

ISLAMIC FINANCE: CURRENT LEGAL AND REGULATORY ISSUES

Social dynamics of the debate on default in payment and sale of debt.

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The current debate on regulatory issues reflects a variety of approaches. Most experts in Islamic law, the *fuqaha* use analogical reasoning and try to make past rulings their guide to a rule for today. Most economists, on the other hand, argue in terms of socio-economic consequences and seek rules that would bring in the desired state of the world. This paper demonstrates this with reference to two important issues. It then proceeds to make a plea for a more integrated approach.

Jurists are trained to arrive at new rules governing a situation that is wholly or partly novel mostly by analogical and deductive reasoning. Social philosophers are concerned with certain values. They are always evaluating new rules on these criteria, often concluding that new rules are not good enough. Insofar as there is a good case for betterment the jurists are obliged to have a second look, invoking methods which are more accommodative of the very values that concern the social scientists like justice and fairness, even promotion of the common weal. In the Islamic tradition we often come across rules arrived at by analogical reasoning (*qiyas*) being abandoned in favor of rules designed to protect/promote the benefit (*maslaha*) desired. In economic literature there has been a debate between those who would maximize production, thereby creating as much new wealth as could be created, and those whose primary concern is with social justice and ensuring dignity and security for every human being.

Law is concerned, primarily, with fairness whereas social good, including economic good, is conceived in terms of provisions that depend, ultimately, on production. Fairness is necessary for ensuring dignity whereas wealth is needed to guaranty security.

In this brief paper I propose to demonstrate that a tension similar to the one described above is discernable in the current debate on legal and regulatory issues in Islamic Finance. To illustrate I select two issues that are attracting considerable attention: How to deal with delays in payment of debts resulting from sales on credit, mostly in murabaha deals, and; Permissibility of securitization and sale of debts resulting from murabaha and other credit transactions. It is well known that widely different positions have been taken on these issues. I will try to show that differences may be rooted in the priorities of the position taker. Those giving more importance to production and creation of wealth care more for efficiency. They want to ensure the flow of credit, economize on use of cash, etc. Those who care more about fair dealings and social justice are more concerned with avoiding any involvement with *riba*/interest, whose prohibition is the first threshold of keeping away injustice and unfair practices.

It goes without saying that Islamic economics as a discipline cares about efficiency as well as justice and fairness. It is well aware of the fact that in a balanced realization the two reinforce each other. This does not, however, preclude the possibility that scholars having different backgrounds may differ in their priorities.

Economists tend to care more for efficiency, or at least think that efficiency comes first. The more you produce the fairer you can afford to be in distribution. The less you have the more the temptation to be self-serving. In dealing with a certain situation economists are always thinking of how to improve that situation, how to have more of what we already have. Law, on the other hand, focuses on fairness in a given situation. Improving situations or caring for more is hardly in focus. As the debate on current legal and regulatory issues in Islamic finance involves scholars drawn

from various disciplines, tensions develop which have the pleasant potential of leading to resolutions a narrower approach would fail to achieve.

The Debate on Delay in Payment

The debate on *mumatalah* or delay in payment of a debt incurred in a credit purchase predates the debate on sale of debt (*bai' al-dayn*). It started in all earnest in the early eighties of the last century. The practice of murabaha, the chief source of debts under discussion, had spread in the late seventies, bringing this issue into focus. The possibility of delay in payment raised the questions: How and when to penalize the defaulter and whether to compensate the creditor and if so, how? The principle of penalizing a defaulter who is capable of payment is universally accepted but neither the need for compensating the creditor nor the method of doing so is agreed upon, fearing it may open the door for *riba* (Saleh, 2002, pp. 92-93).

The debate was conducted in various forums, e.g., Shariah Advisory Boards, Seminars and Conferences and Academic Journals. In this brief note I confine myself to the last one, especially to the Journal published by the Center for Research in Islamic Economics at the King Abdulaziz University in Jeddah. Since it has been mostly the same scholars involved at all these forums, nothing of significance will be missed, I hope.

A good summary of the debate, as at the end of the eighties, is provided by a paper jointly authored by Mohammad Anas Zarqa and Mohammad Ali Elgari, henceforth referred as Zarqa & Elgari¹.

To restate the issue: How do we deal with one who buys on the promise of paying the price on a certain date in future but delays

¹ Mohammad Anas Zarqa and Mohammad Ali Elgari, AFTA 'wid 'an darar al-mumatalah fi'l dayn bain al-fiqh wa'l Iqtisad, *Journal of King Abdulaziz University: Islamic Economics* (Jeddah) vol. 3, 1411/1991, pp.25-57, Arabic Section

payment thereby inflicting harm on the seller/creditor? Zarqa & Elgari rightly begin by noting the importance of this issue for a system that does not charge interest as more time passes before payment is made. They also note the importance of credit for the economy that thrives by division of labor and exchange. Islamic finance needs a mechanism capable of eradicating the phenomenon of delay in payment by those capable of making payment on time, a phenomenon they characterize as delinquency.

How to deter the delinquent? Do we compensate the creditor? If yes, why, how and when? Answers to these questions differ. Some see deterrence in punishment by incarceration, even corporal punishment for the debtor. Black listing delinquents and exposing them in public is also suggested. All these involve courts of law, and litigation takes time. This is rightly seen as a negative point decreasing the efficiency of the Islamic financial system.

Efficiency calls for a mechanism that is triggered automatically. Such a mechanism can be a penalty, in terms of a fine, a certain quantity of money. Such a fine can be proportional to the sum of money involved. It can also be related to the actual period of delay. That would make it similar to riba/interest in form if not in spirit. Some claim that it may also fail in its avowed purpose of being a deterrent, insofar as the market rate of interest at any particular time may be higher than the rate at which the fine is imposed. The delinquent debtor may simply decide to pay the fine and 'roll on' the debt, much to the chagrin of the creditor!

As hinted above, in the Islamic analysis, riba/interest acts as a surrogate for justice and fairness. Characterizing any procedure as involving riba/interest amounts to declaring it to be unfair and unjust.

Answers to the question, how to deter the delinquent, can be classified in two categories. A monetary penalty automatically triggered ensures efficient operations. It may be noted, however, that some opting for a fine nevertheless opine that only a court of law can fix its quantity. It cannot be made a part of the contract

coming into effect automatically. On the other hand, the obligation to avoid interest makes some scholars reject the fine option altogether, irrespective of who levies it. Out of the eight opinions listed by Zarqa & Elgari, one scholar (Nazeeh Hammad) insists that only punishment by a court of law can deter a delinquent whose own conscience fails to deter him. Two scholars (Shaikh Mustafa Zarqa and Zakiuddin Sha‘ban) opt for a fine that must be decreed by a court. Two other scholars agree to a predetermined fine that, according to one of them, goes to a charity (Ali al-Saloos, who combines incarceration with a fine). Another suggestion is to send it to a special fund under the aegis of the state (Siddiqi). The remaining (Siddiq al-Dareer and Zaki Abdul Barr) agree on a fine which would serve as a deterrent but insist that the fine should not exceed the actual harm done the creditor/Islamic bank. Al-Dareer regards the average rate of profit earned by the bank in the relevant period as a good measure of the loss suffered by it. Abdul Barr also emphasizes the role of other kinds of punishment as a deterrent.

When it comes to compensation, one opinion (Nazeeh Hammad) totally rejects the idea, saying it is only the sum owed him that the creditor gets. One can say the possibility of delay must have been taken into consideration in the mark-up, the increase over and above the cash price. Sheikh Dareer would compensate only to the extent of actual profit lost, which he then equates with the average profit earned by the creditor (Islamic bank, for example). This in effect is what the creditor gets according to the formula approved by Shaikh Zarqa. But Zaki Abdul Barr is not comfortable with this formula. He would rather get it looked into by a court and the compensation given in exceptional cases only. Siddiqi would make the affected creditor seek compensation from the special fund under the auspices of the state to which all the fines for delay go.

To complete the picture, mention must also be made of the proposal of the authors themselves, Zarqa and Elgari. The delinquent debtor is to be obliged, by a court of law, to make a

counter loan (interest free, of course) to the creditor in the amount owed and for a period equal to the period of delay. The idea is to compensate a lost opportunity by providing a similar opportunity, and no more. The proposal did not get any endorsements, however. One commentator (Rabi' al-Roobi, 1992) said it was neither efficient nor fair. The marginal efficiency of money to the creditor was not necessarily the same at the two points of time involved. The different timings of the two opportunities, the one lost due to delay and the one being provided as compensation, could not be treated as equal. Also, the counter loan being provided as part of the contract made it similar to *riba*/interest, insofar as the extra time was matched by a 'benefit'.

Zarqa and Elgari visited the issue again when they co-authored with Siddiqi: 'Banking Law—A Suggested Model for Organizing the Islamic Banking Sector' (Elgari, et al, 1993). Appendix 9 to this Law details what is provided briefly in clause 4 of the Law. All fines for delay are to go to a public Fund supervised by the Central Bank. The Fund serves society in various ways but the lender does not benefit from it in any way.

In the year 2000, the Islamic Fiqh Academy, a subsidiary of the Organization of the Islamic Conference, headquartered at Jeddah, passed a resolution on this issue that went beyond its earlier resolution in 1990 which said: 'If the buyer/debtor delays the payment of installments after the specified date it is not permissible to charge any amount in addition to its principal liability, whether it is made a precondition in the contract or it is claimed without a previous agreement, because it is *Riba*, hence prohibited in *Shariah*' (Islamic Fiqh Academy, 2000, p. 104). The new resolution reaffirmed the above, but added: 'It is permissible to include a Penalty Provision in all financial contracts except when the original commitment is a debt. Imposing a Penalty Provision in debt contract is usury in the strict sense.' It also lays down that: 'The loss that may be compensated includes actual financial loss incurred by the partner, any other material loss and the certainly obtainable gain that he misses as a result of his

partner's default or delay. It does not include moral loss.' (Islamic Fiqh Academy, 2000, p.252). These resolutions provide some relief only to those affected by delays in fulfillment of salam/istisna obligations. The amounts owed in installment sales and murabaha sales having become debts remain outside their purview. In other words little attention is paid to the efficiency-based pleas of the scholars reported above and the verdict focuses only on the ethical aspect as surrogated by riba/interest.

The issue of delay in payment is taken up in Chapra and Khan (2000). Obviously concerned with efficiency of the Islamic financial system, they observe: 'If the late payment does not lead to any penalty, there is a danger that the default may tend to become a widespread phenomenon through the long run operation of self-enforcing mechanisms. This may lead to a breakdown of the payment system if the amounts involved are significantly large' (p.72). They proceed to suggest an index of 'loss given a default' (LGD) 'to determine the compensation in a way that reduces subjectivity as well as the possibility of injustice to either the defaulting or the aggrieved party' (p. 73). This comes, however with the proviso: 'If the concept of compensation for loss becomes accepted by the *fuqaha*' (p.73). The authors report without any comments the 'conservative view' that 'prohibits the imposition of any compensation to the aggrieved party for fear that this may become equivalent to interest' (p.72).

The latest response to the challenge posed by this issue seeks to strike a balance. It makes a penalty for default/delay automatic, but the proceeds of the penalty go to charity. As regards compensation for harm done the issue is left to courts of law. In its guidelines relating to murabaha, the State Bank of Pakistan says: 'It can be stipulated while entering into the agreement that in case of late payment or default by the client he shall be liable to pay penalty calculated at percent per day or per annum that will go to the charity fund constituted by the bank. The amount of penalty cannot

be taken to be a source of further return to the bank (the seller of the goods) but shall be used for charitable purposes....The bank can also approach competent courts for award of solatium which shall be determined by the courts at their discretion, on the basis of direct and indirect costs incurred, other than opportunity cost' (State Bank of Pakistan,2004. p. 3).

One of the peculiarities of a market economy is to press for efficiency. This is done largely through competition. Unfortunately the market has no such mechanism to ensure justice and fairness. That is left, in the first instance, to the conscience of the players, the economic agents, themselves and then to the regulatory authorities. In other words, the market works for the private interests of the participants whereas the public interest (which includes the interests of non-participants also) has to be taken care of largely by the state, the guardian of public interest. Islam works on the conscience of the economic agents through moral orientation. Also, Social Authority is empowered to take steps necessary to protect public interest, a principle enshrined in the traditional Islamic institution of *hisbah*. Since the prohibition of *riba*/interest is directed at ensuring justice, the jurists rightly insist that no provision should involve interest/*riba*. But can they stop there? If they do, as they seem to have done till now, can the market stop pressing for an efficient solution to the problem under scrutiny?

Sale and Securitization of Debt

The second issue we take up is the sale of debt, *bai 'al-dayn*. Prohibition of interest almost eliminates the direct lending of money for business. So there is no bond market in an Islamic economy whose liquidity should become an issue. Direct lending of money is replaced by *murabaha* and similar credit transactions, effectively tying the expansion of credit with the growth of the economy. In place of conventional treasury bonds Islamic financial

markets have bonds based on Ijara (leasing), Salam (prepaid orders) or Istisna' (manufacturing orders on a pay as you get basis). But there also is a huge debt created by installment sales and murabaha. To some, making all these wait till maturity implies waste. This waste occurs at two levels. Firstly, those holding IOUs will need credit to command real resources in order to continue producing, having presumably exhausted their own resources in producing what they already sold on credit. This means the society will always carry lots of illiquid assets, the IOUs. Secondly, this may force sellers/producers to refuse selling on credit, demanding cash instead. A society in which all IOUs must await redemption by the original debtor cannot economize on the use of cash. This is rather inefficient (but not a big deal in a fiat currency regime!). It may rightly be pointed out that somebody must await maturity of debts incurred in the process of acquiring command over real resources on credit. As Keynes pointed out commenting on the 'liquidity fetish', not everybody can be liquid all the time. It is, however, more efficient to provide opportunities for exchange between those who are willing to wait and share the risks involved (as the Islamic framework does not reward pure waiting) and those who seek liquidity. One way to do so is to allow IOUs as collaterals for fresh credit---a practice already in vogue in the Islamic financial market. It is also permissible to exchange these IOUs for goods and services. But some want more, let us see if they can have it.

The juristic objection to sale of debts resulting from murabaha, etc. is the same as in case of selling a debt created by a money loan. If I buy for 90 an IOU worth 100 after a year, I am doing so in order to earn 10 as interest. They see no reason to distinguish between IOUs created by murabaha and IOUs created by lending money. This seems to be underlying the latest Islamic Fiqh Academy resolution on the subject that states: 'It is not permissible to sell a deferred debt by the non-debtor for a prompt cash, from its type or

otherwise, because this results in *Riba* (usury). Likewise it is not permissible to sell it for a deferred cash, from its type or otherwise, because it is similar to a sale of debt for debt which is prohibited in Islam. There is no difference whether the debt is the result of a loan or whether it is deferred sale' (Islamic Fiqh Academy, 2000, p.234). However, the view equating, in this context, money loans and debts resulting from credit has been challenged. There are reasons to treat the two differently, say Chapra and Khan : 'The debt is created by the *murabaha* mode of financing permitted by the Shariah and the price, according to the *fuqaha* themselves, includes the profit on the transaction and not interest. Therefore, when the bank sells such a debt instrument at a discount, what it is relinquishing, or what the buyer is getting, is not interest but rather a share in profit' (Chapra and Khan, 2000, p.78). In other words, a debt resulting from murabaha has an element absent from a debt arising from borrowing money-- the mark up on spot price. Sale and purchase of murabaha-based debt would take place on this extra profit margin.

The problem with this proposition is that what was a profit margin for the seller of goods and services (on a murabaha basis) may not necessarily remain so when the same seller 'sells' the IOU arising from that transaction. Some of the factors involved in the determination of the mark up on spot price in murabaha may be different from those involved in the sale of the resulting IOU at a discount. Furthermore, the extra profits earned in murabaha sale, over and above those earnable on selling for cash, are still against sale of goods and services. But the part of it that goes to the buyer of the murabaha based IOU (according to the above mentioned rationalization) has no goods and services corresponding to it. It is money for money, with a difference of dates.

The authors go on to argue that there is hardly any *gharar* involved in the sale of debt-instruments under discussion, a point we may ignore because of the limited purpose of this paper. What interests

me is their plea that the *fuqaha* reconsider the case of asset-based debt instruments and allow their sale as it would lead 'to the accelerated development of an Islamic money market' (ibid, p. 79) They proceed to emphasize the need for such a market by pointing out that Islamic banks may face a liquidity crunch in its absence, paralyzing the whole system. They also believe 'it is difficult for banks to play effectively their role of financial intermediation, without being able to securitize their receivables' (Chapra and Khan, 2000, p.79). After discussing alternative avenues of raising large funds required by client companies through banks, they conclude that 'it would be preferable to allow banks to rely on the sale of their own assets to raise liquidity.'(ibid, p.80)

So it is efficiency that is at stake, in an environment where the inefficient may not long survive. Once again the same story: the jurists bent on ensuring justice by avoiding anything similar to *riba*/interest and the economists keen to maintain efficient markets. Do they understand each other's concerns? Is the rationale (*hikmah*) of prohibiting *riba* also applicable to sale of debts resulting from *murabaha* so that it must be blocked to ensure justice? What about a trade-off between the two objectives of Shariah, justice and wealth creation? Is such a trade off acceptable under certain circumstances? Does it become unavoidable sometimes? Can we agree on some formula that ensures a reasonable degree of fairness with a reasonable level of efficiency? These questions have yet to be thoroughly examined. Those arguing in favor of legitimizing sale of debt have to demonstrate that no alternative methods of ensuring liquidity are available. They have also to meet the objection that once sale of debt is allowed insofar as asset based IOUs are concerned, prohibiting the sale of IOUs based on money lending will be difficult, if not impossible, to sustain.

Bai' al-dayn is approved by Malaysian Shariah scholars (Securities Commission, 2002). It has a place in Islamic banking as practiced

in Southeast Asia. Shariah scholars in that region which follows the Shafi 'i school of Islamic Law base their opinion on certain rulings which the scholars in the heartland of Islamic finance following other schools, generally speaking, do not agree with (Usmani, 2000). Bank Islam Malaysia is marketing Negotiable Islamic Deposit Certificates (NIDC) backed by murabaha based assets (Archer and Karim, 2002, p.132). 'In Malaysia the Islamic benchmark bond was introduced in 1990 and is believed to be based on the *murabahah* concept. They are the most popular form of Islamic financing method used in Malaysia' (al-Amine, 2001, p.3). Al-Amine goes on to note, however, the controversy that still surrounds the Shari 'ah legitimacy of these bonds (ibid, p.4). Many Islamic debt instruments on sale in the Malaysian market are criticized on the ground that they involve *bay' al-dayn* and *bay' al-'inah* (Rosley and Sanusi, 1999). But some scholars refer to certain Hanbali and Maliki jurists (.e.g., Ibn e Qayyim and Dasuqi, respectively) who 'are of the opinion that selling *dayn* to a third party is not against syarak (*shar'*)' [Ishak.1997, p.6]. It is noted that there is a difference between the debtor being asked by the creditor to pay more than the price agreed upon in a credit sale in lieu of delay in payment, and selling the IOU arising from that credit sale to a third party. In the latter case the seller on credit, who holds the IOU, is no longer dealing with the debtor. He is dealing with a third party to whom he sells the IOU. The deal between this third party, which now holds the IOU, and the debtor, is free of the constraints attending upon the deal between the seller on credit and the one who buys on credit. 'Bay *al-dayn* to a third party, however, is different because a third party does not ask for increase in price from the debtor. The debtor will just pay according to the initial contract. As *dayn* has been sold to a third party, the initial creditor will no longer make a claim but the third party will.' (Ishak, 1997, p.7). Ishak proceeds to argue, ' Can *haq al-dayn* (be) sold at a lower price? The answer is yes, because it is not a currency and the attributes transferred when bought consist of *haq mall* not currency.....Based on the above, if the initial seller

is willing to reduce his right and give the third party the full right, it is not at all against syariah (Shari 'ah) principles. The same with share certificates traded, it is an ownership right in a company and when sold in the secondary market the price is essentially different from the initial price' (Ishak, 1997, p.7).

Does not sound very convincing, as a shareholder does not hold a claim to a definite sum of money to be paid in future. But there is no need for me to evaluate these arguments in analogical terms. What I am interested in is their focus on distancing sale of debt from riba/interest and trying to show it is fair trade, free of injustice as symbolized by riba/interest. Hence the claim that asset based securities are like share certificates and necessary for the well being of people. This is evidenced by Ishak's appeal to the 'syari'ah (Shari 'ah) principles of *ra'fah* and *takhfif*' in his conclusion (*ibid*, p.8). In other words, it is being asserted that allowing sale of debt arising from credit sales is neither unjust nor unfair as it does not involve riba/interest. Also it is emphasized that it should be allowed in order to make life easy and prosperous. I think it would have been better if instead of finding an analogy between a certificate of ownership in a company and an IOU, Ishak had pursued the *maslaha* based arguments on which he concludes.

It would be far better to conduct the debate openly in the framework of ease versus hardship, efficiency versus fairness, growth versus distribution. The trade-offs could then be openly examined, sometime even measured. At the macroeconomic level, we need to know why liquidity cannot be guaranteed without legitimizing the sale of debt. It has to be discussed how giving debt-financing a greater role is likely to change the nature of Islamic economy which emphasizes risk sharing and participatory finance. Alas! That is not the way legal issues are handled, especially in an industry in a hurry, as the Islamic financial industry currently seems to be, under tremendous pressure from its more 'efficient' competitors. While the Shariah scholar sitting on an Islamic bank's advisory board may have barely the time to

check the relevant texts and whether a particular analogical reasoning is acceptable, the task of the social scientists/moral philosophers is more contemplative, time taking. An appeal to *maqasid al-shariah* (objectives of Shari‘ah) is not that easy as it may seem to the un-initiated. It involves a far deeper understanding of Islam as a way of life, a process of social reconstruction and a mission with humanity that one would normally expect in a legal expert these days. Islamic Finance is about all these objectives, some of which are hard to realize through analogical reasoning, even financial engineering.

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