Islamic Securitization by Means of Sukuk and the Struggle for Shari’ah Compliance

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Abstract:

As the growth and dispersion of Islamic Financial products over the last couple of decades has shown, a large demand for Shari’ah compliant financial products exists. This study shows that Islamic financial products, and sukuk securities in particular as they exist today, mostly do not comply with the basic Shari’ah provisions laid down by Shari’ah specialists and standard setting bodies. These provisions are put in place order to avoid *riba* (usury) and *gharar* (excessive risk-taking), and include asset backing of sukuk contracts, the basic principle of profit and loss (PLS) and risk-sharing and the prohibition of coupling returns to investors to benchmark interest rates. The difficulties in making sukuk contracts Shari’ah compliant are placed in the context of the discourse among Shari’ah specialist whether to take a pragmatic or idealist approach to Islamic finance, and the main reason for non-compliance is found to be the tendency of financial practices to mimic western financial practices as these are usually standard setting and unavoidable in today’s globalized financial market.

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Introduction

While the Arab world is still largely in uproar as a consequence of the ''Arab Spring'' as we can see through the chaos and changes taking place across the region, the British prime minister David Cameron announced last October the first ever issuance of Shar'iah compliant sukuk bonds on the London Stock Exchange. He stated that

> Already London is the biggest centre for Islamic finance outside the Islamic world. Today our ambition is to go further still. Because I don't just want London to be a great capital of Islamic finance in the western world, I want London to stand alongside Dubai and Kuala Lumpur as one of the great capitals of Islamic finance anywhere in the world. (''Cameron announces UK plans for debut issue of Islamic Gilts'', Bloomberg, 2013)

Thus the goal of this ''Islamic Bond'' issuance is to compete with the highly developed Islamic Financial Centres in places such as Malaysia and the Gulf region. While this and the Arab spring at first glance seem to be unrelated, they are not. They point to a paradox in western orientalist views on the Arab world. On the one hand orientalists point to the Arab upheavals deemed ''the Arab Spring'' as the long overdue transition of the Arab world towards modernity and enlightenment (although current developments in Arab Spring countries may counter that). On the other hand, as the Bloomberg report indicates, the Arab (or Muslim-) world is beginning to become highly integrated in the advanced financial system and global financial markets, helping create rich city-states such as Dubai and others in the Gulf. (Bassens, Engelen, Derudder & Witlox, 2011, p. 85)

This paper tries to answer the question as to what extent Islamic financial practices, specifically sukuk securitization practises, are actually exceptionalist. This question matters since Islamic finance is seen as inherently different from other forms of finance, stemming largely from the prohibition within Islam on *riba* (usury, interest) and *gharar* (excessive risk-taking). Islamic financial markets are thus claimed, not in the least by many Islamic financial elites, to be non-conventional in that they are grounded in Islamic faith instead of mechanical or technical considerations preferred in conventional finance. While Islamic financial institutions claim their products to be exotic and fundamentally different from western forms of finance, this research shows that in many cases sukuk practices are not Shari'ah compliant (by avoiding *riba*) but in fact are used as a mere stratagem to circumvent *riba* while the mechanics of the construction almost completely mimic conventional financial products. This in turn is highlighted by the fact that even conventional western finance is tapping into the ''Islamic sukuk market'' in order to diversify its portfolios, pointing at the globalized nature of current Islamic sukuk markets.

In order to analyse to what extent sukuk markets mimic western conventional finance, and in how far they actually differ from them and are exceptionalist, this research analyses the differences and similarities between them. First a general Shari'ah perspective on the main two prohibitions in Islamic finance (namely *riba* and *gharar*) will be presented. Secondly the need for Islamic financial engineering and some grounding principles in Islamic jurisprudence (*usul al fiqh*) needed for constructing modern Islamic financial products will be analyzed. Thirdly, a theoretical description of Shari'ah compliant bonds (sukuk) as constructed by Muslim financial scholars and Shari'ah standard setting bodies is presented. In the last chapter, the practical application of sukuk securities is discussed, and found to be largely non-compliant with Shari'ah principles. We relate all this to the discourse regarding Islamic finance among Muslim liberalists or pragmatics and idealists or fundamentalists. We show that while current sukuk practises largely do not comply with basic Shari'ah provisions, some principles of Islamic jurisprudence do give a rationale for some kind of leniency with regard to mimicry of western finance as propagated by pragmatists.

While most previous research on this topic has primarily approached it from the perspective of one discipline, this research is inherently multidisciplinary and relies on several disciplines. Some research into sukuk securitization has been done completely from an economic or (western) legal perspective while other literature deals only with theoretical aspects of sukuk financing from a Shari'ah viewpoint. Here these views are combined to grasp the current state of sukuk financing and the challenges it faces with regard to Shari'ah compliance.

Chapter 1: The Islamic Prohibition on *Riba* and *Gharar*

Riba (usury) in Islamic Law

In the Qur'an and Islamic Law (Shari'ah), the term used for usury or interest is ''*riba*'', which literally means ''increase, growth''(Hans Wehr, 1994, p. 374). What is meant here is the increase capital (or nonmonetary possessions for that matter) over time for which no compensation is given whatsoever. El Gamal (2006, p. 49) states the forbidden *riba* according to classical jurists is the ''trading two goods of the same kind in different quantities, where the increase is not a proper compensation''. According to the Encyclopaedia of Islam (2012, 2nd edition), derivatives from the same root are used to describe interest in other Semitic languages. The prohibition in the Shari'ah regarding interest on loans should be seen in the light of ''Islam's'' view on property rights. According to Mohieldin (1997, p.4), Islam only recognises two forms of property rights: firstly the output of one's individual labour and natural resources, and secondly property rights acquired through trade, inheritance and grants. A loan is seen as the (temporary) transfer of those rights from a lender to a borrower and should not give the lender the right to any increase in his property. Thus interest is regarded as unnatural and unjust since it equals instantaneous creation of a claim of the lender over the borrower regardless the outcome of the project for which the loan was granted. Later in this research paper we will see how profits or gains made through ''loans'' can nonetheless in partial form be paid to the ''lender'' in Islamic financial constructions.

Riba is forbidden based on the following Qur'anic verse, revealed in the final period of the Prophet's life:

> But those who take usury will rise up on the Day of Resurrection like someone tormented by Satan's touch. That is because they say, 'trade and usury are the same', but God has allowed trade and forbidden usury. Whoever, on receiving God's warning, stops taking usury may keep his past gains – God will be his judge –But whoever goes back to usury will be an inhabitant of the Fire, there to remain (forever)... give up any outstanding dues from usury, if you are true believers. If you do not, then be warned of war from God and His Messenger. (Al-Baqara: 275-279)

According to classical Islamic jurisprudence (*fiqh*) there are two forms of *riba: riba al nasi'a* (delay usury) and *riba al-fadl* (excess usury). *Riba al nasi'a* consists of two types. First of all is the increasing of the debt of an insolvent borrower. When the loan has matured, the borrower needs to pay the lender a bigger sum of money than the original loan that was given to him. It is also possible that the borrower is unable to pay back the initial loan, and the lender gives him the option to pay him back at a much later time on the condition of payment of some amount of interest. The Qur'an specifically stipulates what a lender should do in the case of an insolvent debtor: ''If the debtor is in difficulty, then delay things until matters become easier for him'' (Al Baqara: 280). This verse commands the lender not to ask for interest but rather to give the borrower a longer grace period until he can pay back the loan. Second of all there is the type where there is *riba* taken through the selling of certain goods in excess with delaying the date of delivery. This includes selling items like gold on credit, although there are some differences of opinion on this matter. Classical jurists have given three important rationales for the prohibition of *riba al nasi'a*: it is a means of exploitation of poor debtors in desperate need of financing, money trading can lead to currency or monetary uncertainty and trading certain goods for larger amounts thereof in the future can lead to shortages in spot markets which in case of food trading could lead to famine. El Gamal (2006, p.50) gives several arguments though as to why this argumentation can be considered defective. The last argument for example is unconvincing since selling deferred claims on goods for immediate monetary compensation, allowed in Islamic law, could lead to exactly the same problem. *Riba al-fadl* constitutes the selling of a good for another good (barter) which is of the same type but in excess. According to classical jurisprudence the prophet forbade this with regard to six goods: gold, silver, wheat, barley, dates and salt. This means that in exchanging these goods it is prohibited to take more than the other in weight or measure. (Fawzan, 2005, vol.2, p.39-45 ; Noorzey, M.S. , 1982, p.5-6). It is important here to note that although we will use the term ''interest'' or ''usury'' throughout this paper to describe the concept of *riba*, one could argue that there are significant differences. As the case of *riba al fadl* shows, forms of forbidden riba exist that according to western standards do not constitute an interest rate. If one for example were to trade one ounce of gold today for one ounce of gold in one year, this is considered *riba al fadl* although it does not constitute an interest rate (rather, a zero percent interest rate). *Hanafi* jurists argued that this is forbidden on the grounds that an ounce of gold today is worth more than an ounce of gold in a year. One would thus never trade an ounce of gold now for an ounce of gold next year, unless some form of compensation (which is clearly *riba* according to some) is paid. Conversely, there are also forms of Islamic finance which according to western financing principles would be considered to entail an interest rate, but which do not constitute *riba.* As we will see in the case of *murabaha* cost-plus contracts, in contracting one would simply state the ''implied'' interest rate instead of ''interest rate''. (El Gamal, 2006, p. 45)

It is clear that there are a lot of inauthentic traditions (*hadith*) regarding usury, which are most likely put into circulation by individuals with certain theological or political goals. It is clear that the most strict and rigid prohibition on usury in Islamic Law has developed gradually over time. Some traditions indicate that the only forbidden usury is the transaction with a time limit, and that any immediate transactions do not constitute usury, although this has also been challenged. The most lenient definition on the prohibition on *riba* is that it only entails interest on loans, whether monetary or in other goods. Proponents of this more lenient view argue that any later prohibitions were more out of fear of falling into *riba* without certainty from a legal point of view whether a transaction entailed *riba*. The second Caliph Omar supposedly said that the harsh verse regarding *riba* was the last one revealed to the Prophet and thus anything resembling it should be avoided. This in some way indicated that Omar wished for there to be a more detailed explanation regarding the ruling on *riba* (Noorzey, M.S. , 1982, p.4). As we have stated earlier, some traditions stress that exchange of goods needs to have the same measurement (gold for gold, silver for silver, wheat for wheat) and that the quality of the exchanged goods must be the same (otherwise it would constitute *riba al fadl*). There is some kind of unanimity among early jurists regarding the exchange of goods that are capable of entailing *riba (mal ribawi)* such as the precious metals of silver and gold, which can only be exchanged through direct transactions. There is some difference of opinion though on goods other than the precious metals. Some scholars have said everything which is liable to *zakat* (alms) is *mal ribawi* and should be treated as such and thus only direct transactions can take place. As stated earlier, the goods specified in traditions with the same ruling as gold and silver are wheat, barley, dates and salt. Most scholars use *qiyas* (analogy) to specify other goods that would be capable of *riba*, and only the *Zahiri's*, who do not except *qiyas* as a source of law, reject it completely and stick with the goods specifically mentioned in the traditions (Encyclopaedia of Islam, 2012, 2nd edition). Most classical scholars viewed the prohibition this of *riba al fadl* more in line with the economic substance of its prohibition. As the famous *Maliki* jusrist ibn Rushd explained,

> It is thus apparent from the law that what is targeted by the prohibition of *riba* is the excessive inequity it entails. In this regard, equity in certain transactions is achieved through equality. Since the attainment of equality in exchange of items of different kinds is difficult, we use their values in monetary terms. Thus, equity may be ensured through proportionality of value for goods that are not measured by weight and volume. Thus, the ratio of exchanged quantities will be determined by the ratio of the values of the different types of goods traded. For example, if a person sells a horse in exchange for clothes ... if the value of the horse is fifty, the value of the clothes should be fifty. [If the value of each piece of clothing is five], then the horse should be exchanged for 10 pieces of clothing. (El Gamal, 2006, p. 52)

Ibn Rushd explained that the economic substance of the prohibition of *riba* is based on the conditions for the efficiency in exchange. Traded quantities should thus be determined by the ratio of their prices, and not the quality of the goods themselves. Some traditions support this view, such as a tradition were the Prophet instructed someone not to exchange low quality dates for high quality dates, but to sell the low quality dates and buy the high quality dates with its proceeds. (El Gamal, 2006, p.52-53)

Within the system of trade law in *fiqh, riba* plays an important role. Most of the laws have to do with the avoidance or prohibition of riba. For example, according to some of the four sunni law schools *riba* is not only present when a creditor demands a larger quantity of repayment, but if any advantage at all is obtained from the loan. Some methods of avoidance of riba have surfaced over the centuries, of which some are explicitly mentioned and allowed in works of some of the sunni law schools. Since the *Zahiri's* reject the principle of *qiyas* (analogy) as a source of law, they are one of the most fervent supporters of some of the most innovative and wide-ranging forms of ''*riba*-evasion''. One of the oldest forms of this so called *riba*-evasion is the *bay al-'ina* (credit sale par excellence). This means that a borrower sells a lender some good for immediate cash, and then immediately sells it back to the borrower on credit for more then what he sold it for (El Gamal, 2006, p.70). We will elaborate extensively on how the practise of *riba* can be circumvented in Islamic law in chapter three.

Gharar (excessive risk-taking)

The second ban in Islamic law regarding finance is on *Gharar*. This comes from the verb *gharra*, which means ''to risk'' or ''expose to danger'' (Wehr, 1994, p. 780). Many scholars define it as excessive risk taking. According to Mustafa Al Zarqa, as stated by Gamal (2006, p. 58), *bay' al gharar* is ''the sale of probable items whose existence or characteristics are not certain, the risky nature of which makes the transaction akin to gambling''. It entails some form of asymmetric information problem or even deception among people engaged in trade or financial dealings. As most scholars realize that complete certainty in financial transactions is basically impossible, they specify *gharar* to mean incomplete information or speculation preventable by complete contracting specifying deliverability, price, quantity and quality to the greatest detail possible. The prohibition of *gharar* is also related to the prohibition of *Qimar*, namely yields depending exclusively on luck or chance, like gambling. Consequently many scholars today prohibit participation in modern derivative trading on grounds that it breaks these rules on speculation and excessive risk-taking. (Ariff, Iqbal & Mohamad, 2012, p. 49)

Chapter 2: The Need For Islamic Financial Engineering and its Legal Justifications

The necessity of modern Islamic Finance

The need for Islamic Finance derives directly from Islamic law, the Shar'iah, since modern financing methods generally do not comply with it. As discussed in the previous chapter, there is a general prohibition of the use of *riba* (usury) in Islamic Law. Furthermore, most conventional bonds or other securities are primarily concerned with the return on investment, not with the actual object that is being financed. So it could be that with conventional bonds, in addition to the use of *riba,* one breaks Islamic Law due to the financing of activities that are *haram* (prohibited). Examples of this could be investments in securities of producers of alcoholic beverages, prohibited meat industry or financial institutions that deal with *riba*. The main goal of bond traders is to make capital gains when the value of their fixed interest rate bond prices rise as market interest rates fall. The bond trader is thus only concerned with interest rate developments in the markets and not in the actual value of underlying assets of their securities or bonds. (Wilson, 2004, p.5)

Moreover, the prominent Pakistani jurist Muhammad Taqi Usmani explains that Islamic finance is justified in that it restricts finance to funding of trade or the production of real assets. The funding of second order financial products such as derivatives is thus mostly forbidden, since it involves *gharar*, or uncertainty (Wilson, 2004, p.5). Usmani himself as the president of the Pakistani Shari'ah committee and the Bahrain-based Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) states that among the duties of the Shari'ah committee is

> To bring about mutual conformity or approximation between the conceptualizations and the practical applications of Shari'ah supervisory boards of Islamic financial institutions so as to avoid inconsistencies and contradictions between the *fatawa* and the implementations of these institutions in ways that lead to the effectiveness of the role of Shari'ah supervisory boards in Islamic financial institutions and central banks. (Usmani, 2008, p.1)

Furthermore, according to Usmani, the establishment especially of a *sukuk* system is essential in developing a healthy and viable Shari'ah compliant financial system. The main difference between *sukuk* (''Islamic bonds'') and conventional bonds is that *sukuk* are not based on interest payments, but on profit sharing in a project or company. Usmani names several benefits of *sukuk* securities. First of all issuing *sukuk* are an excellent alternative to conventional finance when companies cannot rely on a single party for their financing needs. Secondly *sukuk* are ideal to investors with a lot of capital who at the same time want to be able to liquidate their financial positions when they need to. Thirdly, *sukuk* could be well used by Islamic financial institutions, buying *sukuk* when they have excess liquidity and selling them when they are in need for more capital. Fourthly Usmani says *sukuk* will be a means of financial redistribution since every party involved will receive part of the profits or revenues made. According to him, the prevention of capital clustering around a handful of wealthy people is among one of the higher purposes of the Islamic economic system. (Usmani, 2008, p.2)

Besides all this there is off course a general need for financial engineering because of the increasing complexity of the international financial system. Ariff et al (2012, p.70) give several factors that stimulate financial engineering, such as reducing agency costs, opportunities to reduce risks in investments or projects and technological advances. Modern financial engineers have developed several strategies or products to accommodate all these new demands in this age, such as mortgages, insurance pension plans, credit cards etcetera. Since not all, or not even most of these, comply woth Islamic standards, a need for an Islamic financing facility arises which accommodates all those modern day financial demands in accordance with Islamic Law. It is important now to first focus on some general guidelines from *usul al fiqh* needed to create Shar'iah compliant financial products.

Some grounding principles of Islamic Jurisprudence

In Kamali's (2003, p. 11-15) extensive work on *usul al fiqh* he states that there are generally four main sources for the Shar'iah, which he refers to as the *adillah shar'iyyah*, or proofs of Shari'ah. These are the *Qur'an*, the *Sunnah (hadith), ijma'* (consensus of jurists) and *qiyas* (analogy). Another secondary source of Islamic jurisprudence is *ijtihad*, which is mainly a tool used by a *mujtahid* to deduce law from its sources. His task is to make sense of the four main sources and deduce tangible rules and regulations which then become law. *Ijtihad* becomes necessary when the simple rules stated in the Qur'an and the *Sunnah* are insufficient to counter real world problems, including economic or financial problems as encountered by Muslims in the world today. So let's focus a little bit more on *ijtihad* and how it can help derive a framework for developing *shar'iah* compliant financing methods.

While Kamali (2003, p. 489-493) classifies *ijtihad* into seven different forms, Ariff et al. (2012, p. 43-46) simplify those to three different forms. The first one is text based *ijtihad* in which a scholar simply deduces rules from the primary sources, as practiced by traditional Islamic scholars, strictly adhering to all the rules of *usul al fiqh*. The second one is eclectic *ijtihad* in which the *mujtahid* decides on whether a problem or matter is legal or in compliance with the Shari'ah, often acting opportunistically and ad hoc and not strictly adhering to the rules of *usul al fiqh*. The third form is relevant to our study here; context based *ijtihad*. This is where the *mujtahid* encounters a new problem and puts it in a historical and contemporary context. The *mujtahid* tries to make an analogy with a historical case which resembles the one at hand, since no direct ruling can be given on the matter through the deduction of texts. In this form of *ijtihad*, the so called concept in *usul al fiqh* of *maslaha* is used. This can be translated as the common good or the public interest. When the *mujtahid* uses *maslaha*, the scholar is primarily concerned whether something is in line with the *maqasid al shar'iyyah*, or the objectives of the Shari'ah, such as equity, justice and fairness (Ariff et al., 2012, p. 43-46). We return to the principle of *maslaha* later.

First of all, we need to take into account that one of the basic goals of the Shari'ah is to make things easy for mankind. This is supported by the Qur'an, where it is stated that ''God wants ease for you, not hardship'' (Al Baqara; 185). Besides this there are several prophetic traditions which stress that when encountered with two options in life, one must always chose the more easier option. This leads us to the second principle which is the doctrine of necessity. This doctrine is derived from the Qur'anic verse which states that in the case of eating prohibited food: ''But if one is forced to eat such things by hunger, rather than desire or excess, he commits no sin'' (Al Baqara; 173). This principle is of rather limited interest to Islamic finance, since riba evasion is usually not a matter of life and death. The third principle we need to take into account is the issue of general permissibility. According to *usul al fiqh*, the Islamic *ahkam* (general rules) can be subdivided into two categories. One are the so called *'ibadat* (acts of worship), and the other the *mu'amalat* (general social dealings). These are two sides of the same coin. This principle says that with regard to acts of worship, all is forbidden except for what is ordained or commanded in the sacred texts. With regard to the *mu'amalat*, it's the other way around. Everything is generally permitted, except for that were there is a specific text prohibiting it. This means that in relation to finance, jurists often need to inquire case by case whether specific contracts break Islamic law or not (Hallaq, 2008, p. 40-41).This means in specific contracts, jurists must determine whether a contract conforms to a classical *mudaraba or ijara sukuk* or other contract, and whether it conforms to its specific rules and regulations. Most modern day financial products are more like hybrids of those kinds of contracts and thus jurists must often use *ijtihad* by looking at the prohibitions in the sacred texts on these *mu'amalat* to determine whether a specific contract is legal under Islamic law or not. (Ariff et al, 2012, p. 74-75; Kamali, 2003, p. 363)

The last principle which is considered important with regard to Islamic finance is the issue of *maslaha mursalah* or considerations of the public interest. According to al Ghazali, *maslaha* takes into account considerations which are beneficial or which prevent harm, but are generally in harmony with the *maqasid* (goals) of the Shari'ah. These goals are the protection of the five essential values, namely religion, life, intellect, offspring and property. All measures that lead to the protection of these values can be considered *maslaha*. On a more technical note *maslaha mursalah* considers the objectives of the Shari'ah to secure a benefit or prevent harm. There are certain conditions to the application of this principle in classical Islamic Law, such as the presence of a genuine need and conformity with the goals of the Shari'ah. (Kamali, 2003, p. 351).

There are considerable differences of opinion with regard to this principle among jurists. Ariff et al (2012, p. 72-73) for example relate the principle of *istihsan* to *maslaha*. This principle means the preference of something (i.e. a legal ruling) over something else. It mostly refers to the departure of a previous ruling on a matter which has been derived by the means of *qiyas* (analogy) in favour of another one which is more easy in that particular case. Some people say this leads scholars to favour their own opinion over a ruling previously made by the means of sound *qiyas*. The defenders of *istihsan* though argue that it means that another ruling is preferred in a specific case due to stronger evidence from the *nusus* (texts), *ijma*' (consensus) by jurists or necessity. *Istihsan* just as *maslaha* takes into account the consequences of a particular ruling, and in that light helps the jurist in making a ruling which is generally considered as the most easy way out. This principle also has to do with the earlier principle of general ease for mankind, and *jalb al manfa'* (seeking of benefit) and *raf' al haraj* (removing harm) which both are also goals of the Shari'ah and can be used as guidelines with regard to *maslaha* and *istihsan*. Ariff et al (2012, p. 73) also consider some examples were the principle of *istihsan* can be used in Islamic finance. One is the *bay' al salam* in which a product which is well-known and well-described is bought on the basis of advance payment and where the goods are delivered at a later point in time since the seller does not have the product at the specific time the sale is conducted. Normally such a sale would be impermissible on the basis that it is prohibited to sell something one does not have, but the principle of *istihsan* leads us to a *hadith* which can defend an exception to this general rule. Also some future contracts which would have been prohibited under normal conditions can be considered legal (such as *istisna'*) because of a general consensus (*ijma'*) of jurists on this issue. It has to be noticed that Kamali (2003) staunchly criticises the incorporation of *istihsan*, or juristic preference, within the boundaries of *maslaha mursala*. He argues that although there are some common characteristics between *maslaha, qiyas* and *istihsan*, they are inherently three different things. They share the feature of being applicable in cases for which there are no clear indications within the *nusus* (texts) as to whether they are legal or not, and they also are alike in the sense that they are based on a *zann* (probability, suspicion) such as an *'illah* (effective cause) regarding *qiyas* and rational considerations regarding *maslaha*. The difference between *istihsan* and *maslaha*, Kamali argues, is that *maslaha mursala* does not follow or departures from existing precedent while *istihsan* is only applicable in cases were a precedent is available and through *istihsan* a jurist decides to depart from this already existing precedent. It has to be noted that most *Zahiri's* and some jurists of the *Shafi'i* and *Maliki* school reject the concept of *maslaha* altogether since according to them all *masalih* (benefits) are already incorporated in the Shari'ah. Most scholars of the four legal schools though adhere to the principle of *maslaha* to some extent, and Imam *Malik* even considers it a norm by itself which may specify the *'aam* (general) of the Qur'an. (Kamali, 2003, p. 361-365)

This discussion can be seen as an extension of the theological discussion on *maslaha* that has been around for centuries. The principle of utilitarianism which is related to *maslaha* (through the seeking of benefit and removing harm) can even be found in early western political economy theory. Jerry Bentham and John Stuart Mill are the founders of the so called Greatest Happiness Principle, which is the cornerstone of Utilitarianism and says that ''one must always act so as to produce the greatest happiness for the greatest number of people'' (Ariff et al., 2012, p. 71). Islamic utilitarianism and *maslaha* differ from this principle in that the main goal of Islamic utilitarianism is securing the *maqasid al shar'iyyah* (goals of the Shari'ah) instead of the maximization of human welfare. According to Hallaq (2008, p. 214-231), the most influential thinkers on religious utilitarianism where Muhammad 'Abduh and Rashid Rida. They tried to undo Islam to some extent from classical juristic doctrines that were deemed too complex and too rigid for the average Muslim to comprehend, let alone use in everyday life. So all positive and theoretical legal doctrines were set aside in order to go back to the basic texts of the Shari'ah, namely the Qur'an, the *Sunnah* and the consensus of the Companions. Because the traditional legal doctrines were so extensive and technical, they rendered adherence to them completely impractical. Thus according to Rida the law has lost its ability to govern the lives of ordinary Muslims and to remain moderate and tolerant.

The issue of *maslaha* relates to the discussion on what kind of approach towards Islamic finance is favourable amongst several different kind of sunni Muslim groups. Some prefer a very strict or idealist interpretation of the classical texts, and thus stick to all the principles developed in the classical period on finance and trade and say hardly anything needs to be added or subtracted to it, even in today´s highly specialized and complicated financial system. They thus stick to the early developed *fiqh* of the traditional *fuquha* (jurists) (Ariff et al., 2012, p. 49-50). This is also in line with what many western orientalist scholars have to say about Islamic finance, namely that Islam as a believe system is inherently political (''a complete way of life'') and unable to adjust to modernity. Hence there is no way to transform Islam, and thereby Islamic finance, to conform to all the complexities of modernity. Warde (2000, p. 14) notes that unlike these prevailing interpretations amongst many western scholars of Islam, in reality a lot of diversion can be found within ''Islam''. Besides well-known diversities such as divergent beliefs (such as shia versus sunni), there are striking differences between Muslim groups on topics such as politics and economics. A main feature of Islam according to Warde (34-35) is its fragmentation and decentralization, as opposed to for example the Vatican church for Catholicism. He also argues that fundamentalism doesn't necessarily conflict with modernity, since authenticity can still be maintained by traditional juristic principles such as *ijma', ijtihad* and *shura*(counselling). In this way, a fundamentalist can in some cases even be called a modernist or a liberal.

This brings us to a second category of approaches to Islamic finance, namely the purely liberal approach. The scholars of this approach argue that *riba* in the modern day era is not something evil, and does not lead to evil. Thus they argue that there is no actual need for a specific Islamic finance mechanism, since the goal of the Shari'ah was to prevent evil and injustice in the specific time it was revealed. When such evils can be averted through means of modernity and simple financial engineering, *riba* as a concept in itself does not oppose the goals of the Shari'ah anymore and the need of Islamic finance largely disappears. (Ariff et al., 2012, p. 49-50)

Most scholars though are more of a hybrid between the two, which we for simplicity can call fundamentalists (or idealists) and liberals (or pragmatists). Ariff et al (2012, p. 49-50) claim that most Islamic bankers and financiers belong to this hybrid category of pragmatists that try to find a middle ground, by applying traditional Islamic principles in a pragmatic way to formulate solutions for modern day financing problems. They prioritize pragmatism over rigidity and thus use an eclectic form of flexible *ijtihad* to create principles that are somewhat in line with the classical texts, and conform to the demands of modern day finance. As we will see now in the final two chapters, this can sometimes lead to questionable results and the issue is therefore highly debated among all different groups of Muslim intellectuals.

Chapter 3: Islamic Financial Instruments and *Sukuk* Securities

Over the last couple of decades, a lot of literature has emerged on so called Islamic Finance facilities and Islamic Investment vehicles. A lot of this literature though is purely practical as opposed to theoretical, and often supported by private institutions that have a stake in the result of this research. Recently a lot of independent theoretical research has also been done on this subject, the subject of Islamic Finance, and specifically so called *sukuk* securities. As mentioned earlier these are oftentimes called ''Islamic Bonds'' (which we will call *sukuk* throughout this paper), but a more accurate description would be Islamic investment certificates. This is because Islamic Bonds denotes an Islamic mimic of modern day western financial instruments, while in fact *sukuk* securities are not supposed to mimic traditional financial instruments and are better described as Shari'ah compliant assets (some scholars indeed have found many mimicries and similarities with conventional bonds in practise as we will see in the next chapter). The basic difference between *sukuk* securities and conventional bonds is that with *sukuk* securities no interest rate is paid, and they are entirely formed on the basis of profit sharing. So the pricing of these Islamic Financial assets is based only on the profits or returns after this profit or revenue is earned. Thus the lender actually takes part in the business risk of the borrowing entrepreneur. By contrast, in conventional modern financial fundraising, returns that lenders receive are based on pre-determined interest rates which are not dependent on the profit that the entrepreneur or borrower makes. Another requirement of *sukuk* securities is that fund seekers won't obtain funds when they cannot back these funds up with assets as we will see (Usmani, 2008, p. 3-4; Ariff, et al., 2012, p. 11-12).

Before we return to the topic of *sukuk*, I will try to describe in some detail the different forms of Islamic financial instruments that are available in financial markets, or more broadly speaking theoretical Islamic financial instruments that could help Muslim governments, businesses and individuals obtain funds in a Shari'ah compliant way. In classical Islamic tradition, there was basically just one form of acceptable loan, the *qard hassan* (good loan), and one form of deposit, namely *al wadia* (or ''safekeeping''). Most deposits in today's Islamic banks are based on this *al wadia* principle, namely for safekeeping and for transaction purposes. Normally no fees are charged for these kind of deposits, and off course no interest is paid. Most Islamic financial institutions offer some kind of profit-and-loss sharing (PLS) deposits so depositors can make money on the ''investment'' they make in a bank. (Warde, 2000, p. 132)

We can basically classify Islamic financial contracts in four categories:

Murabaha (cost-plus contract):

Murabaha is a cost-plus sale, in which a financial provider buys goods, equipment or other assets on behalf of his client and subsequently resells them to the client with a predetermined profit margin. According to El-Gamal (2000, p. 10) there exists a tradition from the well known companion Ibn Mas'ud in which he declared that there is no prohibition on such lump sum or percentage profit margins with regard to cost-plus sales. Although percentage points in such contracts may scare some into thinking this actually is *riba,* the very nature of this transaction only implies the buying and reselling with a profit margin that does not reflect the time value of money, but the hardship of the financial provider of buying something for someone else's behalf (and thus is normal trade). According to Warde (2000, p. 133) 80 to 95 percent of all investments conducted by Islamic financial institutions consist of some kind of mark-up or cost-plus contract. Especially within the housing market the principle of *murabaha* is used in order to avoid interest bearing mortgages.

Several forms of *murabaha* can be identified. Since immediate payback by the borrower would render the *murabaha* transaction useless for borrowers, the credit sale (*bay' al-mu'ajjal*, or *bay' bi-thaman 'ajil*) is the most common form. When a product is only bought on someone's behalf, the financial institution would just be a middle-man or a broker agent. With a credit sale, the good is delivered immediately and payment is done either at a later point in time or, more commonly, in instalments. According to El-Gamal (2000, p. 11-13), what this boils down to is whether deferment of payment justifies an increase in price. He lists several quotes from traditional sunni jurists from all schools, who confirm the permissibility of increasing price in this case. Famous jurists such as Ibn 'Abidin (Hanafi), Ibn Rushd (Maliki), Al-Subki (Shafi'i) and Ibn Taymiyya (Hanbali) all confirm that deferment of payment indeed justifies a higher price. By contrast, the so-called *salam* contract/security can be seen as the inverse of *murabaha.* Instead of deferred payment this contract specifies deferred supply of the goods that are purchased, thus it can be regarded as ''advanced payment''. This gives the supplier (such as a farmer) the opportunity to further grow their crops while being able to fulfil their immediate financial obligations. Since deferment of the supply of goods justifies a *decrease* in price, this contract has obvious advantages to the buyer too. (Wilson, 2004, p. 6)

As one can imagine, there has been significant criticism of *murabaha* contracts. One of the questions is how much risk is actually incurred by the lender, since risk-sharing is one of the main goals of Islamic Finance. As the deferment of payment is shorter, risk incurred by a bank is less as the chance of default by the borrower is small. Besides this, the purchased assets can serve as a guarantee (as they are still in the possession of the bank/lender) and some banks even require borrowers to offer collateral for their purchases. This renders the risk incurred by the bank negligible. Secondly some say there is hardly any difference between such mark-up schemes and interest paying loans, since the end result is usually the same. Eventually the core religious issue is whether the banks remuneration is a lending fee, in which case it is akin to *riba*, or a remuneration for the service which is provided, or the risk incurred, in which case it is acceptable *murabaha*. Since the bank owns the assets up until the borrower fully pays for it, the bank incurs all risk of the asset being damaged or destroyed, and of default on the buyers part. Because of this criticism, many financial institutions have adjusted their *murabaha* business to reflect the magnitude of their service and risk incurred as opposed to prevailing interest rate benchmarks which they took into account setting up *murabaha* contracts in the past (Warde, 2000, p. 133-134).

Ijara (leasing)

In many ways, leasing in Islamic Finance is similar to conventional leasing. In legal terms, a lease contract is the sale of the *manfa'* (usufruct, or the right of using the object that is leased) of the product for a predetermined time and fee, while the object remains in the possession of the lessor. El-Gamal (2000, p. 13) lists several verses from the Qur'an and *ahadith* which confirm the legality of leasing, and compares employment for wages to the leasing of one's (intangible) work(time) to an employer. Several small differences between Islamic leasing and conventional leasing exist to avoid *riba* and *gharar*. The lessor for example always has the duty to repair, and since usufruct is something intangible and uncertain, the law provides plenty of flexibility for the lessee to cancel the contract. At the end of the specified lending time, the product may be sold to the lessee, but not for a predetermined price. (Warde, 2000, p. 135) So-called *ijara* securities are certificates of ownership of products that are leased. They are fixed in time and can be sold on the secondary market. We return to these securities in our detailed analysis of *sukuk*.

Istisna'

Normally, due to the prohibition of *gharar*, the sale of non-existent goods is prohibited. In order to facilitate some types of business there are two exceptions though. First is the already mentioned *salam* contract, and secondly there is *istisna'*. *''Istasna'a''* means ''asking someone to manufacture'' (Sharjah Islamic Bank, 2013). As there are specific texts in the Shari'ah condoning the *salam* contract, *mujtahidun* (jurists using *ijtihad*) argued by means of *qiyas* (analogy) and *istihsan* (preference) that *istisna'* is permitted (El Gamal, 2000, p. 17). In such a contract funds for a project are advanced or paid in instalments to finance capital and labour costs. After the project is completed, funds are repaid to the financier from the revenues from the project with a pre-determined profit margin. *Istisna'* contracts are ideal for financing of industrial manufacturing where costs are often incurred before production of the goods starts, due to for example high capital intensity. Two conditions need to be fulfilled in order for the *istisna'* contract to be valid: First, all the specifications of the product that is to be manufactured should be specified. Second, the time of delivery of the product should be pre-determined. (Al Baraka Banking Group, 2007; Wilson, 2004, p. 8-9)

Profit and Loss Sharing (PLS) agreements

The last two basic Islamic contracts are the contracts/securities based on Profit and Loss Sharing (PLS). This kind of financing method lies at the heart of Islamic Banking principles as precedent for it can be found in the classical texts and it corresponds to the value system of Islamic Economics. Islamic PLS schemes can be either so called *mudaraba* or *musharaka* contracts/partnerships. These can be seen as Islamic equivalents of conventional PLS contracts, such as those engaged in by venture capitalists and merchant bankers. They differ from other lending schemes in that the financial institution does not profit through interest payments on ''loans'', but instead shares both the risks and the profits of the enterprise that they provide with liquidity. In this way the financing institution ties its own future, or more specifically their investment, to the future of the enterprise they finance. This allows capital poor entrepreneurs which have promising business models to obtain financing. This is clearly in the public interest since it incentivises financial institutions to invest in promising profitable projects, and does not choke entrepreneurs with debt and interest burdens that obstruct their business. (Warde, 2000, p. 135-138)

In the case of a *mudaraba* partnership, the ''lender'', in this case called the *rabb al-mal* (sleeping partner), finances the ''borrower'', called the *mudarib* (managing trustee), who will use the funds for his business or project. Upon maturity of the contract, the *rabb al mal* receives his investment plus a predetermined *percentage* of profit made. The *mudarib* is to keep the remaining profits he made in his business. In case no profits are made, or even losses are incurred, the *rabb al mal* risks losing part or all of his investment. The division of profits cannot be a predetermined lump-sum (it must be proportional), and the *mudarib* does not share in losses except for those funds he puts in himself, and his time and effort. Since the financier is fully liable for the invested capital, he bears the full risk of losing his investments. Therefore, most regulations in Islamic financial markets stipulate that the entrepreneur can be financially liable in case of fraud or mismanagement (we will see how some of these constructions run in significant Shari'ah compliance issues in the next chapter). The *musharaka* partnership is similar to this except for that it is more like a joint-venture agreement with sharing of ownership and control (and thus resembles modern day equity markets). In this case the division of profits is predetermined and paid out proportionally to each investor (Warde, 2000, p. 136-137; Ariff et al., 2012, p. 14). Several hybrids of *musharaka* and *mudaraba* exist, such as the *musharaka mutanaqisa* (diminishing partnership), which is a hybrid of *musharaka* and *ijara*. Whereas with *ijara* the lessor owns the object for the entire leasing period, in case of the *musharaka mutanaqisa* the ownership of the object is shared between the two parties. The customer subsequently pays both rental payments each period and buy out payments until the end of the contract, when the object is completely owned by the customer. The attentive reader will notice that this resembles modern day mortgage agreements. The periodic rental payment can be compared to the periodic interest payments with conventional mortgages, and the buy-out payments to principle payments. While this resemblance may be cause for concern, according to El Gamal (2000, p. 36) this should not be the case as long as all the contractual stipulations are in accordance with the Shari'ah.

Islamic securitization: the sukuk market

Now we turn to the specific topic of securitization through *sukuk* securities. Linguistically speaking, a *sakk* (pl. *sukuk*) document or certificate, and it denotes a certificate of ownership of some pool of assets provided by a borrower to a lender as a proof of ownership of those assets. This means that a condition of *sukuk* is that they are asset based, meaning that a borrower has to create a special entity in which specific assets to be owned by the lender are pooled together, and owned by the lenders in proportion to the funds they provide. This asset backing principle is one of the most important differences of *sukuk* securities with conventional bonds, which are inherently not asset based. By extension this entails that on this particular issue, *sukuk* securities are deemed safer than conventional securities since the latter do not provide such an asset backing, and lenders can only claim right of ownership after consulting a court of law following actual default on payments. *Sukuk* are thus funding arrangements between investors providing funds and borrowers (such as governments or companies) who use these funds for legal (*Shar'i*) activities. (Ariff, et al., 2012, p. 14-15). Regulatory authorities in different geographical locations maintain somewhat different definitions of *sukuk*, which may be found on each regulatory authorities' website. The most commonly used definition though is the one from the previously mentioned AAOIFI which states that *sukuk* are

> Certificates of equal value representing, after closing subscription, receipt of the value of the certificates and putting it to use as planned, common title to shares and rights in tangible assets, usufructs and services, or equity of a given project or equity of a special investment activity. (AAOIFI, 2008, p. 307)

Broadly speaking, these securities are based on the financing principles just examined, such as leasing, ownership and control (PLS) share type securities, project specific securities, or a hybrid thereof. *Musharaka sukuk* are contrary to other forms of *sukuk* based on ownership and control of the entire firm, and these *sukuk* holders receive payoff based on predetermined profit ratios. Most *sukuk* contracts though do not involve ownership and control over the entire company, but involve a set aside portion of assets of the income-producing assets of the company. These are pooled together in a Special Purpose Company and are officially owned by the *sukuk* holders in proportion to their funding. Thus as Ariff et al. (2012, p. 15) argue, finite period *sukuk* contracts are characterized by the moving of some of the borrowers assets to a SPC which is ought to be owned by the lenders until the contract matures or the *sukuk* securities are sold on secondary markets. The fact that *sukuk* securities are asset-backed puts a limit on borrowing, since a firm or government can only borrow to the extent it can offer (future) assets. This in theory makes this system more financially stable by preventing excessive lending to risky borrowers which have nothing to provide should they go bankrupt. Since excessive borrowing (without asset-backing) has been of the major factors in causing the 2007 financial crisis, one could argue that a securitization system similar to *sukuk* securitization could inherently make financial markets more stable.

We have now seen that asset-backing is a characteristic that makes *sukuk* securities somewhat safer to investors than conventional bonds. One other important characteristic of *sukuk* securities though is that the returns are not based on predetermined interest rate payments, but on a predetermined profit ratio. This reflects on the previously discussed principle of profit and loss sharing (PLS). Depending on which type of *sukuk* security is owned, different forms of profit sharing entail different periodic or end-term returns to the investors. This indicates that an important principle in *sukuk* securities is that ''reward is given only if profits are earned'' (Ariff et al., 2012, p. 18). So there is the guarantee of return on investment only to the extent that the investor and borrower expect the assets of the company to create wealth. There are exceptions to this, namely products based on the already discussed *bay' bi-thaman 'ajil* principle, which can be constructed as kind of a *murabaha* (cost plus) type of constant growth *sukuk*, with increasing periodic payments. Another is the *ijara sukuk*, which is based on periodic lease payments and not only depends on the profits the lease creates.

Besides the fact that investors have no guarantee of return on their *investment*, because of the volatility of the value of underlying assets in the SPC there is no guarantee as to repayment of the *principle*. So the value of the principle depends on the value of the underlying assets in the SPC, and thus can be much lower than the initial funding. This on the one hand increases safety for the investor, since they own the assets in the SPC, but also restricts the claim to any other assets of the company should the project go bad. Thus, haircuts can be applied to the assets in the SPC (which can be sold), but not to the entire firm. This makes *sukuk* securities riskier to investors, but on the other hand prevents complete liquidation of assets of a company should a specific project go bad, since the investors share the risk in the risk of these projects. Consequently, in theory, during crisis less bankruptcies will occur. One other societal benefit is that over the last couple of years more and more complex *sukuk* structures have been developed in order to meet the demands of Islamic entrepreneurs who desire special structures which match their specific project cash flows. Through for example *istisna sukuk* some of those entrepreneurs are able to obtain funds before production of specific products even starts. (Ariff et al., 2012, p. 18-19)

Now we have discussed the basic idea behind *sukuk*, we can take a look at classification issues. The question is how we should classify all these different kinds of *sukuk.* Some scholars or institutions classify *sukuk* based on the originator or issuer of the *sukuk.* They thus differentiate for example between government *sukuk* which mimic western publically traded treasury bills, and are therefore called treasury *sukuk*. These are issued by governments for basic debt-funding and the like, and contrasts special purpose government issuance of *sukuk* for specific projects. Besides these government *sukuk* there are the more risky *sukuk* issued by private institutions. All these *sukuk* are usually rated by western rating agency's such as Moody's and Standard & Poors according to their riskiness, and according to principles also applied to conventional bonds. This makes these ratings rather questionable and controversial. The more common way to classify *sukuk* though is according to the practise that defines and explains the mechanism of the actual application of the *sukuk*. In this way recent literature differentiates between at least 14 different *sukuk* structures all based on the previously explained basic Islamic finance contracts. (Ariff et al., 2012, p. 23)

To explain the basic mechanism of *sukuk* securitization, we will examine the structure of two basic *sukuk* structures, namely the *sukuk al-ijara* and the *sukuk al-mudaraba*.

The first is the basic sale-and-lease-back *ijara sukuk*. The basics of an *ijara* contract have already been explained, namely the transfer of the usufruct of a specific object in return for periodic rental payments. In practice, a *sukuk al-ijara* contract starts with an originator who needs financing and is explained in figure 1.

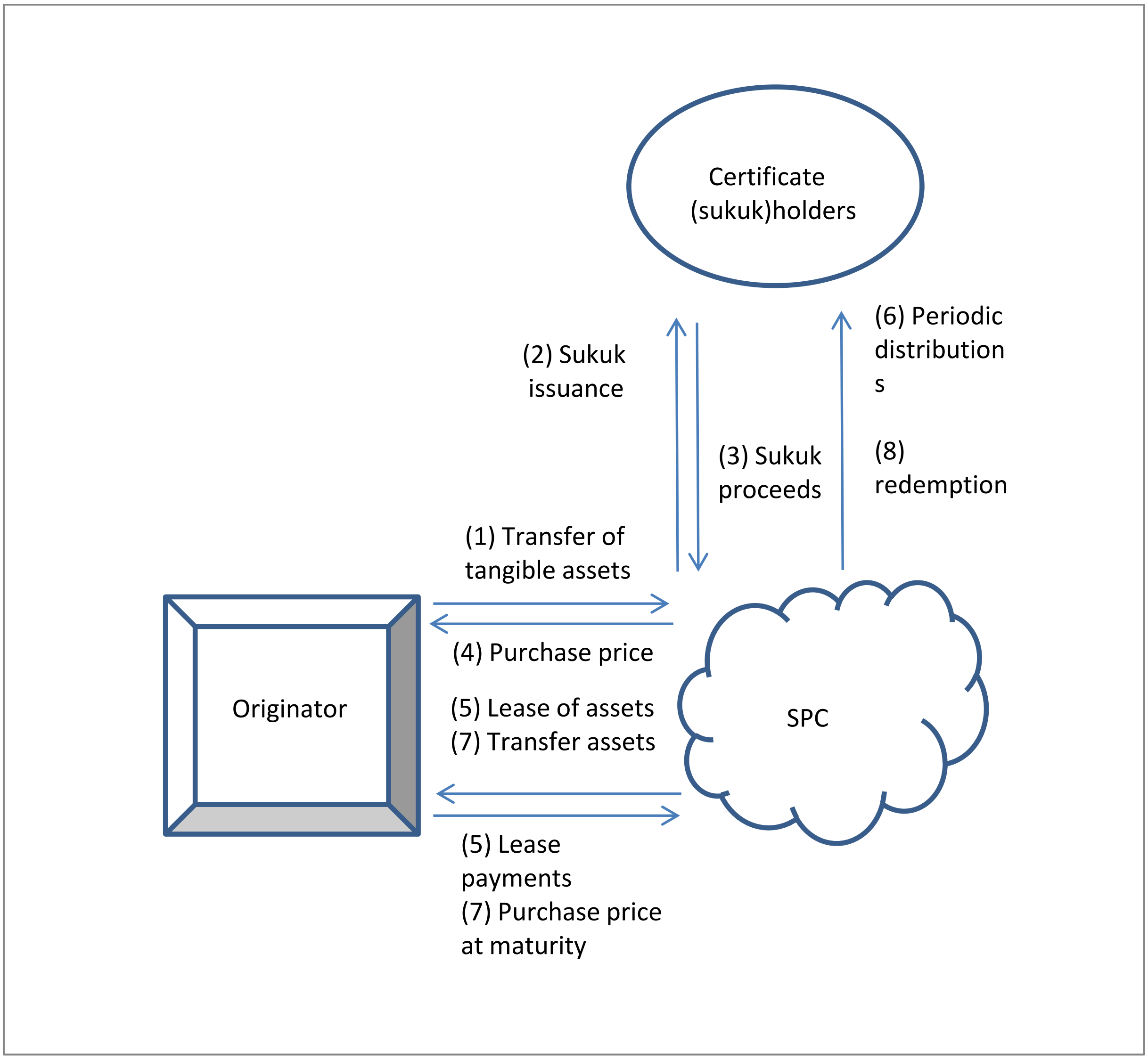

Figure 1: sukuk al ijara structure (Ariff et al., 2012, p. 53-55; Bassens et al., 2012, p. 96; Authors' own)

The originator creates a separate bankruptcy-proof SPC to which it sells certain assets (1). In return for these assets, the SPC has to pay the originator a price (4), the funds for which it will obtain through issuing *sukuk* securities to investors looking for Shari'ah compliant investments (2). The price the SPC pays the originator (in need of funding), equals the principal amount paid by the investors for the *sukuk* securities (3). This sale makes the SPC the trustee of the assets of the originator on behalf of the investors. After this, the SPC will enter a lease agreement with the originator for a predetermined period of time. This specifies that the SPC (trustee of the assets legally belonging to the *sukuk* owners) leases back the assets to the originator, which pays periodic rental payments to the SPC (5), which in turn transfers these rental payments as periodic returns to its *sukuk* holders (6) (since they are the legal owners of the assets). At the maturity date, the originator buys the assets back from the SPC at a predetermined value or market value (7) (depending on the specific contract), which the SPC in turn pays out to the *sukuk* holders (8) and which redeems the *sukuk* certificates and makes the originator the legal owner of the assets again. We will see later that this structure encounters some practical and legal problems in terms of ownership, since in practise it is almost impossible to make the *sukuk* holders the temporary legal owners of the assets within the SPC. (Ariff et al., 2012, p. 53-55; Bassens, Engelen Derudder & Witlox, 2012, p. 95-96)

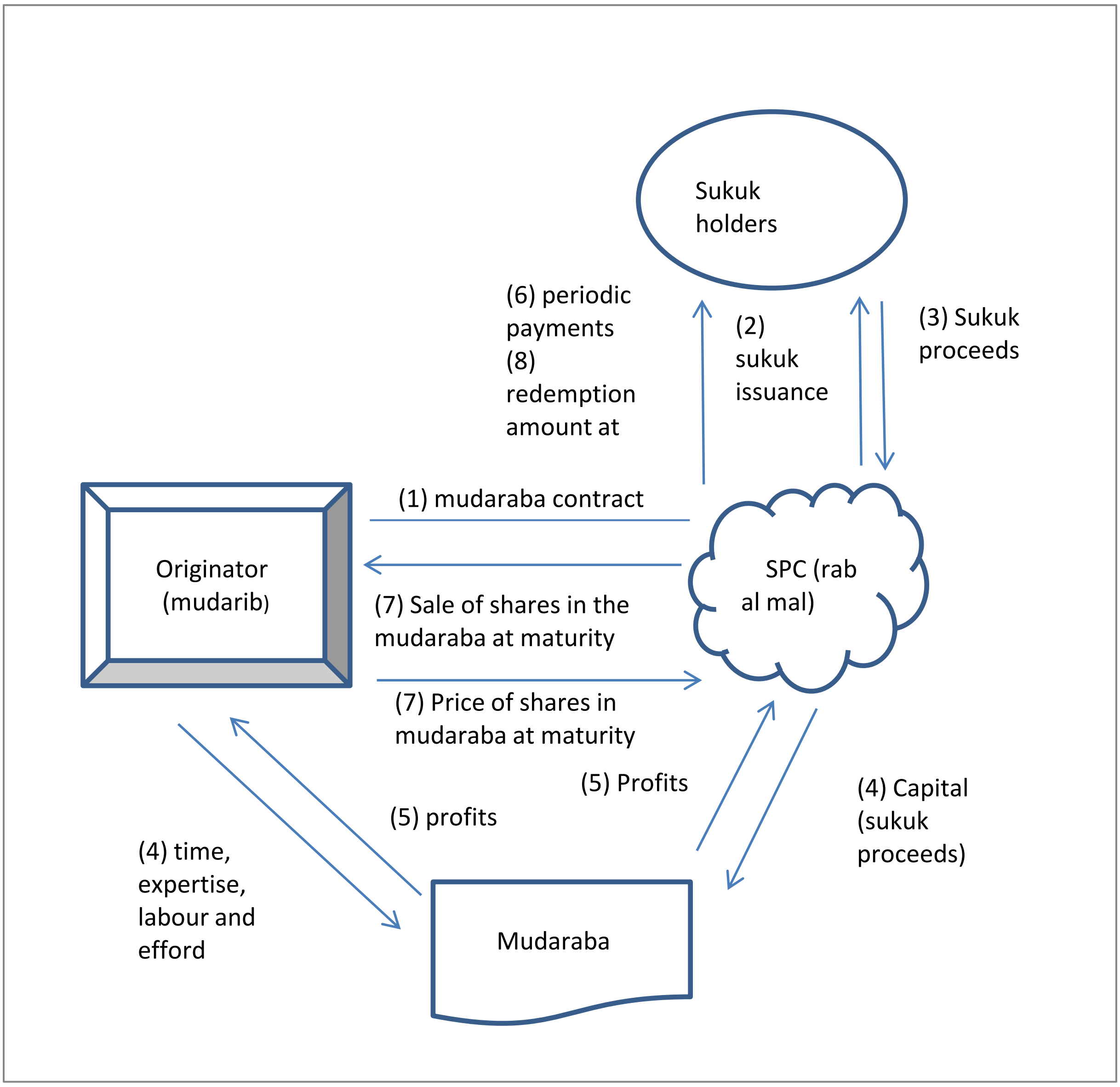

Figure 2: sukuk al mudaraba structure (Ariff et al., 2012, p. 58; Bassens et al., 2012, p. 98; Authors' own)

The *sukuk al mudaraba* is based on the previously discussed *mudaraba* partnership contract, and is sketched in figure 2. Just as with the *ijara* structure this starts with an originator (institution, company, government) looking for Shari'ah compliant funds. It establishes a SPC with whom it will enter into a *mudaraba* contract (1). The originator in this contract is called the so-called *mudarib,* or the managing partner or entrepreneur in need of funds. The SPC is called the *rab-al mal* of the *mudaraba* partnership and provides the funds. To do so it issues *sukuk* certificates to investors (2), the proceeds of which (3) will be funnelled to the *mudaraba* partnership (4). The SPC will take its assets in the *mudaraba* in trust for the *sukuk* holders in proportion to their investments. They are thus also entitled to the proceeds of the *mudaraba* in proportion to their investments (6), which in turn depends on a predetermined percentage of the revenues of the *mudaraba* which the SPC is entitled to (5). At maturity the managing partner (*mudarib*) buys the assets from the *mudaraba* from SPC (7) (most commonly at market value), so the latter can pay back the principle amount (at market value) to the *sukuk* holders (8) and the *sukuk* can be redeemed. (Ariff et al., 2012, p. 57-58; Bassens et al., 2012, p. 96)

Besides the omnipresence of *ijara* and partnership contracts in Islamic finance, so called hybrid *sukuk* structures have emerged over the last couple of years. This is due to the fact that most *ijara* structures limit the originator in the case he does not have sufficient tangible assets. To accommodate investors and borrowers, hybrid *sukuk* rely on a pool of assets comprising for example *istisna, ijara* and *murabaha* contracts. This gives possibilities for refinancing methods as it basically involves receivables being transferred to a SPC which issues *sukuk* over them. As we shall see in the next chapter, this *sukuk* structure has been the target of fierce criticism from Islamic scholars, since it violates the prohibition of trade in debt receivables (and *murabaha* and *istisna'* involve debt). (Ariff et al., 2012, p. 58)

Chapter 4: Discussion: Islamic Securitization and Mimicry of Conventional Finance

Historical developments

Historically speaking, the first documentation of the use of sukuk securities dates from the 13th century in the Ottoman empire, where Islamic jurists had to create a vehicle to ensure borrowing for the sultan in order to reconstruct and rebuild the empires' infrastructure after the devastating crusades. Islamic finance practices largely disappeared though and were replaced by modern finance alongside western colonial expansion. According to Warde (2000, p. 49), the Ottoman empire started giving out interest bearing treasury bonds around the year 1840, and in the 20th century Egypt's French inspired legal code served as an example for Arab financing practices based on modest interest rates. The earlier mentioned Egyptian Mufti at the time, Muhammad 'Abduh, and his principles regarding religious utilitarianism (*maslaha*) played a crucial role in this. With the end of colonialism came a new age of finance in the Muslim world. In practically all Muslim countries' financial systems included interest rate practices (including central banks) on the (judicial) basis of custom, necessity and the public interest. Jurists justified interest bearing financial transactions or financial dealings with conventional banks on these principles, although some followed a more strict line with regard to this issue and did not see participation in modern conventional finance as a necessity. Islamic financial institutions that were established with the advent of Islamic finance differed with respect to its dealings with interest and some (such as the Faisal Islamic Bank of Egypt) had placed their excess funds on interest bearing bank accounts abroad, while others refused to do so (and succeeded therein to different degrees). (Warde, 2000, p. 49-50)

A lot of emphasis must be put on the fact that there was and is a huge amount of geographical variegation regarding Islamic Finance principles in the Muslim world. Warde (2000, p. 112-128) devotes an entire chapter in his landmark work on Islamic Finance to the different financial regimes in Muslim countries claiming to have a financial system based on Shari'ah principles. His case studies of Pakistan, Iran and Sudan show that the Islamization process happened within different religious, political, economic and cultural circumstances. In most cases over the last couple of decades the introduction of Islamic finance was done on an ad hoc basis instead of actual fundamental financial or regulatory reforms. Bassens et al. (2012) also devote a lot of their paper to the fact that the global sukuk market is and was never a well-defined entity, but a market that has shown a great deal of country differences.

The rediscovery of sukuk and laying down the basis for modern day Islamic securitization was arguably done in 1988 by the Council of the Islamic Fiqh Academy in Jeddah, Saudi-Arabia. In a decree it argued that assets could be bundled together and be the basis of a bond which consequently could be sold at market price with the condition that the bundled assets consisted largely of physical assets. Although the basis was thus laid down in the Gulf, the first issuance of actual sukuk took place in the less religiously strict Malaysia. In 1990, the so called Shell MDS (a Royal Dutch Shell subsidiary in Malaysia) issued the first official sukuk worth $30 million based on the *bay' bi-thaman 'ajil* principle. It was structured on a deferred payment basis with a pre-agreed price and profit margin, and thus resembled a normal mark-up conventional bond. This was the start of the sukuk market in Malaysia, and eventually spread over the world since the early 2000s through the establishment of sukuk markets in the Gulf, notably sovereign issues by Bahrain and Qatar, followed by corporate issues in the UAE and Saudi Arabia. Here, the newly introduced sukuk had to comply to stricter interpretations of the Shari'ah regarding sukuk and thus many debt-based structures as those introduced in Malaysia were unacceptable in the Gulf. This was because while the underlying contracts that underpinned those debt-based structures were indeed deemed Shari'ah compliant (i.e. based on *murabaha, ijarah*, etc.), the general structure was not since the investors in the sukuk received fixed payments specified in the contracts. This according to Gulf regulators contradicted the basic risk-sharing principle underlying sukuk contracting. Trying to solve this issue and making sukuk more based on the profit and loss sharing principle, recent sukuk issues have been more based on specific projects (*istisna'*) or asset-backed (such as *musharaka mutanaqisa*; diminishing partnerships). These structures do not involve a fixed return at maturity, and the return is actually highly related to the performance of the underlying assets. As the Dubai debt crisis has shown however, these sukuk do not protect against speculation on the underlying assets themselves and thus make the sukuk just as speculative as conventional bonds (Bassens et al., 2012, p. 93-94). Figure 3 shows the evolution of the global sukuk market (in terms of market value and number outstanding) since the early 2000s, indication exponential growth with only a dip during the global financial crisis of 2008, also corresponding to the Dubai debt crisis.

Recently, this new sukuk market has also played a role in the integration of Islamic markets into the global financial system. When western corporations or governments for example wish to attract investment from Muslim countries, they can issue sukuk. A lot of work still needs to be done though before this integration can take place on a larger scale, since regulatory systems often times contradict each other. This means regulatory regimes in western countries need to be partially adjusted or the issuers themselves need to be more innovative in structuring there securities in such ways that they conform to both regulatory regimes. (Bassens et al., 2012, p. 94-95)

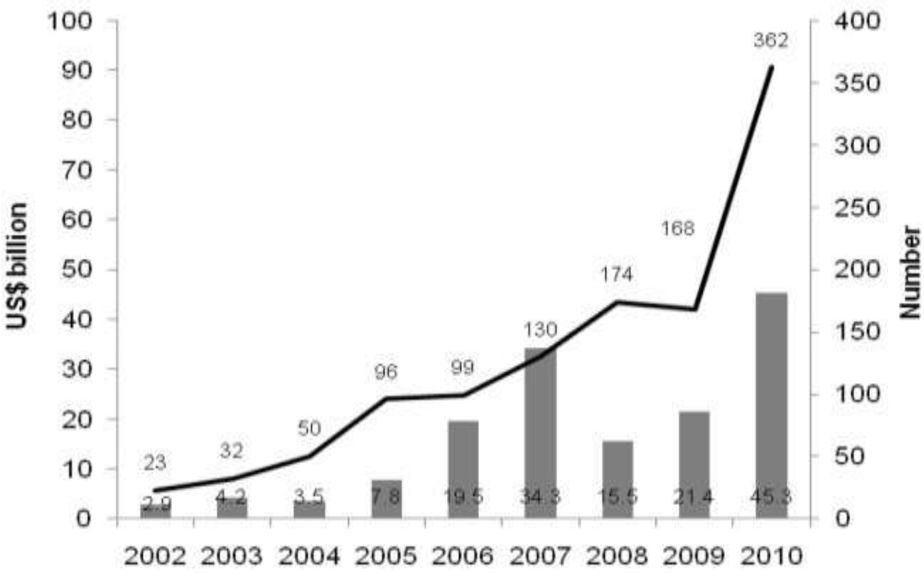

Figure 3: Evolution of the Global Sukuk Market since early 2000s (Zawya Sukuk Monitor, 2013)

How Shari'ah compliant are current sukuk markets?

In their very informative paper, Bassens et. al (2012, p. 95-102), try to explain the complexities and issues that current sukuk securitization is facing. Through a case study of the so called Emaar Sukuk Limited, emitted by the Dubai based Emaar Properties PJSC, they show the complexity and globalized nature of current sukuk structures. The sukuk issued are based on the earlier discussed sale and lease back *ijarah* structure, where the obligor Emaar Properties PJSC sells assets to a bankruptcy proof SPC called Emaar Sukuk Limited, which consequently issues sukuk to investors. After this the obligor Emaar Properties PJSC leases the assets back from the SPC, which creates a cash-flow that the SPC pays out to certificate holders. At maturity the obligor buys back the assets from the SPC, the cash of which will be used repaying the principle to the certificate holders. This is an oversimplification of reality and the globalized nature of these kind of sukuk structures. Indeed in the Emaar case the SPC is actually registered in the Cayman Islands, while the deal itself is done from the offices in London of banks such as HSBC. The in house ''Central Shari'ah Committee'' consisting of essentially four scholars assesses the Shari'ah compliance of the structure. Secondly the SPC is managed by a licensed trust company in the Cayman Islands. Similar to conventional securitization, this implies transfer of title to a trustee which will hold it on behalf of the investors. In conventional finance this enables parties to reap the benefits of off-shoring while investors themselves have little access to the assets themselves. The basic *ijarah* structure though requires the SPC to actually own the assets themselves, which led to the emergence of a ''delegate'' of the SPC, based again in London, who is actually the legal trustee of the assets. After this, to issue these sukuk, one can go to for example the London Stock Exchange (as was done in this case), before which the sukuk need to be rated by well-known rating agencies such as Moody's. Most sukuk trading is done though in the Over The Counter (OTC) secondary market which necessitates the involvement of bilateral trade brokers to act as mediators between buyers and sellers of sukuk. After this several other bureaucratic formal actions need to be taken, in which several different parties in different geographical locations are involved. This involves registration, calculation of payments, and most importantly the involvement of legal firms figuring out the legal implications in all jurisdictions (in this case in Dubai, Britain and the Cayman Islands).

This case study indeed highlights the globalized nature of Islamic financial (sukuk) markets in the current stage. The interconnectedness of these different financial systems is the result of financial elites who in their endeavour for new markets use conventional finance techniques aided by basic principles of local culture and practise. This interconnectedness consequently leads to the transplantation of techniques to other geographical and cultural dimensions. (Bassens et al., 2012, p. 98-99)

This is confirmed by taking a look to for example the prospectus of the Emaar Sukuk case, which indicates this is in fact very similar to a conventional securitization structure. It is dissimilar to conventional products in the sense that the structure is much simpler than conventional securitization, which deals with different classes of bonds, tranches and complicated credit ratings. Bassens et al (2012, p. 99) claim that the simplicity of sukuk structures compared to conventional products such as Mortgage Backed Securities

> strongly suggests that the technique of securitizing assets is used here as a mere stratagem to circumvent Shari'ah rules, as they are 'Islamic' in form, but not in substance.

They support this claim with three arguments. First of all they indicate that in most sukuk structures, just like in conventional asset-based structures where periodic payments are benchmarked on the LIBOR rate, returns are fixed to a certain percentage, which leads the returns to investors to be completely detached from the underlying assets. Thus the sukuk are rated not on the merits of the underlying assets (which is a prerequisite in asset-based sukuk), but the rating of the seller himself. This leads the prospectus of sukuk securities to be very detailed regarding the credit rating of the obligor. Secondly, the investors are guaranteed payback of their principle at maturity, which contradicts the basic risk-sharing and PLS principle in Islamic Finance. Thirdly there is a problem with the legal ownership of the assets supposedly in the SPC. In reality, in case of default, the investors do not have actual ownership of the assets which are supposed to be in the SPC. This also explains why a fixed rate is paid out to investors, essentially making the practice an unsecured bond issue (Bassens et al. 2012, p. 99-100). Were Bassens et al give a specific account of mimicry in *ijarah* sukuk, Khan (2010, p. 814) gives a detailed example of how *murabaha* contracts in mortgage dealings in fact mimic conventional mortgages, and that in practice realized cash flows are almost exactly the same for both structures.

Their case is supported by Usmani (2008), who has elaborated extensively on how the current sukuk market is largely not compliant with the Shari'ah. He even stated that at least 85 percent of sukuk currently in the market are not Shari'ah compliant (Ariff et al., 2012, p. 59). Especially in the case of *ijarah* sukuk he emphasized the necessity that ownership of underlying assets is for the sukuk holders, while in a majority of current sukuk structures the actual legal ownership is still with the obligor, and contracts merely stipulate a right of returns to sukuk holders. These can thus never be Shari'ah compliant. He further criticized certain hybrid sukuk structures on this point since they often include *murabahah* contracts. This necessarily leads to the sale of debts (*bay' al dayn*) and this is clearly forbidden in Islamic Law. (Ariff et al., 2012, p. 59 and Usmani, 2008, p. 3-4)

With regard to the periodic payments to the investors Usmani (2008, p. 4) also expressed significant criticism. As already mentioned, most if not all current sukuk returns are fixed percentages or based on a benchmark such as the LIBOR rate. So for example sukuk payments could be based on the floating LIBOR rate plus 50 basis points. The cash flows are thus not at all dependent on the underlying assets, but are pre agreed in the contract (Ariff et al., 2012, p. 103). Some justify this practice by agreeing that any profits in excess of the pre-agreed LIBOR related percentage payment to investors will be paid to the manager of the company as an incentive payment. This again mimics conventional finance and undermines the risk-sharing principle in Islamic Finance. The violation of Islamic Law in this case is thus twofold. Firstly the risks are not born to a greater extend by the investors (since their periodic returns are fixed, or related to benchmark interest rates), and secondly excess profits which should be paid out to investors (since they have to take more risk) are actually paid out to managers as incentive fees. Although Usmani (2008, p. 5-6) extensively explains from a Shari'ah perspective that incentive fees could be permissible, in the case of sukuk they are forbidden since they are based on interest rates and limit the PLS between investors and managers and thus defeats the purpose of this mode of Islamic Finance. (Ariff et al., 2012, p. 59)

The last main criticism of Usmani is (corresponding to Bassens et al, 2012, p. 100) the promise by the manager of obligor firms to repurchase the assets at face value. Rewards can only follow after risk, and when payback of face value of investments is guaranteed, this again undermines the principle of risk-sharing and is unlawful according to Islamic Law. For this part of a sukuk structure to be lawful, the payback of the ''principle'' at maturity needs to be based on the market value of the underlying assets at that moment in time. This again leads to mimicking conventional bonds, since it implies profits and losses be borne by the manager while the investors do not share in profits or risks. (Usmani, 2008, p. 8-10)

It becomes clear when reading Usmani's critique of sukuk structures, that he takes a mostly idealist approach to Islamic finance. This becomes even more apparent observing he puts all his arguments in the context of the higher objectives of Islamic finance and economics. The AAOIFI, which is headed by Usmani, came out after his critique with a resolution working towards Usmani's criticisms of current sukuk structures. It confirmed the assets need to be legally owned by the investors, and this carefully needs to be laid down in the contracts. Secondly it mentioned sukuk can not represent any debt whatsoever. Thirdly it prohibited any loans of the obligor to the investors in the case of shortfalls of profits. And last of all it stipulated that purchase undertakings in partnership sukuk where sukuk are bought back at face value are impermissible (rather they must be bought back at market value). With their resolution, the AAOIFI reaffirmed itself as an idealist institution with regard to sukuk, although it did took practical implications into account. Nevertheless, many of the objections of the council have still not been addressed by Islamic Financial Institutions. (Ariff et al., 2012, p. 60-61)

Reasons, background and problems of mimicry of conventional debt structures

One not to be overlooked reason for mimicry of conventional debt structures is the pragmatic observation that in today's financial world, debt finance is almost always superior to equity finance. The preference of Islamic financial institutions of non-PLS financing is thus not even necessarily a mimicry of conventional finance practices, but a mere rational response to problems of asymmetric information inherently present in equity finance. According to Khan (2010, p. 812), there is an *ex ante* problem in finance regarding adverse selection which leads to loans or investments being made in poor credit risks, while the *ex post* problem is the moral hazard problem of funds being utilized in ways unfavourable to the investor. Institutions like regulatory agencies and credit rating agencies work to minimize these kind of asymmetric information problems, but in the absence of or in case of these institutions not working well, debt finance will always be preferred to equity finance since it is inherently less risky. Warde (2000, p. 154-158) devotes an entire chapter to the so called ''Islamic Moral Hazard'' problem of certain features of Islamic finance practices which can encourage ''unscrupulous behaviour'' (Warde, 2000, p. 154). Most Islamic scholars do not address this issue since they *ex ante* assume investors, bankers and their employees to act virtuous. He continues to state examples of Islamic banks such as the Dubai Islamic Bank, involved in scandals in which their employees acted without consent of their superiors, incurring huge losses for the bank. The absence of due diligence of Islamic bankers caused them to trust people (their employees and customers) who turned out could not be trusted. Besides this, risk-averse investors also tend to shy away from Shari'ah compliant sukuk securities since they do not want to share in risk. This led some (largely) Shari'ah compliant banks not to be able to finance certain activities. Thus increased internal control and monitoring of stakeholders by banks and regulators need to take place to minimize these moral hazard problems.

At the heart of this Islamic moral hazard problem lies the fact that western conventional finance is intrinsically oriented towards the needs of modern economics and finance, and thus technicalities, so profit and risk considerations take the upper hand compared to moral considerations preferred within Islam (Warde, 2000, p. 156). Also, El Gamal (2006, p. 24-25) argues that since Islamic banks deal with problems of allocating credit and risks just like conventional banks, they have no choice but to mimic their practices, basically degenerating Islamic finance as meaningless distinction of form without substance, and will be forever doomed ''to be an inefficient replication of conventional finance, always one step behind developments in the imitated sector'' (El Gamal, 2006, p. 25).

Examples of mimicry like following LIBOR benchmarks are defended by some practitioners only rhetorically, by not calling them interest but merely the ''profit rate'', or in some contracts even the ''implied interest rate''. These practices can lead Islamic clients to be increasingly disenchanted from these institutions due to the mere lip-service they provide to Islamic standards, while in fact their entire structure is based around conventional financing practices. Financial practitioners could be scared away from the industry, finding prove in the failure of Islamic finance that there is no such thing as finance without interest. Hope for Islamic finance to ever become a viable alternative to conventional finance can be lost forever. Ironically, the hypotheses of losing religious provisions due to practical implications led some Islamic scholars in the middle ages to declare that the door to *ijtihad* has to be closed. (El Gamal, 2006, p. 24)

Another reason for mimicry is simply that sukuk trade in different geographical locations and due to the head-start of conventional Anglo-Saxon financing and regulatory practices, Islamic Finance has no choice but to mimic these to become viable in the legal jurisdictions of these nations. Some purely Shari'ah compliant measures would be outright incompatible with some countries' commercial law (Khan, 2010, p. 813). Sacarcelik (2011, p. 1-5) extensively investigates the divergence gap between Shari'ah principles, sukuk contracts and European (German) civil law and argues that besides the struggle for Shari'ah compliance, in Islamic finance (sukuk in particular) there is always a struggle for compliance with western law, as in some civil law systems concepts like beneficial ownership are not recognized.

The interpretations of the similarities and idiosyncrasies of sukuk structures can also be viewed from an organisational sociology viewpoint. Concepts like ´´organisational mimicry´´ and ´´mimetic isomorphism´´ reflect the fact that organisations or institutions tend to follow leaders in their organisational fields and imitate their technologies, management techniques and organisational models in the hope to surpass them. This in many cases, such as with Islamic finance, can result in unintended consequences and hybrid forms of these technologies because of the dissimilarities of context and background of the leader and the follower. We can see in our case that the Anglo-Saxon way of securitization is the dominant and hegemonic template target of this mimicry by outsiders such as Islamic Financial Institutions. To do this, they adjust their context and techniques to the leader. We can see this happen in practise as Gulf legal systems begin to show more and more similarities to Anglo-Saxon ones. The mirroring of these Anglo-Saxon legal and financial constructs is asymmetric in the sense that hybrid forms between the two contextually different forms of securitization and law develop mostly because of mimicry on the part of Islamic financial institutions. All this does not prove that mimicry happens in a one way straightforward fashion. Rather, looking at Islamic finance from a geo-historical perspective, it happened more on a trial-and-error basis, with different hybrid outcomes in different geographical locations. (Bassens et al., 2012, p. 101-102)

With regard to the future of sukuk securitization, or more broadly Islamic finance in general, the pragmatists engaged in Shari'ah arbitrage focussed on the mechanics of the operation instead of Islamic religious values claim that time will eventually make Islamic finance more technically efficient, resulting in that more attention can be paid to making products more Islamically authentic. El Gamal (2006, p. 184-189) though argues that Shari'ah arbitrage has wasted the practical content of classical Islamic Jurispudence (*usul al fiqh*), while increases in efficiency are doubtful. An alternative to this practical Shari'ah arbitrage can be to redefine the brand name of Islamic finance to more general truly religious, social and development goals. When the industry is focussed more on its effects in society than on its mechanics, it will increase in reputation among all its stakeholders, such as financial institutions, governments and religious Muslims wishing for a more religiously acceptable way of finance. When these ideals are used as primary focus when creating Islamic financial products instead of mainly focussing on mechanics, the resulting products will serve more substantial values instead of being pure technical structures.

Conclusion

As the growth of Islamic finance and sukuk markets in particular over the last two decades has shown, there is a large portion of Muslims who crave for Shari'ah compliant financial products. As financial institutions observed this desire and saw opportunities in the Muslim world, they quickly jumped into the market by trying to make their different conventional products Shari'ah compliant. What this research has shown is that while trying to become Shari'ah compliant, most sukuk offering' financial institutions violate conditions laid down by Shari'ah scholars and standard setting bodies like the AAOIFI which lay down the theoretical application of sukuk securities in order to circumvent the practice of *riba* that is omnipresent in conventional finance. Basic conditions for Shari'ah compliance are to a large extent ignored by these institutions. These include the basic principle of asset backing for sukuk securities that is violated since investors most of the time do not legally own assets in sukuk securitization constructions. Besides this, investors are guaranteed payback of their principle investment, defying the principle of Profit and Loss Sharing and risk-sharing on which Islamic financed was supposed to be based. The observation that rates of return to investors are benchmarked to basic interest rates such as LIBOR nail the pin to the coffin to the claim that current sukuk securitization practices are fully Shari'ah compliant. All this indicates that Arabic terminology is only used as a mere stratagem to circumvent the prohibition on *riba*, without providing any substantive alternative to conventional finance. Reasons for these mimicries include the complexity of current financial systems, and by extension the fact that organisations and institutions tend to mimic leaders in their organisational fields. We can also see this in light of the imbalance between the pragmatic and idealist approach to sukuk securitization by Islamic scholars, which is contextualized by the Shari'ah framework of sukuk. The future will tell how the market will respond to the criticism of the idealists of current sukuk practices, and whether significant changes can be made while maintaining the mechanics necessary for modern finance. Most likely is a new kind of hybrid between the current pragmatist and idealist approach, leaning more towards idealism than is the case today. It is important to note here that although mimicry of conventional finance is widespread among Islamic financial institutions, some western financing products, like credit default swaps, could probably not even under the most pragmatic approach be justifiable in Islamic finance. Defending the pragmatist approach, one could argue that a more context-based *ijtihad* could be employed by Shari'ah boards and scholars, using the concept of *maslaha* to shift focus from the form of Islamic securitization to the *maslaha* (benefit) of Islamic securitization based on the goals of the Shari'ah. More research needs to be done to bring these two opposing views closer together and to develop a real long-run sustainable Islamic financial system.

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