Islamic Finance-Products & Procedures

Learning Outcomes

By the end of this unit the learner will be able to:

- ✓ Identify the Role of Financial Institutions and Products in Conventional and Islamic Banking.
- ✓ Outline the Principles Relating to Stocks

Islamic Finance – Products and Procedures

Overview of Financial Institutions and Products: Conventional and Islamic

To understand the concepts and operations of Islamic finance, it is worthwhile giving an overview of the financial institutions, markets and instruments in the conventional set-up, as well as in the Islamic framework. This will help in understanding how financial institutions and products affect individuals, firms, societies, economies and States and how they perform to fulfil the needs of various segments in an economy.

In this unit, we shall briefly indicate the alternatives in Islamic finance to their counterparts in conventional finance. Details of these alternatives are given in subsequent units.

The Strategic Position of Banks and Financial Institutions

Finance is the most strategic part of modern economics that functions like blood arteries in the human body. In every society there are surplus as well as deficit households and institutions. While a large number of people have relatively smaller savings, a number of others, particularly businesses, are short of funds for their business expenses or production needs. Financial institutions provide a link between the deficit and the surplus units. In a conventional set-up, individuals and households provide funds to business and industries through financial institutions, which charge a fixed or floating but risk-free rate of return from the fund users and give a part of the return to the fund owners (savers/investors),keeping the remainder for themselves as spread.

Like all other goods and services, the availability of the funds is governed by the forces of demand and supply and the risk profiles of various stakeholders. While the supply of funds comes from individuals or households and corporate bodies, demand is generated in trade, business, industry, agriculture, corporations and government sectors. The institutions involved in this process of resources transfer are commercial banks, investment banks, savings and loan institutions, specialized institutions like micro credit, SME credit, industry, agriculture, trade, export/import, housing, leasing, venture capital, discount houses, insurance companies, fund management companies, asset management companies, etc. These institutions can be divided from one angle into two broad categories of banks and non bank financial companies or institutions (NBFIs). Further, there are some development finance institutions (DFIs) operating both as banking and non-banking institutions and providing finance to industry, agriculture and other sectors or subsectors for developmental activities.

Commercial banks undertake the intermediation function between the saving surplus and the fund user units and entities and provide checking facilities to the savers/investors. NBFIs normally do not provide checking facilities to the savers and facilitate the raising of funds for business and industry directly from the saving surplus units/households. Investment banks are included in the NBFIs. Investment banks derive their income primarily from fee-based activities or profits from trading in securities rather than from a margin between the borrowing and lending costs. The services provided by these banks take many forms, including securities underwriting, stock and bond trading, facilitating mergers and acquisitions, arranging and funding syndicated loans and providing financial advice to companies needing funds.

The above types of institution are regulated by central banks or monetary authorities and the securities and exchange commissions in respective countries. In addition, there are some international financial institutions that coordinate the services of banks and financial institutions at a global level. The most important of these institutions is the Bank for International Settlements (BIS), which performs the function of coordination and standardization of the services of the financial institutions in various parts of the world.

The Need for Islamic Banks and NBFIS

Interest is the cornerstone of the modern financial system. Keeping in mind the strict prohibition of interest in the Islamic framework, one may consider that an Islamic finance and economic system may be developed without intermediaries like banks and financial institutions, but this is a misconception. Banks and financial institutions will remain a part and parcel of economics and finance in the Islamic framework as well. Modern businesses need huge amounts of funds, while people at large have mostly small savings. This necessitates the presence of such intermediary institutions through which business needs can be directly and indirectly fulfilled with savers' pooled money in such a way that savers/investors can also get a just return on their investments and business and industry can get the funds required for ensuring a sufficient supply of goods and services for the welfare of mankind.

The Structure of Islamic Banking

Islamic financial institutions (IFIs) also serve as intermediaries between the saving surplus and the deficit units/households. However, the instrument of "interest" is replaced by a number of instruments. While conventional banks mainly pay and charge interest in their operations, Islamic financial institutions have to avoid interest and use more than one key instrument as the basis of their intermediary activities. The striking difference is that risks in Islamic banking remain with the ownership, as a result of which, IFIs share profit or loss arising on investments and earn return on their trading and leasing activities by dint of the risk and liability taken and adding value in real business activities. They mobilize deposits on the basis of profit/loss sharing and to some extent on the basis of Wakalah against pre-agreed service charges or agency fees. On the assets side, they take the liability of loss, if any, in case of Musharakah / Mudarabah based financing and bear risk in trading activities so long as the assets remain in their ownership. In leasing activities, they purchase the assets, give them on rental and bear ownership-related risks and expenses. This implies that IFIs will remain as intermediaries, as they collect savings from a large number of savers/investors for financing the needs of business, agriculture and industry, but their modus operandi will change. Their subject matter will be goods and real business activities.

There are broadly three models of organizational structure that the banks can adopt, according to their span of activities: the "Universal Banking Model", the "Bonafide Subsidiary Model" (all subsidiaries having their own capital and separate operations) and the "Bank Holding Company Model" (a bank holds separate organizations owned by itself for different activities, e.g. investment banking, Murabaha /trading transactions, commercial banking, etc.). The first two models may not best suit Islamic banks because of the wide difference in the nature of activities that they will have to adopt for their operations. The fully owned (by the parent bank) subsidiaries model is best suited to banks if they establish a number of subsidiaries for various types of operations, namely investment banking, commodity trade-based banking, leasing-based banking, Istisnaʻa-based banking and the normal commercial banking. Alternatively, IFIs can have special branches for industry, agriculture, commerce, and real estate and Takaful businesses.

The Deposits Side of Islamic Banking

In the fast-developing world of finance, Islamic banks are obliged to innovate a set of techniques to mobilize deposits, keeping in mind the priorities and risk preferences of various categories of depositors. They will also have to cater for safeguarding the depositors from loss on PLS deposits.

Recent developments on the deposits side reveal that Islamic banks, in addition to the general categories of savings and investment deposits, have started offering commodity funds, leasing funds, Murabaha funds and COIs. The funds thus mobilized are used in lease or Murabaha operations, giving fees or fixed margins of profit to the banks. Thus, savers are in a position to get a quasi-fixed return. However, this fixity of return may create ambiguity with respect to their Shari'a position unless strict Shari'a controls are applied to the operations and distribution of returns thus achieved. The majority of authors allow third party guarantee to depositors to the extent of a nominal amount of deposits. However, for enhancing confidence of the depositors and to avoid any scares or chaos, any Takaful scheme for deposits would be desirable. This is because the provision of third party guarantee has some objections, both from practical as well as Shari'a aspects. On the deposits side, Islamic banks will provide the products discussed below.

a) Current Deposits

Generally, no return is given on current accounts on the grounds that such deposits take the form of loans given to Islamic banks and the loans cannot carry any return. They are kept as Am¯anah; but if the proceeds of such accounts are used by banks in their business, they are treated as loans that have to be paid back without any increase or decrease. Banks shall guarantee the principal amount of deposits. Subject to agreement, banks may have the option to use such accounts at their discretion in permissible business activities. The relationship of debtor and creditor between the bank and the depositor will continue. The bank and the depositor shall agree at the time of account opening whether the bank is allowed to use the money in its business or not. There will be no need to develop and implement a weight age system for this type of account.

However, some writers favour giving a gratis return even to current account holders. They add that it can be only at the discretion of the banks and the depositors should not have any entitlement. A further condition for such an incentive is that they should not be offered regularly. This is because, with the passage of time, the practice will become customary and, in turn, take on the ruling of benefits stipulated in a contract of deposit.

b) Savings Deposits/Investment Deposits/ Term Deposits

All remunerative deposits in Islamic banks, including saving deposits against which banks provide a free checking facility, shall be accepted on a profit and loss sharing (PLS) basis.

The ratio of profit distribution between the bank and the depositor shall be agreed at the time of account opening subject to the condition of the Shari'a that a partner may agree on a ratio of profit which is different from the ratio of capital but losses have to be shared strictly in the ratio of capital.

Investments/financing made by banks from their own capital and from the monies raised from PLS accounts shall form the "earning asset base", the returns from which shall be allocated between the banks and their account holders in the agreed ratio. Deposits of longer duration shall be compensated through assignment of higher weight ages. Regulators may notify a range within which these allocations could be made. Alternatively, such assignment of weights may be left at the discretion of the banks. The following are the other considerations in this regard:

- Deposits of the risk-averse clients will be accepted either in current accounts as interest free loans that will be guaranteed with no share in return from financing operations of the banks or by creating special pools or establishing Murabaha and leasing funds, where in they will be treated as Rabbul-m¯al and get the quasi-fixed return out of profits or rentals earned by the respective funds.
- Risk-prone deposits will become part of the bank's equity, involving a weight age system(the longer the maturity, the higher the weight) on a daily product basis (DPB).
- Specific investment accounts can be managed as per savers' instructions on a Mudarabah or Wakalah basis. Banks can float equity funds on the principle of Mudarabah against a share in the actual profits. However, there may also be an agency relationship, wherein the bank would be managing depositors' funds against pre-agreed fees and passing on the profit/loss to the depositors.
- Banks may establish closed/open-ended mutual funds.
- Inter-bank financing will also become part of the equity of the bank, using appropriate weight age and DPB to calculate profit.

Instruments on the Assets Side

In order to properly manage the risk, the banks should manage diversified portfolios and select the proper modes/instruments. The volume of investment deposits determines banks' investment strategies– if depositors are risk-averse, banks should also be risk-averse – investing in less risky modes.

Musharakah/Mudarabah can be used for short-, medium- and long-term project financing, import financing, reshipment export financing, and working capital financing and financing all single transactions. Banks use Diminishing Musharakah for purchase of fixed assets like houses, transport, machinery, etc.

Murabaha can be used for the purchase and sale of automobiles, consumer durables and trade financing, acquisition and holding of stock and inventory, spares and replacements, raw material and semi-finished goods. Buy-back and rollover in Murabaha are not allowed.

Musawamah can be used for the financing of huge single transactions. Salam has a vast potential in financing the productive activities in crucial sectors, particularly agriculture, agro-based industries and the rural economy as a whole for financing agriculturists/farmers, commodity operations of public and private sectors and other purchases of homogeneous goods.

Banks' subsidiaries as trading and leasing companies can also provide finance on the basis of Murabaha and leasing. They can deal with priority areas not only on the basis of Murabaha, Salam and operating lease, but also on the basis of partnership. Ijarah, or leasing, is best suited for financing of automobiles and machinery. There could also be a combination of more than one mode like Istisnaʻa plus Murabaha, Salam plus Murabaha or Salam plus

Istisnaʻa for financing of trade and industry. Finance for the purchase and construction of houses can be based on Diminishing Musharakah or Murabaha. Working capital finance can be provided on the basis of Salam, Istisnaʻa and Murabaha. Financing of big projects can be made through syndicate Mudarabahs using the modes of Istisnaʻa or Murabaha. Appropriate modes of financing, as recommended by experts on Islamic finance, for particular areas and transactions are as given below.

Modes for Financing Trade, Agriculture and Industry

Murabaha, instalment sale, leasing and Salam are particularly suitable for trade, while Istisnaʻa is especially suitable for industry. More specifically, in trade and industry, financing is needed for the purchase of raw materials, inventory (goods in trade) and fixed assets as well as some working capital, for the payment of salaries and other recurrent expenses.

Murabaha can be used for financing of all purchases of raw materials and inventory. For procurement of fixed assets, including plant and machinery, buildings, etc., either instalments sale or leasing can be used. Funds for recurrent expenses can be obtained by the advance sale of final products of the company using Salam or Istisnaʻa.

Household, Personal Finance, Consumer Banking

Personal finance for consumer durables can be provided through Murabaha, leasing and in special cases by way of return-free loans out of the current accounts or the banks' own funds(depositors' money in PLS accounts is a trust in the hands of banks and should not be used for charitable and social purposes without their explicit approval).Wakalah and Murabaha can be used for cash financing through charge and credit cards. The alternatives for auto finance are Ijarah Muntahia-bi-Tamleek and Murabaha. Housing finance is possible through Murabaha, Diminishing Musharakah and rent-sharing.

Treasury Operations – Liquidity and Fund Management

Liquidity management means ensuring that the bank has sufficient liquid funds available for a smooth running of its operations and to meet short-term financial obligations as and when due. It has to invest surplus funds, match maturity of assets and liabilities, accommodate decreases in deposits/liabilities and increases in assets in an efficient and economic manner.

Fund management refers to securing and managing funds for the development of business.

Islamic banks may sell and purchase Shari'a -compliant money and capital market instruments like stocks and Sukuk. Direct placement or acquisition of funds (in the inter-bank funds market) on the basis of Mudarabah and Musharakah is also possible. The deficit bank agrees to give a share of its profits according to a Mudarabah ratio that can either be negotiated according to the market conditions or recommended by the central bank, for the duration of the contract. In the case of Mudarabah, the following process can be adopted:

1. A Mudarabah relationship will be created.
2. Funds received will be allocated to pools.
3. Weight ages will be assigned periodically, based on different tiers/categories.
4. Profit earned will be allocated according to weight ages assigned at the beginning of the period.
5. The bank will charge a pre-agreed Mudarib fee as a percentage of the realized profit; the bank can pay additional profit from its own share.
6. The investor will bear a loss unless it arises from misconduct or negligence of the Mudarib.

Islamic banks may also agree to an arrangement with the central bank serving as a lender of last resort. One option is financing on a Mudarabah basis; the central bank may agree to provide liquidity for, say, a three day grace period with ceilings, followed by a Mudarabah with profit-sharing ratio heavily favouring the central bank to discourage the Islamic bank from resorting to the central bank's funds for longer periods. Another option is the sale and purchase of Shari'a -compliant certificates/ Sukuk.

Sukuk are important for liquidity management. In Sukuk, an investor gets returns on the basis of ownership rather than interest. Ijarah Sukuk are more common instruments in this regard and are issued against assets for rental. To generate liquidity, Sukuk can be sold/purchased in the secondary market. If the regulatory structure allows, Islamic banks can sell the Sukuk to the central bank to generate liquidity. Sukuk can be structured on an amortizing or bullet maturity basis.

Foreign Exchange Operations

Exchange of currencies and monetary units has to be subjected to the rules of Bai' al Sarf,i.e. it must be simultaneous. Accordingly, spot purchase and sale of one currency against another currency is allowed; forward purchase and sale is not allowed. However, IFIs can enter into a promise to purchase and sell agreement.

Government/Public Sector Financing

Government and public sector enterprises can obtain finance by way of Mudarabah or Musharakah certificates, which can be issued to purchase equipment or utility-generating assets in order to lease them to public sector corporations. Ijarah and Istisna'a are best suited for infrastructure projects in the public sector. Recently, Ijarah Sukuk have emerged as the most crucial instruments for financing of the public sector. Through syndication arrangements, Islamic banks can supply goods/assets of enormous value to government entities or corporations on a Murabaha basis by setting up joint Murabaha funds. In such cases, ownership of Murabaha funds can also be securitized to offer equity-based investment opportunities to the investors and the banks themselves. Returns on these funds would be distributed among Sukuk/certificate holders on a pro rata basis.

Alternatives to Foreign Loans

For the inflow of foreign resources, the instruments of portfolio investment through stock markets, flotation of various categories of Sukuk and direct investment by foreigners can be used. Public as well as private enterprises can issue Musharakah and Ijarah Sukuk to finance projects, especially development projects. Sukuk can be denominated in foreign as well as domestic currencies and carry a predetermined proportion of the profit earned by their respective projects. The Sukuk issued can be restricted to a particular project or earmarked to a group of projects.

Various funds can be established to finance the economic activities of public and private enterprises on equity, partnership, leasing, Salam and mixed asset pool bases. Funds can be established to finance a specific sector, for example, agriculture, industry or infrastructure; a particular industry, for example textiles, household durables, etc.; or general types of projects.

The Issue of Mode Preference

According to the majority of scholars, the main instrument by which the interest-based system has to be replaced is profit/loss sharing, encompassing Musharakah, Mudarabah and their variants. The idea of replacing interest by profit sharing in the depositor–bank and bank–business relationships, first mooted during the 1940s to 1960s, gained considerable acceptance in the 1980s and 1990s. However, there are slight differences in approach and priorities.

In the case of big projects, the IFIs may form a consortium to issue certificates to the public for subscription. Similarly, they can carry out work on infrastructure and socio-economic projects in coordination and partnership with the engineering firms. The non-PLS techniques not only complement the PLS modes but also provide flexibility of choice to meet the needs of different sectors and economic agents in society. Murabaha with less risk has several advantages vis-à-vis other techniques and can be helpful in employment generation and alleviation of poverty. Leasing can be very much conducive to the formation of fixed assets and medium- and long-term investments.

Salam has a vast potential in financing the productive activities in crucial sectors, particularly agriculture, agro-based industries and the rural economy as a whole. It provides an incentive to enhance production and leads to the creation of a stable commodities market with stability in prices. To realize this potential, IFIs could organize a forward commodity trade market on the basis of Salam. This would provide not only a non speculative forward market for resource mobilization and investment but would also be a powerful vehicle for rural finance.

Islamic Investment Banking

Islamic investment banking can be easily understood in the light of conventional investment banking. An Islamic investment bank provides exactly the same products and services as a conventional bank does. The distinguishing factor, however, is that their products and services are tailored in a Shari'a -compliant manner while meeting the clients' requirements. Islamic investment banks manage portfolios for institutions, corporate clients and high net worth individuals, as well as pooled investment vehicles such as unit trusts and mutual funds. Asset management companies managing conventional funds are now gearing up for Islamic funds.

The following are the opportunities for Islamic asset management:

- open and closed-end mutual funds;
- equity benchmarks;
- leasing companies involved in asset-backed financing.

Islamic investment banks provide venture capital financing to small, medium and big companies in a number of sectors. They avoid involvement in prohibited and un lawful activities and offer services to all projects except those manufacturing or dealing with forbidden products and services, such as alcohol, pork, entertainment, interest-based financial services and the like. Their services relate to venture capital and corporate finance, including syndication finance, project finance and transactions in the capital markets. Asset management or management of funds includes equity funds, real estate funds as well as alternative investments in Ijarah and other Sukuk. They engage in treasury operations for managing the asset–liability mismatch created by different tenors of investment opportunities and different return profiles.

Islamic corporate finance activities of investment institutions are similar to conventional corporate finance except that the products and services offered are Shari'a -compliant. These services include:

- equity issues such as IPOs, offers for sale, rights issues;
- private placements;
- strategic reviews;
- financial restructurings;
- acquisitions, divestments, mergers;
- joint ventures, alliance searches and studies.

Islamic investment banks also undertake syndicate financing, which is usually a large financing facility granted to a key industrial or trading organization and lead-managed by a bank of strong base. Since the amount involved is large, a number of financial institutions participate in the financing. An Islamic syndication facility can be provided through Murabaha, Mudarabah, Musharakah, Ijarah or leasing.

Islamic Financial Markets and Instruments

Islamic financial markets, like their conventional counterparts, comprise money and capital markets, but the instruments and the procedures of functioning are different. An Islamic financial market would be free of interest and would work on a different set of principles.

The Islamic Fiqh Council of the OIC has observed:

"Although the original concept of financial markets is sound and its application is very much needed in the present-day context, yet their existing structure does not present an example to carry out the objective of investment and growth of capital within the Islamic framework. This situation require esserious academic efforts to be undertaken in collaboration between the jurists and the economists, so that it may be possible to review the existing system with its procedure and instruments and to amend what needs amendment in the light of the recognized principles of Shari'a".

The major instruments of Islamic financial markets are equity related. Besides equity instruments in the form of shares in any company, the Islamic financial system has other redeemable short-, medium- and long-term participating instruments representing ownership in the assets, and hence entitled to participate in the profit/loss resulting from the operations on the assets. Various types of participatory instruments can be based on (i) profit/loss sharing(Mudarabah/Musharakah), like instruments issued by Mudarabah and asset management companies and participation term certificates (PTCs), and (ii) rent-sharing in the form of Diminishing Musharakah or otherwise.

A pure debt or bonds market is not an active part of the Islamic financial markets because debt liabilities have to be paid at the nominal value subject to observance of the rules of

Hawalah (recourse to the original debtor if the assignor is not able to pay the liability). The instruments on the basis of which the Islamic market has to function need to be backed by or represent real asset transactions.

These instruments may be of either a variable or quasi-fixed/fixed return nature. Equity instruments having a claim to share in the net income and the assets of a business give a variable return, while debt-related instruments can be issued in respect of trade or leasing based transactions subject to the observation of the principles of the underlying Islamic modes. Backing by real assets according to the rules of the relevant modes is a must and mere replacement of one paper transaction with another kind of similar paper transaction will not serve the real purpose.

Islamic financial market instruments can be of two types in terms of their nature and flow of return:

1. Fixed/quasi-fixed (stable) income securities. A bank can securitize or sell a pool of assets or offer certificates of deposit (CODs) against a fund composed of pooled Ijarah and some Murabaha and Istisna'a contracts. It will offer the investors/depositors a defined stream of cash flow constituting the return on the pooled assets. Such securities would accommodate risk-averse investors like widows, retired people, etc. and generate new resources for additional intermediation and income flow to the banks.

2. Variable income (Shirkah-based) securities. For such securities, banks can securitize a pool of Musharakah and Mudarabah contracts that are part of their asset portfolio. Such securities will offer the investors a stream of variable income with potential for growth, based on the strength of the underlying projects – profit and risk both would be higher than in the case of stable income securities. These would accommodate risk-taking investors with the commensurate possibility of a higher income.

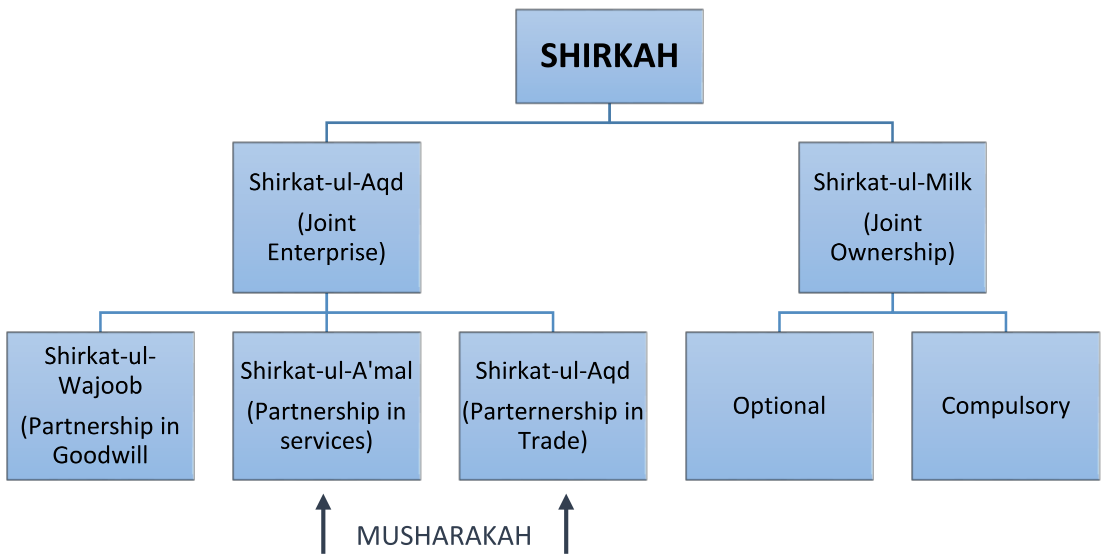

Fig 1.1

Islamic Funds

Fund management can be conducted both by commercial and investment banks, but presently, mostly investment banks are involved. Due to the asset-based nature of Islamic finance, this type of business is more suitable for IFIs than short-term commercial banking.

Fund management refers to investors pooling their resources to purchase a larger numberof shares through any manager collectively, which otherwise they could not purchase individually. About 150 mutual funds of various categories are providing low risk/moderate return, balanced risk/return and high risk/high return Shari'a -compliant investment facilities to investors in various parts of the world. While presently Islamic mutual funds are operating mainly in Saudi Arabia, UAE, Bahrain, Kuwait, Qatar, Pakistan, Malaysia, Brunei, Singapore, Germany, Ireland, the UK, the USA, Canada, Switzerland and South Africa, efforts are underway to provide investment facilities through mutual funds in all parts of the world to capture the emerging demand. Most of these funds are equity funds while a number of hybrid funds are managing leasing, real estate, Takaful and other funds.

Management of the funds can be carried out on Mudarabah or agency basis. In the case of Mudarabah, the fund manager would get any pre-agreed percentage of the realized profit, while in the case of an agency arrangement; the manager would get a fee on agreed terms that may be any specified amount or percentage of the net asset value of the fund.

Asset Management through Equity Funds

As compared to a conventional equity fund, in which a fixed return is tied up with its face value, an Islamic equity fund must carry a pro rata profit actually earned by the fund.

Therefore, neither the principal nor a rate of profit (tied up with the principal) can be guaranteed. On the basis of the risk profiles of the investors and the investment strategy of the asset management companies, equity funds can be divided into four categories:

1. Regular income funds: the objective of these funds is to earn profit through dividends of investee companies. Such funds provide a regular income stream by way of dividends to their investors who are mostly risk-averse, like old and retired people.
2. Capital gain funds: the objective of these funds is to earn profit through capital gain from frequent sale and purchase of Shari'a -compliant stocks. These funds can provide a better return to moderate risk-taker investors by proper management and risk diversification.
3. Aggressive funds: these funds invest in high-risk securities to generate abnormal profits for their investors. They do not allow every investor to invest and limit the portfolio to high-risk investors as chances of loss are greater.
4. Balanced funds: such funds invest in high quality securities with less risk and give to the investors a regular income stream based on dividends and capital gain. These funds adopt a "capital proactive" approach.

Screening and Purification Criteria

Equity stocks included in the funds need to be compliant with Shari'a guidelines. Shari'a boards of IFIs develop a tolerance level in respect of investments in stocks. The selection of stocks goes through a strict screening process decided by the respective Shari'a boards.

Keeping in mind the scenario in the markets, this tolerance level might be different in different financial institutions and markets. Generally, the screening criteria tend to ensure that:

1. The investee company's capital structure is predominantly equity based (debt less than 33 %).
2. Prohibited activities such as gambling, interest-based financial institutions, alcohol production, etc. are excluded.

3. Only a negligible portion of the income of an investee company is derived from interest on securities.
4. The value of share should not be less than the value of the net liquid assets of the company.

Principles Relating to Stocks

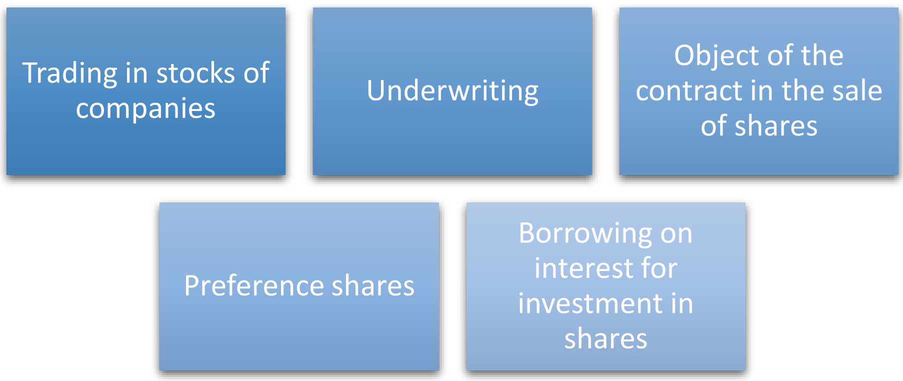

Fig 1.2

Since investment in stocks of joint stock companies is the core business of Islamic investment banks and other NBFIs, we may briefly discuss its main features and aspects. The Islamic Fiqh Council of the OIC in its seventh session (9–14th May, 1992) resolved the following in respect of shares of joint stock companies:

1) Trading in stocks of companies:

- Since the essential thing about transactions is the nature of their business, the establishment of a joint stock company with un prohibited purposes and activities is permissible.
- Trading in stocks of companies whose main purpose is a prohibited activity, such as transactions with Riba, production of, or dealing in, prohibited products is prohibited.
- Trading in stocks of companies that deal at times in prohibited things, such as Riba, etc., but their main activities are not based on any prohibited business is permissible.

2) Underwriting: underwriting is an agreement made upon establishment of a company with someone who undertakes to guarantee the sale of all or part of the shares being issued, i.e. to undertake to subscribe for shares that remain unsubscribed by others. There is no Shari'a objection to this provided that the obligee subscribes to the shares at nominal value without any compensation for the commitment per se, though the obligee may receive compensation for work other than the underwriting – such as making feasibility studies or marketing of shares.

3) Object of the contract in the sale of shares: the object of the contract in the sale of shares is the unidentified portion of the company's assets (known as Musha'a in Islamic jurisprudence) and the share certificate is a document attesting entitlement to the said portion.

4) Preference shares: it is not permissible to issue preference shares with financial characteristics that involve guaranteed payment of the capital or of a certain amount of profit or ensure precedence over other shares at the time of liquidation or distribution of dividends. It is, however, permissible to give certain shares such characteristics as are related to the procedural or administrative matters.

5) Borrowing on interest for investment in shares: it is not permissible to purchase a share with an interest-bearing loan offered to the purchaser by a broker or any other party against pawning of the share, as this involves Riba. Nor is it permissible to sell a share that the seller does not possess but has received as pledge from a broker, since such a deal falls within the framework of sale of something that the seller does not own. The prohibition shall be more categorical if the deal is conditional upon payment of the share price to the broker, who would then benefit by depositing this price at interest in order to obtain compensation for the loan.

Investment Sukuk as Islamic Market Instruments

Sukuk (the plural of the word Sak) were used by the Muslim societies of the Middle Ages as "papers" representing financial obligations originating from trade and other commercial activities. However, the Sukuk structures presently found in Islamic finance are different from the Sukuk originally used and are akin to the conventional concept of securitization ,a process in which ownership of the underlying assets is transferred to a large number of investors through papers commonly known as certificates, Sukuk or other instruments representing proportionate value of the relevant assets.

Investment Sukuk are different in nature from common shares of joint stock companies. These are certificates of equal value representing undivided shares in ownership of tangible assets of particular projects or specific investment activity, usufruct and services. Sukuk can be of a number of types, based on the Shari'a mode used as the underlying contract or subcontract, the most important of which are Shirkah, Ijarah, Salam and Istisna'a.

As per the basic rules of Shari'a, investment Sukuk have to be structured, on one side, on the Mudarabah principle. On the other side, business can be conducted through participatory or fixed-return modes/instruments. Thus, the rates of return on Sukuk will be either variable(if the modes on the second leg are participatory) or quasi-fixed (in the case of modes witha fixed return). Sukuk can be made fixed-return Sukuk through the provision of any third party guarantee.

The primary markets operate on the basis of equity principles like shares, redeemable equity capital, Mudarabah/Musharakah certificates (MCs) or Sukuk representing ownership in leased assets or debt instruments resulting from trading modes issued directly to investors or fund providers. While the price of

Sukuk in the primary market is derived through calculating the weighted average of the bids received for the premium to be offered over the benchmark, the price in secondary market trading depends upon the nature of the security being traded.

Sukuk can be issued by governments, corporations, banking and nonbanking financial institutions and by business/industrial concerns. As forward sale/purchase of goods through

Salam rules is permissible, there is also the possibility of a commodity forward market, which, of course, will be different from the conventional commodity futures market. As such, the following types of market governed by principles of relevant contracts or modes are available in the Islamic financial structure:

- equity or stock markets;
- securities markets like nongovernment securities (banks, non-banks, corporate and housing securities);
- government and municipal securities market;
- commodity futures market;
- inter-bank money market for placement of funds on a Mudarabah basis;
- Foreign exchange market (limited).

Trading in Financial Instruments

Islamic investment vehicles that are traded in Islamic financial markets include Shari'a compliant stocks wherein income is derived from dividends and capital gains keeping in mind the screening criteria recommended by Shari'a scholars. Other instruments are Mudarabah/Musharakah certificates, units of open- or closed-ended mutual funds and investment Sukuk, wherein income is derived from buying, selling and also getting returns from the underlying businesses and assets.

Stocks/securities/certificates/Sukuk can be traded in the market depending on market signals, provided there is compliance with the following Shari'a rules:

- Instruments representing real physical assets and usufructs are negotiable at market prices.
- Certificates or Sukuk issued by Musharakah, Mudarabah and Ijarah are covered under this category.
- Instruments representing debts and money are subject for their negotiability to the rules of Hawalah (assignment of debt) and Bai‘ al Sarf (exchange of monetary units).
- Instruments representing a pool of different categories are subject to the rules relating to the dominant category. If cash and debts/receivables are relatively larger, the rule of Bai‘al Sarf applies, and if real/physical assets and usufructs are overwhelming, trading would be based on the market price.

Inter-bank Funds Market

The Islamic inter-bank funds market can function on the Mudarabah principle or sale and purchase of instruments under the relevant rules of the Shari'a. Presently, a Mudarabah based regular market is functioning in Malaysia. In other countries, banks place their surplus funds with deficit banks for short periods ranging from a day to a week. Mostly, these short-term deposits are treated just like other deposits mobilized from the public and profits are paid on the basis of weight ages assigned and the daily product of the deposits, while sometimes a special procedure is adopted, according to which the deficit bank agrees to give a share of its general profits according to a Mudarabah ratio that is negotiated according to the market conditions. Central banks can also advise profit-sharing ratios for the duration of the fund placements.

Islamic Forward Markets

Based on the three types of contracts relating to future delivery, three different types of forward market can be considered in the framework of Islamic finance:

1. A Salam-based forward market (for products and commodities for which a regular market exists).
2. An Istisna'a-based forward market, basically for infrastructural and developmental projects.
3. A Ju'alah-based forward market for service-based activities.

Three points require serious attention in the concept of Salam trade from the point of view of future trading. First, delivery of the goods is compulsory. Second, unlike the contemporary futures market, reselling of a Salam commodity before it is received is not permitted by the Shari'a experts. However, Parallel Salam of the same goods, for the same date of delivery, is allowed. Third, a Salam contract strictly requires advance payment of the price of the goods. The contemporary futures market, on the contrary, does not require any advance payment to the seller.

Earning income from mere speculation on prices without having an explicit part in the real activity comes under the category of gambling. All such activities in the futures market that are meant to make a possible income simply by making good guesses with no intention to receive or deliver goods are not allowed. Unlike the conventional futures market, the actual delivery as well as its receipt will be mandatory and cannot be offset by writing a reversing futures contract in the Salam-based futures market.

In Istisna'a and Ju'alah markets too, the contract will be completed only by making or receiving actual delivery of the goods or service concerned. An Istisna'a contract can be made only for those commodities that are required to be specially produced according to the defined specifications and are not otherwise available in the market. For a Ju'alah contract, no physical goods qualify; only services qualify for such a contract.

Prices will be determined by competitive bids and offers made by traders interested in real selling and buying. For an Islamic future exchange, a bidding to purchase means a commitment to make the payment in advance. It also requires determining a certain timeinterval for quoting the new prices, unlike the conventional futures exchange where new prices can be offered at any time.

An Istisna‘a-based futures market will be different from a Salam-based market because of longer term transactions and hence will require a different legal institutional framework. Though there is nothing in Shari’a to bar Istisna‘a contracts for a short run, for the development of a meaningful futures market, particularly with the aim of resource mobilization for development, it will be the long-term Istisna‘a-based futures contract that will serve the purpose. Prices of Istisna‘a-based futures contracts in the market may not widely fluctuate over the short term, as they are expected to in the Salam-based futures market. This would make this market useful for small savers who are interested in protecting the real value of their savings. These contracts would provide them with a means to index their savings with inflation.

Foreign Exchange Market in the Islamic Framework

A foreign exchange market can function in the Islamic financial structure keeping in mind the limitations set by the Shari’a. IFIs can engage in direct placement or investment inShari’a-compliant F.E. denominated securities like Solidity Trust Certificates issued by IDB in 2003 and many other Sukuk.

A foreign currency forward cover facility is also available in the present Islamic financial structure. Contemporary Shari’a scholars have observed that forward cover is permissible subject to the following conditions:

- The amount of foreign currency is needed for genuine trade or payment transactions. This need will have to be supported by appropriate documents so as to prevent forward cover for speculative purposes. It implies that money changers or for ex dealers relying on book-out transactions cannot take such cover.
- The forward cover shall be through a formal promise to sell or purchase and it shall not be a sale and purchase agreement. This means that sale/purchase shall take place simultaneously at the agreed time in future at the rate agreed upon initially at the time of agreement to sell or purchase.
- While it will be permissible to fix the price of foreign currency in terms of local currency according to the agreement, no forward cover fee shall be recovered. However, an amount may be demanded by the bank from its client in advance by way of earnest money(Hamish Jiddiyah) against foreign currency agreed to be purchased/sold at a future date. If, at the agreed time, the promisor does not perform, the bank can recover the differential and adjust the earnest money there against.

Derivatives and Islamic Finance

Conventional options, swaps and futures stem from debts and involve sale and purchase of debts/liabilities. As a group, such instruments are called derivatives, i.e. they are derived from the expected future performance of the respective underlying assets. These are very complex and risky contracts with a present market value of trillions of dollars around the world. It has been observed, however, that the global financial market is becoming increasingly fragile as more and more derivatives and "hedging" instruments emerge.

Conventional options confer merely rights and not liabilities. An option has a nominal size, this being the amount of underlying asset that the option holder may buy or sell at the strike price – the price at which the holder may like to buy or sell the underlying asset upon exercise of the option. If the price moves favourably, the option is exercised and the commodity is bought/sold at the agreed price. If the price moves unfavourably, the buyer of the option simply abandons it. This is against the principle of the Shari'a, according to which delivery has to be given and taken pursuant to the sale contracts without regard to movement in prices. The buyer of the option pays a price (the premium) to the seller (the writer) of the option. Hence, the feature that an option contract confers the right but not the obligation to enter into an underlying contract of exchange at or before a specified future date (the expiry date) makes the contract non-Shar¯ı´ah compliant.

The institutions dealing in derivatives and hedge funds claim that the diversity of hedging products protects their clients against market volatility and provides a larger spectrum of risk management to the benefit of society. But actually, volatility is caused by their activities when they trade in derivatives and the clients are sold nothing for something – protection against a danger that never needed to exist in the first place. They may produce huge profits for financial institutions at the cost of others, but these profits are not necessarily indicative of productive efforts. Mr Warren Buffet, Chairman of Berkshire Hathaway once said:

"Derivatives are financial weapons of mass destruction, mainly due to opaque pricing and accounting policies in swaps, options and other complex products whose prices are not listed on exchanges; credit derivatives and total return swaps that are agreements to guarantee counterparty against default or bankruptcy merit special concern."

Study of the behaviour of the derivatives market reveals that it has the potential to cause a serious breakdown in the financial system. The degrees of leverage that are afforded by option contracts can be so high that large unpredictable market moves in underlying prices may one day lead to the insolvency of major financial institutions.

Further Reading:

- ✓ ***Understanding Islamic Finance By Muhammad Ayub***
- ✓ ***Islamic Financial Institutions and Products in the Global .Issues 2002-2192 By Vasudevan Sundararajan, Luca Errico***