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IS THERE THAT MUCH OF A DIFFERENCE: A COMPARISON BETWEEN CONVENTIONAL AND ISLAMIC INVESTMENT VEHICLES

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Abstract

The field of Islamic finance has largely focused on providing loans that are compliant with principles of the Islamic faith. A new market for sukuk bonds has been established to address the concerns that many Muslims have when it comes to the preservation of capital. Sukuk bonds while similar to conventional bonds are typically backed by a particular asset and investors receive derived profits instead of interest. While some have applauded such an achievement, others have stated that these bonds, while asset-backed, are indirectly based on risk-free interest rates and therefore should be prohibited. In the West, there are those who are even more concerned that these shariah-compliant investment vehicles may usurp conventional bonds. To quell in part this potential crisis, this paper explains benevolent principles of Islamic finance and offers similarities with conventional finance. Thus, the purpose of this paper is to help foster a dialogue that might bring both sides of this debate closer to realizing the similarities in investment vehicles so that bridges of understanding may be built and used.

Keywords: **Islamic Finance; Shariah-Compliant; Sukuk; Finance; Investments; Bonds**

JEL Classification: **E43; E44; G21; K49; P51; Z12**

INTRODUCTION

In Islamic finance there are financial instruments utilized under the teachings of the Quran. These instruments use qualities of shariah, which means they all are required to exist within a moral code and laws of the Islamic religion. These instruments are being acknowledged worldwide and are beginning to be incorporated in some governments. In fact, Karasik, et al. [1] state that "Islamic Finance is slowly becoming more regulated and practiced in countries where Muslims are a majority and even in countries where Muslim minorities dominate the political and business environments".

Countries like Malaysia, Indonesia, and The United Kingdom are using Islamic finance principles as well as conventional practices to improve their economies. There is evidence that these countries have grown substantially with these two practices intertwined [1]. As the popularity of this combining of systems continues to grow, the consistency of employing both vehicles ranges to countries where only Islamic finance exists to a hybrid coexistence where each system completes or complements the other [1].

Even though bridging the gap between Islamic finance and conventional finance seems ideal to the public's benefit, some Westerners are skeptical when the word shariah is advocated [2]. These skepticisms are generally fueled by the stigma placed on the Islamic community where one associates Islam with violence. People against the Muslim community have even begun to act in anger and assail innocent people of the Muslim faith [3]. Aggressive behavior, towards those who practice Islam, is continuing to rise says Hooper [4]. In fact, studies say that the anger towards the Muslim community and the law of shariah are growing even though most people are ignorant of the word "shariah". The reasons behind these attacks are unknown. For example, Potok [5] states the following:

It's impossible to say definitively what is driving anti-Muslim violence, 2011 saw continued and well-publicized attacks on Muslims in the form of anti-shariah law crusades and battles over proposed mosque construction. A year earlier, in 2010, anti-Muslim crime apparently was first driven up by disputes over an Islamic center planned for lower Manhattan and the baseless claim that Islamic shariah religious law was being imposed on the United States.

This behavior could be driven by the ignorance on shariah law and the associated benefits. As humans we tend to fear things we do not fully understand. Lovecraft [6] writes, “The oldest and strongest emotion of mankind is fear, and the oldest and strongest kind of fear is fear of the unknown”.

Thus, the purpose of this research paper is to attempt to break down this stigma as well as utilize the benefits from Islamic finance to the conventional finance world and contrariwise. This paper will be divided into two parts. The first part of this paper will go through what separates the two financial systems and what brings them together. The second part provides some examples of investment vehicles that are employed by both parties in order to illustrate how little the differences are between Islamic finance and conventional finance. By enervating the differences, the goal is to extend knowledge to the public associated with both financial systems.

LITERATURE REVIEW

Islamic Finance

According to Karasik, et al. [1], “Islamic finance was first institutionalized and established in 1963 in the Egyptian town of Mit Ghamar”. Like many new systems that become fortifying in the future, Islamic finance has slowly grown over the years. From the start of its existence, Islamic finance started to spread to multiple countries and branch out from its origin. It evolved and expanded globally, helping diminish the gap between the poor and wealthy with no expense or overt gain to either side. Islamic finance, in a way, modernizes the way money is handled while also bringing moral behavior and social responsibility to the population [7].

Islamic finance was created to use compassion and commerce in a rapacity driven monetary system. It offers a more convivial approach to handling money and how it should be used. Islamic finance combines development of one’s possibilities and faith to a religion or general well-being. This is why the term riba is prohibited in Islamic finance. Riba is defined as the same definition of the term, used in conventional finance, interest. Interest, is the predetermined charge placed on a new or existing loan. Interest according to an orthodox view is prohibited because it can easily be used to take advantage of the borrower in a loaning situation and can also fuel greed. Such interest is abhorred according to the Quran (2:275).

Often principles that utilize alternatives for usury are abused or altered to favor those who participate in using certain investment vehicles. However due to the modernization of banking and the fact that there is a time value of money, there seems to be a lack of consensus on the issue of what is and isn't considered usury. Farooq [8], has reviewed different opinions varying from the orthodox view to that which accepts the fact that due to inflation, there is a time value associated with money. For this paper, we will consider the sukuk bonds which are presented as an alternative to conventional bonds but nonetheless pay a certain rate on the investment. Most papers on Islamic finance begin by stating that it is a compassionate alternative as it does not involve interest [9]. A very benevolent notion as the borrower may not be able to secure the cash flow required to pay off the interest payments let alone the principal amount. But upon further investigation, one notices that due to price mark-up or rent, the amount at the end of the loan is quite similar to (if not more expensive than) that of a conventional loan. Scholars have claimed that this is not a loan but rather an investment as to avoid the terms of usury or interest. This is certainly understandable as bank holding companies would essentially dissuade the retail market of Muslim investors.

Conventional Finance

Conventional finance has been in existence and started growing exponentially from the time man discovered the acts of trading goods for other goods. Over the years it has expanded geographically and is now commonly used worldwide. It was created to regulate the use of materials that are produced. Over time, as companies were expanding and new companies was beginning to form, conventional finance used to help amateur business people start new businesses. These businesses needed funding in the primal stages in order to become something greater. Debt instruments were created so that they may be bought in order for the company to gradually flourish. When bonds are bought, the funds are used to attain materials or additional aid the company might need.

Those who bought bonds within conventional financing standards would be reimbursed and additional money would be given in the form of interest. Depending on the interest rate (and credit worthiness), this would give bond purchasers an incentive to buy bonds of an issuing company. Bond purchasing aided those looking to maximize their profits while minimizing the risk towards the invested principal.

Other Investment Vehicles and Islamic Finance

There are different kinds of investment vehicles available such as life insurance, annuities, preferred stocks, commercial paper, and common stocks to say the least. But one type of investment seems to be common in both fields and that is the investment of common stock [10]. With common shares of a publicly held corporation, an investor seeks to earn a reward based on the market share value of the tradable security. For a Muslim investor, there is a tight-rope to walk on as it is indeed permissible to purchase shares of a corporation as one would invest in a small business. The risk associated with either is still a business risk as a corporation can go bankrupt and a small business can fail, too. But, the problem lies with some Muslim investors as they may be day-trading a particular security and their intention is to simply “buy low and sell high”. While some may interpret this as gambling, day-trading isn’t left entirely up to chance as there other factors at play (e.g., interest rates, options expirations, buy/sell ratio, earnings speculation, etc.).

At this point, if one agrees that the purchase and sale of common shares is acceptable, then it is appropriate to investigate other instruments that tie into these procedures, such as buying on the margin. Buying on margin is when one borrows money from a broker/dealer to purchase a particular security. If the investment fails, money is lost and the purchaser would still need to reimburse the broker at a certain interest rate. From an Islamic perspective, this would be akin to gambling as an investor is speculating that the price of a security will rise at a rate that exceeds the prescribed interest rate on the loan for the buy on margin. When compared to owning common shares without employing a margin purchase, the loss is limited to the capital invested (i.e. should the share price drop to 0). Most Islamic scholars agree that purchasing common shares is permissible (Ross, N/A) as the risk involved is similar to owning one’s own business. The hope is that one invests in a company so that it will succeed. This leads us to another type of investment vehicle that would be prohibited in Islamic finance and that is “short-selling” a security. A short sale of a security is when an investor sells shares of a security that he/she may not own. This “naked” type of short sale is perhaps the riskiest type of investment as the potential losses are unlimited (not to mention that the investor is speculating a downfall for the company). Also, according to hadith, one should not sell that which he does not own [11].

According to Naughton and Naughton [12], “short selling and margin trading are severely restricted” (p. 145). The authors continue to say that, “the use of stock index and equity futures and options are also unlikely to be acceptable within an Islamic market”. There is more gray area here as some scholars have stated that writing “covered calls” are permissible. In this case, an investor owns shares of a particular security and is willing to part with those shares at a specific price if an option buyer is willing to exercise their right to buy. The common shareholder would’ve sold at the price anyway but would like to earn the extra premium on the sale of the call option. The “gamble” here is on the part of the buyer of the call option and thus beyond the realm of the common shareholder as the buyer is speculating on an increase in the share price of the security above the strike price (plus the premium paid) while the seller of the option essentially is either waiting for the share price to reach the strike price or he/she is waiting for the option to expire. But, one might argue that a Muslim should not engage in practices that allow others to do what is prohibited. For example, a Muslim should not own a liquor store or sell pork products as both are prohibited, even if he/she does not consume them they are enabling others to consume them. On the other hand, there are those who state that these are necessities in business as is the case when a Muslim works at a bank holding company providing loans and/or investment advice in congruence with conventional finance vehicles.

METHODOLOGY

Islamic finance can be viewed as one defined by morals and ethics. In the United Kingdom and United States, there are funds that are designed for ethical investing. These ethical funds are aligned with conventional finance but there are certain criteria that are consistent with Islamic finance. While these two financial systems may differ on the underlying moral value, those on either side can learn much from the other [13].

Different Bonds

To bring about a better understanding of Islamic finance, one investment vehicle was considered to demonstrate the similarities between the two systems. The investment vehicle is the sukuk type bond that has similar characteristics to those of a conventional system. Sukuk bonds, commonly known as Islamic bonds, are bonds based under shariah law and are not (supposed to be) based on interest. They are an investment vehicle that seeks the preservation of capital and offers creditors a priority to common shareholders in the event of liquidation/bankruptcy. These bonds often represent a company and are typically backed by an asset. Afshar [14] explains that there are two types of sukuk bonds: asset-based and asset-backed. In an asset-based vehicle, the holders are creditors and have no rights over the hard asset itself. On the other hand, in an asset-backed vehicle, the owners have recourse to the asset itself as they are owners of the asset.

If we switch gears and evaluate conventional bonds we see that asset-based sukuk bonds are similar in that both seek to preserve the initial capital invested in the vehicle. Both also have similar risks associated with the investment. In the United States, bondholders are exposed to inflation risk, interest rate risk, and of course default risk. The same is true for sukuk holders of an asset-based vehicle. Now, consider asset-backed vehicles and their potential returns on investment. In this case, the bondholder is actually an owner and their coupon payment is directly linked to the profit generated from the asset. It is not seen as a debt instrument but yet the intention is to also preserve the initial investment. But how does this differ from a conventional revenue generating bond? Besides the obvious of a corporate issued bond versus a municipality, both rely on revenue to repay investors and reward them for their investment. A toll road may be built through a revenue bond and the tolls paid will go towards the cost of building, maintenance, and interest or reward. Hassouna and Thoumi [15] proposed a model for the Perak State Parks Corporation (in Malaysia) in which park entry fees can be used to repay bondholders. Yet interest is prohibited in Islam but according to these types of bonds, there is essentially no danger to the initial capital as is seen when one owns common shares of a security. So in this case, a sukuk bond is more in tune with a conventional bond than owning common shares of a corporation.

Next, consider a zero coupon bond and how similar it is to certain types of sukuk. In both cases the investor expects to receive a nominal amount at the end of the term. In the United States, the investor in a zero coupon bond will likely declare the implicit interest earned each year on his/her taxes until maturity as there is no coupon rate and it is expected that the purchase price of the bond is heavily discounted. In a sukuk bond, an investor pays a discount to receive a nominal amount at maturity.

The difference may lie in the terminology. For example, instead of “interest” paid to a bondholder, “dividend” or “income” may be paid to a sukuk holder. Interest may be based on the credit rating and type of investment vehicle, while income should be based on the future earnings that the underlying asset generates to the sukuk holder. As was mentioned earlier, Afshar [14] summarized differences between asset-based and asset-backed sukuk. In the event of a loss or a default in payment, investors of an asset-backed sukuk have recourse to the actual asset itself and even in asset-based sukuk they are much like asset-backed conventional bondholders. There would be an underlying hard asset (e.g., a home, farming equipment, and transportation vehicles) that an investor can seek recourse in the event of a loss or default in payment. As for the asset-based bonds, the investor is providing capital but has little/no recourse in recovery in the event of a loss or default (similar to those of most corporate issued bonds). There is also another difference between the two and that is in the sale of the sukuk. In the event of a sale, under an asset-based sukuk, the investor receives face value for investment with all excess going to the originator. In an asset-backed sukuk, since the investor is a part owner of the asset he/she has recourse to recoup a profit (if any) from the sale.

While investors in a sukuk should be profiting from the revenue the asset generates, this does not seem to be the case. Unfortunately, the practice of generating income from an asset is not used in practice as most sukuk bonds are indeed asset-based [16]. In fact, El-Gamal [17] states that Islamic finance has “done little more than mimic conventional financial products less efficiently, through multiple spurious trades, leases, and special-purpose-vehicle trading partners, thus increasing rather than reducing social and financial risks”. This certainly defeats the spirit of compassion associated with Islam as when one loans money it is in fact better to forgive the loan entirely (Quran 2:280).

One of the reasons sukuk may be popular with Muslims is that it is considered in accordance with shariah. Also, there are those investors who would like to see some appreciation in their capital without exposing it to a market risk. Gerrard and Cunningham [18] hinted that the results of a 1989 study by Erol and El-Bdour in Jordan found religious motivation was not a primary role in an investor’s selection of a bank and slightly over half of the respondents were motivated by profit. They also conducted their own study in Singapore and compared the views of Muslims and non-Muslims attitudes towards Islamic banks. Their findings showed that while roughly ¾ of Muslim respondents agreed that charging for loans on a profit-loss sharing basis would benefit the borrower, only about ¼ of the Muslim respondents agreed that religious motivation would be enough to invest in an Islamic bank. They also did find that Muslim respondents might be more loyal to a bank if it suffered a loss, but it's also important to note that over 66 per cent of the Muslim respondents would deposit for religious and profitability reasons. If profitability remains a top priority, then proponents of Islamic finance haven't quite achieved the goal of presenting an alternative system based on fairness and social justice [19].

DISCUSSION

This article has shown that there are indeed similarities between the two financial systems and that the two are almost the same except for certain terms and, in the case of Islamic finance, the avoidance of certain investment trades (i.e. short selling and buying on the margin). It would seem that ownership of common shares of a corporation's stock that is "halal" (i.e. socially aware and avoids un-Islamic products) is the most Islamic investment vehicle permitted. According to McMillen and Issa [20] a company can be deemed consistent with Islamic finance as long as it does not consist of any of the following:

Produce, sell, trade, or distribute pork-related products; engage in pornography or obscenity; engage primarily in the entertainment business; engage in gambling, casinos, lotteries, or related businesses; conduct conventional financing or insurance; produce weapons or are involved in the defense industry; or produce, sell, trade or, distribute alcoholic beverages, tobacco or related products.

But also highlighted in this article is what is forbidden in Islamic finance. As one can see, each haram (prohibition) is justified with its definition and how others can easily utilize these techniques in their own best interest while harming others. If anything, gambling and interest are prohibited but investments that involve business risk are not. According to the body of literature that has been cited, bonds are considered to be permissible in Islamic finance. This is because, as was earlier described, asset-backed investments are permissible under shariah law and they hold essentially as much value as their asset-backed sukuk bonds. In reality, sukuk bonds, being asset-based, hold essentially as much value do their asset-based counterparts in conventional finance.

Conventional and sukuk bonds both serve the same function and that is preservation and an increase in wealth. Both carry inflationary risk as well as business risk. While some claim that in one case it's permissible and that in the other it is not, the sukuk bonds do not seem to look like an investment but more of a loan. Granted, in the case of sukuk, there should be a hard asset associated with the investment vehicle and this may or may not be the case with a conventional bond but if one were to employ the verse from the Quran (2:275), it still seems puzzling how sukuk bonds are akin to trade and not interest. To that end, people who are concerned about "shariah-compliant" investment vehicles, we say that there really is no need to worry as there are striking similarities with conventional vehicles and in the case of common shares or mutual funds, they can be identical. In fact, the liquidity requirements of many Islamic banks are much higher in order to avoid borrowing from other banks with interest [18]. Thus conventional bank holding companies have the advantage to be more profitable for they are allowed to use commercial paper and pay interest on these short-term loans to increase their liquidity and they are not bound to investing in corporations that are “halal” and free of interest [21]. But while this lack of accessible liquidity does not allow for growth opportunities in the Islamic financial arena, it is important to note that it does minimize the risk of default. In the United States, the market for Islamic finance may be growing but Muslims and Islamic centers have deposits in conventional banks and bank holding companies. At one local Islamic center, funds were deposited in a money market account receiving interest and the language was changed to state “dividends” received. The imam advised that if there is a profit or loss in the market then it would be permissible but to have a guarantee then this was something that required further study [22]. On the other hand, part of the long-term investments that this Islamic center invests in includes corporate bonds and bonds do pay interest so how does one reconcile faith and interest in this case? To answer this question, the following hadith may provide some justification for investing in corporate bonds:

Narrated Jabir bin 'Abdullah: "I went to the Prophet in the mosque (the sub-narrator Mas'ar thought that Jabir had said, "In the forenoon". He ordered me to pray two Rakat. He owed me some money and he repaid it to me and gave me more than what was due to me” [23].

From this hadith, a Muslim could hypothetically purchase a corporate bond at certain price (premium, discount, or par) and receive “dividend” payments twice a year with a maturity date sometime in the future. From the hadith above; if a Muslim were to purchase a corporate bond and that bond did reach its maturation date and paid a coupon twice a year, isn’t this in the same spirit that one can receive more from a loan? It is highly unlikely that a bond holder will negotiate the coupon rate, so can’t this be viewed as paying someone more than they were due - a practice that is acceptable?

Tautologically, a devout Muslim should invest primarily in Islamic financial institutions. While reasonably protecting one’s capital, one should not be led astray and indulge in the business of loaning. Whether capital is being received or bestowed to another party on a lending basis, one should keep away from such practices if there is a financial benefit such as interest as this is obviously considered haram. However, it seems that there are acceptable ways around this with similar profitable goals.

CONCLUSION

In this paper, characteristics that are common to both systems of finance were presented with the intention of illustrating the similarities between the two. Of particular interests were the similarities between conventional bonds and sukuk. The differences between the two types of bonds are negligible at best as the intention of each is to preserve investment capital.

However, to someone new to the field of Islamic finance, the underlying premise in Islamic finance is one based on moral and religious guidelines. For the purpose of this paper, one can see that the two systems are not mutually exclusive and after reviewing the similarities, one need not fear the other. While some may disagree on whether or not various financial instruments are permissible or prohibited, the purpose was not to debate this but rather to shed some light on each financial system's similarities in the hopes of addressing concerns by both sides in the general public and in the investment community so that a meaningful dialogue can be made.

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