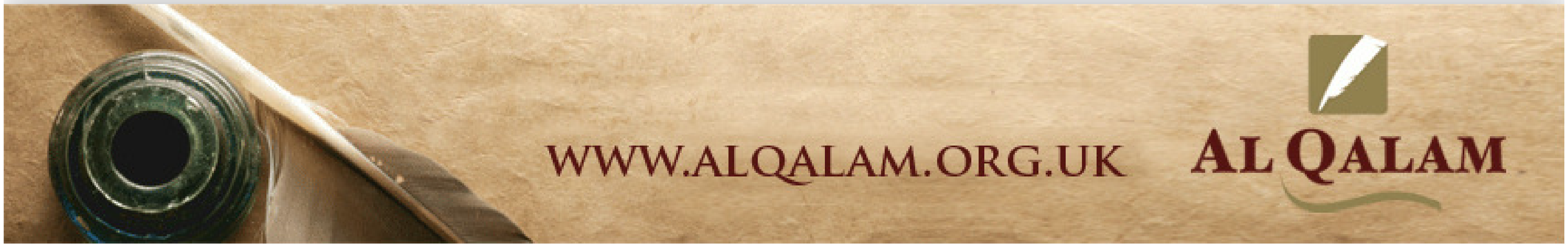
Banking and Financing Products

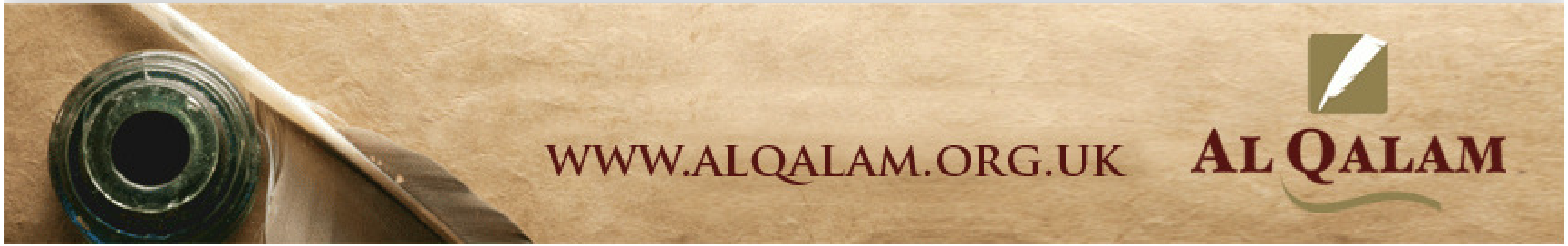


Overview

- Islamic commercial bank accounts
- Islamic home finance
- Bank cards
- Islamic credit cards
- Overview of current financial markets in existence
  - Stock
  - Bond
  - Derivatives
    - Forwards
    - Futures
    - Options
  - Forex

Islamic Commercial Bank Accounts

- Current Account
  - Loan by client to bank?
    - Money becomes property of bank
    - Bank has corresponding liability to customer
    - Payment by A to B by cheque (£100) is transfer of debt – i.e., A's bank now owes B £100 instead of owing to A



Islamic Commercial Bank Accounts

- Current Account
  - Deposit by client at the bank?
    - Bank is safe keeper only
    - Money is available for immediate withdrawal
    - Bank cannot use money without consent
    - Payment by A to B by cheque (£100) is transfer of money, not debt – i.e., A's bank now holds £100 for safe keeping on behalf of B
    - If bank utilises the deposit with permission it becomes a deposit of guarantee
      - No modern bank has sufficient funds to guarantee all deposits so any such guarantee is worthless
      - If it is now considered a loan then it is this sale of debt (بيع الدين) or transfer of debt - ḥawālah?

Islamic Commercial Bank Accounts

- Investment Account – muḍārabah/wakālah
  - Restricted – requires bank to invest in only certain kinds of assets on both Sharīʿah and commercial grounds
  - Unrestricted – bank can invest in any Sharīʿah-compliant manner
  - Recorded as assets of the bank when in fact the bank is a muḍārib/wakīl
- Profit equalisation reserve (PER) must be from share of muḍārib/wakīl
- Bank can advertise expected yield based on past performance and contribution from PER

Islamic Commercial Bank Accounts

- Investment Account
  - Customer pressure to achieve fixed-rate returns
  - Regulatory and financial reporting requirements designed for interest based institutions
- All commercial banking organisations in UK are subject to regulations on capital certainty
  - Creates a problem as profit & loss must be shared
  - IBB has attempted to resolve this by a ‘voluntary gift’ from the PER – amounts to a capital guarantee
  - Customer is sometimes also advised that he is not permitted to take the guaranteed amount

Islāmic Home Finance

- In view of rising house prices saving to purchase home has become nearly impossible
- Most ‘home purchase plans’ in the UK are structured in the form of murābaḥah, ijārah wa iqtināʿ or mushārakah mutanāqiṣah
- Does the source of funding have to be ḥalāl?
  - Interest-based borrowing tends to be reflected in the nature of the Islāmic product

Islāmic Home Finance

Murābaḥah

- Customer promises the bank to purchase the identified property from the bank
- Bank purchases property from vendor e.g. £100,000
- Customer purchases the property from bank for £150,000 payable in instalments over a period e.g. 10 years
- Title is transferred to customer at time of sale but is mortgaged to secure customer's instalment payments
- Home insurance is usually required and is payable by the customer as owner
- Early settlement requires payment of full price unlike conventional mortgages – but bank may unilaterally waive some instalments

key challenges

- Legal enforceability of promise

Islāmic Home Finance

Ijārah wa Iqtināʿ

- Customer enters into a promise to lease agreement with the bank for the property identified by the customer
- Bank purchases property from the vendor e.g. £100,000
- Bank leases the property to the customer for an agreed period
- Customer pays rent + an on-account payment held in trust by the bank
- At the end of the lease period bank sells the property to the customer for £100,000 from the on-account payments

key challenges

- Legal enforceability of promise
- Bank use of on-account payment
- Rental being linked to LIBOR
- In 2006 HSBC ceased this type of home purchase plan in the UK

Islāmic Home Finance

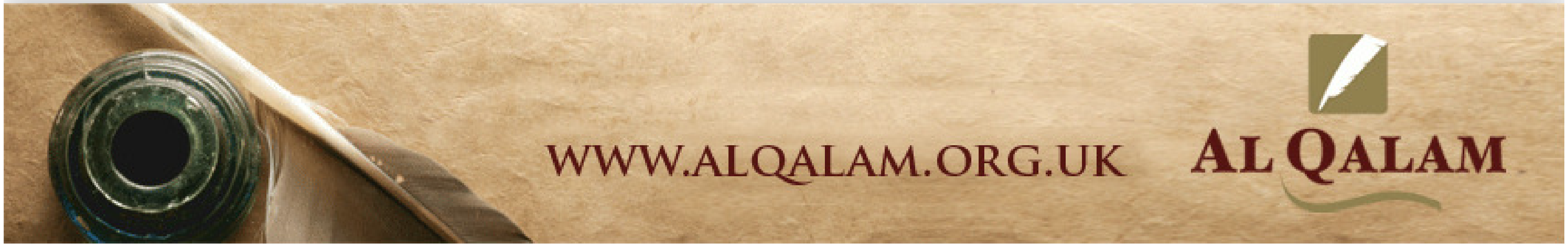
Diminishing mushārakah

- Customer promises the bank to purchase the identified property from the bank
- Joint ownership – *shirkat-ul-milk* is created in the desired property: usually c. 70% financier - 30% client
- Separate unilateral promise from client to purchase financier’s undivided share (حصة مشاعة) in units.
- Bank’s share is leased to the client by a separate contract
- Customer pays rent + an on-account payment held in trust by the bank
- Actual periodic purchase of units of the financier’s undivided share by exchange of offer and acceptance – preferably at market price, but can also be at the price promised by the client.
- Adjustment of the rental to reflect the decreased ownership of the financier.

Islāmic Home Finance

Diminishing mushārakah

- **Key challenges**
- Shirkat-ul-milk or shirkat-al-ʿaqd
  - Shirkat-ul-milk – neither party intends to make a profit on the property so advance agreement of price for sale of share is not prohibited
  - Shirkat-ul-ʿaqd – bank only engages to make a profit so price of share cannot be fixed in advance
- Legal enforceability of promise
- Rental being linked to LIBOR
- **Anvantages of DM**
- Bank can utilise on-account payment after purchase of share by customer
- Ownership of property transfers to customer sooner than in the Ijārah plan



Conventional Bank Cards

- **Debit Card**
  - Linked to bank account
    - Solo/Electron – availability of funds is checked
    - Switch/Visa/Delta - availability of funds is not checked, may have over draft facility, may exceed overdraft
  - Less interest than Credit Card
- **Charge Card**
  - Creates a debt with often no spending limit payable in full by due date or otherwise incurs severe late fees
- **Credit Card**
  - Creates a debt with minimum payable and balance carried forward as interest bearing loan

  – **KEY CHALLENGE:**
  - Are Credit Cards permissible if holder is sure he will pay loan off before any interest is incurred? What about interest charges condition in a Debit Card?

Use of Conventional Bank Cards

- **Debit Card**
  - Permissible - as long as the cardholder does not exceed the available balance in his account and no interest charge arises out of the transaction. [AAOIFI Standards, p. 21]
  - Based on a restricted ḥawālah (الحوالة المقيدة) contract wherein the bank (المحال عليه) is already indebted to the cardholder (المحيل)
- **Charge Card**
  - Not permissible unless the cardholder is not obliged to pay interest in the form of late fees?
  - Based on an unrestricted ḥawālah (الحوالة المطلقة) contract wherein the card issuer (المحال عليه) is not already indebted to the cardholder (المحيل)

Use of Conventional Bank Cards

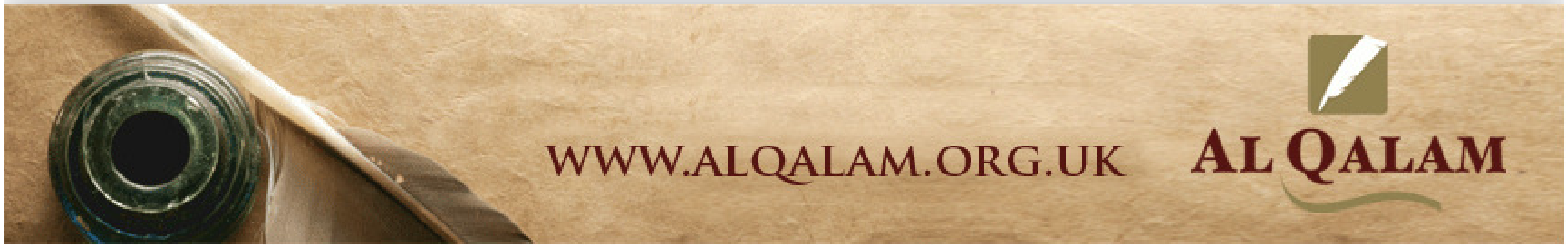
- **Credit Card**
  - Not permissible by consensus if interest is paid
  - If interest is not paid:
    - Not permissible – permissibility is not dependent solely on the result of the contract but also on the form which here includes an agreement to pay interest
    - Permissible – interest condition is void whilst the loan is valid as a loan is initially a gratuitous contract even if the loan is returned at the end
    - Valid but not permissible as although the interest condition is void and the contract valid, agreeing to the interest condition is a sin
  - Based on an unrestricted ḥawālah (الحوالة المطلقة) contract wherein the card issuer (المحال عليه) is not already indebted to the cardholder (المحيل)

Islāmic Credit Card

- Current structures of ‘Islāmic’ credit cards are not ‘credit’ cards in the conventional sense but rather debit cards
- A South East Asian solution – based on beyʿ al-ʿīnah
    - Customer purchases an asset from bank on deferred basis at price P
    - Bank buys back the asset at spot at price P-1
    - Price P-1 is deposited in to a Wadīʿah Account from which the customer makes purchases or cash withdrawals
    - Bank may also allow customer to use funds in excess of the balance of the Wadīʿah Account on the basis of qarḍ ḥasan
- Critics of the beyʿ al-ʿīnah construct argue that it is ethically flimsy as the sale transacted is a fake sale and thus just a means of masking ribā.

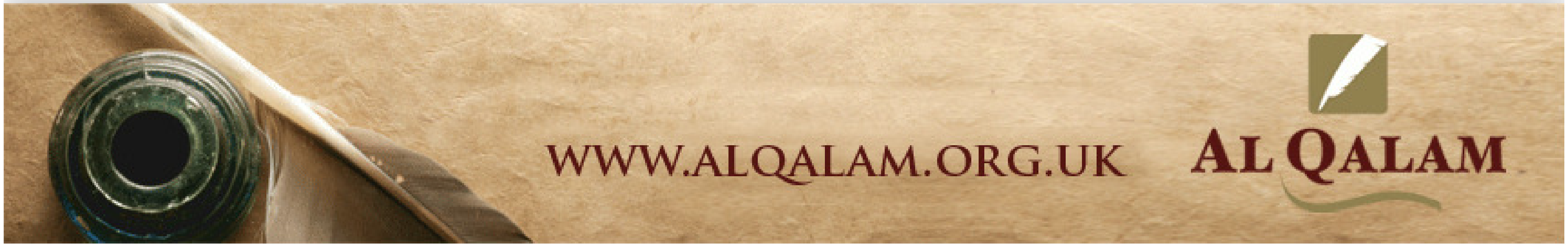
Islāmic Credit Card

- A GCC solution – based on tawarruq
    - Bank purchases an asset from the market at cost C and sells it to the customer on a deferred basis at C+1
    - Customer sells the asset in the market to a third party in a spot sale at C
    - C is deposited in to a Wadīʿah Account from which the customer makes purchases or cash withdrawals
    - At the end of every month, the value of total transactions by the customer is computed. A fresh tawarruq for this value is undertaken to replenish the Wadīʿah Account.



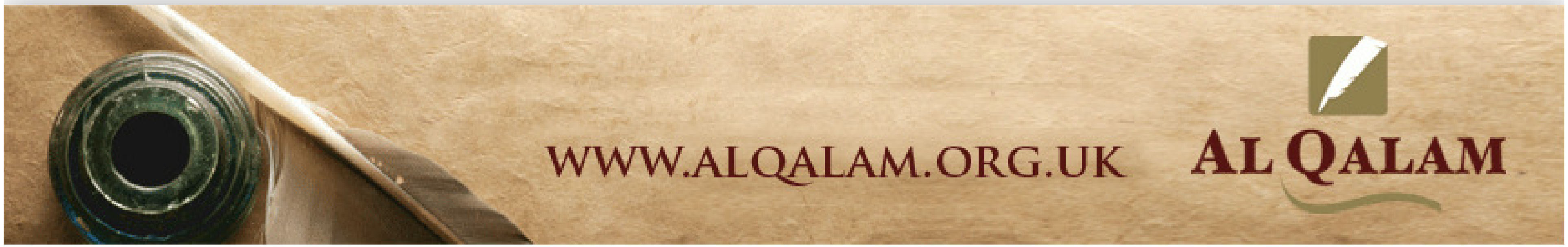
Prepaid Mastercard

- Cordoba Gold Cashplus Prepaid Mastercard
  - UK's first prepaid Shariah compliant Mastercard card launched 11/08/2008
  - No interest charges, late payment fees or minimum monthly payments
  - User purchases the card from Cordoba Financial Group (est. 2006) for a small fee (£9.95) which covers administration costs
  - Cardholder tops up card at a top-up point and the value is deposited in an escrow account with AFL Bank [an SPV] within 24 hours as a trust.
  - A monthly fee (£4.95) is levied if there is a balance on the card
  - Whilst physical isolation of the funds of each individual account is not possible, it is entered on the banks balance sheet as an amount due to a specific individual [and not as a loan] and is not used by the bank nor entered as an asset of the bank
  - Purchases/withdrawals + transaction fee are deducted from the escrow account and the balance on the account cannot be exceeded



Financial Markets

- **Stock market -** a public entity for the trading of company stock (shares) and derivatives at an agreed price
- Allows businesses to be publicly traded, or raise additional financial capital for expansion by selling shares of ownership of the company
- Examples are NYSE, LSE, Paris Bourse, Deutsche Börse, KSE, etc
- Exchanges can be:
  – physical locations [e.g., NYSE] where transactions are carried out on a trading floor, by a method known as open outcry, or
  – virtual [e.g., NASDAQ] - composed of a network of computers where trades are made electronically via traders



Financial Markets

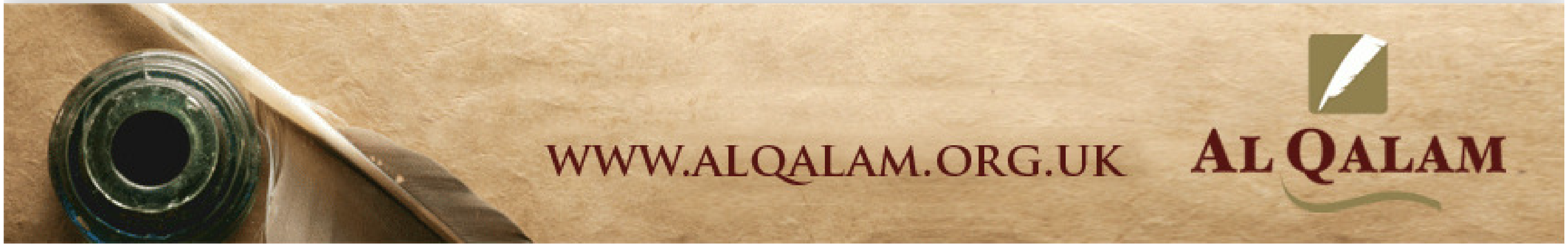
- **Screening criteria**
- Business of investee company must be fundamentally lawful
- Debt to total assets should not equal or exceed 33%
- Illiquid to total assets should be at least 51%/33%/must not be negligible
- Total investment in non compliant activities should not equal or exceed 33%
- Income from non compliant investment should not equal or exceed 5% of gross revenue
- Net liquid assets [total assets – (tangible fixed assets + inventory) – liabilities] per share should be less than the market price of the share

Financial Markets

- **Bond market –** security that gives its owner the right to receive an amount of money stated on the face of the bond certificate (face value) at a specified time in the future (redemption date) and often also to receive payments of interest (coupons) at specified dates (coupon dates) throughout the life of the bond.
- Callable bond – can be redeemed by issuer at 100% face value on a call date at the issuer's preference
- Term bond - can only be redeemed on a single redemption date
- Bonds can be 'convertible' in to other bonds or equity
- Most bonds involve the charging of riba and where callability and conversion rights are made available gharar is also likely

Financial Markets

- **Derivatives –** 'A security whose price is dependent upon or derived from one or more underlying assets.'
- Common types of derivatives:
  - Forwards
  - Futures
  - Options
- Used for:
  - hedging - تأمين الربح - to manage or reduce risk resulting from business activities
  - arbitrage - process of trying to take advantage of price differentials between markets
  - speculation – المخاطرة - take positions in assets or markets without taking offsetting position

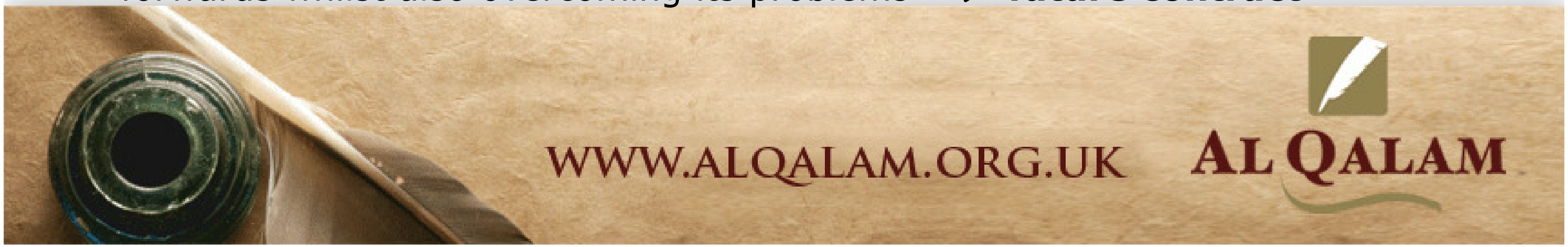


Financial Markets

- **Forward contract –** two parties undertake to complete a transaction at a future date but at a price determined today.
- E.g., a cocoa farmer (producer) and a confectioner (consumer) who needs cocoa for his products
  - Farmer has planted cocoa and expects to harvest 120 tons of cocoa in 6 months
  - Confectioner has a 6 month stock of cocoa but will need to replenish it in 6 months with 120 tons.
  - Both parties are faced with price risk - farmer is fearful of a fall in the spot price in six months from now; confectioner is susceptible to an increase in the spot price
  - It would be beneficial for both parties to meet, negotiate and agree on a price at which the transaction can be carried out in six months to eliminate price risk. The farmer now knows the price he will receive for his cocoa -regardless of what happens to cocoa prices over the next 6 months. The confectioner too has eliminated price risk since he will only have to pay the agreed price regardless of spot prices in the next 6 months.
  - Confectioner can also now confidently quote to his customers the prices at which he can deliver them products in the future.

Financial Markets

- **Forward contract - problems**
  1. Double coincidence of wants – each party to a forward contract would have to find a counterparty who not only has the opposite needs with respect to the underlying asset but also with regards the timing and quantity
  2. Forward price may be forced upon the other party. This may either be due to urgency on the part of one party (e.g. perishable goods) or more commonly due to informational asymmetry.
  3. Default risk of counterparty – not so much from dishonesty counterparties but from increased incentive to default as a result of subsequent price movement. When spot prices rise substantially above the forward price, the short position (seller) has the incentive to default. The long position would have the incentive to default if the opposite happens i.e. spot price falls heavily.
- New instrument needed that would provide the risk management benefit of forwards whilst also overcoming its problems → **future contract**



Financial Markets

- **Futures contracts – عقود المستقبليات** a futures contract is a standardized contract traded on a futures exchange between two parties to exchange a specified asset of standardized quantity and quality for a price agreed today (strike price) but with delivery occurring at a specified future date
- Essentially a standardized forward contract
- Standardization allowed it to be traded on an exchange thus increasing liquidity and reducing transaction cost
  1. Problem of double coincidence of wants overcome due to increased market players
  2. Possibility of being locked in to an unfair price also removed as the price is determined by the market
  3. Counterparty default risk is overcome as performance is guaranteed by the exchange which minimizes risk by the margining process

Financial Markets

- **Futures contracts – particulars**
- The buyer is said to be 'long' as he hopes the asset price will increase
- The seller is said to be short as he hopes the price will decrease
- The underlying asset can be commodities, currencies, securities, stocks, interest rates or financial instruments
- Both parties must put up a margin to cover any default in the case of loss
- Each day, the difference in the agreed price and the daily futures price is settled by drawing the appropriate amount from the margin of one party and putting it in to that of the other (known as marked-to-market)

Financial Markets

- **Futures contracts – particulars**
- If the margin account goes below a defined amount it must be replenished.
- On the delivery date the spot value of the asset is exchanged, since any gain or loss has already been previously settled.
- Both parties of a futures contract must fulfil the contract on the delivery date. The seller delivers the underlying asset to the buyer, or, if it is a cash-settled futures contract, then cash is transferred from the futures trader who sustained a loss to the one who made a profit.
- However, futures contracts are quite frequently employed by speculators, who bet on the direction in which an asset's price will move and they are usually closed out prior to maturity and delivery usually never happens.

Financial Markets

- **Futures contracts – inadequacies**
- Whilst futures enabled easy hedging by locking in the price at which one could buy or sell, being locked-in also meant that one could not benefit from subsequent favourable price movements.
- Futures (and forwards) were unsuited for the management of contingent liabilities or contingent claims - liabilities or claims on a business entity that could arise depending on an uncertain outcome
  - E.g., a British manufacturer of an electrical component submits a bid in an international tender by a foreign government for supply of the components with payment in a foreign currency. The winning bidder will be announced in one month's time, who will then supply over the following five months and be paid in full at the end of the fifth month.
  - If chosen, the British company faces the risk that the foreign currency could depreciate against sterling and since its costs would be in sterling this would cause it to make losses. This currency exposure begins the moment the bid is submitted, yet becomes reality only if their bid is chosen.

Financial Markets

- **Futures contracts – inadequacies**
  - There are two sets of uncertainty:
    - Whether the bid would be chosen
    - If chosen, sterling amount that will be received due to currency fluctuation
  - To hedge against risk:
    - a forward would not be suitable, since if not chosen, a forward cannot easily be reversed out
    - with futures, the company has two choices:
      - (a) take a short position in a 6 month currency futures contract now and reverse out in a month if not selected or
      - (b) wait until the result is known in a month's time and then if chosen, take a short position in 5 month currency futures.
  - While at first glance it may seem appropriate, neither of these alternatives would really be suited.
  - New instrument needed to manage such complicated risks → **options contract**

Financial Markets

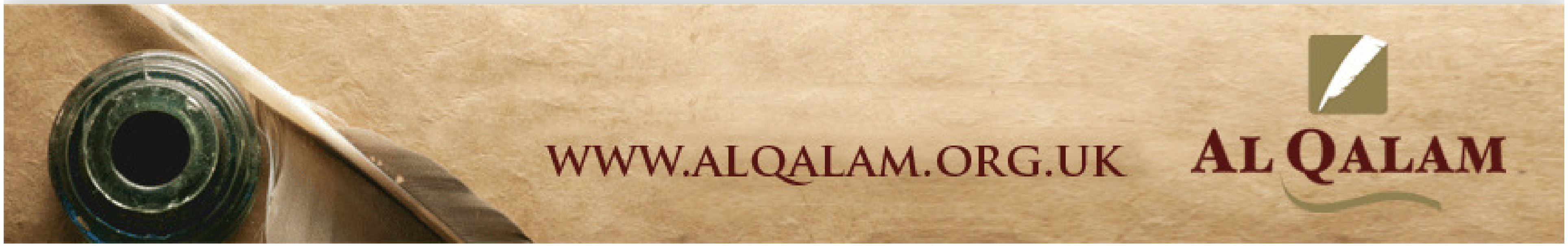
- **Options contracts – عقود الخيارات**
- An option is a contract that gives the buyer the **right**, but **not** the **obligation**, to buy or sell an underlying asset at a specific price on or before a certain date.
- All exchange traded options come in two types:
  - A **call** option – خيار الطلب entitles the holder the right but not the obligation to buy the underlying asset at a predetermined exercise price at or anytime before maturity. Calls are similar to having a long position on a stock. Buyers of calls hope that the stock will increase substantially before the option expires.
  - A **put** option – خيار الدفع on the other hand entitles the holder the right but not the obligation to sell the underlying asset at a predetermined exercise price at or before maturity. Puts are very similar to having a short position on a stock. Buyers of puts hope that the price of the stock will fall before the option expires.
- Options provide increased flexibility which is the key advantage over forwards and futures.
- Buyer of the option pays a non-refundable premium to the seller which represents his maximum possible loss if he chooses not to exercise the option.

Financial Markets

- **Options contracts – عقود الخيارات**
- To hedge against risk:
  - The British manufacturer would at the time of it submitting the bid simply buy (long) 6-month-put options on the foreign currency.
  - By buying the needed number of 6-month-put option contracts to equate to the amount of the foreign currency receivable the British manufacturer would fully hedge both the currency risk and the uncertainty about the outcome of the bid.
  - In the event the company's bid is not chosen, the put options could be left unexpired with losses limited to the cost of the premium.
  - If the bid is chosen and the company receives a depreciated foreign currency, the put options purchased become profitable and would be exercised.
  - In addition, the British manufacturer can also take advantage of favourable price movements. i.e., if the foreign currency appreciates over the 6 month period and the foreign currency exchange rate is higher than the exercise price, the British manufacturer would not exercise the put option but sell the received foreign currency at the higher spot rate.
  - Put options are useful where protection is needed from price falls but where price increases would be beneficial. Call options on the other hand would be useful where protection is needed from price increases but where price declines are beneficial.

Financial Markets

- **Sharīʿah considerations**
  - If the seller does not own or possess the underlying asset the sale is void.
  - If the seller owns and possesses the underlying asset and contracts the sale today for a date in the future – البيع المضاف إلى المستقبل the sale is void as a sale contract cannot be contracted for a future date.
  - If the seller owns and possesses the underlying asset and contracts the sale today on a deferred basis – البيع المؤجل he must deliver the asset today and cannot withhold it until receipt of payment. However, it is permissible to retain the asset after delivery to the buyer as a pledge (rahn)
  - If the seller promises to sell and/or the buyer promises to buy the asset at a future date for an agreed price, can this be allowed on the basis of need or should this be discourage to discourage speculation?



Financial Markets

- **Sharīʿah considerations**
- An options is a sale of a right that does not have Sharʿī sanction in its origin - أصالةً but is purchased to remove potential harm
- Rights that do not have Sharʿī sanction in their origin - أصالةً but are acquired to remove potential harm cannot be sold

... أن عدم جواز الاعتياض عن الحقوق المجردة ليس على إطلاقه ، بل فيه التفصيل:
وهو أن ذلك الحق المجرد إن كان الشرع جعله لصاحبه لأجل رفع الضرر عنه ،
كحق الشفعة ، وحق القسم للزوجة ، وحق الخيار للمخيرة ، فالاعتياض عنه بمال لا
يجوز ... لأن صاحب الحق لما رضى علم أنه لا يتضرر بذلك ، فلا يستحق شيئا.
[شرح المجلة للأتاسى ، 121/2]

Financial Markets

- **Sharīʿah considerations**
  - Futures on the basis of salam?
    - Salam requires full payment at time of contract whereas in futures the price is deferred as a condition of the contract. This is prohibited by consensus. Imām Mālik allows 2-3 days delay provided it is not a condition of the contract.
    - The margin is not partial payment but a guarantee of performance. Had it been partial payment it would have still been insufficient in salam.
    - Guarantee provided by exchange cannot be considered constructive payment as a third party guarantee in salam is not considered payment – actual payment is required otherwise double deferment will result which is prohibited.
    - Condition of settlement with original seller is a voiding condition and even if it is not conditional selling the muslam fīh to the seller is not permitted.
    - Even if it is conceded to be a valid salam it is not permissible to sell on the the muslam fīh before possession. [Fiqhī Maqālāt, 2:205]

Financial Markets

- **Forex –** Foreign Exchange
- Allows counterparties to exchange different currencies at market exchange rates which can be seen as the price of one currency in terms of another.
- Two ways of quoting a forex rate:
  – \$/£ = 0.66667 - 1 USD (base currency) is worth 0.66667 GBP (counter/quote currency)
  – £/\$ = 1 GBP is worth 1.50 USD.
- Each market has its own convention for choosing the base currency.
  – In sterling against dollars, exchange rates are quoted as the number of dollars per pound GBP/USD
  – For other currencies, it is the dollar that is the base currency (except Australian Dollar – AUD and Euro - EUR)

Financial Markets

- Traders open an escrow account via an authorised broker with the market manager
  - Standard account – 1 'lot' controls $100,000 of currency with a margin requirement of $1000 with a leverage of 100:1
  - Mini account – 1 lot controls $10,000 worth of currency with a margin requirement of just $50 for a leverage of 200:1
- The broker leverages the account – i.e. For every £1000 traded broker allows trade of £100,000
  - The leverage is described as a 'loan' but in reality no money is lent. (broker simply does not have the funds to lend 100 times the deposit!) It is a margin trade by definition.
  - The margin allows one to trade and covers the shift in price in case of loss. If one gains the profit is deposited in the account at the end of the day.
- Trade can be at spot or futures
- If position is not closed at the end of the day (5pm) then interest may be payable or receivable

Financial Markets

- Is forex governed by the rules of beyʿ al-ṣarf?
  - Currencies of different countries can be exchanged at spot in unequal amounts by general consensus
  - Majority of scholars agree that currency exchange on a forward basis (rights and obligations of both parties relate to a future date) is not permissible
  - There is a difference of opinion if only one of the countervalues is deferred
  - Central to the discussion is whether paper currency holds the same rule as gold and silver (thaman khilqī) or that of inferior metals (thaman isṭilāḥī)
    - One opinion is that they should be treated at par with thaman ḥaqīqī (gold and silver) since these serve as the principal means of exchange and unit of account like gold and silver. This is supported by the agreed prohibition of exchanging the same currency in unequal amounts.
    - A contrary view asserts that they should be treated in a manner similar to 'fals' or thaman iṣṭilāḥī as their face value is different from their intrinsic worth. Juristic references exist which indicate that jurists do not classify an exchange of fals (thaman iṣṭilāḥī) for another fals (thaman iṣṭilāḥī) or gold or silver (thaman ḥaqīqī), as of beyʿ al-ṣarf. Thus, deferment of one of the countervalues is permitted.
      - This is countered by the assertion that in the early days of Islam, dinars and dirhams were mostly used as medium of exchange in all major transactions whereas fals did not possess the characteristics of money or thamaniyya in full and was more in the nature of commodity. Present day currencies have all the features of thaman and are meant to be thaman only.

Financial Markets

- Should forex even be encouraged?

"Currencies are a medium of exchange in their origin. Thus, to make them a tradable commodity solely to earn a profit is also against the basic philosophy of Islamic Economics. Exchange should only be for personal use and to facilitate trade." [Fatwa of Mufti Taqi Usmani]

- Permissibility of currency trading is subject to two conditions:
  1. Transaction must be completed with delivery at spot.
     - Spot currency transactions are delivered within three days. Although this does not constitute 'yadan bi yadin', IFA-OIC considered this to be immediate because this is the normal time for a spot transaction. However, the currency cannot be resold until delivery is secured.
  2. Exchange of the same currency must be of equal quantities regardless of a difference in quality.

Financial Markets

- Thus:
- Forward trading of currencies is not permitted.
- Full payment of both currencies is required at the time of the contract whilst trades are done with a margin of 1% (or similar) – this is not full payment! Therefore, no margins and no leverage is permitted.
- Payment or receipt of interest if position is not closed at the end of the day is also not permitted.