A PRIMER ON ISLAMIC BANKING

An Introduction to Islamic Banking and Market Application

Safdar Alam

WHAT IS THIS BOOK ABOUT?

This book introduces the main rules and principles used in Islamic banking and finance. However, this is just the start. The book then goes on to show how these contracts are actually utilised and used in market practice. This informs the readers of many interesting aspects of Islamic banking that are not easily apparent such as:

- How classic commercial contracts form the basis of market products and transactions (in this case, Murabaha contracts)
- The actual intentions of the parties are often in contradiction to the main reason why these contracts were developed
- This contradiction means that the underlying contracts must be manipulated
- This manipulation is clear and evident, and has consequences
- This results in having purchase and sale transactions of assets that neither party has any real commercial interest in
- In many cases, this manipulation is used in order to deliver interest, that is otherwise forbidden in Islamic banking

Primer on Islamic Banking

An introduction to Islamic Banking and Market Application

Safdar Alam

"The content of your character is your choice. Day by day, what you choose, what you think and what you do is who you become."

Heraclitus

Also by Safdar Alam:

Islamic Banking in Practice, Volume 1 – Treasury, Risk Management and Structured Investments

Islamic Banking in Practice, Volume 2 – Sukuk – Structuring, Pricing and Risk Management

Islamic Banking in Practice, Volume 3 – Retail Banking, Finance, and Investments

Islamic Banking in Practice, Volume 4 – An Evaluation of the Industry

Visit www.safdaralam.com for more details

First edition 2019

PREFACE.....1

CHAPTER 1 OVERVIEW OF RULES AND PRINCIPLES 4

CHAPTER 2 OVERVIEW OF CONTRACTS USED.....12

CHAPTER 3 MURABAHA SHARE FINANCE, PART 1.....18

CHAPTER 4 MURABAHA SHARE FINANCE, PART 2 25

CHAPTER 5 MURABAHA SHARE FINANCE, PART 3 33

CHAPTER 6 SUMMARY AND CONCLUSION 41

PERSONAL NOTE..... 46

ABOUT THE AUTHOR..... 48

Preface

I have written this short eBook to help interested readers find out a little more about Islamic Banking. I will cover two main areas:

1. An overview of the main rules and principles that apply, and
2. An overview of the types of contracts and structures that are used by market participants.

This will help to introduce the topic of Islamic Banking and give provide useful background when looking at market practice.

I believe that the best way to illustrate these rules and principles is to show how they are applied and practiced in the markets. **Hence, I have included a detailed example of this application for a product**. This product is Murabaha Share Finance. It is a structure used by a growing number of Islamic banks to deliver a loan to their retail customers.

Who am I?

I am an Islamic banker, I have spent my career in this industry, and I make my living in this sector. I have established the Islamic banking teams at some of the largest global investment banks in the world: UBS (London) and Credit Agricole (in Dubai).

In addition, I set up and then led the business at JP Morgan (London and Dubai).

My experience has been in structuring products that are used for real transactions – I have led transactions in excess of $10bn.

I also made sure these transactions were profitable for my bank – I generated in excess of $150mn in profit.

I have learned a lot during my career, and now I wish to share what I have learnt.

Safdar Alam

Chapter 1 Overview of Rules and Principles

Islamic finance (or Islamic banking) has sets of rules and guidelines for Muslims to adhere to. These are generally created to support a transactional environment that is seen as positive.

By positive, I mean it covers the following high-level areas:

Transparency

Business should be conducted with openness, where all the relevant information is presented and available. Transactions should occur as the result of clear analysis of all the facts at hand. It is clear that withholding important information can lead to a conclusion, or transaction, that otherwise may not have taken place. Or if it were to take place, some key aspects of it would likely be altered.

A deliberate withholding of facts or information, in order to gain an advantage over your client or the party you are dealing with, is clearly to be avoided. I am reminded of a story (in a text covering business rules in Islamic law) of a textile trader. He was selling his goods in a market, and he would point out any flaws in his materials. This would enable the buyer to make a more informed choice about whether to buy the goods, and what price the buyer is willing to pay. A deal may or may not be struck. But the outcome would occur with full transparency being provided.

Justice

This notion, applied to business dealings, refers to the fact that all parties doing business should be doing it of their own free will, and all commercial considerations (and contracts) should reflect the clear willingness of the parties to agree to the relevant terms.

One party should not be 'forcing' another into a transaction, because we can see this could lead to the imposition of uneven obligations and rewards and risks. One party should not have an unfair advantage or position of strength over another. This is because, again, this could well be reflected in business that is conducted on unbalanced terms. One party may well be more wealthy and more influential than the other. In that case, this party is still required to ensure any contractual outcomes are balanced and to provide the appropriate risks and rewards for both parties.

There is no issue with one party being rewarded more than another – as long as this is justified as a result of superior contribution to, for instance, an enterprise.

There are also more specific requirements and prohibitions in Islamic finance. In the following paragraphs, we will introduce some of the key ones.

No interest (Riba)

There are many publicly available discussions about the prohibition of Riba. I will keep my definition as brief as I can. Riba refers to an increase in something, particularly, in the context of business, in an amount that is owed. It can apply outside of debts. For the purpose

of this book, and in accordance with the general opinion of scholars, we can say that Riba is interest.

Riba (interest) is prohibited.

This includes the person who pays it, the person who receives it, the person who draws up the contract and any witnesses to the contract. They are all deemed blameworthy and sinful.

I do not intend to go into any further detail on this topic, because I want to avoid any scholarly or juristic issues in this book. There are various reasons provided for the prohibition of Riba and they tend to focus on the inequality of the parties.

There is a verse in the Quran that states that those who benefit from Riba shall be at war with God and his Messenger. As far as I am aware, there is no other act or sin that commands this punishment.

No gambling or speculation (Maysir)

This relates to games of chance. We should not try to benefit by resorting to games of chance. This also applies to gambling. In the finance field, this can apply to speculation undertaken, for example, by the use of derivatives. It is important to note that the same, or similar, derivatives, can be used as hedging tools (eg options and swaps and forwards). If this is the case, then some form of derivatives may be permissible, as long as they do not contravene any other rules in Shariah.

No short selling

Simply put, you cannot sell what you do not own. You must take ownership and possession of an item before selling. In modern investments, ownership need not be physical ownership. If the market has a conventional document that reflects ownership, for example a warrant or other financial instrument, then physical delivery may not be necessary to demonstrate ownership of that asset.

There is an argument that short selling can provide an important counterbalance to help prevent markets becoming overpriced. This may be true. However, it is also clear that short selling can lead to market instability. It was interesting to note that many significant markets put a temporary ban on short selling during the global crisis, stating that it added to instability.

No forward transactions

In general, agreeing a transaction today to be executed in the future is not permitted. This is because we are not always in control of what may happen between today and the forward date. Thus, one or both parties may be unable to fulfil what they have contracted.

In a sale contract, it is possible to take ownership of the goods today, and agree for the price to be paid at a later date, or deferred. This does not negate the fact that this is a 'spot' or immediate contract of sale.

It is also possible, in some circumstances, to have the payment today, and deliver the goods at a later date. Two examples that come to mind are:

- Agriculture – where a farmer may desire or need to forward-sell his crop, with payment now in order to fund his ability to grow the crops.
- Manufacturing – some goods may need to have an order placed so they can be constructed or made. This could be in the case where the goods are made to order, and the maker requires immediate payment in order to execute the manufacturing process.

No trading of debt, only transfer at par

It is important to note that while Riba is forbidden, the debt itself is not forbidden. A debt can arise from the deferred payment arising from a legitimate sale, as described previously. Or it may arise simply from the provision of a loan without interest. In any case, the amount of the debt cannot be increased. This would be Riba.

If it is payment on a sale, and the payment is not made on the agreed future date, the seller cannot increase the amount due or charge interest on it. The same applies to a loan. Only the principal is repayable.

Now that we have established it is possible to have permissible debt, there is a rule that applies to the transfer or sale of that debt. The debt can indeed be transferred to a third party. However, it must be transferred at par, being the full amount of the debt that is to be paid in the future. It cannot be traded at a value different to par.

This is relevant in modern finance because we do see that some loan markets have an active secondary market. There is a market value attached to future cash flows with known credit risks. Thus, a

loan provided to Party A can trade at 99% or 101% of par in the secondary markets. This is not permitted in Islamic finance. What is permitted is simply a transfer of a Shariah compliant loan at par.

Clearly, if the loan is not Shariah compliant in the first place (eg if it has interest), then the issue of its sale or trading does not occur.

Gharar

This refers to ambiguity in the contract. In this sense, it can be said to relate to uncertainty. For example, if a sale agreement is specified as "I agree to sell a red car to you for GBP1,000" and you pay the price and I deliver a different red car to you, I could maintain that we did not agree which specific red car is to be delivered and it's also not referred to in the contract. I could use this ambiguity to try to obtain an unfair advantage.

Even if I am not trying to obtain an unfair advantage, the contract is still said to contain Gharar due to its ambiguity. This kind of uncertainty is distinct from the kind of uncertainty that may be possible in a legitimate contract. For example, if I make an investment and I am uncertain as to the profit I may make (or indeed the loss I may incur), this does not constitute Gharar. It is merely an acceptable level of uncertainty as to the outcome of an investment.

Forbidden activities or sectors

If an act or activity is forbidden for Muslims to do or engage in, then any investment or financial activity in the same matter is also forbidden. As a Muslim, I am not permitted to drink alcohol.

Equally, I am not permitted to buy shares in a company that has, for example, the manufacture or selling of alcohol as its business.

Thus, investments in the following sectors and activities are not permitted:

- conventional finance where activity is undertaken that is not permitted (eg interest-based financing, options for speculation, etc). For this reason, general investment into conventional banks is not permitted
- certain food and beverage sectors – entities whose core business includes alcohol, pork or other substances not permissible for Muslims to consume
- the tobacco industry or illegal drugs
- gambling – this includes casinos and other forms of gambling such as poker and lotteries, and
- certain aspects of the military sector. I recall having a discussion with a scholar once about a hypothetical clothing or shoe company providing uniforms/boots to soldiers, and whether this should be counted as permissible activity or not. I do not recall what conclusion we came to, but we did agree that if I ever had a client request in this area, we could then discuss the matter at hand, when it is relevant. I have yet to receive such a client request.

General equitable principles

As well as the aforementioned high-level principles and specific prohibitions, there are other principles that should be adhered to in Islamic business as follows:

- Profits should be earned fairly, not to the disadvantage of others.
- Profits should result from acceptable and permissible trading activities, investments, service provisions, etc.
- Funders should participate in the risks of a project, and not just provide debt and take the credit risk of the counterparty.
- No party should benefit disproportionately at the expense of another.
- Parties are to benefit in accordance with their contributions on a predetermined basis (contributions can be cash or other assets or intangibles such as skills or knowledge of the enterprise matter).
- Profits should not be earned to the detriment of the environment.

Chapter 2 Overview of Contracts Used

The contracts that we will refer to, and use, were generally constructed many centuries ago. In many ways, they refer to an 'old-fashioned' way of doing business. Yet they are clear and transparent.

Each contractual form does have a lot of research about it available in the public domain. My aim is not to spend much time further on that aspect. We will refer to the contractual forms to the extent that we need to. And we will only discuss elements that are relevant to their use.

The reason for this is that as a result of my experience of structuring and executing transactions, I have had to learn about these types of contracts and contractual forms. I have had to learn about any aspects of them that could impact the desired outcome or risks of the transaction we are trying to execute. To the extent there are aspects of the contracts that do not impact the transaction, then there is little need to discuss these further apart from academic interest.

One key thing to remember here is that each contract, on its own, is often not enough to deliver a workable product in the financial markets. Instead, contractual forms are used as a starting point, and each contract is amended and tweaked in order to deliver the desired results. As such, these contracts can be viewed as building blocks.

Murabahah

This is a sale where the cost price is disclosed to the buyer. The reasoning for this is simple enough. It provides transparency and enables the buyer to decide if the seller is making a reasonable amount of profit or not. This clearly provides a further level of transparency than if the buyer is just aware of the full sale price. We are enabling the buyer to make some kind of judgment call, or to form an opinion, as to whether the profit earned by the seller is in accordance with the benefit the seller is providing to the buyer.

For example, let us consider that I wish to buy a second-hand car, and the sale price is GBP1,000. The seller discloses that his cost price was GBP800. This would then be a Murabahah transaction. He is informing me that he is making a profit of GBP200 on this transaction. I may conclude that represents a reasonable profit margin, and I may decide to purchase the car on this information.

However, if the seller informed me he had paid GBP200 for the car, this may change my thinking. I may wonder how he was able to buy the car so cheaply. Is there something wrong with the car? Perhaps he is an experienced and astute buyer who can source his cars at very cheap prices. Am I paying too much for the car?

All these points I can consider now because I have been informed of the cost price. In theory, I can make a much more informed decision whether to buy the car or not.

Musawamah

This is simply a bargain transaction. A transaction where the sale price of a good is agreed. On the face of it, it may not be apparent

how it can have much use. We shall illustrate its use in the coming chapters.

Waad

This is an undertaking. It relates to an activity that is to occur in the future. It cannot really relate to something to be done immediately, because we would just do that activity now. Of course, it can only relate to a Shariah compliant activity. You cannot undertake to buy alcohol tomorrow. You can, however, undertake to buy some goods one week from now, and can agree some parameters for the price. You can agree the sale price, for example. On the face of it, this may appear to contradict what we have said about forward transactions being impermissible.

The key difference is this: the undertaking is only binding on the party that makes it. The party that receives the undertaking is not obliged to ask the party making the undertaking to execute pursuant to that undertaking.

For example, I can provide an undertaking to purchase a specific car, in one week's time, for GBP1,000. The car seller is the recipient, or beneficiary, of my undertaking. This undertaking is binding on me. However, the seller has the choice, in one week's time, to ask me to buy the car for GBP1,000 or not. He may have tried to sell it for a higher price in the intervening week, and not been able to. In this case, he may conclude that GBP1,000 is indeed a good price, and thus ask me to execute on the undertaking I have made.

The seller may, alternatively, have discovered he can probably sell the car for a higher price. Or he may well have managed to sell it,

before the week is up, for a higher price. Thus in this case, the seller would not ask me to execute pursuant to the undertaking. If he asks me to execute, then I have to. If he decides not to ask me to execute, then we both walk away from the transaction referred to in the undertaking.

It is this fact – that there is no explicit two-way binding commitment on both parties to this transaction – which means this does not contravene the rule that forwards are impermissible. It is not a forward transaction.

Mudarabah

This is an agreement whereby one party (or more than one party) provides some capital, and another party provides investment services to manage the capital or venture. The owner of capital is referred to as Rab Al Maal (literally the owner of wealth) and the manager is referred to as the Mudarib. The parties can agree to split profits in any portion they wish. It may be 90:10 in the Rab Al Maal's favor, or 50:50, or any other split. The agreed split will be in line with the assessment of both parties as to their relative importance to the success of the venture.

If any loss is made however, it is borne in full by the Rab Al Maal. The reason is that the 'loss' for the Mudarib is deemed to be the fact he has worked and provided his services for the period of time and not earned any income for it.

Musharakah

This is an agreement whereby two (or more) parties come together for a joint purpose. This can be an enterprise. The aim, naturally, would be to make some profit. Each party should contribute some form of capital to the venture. The capital can be in any relevant form, eg money, fixed assets, other assets, etc.

If a profit is made, it can be split in any ratio the parties agree.

If a loss is made, however, it must be split in the same ratio as the injection of capital. Thus, if three parties combine assets in the ratio 20:30:50, and the venture makes a profit, then they may split this profit in any pre-agreed ratio.

Maybe they can agree that though one party is providing only 20% of the capital, or assets, but perhaps those assets played a crucial role to the success of a venture, and thus that party is entitled to a greater share of profit than 20%.

This provides flexibility for the parties to agree the relative importance and contribution of the parties to the venture.

However, if a loss is made, this must be borne by the partners in the ratio of their capital contributions. It must be split 20:30:50.

Wakalah

This is similar to an agency agreement. One party may simply be unable to conduct a certain kind of transaction. This may be because it may not directly know a party wishing to buy something that it owns. Or it may wish to conduct a transaction in a different country where it requires some license or permission it does not

have. In these cases, the party can appoint a Wakeel to conduct the transaction on its behalf. The Wakeel would typically be the counterparty to any transaction it makes on the party's behalf. But it would be acting in its capacity as a Wakeel only.

The Wakeel may also conduct some transactions on behalf of its client, simply because it is more convenient. The client may be able to execute, but might prefer not to for various reasons of convenience or expediency. The Wakeel is entitled to charge for this service.

Ijarah

This relates to the leasing or renting of an item or property. It certainly has very key applications in Islamic finance; however, not in this volume, so no further explanation is necessary at this stage.

Putting Contracts into Practice

Now, this is one area on which there is little transparency in Islamic banking – exactly how these major contracts are used to create products for banks and the markets.

In order to demonstrate how this process works, I have decided to choose a popular market product (Murabaha share finance) and show how the banks structure this using one or more of the above types of contracts.

Chapter 3 Murabaha Share Finance, Part 1

In my career, I have been in the position where I had to create Shariah compliant structures to enable transactions to take place. This has been perhaps the most interesting (and challenging) aspect of my work, for several reasons. First of all, I have always enjoyed solving problems, whether it is a crossword, logic puzzles, trying to play chess and so on. I am very fortunate that I was made responsible for finding solutions to problems and puzzles in banking too.

Before specialising in Islamic banking, I had worked in the area of exotic derivatives. This involved creating quite complex transactions from building blocks with a view to delivering a solution to clients. At the same time, I had to understand very well the consequent risk that the bank was taking on (as a result of selling the products) so that these risks could be identified, and then hedged by taking positions in various markets.

This provided me with a strong background to support my work in Islamic banking.

In public literature, we are often presented with an overview of how Islamic products work. X buys this asset, Y sells this asset, and various cash flows are exchanged, and everyone is happy. I find this a little frustrating personally, because I am aware of the (often complex) underlying work that is involved in creating these transactions. I wish to share some of these aspects with the reader.

As an example, let us look at a product offered by a particular Islamic bank. It offers financing to their retail clients, in the form of Murabaha Shares Finance.

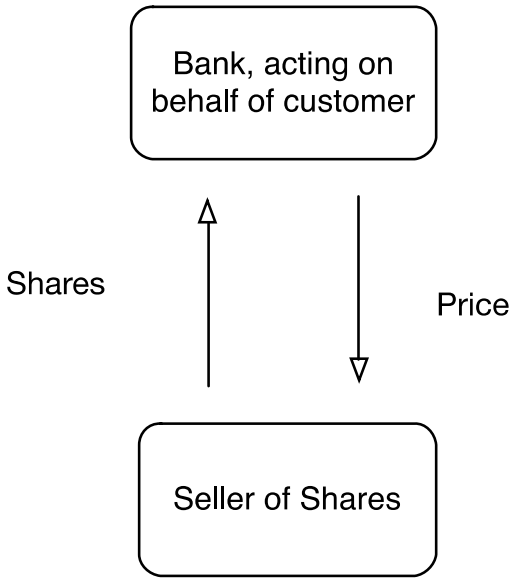
Let us see how this is described on the bank's website:

> *The bank "offers you a Murabaha Shares Finance to provide you with direct liquidity as well as the ability to own the shares in accordance with sharia requirements."*

This sounds interesting – let us read a little more:

The bank *"purchases the desired shares on your behalf. You then have the option to sell the shares and transfer the liquidity to your current account or you can transfer the shares to your investment portfolio."*

Let us try to put this into a structure diagram. It would look as follows:



At the moment, we have a situation where the customer is paying money for shares. However, the customer is looking for financing here, so why is he agreeing to do the opposite and pay cash to another party?

The answer is simple enough – this cash flow represents the repayment of the financing by the customer in the future.

If this is the case, then the customer is still waiting to receive the loan amount. To achieve this, the customer must now sell the shares that have just been purchased.

Another point to consider is this – who exactly is the customer buying the shares from? The answer to this lies in what the desired outcome of the parties is.

Given the subsequent cash flow represents the repayment of the financing in the future, the client may well be indifferent if he is to repay the bank, or another party that is selling the shares. However, as far as the bank is concerned, it would prefer to have the legal obligation of repayment to be from the client to the bank directly. This implies the seller of the shares should be the bank itself.

(**NOTE:** this is not the only possible scenario, it just appears to be the most likely one.)

In this case, we would have the bank (as seller) selling the shares to the bank (acting on behalf of the customer). This is permissible, and the bank will have obtained permission from the client to act on the client's behalf to purchase the shares (from itself). The general requirement in this case is that the transaction must be deemed to be at arm's length, will full documentation to be exchanged as required (for example a sale contract - or an offer and acceptance).

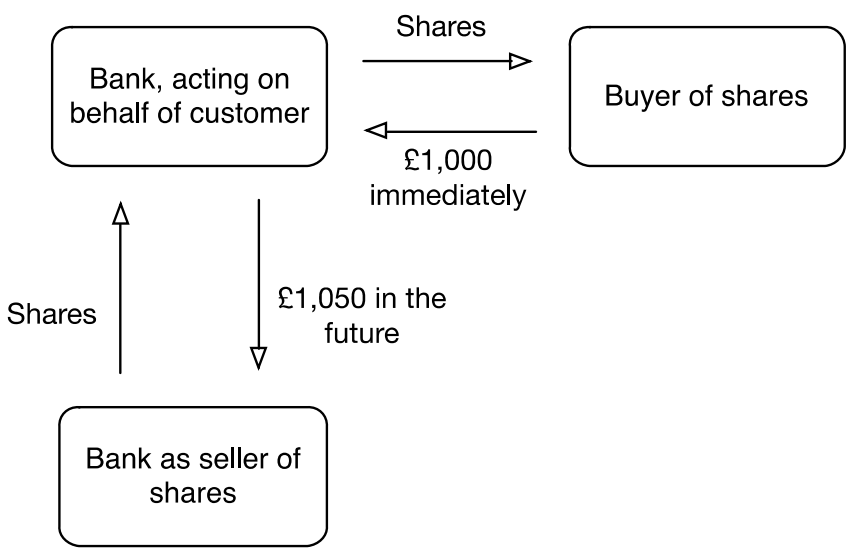
Now the customer has the shares, what happens next? The website informs us the customer can now sell the shares (and receive the funds from this sale) or transfer the shares to their investment portfolio. If the client wishes to obtain financing (and remember this is the only reason the customer would have approached the bank in the first place), then the customer must sell the shares.

So, now we have two further questions: who does the customer sell the shares to, and for what price?

The second question is easier to answer – the price must be the size of the financing agreed by the bank and the customer. This amount is to be paid immediately by the new buyer, and thus the customer now has the cash amount that is required.

We will note that the sale price of this second transaction must be lower than the sale price in the first transaction. This is because the second transaction delivers the agreed financing amount and the first transaction delivers the repayments (being the principal plus agreed profit amounts) from the customer to the bank.

Let us assume the loan amount is £1,000 and the agreed repayments total £1,050. Thus. the two sale transactions would look as follows:



It is reasonable to assume that the bank would also be acting on behalf of the customer for the second transaction. The reason is that the customer is not expected to be able to arrange the sale of shares on his own – he can reasonably expect the support of the bank (acting on the customer's behalf) to arrange to sell the shares to a suitable buyer.

Well, it appears that we have achieved the desired outcomes for the customer – he is receiving the principal amount immediately, and is delivering the repayments to the bank in the future.

However, from a structuring point of view, we are far from finished.

Firstly, we have to address the question of who the buyer (in the second transaction) is.

It must be a buyer prepared to pay a pre-agreed price for the shares. The buyer will also have to accept this basket of shares as is – the buyer cannot refuse to purchase the shares because they think one of the target companies might pose a risk that the share price may go down in the near future.

Perhaps the buyer purchases the shares for £1,000 (and pays the customer immediately) and then the share price falls within the next minute. Is this a risk that this buyer can deal with?

The final point to make at this stage, is to remember that the bank has agreed to provide financing to the client. But at the moment, we have not seen how the bank delivers the principal of £1,000 to the client. Currently, it is the buyer of the shares that is delivering the principal to the client.

Of course, one easy solution is that the bank itself could be the buyer of the shares in this second transaction. That solves all the issues of price risk quite nicely.

However, this simple solution may fall foul of other restrictions in Shariah compliance.

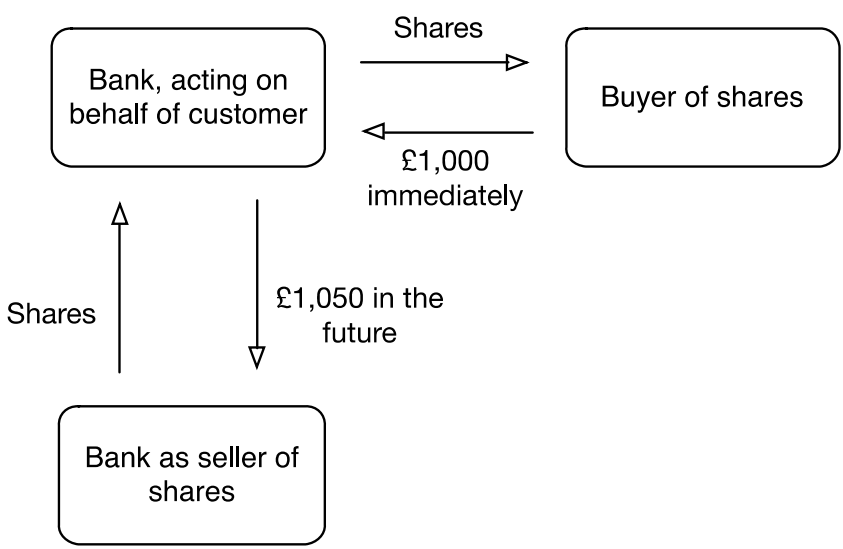
We shall continue our discussion of this structure in the next chapter, and look at more than one solution to complete this

structure. As we do so, we will highlight further issues and risks that all the parties take on in this Murabaha share financing structure. And the potential solutions to these risks will provide some key insights as to how similar risks are mitigated in other Islamic structures that involve the purchase and sale of assets.

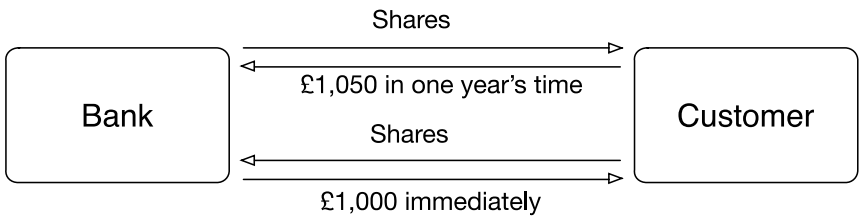
Chapter 4 Murabaha Share Finance, part 2

As a recap, we assumed a scenario where the bank is providing financing to the customer of £1,000, and the customer shall repay £1,050 in one year's time. The bank will sell shares for £1,050 to the customer (payable in one year's time), where the bank is acting on the customer's behalf as the buyer.

Now, the customer has the choice to retain the shares (which is not really a practical option), or to sell the shares. Of course, the customer has already approached the bank for financing, and hence we can reasonably expect that the customer will decide to sell the shares. And, of course, he will expect to receive £1,000 (immediately) for selling the shares, because this is the amount of financing he has arranged with the bank. So far, the structure will look as follows:



Now, let us look at who will be buying the shares from the customer. This could well be the same bank, because the bank has yet to disburse the £1,000 financing. Then, effectively, we have the following:



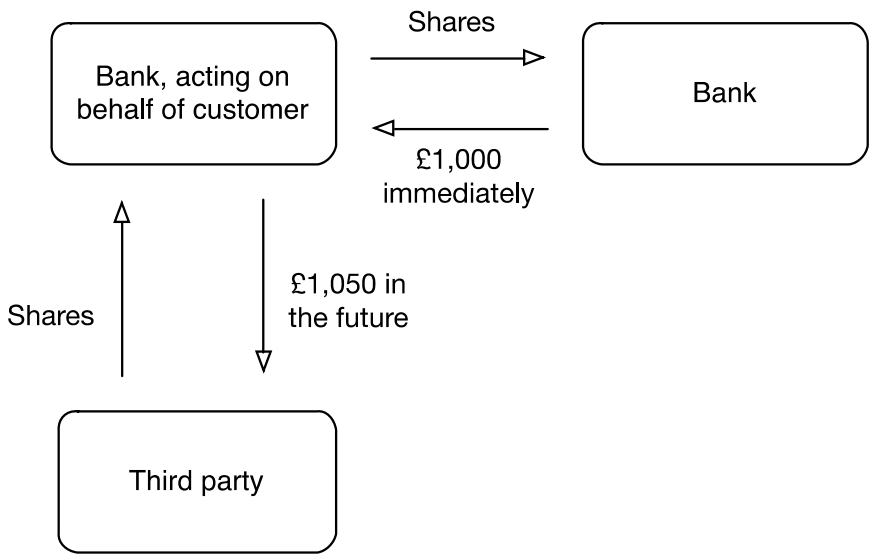
This certainly creates the cash flows that both parties require. The bank delivers £1,000 to the customer immediately, and the customer repays £1,050 in one year's time. However, this sale and immediate buy back of an asset is typically not permitted in Islamic finance. This is referred to as Bay al Inah, and is defined in AAOIFI's Shariah Standards as follows:

> *"It is a sale whereby one party, for instance, sells the commodity to the other for one hundred dollars, on deferred payment basis, and repurchases it from the other for eighty dollars payable on spot. In fact, the sale transaction here is nothing but a mere trick for practicing usurious lending, and the commodity is used for no purpose other than facilitating the usurious transaction. The deal in this case has nothing to do with the purposes and objectives of sale, nor does it contain any element of them. In other words 'Inah takes place when one party buys a commodity from the other on deferred payment basis and before making payment sells back the same commodity to the other for a less amount of money payable on spot. "*

Clearly, this would apply to the above transaction, and so it is not permitted.

(**NOTE**: The classical jurists are not all in agreement on this point. It has been prohibited by the majority of jurists including the Hanafis, Malikis and Hanbalis, but allowed by Imam Al Shaafi with strict conditions. As such, this type of structure is deemed permissible in certain jurisdictions. However, the stance taken by AAOIFI is as per stated above.)

So, the bank cannot be both the original seller of the shares, and then the final buyer of the same shares. Let us look at the scenario where a party other than the bank is the initial seller of the shares (and the bank remains as the final buyer).



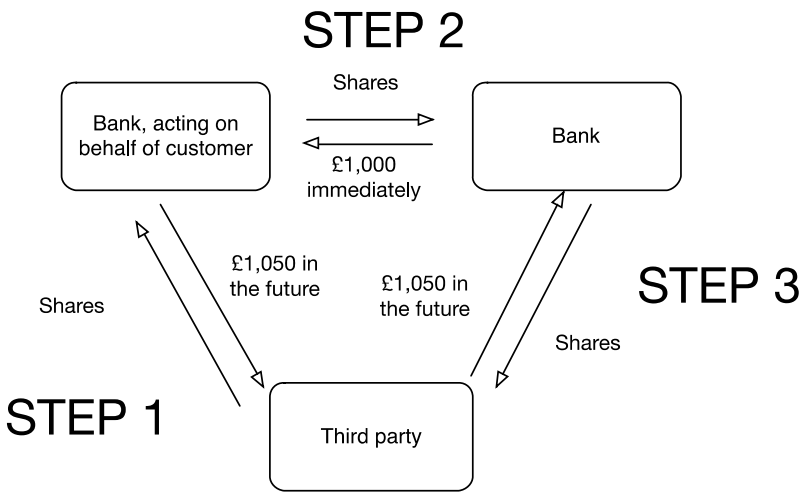
The customer is in the financial position that he requires: he receives the financing of £1,000 and repays £1,050 in the future. The bank has certainly disbursed the financing amount to the customer, but is not the party that is due to receive the repayment from the customer. This is not ideal. The bank has delivered £1,000 in return for shares. What can the bank do with the shares?

Well, we can say it is now in the position that the customer initially found himself in. It has bought shares and paid money for them. It can either keep the shares (and, presumably, hope to make a profit on this basket of shares) or it can arrange to sell the shares.

Our understanding of banks will show that the possibility of keeping the shares is a highly unlikely scenario – banks are in the business of providing loans and (ideally) having them repaid. At the moment, the repayment after one year is being delivered to the third party.

This is not a difficult situation to solve – the bank can now sell the shares to the third party, for a price of £1,050 to be paid in one year's time.

Now, we have three transactions:



It is useful to add the steps here, because they must occur in this order, so that we do not break the prohibition on short selling (or selling what do you not (yet) own).

In terms of cash flows, all three parties are in the positions they desire to be in. The customer is receiving the financing, and repaying in the future. The bank is paying out the financing and receiving the repayments in the future. The third party is receiving and paying out the same amount of £1,050, at the same time in the future (after one year).

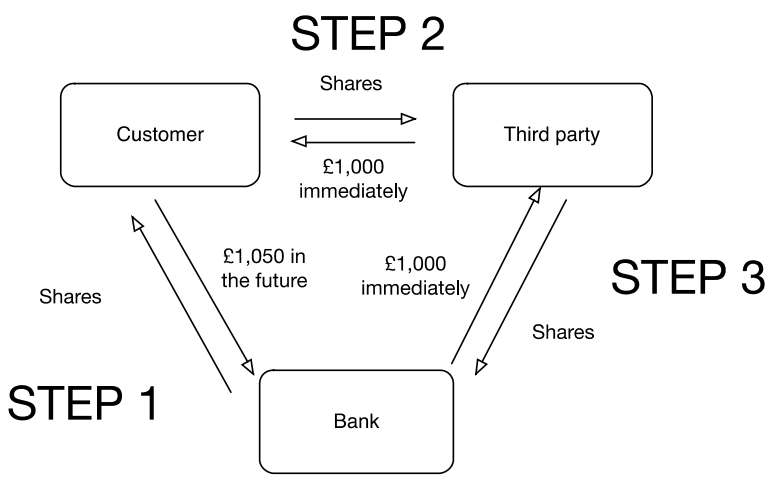
Each party has also purchased and then sold the shares, except for the third party, being the original owner of the shares, and has sold them first, and then re-purchased them back later.

What is not ideal here is that the bank is not the direct recipient of the repayment from the customer. In a typical situation, this is an important outcome to secure. If the customer is contractually bound to repay the bank, then any default can be pursued by the

bank. In the scenario above, if the customer defaults, it seems that it is the third party that would have the legal right to pursue the repayment, and not the bank.

It could be possible for the third party to transfer this legal right to the bank, of course, however it is still not ideal for the bank. The bank would much rather have this right via the relevant sale transaction.

As such, let us now consider the situation where the bank is the original seller of the shares in step 1, and the customer then sells the shares to the third party:



This diagram is almost the same as the one above (with the roles of the parties changed) but for one difference – the sale price in step 3 has changed. The reader is encouraged to have a little think about this to see why this is necessary.

If you can see why, then feel free to leave a comment below.

The key difference now is that the legal obligation for the repayment of the financing is directly from the customer to the bank in one year's time. This is what the bank desires.

For this reason, this version of the structure is more likely in practice.

To some people, the above structure may appear to be complete. We can be satisfied with a structuring job well done, and move on. However, in my mind, this gives rise to some important points that we have not yet considered or addressed.

The first question we should ask is – who is this third party that has appeared out of the blue?

It is buying shares from someone who it would previously not have known (the customer) and then selling them to the bank. And by buying the shares, it is accepting an obligation to pay the customer £1,000.

This gives rise to some interesting questions:

- Why would the third party pay £1,000 to purchase shares? What does it intend to do with these shares?
- Did the third party choose exactly which entities or companies these shares represent? Can it request that the basket only comprise shares in Company X and Company Y, and not in Company Z (because, unfortunately, Company Z is having a hard time of things right now)? If it cannot make this choice, then why would it buy a basket of shares that it can not control the composition of?
- How does the third party know that the bank will purchase the shares in step 3? What happens if the bank does not in fact execute this step? What risk does the third party have here?

What if, after executing step 2 (and not yet paying the customer – it would typically have until the end of the business day to deliver an "immediate" payment) – the third party continues to execute step 3 with the bank, receives the £1,000 from the bank, and then refuses to pay the customer? What happens then?

After the customer purchases the shares in step 1, what happens if the shares fall in value suddenly and they are now only worth £900. Will the third party still agree to pay £1,000 for them in step 2, which is now £100 more than their current market value?

What if, after the third party purchases the shares in step 2, the bank refuses (or is unable) to execute step 3? Is the third party stuck with shares it might not really want to own on a long term basis?

What about the presence of any sales tax, or transaction costs, or brokerage fees for transaction on the relevant stock exchange? What if these costs are more than the profit made by the bank here? What if they are large enough to make the transaction no longer attractive for the bank?

What does the third party get out of all this – it is buying and selling shares for the same price (and thus making zero trading profit), and in fact accepting some significant risks. What is the incentive for the third party here?

There are other questions that arise in my mind, but the above sounds like it is enough to be getting on with for right now.

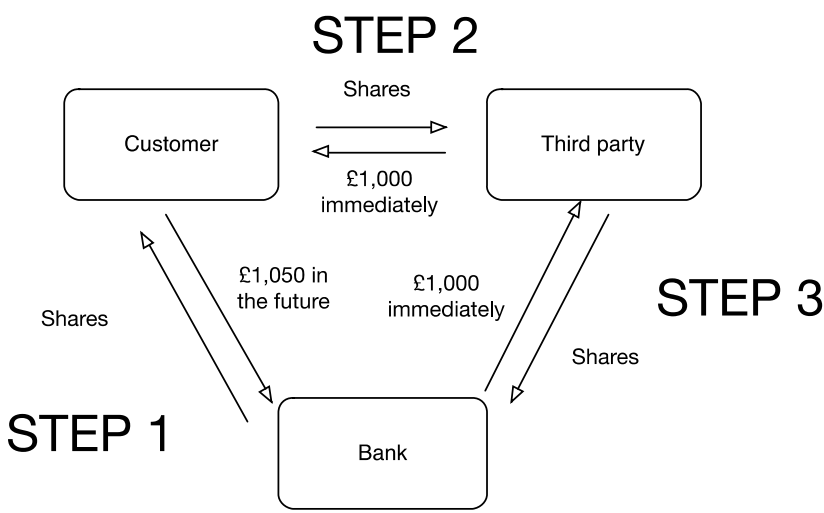
If you have any great ideas on how the above risks can be mitigated, then do please let me know below.

We will begin to look at some of these issues in more detail in the next chapter, insha Allah.

And, of course, the mechanisms used to mitigate these risks will be present in many Islamic banking transactions, and not just in loans of £1,000 to retail customers. These are used in transactions worth £1 billion and more.

Chapter 5 Murabaha Share Finance, part 3

As a recap, this is the structure that we ended up with:



In reality, the structure used by any specific bank for Murabaha share financing may differ from this, however from my experience

this is not often the case. If there is any departure from this, it will not be meaningful.

Once we concluded that we needed the 3 parties working together in this manner, we began to raise some issues around the risk surrounding these transactions.

When a bank gives a loan to a customer, the only risk it really wants to face is the risk of the customer not being able (or willing) to repay the bank. This credit risk is what a bank specialises in. That is why you (the customer) are asked to provide information about your earnings and financial status to the bank when applying for a loan. Where possible, the bank would try to reduce the credit risk it faces on you by various mechanisms such as the use of a guarantor, ensuring your salary is paid directly to the bank, or using an asset as collateral in some manner.

This credit risk certainly exists in our structure. It arises as a result of step 1, where the customer contracts to pay £1,050 to the bank in one year's time. This is reflected, technically, as the deferred sale price paid to purchase the shares from the bank. In a conventional loan with interest, this amount is simply seen as the repayment of the loan (with interest of £50 having been added to the principal of £1,000).

We can see that in both cases, the amount owed to the bank is the same, and it is paid at the same time in the future. In that sense, the Islamic bank still ends up taking credit risk on the customer. This is exactly the outcome desired by the bank. It specialises in credit risk.

What the bank does not specialise in is the risk associated with the asset in question. In this case the asset is shares. Any risk that arises from the above structure, that relates to the shares, is a risk that the

bank (and indeed the other two parties) desire protection from. These risks must be identified and mitigated.

At the end of part 2, I identified some of these risks. Now, we can take each risk in turn, and discuss how, in practice, Islamic banks deal with these risks. In addition, we will look at some of the commercial aspects of these three transactions.

1) Why would the customer pay £1,000 to purchase shares when all he wants is financing?

First of all, how do we know he wants financing, and he does not just want to invest in shares and keep them? Well, we know that these transactions only take place after the bank and customer have agreed a financing facility. They will agree the amount of the loan, the duration, and the (profit) rate to be paid. Once this is agreed, then the specific basket of shares is identified. So, the customer is not purchasing the shares for investment, he is purchasing the shares because:

- He has decided he wants financing
- He has decided to approach this specific bank for financing
- He has made an application for financing from this bank
- He has provided all required documents to support this loan application
- He has agreed the loan amount, and profit repayments, and the length of financing with the bank
- He has then been informed that he will purchase shares from the bank, and that the bank will act as his agent for this purchase

- He is then informed that he may keep the shares, or sell them, and that the sale price would be equal to the loan he has requested

Given all this, do we think that the customer will now decide he no longer wants the financing, and that he will instead choose to keep the shares for investment purposes? It is possible, but I would suggest it is not at all likely.

NOTE: the customer sells the shares for an amount less than what he is paying for the shares. He is making a loss on this sale transaction. And he agrees to do this upfront.

Going back to our question here, why would he agree to purchase these shares and pay £1,050 in the future? The only rational reason is that he knows, with certainty, that he can immediately sell the shares for a price of £1,000, and that he will receive the money immediately. It is this delivery of £1,000 that is, in effect, the disbursement of the loan from the bank. This is what he applied for.

2) Can the third party choose which shares comprise this basket, given that it is buying these shares in step 2?

The answer is – perhaps.

However, we will see that this is redundant. The third party will have arrangements to enter into step 3 immediately after step 2. Thus, it knows it will sell the shares - and for the same price that it has just paid for the shares. It makes no profit, but conversely it

makes no loss on the trading of these shares. As such, the actual composition of the basket of shares is not relevant at all.

3) After the customer purchases the shares in step 1, what happens if the shares fall in value suddenly and they are now only worth £900. Will the third party still agree to pay £1,000 for them in step 2, which is now £100 more than their current market value?

The answer is – yes. Why will the third party agree to pay £1,000 for shares that may only be worth £900? The answer is as per above – it knows, with certainty, that it will immediately sell the shares to the bank for £1,000. As such, the actual market value of the shares is not relevant at all.

4) What if, after the third party purchases the shares in step 2, the bank refuses (or is unable) to execute step 3? Is the third party stuck with shares it might not really want to own on a long term basis?

Potentially – this is a risk that the third party will want protection from. This can be in the form of a written guarantee from the bank. In addition, if the third party is somehow affiliated to the bank, there might in fact be no need for this risk to be mitigated – the parties can simply agree that this risk will not crystallise.

5) What about the presence of any sales tax, or transaction costs, or brokerage fees for transaction on the relevant stock exchange? What if these costs are more than the profit made by the bank here? What if they are large enough to make the transaction no longer attractive for the bank?

This is a real risk – the only way to avoid is it to ensure these 3 sales transactions are not liable to any form of taxation. This is a specialised area, and is highly dependent on the asset involved, and the jurisdiction that these transactions take place in. To avoid exchange brokerage costs, the simple solution is to ensure these trades do not occur on the exchange. They are in effect private sale transactions.

6) - What does the third party get out of all this – it is buying and selling shares for the same price (and thus making zero trading profit), and in fact accepting some significant risks. What is the incentive for the third party here?

The third party will be paid a fee for its services in facilitating step 2 and step 3. Alternatively, if the third party is affiliated to the bank, then a fee may not well be payable. The general profit from this structure is retained by the bank, and can be shared (or otherwise recognised) by the third party via an agreed profit sharing agreement.

What does all this mean?

It means the following:

- The bank and the customer agree a financing deal
- the only desired outcome of the structure is that the bank wants to finance the client (ie lend some money and receive more money back in the future - this includes the required profit amounts)
- assets are introduced to facilitate the relevant cash flows
- the assets bring a whole new raft of risk aspects into a structure
- each risk is identified and mitigated
- whoever buys the asset sells it again immediately for a price that has already been agreed between the parties
- a direct sell and buy-back (between the bank and the customer) is not permitted as this will be a Bay al Inah transaction – this is why we involve an extra party here.

One final question from me is – **how is the profit amount (that is included in the final £1,050 payable by the customer to the bank in one year's time) calculated?**

Up to now, we have just assumed that the customer will receive a loan of £1,000 and will repay an amount of £1,050 back to the bank in the future. In reality, the banks will have a strict method by which is works out the final amount repayable. And, of course, this methodology is that of interest – they use the same method to calculate the amount of "profit" that the bank requires, as does a conventional bank that charges interest.

However, the key difference is that, whereas the conventional bank just charges interest, in this case, the Islamic bank is making a profit on the trading of compliant assets – in this case, shares.

Is what we have learnt interesting? To me, it is fascinating. This process of identifying and injecting assets, creating new risks and mitigating those risks is one that interests me greatly. Of course, this method is exactly the same that is used for many kinds of financing in Islamic banking. It is not just used when a bank wishes to lend £1,000 – it is also used when a corporate wishes to raise £2 billion.

How do I know things work this way? Well, this is my job. I have been paid to deliver these solutions to clients, who have been mainly Islamic banks. And I have been employed by some of the most high-profile and demanding banks in the world – second rate solutions are not good enough.

Chapter 6 Summary and Conclusion

First of all, let me summarise the path we have taken in the last few chapters

1) We started off with a clear product that the bank wants to offer to its customers.

This is a financing product. People like us, as customers of banks, often want some kind of financing from time to time. The bank is serving a need. However, of course, the bank can not just offer a loan at interest – it must find another way.

2) A classic contractual form was chosen as the basis for this product

The Murabaha contract was chosen here. This is no surprise – most forms of financing in Islamic banking are delivered via Murabaha contracts. There are good reasons for this, and I will esplain that later in this chapter.

3) This contractual form is not designed to deliver loans at interest

This is obvious – how can a class Islamic contract be created in order to deliver interest, which is forbidden? Hence the purpose of a Murabaha contract is not to deliver interest. The purpose is to

enable a buyer and seller engage in a sale contract with a beneficial level of transparency.

4) Hence, this contractual form must be manipulated in order to mimic a loan at interest

And this is the crux of the situation. The classic contract must now be used to deliver what it was never designed to deliver – loans at interest. This manipulation is clearly described in the previous chapters.

Whilst we can see that (on the surface), no rules are broken, it is evident that the end product is that the customer is receiving a loan and paying a "profit" amount to the bank (which is calculated in the same way as interest is calculated).

5) This manipulation creates a conflict

What is this conflict? It is the conflict between taking a classic contract on the one hand, and using it to deliver debt and interest on the other. This was never intended when these contracts were first developed.

This manipulation, therefore, leaves a footprint that is obvious for us to see. This footprint screams out at us that something unnatural is going on. In this case, the following are evident signs of this conflict:

- The bank is buying and selling assets it has no interest in making a trading profit from – the bank can equally use timber, cars, or Liverpool football tops to deliver this Murabaha structure.

- The customer is buying an asset he has no desire to own
- The customer then sells this asset at a pre-agreed price to a party he does not know
- The customer actually makes a loss on this sale transaction!
- The size of this loss has nothing to do with the asset in question (shares). It is only a function of the size of the loan, and the duration of the repayments (and the interest rate the bank wishes to charge on this loan)

Why are things done this way?

The answer is simple – in order to maintain the appearance of Shariah compliance.

We have described how a Bay al Inah transaction is forbidden – we can see, in fact, this Murabaha structure delivers exactly the same outcome as Bay al Inah – which is a proxy for giving a loan at interest. However, due to the intricate and precise steps taken, the appearance of a structure that does not look like Bay al Inah is given.

This enables the bank to claim the product is Shariah compliant. Indeed, it is enough for the bank to obtain a pronouncement of Shariah compliance from scholars.

For those who are interested, I suggest reading the Shariah Standards published by AAOIFI relating to Commodity Murabaha. These standards clearly outline what is forbidden –but this practice of Murabaha in the markets skirts these prohibitions.

In my view this is dangerous practice – it is not becoming of transactions that are supposed to be based on the values we

discussed at the beginning of this book. We simply should not be lowering ourselves to conduct such manipulation in the name of profits.

Why is Murabaha often used for loans and finance?

The reason is that the final amount to be repaid by the customer is a consequence of a sale transaction. This is a clear legal obligation. Any failure of the customer to repay the bank is a breach of contract – the bank will have clear redress in a court of law for this.

If the bank delivered the finance to the customer on an investment type contract (such as Mudarabah) then the bank can not make the customer contractually liable to repay the principle plus profit/interest. You simply can not have this kind of guarantee in a Mudarabah contract.

What is interesting, is the banks often offer to accept deposits from customers on this basis – on a Mudarabaha basis. In this case, even though the bank has no legal (Shariah) obligation to repay the deposit to the customer (plus any profit/interest), in reality the bank will always do this.

This is because the risk of failing to deliver the principle back to the client is catastrophic for the bank. Imagine having a bank that accepts deposits from customers, but then it fails to give those deposits back to the customers. If that happens, then every single customer will leave that bank, and the bank will struggle to continue to exist.

Hence this obligation of the bank to return the deposit is not a legal (Shariah) obligation in this case – it is a moral or commercial obligation.

The bank can not rely on this method when giving loans to customers, however. Customers do not have the same commercial obligation to repay that the banks do. Thus, the banks wish the customer to have a legal obligation to repay the loan. This legal obligation is created by a sale contract and not an investment contract.

As a summary, we can see that when we use classic contracts to deliver loans (which are always priced at interest), then this requires manipulation of the underlying contracts. This manipulation gives rise to buy and sell transactions that are not at arms length. They are no longer commercial transactions entered into by two counterparties. These are manufactured transactions, organised in such a way that they achieve a very specific outcome.

This manipulation of contracts is a clear manifestation of the conflict that exists in the vast majority of transactions in Islamic banking and Islamic finance. The conflict that arises when interest is forbidden, but all the parties still wish to execute transactions that must be priced at interest.

This conflict is apparent in virtually every segment of Islamic banking. This conflict, of course, is at the heart of my ***Islamic Banking in Practice*** series.

Visit www.safdaralam.com for more information on Islamic Banking and Finance

Personal Note

Dear Reader,

I would like to personally thank you for making it to the end. I have made the eBook available for free (where this is possible) because I just wish to share some of my knowledge. If you have learnt something interesting, or otherwise enjoyed the book, I would appreciate if you could do the following for me:

1. Go to www.safdaralam.com and please subscribe. This enables me to stay in touch with you regarding what else I am doing, and writing. Also, I often try to give something free to new subscribers on my site
2. Take a look at the other work I have published. My main focus is the Islamic Banking in Practice series, which is available both on Amazon and also on my website www.safdaralam.com. You can see the books on my website HERE
3. Follow me twitter HERE to keep up to date on new books and articles that I publish

Thank you again for your patience.

Safdar Alam

ABOUT THE AUTHOR

Safdar is an investment banker and has been specialising in Islamic Finance for almost two decades. He has established and led the Islamic Banking teams/businesses at some of the largest banks in the world (UBS, Credit Agricole, JP Morgan).

He is well known in the global industry, and played a key role in several landmark transactions and ground-breaking developments in the industry. His experience has been gained working in the City in London (over 15 years), and being based for 6 years in Bahrain.

Safdar's experience has been gained in front office roles - developing products, executing transactions and client coverage. He has deep relationships with Islamic banks from London to the Middle East and Asia.

He has led and executed transactions in excess of $10bn.

Safdar has considerable expertise and experience in the following areas (Islamic and conventional banking), in structuring, pricing, creating legal documentation, execution, operations and governance:

- Money markets and FX markets
- Capital markets (DCM and ECM)
- Sukuk
- Syndicated financing, corporate financing
- Risk management (derivatives)
- Investments and funds
- Asset management
- Structured investments

Safdar has consulted with and advised Governments/ Ministry of Finance/ Central Banks in the UK, Bahrain, Saudi Arabia, Turkey, Hong Kong, Singapore, Brunei, Kazakhstan, Pakistan and Nigeria.

As well as international experience with the largest global banks, Safdar has extensive experience of supporting the growth and implementation of Islamic finance globally.

Safdar has played a role in advising key government entities (e.g. Ministry of Finance) and banks in countries where Islamic banking has been introduced for the first time. Specifically, Safdar played a key advisory role in Kazakhstan, supporting the first two domestic banks to conduct large international financing transactions (Shariah compliant) and also in the onward domestic utilisation of funds by providing Shariah compliant financing to SME's.

At all stages, the parties involved required education on Islamic principles and rules, and advice on how to use specialised contracts for financing and remain aligned with global best practice, and also general education about Islamic finance.

Safdar has also provided bespoke support to the Ministry of Finance in Nigeria during the initial stages of the application of Islamic finance there.

In Singapore, Safdar advised the regulator with regards to the creation and management of Islamic funds.

In Bahrain, Safdar has worked on several advisory boards for the Central Bank of Bahrain, to assist with key projects in Islamic banking and also with regards to regulation.

Safdar has been an advisor to the International Islamic Financial Markets company in Bahrain, a standard-setting body in Islamic finance, with regards to the ground-breaking work performed on Islamic derivatives, in coordination with ISDA.

Safdar was an advisor to the UK government in their preparation in launching the first Sukuk in 2014.

Safdar is a published author, the first book in his series (Islamic Banking in Practice) of four volumes has been published, with the others to follow in 2018 and 2019.

Some Key Achievements

He executed the first syndicated financing transactions (USD 500m and USD 650m) for the two largest Islamic Banks in the world (Al Rajhi and Kuwait Finance House) in the roles of Advisor and Mandated Lead Arranger

He also originated and executed the first Islamic financing transactions to originate from Kazakhstan

Executed the largest equity linked Sukuk - for Dana Gas (USD 1bn)

Created award winning financial instruments (Most Innovative Product awarded by

Euromoney)

Developed the first Profit Rate Swaps to be utilised in the industry

Worked closed with Central Bank of Bahrain on local initiatives for Islamic finance

Developed the first overnight liquidity sweep facility for Islamic Banks (while at JP

Morgan

Worked with IIFM (a standard setting body based in Bahrain) to develop global

contracts for Islamic money markets and derivatives, in coordination with ISDA.

First edition 2019

Visit www.safdaralam.com to obtain a free mini book on Islamic Retail Banking, while offer lasts