In what ways does Islamic banking differ from conventional finance?[1]

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Abstract

Prominent Islamic scholars have taken the system of Islamic finance to task on the grounds that the contractual modes offered by Islamic bankers are little different from conventional ones. One reason is that the profit-and-loss sharing (PLS) concept is not readily adaptable to consumer, trade and government finance. In seeking to fill this void, the adaptation of classical merchandising sales contracts for financing using deferred pricing contractual forms has changed the landscape in two ways. First, the risk of merchandising is retained by the traders but the risk of credit is shifted to the bankers. This is precisely what happens in conventional interest-based finance. Second, banks' profit rate comes from the charging of a difference between the deferred price and the spot price that can be 'benchmarked' to conventional interest rates. Controversial even by classical standards, this practice leaves the system open to the charge that there is seemingly little, if any, substantive difference between conventional and Islamic finance. This paper elucidates these arguments and examines these views.

The Problem with Interest

Perhaps the most far-reaching and controversial aspect of Islamic economics, in terms of its implications from a Western perspective, is the prohibition of interest (*riba*). Financial systems based in Islamic tenets are dedicated to the elimination of the payment and receipt of interest in all forms. It is this prohibition that makes Islamic banks and other financial institutions different in principle from their Western counterparts. Both the Holy Qur'an and the *Sunna* treat interest as an act of exploitation and injustice and as such it is inconsistent with Islamic notions of fairness and property rights. Islamic banking thus derives its specific *raison d' être* from the fact that there is no place for the institution of interest in the Islamic order.

Why is this so? In searching for reasons as to why interest is unjustified, early Islamic writers emphasised the social welfare aspects, in terms of those activities which increase utility (*musalih*) and those that do not (*mafasid* or disutilities). For example, Ghazali (d.1127 CE) rejected lending because 'whoever uses money in *riba* practices becomes ungrateful and unjust', since money is 'not created to be sought for itself but

[1] This paper has drawn considerably upon a new book written with Zafar Iqbal (Iqbal and Lewis, 2009)

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for other objects'. And since 'hoarding money is injustice, it is meaningless to sell money for money except to take money as an end in itself which is injustice'.

Leading twentieth century scholars, such as Siddiqi (1980, 1982), Chapra (1985), Khan (1985), moved away from equity considerations, and criticized conventional theories of interest for equating interest with either 'impatience' or 'waiting', on the savings side, or with the 'productivity of capital', on the investment side of, respectively, the supply and demand for loanable funds. These writers questioned first the view that interest is a reward for saving in the form of 'abstinence', arguing that such reward can be justified, from an economic standpoint, only if such savings were used for investment to create additional capital and wealth. Their contention is that the mere act of abstention from consumption should not entitle anyone to a reward. As to productivity, the Islamic economists argue that although the marginal productivity of capital may enter as one factor into the determination of the rate of interest, interest *per se* has no necessary relation with capital productivity. Interest, they contend, is paid on money, not on capital, and has to be paid irrespective of capital productivity.

Interestingly, the Islamic writers are by no means alone in making these points, for such views have a respected heritage in conventional economic analysis. The Austrian economist Eugen von Boehm-Bawerk (1922), for example, made much the same arguments. He rejected the 'sacrifice' or 'pain' theory of value implicit in the 'abstinence' theory by arguing that the utility of goods in productive use was the relevant consideration. At the same time, he objected to the 'productivity' theories of interest since if the capital investment produced nothing, it would presumably be of no value. Indeed, what Joseph Schumpeter (1951) called the 'dilemma of interest' has troubled a number of writers. Schumpeter himself (pp. 159-69) was unable to resolve whether the equilibrium rate of interest is positive, that is, whether interest could exist in equilibrium.

Another approach to the question of *riba* revolves around the Islamic law of property rights, the argument being that interest on money (*riba*) leads to the creation of unjustified property rights. A general principle of Islamic law, based on a number of passages in the Holy Qur'an, is that unjustified enrichment, or 'receiving a monetary advantage without giving a countervalue', is forbidden on ethical grounds. According to Schacht (1964), *riba* is simply a special case of unjustified enrichment or, in the terms of the Holy Qur'an, consuming (that is, appropriating for one's own use) the property of others for no good reason, which is prohibited.

In fact, only two individual claims to property are recognised by *shari'a*: property that is a result of the combination of creative labour and natural resources; and property the title of which has been transferred as a result of exchange, remittance, outright grants or inheritance. Money is a claim of its owner to property rights created by assets that were obtained through one of the above means. Lending money is a

transfer of this right, and all that can be claimed in return is its equivalent and no more, that is principal only. By contrast, when the financial resources of the lender are used in partnership with the labour of the entrepreneur, the lender's right to his property is not transferred and remains intact, thus making him a co-owner of the enterprise. His money then has a legitimate claim and a right to share in the wealth it helps to create (Khan and Mirakhor, 1987).

For most scholars, however, Razi's ([1872] 1938) conclusion is compelling. Razi advanced five reasons for the prohibition on *riba.*

1. That *riba* is but the exacting of another's property without any countervalue while according to the saying of the Prophet a man's property is unlawful to the other as his blood.
2. That *riba* is forbidden because it prevents men from taking part in active professions, and earning their livelihood by way of trade or industry.
3. That the contract of *riba* leads to a strained relationship between man and man, which results in friction and strife and strips society of its goodliness.
4. That the contract of *riba* is a contrivance to enable the rich to take in excess of the principal which is unlawful and against justice and equity.
5. That the illegality of *riba* is proved by the text of the Holy Qur'an and it is not necessary that men should know the reasons for it. We have to discard it as illegal though we are unaware of the reasons (Vol. 2, p. 531).

It is the last point that is telling. The meaning and scope of *riba* and its grave nature have been brought to light in the Holy Qur'an (S2: 225). Its prohibition cannot be questioned, as the verse 'God permitteth trading and forbideth *riba*' is quite clear. When the text is clear on this point there is no need for further clarification. Because the Holy Qur'an has stated that only the principal should be taken, no alternative interpretation is possible. The existence or otherwise of injustice in a loan transaction is irrelevant. Whatever are the circumstances, the lender has no right to receive any increase over and above the principal. Moreover, in the *ahadith*, the next most authoritative source of Islamic law, the Prophet Muhammad condemns the one who takes *riba,* the one who pays it, the one who writes the agreement for it and the witnesses to the agreement.

In general terms, it can be said that what Muslims find most objectionable about lending at interest is that the interest rate on a loan is fixed and certain (Algaoud and Lewis, 2007). The interest rate is a fixed payment specified in advance for a loan of money without risk to the lender. In the description of Razi, profit in business is uncertain while the excess amount which the creditor gets towards interest is certain. Hence insistence upon a sum certain in return for what is uncertain is but harm done to the debtor (p531). The sum is certain because whether or not the borrower gains or loses from the venture, the lender uses collateral and other means to enforce payment.

It is much fairer to have a sharing of the profits and losses. Fairness in this context has two dimensions: the supplier of capital possesses a right to reward, but this reward should be commensurate with the risk and effort involved and be governed by the returns on the projects for which funds are supplied.

Hence, what is eschewed in Islam is the predetermined return. The sharing of profit is legitimate and the acceptability of that practice has provided the foundation for the development and implementation of Islamic banking. In Islam, the owner of capital can legitimately share the profits made by the entrepreneur. What makes profit-sharing permissible, while interest is not, is that in the case of the former it is only the profit-sharing ratio, not the rate of return itself, that is predetermined.

In the interest-free system sought by adherents to Muslim principles, people are able to earn a return on their money only by subjecting themselves to the risk involved in profit-sharing. The basic building block of the Islamic banking alternative is to link the return on an Islamic financial contract to productivity in the real sector and the quality and success of the project, in this way seeking to achieve a more equitable distribution of wealth and financial returns.

Instruments of Islamic Finance

The essence of Islamic finance is that loans should be advanced free of interest for charitable bodies (*qard hasan*) and on a profit and loss sharing (PLS) basis for commercial purposes. With PLS an arrangement, an Islamic bank does not levy interest as such but rather participates in the yield resulting from the use of funds. The depositors also share in the profits of the bank according to a predetermined PLS ratio. There is thus a partnership between the Islamic bank and its depositors, on one side, and between the bank and its investment clients, on the other side, as a manager of depositors' resources in productive uses.

Profit-and-loss sharing

*Mudarab*a and *musharaka* are the two profit-sharing arrangements preferred under the value system of Islam, and of these *mudaraba* is the PLS method employed by banks in the raising of funds. A *mudaraba* can be defined as a contract between at least two parties whereby one party, the financier (*rabb al-mal*), entrusts funds to another party, the entrepreneur (*mudarib*), to undertake an activity or venture. This type of contract is in contrast with *musharaka*, where there is also profit-sharing, but all parties have the right to participate in managerial decisions. In *mudaraba*, the financier is not allowed a role in management of the enterprise. The *mudarib* becomes a trustee (*amin*) for the capital entrusted to him by way of *mudaraba*. The *mudarib* is to utilise the funds in an agreed manner and then return to the *rabb al-mal*

the principal and the pre-agreed share of the profit. The *mudarib* keeps for himself what remains of such profits as a reward for his labour and entrepreneurial contribution. Monetary losses are borne entirely by the investor. Liability for losses, however, is limited to his investment unless he has given the *mudarib* an express permission for incurring debts (Usmani, 2000).

A *Musharakha* is a contract among two or more parties, each contributing some of their capital in a joint commercial venture. Profit ratios have to be specified in advance but in case of a loss, it must be shared in proportion to the capital sums contributed. There are differences of opinion in *fiqh* as to whether profit ratios can differ from ratios of capital contribution. Among the classical jurists, Malik and Shafi'i do not permit it; Ahmad makes it subject to free consent, while Abu Hanifah caps the share of a perpetual sleeping partner to no more than the proportion of his investment (Usmani, 2000).

The basic concept of a *musharaka* has been used as a technique for Islamic financial institutions to provide finance to commercial enterprises. For example, *musharaka* can be used to structure a working capital facility for a company, or it can be used for joint investment in activities such as real estate development and rural finance. In Western countries, diminishing *musharaka* has been used for residential property financing.

Islamic bankers have also adapted and refined the *mudaraba* concept to form the two-tier or triple *mudaraba*. In this arrangement, the *mudaraba* contract has been extended to include three parties: the depositors as financiers, the bank as an intermediary, and the entrepreneur who requires funds, The bank acts as an entrepreneur (*mudarib*) when it receives funds from depositors, and as a financier (*rabb al-mal*) when it provides the funds to entrepreneurs.

Mudaraba and *musharaka* constitute, at least in principle if not always in practice, the twin pillars of Islamic banking (Ariff, 1982, 2007). The two methods conform fully with Islamic principles, in that under both arrangements lenders share in the profits and losses of the enterprises for which funds are provided. The *musharaka* principle is invoked in the equity structure of Islamic banks and is similar to the modern concepts of partnership and joint stock ownership. *Mudaraba* is used for investment accounts for depositors, and the Islamic bank acts as a *mudarib* which manages the funds of the depositors to generate profits subject to the rules of *mudaraba.* There is a sense in which an Islamic bank acting as *mudarib* or agent in such a PLS arrangement can be considered more as a fund manager than a bank (El Qorchi, 2005). If the bank in turn uses the depositors' funds on a *mudaraba* basis, then the circle is closed in terms of the two-tiered or triple *mudaraba* arrangement.

Obviously, if Islamic banking took his form it would be very different from conventional banking. In fact, it would resemble modern day merchant or investment

banking or venture capital firms, in which funds are collected and invested on a private equity-type basis in existing or new ventures. The reality, however, is that neither *mudaraba* nor *musharaka* constitutes the main conduits for the outflow of funds from Islamic banks. The latest available global statistics on Islamic banking (Algaoud and Lewis, 2001, chapter 6) shows that *mudaraba* and *musharaka* combined account for only 2 per cent of financing in Pakistan, 11 per cent in the Gulf countries, 13 per cent in South Asia, and less than 1 per cent in South East Asia. These financing modes have assumed greater importance in the fully-Islamicized system of Iran, in Sudan and other parts of Africa (where *musharaka* has been used for agricultural financing), and in the West (diminishing *musharaka* for residential property financing).

Thus, it would seem that PLS financing arrangements cannot cater exclusively for the peculiarities of a modern economy which is inherently cast in an interest based mould.[3] Debt has proved indispensible in Islamic banking and constitutes by far the greater part of the system (Chapra, 2007). A major challenge facing Islamic finance was to design a more diversified set of interest free instruments. This challenge was met by adapting permissible trading contracts, originally designed for buying-and-selling of real goods, for financing purposes. Broadly speaking, the prevailing instruments of interest free finance along these lines relevant for financing can be divided into three categories: the different buying-and-selling arrangements adapted for credit financing through the process of *ijtihad* in the last three decades; leasing (rental) operations; and, most recently, Islamic bonds (*sukuk*). Below we outline these instruments and explain how they have been modified and legitimized by the bankers and jurists.

Credit instruments

On a strict interpretation there is no scope for interest- or discount- based financing instruments in Islam. Given the teething difficulties of operating PLS contracts in developing economies, however, jurists adapted some contracts for finance that in the classical interpretation were meant for engagement in the real business of buying and selling. For instance, *bai' bi-thaman ajil* (BBA)/*bai' muajjal* is a deferred payment sale of goods permitted in *shari'a*. According to some *shari'a* scholars, the mutually agreed price could be different than the spot price.[4] Likewise, *shari'a* does not object

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[3] In addition to the well-known vulnerability of PLS financing arrangements to the agency problems of adverse selection and moral hazard, Dar and Presley (2000) identify other factors such as poorly defined and protected property rights in many Muslim countries, the lack of secondary markets for trading mudaraba and musharaka instruments, and taxation issues as inhibiting the use of PLS instruments.

[4] 'A group of jurists are of the opinion that, should the seller increase his price if the buyer asks for deferred payments, as is common in instalment buying, the price differential due to the time delay resembles interest, which is likewise a price for time; accordingly, they declare

to a *murabaha* arrangement wherein a seller discloses his cost of goods to a buyer and a mark-up is mutually agreed in lieu of profit for the seller. These concepts, combined and adapted for Islamic banking, allow a prospective trader or a potential real asset purchaser to approach a bank specifying his need for a real good. The bank purchases the asset and on-sells it to him adding its mark-up covering deferred payment and the risk that it takes in owning the goods between the original purchase and its on-selling to the customer.

The counterpart to the earlier statistics on the low usage of PLS instruments is the dominance of *murabaha* and other debt-based financing in the asset portfolios of Islamic banks. Dusuki (2007) reports more recent evidence showing that *murabaha* and other mark-up instruments represent 86 per cent of financing in Islamic banks in the Middle East and North Africa, 70 per cent in East Asia, 92 per cent in South Asia and 56 per cent in Sub-Saharan Africa.

While the mark-up may seem to be just another term for interest as charged by conventional banks, its legality is not questioned by any of the schools of Islamic law. What makes the transaction Islamically legitimate in *fiqh* is that the bank first acquires the asset for resale at profit, so that a commodity is sold for money and the operation is not a mere exchange of money for money (Wilson, 1983, pp. 84-5). In the process the bank assumes certain risks between purchase and resale; for example, a sudden fall in price could see the client refusing to accept the goods. That is, the bank takes responsibility for the good before it is safely delivered to the client. The services rendered by the Islamic bank are therefore regarded as quite different from those of a conventional bank which simply lends money to the client to buy the good. In short, the mark-up is not in the nature of an additional amount paid on the principal amount of a loan but is in the nature of a profit charged in a trade transaction, with attendant risks attached.

It is the associated risk-taking that legitimizes the reward. As the Prophet said ‘profit accompanies liability for loss’ (Vogel and Hayes, 1998, pp. 83-5, 112-4). This *hadith* means that one can earn profits (*al-kharaj*) from possession of property only if one also assumes the risk of loss (*al-daman*). The difficulty was that bankers felt

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such sales to be haram. However, the majority of scholars permit it because the basic principle is the permissibility of things, and no clear text exists prohibiting such a transaction. Furthermore, there is, on the whole, no resemblance to interest in such a transaction, since the seller is free to increase the price as he deems proper, as long as it is not to the extent of blatant exploitation or clear injustice, in which case it is haram. Al-Shawkani says, "On the basic of legal reasons, the followers of Shafi'i and Hanafi schools, Zaid bin 'Ali, al-Muayyid Billah, and the majority of scholars consider it lawful." (Nayl al-awtar, vol. 5, p. 153. Al-Shawkani said, "We have compiled a treatise on this subject and have called it 'Shifa al'ilal fi hukum ziyadat al-thamam li mujarrad al-ajal' (The Reason for Increasing the Price Due to Lapse of Time), and have researched it thoroughly.")’ (Al-Qardawi, 2003, Chapter 3: Business Transactions, p.6 of 13). The writer is indebted to Zafar Iqbal for these points.

themselves ill-equipped to bear this risk. The source of the problem was that *murabaha*, as inherited from Islamic jurisprudence, was not conceived as a financing technique. Rather, it is a particular type of sale (*murabaha* simply meaning 'mark-up sale') that Islamic jurisprudence considers as a trust contract, because the seller and the buyer do not negotiate the price, but rather agree on a certain profit margin added to the cost, as faithfully declared by the seller (Saadallah, 2007). Moreover, in classical Islam a *murabaha* transaction involving a sale for cash was the norm. The first step in converting the original *murabaha* into a vehicle for financing was to make the extension of credit an essential feature of the transaction. This was done by having the *murabaha* concluded on the basis of deferred payment instead of cash settlement.

The second step in transforming the *murabaha* into a financing technique (or in Saadallah's words, making the original *murabaha* into a 'financial *murabaha*') was to address the issue of the inherent trading risks. As Saadallah points out, Islamic banks using the *murabaha* as a means of financing would be obliged to undertake a commercial intermediation function, in addition to their original function as financial intermediaries. That is, they would have to assume the dual role of intermediary buyer and seller and financier between the ultimate buyer and seller. However, the banks are not specialized in commerce and are not traders. They sought to depart as little as possible from their traditional financial intermediation function, while keeping their commercial role to the minimum needed to comply with Islamic principles. In particular, the banks sought to avoid holding inventories of goods and marketing them over prolonged periods of time. An important way of achieving this goal was through the requirement that the sale contract be preceded by the customer's promise to buy the desired goods, once they are acquired by the financier.

Consequently, in order to meet the second requirement and make a prior promise to buy (matching the reciprocal promise to sell by the financier) a prerequisite to the extension of credit, the following actions have been found possible within the premises of Islamic law. First, the Islamic bank may appoint the client itself to select the supplier, negotiate the relevant terms and conditions, and then purchase on the bank's behalf the commodities that the client wants the bank to finance so that there is no risk of purchasing something that the client may not want or that does not conform with the required specifications. Second, arrangements can be made that, as soon as the goods are purchased on behalf of the bank, they are immediately sold to the client on an agreed cost-plus mark-up basis so that the period of ownership of physical goods by the financial institutions and the commercial and trading risks associated with the ownership are reduced to a minimum. These two elements allow the risks in the transaction to become almost negligible (although not entirely removed) for the Islamic financial institutions and the return on the financing provided by the financial institution becomes almost fixed and predetermined (Khan, 2007).

Leasing operations (*ijara*)

Ijara literally means 'to give something on rent', and technically it relates to transferring the usufruct of a particular property to another person on the basis of a rent claimed from him. The difference between sale (*bay*) and *ijara* is transfer of ownership *vis-a-vis* transfer of the usufruct (*manfa'a*). That is, the leased property remains in the ownership of the lessor and only its usufruct is transferred to the lessee for specified rental payments which incorporate an element of profit.

This profit element in the lease is permissible, despite its obvious similarity to an interest charge. According to Islamic jurists, *shari'a* allows a fixed charge relating to tangible assets (as opposed to financial assets) because by converting financial capital into tangible assets the financier has assumed risks for which compensation is permissible. These risks legitimise any profits obtained. The conditions attached to *ijara* clarify the risk involved to the lessor: first, the duty of repair is incumbent upon the lessor, second, the lessee is free to cancel the lease if the usufruct proves less beneficial than expected, and third, the price of the asset at the termination of the lease period cannot be fixed in advance (Warde, 2000, p.135).

As in the case of the *murabaha*, the financier is able to ameliorate most risks. The requirement that the lessor is responsible for maintenance can be circumvented by the lessor appointing the lessee as its agent to undertake the maintenance, and by taking out an appropriate insurance policy. Uncertainty with respect to the scrap or residual value of a leased asset can be taken care of if the contract can be made for a period during which the financial institution will recover the principal amount as well as an appropriately benchmarked rate of return. The asset at the end of the lease period can then be transferred to the lessee. This makes the contract generate a fixed return for the financial institution on its investment. Strictly speaking, the rental charges cannot be set on a floating rate basis (pegged to LIBOR for example) because the rules on *gharar* (uncertainty) deem that the contract has to fix and define the terms of the lease. However, this requirement can be bypassed by a non-binding 'gentleman's agreement' to renew the lease from time to time throughout its life at a new rate.

Leasing has become an integral part of Islamic finance, for two reasons. First, Islamic banks have made extensive use of the *ijara* contract to finance an array of activities ranging from devising solutions to the financing of cars and residential homes to 'big ticket' items such as construction equipment, aeroplanes and ships. Once the banks adapted to the restrictions on Islamic leases in ways described above, the instrument emerged as a very flexible mode of finance, eminently applicable to different uses, and which solves the problem of collateral by generating its own specific to the asset. *Ijara* contracts are now being standardized and the documentation merged with that for conventional leases (Tag El-Din and Abdullah, 2007). Also, when combined with the permissible modes of buying and selling, the contract provides the basis for

synthetic *sukuk* transactions with cashflows akin to conventional fixed interest securities.

Islamic bonds *(sukuk)* and financial engineering

Muslim jurists subject the buying and selling of debt obligations to certain conditions in order to comply with the prohibition of *riba* (interest), *gharar* (uncertainty), and *maysir* (gambling). Rosly and Sanusi (1999) specify these conditions in detail. In summary, the debt must be a genuine one i.e., it must not be a subterfuge to borrow money such as an asset-linked buy-back arrangement. The debtor must acknowledge the trade and creditors must be known, accessible, and sound. Trading must be on a spot basis and not against debt. Importantly, the price cannot be other than the face value. In line with these principles, early doctrine on interest-free finance disallowed corporate or government bonds and the discounting of bills. Pressures for innovation have resulted in finding a way out of these limitations, admitting 'financial engineering'. In particular, leasing-based bonds (*sukuk al-ijara)* have been developed. Although other *sukuk* have been issued, eg *sukuk al-mudaraba, sukuk al-musharaka, sukuk al-murabaha,* the *ijara sukuk* remains the most popular.

Sukuk means participation certificate, and is commonly referred to as an 'Islamic bond'. Techniques similar to conventional structured finance securities are employed, with *sukuk* akin to pass-through certificates. A *sakk* simply represents a proportional or undivided ownership interest in an asset or pool of assets (McMillen, 2007). Islamic bonds are more useful if they can be traded on the secondary market to gain liquidity. As indicated above, certain requirements must be met with respect to the trading capacity of the bonds on the Islamic financial market. Specifically, they cannot represent a debt (in Islam, debt-selling is forbidden), as conventional bonds can. Instead they must constitute property of an approved asset. Such a bond is obtained through the securitization of the asset, the property of which is divided into equally valued units and incorporated in the *sukuk* certificates. The value of the *sukuk* thus remains connected to the value of the underlying asset. While they come in zero coupon and coupon versions, the productivity and return is linked to the profit of the underlying asset and not to an interest rate (although an interest rate such as LIBOR can be used as a 'benchmark').

Consider, for example, the case of the *sukuk al-ijara*. The originator holds assets (land, buildings, aircraft, ships, etc) that are to constitute the basis of the returns to the *sukuk* investor. These assets are sold by the originator to a special purpose vehicle (SPV) and then are leased back at a specified rental. The SPV securitizes the assets by issuing *sukuk* certificates that can be purchased by investors. Each *sukuk*

certificate represents a share in the ownership of the assets, entitling the investor to periodic distributions from the SPV funded by the originator's rental payments on the leased assets. The returns can be either fixed rate or floating rate (often referenced to LIBOR as a 'benchmark') depending on the originator.

So far, AAOIFI (the Accounting and Auditing Organization for Islamic Financial Institutions) has issued Standards for fourteen types of *sukuk* (AAOFI, 2003). These can be broadly grouped into *sukuk* that bear predetermined returns and *sukuk* that allow for sharing of profit and, in some instances, loss. *Sukuk al-murabaha* and *sukuk al-murabaha* are examples of profit-and-loss-sharing *sukuk.* To date, most issued *sukuk* have borne predetermined returns, and the majority of such *sukuk* have been *sukuk al-ijara*, frequently at a predetermined rate of return.

In fact, the basic structure of a *sukuk* is very flexible and can be varied in a number of ways. The underlying assets that are pooled and securitized can be *ijara, murabaha, istisnaa* or *musharaka* receivables, or combinations of them, and the rates of return can be fixed, floating or zero coupon. Investment risks (credit risk, interest rate risk, foreign exchange risk, market price risk, liquidity risk) are much the same as those of conventional bonds, and depend on the way the securitization is structured, although one unique risk is that of *shari'a* compliance, a factor which also governs the tradeability of the *sukuk.*

Indeed, it is the potential for tradeability that primarily makes for the popularity of *sukuk al-ijara. Ijara*, though less commonly employed than *murabaha* as an asset in Islamic banks' balance sheets offers much greater flexibility for the Islamic bond market. Each security called *sukuk-al-ijara* represents a pro rata ownership of physical assets as against a pro rata share in financial claims or debt in the case of *sukuk-al-murabaha*. While debt can only be transferred at par, ownership in physical assets can always be transferred at a mutually negotiated price (Obaidullah, 2007). Hence *sukuk-al-ijara* allow for creation of a secondary market since they represent a share in the ownership of a physical asset.

How Islamic Is Islamic Financing?

What are we to make of these developments? In the case, for example, of the *sukuk* that bear predetermined returns, it is fair to say that not so long ago, it was unthinkable to even talk about an Islamic financial instrument, especially a bond, that would guarantee a fixed return. Since 2001, when the Bahrain Monetary Authority issued Islamic leasing certificates with a five year maturity to the value of $100 million, it has become a reality to offer *shari'a*- compatible fixed returns. Thus the *sukuk al-ijara* 'financially engineers' the payoff profiles, generating returns to

bankers and investors that are, being derived from the levying of a 'cost-plus' rate of profit formula, as fixed, certain and safe under Islamically-compliant financing modes as any interest-based conventional loan.

Moreover, they are openly advertised as such. For example, the certificates for the first *shari'a*-compliant securitized market financing of US assets are structured so that Islamic investors effectively get a fixed rate of return (11.25 per cent annually) while considering themselves owners of the underlying assets. An official *shari'a* adviser issued a *fatwa*, or declaration, certifying that the instrument 'will yield returns, Allah willing, that are lawful and wholesome' (*Business Week*, July 17, 2006, p9).

Opinions on these new products differ markedly. El Qorchi (2005), viewing them from a multilateral bank perspective, recognizes the competitiveness of many of the products in attracting both Muslim and non-Muslim investors, while the asset-based bonds (*sukuk*) are seen as a particularly innovative, rapidly growing market sector tapped by sovereign and corporate borrowers alike. Many innovative new products such as *sukuk* built around mark-up financing methods have allowed banks and their clients to engage in investment, hedging and trading activities that would have been almost incomprehensible not so long ago. But do these instruments go too far? Unlike other financial arrangements, the Islamic system must meet another test, the religious test, and remain within the scope of Islamic law.

Fahim Khan (2007) sets out the case for *sukuk* and other newly developed instruments enabling participants in Islamic financial markets to borrow and invest and manage liquidity along conventional lines. He is convinced that fixed interest rate government debt along conventional lines has to be replicated with fixed return, negligible risk, Islamic securities, based upon mark-up arrangements, if a successful secondary market is to develop that can rival those in conventional financial systems. A fixed return is attractive to borrower and lender alike, and in the absence of liquidity the demand for the securities from ultimate investors and financial institutions will be greatly reduced.

Khan is probably correct in this judgment. But the question then becomes one of whether, in the process of achieving this objective, desirable as it may be, the 'baby is thrown out with the bathwater' (Hassan and Lewis, 2007a). Certainly, one can discern unease in some circles as to the pace of innovation and the direction of change in Islamic capital markets in the current decade (Hamoudi, 2006; Neinhaus, 2007). If Islamic banking merely modifies conventional financing in such a way as to satisfy the *shari'a* scholars, there is then the question of what is there that remains distinctive about the Islamic system? In short, what is the essential point of departure between the two systems? Should the adaptive devices come to dominate the system and come to be regarded as tantamount to legal fictions (*hiyal*), there could be the danger that

Islamic banking begins to look like an issue of branding, like Mecca Cola instead of Coca Cola (Hassan and Lewis, 2007b).

In these circumstances are any real purposes being served? Chapra (2007) thinks that there are. One way of introducing his argument is by noting that the growth of financial systems in the West has been described by a number of writers (for example, Martin, 2002; Stockhammer, 2004; Froud *et al*, 2006) as driven by what is termed 'financialization'. Financialization can be seen as a process of economic change in which the structure of advanced economies has shifted increasingly towards the provision of financial services and where the value of financial assets greatly exceeds that of tangible assets. As part of this change, managerial culture and behaviour, corporate governance, executive remuneration and the distribution of income and wealth are all substantially modified by the demands of financial capital. Foster (2007) describes the process of financialization as one in which there is a decoupling of financial activity from productive tangible asset investment:

'Although orthodox economists have long assumed that productive investment and financial investment are tied together - working on the simplistic assumption that the saver purchases a financial claim to real assets from the entrepreneur who then uses the money thus acquired to expand production - this has long been known to be false. There is no necessary direct connection between productive investment and the amassing of financial assets. It is thus possible for the two to be decoupled to a considerable degree.'

Against this backdrop, let us now return to the views of Chapra. He considers that differences do remain between conventional lending and sales-based financing (via, say, *murabaha* or *ijara*), and that these are important in two respects. First, because the seller of goods (the financier) must legally own and possess the goods being sold, he argues that speculative short-selling is ruled out, helping to curb the type of excessive speculation that takes place and has been so evident recently in conventional financial markets. Second, the sales-based financing methods do not involve direct lending and borrowing but comprise purchase or lease transactions based on real goods and services. Financing in the Islamic system thus tends to expand *pari passu* with the growth of the real economy, constraining excessive credit creation and limiting one of the causes of instability in the international markets. In similar vein, El-Gamal (2007), while more critical of recent developments, sees some mitigating elements in synthetic loan structures based on credit sales and leasing, since they represent a form of secured lending that limits excessive borrowing by virtue of the fact that debt-based financing rises in line with the growth of the assets financed. In short, unlike many of those financial systems in the West, Islam financial markets are not, as yet, marked by a decoupling of financial activity from tangible asset investment.

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