A Critical Perspective on the Principles of Islamic Finance Focusing on Sharia Compliance and Arbitrage

James M Garner*

Abstract

This essay is a comprehensive discussion of the crucial Islamic finance principles written within *Sharia* law that govern the sector. *Riba* (prohibition of interest) being the major and most widely known is central to the discussion. However, this essay deals with many other of the major financial principles, for instance *Gharar* (avoidance of excessive risk), *Maisir* (avoidance of transactions based on luck or chance) and unjust enrichment. The essay then analyses and evaluates how many popular and intrinsic Islamic financial products used today remain commercially competitive whilst still abiding by these strict *Sharia* principles. This essay also highlights a contemporary issue and idea within Islamic finance, namely that of so-called *Sharia* Arbitrage. The theory posits that many of the *Sharia* complaint products available today are not so different from their Western counterparts. Despite the fact that methods that will be highlighted and used to ensure compliance, they do not go far enough to alter the nature of the products themselves.

Keywords: Islamic finance, *Sharia* law, *Sharia* Arbitrage, *Riba*, *Gharar*, *Maisir*, unjust enrichment

* *LLM in International Banking and Finance Law (University of Leeds), LLB (University of Nottingham)*
jamesgarner2280@gmail.com

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I. Introduction

> Allah has allowed trading and forbidden Riba[1]

This principle is crucial to the development of Islamic finance in the modern world. It emphasises that by no means does the *Qur'an* or Islamic teachings prohibit trade or profit within finance; rather there are certain principles that *Sharia* law prohibits, usually due to unfairness.

This essay will discuss the key prohibitions within Islamic finance and how the Islamic financial products abide by these prohibitions. It should be noted at the outset that in referencing '*Sharia* law' this author is predominantly referring to modern interpretations of *Sharia* laws that exist within the lived reality of capitalism and the Western financial system that has heavily influenced the Islamic financial sector, rather than traditional and classical interpretations of *Sharia* law and principles.

The aim of this essay is to evaluate the ways in which these products become *Sharia*-complaint. This essay also highlights a contemporary issue and idea within Islamic finance, namely that of so-called '*Sharia* Arbitrage'.[2]

This theory posits that many of the *Sharia*-compliant products available today are not so different from their Western counterparts, and despite the fact many methods will be highlighted ensure compliance, they do not go far enough to alter the nature of the products themselves to become compliant with the classical moral based *Sharia* principles.

Sharia law is, as noted by Khan J, 'the law laid down by the *Qur'an*... the holy book of Islam, and the *Sunnah*'.[3] These different sources create principles by which Muslims should live. Crucially however, it does not form a binding source of law in the sense of legally binding obligations. However, these principles can be contracted for within a financial agreement like any other contractual clause and this is how Islamic financial products have come into

1 Verse 2:275, Koran.

2 M El-Gamal, 'Opinion: Mahmoud El-Gamal: Incoherent pietism and Sharia arbitrage' *Financial Times* (London, 23 May 2007).

3 *Beximco Pharmaceuticals Ltd v Shamil Bank of Bahrain EC* [2004] EWCA Civ 19, [2004] 4 All ER 1072 [2] (Khalil-Ur-Rehmam Khan J, defendant's expert).

fruition.

The *Financial Times* has recently estimated the size of the Islamic finance industry at $1.1 trillion.[4] This is vast given the industry began just 50 years ago with the establishment of the Mit Ghamr Local Savings Bank in Egypt.[5] The Islamic finance industry is also experiencing incredible growth, with some estimates putting it as high as 20 per cent in 2011 and within the United Arab Emirates at 65 per cent.[6]

II. The History of Islamic Finance

Islamic finance dates back to medieval times when *Sharia* law would govern financial transactions in the Middle East, principles that incidentally were also found within the European financial systems at the time. Wherever trade occurred between a European and a Middle Eastern nation at the time, they tended to eschew principles of interest in favour of a profit sharing system, for instance within the trading relationships between the Ottoman Empire and the Spanish.[7] However, as Western financial models began to spread around the world, the principle of interest took worldwide precedence over *Sharia* principles. This trend continued until the 1960s with the establishment of the Mit Ghamr Local Savings Bank in Egypt. From here, smaller *Sharia*-compliant banks have sprung up across the Arab world, catering for growing demand within the Arab world for *Sharia*-compliant banking services, sparking a trend of growth that since the late 1990s has seen a rate of 10–15 per cent year on year.[8] The market, although still significantly smaller than the traditional Western model contains both smaller niche 'totally compliant' Islamic finance institutions, as well as conventional worldwide banks offering *Sharia*-compliant services through what Dr Schoon calls *'Islamic Windows'*. However, regardless of the business model, they must all abide by the same Islamic laws to

[4] C Hall, 'Islamic banking: Impressive growth underscores success' *Financial Times* (London, 27 March 2012).

[5] A El-Ashker, *The Islamic Business Enterprise* (1st edn, Biddles 1987) 155.

[6] Hall (n 4).

[7] N Schoon, 'Islamic Finance – An Overview' (2008)9 *European Business Organisation Law Review* 621.

[8] ibid.

offer similar compliant products to the markets.

III. *Sharia* Products

Procter notes there are four main prohibitions within Islamic finance law, 'namely, *Riba, Maisir, Gharar,* and unjust enrichment'.[9] Indeed *Riba* is the most commonly known prohibition. However the others are also important in terms of establishing a product that complies with *Sharia* law.

Riba broadly means increase[10] and is known within the *Qur'an* as an injustice or oppression, but specifically Khorshid notes *Riba* 'means usury and interest, and in general any unjustifiable increase in capital for which no compensation is given'.[11] *Riba of hadith* (or *riba al fadl*) also exists; this is in effect *Riba* hidden in sales, for instance, the charging extra for a foreign exchange transaction would also be forbidden as *Riba*.

Warde points to interest as being a common example, but also the charging of late fees[12] would be a form of exploitation of others.[13] Procter notes that interest is prohibited because 'money is a medium of exchange; it thus has no independent value and should not be a tradable commodity which is itself capable of being exploited for profit'.[14] It would seem, therefore, that the unfairness associated with a rich man lending money to a poor person and making money simply via exploitation on the basis of him having money to lend, is largely unfair. This unfairness underpins the basis of a great deal of Islamic finance.

El-Gamal notes that of the two forms of *Riba*, it is *Riba-al-nasia*, or 'credit transactions',[15] 'where money is exchanged for money with deferment'[16] that is the form of finance by which the Western

9 C Procter, *The Law and Practice of International Banking* (1st edn, OUP 2010) 769.
10 ibid.
11 A Khorshid, 'Islamic Insurance, A Modern Approach with Particular Reference to Western and Islamic Banking' (Phd, University of Leeds 2001) 18.
12 I Warde, *Islamic Finance in the Global Economy* (2nd edn, Edinburgh University Press 2010) 52.
13 Procter (n 9) 770.
14 ibid 769.
15 C Phull, 'The Concept of Riba in Islamic Banking Law: An Introduction' (2011) 26(8) JIBLR 405, 407.
16 M El-Gamal, *A Basic Guide to Contemporary Islamic Banking and Finance* (Rice

finance sector has been built'.[17] Procter further notes that very wide scope has been given to what is defined as *Riba* following a judgement by the *Sharia* Appellate Bench of the Supreme Court of Pakistan,[18] where it was held that *Riba* constituted, 'any additional amount over the principle in a contract of loan or debt'.[19] Therefore, it would be right to assume that particularly in very strict Muslim countries; compliance with certain aspects of *Sharia* law can be highly onerous. Attempts to formulate a viable and successful financial system have therefore been difficult. This has led to the creation of products whose compliance is arguably a result of so called '*Sharia* Arbitrage', a point to be discussed later.

Other key prohibitions exist, such as *Gharar*. *Gharar* is prohibited given it 'connotes a transaction based on incomplete information (or deception) and which incorporates an unnecessary degree of risk and/or uncertainty'.[20] Vogel further notes that *Gharar*:

> ...bar[s] only risks affecting the existence of the object as to which the parties transact rather than just its price. In the hadiths, such risks arise either (1) because of the parties' lack of knowledge (jahl/ignorance) about that object; (2) because the object does not now exist; or (3) because the object evades the parties' control.[21]

Rodinson summarises this as 'any gain that may result from chance, from undetermined causes, is here prohibited'.[22] However, crucially, risk is present within all modern transactions, and to prohibit all risk taking would be to prohibit trade, which as the above seminal quote confirms, was not the aim of *Allah*.[23] Therefore, *Gharar* is crucially prohibiting unnecessary risk, or blind risk. This in many respects makes good commercial sense. However, El-Gamal has noted 'jurists have been more lenient to varying degrees

University, 2000) 4.

17 ibid.

18 Procter (n 9) 770.

19 M Islam Khaki & Others v Syed Muhammad Hashim & Others PLD 2000 (Supreme Court 225), [242], noted by Procter (n 9) 770.

20 Procter (n 9) 771.

21 F Vogel and S Hayes, *Islamic Law and Finance: Religion, Risk and Return*, vol 16 (Arab and Islamic Law Series, 1st edn, Kluwer Law International 1998) 89–90.

22 M Rodinson and B Pearce, *Islam and Capitalism* (1st edn, Penguin 1977) 16.

23 Verse 2:275, Koran.

with the prohibition of *Gharar* since no contract can be totally devoid of uncertainty'[24] and 'in many cases, *Gharar* can be eliminated from contracts by carefully stating the object of sale and the price to eliminate unnecessary ambiguities'.[25] Therefore, as Procter notes, *Gharar* will:

> ... only invalidate a contract if; (i) the risk or uncertainty is significant; (ii) the risk affects the price or the principal objective of the contract; and (iii) the risk cannot be satisfactorily addressed through other available products which are Islamic compliant.[26]

Therefore, this suggests an element of flexibility within the prohibition of *Gharar* that is not present within *Riba*. This flexibility has allowed for a greater diversity of Islamic financial products to arise through innovation. Areas such as insurance, originally strictly prohibited, are now allowed through a carefully structured Islamic finance product called a *Takaful*, which will be explored later.

Contracts based on luck, or effectively a gamble, are also prohibited. These are called *Maisir*[27] or *Qimar*. Procter clarifies this by stating, 'whilst any commercial contract inventively involves a degree of speculation, the prohibition applies to contracts where the *outcome* depends on luck or chance',[28] or as Balala notes, essentially any form of speculation.[29] For example, Procter points to a decision by the Court of Cassation in Abu Dhabi that held invalid foreign exchange contracts.[30] Therefore, this would also include the trading of futures and other dealings of a similar nature, important elements of the Western financial system.

Procter noted another prohibition, that of unjust enrichment.[31] Namely, 'a contract which is unfair or which is imposed (e.g. under

[24] El-Gamal, 'A Basic Guide to Contemporary Islamic Banking and Finance' (n 16) 4.

[25] ibid 7.

[26] Procter (n 9) 772.

[27] M Balala, *Islamic Finance and Law, Theory and Practice in a Globalized World* (1st edn, (IB Tauris 2011) 25.

[28] Procter (n 9) 773.

[29] Balala (n 27) 25.

[30] Procter (n 9) 772.

[31] ibid 773.

duress) on a weaker counterparty to his detriment, will not be *Sharia*-compliant'.[32] Procter identifies late fees as an example, given it exploits a debtor's weaker position.[33] However, there is another final prohibition in that the object of finance must be *Halal*, i.e. not *Haram* (forbidden).[34] This includes products such as pork and alcohol.

Western banks traditionally make money by charging interest on lent money or through a finance transaction with debtors. This constitutes making 'money on money'[35] and is prohibited as *Riba*. Therefore, in order to become viable and profitable businesses, Islamic banks found alternative and innovative methods of using depositor's funds, or providing finance without breaching the four main prohibitions. Procter notes, they do this by taking advantage of the fact *Sharia* law:

> ...allows profit for labour or for the taking of risk, but not merely for the use of money...*Sharia*-compliant products depend their validity on the sale of assets or the receipt of rent for the use or occupation of property.[36]

Therefore, the products that have arisen are ways that banks have inventively avoided the '*Harams*' within Western banking to create viable and profitable Islamic financial products. These will now be considered.

One of the most widely used products is a *Murabāha*, effectively a finance agreement. Traditionally, Western banks would charge interest at the market rate (i.e. London Interbank Offered Rate, LIBOR) over and above the cost of purchase and this would be charged to the debtor over a fixed period of time along with payment of the cost price, in order to pay off the cost of the product. However, this agreement would be *Riba*. Instead, an agreement is reached under contract between the bank and the customer. Then the bank purchases the pre-identified product, and ownership is transferred to the bank, a pre-agreed mark-up is placed on the price

32 ibid.
33 ibid.
34 B Chong and M Liu, 'Islamic Banking: Interest-free or interest-based?' (2009) 17 Pacific-Basin Finance Journal 125, 128.
35 Procter (n 9) 775.
36 ibid.

of the product and it is sold to the customer at a fixed price to be paid back over instalments.

IV. *Sharia*-Compliance

There are two crucial factors involved within this transaction that are present to ensure *Sharia*-compliance. Firstly, the fact ownership transfers to the bank prior to being sold to the customer, is crucial. This is because, as Warde notes, it equates to the bank 'selling the customer the specified good' as if they were a trader adding a mark-up on a product. Khan supports this by stating that 'a *Murabāha* is permissible since the bank has actual ownership of the [product] and so has borne some risk'.[37] Procter affirms that whilst the bank is in ownership of the produce it is exposed to the 'risks involved in ownership of the asset',[38] if even for a short while, justifying the mark-up.

Therefore, as noted above, *Riba* is avoided given the bank can justify the profit or mark-up due to the risk it has exposed itself as well as the labour or service it has provided. The increase in price has not been made purely out of the use of money or the finance agreement. Procter underlines that due to the trading relationship rather than the Western structure of a 'secured lender/borrower relationship',[39] there are greater risks, again justifying the mark-up by the bank.[40]

Secondly, there are a number of factors that must be abided by to ensure that the prohibition of *Gharar* is satisfied and the transaction is 'certain'. Procter outlines the necessary precautions:

> (i) the object of the sale must exist at the time of the transaction, (ii) the seller must have a valid title to, and possession of, that object, (iii) there must be certainty of price.[41]

These exist to ensure *Gharar* is not present, although it is widely accepted that 'both actual and constructive possession are sufficient

37 F Khan, 'How "Islamic" is Islamic Banking?' (2010) 76 Journal of Economic Behaviour and Organization 805, 809.
38 Procter (n 9) 776.
39 ibid.
40 ibid.
41 ibid.

on the part of the bank'[42] to ensure compliance. Therefore, this product is a good example of how Islamic banks can carefully structure a product in order to comply with *Sharia* law. Often there are only quite subtle differences from Western financial products. This compliance is often aided by the method by which these products achieve *Sharia* compliance. For instance, it tends to be an interpretation or judgement made as to a products compliance with *Sharia* law by a mixture of scholars and *Sharia* advisory boards. These boards often exist as part of a larger bank and it could be argued are therefore subject to a strong conflict of interest, further strengthening the argument of El-Gamal discussed below.

V. *Sharia* and Western Finance Principles

Warde agrees by observing many parallels exist between a *Murabāha* transaction, and a traditional Western interest based finance agreement. Namely that of due diligence, credit assessments and also the fact the asset is used as collateral.[43] Other parallels can also be drawn, namely, as El-Gamal remarks, the mark-up charged by the bank will often equate to the interest charged by the Western banks in similar finance agreements.[44] Also, Procter notes 'the bank will usually appoint the customer as its agent for the purpose of selecting, inspecting, ordering, and taking possession of the goods'.[45] This act crucially reduces the transaction to becoming very similar to its Western counterpart as the customer even orders and collects the product. Therefore, the bank only has constructive ownership, exposing itself to only questionable levels of risk.

This demonstrates that despite the subtle differences many similarities remain, even to the point that the bank can appoint the consumer as its agent to carry out a great deal of the labour on its behalf. However, *Sharia* abidance is crucial, via well drafted rules within the financial product, even if it means effectively jumping through hoops to do so.

42 ibid.

43 Warde (n 12) 141.

44 El-Gamal, 'A Basic Guide to Contemporary Islamic Banking and Finance' (n 16) 14.

45 Procter (n 9) 776.

The *Murabāha* is used to finance the purchase of an asset, but another slightly more controversial product has been developed in order to provide capital on credit to a customer. This is called a *Tawarruq* and it originally involved as Warde notes, 'buying a commodity on credit and immediately selling it on to a third person for cash'.[46] Warde notes the modern day equivalent is called an 'organised *Tawarruq*', with the Islamic bank involved throughout the whole transaction.[47] This means:

> The bank purchases some commodity from the market, then sells the commodity to the customer on a Murabāha basis for deferred payment. Subsequently the bank (as the customer's agent) sells the [commodity] on the market for immediate cash. As a result the bank will gain Murabāha profit and agency fees, and the customer will obtain cash. The [commodity] will not change hands.[48]

Ward submits that the *Tawarruq* is one of the more controversial products available from Islamic banks, due to the spurious link to the asset by both the bank and the customer.[49] This is underlined by El-Gamal who notes 'it is only within the *Hanbali* School that some jurists approved the practice of *Tawarruq*'.[50] Crucially, however, this product satisfies *Sharia* law. It does so by ensuring title is transferred from the market, to the bank, then from the bank to the customer, then back to the markets. Even if the bank acts as the customer's agent to ensure this sequence of events takes place, title nonetheless moves to the appropriate parties to ensure compliance with *Sharia* law. It mirrors the compliance necessary within the *Murabāha* transaction, whereby the fact title moves ensures there is no *Gharar*. The product bought and sold must be *Halal* and, as a fixed price is specified, there is no *Riba*. It is an innovative way of ensuring the bank can lend capital without breaching the *Riba* and *Gharar* prohibitions.

Due to the fact this transaction is for capital rather than an asset, it is frowned upon. Warde notes this is because 'it can lead

46 Warde (n 12) 143.
47 ibid.
48 ibid.
49 ibid.
50 M El-Gamal, *Islamic Finance, Law, Economics, and Practice* (1st edn, Cambridge University Press 2006) 29.

to the proliferation of debt'.[51] Due to this, 'the Accounting and Auditing Organization for Islamic Financial Institutions has stated that *Tawarroq* is acceptable if it involves four parties (a buyer, a seller, the buyer's commodity broker, and the seller's commodity broker)'.[52] Therefore, the many stages clearly emphasise the fact that assets must change hands, and capital is the end result, rather than the bank just using money to make money, as this would be prohibited as *Riba*.

Another product, the *Musharaka*, is in effect a joint venture agreement or partnership agreement, whereby the bank will finance an asset or a project and 'take an equity stake in the business venture'.[53] Warde submits that, 'partnership finance was at [one time] the most 'authentic' form of Islamic finance since it replicated transactions that were common in the early days of Islam'.[54] However, many banks have shunned the widespread use of such an instrument simply due to the very nature of shared risk, such risk that does not exist within many other Islamic products. In order to combat this, many banks have started to guarantee profits, but this contravenes the basic *Sharia* law of linking risk to reward.[55] Such actions only provide more evidence to critics such as El-Gamal that argue the current system of Islamic finance is nothing more than an interest-based system operating under the guise of profit.[56]

In addition Procter crucially notes, 'the losses must be borne pro rata to their respective investments but profits may be divided according to agreement'.[57] This clearly demonstrates how the introduction of risk on the part of the bank is crucial in order to avoid *Riba*, and also to justify the banks profits and comply with *Sharia* law. The *Musharaka* generally involves finance from both parties,[58] but the customer will likely give less and their contribution in labour is recognised in the equity share of profit

51 Warde (n 12) 144.
52 ibid.
53 ibid, 145.
54 ibid, 146.
55 I Warde, *Islamic Finance in the Global Economy* (1st edn, Edinburgh University Press 2000).
56 Special Report 'A survey of Islam and the west: The cash-flow of God' *The Economist* (London, 6 August 1994) 9–10.
57 Procter (n 9) 781.
58 ibid.

within the agreement.

An innovative form of *Musharaka*, called a diminishing *Musharaka*, is commonly used as a method of financing to form a *Sharia*-compliant mortgage. Procter notes that under this arrangement 'the financier invests in the customer's business, on the basis that the customer will progressively buy out the financier's share over a period'.[59] This can easily be translated into a home buying scheme whereby the business is effectively the house and the financiers share is bought out and the financiers profit 'effectively represents rental income'.[60]

A subtly changed *Musharaka*, can form a *Mudaraba*, a 'silent partnership'[61] or 'profit-sharing partnership'.[62] This product mimics that of a mutual or investment fund. Procter notes the procedure whereby, 'one or a group of investors (*Rab al maal*) pool their resources for a given business venture under the management of a fund administrator or manager (*Mudareb*)'.[63] This is known as a silent partnership as the investor takes a back seat with little to no involvement, as with a Western investment fund. The *Mudareb* acts much like a fund manager in Western terms and similar to a Western fund, if the initial due diligence proves effective; it is the investor that will bear the full loss.

Another investment vehicle used in the Western world is that of a bond. This is a form of transferable security whereby the issuer owes the purchaser a debt plus interest. This can be issued by a government (e.g. UK Guilt, a government issued liability in sterling issued by the HM Treasury) or by a company as a method of raising capital. Due to the interest element, Muslims are obviously forbidden to invest in or issue such instruments. However, Islamic finance has found an alternative in a *Sukuk*. This is effectively a product that, as Procter notes, 'evidences a share in an underlying asset and the revenues which may be derived from it'.[64] As Khorshid observes the *Sukuk* is a needed financial innovation for

59 ibid.

60 ibid.

61 El-Gamal, 'A Basic Guide to Contemporary Islamic Banking and Finance' (n 16) 15.

62 Procter (n 9) 782.

63 ibid.

64 ibid.

the Islamic world given that the huge liquidity surplus created by oil wealth can be securitised and traded on the secondary market.[65]

This product works by the Islamic bank issuing the *Sukuk* (certificates[66]) to raise a pool of capital. This is then used to purchase an asset that the subject company wish to use, and it is then leased to the company, representing income (equivalent to interest pegged at LIBOR[67]) for the *Sukuk* holders. Ultimately, as with a bond the premium is ultimately repaid, and within a *Sukuk* the assets are 'sold or transferred back to the primary entity'.[68] Importantly a *Sukuk* is effectively a securitized asset financial product[69] that can be traded and sold on the secondary market.[70] This factor increases the negotiability of the bonds making them a more valuable and prudent commercial investment, with less risk.

The *Sukuk* represents legal ownership of an identified asset. Importantly *Sharia* law considers the many investors within a *Sukuk* to be 'co-owners of an asset, although held on trust',[71] therefore it does not breach the principles of *Gharar*. Also, because the owner is exposed to any risk associated with the investment subject (asset), there is no *Riba*, as both the investor and investee are seen as equally exposed to risk. This point is summarised by Warde, 'In contrast to a real bond, *Sukuk* holders are the owners of a specific asset and are entitled to receive the profit or usufructs generated by such assets, as well as the proceedings from the sale of the asset'.[72] However, the *Sukuk* is a controversial Islamic financial product. Conservative scholars reference the fact the *Sukuk* requires payment for the time-value of money, as well as a fixed return, both fundamental characteristics of interest. Importantly, the compliance principles of the *Sukuk* were questioned by Sheik Muhammad Taqi Usmani, President of the Sharia Council of the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI)[73]

65 A Khorshid, 'Sukuk and Securitization' in Aly Khorshid (ed), *Euromoney Encyclopedia of Islamic Finance* (Euromoney Books 2009) 279.
66 ibid 280.
67 ibid 283.
68 Procter (n 9) 782.
69 Khorshid, 'Sukuk and Securitization' (n 65) 281.
70 Procter (n 9) 782.
71 Khorshid, 'Sukuk and Securitization' (n 65) 283.
72 Warde (n 12) 151.
73 M Usmani, 'Sukuk and their Contemporary Applications' (Sharia Council of

published in 2007. Within this paper, Usmani pointed out that in many ways the *Sukuk* mirrored many characteristics of the conventional interest-bearing bonds, as they do not return to investors more than a fixed percentage of the principal, based on interest rates, while guaranteeing the return of investors' principal at maturity.[74] He posited that up to 85% of all issued *Sukuks* were not *Sharia*-compliant, sparking a collapse in the *Sukuk* markets, from US $33.9bn in 2007 to approximately $14.9bn in 2008.[75] The fact such high level scholars are questioning the basis of *Sharia* compliance within such prevalent products certainly adds great strength to the arguments of *Sharia* arbitrage posited by El-Gamal, a view shared by this author.

Ijara is a form of lease or a sale contract, essentially, the customer and the bank will agree on the asset to be the subject of the *Ijara*, then the bank will purchase the asset, then as Warde notes, 'the bank leases an asset to a [customer] in exchange for specified rent. The amounts of payments are known in advance and the asset remains the property of the lessor'.[76] These lease payments essentially give, as El-Gamal argues, 'the *usufruct* (the right to use the object) for a specified period of time'[77] and include as Procter observes, 'the financier's required margin of profit'.[78]

There are many intricate essential conditions in order for an *Ijara* to achieve *Sharia* compliance. First, the bank or 'leasing agency, must own the leased object for the duration of the lease'.[79] This is important as it means that a leasing arrangement is in place with the customer paying for use of the asset, rather than the bank effectively offering a loan to the customer to purchase the asset, obtain title and then pay the bank back over time with interest added on the loan. This also ensures the object is certain, and therefore there is

the Accounting and Auditing Organisation for Islamic Financial Institutions, November 2007).

74 ibid 4.

75 Frederik Richter, 'Gulf sukuk market revival seen unlikely in 2009' *Reuters* (Manama, 28 January 2009).

76 Warde (n 12) 144.

77 El-Gamal, 'A Basic Guide to Contemporary Islamic Banking and Finance' (n 16) 13.

78 Procter (n 9) 778.

79 El-Gamal, 'A Basic Guide to Contemporary Islamic Banking and Finance' (n 16) 14.

no *Gharar*. This is a subtle difference that ensures the key principles of Islamic finance are not broken. Secondly, as title belongs to the bank, so do the risks and duties associated with owning an asset e.g. maintenance. Thirdly, as Procter notes, 'payments under an *Ijara* can only continue whilst the customer has the use of the asset. Consequently, if the asset is lost, stolen, or destroyed, then the obligation to pay rent must terminate'.[80] This and the second noted condition, similar to a *Murabāha* transaction, justify the profit margin charged by the bank. This is because as previously noted, and highlighted by Procter, 'the lessor cannot pass the entire risk of the asset to the lessee'[81] as this would mean money would have been made devoid of risk, as this would be borne by the lessee, therefore the bank in making a profit would be charging *Riba* to make this profit. Another key element is that the bank cannot, as Procter notes, 'stipulate for an increased payment as a result of late payment of the rent. This would amount to *Riba*, and would hence be prohibited',[82] this would consequently also amount to unjust enrichment, another prohibited act again supported by Procter.[83] Finally, the lease cannot finance an asset that is used for a *haram* purpose.

VI. *Sharia* Arbitrage

As it may be clear from the products noted above, many involve a subtle adaptation of a Western principle in order to comply with *Sharia* law. It is certainly interesting to note how far these products break from contemporary Western principles of finance in order to become acceptable to the *Sharia* Supervisory Boards that warrant their compliance and use. The answer posited by a number of commentators[84] is in fact not far enough. For example, El-Gamal a prevalent author within the subject of Islamic finance posits the existence of what he calls *Sharia* Arbitrage:

80 Procter (n 9) 778.
81 ibid.
82 Procter (n 9) 779.
83 ibid 773.
84 El-Gamal, 'Incoherent pietism and Sharia arbitrage' (n 2); Khan (n 37); R Kamala, 'Critical Insights into Contemporary Islamic Accounting' (2009) 20 Critical Perspectives on Accounting 921; Chong and Liu (n 34).

> . . . whereby legal devices are used, often employing special purpose vehicles to restructure interest-bearing debt, collecting interest in the form of rent or price mark-up. Designing such instruments and their certification as 'interest free' constitutes the bulk of Islamic finance.[85]

This is a strong accusation, effectively suggesting that the *Sharia*-compliant products are simply remodelled Western banking products, with different notions of how interest is charged under an Islamic name. This is not such an outlandish suggestion given a key principle of finance and indeed making profit from money itself. Remodelling a product that has proven effective to make money in order to become compliant with religious principles seems a purely sensible notion. After all, El-Gamal argues that *Sharia* Arbitrage is demand driven, and traditional financial models are simply repackaged to meet this demand.[86] He asserts that this *Sharia* Arbitrage has enabled 'juristic efforts to re-characterize modern financial transactions, rather than legal stratagems to circumvent prohibitions'.[87] El-Gamal goes further to note that this act of 'arbitrage' to achieve compliance breaks from the spirit of the law,[88] looking to achieve legal compliance *Sharia* law and ignoring *why* the principles existed in the first place. In effect these modern day products, despite their compliance status, play against the moral foundations of *Sharia* law.

This point is supported by Kamala given his comments on the importance of the *Sharia* Supervisory Boards within these Islamic banks, approving what he calls 'interest-bearing products'.[89] These are then 'marketed and passed as Islamic'[90] by the banks, legitimised by the decision of the *Sharia* Supervisory Board. Kamala highlights the vital importance the boards play in the marketing and legitimization of these products.[91] Crucially, he notes that 'in effect the activities of Islamic banks promising interest free banking

85 El-Gamal, 'Incoherent pietism and Sharia arbitrage' (n 2).
86 El-Gamal, *Islamic Finance, Law, Economics and Practice* (n 50) 190.
87 ibid.
88 ibid.
89 Kamala (n 84) 925.
90 ibid.
91 ibid.

are described by a number of observers as merely a fiction'.[92] Further, Useem sums up this arbitrage situation by describing modern day Islamic products, such as the *Murabāha*, as looking 'a lot like interest, and some argue [they are] simply a thinly veiled version of it'.[93] Further, Khan observes that due to the view of a *Murabāha* being simply 'disguised interest. . . the Pakistani Federal *Shariat* Court and the *Shariat* Appellate Bench of the Supreme Court ruled against the existing system of Islamic Banking in 1991 and 2002'.[94]

Perhaps the fact that the mark-up or the lease payment of products, so clearly and unashamedly replicates the interest rates of the market (e.g. LIBOR), is proof enough that the Islamic products are not so different after all. El-Gamal points to the innovative diminishing *Musharaka*, effectively an Islamic mortgage as an example of a simple replication or re-packaging of a conventional Western financial instrument, given the payment schedule replicates a mortgage schedule payment plan with equivalent rates of interest built into the *Musharaka's* lease payments.[95]

Perhaps the best example of this '*Sharia* Arbitrage' by the Islamic banks, in search of innovative ways of developing products that will be granted *Sharia* compliance, is that of *Takaful*,[96] a compliant form of insurance. It is operated 'on the basis of shared responsibility, brotherhood, solidarity and mutual cooperation or assistance, which provides for mutual financial security and assistance to safeguard participants against defined risk'.[97] The main method of arranging a *Takaful* is via a cooperative whereby, 'a group of subscribers contribute to a pool of funds. Whenever one of the members makes a legitimate claim, they draw money out of the pool'.[98] Hassan explains the contributions are placed into two accounts, one following the model of the *Mudaraba* (the bank

92 ibid.
93 Jerry Useem, 'Banking on Allah' *Fortune Magazine* (10 June 2002)
94 Khan (n 37) 810.
95 El-Gamal, 'A Basic Guide to Contemporary Islamic Banking and Finance' (2000) (n 16) 16.
96 M Hassan and M Lewis, *Handbook of Islamic Banking* (1st edn, Edward Elgar 2007) 405.
97 ibid.
98 El-Gamal, 'A Basic Guide to Contemporary Islamic Banking and Finance' (n 16) 26.

and investors share profits[99]) and the other treated as a charitable donation to the principle of *Tabarra*, with payments made to assist members when necessary.[100]

As this is effectively a form of insurance, it makes it perhaps the most controversial modern Islamic financial product. One reason being the tendency of traditional Western insurance companies to invest premiums into investment bearing bonds and financial instruments.[101] Another is the fact that the Western sense of insurance would be forbidden as *Gharar*, as essentially, it as a gamble by the issuer over whether a payment will or will not be made. This is affirmed by Khorshid when he notes:

> The prohibition of Gharar in Islamic law has been the major argument put forward against the validity of insurance. Those who argue that insurance cannot be accepted under Islamic law, argue that uncertainty is a prominent feature of insurance.[102]

This uncertainty relates to the fact that repayment may never occur, and if a claim is made, what the reward will be is also uncertain as that is measured based on the incident (that is in-itself an uncertainty). Importantly, Khorshid goes on to observe:

> Insurance manifestly involves uncertainty, and this uncertainty is equivalent to the element of Gharar, expressly prohibited in sales contracts in Islamic law. Thus [strictly] insurance in Islamic law cannot be permissible.[103]

However, Korshid clarifies how the *Takaful* can become complaint by noting 'that *Gharar* is not rejected in the same manner as *Riba*'.[104] However, this exception seems remarkably convenient in order to create another market in which Islamic banking can compete with the Western world and in this author's opinion, it seems like another example of what El-Gamal has labelled '*Sharia* Arbitrage'.[105] However, on the other hand, insurance is in essence

99 Khorshid, 'Islamic Insurance' (n 11) 196.
100 Hassan and Lewis (n 96) 405–406.
101 Warde (n 12) 23.
102 Khorshid, 'Islamic Insurance' (n 11) 103.
103 ibid.
104 ibid 59.
105 El-Gamal, 'Incoherent pietism and Sharia arbitrage' (n 2).

a modern public necessity, meaning that an Islamic compliant alternative was always needed in order to provide Muslims with the similar benefits enjoyed by those following the traditional Western financial principles. Therefore, although the *Takaful* morally breaks from the rules underpinning *Sharia* law it was a necessary innovation that certainly provides a strong example of '*Sharia* arbitrage' in practice.

VII. *Sharia* Arbitrage – A Paradox?

Another issue surrounding the use of these products and the extent of their compliance lies within the aims and justifications of Islamic finance. Khan points to a statement by the Islamic Research and Training Institute of the Islamic Development Bank that highlights the aims of Islamic finance:

> The most important feature of Islamic Banking is that it promotes risk sharing between the provider of funds... and both the financial intermediary (the bank) and the user of funds... in conventional banking the risk is all borne by the entrepreneur.[106]

This clearly shows that Profit Loss Sharing (PLS *herein*) schemes should be central to a system of Islamic banking. However, instead of engaging in the more *Sharia*-compliant PLS arrangements such as the *Murabāha*, Kamala notes, most Islamic banks are opting for the mark-up products (such as the *Murahaba*) whereby the principle of shared risk is avoided on the most part or minimised, and the mark-up, principally based on market rates of interest,[107] is marketed as an approved product.[108] This is supported by Khan who notes that in a 'typical Islamic bank, [non-PLS forms] dominate the assets portfolio'.[109] Khan claims also that often Islamic finance products

106 Khan (n 37) 807, quoting the Islamic Research and Training Institute of the Islamic Development Bank, originally within M Iqbal, A Ahma, and T Khan, 'Challenges facing Islamic Banking' (1998) Islamic Development Bank, Islamic Research and Training Institute Occasional Paper.

107 El-Gamal, *Islamic Finance, Law, Economics and Practice* (n 50) 73.

108 Kamala (n 84) 925.

109 Khan (n 37) 809.

are barely risk sharing and even often 'use current market interest rates as pricing benchmarks'.[110]

Khan also, perhaps rather controversially, points to a possible conflict of interest between the large sums of money paid to the members of the *Sharia* Advisory Boards and the credibility an authorisation from these boards brings.[111] This conflict of interest can be likened to the vast sums of money paid to the Credit Rating Agencies in the West and the independent ratings they are meant to provide. It certainly could be argued that a conflict does indeed exist between a financial system seeking to comply with principles of risk sharing and fairness, and a system seeking to become profitable and in competition with the West. Perhaps then, it is this conflict that has led to the possibility of '*Sharia* Arbitrage' and the creation of some products that are not so different to their Western counterparts. Ultimately, Khan finds that 'Islamic Banking and Finance is virtually indistinguishable from conventional banking and finance. What makes it Islamic is *Sharia* Arbitrage'.[112] However, the level of possible arbitrage differs among many products, with many products arguably providing a better system than Western counterparts. For example, the PLS schemes within Islamic finance, where ownership is shared in an asset/venture with a bank and profits are based on the success of the venture, seem a fair method of investment with joint risk and quite different from Western alternatives such as a bond or a loan.

In the opinion of this author the notion of *Sharia* Arbitrage is well founded. It is likely how the Islamic banking world has managed to become a realistic alternative to Western banking. Trust has been established by largely 'repackaging' familiar products. Indeed, the growth of Islamic finance has been so acute, perhaps mostly due to the fact models of profitable banking methods were available within the Western banking world only to be tweaked to become *Sharia*-compliant. Whether this is moral, to be marketing products as being effectively unique that are in fact a loose copy is another question. However, in reality for totally unique products to have arisen through the development of Islamic finance, given the

[110] ibid 817.
[111] ibid.
[112] ibid.

relatively short period in which Islamic finance has been available may be an unrealistic expectation.

Nevertheless, unique *Sharia*-compliant products have certainly arisen which suggests over time the 'copy-cat' effect may well diminish reducing the impact of *Sharia* arbitrage, despite the possibility of there being some truth behind the argument of '*Sharia* Arbitrage', this essay has demonstrated how some of the most important Islamic financial products have been modelled, perhaps creatively or with a genuine desire to provide a complaint service, in order to be granted *Sharia* compliance, avoiding the many crucial principles inherent within the rules of *Sharia* financial law.

VIII. Conclusion and the Future of Islamic Finance

It is clear from the arguments posited by this essay that Islamic financial principles are in essence cleverly repackaged traditional Western financial products, effectively charging interest in ways that ensures the product is *Sharia*-compliant. Over the years since the founding of the Mit Gamil Savings Bank in Egypt in 1963, the Islamic financial products on offer have evolved from the purest kinds of *Sharia*-compliant products (i.e. *Musharaka*) to products based on a 'mark-up' system. This evolution has meant Islamic finance products have eschewed risk and profits from a partnership investment in favour of more regulated and risk free methods of leveraged finance. Clearly this evolution has resulted in an Islamic financial system containing products that are neither pure *Sharia*-compliant or mirror images of Western products. However, this author would argue that finding this middle ground may not be such a bad thing given the fact Western financial products have themselves been imitated and honed over hundreds of years, from the first Florentine bankers of the 14th century. This has made them both effective and prime candidates for imitation, and it is this refinement and development that will become part of the Islamic financial sector for the next few hundred years. What is also clear since the 2008 financial crisis is a worldwide shift in global capital. Western banks are now required to increase their capital buffers and ensure more capital is held on their balance sheets, ultimately reducing the available capital for loans and shrinking the Western financial sector in the process. Meanwhile, Islamic nations, many rich from vast oil reserves, are the new hubs seeking investment and capital, all of which will be governed by the principles of Islamic Finance going forward. This global shift could not have occurred without a solid foundation of principles and products that are the basis of Islamic finance today.