

Acknowledgment

Securities & Exchange organization (SEO) as the supervisory & regulatory body of Iranian Islamic Capital market considers informing financial practitioners in the world about its new achievements in Islamic finance as one of its main tasks.

For this, we organized the 1st international course on “Islamic Capital Market Products” to introduce new Islamic financial instruments in Iran with the aim to develop Islamic financial system in the globe.

My colleagues at SEO, who did their best for a well-organized conference, are highest thanked. Here, I'd like to name them for their nice endeavor in organizing the conference.

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Inaugural Speech

In the 1st International Course on Islamic Capital Market, 18th of January 2009, Iran, Tehran

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In The Name of God,
The most compassionate, the most merciful.
Assalamu Alykum wa rahmatullah

Honored guests, distinguished delegates, ladies and gentlemen it is a pleasure to welcome you to this International workshop on behalf of the Securities and Exchange Organization of Islamic Republic of Iran (SEO). I hope that these meetings would be informative and facilitate communication between Islamic researchers interested in Islamic Finance.

First of all, I shall mention the history of Islamic finance at a glance and why it matters. Then I will examine the current situation of Islamic Finance in comparison with conventional financial system. Finally I will introduce Islamic Capital Market of Iran and the recent developments which have been occurred in such a market.

The Islamic Capital Market (ICM) represents the market in which all activities, transactions and operations should be carried out in line with Islamic Principles and in a way that does not conflict with Shariah rules and regulations. The ICM enforce Islamic Laws in capital market transactions as the market is empty from prohibited activities such as riba (usury), Gharar (ambiguity) and gambling.

Not only in the Muslims Communities but also in the Non-Muslims Communities, the demand for and awareness of investing in accordance with Islamic Laws has been grown and it necessitates flexible, flourishing and innovative Islamic Capital Market. We can have

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a glance through some statistics in order to emphasize our approach:

- Nowadays the population of Muslims all over the world is around 1,5 billion persons, which represents 24% of total world population of 6,3 billion.
- Regarding the size, Islamic financial market is estimated to be US\$230 billion, with an annual growth rate of 12% to 15%.
- It is said that over 250 Islamic financial institutions currently operating in about 75 countries through out the world, with more than 100 Islamic equity funds managing assets in excess of US\$5,0 billion.



Because of rapid and vast developments in the Islamic financial market, varieties of international Islamic organizations have been established during the recent decade aiming to promote and regulate such a market. Besides these organizations like Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), this International Course will be held this week providing opportunities once again in order to achieve such goals.

Today, the Islamic financial market runs parallel to the conventional financial market. Although it results in some challenges and difficulties for growing Islamic Financial System but also provides historical and remarkable opportunities for such a system.

Let me now expand on this last point and talk about global financial crisis. We meet at a crucial time. We are living through the most dangerous financial crisis since the one that led to the Great Depression. All of us know about technicality of such a crisis, I mean the story of sub prime mortgage crisis which reflects excessive and imprudent lending. But at this moment I want to emphasize on the weakness aspects of conventional financial system which lead to crisis. First I should refer to Strauss Kahn, the Managing Director of IMF. He said at the Joint Annual Discussion, October 2008, that the crisis in financial markets is the result of three failures:

- A regulatory and supervisory failure in advanced economies;
- A failure in risk management in the private financial institutions;
- A failure in market discipline mechanisms.

Regarding these three failures according to Strauss Kahn, I should say that through Islamic Financial System we can prepare and actualize the framework in which these failures could not be seen forever. This is a natural and inherent aspect of Islamic Financial System which I want to elaborate more. The focal point in such a system is justice and fair. This is a key and substantive criterion on which all activities, transactions and operations should be assessed. Justice is a balancing factor which assures financial system not deviating from Islamic goals. Setting Islamic Law in financial system will immune such a system not to be exposed by crisis. Let me review some Islamic principles in financial system and the justice-oriented consequences which will be succeeded.

1. Prohibition of imaginary and notional transactions, hence decline in excessive speculating operations and increase in market discipline mechanisms.
2. Greater reliance on equity financing will increase PLS mechanism, hence supervision will be improved and collapse of regulatory systems would be minimal.
3. Extreme emphasis on ethical and moral principles will alleviate greed and avidity of people, hence behavioral stimulus of financial crisis would be vanished.
4. Constraints on short sells with respect to ownership and possession, hence the dilemma of steep and continuous decline in asset prices during global financial crisis would be disappeared.
5. Persuasion to financial aid like interest-free loan to poor people, hence the sub prime mortgage crisis which created based on need of housing would not to



be occurred.

6. Prohibition of Gharar and Islamic concentration on transparency eliminates those non- transparency issuing securities.

These are only some of financial principles of Islam. As you see what is considered as a weakness of conventional financial systems and results in global financial crisis, simply could be solved through golden principle of Islam.

Dear Audience, we should praise God to make us proud by Shariah and its holy and sacred rules and regulations. This global financial crisis evidences conclusively once again the huge potentials of Islam to regulate our financial system. Our key duty at this historical stage is to introduce Islamic Financial System as an alternative of conventional one. This could not be achieved unlike cooperative and collaborative efforts in order to obtain relative advantages and then absolute one.

After all I should briefly remark recent developments in Islamic Capital Market of Iran. The Securities and Exchange Organization (SEO) has established as a supervisory entity under the Securities Market Act (SMA). It is the sole regulatory entity for the regulation and development of the capital market in Iran. It is directly responsible for the regulation and supervision of all activities of the market institutions, including but not limited to stock exchanges, clearing and settlement procedures, financial instruments and financial institutions. SEO as an important regulatory body for designing new instrument established the Shariah Board (2006). The Board is required to evaluate that what is and is not compliance with Shariah objectives and rules. All matters pertaining to Shariah Law should be considered by the Board and the Resolutions of this Board are mandatory and binding. Another function



of the Board is related to design and establish procedural and substantive standards aiming to facilitate applications of Islamic Products including instruments and institutions. We also established Research, Development and Islamic Studies (RDIS) as a supporting body of the president.

It is remarkable that all the Iran capital market is pure ICM, there is no any non- Shariah compliant stock in TSE. The Board in two recent years has been very successful in designing of new products in TSE. 5 Islamic scholars are the member of the Board.

Privatization should be considered as another development in our capital market. After communiqué of the General Policies of Article 44 of the Constitutional Law, new vast opportunities have been created which can expand our capital market three times in terms of market capitalization ratio. Now the MC is around \$50billion.

Ladies and Gentlemen; On behalf of the Government of Iran, invite all Muslim brothers and sisters around the world to participate in privatization process through foreign investment.

The other development is expansion of IT infrastructures in capital market. Most of the operation of capital market is now IT- based and computerized.

We have good and efficient software here with Shariah compliant. We can help you to expand these developments in your markets based on Shariah.

At the end I suggest the participants to continue these meeting aiming for strengthening ICM.

We are ready here to play this role for making some arrangements to help the other securities and exchange organizations and prepare our findings to your esteemed organizations.

At the end once again I should welcome you to be here and hope your presence in this International Islamic Workshop to be useful and supportive.

والسلام عليكم ورحمة الله وبركاته



Banking on Integrity: The Prospects of Islamic Finance in a Diverse World

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■ Abstract

As expounded by Hyman Minsky, the present-day financial system demonstrates that stability can be ultimately destabilizing in the long run. The world is now in the midst of the worst financial crisis and desperately looking for a viable solution towards a sustainable financial system. Can Islamic finance provide an alternative and sustainable financial system? In the Islamic model, the risk-averse depositors will have security of deposit at all times given that their deposits will be 100% risk-weighted. The banks will also not be able to deploy the funds deposited in wadiah accounts. As a result, there will be no cause for bank runs and no need for a deposit insurance scheme and costly lender of last resort measures. In reality, deposit insurance schemes only end up subsidizing the banks by enabling them to mobilize risk-free low-cost deposits and channel them towards even more risky credits for higher return margins.

It is a well-researched fact that the major cause of the current financial turmoil and most of the previous financial crises is excessive leverage. Islam discourages debt in general, and in particular, incurring debt for living beyond one's means or to grow one's wealth. Instead, Islam encourages investments through direct risk-bearing ventures such as mudarabah (investment trust). Similar to the conventional investment trust, if the underlying mudarabah investment performs well, investors share in the higher return. Conversely, if the investments perform poorly they receive a lower return. In the Islamic model, the financial institution will not guarantee a fixed rate of return to the investors. The mudarabah investments will be treated as off-balance sheet assets and will be 0% risk-weighted for capital adequacy purposes. Interestingly, this is comparable to the model advocated by the Chicago Plan in the 1930's and the prominent economists who opposed the fractional reserve banking. However, this alternative financial model, which is far stable than the existing one, has not been adopted for various reasons in the past. Will this alternative financial model get implemented now?

Key word: financial crisis, leverage, mudarabah, musharakah, financial Intermediation,

▣ Introduction

The ongoing global financial turmoil has prompted many to question the integrity and the sustainability of the existing financial system. Regulators are blaming bankers' greed as the root cause of the unfolding crisis. Bankers are blaming regulators for prolonging a low-interest rate environment that forced banks to seek riskier assets to remain profitable. Mortgage lenders have been blamed for booking sub-prime assets and perpetrating predatory lending. Sub-prime lenders blame the securitization and credit derivative markets for forcing them to scrape risky assets from the bottom of the credit barrel. Others blame the ratings agencies for failing to analyze the risks involved in packaged securitized products, assigning inflated ratings for risky portfolios. Many blame investors for demanding high returns even in a low-rate environment; which prompted investment managers to assume risky strategies that yielded high returns. Accountants have been blamed for the off-balance sheet treatment of securitization vehicles like the Qualified Special Purpose Entities ("QPSE") that contributed to the excessively high leverage in the system.

The present-day system demonstrates that stability can be ultimately destabilizing in the long run. As expounded by Hyman Minsky, long periods of stability have led to complacency in lending practices, causing debt to evolve from manageable debts (like amortizing home loans where the borrowers can afford both principal and interest payments), to speculative lending (like interest-only mortgage where the borrowers can only afford interest payments and principal will be payable at the end of the loan term), to eventually the riskiest "Ponzi" lending (like sub-prime mortgage, which required no initial down payment, a reduced fixed interest rate for two years, and an option to pay interest by adding back to the principal amount). When the Ponzi gamble failed, i.e. when house prices started falling and interest rates rising, the loan servicing became untenable, leading to defaults and asset sales, which further brought down asset prices due to the flood of supply on the market, and brought about the start of a downward cycle and "domino effect" which rippled through borrowers defaulting, creditors tightening and eventually the banking system nearly collapsing. The world is now in the midst of the worst financial crisis and desperately looking for a viable solution towards a sustainable financial system. The following discussion highlights the prospects of Islamic

finance providing an alternative and sustainable financial system provided there is a strong political will to reform the existing financial landscape.

▣ Time to Replace the Fractional Reserve Model

Under the current system, risk-averse depositors place their funds in bank deposits which usually pay a nominal interest rate. Under the fractional reserve banking model, the banks will retain a certain amount (average 8%) of deposits and deploy the rest through loans at a higher interest rate to a diversified pool of borrowers. In reality the risk-averse depositors (savers) are lending money to banks at low rates without any form of security (other than deposit insurance) or restrictive covenants to monitor the lending activities of banks. In theory, the savers rely on the banks ability to lend prudently and diversify their loan portfolio based on the banks' ability to gather and monitor information on borrowers; but given that banks always keep such information private this often leads to adverse selection and moral hazard problems. Banks often end up making loans to risky borrowers to earn higher returns to the detriment of the depositors who don't share in the bank's upside and lack the incentive and ability to monitor the lending activities of the banks.

Following the Great Depression in the 1930s, a group of economists from the University of Chicago presented a banking reform plan to President Roosevelt. The Chicago Plan primarily proposed the abolition of the fractional reserve model and the separation between commercial and investment banking (i.e. payment and capital deployment activities), among other banking reforms. The opponents of the fractional reserve system have included prominent economists such as Irving Fisher, Frank Knight, Milton Friedman, Murray Rothbard and Ludwig von Mises. Unfortunately, the Chicago Plan was only partially adopted under Roosevelt's New Deal program. Despite the 1933-35 periods seeing one of the greatest dislocations the U.S. economy and the collapse of the financial system, the proposal to abolish the fractional reserve system was dropped due to strong lobbying by bankers, who directly benefited from the status quo model. Ultimately, fractional reserve banking has left the door open for banks to assume even greater risks and expose the depositors to bank failures.

▣ Principle of “No Risk, No Reward”

In working to alleviate the systemic banker-depositor incentive mismatch which, as currently seen, can spiral out of control, an Islamic financial system proposes for the risk-averse savers to deposit their savings in wadiah accounts (like demand deposits) which will not generate any returns to savers. The key Islamic principle that governs all investments is “al-ghurm bil ghum” (risk is with reward or, conversely; no risk, no return). Since the savers demand no risk, they are not entitled to any return. The banks will also not be able to deploy the funds deposited in wadiah accounts, which will have to be 100% risk-weighted. The banks may end up charging a service fee to the risk-averse savers for keeping their deposits safe and providing the payment functions through branches, ATMs, etc. Further, the depositors will be liable to pay zakah (a form of wealth tax) if the funds kept in the wadiah accounts meet certain zakah conditions. Interestingly, this is comparable to the model advocated by the Chicago Plan and the prominent economists who opposed the fractional reserve banking. In the Islamic model, the risk-averse depositors will have security of deposit at all times given that their deposits will be 100% risk-weighted. As a result, there will be no cause for bank runs and no need for a deposit insurance scheme and costly lender of last resort measures.

▣ Deposit Insurance Scheme Subsidizes Banks

Instead of strengthening the banking system by abolishing the fractional reserve model, various governments across the globe have introduced deposit insurance schemes that insure depositor funds up to a certain amount, for example up to \$250,000 in the US. Many, including President Roosevelt who established the Federal Deposit Insurance Corporation (FDIC) during the New Deal era, have opposed deposit insurance schemes on moral hazard grounds. Due to political expediency, the Roosevelt administration ended up introducing the deposit insurance scheme in an effort to strengthen the fractional reserve system. In reality, deposit insurance schemes only end up subsidizing the banks by enabling them to mobilize risk-free low-cost deposits and channel them towards even more risky credits for higher return margins. The risk-averse depositors are content with the low rate of return as long as their deposits are insured. Even uninsured depositors are not too concerned with the excessive risks taken by

the banks given that FDIC have often protected uninsured depositors when “too big to fail” or “systemically critical” financial institutions get into trouble. As pointed out elsewhere, the subsidy in fact increases in value for the banks as they take on progressively greater risk, providing an additional incentive for a risk preference.

Whilst deposit insurance schemes may prevent bank runs and contagion effects in the short-run, they often encourage excessive risk taking that in the long-run increases bank failures and financial crises. Since the FDIC’s inception in 1934, a total of 3565 bank failures have been noted - averaging around 10 per year between 1934 and 1981 but rocketing to between 100 and 300 per year from 1982-1992 (peaking at 534 failures in 1989). There may be even more banking failures in 2009, with already 28 failures recorded between 2007 and 2008.¹ Further, deposit insurance schemes always run the risk of mispricing the insurance premium payable by banks due to the fact that premiums are calculated on ex-ante basis. For example, FDIC’s total pay-out to insured depositors of failed banks often exceeds the total inflow from bank insurance premiums. Even the newly introduced risk-based premium does not remove the moral hazards risk. It is very hard – and costly- for a deposit insurer to even evaluate the bank’s loan book, let alone a complicated portfolio of financial derivatives.

▣ Debt-based Financial Intermediation is Unsustainable

Because banks have access to cheap deposits subsidized by the deposit insurance schemes, banks are able to offer cheap and easy credit to their customers. For banks to achieve revenue growth, consumers are enticed and bombarded through clever marketing to borrow and live beyond their means. Corporations invariably resort to high leverage to improve their return on equity to appease shareholders. Such excessively high leverage in the system inevitably leads to excessive aggregate demand in the economy which rapidly builds inflationary pressures. To avoid a financial crisis, regulators will usually respond by shrinking the money supply through interest rate hikes or other monetary tools with the hope of reducing credit expansion and aggregate demand. When credit becomes expensive and scarce, individuals and corporations will struggle to repay their debts and bankruptcy, insolvency and unemployment

¹ <http://www2.fdic.gov/hsob/HSOBSummaryRpt.asp?BegYear1934=&EndYear2008=&State2=>

rates will increase. The process of deleveraging will begin and increase the severity of the financial crisis. Some regulators dread this painful process and opt for a softer landing which sometimes leads to a bigger problem. The current US financial crisis is a case in point.

When the investors 'irrational exuberance' fueled by excessive leverage led to the stock market bubble in the US in the 1990s and subsequent collapse, the Federal Reserve decided to cut interest rates to avoid a financial crisis. The Fed maintained a low-rate environment for almost a decade and banks consequently went on a lending-frenzy. The lower cost of deposits incentivized banks to offer even more easy credit at even cheaper rates. Predictably, the corporate and personal debt levels increased to unprecedented levels. For instance, the household debt level in the US and UK increased rapidly from around 60% of GDP in the 1990s to more than 100% of GDP by 2008. Further, the low-interest rate environment facilitated prime credit to borrow at incredibly low rates. Banks were then compelled to lend to risky credit grades at higher rates in order to boost their profitability in an otherwise low return environment.

▣ **Basel II Failed to Discourage Excessive Risk-taking**

Under Basel II, banks that partake in higher risk lending - in pursuit of higher returns - are required to allocate higher capital to commensurate with risk levels assumed. In theory, banks will avoid excessive risks in order to avoid allocating more risk-weighted capital to their reserves, which in turn reduces their return on equity. However, due to accounting loopholes banks were able to devise off-balance sheet solutions which gave them access to risky assets and excessive leverage without the need to commit any capital. The banks incentivized intermediaries - such as mortgage brokers - to book sub-prime assets which the banks underwrote and securitized through the off-balance sheet vehicles in return for a high fee income. Banks were prepared to extend loans to risky borrowers given they ultimately packaged and sold on the risk, hence keeping their balance sheet free from risk exposure. But, when the off-balance assets become non-performing due to the economic downturn, the banks were forced to treat them as on-balance sheet due to their 'retained interest' in the off-balance sheet assets or due to reputational risks. Suddenly, the leverage ratio of banks

increased multi-fold and led to high profile bank failures due to inability to inject more capital to meet regulatory requirements.

▣ Shift Towards Equity-based Financial Intermediation

It is a well-researched fact that the major cause of the current financial turmoil and most of the previous financial crises is excessive leverage - an inherent consequence of the current debt-based financial system. Islam, on the other hand, discourages debt in general, and in particular, incurring debt for living beyond one's means or to grow one's wealth. Debt should be considered as a last resort in economic transactions. To promote a debt-free lifestyle, Islam strictly prohibits the loaning of surplus funds on interest. Instead, Islam encourages investments through direct risk-bearing ventures such as mudarabah (investment trust). Similar to the conventional investment trust, if the underlying mudarabah investment performs well, investors share in the higher return. Conversely, if the investments perform poorly they receive a lower return. In the Islamic model, the financial institution will not guarantee a fixed rate of return to the investors. The mudarabah investments will be treated as off-balance sheet assets and will be 0% risk-weighted for capital adequacy purposes. Given that the financial institution and investors have to share the risk and reward of the underlying investments, the financial institutions will become more prudent and engaged in managing the assets. If their portfolio is not performing well the financial institutions will not be able to attract more investments. There is no deposit insurance to help them attract cheap deposits. Additionally, investors may liquidate their investments in a low-performing portfolio and re-invest with another manager offering a better performing portfolio.

It is believed that the Islamic model will ensure that: (i) financial institutions are more prudent in managing the assets and disincentivized from taking excessive risks; and (ii) investors would be incentivized to exercise adequate market discipline on financial institutions. Interestingly, a similar approach was proposed by the Chicago Plan which advocated: (i) a 100% reserve for all demand deposits; (ii) a 0% reserve for investment trusts; and (iii) no deposit insurance. More recently, the Narrow Banking and Core Banking proposals have also advocated the separation between the deposit-taking and lending activities of banks.

Arguably, most savers are risk-averse and are envisioned to place their deposits in “risk-free” wadiah accounts, which will remain as idle capital and create a drag on the economy’s growth potential by constraining the flow of capital in the system. However, the Islamic model has a number of factors that incentivize the risk-averse depositors to invest more of their savings in mudarabah investment accounts through the following deterrents: (i) a wadiah account “custody” fee, (ii) zero wadiah account return, (iii) zakah obligation (exclusive to Muslims), and (iv) general inflationary pressures. Financial institutions will also be incentivized to create a range of investments with a broad risk-reward spectrum to attract investors with different risk profiles. For example, if savers prefer a low risk-low return profile, the financial institutions will offer mudarabahnya which invest in low risk investments, such as government asset-backed obligations. The financial institutions will have to differentiate themselves on superior investment and risk mitigation strategies, and returns within the risk spectrum to attract and retain funds from investors. They will also prefer investments in productive assets and will avoid “unproductive” assets to remain competitive.

The Islamic system will also need to be regulated to ensure, among others, that (i) the wadiah funds are safe and secure; (ii) investors are given adequate information disclosure on mudarabah investments; (iii) there are no conflict of interest or illegal investments; and (iv) the marketing is not misleading, confusing or deceiving. To put some “skin in the game”, the regulators can require financial institutions to also co-invest in their fund portfolio (known as musharakah or partnership financing). The nature of regulation, hence, may be a hybrid between banking and securities industry regulation. Certainly, a lot more research needs to be conducted to ensure the gradual transition to the alternative Islamic model is not disruptive to the economy. Without such a transition, Islamic finance will never become an alternative and sustainable financial model.

▣ Islamic Finance in a Subsidized Conventional Financial System

Over the last three decades the Islamic finance industry has been slow to establish a meaningful presence as an alternative and viable financial system. Its roots are based in economic values cherished by all humanity, such as the equitable distribution of wealth and sustainable economy

achieved through a fair system of capital intermediation. Islamic banking, established with these values in mind, had in the beginning tried to promote capital intermediation through profit and loss sharing mechanisms involving mudarabah and musharakah. The savers were invited to invest their surplus funds through mudarababs managed by the Islamic banks in return for a share of their profit. The Islamic banks neither guaranteed the principal nor the returns. The Islamic banks then offered Muslim customers (e.g. corporates) to obtain financing on a mudarabah and musharakah basis. The Islamic capital intermediation model is comparable to the investment trust model (0% reserve) advocated by the Chicago Plan. It is a fairer system compared to the prevailing financial system which is built on debt intermediation. Savers would generate a higher return when corporates earn greater profits during an economic boom period, and a lower return (or may even lose their investment) during an economic downturn. Hence corporate financing would be linked to their operating cash flow, paying more during good times and less during bad times. There would be no bank runs per se in bad times due to the fact that the banks do not guarantee the principal used in investing. Undoubtedly, the investors will be exposed to the risks and moral hazards of mudarabah and musharakah investments and will need to mitigate those risks by choosing the right manager with the right track record and investment strategy. Obviously, this will require effort and due diligence on the part of the savers and some, if not most, will not have the expertise or capacity to evaluate the risks and mitigants involved. According to conventional wisdom, due to the depositors' lack of expertise or capacity, their savings in bank deposits must be protected through deposit insurance and lender of last resort measures.

When the Shariah promotes mudarabah and musharakah investments, it is not oblivious to the fact that not all savers will have the same the capacity to understand and measure the risks and mitigates. The Quran clearly states that:

أَنْظُرْ كَيْفَ فَضَّلْنَا بَعْضَهُمْ عَلَى بَعْضٍ وَلِلْآخِرَةِ أَكْبَرُ دَرَجَاتٍ وَأَكْبَرُ تَفْضِيلًا

“See how we have bestowed more on some than on others; but verily the Hereafter is more in rank and gradation and more in excellence. (Al-Isrâ' [17:21])”

If some of the investors fear that they do not have the capacity to evaluate the risks in mudarabah investments and to assume the risks involved, the shariah does not force them to invest in mudarabah or musharakah investments. The Quran emphatically states that:

وَلَا نُكَلِّفُ نَفْسًا إِلَّا وُسْعَهَا وَلَدَيْنَا كِتَابٌ يَنْطِقُ بِالْحَقِّ وَهُمْ لَا يُظْلَمُونَ

On no soul do We place a burden greater than it can bear: before Us is a record which clearly shows the Truth: They will never be wronged. (Al-Mu'minûn [23:62])

For those who do not have the capacity or appetite to assume mudarabah risks, the Shariah alternates are for them to store their money at home or in a wadiah account with Islamic banks. The Shariah maxim makes it very clear that unless savers assume risk, they are not entitled to any return. Unfortunately, when Islamic banking emerged, conventional banking practices were already deeply entrenched in the Muslim world. Savers were accustomed to receiving nominal returns on their bank deposits – which, as previously highlighted, are effectively government, guaranteed risk-free investments. Naturally, Muslim savers also wanted a risk-free Islamic product alternative. To remain competitive, Islamic banks were forced to offer hybrid mudarabah and wadiah accounts to their customers. The mudarabah investment accounts were treated as on-balance sheet liabilities of Islamic banks, similar to a conventional deposit, and banks would be required to set aside a portion of their capital reserves to protect the Islamic saver deposits, identical to the treatment for conventional deposits. Islamic banks provided mudarabah returns which were structured to be invariably similar to a subsidized conventional risk-free deposit. For example if a 3-month conventional bank deposit pays 3%pa, the profit sharing in a 3-month hybrid mudarabah investment will be ‘structured’ to offer a similar return of 3%pa. Islamic banks also make a periodic ‘gift’ (hiba) to those savers who place their funds under wadiah accounts which are also provide comparable returns to conventional bank deposits. From a classical Islamic jurisprudence (fiqh) perspective, a mudarabah is not a risk-free investment and should be treated as off-

balance sheet. In addition, there is no justification for a discretionary gift payment to wadiah deposit account holders in the classical form of the contract. By contrast, in light of the risks involved, mudarabah investors should be entitled to a higher return compared to the risk-free conventional deposits, and wadiah depositors could be required to pay a fee to the banks for safe-keeping of their funds.

As highlighted, access to cheap deposits subsidized by the government allows the conventional banks to offer cheap loans to the customers. At attractive rates, debt enables a “buy-now-pay-later” consumer culture, and enables corporates to increase their return on equity for their shareholders. However, if Islamic banks were to offer mudarabah financing to corporates sourced from unsubsidized mudarabah deposits (which offer higher returns to its depositors compared to conventional deposits), corporates will have to part with a higher profit amount with the Islamic banks in good times given the profit-and-loss sharing nature of the transaction. The effective cost of the mudarabah financing would be greater than the cheap loans conventional banks would be able to offer. Profit-maximizing corporates would consequently prefer the cheaper conventional loan than the mudarabah financing alternative.

As a result of the market realities, the described typical corporate behavior forced Islamic banks to shift from a classical mudarabah financing structure to debt-type financing such as the hybrid murabaha, ijarah and istisna structures, where customers incur a fixed financing rate similar to the conventional loans. Arguably, there will be a minority of customers who prefer the classical mudarabah and musharakah solutions, which have been successful in some markets such as Sudan, Iran and Indonesia (during the aftermath of the Asian financial crisis). But a closer analysis evinces that the cost of debt financing in those countries was so high so as to almost equal to the cost of equity financing. In such a high inflationary environment, the customers were rather agnostic towards debt or equity financing given the parity in costing. In fact given the macro circumstances, there may have been a preference for equity financing given the fact that the loss is also shared by the banks, unlike in conventional debt financing. Indonesia saw the issuance of a number of mudarabah sukuk - with true profit-and-loss sharing economics - during the late 1990s. However, when the Indonesian economy

recovered after the Asian Crisis, most of mudarabah Sukuk were quickly refinanced through debt financing alternatives when the fund market became amenable. There has not been a classical mudarabah Sukuk since then in Indonesia.

■ Conclusion: Promote Good and Forbid Evil

The stark reality is that due to the fractional reserve system and deposit insurance scheme prevalent in the conventional banking system, the Islamic banks are facing an unlevel playing field in terms of pricing dynamics. Savers are not incentivized to invest in classical mudarabah investments. In addition, Muslim savers also demand the benefits of risk-free accounts in addition to returns, which require Islamic banks to offer hybrid mudarabah and wadiah accounts. Furthermore, corporates have no incentive to share their upside with Islamic banks under a classical mudarabah financing when they can obtain cheap loans from the subsidized conventional financial system. Islamic banks are induced to offer hybrid murabaha, ijarah, istisna, mudarabah and musharakah solutions with fixed returns to cater to market demands. The prevailing practices of Islamic banks have provoked severe criticisms from many quarters, including recently, from the eminent scholar Sheikh Taqi Usmani. The underlying constraint is that due to the prevailing subsidy in the conventional financial system, it is almost impossible to promote the sound financial products and solutions of Islamic banking. The Quran unequivocally states:

كُنْتُمْ خَيْرَ أُمَّةٍ أُخْرِجَتْ لِلنَّاسِ تَأْمُرُونَ بِالْمَعْرُوفِ وَتَنْهَوْنَ عَنِ الْمُنْكَرِ وَتُؤْمِنُونَ بِاللَّهِ

You are the best of Peoples, evolved for mankind, enjoining what is right, forbidding what is wrong, and believing in Allah.

This verse reminds us of the collective responsibility to promote the goodness in Islamic banking as well as to correct the wrongful practices in conventional finance. One cannot harvest the goodness of Islamic finance unless the wrongs of conventional finance are made

good. This is one of the many valuable lessons that we can learn from the current global financial crisis. What is needed now is strong political will to initiate and complete the gradual transition process of the conventional financial system as advocated by the Chicago Plan and other similar proposals towards a Narrow Banking and Core Banking framework. Only then can a truly Islamic financial system be nurtured that is in line with the letter and spirit of the glorious Shariah. President Roosevelt missed a great opportunity seven decades ago. Let us not miss this opportunity now.

Islamic Futures and Options Contracts ¹

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¹ Jurisprudential views of this article are on the basis of SEO Shariah Board Resolutions.

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■ Abstract

Islamic derivatives including Islamic futures and options contracts are financial instruments which are designed and adjusted to be compliant with Shariah principles. These are new contracts which did not exist at the time of Prophet Muhammad (P. B. U. H.).

A futures contract is an agreement (not transaction) in which both parties of the contract are obliged to make cash transaction on a particular date in the future with volume and price of the asset (which is compliant with Shariah) specified. Using the commitment against commitment contract, the seller undertakes the sell of a specific amount of asset against a specific amount of money and the buyer undertakes to buy it. Both parties, according to “the article added to the contract” (Shart-u zimm-al-aqd), “pay a specified amount of money to the broker as margin”. They, according to the article added to the contract, give the broker “the power of attorney” (Wakalah) to transfer a part of each party’s margin to the other party (based on Wadiah contract) and the other party has the “permission to use” (Ibaha al-tasarruf) the said property to be settled on maturity date or when leaving the contract.

An option contract is an agreement between the option grantor and the holder of call or put options of the underlying asset. Here, the option holder shall have the right to buy or sell a certain asset (financial or real) at specified price and up to a specified date in future. But, the option grantor commits to sell or buy the same asset. Other definitions are as the same as futures contracts except that in options contracts, only option grantor should pay margin.

According to the nature of the options and futures contracts, those are new and independent contracts; they can be correct and permissible contracts if all general provisions of the contracts, such as prohibition of “having an asset on a non – Shariah – permissible manner”, prohibition of loss, prohibition of Gharar and prohibition of usury are fully observed. Also according to the fact that in options (call and put) and futures contracts all these provisions are observed, such contracts would be permissible.

Key Words: Islamic derivatives, Islamic futures contracts, Islamic options contracts

1. Islamic Futures contracts

1.1. Forward contracts (Definition)

A forward contract is an agreement between both parties of the contract to make a transaction on a particular date in the future with volume and price of the commodity specified. In this contract, both parties may compose the contract on the basis of their own acquaintances and requirements. Since a forward contract is not a standard contract it may be signed for all types of assets according to opinions of both parties. Only people with good credit can use forward contracts. Also this kind of derivative is executed in investment banks and there is no secondary market.

1.2. Types of Forward contracts

Forward contracts are executed on the basis of the underlying asset. So, in terms of the underlying asset, we have different types of forward contracts:

- Forward Rate on Exchange Rate (FX Forwards),
- Forward Rate Agreements (FRAs),
- Forward Contracts on Securities,
- Forward Contracts on Commodities.

1.3. Forward Restrictions

Since forward contracts are signed directly between buyer and seller, some restrictions may be found to increase the risk of signing such contracts and prevent it to become a commonly used agreement.

Thus, forward contracts are usually signed between financial institutions, industrial companies and reputable banks. Forward contracts are issued by investment banks.

1.4. Futures Contracts (Definition)

A futures contract is the standardized form of forward contracts. In this contract, future transaction (both delivery and payment) is committed and price and all details of the contract would be fully specified on the date of agreement.

A futures contract which is traded in futures market is executed by a clearing house as an intermediary between buyer and seller. However, regulations of futures exchange are so developed to protect market participants.

1.5. Differences between Futures and Forward Contracts

Futures contracts are exchange-traded, while forwards are traded over-the-counter. Thus futures contracts are standardized and face an exchange, while forward contracts are customized and face non-exchange counterparty. Futures contracts are margined, while forward contracts are not. Thus futures contracts have significantly less credit risk, and have different funding.

The followings should be specified in detail in the contracts. Usually, based on the rules and regulations, exchanges determine these items for any contract and all of the participants should be aware of these terms and conditions and also should be aware of the risk of the contracts by signing the risk statement.

- Volume of commodity,
 - Quality of commodity,
 - Maturity month,
 - Delivery conditions,
 - Delivery date and place,
 - Minimum amount of daily price movements,
 - Permissible limit of daily price movements,
 - Time and date of transactions.
-

1.6. History of Futures market

Here is a brief review of futures markets history:

- **1730: Osaka**, (Rice transaction center¹)
- **1848: CBOT** (Chicago Board of Trade)
Quality & quantity standardization of the grains
- **1874: CPE** (Chicago Produce Exchange)
Butter, Eggs, poultry and other perishable agricultural products
- **1898: CBEB** (Chicago Butter & Egg Board)
Withdrew of dealers from CPE to CBEB (1919 CME)
- **1972: CME** (Chicago Mercantile Exchange)
Transactions of foreign currencies commenced
- **1975: CME** (Chicago Mercantile Exchange)
Transactions of Interest Rate Futures commenced
- **1982: KCBT** (Kansas City Board of Trade)
Transactions of S&P 500 Index futures commenced

1.7. Definition of Islamic Futures

A model for futures contracts in compliance with shariah rules and principles, presented as follows:

Futures contract is a commitment for executing a cash transaction in the future and would be studied in two assumptions as follows:

1. Buy and sell with the intention to deliver the particular asset,
2. Buy and sell without the intention to deliver the particular asset.

¹ In 1716, Cho-gomai transaction was introduced and recognized by the government in 1730, which is said to be the origin of futures transactions in Japan.

Islamic futures contract is based on the first assumption and it is supposed that both parties have the intention to trade in real asset with a specific quality on a specific date.

However, a group of investors who have entered this particular market may not have any need to the assets or prefer to make cash settlement and find what really need in the spot market. Actually, this would be more sensible on physical assets. Suppose that the place of consumption is about 700 kilometers far from the nearest futures market warehouse. You would probably prefer to make cash settlement in futures markets and provide your required commodity from a near spot market. So, there would also be cash settlement in the Islamic futures market and each cash settlement is not a form of superficially transaction. But to prevent any harmful superficial transactions the total volume of the issued contracts (short position) must be compliant with the real asset market to prevent any kind of speculation and the supervisory body of the futures market is responsible for controlling.

Transactions with intention to deliver the particular commodity would be in three different cases, as follows. The followings are so explained with a particular view to the commodities futures market but could be applied to any other Shariah compatible assets, such as stocks.

1. A kind of Bay' is occurred at the time of signing the contract and both parties actually make a real buy and sell, but delivery of the asset and payment of the price will be in future. Producer sells his future product, which is fully specified in terms of material, model, volume, date of delivery, and other specifications against a specific amount of money which is fully specified in terms of date, place and quality of payment. Purchaser also buys the commodity with these conditions.
2. Producer sells his "commitment to sell" of a specified amount of his future product, which is prescribed in terms of material, model, date of delivery against a specified amount of money (usually a small percentage of the commodity price). Purchaser also buys the commitment of that producer against the payment of that particular

amount of money.

3. Producer undertakes the selling of a specified amount of his future product, which is fully specified in terms of material model, date of delivery and other specifications against a specified amount of money which is specified in terms of date, place and quality of payment. Purchaser also undertakes the buying of such commodity on that particular price and date of maturity.

1.8. Jurisprudential Considerations for Models:

Problem with the first case:

In this transaction, if the whole money be in the future, there would be a kind of *kali bi-al-kali* sale (selling in which both commodity and money are transferred in the future), and if a part of money be in the future, there would be some sort of buy/sell on *Salam*-basis in which the whole money has not been paid. Both assumptions have jurisprudential problems.

Problem with the second case:

Problem occurs when the “commitment to sell” stands as *mabi’*, which is something to be sold, and would not be permissible in most jurists’ opinions because they believe that *mabi’* (something to be sold) should be a tangible object and “commitment to sell” is not amongst sensible objects.

1.9. A favorite model for Islamic Futures contracts

Using the commitment against commitment contract, while the seller undertakes to sell a specific amount of commodity against a specific amount of money and the buyer undertakes to buy it. Here, there would be no doubt of *akl al-mal bil-batil* and each party has accepted a particular commitment. This commitment could be transferred to the third person(s) in a secondary market.

1.10. Futures markets operational mechanism

Clearing houses

All transactions in a futures market are executed through the clearing houses. These institutions have different functions. The most important function is making both parties to guarantee the execution of transaction.

A clearing house is an intermediary between a person who undertakes to buy and a person who undertakes to sell futures to remove counterparty risks.

Paying margin

Investors in futures market pay a particular amount of money as deposit or margin or initial deposit to the clearing house to decrease the default risk.

Example: Two futures contracts to buy 200 ounces of gold (100 ounces each) have been signed on 5 June. Maturity date of this contract is the end of September. When signing this contract, the future price of gold is \$800 per ounce. Futures exchange has determined a margin equal to %10 of the volume of contract.

However, the minimum amount of margin retained would be equal to a specific percent of the initial margin (e.g. 75%).

1.11. Margin mechanism

If two investors directly agree to trade an asset on a specified price in future, they will encounter a few problems. For example, one of these two may regret and fail to execute the transaction in a manner that there would be no default risk margin in futures contracts.

In case of any increase in futures price, a part of the seller's margin account would be transferred to the buyer's and in case of any decrease in futures price, a part of the buyer's margin account would be transferred to the seller's.

In a few markets, the one who has benefited from the price movements is permitted to take a part of the margin.

In the other markets, participants are permitted to do so if they want to leave the market. The one who has lost a part of his margin to a specified limit (maintenance margin) due to price movements is bound to complete his own account.

The one who leaves the market receives his final margin (which would be higher or lower than his own initial margin) from his broker and the substitute would pay an amount equal to the initial margin and becomes the new party to the contract.

1.12. Jurisprudential Consideration

Transferring the margin from one party's account to the other's against the futures price fluctuation causes the doubt of "having an asset on a non-Shariah permissible" (akl al-mal bil-batil). Because a sum of money is transferred without something is existed in exchange for that money. However, there are models to correct this particular issue.

Margin in Islamic Futures Contracts

1. Both parties, according to "the article added to the contract" (Shart-u zimn-al-aqd), "pay a specified amount of money to the broker as margin". Broker records changes of margin account on the basis of changes of futures prices. The margin of each party would be left in his ownership until the maturity date or until a party decides to leave the contract. In the case of leaving the contract, he receives the final margin (which would be higher or lower than his own initial margin). So, balance of margin account which will be received, is equal to selling price and it is not "the case of having an asset on a non-Shariah – permissible manner" (akl al-mal bil-batil).
2. Both parties, according to "the article added to the contract", undertake, in addition to what was explained in the previous approach, lend (qard) to the other party, sum of money on – account, to be settled on maturity date or when leaving the contract.

3. Both parties, according to the article added to the contract, in addition to what was explained in the previous approach, give the broker “the power of attorney” (Wakalah) to transfer a part of each party’s margin to the other party and the other party has the “permission to use” (Ibaha al-tasarruf) the said property to be settled on maturity date or when leaving the contract.

The first approach is of no jurisprudential problem and is applicable. In the case something more than the first approach is required (both parties are able to benefit daily from price fluctuations), it is also possible to use the third approach.

1.13. Trading instrument

Commodities as underlying assets

Futures contracts could be designed for all kinds of assets in conventional markets. However, Islamic futures contracts could be defined on those assets which are tradable in compliance with shariah principles, such as:

- Metals,
- Energy products (Crude oil and others),
- Agricultural products,
- Precious metals,
- Minerals,
- Currency futures.

1.14. Dealers in Futures Markets

Dealers of the futures markets are as follows:

1. Hedgers: (Those who try to decrease the risk of price fluctuations),
 2. Speculators: (Dealers who seek for profit by accepting risk and executing of frequent
-

transactions),

3. Arbitrageurs: (They try to get profit by entering two or more markets simultaneously).

Futures markets are primarily established for the hedgers but the presence of speculators and arbitrageurs helps the liquidity of the markets. In other words, in the absence of these two market participants, hedgers may not be able to cover their own risks efficiently. In the Islamic futures market, these two groups will have their own activities but the market regulator has a particular duty to supervise such activities and prevent any kind of harmful speculation. Limited number of trades, limited price fluctuation, and limited number of contracts issued on a certain asset would be amongst the market regulator's means of supervision.

1.15. Closing a position

There are two ways to leave a futures contract:

- Physical delivery
- Cash settlement

Most futures contracts (98%) will not be finished in physical delivery because most investors close their positions before the date of physical delivery.

To deliver or take delivery of commodities under conditions of futures contracts is usually difficult and in some cases quite expensive.

A hedger usually prefers to close his position and buy and sell properties in spot markets. Closing a position means to enter a new transaction and opening a position is in contrast with the previous one.

1.16. Possibility of Fraud in Futures Markets

Long position in futures contracts and hoarding of assets (Corner the market):

Suppose an investor group takes a huge long futures position and tries to exercise some control over the supply of the underlying commodity. The investor group does not close out its position until maturity date, thus, there may be more futures contracts than the amount of commodity available for delivery. As the result, those investors with short position find it difficult the physical delivery of the commodity and fail to close their position so cash and future prices increase incredibly.

1.17. Operational limits in futures contracts

Limits in daily price movements

Official exchanges usually prescribe a particular limit for daily price movements in order to prevent any extreme fluctuations and harmful speculation. Example:

- $\pm 10\%$ for wheat, cotton, gold, index, dollar.
- $\pm 2\%$ for interest rate contracts

▣ Speculative position limits

Speculation position limit means the maximum number of futures which speculators could open. For example, in lumber futures traded in CME the limit is 1,000 contracts, in which the maximum number in each maturity month is 300 contracts. This limit is to prevent the excessive impact of speculators on the whole market

Example: Absolute positions limit (1,000 contracts, 20,000 currencies) for all maturities:

Percentage position limit (10%)

The seller's ability to deliver:

Regulations should be so enacted that one in long position be able to deliver the specified commodity.

▣ This would help:

1. Prevent the paper contracts to increase incredibly against the real (market)
2. Those who have entered the market with the intention to take physical delivery at commodities could be assured of receiving their commodities on maturity date.

1.18. Leverage and Price Discovery

One of the main characteristics of the futures markets is that those investors who may trade in the spot market, in order to future consume (sell) and cover the risk of price increase (decrease), could make a similar trade in the futures market by paying a small portion of the whole price (initial margin). So, there would be no irregular demand increase and people buy the commodity at the time of consumption.

A building constructor needs 1,000 tons of steel bars with a maturity of 6 months. The price of steel bars is 7,800 IRRs² per kg, now he would have two ways to prevent the loss due to steel bars price increase:

Paying a sum of 7,800 million IRRs to buy steel bars NOW and holding them until consumption.

Opening a long position by paying only 5% (390 million IRRs) as margin

2. Islamic Option Contracts

3. As in a futures market both parties have undertaken to make the trade, there would be a probability for a real loss at the end for those who have entered the market with the intent to cover the risks. For example, someone intends to cover the risk of copper price increase. Now, the spot price for this particular asset is 1500 USD / ton and the futures price for the next 6 months is 1750 USD / ton. If the spot price will be 1600 USD / ton on due date, the buyer would make a loss on this deal. In options contracts, the buyer has the option to buy, so he/she can refer to the seller and buy the commodity or buy it from the spot market. Here, if the futures contract is replaced by an option contract, the

² Iranian Rials (IRRs)

buyer would not execute his/her option and buys the required commodity from the real market.

The element of option can be found in a few financial instruments, including:

- ✓ Convertible bonds in which the holder, if he wishes, can convert them into shares,
- ✓ Repo stocks,
- ✓ Callable bonds in which bonds may be redeemed by the issuer on specified dates.

3.1. Definition of Options Contracts

An option contract is an agreement between the option grantor and the holder of call or put options of the underlying asset. Here, the option holder shall have the right to buy or sell a certain asset (financial or real) at specified price and up to a specified date in the future. So, option holder has the right to choose, not obligation to trade. Payment of the margin in options is just done by the short position and there is no need for the long position to pay any margin. Indeed, there should be a default only by the short position.

3.2. Profit (and loss) of option

Call option is a contract that gives the holder the right to buy a contract quantity of the underlying asset from the writer, at a specified price up to a specified date.

▣ Example (exercises / not exercises / strike price)

Suppose that you have received the call of stocks of the company X, at the strike price of 5,000 IRRs³ for March 20, against the payment of 200 IRR. The spot price, when signing the contract is 4,500 IRR:

- First case: the market price on March 20 is 4,000 IRRs – Not exercise;

3 IRRs (IRR)

- Second case: the market price on March 20 is 6,000 IRRs – Exercise.

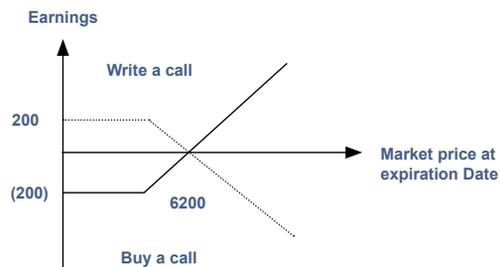
Suppose that you have received a call of the stock A for next 12 Months. The Current Price of this stock in the exchange is 5,000. The strike price is 6,000 and call option price is 200. So, you will have the right to exercise your option at next 12 months.

Table 1: Comparison between options and futures contracts with assumed stock price on maturity

Stock Price on Maturity	Strike Price	Call Price	Call Profit/Loss	Exercise/Not exercise	Futures Profit/Loss
5,000	6,000	200	-200	Not exercise	-1,000
5,500	6,000	200	-200	Not exercise	-500
5,800	6,000	200	-200	Not exercise	-
6,000	6,000	200	-200	Indifference	0
6,200	6,000	200	0	exercise/ Breakeven point	200
6,500	6,000	200	300	exercise	500
7,000	6,000	200	800	exercise	1,000

As it can be seen in this table, in options contracts the loss would be at most equal to the options price and profit would be equal to the futures contract minus options price. Profit and loss are higher in futures contracts. When a higher price is prescribed for the future, it is suggested to sign a futures contract and if the price movement in

Figure 1: Call Earning curve



the future is ambiguous, options are suggested.

Put option is a contract that gives the holder the right to sell a certain quantity of the underlying on a specified date.

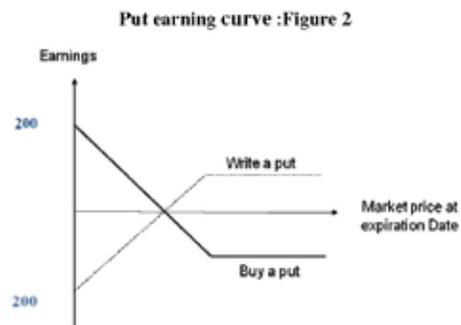
Example (Exercise/not exercise/strike price):

Suppose that you have received a put of stocks of the company X, at the strike price of 5,000 IRRs for March 20, against the payment of 200 IRRs. The strike price, when signing the contract is, 4,500 IRRs.

First case: the real price on March 20 is 4000 IRRs – Exercise;

Second case: the real price on March 20 is 6,000 IRRs – Not exercise.

Suppose that you have received a put of a certain stock with the strike price of 5,500 price units against the payment of 200 price unit as the option for next 5 months.



3.3. Applications of options

- ✓ Financial (Risk hedging)
- ✓ Speculation for maximizing the benefit and return in the period of price movements.
- ✓ Arbitrage, or attempting to profit from price differences of identical or similar financial instruments, on different markets,
- ✓ Making profit by writing of options.

3.4. Positions

As there are two types of option contracts, namely as call option and put option, and each contract has two parties (seller and buyer), there would be four typical option contracts.

- ✓ Long position of a call
- ✓ Long position of a put
- ✓ Short position of a call
- ✓ Short position of a put

3.5. European / American option

American option can be exercised at any time between the purchase date and the expiration date.

European option (option to exercise on maturity date) can only be exercised on the date of expiration.

3.6. Hedging (Stock Purchase)

Financial manager of the company A has bought a certain amount of stocks by a part of his funds and has got short position in an option contract to cover the risk of price decrease of stocks because he needs fund for a part of the company's development plan on a date in next six months. A total available fund is 2,000,000 IRRs which goes to buy 2,000 shares of stock of the company. The price of each share is equal to 100 IRRs and for buying of the put of a share a sum of 0.5 price unit has been spent. Also strike price on expiration date, which is nearly six months later, is (strike price is 120 IRRs per share and option price is 0.5 IRRs per share).

A) Suppose that the market price on expiration date is 130 IRRs. Now, profit (or loss) of a put is calculated as follows:

Since the strike price is below the market price, investor will relinquish his right and sell his

shares in the market with higher price. Thus, the loss will be equal to the put price: $(0.5 \times 20.000 = 10,000)$

B) Suppose that the market price on expiration date is 110 IRRs. Now, profit (or loss) of the put is calculated as follows: since the strike price is above the market price, investor will exercise his right and sell his shares at a price above the market price.

3.7. Hedging (write an option)

A person has sold stock futures with the value of 500 IRRs for the next months. So, he also buys a call of stock for the next eight months to cover the risk of futures. In this case, the strike price of the option is 470 IRRs and the option price is 30 IRRs.

If the stock price in next eight months goes up to 520 IRRs, calculate the profit (or loss) of the investor.

Now, if the stock price goes down to 400 IRRs at expiration date, how much the profit (or loss) of the call option will be?

Table 2: Profit of loss in case A & B

Profit of call	Profit and loss in case A	Profit and loss in case B
Option price (deducted)	520-470-50	0
Profit or loss of call	(30)	(30)
Profit or loss of futures	20	(30)
Total profit loss	(20)	40
Profit of call	0	10

So, there would be no loss in this strategy. Different combinations of option contracts could be designed. For example, the investor who purchases a stock in the spot market would be in a high risk position and make a great loss after a fall in prices. Here, the investor should buy a put option in derivatives market beside his spot trade. Also, the stock seller must buy a call option of the same stock in order to not be in loss in case of any price increase.

3.8. Islamic Option Contract

Option contract is a kind of commitment. In this contract, the short position has the commitment to sell and the long position has the right to buy. So, no transaction is carried out at the time of signing the contract. The payment of margin is also similar to futures but in option, margin is not paid to the long position, thus there exists less shariah doubt. The benefit for the long position is just because of the option to buy.

3.9. Jurisprudential Questions about Options Contracts

1- An option does not have any financial value until the contract is signed by the two parties. How does it receive financial value after the contract is signed by the two parties?

Answer: Although different forms of buy or sell, which are the natural rights of each person, are amongst the rules of Shariah and do not have any financial value, but when someone undertakes to carry out a specific function, it will commonly receive a financial value and become tradable.

2- In an option contract, what the price stands against, and what is transferred to the grantor.

Answer: Option contracts (call and put) are some sorts of commitment in which the writer undertakes to, at the will of the holder, buy or sell at a specified price and gets a sum of money which is called the option price, against his commitment. In the other words, the option holder buys another commitment to execute a legal action of buy or sell. Thus, the option contract will be an independent contract.

3- What is the nature of an option contract? Is Bay`, Insurance, Araboon, or an independent contract?

Some Definitions:

Bay` means buy and sell, or changing ownership of the asset against a specified return.

Araboon means prepayment and in jurisprudential definition, it is a payment to the seller by the buyer upon the condition that if he buys the goods, it would be as a part of the price; but if he does not buy the goods, the money goes to the seller. This is called Bay` al-araboon, which is not permissible in Islamic jurisprudence.

Insurance is a promise of compensation for specific potential future losses against periodic payments. In exchange for payments from the insured (called premiums), the insurer agrees to pay the policy holder a sum of money upon the occurrence of a specific event.

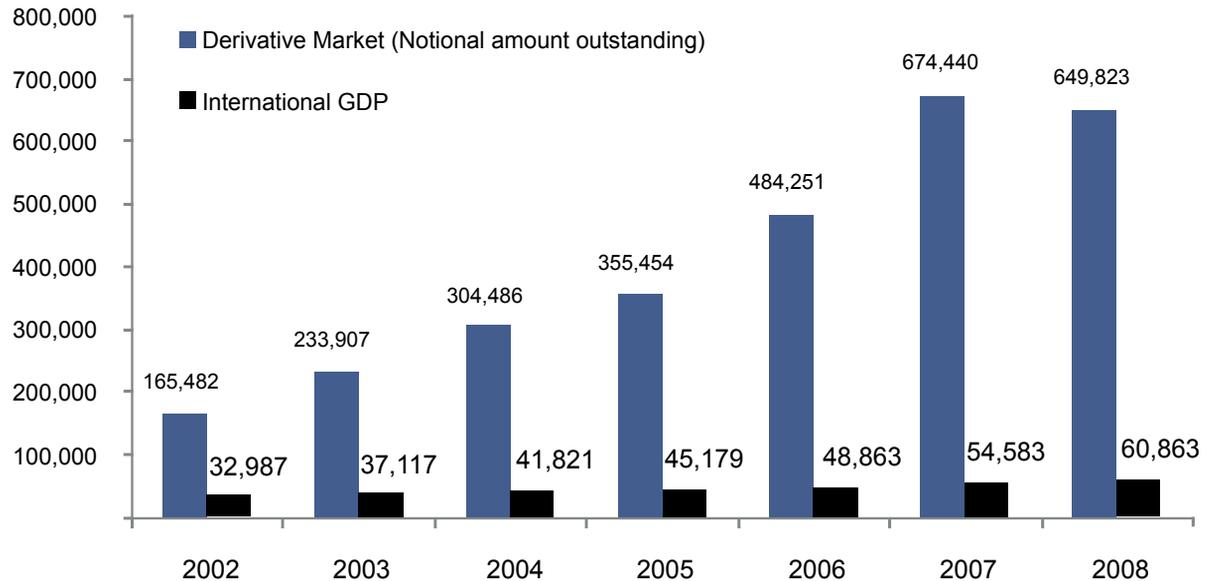
Answer: According to the nature of the option contract, which is a new and independent contract, it can be a correct and permissible contract if all general provisions of the contracts, such as prohibition of “having an asset on a non – Shariah –permissible manner”, prohibition of loss, prohibition of Gharar (excessive uncertainty), and prohibition of usury are fully observed. Also according to the fact that in option contracts (call and put) all these provisions are observed such contracts would be permissible.

After a commitment by the writer (grantor) and receiving the specified payment, the holder will have the right to execute his/her call or put option on expiration date or relinquish his/her right or sell it to someone else. So, all next trades on options are some sorts of buy or sell of the right.

3.10. Important

Enacting of executive bylaws and guidelines should be carried out with a particular concern about preventing superficial and irregular transactions which causes such transactions be cancelled and makes the whole economic system work properly.

Figure 3 :Comparison of real market (International GDP) and Derivatives Markets (US Million \$)



4. Facts and figures of derivative market

One of the most important issues in the Islamic transactions is the absence of what are called superficial and paper transactions. Islamic principles are to control the financial market and prevent the overgrowth of the financial market beside the real market. In other words, Islamic principles attempt to make the financial market serve for the real market and prevent the financial market stand at the center of all attentions in the economic system. This will help the macro economy and having an economic stability with no financial crisis.

The following table shows how the world derivatives market, including exchange –traded and OTC–traded, has been developed in comparison with the international GDP. This is an example of the consequences of paper transactions and overrating of the financial market which can be resulted in crisis.

However we are not to describe the said issue as the only reason of any financial crisis but it can provide, beside all other reasons, a particular space for that situation. This is the duty of the regulatory body of the derivatives market to supervise and make a balance between the volumes of trades in both markets.

Figure 3: Comparison of real market (International GDP) and Derivatives Markets (US Million \$)

Source: www.bis.org, www.worldbank.org

5. Conclusion

Futures and options, as two hedging instruments, are widely applied in the financial market. As a futures contract is a kind of commitment to buy and commitment to sell and designed according to a contract in which all details are fully described, it is concerned as a new contract just like options in which the short position has a commitment to sell with a certain price in future and the long position has the right to execute the contract. The process of transfer in margin account is so designed that there would be no doubt of akl al-mal bil-batil. In futures contracts, both parties are bound to pay the margin but in options only the short position in which a likely default is apparent is bound to pay the sum.

Thus, an Islamic derivatives market, including futures and options on permissible assets, can be designed with no jurisprudential problems. But, what is so important is the role of the regulator to prevent this market to not surpass the real market.

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Islamic View point of Shortselling¹

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¹ Jurisprudential views of this article are on the basis of SEO Shariah Board Resolutions.

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Abstract

Compliance or noncompliance of contracts in conventional financial system with the Islamic jurisprudence has been always one of the major concerns of capital market principals in Islamic countries.

Short selling as one of these contracts is regarded as a useful contract in finance community. It is an essential element of portfolio management and is used as an instrument for maximizing the return while minimizing the risk. Market Makers and Proprietary Traders are generally by far the largest borrowers of stock and are responsible for the majority of securities lending transactions in capital markets.

In this essay we are going to discuss about the mechanics of short selling and then we will go through a survey about the compliance of short selling with Islamic principals and jurisprudences. In order to do that we followed two approach:

First, Survey of any prohibition that may exist in this contract due to Islamic jurisprudence point of view was performed. By seeking for any prohibitions in short selling mechanism we found that Riba evidences exist in this contract.

Second, comparative study of short selling with Islamic traditional contracts was done to distinguish the conformability of this contract with Islamic contracts. We came to this point that short selling is not conformable with traditional contracts.

Finally a shariah compliance solution for this contract is introduced.

Keywords: short selling, Islamic jurisprudence, contract, Islamic contract

Introduction

Compliance or noncompliance of contracts in conventional financial system with the Islamic jurisprudence has been always one of the major concerns of capital market principals in Islamic countries.

Short selling as one of these contracts is regarded as a useful contract in finance community. It is an essential element of portfolio management and is used as an instrument for maximizing

the return while minimizing the risk. Market Makers and Proprietary Traders are generally by far the largest borrowers of stock and are responsible for the majority of securities lending transactions in capital markets.

Definition of Short Selling

Short Selling is the selling of a security that the seller does not own, or any sale that is completed by the delivery of a security borrowed by the seller. Short sellers assume that they will be able to buy the stock at a lower amount than the price at which they sold short.¹

The Mechanism of Short Selling

An investor who wants to sell a stock short must first find a party willing to lend the shares.

Once a lender has been located and the shares are sold short, exchange procedures generally require that the short-seller deliver shares to the buyer on the third day after the transaction (t + 3) and post an initial margin requirement at its brokerage firm.

NYSE and NASD require the short seller to maintain a margin of at least 30% of the market value of the short position as the market price fluctuates.

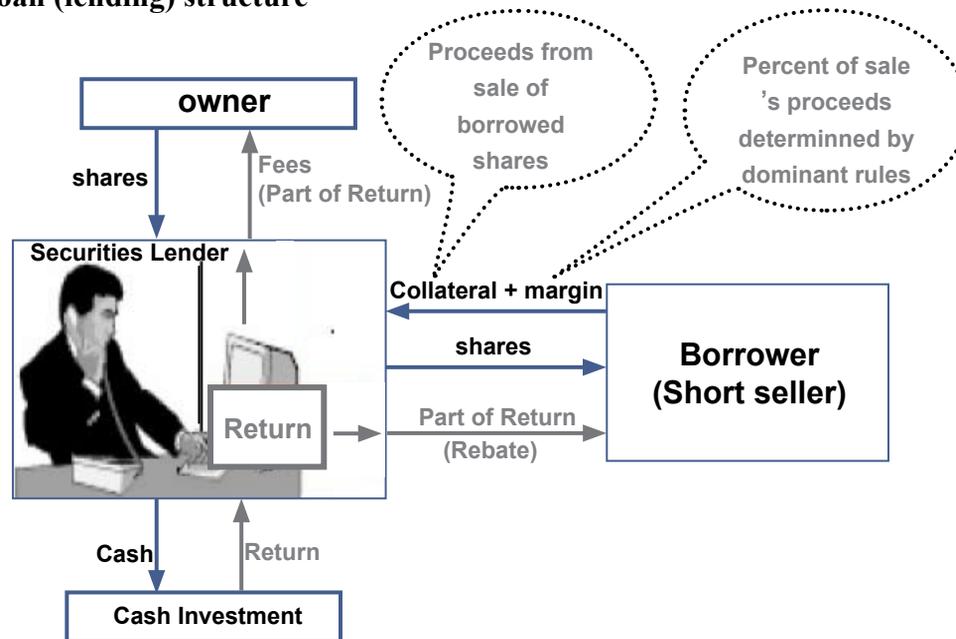
The proceeds from the short sale are deposited in an investment account with the lender of the stock. For U.S. stocks, the lender requires 102% of the value of the shorted stock value in collateral. The interest on this deposit is often split between several parties participating in the lending process.

The value of the shorted stock is marked to market daily; an increase in the stock price will result in the lender requiring additional collateral for the loan, and a decrease in the stock price will result in the lender returning some of the collateral to the borrower. When the borrower returns the shares to the lender, the collateral will be returned.

¹ www.investopedia.com

While a stock is on loan, the lender (often brokerage firm) invests the collateral and receives interest on this investment. Generally, the lender returns part of the interest to the borrower in the form of a negotiated rebate rate.

Equity loan (lending) structure



Lender's Rights

The owner of a stock retains beneficial ownership of the shares it lends. This status gives the owner the right to receive the value of any dividends or distributions paid by the issuing company while the stock is on loan. However, rather than being paid by the company, the dividend and distributions are paid by the borrower. This is referred to as a substitute payment. The only right the lender gives up when lending their assets is the right to vote on a security.

Recall; end of procedure

In the event of a recall, the borrower is responsible for returning the shares to the lender within the normal settlement cycle (i.e. $T + 3$)

If the shares are returned within this period, the custodian can settle the pending sell trade. If the borrower fails to return the shares by $(T + 3)$, the agent may use the collateral to buy shares to cover the position, therefore closing out the short position of short seller.

Lenders Incentives

1. Long term holder (pension fund, tracker fund) receives dividend plus borrowing cost so increases yield on portfolio.
2. Another incentive for investors to act as a lender in short sale mechanism is the benefit of covering the risk of long positions. In the other words, whereas long position itself brings about the risk of decrease in value of securities, short sale can act as a mechanism to neutralize this kind of risk because of its short position function.
3. The third motive which is often beneficial for market principal is using short sale as an instrument to make securities liquid by improving the side of supply for a specific security or the whole market. As sometimes securities owners don't offer their securities with the hope to benefit of price increase and make the market illiquid, market principal can short sell that illiquid security to make it liquid.

Borrowers Incentive

1. The first and also the main incentive for investors to play the role of short seller is the incentive to exploiting the leveraged investment property of short sale. Because of using a margin mechanism in short sale, the short seller doesn't have to pay the whole price of shorted security but gaining the benefit of whole price decrease.

In the table below you can see the function of margin in short sale mechanism.

Initial margin= 50%

Maintenance margin=30%

At Time of short sale	Shares	Share Price	Short Sale Value	Initial Margin Requirement	Total Margin Requirement
	1000	\$50	\$50,000	\$25,000	\$75,000

As Stock Price Increase	Shares	Share Price	Short Sale Value	Maintenance Margin Requirement	Total Margin Requirement	Margin Call
	1000	\$55	\$55,000	\$16,500	\$71,500	\$0
	1000	\$60	\$60,000	\$18,000	\$78,500	\$3,000
	1000	\$75	\$75,000	\$22,500	\$97,500	\$22,500

As Stock Price Decreases	Shares	Share Price	Short Sale Value	Additional Margin Requirement	Total Margin Requirement	Margin Released
	1000	\$45	\$45,000	\$22,500	\$67,500	\$7,500
	1000	\$40	\$40,000	\$20,000	\$60,000	\$15,000
	1000	\$35	\$35,000	\$17,500	\$52,500	\$22,500

2. "Making profit of down-ward security or down-ward market" can be mentioned as a willing for short seller to make profit in a security or market which is expected to experience a down-side tend in price.

3. Market principals who concern about the market price Efficiency may use the mechanics

of short sale to make the market efficient by playing the role of short seller to neutralize the speculators' price up-ward activities and consequently making the market trends more regular.

4. Borrow for failed trades -A failed trade may be defined as where delivery cannot be completed because of insufficient securities available.
5. Borrowing for market making and proprietary trading. Market Makers and Proprietary Traders are generally by far the largest borrowers of stock and are responsible for the majority of securities lending transactions in the country.

Lender's Risks

There are three types of risk the beneficial owner faces when lending stock: investment risk, counterparty risk, and operational risk. Investment risk involves the choices that the beneficial owner or their agent makes in investing collateral. Some lenders are reluctant to take risk in their reinvestment of collateral, and they invest primarily in overnight repurchase agreements or other very low risk investments. Other lenders look to achieve extra income by investing in higher risk assets. For example, lenders can earn more return by investing in longer term investments and short-term corporate debt with lower credit ratings. It is the beneficial owner's responsibility to monitor the investment of the collateral to manage these risks. Even if there is a loss from investing the borrower's collateral, the beneficial owner is still responsible for returning the borrower's full collateral when the security is returned. Counterparty risk is the risk that the borrower fails to provide additional collateral or fails to return the security. The beneficial owner can manage this risk by approving only the most creditworthy borrowers and by imposing credit limits on these borrowers. Furthermore, the fact that collateral is marked to market daily allows lenders to buy shares to cover the loan if the borrower will not return the shares.

The last major risk to the beneficial owner is operational risk. This is the risk that various responsibilities of the agent lender or borrower are not met. This could be the failure to collect dividend payments, the failure to instruct clients on corporate actions resulting in

missed profit opportunities, the failure to mark a loan to market, and the failure to return a security in the event of a recall. These risks can be minimized by maintaining a good lending system which tracks dividends, corporate actions, and the collateralization of loans.

Borrower's Risks

two risks that a borrower faces are the risk of a loan recall and the risk of a decrease in rebate rates. A borrower's challenge is to find a lender that best balances these risks. Recall risk is the risk of the stock being recalled by the lender before the borrower is prepared to close out his position, which happens in approximately 2% of the loans in the sample of one study. Borrowers would prefer to have loans lasting the duration of the short position, but guaranteed term loans are rare. So, borrowers need to manage recall risk by working with a lender that is likely to be willing to loan the stock for an extended period of time. Often the most stable sources of stock loans are portfolios with little turnover, such as index funds.

Buy-in

If the borrower fails to return the shares, the lender can use the borrower's collateral to buy shares to cover the loan, which is known as a buy-in. In the other words, recalls can force borrowers to unwind their trading strategies Sub-optimally or expose the borrowers to potentially poor execution in the case of a buy-in.

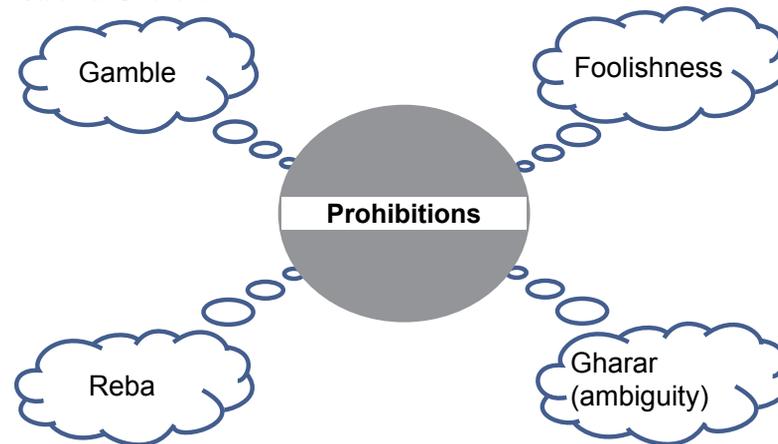
Survey of short selling legitimacy on the basis of Islamic jurisprudence

In current survey two views were considered:

First, Survey of any prohibition that may exist in this Contract due to Islamic jurisprudence point of view. So if any kind of prohibition exists in the contract we consider it as an illegal contract and vice versa.

Second, comparative study with Islamic jurisprudence conformable contracts (Traditional contracts).

As shown below, according to Islamic jurisprudence principles, there are four prohibited factors which Muslim have to avoid any contract contains one or more of them: Gamble, Foolishness, Riba and Gharar.



The criteria to distinguish the existence or lack of prohibitions are the common expectation and interpretation of Islamic jurists.

Verifying any kind of foolishness in short selling

Short seller and lender know everything about risks and pitfalls in this contract and decide by analyzing the market situation, technically and fundamentally. Furthermore, rational incentives exist for both sides in this transaction and both sides expect to benefit according to their own analysis of securities price, so foolishness evidence doesn't exist in this contract.

Verifying the existence of gharar in short selling

Gharar occurs when one of the two parties is not aware of any aspects of the contract and may make loss because of that unawareness. Verifying potential losses related to both parties in this contract and the sources of loss will lead us through this verification.

Potential losses for borrower

If the price of borrowed securities goes up the borrower will make loss. As the borrower is aware of this risk, it cannot be taken as gharar, because rational associated risks cannot be supposed as gharar of unawareness.

Potential losses for lender

As mentioned previously, investment risk, counterparty risk, and operational risk are referred to as lenders risk that again we can say as the lender is aware of these and use hedging actions to avoid these risks, they cannot be mentioned as sources of gharar.

So no sign of gharar can be considered in short sale contract.

Verifying any evidence of gambling in short selling

Gamble is any action that relies on chance or luck which results in obtaining without paying or bearing any suffering. In short selling two parties do transactions based on their technical or fundamental analysis about the future of prices. Market principles and market makers also may pay the way for that to make the market more liquid.

Riba and short selling

As short selling is defined by words; borrowing and lending it assumes to be a kind of debt (qard). The lender receives an amount more than borrowed securities in the form of investment proceeds. This amount is supposed as riba in debt, so if we consider it as a kind of qard as the conventional financial system suppose it (securities borrowing and lending (SBL)) it can not be conformed with Islamic conformable qard.

Conclusion

By seeking for prohibitions in short sale you come to this conclusion that

Riba evidence is founded in short selling contract.

Comparative study with Islamic jurisprudence conformable contracts (traditional contracts approach)

At the first look short sale contract seems to be able to conform with Rent or lease (Ijarah), bay' al- khiar, debt (qard)

Comparing with ijarah

Although short sale is similar to ijarah in many aspects but some main distinction can be considered:

- 1- The “right to benefit” of underlying asset is sold in ijarah but “the right to sell the asset itself” is not transferred.
- 2- The benefits such as DPS and participating in tender offers is not transferred to short seller in this contract which is the opposite of ijarah because in ijarah all of the benefits are transferred to the counterparty (tenant).

Comparing with bay' al- khiar

Although short sale has some similarities with **bay' al- khiar** in seller's right to return the price of the sold goods to buyer and the buyer's obligation to return the good to the seller in a predetermined period, its mechanism has some differences as follows:

- 1- As Islamic jurisprudence point of view in **bay' al- khiar** transition, asset and all of its beneficiaries are transferred to buyer, but in short sale some part of beneficiaries of underlying securities is not transferred to buyer (short seller).
- 2- In bay' al- khiar the price is fully paid to seller but the option of taking the asset back is given to seller for a period, too. But in short sale the margin is paid not the whole price.

Comparing with debt (qard)

1-Debt (qard) is a kind of ownership contract and the borrower in debt will acquire the asset itself and its beneficiaries. In sale, this is not achieved.

2-In jurisprudence point of view an acceptable debt is not compensated by anything more than something like the underlying asset. But in short sale the lender receives an amount more than borrowed securities in the form of investment proceeds. So short sale is not a legal qard contract.

Malaysian Shariah Advisory Council point of view

Our brothers in Malaysia adopted short selling as rent (Ijarah) on the basis of ISTIHSAN principle. They describe it as follows:

"SBL (securities borrowing and lending) contract is similar to the terms in the ijarah contract in many situations, such as the authority of the owner recalling the assets, evaluating the assets according to current market value and so forth. The SAC members resolved that the ijarah concept, with the consent of the owner to sell the leased shares can be applied to the Islamic capital market."

Yet you have considered unlawfulness of short sale according to jurisprudence point of view, here my some questions may spring to your mind.

Questions:

Is there any solution to make use of advantages of short selling regarding principles of jurisprudence? Or in the other words is there any substitute mechanism to benefit of short selling contract without preparing any prohibition as an independent contract shariah conformable contract?

It seems yes.

Solution

The substitute mechanism can be considered as:

Simultaneous cash sale and salam purchase (bay' al- salam)² of the stock by the owner to short seller.

Example

The owner sells his shares to the other counterparty in cash at 100\$.

The owner purchases the same amount of shares from that counterparty at an agreed price on salam at 85\$ for a specific period.

Dividend and amounts equal to proposed interest on proceeds of shorted stock sale are included in credit purchase price. (So maybe the salam price amounts to 90\$)³

Balance of payments

Share Owner	Short Seller
<p>10\$ in cash</p> <p>90\$ on salam</p>	<p>100\$ in cash</p>

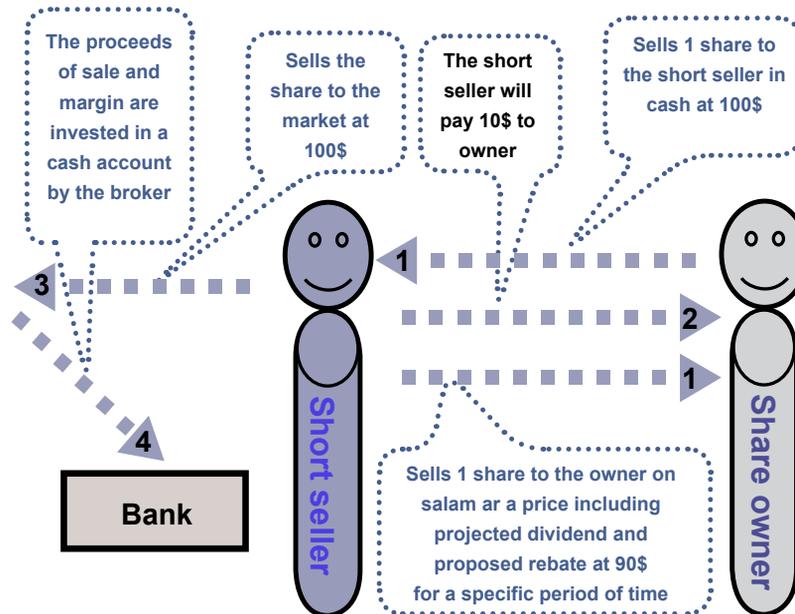
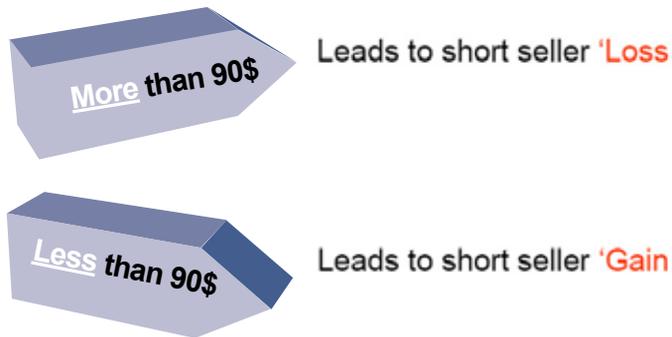
The shares are transferred by the owner to the short seller instead of 10\$ in cash. So the Leverage property of short sale is considered.

² Pay in advance

³ As you know the salam price is always lower than cash price.

Two likelihood scenarios after the expiration of salam sale period

Share price amounts to

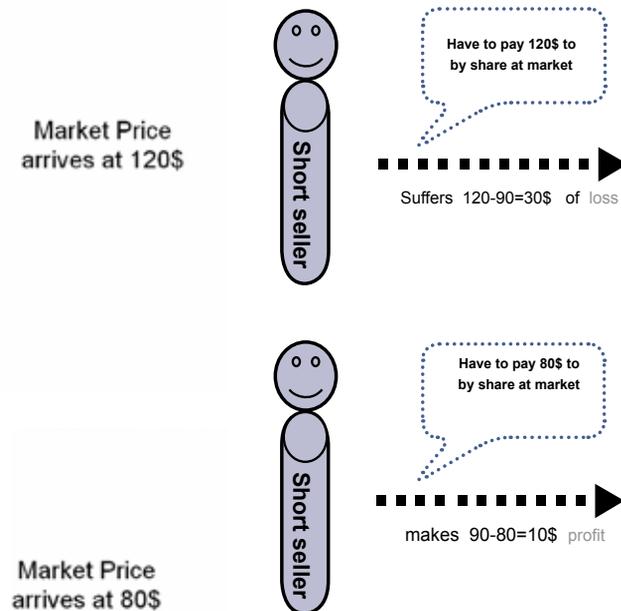


But there may be seen some differences between short sale and the above mechanism:

1-Although the proposed solution covers the aim of short selling (benefit from decrease in prices) but it is somehow different from short sale

2-In Short sale there isn't maturity date. Returning shorted stocks depends on both parties desire. (Liquidity for owner is considered)

3-New terms have to be used instead of LENDER and BOROWER in proposed solution.



Although the proposed solution covers the aim of short selling (benefit from decrease in prices) but it is somehow different from short sale.

Conclusion from SEO Shariah Board Point of view

The Board approved this solution considering 2 reservations:

Although this transition can not be considered as bay' al-'inah but in order to avoid bay' al-'inah evidences in the proposed solution, the second salam purchase should not be considered as an obligation in the first cash sale contract and the broker should be authorized to do the cash sale contract when the case for salam purchase occurred.

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Musharakah Sukuk in Islamic Republic of Iran

Seyed Hosien Mirjalili ¹

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Abstract:

After Islamic revolution in Iran, investing in bonds by private sector was recognized as incompatible in accordance with Islamic jurisprudence. Therefore Musharakah certificate substituted bond. Musharakah Sukuk is bearer or registered securities which issued based on certain par value for the certain period of time and sold to the investors which want to participate on execution of projects. Issuer, subject-matter of participation, on-account profit, agent and Trustee are the components of the sukuk in the Law concerned. Development of Musharakah sukuk in two phases, from its commence in 1994 to now, was explained in the article with the characteristic of some projects. In spite of remarkable successes of Musharakah sukuk in Iran, it faces some challenges.

Key words: Musharakah, Iran, Sukuk, participation-on account profit

Introduction:

After Islamic Revolution of Iran, buying bonds by private sector was recognized as incompatible in accordance with Islamic Jurisprudence. Because capital from issuing bonds should inject for the development plans of Government and profit-based construction plans with desirable level of return, one alternative of conventional bond could be a specific type of sukuk which is similar to the certificate of deposit with respect to disbursement of profit. In this regard like CDs in banking system in Iran, based on IRR or ROR of the projects, specific portion of profit could be paid to the sukuk holders in advance and at the end of period of Musharakah Sukuk, materialized profit could be payable to the investors. It means that at the beginning of issuance and based on the ROR of the project, percentage of profit paid to holders of Musharakah Sukuk and at the maturity based on final calculation of profit, materialized profit could be determined. This module became as basis for first issuance of Musharakah Sukuk in Iran and rules and regulations governing such an issuance. Issuing Musharakah Sukuk and its payable profit has been exempted from tax.

Musharakah Sukuk based on its definition, are bearer or registered securities which based on

law or central bank permit shall be issued based on Par value and certain period of time and in order to afford financial resources required for construction, completion and development of producing, building and service projects including financial resources required for procurement of raw material of producing units by government, state-owned companies, municipalities and public non-governmental institutions, non-profit institutions and affiliate companies of all these entities, public and private joint stock companies and producing cooperatives. These Musharakah Sukuk are sold through public offering to the investors which want to participate to the aforementioned plans.

One of differences between Musharakah Sukuk and ordinary share is related to the lifetime of the project. By issuing Musharakah Sukuk companies which their life period limited to the period of project execution will be formed while joint stock companies formed based on unlimited lifetime. According to the current rules and regulations, for each investment plan, the volume of issuing Musharakah Sukuk should not exceed 50% of total amount of investment in IRRs terms and the ceiling of 70% of NAV of issuing company. Therefore board of directors of issuer undertakes executive management of participation project. Issuer can guarantee principal and on-account profit of Musharakah Sukuk at the maturity date. It means that buyers of these Sukuk share only expected profit of project and potential losses are related to the issuer. However in joint stock companies, shareholders share both profit and loss of company.

Although based on commercial act of Iran, share could be issued in form of registered or bearer but in Iran shares are mostly issued in registered form. However all Musharakah Sukuk are issued during recent years in bearer form.

The main difference between Musharakah Sukuk and conventional bond refers to the fixed and predetermined interest rate which conventional bonds have. However Musharakah Sukuk are formed as participation contracts (Musharakah Contract) and materialized profit (interest) will be determined after final calculation of project profit and will be disbursed after deduction of on-account profit (interest).

Objective of Issuing Musharakah Sukuk

According to Article 1 of Musharakah Sukuk Act, Objectives and targets of Musharakah Sukuk are:

- For public participation in execution of profit-based construction projects of Government included in Annual Budget Acts and producing, building and service profitable projects, government, state-owned companies, municipalities and public non-governmental institutions, non-profit institutions and affiliate companies of all these entities and also public and private joint stock companies and producing cooperatives are authorized to afford some amount of financial resources required for execution of aforementioned projects including financial resources required for procurement of raw material of producing units through issuing Musharakah Sukuk based on public offering and according to the regulations of this Act.”¹

Therefore, the main objective of issuing Musharakah Sukuk is financing of projects of Government, state-owned companies, private companies and cooperatives. Another objective which is considered for issuing Musharakah Sukuk is as an instrument for implementing monetary policy by central bank of Iran and will be elaborated more during this paper.

Definition of Musharakah Sukuk

According to Article 2 of Musharakah Sukuk:

“Musharakah Sukuk is bearer or registered securities which according to this Act issued based on certain Par value for the certain period of time and sold to the investors which want to participate on execution of projects which mentioned in Article 1 of this Act. Holders of Musharakah Sukuk share profit generated from execution of specific project based on Par value and participation period. Buying and selling of Musharakah Sukuk authorized directly or via stock exchange.” (Ibid, Page 282)

Therefore Musharakah Mukluks are deeds imply ownership of its holder toward a portion of

¹ See Monetary and Banking Rules and Regulations, Page 281.

one physical property which belongs to government, cooperatives or private companies and till maturity of Sukuk, any change in price of property is pertaining to the holder of Sukuk.

Components of Musharakah Sukuk

According to the Act, major components of Musharakah Sukuk are:

1. Issuer:

According to the Act and its executive bylaw, ministries, state-owned companies, municipalities, public institutions, non-profit institutions, public or private joint stock companies and cooperatives are authorized to issue Musharakah Sukuk based on Act and permission of Central Bank of Islamic Republic of Iran.

2. Subject-matter of Participation

The meaning of Subjects refers to the projects planned to be financed via issuing Musharakah Sukuk and during certain period of time will be sold or utilized and it is expected that the value of project will be exceeded materialized costs and expenses. Article 3 and 4 of the Act, describe responsible and the manner through which projects will be ratified and approved according to the subject-matter of participation.

“Issuing Musharakah Sukuk by Government is authorized only for affording financial resources required for executing profitable construction projects of government, subject of Article 1, and to some extent which predicted and planned in Annual Budget Acts. (Ibid)”

According to Article 4, Central Bank of Islamic Republic of Iran examines projects of state-owned companies, municipalities and non-governmental companies and institutions and if the project is economically, technically and financially feasible, it will issue its permission for issuing Musharakah Sukuk after it receives enough guarantees from Applicant Company and/or institution. (Ibid, Page 282)

3. Capital, Profit and Loss

Financial resources originated from selling Musharakah Sukuk considered as cash capital and according to Article 10, any Seize of money gathered via selling Musharakah Sukuk for cases rather than execution of relevant project is considered as seize of public funds and properties. (Ibid, Page 284)

Articles 3 to 5 of this Act and bylaw describe the manner through which principal and accrued profit will be disbursed. It is stated in Article 3 that in relation to the profit-oriented projects of Government:

“The disbursement guarantee of principal and on-account profit and materialized profit of Musharakah Sukuk will be provided by Ministry of Economic Affairs & Finance based on budget resources which provided for in the annual budgets with regard to these sukuk by Managing and Planning Organization”(Ibid, Page 282).

Article 5 of the Act describes disbursement of principal and profit of non-governmental projects as follows:

“State-owned companies, municipalities and non-governmental institutions and companies which are the subject-matter of Article 1, are obliged to guarantee and assure the disbursement of principal and accrued profit of Musharakah Sukuk at due date if they issue such sukuk”(Ibid, Page 283).

In accordance with Note of Article 5, issuer is authorized to disburse on-account profit to the holders of Musharakah sukuk monthly, quarterly or yearly and deduct it from the certain and materialized profit at maturity(Ibid).

4. Agent (Broker)

Agent is a bank which on behalf of issuer proceed to issue Musharakah sukuk and undertake disbursement of on-account profit, certain and materialized profit and reimbursement of principal amount of these sukuk at maturity and in accordance with Article 5, if issuer fails to

meet its obligations at maturity, agent bank can directly take an action through predetermined guarantees. (Ibid)

5. Trustee (Custodian)

Trustee is personal or legal entity which is selected by central bank and preserves interests of Musharakah Sukuk holders with respect to the utilization of principal, manner through which accounts are managed, financial statements and executive performance of projects. In accordance to Article 13 of the Act “ Ministry of Economic Affairs & Finance and Central Bank of Islamic Republic of Iran are obliged to send document or report which consists of principal amount (capital) and types of Musharakah Sukuk issued during each year in addition to their assessment with respect to economic impacts of issuing relevant Musharakah Sukuk for information of Planning and Budget Commission, Economic Affairs and Finance Commission, Cooperative Commission and Supreme Audit Court Commission of Parliament of the Islamic Republic of Iran.” (Ibid, Page 284)

Therefore in addition to personal or legal entity on behalf of Central Bank as trustee for each of specific projects, legal personality of Ministry of Economic Affairs & Finance and Central Bank are taken into account as trustee for all projects.

6. Characteristics of Musharakah Sukuk

According to the foregoing, Musharakah sukuk are a new financial instrument which introduced to the capital market for the first time. Although such instrument has some similarities to other instruments like bond, common and preferred stocks but the Act of Issuing Musharakah Sukuk and records of recent years have created some sole features for this type of financial instrument. Some of these features are as following:

1- Ownership without voting right

Accordance to the Act, holders of Musharakah Sukuk are partners of the relevant projects with

respect to the Par value of Sukuk and will be mutually owners of project and its properties and assets. If project needs more amount of capital generated from selling Musharakah Sukuk and raised through issuer, issuer will be also partner of project like owners of Musharakah Sukuk. The Act is silent about management right, voting right and supervision right of Musharakah Sukuk holders but practical procedure of recent years implies non intervention of Sukuk holders in terms of execution of project. In this regard, Musharakah Sukuk are similar to bond which their holders don't have any intervention to the management of economic activities of bond issuer.

2- Temporary Participation

Although the Act of Issuing Musharakah Sukuk does not have certain particular time which indicates maturity for participation in the project but practical procedure of issued Musharakah Sukuk during previous years shows maturity between 6 months up 5 years. It means that issuer of Musharakah Sukuk based on particular planning buys the owner's share of Musharakah Sukuk with respect to the project at maturity based on actual market price or agreed price and terminates the participation. Maturity of Musharakah Sukuk usually determined according to the period required for construction and start up of the project. In this regard Musharakah Sukuk is similar to bonds which have certain maturity.

3- Return of Musharakah Sukuk

Because of nature of Musharakah Sukuk and ownership of their holders toward participation project, any profit derived from execution of project and any price increase of project properties and in the other words any value-added of project belongs to holders of Musharakah Sukuk. For example in projects like hospital, university, dam or highway which started up within 5 years with certain costs and expenses, return of Musharakah Sukuk will be the difference between present value of project and materialized costs or expenses and such amount belongs to Sukuk holders. In accordance with the Note of Article 5 of the Act, issuers of Musharakah Sukuk can disburse a profit in advance in a timely manner and at maturity deduct on-account profit from final and materialized profit of project. (Ibid, Page 283) Records of issuing Musharakah Sukuk during previous ten years show that all issuers have disturbed profit in advance to owners of Musharakah Sukuk on quarterly or semi annually base. (Mirmotahari, Page 151)

Musharakah Sukuk are similar to participation type of preferred stocks from the perspective of return because preferred stocks pay fixed rate of profit to their holders and at the end if the actual profit is more than on-account profit, stockholders will become partner. The only difference between Musharakah Sukuk and this type of preferred stock relates to the certainty of on-account profit. It means that on-account profit of Musharakah Sukuk isn't certain and final profit might be lower than on-account profit. Although in practice, for 35 projects which are financed by issuing Musharakah Sukuk during previous years, on-account profit rate and final pricing of project have been in a manner that on-account profit have been considered as base and certain profit from the viewpoint of Musharakah Sukuk buyers.

4- of principal and accrued profit

Although because of nature of partnership contract, profit and loss derived from partnership relate to all partners but according to the viewpoint of some Islamic jurisprudent, some of partners can accept probable loss and assure principal of other partners. On the other hand as mentioned previously under the discussion about components of Musharakah Sukuk, Act of Issuing Musharakah Sukuk describes how to reimburse principal and disburse on-account and materialized profit through Article 3 to 5, making Ministry of Economic Affairs and Finance as guarantor in case of governmental projects and issuers for the other cases². For interpretation of above-mentioned articles, two possibilities can be delivered:

From phrase of “guarantee of reimburse of materialized profit”, the first interpretation can be explained as follows: guarantee doesn't mean assurance of money and determined rates but it means guarantee of principal operation, reimbursement of principal and disbursement of on-account and materialized profit if any. In other words, Ministry of Economic Affairs and Finance assures in favour of Musharakah Sukuk owners that if project done successfully and profit derived, surely principal and its accrued profit will be disbursed. But there isn't any guarantee about the amount of profit rate. This interpretation doesn't have any discrepancies regarding nature of partnership contract³ and in fact it's pursuant to the nature of partnership

² See Monetary and Banking Rules and Regulations, Pages 282 and 283

³ See Hadavi Tehrani, Mehdi, Jurisprudent Principals of Musharakah Sukuk, Essay on 10th Islamic Banking Conference, Page 49

contract.

Based on the second interpretation, guarantee means assurance of money and declared rates as principal, on-account and materialized profit. Although records of past years also imply this interpretation but it is contrast to the nature of partnership contract (profit and loss sharing) and makes Musharakah Sukuk very similar to bonds. (Ibid, Page 50)

5- Buying and selling Musharakah Sukuk through secondary markets and convertibility to or substitution by stock

Under Article 2 of the Act of Issuing Musharakah Sukuk, trading of these Sukuk is authorized directly or through stock exchange⁴ and in accordance with Article 6, public joint stock companies can issue Musharakah Sukuk which can be converted to or substituted by stocks based on provisions of this Act.(Ibid, Page 283) Tradability, convertibility and substitution features of Musharakah Sukuk double importance of these Sukuk and provide a chance for Central Bank to enter and exit to the secondary market of Musharakah Sukuk and use them as an instrument for monetary policy. We will discuss it more through the other parts of this paper.

Evolution and recent development of Musharakah Sukuk of Iran

Development of Musharakah Sukuk in Islamic Republic of Iran has been done during two phases:

First Phase: from 1994 up September 1997

Second Phase: from September 1997 up to now

Legal framework and executive module of Issuing Musharakah Sukuk settled out based on rules and regulations governing issuance of Musharakah Sukuk (25 June 1994) its bylaw(5 September 1994) which ratified by Money and Credit Council (Central Bank).

⁴ See Monetary and Banking Rules and Regulations, Page 282.

In this period, for 6 projects totally 948.1 billion Rials of Musharakah Sukuk issued:

First: Navvab Project; the first experience of issuing Musharakah Sukuk goes back to the October 1994 in which Musharakah Sukuk of Navvab project issued by municipality of Tehran. This project includes construction of expressway with length of 5.5 Kilometers which connect north of Tehran to its south and construction of 6596 apartment buildings, 4479 commercial and administrative buildings next to the expressway. Total amount of Musharakah Sukuk issued for execution of Navvab project was 250 billion IRRs which issued through four tranches. The maturity of these Sukuk was October 1998. Principals of these sukuk repaid by Bank Melli Iran as a guarantor. Because this was the first experience at that time and there were not any rules and regulations with this respect, Central Bank made “Regulations Governing Issuing Musharakah Sukuk” at 25 June 1994 ratified by Money and Credit Council and this rules became as a legal base for issuance of Musharakah Sukuk of Navvab project.

On-account profit of this Sukuk was 20% which disbursed semiannually. Holders of these Sukuk had preemptive rights to select their arbitrary building including apartment buildings, commercial and administrative buildings in proportion to their Sukuk which they had. Maturity was 2.5 to 4 years in proportion and trustee was Auditing Organization. Materialized and final profit of Navvab project was totally 2% more than on-account profit (0.5% annually) which paid to Sukuk holders at maturity.

Second: project of healthy city and development of Abdul-Azim’s Holy shrine

Healthy city project includes 6 projects which proposed by municipality of Tehran as below:

- Construction of Shahre-ray Ring Road
- Completion of torrent place of Kebritsazi
- Substitution of Varamin road

- Construction of eastern boulevard of Abdul-Azim's Holy shrine
- Construction of southern boulevard of Abdul-Azim's Holy shrine
- Construction of a park named Sizdah-Aban

In this regard, Central Bank issued permit of issuance of Musharakah Sukuk at October 1995 which amount 70 billion IRRs with 20% annually of on-account profit and maturity of 2.5 years. In this project agent bank was Meli Bank of Iran. Based on approval of the President at that time, municipality of Tehran paid 20 billion IRRs of money gathered by selling Musharakah Sukuk for development project of Abdul-Azim's holy shrine to the management of holly shrine. Because of this transfer, Council of Ministers approved that 10% of on-account profit of this Sukuk which equivalents to 17.5 billion IRRs shall be paid by Government. Regarding prepared plan for feasibility study, actual expense and cost of healthy city project and development project of Abdul-Azim's holy shrine has been predicted equivalent to 231 billion IRRs out of which a sum of 70 billion IRRs gathered by selling Musharakah Sukuk and the rest derived from cash capital of municipality of Tehran, holy shrine of Abdul-Azim and government aid. Trustee of project was Auditing Organization.

Third: 10 hospital projects which not fully constructed and completed by Ministry of Housing and Urban Development (Note 68, Annual Budget Act of 1374 (1995-1996) and Note 39 of Annual Budget Act of 1375 (1996-1997))

According to Note 68 of Annual Budget Act of 1374 and also its bylaw which also ratified by Council of Ministers, Ministry of Housing and Urban Development became authorized to attract people participation by issuing Musharakah Sukuk in order to complete building of 10 hospitals which were under construction. For this purpose, Bearer Musharakah Sukuk was issued by Ministry of Housing and Urban Development with maximum amount of 30 billion IRRs. The maturity was 5 years and on-account profit was annually 20% which disbursed semiannually. These hospitals were:

- Birjand Hospital

- Gha-en Hospital
- Kordkoy Hospital
- Ahar Hospital
- Boieen Zahra Hospital
- Kazeroon Hospital
- Nour abad Hospital
- Eghleed Hospital
- Sa'adat Shahr Hospital
- Ardakan Hospital

These Sukuk were the first one which could be tradable in Tehran Stock Exchange after listing. In accordance with Note 68 of Annual Budget Act of 1374, Government guaranteed reimbursement of principal and disbursement of accrued profit of these Sukuk and Management & Planning Organization on behalf of Government obliged to predict required financial resources in annual budget of Ministry of Housing and Urban Development. Also it was stipulated that Ministry of Housing and Urban Development on behalf of Government buys assets and properties of project based on actual and materialized costs and expenses associated with considering materialized profit of participation. These Sukuk were not noteworthy from viewpoint of people because of their non tradability before maturity and in overall during issuance period, approximately 16.4 billion IRRs of these Sukuk have been sold. Consequently approximate amount of 2 billion IRRs on behalf of Ministry of Housing and Urban Development sold to project contractors in consideration of delivered progress reports and the rest delivered to Bank Maskan of Iran. They Sukuk have been matured at 24 January of 2001 and Mellat Bank as agent bank paid principal and profit of last coupon to their holders.

Fourth: Project of Khorasan (Thamen) House Builders

The company of Khorasan House Builders was established based on Directive of Government

and in accordance to Commercial Act. Its stockholders were as follows: National Organization of Land & House (Ministry of Housing and Urban Development) (40%), Razavi Holy Shrine (35%), Municipality of Mashhad (10%) and environment Construction (affiliate of Ministry of Housing and Urban Development) (15%).

This company has undertaken reconstruction and rehabilitation of 262 hectares of timeworn zones of city of Mashhad adjoining to Holy Shrine of Imam Reza (peace be upon him). Saderat Bank of Iran as agent bank issued Musharakah Sukuk during three phases. Maturity was 5 years and on-account profit determined 20% annually which was paid semiannually and also Auditing Organization selected as trustee of Central Bank in the project.

In addition to having redemption privilege in proportion to the amount of Musharakah Sukuk which their holders had, they also had preemptive rights to buy prepared lands and constructed buildings based on preferential prices.

Fifth: National Automobile Production Project

Iran Khodro Company requested to issue Musharakah Sukuk in order to execute projects aiming at increasing capacity of car building companies to produce modern automobile at the beginning of 1997. This project comprised 16 projects including reformation, reconstruction and rehabilitation of cutting and press factory, body construction, final assembly of founding, research & development, body of Peugeot 405, cylinder founding of Peugeot 405 and diesel engine and etc. After preliminary study by Melli Bank of Iran as agent and broker, Central Bank agreed that Iran Khodro Company issues Musharakah Sukuk of National Automobile Production Project through 3 tranches up to maximum of 585.8 billion IRRs⁵.

During first stage, Musharakah Sukuk of aforementioned project issued equivalent to 325.6 billion IRRs at 21 December 1996. Maturity of Sukuk was 4 years and on-account profit rate determined 24% annually which disbursed semiannually. Each unit of Musharakah Sukuk embedded one coupon to buy automobile. In addition to receive principal, on-account and materialized profit, holders of Sukuk can refer to the company at maturity and in consideration

⁵ Only the amount of 5131/ billion IRRs Musharakah Sukuk issued

of delivery of coupon of 50 million IRRs of Musharakah Sukuk, they enabled to receive one automobile with 20% discount rate in terms of market price. Second and third stage of Musharakah Sukuk of abovementioned project were issued and publicly offered at 7 October 1997 in lump-sum of 187.525 billion IRRs. Maturity of these Sukuk was 3.5 years and on-account profit rate was equivalent to 20% annually which disbursed semiannually. Therefore total amount of capital which derived from these stages was 513.1 billion IRRs. Auditing Organization was trustee of this project.

Sixth: construction project of apartment buildings in towns of Hashtgerd and Andishe and Urban Development by National Organization of Land & House (affiliate of Ministry of Housing & Urban Development) (Note 85 of Iran's Second Economic, Social and Cultural Development Plan (1989-1993))

According to Paragraph A of Note 85 of Iran's Second Economic, Social and Cultural Development Plan, Ministry of Housing and Urban Development (National Organization of Land & House) authorized to raise capital in housing sector through Maskan Bank and issuing (selling) Musharakah Sukuk aiming at execution of housing projects in towns of Hashtgerd and Andishe. Ministry of Economic Affairs & Finance on behalf of Government assured redemption of these Sukuk and its accrued profit.

Money and Credit Council determined the characteristics of Sukuk as follows: maturity of 3 years, 20% annual on-account rate of profit, semiannual payment of on-account profit and 3 tranches totally equivalent to 110 billion IRRs.

The first tranche of Sukuk issued for construction of 800 apartment buildings in phase 2 of New City of Parand, infrastructure preparation and construction of apartment building in phase 2 of New City of Andishe, preparation and construction of 1000 apartment buildings in phase 3 of New City of Hashtgerd. Broker of these issuing was Maskan Bank. If Musharakah Sukuk holders wanted, they could have preemptive right to buy land or apartment building of abovementioned project in consideration of 20 million IRRs of Musharakah Sukuk and benefited from 7% annual discount rate with respect to total amount of Musharakah Sukuk.

New Construction Towns Company was as executor and Auditing Organization was as trustee. Principal amount and profit of last coupon of these Sukuk which matured at 9 May 2000 disbursed through Maskan Bank to their holders. (Rahimi, 2002)

Legal framework and executive procedure of first phase of issuing Musharakah Sukuk and its bylaw (approved by Money & Credit Council) are as follows:

1. Musharakah Sukuk issued by project executor which was the owner of project for the purpose of financing required for profitable producing and service projects based on the framework of partnership contract and Central Bank permission.
2. Each of Musharakah Sukuk implied share of its holder considering partnership (participation). Relation between attorney and constituent corresponded between issuer of Sukuk and their buyer.
3. Broker was a bank or institution which proceeded on behalf of issuer to offer Sukuk, disburse on-account profit in due time and reimburse principal at maturity.
4. Trustee was a legal or personal entity which examined using capital in due manner, accounts and project progress on behalf of Central Bank.
5. Materialized profit of project shall be approved by trustee and the margin between materialized profit and on-account profit shall be disbursed to Sukuk holders.
6. Musharakah Sukuk could be assigned to others.
7. On-account profit paid to the Sukuk holders in due dates in consideration of embedded coupon of Sukuk. (Money & Credit Council, Rules and Regulations Governing Musharakah Sukuk approved at 25 June 1994 and its bylaw approved at 5 September 1994).

Eventually the Act of Issuing Musharakah Sukuk ratified by Parliament of Islamic Republic of Iran at September 1997 and its bylaw approved by Council of Ministers at August 1998.

Legal framework and executive module of issuing Musharakah Sukuk was based on the Act of Issuing Musharakah Sukuk (ratified by Parliament of Islamic Republic of Iran at 21 September 1997) and its bylaw (approved by Council of Ministers at 9 August).

Second feature of second phase of issuing Musharakah Sukuk was related to different types of Sukuk as:

- Governmental Musharakah Sukuk (Budgetary and Non-budgetary)
- Sukuk issued by Central Bank for monetary policies
- Sukuk issued by Corporations

Headlines of Issuing Musharakah Sukuk Act are as follows:

- 1- Authorized institutions to issue Musharakah Sukuk are Government, state-owned companies, municipalities, public and non-governmental institutions, non-profit institutions, public joint stock companies, private joint stock companies producing cooperatives (Article 1).
- 2- Holders of Musharakah Sukuk are partners with respect to profit generated from execution of the project based on par value and time period of partnership (Article 2).
- 3- Musharakah Sukuk can be issued by Government if and only if such issuance required for financing of profit-oriented construction projects (Article 3)
- 4- Maximum amount of Musharakah Sukuk which can be issued yearly shall be determined by Money & Credit Council in accordance with Fiscal and Monetary policies of Iran (Note 2 of Article 4)
- 5- Joint stock companies can issue Musharakah Sukuk which can be converted to or substituted by stock (Article 6)

Operational procedure of issuing Musharakah sukuk is sequent:

First: request of applicant from Central Bank attached with a technical, economic and financial feasibility study of project which indicates its profitability and introduce agent bank.

Second: Central Bank permits issuance and determines the date, conditions and stages of Sukuk offering based on stock market conditions.

Third: After Central Bank permit, issuer shall announce the subject-matter publicly through media.

Fourth: Trustee (Auditing Organization) is selected by Central Bank and appraises continuously performance of project issuer with respect to capital employed, accounts, financial statements and executive performance of issuer and discloses its opinion in order to preserve interests of Sukuk holders.

Fifth: Issuer of Sukuk holders shall deliver required collaterals to the agent bank in order to guarantee principal and its accrued profit of Sukuk.

Sixth: Agent bank offers Musharakah Sukuk for selling and disburses on-account profit after tax in due dates and reimburses principal at maturity. If materialized profit is lower than on-account profit, issuer would compensate difference from its own financial resource.

Seventh: Musharakah Sukuk can be redeemed by agent banks before maturity (bylaw of Musharakah Sukuk Issuing Act approved by Council of Ministers).

Musharakah Sukuk Status Report

Table (1): Musharakah Sukuk issued between 1994 and 2006

Year	Number of Project financed through Musharakah Sukuk	On-account Profit Rate (annually) (Tax Exempt)
1994	1	20
1995	3	20
1996	3	20
1997	5	20
1998	6	20
1999	5	19
2000	4	19
2001	11	17
2002	11	17
2003	11	17
2004	15	17
2005	17	15,5-19
2006	18	15,5
Total	109	---

Source: Central Bank of Islamic Republic of Iran, Economic report and Balance of Payments between 1994 and 2006

Table (2): Status Summary of Musharakah Sukuk issued at year 2006

Type of Musharakah Sukuk	Subject-matter project	of	Maturity (year)	On-account profit rate (annually)
Issued by Government for:				
1. Investment through the Budget	Construction budget		5	15.5
2. Investment by state-owned companies	Transportation and electricity development		6	15.5
Issued by Central Bank	Monetary Policy		1	15.5
Issued by corporations	Petrochemical plants		4	15.5

Source: Central Bank of Islamic Republic of Iran, Economic report and Balance of Payments (2006) pages: 256-257

Musharakah Sukuk has been issued in bearer form till now. Based on first and third type, Musharakah Sukuk are issued for financing capital assets and working capital of producing factory but based on the second one, Musharakah Sukuk issued for controlling monetary base and decreasing liquidity volume. Musharakah Sukuk of Central Bank issued as tools of monetary policy as well as controlling inflation in the manner through which it can speculate on international gold and silver market and Musharakah Sukuk holders share the profit of assets portfolio of central Bank. While Sukuk of Central Bank usually has maturity of one year, (short-term Sukuk) the other types of sukuk have maturity of 3 to 5 years.

Governmental Musharakah Sukuk (budgetary type) are issued in order to facilitate purchase

plans of capital goods and repaying principal and their accrued profit are mentioned in Annual Budget Acts.

Governmental Musharakah Sukuk (Non-budgetary type) is issued in order to complete purchase plans of capital goods of state-owned companies and principal amount repaid through their internal cashes.

Corporation Musharakah Sukuk is issued in accordance with Article 4 of the Act of Issuing Musharakah Sukuk (approved at 1997).

Secondary Market of Musharakah Sukuk

All Musharakah Sukuk issued by governmental organizations can be redeemed before maturity based on par value and daily profit. Although this possibility increases Sukuk liquidity for the benefit of Sukuk holders but it also decreases issuer reliance in terms of capital employed. Solution is the trading of Musharakah Sukuk via stock exchange which makes Sukuk as marketable instruments. Because only registered instruments can be traded in stock exchange, Musharakah Sukuk shall also be registered in stock exchange by means of subscription method. Subscription of Musharakah Sukuk can be done like stock subscription by virtue of agent bank and or brokers and through trading system of stock exchange in a manner of order registration. This option cancels redemption guarantee of Musharakah Sukuk by bank and any trading of these Sukuk shall be done through stock exchange. Trading of Musharakah Sukuk in stock exchange decreases their liquidity and this necessitates market makers operations for them. (Securities and Exchange Organization, Surveillance Deputy of exchanges and issuers," assessment of structuring secondary market of Musharakah Sukuk", January 2008, pages: 2-7)

Challenges of Musharakah Sukuk in Iran

Main challenges are as follows:

- 1- Because of redemption option before maturity based on par value and daily profit,

these Sukuk have not been designed in marketable manner and does not change with respect to economic recession and growth.

- 2- Agent banks guarantees redemption of Sukuk at a specified time. This causes increase in agency costs of bank, decrease in accessible financial resources of issuers, increase in possibility of using from financial resource of bank, residue of Sukuk in bank assets portfolio and consequently increases in issuer costs. In addition banks commitment to redeem Sukuk before maturity and/or at maturity restricts management of banks financial resources. Liquidity preference of Musharakah Sukuk doesn't have any costs and expenses for their owners.
 - 3- In case of issuing Musharakah Sukuk by Central Bank, financing costs increase from 15.5% to 17.2%. Considering 5% to 25% of principal amount which shall be retained by agent bank aiming at market making, the rate of 17.2% exceed approximately to 18% up to 22.4%.
 - 4- In accordance with Article 2 of the Act of Issuing Musharakah Sukuk, Sukuk holders share profit derived from project based on par value and partnership period. While a specific project might be profitable at the time of preparation of technical, economical and financial feasibility study but in practice, its expected profitability might be decreased even lower than disbursed on-account profit because of some uncontrollable and predictable variables or even it might be faced with loss. In such cases, issuer shall consider disbursed on-account profit as certain profit and repay principal and the difference between on-account profit and materialized one (certain profit) from its own financial resourced because of its commitment at the time of issuance. If issuer wants to share probable loss with Sukuk holders, it won't be possible to distinguish all their holders because such Sukuk are bearer and they might be traded for many times. That is why only the last holder shall undertake loss of project execution at maturity. But this doesn't make sense because Sukuk owners do not supervise issuer activities and in order to prevent any uncertainties for Sukuk buyers, repayment of principal at maturity is guaranteed by issuer. On the other hand, issuer of Musharakah Sukuk frequently considers on-account profit as a profit which surely shall be paid
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and repay merely principal amount at maturity. But value of project assets usually increases and according to partnership contract, holders of Musharakah Sukuk shall be entitled to capital gain of project assets.

- 5- According to the Act of Issuing Musharakah Sukuk, it is authorized to buy and sell such Sukuk but in practice, small volume and amount of these Sukuk are traded among institutional traders in stock exchange in manner of block trading. Trading of Musharakah Sukuk in stock exchange is faced with two problems:

First: although Musharakah Sukuk are bearer instruments and there isn't any limitations among traders with respect to buying and selling but trading of these Sukuk has transaction costs and brokerage fees.

Second: because Musharakah Sukuk can be liquidated by agent bank based on par price and receiving daily profit before maturity, one who wants to buy Musharakah Sukuk isn't happy with prices which higher than par price and one who wants to sell Musharakah Sukuk aren't happy with prices which lower than market price in stock exchange. Therefore the possibility of having market is vanished in this regard and regardless of trading authorization of Musharakah Sukuk in stock exchange, buying and selling of these Sukuk practically done by branches of agent bank. In fact secondary market of Musharakah Sukuk is the agent bank and in this market buyer (agent bank) plays passively with respect to buyer action.

- 6- In the process of issuing Musharakah Sukuk, project and its profitability are considered but economic and financial status of issuing company is not well enough assessed. While in other countries, credit rating of financial instruments calculated based on country risk and issuing company risk and independent agencies undertake rating of financial instruments. Although the distinction between governmental and corporate securities assessment in other countries and Musharakah Sukuk assessment in Iran can be arisen from the different nature of bond and Musharakah Sukuk, it is necessary to have some institutions which undertake rating responsibility of corporations and securities in Iran. Such institutions enable buyers of Musharakah Sukuk to assess risk and return of their Sukuk.

- 7- Direct sale and creating Central bank debts towards local public are considered to be done only by issuing local currency.
- 8- No possibility of selling Musharakah Sukuk directly to the banks and affecting their ability to provide facilities (loans).
- 9- By paying 15.5% as profit rate to Sukuk holders, efficiency of Sukuk to gather purchase power of Iranian society vanished about 15.5%. Effectiveness of Musharakah Sukuk will be remained only if their profits are collected from economy through taxes.
- 10- According to Unpleasant Monetarist Arithmetic, Musharakah Sukuk of central bank in their current structure transfers only liquidity from one year to the next year and doesn't have sustainable effect to control monetary volume.
- 11- Because in other countries the government uses widely bonds, central bank can control liquidity by selling and buying of treasury bonds so-called open market operation. But in Iran because of limited volume of governmental Musharakah Sukuk, in practice, Central Bank has to issue directly Musharakah Sukuk in order to neutralize monetary base expansion.
- 12- In minority group of monetary policy-making regimes, central bank issues debt instruments by its own. World successful experience proofs that long-run debt instruments should be issued by treasury and traded by central bank for open market operation.
- 13- From the beginning of Iran's Fourth Economic, Social and Cultural Development Plan and based on reformation of Paragraph (H) of Article 10, the authority of Central Bank to issue Musharakah Sukuk has been repealed and it became subject to the ratification of Parliament of Islamic Republic of Iran. This causes delay of Central Bank when it decides to implement its monetary policy. Therefore Musharakah Sukuk encounters with problems which cause failure to achieve planned objectives of the policy maker. Consequently, it necessitates doing some renovations with respect to definitions and conditions of issuing Musharakah Sukuk in order to eliminate their shortcomings and restrictions⁶.

⁶ See Pathology of Governmental, Corporate and Central Bank Musharakah Sukuk, Central Bank of Islamic Republic of Iran, Department of Analysis and Economic Policies, 2007, Pages 5 to 10

Conclusion

- 1- Musharakah Sukuk could be divided into two types: governmental and non-governmental. At the moment, because Musharakah Sukuk are new financial instruments in Iran, non-awareness of people and also their non-established culture in Iran, all Musharakah Sukuk have been guaranteed by banks. This guarantee means that agent bank assures repaying of principal and profit at maturity date and at due of profit amounts. But based on economic and financial theories it seems that governmental Musharakah Sukuk should be offered at lower rates of profit and risk averse investors buy this type of securities because they are guaranteed and assured by Government. On the other hand, it is necessary not to provide abovementioned guarantees for non-governmental Musharakah Sukuk and issuer should undertake assurances. Therefore non-governmental Sukuk have a higher rate of profit versus governmental ones and risk-taking investors will select this type of Sukuk. In spite of what discussed above, in practice, there have not been any distinctions between Musharakah Sukuk issued by governmental sector and non-governmental sector with respect to their profit rate yet.
 - 2- It is important to assess economic power of Musharakah Sukuk issuer. In the process of issuing Musharakah Sukuk in Iran, project assessment and its profitability are examined but another important issue which is rarely considered financial, economical and social status of Sukuk issuer. For example, a specific project might be profitable but issuing company is comparatively at a lower rank with respect to its efficiency. Usually in other countries, ranking of debt securities like Musharakah Sukuk are calculated according to the country and issuing company risk and independent agencies undertake their ranking. It is necessary to establish such agencies to undertake this function in order to prevent issuing Musharakah Sukuk by deficient companies (Rahimi: 2002-2003).
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Operational Models for Ijarah, Istisna, and Murabaha Sukuk from Islamic Point of View¹

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Abstract

The absence of bonds in the capital market and the capability of Islamic contracts in designing of new financial instruments have come to different Islamic financial instruments as sukuk be proposed by the Islamic financial experts. However, although they all lack of those required jurisprudential and economic criteria, few of them have a high operational and economic feasibility in compliance with Islamic jurisprudential rules.

Three of such instruments which have been designed on the basis of Ijarah, Istisna, and Murabaha contracts, are presented in this article. Those who are active in different economic and productive sectors, including government and state companies, private companies, municipalities and all commercial and leasing companies would be able to issue such securities and collect funds of natural and legal entities and enter the investment in forms of Ijarah, Istisna' and Murabaha. The profit made by these contracts would be distributed among the owners of securities after deducting the wakalah fee. Ijarah, Istisna and Murabaha sukuk are some kinds of fixed-income financial instruments in proportion to the rate of return in the real part of the economy. These instruments will cause higher production statistics and increasing job opportunities by redirecting liquidity to the productive sectors of economy; and on the other hand, will be a bases for the development of Iran financial markets.

Keywords: Ijarah, Istisna, Murabaha, Ijarah sukuk, Istisna sukuk, Murabaha sukuk, wakalah, primary market, secondary market, financial policy, monetary policy.

Introduction

Following the realization of Riba – free Banking thought in a few Islamic countries, Muslim intellectuals decided to design particular Islamic financial instruments and started a series of studies on shariah – compatible contracts and the capability of which to help replace some financial instruments such as bonds with Islamic ones. Muslim intellectuals succeeded in designing financial instruments in compliance with Islamic principles and compatible with true requirements of Islamic societies. These instruments, some of which with more than ten years of scientific experience and some just in form of ideas include three main groups as

follows:

- Non – profit financial instruments, designed in accordance with such charitable intentions as qard ul – hasana and endowment;
- Financial instruments with expected rate of returns, designed on the basis of such participation contracts as Mudarabah, Muzara’ah, and Musaqat;
- Financial instruments with specified rate of returns, designed on the basis of contracts such as Murabaha, debt buying, Ijarah, and Istisna.

In this article, three types of these instruments which have been designed on the basis of Ijarah, Istisna’ and Murabaha contracts are presented in compliance with Imamia fiqh and economic conditions in Iran. Since the legal and jurisprudential issues of these contracts are studied in designing such securities as Ijarah, Istisna and Murabaha, we will have a quick look at the legal and jurisprudential nature of these contracts.

Islamic securities experience

Islamic securities or sukuk are such certificates with a unique par value which after subscription implies the payment of par value to the issuer by the buyer and the holder of which is the owner of one or a pool of assets and their benefits.

The total of US Dollars 5 billion of sukuk has been issued by the governments of Bahrain, Malaysia, Pakistan, Qatar and Saxony – Anhalt state of Germany, between 2002-2005. These securities have been rated by credit–rating firms in accordance with the risk rating in the issuers’ country. However, Bahrain government did not take the required measures for rating its first local issue. Malaysia was the first issuer of global sukuk with an international rating called global Ijarah sukuk.

Ijarah, Istisna and Murabaha Contracts

Definitions

Ijarah is a contract in which lessee is the owner of the benefits of a specified asset in a specified period of time for the fund paid to the lessor and is divided into regular Ijarah and Ijarah Al-muntahiyah Bi-ttamlik.

In regular Ijarah, the specified asset shall be returned to the lessor after the specified period but in Ijarah Al-muntahiyah Bi-ttamlik the lessor, according to a condition stated in the contract, shall change the ownership of the asset for the benefit of the lessee.

The word Istisna means to order for producing a commodity. In this contract, one of the two parties undertakes to produce and deliver a specific commodity or project for a certain amount of money and in a specified period of time. Istisna contracts include, order to produce a commodity or complete a project, order to produce a number of conventional commodities, order to produce a certain commodity, order to establish certain projects, and order to produce for making a transaction.

Murabaha is a sale contract in which the seller informs the cost price, including purchase price plus transportation costs, maintenance and other costs to the customer then sells the subject of contract by adding a sum of money or a percent of total costs as profit.

Islamic securities (sukuk) structure:

1. Originator: A legal entity for which securities are issued.
 2. Issuer (SPV): A legal entity established on behalf of the owners of securities for transferring and issuing of securities.
 3. Investors: Natural or legal entities who buy such securities and become partner owners of the underlying asset.
 4. Custodian: A legal entity with the responsibility of supervising the whole operation on behalf of the investors and to protect the rights of whom, in compliance with the rules and regulations.
 5. Investment bank: A company working as an intermediary between issuer and
-

investors.

6. Agent: A bank or a financial and credit firm which has the function at collecting funds from the investors and paying the principal and profit of the securities on certain maturities on behalf of the issuer, in accordance with the agency contract.
7. Guarantor: A legal entity who undertakes and guarantees the repayment of the principal and the profit on maturity dates.
8. Auditor: Trusted auditor of the Securities and Exchange Organization working under supervision of the custodian.
9. Rating agency: An agency authorized by the SEO to rate securities.
10. Market maker: An authorized broker/dealer or investment bank which is engaged in trading of securities with the intent to increase liquidity, regulate supply and demand of the securities, and limiting their price fluctuations.
11. Regulator: securities and Exchange Organization. Public issuing of any kind of securities shall be approved by the SEO.

Ijarah, Istisna and Murabaha sukuk

Definitions

The owner of Ijarah sukuk is the owner of a part of a certain asset which is transferred on the basis of a regular or on Ijarah Al-muntahi Bi-ttamlik contract. It has a specified return called rental and can be transferred to others.

The owner of Istisna sukuk is the owner of a part of the underlying financial asset of an Istisna contract. It has a specified return and can be traded in the secondary market.

The owner of Murabaha sukuk is the owner of a part of on underlying financial asset of a Murabaha contract. It is fixed-income and can be traded in the secondary market.

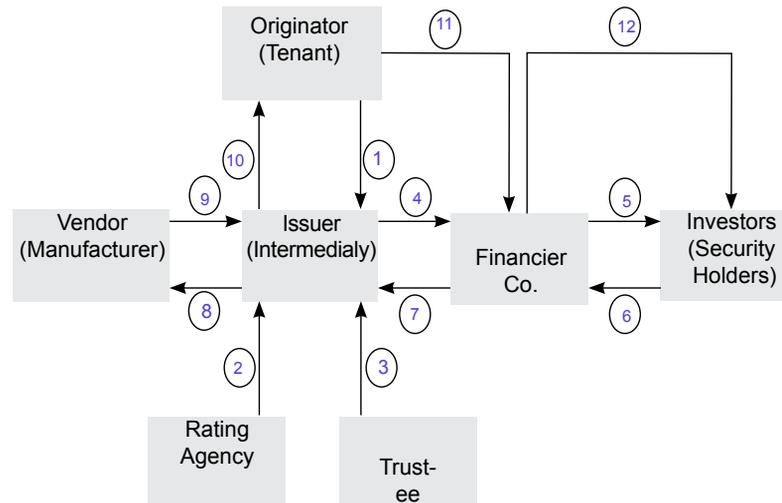
Types of Ijarah, Istisna, and murabaha sukuk

Ijarah sukuk:

1- Ijarah sukuk for finance

Issuer collects the investors' funds and buys the originator's required asset from the producer (seller) in cash and on behalf of the investors, then leases the asset to the originator in form of a regular Ijarah or an Ijarah Al-muntahi Bi-ttamlik. Originator undertakes to pay the rentals to the owners of securities via an investment bank on certain maturity dates. Issuer, at the end of the regular Ijarah, gets back the underlying asset and sells it in the used assets market on behalf of the investors, then changes its ownership to the lessee. The owners of securities can either wait until maturity and receive the rentals or sell their securities in the secondary market.

The operational model of the Ijarah sukuk for finance is as follows:

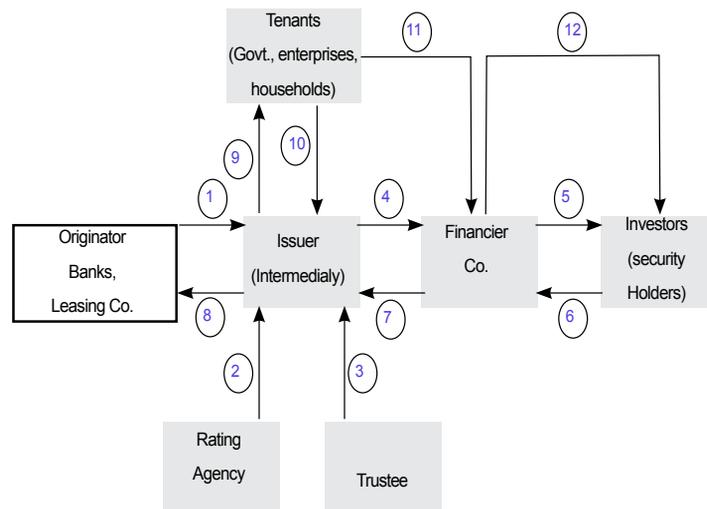


The primary market for this kind of Ijarah sukuk is a combination of wakalah contract, cash selling, regular Ijarah, or Ijarah Al-muntahi Bi-ttamlik. Issuer collects the funds, buys the originator's

As far as the Islamic jurisprudential point of view is concerned, these securities, like the previous model, have got no problem in the primary and secondary market but it should be emphasized that buying and leasing should be done in a real manner. Originator should really identify the specified asset and when changing the ownership, the said asset should really sell to the issuer. So, bay' and Ijarah contracts, should be applied as two independent contracts, and in the buying contract, the ownership should be really transferred to the investors and leased to the originator via a real contract. Here, the Bay' ul inah doubt is not accepted. Bay' ul inah is a trick to bypass Riba and is not permissible in Islamic jurisprudence. However, There exists such doubt in Murabaha sukuk and is quite acceptable but in Ijarah sukuk you sell your own asset and lease it for a five years period. Here, in these five years, the ownership of the asset is transferred to the buyer. So, it would be a real contract and quite different from Bay' ul inah.

3- Mortgage Ijarah sukuk

Here, issuer collects the investors' funds by issuing Ijarah sukuk, then buys those assets which the originator (bank or leasing company) has transferred to the government, firms or families, in form of Ijarah Al muntahi Bi-ttamlik, on behalf of the investors. Originator undertakes to collect all rentals of the assets from the lessees on specified maturity dates and pay them to the owners of securities via an investment bank. Owners of securities can either wait until maturity date or sell their own securities in the secondary market. Operational model of the mortgage Ijarah sukuk is as follows:



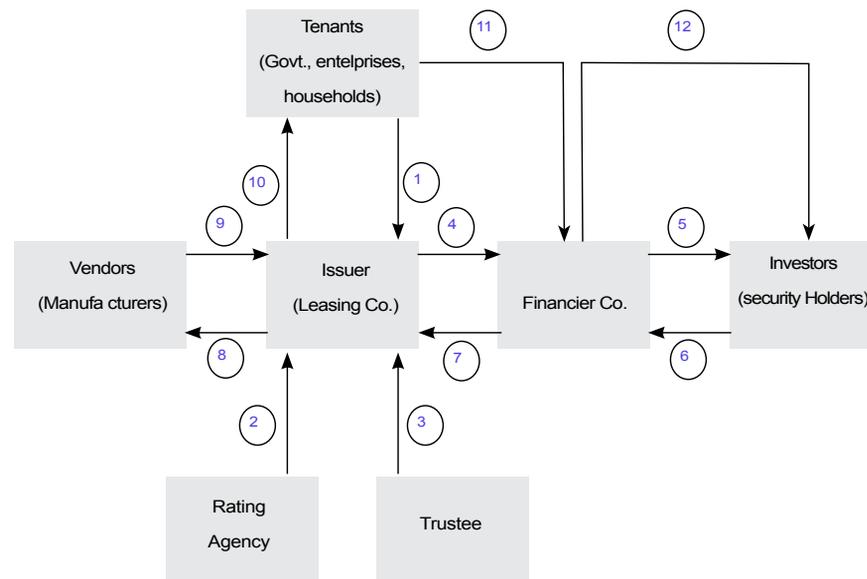
As far as the Islamic jurisprudential point of view is concerned, these securities have got no particular problem in either primary or secondary markets.

4- Leasing companies Ijarah Sukuk

In this model, issuer (leasing company) collects the investors' funds by issuing Ijarah sukuk, then buys the government, firms, or families' required assets in cash from the producers (sellers) and leases them to the government, firms or families after adding all particular costs and also the benefits of the owners of securities.

Issuer (leasing company) collects all rentals on maturity dates from the lessees (government, firms and families) and pays them to the owners of securities via an investment bank. The owners of securities can either wait until maturity date or sells their own securities in the secondary market.

The operational model of leasing companies Ijarah sukuk is as follows:



As far as the jurisprudential point of view is concerned, these securities have got no particular problem in either primary or secondary markets.

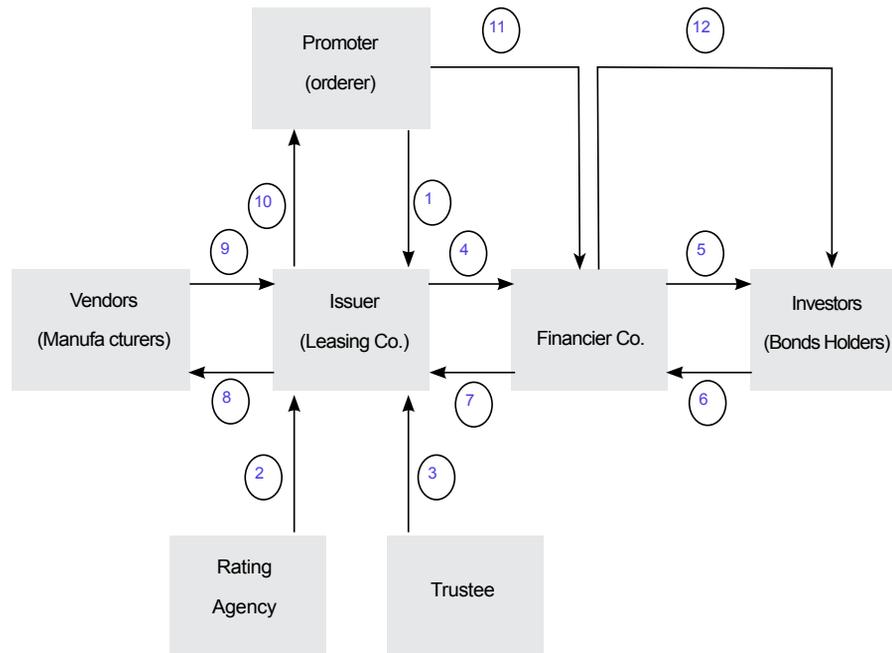
Istisna sukuk

Ministries, municipalities, state and private companies can use Istisna' sukuk for the finance of their development projects and this could be executed in two forms:

1- Parallel Istisna

Originator establishes an intermediary (SPV) and transfers the functions of finance and executing the project via an Istisna contract then pays the price of the contract by Istisna sukuk with certain maturity dates. Issuer of securities also, according to a different Istisna contract orders those particular projects to the contractor and undertakes to pay for the price of the contract in due course. SPV also sells the Istisna sukuk to the investors via an investment bank and pays its debt to the contractor. For example, ministry of Road and Transportation establishes an SPV and seeks to execute a particular project via an Istisna contract. SPV undertakes to execute the project against a sum of one thousand billion IRRs (US Dollars 1 billion) and it is paid in form at Istisna sukuk with certain maturity dates. SPV gives the project to a certain contractor on the basis of a different Istisna contract and this contractor undertakes to deliver the project against a sum of seven hundred billion IRRs (US Dollars 700 million) in due course, e.g., 3 years. After beginning the execution of the project, the SPV sells the Istisna sukuk via a particular bank or an investment bank to the public, and then pays its debts to the contractor out of the collected funds.

The operational model of the parallel Istisna sukuk is as follows:



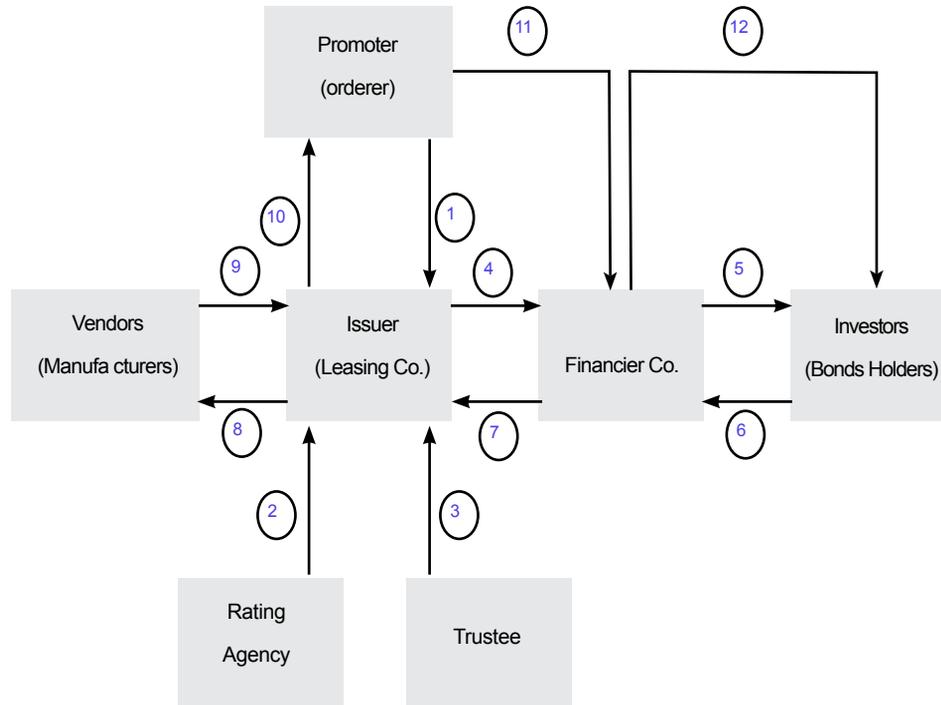
The secondary market for the parallel Istisna sukuk is on the basis of debt buy and sells and requires a jurisprudential study. The majority of shi'it jurists and a group of shaafe'i jurists believe that the process of commercial papers discount by a third person is a kind of Bay' dayn and is permissible if the document is a real one. However, it is possible to buy and sell these securities in the secondary market because Istisna sukuk is a kind of commercial paper which is issued on the basis of Istisna contract and against an economic operation, so it is real.

2- Istisna and Ijarah Al-muntahi Bi-ttamlik

In this model, originator establishes an intermediary firm (SPV) and undertakes to receive a particular commodity or project supplied by this firm in form of Ijarah Al-muntahi Bi-ttamlik. The SPV also orders the commodity or project to a contractor to be manufactured

according to an Istisna contract and undertakes to pay the price in due course, then offers the Istisna sukuk to the public via an investment bank and collects the funds and pays for its debts to the contractor. The SPV receives the commodity or project from the contractor and gives it to the originator in form of Ijarah Al-muntahi Bi-ttamlik on behalf of the owners of securities.

The operational model of Istisna sukuk and Ijarah Al-muntahi Bi-ttamlik is as follows:



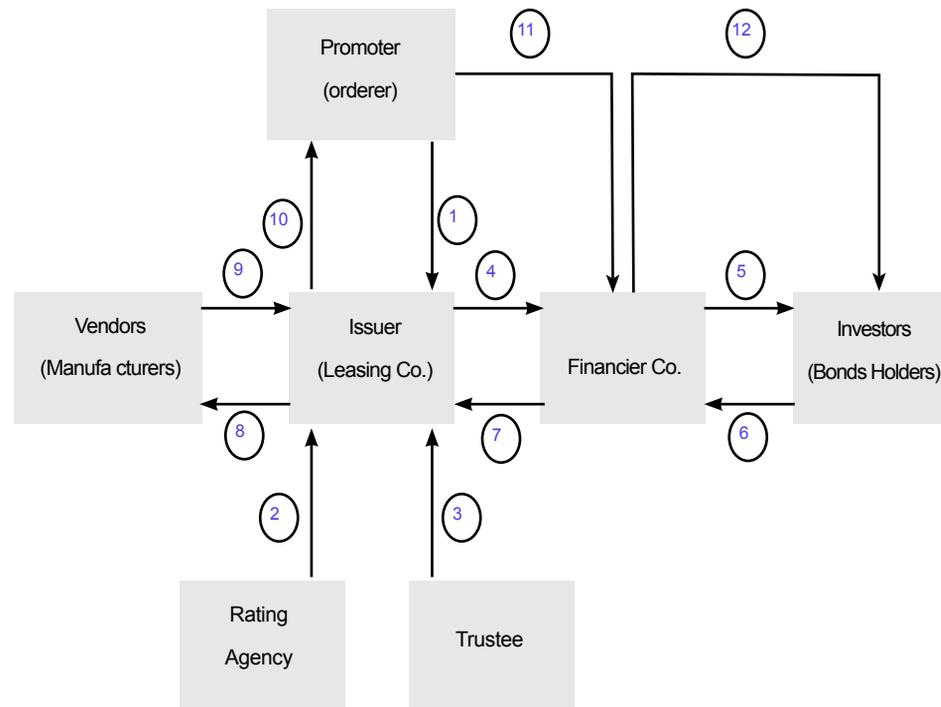
The secondary market for Istisna sukuk and Ijarah sukuk will be on the basis of trading a title deed of a physical asset and there is no legal and jurisprudential problem.

Murabaha sukuk

1-Murabaha sukuk for finance

In this model, issuer collects the investors funds, buys the originators' required commodity from a producer (seller) in cash on behalf of the investors, then sells it to the originator in a higher price and in form of a Murabaha Bay' with deferred payment. Originator undertakes to pay the price to the issuer on certain maturity dates. Then issuer gives the originators' payments to the owners of securities via an investment bank. The owners of securities can either wait until the maturity date or sell their securities in the secondary market.

The operational model of Murabaha sukuk for finance is as follows:

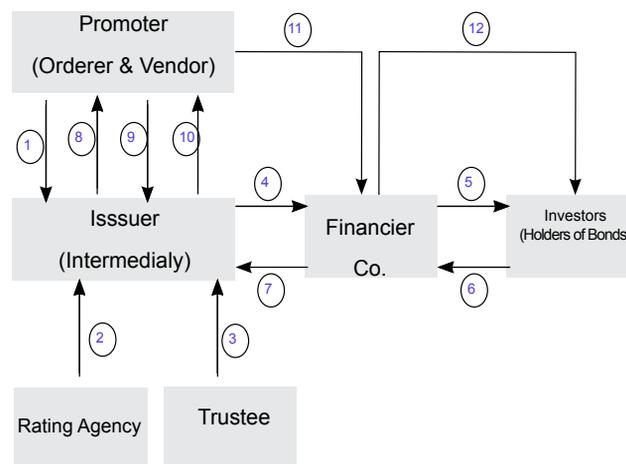


The primary and secondary markets for these securities are a combination of Wakalah, cash selling, Murabaha Bay' with deferred payment, and Bay' Dayn (discount) contracts in such a manner in which the issuer collects the funds, buys the originators' required commodity on cash and on behalf of the investors, then sells it to the originator in form of Murabaha with deferred payment. As far as the jurisprudential point of view is concerned, there shall be no problem with Wakalah, cash selling and Murabaha Bay' with deferred payment contracts but there is a dispute on selling securities in the secondary market (discount). Majority of shi'it jurisprudent believe that this is permissible but majority of Sunni jurisprudents do not accept it and believe that it is batil.

2-Murabiha sukuk for liquidity

In this kind of Murabaha sukuk, issuer collects the investors funds, buys one of the originators' physical asset in cash on behalf of the investors, then sells it to the originator on a higher price in form of Murabaha Bay' with deferred price. Originator undertakes to pay the price on certain maturity dates, and then issuer gives the funds received from the originator to the owners of securities via an investment bank. Owners of securities can either wait until maturity date or sell their securities in the secondary market before maturity.

The operational model of Murabaha sukuk for cash supply is as follows:

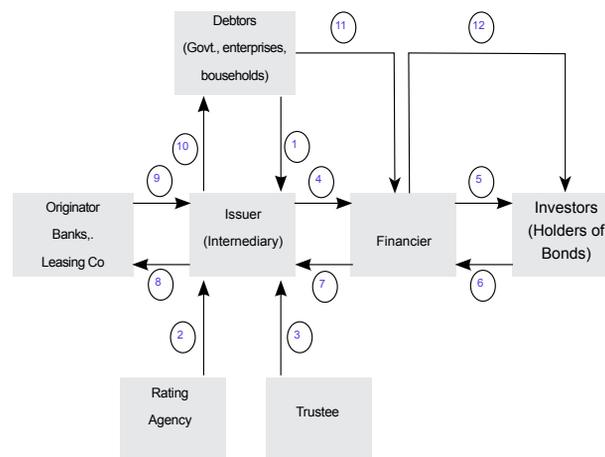


The primary and secondary markets for these securities are a combination of Wakalah, cash selling, Murabaha Bay' with deferred payment, and Bay' Dayn (discount) contracts, in such a manner in which the issuer collects the funds, buys one of the originators' required commodity in cash and on behalf of the investors, then sells it to the originator in form of Murabaha with deferred payment. Here, in addition to discount issue, buy and sell in cash and with deferred payment in the primary market which is called Bay'al inah, shall be of jurisprudential problem and majority of shi'it and Sunni jurists believe that it is batil and not permissible.

3-Mortgage Murabaha sukuk

In Mortgage Murabaha sukuk, issuer (SPV) issues Murabaha sukuk, collects investors' funds and buys, on behalf of the investors, the originators' (bank or leasing company) mortgage facilities of the Murabaha Bay' (installment selling) to the government, firms and families in cash and in a price lower than nominal price, then the originator undertakes to collect the facilities from the debtors (government, firms and families) and give them to the issuer. Issuer also pays the funds received from the originator to the owners of securities via an investment bank. Owners of securities can either wait until maturity date or sell their securities in the secondary market before maturity.

The operational model of mortgage Murabaha sukuk is as follows:

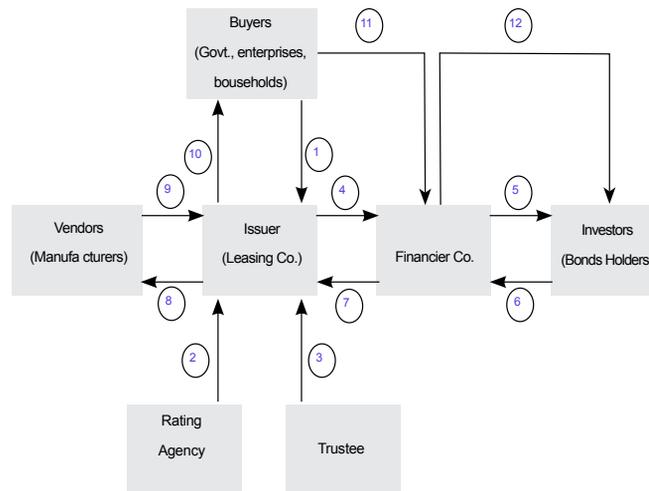


The primary and secondary markets of these securities are combinations, of Wakalah and buy and sell of debt (discount) contracts in which issuer collects funds and buys the originators' debts of mortgage facilities in cash on behalf of the investors (owners of securities). Investors can either wait until maturity date or sell these securities in the secondary market (discount). In jurisprudential point of view, buy and sell of debt (discount) is disputable and majority of shi'it jurisprudents believe that it is permissible but majority of Sunni jurisprudents believe that it is batil.

4-Companies Murabaha sukuk

Here, the issuer of Murabaha sukuk (company) collects the investors' funds, frequently buys the required commodity of the government, firms, and families in cash from the producers (sellers) on behalf of the investors and sells it to the government, firms, and families in form of a Murabaha Bay'. The issuer (company) receives the price of the commodity from the debtors (government, firms, and families) on maturity dates and pays to the owners of securities via an investment bank. The owners of securities can either wait until maturity date or sell their securities in the secondary market.

The operational model of this kind of Murabaha sukuk is as follows:



The owners of securities give their funds to the company to be engaged in Murabaha trades in form of partnership on behalf of the investors. Company buys the required commodities of the government, firms, and families in cash and sells it in form of Murabaha with deferred payment, then collects the receivables of the owners of securities in certain maturity dates and at the end of the fiscal year, distributes the profit among the owners of securities after deduction Wakalah fee. The owners of securities can sell their own portion of the company's assets whenever they decide to do that. Trades of this kind are combinations of Wakalah, Wakalah purchase, Wakalah selling, and asset selling in the secondary market which are permissible.

Economic domain of Ijarah, Istisna and Murabaha

- 1- Families finance for buying consuming goods and durable assets.
- 2- Firms finance for buying production tools, material, and leasing fixed capitals and production tools.
- 3- Government and state enterprises finance for buying required commodities and leasing durable goods.
- 4- Cash supply required by government and firms.
- 5- Securitization of mortgage facilities of the banks and leasing companies.
- 6- Supply of capital for commercial and leasing companies.

Possibility of secondary market for Ijarah, Istisna, and Murabaha sukuk

All kinds of Ijarah, Istisna, and Murabaha sukuk are from amongst the beneficiary fixed income financial instruments, so they can cover the goals and preferences of a major group of the owners of excess funds willing to make a risk-free investment. Thus, if there is no jurisprudential problem, they could be of a great capacity to be bought and sold in the secondary market.

Microeconomic study of Ijarah, Istisna, and Murabaha sukuk

- 1- All kinds of Ijarah, Istisna and Murabaha sukuk are amongst the financial instruments.
- 2- All these securities are fixed – income.
- 3- All these securities are in a high level of liquidity, in the secondary market.
- 4- The more the various the securities, the more efficient they are.

Macro economic study of Ijarah, Istisna, and Murabaha sukuk

- 1- These securities would have a great impact on macroeconomic variables, including consuming costs, government costs and investment, and the particular impact on real economic growth could be examined.
 - 2- When there is a competition, the rate of return of these securities, would be close to the real rate of return and this would help the fair distribution of incomes, but when there is no competition, the rate of return of these securities would be more than the added value.
 - 3- Such securities would be applied as the instruments of financial policy against budget deficit of the government, state institutions, ministries and municipalities and would have an inflation impact of less than borrowing from the central Bank.
 - 4- If there exists a well-developed market with a good variation of Ijarah, Istisna, and Murabaha sukuk, the Central Bank could make a great impact on the volume of liquidity by trading such securities in the secondary market; thus, these securities could be introduced as an instrument for monetary policy, and especially in Muslim countries in which bonds are not permissible and the Central Banks can not apply their monetary policy of open market operation by trading of bonds. This would be possible by trading such securities. So, in recession conditions in which the Central Bank would have an expansionary monetary policy, it would enter the secondary
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market of Istisna sukuk and buy the people's and commercial bank's securities on a higher price and expand the volume of liquidity amongst the society and increase the credit impact of the banks, but when it is to apply a concretionary policy, it lowers the price and sells the securities in order to collect the liquidity.

- 5- Murabaha sukuk could be designed for very short-term maturities of three, six and months in special cases, and be used instead of state treasury bonds, with short-term maturities.

Summary and suggestions

We believe that it is possible to design various financial instruments in line with Muslim clients' objectives and preferences using the Islamic contracts. By issuing the Ijarah, Istisna and Murabaha sukuk, there would be provided secure instruments for risk-averse and conventional investors, and on the other hand, such appropriate instruments are provided to be used by the government, municipalities and state enterprises for project financing. However, they could be supplements for other Islamic securities and would help capital market be well developed. They could provide designers of financial markets with good opportunities for designing beneficiary fixed income instruments and could also be good substitutes for bonds. Thus, regulating authorities, including the government, Central Bank, Islamic Consultative Assembly, and Securities and Exchange Organization are requested to pave the roads to institutionalize the Islamic financial instruments, including Ijarah, Istisna and Murabaha sukuk.

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Operational Model of Futures Contract Trading in Iran Mercantile Exchange

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(SEO)

Abstract

In this article the Operational Model of Futures Contracts Trading as performed in Iran Mercantile Exchange (IME) is presented in details. Herein the most fundamental factor which sets the operational framework was the question of compliance of such trading with Islamic Shariah principles. In fact there were challenges to retain the basic alternatives of the Futures markets and their functions and at the same time to observe and duly comply with Islamic Shariah principles in Futures trading. Hence, the conceptual framework was adopted from a definition developed by the Islamic Shariah to launch Futures market trading in Iran. The definition led us all the way through to prepare Regulations, to develop the required software, to execute the Futures market and to tackle the executive questions and issues posed in the course of execution.

Design of the market, requirements of a standard contract, process of listing the contracts, marking to market and other aspects of Futures Trading are discussed in this article.

Keywords: Futures Contract, Islamic Shariah principles, Futures market, Margin, permission for possession, Iran Mercantile Exchange

Introduction

In this article the operational model of futures contracts trading as performed in Iran Mercantile Exchange (IME) is presented in details.

A major issue we tried to tackle last year in Iran capital market in conformity with Islamic Finance was the question of futures contracts trading.

The most fundamental and a basic factor which sets an operational framework for execution of futures contracts trading were the question of conformity and compliance of such trading with Islamic Shariah principles and Islamic Jurisprudence. Hence, to devise an operational model for execution of futures contracts, the conceptual framework was adopted from a definition developed by the Islamic Shariah and Jurisprudence to launch and initiate Futures market trading in Iran. Based on this approach, two principles set the stage for execution

of Futures contract trading: (1) to find the standards governing Futures Contracts trading at international levels in different countries whose experiences have led to establishment of a standard structure in capital markets world wide and which formed a basis for us to launch Futures market. On the other hand, all operations in the Futures market, the relations among market participants and their activities should necessarily comply with and conform to the framework set by the Shariah Board. Probably, a point which is of great significance in this respect and a major issue which is experienced by those who, technically speaking, design Futures markets and who at the same time wish to establish a compatibility between such markets and fundamental pre-conditions like Islamic Shariah principles is the sequence of processes and procedures.

One may wonder should one start with standard methods and procedures and then to make them compatible with Shariah principles; OR should we choose a market which already conforms to Shariah principles and then change it in a way that it simulates and looks like Futures market and which covers the functions of Futures market to some degree.

The experiences we had in the past demonstrated that none of the above solutions could meet our needs and requirements, because it was imperative that we considered the technical needs and requirements of the procedures prevailing at Futures market, parallel and simultaneous with Islamic Shariah principles. This simply meant that we had to exercise utmost care to retain maximum features and generalities needed in Futures markets so as not to inflict any damage against actual nature of the market in order not to impose any basic problem whatsoever against the market and at the same time to find solutions which would prove compatible with Islamic Shariah principles.

However, this could not be attained unless the Shariah Board and the technical team in charge of the market design worked together to formulate a conceptual framework on which they would mutually agree.

Hence, in the Iran Capital Market it was decided that the operational design of the Futures market be initially presented to the Shariah Board and based on the different alternatives discussed earlier, a basic definition be developed for Futures market. The meetings which were held with the Shariah Board in order to design Futures market were in fact the challenges

we had in order to retain the basic alternatives of the Futures markets and their functions and at the same time to observe and duly comply with Islamic Shariah principles in Futures trading. The final outcome of this constructive interaction was a definition as discussed in the following section.

Futures Definition

The following definition led us all the way through to prepare Regulations, to develop the required software, to execute the Futures market and to tackle the executive questions and issues posed in the course of execution:

“It is a contract in which seller is obligated to sell a specified quantity of goods, on a specified due date, at a price currently determined, and the other party, in its turn, is obligated to buy the same goods. To prevent the default by any party to such contract, based on the proviso laid down in the Contract, they are obligated to deposit a given amount of money with the Clearing House as an Initial Margin, the amount of which is subject to adjustment, provided that in the futures prices change, in which case the Clearing House shall have the discretion and authority to leave a part of the Margin deposited by one party with the other party named as having the permission for possession, and it may be utilized by the party concerned until the final settlement is made on the due date.”

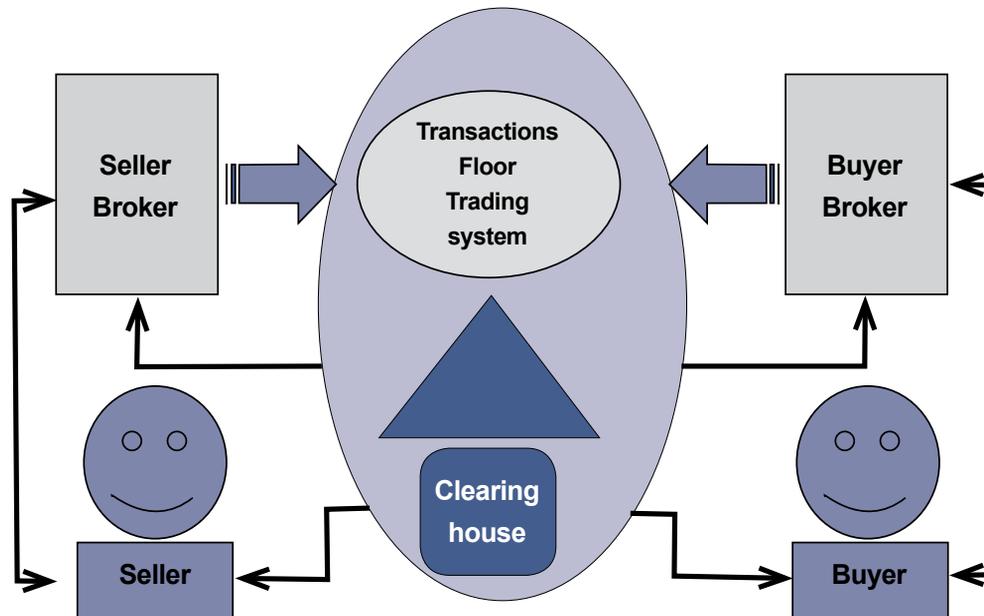
This is a concise and precise definition but it proved sufficient for those who were in charge of designing Futures in conformity with Islamic Shariah principles.

The first sentence in fact defines those who adopt a Short Position in Futures market, which actualizes or realizes their operations in the form of a commitment. Logically speaking, those who adopt a Long Position are known as the ones who are committed to buy the goods.

The second sentence concerns the Initial Margin to be deposited by the parties to such contracts. The last part of the definition which was proposed by the Shariah Board for Futures trading made it feasible for us to devise procedures and processes for Marking-to-Market which would prove as close as possible to international standards.

In the following section we will demonstrate the Operational System which is executed presently in the IME. Hopefully we will show how we managed to set up a standard Futures market based on reliable executive procedures and which at the same time proved compatible with Shariah principles.

Diagram 1: The Operational System of Futures Market



This diagram shows the relations among Futures market Participants, Brokers, Selling/ Buying Parties, the Clearing House and the Exchange. The relations among them conform to the standard relations as defined in Exchanges worldwide.

The Brokers stationed in the Transactions Floor compete with each other, using an electronic system, on behalf of their clients, receive orders from their clients and, proportionate with the

transactional authority they have in the Futures market. They deposit margins and guarantees with the Clearing House. The clients do not have direct access to the market and they are connected to the market only through their brokers. However, each Client may have direct relations with the Clearing House and they have separate accounts for themselves as well.

Buy-Sell-Obligation

The definitions which are provided here are taken from the text of the Regulations prepared for Futures market. As it is evident, in our Futures market, by the clients it is conventionally meant Buyer or Seller.

- ┆ **Client:** the one who acts in the Market as a Buyer or Seller

Buyer is defined as the one who is committed to buy the goods, and Seller is defined as the one who is committed to sell the goods. In international standards, they are called “Goes Long” and “Goes Short”. Here, in our Futures market we say “buys” or “sells”.

- ┆ **Seller:** the one who is committed to sell the “underlying asset” in the due date, calling the Seller on the market custom.
- ┆ **Buyer:** the one who is committed to buy the “underlying asset” on the due date, calling the Buyer on the market custom.

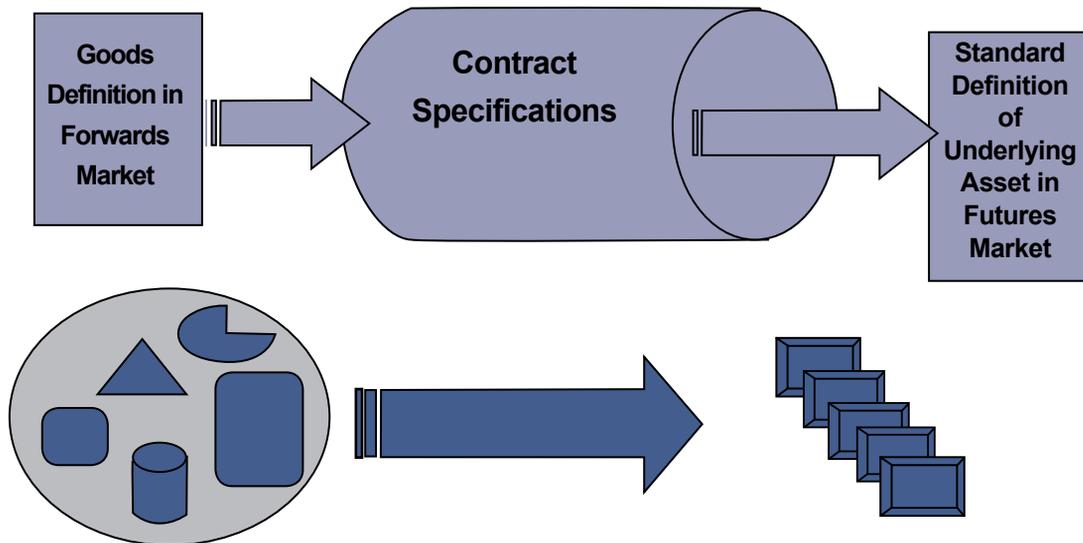
All these terms imply that they are committed either to sell or to buy in the future. Naturally, Position, Short Position, Long Position and Open Position are terms which suggest and imply the same concepts as set in the international standards.

- ┆ **Position:** A commitment for “Futures Contract”
 - ┆ **Short Position:** is a position where a designated Client is committed to buy the “underlying asset” as mentioned in the “futures contract”.
 - ┆ **Long Position:** is a position where a designated Client is committed to sell the “underlying asset” as mentioned in the “futures contract”.
 - ┆ **Open Position:** a position which has not been settled yet in the Market.
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Standardization of the commodity

Standardization of the commodity based on Contract Specifications, in conformity with the basic definition provided for the Futures Market, is given serious consideration in the structure of Futures market which conforms to Islamic Shariah principles. In the definition provided for Contract Specifications, and at the same time in order to have at our disposal an actual and deliverable commodity; a commodity which is both standard and which converts the Forward Market Instrument into Futures Market Instrument.

Diagram2- Contract Specifications



Here focus in on the Futures. Development of Futures Contract Specifications is the key to the success of Futures market and guarantees the compliance and compatibility of Futures standard concepts with Shariah concepts and principles.

Table 1- Futures Contract Specifications

Titles	Definition	Example
Underlying asset	Inventory or other assets underlying the contract	Copper rod, gold coin
futures contract size	A given amount of inventory is obliged in the contract	
Standard of underlying assets	Full qualitative specification of the asset	
Month of the contract	Month on which contract dues	
Daily price limits	Maximum authorized price volatility in one day relative to the settlement price of the day before	2 percent 3 - percent
Transactions period	Determination of the first and last authorized transactional day	1st Mehr – 25th Azar
Delivery date	A period where the seller is to deliver the underlying asset	25th to 30th Azar

Underlying Asset should be selected from among the commodities which prove feasible to be deliverable on the basis of market size. Such careful scrutiny suggests and implies that commitments are not formalities and formalisms to be observed.

In order to create a balance between commitments and market size, so as to have greater options to choose the underlying asset, and in order to give practical and actual quality to the commitments, Contract Size is given due consideration when designing Futures market. Earlier we talked about “Underlying Assets Standards”. Every attempt is made to increase the chance of delivery and to this end all deliverable commodities are rendered deliverable in conformity with similar standards taking into consideration the Premium. Under such circumstances the volume of deliverable commodities increases noticeably and get closer to the realities of the actual market.

Daily Price Limit: is a control system which contributes to settlement processes and counter-party risk coverage.

Transaction Period: Out of the contract period, some part is utilized for delivery operations and the remaining time is meant to carry out the transaction. Hence, it is a period of time in which clients may undertake commitments.

Delivery Date: There exists a delivery mechanism which will be explained later. In the delivery mechanism, a “Delivery Date” is stipulated on which a clear decision will be made with respect to the “fund” of the Buyers and Sellers. In fact, on the “Delivery Date”, the clients who are determined to receive and take delivery of the commodities, should have already met and satisfied all the commitments. In other words, on this “Date”, the Sellers should submit their commodity receipts and the Buyers should deposit all the sums.

Table 2- Futures Contract Specifications

Title	Definition	Example
Delivery Point	The point where inventory is delivered to the buyer	Stores registered to the exchange
Minimum Order Price Changes	Increase or decrease in the order price is multiple of this number	Rls 1000 94000 95000 96000
Initial margin	It is a margin to guarantee that customers meet their obligations and to create a “position”	10 percent of the underlying price
Maintenance margin	Minimum level of “initial margin” which has to be in accounts for each and every open interests	60 percent of initial margin

Other specifications of Futures which are dependent upon “Delivery Conditions” will be presented in Table 3. Further, we will elaborate on the Initial Margin and Maintenance Margin separately in the upcoming section.

Table 3- Futures Contract Specifications

Title	Definition	Example
Maximum volume of each order	Maximum contracts ordered in each order	10 contracts
Transactions fee	Brokerage, exchange, settlement and delivery commission	Rls 10,000 for each contract or percentage of contract's value
Transactions hour	The authorized time period for trading	
Transactions symbol	A symbolic name in the trading system	
Limit of open interests	Maximum authorized position for each person	100 contracts
Penalties	Determined penalties in cases of failure to deliver or settle	1 percent of contracts value

According to “Limit of Open interests” each and every person may enjoy a limited number of open interests. In view of the fact that the Futures market is based on a commitment for delivery, in conformity with a proposal made by the Shariah Board a specific limit has been laid down in the Contract Specifications.

The market was designed in a manner so that the total number of Open interests of the clients, which are created considering the limits imposed on the Open interests of each and every broker and clients, proves proportionate with the total deliverable commodity in the market.

Penalties: In the Contract Specification, a special ruling is stipulated as penalties. This means that a person who undertakes a commitment is a responsible person. If within the commitment period, he does not transfer his undertakings to another person, i.e. if he does not offset his position and if he approaches the Delivery Period, he is under commitment to make the delivery.

However, should he fail to do so, as a defaulting party he will be penalized.

Margin

In our futures model in Persian, Margin is called “vajhul tazmin” or “vajhul ziman”, and in fact it is the “money” or “cash” deposited by the parties in order to guarantee fulfillment of the commitments which they undertake.

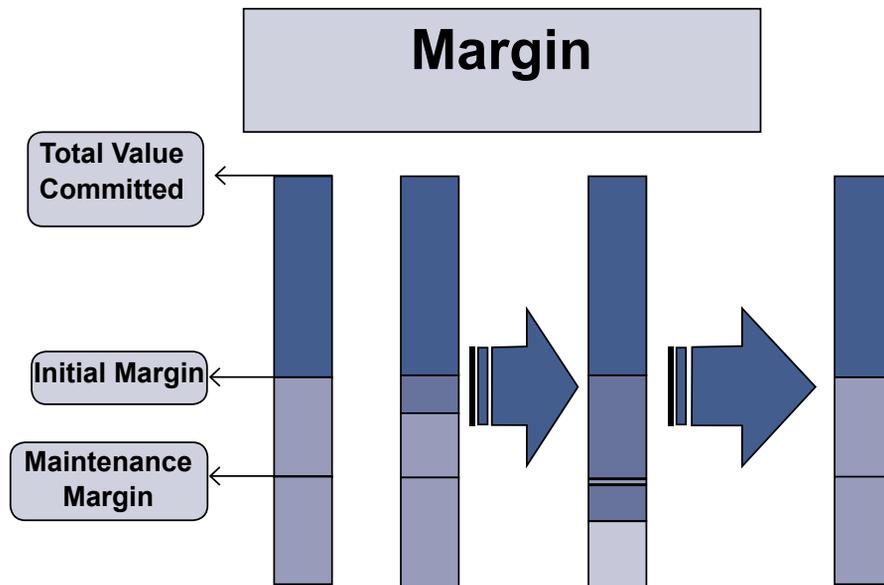
Based on this definition, the basic concepts of the Margin in Futures market, including Initial Margin, Call Margin, Variation Margin and Maintenance Margin are defined herein:

- ┆ **Initial Margin:** An amount of cash deposited by clients to insure they will meet their commitments and to open the “position”. Its amount is to be determined in every “futures contract”.
- ┆ **Margin Call:** an amount of cash a clients is committed to bring to the Clearing House after receiving the “margin declaration”.
- ┆ **Variation Margin:** In cases where the Initial Margin is not sufficient to cover price volatility risks, after a declaration is made by the Clearing House, and within a specified time period, clients with “open position” should bring additional margin to the Clearing House, the amount of which shall be determined by the “Exchange”.

Diagram 3 shows the 4 stages formed in the process of the keeping of accounts and margins. A part of the transaction value is collected in the form of Initial Margin calculated on the

basis of transactions price. However, should it drop below the Maintenance Margin, it will be compensated for.

Diagram 3- Keeping Accounts and Margin



Listing Futures

In the Iran capital market is a “Listing Board” comprising the representatives of the Surveillance Entity, the Executioner, and the representatives of the Industries Sector, who examine the Contracts and approve their being listed before such contracts are transacted.

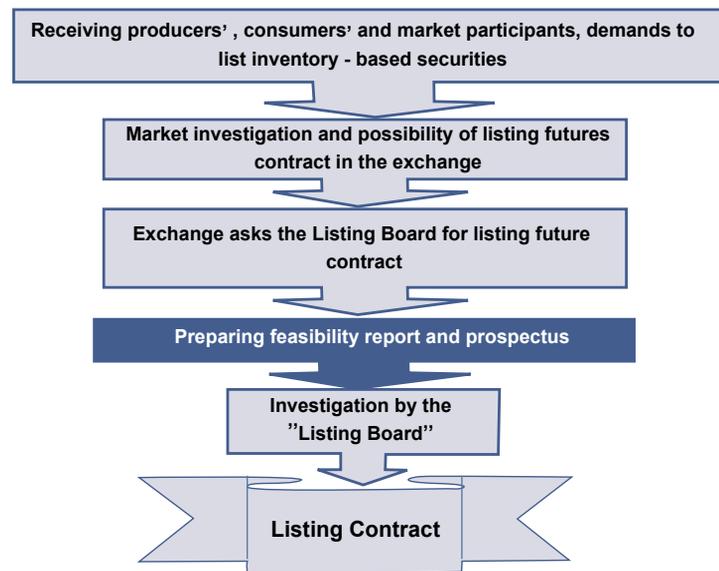
In the course of listing compatibility between commodities or commodity-based securities with the terms and conditions stipulated in these Directives are investigated in order to list them in the Exchange.

Another document, Prospectus, contains all the information needed to be brought to the

attention of the investor, including the commitments and responsibilities he has to take into consideration in order to realize that Futures Market involve real commitments that he is going to be a party to an actual and real market. The Prospectus is meant to give a chance to those who intend to step into Futures market to understand that they are undertaking a real commitment so that they need to establish their ability to make delivery of the commodity.

To list any futures contract, the process works likes the following diagram:

Diagram 4- Process of Listing Futures Contract

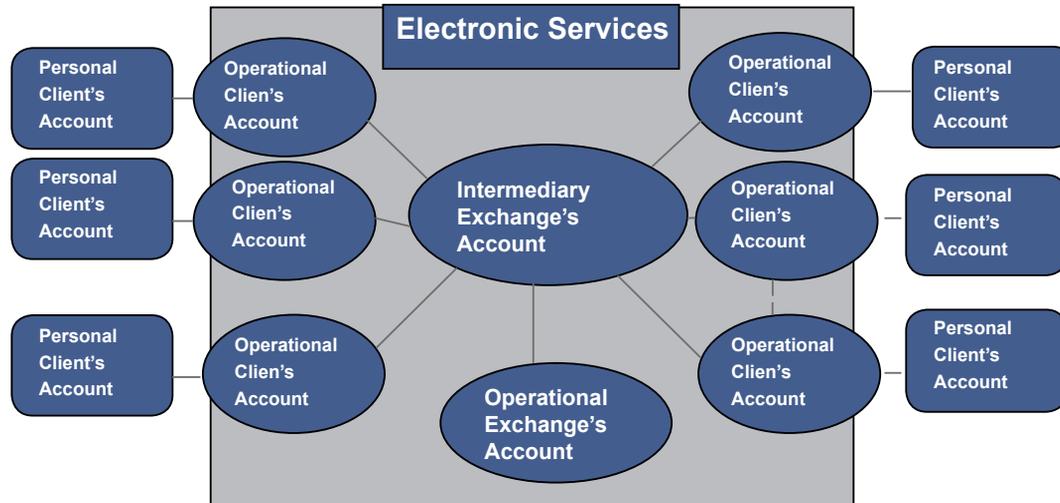


This process is designed to know the clients (on the basis of recommendation made for example for Anti-Money-Laundering) and establish his credit status which should be proportionate with amounts undertaken by the clients.

Should the client wish to register in the Futures Market, he should first choose a broker and

submit his identification documentation. In the next step, he should sign the Risk Statement which is meant for the client to realize that he is stepping into a market which is risky by its nature. The signing of the Risk Statement is a requirement for opening of the bank account. As it is shown in Diagram 5, this model paved the way for our Daily Marking-to-Market operations.

Diagram 5- A Model for Opening Account in Futures Contract Transactions



One of the greatest challenges which was experienced in connection with Futures Market within the context of Islamic Shariah principles, was the calculation of gain or loss on the basis of Daily Settlement Price for the accounts and transfer of the same to the accounts, especially when the person was not involved in a transaction on that day and had no role in setting the Settlement Price (which functions as the basis for calculation of gain or loss). Under such circumstances, we had two options only. Either:

1. We had to design Futures Market, in a manner that we would deviate the standards

which govern Marking-to-Market operations which cover parties risk, in which case the structure of FC trading will experience difficult issues; **OR**

2. We had to find a solution whereby we would carry out Marking-to-Market operations in conformity with Shariah principles.

The latter option was seriously considered and examined in the course of a number of meetings held jointly by the Shariah Board, Legal Committee and Futures Market Executive Committee. The final conclusion and outcome of the deliberations was that the clients' accounts should be given to the Clearing House in their names with the permission for possession. Under such conditions, the Clearing House is authorized to carry out Marking-to-Market operations on the basis of Daily Settlement Prices, a procedure which is stipulated in the contracts and accordingly transfers the clients' sums.

In this model, the clients' and brokers' operational accounts are put at the disposal of the Clearing House to carry out contract settlement operations and upon Offsetting or cash settlement, the sum are transferred to their personal accounts. However, during the Open Position Period, using the electronic service developed to this end, the Clearing House performs the Marking-to-Market Operations in conformity with the powers and the authority given to it.

We developed the required infrastructures such as establishment of commitment, financial and operational relations in order to perform certain post-trade operations on the basis of the system which was designed.

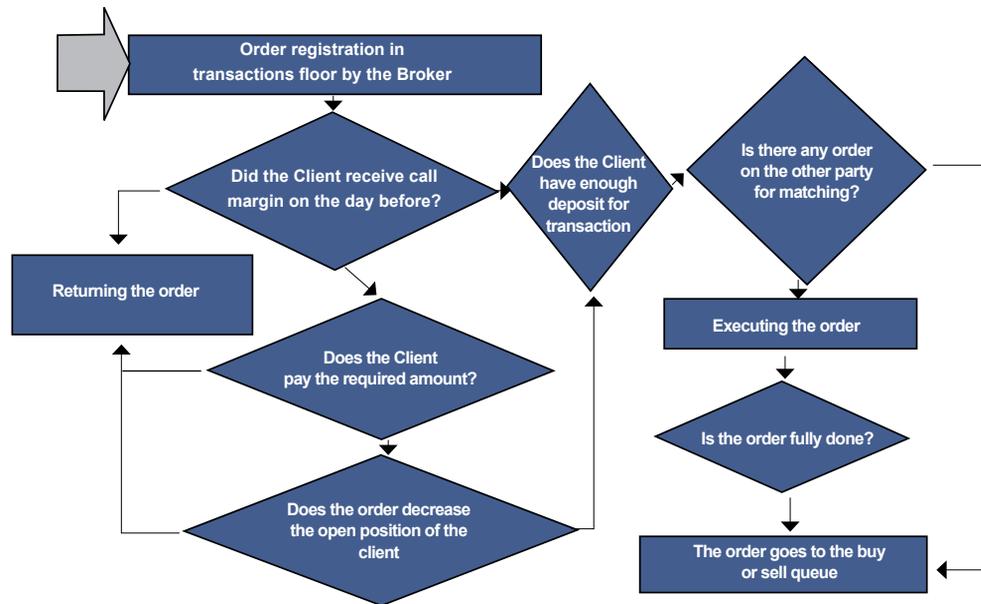
From this moment on, upon placing orders, the clients adopt either a short position or a long position in the market.

Order Booking in Transactions Floor

Based on Diagram 5, all orders are controlled under different requirements including sufficiency of the client's Margin, no call margin in the previous day, and sufficiency of the margins for the transaction, and this way the clients acquire an order routing indicating

that they will be able to settle the funds. From this point on, orders booking process will be followed up for transactions and orders.

Diagram 6- Order Booking in Transactions Floor



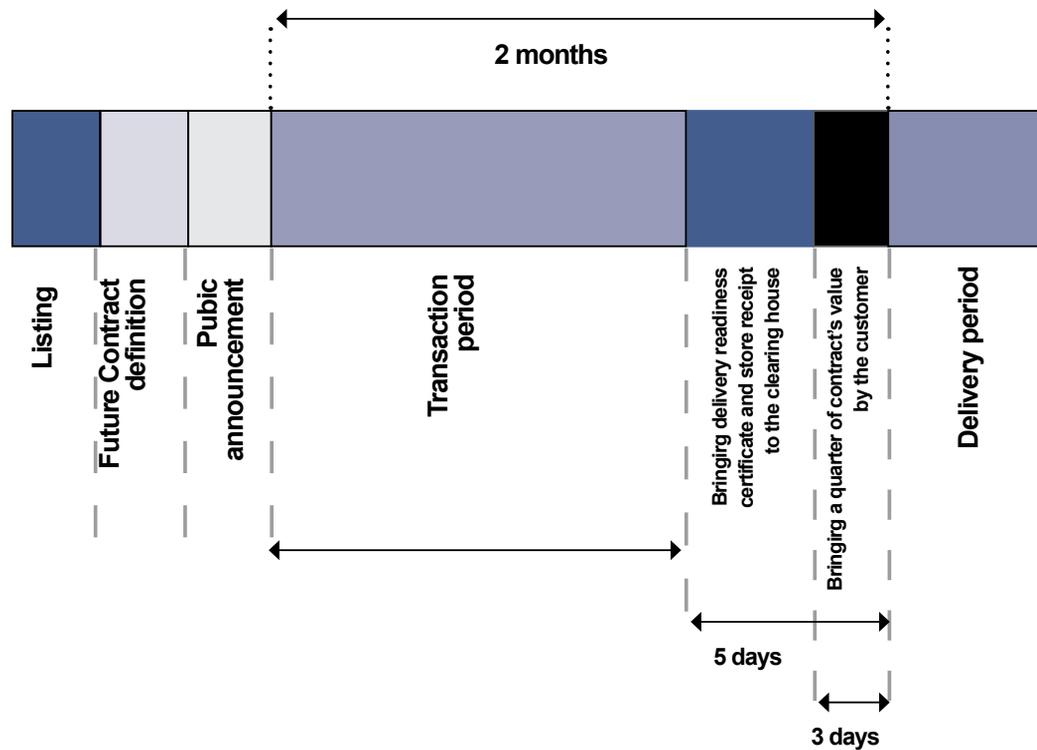
As per every Order, there is an Order Registration Form on which the Client's and the Broker's undertakings and responsibilities are clearly specified. In fact it is a document based on which powers are vested with the Broker by the Clients and the scope and limits of duties and responsibilities of the Broker are determined.

Transaction Period

In an overall view, after listing, Futures contract definition and public announcement, there is a specified period (for example 2 months) between the first transaction period and the beginning of the settlement period, during which the major transactions of the market are

carried out. The 5 days time until the delivery period is in fact a period designed to be prepared for the delivery.

Diagram 7- Transaction Period



Daily trading sessions consist of an opening period, a continuous period and a final transaction:

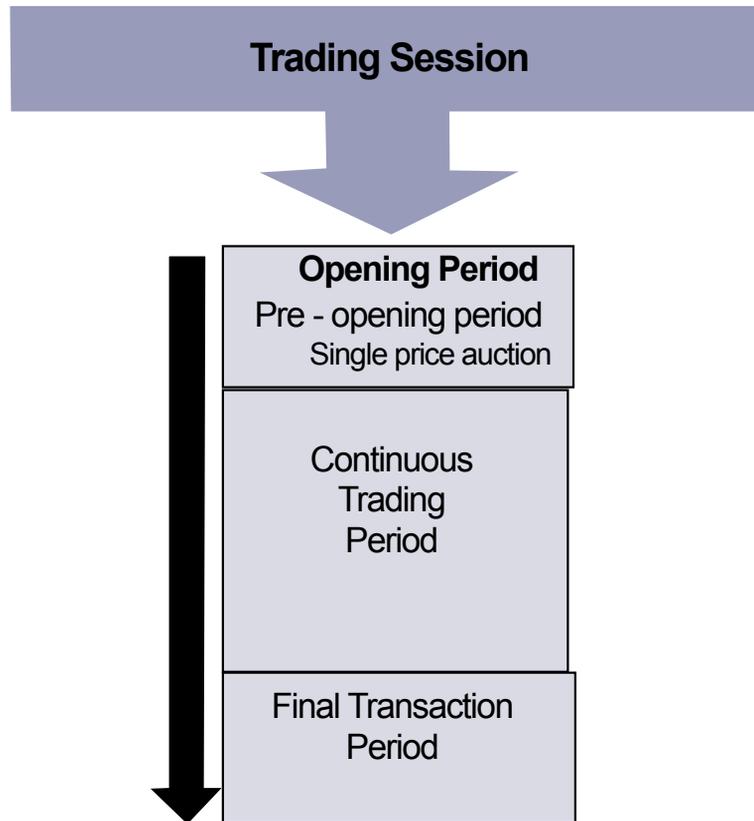
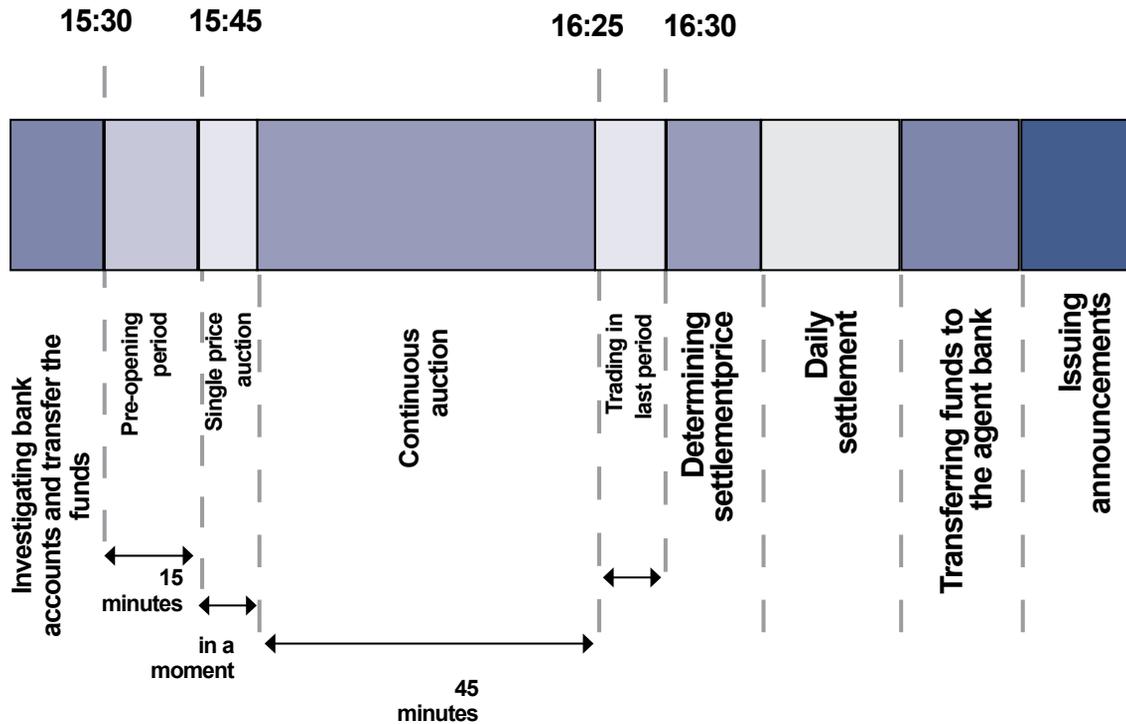
Diagram 8- Daily Trading Sessions

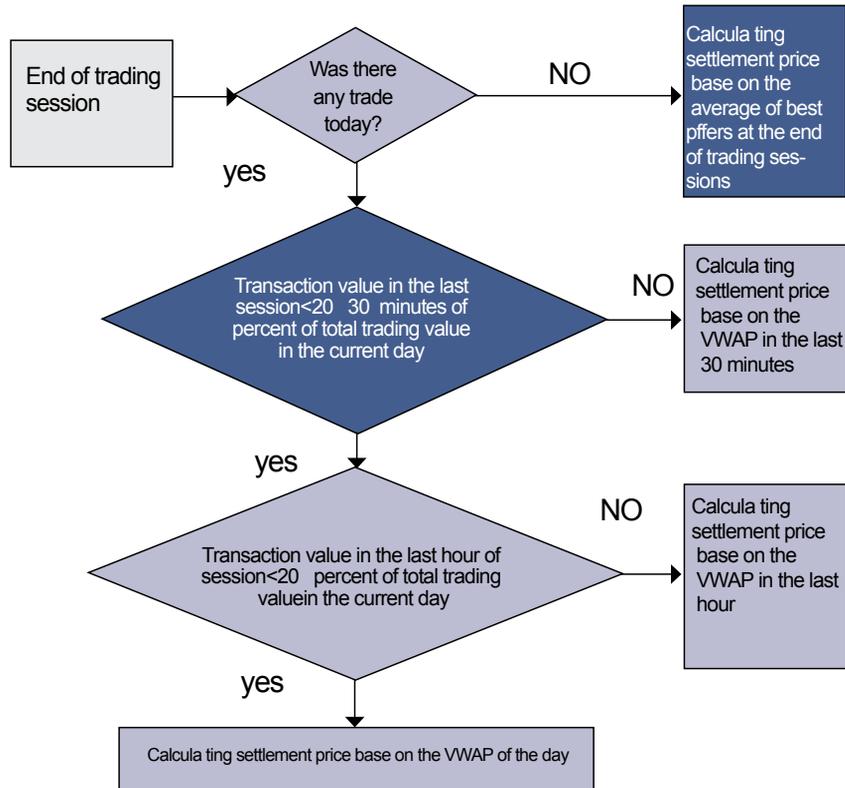
Diagram 9 shows complete process of a transaction which begins with the deposit of funds by clients prior to the transaction. Following these, we have settlement price, daily settlement price, and transfer of funds to the agent bank account and issuance of trading announcement relevant to the transaction. The timing depends on contract and it is defined in contract specifications

Diagram 9- Transaction



Trading software was developed based on the definition, provided by the IME software experts. This software is capable to immediately receive the orders, to create buy and sell queues, to make competitions and finally to execute the orders and transactions. After a transaction is executed, daily settlement is performed, and then on the basis of the daily settlement prices and in conformity with the permission for possession granted to the Clearing House, the funds are transferred on a daily basis.

Diagram 10 shows Daily Settlement process which is consists of 4 phases.

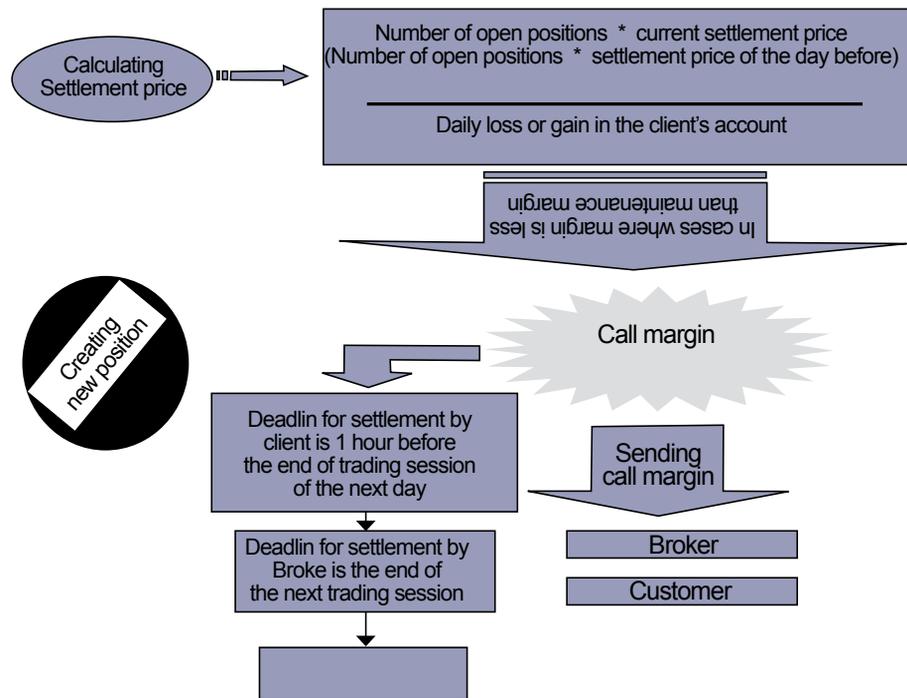
Diagram10- Calculating Daily Settlement Price

If a transaction is performed during the day, the Value Weighted Average Price (VWAP) in the last 30 minutes of the trading session, in the last hour of the session and during the day of trading session is calculated based on the proportion between the trading volume at the end of the trading session and the total volume of transactions.

Otherwise, upon calculation of the Settlement Price, the calculation of the Difference, i.e. the

difference in the value of open interests in the previous and current day, functions as the basis for loss or gain and on the basis of which bank accounts and client's operational accounts are adjusted accordingly. However, if the Margin drops below the level of Maintenance Margin, a Margin Call is sent to both the Clients and the Broker. Under such conditions, the Clients may close or settle his position one hour before end of the next day's trading session. However, should the Clients fail to do this; the broker may do the same. If none of these courses of action leads to the client's settlement of account, the Buy-in Market is stipulated in Iran Futures market in order to compensate for this. This process is shown in Diagram 11.

Diagram 11-Marking to market process



Marking to Market

The definitions provided for Marking to Market in the regulations is presented herein. Marking-to-Market regulations are prepared within a legal framework. Marking to market is a process done by the Clearing House after trading session, aiming at controlling the margin of customers:

1. Regarding “open interests”, the difference in the value of underlying asset in the “futures contract” is calculated and accounted for customers based on the difference between “daily settlement price” of current trading day and the preceding trading day.
2. After completion of the aforementioned operation, if the customer’s “initial margin” proves less than the “maintenance margin”, the Clearing House will send a “margin call” to the designated broker.
3. Brokers are to inform the customer immediately after receiving the “margin call”, so that he will pay for the “call margin” in a given time period.

Note 1: “call margin” is to be paid 1 hour before the end of the next day’s trading session.

Note 2: Customers who receive a “margin call”, will be authorized to open another “position” only after they pay for margin.

4. In cases where a customer fails to pay the “margin call” and to recover his account up to the level of the “initial margin”, the designated broker may close all or part of client’s “open interests” to provide the “margin” needed.
5. If the broker is not able to provide the “margin” even after the aforementioned operation, it will be handled in the Buy-in Market
6. If in the last solution, customer’s liabilities are not covered, the margin will be provided by the designated broker account or by his deposit in the Clearing House.

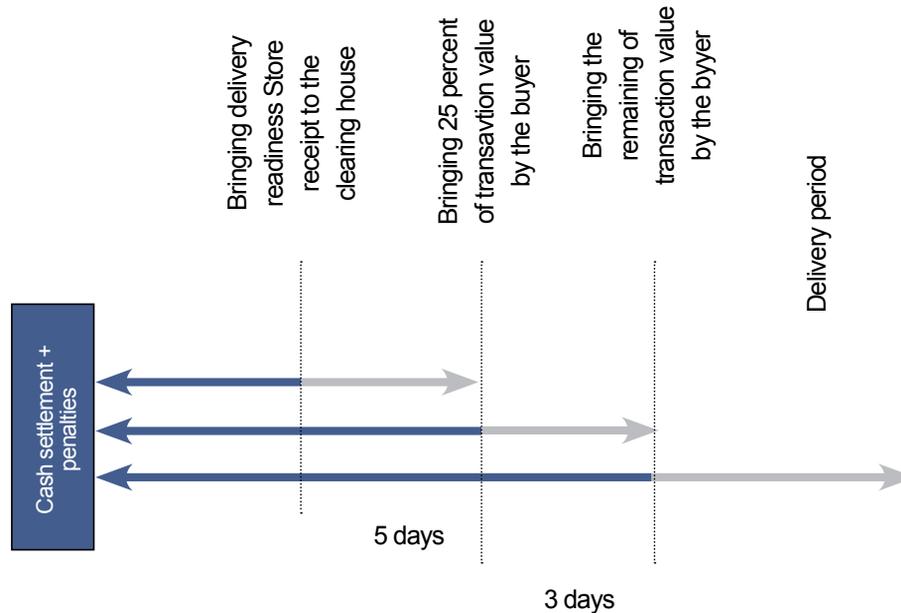
Delivery and Final Settlement is a process which demonstrates that Futures in Futures markets are designed in conformity with Islamic Shariah principles. Practically speaking, the pre-requisite for goods delivery is to meet the stages which appear before this. In the

contracts specifications, the contract month of the contract is specified. Definition of terms such as Delivery, Delivery Announcement, and Delivery Readiness Statement are provided for in Transactions Settlement.

Delivery Announcement is an announcement by the Clearing House for the purpose of informing buyers about the delivery status.

Delivery Readiness Statement is a specified certificate filled by the “futures contract” seller, in order to inform the Clearing House of his readiness to deliver goods.

As it is evident in Diagram 12, 5 days before the Delivery Period, those who have Open Positions (Long or short) should submit the Warehouse Receipt and Delivery Readiness Statement to the Clearing House. Sellers at this juncture are practically obligated to submit corroborating evidence in respect of the assets they have undertaken. As for those who witness this date and who have undertaken a commitment in the market, the sale of the commodity is a “Must”. Hence, a Seller under commitment will be penalized if he fails to submit the documents needed in this respect. The penalty consists of a fixed amount in respect of the failure to meet commitments plus a variable amount to be calculated on the basis of Commodity Spot Market. Naturally, the clients’ loss or gain is calculated on the basis of the last Settlement Price, and the transaction refused by the Seller is settled after collecting of the penalties. If the seller submits the corroborating evidence within the time period stipulated to this end, the Buyers are to pay 25% of the contract value as the advance payment. Within 3 days after this, Buyers have to pay the total contract value based on its value on the last trading day. The Buyers who dishonor and refrain from paying the contract value will have to pay the penalty stipulated in the Contract Specifications to this end. Such penalty will be calculated on the basis of Settlement Price of the day the Buyers refuse and will accordingly be collected and settled.

Diagram 12-delivery process

This procedure implies a general concept indicating that commitment to buy is a basic and real concept. Buyers and Sellers are held responsible in respect of their undertakings and if they refuse to honor their obligations, they will be penalized.

As the final step, definition of final settlement (Cash Settlement) which is compatible with Futures market mechanism is an agreement made by every party to the effect that he either meets his commitments or pays penalties if he refuses to do so.

Concluding Remarks

The model we defined is an Operational Model which is the outcome of a parallel

interaction among Legal, Juridical and Technical Committee. The system developed by these Committees is operationally executed in the IME. Although it is experiencing its early stages of development, it has already contributed to further achievements by the Iranian capital market. Definitely the great advantages that Futures markets have will shortly be transferred to Iran financial market and to Iran's economy.

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Recent Trends and Innovations in Islamic Debt Securities: Prospects for Islamic Profit and Loss Sharing Securities

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Abstract

The concept of sukuk has been with the Islamic world since the early days of Islamic civilization. In the 1st century Hijri (corresponding to the 7th Century AD) the Umayyad Government would pay soldiers and public servants both in cash and in kind. The payment in kind was in the form of sukuk al-badai. Also, the origin of the word check, ubiquitous in the modern financial world, is from the Arabic word sakk. The financial community in the west adopted and refined the concept of sukuk and expanded its scope of use to a wide range of commercial and financial activities. Today, we see the Islamic financial world adopting the practices of the Western finance and adjusting them to meet the requirement of shariah. This article elucidates the salient features and characteristics of 3 key sukuk products: sukuk al-ijarah; sukuk al-istismar and ba'i bithaman ajil or BBA bonds and also compares them with conventional securities like ETCs and bonds.

The second part of the paper explores the prospects for Islamic profit-sharing bonds and addresses the various impediments faced including, among others: the pricing advantage of debt-based products; the conventional mindset of the industry; the customers' reluctance to share the economic upside; the investors aversion to share the economic downside; the moral hazards of equity financing; and the lack of level playing field from a tax perspective.

Key words: sukuk, shariah, sukuk al-ijarah, sukuk al-istismar

INTRODUCTION

The Twentieth Century witnessed the revival of Islamic finance in various parts of the Muslim world as an alternative mode of financing that is in compliance with shariah. From its mundane beginning, when Islamic financiers were mainly providing Islamic trade financing solutions, the Islamic finance industry today offers a wide range of products and services including personal finance, corporate finance, project finance, equity funds, property funds and private equity. All these products and services are structured in accordance with shariah principles as interpreted in their respective jurisdictions. The existing product range, which is often priced competitively, provides Muslims with a viable option to manage their financial

matters Islamically.

With the dawn of the Twenty-First Century, we are witnessing the Islamic finance industry constantly venturing into new and exciting areas of finance. One of the important recent endeavors is the development of Islamic debt securities commonly known as sukuk. Most Islamic financiers often have high levels of liquidity for various reasons. While the liabilities of Islamic financiers are often short-term, most of their assets are medium to long-term and very non-liquid. The Islamic finance industry also lacks shariah-compatible derivative products that could mitigate any asset-liability mismatch risks. The high levels of liquidity often led to inefficiency in the Islamic finance market and the industry leaders actively sought solutions. The sukuk, which is a tradable and potentially liquid investment, was seen as a possible avenue for the Islamic financiers to invest their surplus liquidity.

HISTORY OF ISLAMIC DEBT SECURITIES

Interestingly, sukuk or sakk is not a new invention of the Islamic finance industry. The concept of sukuk has been with the Islamic world since the early days of Islamic civilization. Imam Malik has recorded the first historical account of sukuk in his famous treatise *al-Muwatta*. It is stated that in the 1st century Hijri (corresponding to the 7th Century AD) the Umayyad Government would pay soldiers and public servants both in cash and in kind. The payment in kind was in the form of sukuk al-badai, which has been translated as “commodity coupons”¹ or “grain permits”.² The holders of the sukuk were entitled to present the sukuk on its maturity date at the treasury and receive a fixed amount of commodity, usually grains. Some of the holders used to sell their sukuk to others for cash before the maturity date. Although the validity of such trade has been questioned by scholars of that period, it shows that the concept of sukuk al-badai as a tradable instrument has been known to the Islamic world for a very long time.

The word sakk, though it may sound unfamiliar, is astonishingly well known to all

¹ See HASHIM KAMALI, *ISLAMIC COMMERCIAL LAW AN ANALYSIS OF FUTURES AND OPTIONS 3* (2000) for more details.

² See MALIK IBN ANAS, *al-Muwatta* 296 (Mohamed Rahimuddin trans., Kitab Bhavan 5th ed. 2000).

of us. The origin of the word check, ubiquitous in the modern financial world, is from the Arabic word sakk. It is well known that many of the commercial practices and customs of the Muslim world were transmitted to medieval Europe through Islamic Spain and sakk is one of them (SCHACHT, 1982). However, like many other inventions of the Islamic civilization, the concept of sukuk was not exploited to its full potential by the Muslims. The financial community in the west adopted and refined the concept of sukuk and expanded its scope of use to a wide range of commercial and financial activities. Today, we see the Islamic financial world adopting the practices of the Western finance and adjusting them to meet the requirement of shariah.

In 2001, almost 14 centuries later, the sukuk re-emerged in Bahrain as an Islamic alternative to conventional debt securities.³ The State of Bahrain⁴ offered its inaugural sukuk al-ijarah issue in the domestic market. The issue amount was USD250 million and had a tenor of 5 years. The sukuk al-ijarah concept was derived from the prevailing practices of “lease ending with purchase” (ijarah muntahia bi ttamlik) which is commonly known in conventional finance as “finance lease”.⁵ The sukuk carried 6-monthly lease rentals which are fixed at the lease inception and paid in arrears during the lease term. The sukuk offering was highly successful. The Bahrain sukuk issue was a major milestone in Islamic finance as it marked the birth of an Islamic capital market where Islamic equity and debt-based instruments are issued and traded.

3 In 2000, the State of Bahrain lead the way by issuing the innovative sukuk al-salam but these securities were however non-tradable.

4 As it was then known; now the Kingdom of Bahrain.

5 For a detailed exposition of ijarah muntahia bi ttamlik, see Standard no. 9, Shariah Standards of the Accounting and Auditing Organization for Islamic Financial Institutions (1424-5 Hijri / 2003-4 AD).

In 2002, the Federation of Malaysia created another landmark by issuing the first Islamic securities that complied with the U.S. Regulation S and Rule 144A formats that are used for conventional global bonds.⁶ The Malaysian sukuk al-ijarah was the first sukuk to be listed in the Luxembourg Stock Exchange and rated by Standard & Poor's and Moody's. The USD600 million sukuk was offered globally to Islamic and conventional investors including 'Qualified Institutional Buyers' in the United States. The issue was hugely successful and was twice oversubscribed. The Malaysian sukuk was a significant development because it was able to successfully fuse the concept of sukuk al-ijarah with conventional bond practices such as listing, ratings, dematerialized scripts and centralized clearance.

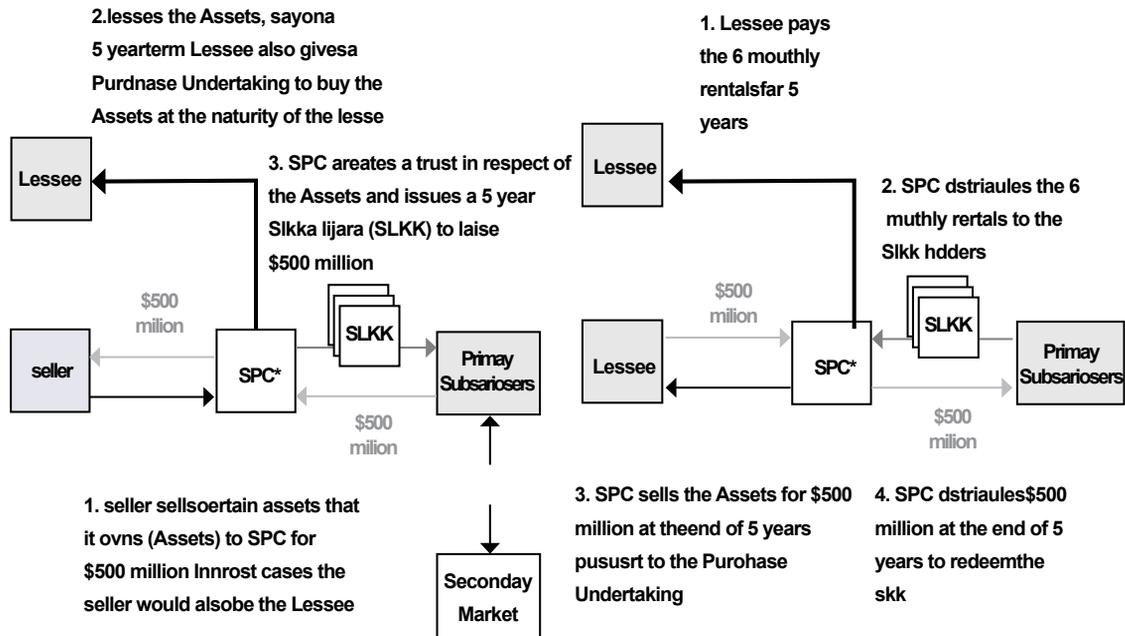
Subsequently, there have been a number of successful sukuk issues in Regulation S format including the Islamic Development Bank's offering of USD400 million sukuk in 2003, the State of Qatar's debut USD700 million sukuk al-ijarah issue in 2003 and the Kingdom of Bahrain's USD250 million sukuk al-ijarah issue in 2004. These successful issues have created a lot of excitement in the Islamic finance markets and more issuers are looking at the sukuk option as a viable, attractive and alternative source of funds. This paper will examine some of the key sukuk products currently available in the Islamic finance markets and analyze the structure of each product. It will highlight the salient features of each product and examine the various shariah innovations and the legal aspects of the structures. The paper will also look at the prospects for Islamic profit sharing products⁷ and the current impediments to the growth of such products.

6 Prior to that in December 2001, Kumpulan Guthrie Berhad, a Malaysian public listed company involved in plantation and construction sector, has offered a sukuk al-ijarah issue in the U.S. Regulation S format. The company offered a USD150 million sukuk issue with a floating rate return and the tenor was divided into 3 years (USD50m) and 5 years (USD100m). The sukuk was listed on the Labuan International Financial Exchange.

7 The term "Islamic profit sharing product" refers to a product or security that is structured on the principle of profit and loss sharing based on mudarabah, musharakah or similar concepts.

1) SUKUK AL-IJARAH

A sukuk al-ijarah issue is typically structured as follows:



The above structure was used, with minor modifications, in the USD250 million Kingdom of Bahrain sukuk al-ijarah issue, the USD600 million Federation of Malaysia sukuk al-ijarah issue and the USD700 million State of Qatar sukuk al-ijarah issue. The underlying assets were bought from the seller and immediately leased to the lessee based on the principle of *ijarah muntahia bittamleek* (lease ending with purchase). The SPC will act as the trustee for the sukuk holders and will distribute to the sukuk holders the rental proceeds of the leased assets in accordance with the terms of the trust. At the end of the lease period the SPC will sell the assets to the original seller for a sum equal to the original sale price, which the SPC will distribute to the sukuk holders to redeem the sukuk. Some of the salient features of the

sukuk al-ijarah are discussed below.

Sukuk characteristics

One of the fundamental requirements of shariah for a security to be tradable is that the security must reflect or evidence the security holder's share in an underlying asset or enterprise⁸. For example, contemporary shariah scholars have allowed investment in equity or share in a company on the basis that the security reflects the holder's ownership of the underlying assets of the company. Through the ownership of the company the shareholders are deemed to indirectly own the assets held by the company.⁹ By making a link between the ownership of the company with the ownership in the company's assets, the shariah scholars have been able to allow "the buying and selling of these securities on the model not of partnership in the enterprise,¹⁰ but of undivided co-ownership of the company's assets".¹¹ If the company as a going concern makes a profit by trading in goods, assets or services the shareholders are entitled to receive from the company a share in the profit through dividends.

A conventional bond on the other hand typically confers on the bondholder a contractual right to receive from the issuer of the bond certain interest payments during the life of the bond and the principal amount at the maturity of the bond. The bondholders themselves

8 The asset or enterprise itself has to be shariah-compatible. Hence, an enterprise involved in alcohol or gambling is not compatible with shariah.

9 At one time the common law also used to treat the shareholders as having some sort of equitable interest in the assets of a company. The company itself was deemed as holding the assets as trustee for the shareholders. However, the prevailing common law position is that a share is a chose in action which confers on the shareholders the contractual right to vote, to receive dividends, return of capital upon winding up and other rights except that it does not confer a right to possess any physical assets. Gower's Principles of Modern Company Law 299-302 (Paul L. Davies ed., 6th ed. 1997).

10 It is important to note that, from a shariah perspective, if the shares in a company are construed as co-ownership in an enterprise only, the shareholders will then be construed as partners in an enterprise like mudarabah and the strict rules of mudarabah will come into play. But, when the link is made with the ownership in the assets owned by the company, the shareholders will be treated as co-owners of an asset or shirkat al-milk and this will allow a co-owner to freely sell his share without the consent of the other co-owners. See Frank E. Vogel & Samuel L. Hayes III, Islamic Law And Finance Religion Risk, and Return 175-176 (1998).

11 See id. at 175.

are deemed as creditors to the issuer of the bond and are ranked as senior unsecured and unsubordinated creditors of the issuer in priority to the shareholders.¹² The juridical nature of a conventional bond is clearly contrary to shariah.

The major challenge was to structure a shariah-compatible instrument that embodies the ownership characteristic of an equity instrument as well as the priority status and the fixed income characteristics of a bond instrument. In addition to those, the shariah compatible instrument also has to be transferable, rated by recognized rating agencies, listed on major securities exchanges, cleared through major clearinghouses, and documented, in terms of legal documents and disclosures, on par with the prevailing standards in the conventional bond market.

After much concentrated effort, a shariah-compatible solution was finally found, interestingly, with the aid of the common law of trust. At common law, when a person holds an asset on trust for another, the latter can be construed as the beneficial owner of the asset held by the former. The relationship between the trustee and the beneficiary is evidenced by a trust deed executed (often unilaterally) by the settlor. The trust deed can also be documented to allow the relationship between the trustee and the beneficiaries to be created through the issuance of a trust instrument by the trustee to the beneficiary or class of beneficiaries. For instance, a settlor can create a trust over say a house pursuant to a trust deed and appoint a trustee to issue trust instruments to a class of beneficiaries. The class of beneficiaries will be limited to the investors who purchase the trust instruments offered by the trustee for a certain consideration. The investors who purchase the trust instruments will automatically become the beneficiary of the trust and be construed as pro-rata owners of the house held on trust by the trustee. The trust deed can also be structured to allow the holders of the trust instrument to transfer the trust instruments to others on a willing-buyer and willing-seller basis. If the trustee leases the house to a tenant for a fixed or variable rental term, the holders of the trust instrument will be entitled to a pro-rata share of the rental income derived from the house held on trust.¹³

These characteristics of the trust instrument squarely meet the requirements of shariah.

12 See generally, Ravi C. Tennekoon, *The Law & regulation Of International Finance* 161-176 (1991).

13 See Philip Pettit, *Equity and the Law of Trusts* 14-17 (1997).

The trust instruments were aptly named in Arabic as sukuk or sukuk al-ijarah because the trust assets were leased out to produce a lease income. The holders of the sukuk will be construed under shariah as co-owners of an asset, although held on trust, similar to a shirkat al-milk. As a co-owner of an asset, each co-owner is entitled to sell his share in the asset without the consent of the other co-owners at whatever price he can command in the market. When the trustee receives the variable rentals from the lessee, the sukuk holders will receive a proportionate share in the rental proceeds. At the maturity of the lease, which corresponds to the redemption date of the sukuk, the trustee will sell the trust asset to the lessee for a price equal to the original acquisition cost of the trust asset.¹⁴ With the proceeds of the sale, the trustee will redeem the sukuk and the sukuk holders will receive their principal investment. The payment profile of the sukuk is thus comparable to a conventional bond or a floating rate note.

The lessee's obligation to pay the lease rentals and the purchase price will be ranked as a senior unsubordinated debt obligation of the lessee towards the trustee, as lessor. This ranking in priority is also comparable to the ranking of a conventional bond instrument.

The concept of trust instrument is also familiar to the conventional investors. In the United States, for example, Equipment Trust Certificates or ETCs have been widely used since the time of the railway boom. A railway company will order the rolling stock from the manufacturer and request the manufacturer to sell the rolling stock to a trustee company set up by the railway company.¹⁵ The railway company will then agree to lease the rolling stock from the trustee for an agreed period. The trustee will then issues trust certificates to the investors to raise the funds required to pay the manufacturer. From the proceeds of the lease collected from the railway company, the trustee will pay the periodic interest and the principal amount to the trust certificate holders. Since the trustee will own the rolling stock it will be able to repossess the rolling stock if the railway company defaults on the lease and re-lease it to other railway companies. Because the rolling stock was quite standardized and

14 This aspect of the transaction is structured as an ijarah muntahia bi ttamlik in line with the Standard no. 9, see Shariah Standards of the Accounting and Auditing Organization for Islamic Financial Institutions (1424-5 Hijri / 2003-4 AD).

15 The trustee company will be an orphan entity with no corporate relationship with the railway company.

there was a deep secondary market for them the trustee was able to obtain the lowest rates in the bond market.¹⁶

The commonality between the sukuk and the trust instrument, such as the ETC, is a key factor because it made the sukuk familiar and easily acceptable to the conventional investors, the leading rating agencies, the major securities exchanges and the leading clearinghouses. The sukuk issues by the Federation of Malaysia, the Islamic Development Bank and the State of Qatar were all rated by international rating agencies like Moody's, Standard & Poors or Fitch. The sukuk issues were also successfully listed on leading exchanges such as the Luxembourg Stock Exchange, the Labuan International Financial Exchange and the Bahrain Stock Exchange. The sukuk were also cleared through Euroclear and Clearstream. These features made the sukuk a truly tradable security that met the requirements of shariah as well as the expectations of the conventional bond investors in line with the bond market norms.

Legal and beneficial ownership

In the Malaysian sukuk issue, one of the shariah concerns was that the trustee was only acquiring the beneficial ownership of the assets held on trust. Usually, when a seller sells a landed property to the buyer, the buyer will acquire the legal ownership of the property when the seller transfers the title to the property to the buyer after receiving full payment from the buyer. In the Malaysian sukuk issue, the seller¹⁷ sold the landed assets to the trustee but did not transfer the title to the landed assets to the trustee in order to avoid payment of certain charges and taxes. Instead, the seller declared that it was holding the landed assets on trust for the buyer. The concern from a shariah perspective was whether such a transfer is valid under shariah.

The position under Malaysian law, which is quite similar to the position at common law, is that when the buyer pays the full consideration for a landed asset, the seller becomes

16 see Frank J. Fabozzi & Franco Modigliani, *Capital Markets: Institutions and Instruments* 515-516 (Prentice Hall 2002).

17 The Federal Land Commission, a statutory body that holds all federal lands in Malaysia.

a bare trustee and the buyer¹⁸ becomes the beneficial owner of the landed assets.¹⁹ As a bare trustee the seller cannot dispose the land to another without the consent of the beneficial owner. From a legal perspective, the law considers the beneficial owner as the true owner with the power to possess and dispose the landed assets.²⁰ To protect the rights of the beneficial owner against any third party who may claim any interest on the landed assets held on trust, the bare trustee was required to procure a trust endorsement on the land title held at the land registry.²¹ The trust endorsement will give a clear notice to third parties of the beneficial owner's right in the landed assets and will avoid the bare trustee from inadvertently transferring the landed assets to any third party.

The distinction between legal and beneficial ownership was initially not familiar to most shari'a scholars particularly those who come from civil law jurisdictions.²² There is no concept of beneficial ownership in civil law. Through fresh interpretations, the contemporary shari'a scholars were able to extend the scope of ownership in shariah to include the concept of beneficial ownership when, as illustrated in Malaysia, the true owner in the eyes of law is the beneficial owner and the seller remains only as a bare trustee.

Unilateral undertaking to buy the assets

The issue of whether a unilateral purchase undertaking given by the lessee to the trustee is a binding promise has been debated among the contemporary shariah scholars. Some scholars are of the view that a unilateral purchase undertaking or promise does not create a legal obligation at all but only a moral obligation on the part of the promisor. The proponents of this view rely on the opinions of Imam Abu Hanifah, Imam Shafie, Imam Ahmad and some

18 The buyer however has to be a bona fide purchaser for value without notice of any prior third party rights attached to the landed asset.

19 This principle was firmly laid down in the Malaysian case of Borneo Housing Mortgage Finance Bhd v Bank Bumiputra Malaysia Bhd, [1991] 2 MLJ 261.

20 Such a disposal however has to be made through the bare trustee who will have to comply with the instructions of the beneficial owner.

21 This endorsement is done under section 344 of the Malaysian National Land Code, 1965. For more details see Mary George, Malaysian TRUSTS Law 11 (1999).

22 Most of the countries in the Gulf Cooperation Council are civil law jurisdictions.

Maliki jurists. The opponents of this view however argue that unlike a bilateral contract of deferred sale,²³ all unilateral undertakings or promises to do something in the future are valid arrangements that are binding on the promisors. The opponents rely on the authority of a prominent companion of the Prophet and the opinions of other renowned scholars including Imam al-Bukhari. Some other scholars, particularly from the Maliki School, have taken the middle view that a unilateral undertaking is only binding on the promisor if “the promisor has caused the promisee to incur some expenses or undertake some labor or liability on the basis of [the] promise”.²⁴ It has been argued elsewhere²⁵ that the proponents of the view that a unilateral undertaking is not binding at all have not been able to successfully attribute their views to Imam Abu Hanifah and Imam Malik. As mentioned below, both the Hanafi and Maliki jurists have recognised the validity of the promise to affect a sale in future made by the buyer in a bay bil-wafa contract. Furthermore, there is also evidence in the primary sources of shariah, the Qur’an and the Sunna, to imply that a promise is binding on the promisor. It is mentioned in the Quran: “O ye who believe! Why say ye that which ye do not? Grievously odious is it in the sight of God that ye say that which ye do not”.²⁶

There are also compelling social and economic arguments to support the view that a unilateral purchase undertaking or promise should be binding. Imagine someone promising to another that if the latter goes and buys certain goods from the market the promisor will buy the goods from him at a specific price. If the promisor is allowed to repudiate his promise and decline

23 The concept of unilateral undertaking or promise has a unique existence in Islamic law because Islamic law prohibits an agreement to sell in future (i.e. a deferred sale) and only allows a sale contract where the property in the goods is transferred to the buyer at the time of contract. Most Muslim jurists argue that for a valid sale under shariah, at least one of the counter values, either the purchase price or the goods, has to be delivered at the time of contract. Deferring both counter values at the time of contract vitiates the contract. Murabaha contracts, for instance, have been allowed because only one of the counter values, i.e. the purchase price, is deferred. Another example is the Salam contract, where only the commodities are deferred whilst the purchase price is paid at the time of contract. The only exception seems to be the istisna contract, where both counter values are allowed to be deferred based on the prevailing custom (urf). For a detailed discussion on the shariah treatment of deferred sale, see Kamali, supra note 1, at 131. For a comparative analysis of the common law position, where both a deferred sale and a sale contract are allowed, see Roy Goode, Commercial Law 201 (Penguin Books 1995).

24 Muhammad Taqi Usmani, An Introduction to Islamic finance 122 (Idaratul Maarif 2000).

25 Id. at 123.

26 61:2-3 (Abdullah Yusuf Ali Trans.)

the goods, the promisee will be left exposed to the risk of liquidating the goods without any remedy against the promisor. The promisee may suffer economic losses due to the breach of promise. For example, the promisee may end up selling the goods to another at a discounted price. This will seriously hinder the development of various economic activities such as the murabaha contracts where the financier will be relying on the promise of the client when it purchases the goods ordered by the client.

Based on these grounds and the views taken by many prominent scholars, the Islamic Fiqh Academy resolved²⁷ that a promise made in a commercial transaction, like a murabaha contract, is binding on the promisor subject however to the following conditions:

- (i) the promise should be unilateral;
- (ii) the promise must have induced the promisee to incur some liability;
- (iii) if the promise is to purchase something in the future, the parties must enter into the actual sale contract at the appointed time; and
- (iv) If the promisor breaches his promise, the promisee can seek legal remedy in a court of law for specific performance or damages.²⁸

The contemporary scholars have extended the above ruling to the sukuk al-ijarah issue and ruled as valid the unilateral purchase undertaking given by the lessee to buy the assets at the maturity of the lease.²⁹ This was a significant development that made the sukuk issue economically feasible. Otherwise, it will lead to an inequitable result where the lessor

²⁷ See Second Resolution, 5th Conference of the Islamic Fiqh Academy (Kuwait, 11-16 Jamadilawal 1409/10-15 December 1988).

²⁸ Actual damages are confined to “actual monetary loss suffered by [the promisee], but will not include the opportunity cost.” Taqi Usmani, *supra* note 27, at 126.

²⁹ It has been argued elsewhere that the scope of the Islamic Fiqh Academy Resolution should not be extended beyond the ambit of murabaha transactions and an example was given of a salam transaction involving unilateral promise that could lead to ‘anomalous and radical’ results from a shari’a perspective. Vogel & Hayes, *supra* note 11, at 126-128. Whilst there is some merit in limiting the scope of the Resolution in cases where it may lead to inconsistent results, this however should not in itself be taken as a ground to bar the extension of the Resolution to cases where if the promisor is allowed to repudiate his promise it would lead to an inequitable situation.

will be exposed to the economic losses that may result from the breach of promise while the promisor will be absolved of any liability.³⁰

Sale of assets to the original seller

Another concern among some shariah scholars was the issue of the trustee selling the assets back to the lessee (being the original seller) at the original cost. Their view was that this arrangement resembles the contract of bay bil-wafa which has been prohibited on the basis of riba by the Maliki and Hanbali schools as well as the earlier generation of scholars from the Hanafi and Shafie schools. Bay bil-wafa is a contract usually involving a landed asset where the seller will sell the landed asset to the buyer for an agreed price and subsequent to the sale the buyer will promise to sell the landed asset back to the seller whenever the seller pays an amount equal to the original purchase price paid by the buyer. The later generation of scholars from the Hanafi and Shafie schools, including the prominent Hanafi scholar Ibn Abidin, however, has allowed this type of contract provided that the promise is made after the sale has been concluded and the promise itself is not made a condition of the sale contract.³¹ They took the opposite view that such a transaction actually prevents one from getting involved in riba and therefore should be allowed.³² Some Hanafi scholars have even allowed a bay bil-wafa transaction where the promise has been given prior to the sale itself.³³

30 It is interesting to note that this development in the contemporary fiqh has some resemblance to the development of the principle of promissory estoppel at common law. The common law had for a long time taken the stand that a promise made in a commercial transaction is only binding if there was consideration for it. In the celebrated English case of *High Trees*, [1947] 1 KB 130, Denning J., changed the course of common law by ruling that when a person makes a promise and knows or reasonably should know that the promisee will rely on his promise, the promisor will be bound by his promise if the promisee has actually relied on that promise and acted upon it. The court ruled that it would otherwise be inequitable on the promisee if the promisor is allowed to dishonour his promise in such circumstances. This is a classic instance where equity has come to remove the rigours of common law, which would have allowed to the promisor his strict right to retract his promise. Since *High Trees*, there has been a plethora of cases reaffirming the principle of promissory estoppel.

31 see Imran Ahsan Khan Nyazee, *The Concept of Riba and Islamic Banking* 74 (Niazi 1995) (citing Hasyiat Ibn Abidin, v, 272 and Rasail Ibn Abidin, ii, 120).

32 See Malaysian Securities Commission, *Resolutions of the Securities Commission Syariah Advisory Council* 26-28 (2002).

33 The validity of bay bil-wafa contract has been explained in detail elsewhere; see Taqi Usmani, *supra* note 27, at

Historically, bay bil-wafa arrangements have been widely practiced in Central Asia and South East Asia for a very long time and they have been recognized as valid by many Islamic scholars.³⁴ In a sukuk issue the sale of the assets to the trustee is made independent of the purchase undertaking given by the lessee to the trustee and the undertaking itself is not made a condition to the sale contract. Based on this arrangement the contemporary scholars have allowed the sale of the assets back to the original seller.

Sale of assets at market value

Some scholars took the view that the sale of the assets to the lessee should be at market value determined at the time of actual sale.³⁵ From a classical fiqhi perspective, the predominant view is that the sale price has to be known to both the seller and the buyer in advance in order to make the contract valid. The Shafie and Maliki schools have both maintained that any ambiguity and ignorance of the price will vitiate the contract and that uncertainty or gharar is removed only by determining a specific price.³⁶ The Hanbali scholars, Ibn Taymiyah and Ibn Qayyim, however have taken a more liberal view by stating that the price can be determined by assigning a fixed amount or by reference to a certain convention, for example, “the price which other people pay; or the market price, provided that the parties find [that] agreeable and is clear enough to avoid disputes”.³⁷ These opinions, when extended to the unilateral purchase undertaking given by the lessee, mean that the price of the asset can either be determined as a fixed sum at the inception or at the time of actual sale based on the market practice. Since

87-89 and 123.

34 In Malaysia, there is ample evidence that this type of arrangement known as jual-janji (sale with promise) has been in practice for decades and they have been recognized as valid contracts under shariah.

35 It is important to observe that, like the issue revolving unilateral undertakings, the issue of selling back the asset to the original seller at the original price goes to the root of ijarah muntahia bi ttamlik where the lessee will invariably undertake to buy the assets from the lessor at the original cost. Such practise has been in vogue for a long time and has been endorsed by Standard no. 9, Shariah Standards of the Accounting and Auditing Organization for Islamic Financial Institutions (1424-5 Hijri / 2003-4 AD). This matter therefore should not be confined to sukuk issues alone. If the practice is acceptable in ijarah muntahia bittamleek transactions, it should be automatically applicable to sukuk al-ijarah since the underlying transaction evidenced by the sukuk is ijarah muntahia bi ttamlik.

36 Kamali, supra note 1, at 95.

37 Id.

both these options were validly recognized under shariah the unilateral purchase undertaking given by the lessee in the Malaysian sukuk issue to buy the assets at a specified amount based on the original purchase price paid by the trustee is a valid arrangement under shariah. This was in fact in line with the majority view that required a fixed sum to be determined by the parties at the inception of a bilateral or unilateral arrangement in order to avoid any gharar.

2) Late payment treatment

Another contentious issue in contemporary fiqh is whether a creditor is entitled under shariah to charge a late payment from a debtor who has either delayed or defaulted on a payment obligation. The general principle of shariah is that any additional amount charged to a debtor for any late payment is riba and is clearly prohibited. This form of riba is commonly known as riba al-jahiliyyah.³⁸ Accordingly, in the early days of Islamic finance, the murabaha and ijarah contracts did not contain any provision allowing the Islamic financiers to charge any late payment amount from the purchasers or the lessees. This practice naturally resulted in some debtors abusing the system by delaying, often willfully, the payments due to the Islamic financiers while making every effort to make their payments on time to their conventional lenders. The conventional lenders will invariably impose on the debtors late payment interests, which are sometimes compounded on a daily basis. The strong moral basis behind the prohibition of riba al-jahiliyyah is that a debtor in difficulty should be given a respite until he could improve his financial conditions instead of imposing on him further hardship in the form of late payment charges. The prevailing practices however led to a moral hazard whereby the Islamic financiers, and their depositors, were exposed to hardship caused by the willful delays of the debtors.

A fresh shariah interpretation was required to address the contemporary problem faced by the Islamic industry. The scholars who favored the late payment compensation to be charged by the debtor relied on the well-known hadith that “a wealthy person who delays the payment of his debts, subjects himself to punishment and disgrace”.³⁹ It is not

38 To connote a type of riba widely practiced during the pre-Islamic days in Arabia.

39 See, Taqi Usmani, supra note 27, at 134.

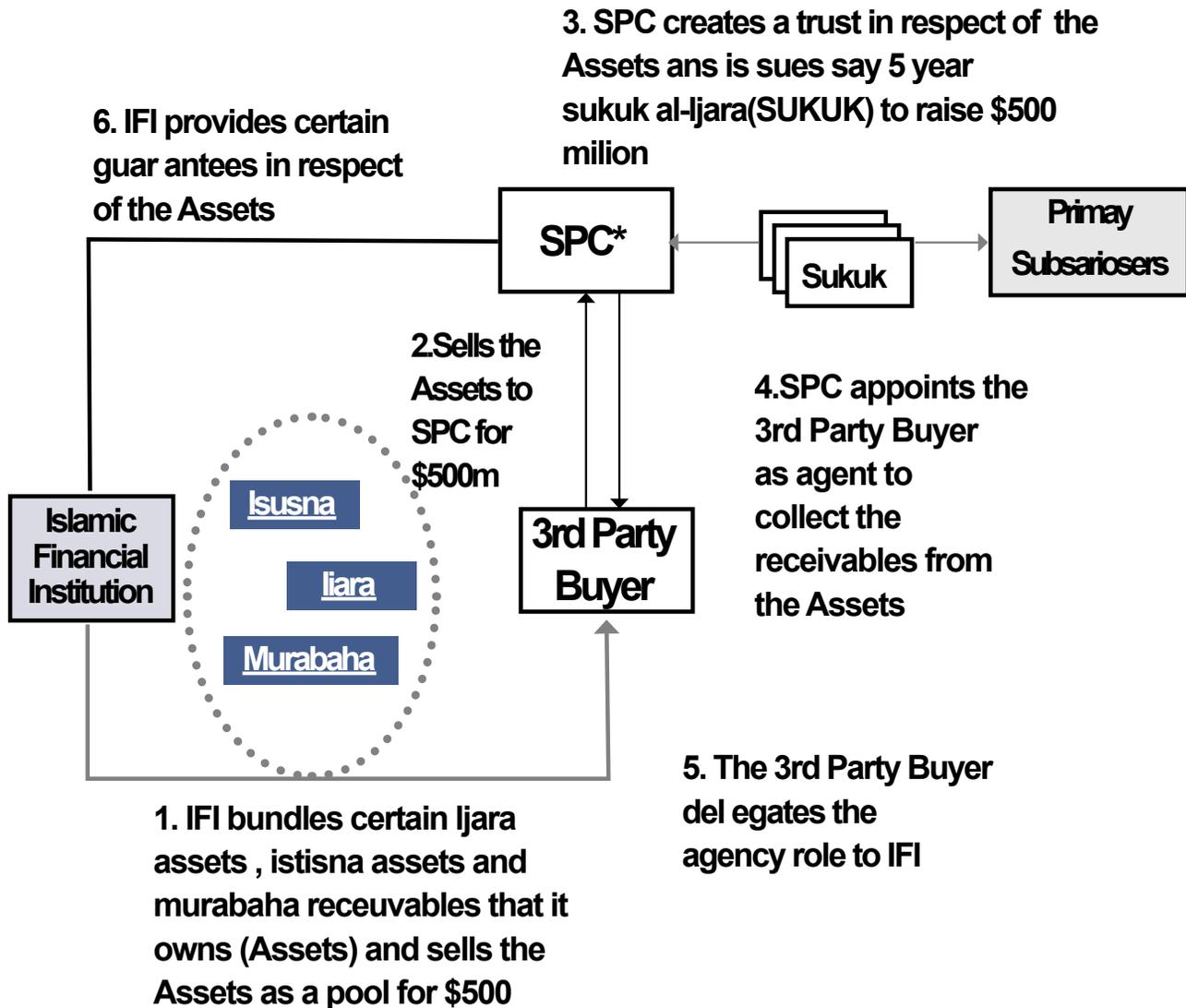
uncommon for a wealthy person to be short of liquidity due to excessive leverage or a lavish lifestyle and based on the above hadith he should not be excused for delaying a payment obligation to another. He should be penalized for the delay and for causing the hardship on the creditor. The form of punishment includes payment of monetary compensation to the creditor. Therefore, late payment charges can be validly imposed on a willful defaulter.

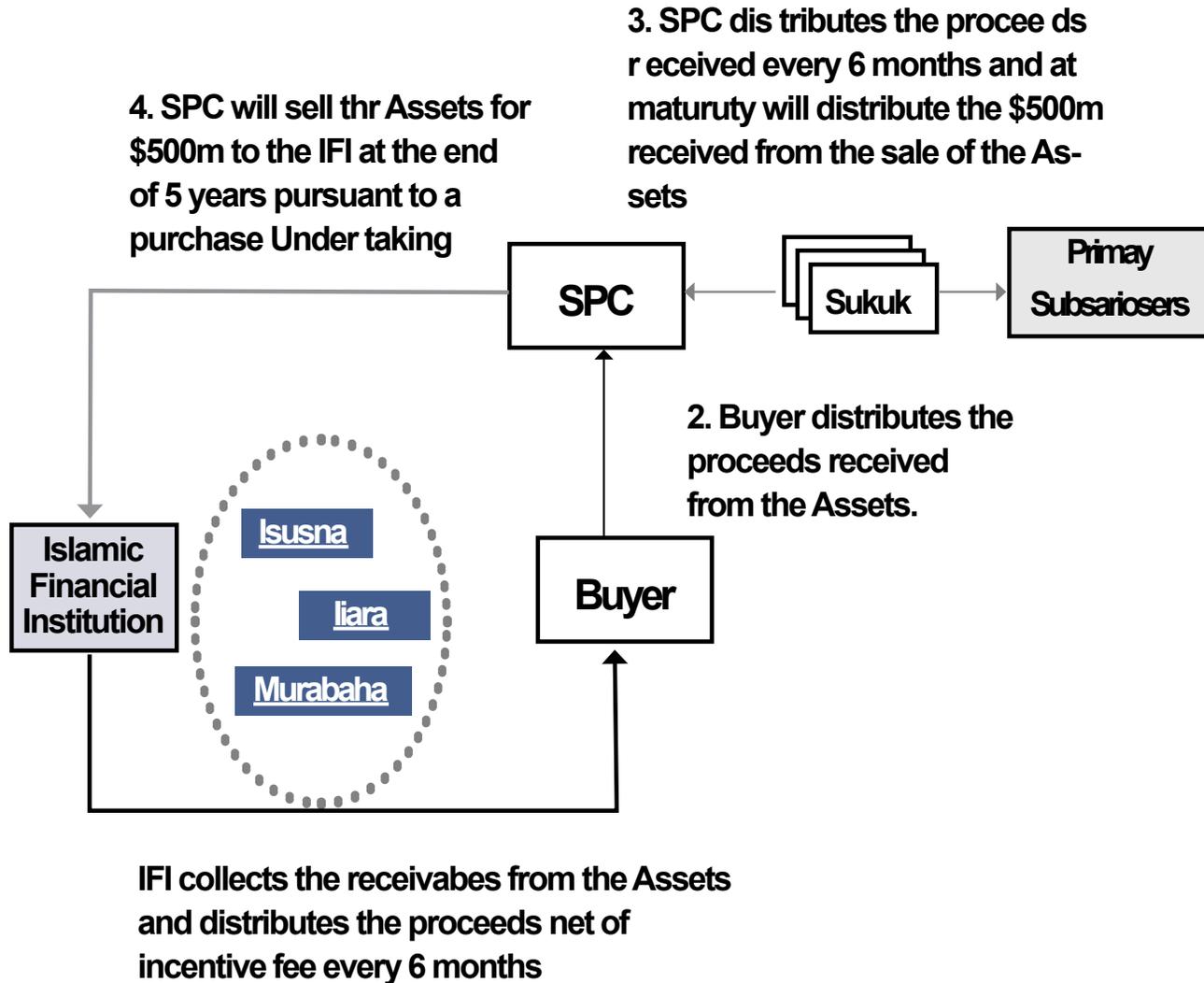
The opponents of the above view however contend that any penalty on the defaulter can only be imposed by a competent judicial authority or by arbitration. Shariah does not allow a creditor to decide unilaterally that the debtor has willfully defaulted and also impose the quantum of compensation payable by the debtor. Unless a creditor brings a legal action against the debtor to prove the willful default, the creditor cannot claim compensation from the debtor.

The middle view is that a creditor can validly procure the debtor to irrevocably undertake that if he delays any payment due to the creditor, he will donate to a charity nominated by the creditor a specific amount of money. Since the creditor does not receive the late payment amount or benefit from it, the scholars have allowed such an undertaking without any need for the creditor to bring a legal action. If the debtor fails to honor his undertaking, the creditor can enforce the undertaking in a court of law.⁴⁰ The scholars hope that this mechanism will eliminate or reduce the moral hazard faced by the creditor. This method was accordingly adopted in the Qatar sukuk issue.

For practical purposes, the scholars have also allowed a debtor who delays any payment to pay the late payment amount directly to the creditor who will then donate the late payment amount to charity after deducting any administrative expenses that the creditor has incurred in monitoring and recovering the delayed payment. This method for recovering a late payment amount was adopted in the Malaysian sukuk issue.

⁴⁰ Whether such an action will be enforceable in a court of law will depend on the respective legal jurisdiction. Under English law, the current view is that such an undertaking will be enforceable by the creditor although the creditor is not the recipient of the payment.





3) SUKUK AL-ISTISMAR

The USD400 million sukuk issue by the Islamic Development Bank (IDB) was based on the following structure:

The IDB sukuk issue was highly structured and a detailed elucidation of the structure is beyond the scope of this paper. Some of the key characteristics are discussed below.

4) Mixed Portfolio of Assets

One of the most innovative shariah features in the IDB sukuk is the extension of the khulta principle to the field of commercial transactions like the sale of a mixed portfolio of assets consisting of tangible assets and receivables. The validity of sale of receivables or debt, known in fiqh as bay al-dayn or bay al-kali bil-kali, has been a contentious subject among the contemporary scholars. The majority of the scholars in the Middle East have taken the view that the sale of debt or receivables is not allowed under shariah because it is tainted by riba. This ruling severely constrains the Islamic financial institutions from securitizing the receivables due from their murabaha facilities, which form the bulk of their assets. However, utilizing the principle of khulta, the Islamic financiers can now create a mixed portfolio or a mixed fund⁴¹ by pooling together the receivables (dayn) with tangible or physical assets (ayn) and then sell the mixed portfolio. The important criterion from a shariah perspective is that the percentage of tangible assets in the mixed portfolio has to be at least 51%.

When an object consists of two substances and one of those is prohibited under shariah, the object can still be construed as shariah-compatible if the quantity of the non-compatible substance is insubstantial. For example, if a ring is made of gold and silver, it is permissible for a Muslim male to wear it if the quantity of the gold substance is insubstantial. There exists difference of opinions among scholars as to what amounts to 'insubstantial' quantity. Most scholars have taken the view that the non-compatible substance will be

⁴¹ The concept of a mixed fund has been espoused for some time by prominent scholars like Sheikh Taqi Usmani and the IDB sukuk has made the concept to gather wider acceptance. See, Taqi Usmani, supra note 27, at 218.

regarded as insubstantial if the quantity of the shariah-compatible substance is at least 51%.⁴² Some Hanafi scholars have taken a more liberal view of the khulta principle. They have not allocated any fixed percentage or quantity but have left the matter to be decided on a case-by-case basis. Hence, there may be circumstances where even if the non-compatible component is more than 50%, the object can still be considered as a whole shariah-compatible.

In the IDB sukuk, the mixed portfolio consisted of ijarah assets comprising 65.8% of the portfolio and murabaha and istisna receivables comprising 34.2%. The 65.8% of ijarah assets is comprised of certain physical assets owned by the IDB and which have been leased out to various counter parties. Since the ijarah assets can be freely transferred at any price by the IDB, by mixing the murabaha receivables (dayn) with ijarah assets (ayn) the IDB was able to transfer the murabaha receivables as well.

Replacement of maturing assets

Since the receivables in the mixed portfolio will mature during the life of the sukuk, the sukuk structure has to accommodate two changes in circumstances. First, the composition of the portfolio will evolve into a mixed portfolio of ijarah assets, murabaha and istisna receivables, and cash from the matured receivables. In this scenario, the cash will be re-invested in new ijarah assets or new murabaha trades to be sourced by the IDB. The key aim is to ensure that the cash is not held idle and is promptly invested in shariah-compatible assets.

Secondly, some of the ijarah assets in the portfolio may be redeemed from the portfolio prior to the sukuk maturity. In the event, the composition of the mixed portfolio will change and the percentage of ijarah assets may fall below the 51% requirement and may taint the shariah-compatibility of the whole portfolio. The shariah scholars have tackled this matter quite ingeniously. They have allowed the percentage of the ijarah assets in the mixed

⁴² Based on the bare or simple majority rule. A similar rule was used in screening shariah-compatible equities: only equities of companies having not more than 45% account receivables were accepted as shariah-compatible. See the Methodology Overview of Dow Jones Islamic Market Indexes (visited 10 Apr., 2004) <<http://www.djindexes.com/jsp/imiMethod.jsp>>.

portfolio to temporarily drop to the level of 25% of the total portfolio during the interim period when the cash is being re-invested into new ijarah assets. The key objective is to give sufficient time for the cash to be re-invested in ijarah assets so that the makeup of ijarah assets can be increased back to the level of at least 51%. However, if the level of ijarah assets falls at any time below the threshold of 25%, the level of shariah tolerance comes to an end and the portfolio has to be promptly unwound. The IDB will then be bound to buy the mixed portfolio of assets at a price equal to the original price paid by the sukuk holders.

Net asset value computation

Another important principle laid down by the contemporary scholars in the IDB sukuk is that the value of the murabaha and istisna receivables to be included into the mixed portfolio can be based on their net asset value (NAV). The pricing model for both the murabaha and istisna financing consists of two components: the cost and the agreed profit margin. The shariah scholars have allowed the NAV for the murabaha and the istisna receivables to be calculated net of all agreed profit margin. In the past, it was unclear whether the value of the murabaha and istisna receivables can be computed based on an NAV basis. The NAV computation method as adopted in the IDB created a strong precedent and is more pragmatic and in line with the needs of the industry.

The same computation method has been adopted for the NAV of the ijarah assets which were computed on the basis of the net lease rentals after deducting the profit margin component. It is a well-entrenched principle that an ijarah asset, being a tangible (ayn) asset, can be sold at whatever price that the parties may mutually agree including on an NAV basis. The NAV computation method for ijarah assets in the IDB sukuk was therefore in line with the prevailing practice.

Seller's guarantee

Another significant principle applied in the IDB sukuk issue is that the seller of an asset can independently guarantee the performance of the end-user of the asset or the payment obligations, of a third party, emanating from the asset. For instance, the seller of a house subject to a lease can guarantee to the buyer that if the lessee defaults on the lease payment

obligations, the seller will indemnify the buyer. The key conditions for the validity of the guarantee are: (i) that the guarantee should be independent of the sale of the house and should not be made a condition to the sale contract; (ii) the guarantor should not charge any consideration for the guarantee; and (iii) the guarantor should not act as agent or mudarib of the person whose liability is being guaranteed.⁴³

To meet all the three conditions above, the mixed portfolio was sold by the IDB to a third party⁴⁴ and the third party then sold the mixed portfolio to the issuer. The IDB then provided the guarantee directly to the issuer covering the payment obligations of all the lessees and the murabaha and the istisna counter parties. There was no consideration paid by the issuer to the IDB. The issuer then appointed the third party as its agent to administer and service the mixed portfolio.⁴⁵ Without the third party's involvement, the issuer would have to directly appoint the IDB as its administrative and servicing agent. This would then mean that the IDB would not be able to provide the guarantee to the issuer because it also has to act as the agent of the issuer.

Liquidity Facility

In the IDB sukuk, there is a likelihood of a timing mismatch between the time for receiving the proceeds due from the underlying lessees and the murabaha and istisna counter parties and the prescribed dates for payment of the periodic distributions by the issuer to the sukuk holders. The issuer may only receive the proceeds a few weeks after the prescribed dates for payment. Technically the issuer is only obliged to make the periodic distributions after it has received sufficient proceeds due from the mixed portfolio. This however will mean that the periodic

⁴³ It is important to note that the above principle does not extend to the Seller guaranteeing the performance of the asset itself. For example, the seller of an equity or share in a company cannot validly guarantee that the equity will yield a certain amount of dividends. If the share does not yield the dividends as guaranteed, the seller will then indemnify the buyer to the extent of the deficit. The ambit of the guarantee as used in the IDB sukuk is only confined to the obligations of an end-user of the assets.

⁴⁴ Islamic Corporation for the Development of the Private Sector ("ICD") was involved as the third party in the IDB sukuk issue.

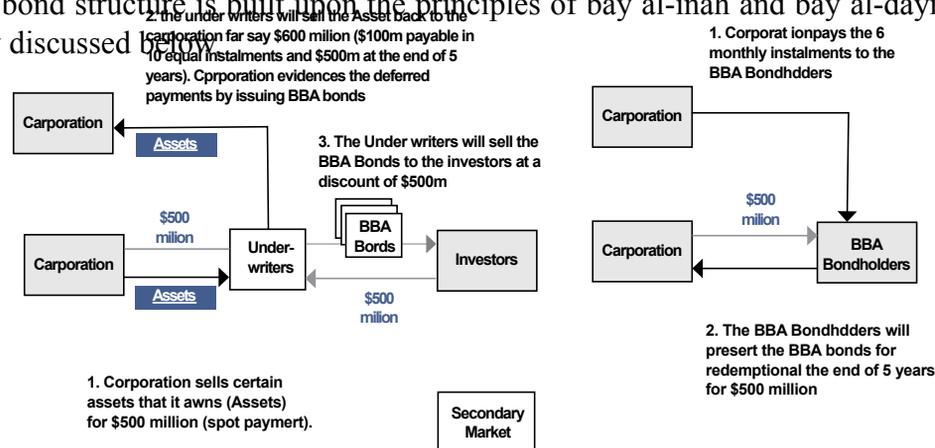
⁴⁵ The third party then delegates the administration and servicing obligation to the IDB. From a shariah perspective, this arrangement does not create a link between the Issuer and the IDB. There is no contractual nexus between the Issuer and the IDB and thus the IDB is not treated as the agent of the Issuer.

payment dates cannot be set in advance which will in turn lead to other logistical problems for the issuer and the investors. To mitigate the timing mismatch difficulties, the shariah scholars have allowed the IDB to provide an interest-free liquidity facility to the issuer whereby if there is a shortfall in the proceeds on the prescribed distribution date, the issuer can draw an amount equal to the shortfall from the liquidity facility. The issuer will then be able to make the full distribution payment on the prescribed distribution date. When the issuer finally receives the proceeds, the advance made by the IDB through the liquidity facility will be repaid in full.⁴⁶ This unique shariah innovation was able to resolve the issues raised by the potential timing mismatch and facilitate the successful issuance of the IDB sukuk.

5) BAY BITHAMAN AJIL BONDS

Bay bithaman ajil (BBA) bonds are the most popular form of Islamic debt securities in the Malaysian domestic debt capital market and in recent years have accounted for almost half of the total new debt securities issues in the domestic market. The structure of the BBA bonds, which is fairly simple, is set out below:

The BBA bond structure is built upon the principles of bay al-inah and bay al-dayn, which are briefly discussed below.



⁴⁶ Alternatively, the advance received by the Issuer can be repaid when the portfolio is sold back to the IDB under the Purchase Undertaking. The Exercise Price for the portfolio will include an amount equal to the outstanding advances.

Bay al-inah

A transaction involving two sales where the seller sells an asset to the buyer on a spot payment basis and the buyer then immediately sells it back to the seller at a higher price on a deferred payment basis is known in fiqh as bay bithaman ajil⁴⁷ or bay al-inah. The term bay al-inah also includes a transaction where the seller sells an asset to the buyer on a deferred payment basis and the buyer then immediately sells it back to the seller at a lower price on a spot payment basis. Both parties end up executing two contemporaneous contracts, one for spot payment and another for deferred payment, without taking any delivery or possession of the underlying asset.

The contemporary scholars who support the validity of bay al-inah rely on the views of Shafie and Zahiri schools.⁴⁸ They maintain that the validity of contracts is to be examined only through their external manifestation. The motive of the parties to the contract is immaterial and it does not invalidate the contract. Hence, the motive of the parties in entering into the two sales in bay al-inah arrangement is irrelevant. The argument goes that only God knows the motive of man and man judges only the external deeds. The motive is left to God. These scholars rely on a hadith that states that that in certain areas of human affairs, such as marriage, divorce and manumission, motive or intention of the parties is irrelevant.⁴⁹

The opponents of bay al-inah strongly contend that the hadith relied on by the proponents do not establish a general rule that in matters of personal affairs such as marriage, divorce and commercial transactions one should not look at the intention of the parties. The well-established rule in Islam, they contend, is that all actions are judged by the intention of the parties. The hadith cited by the proponents merely lay down an exception to the general rule in certain limited circumstances. The reason for the exception, as pointed out

47 The term bay bithaman ajil (similar to bay al-muajjal) is used mainly in Malaysia.

48 See Malaysian Securities Commission, *supra* note 33, at 21.

49 The hadith relates to the pronouncement of nikah or talaq in jest. It has been recorded that the Prophet (pbuh) said: "He who jests with the words that will make a binding contract of marriage, or with the words that pronounce a divorce or declare a slave free, shall be taken to have meant the words seriously. See Malik Ibn Anas, *al-Muwatta*, Book 28 (Aisha Abdarahman at-Tarjumana & Yaqub Johnson Trans.).

by Ibn Qayyim, is that the acts of marriage, divorce and manumission involve the right of God (hukk Allah) and it is not desirable for humans to act in jest with God. The Prophet, due to the magnitude of the acts involved, had imposed the strict obligation on those who make statements in jest. This exception however is only confined to marriage, divorce and manumission and accordingly the hadith clearly mentions only these three circumstances. If it had been meant to include all types of commercial contracts the Prophet would have expressly mentioned it. Since no such express statement was made the hadith should only be confined to areas of marriage, divorce and manumission and there is no justification to extend it to commercial transactions.

The proponents also rely on another hadith regarding a case of adultery and the issue of lian.⁵⁰ In this case, there was a strong possibility that the accused was taking a false oath and despite that the Prophet decided that she is not guilty based on her oral statement and her external conduct. This hadith was relied upon to prove that motive or intention is not relevant in personal matters that include commercial transactions. The opponents strongly deny this by submitting that the Prophet in hearing the dispute was weighing between two probabilities. The probability that the charge against the accused was true and the probability that her oath denying adultery was truthful. The Prophet acting as a judge has to weigh both probabilities and deliver a just ruling. Based on the peculiar facts of that case, the Prophet decided that the probability of the truth of an oath was stronger. The hadith, therefore, does not support the proposition that one is always judged by one's external deeds rather than one's intention or motive.

The majority of the scholars have therefore decided that bay al-inah is not a valid contract under shariah and regard it as a hilah or hiyal (legal fiction) to practice riba.⁵¹ The Malaysian scholars however have adopted the minority opinion and allowed it as a valid

50 The hadith relates to lian and the wife of Hilal bin Umaiyyah. The wife of Hilal was charged for adultery and she denied the charge by taking the oath. Before taking the fifth oath, she faltered. It seemed for a moment that she might admit adultery but then she said that she is not going to dishonor her tribe by admitting adultery and took the fifth oath denying her adultery. Here, there was a strong possibility that she was taking a false oath and despite that the Prophet decided that she is not guilty based on her external deed (oral statement); see Muhammad Al-Bukhari, Sahih al-Bukhari, Volume 6, Book 60 (M. Muhsin Khan trans).

51 see Malaysian Securities Commission, supra note 33, at 21.

shariah transaction.

Bay al-Dayn

The debt arising out of the two contracts of sale or exchanges (awad al-muawadhat) as described above are securitized using the concept of bay al-dayn. Pursuing the above example, the corporation will evidence its debt (i.e. the sale price payable on deferred terms) to the underwriters by issuing debt securities known as shahadah al-dayn and these are comparable to zero coupon securities. The debt securities or BBA bonds are issued to the underwriters at par. The underwriters will then offer the securities in the primary market at a discount similar to a primary offering of zero coupon bonds.

The subject of bay al-dayn is still being debated by contemporary shariah scholars. The majority of the scholars in the Middle East have prohibited bay al-dayn on the basis of an ijma (consensus of opinion) among the scholars. Imam Ahmad has recorded that such an ijma has taken place. These scholars also rely on a hadith where it is reported that the Prophet has expressly prohibited bay al-kali bil-kali.⁵² Others argue that if the exchange of \$100 today for \$110 payable in cash one month later is considered as riba, it is inconceivable that shariah would allow an exchange of \$100 today for \$110 worth of receivables that will accrue one month later. The “prohibition of bay’-al-dayn is a logical consequence of the prohibition of ‘riba or interest. A ‘debt’ receivable in monetary terms corresponds to money, and [in] every transaction where money is exchanged for the same denomination of money, the price must be at par value. Any increase or decrease from one side is tantamount to ‘riba and can never be allowed in shariah.” (TAQI USMANI, supra note 27, at 217)

The proponents of bay al-dayn however contend that there is no evidence to support the existence of an ijma on the issue of bay al-dayn. They also maintain that the various schools have different views on what constitutes bay al-dayn or bay al-kali bil-kali and it is impossible for an ijma to materialize with such a divergence in views. They also rely on prominent scholars like Imam Ahmad, Ibn Qudamah and Ibn Taymiyyah who have refuted

⁵² See Kamali, supra note 1, at 128 (citing the hadith reported by Musa ibn Ubayday on the narration of Abd Allah ibn Umar).

the validity of the hadith prohibiting bay al-kali bil-kali. They conclude that since there is no clear evidence in the shariah that prohibits bay al-dayn the guiding principle should be that it is a permissible transaction (KAMALI, supra note 1, 125-130). They however have not been able to respond to the argument of the opponents that the debt, being traded for money, should also be treated as money and consequently money traded at a discount is tainted with riba.

The scholars in Malaysia however have adopted the minority view and using the concept of bay al-inah and bay al-dayn were able to permit the issuance of bay bithaman ajil bonds.⁵³ Both these contracts have been prohibited by scholars in the Middle East.

PROSPECTS FOR ISLAMIC PROFIT SHARING PRODUCTS

The common thread permeating all the three sukuk structures discussed above is that all these structures share a close resemblance to conventional debt securities. In particular, their economic profile is often identical to that of a conventional bond. All of them have a fixed income component, either in the form of a fixed profit margin or variable lease rental. Like conventional debt securities, all of them have a redemption feature where the principal investment is returned at the maturity date of the sukuk. These features have inevitably led to the criticism that the Islamic alternatives are merely alternatives in form and not in substance. They argue that if in substance the Islamic alternatives are not dissimilar to their conventional counterparts then the Islamic products are merely another type of product within the broad range of conventional products. The argument does hold certain weight when one looks at it from purely an economic perspective. For customers who seek Islamic alternatives, often the paramount consideration is whether the Islamic products offered are competitively priced. The yardstick used for measuring the competitive pricing for Islamic products is unfortunately the pricing prevailing in conventional finance. For example, when a customer walks into an Islamic bank seeking Islamic home finance, one of the key considerations for the customer is whether the pricing of the Islamic product is on par with the conventional mortgage products available in the market. Hence, if the pricing for a fixed rate 20-year

53 See Malaysian Securities Commission; supra note 33, at 16-19.

mortgage is 10% par the customer will invariably demand the same pricing for the Islamic product. While the majority of the customers seek Islamic finance solutions to satisfy their religious conviction, the economic reality is that the pricing consideration often prevails over their religious conviction. If the pricing of the Islamic product is more expensive then there will be less demand for the Islamic alternative. It appears that only a handful of customers will be prepared to pay a premium for an Islamic solution.

Pricing an Islamic debt-based product

Faced with this reality, the Islamic finance providers are compelled to structure the Islamic products in a manner that the risk profile of the Islamic alternatives is as close as possible to their conventional products. For instance, if we look at the murabaha home financing solutions available in the market it will be evident that the risk profile of the murabaha is not dissimilar to the risk profile of a conventional mortgage. The Islamic financier will buy the property chosen by the customer and immediately sell the property to the customer for a fixed price payable over a period of, say, ten years pursuant to a murabaha arrangement. To secure the deferred payment obligations of the customer the Islamic financier will take a mortgage over the property. What is the risk profile of this transaction? The Islamic financier is exposed to the credit risk of the customer and this risk is secured by the value of the property held on mortgage. Isn't this risk profile identical to the risk profile of a conventional mortgage? The law of one price⁵⁴ would dictate that in an efficient market similar products must be priced alike otherwise it would create riskless arbitrage opportunities. It follows from this principle that an Islamic home finance product, which shares a similar risk profile to a conventional mortgage, must share the same pricing as the conventional mortgage product. The stark reality is that Islamic finance providers, being driven by the customers to price their products competitive to the conventional products in the marketplace, are compelled to structure the

54 A well-entrenched principle of economics which states that the same item or closely equivalent item must sell for the same price or related prices in an efficient marketplace. The principle also shows that financial products with similar cash flows or payoffs should command the same price thereby denying the arbitrageurs the opportunity to profit from riskless arbitrage opportunities.

Islamic alternatives with a comparative risk profile. If a 20-year fixed rate conventional mortgage is priced in the market at 10% pa, a 20-year murabaha financing will inescapably also be priced at 10% pa. This then begs the question of whether the similarity in risk and pricing profile makes the products like murabaha or ijarah doubtful in the eyes of shariah.

Fortunately, the Qur'an has addressed this very question where the text states: "they (non-believers) say: "Trade is like usury," but God hath permitted trade and forbidden usury".⁵⁵ According to the renowned commentaries of the Qur'an⁵⁶, this verse was revealed to address the confusion among the non-believers regarding a particular type of transaction prevailing at the time of the Prophet. It was common at that time for people to buy goods and commodities on credit or deferred payment terms and the sellers will charge a higher price for the credit sale. For instance, if the cash sale price is \$10, the price for a deferred sale payable in one month will be say \$12. If at the time of payment, the buyer requests for an extension of one month, the seller will increase the price to say \$14 and then grant the extension. The Prophet has prohibited any increase in the debt in return for an extension of time and such increase is known in fiqh as *riba al-jahiliyyah*. The non-believers "used to say that it is all equal whether we increase the price in the beginning of the sale, or we increase it at the time of maturity. Both are equal".⁵⁷ To them the \$2 increase at the time of sale is the same in substance as the \$2 increase at the time of extension. Why should the first \$2 be allowed as sale and the second \$2 prohibited as *riba*? This complex issue was resolved by the Qur'an in very simple terms: "God hath permitted trade and forbidden usury". According to a prominent jurist:

[t]he Holy Quran could have mentioned the difference between interest and profit in pure logical manner, and could have explained how the profit in a sale is justified while the interest is not. The Holy Quran could have also spelled out the evil consequences of *riba* on the economy. But this line of argument was intentionally avoided....The hint given is that the question whether these transactions have an element of injustice is not left to be decided by human reason

55 2:275 (Abdullah Yusuf Ali Trans.)

56 See Muhammad Taqi Usmani, *The Historic Judgement on Interest Delivered in the Supreme Court of Pakistan* 36-37 (Idaratul Maarif 2000) (citing *Tafseer Ibn Jarir*, iii, 101 and *Tafseer Ibn Abi Hatim*, ii, 454).

57 *Id.* at 37 (citing *Tafseer Ibn Abi Hatim*, ii, 454).

alone, because the reason of different individuals may come up with different answers and no absolute conclusion of universal application may be arrived at on the basis of pure rational arguments....once a particular transaction is held by Allah to be haraam, there is no room for disputing it on the basis of pure rational argumentation because Allah's knowledge and wisdom encompasses all those points which are not accessible to ordinary reason.⁵⁸

The above verse and commentaries clearly lend support to the view that the similarity from a risk and return profile between a murabaha sale and a conventional loan financing does not necessarily mean that the murabaha sale is tainted with riba. From a shariah viewpoint, the similarity in risk and pricing profile does not affect the shariah authenticity of these products.

The role of debt in Islam

One could then argue that the above conclusion would mean that the Islamic finance industry could be built on the basis of murabaha, istisna, ijarah and other similar debt-oriented products all of which would have risk and return profiles comparable to conventional financial products. We have already seen the economic resemblance between a murabaha and a loan transaction. An ijarah muntahia bittamleek transaction, where the lessor leases an asset with an option to sell to the lessee, also has some resemblance to a conventional finance lease. An istisna arrangement, where the Islamic financiers will finance the construction of an asset and then sell the completed asset to the customer, also shares common features with a conventional construction loan facility. In all these Islamic transactions the customers incur debt obligations, either in the form of installment payments or lease rentals or purchase consideration payable under a purchase undertaking⁵⁹. This then attracts the criticism that Islamic finance, as currently practiced, is actively promoting debt transactions in the society instead of promoting the Islamic profit sharing products. If, for the sake of argument, a financial system moves from a conventional debt-based financing model to an Islamic debt-based financing model, will the ills of a debt-driven financial system be removed from

58 Id. at 87.

59 Particularly in an ijarah muntahia bi ttamlik transaction.

the Islamic model? According to a prominent jurist, when “the whole economy turns into a debt-oriented economy ...[it] not only dominates over the real economic activities and disturbs its natural functions by creating frequent shocks, but also puts the whole mankind under the slavery of debt”.⁶⁰ One then wonders whether the Islamic finance model based on predominantly debt-based solutions will end up experiencing the same problems encountered in the conventional finance model.

The above criticism does have some merit when one looks deep into the wisdom or hikmah behind the prohibition of riba. One of the wisdoms behind the prohibition is to discourage Muslims from incurring debt without a reasonable need. For example Muslims are discouraged to incur debt for “living beyond one’s means or to grow one’s wealth”. It has been said elsewhere that “[t]he well known event that the Holy Prophet (pbuh) refused to offer the funeral prayer (salat-ul janaazah) of a person who died indebted was, in fact, to establish the principle that incurring debt should not be taken as a natural or ordinary phenomenon of life. It should be the last thing to be resorted to in the course of economic activities” (TAQI USMANI, supra note 58, at 100). If one wants to grow one’s wealth through commercial and other revenue-generating activities, Islam actively promotes financing through equity participation and profit and loss sharing mechanisms such as mudarabah or musharakah. It follows from this analysis that a debt incurred through murabaha, ijarah or other comparable products will be discouraged under shariah if the debt has been incurred without a reasonable need. The key issue for consideration, then, is what is a “reasonable need”?

When analyzing a reasonable need, the scholars usually look at various factors including, among others, the nature of the need, the economic conditions of the debtor, and the prevailing conditions in the country of the debtor. The scholars are not oblivious to the reality of the prevailing economic conditions in the world today. For instance, they clearly understand that under the current economic conditions it is extremely difficult for many individuals to acquire a house without incurring a debt. For many individuals, even a lifetime of savings may not be sufficient to achieve their aspiration of owning a home. In many

⁶⁰ Taqi Usmani, supra note 58, at 101 (citing the existing state of economic affairs in the world where many countries, including those in the developed world, are over-burdened by excessive domestic and foreign debts, which in some case even exceed the country’s total GDP. See also Tarek El Diwany, *The Problem With Interest* 61-74, 115-122 (1997).

markets house prices keep increasing at an alarming pace and one may not be able to rely on savings alone to purchase a house. And, no one will deny the fact that owning a house for self-occupation has become an indispensable requirement. It can therefore be strongly argued that if one can only acquire a house through incurring a debt then such a debt is a just and reasonable need. The shariah should therefore allow the individual to incur a debt provided there is no element of riba involved. The homebuyer can seek islamically structured home financing based on say murabaha, ijarah or musharakah mutanaqisah. Conversely, if someone wants to incur a debt to acquire a house in say the south of France for his family to reside during the summer break, most scholars may conclude that such a debt is for an unreasonable or excessive need and should be discouraged.⁶¹

The shariah scholars believe that, by screening the use of Islamic debt-oriented products through the filter of reasonable need, the Islamic products will not be used to proliferate the spread of debt in the society. Such a safeguard will hopefully prevent the Islamic finance model from inheriting the kind of problems encountered in the conventional finance world. Like many other predicaments faced by the contemporary Muslim world, the hurdle lies in the implementation. Islamic finance is currently being used to finance almost all the needs of the society, from financing a home to financing a holiday. In its zeal to compete with the conventional finance world, the Islamic finance industry is constantly innovating to produce various Islamic alternatives to match the conventional product range. While innovations are certainly healthy and always welcomed, the Islamic finance industry should be careful to avoid being used as a medium to proliferate debt in society. Various safeguards should be built-in to screen the type of debt that can be incurred Islamically. Indiscriminate extension of credit without the safeguards provided by shariah will eventually lead to the Islamic finance industry facing the same problems faced by the conventional finance industry.

Impediments to the growth of Islamic profit sharing products

⁶¹ Some contemporary scholars argue that the issue of reasonable need is very subjective and should be left to the individual incurring the debt. If the debtor decides that it is a reasonable need for him, he can incur the debt through Islamically structured financing.

If the Islamic finance industry is aware of the potential hazards linked to the debt-based products, why is the industry not actively promoting or offering more Islamic profit sharing products? The Islamic finance industry is constrained by several factors in seeking to do this and some of them are highlighted below.

1. Mindset in the Industry

In any given industry the most important factor for its success is its human resource. The Islamic finance industry is no exception. Since the Islamic finance industry is relatively new, most of the Islamic finance practitioners have been appointed from the conventional finance market. It is inevitable that most of the practitioners, having been brought up in the conventional banking environment, will find it difficult to shift from the conventional finance mindset to an Islamic finance mindset. Due to the familiarity with conventional debt products, the practitioners often tend to perceive Islamic products purely from a debt perspective. Often the key focus and energy is concentrated on finding Islamic substitutes to the conventional products that the practitioners are familiar with. For example a practitioner with corporate loan origination background may, consciously or sub-consciously, end up designing an Islamic product comparable to the conventional counterpart. Often an Islamic product is offered to the customer in the same way as a conventional product, without taking the extra effort to explain the rationale behind the Islamic structure or to explain the pricing justification. Many a time we hear the simplistic response: “The Islamic product is the same as the conventional product. Instead of paying interest you pay a profit or rental”. This type of approach and mindset is injurious to the industry and a paradigm shift is urgently required. The industry leaders should promptly look into this issue and develop training programs and workshops to inspire an indigenous culture and frame of mind in the Islamic finance industry. In particular, the programs should focus on the development of real alternatives, based on

profit and loss sharing mechanisms, for suitable commercial or productive activities.⁶²

2. Customers' reluctance to share the economic upside

The customers who seek Islamic finance solutions also view Islamic products through the spectacles of conventional finance. Most of the customers, being familiar with conventional finance products, expect to see in the Islamic structure some resemblance to the conventional counterpart particularly in terms of pricing and security. If the customer can get a clean corporate loan at say 5% pa, it expects the same terms for the Islamic facility. If the corporate is offered an alternative Islamic financing structure based on profit and loss sharing mechanism most often the offer is declined. From a conventional finance perspective, the corporates key aim is to maximize profits for its shareholders.⁶³

If, say, a corporate obtains a loan of \$100 at 5% pa and is thereby able to generate a profit of \$10, the corporate has maximized its profit by \$5 after paying the \$5 interest. And if the profit generated is \$15, the corporate has maximized its profit by \$10. If the same corporate were to take an Islamic profit and loss sharing facility with a profit ratio of, say, 50:50, in the first scenario where the profit generated is \$10, the company will increase its own profit by \$5. The remaining \$5 will be distributed as profit to the Islamic investors. In the second scenario however, the corporate only gets \$7.5 because it has to share the profit of \$15 with the investors in the ratio of 50:50. This scenario makes the profit and loss structure less appealing to most of the customers. The following third scenario is however beneficial to the customer if they were to take the Islamic alternative. Assuming the profit generated is only \$3, the corporate will still make a profit of \$1.5 because it only has to distribute \$1.5 to the Islamic Investors as their share of the profit. Under the conventional loan, the corporate would have suffered a \$2 loss since it has to pay a fixed interest amount of \$5. But in reality, the well-established corporates are not prepared to share the economic upside. Often they are

⁶² Not all financing are suitable for profit-sharing mechanism. For instance, consumption-related transactions like home and car financing transactions are not suitable for profit-sharing mode of financing. Although home financing products have been structured through musharakah mutanaqisah, the underlying transaction is still based on ijarah.

⁶³ Islam also encourages the maximization of profit but within the framework of shariah that, among other things, discourages leverage and encourages growth through profit and loss sharing mechanism.

tempted by the best-case scenarios where they can maximize their profits manifold and the worst-case scenarios are disregarded as remote.

The above example, although rather simplistic, shows that profit and loss sharing solutions do not generate much appetite, particularly among the well-established corporates. Newly established companies, who often find debt financing too costly or limited, may however be attracted by the profit and loss sharing solution but, unfortunately, very few investors will have appetite for such type of credit risks. This anomaly is likely to remain so long as the corporates have access to conventional debt solutions at competitive rates. We hope however that one day a paradigm shift will occur among the Muslim corporates and they realize that Islam provides only a limited role for leverage and they re-organize their financing requirements through profit and loss sharing means. The contemporary scholars, realizing the problems faced, have even allowed the financiers to agree on “capping” their potential returns on their investment with the corporate. If the investment generates profit beyond the agreed cap, the financiers will distribute the upside to the corporate as an “incentive fee”. It is hoped that this mechanism will persuade the well-established corporates to accept Islamic profit sharing products.

3. Investors aversion to share the economic downside

On the other side of the coin, some Islamic investors are risk-averse and reluctant to share the economic downside of the Islamic profit and loss sharing mechanisms. These investors are used to investing in Islamic investments with a fixed income profile like murabaha, ijarah and istisna. Their investment strategy is often conservative and has little room for taking equity-type risks where the investors are also exposed to the economic downside of the investment. This mindset again inhibits the development of Islamic profit sharing products. Frequently, the investment strategy is designed by practitioners who come from conventional commercial banking backgrounds. Most of these practitioners have little exposure to profit and loss participation investments and lack the necessary skill sets. Investing in profit and loss sharing ventures requires a different type of, and more onerous, due diligence exercise and investment analysis compared to debt-based investments. These investments also require the

investors to regularly monitor the performance of the business. Occasionally it may require the investors to take over the conduct of the business and appoint their own management to replace the defaulting entrepreneur. These tasks require resources with a wide range of skills including corporate finance and private equity expertise. The Islamic investors must therefore employ more people with such backgrounds to enable the shift from debt-based products to the Islamic Profit Sharing Products.

The industry is not expecting all the investors to convert over-night their investment strategy to a strategy entirely based on profit and loss sharing investments. The Islamic investors must gradually revise their investment strategy in line with the ideals of Islamic finance and give priority for Islamic Profit Sharing Products. This will certainly take time and needs the critical support of all the corporates and entrepreneurs who seek Islamic financing. If the entrepreneurs are hesitant to take Islamic Profit Sharing Products then there will be less appetite among the Islamic investors. Conversely, if the Islamic investors are reluctant to invest, there will certainly be less interest among the entrepreneurs. It is encouraging to note that some Islamic banks have been strongly advised by their Shariah Boards to develop as well as to invest more in Islamic profit sharing products.⁶⁴

4. Moral hazard

Another reason for the slow development of Islamic profit sharing products is the minimal level of corporate transparency and corporate governance prevailing in most Muslim countries. Some Muslim countries also lack a well-defined property rights law, which is critical for profit and loss sharing mechanisms to work.⁶⁵ The investors also fear the lack of transparency and good corporate governance among the entrepreneurs (mudarib). There is always the concern that the entrepreneurs may conduct the business dishonestly and may disclose a lower profit. All these concerns added with the lack of accountability on the part of the entrepreneurs

⁶⁴ All Islamic banks offer profit and loss sharing investment accounts where the depositors share the profits and the losses with the Islamic banks. But these funds are invested in mainly murabaha, ijarah and istisna products.

⁶⁵ In some countries ownership in a company and landed property has to be effected through a local sponsor and the enforceability of the contractual arrangement between the investors and the local sponsor is often hazy.

who violate these obligations result in the Islamic investors shying away from Islamic profit sharing products. To alleviate these moral hazards, Islam advocates the importance of good corporate governance and transparency in all dealings including commercial transactions. The Qur'an unequivocally states:

O ye who believe! When ye deal with each other, in transactions involving future obligations in a fixed period of time, reduce them to writing.... Let him who incurs the liability dictate, but let him fear his Lord Allah, and not diminish aught of what he owes.... And if one of you deposits a thing on trust with another let the trustee (faithfully) discharge his trust, and let him fear his Lord. Conceal not evidence; for whoever conceals it - his heart is tainted with sin. And Allah knoweth all that ye do.⁶⁶

These Qur'anic injunctions highlight the importance of the entrepreneur who is entrusted with the trust obligations to exercise proper care and due diligence and conduct the business (for example, a mudarabah business) in a transparent manner. The mudarib is obligated to conduct the business profitably within the boundaries of shariah and to truthfully make a full disclosure of the business profits and distribute the due share of profits to the rab al-mal (investors). The mudarib is also fully accountable for any breach of trust including any negligence in carrying out the terms of the investments or willfully defaulting in its duties. Since Islam firmly advocates the importance of good corporate governance and transparency, it is obligatory upon all Muslims to implement them in their daily activities.

The industry leaders, realizing the importance of implementing these safeguards, have established the Islamic Financial Standards Board (IFSB) that will, among others, promulgate standards for corporate governance and transparency for the Islamic finance industry. The IFSB, based in Malaysia, is expected to issue standards, which meet the international prudential standards and comply with the principles of shariah. The Muslim countries will then adopt these standards and proper sanctions will hopefully be put in place by the respective countries for any breach or violation of these standards. These standards and sanctions, once in place, will create the conducive platform for Islamic Profit Sharing

Products to flourish and reform the current landscape of the Islamic finance industry.

5. No level playing field

Another barrier to the entry of Islamic profit sharing products is the uneven tax treatment currently in place for equity-based products. Interest payment, and correspondingly profit payment in murabaha and rental payment in ijarah, are all tax deductible on the ground that they constitute cost items. A profit distribution under a mudarabah or musharakah is, on the other hand, not tax-deductible. The distribution is made net of tax. This unfair tax treatment frequently makes the Islamic profit sharing products more expensive for the corporates. The existing tax environment inevitably makes leverage and gearing more attractive to the corporates.⁶⁷ Assuming the corporate tax is 30% and a corporate, with say \$100 equity, borrows \$900 at 10% pa and makes a profit of 20%, then the leverage will produce a return on equity of 77% for the corporate.⁶⁸ Conversely, if the corporate raises the \$900 in equity instead of debt and still makes a profit of 20% the return on equity is merely 14%.⁶⁹ The existing environment creates an uneven playing field for the Islamic investors who are keen to offer Islamic profit sharing products. The economics of the profit and loss sharing mechanism simply makes it less appealing for the corporates. The industry regulators must take urgent steps to reform the tax system in their respective countries and to create a level playing field for the Islamic profit sharing products. Perhaps, with equal tax treatment, the appetite among corporates to seek profit and loss sharing solutions may increase and promote less reliance on the Islamic debt-based products. Obviously, more research has to be done in this area before it can be successfully implemented.

CONCLUSION

The various sukuk products discussed above have opened up to the Islamic finance market a

⁶⁷ For an interesting discussion on the negative impact of leverage to the economy and the limited role of leverage in Islamic economy, see Tarek El Diwany, *supra* note 52, at 167-172.

⁶⁸ $(\$200 \text{ profit minus } \$90 \text{ interest minus } \$33 \text{ tax}) / \$100 \text{ (equity)} = \$77.$

⁶⁹ $(\$200 \text{ profit minus } \$60 \text{ tax}) / \$1,000 \text{ (equity)} = \$140.$

new and attractive asset class with a fixed income profile and tradability feature. This asset class will hopefully be able to consume the huge surplus liquidity existing in the Islamic finance market. The credit goes to contemporary shariah scholars who were able to inspire and guide the industry in producing the various shariah innovations that made the sukuk a reality today. The sukuk product, however, should be employed judiciously to ensure that it is not used as an avenue to proliferate debt in society. The Islamic finance practitioners should channel their focus and energy in spreading the growth of Islamic profit sharing products. There are various hurdles but these are not insurmountable. History speaks for itself. Three decades ago, very few would have believed that the sukuk would be a reality. Perhaps, three decades from now, the Islamic profit sharing products will be the mainstream products in the Islamic finance market.

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Speculation from the Islamic Perspective (Islamic Jurisprudence)

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Abstract

Speculation, in a general sense, is an economic activity with the primary goal of making a profit by predicting changes in the price of commodities, securities and currency. This paper is a proper investigation into the speculation from the viewpoint of religious Jurisprudence in a sound manner and far from any hoard, coalition spread of false news, fictitious deals and the like. The attempt is directed to prove the permissibility of speculation -obviously in the context of the Shariah tenets prescribed for transactions- on the authority of various verses from the Holy Quran and religious Hadiths (narrations).

Key words: Speculation, Gambling, Hedging, Mudarabah Contract, Riba

Introduction

Speculation is an economic activity with the intention of making a profit by predicting changes in the price of commodities, securities and currency. Hence, the primary motive of speculators is to gain profits by trading in various assets. Speculators may buy a commodity which they do not, in reality, need it but only for this simple reason that they forecast its value will appreciate in the future. Additionally, they may sell a commodity that they really do need it only in the hope that its price will drop in the future (Black, 1997).

Shares, Stocks, bonds and treasury notes are traded in the securities market in a financial context. The term “speculation” is typically used for such dealings. Speculators can presumably influence the market prices to their own advantages through fictitious trades, spreading rumors, collusion and hoarding commodities. To avoid such occurrence, various countries have established rules and regulations to oversee the speculators and preclude their sway over the artificial price changes (Jahankhani: 1386).

Doubtless, the Islamic principle has prohibited any activity which may be the cause of artificial change in the price of commodities or any type of asset. There are tenets in the Islamic Shariah which forbid the fictitious deals, hoarding, coalition, spread of false news

and the like. There is no attempt to explain such principles and rules in this article¹. Upon the assumption that no rules are to be broken, the topic focuses on the Islamic viewpoint to find out whether the trading in commodities, currency, equity and the like as stimulation for making a profit through price fluctuations in the future are permissible.

Impacts of prescribing speculation

If the speculation is successfully practiced in a controlled manner, it will trigger positive outcomes like price movements, increase in the level of liquidity and ease of providing funds². Thus when the exercise of speculation is prescribed, it will offer the possibility of using its positive outcomes and will additionally affect macroeconomic analyses.

In capital economics, the permissibility of interest, existence of securities market and prescription of speculation will provide the necessary grounds for the Keynesian Theory of Liquidity Preference. In this theory, money is introduced to be a type of asset that people wish to keep it in certain situations in preference to other items of asset (Tafazzoli: 1997).

In view of the fact that in Islamic economics, “Interest” is the same as “forbidden Riba or Usury” and the securities market is non-existent, this question is raised whether there is not any money demand as a motive for speculation in such economy either. To put it in another word, when analyzing the role of money in Islamic economics, which theory is correct, the Quantity Theory of Money or the Keynesian Theory of Liquidity Preference?

If the speculation is to be forbidden, the Keynesian Theory of Liquidity Preference does not definitely apply in the Islamic economics. However, if the speculation is permitted, it may be argued that in Islamic economy there exists the money demand as stimulation to get involved in speculation and thus the theory of Liquidity Preference can be used in analyzing the role

1 These rules based on Shiism, have been discussed in various religious sources, inter alia: Al-Makaseb-ol-Moharrameh Va Javaher-ol-Kalam. Similar rules based on Sunnite traditions are also explained in: Yousef Kamal Mohammad: Fegh-hol-Eghtesad-ol-Naghdi, Darol-Sader-fi, Darol-hedayah, 1993 PP., 272-285.

2 See: Hassan Golriz: Stock Exchange Securities, Amir Kabir Publishing Firm 1993, PP. 101-106 and Gholamreza Sarab - dani: Islamic Viewpoint of Stock Exchange activities, Master Thesis in the Economic Sciences, Mofid University, 2000, P/ 66.

of money.

Martyr Sadr's Theory on the speculation with a critique

Martyr Sadr views trade to be a section of production and believe that: the profit gained from buying and selling activities must derive from a certain kind of service which is generated by the merchant and the mere ownership transfer without service production is not permissible for gaining profits³. He divides the trade into two categories: lawful trade and physical trade. He interprets physical trade as movement of objects from one place to another and the lawful trade as the mere ownership conveyance via transactional contracts and believes that: If the lawful trade is not combined with physical trade (service production) it can not be a motivation for profit. (Ibid) This creed is rooted in his Theory of Distribution after production in which he deems the only source of income is the potential or reserved useful action in the production tools or capital goods. (Ibid, P. 588) He draws a conclusion that the venture and risk can not be the source of income. Hence, the profit which is permitted in the Mudarabah Contract for the capital provider is not for the reason that he (the capital provider) tolerates the investment risk but owing to the Principle of Ownership Stability. (Ibid, P. 601) Based on this principle, if a raw material, on which the agent is working, belongs to another individual, the product and the profit so gained also belongs to such individual and the agent only deserves his wages. Obviously, the owner of raw material may regard the agent's wages as a portion of his profit. (Ibid, P. 564)

As a result, from Martyr Sadr's viewpoint, the speculation which is entrenched in the concept of lawful trade cannot serve as the source of legitimate income.

Dr. Tootoonchian, by quoting such topics from Martyr Sadr, has also forbidden speculation and believes that: The speculation permissibility means the exchange of money with money via shares or other assets⁴.

Martyr Sadr is not seeking an interpretation of religious pronouncement for such issues in

³ See: Mohammad Bagher Sadr, Eghtesadana (Our Economy), Maktabol-Elamol Eslami (an Islamic School), Far'e Khora - an, 1996, PP. 645-652.

⁴ See: Iraj Tootoonchian, Money and Islamic Banking and, PP. 242 & 243

his book named “Eghtesadena”. He is exploring the principles of Islamic Economy from the works (pronouncements) of various religious jurists (Mujtahedin) as he has expressly described in the introduction to “Eghtesadena”: The principles of religion are to be extracted from religious edicts which are contrary to his own opinions on this issue⁵. Now considering the point at issue, we critically examine Sadr’s views on the source of legitimate income and the profit earned from the lawful trade and speculation.

In his opinion, the source of legitimate income is a useful economic activity which is potential or reserved in the production tools and physical capitals whereas there are some legitimate incomes which do not arise from useful economic activities. One of such items is the profit share of capital providers in the Mudarabah Contract: Martyr Sadr justifies the legitimacy of such incomes by means of the Principle of Ownership Stability. Then this question comes up whether such principle can justify the income earned from increase in the price of a commodity whose owner is a particular individual. For example, assume that a person buys a car for 40,000,000 IRRs. After a period of time, owing to the changes in the auto market, the price of the car increases to the amount of 45,000,000 IRRs whereas the prices of other commodities remain stable. Now, if this person sells his car and makes a profit of 5,000,000 IRRs, there is no doubt that such profit is legitimate and the principle of ownership stability, as an origin for the profit share of capital provider in Mudarabah, can serve as the source of Income. The reason is that the increase in the commodity price occurs in that person’s property and he who owns the commodity owns the financial creditworthiness and its price increase as well⁶. From this angle, the purchase and sale of asset for gaining profits through price movements and by using the opportunities available in the Islamic market is permissible, even if it does not coincide with service production (in the sense interpreted by Martyr Sadr, namely physical transfer).

Theories Expounded by some Sunnite Economists and Scholars

⁵ See: Mohammad Bagher Sadr, Eghtesadena P. 49.

⁶ See: Seyed Hossein Mirmoezzi, Islamic Economic System based on Imam Khomeini’s viewpoints, Master Thesis, Mofid University, PP.72-74.

Khorshid Ahmad who interprets speculation as a game of chance and forward purchase asserts that:

A large number of authors have briefly explained that Islamic teachings do not allow “speculation” (Ahmad 1995). After quoting the “Illegitimacy of speculation” from Mowlana Mohammad Taghi and Ghorashii, he adds:

A. Manan says: as long as the speculation serves the society through helping the production and control of price changes, it is consistent with the spirit of Islam. But the speculators, who are seeking their personal benefits, will cause artificial shortages leading to pressure on the economic system. Islam condemns such speculative actions and forward purchases.(Ibid)

Accordingly, by quoting from Monzer Kahf, he states that:

Economists reject speculation for two reasons: first, speculation is a type of gambling and, second, speculation means the sale of an object that a person is not its owner.

In the end, Khorshid comments that:

The efficient buying and selling of currencies during a period of time is as much as the buying and selling them in a location a social need and the arguments of Muslim economists will still have to grapple with this issue. (Ibid)

Adnan Khaled-Al-Torkamani, by defining Al-Mudarabah as “buying and selling at present time in the hope of buying or selling in the future when prices change, inhibits «speculation in the monies”. He argues that Islamic scholars consider the money to be a means to facilitate the trade exchanges between people and a means to measure the value of goods and services. Hence, money is not a commodity to be traded with and if money stays the object of trading as a commodity, it will cause economic inflation, recession and instability (Al-Torkamani 1988).

Ghalavi asserts that:

What is meant by speculation (Mudarabah) is trading in financial assets and cash or possessory documents of commodities and properties without availability of the commodities per se and without having the intention of handing over or taking delivery of the commodities or

precious stones or similar objects which fall in the category of transacting in the money and capital markets as well as in the commodities market and, further, without having the determination of retaining financial assets such as stocks and bonds until when the accrued interests or benefits are to be received. His remarks aim at speculations which are presently the common practice in the financial markets. He also contends that:

It is not possible that the Islamic Shariah prescribe Mudarabah. This is because Mudarabah is similar to a gamble which generates losses or profits that are not associated with the excessive profits earned from commodities, services or financial assets exchanged. Additionally, Mudarabah does not meet the conditions required by the Islamic rules for the legitimacy of purchase and sale because it lacks the intention for acquisition and generation of proper economic benefits. Furthermore, another fundamental aspect which, from the Islamic perspective places transactions in the global financial and money markets in the realm of prohibition is the price composition in such markets, in particular, in the area of futures transactions or interest (Riba) as an essential element (Ghalavi 1998).

As it is noted, the controversial issue in such doctrines is the conventional speculations in the West which are achieved along with fictitious deals, spread of falsehood, hoarding, collusion and the like. In the meantime, some Sunnite scholars have not discussed the matter of buying and selling in the hope of making a profit. They have addressed the legal and religious frameworks of the contracts used by speculators. It can be inferred from their comments that speculation (buying and selling with the stimulation of making a profit) is permissible if it is operated within the context of Islamic rulings and contracts. If not, it is not permissible. For example, Ahmad Aldrivish classifies the stock markets into the Commodity Exchange and Financial Securities Exchange and, then, divides the transactions on the Stock Exchanges into the cash basis and deferred payment basis. He then separately deals with the rulings for each one of the four types of profits.

He does not see any contention if, in each of the four types of stock exchanges, transactions are conducted on the cash basis or on the deferred payment basis (credit or forward deals) within the framework of Shariah laws and principles. However, he believes that if the price

of deal is not determined in the contract and then an object is bought and sold at the price set for one or several next months, this action is the same as “speculation” which means making a profit from price differences and it falls under the category of Rihan (a race accompanied by betting or wagering) which is religiously invalid. In reality, the seller bets on the price decline on a specific day and the buyer bets on the price increase on that same day and, whoever wins the bet, will be the gainer of the price differential.

Also if somebody sells, on the credit basis, a commodity or object which does not belong to him, he is involved in the sale of a property which is not owned by him and thus such deal is invalid⁷.

Yusuf Kamal Mohammad also argues with the same viewpoint. He first raises this question that the stock market operations have evolved from actual investment to fictitious actions in which both sides of the deal (price and commodity) are deferred. Such fictitious actions are seeking to access the opportunities which will be provided through change in prices. In this case, should the stock dealers’ prediction turns out to be accurate, they will gain profits and, if not, they will be losers. Under such circumstances, the stock dealers often turn into gamblers who gamble on the rise and fall of prices. Then assessing the issue religiously he says:

Islam has defined various rules on the proper financial activities, inter alia:

1. Cash purchase and sale
2. Islam has not inhibited “Hedging”⁸ but it is conditioned that either of the two elements in the deal must be paid or delivered.
3. Islam has not prohibited the preference between prices in terms of time and place

⁷ See: Ahmad Aldrivish, Market Practices in Islam and their impact on the Islamic Economics, Alem-ol-Kotob Publishing House, 1989, PP. 573-584.

⁸ Hedging means futures buying and selling as a protection cover against possible risks and reducing the minimal changes in prices (see, Economic Dictionary by Manouchehr Farhang, vol. 1, P.907.

(Arbitrage⁹) to gain from differences arising out of such action. For a commodity may be scarce in one particular place or time while it may be abundant in another place or time. But Islam has prescribed some criteria for futures buying and selling so as to avoid deviation in the market.

Thereafter he addresses the intended criteria and explains how such criteria can avoid deviation in the market. He draws a conclusion by quoting the edict pronounced by the Shariah Jurisprudent Assembly. The content of such religious edict on the stock market is that the essence of the stock market is considered to be useful. But illicit trades, gambling, abuses and misappropriation as faulty actions are also embedded with expediency. Hence it is out of the question to pass a general religious edict on the stock market and edicts are to be issued for each and every transaction which is executed in such markets. Finally, the Religious Jurisprudent Assembly deals with the ruling for stock market trades (Mohammad 1993).

As noted earlier, all of the foregoing rulings, as quoted from Sunnite sources, cover the conventional speculation practice in our age which is accompanied by hoarding, collusion, false deals and the like in order to bring about artificial changes in the market prices in favor of speculators. On the face of it, in one sense, “Al-Mudarabah” means the same as “speculation” in the contemporary Arabic Terminology¹⁰. However, if the buying and selling are handled within the framework of Shariah rules and principles in the hope of making a profit, there is no religious prohibition whatsoever from the viewpoint of Sunnite scholars.

Assessment based on Shiite Jurisprudence

Where the cash or credit or forward purchase and sale is carried out with a motive of making

⁹ The practice of buying an asset in one place and selling it immediately in another place where the price is higher so as to gain from the price differences is called Arbitrage or foreign exchange speculation for profit. See: Economic Sciences Dictionary, By Manouchehr Farhang, P. 82.

¹⁰ Almost all Arabic books that have addressed the issue of “speculation” and some have been mentioned in the footnotes herein, have connoted the term, “Mudarabah”. In contemporary dictionaries, one meaning of Mudarabah is stated to be “speculation” please see:

- Azartash-Azarnoush: Contemporary Arabic-Persian Dict. Nashre Ney, 2000, P.383

- Dictionary of Modern Terminology, Najafgholi Mirzaie, Daroletesam, P.548-under “Speculation in Real Estates.”

a profit within the context of Shariah rules and principles, such action is permissible from the viewpoint of Shiism. In this respect, there is a consensus with the Sunnite scholars. Certain evidence out of many used to prove this argument can be stated as follows:

1. Qurananic Verses

These two verses in the Holy Quran “God has made trades permissible¹¹ “ and “Do not squander your wealth unless you are involved in a trade mutually agreed on¹²” imply general applications and include such buying and selling activities. For instance, assume that an individual envisages that the price of cars will increase in the future. He buys a car for cash to sell it and make a profit when the prices rise. He sells such a car and, in this way, makes a profit. Buying a car is a trade that is accomplished upon the mutual consent of the two parties and selling it also applies to the meaning of a trade that is based on mutual agreement. Hence, the foregoing two verses include both types of transactions.

It may be contended that the said individual has done nothing in return for the profit he has made. Thus the injunction against squandering the wealth as ordained in the second verse of the Holy Quran applies here. However, this argument does not appear to be accurate. Based on the grammatical rules in Arabic, “ba’e” in the term “bil batil” meaning “wastefully” is either for causality or for contrast. If “ba’e” is “causality”, the sense of the verse is like this:

“Do not consume (eat) your wealth due to wastefulness among yourselves”. To put it in another word, do not intervene in each other’s property via “invalid cause”, that is to say, a deal which is religiously invalid. If “ba’e” is for “contrast”, the sense of the verse is like this:

“Do not consume (eat) your wealth, in return for an invalid matter, among yourselves”.

In this case, that verse of the Holy Quran shall consists of the transactions in which a person takes possession of another party’s property and, does not, in return, deliver a valuable consideration to the owner.

The current point at issue, two transactions has been executed whereby either of the two is

11 See Chapter “Baghareh”, the Cow (2): 275.

12 See Chapter Nesa, “Women” (4): 29.

underpinned by the religious cause. This is because the cash or credit or futures sale and purchase is religiously proper deals and, further, in each of the deal, a valuable consideration is delivered or paid (allowing the asset ownership to be transferred from one party to another).

For the asset bought or sold, if the anticipation turns out to be right, some profit is reaped from this buying and selling. But the source of profit is the rise in the market price from the time of purchase up to the time of sale and since such price rally occurs in the asset of the person who has bought the car, he is entitled to such price difference. Because he who would own the property itself, would own its financial worthiness and the value there to as well.

It may also be contended that when a person buys an asset and stores it to take advantage of an anticipated price increase, he is a hoarder and keeping an asset is tantamount to hoarding which is forbidden in the Shariah Law. This argument can be addressed in several ways:

- A. In many cases, no hoarding occurs. For instance, if a person anticipates that the price of a commodity will rise and buys such commodity in the form of futures to profit from the deal and, then upon lapse of the given period, he will take delivery of the commodity to sell it for cash. In such case, it does not imply that he has stored the purchased commodity and thus the rule for the hoarding does not apply here.
- B. A large majority of the religious jurists have cited wheat, barley, raisin, dates, cooking oil and salt¹³ on the hoarding list to be Haraam (forbidden) and have further added that hoarding is otherwise not forbidden.
- C. Almost all religious jurists have stated two conditions for the forbidden hoarding:
 1. A person should buy a commodity and hoard it in anticipation that its price will rise in the market.
 2. There should not be another person who can meet the market needs other than the hoarder¹⁴.

13 See: Al-Sheik Morteza Al-Ansari, Al-Makaseb-ol-Moharrameh (Forbidden Businesses), Etela'at Publication, Tabriz, 1996, P.212.

- Mohammad Hassan Najafi, Javaher-ol-kalam, Islamic Books Center, 1995, vol.22, P.482.

14 See: the references introduced in the footnote 1 and Al-Shahid-ol-Sani: Masalek-ol-Afham, Islamic Educational Institute, 1414, vol. 3, P.192.

Some of the jurists have also affirmed the condition of need; namely, the public should be in need of the commodity to the extent that the decrease in its supply in the market will cause economic hardships and woes for the people. (Ibid)

Considering these conditions, three circumstances are excluded from the forbidden hoarding:

Firstly, the hoard of a commodity which is not needed by the people - in a manner that their shortages may cause living hardships-, likes luxury goods;

Secondly, where the hoard of a commodity by a person does not result in the rise of market price owing to the abundance of such commodity and his motivation for hoarding is otherwise the anticipation of price increase in the future.

Thirdly, in case there are other persons who are ready to offer such commodity at market price.

As already noted, considering the conditions stated earlier, the hoarding which is a requisite for speculation in our age, is, in many more circumstances, excluded from the realm of forbidden (Muharram) hoards. Obviously, where the hoard of commodities and speculation reach such an extent that Muslims will sustain losses, they will be absolutely prohibited. Saheb Jawahir has interestingly put his words in this regard. He, in replying those who believe that hoarding has rational abomination, says:

It is evident that reason (wisdom) in perceiving the abomination of hoarding is not independent. In particular, for the issue in question, shutting up the food in anticipation of price increase is like shutting up the non-food out of the goods traded, in that the goods are regarded for trading purposes but losses do not result for Muslims. Muslims may sustain losses if a person buys all of the foods and then sells them to the people at any price he wishes or whatever he does will bring about high prices or most traders agree on hoarding in a manner that the commodity price will rise and losses will result for the people, being inconsistent with the policy and expedience of governance and administration. For this reason, Imam Ali commands Malik Ashtar to launch a campaign against hoarders. Additionally, hoarding may occur for other purposes which may be otherwise forbidden and has no bearing on our discussion.

The conclusion is that the shutting up of any commodity which people urgently needs it and there is no other alternative such as food, water, clothing and the like, is forbidden. This impermissibility is not tied to any particular time or any particular commodity or conversion to any particular contract and nor is it confined to any limit and realm [In brief, words do not count in this respect]. The core point is keeping food in anticipation of having higher prices, in the manner that other traded commodities are kept. The argument here is the religious edict for keeping such commodities as people ordinarily need them but not with urgency. The rejection of this claim that reason (wisdom) can recognize the abomination of prohibiting such action is clear and straightforward (Najafi vol.22).

It can be concluded that keeping a commodity in the hope of higher prices is forbidden when it is urgently needed by the people and by hoarding the commodity, its price will rise and, as such, the Muslims will sustain a loss. Under the circumstances, the Islamic government must, as a protector of Muslims' rights, prevent such action. However, if this situation does not occur no contention will arise.

The only issue which remains is that the speculation is likened to a gambling game. Some of the Sunnite scholars have addressed this issue in a way that only includes the speculative trades common across the global and are based on fictitious contracts and false deals¹⁵.

Yusuf Kamal Mohammad distinguishes between Muqhamarah (gambling) and Mokhatarah (risk-taking) and asserts that:

Muqhamarah is based on the estimate of price changes in the future whereas Mukhatarah is based on the profit from investment. He believes that Muqhamarah has an adverse effect on the economy and, by quoting Keynes, argues that:

As long as the speculators do their own practices, no loss will result in the market. Because they are, in such case, like bubbles which appear on a river running on the risk bed (Mukhatarah). But the market will become of great importance when it revolves around Muqhamarah and Mukhatarah will be like bubbles moving behind Muqhamarah....¹⁶.

15 As quoted earlier by Ghalavi and Drivish

16 See Yusuf Kamal Mohammad, Fegh-ol-Eleghtesad-ol-Naghdi, P.260-262.

One of the economists also distinguishes between gambling and speculation and says:

It should be noted that the speculative action differs from gambling in nature. Because Speculation occurs on the basis of complicated business calculations whereas gambling depends, to a great extent, on chance and luck¹⁷.

In any event, there are certain differences between speculation and gambling. But in the Sunnite jurisprudence which relies on deduction, the existence of similarities will be sufficient to pass an equal edict for both. The speculation, as quoted earlier by Ghalavi, in some of its facets is in need of a type of bet on future prices and, as such, resembles gambling. Thus in the Sunnite jurisprudence, its prohibition may be declared on account of such resemblance.

This contention is, nevertheless, related to the speculative deals based on fictitious transactions and is beyond the purview of our current discussion. Our discussion deals with buying and selling with the motive of making a profit via price forecast which is achieved within the framework of the rules and principles pertaining to cash, credit and futures purchase and even the Sunnite scholars do not regard such speculative deals as gambling.

Furthermore, in Shiite jurisprudence gambling occurs and is ordained to be Haraam (forbidden) if, firstly, it is done with gambling tools and, secondly, there is betting involved whereas speculation is lacking in these two elements.

2. Specific Narrations

There are various narrations implying the permissibility of sale and purchase with the motive of making a profit without doing any useful economic activity in return for such profit¹⁸. Some of these narrations are quoted here:

A. Ebrahim Karakhi says: I asked Imam Sadiq: “I sold a number of date-palms at a certain price (each palm tree at given dirhams) to an individual. The buyer resold the palm trees to another party and made a profit. The second deal occurred while I had not received any cash in settlement of my selling the date palms”. In response, Imam Sadiq said: it did not matter.

17 See Hassan Golriz, Stock Exchange, P.103

18 Such narrations are Mostafizand and hence no need to see the sources

Did the buyer not guarantee to pay the price of the palm tree: I answered: “yes. He did”. Imam said: In such case, the profit belonged to the buyer¹⁹.

Apparently the narration implies that the buyer of palm trees has done nothing in the interval between his purchase and sale of such trees and, further, the purchase and resale were handled in cash without any interval between the two deals. Since the Imam said that the profit belonged to the buyer, the profit earned from lawful trading (as quoted by Shahid Sadr) does not meet any religious prohibition.

B. There are several narrations implying the asset which is measured by counting. If a person buys it, he will be allowed to resell it prior to taking delivery and thus will make a profit²⁰.

It is quite evident that, under the circumstances, trading is also lawfully executed and it can not be argued that in return for the profit gained from such purchase and resale, a piece of useful economic action has been necessarily done.

C. Halabi asked Imam Sadiq: A man hoarded food in anticipation that the price would increase. Was this a proper action? The Imam, in reply, said: “If the food was in ample supply to meet the needs of the people, such action did not matter” ...²¹.

Earlier in dealing with Ihtikar (hoarding), the hoard was defined as the purchase of and keeping a commodity in the hope of price increase in the future and resale for making a profit. Such a deal is Haraam (forbidden) only when it will generate a loss for Muslims and hardships in their life and it will not otherwise be permissible.

For this reason, Imam Sadiq said: If there is another seller in the area (town) who sells the same commodity, it does not matter whether a person buys and keeps such a commodity and demands a higher price for its resale or keeps it and anticipates improvement in the situation for a price rise²².

19 See Al-Sheik Horre-Amoli, Vasaelol-Shii, Al-Albeyt la Hayya-ol-Torath Institute, vol.18, P.64, chapter 15, H 1.

20 See, Vasael-o-Shia’a, vol.18, P.45, chapter 16, 1, 8, 12, 16.

With respect to the properties measured by weighing, there are various comments and quotations by jurists vary-see, Ma-sael-ol-Ifham. Vol.3, PP.247-249.

21 See Vasael-o-Shia’a, vol.17, chapter 27, H.2.

22 See Vasael-o-Shaia’a, , vol.17, chapter 28, PP.427-429.

If there are various sellers offering a commodity in the market, a person may be motivated to buy and keep it when he anticipates a higher price in the future and there is no other rival for such deal. This deal is typically a kind of speculation that Imam has prescribed it.

Conclusion

A modus operandi to avoid speculation:

Speculation in the sense of buying and selling an asset with the profit motive through price increase in the future is permissible under two conditions:

1. It must be executed in the framework of the rules and norms prescribed for cash, credit and forward trades (purchase and sale). Under this condition, the fictitious deals²³ and the transactions having the two sides on deferred payment basis or the transactions in which the commodity price is not known and the like will be excluded from the scope of such deals.
2. It should not generate losses for Muslims, or else, the Islamic government must, as a protector of Muslims' interests, hamper it by lawful means and executive writs. Under this condition, the speculation which is accompanied by spreading falsehood and collusion towards artificial change in prices will be excluded from the scope of such deals. In other words, as long as the speculators are amenable to prices, the speculative deals are permissible. However, if they intend to generate prices through actions like the spread of falsehood and collusion so as to make a profit, speculation is not permissible.

In conclusion, it is noted that some people believe that if speculation becomes permissible in satisfaction of the two conditions stated above, it can be argued that: in Islamic economics, the money demand with profitability motive and also liquidity preference prevails and non-existence of interest and securities market, will not deny this type of money demand in Islamic economics. This topic, due to its importance and accuracy in the macroeconomics, will necessitate a profound investigation in another article.

²³ Fictitious deals mean transactions in which one party alone or helped by a third party executes simultaneous trading in shares. Although a deal has apparently been executed, the actual change in possession has not been effected. The goal of such transactions is to create artificial and false prices for shares so as to make a profit or reflect artificial loss for taxation. See, Ali Jahankhani and Ali Parsaeian, Stock Exchange, P.118.

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