-269 at 247-8.

[56] *Kutchera v Buckingham International Holdings Ltd* [1988] 1 IR 61, In this case an English domiciled plaintiff and Canadian defendant entered into a contract which provided that; "[t]his Agreement and all aspects herein shall be construed and governed by the Laws of the Republic of Ireland (Eire)." The Supreme Court confirmed that even if Irish law was "unconnected with the realities of the contract" the proper law of the contract was clearly Irish law; this is the law which had been expressly chosen by the parties and this is the law which the Irish courts would apply. Walsh J (Finlay CJ and Hederman J concurring) emphasised the freedom of the parties to choose the governing law of their contract and reinforced a fundamental doctrine of private international law that no connection with the chosen law was necessary in order for the court to uphold this choice. *Kutchera v Buckingham International Holdings Ltd* [1988] 1 IR 61.

[57] Mann, F. A., "The Proper Law of the Contract", (1950) 3(1) *The International Law Quarterly*, 60-73 at 61.

[58] Mayer, Pierre, *Droit International Privé*, (4th ed., Paris, 1991), at 697-701 quoted in Nygh, Peter Edward, *Autonomy in International Contracts*, (Oxford University Press, Oxford, 1999), at 61.

[59] Nygh captured the general approach to choice of law when he noted that; "[t]he prevailing concept sees the role of the parties to an international contract as 'filling in the blank' in the choice of law rule of the forum which indicates the law by which the contract is to be governed, Nygh, Peter Edward, *Autonomy in International Contracts*, note 58, at 60.

[60] Sweet, Alec Stone, "The new *Lex Mercatoria* and transnational governance", (2006) 13(5) *Journal of European Public Policy*, 627–646 at 631.

[61] *The Attorney General v Scot Dyer*, unreported, High Court, 26th day of March 2003, *John Francis Kutchera v Buckingham International Holdings Ltd* [1988] 1 IR 61.

Notwithstanding a growing prioritisation of party autonomy in relation to choice of law,[62] this freedom is subject to the caveat that the parties' choice must be valid; it must be a choice of "law." This restriction on the ability of the parties to choose to subject a contract to whatever collection of rules they wish arises from the fact that contracts are intended to create rights and obligations which are legally binding on the parties. A court must be able to determine what those rights and obligations are and be able to enforce them.[63] As contracts are not autonomous, self-reliant arrangements and instead establish their legitimacy from an underlying legal system, courts determining the implications of a contract will rely on an external set of laws which contains the machinery needed for enforcement of the contract. Without this, the arrangement between the parties would create nothing more than moral duties.[64] Commenting on the need for a governing law in a contract, Lord McNair noted that

> It is often said that the parties to a contract make their own law....Nevertheless, agreements that are intended to have a legal operation (as opposed to a merely social operation) create legal rights and duties, and legal rights and duties cannot exist in a vacuum but must have a place within a legal system which is available for dealing with such questions as the validity, application and interpretation of contracts, and, generally, for supplementing their express provisions.[65]

Similarly, Lord Diplock in *Amin Rasheed Shipping Corp v Kuwait Insurance Co*[66] suggested that

> ...contracts are incapable of existing in a legal vacuum. They are mere pieces of paper devoid of all legal effect unless they were made by

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[62] Brand, Ronald A., "Balancing Sovereignty and Party Autonomy in Private International Law: Regression at the European Court of Justice", *University of Pittsburgh School of Law University of Pittsburgh School of Law Working Paper Series*, Paper 25, (2005), at 8 noting that; "Respect for party autonomy in private relationships has become a cornerstone of modern private international law."

[63] The creation of a contract which is *enforceable* in accordance with the chosen law is one of the key reasons for making a choice of law, otherwise there appears to be little reason why parties to a contract would pick the law of a country other than that which has jurisdiction over the dispute. *Application of 1902 Convention on Guardianship (Netherlands v. Sweden)* [1958] I.C.J Rep. 55 at 94 per Sir H. Lauterpacht, Weintraub, Russell J, "Choice of Law in Contract", (1968-1969) 54 *Iowa Law Review*, 399-434 at 406 discussing choice of law in the context of US states.

[64] Nygh, Peter Edward, *Autonomy in International Contracts*, note 58, at 172.

[65] McNair, Arnold, "The General Principles of Law Recognised by Civilised Nations", (1957) 33 *British Yearbook of International Law*, 1-19 at 7.

[66] *Amin Rasheed Shipping Corp v Kuwait Insurance Co* [1984] AC 50.

> reference to some system of private law which defines the obligations assumed by the parties to the contract by their use of particular forms of words and prescribes the remedies enforceable in a Court of Justice for failure to perform any of those obligations.....[67]

The Irish courts have not confirmed what they consider to be the requisite characteristics of a valid governing law of a contract. European choice of law rules, as well as English caselaw, indicate that in order for a choice of law to be valid, the law must be the functioning law of a state.[68]

The ineffectiveness of a choice of governing law that elects a non-national, delocalised set of rules has proved to be a considerable restriction on the ability of the judiciary in the UK to interpret Islamic finance contracts in accordance with the principles of Islam.

1. Islamic Finance Contracts Governed by a Non-Islamic National Law[69]

Although Islamic finance contracts may be intentionally structured to comply with the teachings of Islam and marketed as such by the parties, the majority of these contracts provide that they are governed by a national law, in particular, by English law.[70] English law provides parties with a stable legal framework in which freedom of contract is respected, where identifiable remedies and contractual enforcement mechanisms are available.[71] However, in light of the UK Government's non-intervention in issues of *Sharī'ah* legitimacy,[72] English law does not contain *Sharī'ah* standards or provisions dealing with *Sharī'ah*-compliance and it certainly does not provide for the superiority of

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[67] *ibid.*, at 65.

[68] *infra.* at 399.

[69] See *infra.* at 412 for a discussion of Islamic finance contracts in which the parties contractually subject the contract to the law of an Islamic country such as Saudi Arabia.

[70] Bälz, Kilian, "Sharia Risk? How Islamic Finance Has Transformed Islamic Contract Law", *Islamic Legal Studies Program Harvard Law School, Occasional Publications 9*, (HLS, Massachusetts, 2008), at 13, Agha, Oliver, "Islamic Finance Dispute Resolution", (2009) *Islamic Finance News Leading Lawyers*, 29-31at 29, Gray, Robert B., "Islamic Finance: Is the time ripe for a private sector trade association?", (2010) *The European Financial Review*, available at: http://www.europeanfinancialreview.com/?p=1312, see for example, the ADIB Sukuk Company Ltd. $5,000,000,000 Trust Certificate Issuance Programme, the NIG Sukuk Ltd. $1,500,000,000 Trust Certificate Issuance Programme and the Islamic Development Bank Trust Services Limited, $1,500,000,000 Trust Certificate Issuance Programme, all of which are explicitly governed by the laws of England.

[71] Fentiman, Richard, *Foreign law in English courts: pleading, proof, and choice of law*, (Oxford University Press, Oxford, 1998), at 170-171, Selwood, Dominic, "Islamic Contracts in a Modern Legal Context", in *The Chancellor Guide to the Legal Shari'a Aspects of Islamic Finance*, Humayon Dar and Umar Moghul, (eds.), (Chancellor Publications, London, 2009), 25-56 at 35.

[72] *supra.* at 382.

Islamic law in the event of conflict.[73] A contract subject to the law of England will be interpreted and enforced according to English law notwithstanding any contractual profession of *Sharī'ah*-compliance made by the parties, or any indication that elements of the transaction are based on the principles of Islamic law.[74]

In *Islamic Investment Company of the Gulf (Bahamas) Ltd v Symphony Gems N.V. and Others*,[75] a *murābaha* agreement expressly stated that "...this agreement and each purchase agreement shall be governed by and shall be construed in accordance with English law."[76] This was quite clearly a choice of English law as the governing law of the contract. However, the contract was described on its face as a *murābaha* and went on to state that "...the purchaser wishes to deal with the Seller for the purpose of purchasing Supplies...under this Agreement in accordance with the Islamic Shariah."[77] The memorandum of association of the claimant also provided that it should conduct its business "...in a manner which is consistent with Islamic laws, rules, principles and traditions..."[78] Though the governing law was English, central elements of the contract - some of which arguably go to the legitimacy of the parties' activities - were dependent upon compliance with Islamic law. When the claimant sought to enforce payment obligations under the *murābaha* agreement for precious stones, a number of defences were raised. First, the defendants[79] claimed that the transaction was a contract of sale and so payment under the agreement was conditional upon delivery of the stones; if no delivery was made, no payment was due.[80] Second, the defendants asserted that the contract was, in fact, in violation of the teachings of Islam and did not represent a valid *murābaha*.[81]

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[73] Hasan, Zulkifli, "Regulatory Framework of Shari'ah Governance System in Malaysia, GCC Countries and the UK", note 22, at 107.

[74] If provisions of Islamic law are incorporated into the contract as contractual terms then these will be enforced by the court. As terms of an English law contract however, the incorporated principles will be enforced in accordance with English law (or whatever other national law is chosen). See *infra.* at 406 for a discussion of this issue.

[75] *Islamic Investment Company of the Gulf (Bahamas) Ltd. v Symphony Gems N.V. & Ors*, The London High Court, 13th February 2002, 2001, 2001 Folio 1226 per Justice Tomlinson, 2002 West Law 346969, QBD (Comm. Ct.).

[76] *ibid.*, Page 5 of the judgment when downloaded from Westlaw [the judgment contains no paragraph numbers], quoting from Clause 5 of the Morabaha financing agreement.

[77] *ibid.*, Page 5 of the judgment when downloaded from Westlaw, quoting from the recital of the Morabaha financing agreement.

[78] *ibid.*, Page 5 of the judgment when downloaded from Westlaw, quoting from the claimant's Memorandum of Association.

[79] The first defendant and two other defendants who were sued as guarantors of the first defendant's obligation.

[80] *Islamic Investment Company of the Gulf (Bahamas) Ltd. V. Symphony Gems N.V. & Ors*, The London High Court, 13th February 2002, 2001, 2001 Folio 1226 per Justice Tomlinson, 2002 West Law 346969, QBD (Comm. Ct.). Page 7 of the judgment when downloaded from Westlaw.

[81] *ibid.*, Page 6 of the judgment when downloaded from Westlaw.

Finally, the defendants claimed that the contract was *ultra vires* the claimant as an institution which operates in accordance with *Sharī'ah*.[82] The defendants also claimed that some of the contract was performed in Saudi Arabia and the contract was contrary to this law, although this argument was swiftly rejected by the court.[83]

Tomlinson J considered the terms of the contract which the parties had agreed upon and heard expert evidence relating to the requisite elements of a valid *murābaha* agreement. Profit paid under *murābaha* agreements is considered to be *Sharī'ah*-compliant due to the ownership risks borne by the financier.[84] The provisions of the *Symphony Gems* contract eliminated the risks faced by the claimant financier. In light of the fact that the contract expressly provided that payment obligations were unconditional on delivery or any other reason connected with the stones or their quality,[85] Tomlinson J concluded that the agreement was "no orthodox contract of sale" and was in reality a "financing agreement facilitating or apparently facilitating the purchase of the goods of the supplier."[86] A *murābaha* agreement is "intended in Islamic law to be a contract which complies strictly with the requirements of the Shariah"[87] and so, as the terms of this agreement were inconsistent with Islamic teaching, the court accepted the experts' view that "this contract does not have the essential characteristics of a Modaraba contract."[88] This questionable *Sharī'ah*-compliance did not, however, impact on the validity and enforceability of the contract and the court did not attempt to supervise the *Sharī'ah*-compliance of the parties. Indeed, the fact that the contract did not contain the requisite indicia of a *murābaha* agreement was wholly irrelevant to the judge who concluded that "it is absolutely critical

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[82] *ibid.*, Page 11 of the judgment when downloaded from Westlaw.

[83] *ibid.*, Page 10 of the judgment when downloaded from Westlaw.

[84] *supra.* at 73. Bälz, Kilian, "A *Murabaha* transaction in an English court – The London High Court of 13th February 2002 in *Islamic Investment Company of the Gulf (Bahamas) Ltd. v Symphony Gems N.V. & Ors*", (2004) 11(1) *Islamic Law and Society*, 117-134 at 127.

[85] Quoting from the *murabaha* agreement Tomlinson J notes that; "Clause 4.4 provides in terms that the instalments are payable whether or not the seller is in breach of any of its obligations under the relevant purchase agreement, which must include a failure to deliver. Payment is not conditional upon the happening of any event. Nowhere in the head contract or in the documents which contain the offer and acceptance is any date for delivery specified. Indeed, nowhere in the contractual documents are the mechanics of delivery dealt with, save only that it is provided in clause 5.2 that "The Purchase will obtain such title to the Supplies delivered as the Seller has received from the Supplier," *Islamic Investment Company of the Gulf (Bahamas) Ltd. v Symphony Gems N.V. & Ors*, The London High Court, 13th February 2002, 2001, 2001 Folio 1226, per Justice Tomlinson, 2002 West Law 346969, QBD (Comm. Ct.). Page 14 of the judgment when downloaded from Westlaw.

[86] *ibid.*, Page 14 of the judgment when downloaded from Westlaw.

[87] Expert evidence of Dr. Martin Lau, *ibid.*, Page 8 of the judgment when downloaded from Westlaw.

[88] Expert evidence of Dr. Yahya Al-Samaan, *Islamic Investment Company of the Gulf (Bahamas) Ltd. V. Symphony Gems N.V. & Ors*, The London High Court, 13th February 2002, 2001, 2001 Folio 1226 per Justice Tomlinson, 2002 West Law 346969, QBD (Comm. Ct.). Page 8 of the judgment when downloaded from Westlaw.

to note - that the contract with which I am concerned is governed not by Shariah law but by English law."[89] The contract, when construed by the court, "according to its terms as an English law contract" was a valid and enforceable financing arrangement under English law, the law chosen by the parties.[90]

The court also dismissed the defendants' claim that due to the doubtful *Sharī'ah*-compliance of the contract, the claimant was acting outside of its corporate capacity when it entered into it.[91] While the court heard expert evidence in relation to the *ultra vires* doctrine in the Bahamas, as the jurisdiction of the claimant's incorporation, it ultimately concluded that the law of the Bahamas on issues of *ultra vires* was the same as that in the UK. A lack of capacity could not be used by one party to a transaction to avoid a contract *ab initio* simply because the other party knew, or was taken to have known, that the contract was beyond its capacity.[92]

Tomlinson J was correct in his decision. First, by claiming that the contract was a sales contract under which payment was conditional on delivery, the defendants were calling on the court to ignore multiple express terms of the agreement which contradicted this assertion. These provisions had been agreed upon by the parties and clearly outlined the structure which the arrangement was to take, a structure which reproduced the economic substance of a credit facility. In light of the expert evidence introduced on the requisite elements of a *murābaha*, it appears that the defendants were relying on the fact that the contract was described on its face as a *murābaha* to ground their defence. However, the agreement was expressly subject to English law, not *Sharī'ah*. As the contract was neither governed by *Sharī'ah* nor was performance to occur in a country which applied *Sharī'ah*, the validity of the agreement was not ultimately dependent on whether it was in accordance

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[89] *ibid.*, Page 8 of the judgment when downloaded from Westlaw.

[90] The court also dismissed the defendants' claim that due to the questionable *Sharī'ah*-compliance of the contract, the claimant was acting outside of its corporate capacity when it entered into it. While the court heard expert evidence in relation to the *ultra vires* doctrine in the Bahamas (where the claimant was incorporated) it ultimately concluded that a lack of capacity could not be used by one party to a transaction to avoid a contract *ab initio* simply because the other party knew, or was taken to have known that the contract was beyond its capacity.

[91] *Islamic Investment Company of the Gulf (Bahamas) Ltd. v Symphony Gems N.V. & Ors*, The London High Court, 13th February 2002, 2001, 2001 Folio 1226 per Justice Tomlinson, 2002 West Law 346969, QBD (Comm. Ct.). Page 12-13 of the judgment concluding that "I conclude that the defendants do not have an arguable defence in reliance on the *ultra vires* doctrine."

[92] *ibid.*, Page 11-13 of the judgment. See *infra.* at 416 for more discussion of *ultra vires* and the place of incorporation.

with Islamic law.[93] The court was able to secularise the term "*murābaha*" by excising its religious underpinnings without removing a fundamental term of the agreement. The result of this was to lose all the implications arising out of the term "*murābaha*" which might have been dependent on whether the contract complied with Islamic law. In effect, the contract was perfectly enforceable as financing agreement, regardless of its title and regardless of any stated intention on the part of the parties to comply with *Sharī'ah*.

In Ireland, the fact that a contract which is governed by Irish law may be influenced by factors outside of Ireland's legal system has not prevented the courts from determining the validity and impact of that contract in accordance with Irish law. This is consistent with the English court's approach in *Symphony Gems*. In *Kutchera v Buckingham International Holdings Ltd*,[94] an English domiciled plaintiff and Canadian defendant entered into a contract which provided that, "[t]his Agreement and all aspects herein shall be construed and governed by the Laws of the Republic of Ireland (Eire)."[95] In the High Court, Carroll J refused to accept jurisdiction over the dispute on the basis that Irish law was "unconnected with the realities of the contract. It has no function to determine the validity of this contract which must be determined by reference to Canadian law."[96] Rejecting the High Court Judge's decision, the Supreme Court confirmed[97] that the proper law of the contract was clearly Irish law; this is the law which had been expressly chosen by the parties and this is the law which the Irish courts would apply.[98] Walsh J emphasised the freedom of the parties to choose the governing law of their contract.[99] Similarly McCarthy J confirmed that "[i]t is not questioned that the agreement must be construed according to Irish law, since it so provides."[100] Because Irish law was the governing law of the contract, "[t]he contract therefore falls to be construed and interpreted by no law save Irish law, and

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[93] *ibid.*, Page 11-13 of the judgment. The defence was also put forward that the substantial place of performance of the contract was Saudi Arabia and as Saudi Arabia applies *Sharī'ah* law, the contract was void. However, the court concluded that while there was some link with Saudi Arabia, "the contract did not call for any performance by the sellers in Saudi Arabia." See also, Tabari, Nima Mersadi, "Islamic finance and the modern world: the legal principles governing Islamic finance in international trade", (2010) 31(8) *Company Lawyer*, 249-254 at 253.

[94] *Kutchera v Buckingham International Holdings Ltd* [1988] 1 IR 61.

[95] *ibid.*, at 67.

[96] *ibid.*, at 66.

[97] Henchy J dissenting.

[98] *Kutchera v Buckingham International Holdings Ltd* [1988] 1 IR 61 at 69 noting that; "The parties to the present contract clearly and expressly chose Irish law and it has not been disputed by the parties in this Court that Irish law is the applicable law or the proper law of the contract" per Walsh J.

[99] *ibid.*, at 68, see Gill who welcomed this confirmation, Gill, A. V., "Choice of Law and Jurisdiction Clauses in International Contracts", (1988) 6 *Irish Law Times*, 203-207 at 204.

[100] *Kutchera v Buckingham International Holdings Ltd* [1988] 1 IR 61 at 79, per McCarthy J.

therefore there is no question of the Irish courts being called upon to apply any foreign law in so far as the construction or interpretation of the contract is concerned."[101]

There is already evidence in Ireland of Islamic finance contracts which are subject to Irish law. The Oasis Crescent Global Investment Fund (Ireland) plc "is managed in accordance with Shari'ah principles"[102] and provides products that are structured to "ensure that full compliance [with those principles] is achieved."[103] Not only is this fund incorporated and managed in Ireland, but contracts entered into in relation to the fund are governed by Irish law.[104] If a dispute were to arise in relation to these contracts, the Irish courts would have to determine the validity of an Islamic finance contract which is explicitly governed only by Irish law.[105] In light of Irish precedent and UK caselaw, it is suggested that the validity and enforceability of such contracts will be determined under Irish law, not under *Sharī'ah*. The parties have explicitly agreed to subject their contract to Irish law; it is from that legal system that the contract must derive its legitimacy and its implications. To conclude otherwise would contradict the ultimate reason for making a choice of law and would override an unambiguous term of the contract. This would increase contractual uncertainty, particularly in arrangements with an international element, as parties would be unable to anticipate in advance the legal norms against which their activities will be judged.

2. *Islamic Finance Contracts Governed by Sharī'ah*

No Islamic finance contract brought before the English courts has been governed solely by *Sharī'ah* on the face of the contract.[106] However, in *Shamil Bank of Bahrain EC v*

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[101] *ibid.*, at 68 per Walsh J.

[102] Oasis Crescent Global Investment Fund (Ireland) plc, *Prospectus*, (Dublin, 30 September 2010), at 15.

[103] Oasis Crescent Global Investment Fund (Ireland) plc, "Shari'ah-compliance", available at: http://www.oasiscrescent.co.uk/default/content.aspx?initial=true&moveto=219

[104] Oasis Crescent Global Investment Fund (Ireland) plc, *Investment Form*, notes at 3 that "All contracts are governed by Irish law."

[105] DeLorenzo, Yusuf Talal and McMillen, Michael JT., "Law and Islamic Finance: An Interactive Analysis", in *Islamic Finance, The Regulatory Challenge*, Simon Archer and Rifaat Ahmed Abdel Karim (eds.), (Wiley & Sons (Asia) Pte Ltd, Singapore, 2007), 132-197 at 162 noting that "[f]ocusing on enforceability issues in purely secular jurisdictions, such as England, other European jurisdictions, and the United States, litigation of a Shari'ah-compliant transaction using the law of the purely secular jurisdiction as the governing law will raise questions of whether, when, and under what circumstances a secular court will apply the Shari'ah in interpreting the contracts involved in that transaction."

[106] Bälz, Kilian, "Sharia Risk? How Islamic Finance Has Transformed Islamic Contract Law", note 70, at 13.

Beximco Pharmaceuticals Ltd.,[107] the choice of law in a *murābaha* contract stated that; "[s]ubject to the principles of Glorious *Sharia'a*, this Agreement shall be governed by and construed in accordance with the laws of England."[108] The defendants suggested in the High Court that the effect of this governing law clause was that "the obligations are only enforceable if they are enforceable both under *sharia'a* law and under English law."[109] There was a dual choice of law and both choices had to be satisfied for the contract to be effective. The defendant then claimed that the description of the contract as a *murābaha* or as an *ijārah* lease was merely a "disguise for an otherwise undocumented interest bearing loan."[110] As a result, the contract could not be valid under *Sharī'ah*. While it may have been enforceable under English law, the contract could not be enforced against the defendant, as it had not satisfied the governing law test of enforceability under both Islamic *and* English law.[111]

Echoing the High Court judgment of Morison J, the Court of Appeal placed heavy reliance on the provisions of the Rome Convention [the Convention].[112] Developed as a means of fostering uniform conflict of laws rules within the European Community for contractual obligations,[113] the Rome Convention replaced much of the contractual choice of law doctrines which operated in member states.[114] Ultimately concluding that the contract was governed exclusively by English law, the courts in *Shamil Bank* noted that the Rome Convention did not permit two laws to simultaneously govern the question of

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[107] *Shamil Bank of Bahrain EC v Beximco Pharmaceuticals Ltd* [2003] EWHC 2118 (Comm) (High Court) [2004] EWCA Civ 19; [2004] 1 W.L.R. 1784 (CA (Civ Div)) (Court of Appeal). In the official transcript of the case, the order of the parties is switched for the appeal however for consistency, both the High Court and Court of Appeal cases will be referred to as *Shamil Bank of Bahrain EC v Beximco Pharmaceuticals Ltd.*

[108] *Shamil Bank of Bahrain EC v Beximco Pharmaceuticals Ltd* [2003] EWHC 2118 (Comm) (High Court), at [5].

[109] *ibid.*, at [15].

[110] The defendants argued that the *murabaha* was intended by the parties to provide general working capital, not for the purpose of purchasing specific goods and was not therefore a valid *murabaha* agreement. In addition to this, the terms of the *murabaha* contradicted its status as a Shari'ah-compliant *murabaha* as delayed payment would have resulted in an obligation to pay further accrued compensation. The exchange agreements may have appeared to resemble ijarah leases but were, in fact not ijarah as the bank did not take title, or the right to usufruct, to the goods leased. The exchange agreements were nothing more than a rescheduling of the *murabaha* arrangements and were not in conformity with Islam, *ibid.*, at [20].

[111] *ibid.*, at [15].

[112] Convention on the Law Applicable to Contractual Obligations opened for signature in Rome on June 19, 1980, 1980 OJ (L 226), 19 I.L.M. 1492 (1980) [hereinafter the "Rome Convention"]

[113] Horlacher, H. Matthew, "The Rome Convention and the German Paradigm: Forecasting the Demise of the European Convention on the Law Applicable to Contractual Obligations", (1994) 27 *Cornell International Law Journal*, 173-201 at 173.

[114] Chuah, Jason C.T., "Islamic Principles Governing International Trade Financing Instruments: A Study of the Morabaha in English Law", (2006) 27 *Northwestern Journal of International Law & Business*, 137-169 at 139. See also; Mann, F.A., "The Proper Law of the Contract – an Obituary", (1991) 107(Jul) *Law Quarterly Review*, 353-355 at 353. The Rome Convention has now been replaced by the Rome Regulation (Rome I) – see *infra.* at 399 for a discussion on how Rome I may differ from the Rome Convention.

enforceability of a contract.[115] This conclusion was discussed primarily in the High Court,[116] where Morison J relied on English caselaw,[117] and Article 3.1 the Rome Convention, which provides that "[a] contract shall be governed by *the law* chosen by the parties."[118] While different laws could validly govern different portions of a contract, any single provision of that contract could be governed only by one law at any one time.[119] In reality, this plurality of governing law proved unimportant, as the High Court determined, and the Court of Appeal confirmed, that while the choice of English law was legitimate, the choice of *Sharī'ah* was not and so there was only one governing law in this contract, English law.[120] In deciding that *Sharī'ah* was not a valid choice of law, the courts looked again to Article 3.1 of the Convention which acknowledged the autonomy of the parties to choose the governing law of their contract. This autonomy however had to be understood in light of Article 1.1, which provided that "the rules of this Convention shall apply to contractual obligations in any situation involving a choice *between the laws of different countries*."[121] The courts concluded, therefore, that the reference in Article 3.1 to the governing law chosen by the parties was a reference only to the law of a country;[122] the provisions of the Convention did not consider the choice of a non-national set of rules as

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[115] *Shamil Bank of Bahrain EC v Beximco Pharmaceuticals Ltd* [2003] EWHC 2118 (Comm) (High Court), at [28], [2004] EWCA Civ 19; [2004] 1 W.L.R. 1784 (CA (Civ Div)) (Court of Appeal), at 1796.

[116] As the counsel for the defendants accepted in the Court of Appeal that the governing law was indeed English law alone. *Shamil Bank of Bahrain EC v Beximco Pharmaceuticals Ltd* [2004] EWCA Civ 19; [2004] 1 W.L.R. 1784 (CA (Civ Div)) (Court of Appeal), at 1796 and 1798.

[117] *American Motor Insurance Co v Cellstar Corpn* [2003] EWCA Civ 206, [2003] All ER (D) 26 (Mar), at 32 where Mance LJ noted that an insurance policy "cannot have two governing laws."

[118] Article 3(1) Rome Convention, (emphasis added), Article 3(1) of the Rome Convention discusses party autonomy and the right of parties to choose the governing law of their contracts. While this provision does not explicitly limit this choice to the law of a single country, it notes that that "A contract shall be governed by *the law* chosen by the parties" suggesting that only one law can apply to any part of the contract at one time. See also, Junius, Andreas, "Islamic Finance: Issues Surrounding Islamic Law as a Choice of Law under German Conflict of Laws Principles", (2006-2007) 7 *Chicago Journal of International Law*, 537-550 at 541.

[119] The High court quoted Dicey and Morris who described the concept of splitting a contract and appointing different laws as the governing laws of each separate part a practice the authors referred to as "depecage" or dismemberment, *Shamil Bank of Bahrain EC v Beximco Pharmaceuticals Ltd* [2003] EWCA Civ 206 at [28]. See also Report on the Convention on the law applicable to contractual obligations by Mario Giuliano and Paul Lagarde, Professor, (November 31 1980), ("Giuliano-Lagarde Report"), Official Journal C 282 , 31/10/1980 P. 0001 – 0050.

[120] *Shamil Bank of Bahrain EC v Beximco Pharmaceuticals Ltd* [2003] EWHC 2118 (Comm) (High Court), at [37-40], [2004] EWCA Civ 19; [2004] 1 W.L.R. 1784 (CA (Civ Div)) (Court of Appeal), at 1798.

[121] Article 1.1 Rome Convention, 1980, (emphasis added).

[122] *Shamil Bank of Bahrain EC v Beximco Pharmaceuticals Ltd* [2003] EWHC 2118 (Comm) (High Court) [27], [2004] EWCA Civ 19; [2004] 1 W.L.R. 1784 (CA (Civ Div)) (Court of Appeal), at 1798. Indeed, while not mentioned by the courts, there are other provisions of the Convention which further emphasis the fact that the Convention applies only where there is a choice of a country. For example, Article 4 notes that where the parties have not made a valid choice of law, the contract will be treated as governed by the law of the country with which it is the most connected. Chuah, Jason C.T., "Islamic Principles Governing International Trade Financing Instruments: A Study of the Morabaha in English Law", note 114, at 143.

legitimate.[123] This conclusion excluded non-country specific rules such as *lex mercatoria* and "general principles of law" from being valid choices in contractual arrangements.[124] It also, according to the courts, excluded *Sharī'ah* as a set of religious norms which are not tied to any particular country.[125]

a. Sharī'ah and Rome I

In 1991, Ireland incorporated the Rome Convention 1980 into Irish law with the Contractual Obligations (Applicable Law) Act 1991.[126] Since the decision in *Shamil Bank*, however, the Rome Convention has been replaced by a Regulation, Rome I.[127] Facilitating harmonisation and legal certainty[128] within the single market,[129] Rome I is similar in ambition to the Convention.[130] Yet despite clear similarities between Rome I and the Convention, several provisions of the Regulation are more broadly worded than the Convention it replaced. Key amongst these modifications is the wording of Article 1 which states that "[t]his Regulation shall apply, in situations involving a conflict of laws, to contractual obligations in civil and commercial matters." This can be contrasted with Article 1 of the Convention which provided that "the rules of this Convention shall apply to contractual obligations in any situation involving a choice *between the laws of different countries*."[131] The drafters of Rome I have therefore removed one of the primary reasons why the English High Court and Court of Appeal concluded in *Shamil Bank* that a non-

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[123] Saleh, Nabil, "A Landmark Judgment of 23 January 2004 by the England and Wales Court of Appeal", (2004) 19(1/4) *Arab Law Quarterly*, 287-291 at 288, Junius, Andreas, "Islamic Finance: Issues Surrounding Islamic Law as a Choice of Law under German Conflict of Laws Principles", note 118, at 541.

[124] *Shamil Bank of Bahrain EC v Beximco Pharmaceuticals Ltd* [2003] EWHC 2118 (Comm) (High Court), at [37].

[125] *ibid.*, at [27], (High Court), 1798 (Court of Appeal), Bälz, Kilian, "Islamic Financing Transactions in European Courts", in S. Nazim Ali (ed.), *Islamic Finance; Current Legal and Regulatory Issues*, (Islamic Finance Project Islamic Legal Studies Program, Harvard Law School, Massachusetts, 2005), 61-76 at 66.

[126] Contractual Obligations (Applicable Law) Act, 1991 (Number 8 of 1991).

[127] Regulation (EC) No 593/2008 of the European Parliament and of the Council of 17 June 2008 on the Law Applicable to Contractual Obligations, OJ 2008, *L 177/6,* (Rome I).

[128] Recital (6) Rome I which notes that; "The proper functioning of the internal market creates a need, in order to improve the predictability of the outcome of litigation, certainty as to the law applicable and the free movement of judgments, for the conflict-of-law rules in the Member States to designate the same national law irrespective of the country of the court in which an action is brought."

[129] Kuipers, Jan-Jaap, "Party Autonomy in the Brussels I Regulation and Rome I Regulation and the European Court of Justice", (2009) 10(11) *German Law Journal*, 1505-1524 at 1506.

[130] Like the Convention therefore, Rome I prioritises the autonomy of the parties to choose the governing law of their contract, as recital 11 notes, "[t]he parties' freedom to choose the applicable law should be one of the cornerstones of the system of conflict-of-law rules in matters of contractual obligations." Recital (11) Rome I, Heiss, Helmut, "Party Autonomy" in *Rome I Regulation: The Law Applicable to Contractual Obligations in Europe*, Franco Ferrari and Stefan Leible (eds), (Sellier de Gruyter, Berlin, 2009), 1-16 at 1 noting that; "[p]arty autonomy has been and will remain the fundamental principle in European private international law in matters of contractual obligations."

[131] Article 1.1 Rome Convention, (emphasis added). Kuipers, Jan-Jaap, "Party Autonomy in the Brussels I Regulation and Rome I Regulation and the European Court of Justice", note 129, at 1509.

national choice of law was not covered by the provisions of the Convention. In an early draft of Rome I, the provisions of the Regulation provided specifically for a choice of an anational governing law with draft article 3(2) noting that "[t]he parties may also choose as the applicable law the principles and rules of the substantive law of contract recognised internationally or in the Community."[132] In the final version of the Regulation, the article providing for the validity of a non-state choice of law was removed;[133] however, the less restrictive wording of Article 1 became part of Rome I, raising the question as to whether a non-national system of rules may govern a contract. Nevertheless, commentators have repeatedly and almost unanimously concluded that the possibility of non-state law as a governing law of a contract has remained the same under the Regulation as under the Convention.[134]

Where *Sharī'ah* is selected as the sole governing law, or, similar to *Shamil Bank*, where a national law subject to *Sharī'ah* is chosen, it is probable[135] therefore, that the contract in

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[132] Commission of the European Communities, Proposal for a Regulation of the European Parliament and the Council on the law applicable to contractual obligations (Rome I), Brussels, (15.12.2005 COM(2005), 650 final 2005/0261 (COD)). This expansion in the scope of the Rome regime was not, however, a complete rejection of the Convention's state-centred approach to choice of law and would only have allowed a choice of "UNIDROIT principles, the Principles of European Contract Law or a possible future optional Community instrument." *Lex Mercatoria* would thus have been excluded as it was not considered to be "precise enough," as would "private codifications not adequately recognised by the international community," Commission of the European Communities, Proposal for a Regulation of the European Parliament and the Council on the law applicable to contractual obligations (Rome I), Brussels, (15.12.2005 COM(2005), 650 final 2005/0261 (COD)), at 5.

[133] Michaels, Ralf, "The True *Lex Mercatoria*: Law Beyond the State", (2007) 14(2) *Indiana Journal of Global Legal Studies*, 447-468 at 458.

[134] McClean, David and Beevers, Kisch, *Sharī'ah Laws*, (7th ed., Sweet & Maxwell, London, 2009), at 356. A review of the substantive provisions of Rome I as a whole does suggest that the choice of law envisaged by the Regulation is one in favour of the law of a state. Article 3(3) for example, outlines principles which apply where the relevant elements of the transaction are located in a country, "other than the country whose law has been chosen," similarly in circumstances where the parties have not made a legitimate choice of law, Article 4 provides that the court must determine the law of the country which is most suitable for the contract in question, while Article 21 notes that "[t]he application of a provision of the law of any country specified by this Regulation may be refused only if such application is manifestly incompatible with the public policy (*ordre public*) of the forum."

[135] Although not *entirely* impossible. The provisions of the Rome Convention applied only where there was a conflict between the laws of different countries; a contract which did not contain such a conflict fell outside the scope of the Convention and the legitimacy of the chosen law was determined according to established common law principles (For example, the contract in *Shamil Bank*). As the provisions of Rome I apply simply where there is a conflict of laws, contracts which would previously not have been covered by the European regime could now appear to be subject to its provisions; while *Sharī'ah* is likely to be an invalid choice of law in a contract subject to Rome I, this does not automatically prevent *Sharī'ah* from being considered to be a system of law within the regime, albeit one which is unsuitable to govern a contract. If this was the effect of the Regulation, it would result in a situation whereby contracts whose choice of law clauses refer to *Sharī'ah*, or any other non-national system of rules, would be interpreted under the principles of the Regulation. As *Sharī'ah*, like *Lex Mercatoria*, does not appear to be a valid choice under the Regulation, a contract which selects only *Sharī'ah* as a governing law may be treated under the Regulation as not containing a legitimate governing law at all; it would then be for the courts to apply Article 4 of the Regulation in order to determine what country's laws will govern. Similarly, where a contract chooses Irish law subject to *Sharī'ah*, the terms of the Regulation suggest that only the choice in favour of Irish law will be

question will fall outside of the Rome Regime; the choice of *Sharī'ah* is not considered by the Rome Regulation to be a valid choice of law and so there can be no conflict of laws to which the provisions of the Regulation would apply. Notwithstanding the creeping impact of European law on domestic, national issues, the extent to which *Sharī'ah* could impact on the interpretation of a financial contract by a court will thus be largely dictated by national conflict of laws rules. In Ireland, this will be the established common law principles which are discussed in subsection (b).

b. Sharī'ah and the Common Law

The enforceability of a contract in which an anational set of norms is appointed, as the governing law, falls to be interpreted in accordance with the national choice of laws doctrines operating in the country of enforcement.[136] How these traditional rules apply will depend on the jurisdiction in which the case was being heard.[137] In *Shamil Bank* and subsequent caselaw approving it,[138] the English common law principles applicable were substantially similar to the standards codified in the Convention.[139] "Delocalised"[140] contracts, that is, contracts which have no municipal legal order underpinning them, were

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upheld as the choice of *Sharī'ah* is not a legitimate choice. This would have reduced almost to obscurity, the established choice of law provisions in member states. While this is unproblematic for countries such as the UK where the common law and European regime are largely consistent with one another, it may cause an alteration in approach in countries such as France where the courts have been previously willing to uphold non-state governing law clauses under French civil law principles. However, in light of the confirmation by the European Commission that in developing a new regime, they had "not set out to establish a new set of legal rules but to convert an existing convention into a Community instrument" (Commission of the European Communities, Proposal for a Regulation of the European Parliament and the Council on the law applicable to contractual obligations (Rome I), Brussels, (15.12.2005 COM(2005), 650 final 2005/0261 (COD)), at 3) it is suggested that the Regulation has not resulted in the considerable expansion in the scope of the European regime which would have occurred if Rome I was applicable even in the absence of a choice of national law.

[136] In *Halpern v Halpern* EWCA Civ 291, counsel for the defendants suggested that as the choice of law in the relevant contract was between Jewish law and English law, the contract fell outside the scope of the Convention as the Convention only appears to cover those contracts in which there is a conflict of laws of *countries*. Waller LJ rejected this argument and appeared to suggest that the principles of the Convention still applied. It is suggested that this approach is incorrect as a choice between a non-national law and a national law is simply outside the scope of the Convention. Waller LJ however, then goes on to cite authority which would suggest that the contract would, in fact, fall to be interpreted in accordance with English common law principles, *Halpern v Halpern* [2007] EWCA Civ 291, at [21].

[137] Mayss, Abla J, *Principles of Conflict of Laws*, (3rd ed., Cavendish Publishing Limited, London, 1996), at 112.

[138] *Halpern v Halpern* [2007] EWCA Civ 291; [2008] Q.B. 195; [2007] 3 W.L.R. 849; [2007] 3 All E.R. 478; [2007] 2 All E.R. (Comm) 330; [2007] 2 Lloyd's Rep. 56; [2007] 1 C.L.C. 527; Times, May 14, 2007.

[139] A fact emphasised by Mance LJ in *American Mororists Insurance Co v Cellstar Corpn* [2003] EWCA Civ 206, at [18]. Collier, John G., *Conflict of Laws*, (3rd ed., Cambridge University Press, Cambridge, 2001), at 190.

[140] Mann, Frederick A., "England Rejects Delocalised Contracts and Arbitration", (1984) 33 *International and Comparative Law Quarterly*, 193-198.

thus already rejected by the English courts prior to the incorporation of the Convention.[141] Indeed, in *Aramco v Government of Saudi Arabia*,[142] a tribunal[143] refused to uphold a choice of law which was explicitly in favour of *Sharī'ah* because

> [i]t is obvious that no contract can exist in *vaccuuo*, i.e. without being based on a legal system. The conclusion of a contract is not left to the unfettered discretion of the parties. It is necessarily related to some positive law, which gives legal effects to the reciprocal and concordant manifestations of intent made by the parties. The contract cannot be conceived without a system of law under which it is created. Human will can only create a contractual relationship if the applicable term of law has first recognized its power to do so.[144]

The Irish courts have been less direct in their determination of what constitutes "law" capable of governing a contract. Nevertheless, the courts have considered anational rules, primarily in the context of Canon Law, on a number of occasions. This experience may provide some indication of how *Sharī'ah* law would be treated by the Irish courts.

Judicial discussion of Canon law in Ireland has vacillated between a view of non-state norms as a self-contained system of law which may be capable of governing a contract and an attitude which treats them as a collection of rules disembodied from national legal

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[141] See for example, Lord Diplock in *Amin Rasheed Shipping Corp v Kuwait Insurance Co* [1984] AC 50, at 65.

[142] *Saudi Arabia v Arabian American Oil Co (Aramco)* [1958] 27 Int LR 117.

[143] This decision relates to arbitration rather than court proceedings, nevertheless, the views expressed by the arbitral tribunal are relevant to a conservative common law position. See *infra.* at 420 for more discussion on arbitration and Islamic law and the contemporary amenability of Islamic arbitration to the enforcement of non-national rules.

[144] *Saudi Arabia v Arabian American Oil Co (Aramco)* [1958] 27 Int LR 117 at 165, quoted in Al-Jumah, Khaled Mohammed, "Arab State Contract Disputes: Lessons from the Past", (2002) 17 *Arab Law Quarterly* 215-240, at 224. See also, Mann, Frederick A., "The Proper Law in the Conflict of Laws", [1987] 36(3) *The International and Comparative Law Quarterly*, 437-453 at 447, when referring to non-Convention choice of law rules in England, "[i]n short, in our society of sovereign States [the chosen law] is a system of law created by a State to which a contract necessarily owes its existence and by which it continues to be governed." A similarly restrictive view of acceptable governing laws has not been adopted in countries such as France where courts have shown a willingness to accept *Lex Mercatoria* and other non-national sets of norms as the governing law of a commercial contract, for a list of cases in which this approach has been demonstrated see; Affaki, G. (ed.), Fadlallah, I., Hascher, D., Pézard, A., and Train, F-X., *Proposal – Group on Governing Law and Dispute Resolution in Islamic Finance*, (Commission on Islamic Finance, France, 21 September 2009), at 16. The authors of the report use the French court's acceptance of *Lex Mercatoria* as a governing law to conclude that a similar approach would most likely be applied to Shari'ah. Indeed, the authors of the report suggest that a clause in an Islamic finance contract which states that "This agreement shall be governed by the principles of Shari'ah" would be sufficient to establish Islamic law as the governing law of the contract, at 18.

structures, not law. In *O'Keefe v Cardinal Cullen*,[145] Whiteside CJ noted in a dissenting judgment that "the Ecclesiastical Law is no longer 'law' in a proper sense; it has ceased to be the Queen's Ecclesiastical Law, and reduced to a matter of contract."[146] This view that Ecclesiastical Law is not "law" would seem to restrict the use of such rules as a valid governing law of an agreement. The majority judgments were more ambiguous. Nevertheless, O'Brien J focused on the binding nature of the rules and teachings of the Catholic Church on those who had voluntarily agreed to be so bound.[147] This alone did not make the teachings and regulations "law;" they were, rather, part of the internal governance structure of a voluntary association. As a result, the judge concluded that the plaintiff's suspension from his position as a priest could not be described as "legal" even if it was "conformable to the laws, ordinances, and discipline" of the Roman Catholic Church as there was

> no tribunal constituted by the laws of this country for the suspension of a clergyman either of the Roman Catholic Church or of any other nonestablished church; and there is no power or machinery whatever for effecting such suspension except what is prescribed by the rules and regulations of those several churches.[148]

In order for a set of rules to be classified as law by the Irish courts, it appears as though it must be capable of producing legal consequences that are enforceable by the courts of the State.

An alternative view of non-national law was reached in *O'Callaghan v O'Sullivan*.[149] In submissions, counsel for the plaintiff presented an argument that Canon Law, to which the parties in this case were bound, was not a system of foreign law requiring proof by expert evidence. It was "not the law of any particular state; it is in operation here and in many other countries"[150] and so the parties were bound by the canons of their Church wherever they lived. In addition to this, the plaintiff submitted that the contract between the parties (which was contained in the *Codex Juris Canonici*) was a foreign written contract and so

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[145] *O'Keeffe v Cardinal Cullen* [1873-1874] 7 IR 319.
[146] *ibid.*, at 424.
[147] *ibid.*, at 398. See also; Barr, Colin, "An Irish Dimension to a British Kulturkampf?", (2005) 56 *The Journal of Ecclesiastical History* 473-495 at 485.
[148] *O'Keeffe v Cardinal Cullen* [1873-1874] 7 IR 319 at 398.
[149] *O'Callaghan v O'Sullivan* [1925] 1 IR 90.
[150] *ibid.*, at 92.

the court was empowered to construe the terms of the contract by itself and determine whether they had been complied with.[151] The Supreme Court did not take issue with the notion of a religious, anational law as the applicable law of a contract, capable of determining the rights and obligations of the parties. Kennedy CJ referred to "the suggestion to be made that the Canon Law is something which is not of the nature of a body of law at all,"[152] but rejected this contention, noting instead that

> it has never before...been contended that the Canon Law is not a scientific legal system and body of law, both substantive and adjective, a body of rules emanating from a legislating authority for the ordering of the conduct, regulating the social and domestic relations, and punishing the disobedience of those who recognise that authority, which speaks and gives judgments through its own tribunals...[153]

As a "systematic form of a code"[154] distinct from the laws of Ireland, Canon Law was foreign law.[155] It therefore had to be proved "by the testimony and opinion of competent expert witnesses shown to possess the skill and knowledge, scientific or empirical, required for stating, expounding, and interpreting that law."[156] Finally, noting that parties may agree to be bound by Canon Law, Scots Law or by the Code Napoléon, Kennedy CJ indicated that the "law" governing a contract in Ireland could be a set of norms other than the law of a state.[157]

The approach taken by Kennedy CJ in *O'Callaghan v O'Sullivan* has yet to be overruled by an Irish court. Nevertheless, it is suggested that *Sharī'ah* is unlikely to be

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[151] *ibid.*, at 92. This argument was based on the principle established in *Di Sora v Phillipps* (1863) 10 HLC 624 where it was concluded that while expert evidence is needed to determine the content of foreign law, construction of a foreign contract was within the competence of the forum, see remarks of Lord Chelmsford; "it is difficult to understand how the construction of a contract can be a question of fact … The meaning of a foreign instrument, therefore (cleared of the difficulty of technical terms), cannot be a fact to be proved; it is at the utmost merely a probable opinion of the witnesses as to the construction which would likely to be put upon it by the foreign tribunal," at 638. Cited with approval in *Russian Commercial and Industrial Bank v Comptoir d'Escompte de Mulhouse* [1923] 2 KB 630 at 643 with the relevant passage subsequently approved in Ireland in *MacNamara v Owners of the S.S. "Hatteras"* [1933] IR 675 at 706.

[152] *O'Callaghan v O'Sullivan* [1925] 1 IR 90 at 107 per Kennedy CJ.

[153] *ibid.*, at 107-108. See also 108-109 where Kennedy CJ noted that; "[n]o jurist—certainly none whose study is English Common Law—would deny to what is called "the Canon Law" of the Roman Catholic Church the character and description of a body or system of Law, and on the facts before us in the present case it is shown to be a living system of law, administered by certain tribunals constituted for that purpose under the same authority from which the laws are derived."

[154] *ibid.*, at 108.

[155] *ibid.*, at 109.

[156] *ibid.*, at 109 and 112.

[157] *ibid.*, at 107.

upheld by an Irish court as a valid governing "law" of a contract. In *O'Callaghan v O'Sullivan*, Canon Law was accepted as the law of a contract because it was a "systematic form of a code,"[158] and the contract between the parties was contained in that code; the rights, remedies and implications arising out of the contract could be found in the code. *Sharī'ah* on the other hand is not codified and is not centrally determined. It is a floating set of moral principles and so, consistent with the suggestion made in Chapter 2, Islamic law is not law in the positive sense of the term.[159] There is no country called "Islam" and where a contract purports to be subject to Islamic law, it is not subject to the recognisable law of an identified state.[160] There are no temporal mechanisms for enforcing *Sharī'ah* and anything flowing from *Sharī'ah* creates moral consequences only.[161] As one commentator has noted, "Shari'ah does not 'state' the law in a strictly legal sense, but rather articulates a system of 'oughts' and 'ought nots' from which the 'law' must be extracted or derived."[162] As the basis for specifically choosing a governing law in a contract is to enable the courts to determine the validity and implications of the contract by applying that law, the "law" must provide the machinery necessary for making and enforcing such a determination. As only a set of rules backed by the authority of a State and its courts can effectively achieve this, only law which is the law of a State can be a valid choice in a contract.[163]

An Islamic finance instrument which is subject solely to *Sharī'ah* may thus be deemed, under Irish law, to involve no valid choice of law at all. In such circumstances, the courts will not attempt to determine whether an Islamic finance contract or activity is compliant with Islamic law. However, a contract must be governed by a law and so the courts would still need to determine what national legal order will be treated as the law governing the contract.[164] This would involve the application of established private international law

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[158] *ibid.*, at 108.

[159] *supra.* at 39.

[160] Bälz, Kilian, "Islamic Law as Governing Law under the Rome Convention, Universalist *Lex Mercatoria* v Regional Unification of Law", note 37, at 43. Indeed as Glen notes, "[s]ome view an Islamic state as "conceptually impossible" since enforcement of the *Sharī'ah* as state law would repudiate the Islamic and revelatory nature of God's law," Glenn, H. Patrick, *Legal Traditions of the World*, (3rd ed., Oxford University Press, Oxford, 2007), at 210.

[161] As Keane and O'Neill note; "non-legally enforceable norms will not yield uniform responses to issues which matter to us...the function of law is to yield high standards in its own right through high legislative standards, effective enforcement and penalties," Keane, Ronan and O'Neill, Ailbhe, *Corporate Governance and Regulation; An Irish Perspective*, (Round Hall, Dublin, 2009), at 73.

[162] Nadar, Aisha, "Islamic Finance and Dispute Resolution: Part I", note 38, at 16.

[163] As already noted, the choice of a governing law of a contract is a distinct issue from the incorporation of foreign legal principles into a contract *as terms of that contract*. See *infra.* at 418 for a discussion on incorporation.

[164] Bälz, Kilian, "Islamic Law as Governing Law under the Rome Convention, Universalist *Lex Mercatoria* v Regional Unification of Law", note 37, at 43-44.

rules.[165] In circumstances where a contract elects a national law, subject to *Sharī'ah*,[166] it is suggested that the Irish courts will rely on the national system as a valid governing law; the validity and implications of the contract will thus be determined in accordance with that law, not Islamic law.

B. Incorporation and Difficulty Identifying the Content of Islamic Law

The first issue restricting the willingness, and ability, of the Irish judiciary to determine whether or not an Islamic finance transaction adheres to the teachings of Islamic law is the invalidity, under both the Rome Regime and Irish common law principles, of a choice of *Sharī'ah* as the governing law of a contract. The second issue is the practical impossibility of the Irish court determining, to the satisfaction of all parties, what the content of Islamic law actually is.[167]

Where an Islamic finance contract is governed by Irish law, the courts will apply established principles of contractual interpretation when determining the rights and obligations arising out of that contract. This will require the courts, when construing the terms of the contract, to give effect to the intention of the parties.[168] This intention must be "ascertained from the words and expressions used in the document as a whole,"[169] and so "[t]he Court must not speculate as to [the parties'] intention, apart from their words."[170] In circumstances where an Irish law contract is based on classical nominate contracts or where it refers to the parties' intention to comply with *Sharī'ah*, this could raise the issue of whether the Irish courts would try to give effect to this intention by incorporating principles of *Sharī'ah* into the Irish law contract - as distinct from applying *Sharī'ah* as the governing law of the contract.

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[165] Article 4 Rome Regulation sets out the hierarchy of tests which must be undertaken by the court in determining the governing law in the absence of choice. See also; Bälz, Kilian, "Islamic Law as Governing Law under the Rome Convention, Universalist *Lex Mercatoria* v Regional Unification of Law", note 37, at 45-46.

[166] As occurred in *Shamil Bank*.

[167] Lombardi, Clark Benner, "Islamic Law as a Source of Constitutional Law in Egypt: The Constitutionalization of the Sharia in a Modern Arab State", (1998-1999) 37 *Colombia Journal of Transnational Law*, 81-124 at 91 noting that, "[h]istorically...there has been no unanimity on what the sharia consists of or on how to define it. The term sharia has meant different things to different people in different countries, and even within one country it has meant different things over the centuries."

[168] *Brendan Keehan & Peter Flannery v Dublin Airport Authority — Shannon Airport* [2008] 19 E.L.R. 281 at 289.

[169] *ibid.*

[170] *Analog Devices BV v Zurich Insurance Company* [2005] 1 IR 274 at 280 per Geoghegan J

Following the English courts' conclusion in *Shamil Bank* that the contract was governed exclusively by English law, the defendants argued that the reference to *Sharī'ah* was intended by the parties to incorporate principles of Islamic law into the English law contract.[171] Incorporation would not establish Islamic law as the governing law but would instead include Islamic contractual rules as terms of the contract to be interpreted by the courts in the same way as the other contractual terms agreed upon by the parties.[172] The courts would then interpret the contract as if the principles of Islamic law which were incorporated, had been written out in full as clauses of the contract.[173] Where the activities of a party failed to comply with the incorporated principles of Islamic law, they would breach a term of the contract. Effective incorporation of Islamic principles acts as a form of indirect *Sharī'ah* supervision. However, the High Court in *Shamil Bank* concluded that *Sharī'ah* consisted of "principles of law derived from religious writings on matters of great controversy"[174] and so a secular court was "not suited to ascertain and determine highly controversial principles of a religious based law."[175] As religious scholars had not yet reached consensus on what the principles of Islamic law actually were, it was not for an English court to determine what religious rules had been incorporated into this contract.[176]

On appeal, counsel for the defendant submitted that, as the principles of *Sharī'ah* relevant to this particular contract were not controversial, Morison J had erred in finding that the principles of *Sharī'ah* were contentious religious norms which could not be determined by the court. The Court of Appeal agreed with the lower court. Potter LJ acknowledged that the doctrine of incorporation was a legitimate means for specific provisions of a foreign or non-national law to be integrated into a contract without undermining the governing law of the contract. However, this doctrine could only operate where "the parties have by the terms of their contract sufficiently identified specific 'black

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[171] *Shamil Bank of Bahrain EC v Beximco Pharmaceuticals Ltd* [2003] EWHC 2118 (Comm) (High Court) [35]-[36], [2004] EWCA Civ 19; [2004] 1 W.L.R. 1784 (CA (Civ Div)) (Court of Appeal), 1798 et seq.

[172] *G. E. Dobell & Co. v The Steamship Rossmore Company, Ltd.*, [1895] 2 Q.B. 408 at 413 per Lord Esher; "They then introduce into their bill of lading the words of the Harter Act, which I decline to construe as an Act, but which we must construe simply as words occurring in the bill of lading." Approved in *Vita Food Products v Unus Shipping Co Ltd* [1939] AC 277 at 291-2 and *Mauritius Oil Refineries Ltd. v. Stolt-Nielsen Nederlands B.V. (The Stolt Sydness)* [1997] C.L.C. 417 at 424.

[173] Clarkson, C.M.V. and Hill, Jonathan, *The Conflict of Laws* (3rd ed., Oxford University Press, Oxford, 2006), at 181.

[174] *Shamil Bank of Bahrain EC v Beximco Pharmaceuticals Ltd* [2003] EWHC 2118 (Comm) (High Court) [36].

[175] *ibid.*, [36].

[176] *ibid.*, [39].

letter' provisions of a foreign law or an international code or set of rules."[177] A general reference to "Islam" or "*Sharī'ah*" in the contract was too vague to determine what principles of the vast body of Islamic law were being incorporated.[178] The Court was not in a position to determine by what rules the parties intended to be bound.[179] As Potter LJ noted, there are

> areas of considerable controversy and difficulty arising not only from the need to translate into propositions of modern law texts which centuries ago were set out as religious and moral codes, but because of the existence of a variety of schools of thought with which the court may have to concern itself in any given case before reaching a conclusion upon the principle or rule in dispute.[180]

Given the potential for dispute as to the correct interpretation of Islamic law, the Court of Appeal was unconvinced that it was competent to make any such determination or that the parties would want a secular court to have such authority.[181] Instead, the Court concluded that the reference to the "Glorious Sharia'a" in the *Shamil Bank* contracts reflected the "Islamic religious principles according to which the Bank [claimant] holds itself out as doing business."[182] Though the courts in *Shamil Bank* were discussing the unsettled nature of *Sharī'ah* in the context of incorporation by reference, it is suggested this feature of *Sharī'ah* is equally relevant as a reason why *Sharī'ah* cannot be a valid choice of law in a contract. The following remarks are therefore applicable whether a court is considering a governing law clause which refers to *Sharī'ah* or where the parties are attempting to incorporate *Sharī'ah* into the substantive provisions of the contract.

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[177] *Shamil Bank of Bahrain EC v Beximco Pharmaceuticals Ltd* [2004] EWCA Civ 19; [2004] 1 W.L.R. 1784 (CA (Civ Div)) (Court of Appeal), at 1799.

[178] A view that Islamic law lacks the requisite stability and identifiability to function as a legal framework for contracts has found favour with the English courts and tribunals. In both *Petroleum Development Ltd v Sheikh of Abu Dhabi* [1951] 18 ILR 144 and *Ruler of Qatar v International Marine Oil Company Ltd.* [1953] 20 Int LR 534 for example, the respective arbitrators noted when discussing the Islamic law operating in Abu Dhabi and Qatar at the time that "there is no settled body of legal principles in Qatar [or Abu Dhabi] applicable to the modern construction of modern commercial instruments." *Ruler of Qatar v International Marine Oil Company Ltd* [1953] 20 Int LR 534 at 544. See also, Fadlallah, Ibrahim, "Arbitration Facing Conflicts of Culture", Paper presented at the 2008 Annual School of International Arbitration Lecture sponsored by Freshfields Bruckhaus Deringer LLP, December 4, 2008, (2009) 25(3) *Arbitration International*, 302-317 at 304-305.

[179] *Shamil Bank of Bahrain EC v Beximco Pharmaceuticals Ltd* [2004] EWCA Civ 19; [2004] 1 W.L.R. 1784 (CA (Civ Div)) (Court of Appeal), at 1800. Bälz, Kilian, Islamic Financing Transactions in European Courts, in S. Nazim Ali (ed.), *Islamic Finance; Current Legal and Regulatory Issues*, note 125, at 66.

[180] *Shamil Bank of Bahrain EC v Beximco Pharmaceuticals Ltd* [2004] EWCA Civ 19; [2004] 1 W.L.R. 1784 (CA (Civ Div)) (Court of Appeal), at 1801.

[181] *ibid.*, at 1801.

[182] *ibid.*, at 1800.

Construing a contract in light of *Sharī'ah* principles either in the context of *Sharī'ah* as a governing law, or following incorporation, would set the Irish courts apart from their English counterparts. Nevertheless, it would be inadvisable for the Irish courts to begin vetting contracts for compliance with a set of religious norms. Despite growing homogenisation of Islamic finance,[183] scholarly disagreements continue to exist on some principles of *Sharī'ah*, a feature emphasised by the growing use of *ijtihād* within the Islamic finance industry. Internal diversity is an unavoidable consequence of the lack of a centralised authority in Islam and the manner in which rules of *Sharī'ah* have been expounded through the work of scholars.[184] These internal schisms in Islam are repeatedly cited as a central difficulty surrounding references to *Sharī'ah* in a contract[185] and were highlighted by Lord McNair as a principal ground why Islamic law is ineffective as a governing law.[186]

Making a determination on an issue in circumstances where there is disagreement or uncertainty as regards the "correct" answer is a practice with which the Irish courts are not unfamiliar. Many areas of Irish law are, have been, and will continue to be vague or contentious and subject to conflicting views amongst academics and experts and amongst the judiciary themselves. Judges will therefore frequently be required to balance competing opinions when faced with a contentious issue which is in dispute. Consistent with the view of the English courts, however, the Irish judiciary's willingness to adopt a specific point of view in the face of disagreement has not been applied to religious issues. In the recent case

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[183] In *Shamil Bank* the court highlighted the unsettled nature of *Sharī'ah* as a reason why the English courts should not and could not uphold any intention expressed in the contract, to comply with Shari'ah. Commenting on the *Shamil Bank* decision, Fadlallah suggests, quite rightly, that rules in *Sharī'ah* are divided between those which regulate the relationship between man and God (*'ibādāt* rules) and those which apply to the relationship between man and man (*mu'āmalāt* rules) (*supra.* at 40). It is proposed that it could readily be assumed that a reference to "*Sharī'ah*" in the governing law provision of a financial contract is a reference to the *mu'āmalāt* rules of Shari'ah, thus eliminating numerous teachings which are of a more religious nature. The rules which the courts would have to consider when interpreting the contract would therefore be reduced to a limited number of Islamic norms which deal with worldly activities rather than those which are overtly religious. Fadlallah, Ibrahim, "Arbitration Facing Conflicts of Culture", Paper presented at the 2008 Annual School of International Arbitration Lecture sponsored by Freshfields Bruckhaus Deringer LLP, December 4, 2008, note 178 at 306.

[184] Hallaq, Wael B., *Authority, Continuity, and Change in Islamic Law*, (Cambridge University Press, Cambridge, 2004), at 125, noting that; "the staggering variety of opinion which resulted from a fundamental structural and epistemological feature in Islamic law, a feature that emerged early on and was to determine the later course of legal development."

[185] See for example, Hamoudi, Haider ala "The Muezzin's Call and the Dow Jones Bell: On the Necessity o Realism in the Study of Islamic Law", (2008) 56 *American Journal of Comparative Law* 423- 470 at 423 who noted that; "[t]he reality is that given the structural pluralism of the rules of the classical era, there is no sensible way that modern rules could be derived from classical doctrine, either in letter or in spirit, and all efforts to do so have largely failed."

[186] McNair, Arnold, "The General Principles of Law Recognised by Civilised Nations", note 65, at 4.

of *Temple Street v D. & Anor*,[187] for example, Hogan J noted that "[a] secular court cannot possibly choose in matters of [religious diversity] and, of course, a diversity of religious views is of the essence of the religious freedom and tolerance which Article 44.2.1° pre-supposes."[188] For Eady J in the English High Court, judicial non-interference in questions of religious doctrine is based on "the well-known principle of English law to the effect that the courts will not attempt to rule upon doctrinal issues or intervene in the regulation or governance of religious groups."[189] Religious doctrine and questions of belief are issues which are not readily resolved through normal legal channels; the courts should not, and indeed, arguably cannot reduce to the status of positive law, matters of religious conscience. To do so, and to adopt a subjective opinion on faith would, in the view of the English courts, be "deeply unprincipled."[190]

Allowing the courts to determine what principles of Islam they consider to be relevant in a financial contract and then allowing them to decide whether those principles have been complied with could also result in a level of an *ex post* determination of a contract's governing principles. The effect of this could be that the parties may find themselves subject to teachings and a particular view of Islam which they did not have in mind when they entered into the contract. The rules relied on by the courts thus would not reflect the intentions of the parties.

10.2.3 Conclusion to Section 10.2

Despite the fact that the Islamic finance industry is defined by its adherence to Islam, it is suggested that the Irish Government is unlikely to implement official supervision of *Sharī'ah*-compliance of financial activity and will instead focus on accommodating basic structures used in Islamic finance. State-level supervision - whether *ex ante* in the form of *Sharī'ah* standards created by the Oireachtas or Central Bank, or *ex post* by the courts - involves the official assumption by Irish authorities of a particular view on what is required in order for temporal transactions to comply with the dictates of religious doctrine. In Islamic countries such as Malaysia and Pakistan, the endorsement of an interpretation of Islamic law and the development of rules and guidelines which adhere to that interpretation

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[187] *Temple Street v D. & Anor* [2011] IEHC 1.
[188] *ibid.*, at [29].
[189] *His Holiness Sant Baba Singh Ji Maharaj v Eastern Media Group Limited and Singh* [2010] EWHC 1294 (QB), at [5].
[190] *McFarlane v Relate Avon Limited* [2010] EWCA Civ 880 at [23].

is a predictable approach to regulation. In a non-Islamic country, there is no legitimate reason why the Government should endorse any one of multiple possible interpretations. As An-Na'im has noted,

> given the diversity of opinions among Muslim jurists, whatever the state elects to enforce as positive law is bound to be deemed an invalid interpretation of Islamic sources by some of the Muslim citizens of the state.[191]

This view could be extended to include not simply Muslim citizens in Ireland but international parties considering Ireland as a domicile for Islamic financial activity. The validity and impact of a contract, the rights arising out of it and the remedies available to the parties will thus be determined by the laws of Ireland. To conclude otherwise would give an executive, legislature and judiciary, with no religious mandate, the power to make enforceable determinations on matters of conscience.[192]

10.3 Private Determination of *Sharī'ah*-Compliance

The absence of official, Government-level endorsement of *Sharī'ah* standards - either by the legislature, executive or by the courts - does not mean that parties to an Islamic finance transaction cannot ensure external *Sharī'ah* supervision of their activities. There are two possible avenues which can be considered as mechanisms for devolving the determination of *Sharī'ah* standards away from the organs of Government and into private hands. The first is to facilitate *Sharī'ah* supervision through the terms of the contract (10.3.1),[193] while the second is to rely on the expertise of an institutional SSB (10.3.2).[194] It will be argued in this section that such measures may prove to be effective and uncontroversial mechanisms for facilitating *Sharī'ah* supervision within an Irish Islamic finance industry.

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[191] An-Na`im, Abdullahi Ahmed, "Shari'a and Positive Legislation: is an Islamic State Possible or Viable?", in *Yearbook of Islamic and Middle Eastern Law*, vol. 5 (1998-1999), Eugene Cotran and Chibli Mallat, (ed.), The (Kluwer Law International, Hague, 2000), 29-42 at 35.

[192] Muneeza, Aishath, Wisham, Ismail and Hassan, Rusni, "The Paradox Struggle Between the Islamic and Conventional Banking Systems", (2010) 1(2) *Journal of Asia Pacific Studies*, 188-224 at 218, Bälz, Kilian, Islamic Finance for European Muslims: The Diversity Management of Shari'ah-Compliant Transactions, (Winter 2007) 7(2) *Chicago Journal of International Law*, 551-567 at 564.

[193] *infra.* at 412.

[194] *infra.* at 425.

10.3.1 Contractual Mechanisms for Facilitating *Sharī'ah* Supervision

Subsection 10.2.2 above discussed the unwillingness of the judiciary (in the UK and potentially in Ireland) to determine the *Sharī'ah* standards to which an Islamic finance contract should be subject.[195] Because, according to the English courts, it is impossible to have a contract governed by *Sharī'ah* and for the courts to determine the content of Islamic financial standards, it is impossible for the courts to conclude whether a particular activity is in violation of Islamic law. If a similar stance was adopted by the Irish courts, Islamic finance arrangements which confer the Irish courts with jurisdiction over disputes would need to be structured so as to ensure that even if the contract is enforced and interpreted in accordance with a law other than *Sharī'ah*, the effect and impact of the contract remains *Sharī'ah*-compliant and the parties can be held to *Sharī'ah* standards.

A number of contract-based approaches can be adopted in order to ensure that a transaction will be subject to the rules of Islamic law without the Irish judiciary having to determine what those rules are. The effect of these mechanisms is close to that which would have been achieved if the courts acted as religious supervisors. However, these mechanisms circumvent the judiciary's refusal to arrogate to *itself* the power to determine the content of Islamic law. Four contractual mechanisms will be considered: choice of an Islamic country's law as the governing law of the contract (A),[196] reference to *Sharī'ah*-compliance in the constitutional documents of a company participating in Islamic financial activity (B),[197] incorporation of specific Islamic legal provisions (C)[198] and use of an arbitration clause (D).[199]

A. Choice of an Islamic Country's Law

The disembodied nature of *Sharī'ah* could be overcome by the parties choosing, as the governing law of the contract, the law of a country where Islamic principles form part of the legal system. The key example of such a country is Saudi Arabia where

[195] Both on the basis that Islamic law could not be the governing law of the contract and that Islamic law was, in any event, too amorphous and unsettled to allow the courts to determine what *Sharī'ah* standards are applicable in any given contract.

[196] *infra.* at 412.

[197] *infra.* at 416.

[198] *infra.* at 418.

[199] *infra.* at 420.

constitutionally, *Sharī'ah* forms the law of the land.[200] Based on the Hanbali school of Islamic thought, the law applied in Saudi Arabia is *Sharī'ah*.[201] A contract which is subject to the law of Saudi Arabia will thus be governed by Islamic law.[202] Irish courts have not yet dealt with such a contract but English courts have.[203] In *Abdel Hadi Abdallah Al Qahtani & Sons Beverage Industry Co v Antliff* [204] the English High Court was called upon to interpret an employment contract which was subject to Saudi Arabian law. Noting that in Saudi Arabia

> [t]here is no codified Civil or Penal Code....The Labour Code deals only with employment relations. If this case was being tried in Saudi Arabia it would be tried in the Sharia Court according to Sharia law,[205]

HHJ Hirst QC received expert evidence from two specialists in Saudi Arabian law.[206] This involved an extended discussion of the principles of *Sharī'ah* as practiced in Saudi Arabia, in which the judge outlined the sources of *Sharī'ah* and the reliance of Saudi judges on the writings of Hanbali jurists.[207] Both experts quoted different verses of the *Qur'ān* and sections of the *Sunnah* in an attempt to justify their particular understanding of the law.[208] Because of this disagreement, HHJ Hirst QC had to decide which interpretation would, "on the balance of probabilities,"[209] most likely be applied by the Saudi *Sharī'ah* Court.[210] In

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[200] Vogel, Frank E., *Islamic law and legal system: studies of Saudi Arabia*, (Brill, Leiden, 2000), at xiv noting that "Western law and legal conception have never invaded the essential core of the Saudi legal system."

[201] Esmaeili, Hossei, "On a Slow Boat towards the Rule of Law: The Nature of Law in the Saudi Arabia Legal System", (2009) 26 *Arizona Journal of International & Comparative Law* 1-48 at 7. As Vogel has noted; "[u]nder the law of Saudi Arabia, it is not the case that the court's result is the law of the land, or Saudi law, while the mufti's is another law upheld due to state-condoned private ordering, as in the instance of commercial arbitration. Instead, both are Saudi law, both the law of the land. Any *fiqh* opinion authoritatively rooted in the Koran and Sunna is Saudi law, because it is a valid statement of sharia, and Saudi law is nothing but sharia," Vogel, Frank E., *Islamic law and legal system: studies of Saudi Arabia*, note 200, at 8. See also; Hanlon, Gayle, "Saudi Arabia," in *The ABA guide to international business negotiations: a comparison of cross-cultural issues and successful approaches*, James R. Silkenat, Jeffrey M. Aresty, Jacqueline Klosek (eds), (3rd ed., American Bar Association, Illinois, 2009), 851-918.

[202] *Harley v Smith* [2010] EWCA Civ 78; [2010] C.P. Rep. 33 at [14].

[203] The US courts have also been called upon to adjudicate disputes governed by Saudi Arabian law, see for example, *Nat'l Grp. for Commc'ns & Computers v. Lucent Techs. Int'l*, 331 F. Supp. 2d 290, 292 (D.N.J 2004) in which a District Court noted that to award expectation damages "would be equivalent to placing a value on fish in the sea, or purchasing food that has not yet been weighed [i.e. gharar]," at 301.

[204] *Abdel Hadi Abd*Allah *Al Qahtani & Sons Beverage Industry Co v Antliff* [2010] EWHC 1735.

[205] *ibid.*, at [30].

[206] *ibid.*, at [29].

[207] *ibid.*, at [35] where Sahih Muslim is cited (presumably as the compiler of a *hadīth* collection rather than a *fiqh* writer) and [31] where Ibn Qudama is referred to.

[208] *ibid.*, at [36] et seq.

[209] *ibid.*, at [50].

[210] *ibid.*, at [50] et seq.

reaching this decision, the English courts had to adopt a particular position on Islamic legal principles. However, in doing so, HHJ Hirst QC (and by extension, the English court) was not deciding for himself what *Sharī'ah* law would require but was rather attempting to resolve the dispute as if he was the judge of an identified country in which a particular view of *Sharī'ah* is practiced. He was therefore deciding which interpretation of Islam was, *from a Saudi perspective*, most correct.[211]

If the Irish courts are willing to uphold a choice of Saudi Arabian law however, subjecting a contract to the law of Saudi Arabia requires the courts to enforce the contract according to a Saudi Arabian interpretation of *Sharī'ah*. Particularly for parties from other jurisdictions, this could be problematic as Saudi Arabian *Sharī'ah* may not be consistent with their own view of religious doctrine.[212] Other countries in the Middle East, such as Kuwait and the UAE, apply a more hybrid and codified version of Islamic law within their legal systems.[213] Legislation has been developed in a manner consistent with western jurisdictions yet the provisions of these laws incorporate *Sharī'ah* principles and are generally consistent with the teachings of Islam.[214] When a contract is governed by the laws of these states therefore, English courts have been willing to consider issues of *Sharī'ah* – through the use of experts and from the perspective of the governing law. In *Glencore International AG v Metro Trading International Inc (No.2)*[215] the High Court determined that the governing law of a contract was the law of Fujairah in the UAE.

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[211] See also; *Harley v Smith* [2010] EWCA Civ 78; [2010] C.P. Rep. 33 in which the Court of Appeal felt that a High Court judge who attempted to determine the meaning to be given to the phrase "work relation," under Saudi Arabian law, in the absence of evidence how the principles of *Sharī'ah* would impact on that interpretation, had gone beyond what he could properly do. "He purported to construe foreign legislation by applying principles of interpretation which had not been established by evidence," and had "in effect, decided for himself what *Shari'ah* law would require" at [50]. See however *Midland International Trade Services Ltd and Oths v Al-Sudairy and Oths* (Unreported), April 11, 1990, in which Hobhouse J noted that the court could order the payment of interest on a judgment of a court in Saudi Arabia even though a Saudi court would have applied *Sharī'ah* law.

[212] Al-Jumah, Khaled Mohammed, "Arab State Contract Disputes: Lessons from the Past", note 144, at 232.

[213] *supra.* at 44.

[214] The Kuwaiti Civil Code for example lists the sources of law available to judges when making a decision; statutory provisions (Article 1.1), custom and judges' personal reasoning (Article 1.2). When undertaking personal reasoning judges should rely on the principles of Islamic *fiqh* (jurisprudence) which are most in accord with "the reality and interests of the country." Article 2 of the Constitution of Kuwait 1962 states "[t]he religion of the State is Islam, and the Islamic *Shari'a* shall be *a* main source of legislation," (emphasis added). See also Article 7 of the Constitution of the United Arab Emirates 1971 (as amended 1996); "The Islamic Shari'ah shall be *a* main source of legislation in the Union" (emphasis added). Federal Law No. 5 of 1985 regarding the law of Civil Transactions in the UAE (the Civil Code). Al-Muhairi, Butti Sultan Butti Ali, "The Position of Shari'a within the UAE Constitution and the Federal Supreme Court's Application of the Constitutional Clause concerning Shari'a", (1996) 11(3) *Arab Law Quarterly* 219-244 in particular, 233, Saleh, Nabil, "Civil Codes of Arab Countries: The Sanhuri Codes", (1993) 8 *Arab Law Quarterly* 161-197, Saleh, Nabil, "The Law Governing Contracts in Arabia", (Oct., 1989) 38(4) *The International and Comparative Law Quarterly*, 761-787.

[215] *Glencore International AG v Metro Trading International Inc (No.2)* [2001] 1 All E.R. (Comm) 103.

Disagreement arose over the meaning of the word "*ghasb*" which was contained in the Fujairah Civil Code. Moore-Bick J noted that "ghasb is a concept developed by the Islamic jurists and the inclusion of loss by *ghasb* in Article 1326 is one manifestation of a general policy of islamicisation."[216] He then heard expert evidence, which included a discussion on how Islamic jurists would define the term, when interpreting the contract.

A choice of law in favour of an Islamic country other than Saudi Arabia may thus allow some elements of *Sharī'ah* to be applied to the resolution of a dispute but is unlikely to result in the contract being governed entirely by the dictates of Islam.[217] In practice, while the laws of countries such as the UAE are influenced by Islamic principles, they are not as rigidly Islamic as Saudi Arabia's laws[218] and so non-Islamic activities, such as the receipt of interest, are explicitly permitted in certain financial situations.[219] Similarly, if the contract is subject to Malaysian law, the parties may not be able to ensure that any disputes will be resolved in accordance with Islamic law, as caselaw has recently confirmed that Malaysia's civil courts must not attempt to determine what is, and what is not, *Sharī'ah*-compliant. Such determinations should be left to scholars who are "properly qualified in the field of Islamic jurisprudence"[220] while the civil courts should apply established principles of contract law when interpreting the agreements.[221]

The choice of an Islamic country's law as the governing law of a contract will be most effective, as a means of facilitating *Sharī'ah* supervision, when the country chosen is Saudi Arabia. In such circumstances the enforceability of the contract and the actions of the parties will be determined in accordance with the principles of *Sharī'ah*, as interpreted by a Saudi Court. By choosing the law of a *State*, the parties to that contract would avoid the European and common law restrictions on the use of a non-national governing law.

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[216] *ibid.*, at [113].

[217] See Shaaban, H. S. "Commercial Transactions in the Middle East: What Law Governs", (1999-2000) 31 *Law and Policy in International Business*, 157-172 at 166-168 for a discussion of the banking laws operating in various Islamic countries.

[218] McMillen, Michael J.T., "Islamic capital markets: developments and issues", (2006) 1(2) *Capital Markets Law Journal*, 136-172 at 156.

[219] Article 76 of UAE Federal Law No. 18 of 1993 which notes that; "A creditor is entitled to receive interest on a commercial loan as per the rate of interest stipulated in the contract. If such rate is not stated in the contract, it shall be calculated according to the rate of interest current in the market at the time of dealing, provided that it shall not exceed 12% until full settlement." Baamir, Abdulrahman Yahya, *Shari'a Law in Commercial and Banking Arbitration; Law and Practice in Saudi Arabia*, (Ashgate Publishing Limited, Surrey, 2010), at 175-179. See also, *Broda Bank v Abu Dhabi Electronic and Commercial Co.*, (1989) 4 *International Lawyers' Newsletter*, 8-9 in which bank interest was distinguished from *ribā*, referred to in Badr, Gamal M., "To the Editor", (1989) 37(2) *The American Journal of Comparative Law*, 424-425 at 425.

[220] *Bank Islam Malaysia Bhd v Lim Kok Hoe* [2009] 6 CLJ 22, [2009] 6 MLJ 839 at [32].

[221] *ibid.*, at [28].

B. *Sharī'ah*-Compliance and Constitutional Documents of a Company

The Investment DAR Company KSCC v Blom Development Bank SAL [*TID v Blom*][222] represents the English court's most recent consideration of Islamic finance contracts. The contract in dispute was a master *wakāla*, or agency agreement entered into between Blom, the *muwakkil* (depositor) and the TID, acting as *wakeel* (agent). The claimant failed to pay under the terms of the contract and the defendant issued proceedings by way of summary judgment in the High Court seeking return of the original sum paid plus anticipated profit. Following summary proceedings TID appealed, seeking a full trial of the issue. In its defence, the claimant argued that the agreement between the parties was not *Sharī'ah*-compliant; it was simply a deposit with a bank that paid interest and was thus unenforceable.[223] However, the *wakāla* contract was explicitly subject only to English law.[224] It also contained a provision under which the claimant accepted its *Sharī'ah* board's conclusion that the activity was *Sharī'ah*-compliant and agreed that it would not "at any time assert that any provision [of the *wakāla* agreement] or any transaction effected pursuant hereto contravenes the Sharia."[225] The basis for the claimant's argument that the contract was unenforceable for want of *Sharī'ah*-compliance was therefore the fact that its own memorandum of association stated that

> [t]he objectives for which the company is established shall be *Sharia* compliant. None of the objectives shall be construed and interpreted as permitting the company to practice directly or indirectly any usury or non-Sharia compliant activities.[226]

The transactions entered into pursuant to the purportedly non-*Sharī'ah*-compliant *wakāla* agreement were *ultra vires* the company as it never had the capacity to enter into the

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[222] *The Investment DAR Company KSCC v Blom Development Bank SAL* [2009] EWHC 3545 (Ch)

[223] *ibid.*, at [16].

[224] *ibid.*, at [3].

[225] *ibid.*, at [10], citing Clause 5.4 of the Master Wakāla Contract. Clauses excluding a claim of non-Shari'ah-compliance are not unusual in commercial contracts which are marketed as Shari'ah-compliant, see; the ISDA/IIFM launch Tahawwut Master Agreement which attempts to estop claims that the contract is unenforceable for non-Shari'ah-compliance, discussed in detail in Barwise, David, Rascoe, Olivia and York, Ingrid, *ISDA/IIFM launch Tahawwut Master Agreement*, White & Case Insights: Derivatives, September 2010, available at: http://www.whitecase.com/files/Publication/9446775f-ab73-45e4-9431-fc8ca9765529/Presentation/PublicationAttachment/378e2415-b4ab-49c3-9c3f-02a221de1d18/alert_ISDAIIFM_Launch.pdf, Bälz, Kilian, "Sharia Risk? How Islamic Finance Has Transformed Islamic Contract Law", note 70, at 23.

[226] *The Investment DAR Company KSCC v Blom Development Bank SAL* [2009] EWHC 3545 (Ch), at [10], citing Article 5 of TID's Memorandum of Association.

contract in the first place.[227] Master Bragge, at first instance, was "not especially impressed"[228] with the claimant's argument, while HHJ Purle QC in the appeal noted that the defence "is a lawyer's construct"[229] which should be approached with "appropriate scepticism."[230] Nevertheless, both the Master and Judge concluded that a triable issue had been shown and HHJ Purle QC determined that a full hearing was justified.

Contrary to what some commentators have suggested,[231] *TID v Blom* did not involve the English courts determining issues of *Sharī'ah*-compliance and it did not contradict the decisions in *Symphony Gems* and *Shamil Bank*. However, the case indicates a potential mechanism by which parties can, through contract, indirectly facilitate the enforcement of Islamic legal principles. In reality, the issue of whether a company has the capacity to enter into a transaction is determined in England by the law of the country in which that company is incorporated.[232] In *TID v Blom*, the claimant was incorporated in Kuwait. As a result, the question of whether TID had capacity to enter into the contract was to be determined in accordance with Kuwaiti law, through the use of expert evidence. The High Court simply did not have the competence, without the help of experts at full trial, to decide how Kuwaiti law would treat TID's defence and whether a Kuwaiti court would conclude that TID did not have the requisite capacity to enter into the transaction. This would inevitably involve the trial judge hearing evidence on whether a Kuwaiti court would consider the *wakāla* agreement to be *Sharī'ah*-compliant for the purposes of Kuwaiti company law. If the Kuwaiti courts were willing to accept the claimant's defence and find that the contract was *ultra vires* and so unenforceable, there would be no contract for the English courts to enforce. As a result, the non-*Sharī'ah*-compliance of the transaction would, indirectly, determine the extent to which the parties could be bound by the underlying contract.

In Ireland, the Supreme Court in *Kutchera v Buckingham International Holdings Ltd*[233] confirmed that questions relating to a company's capacity are governed by the law of the

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[227] *ibid.*, at [16]. Proctor, Charles, *The Law and Practice of International Banking*, (Oxford University Press, Oxford, 2010), at 792.

[228] *The Investment DAR Company KSCC v Blom Development Bank SAL* [2009] EWHC 3545 (Ch), at [16].

[229] *ibid.*, at [17].

[230] *ibid.*, at [17].

[231] Proctor, Charles, *The Law and Practice of International Banking*, note 227, at 792.

[232] Redfern, Alan, *Law and Practice of International Commercial Arbitration*, (Sweet & Maxwell, London, 2004), at 146, Rammeloo, Stephan, *Corporations in Private International Law: a European Perspective*, (Oxford University Press, Oxford, 2001), at 127.

[233] *Kutchera v Buckingham International Holdings Ltd* [1988] 1 IR 61.

country of incorporation, even if the transaction as a whole is governed by Irish law.[234] Where an institution is incorporated in a country in which the *ultra vires* doctrine is enforceable against third parties,[235] the failure of that institution to act in accordance with its constitutional documents may be a ground for avoiding the contract *ab initio*. Where the articles of association or memorandum of the company provide that it will act in accordance with Islam, non-compliant activity would be outside its capacity and may be treated as *ultra vires* under the law of the jurisdiction of incorporation.

The effect of this mechanism in an Islamic finance contract brought before the Irish courts would be to ensure that even though a contract is subject to Irish law, the actions of the parties will still be considered in light of their compatibility with *Sharī'ah*. The content of those *Sharī'ah* standards are not, however, determined by the Irish courts but by the courts of the country of incorporation as proved by expert evidence.

C. Incorporation of Specific Islamic Legal Principles

The Court of Appeal in *Shamil Bank* suggested that a reference in a contract simply to "*Sharī'ah*" was too vague and undefined to incorporate terms of Islamic law. However, noting that if the "Sharia law proviso *were* sufficient to incorporate the principles of Sharia law into the parties' agreements, the defendants would have been likely to succeed,"[236] the court appears to have been of the view that a reference to more specific *Sharī'ah* dictates within the terms of the contract may be sufficient to incorporate them into that contract.[237]

The Irish courts have acknowledged the validity of incorporation of foreign legal provisions into Irish law contracts[238] and in the context of *Sharī'ah*, incorporation could occur in two situations. The first is through the incorporation directly into the contract of

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[234] *ibid.*, at 68 per Walsh J

[235] In *Symphony Gems* the *ultra vires* argument was dismissed as the law in the Bahamas was the same as that in the UK under which *ultra vires* was not a defence against third parties acting in good faith, *Islamic Investment Company of the Gulf (Bahamas) Ltd. v Symphony Gems N.V. & Ors*, The London High Court, 13th February 2002, 2001, 2001 Folio 1226 per Justice Tomlinson, 2002 West Law 346969, QBD (Comm. Ct.). Page 11-13 of the judgment, *supra.* at 394.

[236] *Shamil Bank of Bahrain EC v Beximco Pharmaceuticals Ltd* (No.1) [2004] EWCA Civ 19; [2004] 1 W.L.R. 1784 (CA (Civ Div)), at 1801.

[237] DeLorenzo, Yusuf Talal and McMillen, Michael JT., "Law and Islamic Finance: An Interactive Analysis", in *Islamic Finance, The Regulatory Challenge*, note 105, at 168.

[238] See for example, *Griffin v Royal Liver Friendly Society* [1942] Irish Jurist Reports 29 at 32, *MacNamara v Owners of the SS "Hatteras"* [1931] 65 I.L.T.R 8 incorporating the Harter Act into a Bill of Lading, Binchy, William, *Irish Conflicts of Law*, note 48, at 523-524.

specific Islamic principles which the parties wish to comply with.[239] These would become provisions of an Irish law contract which the courts could interpret using established adjudicative mechanisms. As the principles derived from *Sharī'ah* would not be anational foreign rules, but rather terms of the Irish law contract which the parties have agreed to be bound by, expert evidence would not automatically be needed by the courts. Instead, judges could interpret the provisions just like any other provision of the contract; where the parties fail to comply with these terms they will have breached the contract. By reducing specific rules of Islamic law to black letter contractual terms, the parties could secure greater compliance with Islam, while eliminating the uncertainty produced by multiple interpretations of Islamic law.[240]

There are already indications of this approach emerging in Ireland. While all contracts entered into in relation to the Oasis Investment Fund are subject to Irish law,[241] the Fund's prospectus sets out specific principles of *Sharī'ah* with which the Fund undertakes to comply. Appendix II notes that

> Shari'ah principles dictate that the Company may not invest in companies which conduct their core business in Shari'ah prohibited activities. These activities may include conducting business in relation to alcohol, entertainment (pornography, gambling etc) pork-related products and companies whose major source of income is generated by interest. Companies that operate with a high level of debt or are associated with interest bearing securities and high levels of accounts receivable or gearing may also be excluded from the Company's investment universe.[242]

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[239] Junius, Andreas, "Islamic Finance: Issues Surrounding Islamic Law as a Choice of Law under German Conflict of Laws Principles", note 118, at 549 noting that "[i]f...the contractual parties intend to incorporate individual principles of Islamic law into the contract, this has to be done in a concrete, specific manner, whether by specific reference to individual rules of *Shari'ah* (which would need to be spelled out) or by incorporating their specific content into the agreement as such."

[240] Hussain, Mustafa, "Letters of wishes, *Shamil Bank* of Bahrain v Beximco Pharmaceuticals Limited and Others [2003] EWHC 2118 (Comm)", (2008) 14 (7) *Trusts & Trustees* 493-494 at 494.

[241] Oasis Crescent Global Investment Fund (Ireland) plc, *Investment Form*, notes at 3 that "All contracts are governed by Irish law."

[242] Oasis Crescent Global Investment Fund (Ireland) plc, *Prospectus*, (Dublin, 30 September 2010), at 15.

By setting out the investment strategy of the Fund, Oasis has reduced to writing the particular dictates of Islamic law under which it operates and against which its activities will be considered.

Another method which could result in the incorporation of *Sharī'ah* would be to specify in the contract that the AAOIFI standards have been incorporated into its provisions.[243] If successful, this could result in the Irish courts interpreting an Irish law contract in a manner consistent with these standards. Although this approach was not mentioned in *Shamil Bank* it is suggested that with the mounting prominence of AAOIFI in the Islamic finance industry and the growing sophistication of its Islamic finance standards in the seven years since the *Shamil Bank* decision, these standards may now be able to provide a codified set of norms which can be incorporated into a contract as terms of that contract. Whether courts in England or Ireland would accept reference in a contract to AAOIFI principles as a valid incorporation of AAOIFI standards remains uncertain.[244] However, as these standards appear to fulfil the conditions necessary for incorporation which were set out by Lord Potter,[245] this option could prove to be a viable method of incorporating the principles of *Sharī'ah* into an Irish (or English) law contract.

D. Arbitration

The final means by which parties could draw elements of *Sharī'ah* into an Islamic finance contract, without requiring official endorsement of Islamic principles by the organs of the Irish Government, would be to subject any disputes arising out of that contract to arbitration.[246] Arbitration is explicitly excluded from the Rome regime[247] and in England and Ireland, arbitrations are subject to their own legislative frameworks.[248] In both

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[243] That is, the AAOIFI *Shari'a Standards for Islamic Financial Institutions* (AAOIFI, Bahrain, 2010) and the AAOIFI *Accounting, Auditing and Governance Standards for Islamic Financial Institutions* (AAOIFI, Bahrain, 2010) both of which contain the black letter rules of the AAOIFI pronouncements.

[244] Hainsworth has suggested that it may be possible when he notes that "[t]o the extent that principles contained in either AAOIFI or ISB guidelines are expressly incorporated into a contract, whether directly *or by reference*, then they may be taken into account by an English court in determining the intentions of a party in entering into a contract," Butterworths, "Islamic Financial Institutions and Islamic Finance", *Encyclopaedia of Banking Law, Division F1*, Antony Hainsworth, (ed), at [118](ii), (emphasis added).

[245] This test is set out *supra.* at 407

[246] de Vries, Henry, "International Commercial Arbitration: A Contractual Substitute for National Courts", (1982) 57 *Tulane Law Review*, 42-79, at 42-43 describing arbitration as "a mode of resolving disputes by one or more third persons who derive their power from agreement of the parties and whose decision is binding upon them" and at 43 noting that "[a]rbitration has long been a favored means of resolving disputes among members of organized commercial groups in the trading countries of the West."

[247] Section 2(2)(e) Rome Regulation 2008.

[248] UK: Arbitration Act 1996 (c.23), Ireland: Arbitration Act 2010, (Number 1 of 2010).

jurisdictions, the law applying to arbitration is noticeably less restrictive than that applying to court proceedings. Arbitrators are not therefore bound by the territoriality requirement that is applied to a governing law when a contractual dispute is resolved by a court.[249] As a result, arbitrators can interpret a contract, resolve a dispute and determine the rights and liabilities of the parties through the application of anational and supranational sets of rules. In the UK this has allowed the application of principles of non-national legal systems, including *Sharī'ah*, in order to resolve a dispute.[250]

In *West Tankers Inc v. RAS Riunione Adriatica di Sicurta SpA*[251] the House of Lords confirmed that arbitrations could be subject to non-national rules giving arbitrators "the right to act as *amiables compositeurs*, apply broad equitable considerations, even a *lex mercatoria* which does not wholly reflect any national system of law. The principle of autonomy of the parties should allow them these choices."[252] In *Al-Midani v Al-Midani*[253] the High Court held that while the decision of the Islamic Shari'a Council of London [ISC] was not binding on the plaintiffs, as all parties had not consented to the ISC's jurisdiction, the proper law of the arbitration agreement was "either Shari'a law or such law as modified by Saudi law."[254] The court was therefore willing to acknowledge that the resolution of the dispute could be determined by an arbitrator in accordance with the principles of Islamic law.[255] S.46(1)(b) of the UK Arbitration Act 1996[256] now provides that an arbitral tribunal shall resolve a dispute in accordance with the law chosen by the parties or "if the parties so

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[249] Al-Jumah, Khaled Mohammed, "Arab State Contract Disputes: Lessons from the Past", note 144, at 231.

[250] Blackaby, Nigel and Partasides, Constantine, Redfern and Hunter, *Law and Practice of International Commercial Arbitration,* (5th ed., student edition, Oxford University Press, Oxford, 2009), at 188. The application of Islamic law in arbitration proceedings has also found favour in other jurisdictions such as Malaysia where the Kuala Lumpur Regional Centre For Arbitration has developed "The Rules for Arbitration of Kuala Lumpur Regional Centre for Arbitration (Islamic Banking and Financial Services) 2007," available at: http://www.klrca.org.my/upload/Islamic_Banking_Rules_for_Islamic_Banking_&_FS_2007.pdf.

[251] *West Tankers Inc v. RAS Riunione Adriatica di Sicurta SpA* [2007] APP.L.R. 02/21.

[252] *ibid.*, at [17] per Lord Hoffman.

[253] *Al-Midani v Al-Midani* [1999] C.L.C. 904.

[254] *ibid.*,at 912. Douglas, Gillian, Doe, Norman, Gilliat-Ray, Sophie, Sandberg, Russell and Khan, Asma, *Social Cohesion and Civil Law: Marriage, Divorce and Religious Courts, Part One: The Regulation of Religion and Religious Law in England and Wales*, Cardiff University, (December 2010), at 18 noting that the case "does not mean an Islamic court or tribunal can never operate under the Arbitration Act. As the High Court made clear, that the ISC was not '*in this instance at any rate*, an arbitral tribunal' (*Al-Midani v Al-Midani* [1999] C.L.C. 904 at 913). There is now at least one clear example of an Islamic court operating under the Arbitration Act 1996: the Muslim Arbitration Tribunal (MAT)," (emphasis in original.)

[255] See also *Sanghi Polyesters Ltd. (India) v. The International Investor KCFC (Kuwait)* [2000] 1 Lloyd's Rep. 480 in which the court considered an appeal from an arbitral decision. The issue, according to the court was whether the contract was "invalidated in the manner claimed . . . under Shari'a law," (at [14]) which the court concluded there was not (at [30]-[33]).

[256] Arbitration Act 1996 (c.23) (UK).

agree, in accordance with such other considerations as are agreed by them...."[257] The "other considerations" to which the section refers have been interpreted by many as including non-national rules. In *Halpern v Halpern*[258] the court confirmed the relevance of this provision to disputes involving religious rules and suggested that if parties want their contract governed by rules which are not those of a country, "then it is open to them to so agree, provided that there is an arbitration clause."[259] In *Musawi v. R E. International UK Limited*,[260] Richards J confirmed the common law view that the proper law of a contract needs to be the law of a country. However, he went on to note that any disputes in relation to the contract could be decided by arbitration in accordance with *Sharī'ah*.[261] The implication of this decision is that the English courts have confirmed their willingness to uphold an arbitration clause in a contract which provides for the resolution of disputes under Islamic law.[262] While the contract which contains the arbitration clause must be governed by the law of a country, the rules applied by the arbitrator when resolving a dispute do not need any territorial connection.

In 2010 Ireland adopted a new consolidated arbitration regime under which the Arbitration Act 2010[263] applies the UNCITRAL Model Law to all arbitrations in Ireland.[264] Article 28 of Schedule 1 of the Act, which sets out the text of the Model Code, provides that

> [t]he arbitral tribunal shall decide the dispute in accordance with such *rules of law as are chosen by the parties* as applicable to the substance of the dispute.[265]

It goes on to confirm that "[i]n all cases, the arbitral tribunal shall decide in accordance with the terms of the contract and shall take into account the usages of the trade applicable

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[257] Section 46(1)(b) Arbitration Act 1996.

[258] *Halpern v Halpern* [2007] EWCA Civ 291.

[259] *ibid.*, at [37].

[260] *Musawi v. R E. International (UK) Limited* [2007] EWHC 2981.

[261] The court quoted *Dicey, Morris & Collins on the Conflict of Laws* (14th ed., Sweet and Maxwell, London, 2006) which notes that section 46(1)(b) Arbitration Act 1996 "allows the parties the freedom to apply a set of rules or principles which do not in themselves constitute a legal system. Such a choice may thus include a non-national set of legal principles (such as the 1994 UNIDROIT Principles of International Commercial Contracts) or, more broadly, general principles of commercial law or the *Lex Mercatoria*."

[262] Sandberg, Russell, "Musawi v R E International (UK) Ltd & (and) ORS", (2008) 160 *Law & Justice - Christian Law Review*, 67-69 at 68.

[263] Arbitration Act 2010 (No. 1 of 2010) (Irl).

[264] Doyle, John, *A New Era for Arbitration in Ireland; The* Arbitration Act *2010*, (Dillon Eustace, Dublin, 2010), available at: http://www.dilloneustace.ie/download/1/A New Era for Arbitration in Ireland.pdf.

[265] Schedule 1, Article 28(1) Arbitration Act 2010 (emphasis added).

to the transaction."[266] Numerous other countries whose arbitration legislation is based on the Model Law have introduced similarly broad provisions.[267] While not explicitly endorsing the use of anational principles, Article 28 of the Model Law, which is reproduced in the Irish legislation, has been acknowledged as permitting parties to choose a wide range of supranational instruments or denationalised norms.[268] In light of the similarities between the Irish and English legislation, it is suggested that if parties to a financial transaction in Ireland want disputes resolved in accordance with the principles of Islam, an arbitration clause which provides for the application of such rules could be an effective approach.[269] Once issued, the arbitral decision and award will be binding on the parties and enforceable by the Irish courts.[270] Only in limited, prescribed situations can the award be set aside.[271] This gives parties to the transaction the assurance that disputes which arise out of their contracts will be determined by the arbitrator in accordance with the teachings of Islamic law and that the Irish courts are likely to uphold and enforce such an arbitral decision.

Reinforcing the suitability of arbitration as a means of facilitating external *Sharī'ah* oversight of contractual arrangements, this form of dispute resolution has been explicitly authorised by the *Qur'ān*[272] and the inclusion of an arbitration clause in an agreement has been endorsed by the schools of Islamic thought.[273] The requisite characteristics of an arbitrator in a dispute have also been outlined in the Islamic *fiqh* providing parties with a

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[266] Schedule 1, Article 28(4) Arbitration Act 2010.

[267] Erdem, Ercüment and Süral, Ceyda, "In support of *Lex Mercatoria*," (April 2009) *International Financial Law Review*, Special supplement on Turkey, 9-10 at 9 noting that arbitration laws of the Netherlands, France, Germany, Russia and Italy are in line with the Uncitral Model Law, Lynch, Katherine L., *The Forces of Economic Globalization: Challenges to the Regime of International Commercial Arbitration*, (Kluwer Law International, The Hague, 2003), at 325-326.

[268] Summary Records of the United Nations Commission on International Trade Law for meetings devoted to the preparation of the UNCITRAL Model Law on International Commercial Arbitration, 326th Meeting, Monday, June 17, 1985 at which wide support was expressed for a broad reading of Article 28. Fouchard, Philippe, Gaillard, Emmanuel, Goldman, Berthold and Savage, John, *Fouchard, Gaillard, Goldman on International Commercial Arbitration* (Kluwer Law International, the Hague, 1999), at 50, Anglade, Leila, "The Use of Transnational Rules of Law in International Arbitration", (2003) 38 *Irish Jurist* 92-123 at 260.

[269] Anglade, Leila, "The Use of Transnational Rules of Law in International Arbitration", note 268, at 115 noting that even prior to the adoption of the UNCITRAL Rules, if the parties agreed, "arbitrators [in Ireland] are relieved from the duty to apply conflicts of law rules and they may choose to apply transnational rules."

[270] Schedule 1, Article 35 Arbitration Act 2010, No. 1 of 2010.

[271] Schedule 1, Article 36 Arbitration Act 2010, No. 1 of 2010.

[272] *Qur'ān* 4:35; "If ye fear a breach between them twain, appoint (two) arbiters, one from his family, and the other from hers; if they wish for peace, God will cause their reconciliation: For God hath full knowledge, and is acquainted with all things." Kutty, Faisal, "The Shari'a Factor in International Commercial Arbitration", (2006) 28 *Loyola Los Angeles International and Comparative Law Review*, 565-642 at 590.

[273] Baamir, Abdulrahman Yahya, *Shari'a Law in Commercial and Banking Arbitration; Law and Practice in Saudi Arabia*, note 219, at 75, Hoyler, Mark, "Specific Issues in Islamic Dispute Resolution", (2009) 75 *Arbitration* 219-222 at 221.

set of criteria against which they can determine whether an arbitrator is suitably qualified to resolve an Islamic finance dispute. The arbitrator must be a Muslim,[274] competent,[275] prudent,[276] honest,[277] impartial[278] and sufficiently knowledgeable in *Sharī'ah*[279] to be able to resolve the dispute in a manner which is consistent with *Sharī'ah*.

Though of only persuasive authority in Ireland, the confirmation by the UK Supreme Court in July 2011 that an arbitration agreement may validly stipulate that the arbitrator must be of a specific religious affiliation,[280] is yet another element of arbitration which is amenable to facilitating *Sharī'ah* oversight. Arbitration thus provides parties with the opportunity to choose an arbitrator who has expertise in Islamic law and who will be able to apply that knowledge in resolving a dispute according to the principles of *Sharī'ah*. As such, it represents the most effective means by which parties in *Sharī'ah*-compliant financial activity can prioritise adherence to Islamic law and ensure that disputes are resolved in accordance with that law.[281]

Through careful contract drafting, the parties to an Islamic finance transaction brought before the Irish courts may be able to compensate for the absence of official *Sharī'ah* supervision in Ireland. In the absence of precedent, it is impossible to determine how the Irish courts would react to private attempts to ensure that Islamic law is enforced. The limited number of relevant cases in the UK suggests that such measures may be effective. However, this type of supervision will only be applicable should a dispute arise between the parties to the contract. Before this point is ever reached, private *Sharī'ah* supervision in the form of an SSB is a widely used means of subjecting Islamic finance activity to regular *Sharī'ah* oversight. These boards will be considered in subsection 10.3.2.

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[274] Al-Kenain, A., *Altahkeem fe AlShari'a AlIslamiyah: Altahkeem Al'am, wa Altahkeem fe Alshiqaq Alzaouji* (1st ed, Dar al Ismah, 2000), at 58 referred to in Baamir, Abdulrahman Yahya, *Shari'a Law in Commercial and Banking Arbitration; Law and Practice in Saudi Arabia*, note 219, at 78.

[275] Al-Kenain, A., *Altahkeem fe AlShari'a AlIslamiyah: Altahkeem Al'am, wa Altahkeem fe Alshiqaq Alzaouji* (1st ed, Dar al Ismah, 2000), at 61 referred to *ibid.*, at 79.

[276] Ibn Qudama, Almughni, (1st ed, Hajar Publications, 1992, Vol. 14), at 170, referred to *ibid.*, at 79.

[277] Saleh, Samir, *Commercial Arbitration in the Arab Middle East: Shari'a, Syria, Lebanon and Egypt* (2nd ed., Heart Publishing, 2006), at 36.

[278] Baamir, Abdulrahman Yahya, *Shari'a Law in Commercial and Banking Arbitration; Law and Practice in Saudi Arabia*, note 219, at 82.

[279] Almawardi, A., *Adab Alqadi*, (4th ed., Dar Al ani Liltiba'a Publishers, 1972, Vol. 2), at 380, referred to *ibid.*, at 79.

[280] *Jivraj v Hashwani* [2011] UKSC 40. See also Dowell, Katy, "Arbitration ruling shields London status", *The Lawyer*, August 1, 2011, available at: http://www.thelawyer.com/arbitration-ruling-shields-london-status/1008804.article.

[281] Vogel, Frank and Hayes, Samuel, *Islamic Law and Finance: Religion, Risk, and Return*, (Kluwer Law International, the Hague, 1998), at 51.

10.3.2 *Sharī'ah* Supervision at Institutional Level

Micro or institutional-level *Sharī'ah* governance and supervision has assumed a pivotal position within the Islamic finance industry.[282] In Ireland, it is suggested that day-to-day *Sharī'ah* supervision of Islamic finance transactions will be devolved primarily to institutions involved such transactions. With institutions themselves overseeing compliance with *Sharī'ah*, this supervision will almost certainly take the form of institutional SSBs and advisers.[283] Conducted by experts in Islamic finance and Islamic jurisprudence,[284] institutional *Sharī'ah* supervision oversees and directs the activities of relevant market participants in order to ensure that they are compatible with the teachings of Islamic law.[285] Frequently described as one of the most important elements of the Islamic finance industry,[286] institutional *Sharī'ah* supervision of Islamic financial activity acts to legitimate that activity and in doing so, significantly reduces *Sharī'ah*-compliance risk[287] or the risk uniquely faced by the Islamic finance industry that "the terms agreed in a contract do not effectively comply with Islamic jurisprudence and thus are not valid under Islamic law."[288] Without the endorsement of *Sharī'ah* supervisory authorities, the actual and perceived *Sharī'ah*-compliance of a transaction may be undermined, threatening the acceptability of the product to Muslims.[289]

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[282] Iran represents the only country in which Islamic finance is present that supervision occurs exclusively at macro level. State Bank of Pakistan, *Strategic Plan for Islamic Banking Industry in Pakistan*, Appendix-C, "Shariah Compliance", at 1; available at: http://www.sbp.org.pk/departments/pdf/StrategicPlanPDF/Appendix-C Shariah Compliance.pdf, reviewing the approaches to Shari'ah supervision implemented in different jurisdictions, van Greuning, Hennie and Iqbal, Zamir, *Risk analysis for Islamic banks*, (World Bank Publications, Washington DC, 2008), at 192.

[283] Ercanbrack, Jonathan, "The Regulation of Islamic Finance in the United Kingdom", (2011) 13 *Ecclesiastical Law Journal*, 69-77 at 20.

[284] Thomas, Abdulkader, "Understanding the Shari'a process", in *Structuring Islamic Finance Transactions*, Abdulkader Thomas, Stella Cox and Bryan Kraty, (eds), (Euromoney Books, London, 2005), 32-44 at 33.

[285] Hainsworth, Antony, "Governance rules for Islamic financial institutions: the new frontier?", (2007) 22(9) *Journal of International Banking and Financial Law*, 515-520 at 515.

[286] See for example, Hasan, Aznan, "The role of Shari'a advisers in the development and enhancement of Islamic securities", in *Euromoney Encyclopedia of Islamic Finance*, Aly Khorshid, (ed.), (Euromoney Books, London, 2009), 49-69 at 49 noting that "Shari'a advice has long been accepted as one of the most important ingredients in the development of Islamic finance."

[287] DeLorenzo, Shaykh Yusuf Talal, "Shari'ah-compliance Risk", note 4, at 398.

[288] Solé, Juan, "Islamic Banking Makes Headway", (September 19, 2007), *IMF Survey Magazine: IMF Research*, available at: http://www.imf.org/external/pubs/ft/survey/so/2007/RES0919A.htm, Akhtar, Shamshad, "Shariah Compliant Corporate Governance", (April-June 2007) 24(2) *Journal of Islamic Banking & Finance*, 9-17 at 10.

[289] Hasan, Aznan, "How Shariah boards add value," (June-July 2009) 7(3) *Islamic Banking & Finance*, 10-12 at 10, Hassan, Abdul, "Shariah-Compliant Corporate Governance", (April 2008) *Business Islamica*, 38-41 at 40.

The following subsection will consider how compliance with *Sharī'ah* is facilitated within institutions engaged in Islamic finance. It will first introduce the SSB, looking at the role of institutional *Sharī'ah* boards (A)[290] and governance issues which are raised by these boards (B).[291] It will then focus on the potential status of *Sharī'ah* boards under Irish law (C).[292] This final subsection will assert that while *Sharī'ah* scholars should generally be treated under Irish law as advisers, this is not a definitive classification and those scholars that act as directors should be treated as such by Irish law.

A. Role of the *Sharī'ah* Supervisor

AAOIFI has defined the institutional SSB as

> an independent body of specialised jurists in *fiqh al mua'malat*...entrusted with the duty of directing, reviewing and supervising the activities of the Islamic financial institution in order to ensure that they are in compliance with Islamic Shari'a Rules and Principles.[293]

Similarly, the IFSB has classified SSBs as a body set up or engaged by an Islamic financial institution to ensure effective independent oversight of the financial institution's *Sharī'ah*-compliance.[294] These institutional boards represent the most widely implemented method of *Sharī'ah* supervision used in the Islamic finance industry today[295] and have been established in Islamic banks, funds, *takāful* operators and investors, as well as other parties operating in the Islamic finance sector.[296] Vetting activity for conformity with Islamic law,

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[290] *infra.* at 426.

[291] *infra.* at 429.

[292] *infra.* at 431.

[293] AAOIFI, "Governance Standard for Islamic Financial Institutions No. 1, Shari'a Supervisory Board: Appointment, Composition and Report", in *Accounting, Auditing and Governance Standards for Islamic financial institutions*, (AAOIFI, Bahrain, 2010), at [2].

[294] Islamic Financial Services Board, *Guiding Principles on Shari'ah Governance Systems for Institutions offering Islamic Financial Services*, (IFSB, Kuala Lumpur, 2009), at [3] when read in light of the definitions section.

[295] Wigglesworth, Robin, "Sharia boards: Scholars hold sway over the success of products", *Financial Times*, May 5, 2009, who noted that; "The ultimate arbiters of the Islamic finance industry are not regulators, bespoke-suited bankers or the authorities, but a small, select coterie of ascetically garbed scholars versed in Koranic verses and arcane areas of jurisprudence."

[296] Grais, Wafik and Pellegrini, Matteo, "Corporate Governance and Shariah Compliance in Institutions Offering Islamic Financial Services", *World Bank Policy Research Working Paper 4054*, (World Bank, Washington DC, 2006), at 3, Khan, M Fahim, "Setting Standards for Shariah Application in the Islamic Financial Industry", (2007) 49(3) *Thunderbird International Business Review*, 285-307 at 293, Ayub, Muhammad, "Shariah Board, Shariah Compliance and Related Issues in Islamic Banking", (April-June 2008) *Journal of Islamic Banking & Finance*, 22-32 at 22.

these *Sharī'ah* boards provide participants in Islamic financial transactions with some level of assurance that financial activity conforms with Islamic principles - albeit the board's expert interpretation of those principles.[297]

AAOIFI and the IFSB have suggested that financial institutions engaged in Islamic activity should have their own *Sharī'ah* boards.[298] Like so much else in Islamic law, there is no default SSB structure which has been consistently established across the Islamic finance industry.[299] *Sharī'ah* boards differ in composition, activity and influence between countries and between institutions, with the IFSB acknowledging that "no single model"[300] of SSB is necessarily preferable to any other.[301] Nevertheless, institutional SSBs frequently carry out a number of core functions which allow them to ensure that products, instruments and services marketed as available to Muslims are consistent with Islam.[302] These functions can be broken down into review and authorisation of financial instruments, advising interested parties on issues of *Sharī'ah*-compliance and *ex post* auditing of an institution's activities to confirm adherence with Islam.[303]

Over the course of a financial service or product's lifecycle, from initial development to when it is offered, the SSB may oversee the religious dimensions of the transaction. This could involve providing assistance in relation to how the transaction should be structured in order to facilitate *Sharī'ah*-compliance, reviewing all relevant contracts and documents for non-compliance and ultimately issuing a ruling or *fatwā*[304] on the religious conformity

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[297] Askari, Hossein, Iqbal, Zamir and Mirakhor, Abbas, *New Issues in Islamic Finance and Economics: Progress and Challenges*, note 21, at 154.

[298] AAOIFI, "Governance Standard for Islamic Financial Institutions No. 1, Shari'a Supervisory Board: Appointment, Composition and Report", note 293, at [3], Islamic Financial Services Board, *Guiding Principles on Shari'ah Governance Systems for Institutions offering Islamic Financial Services*, note 294, at [2] and Principle 1.1.

[299] Laldin, Mohammed Akram, "Roles and responsibilities of Shari'a scholars in Shari'a advisory services", in *Euromoney Encyclopedia of Islamic Finance*, Aly Khorshid, (ed.), (Euromoney Books, London, 2009), 195-207 at 196.

[300] Islamic Financial Services Board, 10 *Guiding Principles on Shari'ah Governance Systems for Institutions offering Islamic Financial Services*, note 294, at [6].

[301] Qattan, Muhammad A.," Shari'ah Supervision: The Unique Building Block of Islamic Financial Architecture", in *Islamic Financial Architecture Risk Management and Financial Stability*, Proceedings of the International Conference on Islamic Banking: Risk Management, Regulation and Supervision, jointly organised by the Bank Indonesia, Ministry of Finance Indonesia and Islamic Development Bank, Islamic Research and Training Institute, Jakarta, September 30-October 2 2003, (Islamic Research and Training Institute, Saudi Arabia, 2004), 273-287 at 273-275. Akhtar, Shamshad, "Shariah Compliant Corporate Governance", note 288, at 11.

[302] Garas, Samy Nathan and Pierce, Chris, "Shari'a supervision of Islamic financial institutions", note 3, at 388, Hassan, Abdul, "Shariah-Compliant Corporate Governance", note 289, at 41.

[303] Grais, Wafik and Pellegrini, Matteo, "Corporate Governance and Shariah Compliance in Institutions Offering Islamic Financial Services", note 296, at 4.

[304] Plural: *fatāwā*.

of the final structure.[305] Both AAOIFI and the IFSB have stated that these rulings should be binding on the supervised institution.[306] *Ex ante* oversight of Islamic financial activity is complemented by an *ex post* audit conducted by the SSB or by an internal *Sharī'ah*-compliance unit[307] over the whole of the institution's Islamic dealings during a specific period, usually a year.[308] The objective of this audit is, according to AAOIFI, "to ensure that the activities carried out by an IFI do not contravene the Shari'a"[309] and it provides the *Sharī'ah* board with an opportunity to review the contracts, agreements and transactions entered into by an institution, as well as the decisions taken by the institution's management and board of directors.[310] This will allow the SSB or compliance unit to verify whether the activities of the supervised institution adhered to directions and *fatāwā* issued by the SSB and whether they were implemented in compliance with Islamic law.[311] The SSB or compliance unit's review may then be made public though inclusion in the annual report of the institution.[312] If this *ex post* audit indicates that some activity which was marketed as *Sharī'ah*-compliant was not in accordance with the teachings of Islamic law, the SSB may issue a qualified review in the annual report while instructing the

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[305] Laldin, Mohammed Akram, "Roles and responsibilities of Shari'a scholars in Shari'a advisory services", in *Euromoney Encyclopedia of Islamic Finance*, note 299, at 198-199. In order to facilitate day-to-day oversight of the activities of the supervised institution and to allow for more instantaneous responses to Shari'ah queries, some have recommended the appointment of a full-time internal Shari'ah adviser who will act on behalf of the SSB but work within the supervised institution. Shikder, Muhammad Nurullah, "Placing faith in Islamic finance", (January-March 2009) *NewHorizon* 30-31, Hassan, Abdul, "Shariah-Compliant Corporate Governance", note 289, at 41, Thomas, Abdulkader, "Understanding the Shari'a process", in *Structuring Islamic Finance Transactions*, note 284, at 33.

[306] The IFSB has noted that Islamic financial institutions "shall comply with the rules and principles issued by their *Shariah* scholars." Islamic Financial Services Board, *Guiding Principles on Shari'ah Governance Systems for Institutions offering Islamic Financial Services*, note 294, at [55], AAOIFI, Governance Standard for Islamic Financial Institutions No. 1, Shari'a Supervisory Board: Appointment, Composition and Report, note 293, at [2].

[307] Islamic Financial Services Board, *Guiding Principles on Shari'ah Governance Systems for Institutions offering Islamic Financial Services*, note 294, Introduction [3(c)].

[308] AAOIFI, "Governance Standard for Islamic Financial Institutions No. 2, Shari'a Review", in *Accounting, Auditing and Governance Standards for Islamic financial institutions*, (AAOIFI, Bahrain, 2010), at [3], Karim, Rifaat Ahmed Abdel, "The Independence of Religious and External Auditors: The Case of Islamic Banks", (1990) 3(3) *Accounting, Auditing & Accountability Journal*, 34-44 at 36.

[309] AAOIFI, "Governance Standard for Islamic Financial Institutions No. 2, Shari'a Review", note 308, at [4].

[310] Lewis, Mervyn K., "Islamic Corporate Governance", note 15, at 18 noting that Shari'ah scholars "provide an independent report to inform shareholders as to the compliance of management with Islamic principles and to the extent that the business is run Islamically."

[311] Nathan, Samy and Ribière, Vincent, "From knowledge to wisdom: the case of corporate governance in Islamic banking", (2007) 37(4) *VINE: The Journal of Information and Knowledge Management Systems*, 471-483 at 472.

[312] AAOIFI, "Governance Standard for Islamic Financial Institutions No. 2, Shari'a Review", note 308, at [13].

management or board of directors of the institution to donate any income which was obtained through non-*Sharī'ah*-compliant activity to charity.[313]

B. Governance of *Sharī'ah* Boards

Although SSBs function simultaneously with the board of directors and advisory bodies such as auditors, lawyers and accountants, they represent a unique moral filter within institutions involved in Islamic financial activity.[314] Concerned principally with religious aspects of an institution's activities,[315] the impact which *Sharī'ah* scholars have over the actions and direction of an institution is imprecise and arguably appears to share characteristics with company directors, advisers and auditors. Notwithstanding the broad impact which *Sharī'ah* scholars may have on the activities of an institution, these boards have traditionally been subject to little or no external oversight in many of the countries in which they operate. Stemming from this lack of supervision and the absence of a centralised authority, as well as the fact that the Islamic finance industry's growth has outpaced the development of expertise and regulatory infrastructure, institutional SSBs raise a number of challenges for regulatory and financial authorities.

First, as *Sharī'ah* scholars are frequently appointed, dismissed and remunerated on the recommendation of the board of directors,[316] their independence from that board and the company which the scholars supervise is uncertain.[317] This could reduce the extent to which such scholars are, or at least appear to be, impartial and effective in their

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[313] Rammal, Hussain G., "The Importance of Shari'ah Supervision in Islamic Financial Institutions", (2006) 3(3) *Corporate Ownership and Control*, 204-208 at 206, Lewis, Mervyn K., "Islamic Corporate Governance", note 15, at 18.

[314] Jabbar, Hjh Siti Faridah Abd, "The Shari'a supervisory board of Islamic financial institutions: a case for governance", (2009) 30(8) *Company Lawyer*, 243-248 at 243, Bassens, David, Derudder, Ben and Witlox, Frank, "Setting Shari'a standards: On the role, power and spatialities of interlocking Shari'a boards in Islamic financial services", (2011) 42 *Geoforum* 94-103 at 94, Bälz, Kilian, "A *Murabaha* transaction in an English court – The London High Court of 13th February 2002 in *Islamic Investment Company of the Gulf (Bahamas) Ltd. v Symphony Gems N.V. & Ors*", note 84, at 129, Karim, Rifaat Ahmed Abdel, "The Independence of Religious and External Auditors: The Case of Islamic Banks", note 308, at 35.

[315] Ayub, Muhammad, "Shariah Board, Shariah Compliance and Related Issues in Islamic Banking", note 296, at 28.

[316] Hegazy, Walid, "Fatwas and the Fate of Islamic Finance: A Critique of the Practice of Fatwa in Contemporary Islamic Financial Markets", in *Islamic Finance, Current Legal and Regulatory Issues*, S. Nazim Ali (ed), (Islamic Legal Studies Program, Harvard Law School, Cambridge MA, 2005), 133 – 152 at 136-137.

[317] Members of the SSB are in a relationship of proximity with an institution which they simultaneously audit for *Sharī'ah*-compliance. This close relationship creates, or appears to create, a position of influence by the board of directors over the *Sharī'ah* scholars and could result in the directors using this leverage to modify the activities of the SSB such that this religious supervisor becomes an ineffective means of ensuring *Sharī'ah* -compliance. Jabbar, Hjh Siti Faridah Abd, "The Shari'a supervisory board of Islamic financial institutions: a case for governance", note 314, at 244, Grais, Wafik and Pellegrini, Matteo, "Corporate Governance and Shariah Compliance in Institutions Offering Islamic Financial Services", note 296, at 6.

supervision.[318] Second, there is a lack of trained scholars globally, which has resulted in those scholars who possess the necessary expertise in Islamic jurisprudence and Islamic finance assuming multiple *Sharī'ah* board memberships.[319] As scholars frequently have access to proprietary information of the firms which they supervise,[320] they could be privy to confidential and sensitive information. This could raise concerns over the extent to which information obtained while sitting on the board of one institution could influence a *Sharī'ah* scholar's activities while on the board of another.[321]

Further reinforcing this unease is the absence of mandatory disclosure of *Sharī'ah* board *fatāwā* and their audits; any disclosure of the procedures adopted in reaching a decision and the decisions themselves are therefore undertaken on an *ad hoc* and voluntary basis.[322] Finally, there is a lack of consistency in *fatāwā* and decisions issued by *Sharī'ah* boards around the world.[323] As there is no centralised authority that can determine definitively what is and what is not *Sharī'ah*-compliant, each individual *Sharī'ah* board may be required to determine afresh the religious legitimacy of a particular practice. Rather than a developing class of standard transactions, Islamic finance is currently composed of a series of structures which may have limited transferability across borders or, indeed, even between institutions.[324] As a means of overcoming these problems as well as ensuring greater regulation of SSBs, the regulatory authorities of a growing number of countries, including Malaysia and Pakistan, have established detailed rules relating to the composition, competence and activities of institutional SSBs.[325] *Sharī'ah* scholars in these

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[318] Anderson, Scott R., "Finance [notes]", (2010) 35(1) *Yale Journal of International Law*, 237-264 at 240.

[319] Alexander, Philip, "Scholars and scale", (March 2010) *The Banker*, Shoon, Natalie, *Islamic Banking and Finance*, (Spiramus Press Ltd, London, 2009), at 143. This may include board membership of institutions which are direct competitors, Grais, Wafik and Pellegrini, Matteo, "Corporate Governance and Shariah Compliance in Institutions Offering Islamic Financial Services", note 296, at 7.

[320] Nathan, Samy and Ribière, Vincent, "From knowledge to wisdom: the case of corporate governance in Islamic banking", note 311, at 472.

[321] In a recent review of the Islamic finance industry, a report suggested that the top three global Islamic scholars sit on the Shari'ah boards of a combined total of two hundred and forty one Islamic finance institutions with the top two sitting on eighty five boards each, Ünal, Murat Hasan, *The Small World of Islamic Finance; Shariah Scholars and Governance – A Network Analytic Perspective*, (Version 6.0, Funds at Work, Madrid, 2011), at 4.

[322] See generally, Bunker, Jack, "Through the Looking Glass: Achieving Transparency in Islamic Finance", *Westlaw Business Talks*, April 9 2010, noting that "a mandatory fatwa reporting scheme would provide more than simple 'optical' transparency; it should also provide substantive structural transparency."

[323] Jabbar, Hjh Siti Faridah Abd, "The Shari'a Supervisory Board: a potential problem in Islamic finance?", (2008) 29(1) *Company Lawyer* 29-32 at 29-30, Shoon, Natalie, *Islamic Banking and Finance*, note 319, at 144.

[324] Pasha, Shaheen, "Islamic finance seeks young scholars to lead growth", *Reuters*, June 1 2010, available at: http://www.reuters.com/article/2010/06/01/us-Islamic-scholars-idUSTRE65021U20100601.

[325] *supra.* at 107 and 121128.

countries are not unaccountable entities within financial institutions but are explicitly subject to oversight by the State.

C. Institutional *Sharī'ah* Supervision in Ireland and the Oversight of *Sharī'ah* Scholars

There is evidence of some *Sharī'ah* board development in Irish domiciled Islamic finance structures. DWS Noor Islamic Funds Plc, an open-ended investment company incorporated in Ireland, provides that it "will undertake its investment activities in accordance with the Sharia Investment Guidelines."[326] The Fund's prospectus confirms the appointment of a "Shari'a Advisor", Khalij Islamic (BVI) Limited, which, under the guidance of one or more scholars from an SSB of five members, will monitor the Fund for compliance with the *Sharī'ah* board's *fatāwā*.[327] The Advisor is also charged with issuing "additional guidance, if required by the Company, under the approved Fatwa and generally accepted Sharia guidelines."[328] Similarly, the Oasis Crescent Global Equity Fund sets out as its objective,

> medium to long-term growth of capital and income by investing in shares of companies and shares or units in collective investment schemes and real estate investment trusts...that are *Shari'ah*-compliant according to the guidelines set by the Investment Manager's *Shari'ah* Advisory Board.[329]

This Advisory Board is composed of four international scholars, who together sit on the *Sharī'ah* board of over one hundred and twenty institutions offering Islamic finance.[330] While the Oasis Investment manager is registered in South Africa, the fund itself, its

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[326] DWS Noor Islamic Funds Range, *Audited Annual Report for financial year ended 31 December 2009*, (Dublin, 2010), at 3. See also, DWS Noor Precious Metals Securities Fund, *Interim Unaudited Report for the period ended 30 June 2010*, (Dublin, 2010), at 3.

[327] DWS Noor Islamic Funds Plc, *Sales Prospectus*, (Dublin, 1 July 2010), at 14.

[328] *ibid.*, at 14.

[329] Oasis Crescent Global Eqiuty Fund, *Prospectus Supplement 2*, (September 30, 2010, replacing a supplement dated April 9, 2010), at 3, available at: http://www.oasiscrescent.co.uk/ContextCMS/Assets/OCGIF Prospectus_Supplement_2_OCGEF.pdf. See also Oasis Crescent Global Investment Fund (Ireland) PLC, *Prospectus 2010* which notes at 15 that; "In addition to the Company's responsibilities in terms of compliance with all conventional regulation that applies to it, the Company is managed in accordance with Shari'ah principles, which are applicable to investment funds. Accordingly, the Company's investment activity is reviewed and audited by the Investment Manager's Shari'ah Advisory Board. This board consists of leading independent Shari'ah scholars."

[330] Based on information provided in Ünal, Murat Hasan, *The Small World of Islamic Finance; Shariah Scholars and Governance – A Network Analytic Perspective*, note 321, at 4.

directors and managers are all located in Ireland. In authorising these and other Islamic funds, the Irish regulator did not require the appointment of an SSB and made no attempt to deal with the composition and role of such boards or the competence and experience of their members.[331] The Irish Government has therefore adopted a non-interventionist approach to the regulation of SSBs.[332] Consistent with this conclusion, Irish authorities have confirmed that it is "a matter for each individual entity wishing to market Islamic finance products to have a Shari'a Board available to give approval as to the conformity or not of a particular Islamic financial transaction structure."[333]

In the absence of a regulatory framework or qualitative standards in Ireland which are specifically established to deal with the oversight of *Sharī'ah* boards, *Sharī'ah* scholars will be treated as ordinary stakeholders in a company. In relation to un-regulated firms, existing principles of Irish company law will apply, while *Sharī'ah* scholars acting in a regulated financial sector will also be subject to the Central Bank's supervisory rules for regulated entities.[334] Supervisory authorities - the Office of the Director of Corporate Enforcement or the Central Bank in the case of financial institutions - will need to consider the role of the SSB within the institution, the influence which that board has over the activities of the institution and whether the members of the board are to be treated as directors or advisers, as only the former are subject to direct Government oversight.[335] Subsection 1[336] will consider the treatment of SSB members as *de jure* directors (a)[337] and

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[331] Correspondence with Geraldine Murphy, Financial Institutions and Funds Authorisation, Appendix 2, *infra.* at 458.

[332] Irish Funds Industry Association, *Ireland: Opportunities for Middle Eastern Fund Managers*, (IFIA, Dublin, 2010), available at: www.irishfunds.ie/content/marketing_collateral/middle_east_web.pdf. A similar view has been adopted in the UK where any institutions which have appointed Shari'ah boards or advisers have therefore done so on a voluntary basis with those boards subject to no tailored governance framework, Hainsworth, Antony, "Governance rules for Islamic financial institutions: the new frontier?", note 285, at 515, Foot, Michael, "The Future of Islamic Banking in Europe", Second International Islamic Finance Conference Dubai, September 22 2003, available at: http://www.fsa.gov.uk/Pages/Library/Communication/Speeches/2003/sp150.shtml.

[333] Department of Finance, *Islamic Finance in Ireland; An Information Note*, (Department of Finance, Dublin, March 2010), at 7.

[334] A similar conclusion has been reached in the UK, see Ainley, Michael, Mashayekhi Ali, Hicks Robert, Rahman Arshadur, and Ali Ravalia, *Islamic Finance in the U.K.: Regulation and challenges*, (FSA, London, 2007), at 13 noting that the FSA "needs, in particular, to know whether and if so how the SSB affects the running of the firm. The FSA has to be clear as to whether the Sharia scholars have an executive role or one that is simply advisory." Ercanbrack, Jonathan, "The Regulation of Islamic Finance in the United Kingdom", note 283, at 20.

[335] Irish Funds Industry Association, *Ireland: Opportunities for Middle Eastern Fund Managers*, note 332, at 10.

[336] *infra.* at 433.

[337] *infra.* at 433.

shadow directors (b)[338] under Irish law. Subsection 2[339] will highlight the more likely classification of these scholars as advisers.

1. Sharī'ah Scholars as Directors

a. Classification as a Director

Depending on the remit which an institution accords to its SSB, the extent to which the board of directors of that institution relies on the rulings of the religious board, and the importance to the institution of public observance to Islam, *Sharī'ah* scholars could have a perceptible impact on the activities of that institution.[340] Particularly in relation to those market participants whose articles of association or memorandum provide either that the institution will uphold the teachings of Islam or that it will adhere to the pronouncements of its appointed *Sharī'ah* board, these religious supervisors arguably occupy a position over and above that of an ordinary adviser; failure to comply with their decisions may not only undermine the credibility of the firm but could result in an *ultra vires* action by the institution and a breach of the directors' duties.[341] Even in institutions which do not profess adherence to Islam in their constitutional documents, but which still undertake Islamic financial activity, disregard for the opinions of the SSB may still lead to public censure and reputational damage.[342] Compliance with the *Sharī'ah* board in such circumstances may therefore function almost like a condition precedent to acceptable Islamic financial activity. Such a position is distinct from that of other advisers, such as lawyers and accountants, whose influence over the activities of an institution appears to be less far-reaching and generally less conspicuous.

It could be suggested that the role of *Sharī'ah* scholars within an institution participating in Islamic finance activity is more closely aligned with that of directors than

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[338] *infra.* at 437.

[339] *infra.* at 440.

[340] Aldohni, Abdul Karim, "Islamic banking challenges modern corporate governance: the dilemma of the Shari'a supervisory board", (2008)29(5) *Company Lawyer*, 156-159 at 158.

[341] Proctor, Charles, *The Law and Practice of International Banking*, note 227, at 802-804, Islamic Financial Services Board, 10 *Guiding Principles on Shari'ah Governance Systems for Institutions offering Islamic Financial Services*, note 294, Introduction, footnote 8. See Ahern, Deirdre, *Directors' Duties; Law and Practice*, (Round Hall, Dublin, 2009), at 80 for a discussion of the constraints which a company's articles of association and memorandum place on directors.

[342] Skully, Michael T., "Corporate Governance and Islamic Banks", in *Foundations of Islamic Banking: Theory, Practice and Education*, Mohamed Ariff and Munawar Iqbal (eds.), (Edward Elgar, Cheltenham, 2011), 103-126 at 104.

advisers.[343] This classification of *Sharī'ah* scholars as directors of the institutions they supervise would draw these scholars within the provisions of Irish company law and direct supervision by the State. Company directors, as distinct from company advisers, are subject to statutory obligations and restrictions set out in the Companies' Acts 1963-2009, as well as common law duties and other statute-based responsibilities. *Sharī'ah* scholars who are deemed to be acting as directors would be required to ensure that the requirements of the Companies' Acts are complied with by the company,[344] they could be found guilty of fraudulent or reckless trading[345] and restricted or even disqualified from acting as a director if the institution on whose *Sharī'ah* board they sat went into insolvent liquidation or receivership.[346] Concurrently with these statutory duties, company directors are also subject to common law obligations including the duty to act in good faith and in the best interests of the company,[347] to act honestly, reasonably[348] and in accordance with the company's constitution, and not to use, without authorisation, the company's property, information or opportunities for private benefit.[349] For *Sharī'ah* scholars, these duties, particularly the duty to act in the best interests of the company, could result in a difficult balance between the exigencies of Islamic law and the financial success of the company with the former not necessarily always compatible with the latter.

The Companies' Acts and other regulatory enactments also set out mechanisms for ensuring that directors are capable of effectively undertaking the responsibilities of his or her position. The Companies (Amendment) (No. 2) Act, 1999[350] provides that a person

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[343] Some commentators have suggested that these boards should be treated as a separate, independent board operating concurrently with and not necessarily subsidiary to the existing board of directors, see for example, Nathan, Samy and Ribière, Vincent, "From knowledge to wisdom: the case of corporate governance in Islamic banking", note 311, at 472 suggesting that in Islamic finance institutions "there are two independent boards (Board of Directors and the Shari'ah Supervisory Board) that work together side by side."

[344] Section 383 of the Companies Act, 1963, as amended by Section 100 of the *Company Law Enforcement Act*, 2001.

[345] Section 297A(10) Companies Act, 1990, defines officer as including shadow director.

[346] *Worldport (Ireland) Ltd (In Liquidation)* [2008] IESC 68, [2009] 1 ILRM 241.

[347] *Banfi Ltd v Moran* [2006] IEHC 257, *Oisin Fanning v Brendan Murtagh, Alan Murtagh, Fergal Murtagh, Smart Telecom plc and Smart Yuroe Broadband Ltd.* [2009] 1 I.L.R.M. 368. Caselaw generally uses the "best interests of the company" however, Company Law Review Group, Head 9(3)(a), "Part A5 – Directors and Other Officers", *Draft General Scheme of Companies Consolidation and Reform Bill*, available at: http://www.clrg.org/cuuploads/editor/file/A5.pdf refers to good faith in the interests of the company, a formula which was used in *Kerry Co-Operative Creameries Ltd and Patrick O'Connell v An Bord Bainne Co-Operative Ltd and Avonmore Creameries Ltd, Avonmore Foods plc and John Duggan v An Bord Bainne Co-Operative Ltd* [1991] I.L.R.M. 851, Ahern, Deirdre, *Directors' Duties; Law and Practice*, note 341, at 151.

[348] *Regal (Hastings) v Gulliver* [1942] 1 All ER 378 see also *Parolen Limited v Patrick Doherty and Lindat Limited* [2010] IEHC 71 (unreported), at [4.9].

[349] Mac Cann, Lyndon, "Directors' Fiduciary Duties", (1991) 9 *Irish Law Times* 104-109 at 108.

[350] Companies (Amendment) (No. 2) Act, 1999 (No. 30 of 1999).

may not be a director or shadow director of more than twenty five companies at any one time.[351] For those scholars treated as director of regulated credit institutions or insurance undertakings, the number of directorships which can be held in these institutions is reduced to just five; any more than this creates "a rebuttable presumption that the director has insufficient time available to fulfil his or her role and functions as a director of a financial institution."[352] The fact that *Sharī'ah* scholars frequently sit on the *Sharī'ah* board of multiple different institutions could be problematic not simply because Irish provisions impose restrictions on multiple board memberships but also because of the conflicts of interest which could arise. Addressing conflicts of interest amongst directors, the Corporate Governance Code for Credit Institutions and Insurance Undertakings 2011[353] prevents a director from participating in "any decisions making/discussion where a reasonably perceived potential conflict of interest exist."[354] No actual conflict of interest is needed and so in the case of a scholar sitting on the *Sharī'ah* board of rival financial institutions, the new Corporate Governance Code could severely restrict the ability of the scholar to conduct *Sharī'ah* supervision of these firms. Finally, the Central Bank implements a Fit and Proper test for directors and managers.[355] This test, which applies to directors and managers of regulated financial services entities,[356] requires that such persons display the competence and capability necessary to successfully fulfil his or her duties. It also stipulates honesty, integrity, fairness, ethical behaviour and financial soundness as essential characteristics of a managerial or directorial role in a financial institution.[357] A *Sharī'ah* scholar who is appointed as a director and subject to the corresponding duties and responsibilities could be required by the Central Bank to display the skill and expertise of an ordinary company director, a standard which that scholar may not necessarily attain, notwithstanding his or her proficiency as a religious scholar.[358]

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[351] Section 45 *Companies (Amendment) (No. 2) Act*, 1999

[352] Central Bank, *Corporate Governance Code for Credit Institutions and Insurance Undertakings*, (Central Bank, Dublin, 2011), at [7.7]. In circumstances where directorships are held outside a financial institution covered by the Code (a non financial directorship), the rebuttable presumption arises when more than eight such directorships are held

[353] *ibid.*

[354] *ibid.*, at [7.12].

[355] Financial Regulator (as it then was), *Fit and Proper Requirements*, (Financial Regulator, Dublin, 2008), available at: http://www.centralbank.ie/regulation/processes/authorisation/Documents/F%20and%20P%20Instructions%20Paper%20Dec%202008.pdf.

[356] Which include credit institutions, funds and their service providers, insurance undertakings and investment intermediaries.

[357] Financial Regulator (as it then was), *Fit and Proper Requirements*, note 355, at section 5.

[358] Ainley, Michael, Mashayekhi Ali, Hicks Robert, Rahman Arshadur, and Ali Ravalia, *Islamic Finance in the U.K.: Regulation and challenges*, note 334, at 13.

The implications for a *Sharī'ah* scholar arising from his or her appointment and regulation as a director are therefore a matter of concern, particularly when compared with the absence of Government intervention in the activities of company advisers. The fact that the wide-ranging responsibilities imposed on directors are entirely untailored to the specific activities and characteristics of Islamic scholars is particularly problematic as elements of *Sharī'ah* supervision, such as multiple board memberships, access to proprietary information from rival firms and the overriding importance for *Sharī'ah* scholars of ensuring adherence to Islamic law, may be inconsistent with the prescriptive duties which a director owes to the company, its members and creditors.[359]

References to *Sharī'ah* boards which have been made by Irish authorities have gone some way towards alleviating these secular burdens faced by *Sharī'ah* scholars. On a number of occasions the authorities have confirmed that *Sharī'ah* scholars who make up SSBs will generally be not treated by the Irish Government as directors but rather as advisers. The Revenue Commissioners' Guidance Notes expressly notes that "[t]he Shari'a Board should not be confused with the Board of Directors of a company, as a Shari'a Board only has an advisory role,"[360] while an earlier briefing by the Department of Finance also observed that "[t]he Shari'a Board is a component of the structure of an Islamic financial institution however it only has an advisory role."[361] From these observations it appears as though authorities in Ireland will countenance a *Sharī'ah* board *only* acting as an adviser. However, it is suggested that the approach of the Government is that where it is satisfied that *Sharī'ah* scholars are acting as advisers, it will not intervene but where it is not satisfied, it may seek to actively regulate these scholars as if they were directors.[362] In relation to non-regulated companies, a similar conclusion may apply; the extent to which specific duties will be imposed on *Sharī'ah* scholars is likely to depend on the position of those scholars within the company which appoints them.

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[359] Considering a very similar conflict between director's duties and Shari'ah supervision in the UK, Ainley et al. have noted that the application of directorial responsibilities on Shari'ah scholars "would put further constraints on an industry already facing a shortage of Sharia scholars with suitable skills," Ainley, Michael, Mashayekhi Ali, Hicks Robert, Rahman Arshadur, and Ali Ravalia, *Islamic Finance in the U.K.: Regulation and challenges*, note 334, at 13.

[360] Revenue Commissioners, "Guidance Notes on the Tax Treatment of Islamic Financial Transactions", note 31, at 8.

[361] Department of Finance, *Islamic Finance in Ireland; An Information Note*, note 333, at 7.

[362] This interpretation of the government's policy towards SSBs is also held by the Irish Funds Industry Association which has suggested that the Central Bank "will require confirmation that the Shari'ah Board is acting in an advisory capacity only with no discretionary powers over the assets of the fund. If acting in an advisory capacity only, the Central Bank will not seek to regulate or approve the Shariah Board." Irish Funds Industry Association, *Ireland: Opportunities for Middle Eastern Fund Managers*, note 332.

b. Post-Appointment Classification as a Shadow Director

The general policy of classifying *Sharī'ah* scholars as advisers rather than director is subject to the caveat that this advisory role must continue for the duration of the scholars' appointment. Scholars who are appointed as advisers must not subsequently assume the role of director without correspondingly accepting the responsibilities of that role. A *Sharī'ah* scholar who is not appointed as a director may therefore still be treated as a director by the courts if that scholar falls within the statutory definition of a shadow director.

Defined in s.27(1) of the Companies Act 1990[363] as "a person in accordance with whose directions or instructions the directors of a company are accustomed to act,"[364] a shadow director will be subject to many of the same statutory provisions of the Companies' Acts 1963-2009 as *de jure* directors.[365] While uncertainty exists as regards the applicability of common law duties to shadow directors,[366] the draft General Scheme of Companies Consolidation and Reform Bill[367] provides that directors' common law obligations could be transformed into statutory duties and imposed on all directors, including shadow directors.[368] As in the case of scholars treated as ordinary directors, those deemed to be shadow directors could owe fiduciary duties to the company on whose board they sit. Finally, the Central Bank's Fit and Proper test is expressly applicable to shadow directors,[369] requiring them to fulfil the same skill and competency requirements as formally appointed company directors.[370]

Unlike the executive, the Irish courts have given no confirmation that they will generally treat *Sharī'ah* scholars as advisory in nature. Nevertheless, it is suggested that only in those situations where the *Sharī'ah* scholar clearly and unambiguously assumes the

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[363] Companies Act 1990 (Number 33 of 1990).

[364] Section 27(1) Companies Act, 1990 (Number 33 of 1990).

[365] *Fyffes Plc v DCC Plc, S & L Investments Limited, James Flavin, Lotus Green Limited*, [2005] 1 IR 59, Ahern, Deirdre, *Directors' Duties; Law and Practice*, note 341, at 65.

[366] *ibid.*, at 66 citing *Ultraframe (UK) Ltd v Fielding* [2005] EWHC 1638 (Ch) as an example of a case in which the court acknowledged (at [1289] that common law duties may be imposed on a shadow director.

[367] Company Law Review Group, "Part A5 – Directors and Other Officers", *Draft General Scheme of Companies Consolidation and Reform Bill*, available at: http://www.clrg.org/cuuploads/editor/file/A5.pdf.

[368] Company Law Review Group, Head 9, "Part A5 – Directors and Other Officers", *Draft General Scheme of Companies Consolidation and Reform Bill*, note 367.

[369] Despite Fennelly J noting in *Worldport (Irl) Limited (in Liquidation)* that "a person may still be held to be a shadow director even though they are ineligible to hold the position of director," *Worldport (Irl) Limited (in Liquidation)* [2008] IESC 68 at [23]. Financial Regulator (as it then was), *Fit and Proper Requirements*, note 355, at section 4

[370] *ibid.*

role of company director will the courts classify that scholar as a shadow director. This conclusion is based on the fact that Irish courts have been reluctant generally to rely on the concept of shadow directorship. In *Fyffes Plc v DCC Plc*,[371] Laffoy J considered in detail the criteria to be applied when identifying shadow directors in Ireland. The judge disagreed with English caselaw which extended the notion of the shadow director to include persons who fall short of being the directing mind and will of the company and concluded that a shadow directorship could arise even if the board of directiors did not always act on the directions and instructions of the shadow director. However, in order to constitute "directions or instructions" sufficient to classify someone as a shadow director, communication made by that person to the board of directors would need to have an imperative quality.[372] Periodic *advice* alone would be insufficient.[373] Most recently, the test of a shadow director in Ireland was narrowed even further when McKechnie J concluded in *Liam Dowall v Stephen Cullen, Paul Rocliffe and David Cullen*[374] that "'advice' or 'the giving of advice' means to recommend, to propose, or to suggest. A 'direction or instruction' is materially more compelling than simply a proposal or a suggestion."[375] Consequently, the High Court refused to accept that "communication which cannot be properly described as a "direction or instruction" comes within the section."[376] "Advice," no matter how regular, cannot be sufficient to classify someone as a shadow director under Irish law.

In light of the criteria needed for a person to qualify as a shadow director in Ireland, the activities of Islamic scholars may be classified as the provision of advice rather than "direction or instruction" without undermining the ability of *Sharī'ah* scholars to supervise an institution for compliance with Islam.[377] As a general rule, *Sharī'ah* boards are concerned directly with the religious aspects of the institution's activities, not with the financial merit of those activities. In ensuring that financial instruments, products and

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[371] *Fyffes Plc v DCC Plc, S & L Investments Limited, James Flavin, Lotus Green Limited*, [2005] IEHC 477 (HC)(unreported).

[372] *ibid.* at 84.

[373] With these criteria in mind, Laffoy J concluded that the second defendant who was chief executive and deputy chairman of a company was not the shadow director of a subsidiary company despite the fact that he gave imperative instructions in relation to the sale of shares and had made decisions in relation to the handling of those shares. As Laffoy J noted; "...while those instances were probably the most important decisions that were made in the corporate life of Lotus Green up to 14th February, 2000, they were specific instances. The evidence does not establish the level of real influence on an ongoing basis which is a requirement of s. 27," *ibid.*at 188.

[374] *Liam Dowall v Stephen Cullen, Paul Rocliffe and David Cullen* [2009] IEHC 580 (unreported).

[375] *ibid.*

[376] *ibid.*

[377] See generally, Warde, Ibrahim, *Islamic Finance in the Global Economy*, (2nd ed., Edinburgh University Press, Edinburgh, 2010), at 234-235.

services comply with the dictates of Islam, *Sharī'ah* scholars may be involved in structuring a transaction or determining the suitability of an activity which the board of directors has already decided to undertake. However much the *Sharī'ah* scholars' determinations are capable of influencing the nature and structure of financial transactions, it is generally at the behest of the company directors that these transactions are undertaken in the first place. It is suggested, therefore, that reliance on the *Sharī'ah* board's opinion is not generally a result of the fact that the board of directors is "subservient to the 'shadow'"[378] but rather because the board of directors is relying on the superior knowledge of *Sharī'ah* scholars on matters of religious compliance. The *Sharī'ah* board's views are of informational relevance to a board of directors of an institution participating in Islamic finance, they are not compelling the directors to act in an involuntary manner. Finally, the *Sharī'ah* audit of the institution, which is conducted by the *Sharī'ah* board itself or by an internal *Sharī'ah* auditor, reviews activities already undertaken by the institution; it is retrospective in nature and acts as a commentary on the extent to which that institution has complied with its self-imposed obligations. Consequently, it is suggested that the activities of *Sharī'ah* scholars generally take the form of advice, recommendations and *ex post* commentaries. While failure to comply with this advice could result in external consequences such as reputational damage, the ability of SSB members themselves to force directors to comply with an unpopular decision, and to dominate the board, is not a default characteristic of SSBs.

The exemption contained in s.27 of the Companies Act 1990[379] for advice which is given to directors in a professional capacity, may also be relevant.[380] The courts in both the UK and Ireland have acknowledged that professional advisers who advise a board of directors on their area of expertise can influence the direction of the institution without those advisers being deemed to be a shadow director. McKechnie J in *Liam Dowall v Stephen Cullen*,[381] for example, noted that a professional adviser, "even if the board was accustomed to act upon advice, should not, by reason of that only, be designated as a shadow director...If it was otherwise the relationship between business and professions

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[378] Courtney, Thomas, *The Law of Private Companies*, (2nd ed., Tottel Publishing, Dublin, 2002), at [8.062] quoted in *Fyffes Plc v DCC Plc, S & L Investments Limited, James Flavin, Lotus Green Limited*, [2005] IEHC 477 (HC)(unreported), at 82.

[379] Companies Act 1990 (Number 33 of 1990).

[380] Section 27(1) Companies Act, 1990 states that; "a person in accordance with whose directions or instructions the directors of a company are accustomed to act (in this Act referred to as "*a shadow director*") shall be treated for the purposes of this Part as a director of the company *unless the directors are accustomed so to act by reason only that they do so on advice given by him in a professional capacity*." (emphasis added).

[381] *Liam Dowall v Stephen Cullen, Paul Rocliffe and David Cullen* [2009] IEHC 580 (unreported).

would have to be re-appraised."[382] "Professional advice" in Irish caselaw has been referred to in the context of lawyers,[383] psychologists,[384] accountants[385] without defining the parameters of that advice. Indeed McKechnie J suggested that "[a]dvice given by a professional in that capacity, or "professional advice" so described, is readily and notoriously recognised for what it is by those who have recourse to it." *Sharī'ah* scholars are appointed and paid to supervise an institution's activities because they are (or at least hold themselves out as) experts in Islamic jurisprudence and/or Islamic finance. Like a lawyer or accountant, *Sharī'ah* scholars provide company directors with information on an area which may be beyond the knowledge of those directors.

Without a corporate governance regime tailored to the specific characteristics of SSBs and the scholars that sit on them, *Sharī'ah* scholars will be classified for the purposes of Irish company law and regulatory oversight in the same manner as non-religious entities operating in a company. *Sharī'ah* scholars are not exempt from categorisation as a director simply because they claim that they are accountable only to God. Where a *Sharī'ah* scholar acts as a director and dominates the activities of the company, they should be prepared to bear the responsibilities and duties that accompany that role; to conclude otherwise would allow stakeholders who would, under normal circumstances be treated as directors, to avoid external supervision. However, the application of the established regime of directors' duties should not be unjustifiably extended to impose liability on those who do not fulfil the characteristics of director. As a result, *Sharī'ah* scholars who do not assume the role of director and instead fulfil their duties as advisers and overseers of religious conformity should not be treated as directors. *Sharī'ah* scholars, acting in accordance with the general activities of their profession should, and it appears will, be treated in Ireland as a category of adviser.

2. *Sharī'ah Scholars as Advisers*

Like lawyers and other company advisers, *Sharī'ah* scholars operating in Irish registered institutions would generally appear to fall outside the scope of direct

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[382] *ibid.*

[383] See for example, *Stephen Miley v Mr Justice Feargus Flood the Sole Member of the Tribunal of Enquiry into Certain Planning Matters and Payments and Law Society of Ireland (notice party)* [2001] 1 I.L.R.M. 489.

[384] *SOC (a minor suing by his father and next friend, COC) v The Minister for Education and Science, the Minister for Health and Children, The Health Service Executive, Ireland and the Attorney General* [2007] IEHC 170 (unreported).

[385] *AIB PLC v Higgins & Ors* [2010] IEHC 219.

Government regulation. Yet the position of *Sharī'ah* scholars is not entirely analogous with that of other company advisers as, unlike lawyers who are regulated by the Law Society or accountants who are subject to the oversight of professional accountancy bodies, *Sharī'ah* scholars are autonomous agents, accountable to no temporal authority.[386] As a result, when acting as advisers, *Sharī'ah* scholars in Ireland do not need to be registered, there are no tailored competency requirements, no rules of professional conduct or codes of ethics and no external supervision of their activities.

Despite the absence of official regulatory oversight of *Sharī'ah* scholars, the Department of Finance has suggested that *Sharī'ah* boards may be considered to function as a "sub-committee" of the Board of Directors of the institution that appoints them.[387] S.19.1 of the Central Bank's Corporate Governance Code for Credit Institutions and Insurance Undertakings 2011[388] sets out the "General Requirements of Committees" of the board of directors.[389] Amongst these requirements is a duty which is imposed on the board of directors to "review and satisfy itself as to the relevant expertise, skill of members [of the sub-committee] and their ability to commit appropriate time to the committee."[390] Where a board of directors establishes an SSB as a sub-committee, the directors must be satisfied that the scholars that make up that sub-committee are sufficiently competent and capable of acting as members of the institution's *Sharī'ah* board. The board of directors will only need to reassure itself that a scholar should be appointed to the SSB. Nevertheless, this requirement could result in financial institutions considering more carefully the background, education and proficiency of each *Sharī'ah* scholar they appoint. The effect of this provision on an Irish Islamic finance market is therefore, that while anyone can hold themselves out to be a *Sharī'ah* scholar regardless of their competency (or lack thereof), only those that are experienced and qualified to act as scholars are likely to be appointed by institutions subject to the Corporate Governance Code.

The application of s.19.1 of the Corporate Governance Code raises a broader concern that Irish institutions have few reference points against which the "relevant expertise" and

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[386] Aldohni, Abdul Karim, "Islamic banking challenges modern corporate governance: the dilemma of the Shari'a supervisory board", note 340, at 158.

[387] Department of Finance, *Islamic Finance in Ireland; An Information Note*, note 333, at 7 noting that "[i]n the context of a Shari'a compliant company, the Shari'a Board can be considered as a sub-committee of the Board of Directors of the company."

[388] Central Bank, *Corporate Governance Code for Credit Institutions and Insurance Undertakings 2011*, note 352.

[389] The Corporate Governance Code uses the terms "committees" and "sub-committees" interchangeably.

[390] Section 19.1(c), Central Bank, *Corporate Governance Code for Credit Institutions and Insurance Undertakings 2011*, note 352.

"skill" needed to be a *Sharī'ah* scholar can be measured. Equally, once a scholar is appointed, that scholar is subject to no code of conduct other that his own conscience and the views of other board members.[391] The ability of a board of directors to evaluate the expertise and activities of scholars against a suitably tailored set of standards is therefore limited. To address this knowledge gap, and to separate Ireland from the UK Islamic finance market, a code of conduct and minimum competency requirements, both of which would be voluntary, could be developed for *Sharī'ah* boards of Irish institutions.[392] The competency requirements could take the form of a fit and proper test for *Sharī'ah* scholars similar to those developed in Malaysia and Pakistan and could represent a benchmark which outlines the requisite characteristics and skills to be displayed by *Sharī'ah* scholars. The code of conduct would then set out broad ethical principles such as honesty, transparency, the avoidance of conflicts of interest and respect for the confidentiality of sensitive information. Similar to non-statutory standards set by bodies such as the Advertising Standards Authority for Ireland, this code would represent a minimum standard of conduct to be followed by *Sharī'ah* scholars. Failure by a scholar to adhere to the standards could result in their removal from an institution's *Sharī'ah* board due to lack of competence[393] and/or public censure, encouraging compliance with the standards of competency and conduct.

Rather than establishing a State entity to act as supervisor of *Sharī'ah* scholars, existing Islamic organisations such as the Dublin-based European Council for Fatwa and Research [ECFR] could be expanded to act as a non-statutory body overseeing the appointment and activities of *Sharī'ah* boards. This Council, which has amongst its members Yusuf Al-Qaradawi and Muhammad Taqi Usmani, as well as numerous other scholars that sit on the *Sharī'ah* boards of financial institutions,[394] has already issued several non-binding *fatāwā* on issues of Islamic banking and finance.[395] The expertise and experience of the ECFR's members, who adhere to different schools of Islamic thought, could be employed to develop the voluntary code and fit and proper test. Once *Sharī'ah* boards are established

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[391] Nathan, Samy and Ribière, Vincent, "From knowledge to wisdom: the case of corporate governance in Islamic banking", note 311, at 476, Karim, Rifaat Ahmed Abdel, "The Independence of Religious and External Auditors: The Case of Islamic Banks", note 308, at 39.

[392] Islamic Financial Services Board, 10 *Guiding Principles on Shari'ah Governance Systems for Institutions offering Islamic Financial Services*, note 294, Principle 1.2.

[393] This arises as a result of the fact that the Board of Directors of an institution that appoints an SSB may no longer consider a member of that SSB to have the "skill" needed to act as a *Sharī'ah* scholar where that member fails to meet the minimum competency or conduct standards.

[394] For example, Ali Muhyealdin Al-Quradaghi sits on the Shari'ah board of the UK's Ahli United Bank.

[395] European Council for Fatwa and Research, *Fatwas of European Council for fatwa and research*, Anas Osama Altikriti and Shakir Nasif Al-Ubadyi (trans.), (Islamic INC, Cairo, n.d.), fatāwā 10-13.

and Ireland's Islamic finance industry begins to mature, the ECFR could also work to facilitate transparency in the industry by publishing *fatāwā* issued by institutional boards of Irish firms. The ECFR would thus act as a centralised body whose objective is to facilitate *Sharī'ah* supervision at institutional level by encouraging the use of competent *Sharī'ah* scholars and transparency in decision making.

However, while one of the ECFR's objectives is "attempting to unify the jurisprudence views between [scholars who live in Europe] in regards with the main Fiqh issues,"[396] if the Council were to issue competency standards for Sharī'ah board members, it should not also attempt to start regulating the Irish Islamic finance industry for Sharī'ah-compliance. Similar to reasons proposed against the Central Bank regulating for Sharī'ah-compliance, any centralised control of religious adherence in financial activity could undermine Ireland's potential as a jurisdiction which is amenable to Islamic finance and could marginalise Muslims who do not agree with the ECFR's views. In addition to this, developments in Islamic finance in Ireland are expected to be centred on international Islamic financial activity in which Ireland is used as a location for transactions and products whose impact is felt abroad either because some of the parties to the transaction are not located in Ireland or because the product is marketed in another jurisdiction. Attempts to develop domestic standardisation of Islamic finance activity would be largely fruitless. As a result, compliance with Islamic law should remain the responsibility of institutions.

10.3.3 Conclusion to Section 10.3

The SSB then, as a layer of religious supervision within Islamic financial institutions, performs two distinct but interrelated roles; one is to provide the supervised institution with the *Sharī'ah* expertise needed to develop and offer products and services which are compatible with Islam while the other is a public relations role through which the SSB acts as an overt indicator to customers and counterparties that Islamic law is being adhered to.[397] These boards are, in practice, vital marketing tools for Islamic financial institutions

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[396] European Council for Fatwa and Research, *Fatwas of European Council for fatwa and research*, Anas Osama Altikriti and Shakir Nasif Al-Ubadyi (trans.), (Islamic INC, Cairo, n.d.), at 6.

[397] Elgari noted that "a fatwā is not obligatory or legally binding. Yet the public at large wants a resolution issued by such [an SSB] to be applicable to the Islamic finance institutions and ought to be followed," *Closed Roundtable Discussion at Inaugural SC-OCIS Forum*, March16, 2010 in Malaysia International Islamic Financial Centre, *HRH Raja Dr Nazrin Urges Islamic Finance Industry to Broaden its Acceptability to Further Promote Market Growth*, (Securities Commissions, Kuala Lumpur, 2010), available at:

and an institution which fails to establish or rely on qualified scholars could struggle to convince other market participants that Islamic dictates are being respected.[398] As a result, a product or service which is marketed as *Sharī'ah*-compliant and which has received an authorising *fatwā* from a board of recognised *Sharī'ah* scholars, may be more appealing to the Islamic finance market than one which has no verification of its religious legitimacy.[399]

The IFSB has recommended that "[i]n the absence of an internationally recognised code of ethics and conduct for members of *Sharī'ah* boards, the IIFS [Institution offering Islamic Financial Services] shall establish its own appropriate code of ethical conduct to be complied with by its *Sharī'ah* board."[400] The development of voluntary codes of competence and conduct for *Sharī'ah* scholars by a body such as the ECFR would reduce the need for each Irish institution conducting Islamic finance to establish its own codes of professional ethics and conduct for its religious advisers. It would, however, still bring these scholars within some form of consistent supervisory structure. While not comparable to the regulation of other professional advisers in Ireland, this development could nevertheless give market participants greater confidence in the quality of decisions emanating from the SSBs of Irish institutions and limit the extent to which scholars on these boards are viewed as beyond the purview of any temporal standards.

10.4 Conclusion to Chapter 10

Compliance with Islamic law is what ultimately separates Islamic finance from all other forms of financial activity; without it, there is little reason for having Islamic finance at all. If the Irish Government is to establish Ireland as a centre for Islamic finance in Europe, the products and structures marketed as *Sharī'ah*-compliant cannot be considered only in the abstract. In order to give accommodating legislative provisions any practical usefulness, the characteristics of qualifying structures will need to be considered and clarified.

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http://www.mifc.com/sift_09/newsletter/MAC-2010/index.html, Hasan, Aznan, "How Shariah boards add Value", note 289, at 10.

[398] De Lorenzo, Yusuf Talal, "Shari`ah Supervision of Islamic Mutual Funds", note 20, Bälz, Kilian, "A *Murabaha* transaction in an English court – The London High Court of 13th February 2002 in *Islamic Investment Company of the Gulf (Bahamas) Ltd. V. Symphony Gems N.V. & Ors*", note 84, at 130 noting that; the *fatwā* "is then used for promotional purposes, disseminated in marketing materials and displayed on the institution's web site."

[399] Hassan, Abdul, "Shariah-Compliant Corporate Governance", note 289, at 40 noting that "the establishment of a Shariah supervisory board is important to instil public confidence in the purity of IFI operations." Karim, Rifaat Ahmed Abdel, "The Independence of Religious and External Auditors: The Case of Islamic Banks", note 308, at 36.

[400] Islamic Financial Services Board, 10 *Guiding Principles on Shari'ah Governance Systems for Institutions offering Islamic Financial Services*, note 294, Principle 1.2 [25].

Whether these characteristics should include adherence to an officially endorsed set of *Sharī'ah* standards has provoked divisions between various other countries seeking to integrate Islamic financial activity into their domestic legal systems. Some Governments have taken a direct role in determinations of Islamic law and now vet Islamic financial activity for compliance with those determinations. Other countries have assumed a more passive approach adopting no official view on what is *Sharī'ah*-compliant and requiring no actual adherence to Islam for structures to be accommodated or enforced.

It is likely that Ireland will adopt the latter approach to Government intervention. *Sharī'ah* supervision implemented at contractual and institutional level may therefore be the primary mechanism for overseeing *Sharī'ah*-compliance in Islamic finance activity in Ireland. Through private mechanisms, the parties to the financial contract can implement or facilitate a system in which the validity of an activity or contract is determined in accordance with the principles of Islamic law yet such *Sharī'ah* supervision requires no official Government endorsement. In order to facilitate this private oversight however, the status of SSBs and their members should be clarified by the authorities and consideration should perhaps be given to (possibly informal) supervision of the boards themselves.

As will be discussed in the Chapter 11 which concludes this thesis, the development of a domestic Islamic finance industry requires a Government which is amenable to accommodation of structures and activities found in Islamic finance transactions. Beyond the development of a level playing field however, the Government is not in a position to determine for the market, the effectiveness, viability or religious adherence of any financial product; these are considerations for transaction participants to determine.

Chapter 11

Conclusion

11. 1 Summary

Commenting on the contemporary development of Islamic finance, Hamoudi has noted that "the legal changes necessary to implement an Islamic finance system do not require wholesale reorganization of private law or even commercial law."[1] Though tinged, perhaps, with an element of cynicism,[2] Hamoudi's views represent the dominant approach of non-Islamic countries and some Islamic countries, towards the accommodation of Islamic finance. If one considers the precedent set in the UK, there is clear evidence that Governments are willing to countenance the existence of domestic Islamic finance activity and indeed, to promote their financial system as amenable to such activity, without entirely renouncing existing legal infrastructure or establishing an separate, bespoke legal regime for finance guided by religious dictates.[3] The preferred mode of dealing with Islamic finance has, rather, been to absorb such activity into existing structures and laws, occasionally subject to some tailoring of those laws.

During the period in which this thesis was being researched and written, the Irish Government's view on Islamic finance in the Irish economy has gone from one which is

[1] Hamoudi, Haider Ala, "The Death of Islamic Law", (2009-2010) 38 *Georgia Journal of International and Comparative Law*, 293–338 at 302.

[2] The comments were made in the context of an article entitled *The Death of Islamic Law* in which Hamoudi highlights the willingness (and perhaps need) of Muslims, Muslim scholars and Muslim states to cherry pick religious legal dictates and amalgamate them into established legal frameworks. Hamoudi, Haider Ala, "The Death of Islamic Law", note 1.

[3] *supra.* at 130.

unarticulated - if not largely absent[4] - to one of overt support.[5] This development has been underpinned not just by official endorsement of an Irish Islamic finance sector but by guidelines and legislative amendments designed to facilitate the creation of this sector. Involving research which has straddled two approaches to Islamic finance in Ireland, this thesis represents the first comprehensive examination conducted on the interaction between Islamic finance and the Irish legal system. Following the publication of the Tax Briefing 2009 and the Finance Act 2010, conclusions reached in Chapters 4 to 10 of this thesis on the amenability of Ireland's legal, fiscal and regulatory frameworks to the unique structures of Islamic finance, have gone from being purely theoretical and speculative to being rooted in concrete application and relevance. As an observation of the integration of Islamic finance into the Irish legal system therefore, this thesis has considered the origin, rules and structures of Islamic finance, whether it should be facilitated within Irish law and if so, how this can be achieved.

11.2 Islamic Finance and Ireland's Legal System

11.2.1 A Level Playing Field Approach in Practice

As an approach to economic activity which is constructed upon religious teachings, Islamic finance has a captive market[6] which other novel financial sectors and products do not generally benefit from. With global financial uncertainty and calls for a re-assessment of the financialisation trend in the conventional market, Islamic finance may now also represent a viable alternative, or supplement, to interest-based activity, even for those who are not driven by religious affiliation.[7] Faced with unprecedented financial difficulty and a rising Muslim population domestically, Ireland's recent interest in expanding the Irish economy is unsurprising. As outlined in Chapter 5, for the Irish Government, the development of an Irish Islamic finance sector could be a means of drawing much needed

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[4] See Appendix 1 and Appendix 2 for correspondence with the Financial Regulator (as it then was) and the Revenue prior to the 2009 clarification and 2010 accommodations, infra. at 454 and 458.

[5] Kenny, Enda, "Speech given at the IFIA Annual Conference", Dublin, June 2, 2011, available at: http://www.merrionstreet.ie/index.php/2011/06/speech-by-the-taoiseach-mr-enda-kenny-t-d-to-the-ifia-annual-conference/?cat=11.

[6] El-Gamal, Mahmoud, "Limits and Dangers of Shari a-Arbitrage", in Islamic Finance: Current Legal and Regulatory Issues, Nazim Ali (ed.), (Islamic Finance Project, Islamic Legal Studies Program, Harvard University, Cambridge, 2005), 127-131 at 127 quoting the Governor of the Bahrain Monetary Agency as saying; "Islamic banks have grown primarily by providing services to a captive market, people who will only deal with a financial institution that strictly adheres to Islamic principles."

[7] Housby, Elaine, *Islamic Financial Services in the United Kingdom*, (Edinburgh University Press, Edinburgh, 2011), at 173. *supra.* at 161.

capital into the Irish economy. It could also represent a new opportunity for Irish investors and a source of finance for Irish companies.[8] Although not the primary subject of the recent legislative amendments, the constitutional protection of religious free-exercise was also presented in Chapter 5 as a justification for the facilitation of Islamic finance activity in Ireland.[9]

As has occurred in the UK, other non-Islamic countries, and, increasingly, in some Islamic countries such as Pakistan,[10] every possible Islamic structure has not been the subject of explicit and positive legislative adjustments under Irish law. Equally, accommodation has not resulted in the prioritisation of Islamic financial activity over non-Islamic alternatives. Based on the concept of establishing a "level playing field" between Islamic and conventional products, accommodations in Ireland aim to ensure that Islamic products are subject to legal treatment which is comparable to that imposed on their conventional counterparts. For Islamic products which operate on an equity-like basis and which are structured to reflect this (for example, Islamic funds), the Irish approach should allow treatment which is in line with economically comparable conventional structures with little or no legislative accommodation needed. However, as noted throughout this thesis, contemporary Islamic financial products are frequently designed to replicate the purpose and effect of conventional debt-based structures.[11] The economic similarities (though legal and structural differences) between Islamic financial activity and those structures condemned as contrary to Islam, represents a prominent feature of the contemporary Islamic finance industry and the primary reason why accommodation has been needed. While Islamic structures such as the real estate financing products considered in Chapters 6[12] and 7[13] and the *sukūk* transactions examined in Chapters 8[14] and 9[15] may be designed to substitute interest-based alternatives, compliance with Islamic legal teachings has resulted in their structural distinctiveness. In the absence of accommodation, Islamic real estate financing products and *sukūk*, amongst others, would be treated by Ireland's legal system in accordance with their legal structure as opposed to economic substance. Legally, there is nothing particularly improper about this; Islamic structures are financial products in their own right, separate from interest-based conventional products and, if they

[8] *supra.* at 159and 161.
[9] *supra.* at 168
[10] *supra.* at 104.
[11] See, for example, *supra.* at 146, 311.
[12] *supra.* at 199.
[13] *supra.* at 222.
[14] *supra.* at 295.
[15] *supra.* at 325.

are offered in Ireland, Irish law will, by and large, apply to them.[16] However, from a policy, economic and perhaps societal perspective, looking only to the legal form of these arrangements and ignoring their substance could result in market participants involved in Islamic finance being subject to legal treatment which is distinct in practical terms from that faced by participants using conventional products.[17] Where those Islamic products function like debt and are designed to provide Muslims with a substitute for conventional debt-based financial activity, this distinct and potentially more onerous legal treatment could represent a hurdle frustrating the development of an Islamic finance sector in Ireland.[18]

As discussed in Chapters 6 to 9, Ireland's accommodations of Islamic finance activity have not yet extended beyond taxation. The regulatory status of Islamic products and their position under other elements of Irish law thus remain unclear. Nevertheless, the accommodations already introduced, and those recommended by this thesis, attempt to align the treatment of Islamic and conventional products to the extent that they function like, and act as substitutes for, each other. Effectively, such accommodations propose that Islamic products that function like debt should be treated like debt. They do not, however, attempt to suggest that the Islamic products *are* debt-based. This fact was particularly prominent in relation to Islamic real estate financing products.[19] As noted in Chapter 7, the *ijārah wa-iqtina* and diminishing *mushāraka* arrangements used to finance real property acquisitions function like mortgages and so "level playing field" accommodations may be needed to ensure that they are taxed like mortgages and subject to the same level of oversight and supervision as mortgages. However, such products are not mortgages and to suggest that they are would result in an extension of the definition of a mortgage to a transaction which displays none of the legal characteristics of such products. This could not only weaken the mortgage definition under Irish law, but may also make it more difficult for the Islamic products to comply with Islamic law because of Ireland's prescriptive mortgage regime.[20]

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[16] *supra.* at 379.

[17] Department of Finance, "Section 1 of Finance Act 2010, Report on Tax Expenditures", *PRN A10/0776*, (July 2010), at [9.3], available at: www.finance.gov.ie/documents/.../reports/2010/taxexpenditure.pdf. *Supra.* at 226, 273, 329, and 362 in which the difficulties are considered for Islamic real estate financing and *sukūk*.

[18] *ibid.*

[19] *supra.* at 273 et seq.

[20] *supra.* at 278.

11.2.2 A Difficult Balance and a Need for Pragmatism

The integration of Islamic finance in Ireland's legal system is thus possible. However, such integration involves maintenance of a delicate balance between on one hand, the need to remove legal hurdles faced by this activity and on the other, the need to tax and regulate Islamic financial activity in the same way as conventional products *only* to the extent that the Islamic transactions are actually comparable to the conventional structures. In light of the complexity of contemporary Islamic finance and the continued relevance of Islamic legal dictates, this balance is difficult to achieve. Even Islamic products structured to replicate the economic effect of debt contain elements which are not found - or as in the case of *sukūk* (discussed in Chapter 9), not allowed - in conventional structures such as real property ownership by financial institutions, SPVs or investors.[21] Accommodating these Islamic transactions so that they are treated like debt may thus require such unconventional elements to be "ignored" by the authorities, potentially undermining the integrity of the established legal system, or restricted, thus hampering *Sharī'ah*-compliance.

The reality is that Islamic finance and Ireland's legal system are mutually incompatible such that they cannot both maintain complete structural integrity while operating together. If Islamic finance is to be established in Ireland as a viable sector of the Irish economy, compromise will be necessary from one, if not both sides. While accommodation may be possible, it may be an accommodation with which neither side is entirely comfortable. As such, the accommodation of Islamic finance in Ireland shadows the wider accommodation of religious diversity in society; an unwavering policy of assimilation into the existing culture and laws would restrict freedom to comply with religious belief while abject deference to the whims of every minority would make it difficult to sustain a functioning legal system.

Ultimately, it will be for the market to decide whether the compromises already made by the Irish authorities in accommodating certain Islamic financial transactions are sufficient to facilitate domestic Islamic finance activity. It is suggested that currently, the Irish legal system is still unequipped to treat Islamic financial products and their participants in a consistent, logical and effective manner while also allowing such activity to fulfil the dictates of Islamic law. Further tax accommodations and adjustments to Ireland's property and regulatory laws should be considered by the Irish authorities.

[21] *supra.* at 349.

However, while the proposals made in this thesis for further accommodation may remove some of the existing hurdles, the Islamic finance industry itself must be pragmatic and acknowledge that a level playing field approach works both ways; if an Islamic product does not function like a particular conventional structure then its participants cannot expect it to be treated like that conventional structure by Ireland's laws.

11.3 Conclusion to Chapter 11

In 1998, Vogel and Hayes suggested that; "Islamic finance is now on the verge of either major transformation, or a period of frustration and probable decline."[22] Since this prediction, the Islamic finance industry has grown significantly and developed into an identifiable segment of the global economy. The prediction also suggested that success in the Islamic finance industry would arise from a move by the industry away from replicating conventional structures and into genuine profit-and-loss sharing arrangements.[23] As this has not happened, the current Islamic banking and finance industry is perhaps not what Vogel and Hayes imagined it would be. Many books on Islamic finance conclude with an appeal by the authors for a greater emphasis on substantive compliance by the industry with Islamic law.[24] Such appeals emphasis the need to reject "pseudo-Islamic"[25] products and to develop a financial sector based on social justice, equitable distribution and risk and reward sharing. It must be questioned whether the approach to accommodation adopted in countries, such as Ireland, may be encouraging the tendency in Islamic finance activity to replicate the substance of conventional debt, as it is only these types of products which are accommodated. Any attempt by the participants to engage in profit-and-loss sharing will thus result in the Islamic structure falling outside the accommodating provisions. It is not appropriate for the Irish Government to make a determination of what is and what is not *Sharī'ah*-compliant[26] yet following developments such as the AAOIFI *sukūk* clarification,[27] there may now be more attempts within the industry itself to comply with Islam in form *and* substance. This could significantly alter

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[22] Vogel, Frank E. and Hayes, Samuel.L., *Islamic Law and Finance, Religion, Risk and Return.* (The Hague, Kluwer Law International, 1998), at 292.

[23] *ibid.*, at 292-293.

[24] See for example, Ahmed, Habib, *Product Development in Islamic Banks*, (Edinburgh University Press, Edinburgh, 2011), at 223-225, Vogel, Frank E. and Hayes, Samuel.L., *Islamic Law and Finance, Religion, Risk and Return*, note 22, at 291-295 and El-Gamal, Mahmoud Amin, *Islamic Finance: Law, Economics, and Practice* (Cambridge University Press, Cambridge, 2006), at 190-191.

[25] Ahmed, Habib, *Product Development in Islamic Banks*, note 24, at 223.

[26] *supra.* at 383.

[27] *supra.* at 316.

the types of products offered to Islamic finance market participants and modify the risks faced by those participants; in such circumstances, Ireland would need to reconsider its accommodation of this sector.

As yet, transactions complying with Islamic law in form and substance remain very much in the minority. The inclination to replicate conventional products is understandable yet the increasingly complex structures used to achieve this similarity, without openly violating religious dictates, do suggest a certain unsustainability of such activity. To reference an expression used by Ballantyne, the conflict in Islamic finance between the lure and omnipotence of modern financial activity on one hand, and loyalty to the enduring principles of Islamic law on the other, is that of an irresistible force against an immovable object. [28] At this point, it is not yet entirely clear which one - if either - will ultimately have to give way.

[28] Ballantyne, W.M., *Legal Development in Arabia*, (Graham & Trotman Limited Publishers, London, 1980), at 121. The exact phrase that Ballantyne used was "an irresistible force against an *irremovable* object" (emphasis added). However, the terminology more widely adopted when discussing this paradox is used here as it is suggested that it in fact better sums up the importance of ancient religious teachings in contemporary Islamic finance; the question is not so much whether such teachings can be removed (clearly they cannot as this would eliminate the very basis for having Islamic finance) but rather whether they can be modified or changed in line with contemporary needs.

APPENDICES

Appendix 1

Email Communication with Thomas Ryan, Financial Regulator (which is now the Central Bank) on April 20, 2009 and May 25, 2009.

Question 1:

I was wondering if you could tell me if there is currently a tailored regulatory framework in Ireland for financial products which are compatible with Islamic legal principles?

Question 2:

I was also wondering if you are aware of any impending developments in the area of Islamic finance in Ireland?

Answer:

The Central Bank and Financial Services Authority of Ireland ("the Bank") is the competent authority in Ireland for the authorisation, regulation and supervision of collective investment schemes. Within the Bank, the functions in this regard are performed by the Irish Financial Services Regulatory Authority ("the Financial Regulator").

There are currently a number of funds which have been authorised by the Financial Regulator which are Shariah compliant. Such funds are subject to the same authorisation process as other funds the Financial Regulator authorise i.e. non-UCITS retail or UCITS funds and the fund itself will oversee compliance with Shariah law. I refer you to our website www.financialregulator.ie where you can access information in relation to UCITS and non-UCITS funds. In order to access this information, please log on to our website and click on "Funds" on the homepage.

On recognising the significant activity in the Shari'ah funds area, the Financial Regulator recently has identified an authorisation team in our Financial Institutions and Funds Authorisation Department that will specialise in the authorisation of Shari'ah funds and this will ensure efficiency and consistency when processing such applications. In addition, the Financial Regulator has also committed to proactively engage with our counterparts in the various Regulatory Authorities, to foster familiarity between the regulatory system pertaining here and in the MENA (Middle East and North African)

countries in anticipation of potential investment managers/promoters approval requests, should they seek to use Ireland as a jurisdiction for their international investment funds.

Question 3:

I was reading the prospectus for the Sun Finance Limited and regarding Ireland it states that "Application has been made to the Irish Financial Services Regulatory Authority (the "Financial Regulator in Ireland") as competent authority under Directive 2003/71/EC, for this Prospectus to be approved." [page 1 of the prospectus] I was wondering if you would be able to tell me how this transaction would be treated under Irish regulatory law in light of the fact that Ireland has no direct equivalent to the UK's FSMA 2000?

Answer:

By way of background, the Central Bank and Financial Services Authority of Ireland (the "Bank") is the competent authority in Ireland for the authorisation, regulation and supervision of collective investment schemes ("CIS"). Within the Bank, the functions in this regard are carried out by the Irish Financial Services Regulatory Authority (the "Financial Regulator").

CIS in Ireland are established under the following pieces of legislation:

- European Communities (Undertakings for Collective Investment in Transferable Securities) Regulations, 2003 ["the UCITS Regulations, 2003"]; (These regulations transpose the provisions of the UCITS Directive into Irish law)
- Unit Trusts Act, 1990;
- Part XIII of the Companies Act, 1990;
- Investment Limited Partnership Act, 1994; and
- Investment Funds, Companies and Miscellaneous Provisions Act, 2005.

The aforementioned pieces of legislation are available from the Irish Governments website: www.irishstatutebook.ie or from the Irish Governments Publication Office.

CIS in Ireland can be established under two broad categories, as follows:

1. **UCITS** (Undertakings for Collective Investment in Transferable Securities) are authorised under the European Communities (Undertakings for Collective Investment in Transferable Securities) Regulations, 2003 ["the UCITS Regulations, 2003"], they are open-ended retail CIS's which may take the form of a Unit Trust, an Investment Company or a Common Contractual Fund; and

2. **Non-UCITS** (NU) which may be constituted as either open-ended or closed-ended and can be authorised as:
    a) a Unit Trust under the Unit Trusts Act, 1990,
    b) an Investment Company under Part XIII of the Companies Act, 1990;
    c) a Common Contractual Fund under the Investment Funds, Companies and Miscellaneous Provisions Act, 2005; and
    d) an Investment Limited Partnership under the Investment Limited Partnerships Act, 1994.

The Financial Regulator has issued a set of UCITS and NU Notices and Guidance Notes detailing our specific requirements in relation to CIS and their service providers. These documents are available from our website www.financialregulator.ie under the "funds" headings.

Before considering an application for the authorisation of a CIS, it will be necessary for an applicant to determine if the proposed arrangement falls within the remit of the above mentioned legislation. It is an offence to operate without the necessary authorisation (the applicant's own legal advice should be obtained in this regard). If it is determined that the applicant's proposal falls within the regulatory regime applied by the Financial Regulator, it will be necessary to consider the proposed parties to the CIS (i.e. investment manager, distributor, administrator, trustee/custodian), and the most important being the promoter. A CIS may not proceed without an acceptable promoter. The promoter is the driving force behind the CIS and usually finances the project. The promoter is not authorised or supervised by the Financial Regulator for this activity. However, the Financial Regulator must be satisfied that the promoter of the CIS is of good repute has a significant level of financial resources and a demonstrable and relevant track record in the promotion of CIS. The Financial Regulator looks at the ownership structure, funds under management and audited accounts. Generally such firms are regulated by a supervisory authority in a regulated jurisdiction.

Finally, with respect to applications for approval under the provisions of the Prospectus Directive, I refer you to the following link on the Financial Regulator's website. The Financial Regulator is the competent authority for the purposes of the Prospectus Directive (2003/71/EC) Regulations 2005. The purpose of the Regulations is to harmonise requirements for the drawing up, approval and distribution of the prospectus to be published when securities are offered to the public or admitted to trading on a regulated

market. In summary, the Regulations require, inter alia, persons who make an offer of securities to the public or seek admission of securities to trading on a European Economic Area (EEA) regulated market, such as that operated by the Irish Stock Exchange Limited, to publish a prospectus that is subject to prior approval by the competent authority.

Question 4:

Finally, you noted that Ireland has authorised a number of funds. I have been able to find reference to the Sun Finance Sukuk and the NICBM Sukuk, are you aware of any others?

Answer:

Registers in relation to Irish authorised funds are available on our website. Unfortunately, the Financial Regulator do not maintain specific statistics in relation to Shariah compliant funds.

Appendix 2

Email Communication with Geraldine Murphy, Financial Regulator (which is now the Central Bank) on July 5, 2009.

Question 1:

I was wondering if you would be able to provide me with more information on the development of a team which is responsible for this authorisation and whether further steps have been taken within the Financial Regulator or the financial services sector more generally to encourage the establishment and operation of *Sharī'ah* funds in Ireland?

Answer:

Further to your email, the authorisation process for a Shari'ah fund is the same as for any other fund seeking authorisation under the same legislation (UCITS Regulations, Companies Act 1990, Unit Trusts Act 1990). The Financial Regulator does not impose any additional restrictions/conditions in relation to a Shari'ah fund. The fund itself will oversee compliance with Shari'ah law. For further information in relation to the authorisation process for a fund please refer to our website, www.financialregulator.ie

Question 2:

There is limited information available about the authorisation or prevalence of Islamic Finance in Ireland. In relation to the authorisation of Shari'ah funds, I have been able to find reference to the Sun Finance Sukuk and the NICBM *Sukūk*, are you aware of any others?

Answer:

Registers in relation to authorised funds are available on our website and each register lists funds authorised under a particular piece of legislation. We do not maintain a separate register for Shari'ah funds.

Appendix 3

Email Communication with Pat O'Connell, Revenue Commissioners, Dublin Stamp Office, on July 5, 2009.

Question 1:

I was wondering if you would be able to tell me if an Islamic mortgage in Ireland is subject to a double imposition of stamp duty as was the case in the UK [first on the purchase of the property by the lender and then its subsequent transfer to the borrower]? On a reading of the Stamp Duties Consolidation Act, 1999 it seems that s.1 will apply to both the initial purchase by the bank and then the transfer to the borrower as both represent a transfer of immovable property situated in the State, or any right over or interest in such property [under schedule 1 of the Act] However, I am not sure that I have understood the legislation correctly.

Answer:

The stamp duty treatment of Islamic mortgages will depend on the manner in which the transaction is structured and the documentation executed to give effect to the transaction. Where the structure involves the purchase of the property by a financial institution and the subsequent sale of the property by the financial to the "borrower", a liability to stamp duty will arise on both transfers of the property as each transfer effects a separate sale of the property

Question 2:

I was also wondering whether any alterations have been made in Irish legislation which are in line with legislative developments in the UK which provide relief from this double taxation in s.71A and s.73 of the Finance Act 2003?

Answer:

I can confirm that no legislative provisions, similar to the UK provisions referred to in your e-mail, have been introduced into the Irish stamp duty code.

Appendix 4

Email Communication with Marie Hurley, Revenue Commissioners, on October 6, 2010.

Question 1:

Trading status of sukuk SPVs - Case law would suggest that an SPV which is just issuing securities and holding assets would struggle to show that it is a trading company for tax purposes and since sukuk SPVs fall outside of the securitisation regime they cant benefit from this exemption. however, someone mentioned that the revenue has acknowledged that they will treat SPVs as trading even if they dont fall within the securitisation regime - I cant seem to find any authority for this though. As a follow up to this I was just wondering what the implications of not being treated as a trading company are? Is it simply that the SPV will fall within case IV rather than case I of Schedule D? Will this impact on the expenses which can be deducted for corporation tax purposes?

Answer:

We have not yet given any thought to the issue of whether a sukuk issuing SPV would be trading. Until we have an actual case, it is difficult to set out a definitive tax treatment. If an SPV is not considered to be trading, its income would be taxed under case III, IV or V depending on the nature of the income. Case IV and V allows for expense deductions whereas Case III does not.

Question 2:

s.110 inapplicability to tangible assets - I was just wondering if there is revenue precedent explaining why this is the policy?

Answer:

Section 110 was drafted to deal with securitisation transactions. As these mainly concern financial assets, the legislation was thus confined to financial assets.

Question 3:

In relation to stamp duty - the UK has a sale and lease back exemption which prevents the double taxation of the documents [this is in addition to the sukuk exemptions recently

introduced] - I cannot seem to find a similar exemption in Ireland and revenue guidelines would seem to suggest that none exists but I could be missing something obvious.

Answer:

No there is no exemption from stamp duty in these circumstances.

Appendix 5

Email Communication with Roy Parker, McCannFitzgerald Solicitors, Dublin on August 25, 2010.

Question 1:

I was wondering if you would be able to clarify the regulation of bond issues in Ireland. Regulation 5(1)(c) European Communities (Markets in Financial Instruments) Regulations 2007 exempts from authorisation;

> persons who do not provide any investment services or activities other than dealing on own account, unless -
>
> > (i) they are market makers, or
> >
> > (ii) deal on own account outside -
> >
> > A. a regulated market, or
> >
> > B. an MTF,

Would this exemption be sufficient to remove bond issuers who do no more than issue securities from the need for authorisation by the Regulator? The UK has specifically excluded the issue of debentures from the ambit of FSMA 2000 thus removing the need for a bond issuer to be authorised Ireland's exemption is significantly less specific and I am unsure if it covers the issue of bonds.

Answer:

I think you need to be clear whether an activity is regulated and if so whether that regulation arises under MiFIS or a domestic regime. For the reasons indicated below, it is not clear to me that MiFID would apply to an issuer which simply issues a sukuk bond.

The starting point with MiFID is that MiFID regulated activity would catch the issuance of sukuk in the absence of an exemption. Exemptions are only relevant if the activity would otherwise be caught as a regulated activity. The main area of MiFID regulated activity is likely to be 'dealing on own account' in the relevant instrument (sukuk here). The issue should be the same for typical debt and equity securities as well as sukuk – nothing for MiFID purposes should turn on the status of securities as sukuk. The term 'dealing on own account' is not precise, but it is not regarded as applying merely to a company/issuer issuing debt or equity securities in order to fund itself. Something more is required – in

particular, a client/professional type relationship between an issuer and its investors. If it were otherwise, any company issuing securities would be regulated under MiFID which is not the case. In fact, many investment vehicles such as funds are not regulated under MiFID rather their financial service providers, including distribution agents – who actually sell their securities, are so regulated.

If the UK authorities introduced a MiFID safe harbour for sukuk, it raises the issue why lots of other issuers are not so exempt. The Irish MiFID position (including the exemption you refer to) reflects the MiFID directive so it may be that the UK exemption you refer to applies in the case of a domestic UK FSMA regime outside MiFID rather than within the UK MiFID regime. Ireland has no such regime other than the Unit Trust Act which we discussed. I am aware that the UK FSMA regime extends beyond the MiFID regime and this may be where their sukuk exemption is relevant.

Neither the UK or Irish authorities can move the goal posts set under the MiFID Directive in terms of what activities are subject to MiFID regulation.

Question 2:

From a structural point of view, it seems probable that the most sukuk structures [involving the collective investment by an SPV of investor subscriptions in income generating assets] would fall under the regulatory classification of CIS generally and unit trusts more specifically. In light of the substantive difference between sukuk structured to replicate debt and those displaying equity-like characteristics however, an overarching regulatory definition of sukuk would appear to be impossible. While those sukuk which are equity in nature should be regulated as CIS, I feel that like the UK, Ireland will have to clarify the regulation of sukuk which are more readily aligned with debt. The UK has specifically exempted the issue of certain conventional debt securities from their own CIS regime and has used this exemption as a guide when clarifying the regulation of sukuk. I cannot however seem to find a similar exemption for conventional debt securities in Ireland would this not potentially catch SPVs in securitisation transactions with the result that rather than being subject to the regulatory regime for debt securities [prospectus and listing rules if issued to the public, companies acts if established as a private or public company, potentially the ECB Regulation 24/2009 reporting standards] securitisation transactions in Ireland could trigger the more onerous regulatory standards applying to collective investment funds? Articles that I have read relating to regulation of the capital markets

consistently state the neither securitisations nor unsecured bond issues will result in regulation other than disclosure requirements and so I was wondering if this conclusion has been reached as a result of market practice or if it is provided for in the legislation/regulators guidance?

Answer:

Securitisation bonds (common law ones) are typically secured debt. The bondholders hold security over specific assets of the SPV for their bond debt. On enforcement, the secured assets are sold and the proceeds used to discharge the debt as in the case of any enforcement of security. If there is a surplus of proceeds after the bond debt is discharged, that surplus is the 'equity of redemption' to which the SPV – not the bondholders – is entitled. The security does confer a security proprietary interest in the SPV's assets, but not a beneficial/equitable interest akin to a unit trust. For that reason typical (common law) securitisation bonds are not regarded as subject to the Unit Trust Act. The same position was, I understand, the same in the UK when it had a Unit Trust Act.

I think that the UK Unit Trust Act was replaced by the FSMA. I do not know whether the FSMA extended the UK Unit Trust regime so that it could catch securitisation bond or whether no extension took place but the opportunity was used in 2000 to state the position about securitisation bonds. The Irish Unit Trust Act was put in place in 1990 which predates by many years the advent of securitisation and that act has not been amended substantially since 1990. As discussed previously, where sukuk are debt/secured debt, the Unit Trust Act should not pose a problem. Where sukuk involve beneficial interest or equivalent the Unit Trust Act is a problem as it could impose onerous and long-term obligations on the parties to the transaction.

Appendix 6

Email Communication with Eleanor MacDonagh, McCannFitzgerald Solicitors, Dublin on August 30, 2010.

Question 1:

When we met at McCanns you mentioned that there was a case/revenue policy dealing with the treatment of SPVs as trading companies even if they do not fall within the s.110 securitisation provisions - I haven't been able to find anything definite to confirm this but I am probably just looking in completely the wrong place - do you know the name of the relevant case?

Answer:

Whether or not a company is conducting a trade is a question of fact that should be analysed with regard to the Badges of Trade and relevant case law. Historically, most cases taken by Revenue in this context were taken to prove that a trade did exist. This is because prior to 1975 capital gains tax did not exist and therefore, on many occasions, gains on disposals of assets were outside the scope of tax unless earned in the course of a trade.

A qualifying company within the meaning of section 110 of the Taxes Consolidation Act 1997 as amended (the "Taxes Act") (a "Qualifying Company") is not regarded as conducting a trade. However, albeit that its profits are taxed as non-trading profits, they are calculated as if the company were carrying on a trade. Revenue permits certain aviation leasing SPVs to be treated as trading companies where the manager of the SPV is located in Ireland.

Also, it is important to note that (i) the fact that a company has been established for a special purpose does not mean that the purpose cannot be to conduct a trade; and (ii) the activity of conducting a trade can be outsourced by a company and yet a trade may still be considered to be conducted by that company provided that the directors of the company manage the outsourcing arrangement to a sufficient degree.

Question 3:

Ireland's securitisation regime is applicable to SPVs holding "qualifying assets." Are you aware of any flexibility on the Revenue's part as regards the nature of these assets?

Answer:

Qualifying assets in the context of section 110 companies is restricted to financial assets such as shares. SPVs have asked for this range of assets to be expanded to include property and tangible assets. However, Revenue has refused to allow section 110 SPVs to hold anything but financial assets due to fears that the section 110 regime may be taken abused if these SPVs could hold property. This could be problematic for sukuk SPVs as they cannot deal in financial assets.

Question 2:

On a more general note, I was just wondering why securitisations are taxed as debt? As investor payments are largely if not wholly dependent on the performance of the underlying assets this seems to be similar to equity (with the result that securitisations are specifically excluded from s.130(2)(d)(iii) TCA 1997) - is this because the investors are exposed to the performance of a distinct pool of assets rather than the performance of a company? If so, this would seem to prevent *mushāraka* and *mudāraba sukūk* which have no purchase undertaking from qualifying for the exemption.

Answer:

A Qualifying Company is only tax neutral because it is taxed as if it conducts a trade and therefore, notwithstanding the provisions of section 130(2)(d)(iii) of the Taxes Act, the Qualifying Company obtains a tax deduction for interest or any other distribution paid on the securities that it issues (provided certain conditions are met). In other words, if the Qualifying Company did not pay interest on debt and instead paid a dividend, it would have a tax bill equal to 25% of the dividend amount; this is because a dividend is not an expense to be deducted in arriving at profits, it is an appropriation of profits by way of distribution.

A dividend is always a distribution for tax purposes and thus non-deductible, while interest is generally tax-deductible if incurred on monies applied for trading purposes (or deemed to be so applied). This is unless section 130 of the Taxes Act applies to treat that interest for tax purposes as if it were a distribution. For profit-participating interest and interest in excess of an arm's length rate, section 130(2)(d)(iii) of the Taxes Act deems that interest to

be a distribution for tax purposes; however section 110 of the Taxes Act, for Qualifying Companies, disapplies that provision in certain circumstances.

Appendix 7

Email Communication with Shahzad Ahmed, Dublin on August 12, 2011 following a series of meetings.

Question 1.

Do you personally believe that there is a market for retail level Islamic financial products in Ireland? Are you aware of a general feeling amongst the Muslim community that such products would be a welcome addition to Ireland's financial system?

Answer:

I personally believe that there is definitely a market, albeit a bit small, at this stage for retail level Islamic finance in Ireland. I do however believe based on my discussions with the community leaders around the country and my own direct liaison and extensive contacts with several community members around the country within the Muslim community that there is a great potential for growth for a community owned credit union type authorized and regulated financial institution. There seems to be an adverse reaction from the community to the banking sector due to the recent scandals. Prevailing attitude of the Muslim community in Ireland is that the majority are looking forward to the introduction of and availability of retail sharia compliant financial products.

Question 2.

If you would be interested in participating in Islamic finance activity, are there any products you would be particularly interested in?

Answer:

Yes indeed - I would be interested in participating in most Islamic financial products such as most sharia compliant models: Murabaha model for car loans, consumer goods, Ijara and Murabaha models for Islamic mortgages and housing finance, Mudaraba for business financial transactions, qard-e-hasana for short term interest free loans, sukuk for long term investing, and other similar models that would allow the community to benefit fully from the long awaited Islamic financial products including much talked about halal "credit cards".

Question 3.

How would you feel about a non-Shari'ah compliant bank providing Islamic products?

Answer:

I personally would have no problem using a conventional bank offering sharia compliant financial products, but only as far, and as long, as there is no sharia compliant institutions to compete with. Once I am aware of the existence of a sharia compliant alternative, I would feel duty bound to explore the fully sharia-compliant alternative, and to carry out the feasibility and practicality of using that option. Once that option is considered, checked out and exhausted, only then will I consider using the interest based equity financed conventional bank offering sharia compliant financial products. Most of my friends and people that are in my circle of contacts have the same views.

Question 4.

Do you feel that the current lack of officially sanctioned retail Islamic finance transactions in Ireland is affecting your ability to fulfil your religious beliefs or do you believe that economics and religious belief should be kept separate?

Answer:

It is not affecting my ability to fulfill my personal religious beliefs because my priorities may be different to the others. For example I have been happy renting my current and previous accommodation as in the present financial climate it is providing me with a better value for money. Also I am privileged to have a good supportive family so if I am ever stuck financially my family bails me out. But as for other Muslims in Ireland, I know that it is affecting a lot of people here in Ireland as argued in the Muslim Entrepreneurship in Ireland report. Several people in my circle of contacts believe that the rent is "dead" or "down the drain" money. Students for example could do with provision of murabaha model of finance in catering for their need for short term financing for the purchase of a second hand car, motor-bike, laptop, and other consumer products etc. I know several people who cannot start, develop or grow their business due to the lack of Islamic financial products. I am happy banking with conventional financial institutions as in I have reached an agreement with them in that they do not charge me interest if I go overdrawn and in return I (happily) forego interest in accordance with my religious beliefs so this agreement is in the interest of both parties. I must however hasten to add that this is not the usual practice

in the banks and is heavily dependent on customer's individual relationship with their branch.

Having said that I do not however believe that economics and religion should be kept separate. A Muslim's entire life revolves around his faith i.e. his religion i.e., his deen: his way of life. Islam as you know is a complete code of life which includes all aspects of a Muslim individual's life: politics, economics, society etc.

Question 5.

In the absence of retail Islamic finance transactions in Ireland have you personally, or are you aware of any members of the community who have, engaged in grass-roots Islamic finance activity (eg money clubs, co-operatives etc)?

Answer:

Due to the stringent regulations it has not been possible for the community to start their own credit union type of financial co-operative such as the ones in existence in the USA, Australia, New Zealand, Canada, Trinidad and Tobago, and Mauritius. However the community is encouraged by the current development in the wholesale area of the Islamic finance sector and looks forward to the introduction of the similar regulatory framework at the retail level which might translate into the formation of a Muslim Credit Union or similar organization.

To the best of my knowledge and experience with members of the Muslim community around the country (including Northern Ireland) several ad hoc unregistered and informal self-help microfinance groups exist. While their basic functions are the same across all cultures in the Muslim Community yet they are called by different names: Some are called The Rotating Savings and Credit Associations, some Co-operative, some called sulfa, some BC, and Ajo. They all exist to discharge the function of often urgent financing needs of the community. They are invariably unregistered self-help credit and saving clubs formed initially to help a closely knit group of individuals who trust each other to obviate the need to go to the bank as they would not be regarded as a good risk by the bank. The needs are as varied and diverse as the community itself coming from several countries.. Examples include repayment of an interest-based mortgage which a Muslims has taken out but now wants to end, purchase of car, purchase of travel tickets, computer purchase, home

renovations, business start-up, home remittance, medical treatment, loan repayment, credit card payment, education tuition fees etc.

Bachchat (Saving) Committee: BC's are Pakistani self-help groups of like-minded people who come and join forces together for a common purpose of helping each other financially to serve a particular need for each individual member of the group. I have been coordinating a few groups every year for the last 9-10 years. Every year around 5,000-10,000 per month is raised by members and given to one individual on the basis of pre-determined draw or mutual agreement based on the need. Our groups have included mainly Pakistanis but have at times on request also accommodated members from the Kurdish, Libyan, Algerian, and Indian and Bangladeshi communities. So far we have been running it without any problems or surprises but it's not easy to manage. There is a lot of administrative burden involved in running after people to collect money- this has its own problems.

Other groups that I know exist:

- Mosque based waqf (trust)
- Nigerian Savings Club - Ajo
- Algerian community Jamaiyyah
- Algerian ladies Jamaiyyah
- Libyan ladies group jamaiyyah/ta'awaniyyah (co-op)
- Palestinian community in Dublin similar group
- Kurdish community around Ireland (sulfa)
- Iraqi community in Dublin
- Pakistani ladies group in Castleknock, Dublin 15, and also in Clonsilla, Blanchardstown, Dublin 15.
- Pakistani ladies group in Liffey Valley, Lucan.
- Egyptian community (both Muslims and orthodox Christians)
- Sudanese both Muslims and Christians (not due to religious reasons but due to the unavailability of finance in general to people with low credit rating)
- Congolese (Non-Muslims) (Financial Co-operative)
- Lebanese Shia community
- Syrian Community in Ballyhaunis (Co. Mayo)

Appendix 8

Survey and Results

Muslims in Ireland – Survey

As part of the ongoing groundbreaking research carried out by "The history of Islam in Ireland" project at University College Cork (UCC), we are delighted to invite you to participate in our survey.

The aim of the survey is to gain a better understanding of Muslims in Ireland. For example: What services do Muslims in Ireland want? (i.e Islamic Banking and Finance?); In what ways do Muslims practice in Ireland?

The survey is completely CONFIDENTIAL and ANONYMOUS which means we will not be able to identify you in any way. Your responses will only be used for purely academic purposes.

We thank you for your time and support for the project.

For more information or comments, please contact:

Dr Vivian Ibrahim (History of Islam in Ireland-UCC) V.Ibrahim@ucc.ie

or

Edana Richardson (PhD candidate –TCD) erichar@tcd.ie

For more information about the 'History of Islam project in Ireland' visit:

http://www.ucc.ie/en/studyofreligions/islamproject/ProjectDescription/

Part 1. Personal Details

1. What is your AGE GROUP?

- ☐ Age 0 – 25 years
- ☐ Age 26 – 34 years
- ☐ Age 35 – 44 years
- ☐ Age 45 – 54 years
- ☐ Age 55 – 64 years
- ☐ Age 65 +

2. Please indicate whether you are MALE or FEMALE

- ☐ Male
- ☐ Female

3. What is your NATIONALITY?

- ☐ Irish
- ☐ Dual Nationality please specify in the space provided)
- ☐ Other (please specify in the space provided)

4. What is your PLACE OF BIRTH?

- ☐ Ireland
- ☐ North America or Europe
- ☐ The Middle East
- ☐ South Asia
- ☐ Other (please specify below)

5. What is your level of EDUCATION?

- ☐ Primary School
- ☐ Secondary School
- ☐ Undergraduate Degree
- ☐ Post-graduate (Masters / PhD)
- ☐ Professional qualification
- ☐ Other
- ☐ Not sure

6. What is your PROFESSION?(Please specify in the space provided)

7. What is your annual combined income?

- Under €20,000
- €20,000 - €45,000
- €45,000 - €65,000
- €65,000 - €90,000
- €90,000 - €125,000
- €125,000 +
- Unsure

Part 2. Islamic practices in Ireland

8. Please indicate which one of the following is the most accurate:

- ☐ I am Muslim by birth
- ☐ I converted to Islam (please provide details in the space provided)
- ☐ details in the space provided)

9. Would you describe yourself as Muslim?

- ☐ Yes (Practising)
- ☐ Yes (Non-practising)
- ☐ No
- ☐ Not Sure

10. Would you describe yourself as a practising Muslim, please specify the ways you practise your religion

- ☐ Daily prayers (5 times a day)
- ☐ Daily prayers (1-4 times a day)
- ☐ Prayers (occasionally)
- ☐ Friday prayers
- ☐ Friday prayers (occasionally)
- ☐ Go to mosque(once a week)
- ☐ Go to mosque (once a month)
- ☐ Go to mosque (occasionally/on special occasions such as Eid)
- ☐ Fast Ramadan
- ☐ Perform Hajj
- ☐ Not sure
- ☐ Other Ways? (please specify below)

11. Would you be interested in the following Islamic Services?

- ☐ Halal food
- ☐ Islamic Finance
- ☐ Islamic Family matters (For example: legalisation of Islamic marriage by Shaykh, Islamic divorce)
- ☐ Not sure
- ☐ No
- ☐ Other (please state in the space below)

12. How would you describe your awareness of Islamic Banking and Finance?

- ☐ Excellent
- ☐ Good
- ☐ Fair
- ☐ Poor
- ☐ Unsure

13. If Islamic banking and finance was available in Ireland would you consider using it?

- ☐ Yes (go to question 14)
- ☐ No (go to question 16)
- ☐ Maybe (please provide details in the space provided)

14. What would be your main reason for using Islamic services?

- ☐ Religious
- ☐ Economic
- ☐ Both Religious and Economic
- ☐ Ethical Considerations
- ☐ Unsure
- ☐ Other (please specify in the space provided)

15. Which of the following financial products would you be interested in using if they could be provided in an Islamically compatible manner?

- ☐ Current Account
- ☐ Savings Account
- ☐ Overdraft Facility
- ☐ Mortgage/Home Loan
- ☐ Personal Loan
- ☐ Foreign exchange facilities
- ☐ Credit Card
- ☐ Capital Market participation (For example: Dealing with shares)
- ☐ Not sure
- ☐ None
- ☐ Other (please specify below)

16. Would you be prepared to use Islamic facilities at a non-Islamic bank (if available) rather than a wholly Islamic bank?

- ☐ Yes
- ☐ No

17. Are there any other Islamic practices that you would be interested in using?

- ☐ Islamic Marriage (recognised by the state)
- ☐ Islamic Divorce (recognised by the state)
- ☐ Multiple marriages
- ☐ No
- ☐ Other (please provide details in the space provided)

18. To what extent do you feel you are "integrated" in Ireland?

☐ Completely Integrated ☐ Mildly/Partially
☐ In what ways?

19. Have you ever felt that you have been treated differently as a result of your religion?

☐ Yes ☐ Maybe
☐ No ☐ Unsure

20. Please provide any other details which you feel are relevant

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THE INTEGRATION OF ISLAMIC FINANCE INTO THE IRISH LEGAL SYSTEM: CURRENT ISSUES AND FUTURE CHALLENGES

Edana Richardson

Abstract

This thesis examines the accommodation of Islamic finance in the Irish legal system. It considers current issues and future challenges which may arise should Islamic financial products and transactions be offered under Irish law. It explores the theological basis of Islamic finance and the legal framework under which an Irish Islamic finance industry would operate. By analysing the interaction between the structures and concepts found in the contemporary Islamic finance industry and relevant provisions of Irish law, this thesis considers the potential legal treatment of Islamic financial transactions and their participants.