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Islamic Finance: Fit for Purpose or Mere Replication?

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Abstract

The form versus substance issue is not a new phenomenon in Islamic finance. Beyond question, one of the verses emphasising the superiority of substance over form is surah al-Baqarah: '*Righteousness is not that you turn your faces toward the east or the west, but righteousness is one who believes in Allah, the last day, the angels, the Book, and the prophets and gives wealth, in spite of love for it, to relatives, orphans, the needy, the traveller, the who ask for help, and freeing slaves…*'(2:177) In the verse, it is stated that the true goodness and respect for Allah is not to turn its face towards east or west during the worship. Put differently, the Qur'an idealises an understanding wider than a mere formalism that is not based on the virtues of faith, religion, and morality. In this article, it is discussed whether the understanding of the substance over form, which is adopted in the sources of Islam, is fully implemented or not.

In this article, first, prohibitions against riba (as a guiding principle of Islamic finance) in the Quran and its historical roots are examined to understand what the purpose of these restrictions is by looking at Islamic finance philosophy. Second, various contract types which have been used to circumvent the prohibition of riba through hilah and their historical origins are also be criticised. Lastly, some Islamic finance contracts, which are frequently used in Islamic finance, and which are similar to the contracts in conventional finance in terms of economic outcome, are examined. It is also evaluated to what extent the Islamic finance sector, which is structured in line with the classical view on riba, is unique. Also, the criticism of Islamic finance being same as conventional finance both economically and legally is examined.

Islamic finance contributes to the expansion of financial inclusion and the growth of the financial industry. Islamic finance may enhance financial access by broadening the scope of available financial products and promoting the inclusion of individuals who lack access to financial services. Islamic banking has a strong emphasis on partnership-style financing, which may be helpful in enhancing access to capital for small businesses. It also contributes to enhancing financial stability due to its relatively uncorrelated financial products operating in line with the risk-sharing and avoidance of leverage principles. However, Islamic finance industry needs to develop new innovative products to differentiate itself from conventional banking and accommodate the concerns of investors regarding the authenticity of the system.

Keywords: Islamic Finance, Islamic Banking, Islamic Finance Theory, Substance over Form

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Introduction

Islamic finance has been labelled as ‘prohibition-driven’ finance as it forbids interest and speculation-based transactions. (El-Gamal, 2006). Ribā term literally refers to ‘usury’. Usury is originated from the Medieval Latin term ‘usuria’. The term was used to mean the fee charged for the use of money. Usuria term was used long before the emergence of the monotheistic religions, and interest was forbidden even in times before these religions. (Rehman, 2008)

The Hammurabi Code of Laws (1760 BC) is the first legal material includes provisions that prohibited interest. Hindu Law dating back to the 400 BC was another one that condemned the interest in money lending (Van De Mieroop, 2004). This practise, which was originated from ancient times, continued in Islam just as in Judaism[1] and Christianity.

Some jurists have been in tendency to perceive Islamic finance terms with the mentality of 1400 years ago, while others have approached innovatively considering the needs and necessities of the modern economy. Indeed, since ribā that means increase or grow was explained in Qur’an and Sunna explicitly, the debate as to what should be understood from the term of ribā and whether it includes all sorts of increase or only usurious interest continues (Eisenberg, 2012).

As stated by Ibn Hanbal the practise of "pay or increase" is the only type of riba that is categorically prohibited by the Qur'an (Ibn Qayyim al-Jawziyyah, d. 1350 cited by Vogel & Hayes, 2006). Although the Quran does not have explicit classification for riba, it is mainly categorised as three forms which are riba-al jahiliyya, riba al-nasia and riba al-fadl by scholars. Ribā al-jahiliyya refers to pre-Islamic practises of ribā in Arabia. In any kind of debt/credit relationship, if no increase is set, when the debt is due and the debtor fails to pay, or if it is already clear that the debtor cannot repay the debt at maturity, the creditor offers either the payment of the principal or the postponement of the debt with the additional amount to be added on the principal (Morrison, 2017).

As this practise called as ‘pay or increase’ had existed in Arabia before revelation of Islam is the only form of ribā according to Ibn Ḥanbal the founder of the Hanbali school (Vogel & Hayes, 2006).

Arabic root meaning nasa’a means delay or defer. This type of ribā refers to money exchange for money with deferment and thereby simply corresponds to interest in conventional finance. Any financial transaction that results giving or getting any additional predetermined payment in exchange of a loan is considered as ribā al-nasia. Ribā al-fadl is originated from the well-known hadith: ‘Gold is to be paid for by gold, silver by silver, wheat by wheat, barley by barley, dates by dates, and salt by salt, like for like and equal for equal, payment being made hand to hand, if these species differ, sell as you wish provided that payment is made hand to

[1] One of the explicit statements in the Hebrew Bible regarding prohibition of usury as follows: *‘If thou lend money to any of my people, even to the poor with thee, thou shalt not be to him as a creditor; neither shall ye lay upon him interest’*. (Exodus 22:25)

hand' (Muslim). According to this rule two prohibition appear regarding exchanging these commodities. The first one is that exchanging of one of the specified commodities with the same commodity of different class. The second one is that the exchanging of equal or unequal amounts of the six commodities in themselves (Morrison, 2017).

The view of the Islamic schools as to whether the list is limited only to those listed, as in many other issues, differs from each other. While Ḥanafīs extend the scope of prohibition to all fungible goods being in measurable quantity, Shāfiʿīs and Mālikīs apply the ban for only storable foodstuff, gold, and silver. Ẓāhirīs, on the other hand, restrict the extent of hadith limiting only to the commodities mentioned in the hadith (Visser, 2009).

Although there has been a fallacy that ribā simply means interest, with the term of ribā is aimed to describe a wider concept including interest. Ribā does not only cover money loans but also unequal exchange of goods (Visser, 2009). The distinctive feature of this type of ribā al-fadl is that it does not include time factor. All sales within a single type with inequality, with or without delay is prohibited. One cannot sell, for example, good quality dates for a larger quantity of poor-quality date (Vogel & Hayes, 2006). As rightly stated by El-Gamal, ribā al-fadl is targeted to prevent evasion of law by way of a credit sale-like transaction as a result of exchanging the same type of goods in different amount (El-Gamal, 2006).

Ribā as the term at the heart of the whole Islamic finance system and the principle and notion behind prohibition of ribā in financial transactions have been perceived differently. Even though, Qur'an and Sunna have explicit provisions on the prohibition of ribā (interest), the problem arises from the interpretation of the verses mentioning riba since Qur'an does not describe the ribā term. Aldohni states, although the meaning given to the word ribā is controversial, the prohibition of ribā is clear (Aldohni, 2011).

Surah Al- Imrān explains the prohibition of interest in the following terms:

'*O believers, take not doubled and redoubled ribā, and fear Allah so that you may prosper. Fear the fire which has been prepared for those who reject faith and obey Allah and the prophet so that you may get mercy*.' (3:130-3:132)

Why does meaning of ribā need to be clarified and its application to modern banking transactions to be addressed before all else? On the assumption that the ribā is understood as an interest as literally used in conventional finance, then the whole modern conventional economic structure would be inappropriate. Whereas, if ribā just stands for usury, then most of the conventional finance transactions become valid as long as interest rates are not unreasonably high which means an independent financial system with its own rules is nonessential (Khalil, 2006).

Since the emergence of the prohibition was based on exploitation of needy people in Prophet's time, some authors have suggested that the prohibition would not be applied in commercial affairs (Balala, 2010). According to al- Ashmawi, Qur'an refers to usury with the word ribā (Shepard, 1996) (Referring the Quranic expression of doubling and redoubling the money). He

also points out that the scope of the prohibition of ribā has been widened by fiqh which is, in essence, religious thoughts not religion. Authors having an innovative approach have supported the view that today's economy has no common ground with the Prophet's time (Shepard, 1996).

Balala emphasises that Qur'an does not refer to interest in loans while using the 'ribā' term, rather it refers to unjustified benefit provided from any transactions such as debt, sale, or lease (Balala, 2010). Although prohibition of ribā was not only addressed for loan (qard), but also debt (dayn), and sale (bay'), ribā has been considered equal to interest and therefore Islamic financial engineers have developed interest-free financial products (Saeed, 2011).

Eventually, those who favour reform among Muslims scholars 'reject the entire mediaeval conception of riba as an outmoded idea, as they think the concept is neither essential to the birth of capitalism nor relevant to modern theories of capital and interest' (Haque, 1995). Therefore, the main argument that is put forward by contemporary scholars has been the fact that modern economy inherently in an inflationary characteristic and thereby the prohibition of ribā would not apply to nominal interest but apply to real interest (means the difference between interest rate and inflation rate) (Baldwin & Wilson, 1988).

On the other hand, according to some, whether prohibition of ribā includes interest is not even disputable and all forms of interest is forbidden (Uzair, 1978). From this perspective, the reason for ongoing debate over what was meant by the concept of ribā is the desire to harmonize the global finance principles of 21st century which interest is considered indispensable and Islamic finance that interest is prohibited.

Siddiqi, one of the proponents of the classical theory, describes contemporary interpretation of ribā as the 'efforts for validating bank interest' which is forbidden by Islam (Siddiqi, 2004). Likewise, Iqbal and Molyneux define ribā as regardless its amount (big or small) any value added to principal in a loan (Iqbal & Molyneux, 2004). Another well-known scholar Usmani favours the classical ribā understanding and characterises it as 'any additional amount charged from a debtor' (Usmani, 2002).

By the same token, Iqbal and Mirakhor, having an opposite view to the idea that ribā only means excessive interest and does not include interest, state that doubling or re-doubling money could happen even at a very low interest rate in a long term. Thus, ribā covers not only exorbitant rate of interest but also any other interest at any level (Iqbal & Mirakhor, 2011).

1. Hīlah (Legal Artifice) and Its Origins

Hīlah is a legal stratagem and artifice. In other words, hīlah is a legal method that enables people to reach economic and legal outcomes that they would not arrive at without violating law through evasion of law. Hīlah, as a method favouring a formalistic approach to financial transactions, has been used since the early era of Islam and has been accepted by all classical scholars (Horii, 2002).

One of the similar legal devices to the hīlah in Islamic terminology was used to circumvent prohibition of usury in medieval Christianity under the name '*Contractum Trinius*'. In the 13th century, a canonist named Hispanus proposed a notion for the first time against the medieval Catholic Church's ban on usury. Although usury was prohibited, if the debt was not paid at maturity, the lender might have charged a certain amount for the period between the maturity and the payment of the debt which was named as '*interesse*' by Hispanus (El Diwany, 2016). Shortly after this notion was proposed, '*Contractum Trinius*' that combined three different types of contracts was devised by European bankers and merchants. Basic principles of the contracts as follows: A lender would invest for a partnership between himself and a borrower for a one year on a profit and loss sharing basis. Following this, the lending party would sell the right to any profit above a pre-determined rate of profit. Lastly, a lender, to be able to secure his investment, would purchase insurance for the sum he would invest. In fact, this contract was nothing more than a modern loan agreement economically in terms of its impacts on both sides (Rehman, 2008).

Indeed, *Contractum Trinius* and many other types of contracts used to disguise interest-bearing loans became so widespread and even the Church itself soon became a party to such contracts. The evolution process of practise of usury is explained by Barnett as follows: '*Medieval lawyers and their clients became spectacularly adept at circumventing the laws by disguising interest payments. The Church itself was a borrower and a lender and it, too, made use of the ingenious methods of casuistry that had been developed for paying interest without appearing to pay interest. In short credit financing had become too pervasive and integral a part of economic life that no amount of theological argument was going to make it go away. Although theologians continued to argue the moral fine points of the usury problem, by the mid 14th century there was a marked decrease in the Church's actual prosecutions of usury, and it even began to change its laws to allow moderate interest rates*' (Mielants, 2007).

After this practice became common and widespread, the pressure of the European merchants on the Catholic Church led to the Church put an end to its doctrine on prohibition of usury. Today, although the rule of prohibition of interest had been abandoned in the Christian laws, the usury is still considered as unlawful gain in Judaism and Islam.[2]

Another contract type is used to circumvent the prohibition of ribā which is defined as '*idealistic but impractical canonical restraint on contractual freedom and on business life in general*' is *'ina* (known as *Contractus Mohatrae* in Canon Law) (Zimmermann, 1996). The contract is based on the principle that one party sells his good to other party for cash payment, and the other party sells it back on credit which enables one party to get a loan with interest from the other party (Vogel & Hayes, 2006). Under the contract, the debtor sells his commodity to the creditor for a certain amount of money in cash and thereafter immediately purchase back the same commodity for a higher price as payable later (the margin between two sales equal to interest income). (Vogel & Hayes, 2006).

[2] The proscription lasted 1530s until Henry VIII removed in England.

Bai al-Wafa (Sale and buyback) contract is considered to have been one of the examples of this practise. A party in need of cash sells his asset to the other party of the contract and rents back the same asset (rent is determined as equivalent to interest rate) on condition that once the seller pays back the full price of the asset, he will have right to repurchase the asset. (Ahmed, 2011).

It can be said that there are two different kinds of views on permissibility of hilah. According to the view that favours the use of ḥilah, the ḥilah is neither a way of circumventing legal rules nor a tool used with intent to disguise interest-bearing transactions; rather it is a concept that meets the needs of social needs and changing Islamic legal system (Horii, 2002).

Although the spirit that Islamic finance has and the ideology behind Islamic finance emphasising equality and fairness in finance is indeed offer a sound concept, the system has evolved into an application of formalistic principles. Ignoring the aims and spirit of Islam, the main goal has become to achieve the desired outcome in conventional finance through Islamic finance (Vogel & Hayes, 2006). Schacht, likewise, stated the scholars in pre-modern era used legal artifices to fill the gap between the legal maxims of Islamic law and social practise of Muslims (Schacht, 1926). As rightly stated by El-Gamal, '*when people examined the nitty-gritty legal details, the issue of Islamic finance became a much more formalistic exercise.*' (El- Gamal, 2008).

2. Islamic Finance Philosophy

Islamic finance philosophy opposes a financial system that allows income to be obtained without considerable effort. So-called non-productive society, in which affluent individuals do not participate in trade because of their interest income, is not desired.

Instead, an idealised society is one in which people invest with their money and engage in commerce for the benefit of entire community. It should be emphasised that Islam do not forbid entrepreneurs from doubling or tripling their money; rather, they do it through debt financing. A society in which people invest with their money and participate in trade would serve the whole community is idealised (Aldohni, 2011). What is forbidden by Islam is not the capitalists to double or triple their money; rather they do so through debt financing.

According to Islamic understanding, when people are left entirely to their own preferences, they tend to excessive borrowing behaviour. Religious or ethical rules imposing people to act in parallel with the divine rules and thereby serve as a pre-commitment mechanism can play an effective role in preventing people from excessive debt to their own detriment (El-Gamal, 2006). And the second reason is that adherence to religion has historically been assured via adherence to forms. Therefore, the contract types were designed by jurists embodied the spirit of the law (El-Gamal, 2006).

Ibn-Qayyim, while explaining the rationale of prohibition of interest, referred to the interest concept used in pre-Islamic times. Qayyim stated the key element of ribā is '*pay or increase*' understanding which is in contradiction with the charity concept in Islam. Islam praises the one gives charity and condemns the person exploiting needy person (Vogel & Hayes, 2006).

Indeed, various aspects of Islamic religion, such as praising almsgiving (sadaqah), considering charity (zakāh) to be one of the five pillars of Islam, and prohibiting ribā in financial transactions, are manifestations of Islam's understanding of preventing the rich from becoming richer, the poor from becoming poorer, and providing economic equality in society. (Vogel & Hayes, 2006).

Cizakca states '*The problem here is that modern Islamic finance is not built directly from the Islamic law but rather from the Islamically modified conventional banking which results high costs, low profits, and a dilution of respectability. Since Islamic finance has not developed its own genuine Islamic instruments, another approach is necessity. The essence of this approach is the realization that there is a substantial difference between the Western homo-economicus, the rational man, who acts purely to maximize his profit, and the homo-Islamicus, the Muslim person, who also tries to maximize his profits but does so subject to the laws and ethics of Islam*' (Cizakca, 2011).

Asutay and Yilmaz states the precepts of the Islamic moral economy express the essence of the notion of shared prosperity, as well as incorporating various social and moral factors that determine economic and financial decisions (Asutay & Yilmaz, 2021).

Kilian Balz argued in a May 2008 speech at Harvard Law School that Islamic finance should not be seen in the context of the "Islamization of the law," but rather as a component of a revival of Islamic religious ethics in international business, where Sharia principles are applied as ethical principles rather than as legal principles (Balz, 2008).

Kay also considers the need of ethical finance business stating that:

We need such business organisations in the financial sector. And we should judge their success not simply by their profitability, not simply in the self-referential terms employed by the financial sector itself, but by the contribution they make to the real economy, and by their effectiveness in meeting the functions which we require the financial sector to deliver (Kay, 2019).

Kay's idea on ethical finance might be considered as valid for Islamic finance and it might be seen as a response to the question of 'what does Islamic finance offer?' as Islamic finance is being regarded as one of the ethical finance types.

3. Similar Practises to Conventional Finance and Different Perspectives

In today's economic conditions, interest is not a desired situation. However, it is a natural consequence of inflation. From an economic standpoint, financial diversification by including Islamic market products which have relatively low correlation to other markets, to portfolios is the greatest benefit for not only devout Muslims but also investors who do not act with religious motives. Even if we ignore Islamic finance products' relatively uncorrelated characteristics in economic crises, diversified portfolios backed by those products may be useful to reduce risks (Cakir and Raei, 2007).

It should be considered as an area that runs parallel to conventional finance and serves customers' needs who are willing to invest on interest-free products. And no matter how

unique or innovator Islamic finance system is, demand on the Islamic finance area must be met.

Although some reformist ideas have been raised on what the ribā is and to reconcile the prohibition of ribā with the modern economy, the view that regards ribā as interest has been the mainstream understanding. Accordingly, Islamic financial products provided by Islamic banking system have been designed aligned with the classical view. Any attempt aims at reinterpreting ribā to adapt it modern economy has been ignored by the dominant practise of Islamic finance. There is almost unanimity among Islamic scholars that the prohibition of ribā covers all kinds of interest regardless of that fact that how big or small or whether it is given for a commercial loan or whether it is given at a real interest rate or less. Lending is not a practical rent- or benefit-seeking financial mechanism in Islam since all loans are considered gratuitous in Islamic finance. The loan transaction is inappropriate because it isn't a loan at all but rather a benevolent offer of help to someone else who needs it (Balala, 2015). Indeed, as sarcastically stated by Kuran, the first and *sine qua non* criterion of being regarded as an Islamic economist is to be opposed to interest rather than to contribute to the literature (Kuran, 1995).

Islamic finance has come under fire for its structure offering financial products replicating their conventional counterparts and thereby not to meet market expectations. Although Islamic finance is legally and conceptually different from conventional finance, Islamic banking setting standards of its operations to conventional banking aims at same practical reality as conventional banking from the economical perspective. (Zaman, 2008).

Zaman claims although Islamic Banks follow different patterns and uses religious slogans emphasising they operate in accordance with Islamic principles and designate their products under the Arabic names, in reality, there is no difference in business manner and the way they operate. Further, the author illustrates his claim with examples that compare Islamic and conventional finance products (Zaman, 2008).

According to some, even the structure of special purpose vehicles (SPV's) and the reason for inventing these vehicles reveal that Islamic finance and its products are in fact nothing more than an imitation of conventional finance. Indeed, SPV's, are widely used in Islamic finance transactions, having no employees and physical presence in essence and have no other purpose than making a specific transaction.

SPV's are the generally used tools to issue certificates due to several practical reasons. SPV's hold the legal title of the underlying asset during the contract term and thus the underlying assets can be ring-fenced. SPV's also act as a means of aggregation pooling various assets that the originator has and making them 'one whole that is divisible into indistinguishable and equal parts that are themselves indivisible and betoken a pro rata ownership claim (Morrison, 2017).

Although the prevalence of the use of SPV in Islamic finance has been criticized because it resembles conventional finance methods, it should be noted, tax evasion or avoidance is not the main motive underlying the originator undertakes a securitisation, it is a fact that

securitisation process through using SPV's can reduce the tax expenses. The reason why offshore financial centres have been found more advantageous than the jurisdictions that a legal person is domiciled is because those jurisdictions enable the issuers to carry out transactions with low cost, difficulty, and the risk (Morrison, 2017).

Accordingly, jurisdictions where offer relatively favourable taxation by way of zero or fixed and agreed taxation have become preferred areas for corporate tax residency. Another reason that put the tax havens more advantageous position in terms of being preferable for establishing a SPV is that some strict conditions may need to be satisfied such as minimum duration requirements as to trading records or profitability for companies that wish to issue securities while some offshore centres offer companies to set up a SPV in an economically and politically stable environment (Deacon, 2004).

Another argument that is believed to show that the current practise of Islamic banking deviates from the aim of Islam is that although one of the main objectives of Islam regarding financial transaction is sharing any potential risk while undertaking a risky business, Islamic finance is still under the domination of murabaḥa as fixed-return-based mode of finance (Khan, 2010). This intensive use of murabaḥa products in Islamic finance is referred as '*murabaḥa syndrome*' (Yousef, 2014). Murabaḥa term is used to define a specific type of sale contract known as 'mark-up sale'. The financier, in this transaction, purchases the commodity and sells it to its customer adding certain amount profit above the owning cost. The customer makes payments on a deferred basis. Such transaction which is economically similar to conventional lending has always been a matter of debate and criticised by scholars due to excessive use of murabaha financing by Islamic banks (Kamali, Suzuki, & Miah, 2018).

In fact, according to current statistical data published by Participation Banks Association of Turkey, even only utilization ratio of murabaḥa finance surpasses 50% in all countries having Islamic banking activities (Except Malaysia, the UAE and Pakistan). Indeed, while this rate is over 90% for just murabaḥa products in Turkey, the UK has the 98% total percentage of using murabaḥa and ijara products by 2013 (Participation Banks Association of Turkey, 2015). Farooq (2015) shares the same perspective on the IFI's business manner and claims that although some distinguishing modes of transactions have been created from the legal perspective, debt-orientation of the sector bears a resemblance to conventional finance from the economic perspective.

Ongoing criticism on the Islamic finance from the emergence of the system has been the correlation between the conventional interest rates and mark-up rates. As Islamic finance transactions are aimed to profit and loss sharing, both the profit and financing profit rates are supposed to be varied in proportion to the rate of return of the financed business. The fixed rate returns regardless of the profitability of the business financed by the deposits invested by the customers raise doubts about the genuineness of the system.

However, it should be noted, due to competitive constraints, certain Islamic banks with a sizable portion of their capital coming from Islamic accounts spread out the returns offered to

depositors over time and absorb some or all losses, as needed. The net revenue from mudaraba investment accounts usually goes towards funding the profit equalisation reserve (PER). The PER benefits both investment account holders and shareholders because the bank is entitled to a pre-agreed portion of earnings from these equity-based contracts. In order to smooth investors' income over time, Islamic banks typically adopt PER. The revenue after deducting the bank's portion, or the mudarib's share, and the payment to PER funds the investment risk reserve (IRR), which is completely accountable to investment account holders. IRR is often utilised to compensate losses from investments funded with investment accounts because the mudarib does not bear losses outside of circumstances of carelessness and/or misbehaviour (Jobst & Sole, 2020).

According to the Guidance Note on the Practise of Smoothing the Profits Pay-out to Investment Account Holders (IFSB, 2010), issues relating the smoothing practises raise five problems namely disclosure and transparency issues, corporate governance issues, issues arising on liquidation, capital adequacy issues, and harmonisation/standardisation issues. In line with the scope of the article, substance over form issue regarding PER and IRR’s needs also be mentioned. The understanding of Islamic banking, which is based on the principle of profit and loss sharing and operate on entirely different grounds and obliges the investment account holders to bear a possible loss, is inconsistent with the PER and IRR’s smoothing function. For instance, in a case an investor who holds a bond which is issued to finance a real estate project and risks his return due to the possibility of failure of the project, the return would be in accordance with the principle of the Islamic law based on profit and loss sharing principle.

Smoothing creates a barrier of obscurity between unrestricted investment account holder (UIAH) in particular, and the Islamic Financial Institutions (IFI’s) striving for their financial support. This opacity can only create the misleading impression that an IFIs are operating better than they actually are.

On the other hand, some scholars argue that the criticisms about the so-called ‘*murabaḥa syndrome*’ in Islamic finance neglects the fact that Islamic finance is a part of real economy and a sub-system. In an economy where debt-based financial transactions comprise the entire system, the tendency of Islamic finance to debt-based transactions shall be more or less the same (Gundogdu, 2016).

Although murabaḥa contract is regarded as a fixed-return-based mode of finance, it is essentially a form of credit rather than an interest-bearing loan. The contract involves real sale transactions and in case of non-payment of a debt when due, the bank is not entitled to charge an additional fee as in conventional loan (Ahmed, 2014). Islamic banks require the purchase and sale of a tangible asset in their transaction which makes it difficult for banks to make speculative transactions.

The correlation between conventional interest rates and mark-up rates is explained with a single reason which is ‘competitiveness’. Admittedly, current account holders will not be

willing to a risky investment model, regardless of which bank they work with. This risk-averse character of a customer obliges portfolio managers to invest in low-risk assets in order to meet customers' needs and expectations and minimize the investment risk (Sarac & Zeren, 2014). However, it is required to make a distinction between expectation of current and investment account holders. In terms of a typical investment account offered by an Islamic bank, the deposits are not '*capital certain*', and therefore the depositor runs the risk of making a loss (Archer & Karim, 2009).

Under tawarruq transaction (as another Islamic financial instrument similar to conventional practises), on the other hand, a person who needs money (mutawarriq) purchases a commodity through deferred sale which allows him to delay his debt and sells the same commodity to third party immediately after the purchasing at a lower price to meet his immediate cash need in the classical tawarruq transaction (Sencal & Asutay, 2019).

This purchase and sale which required a person seeking for cash to be involved with the market in person rather meeting his need via loan agreement promotes direct embeddedness with the surroundings and make the transaction permissible in terms of Islamic law (Sencal & Asutay, 2019). Contrary to the International Council of Fiqh Academy's view on classical tawarruq deeming it permissible, the organized tawarruq which refers to a transaction where the bank itself sells the commodity as an agent on behalf of the customer to the third party and pays the money to the customer eliminating the intermediary steps and transfers these steps to banks, trading companies, or brokers is considered illicit (The International Islamic Fiqh Academy- Resolution No.179 (5/19), 2009).

Therefore, all stages of the transaction, including the risk of buying the commodity with instalments and finding the buyer of the commodity, are carried out by the bank or the institutions authorized by the bank, and the customer obtains the cash he needs without being involved in any stage of the transaction. The commodity, usually, is not change hands and only exchanged with other commodities in the market without any effort of the customer.

Islamic banks that include tawarruq transactions in their portfolio have always come under fire for several reasons. The formation of a tawarruq transaction that allows parties to trade same commodity many times with the main intention of having credit have caused the transaction to have been seen illicit. According to Islamic scholars, the client becomes a party of a transaction for purchasing a commodity that he would not actually want to have, and the banks becomes a mere device to provide a loan to the customer. As the bank also acquires back the same commodity that it already purchased at the first stage and there is nothing that has changed but providing the cash needed to the customer (Wilson, 2012).

Gharar, as a term refers to uncertainty, risk or speculation is one of the fundamental concepts in Islamic finance just as ribā. Although there is no direct reference to gharar in the Qur'an, some verses are thought to refer to the concept of gharar. Prohibition of gharar is stated in several hadiths with different definitions. Sale of '*the birds in the sky or the fish in the water*', '*the*

catch of the diver', 'the unborn calf in its mother's womb' illustrate the uncertainty in financial activities in several hadith (El-Gamal, 2001).

Since there is no guarantee that the subject matter of a contract will exist at the time the agreement is to be conducted, futures, forwards, and other derivatives are typically regarded as gharar. Islamic banks don't hesitate, nevertheless, to push the boundaries of what sharia boards consider appropriate (Visser, 2009).

Two forward sale contracts in Islamic finance are the exceptions to the prohibition. Salam, may be described as a sale with a payment in advance for a future delivery. An illustration of such a transaction would be the whole amount being paid in advance for a fungible good to be delivered at a certain future date and in the stated quantity and quality. Such an agreement is equivalent to a forward sell contract. During the contractual session, the entire payment must be paid. Salam fundamentally differs from a standard forward sell contract in this sense because there is no upfront payment necessary (Eisenberg, 2012). Although the crop, for example, is not guaranteed to exist in the future, agriculture would suffer significantly if this type of buyer's credit were prohibited.

The other similar practise to conventional finance is the istisna contract, which is a request to produce or construct an item with a portion of the cost paid in advance. According to Islamic law, istisna is legal due to a custom that was prevalent at the time of the Prophet that is similar to this type of agreement, based on a qiyas reasoning, as well as due to the necessities of commerce (Visser, 2009).

Under ijara contract, which is said to be the equivalent of sale and leaseback finance model in conventional finance, a company sells its property to third party and lease the same property from the buyer and thus the company obtains the cash it needs without disposing of the asset it sells. This method is frequently used in both Islamic and conventional finance with its advantages in various aspects such as freeing up cash on a balance sheet, enhancing liquidity and provide cash flow infusion to use commercial purposes as well as its accounting and taxation implications. Ijara arrangements are occupied a significant proportion of Islamic banks' portfolios.

Under wakala model, on the other hand, in order to carry out commercial business activities on his behalf, the principle appoints a person to serve as his agent, supplies the money to be used in commercial activities. An incentive charge or a performance fee may be included in the amount the principle pays the agent in exchange for his services. After deducting any performance fees, the agent gives the principal the proceeds from those commercial operations (Eisenberg, 2012). Wakala can be regarded as a more consistent structure with the Islamic principles and operationally more straightforward and more cost effective as it does not require third party involvement. Just as wakala contracts, musharaka finance model which is a universal cooperative principle based on bringing two or more parties for their shared interests seems in line with the Islamic finance principles within Islamic finance instruments.

Conclusion

The concept of maslahah, or public interest, is used to open the door for the creation of hybridity in the form of innovative Islamic financial products, based on their modern conventional equivalents, for the modern practice of Islamic banking and finance, which is constructed through the 'transformation of exception into norm' (Sencal & Asutay, 2019).

Islamic finance industry needs to develop new innovative products to differentiate itself from conventional banking. The whole system should be structured in accordance with the requirements and spirit of Islam. Nevertheless, even though there are considerable resemblances between two systems economically, even the current position of Islamic finance cannot be considered as a system that is just an imitation of conventional finance from a legal perspective.

The largest benefit, from an economic perspective, is financial diversification, which is achieved by adding Islamic finance products to portfolios, which have a relatively low correlation to other markets (Cakir and Raei, 2007). This benefit extends to both devoted Muslims and investors who are not motivated by religious beliefs. Diversified portfolios supported by Islamic finance products may be helpful to lower risks in economic crises.

Hence, there should be substantial efforts made to promote knowledge of and comprehension of Islamic finance. Islamic finance should not be portrayed as simply religious, but as a sector that provides alluring financial goods and services that are fair and reasonable.

Islamic finance is still under the domination of murabaḥa as fixed-return-based mode of finance. Murabaha financing with a profit rate benchmarked to market interest rates appears uncomfortably similar to a traditional loan. Therefore, Islamic benchmark rates need to be developed to accommodate the concerns of investors regarding the authenticity of the system.

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