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Sale-Based Islamic Finance

As noted in earlier chapters, nominate contracts in classical Islamic jurisprudence play a very prominent role in contemporary Islamic finance. This prominence is in large part a function of the common-law nature of Islamic jurisprudence. Contemporary jurists are generally reluctant to declare that a contemporary financial practice is permissible under Islamic law, even though the default rule in transactions is permissibility. Thus, jurists seek precedents in classical jurisprudence to justify proposed contemporary practices.

To illustrate, consider the Chapter 1 example of conventional mortgage loan transaction and the Islamic version based on *murabaha* financing. Background credit checks, and other financial considerations to determine whether or not credit should be extended to a particular customer, are identical in both settings. Indeed, the mark-up charged to a customer under the Islamic model can be determined based on the customer's credit rating and benchmarked to interest rates on potential conventional loans to the customer. The main difference between conventional and Islamic financing procedures is thus inherent in the contracts used.

In the case of conventional mortgage lending, the bank collects principal plus interest on debt documented as a loan. In contrast, the *murabaha* model of Islamic finance is predicated on the permissibility of charging a credit price that is higher than the spot price of a property. Thus, the Islamic bank collects principal plus interest on debt documented as a credit price. As noted previously, the price mark-up can mimic conventional interest rates, and indeed the amortization table for a *murabaha* financing facility may be identical to the corresponding table for a mortgage loan. However, the *murabaha* financing return on capital is characterized rhetorically as profit or price mark-up in a sales transaction rather than interest on a loan.

One problem in applying the credit sale *murabaha* model directly to mortgage financing is that the bank does not own the property it finances. In fact, most

banks in the West are prevented from owning real estate or trading it. Thus, the Islamic model requires that the bank must first purchase the property (possibly through a special-purpose vehicle) and then sell it (or lease it then sell it, in *ijara* financing) to the customer. This imposes a number of additional transaction costs, including legal fees and sales taxes.

Some of those costs may be reduced by lobbying regulators. For instance, the Financial Services Authority (FSA) recently made *murabaha* financing, for example, as practiced in the United Kingdom by HSBC, more affordable by eliminating double-duty taxation when the two sales are executed to facilitate financing.¹ Other costs can be reduced by allowing the customer to act as the bank's agent, thus buying the property on the bank's behalf and then selling it to himself. Those and other steps allow the Islamic model progressively to approximate the conventional model's procedures and costs.

Islamic finance as practiced today serves a primary goal of replicating conventional financial products and services, as efficiently as possible, utilizing classical contract forms (such as sales and leases). Toward the end of enhancing efficiency in Islamic finance, bankers and lawyers venturing in the field need to understand some of the basic features of classical nominate contracts, which are used to mimic conventional financial products and services. However, one can hope that as the industry matures, its practitioners will look beyond mimicking contemporary financial practices utilizing those classical contract forms. As we review the main classical contract forms, we should reflect on our Chapter 3 analysis of the main prohibitions in Islamic financial jurisprudence, their economic merit, and the way classical nominate contracts implemented the principles enshrined in the jurisprudence. This can help in our quest for a thoroughly contemporary Islamic financial model that retains the substance of classical jurisprudence, rather than falling into superficial adherence to classical contract forms while possibly violating the substance of Islamic law.

4.1 Basic Rules for Sales

Sale is the ultimate permissible contract, as indicated by the Qur'anic verse asserting that God has permitted trade and forbidden *riba* [2:275]. Sales generally are characterized by classical jurists as exchanges of owned properties, including services and some property rights for non-Hanafi jurists. A sales contract requires offer and acceptance, with a meeting of minds for buyer and seller. For Hanafis and Malikis, a sale is concluded and binding on both parties on the expression of offer and acceptance. On the other hand, Shafi'is and Hanbalis ruled that buyer and seller retain the option to rescind the sales contract as long as they have not parted from the contract session. This is called the "contract session option"

(*khiyar al-majlis*), which is based on an authentic Prophetic tradition: “The two parties to a sale have the option [to rescind it] as long as they have not parted, and one of them may give the other the option for a longer period.”²

A number of restrictions on objects of sale were put in place, in part to ensure that sales contracts are not used as ruses for *riba*, and in part to protect the interests of contracting parties. With the exception of prepaid forward sales (*salam*) and commissions to manufacture (*istisna'*), to be discussed separately in later chapters, objects of sale must exist at the time of the contract. Moreover, for a sale to be executed, objects of sale must be owned by the seller, in his possession, and deliverable to the buyer. This set of conditions is central to the practice of Islamic financial institutions, wherein the financial institution must own a property in order later to sell or lease it to its customer. As noted above, this requirement results in additional legal costs for the extra sale and establishment of SPVs, as well as potential additional sales taxes, licensing fees, and the like. Interestingly, although the Shafi'is and Hanbalis listed the seller's ownership of an object of sale as a condition of conclusion of the sale contract, Hanafis and Malikis deemed it only a condition of execution of the sale. Thus, the latter two groups of scholars deemed sales by an “uncommissioned agent” (known in Arabic as *bay' al-fuduli*) concluded but suspended pending the [ultimate] seller's approval.³

The Underused Uncommissioned Agent (Bay' al-Fuduli) Structure

In this regard, while most areas of Islamic finance tend to be dominated by the Hanafi and Hanbali schools of jurisprudence,⁴ there is ample evidence that opinions from other schools of jurisprudence have been accepted in the industry. For instance, in the classical *murabaha* practice, wherein the bank buys a property and then sells it on credit to customer, jurists and banks have accepted a Maliki opinion of the jurist Ibn Shubruma – to allow the bank first to obtain a binding promise by its customer that he will buy the property after the bank buys it. It appears that developments along the “uncommissioned agent” opinions of the Hanafis and Malikis can greatly reduce the transaction costs in *murabaha* financing, by approximating conventional procedures more accurately.

Thus, the bank may act as an uncommissioned agent for the seller, selling his property to the customer on credit. At this stage the customer will owe the seller that property's price plus mark-up as determined by market interest rates, if the seller were to accept it. The seller may accept to provide financing to the customer directly, in which case the bank would be entitled only to its agency commission. On the other hand, if the seller demands receiving the price in cash, the bank – as agent – may conclude the sale by paying him the cash price he demanded, while collecting from the customer the credit price he agreed to pay. Thus, the bank

would act as a traditional financial intermediary, with the associated lower costs, rather than trading in property.

Although this alternative structure based on uncommissioned agent trading (*bay' al-fuduli*) may not necessarily be acceptable to all jurists, it appears to have been used in Islamic finance in the GCC. For instance, *fatwa* #62 for Dalla Al-Baraka and *fatawa* #17 and #24 for Kuwait Finance House all permitted the uncommissioned agent structure, arguing that ex post acceptance of the Islamic bank (that the customer bought on its behalf) is equivalent to ex ante agency authorization.⁵

Trust Sales: Murabaha, Tawliya, Wadi'a

The most common type of sale in Islamic jurisprudence is negotiated-price sale (*bay' al-musawama*), wherein the two parties agree on a price at which they are both willing to conclude the transaction. However, there are three other types of sale, wherein the two parties agree on a profit or loss margin, and the buyer relies on the seller's truthful revelation of his cost. In *murabaha* the two parties agree to trade at a price equal to the cost plus mark-up or profit, in *tawliya* they trade at cost, and in *wadi'a* they agree to trade at a marked-down price.⁶

In *murabaha* and *tawliya*, jurists ruled that the seller must be the owner, otherwise it is impossible for the seller to disclose the cost at which he obtained the property. The most common method of financing by Islamic financial institutions is "*murabaha* to order." It is based on a concatenation of two opinions, one by Al-Shafi'i that permitted a potential buyer to tell a seller "buy this property, and I will buy it from you at x percent mark-up," and an opinion of the Maliki jurist Ibn Shubruma that allows the potential buyer's promise to be made binding. In the first conference of Islamic banks in Dubai (1979), participants concluded that "this type of promise is legally binding on both parties based on the Maliki ruling, and religiously binding on both parties for all other schools." This ruling was reiterated in 1983, at the second conference of Islamic banks in Kuwait, reasoning that "this [*murabaha*] sale is valid as long as the bank is exposed to the risk of destruction of the good prior to delivering it to the buyer, as well as the obligation to accept return of the good if a concealed defect is found therein."

Led by the Pakistani jurist and retired Justice M. Taqi Usmani, jurists who are involved in Islamic finance have allowed the rate of return in *murabaha* to be benchmarked to conventional interest rates. In this regard, the rate of return earned by the bank was justified by two risks: (1) the risk of ownership between the two sales, and (2) the risk that the property may be returned to the bank (as seller) if a defect is found therein. We must note, however, that the risk of ownership can be made minimal by restricting the time period between the two sales

to minutes, if not seconds. Moreover, although jurists insist that any cost of insurance of the property during that period must be borne by the Islamic financial institution, the bank may negotiate a mark-up that compensates it for that cost. Similarly, the cost of insuring against the risk of having to accept the return of defective merchandise can be transferred easily back to the original seller or forward to the buyer. Thus, the only material risks to which the bank is exposed are credit risk and interest rate risk, which conventional banks specialize in managing. Indeed, many of the transaction costs associated with Islamic finance arise precisely for the purpose of eliminating all other (e.g., commercial) risks, which banks are not particularly well equipped to manage.

Currency Exchange (Sarf)

The well-known Prophetic tradition on *riba*, discussed in Chapter 3, listed six commodities that should be traded hand-to-hand and in equal quantities. In a variation on this Prophetic tradition that applied exclusively to monetary commodities, 'Umar ibn Al-Khattab said, "Do not sell gold for gold or silver for silver except in equal quantities. Moreover, do not trade gold for silver with one of them deferred. Even if your trading partner asks you to wait until he can fetch the money from his house, do not accept the deferment. I fear that you will fall in *riba*."⁷ Thus, *murabaha* financing cannot be applied to trading gold for silver with deferment for equal or different quantities.

Of course, gold and silver represented the bimetallic monies of the time, and thus trading gold for gold, silver for silver, or gold for silver were all grouped together under the title "currency exchange," or *sarf*. In those trades the aforementioned Prophetic tradition requires the exchange to be hand-to-hand (i.e., without deferment), and if the two compensations are of the same genus, then they must be equal in weight. No conditions or options are allowed in this contract, which is deemed binding at its conclusion.

The earliest jurists reasoned by analogy that currency exchange contracts may not be used to settle existing debts (e.g., settling a debt for gold with payment in silver). However, later jurists reasoned by juristic approbation that clearing a debt in one currency with payment in another currency is permissible if both parties consent to it, regardless of when and how the debt was initiated, and in some cases, the exchange would be enforced without need for mutual consent.⁸

Contemporary jurists have allowed regular currency-trading transactions, in which a payment in one currency is made in one country, and receipt of another currency is made in a different country, possibly at a later time. This practice was characterized as an instantaneous currency exchange contract in the first country, followed by an interest-free loan to be repaid at the later date in the other

country.⁹ Of course, the underlying assumption is that exchange will be carried out at the spot exchange rate of the initiation date, to avoid suspicion of *riba*. On the other hand, those familiar with the evolution of modern banking in Europe will recognize bills of exchange along those lines (known by the Arabic name *suftaja*) as the classical forms through which Medici bankers managed to embed interest rates in exchange rates, to circumvent the classical Catholic prohibition of “usury.”¹⁰

Metals and Tawarruq

Another interesting development in Islamic finance is that some precious metals (e.g., platinum) were exempted from rules of currency exchange. For instance, the Rajhi Investment Company’s Shari‘a board reasoned as follows in its *fatwa* #101:

Platinum is a precious metal that does not inherit the legal status rulings of gold and silver, even though some people call it “the white gold.” Thus, mutual receipt during contract session is not required for platinum, and it may be sold with deferment in exchange for currency.

In general, platinum is subject to legal status rulings for metals other than gold and silver. Thus, if the company [Al-Rajhi] wishes to deal in this metal when it is not present [in the seller’s possession], it may only buy it through *salam* [prepaid forward contract], subject to all the conditions of that contract. Moreover, the company must receive the metal prior to reselling it.¹¹

Thus, although the classical rules of currency exchange very strictly ensured that an interest-bearing loan cannot be manufactured out of trade, recent developments in jurisprudence have allowed trade-based financing to replicate loans. This is especially prevalent today through the *tawarruq* contract that is increasingly practiced in GCC countries. Thus, if a customer wishes to borrow \$10,000 and pay 5 percent interest, and the bank wishes to lend him the money at that rate, the bank needs only to buy \$10,000 worth of platinum from a dealer, sell to the customer on a credit basis for \$10,500 to be paid later, and then sell the platinum on behalf of the customer back to the dealer, thus generating the desired result. Needless to say, all interest-based financial transactions (including loans and bonds) can be (and are in fact) generated through such trade cycles, which involve a credit component through either credit sales or prepaid forward sales.

In the context of *tawarruq* as practiced by Islamic banks, it is noteworthy that most classical jurists deemed it impermissible for one entity to execute a sale as agent for both trading parties, with the exceptions of judges, plenipotentiaries, and parents.¹² This restriction was intended to ensure that sales contracts are legitimate, and that they are perceived by all parties to be beneficial to them. One particularly troublesome practice that would be voided by this restriction applies

to banks engaging in “trade” for the purpose of *tawarruq* financing, whereby the bank acts as an agent for its customer and the merchant – buying commodities from the merchant, selling to the customer on credit, and then selling back to the merchant for the amount of cash desired by the customer.

4.2 Same-Item Sale-Repurchase (*‘Ina*)

Most recent developments in Islamic finance involve the utilization of a commodity or property as one degree of separation to recharacterize an interest-bearing loan in the form of trade. Thus, we have just described the most common form of *tawarruq* financing that has become increasingly popular in Saudi Arabia, UAE, and other GCC countries in recent years. This practice was common in earlier decades for larger corporate customers of Islamic banks and financial institutions. For those larger customers, the bank did not need to provide agency services for all sales. Indeed, larger customers were capable of borrowing through a simple *murabaha* transaction for platinum, and they had the necessary recourses to sell the platinum on the spot market to obtain desired liquidity. This was particularly advantageous to bankers who operated in countries wherein *tawarruq* was unacceptable, whereas *murabaha* was.

As noted briefly in previous chapters, most Islamic bond (*sukuk*) structures developed in recent years also involve the sale and repurchase of some property or commodity. Thus, short-term bill-like instruments are manufactured through prepayment (*salam*) sale of commodities, and long-term bondlike instruments are manufactured through sale of a property, followed by leasing back the same property, and possibly buying it back at lease end. In this section we shall review classical and contemporary juristic rulings on same-property sale-repurchase and their implications for Islamic finance.

Same-Item Trading in ‘Ina and Tawarruq

The classical *bay‘ al-‘ina* (same-item sale-repurchase to circumvent the prohibition of interest-based lending) was discussed extensively in the classical juristic literature.¹³ Discussion centered mostly around Prophetic traditions, the authenticity of which were accepted by some jurists but not others. In the simplest form of *‘ina* sale to produce interest-based debt, the “borrower” sells some property to the “lender” and receives its cash price. Then, the “lender” turns back and sells the same property to the “borrower” on credit, at a higher price equal to the “principal,” or cash price, plus interest. Classical jurists also recognized that a third party may be introduced as an intermediary, whereby A (dealer) sells to B (bank) in cash, B sells to C (customer/borrower) on credit, and C sells to A

in cash. Of course, if jurists were to forbid same-item repurchase through one intermediary, more degrees of separation – for example, trading parties D and E – may be added.

Abu Hanifa had generally ruled that the validity of sales is determined by contract language. However, he ruled that same-item sale-repurchase without an intermediary third party is defective, based on a tradition of Zayd ibn Arqam.¹⁴ He also reasoned that if someone sells a property on credit, and then the buyer sells it back to him for cash, the second sale would not be valid. He based that ruling on the view that the deferred price in the first sale would not have been received, and thus the second sale (which is contingent on the first) could not be definitively concluded. Of course, the latter objection can be circumvented formally in Islamic banking by asking the customer first to sell any property to the bank for cash, and then turn around and buy it back on credit.

The two closest associates of Abu Hanifa differed in opinion regarding this contract. Thus, the judge Abu Yusuf ruled that the contract is valid and not reprehensible, whereas Muhammad Al-Shaybani found it extremely reprehensible, as an obvious stratagem invented to circumvent the prohibition of *riba*. Similarly, Shafi'i and Zahiri jurists ruled that the contract is valid, since it satisfies the cornerstones and language of valid sales, and since Al-Shafi'i himself did not accept the tradition of Zayd as authentic. However, they reasoned, it is reprehensible since the intent to legitimize *riba* through sales is clear, although their legal theory did not allow them to invalidate a contract based on such analysis of intent.¹⁵

Interestingly, Maliki and Hanbali jurists ruled that same-item sale-repurchase without a third-party intermediary is forbidden, by invoking the rule of preventing means of legitimizing illegitimate ends (*sadd al-dhara'i'*). However, if a third-party intermediary is present (as in the case of *tawarruq*), most Malikis and some Hanbalis reasoned that the contract is merely reprehensible. Since the use of *tawarruq* has been spreading quite rapidly in the GCC region (especially Saudi Arabia and UAE) based on its permissibility among some Hanbali jurists, it seems appropriate to review some of the more recent classical and contemporary juristic opinions regarding this contract.

Hanbali Denunciation of Organized Tawarruq

Ibn Qayyim Al-Jawziyya, a prominent Hanbali jurist and star student of Ibn Taymiyya, said the following regarding Ibn Taymiyya's attitude toward *tawarruq*: and our teacher (God bless his soul) forbade *tawarruq*. He was challenged on that opinion repeatedly in my presence, but never licensed it [even under special circumstances]. He said: "The precise economic substance for which *riba* was forbidden is present in this contract, and transaction costs are increased through purchase and sale at a loss of some commodity. Shari'a would not forbid a smaller harm and permit a greater one!"¹⁶

Similarly, Al-Ba'li reported in his selection of juristic rulings of Ibn Taymiyya that the latter had forbidden *tawarruq*.¹⁷ More recently, two very prominent juristic councils, both housed in Saudi Arabia, tackled the issue of *tawarruq*. The more prominent Fiqh Academy of the Organization of Islamic Conference, in Jeddah, Saudi Arabia, forbade *tawarruq*. The second and generally less prestigious Fiqh Academy of the Muslim World League, in Makka, Saudi Arabia, issued two rulings on the transaction. The first opinion was issued in the fifteenth session of the academy in October 1998. It permitted the contract subject to the condition that the customer does not sell the commodity to its original seller, to avoid direct evidence of *'ina* as a legal stratagem to circumvent the prohibition of *riba*. In the seventeenth session of the academy, held in December 2003, they tackled the issue of “*tawarruq* as practiced by Islamic banks today” and forbade it. They based their decision on the following characterization and reasoning:

After listening to presented papers on the subject, and discussions thereof, the Academy recognizes that some banks practice *tawarruq* in the following manner:

The bank routinely sells a commodity (other than gold or silver) in global markets or otherwise to the customer on credit, wherein the bank is bound – by virtue of a contract condition or convention – to sell the commodity to another buyer for cash, which the bank delivers to the customer.

After study and deliberation, the Academy ruled as follows:

First, *tawarruq* as described above is not permissible for the following reasons:

1. The seller's obligation to act as the buyer's agent to sell the commodity to another buyer, or making similar arrangements, makes the dealing akin to the forbidden *'ina*, whether that obligation is spelled out as an explicit contract condition, or determined by custom.
2. In many cases, this type of transaction would result in nonsatisfaction of receipt conditions that are required for validity of the dealing.
3. The reality of this transaction is extension of monetary financing to the party characterized as a *tawarruq* customer, and the buying and selling operations of the bank are most often just meant for appearances, but in reality aim to provide the bank an increase in compensation for the financing it provided.

Some banks have attempted to address those concerns of the Muslim World League Fiqh Academy by ensuring that all transactions are bona fide sales and purchases, with corresponding transfer of commodity risks. Towards that end, many banks in Saudi Arabia have begun to emphasize that all commodities used for *tawarruq* are bought and sold in domestic markets, with real merchants delivering the goods or reassigning their ownership as dictated by trade. However, it would appear that this increased emphasis on forms misses the argument made by Ibn Taymiyya as reported by Ibn Qayyim: that the difference between what is

permitted and what is forbidden cannot possibly be determined by the amount of transaction costs involved (with higher transaction costs favored!).

Returning to our analysis of *riba* in Chapter 3, it appears that the true demarcation should be determined by “marking to market.” We explained the canonical prohibition of trading dates for dates in different quantities by arguing that when dates are sold for money, one seeks the highest bid, and when one uses the money to buy dates, one seeks the lowest offer. This enhances efficiency in markets (especially if added transaction costs are negligible) and ensures equity in exchange. Similarly, if financing is replaced by bona fide trade, as both Fiqh Academies have agreed, then the financing charge in *murabaha* financing (whether or not the customer plans to sell the commodity for cash) will be determined by the difference between actual cash and credit prices in the marketplace.

In contrast, a *tawarruq* transaction is usually structured by banks to equate financing charges to market interest rates on loans to similar borrowers, regardless of the actual underlying commodity. It is thus possible to understand the Fiqh Academies’ opinions in terms of rejection of robbing the trading components of Islamic finance of all economic significance, thus squandering the potential efficiency-enhancing provisions built into Islamic jurisprudence. The distinction based on marking to market is more significant in Islamic transactions structured through leases, where a market lease rate may be computable and useful for comparison to the interest rate being charged on similar financial products.

Custody Sale (Bay‘ Al-‘ubda) and Sukuk Al-ijara

We have described the recent lease-backed Islamic bonds briefly in the introduction, and we shall discuss them in much greater detail in Chapter 6. The structure quite simply proceeds as follows. The entity that desires to issue bonds (be it a sovereign government, a corporation, etc.) creates an SPV that sells certificates (*sukuk*) for the amount of the bond issuance. The SPV uses the proceeds to buy some property (typically, land, buildings, machines, etc.) from the issuer and proceeds to lease the property back to the seller. The issuer pays rent, which is passed through the SPV to certificate holders. At lease end, the issuer typically buys the property back from the SPV (although in at least one structure that we shall discuss in detail, the property will be given back as a gift from the SPV to original seller).

We have noted in Chapter 1 that there are two elements of same-item sale-repurchase in this structure: (1) the property and its usufruct are sold to the SPV, and then the usufruct is purchased back through the lease, and (2) the property itself (and all of its remaining usufruct) is purchased back at lease end. This raises the issue of *‘ina*, which would deem the contract forbidden. However,

same-item sale-repurchase has been approved in lieu of debt by some schools of jurisprudence. That sale form is called fulfillment sale (*bay' al-wafa'*), wherein a property is sold on condition that once the seller returns the price, the buyer must return the property. Shafi'i jurists call this trade *bay' al-'uhda* (custody sale), and the Hanbalis call it *bay' al-amana* (trust or faithfulness sale).

Maliki and Hanbali jurists, as well as early Hanafi and Shafi'i jurists, ruled that such sales are defective, since they were viewed as legal stratagems to reach illegitimate ends (forbidden *riba*) through legitimate sale means. In this regard, they forbade the practice by characterizing the apparent sale as a loan of the price, with usufruct of the property being the profit or interest collected on the loan. Interestingly, this ruling is reinforced in *sukuk* structures, wherein the usufruct is further monetized through leasing the property back to the seller. However, some later jurists have allowed the contract based on convention, thus paving the road for its contemporary utilization.¹⁸

In general, Islamic jurisprudence does not forbid the same property being sold back to its original seller, provided that the two sales are not stipulated in the original contract. Otherwise, a sales contract that requires the buyer to sell the property back is not a sale at all, since the buyer never in fact obtains ownership rights, which include the right not to sell the property, and certainly the right not to sell it to any given individual or entity (e.g., the original seller). However, the precedent of fulfillment sale mentioned in this section opened the door for the possibility of constructing the *sukuk* structures that have become popular in recent years, which we discuss in Chapter 6.

Now, we may return once more to the issue of “marking to market,” which we argued to be at the heart of the prohibition of *riba*. Many Islamic finance practitioners have hailed the ability of countries and corporations to engage in secured lending through sale-lease-back-repurchase certificates, which may – in theory, if not in practice – allow them to borrow at lower rates. Indeed, because of the recent preponderance of those issuances, Standard and Poor's has developed a rating methodology for such lease-backed bonds (discussed in Chapter 6), and the country of Bahrain has progressively used that tool to refinance substantial amounts of its conventional debt at lower interest rates. Invariably, however, the interest rates on those secured bonds are benchmarked to interest rates for conventional bonds with similar credit ratings. We must thus turn to this issue of benchmarking Islamic financing rates to conventional interest rates.

4.3 Cost of Funds: Interest-Rate Benchmarks

Contemporary jurists have simultaneously lamented benchmarking implicit interest rates in Islamic sale- and lease-based financing to conventional interest rates

(such as the London Interbank Offer Rate [LIBOR]) and argued that such benchmarking by itself would not deem the financing un-Islamic. A favorite argument of contemporary jurists' has been drawing an analogy to two lines of business, one legitimate and the other illegitimate. Just the fact that the legitimate business (say, a carpenter's shop) may demand the same profit rate as the illegitimate one (say, a brewery, which earns a 6 percent profit rate), they argued, does not render the legitimate business illegitimate. Other analogies that one hears at Islamic conferences compare the price of *halal* chicken (chicken slaughtered according to Islamic standards) to the prices of chicken processed otherwise, again arguing that numerical equality of prices does not imply similar legal status of the priced properties.

Needless to say, those analogies are patently fallacious: The object of sale in Islamic finance does not differ from the object of sale in conventional finance the way carpentry differs from brewing, or even the way *halal* or kosher chicken differ from regularly slaughtered chicken. When an Islamic financial provider structures an "alternative" to conventional finance (say, a conventional mortgage) through double-sale *murabaha* financing facility, the ingredients of the financial transaction are the same as those for conventional mortgage (cost of funds, credit risk, collateral property risk, etc.), and the output is the same (a debt on the customer equal to the sum of money he needed to purchase the property plus finance charges exceeding the bank's cost of funds).

In this regard, whether a double-sale procedure is followed, or a simpler single sale takes place via an uncommissioned agent (*bay' al-fuduli*), as suggested earlier in the chapter, the financial provider still converts funds now into funds in the future and compares his future cost of funds (the interest rate he has to pay to fund providers, whether they are depositors, *sukuk* holders, etc.) to the rate of return that he collects. It is in this spirit that we have argued that the "*murabaha*" disclosure rules – when applied to finance – dictate that the Islamic financier should report his cost of funds and interest-rate mark-up to its customers.

Opportunity Cost for Conventional Fund Providers

It is not surprising that LIBOR is the benchmark of choice for Islamic bankers and financiers. That interbank rate represents the opportunity cost for bankers who are operating or were trained in the United Kingdom, as most Islamic bankers have been. If the bank is left with idle funds, LIBOR represents the rate of return it can obtain by lending those funds to other banks. Hence, other borrowers/finance customers must pay the bank a rate of return equal to LIBOR plus a mark-up commensurate with the level of credit risk to which the bank is exposed by lending to them, rather than lending to other banks. Thus, LIBOR has been

the appropriate benchmark for London bankers to use, and the historical precedent for the majority of Islamic bankers who started their careers in U.K.-based conventional banking.

In contrast, the Islamic financial customer has no access to funds at LIBOR, and any familiarity he may have with interbank rates would merely result from his education and level of familiarity with various financial publications. Bankers will naturally demand at least LIBOR plus the appropriate spread, and competition will naturally drive implicit interest rates on Islamic financing closer to that benchmark rate (as Shari‘a-arbitrage rents vanish). However, bankers do their customers a disservice by limiting the process of Islamic financing to explicit benchmarking of interest rates to LIBOR or any other market rate, and implicitly to rates that competitors would charge (as dictated by truth-in-lending provisions in various Western countries).

Indeed, the customer should also consider his own opportunity cost to involvement in a financing contract with any particular financial services provider. In this regard, the asset-based nature of Islamic finance, if taken seriously, can provide the customer with another economic comparison to determine whether or not he should engage in any particular financial transaction. Within the context of our mortgage example, an appropriate Islamic model (whether it is a buy-sell-back *murabaha* transaction, or a buy-lease-back *ijara* transaction, etc.) should do more than merely camouflage a conventional mortgage loan through sales, leases, and the like. It should provide the customer with appropriate tools for determining whether or not the purchase of a particular property at a particular price and financing that purchase at a particular interest rate constitute a good investment or financial decision. Islamic financial providers should be equally interested in looking beyond the quality of collateral and borrower in terms of the credit risk associated with an Islamized mortgage loan.

This may be done by disentangling the benefits from owning a property and benchmarking each component to the appropriate market variable. Thus, capital gains on the property (at the appropriate level of leverage) should be compared to capital gains that could be made on other investments. Rental rates (value of usufruct) of similar properties should be compared to interest paid on the borrowed sum, after factoring in tax advantages of deducting mortgage interest for income tax purposes, where applicable.

Financially wise customers make such comparisons in conventional as well as Islamic financial transactions. One difference between conventional bankers and Islamic bankers should be increased involvement of the banker in the real transaction being undertaken by the customer, even if – in the end – it is only a financial transaction for the bank, which should be benchmarked to the bank’s opportunity cost as measured by LIBOR or other interest rates. An Islamic banker would thus

use additional benchmarks (which every customer should use, but often many would not without the help of a financial advisor) to decide whether or not the financial transaction is advantageous to the customer.

The explicit mechanics of a real transaction (the bank having actually to get involved in buying and selling the property, or leasing it, etc., even if at arm's length through special purpose vehicles, or ex post through uncommissioned agency) force Islamic financial providers to take their customers through this cold unemotional financial calculus. Although efficiency would dictate performing those calculations only within the context of counterfactual financial scenarios (thus avoiding unnecessary transaction costs), the sad reality is that Islamic finance in the short-to-medium term will likely remain captive to premodern procedures, where the actual trading, leasing, and the like is required. The use of additional benchmarks, as discussed in this section, would – at least – allow the spirit of Islamic jurisprudence to be served through adherence to those premodern forms as adopted by Islamic financial providers.

Viability of Islamic Benchmark Alternatives

In recent years a number of jurists and Islamic bankers have called for the development of “Islamic benchmarks,” while maintaining that benchmarking rates of return in sale- and lease-based Islamic financing to conventional interest rates is legitimate. The reason suggested by those Islamic finance practitioners is that *murabaha* financing with a profit rate benchmarked to market interest rates looks suspiciously similar to a conventional loan. Those proponents of an Islamic benchmark have also expressed the ambitious goal of eventually developing an entire Islamic yield curve, to be used for benchmarking rates of return in Islamic finance facilities of varying maturities. The recent growth in Islamic bonds (*sukuk*) issues was thus hailed as a positive step in the direction of developing that Islamic yield curve, which presumably can easily emerge once that market develops sufficient depth and liquidity.

In fact, however, this search for Islamic benchmarks and yield curves is misguided, for a number of good reasons. First, Islamic financial practitioners' discomfort with benchmarking to conventional interest rates seems to be based on continuing misconceptions such as that Islamic finance is “interest free” or that Islamic jurisprudence does not recognize the time value of money. As we have seen in Chapter 3, those views – which were foundational for the Islamic economics literature that predated Islamic finance – are fundamentally flawed. Indeed, Islamic jurisprudence does recognize the time value of money, which is precisely why a seller may charge a higher price for a credit sale than he would for a cash sale of the same property.

In this regard, one must note that the juristic argument that “time value is recognized in sales but not in debts or loans” is at best insufficient, and at worst disingenuous. If the claim is based on the need for pricing time value for each transaction separately (based on credit rating, quality of collateral, etc.), then there is a valid argument to be made (in conventional as well as Islamic finance). However, the mere claim is insufficient in this case, since the manner in which appropriate interest rates are determined in sales, leases, and the like remains unspecified. On the other hand, if interest rates in Islamic finance (including the pure time-value components thereof) are benchmarked to conventional interest rates, it would appear that the general claim is vacuous and disingenuous, since it serves only to create arbitrage opportunities, from which jurists stand to be primary beneficiaries.

Divergence of Rhetoric from Reality

With regard to “interest rate” (or the equivalent Arabic “*si‘r al-fa’ida*”), we have to recognize that although the term may have initially applied only to interest on loans, modern usage applies it to any compensation for time value. In fact, an Islamic financial provider in the United States is required by “truth-in-lending” regulation Z to report the implicit “interest rate” in lease or double-sale financing. The sooner Islamic finance providers can disabuse their customers of those lingering misconceptions about time value and permissibility of charging interest in certain types of transactions, the higher will be the industry’s credibility with regulators and customers alike.

A closely related reason why Islamic finance practitioners feel uncomfortable about using conventional interest rates as benchmarks is the Shari‘a arbitrage nature of Islamic finance, as illustrated in Chapter 1. In fact, Islamic finance has been, and continues to be, fully dependent on conventional finance for its existence and the nature of its products, as well as its rates of return. If Islamic financial providers continue to market their industry based on the rhetoric that conventional finance is generally forbidden and exploitative, then benchmarking to conventional interest rates will continue to be an embarrassment, prompting skeptical customers to ask: “What is the difference between Islamic and conventional finance?” In contrast, if Islamic financial providers were to focus on the substance of Islamic jurisprudence instead of its forms, they can explain to customers that some – but not all – forms of debt are harmful, and some – but not all – forms of interest are harmful.

Indeed, industry rhetoric needs to change so that a double-sale (*tawarruq* style) at 100 percent interest is recognized as usurious predatory lending rather than legitimate trading. Islamic financial providers need to explain to customers that the purpose of following nominate forms of classical Islamic jurisprudence is to

impose discipline and ensure that we select from the wide range of conventional financial products only the ones that are advantageous to particular individuals based on their specific circumstances. Then the fact that credit selected through that methodology costs the same as credit selected through different (conventional) screens would no longer be a source of concern or embarrassment for the industry.

Finally, one of the potential advantages of asset-based Islamic financing is that it can be provided at rates that deviate substantially from a time-value benchmark plus credit-risk premium. For instance, a country or corporation with a poor credit rating may be able to obtain financing at implicit interest rates substantially below those dictated by its credit rating if it genuinely collateralizes its debt with real assets, for example, through the currently popular sale-lease-back *sukuk* structures. At least theoretically, lease-backed *sukuk* with different underlying assets should have different implicit interest rates, depending on the quality of collateral, its depreciation rates, market rent, and the like. Moreover, as we shall argue in Chapter 10, lease *sukuk* built on bona fide sale of government assets can help in restarting stalled privatization programs in various Islamic countries.

Disadvantages of “Islamic Benchmarks”

It is true that if implicit rates in Islamic finance were indeed to vary according to the qualities of underlying assets, then the “Islamic-debt” market would never develop sufficient depth and liquidity to generate a uniform benchmark that can be used to determine implicit rates for other Islamic financial transactions. On the other hand, if – as has indeed been the case – the issued *sukuk* are backed by the full faith and credit of issuing governments and corporations, and thus resulting implicit interest rates are determined solely by the issuing entity’s credit rating and a conventional benchmark (typically LIBOR), then referring later to those implicit interest rates is at best cosmetic, and at worst misleading. It would be cosmetic if we first strip the implicit interest rate of its credit-risk premium, essentially to reproduce LIBOR under another name, prior to adding the appropriate credit-risk premium for another Islamic debt instrument. To the extent that reproduction of the underlying measure of time value may be erroneous, benchmarking to such rates may lead to erroneous pricing of other Islamic financial instruments.

Consequently, the development of an “Islamic benchmark” is (1) unnecessary, since there is no reason to be embarrassed about using conventional benchmarks, (2) impractical, since sufficient depth and liquidity of homogeneous Islamic financial assets is unlikely, and (3) superfluous or dangerous, since the only logical or practical approach to developing such an Islamic benchmark would be to try to recover the underlying conventional benchmark, which may be done erroneously.

It would be more advantageous for industry practitioners to explain to customers that the products they offer must meet all conventional product requirements, in addition to Islamic considerations that essentially provide further protection to those customers. Then, if Islamic financial products are more expensive than their conventional counterparts (which they are, almost always), bankers can explain that this additional cost is compensation for the service being provided through adherence to those prudential requirements of Islamic jurisprudence, in analogy to higher fees charged by full-service brokers who provide investment advice to their customers.

Other Conventional Benchmarks

While we are discussing the subject of interest-rate benchmarks, it is worthwhile noting that the use of LIBOR as a benchmark, while reasonable for many bank-type financial instruments, seems less appropriate for sovereign bonds. Benchmarking to LIBOR reflects the industry's dependence on London-based banks, and domination – even after the industry's centers of gravity moved from London, Geneva, and Luxembourg to Kuala Lumpur, Bahrain, and Dubai – by bankers who are based, or used to be based, in London. In this regard, no reasonable person would disagree that LIBOR is perhaps the best measure of an English bank's opportunity cost of funds, and hence benchmarking to that rate makes perfect sense for Islamic financial instruments that are similar to bank loans.

In contrast, many of the countries that continue to issue “Islamic debt” (mainly Bahrain, Qatar, Malaysia, Pakistan, and others likely to join the sovereign *sukuk* movement in part to retire their conventional debt, as in the case of Bahrain), would like to be viewed as “emerging markets.” Indeed, Malaysia and Turkey – which is currently contemplating issuing *sukuk* – have been on the radar screens of emerging market debt traders for a number of years. In that market the benchmark most commonly used is the yield on U.S. Treasury bonds – with emerging market bond yield spreads (e.g., on indices such as JP Morgan's EMBI+) over U.S. Treasury yields now serving as the most common measures of global economic risk. Migrating sovereign *sukuk* benchmarking from LIBOR to Treasury yields would be a sign of maturity in the sector, signaling graduation of those *sukuk* from a market-niche curiosity generated by bankers and lawyers.