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# Bonds and Loans in the Islamic Financial Law; and a Comparison with International Bond Issues

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**Abstract**

This study compare bonds and loans in the Islamic financial law and international financial law (conventional bonds). It will also compare Islamic financial law and the international financial laws. Furthermore, the study focus on certain legal and economic issue related to the system of the Islamic banks such Islamic syndicated loans. Furthermore, the study will attempts to show both differences and similarities concerned the Islamic syndicated loans and international syndicated.

## Introduction

Islamic financial systems are distinguished for their wide variety of its financial standard, offers and alternatives. The most important element in the Islamic financial system is that it derives it authority, values, and principles and even its behavior from the Islamic Shari' or Islamic jurisprudence. Accordingly, this attempts to know whether the Islamic economy and Islamic financial system can be separated from the Islamic Shar'a.

Islamic banking can be defined as a financial system that is affiliated to the Islamic Shar'a principles and values. For examples, Islamic Shar'ia prohibits the interest rate imposed upon bank credits or loans. At the same time, it also forbids the interest rate incurred by bank deposits. Such interest rate called in Islamic Shar'ia as Riba. Furthermore, Islamic Shar'ia forbids any business treatment or any offered services that are contradicted with the principles of Harem as stated in the Islamic Jurisprudence.

The Islamic principles participated mainly in the flourishing of the earlier Islamic economy during the age of Cahaba and caliphate. However, these Islamic principles were overlooked for a longer time. By the late of the twentieth century a few number of Arab states had applied the idea of the Islamic bank, which derives its economic and financial principles from the Islamic shar'ia

We can categorize the financial assets in terms of the Islamic Shar'ia to two categories, the first tradable assets and the second is the non-tradable. According to conservative estimates taken during a period of ten, the amount of money invested according to Islamic investment principles reached over $1.2 trillion of an asset.

According to the survey made by In the Arab Gulf and Asia, Standard & Poor, it was found that about 20 percent of bank customers have chosen the Islamic financial system, refusing the traditional bank system.

The current study will focus on the Islamic financial system and its principles and values. It will compare the bonds and loans in terms of the international banking system.

Syndicated loan can be defined as that type of loan offered a set of different lenders to the same borrower. It is noted that Syndicated loans reached higher amounts of money, which makes it so difficult to be given by one lender. However, the syndicated loan share in common with the ordinary loans in terms of the interest rate (fixed or floating) and settlement time of debt. The syndicated loan can be divided into two groups, the first is a direct loan and the second is a revolving line of credit or a combination of the two. However, in the conventional system of bonds, syndicated loans system is well devised in a way that allows the lenders to lend the loan according to financial potentiality.

Popular Islamic finance products used in syndicated Islamic finance are Murabahah and Sukuk. However, most conventional Islamic finance products can be syndicated.

Murabahah is an agreement entered into between a bank and client by which bank purchases an item for a client and then sells it to him on a cost plus basis. However, the bank applies the transparency system as he shows the client both cost and profit.

Sukuk is considered a form of Islamic bond, generally an asset-based investment, as an investor possesses an undivided interest in an underlying tangible asset. Accordingly, the investor shall receive a proportional share of the investment return.

“Sukuk” is the Arabic equivalent for a financial certificate, but it refers to the bond. Sukuk securities are made to be compatible with the Islamic Shar'ia economic and investment principles that fight the interest rate or what is known as Riba.

## Findings

### 1) Rules and Principles Governing Islamic Financial System

#### i. A Historical Back-ground

The early Islamic banking could manage to present a set of innovative concepts and techniques, such as the bills of exchange, the first forms of partnership, limited partnerships (mudaraba), and capital (al-mal), capital accumulation (nama al-mal), checks, promissory notes, trusts (or Waqf) startup companies, transactional accounts, loaning, ledgers and assignments.

In the medieval Islamic ages, there was what is known as the institutional companies that are similar to corporations, which are not affiliated to the state authority and there was the agency, too,. The medieval Europe adopted many Islamic capitalist concepts that participate to flourishing European economy.

#### ii. Riba

The Quran (3: 130) clearly condemns "riba," translated into "interest": "O, you who believe! Devour not riba, doubled and redoubled, and be careful of Allah; haply, so you will prosper."

"Riba" can be defined as excess, increase or extra. However, according to modern Islamic Shari'a, it can be explained as any excessive or over compensation that surpasses the loan without due consideration to loss or profit. The classical Islamic jurisprudence defined it as the increased value over the real value without counterpart. In other words, the lender shall be refunded back the amount of lent money including the interest rate, paid in return for money lending and its duration.

During this period, gold and silver currencies were the metals used to define the value of all other materials. Accordingly, gold and silver kept a steady and unchanged and permanent value as they were the measure for all other materials. Therefore, it was difficult to impose on them the interest rate. However, applying the interest rate was acceptable under some circumstances. Currencies that were depended on guarantees made by government to honor the stated value (i.e. fiat currency) or depended on other materials such as paper or base metals were permitted to have an interest applied to them.

It is surprising to note that when the base metal currencies were provided in the Islamic world, the value of the metal base was measured in terms of its weight, not its number. Thus, paying a dept in relation to an excessive number of metal base was not considered as riba; however, the weight difference was the measurement for determining riba.

For example, if the loan amount reaches 1000 gold Dinars, we can pay it back as 1050 Dinars ; however, the weight must be the same without any difference.

### iii. Debt arrangements

Most Islamic financial institutions apply participatory arrangements between capitalist and borrower. That rule reflects the Islamic norm that the borrower must not bear all the cost if a failure occurs.

Traditional debt arrangements are refused from the Islamic perspective; however, the traditional venture investment can be applied within a limited scale. However, not all debt arrangements can be understood according to the venture investment structures. For instance, buying a home does not mean an investment in the business venture-person's shelter is not affiliated to the business venture. Similarly, purchasing other commodities for personal use, such as cars, furniture cannot be considered a venture investment.

### iv. Welfare

Islam has its own assessment and point of view towards social welfare, unemployment, public debt and globalization. Islamic banks have been increased recently in the Muslim world; however, they exemplify is a very small portion of the global economy in comprison to the Western debt banking standard.

### v. Interference

Islam advocates a form of a free market as it is against fixing prices, monopoly and hoarding. Furthermore, from Islamic perspective, the government intervention in the economy and market permitted under specific circumstances.

Islam forbids the monopoly system and the united prices made by a group of sellers in order to control the market. During the days of Prophet Muhammad, there was a small group of merchants who used to monopolize the agricultural commodities as they planned cleverly for such a monopoly. They used to hold private business agricultural transactions with producers for buying bought the whole crop; accordingly, they can get the monopoly over the market. Therefore, they can control the market and raising the prices of the commodities to be higher level. “The Prophet peace upon him disdains such practice and resists it as it results into grave harm falling upon both to the producers (who in the absence of numerous customers were forced to sell goods, at a lower price) and the inhabitants of Medina ”.[1]

The above-mentioned story shows that the Islamic market is distinguished by free information and justice as it helps provide both sellers and customer the necessary protection to keep the interests of all. Furthermore, there was transparency with respect to the available information concerned with “demand and supply conditions. Producers are expected to inform consumers of the quality and quantity of goods they claim to sell.

Subsequently, the Islamic finance paradigm is based on the following set of prohibitions:

i. Immoral Transactions of goods and services;

ii. Getting returns from a loan contract (Riba/Interest);

iii. Compensation-based restructuring of debts;

iv. Excessive uncertainty in contracts (Gharar);

v. Gambling and chance-based games (Qimar);

vi. Trading in debt contracts at discount.

vii. Forward foreign exchange transactions

[1] Jairus Banaji (2007), "Islam, the Mediterranean and the rise of capitalism", Historical Materialism 15 (1), pp. 47–74, Brill Publishers.

These above-mentioned prohibitions have significant implications for the nature of financial assets, trading in these assets, for the risks of the assets and their mitigation and for management of Islamic financial assets.”[2]

## 2) Islamic Bonds and Loans

In the classical period of islam , "Sakk (sukuk)" that is similar to the European root "cheque" - can be defined as document representing a contract or transmitting of rights, obligations or monies that is conformord to Islamic Shar'a . Empirical evidence shows that sukuk were extensively used during the medieval Islam for transferring of financial obligations resulting from trade and other commercial activities.

According to the modern Islamic persective, SukukI can be defined as the concept of asset monetization ( the so called securitization) achieved by issuing of Sukuk (Taskeek). The importance of sukuk lies in transforming an asset future cash flow into present cash flow. Sukuk may be issued in relation to the existing and specific assets that may become available in future date.

### 2.1. Examination and Comparison

A conventional bond is just a promise to repay a loan; however, Sukuk constitutes partial ownership of the debt (Sukuk Murabaha), asset (Sukuk Al Ijara), project (Sukuk Al Istisna), business (Sukuk Al Musharaka), or investment (Sukuk Al Istithmar). Sukuk can be made in connection with different techniques.

[2] Tariq, A. (2004) Managing financial risks of sukuk structures. p 9.

One of the most common techniques for structring Sukuk is to duplicate the cash flows of conventions.. These structures are listed on exchanges stocks, such as Luxembourg Stock Exchange and London Stock Exchange in Europe,

A key technique to protect capital protection without resorting to loan is the binding promise to repurchase certain assets, e.g. in the case of Sukuk Al Ijara, In meantime a rent is paid, often measured to an interest rate like LIBOR (which is disapproved by Sharia Scholars).

According to Shar'a's point of view, certificates of debt are not tradable (although a different opinion is held by many in Malaysia), Certain structuring elements for Sukuk Al Musharaka, Sukuk Al Mudaraba and Sukuk Al Istithmar

Therefore, the Sukuk Al Ijara , tradable, can be considered as the most accepted structure. Debt certificates can be purchased prior to the finance occurs; thus, they are held to maturity from an Islamic perspective. This is critical on debt trading at market value regarding any difference to be like the prohibited Riba (interest on money).

Sharia considers money the measuring tool that calculates the value of money, not an asset in itself. Therefore it requires that one should not receive income from money alone. Such regeneration of money from money (simplistically, interest) considered as “Riba", which is forbidden in terms of Islamic Shar'a. According to the Islamic financial system,selling debts, the receivable and conventional loans and credit care are illegal and prohibited.

The Islamic Shar’ia particularly the Islamic financial system has applied the principle of doubt or uncertainity in all affairs related to the existence of an asset in the contract. Furthermore, Shar’ia also applies the concept of maslahah or "public benefit", denoting that if the cancellation of the bank treatment accompanied by interest rate may affect badly the public benefit, we should avoid canceling. However, the idea of public benefit is Debatable.

In short, Sukuk is known for asset-backed, stable income, tradable. Furthermore, it is compatible with Shar'ia trust certificates. It is noted that Sukuk can be issued provided that the government monetary authority, corporate body, the banking and financial institution or any concerned entity provides assets on the balance sheet. The identification of suitable assets is the first and the most integral step in the process of issuing Sukuk certificates.

## 2.2. Types of Sukuk

### 2.2.1 Pure Ijarah Sukuk

This type of certificates is issued on the independent assets shown in the balance sheet. “The assets are divided into leased parcels of land or leased equipment such as aircraft and ships. The rental rates of returns imposed on these Sukuk can be both fixed and floating, depending on the particular originator”[3].

### 2.2.2 Hybrid/Pooled Sukuk

Recording to Triq “The underlying pool of assets consists of Istisna’, Murabahah receivables as well as Ijarah. Having a portfolio of assets including variable classes

[3] Abdulstif, M.(2005) Issuance of sukuk landmark tow ards Islamic capital market Brunei.

allows a greater mobilization of funds' Murabaha and Istisna assets may include portfolio. However,at least 51 percent of the pool must comprise of Ijarah assets. Because the fact the Murabahah and Istisna' receivables belonging to the pool, the return on these certificates can be described as a pre-determined fixed rate of return"[4].

### 2.2.3 Variable Rate Redeemable Sukuk

"The above mentioned two types of Sukuk would partially exemplify the strength of the issuer's balance sheet under certain conditions. Implementing Sukuk by indicating the full strength of an issuer's balance sheet is beneficial."[5]

Several entities refer to this type of Sukuk as Musharakah. Musharakah is considered as an alternative to Sukuk as it reflects greater importance "to the issuer's equity, its fixed nature and its y stable rate in comparison to dividend payout"[6].

## 2.3 Conventional bonds

A bond can be defined as a formal contract that helps to repay borrowed money with interest a fixed time. Unlike the Islamic Sukuk, a bond is a debt security in which the authorized issuer is obliged to pay interest (the coupon). The interest rate is fixed in connection with the terms of the bond and ; the debtor shall repay the principal at maturity or the due date .

Accordingly, the bond is similar to the loan. The issuer can be called "a borrower (debtor); the holder can be called a lender (creditor), and the coupon is equal to the

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[4] Tariq, A. (2004) Managing financial risks of sukuk structures. P20.
[5] The same above mentioned source.
[6] Tariq, A. (2004) Managing financial risks of sukuk structures. P21.

interest. Bonds supply the debtor with funds to finance his long-term investments”[7]. In the case of government bonds, the bonds are used to finance current expenditure.

Certificates of deposit (CDs) or commercial paper are considered the instruments of money market not bonds. Bonds must be repaid at fixed dates.

Bonds and stocks are affiliated to securities. However, the main difference between the them is that the stockholders possesses shares at the company (i.e., they are owners),. The bondholders have creditor shares in the company (i.e., they are lenders). Additional difference is that bonds shall be paid at maturity, or at the due date, and in case of payment failure, the bond is deemed nullified., However, the stocks may be outstanding for ever.

### 2.3.1. Issuing of conventional bonds

Underwriting is considered the most common technique for issuing bonds. The underwriting process can be made as follows; one or more securities firms or banks formed a syndicate, then buy an entire issue of bonds from a debtor and finally re-sell them to investors. However government bonds are sold in public auction. In reality, the financial crisis reveals to what extent the security’s firms are ready to perform underwriting. Primary issuance is made by book runners who are responsible for organizing the bond issue, having direct contact with investors and acting as advisors to the bond issuer, advising then about timing and price of the bond issue. The book runner’s potentiality to underwrite should be investigated prior to opening books.

[7] O'Sullivan, M. & Sheffrin, S. (2003). Economics: Principles in action. Upper Saddle River.pp 197-205.

### 2.3.2 Examples of conventional bonds

1) Fixed rate bond can be defined as the traditional bonds that have a coupon as they remain steady and unchanged throughout the life of the bond.

2) Floating rate notes (FRNs) can be defined as conventional bonds that have changed the coupon connected “with a reference rate of interest, such as LIBOR or Euribor. For example, the coupon may be defined as three month USD LIBOR + 0.20%. The coupon rate is recalculated regularly per month or per three months”[8].

3) Zero-coupon bonds are conventional bonds that do not incur any “regular interest. They are issued at a substantial discount to the par value, accordingly, the interest rate is effectively delayed till maturity (and usually taxed as such). The bondholder receives the full principal amount on the redemption date”[9].

4) Inflation linked bonds are traditional bonds in which the principal amount and the interest payments are affiliated to inflation. The interest rate becomes lower than fixed rate bonds paid at the same due date (this position briefly changed itself for short-term as what happened with UK bonds in December 2008). However, the more the principal amount grows, the more the payments increase with inflation.
5) Other indexed bonds are “equity-linked notes and bonds indexed on a business indicator (income, added value) or on a country's GDP”[10].

[8] Edelman, R. (2004) The trutn about mony. Pp 85-97
[9] The same above mentioned source.
[10] Edelman, R. (2004) The trutn about mony. Pp 85-97.

6) Asset-backed securities are conventional bonds whose interest and principal payments are supported "by underlying cash flows from other assets. Examples of these are mortgage-backed securities (MBS's), collateralized mortgage obligations (CMOs) and collateralized debt obligations (CDOs)[11]".

As examined above, the essence of the conventional bond investment provides the best interest for the lender as it affects badly the borrower. Furthermore, it does not pay attention to any ethical considerations. Scholars argue that world's financial crisis resulted from the unethical and immoral practices such as imposing too many interest rates and/or overestimating the value of assets; the unfair and deceptive lending practices to attract borrowers into loans that they will not be able to repay them.

Bringing light again onto the Sukuk, "the Sukuk market has come to light during the previous three years at the beginning Bahrain issued domestic sovereign fixed-rate Ijara and Salam Sukuk. Then, it was followed by the issuance of floating rate Ijara Sukuk as well as pooled Sukuk by both corporate and governmental bodies in several countries. These Sukuk are based on Salam, Ijarah, Istisna, Istisna-cum-Ijarah and on the basis of pooled portfolios"[12].

### 3. Risks Underlying Sukuk Structures

Although the Sukuk system has provided its fairness and justice , as it is ethical than the conventional bond system, it reflects various risks such as the type of investment .

[11] Kahf, Monzer (1997), "The Use of Assets Ijarah Bonds for Bridging the Budget Gap", in Ausaf Ahmad and Tariqullah Khan (eds), Islamic Financial Instruments for Public Sector Resource Mobilization, Jeddah: Islamic Research and Training Institute, p. 265

[12] Khan, Tariqullah and Habib, Ahmad (2001), Risk Management: An Analysis of Issues in the Islamic Financial Industry, Jeddah: IRTI Occasional Paper # 5.

In addition, some of these risks are inherent n the market disregarding the type of investment involved.

### 3.1 MARKET RISKS

It is very important to differentiate between market risks and other types of risks. Market risk is defined as the risk falling on the instruments traded in the market. Two categories of market risks are exemplified: the first is the general (systematic) and the second is the specific (unsystematic). Systematic or general risks result from the shifts in the governmental and economic policy. However, the unsystematic risk results from applying different instruments by each firm as each company adopts its own specific instruments Market risk consists of interest rate risks, foreign exchange risks, equity price risks and commodity risks.

### 3.2. Interest Rate Risk

As far as Sukuk is concerned, this can be considered as a rate of return risk. Repeatedly speaking, Sukuk based on fixed rates are exposed to the same risk as fixed rate bonds. “The rise in market (interest) rates leads to the fall in the fixed-income Sukuk values. For example, on January 1, 2009, an investor buys a 2 year Sukuk at 10% annual return rate. On January, 2, the market rates increase to, say, 15%. Although the market rates have changed, the Sukuk holder will still get the 10% coupon payments. Hence his asset now earns less than the 15% market rates”[13].

### 3.2. Unfair Competition with Conventional Bonds

[13] Tariq, A. (2004) Managing financial risks of sukuk structures. P43.

Sukuks are designed by detaching the assets from the balance sheets. In fact, this represents a great difficulty that faces the Islamic financial institutions. Recording to Tariq "Non-tradable debts control the assets of Islamic financial institutions. Hence, there is no possibility for these institutions to issue Sukuk, unless they undertake more Ijara contracts"[14].

Furthermore, product-mix and contract specifications are very competitive, which appears clearly in the dualistic global financial market dominated by a conventional system. "Ultimately, despite all efforts made by Islamic banks to design Ijarah contracts on a fixed rate basis, floating rates is only significant foundation of investment as a result of market forces and severe competition"[15].

### 3.3. Foreign Exchange Rate Risks

Currency risk arises from unfavorable fluctuations of exchange rate that affects gravely on the foreign exchange positions. In in case of arising from a disagreement between the unit of currency in which the assets in the Sukuk pool are designated, and the currency of designation in which the Sukuk funds are accumulated, the Sukuk investors are exposed to an exchange risk.

### 3.4. Credit risk

Credit risk shows that an asset or loan may become irrecoverable because of default in settlements. If the relationship involves a contracting or written arrangement, the counterparty risk can be stated in the probability that the counterpart refuses to

[14] Tariq, A. (2004) Managing financial risks of sukuk structures. P43.
[15] Tariq, A. (2004) Managing financial risks of sukuk structures. P 45.

comply with the conditions of the contract. The consequences can be represented in the decline of the value of a bank's assets.

### 3.5. Sharia Compliance Risks

"Shari'ah compliance risk refers to the loss of asset value as a result of the issuers' breach of its fiduciary responsibilities with respect to compliance with Shari'ah. There could be several cases of willful or innocent breaches. The dissolution clauses of the Sukuk define events that will make the Sukuk deed null and void due to Shari'ah non-compliance. For example, if the Sukuk is based on a hybrid of Ijara and Istisna' assets, Ijara must always be more than Istisna' in the pool, otherwise the Sukuk deeds will dissolve"[16].

### 3.6. Operational risks

II. **Default Risk**: This occurs when each document has conditions for the termination of the certificate in case of a default by the obligor.

III. **Coupon Payment Risk**: This occurs when the obligor may fail to pay the required coupons on time.

IV. **Asset Redemption Risk**: This happens "when the originator has to buy back the underlying assets from the certificate holder. The principal amount paid may not be equal to the Sukuk issue amount and, as a result, there is the risk that the assets may not be fully redeemed"[17].

[16]Global investment House.
[17] Tariq, A. (2004) Managing financial risks of sukuk structures. P 52.

V. **Investor Specific Risks:** These are primarily regarding liquidity issues and in such a case, the certificate holder is subject to several risks related to Sukuk structures.

VI. **Risks Related to the Asset:** This occurs when the "underlying assets of the Sukuk certificates are subject to numerous risks as well. Primarily, there is the risk of loss of the assets. These are minimal with regards to Ijarah assets of land parcels. However, in the case of equipment and large scale construction typifying some of the underlying IDB assets the risk of loss may not be so negligible"[18].

### 3.7. Institutional Inflexibility

Sukuk originated in "developing countries. The financial infrastructure in some of these countries such as Bahrain and Malaysia are well developed. However, generally this infrastructure is weak in most emerging economies"[19]. Furthermore, Sukuk require unique Sharia structures. This creates a state, called of the institutional rigidity that cannot be removed in the short run As it helps consistently increase the risks of Sukuks. The features of this state are:

- Lack of best practice uniform regulatory standards and regimes;
- Weaknesses in "legal framework support, particularly, in the treatment of default;
- Non-uniform accounting, auditing and income and loss recognition systems;

[18] Tariq, A. (2004) Managing financial risks of sukuk structures. P 53.
[19] Tariq, A. (2004) Managing financial risks of sukuk structures. P 54.

- Non-robust investment appraisal, promotion and monitoring infrastructure”[20].

**Conclusion**

The use of Sukuk or Islamic securities have become increasingly popular in the last few years, as a means of raising government finance resources through sovereign issues, and as a way of providing companies with the fund through the offer of corporate Sukuk.

“Sukuk has developed as one of the most significant mechanisms for raising finance in the international capital markets through Islamical approved structures. Multinational corporations, sovereign bodies, state corporations and financial institutions use international”[21] Sukuk issuance as an alternative to syndicated financing.

“A bond is a contractual debt obligation whereby the issuer is contractually obliged to pay to bondholders, on certain specified dates, interest and principal”[22]. However, the Sukuk holders claim an undivided beneficial ownership in the underlying assets. Consequently, Sukuk holders are entitled to share the revenues generated by the Sukuk assets as well as being entitled to share in the proceeds of the realization of the Sukuk assets.

A distinguishing feature of a Sukuk is that in instances where the certificate represents a debt to the holder, the certificate will not be tradable on the secondary market and instead is held until maturity or sold at par.

[20] Tariq, A. (2004) Managing financial risks of sukuk structures. P 54.
[21] Global Investment House, Sukuks – A new dawn of Islamic finance.
[22] The same above mentioned source.

The market for Sukuk "is now maturing and there is an increasing momentum in the wake of interest from issuers and investors"[23]. Sukuk has confirmed their viability as an alternative means to mobilize "medium to long-term savings and investments from a huge investor base.

Different Sukuk structures have been emerging over the years but most of the Sukuk issuance to date have been ijara Sukuk, since they are based on the undivided pro-rata ownership of the underlying leased asset, it is freely tradable at par, premium or discount"[24]. Tradability of the Sukuk in the secondary market makes them more attractive.

With the financial crisis, that stroke the global financial markets, calls for more ethical financial products and financial laws have emerged worldwide paving the way for Islamic financial products to prosper and probably lead in the future.

[23] Finance in Islam, Islamic bonds sukuk.
[24] The same above mentioned source.

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