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# Islamic Transactions

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## INTRODUCTION

In the context of the ongoing globalization of the world's financial markets and the current financial crisis, the relevance of Islamic financial markets and Islamic funds has continuously grown. Today, an increasing number of transactions and finance products are structured in compliance with the principles of *Sharia*. Recent surveys show annual growth rates of 15 to 20 percent for the past five years. This is also reflected by the number of more than 300 Islamic financial institutions existing all over the world and the well over 250 mutual funds whose investment strategy complies with Islamic principles.

Against this background, *Sharia* compliant financing and finance products attract more and more interest from both investors and financial intermediaries who would like to understand, make use of and benefit from the structures and products available.

From a conventional finance perspective, major differences between conventional and Islamic finance may be seen in the fact that *Sharia* requires (i) compliance with certain principles atypical to conventional finance, (ii) (many) finance structures to be asset based and (iii) that all parties to a transaction assume genuine commercial risk (even if it is only for a limited period of time).

This publication is intended to serve as an introduction into the fascinating world of Islamic transactions by summarizing the major principles applicable to, and most common structures of, *Sharia* compliant transactions.



## BASIC PRINCIPLES

**Sharia** Other than the legal provisions applicable to conventional finance transactions, the *Sharia* is not codified law embodied in a statute. Rather, the provisions applicable are derived from different sources and are subject to interpretation. Hence, the products and structures permitted must be developed in cooperation with Islamic scholars. In order to ensure compliance of a finance transaction or a finance product with the principles of *Sharia*, financial institutions involve committees of Islamic scholars, so-called *Sharia* boards, which are appointed to review compliance with the *Sharia* and to issue a *fatwa* (legal opinion).

It should be noted, however, that there is no common understanding between the different *Sharia* schools of thought what is to be considered a *Sharia* compliant finance transaction. Hence, a finance transaction approved by one committee of Islamic scholars may not necessarily be recognized by other *Sharia* boards. In order to resolve this issue and to establish a common set of *Sharia* compliant financial documents, the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) has launched a contract certification program which intends to harmonize Islamic finance practices and to provide independent endorsement on *Sharia* compliance.

In order to invest funds in accordance with the rules of *Sharia*, the following widely accepted major principles have to be complied with:

**Riba (Interest)** Islamic law considers money to be merely a means of exchange in order to purchase goods. Other than in conventional (credit) finance, to increase wealth, money must be used productively by investing it into (profitable) ventures whereby added value is created and all parties assume, and share, commercial risks.

Pursuant to the principle of *Riba*, the charging of interest is prohibited, i.e. any financial return on funds invested should be generated through the profit of the business the funds were invested in.

The concept of *Riba* extends beyond our conventional understanding of interest and usury; *Riba* includes all kind of return which is to be paid as a condition for making available funds and any obligation to pay *Riba* would be void.

**Maisir (Gambling)** Any business whose outcome is driven by, or contingent upon, chance is forbidden as it distracts individuals from productive activities and may allow for effortless profit.

It should be noted, though, that general commercial speculation is not prohibited which, in particular, has an impact on the structuring and issue of structured products (cf. below, FINANCE INSTRUMENTS).

**Haram (Prohibited Investments)** Certain products such as pork, alcohol or weapons, and certain activities such as gambling, etc. may not be invested in.

With respect to investments where such products or activities are only adjacent to the main product or activity (e.g. the sale of alcoholic beverages in a hotel and leisure complex), it is disputed amongst Islamic scholars whether such investments are in compliance with the *Sharia*.

**Rebh (Profit)** Any profit realized must be the result of commercial risks assumed by the investor in the context of a specific transaction or business; there cannot be any assured or guaranteed return on investment or profit.

Although *Sharia* compliant investments require the assumption of risk, it also allows – in order to provide protection against negligence, wilful wrongdoing or breach of contract – the taking of collateral security.

**Gharar (Uncertainty)** Contracts setting forth an uncertain or ambiguous subject matter, e.g. if it is unclear whether or not a particular event will occur (such as, for example, in a conventional insurance contract), do not comply with the principle of *Gharar*. As a consequence, the major terms and conditions, such as the price, subject matter or time of delivery, must be determined when concluding the corresponding agreement.

**Ithikar (Hoarding)** Since money is considered being a means of exchange and should not be treated as a commodity, hoarding money is inopportune.

## FINANCE STRUCTURES

### Partnership Structures

**Mudarabah** The *Mudarabah* is a partnership structure where one or several investors contribute funds and the other party (often a financial intermediary), the so-called *Mudarib*, contributes investment management services to the partnership. Alternatively, a financial institution may collect funds of its customers and forward them on behalf of its customers to the *Mudarib*. In such structure, the financial institution acts as trustee for its customers and assumes the obligation to take all measures necessary to safeguard their interests.

The *Mudarib* invests the funds contributed by the investors in compliance with the *Sharia* and the investment memorandum. While the investment memorandum may provide for guidelines to which the *Mudarib* is required to adhere to, certain transactions are *per se* forbidden to the *Mudarib* and require the explicit consent of the investors.

Usually, the *Mudarib* receives a fee for its services. This fee may either be fixed or calculated in proportion to the profit generated. The net profit remaining after deduction of all fees is distributed among the investors in proportion to their contribution. However, there is no guarantee that a profit will be achieved or any of the funds invested will be returned.

**Musharaka** Other than with a *Mudarabah*, in a *Musharaka* structure (i) all partners contribute funds or other assets (but not only services) to the partnership, and (ii) all partners may, but are not required to, assume an executive position. Further, the profits generated (however, not the losses) may be allocated pursuant to a ratio different from the proportion of the funds invested.

*Musharaka* structures are often used for long-term investments such as the construction of infrastructure: The customer contributes certain assets (e.g. real estate) and is appointed manager and a financial institution (or a syndicate of financial institutions) contributes the funds required for the financing of the construction.

*Musharaka* structures may be deployed in different forms such as the Diminishing *Musharaka* (*Musharaka munthaia bi Tamaluk*) or the Limited Permanent *Musharaka*. In a Diminishing *Musharaka* specific mechanisms allow the financial institution, which contributed the funds, to reduce its participation in the partnership continuously over time and to ultimately transfer ownership in the assets to the other partners. A Limited Permanent *Musharaka* is a structure which has been established for a non-defined period of time and will be continued as long as the partners wish it to continue. It is often used for long term investments.

Alike the *Mudarabah*, the manager may charge a fee for services rendered. It should be noted, however, that such fee, if any, is rather small if the customer is appointed manager.

## Sale and Purchase Structures

**Murabaha** *Murabaha* structures are widely used for trade financing and, generally spoken, are based on the cost-plus principle.

In a *Murabaha* a financial institution, instead of lending money, acquires upon request of one of its customers a specified asset (equipment or commodity, etc.) and – directly or indirectly – takes title to it. In a second step, the financial institution sells the asset and transfers title to its customer at a price which equals the cost of the asset and an agreed upon margin. The payment of the purchase price may be deferred and/or paid in installments, and the financial institution may take collateral security to ensure proper fulfilment of the contract.

By acquiring title to the asset, the financial institution assumes commercial risks for reason of which it is entitled to profit (i.e. the aforementioned margin).

*Murabaha* transactions may, as in conventional finance, be syndicated among several financial institutions. The relationship between the syndicate members does not form part of the *Murabaha* but is structured as a (separate) *Mudarabah* (cf. above, PARTNERSHIP STRUCTURES). Contractual party to the *Murabaha* is only one of the syndicate members.

**Istisna'a** *Istisna'a* is a form of financing similar to the *Murabaha*.

Deployed for agricultural purposes in earlier days, it is used today for the (advance) financing of the construction of industrial or infrastructure facilities, or of large components thereof. Hence, while a *Murabaha* is used to finance the purchase of a specific asset, an *Istisna'a* serves the purpose of financing the construction of a particular asset.

For reason of the financing of the construction, the financial institution acquires title to such facility or component (and assumes commercial risk). It then makes available to the customer the facility or component either by transferring title to the customer against payment of the purchase price (cf. above, *MURABAHA*) or based upon a leasing structure (cf. below, *LEASING STRUCTURES*).

**Tawarruq** This structure is also called *Reverse-Murabaha*.

A financial institution purchases an asset from a third party and sells and transfers it, on a deferred payment basis, to its customer. The customer immediately sells the asset to another third party for immediate delivery and payment.

As a result of such transaction, the customer receives immediately cash for the sale of the asset and has a deferred payment obligation towards the financial institution.

**Bai al Salam** A *Bai al Salam* structure may be characterized as advance payment of the (discounted) purchase price of an asset yet to be manufactured. Upon delivery (the date of which must be defined), the purchaser may (re-)sell it at the full purchase price and, thereby, realize a profit.

It is disputed among scholars (i) whether the asset must be available when signing the agreement or at the defined time of delivery, and (ii) what period of time must elapse between signing of the agreement and delivery of the asset.

## Leasing Structures

**Ijara** Under an *Ijara* structure (operating lease), a financial institution acquires a specified asset (e.g. based upon a *Murabaha* or *Istisna'a*) which it immediately leases to a customer for an agreed upon period of time at rental payments either predetermined, or determinable by reference to an underlying (e.g. LIBOR) plus an agreed upon margin.

Other than under the sale and purchase structures described above, the financial institution bears the ongoing commercial risks related to the leased asset during the entire term of the *Ijara*. Consequently, issues such as insurance and maintenance are within the responsibility of the financial institution (pursuant to principles of *Sharia*, the customer is required to pay rent only as long as he can use the leased asset and it is not destroyed or lost). Insurance matters often raise new problems as conventional insurance is problematic from a *Sharia* perspective (there is *Sharia* compliant insurance business, the so-called *Takaful*, which, however, today is only of minor importance).

In order to mitigate the risks related to such structure, often special purpose vehicles (**SPV**) are deployed to hold title in the assets and to lease them to the customer.

**Ijara wa-iqtina**

Based on an almost identical structure as an *Ijara*, this type of leasing structure provides for the customer's additional right to acquire ownership in the leased asset at the end of the contractual term.

For that purpose, the customer will make payments into an investment account the profit of which (i.e. the profit which is realized by investing these funds in *Sharia* compliant investments) is used to pay the purchase price.

## FINANCE PRODUCTS

**Bank Accounts** Alike conventional banks, Islamic financial institutions offer current accounts, investment accounts and savings accounts; however, for the reasons outlined above (cf. BASIC PRINCIPLES), they are different from the accounts conventional banks offer:

*Current Accounts:* Current accounts are no source of income for the customer and at all times must maintain liquidity at one hundred percent. The customer may withdraw funds without notice. If the financial institution deploys such funds for investments, it does so at its own risk and may retain any profit achieved.

*Investment Accounts:* Funds deposited on an investment account will be invested into Sharia compliant investments and any profits achieved or losses accrued are to be accounted for the customer directly. For reason of these investments, the customer may withdraw any amounts only upon notice. Typically, the financial institution charges a fee for its services.

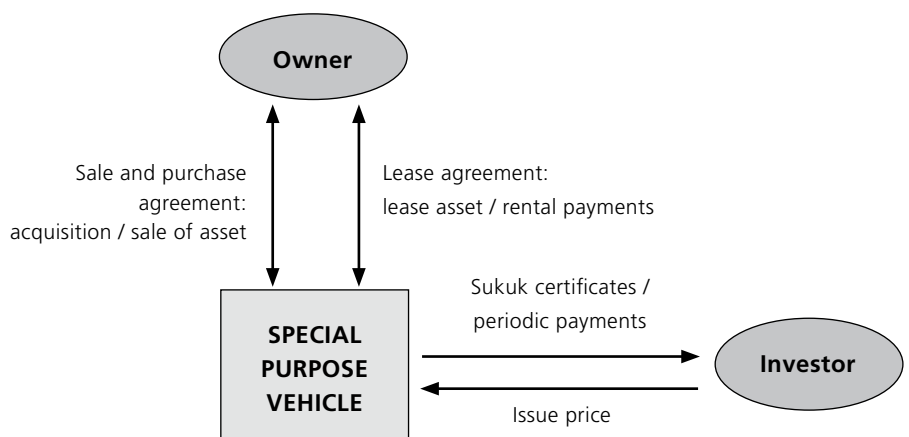
*Savings Accounts:* Finally, for reasons of the principle of *Riba* (cf. above, BASIC PRINCIPLES), savings accounts are non-interest bearing accounts. However, savings accounts benefit from the profits the financial institution has achieved throughout the year by deploying the funds deposited. Alike the investment account, the right of the customer to withdraw funds may be limited.

**Sukuk** *Sukuk* may be characterized as asset based bonds or notes that are structured on a back-to-back basis: The proceeds achieved through the issue and sale of the *Sukuk* certificates are used to purchase a predefined asset (wherein the holders of *Sukuk* certificates acquire an undivided ownership share). This asset will be made available to a third party in order to generate a flow of returns that allows making the payments to the investors in accordance with the *Sukuk* documentation. Hence, *Sukuk* structures are always combined with other *Sharia* compliant instruments such as *Ijara*, *Musharaka* or *Mudarabah* (cf. above, FINANCING STRUCTURES).

In a typical *Sukuk al Ijara* structure (cf. the structure chart below), an SPV issues certificates which are subscribed and paid for by investors. The net profits resulting from the sale of the certificates, in a first step, are used to purchase a specific asset from its owner (which usually is the sponsor behind the aforementioned SPV). In a second step, the asset is leased back to the former owner (for a period of time equal to the term of the *Sukuk*). Under the lease agreement entered into for that purpose, the former owner is required to remit rental payments that correspond to the payments of the SPV pursuant to the terms and conditions of the *Sukuk*. Finally, based upon a put option alike structure, the former owner is required to (re-)purchase the asset at the end of the contractual term, at a price that equals the principal amount of the *Sukuk*.

Since the holders of *Sukuk* certificates do not necessarily (and usually do not) have a claim over the asset, the credit rating of the *Sukuk* entirely depends on the credit-worthiness of the former owner.

Sukuk al Ijara:



If, instead of the purchase and lease of assets, new businesses or new projects shall be financed, *Sukuk* structures other than a *Sukuk al Ijara* must be used. Usually, for such purposes, *Sukuk al Musharaka* or *al Mudarabah* structures are implemented:

Alike for the *Sukuk al Ijara* an SPV is formed that issues certificates which may be subscribed for by investors. The net proceeds resulting from the issue are contributed by the SPV to the partnership and, depending on whether the other party to the partnership (which is usually identical to the sponsor behind the SPV) provides equity, other tangible assets or management skills only, the partnership is either structured as *Musharaka* or, in the latter case, as *Mudarabah* (cf. above, FINANCE STRUCTURES / PARTNERSHIP STRUCTURES).

### Collective Investment Schemes

Based on the partnership principles described above, *Sharia* compliant collective investment schemes may be set up. Usually, investment funds are structured as *Mudarabah*.

It should be noted, however, that the investments such collective investment scheme is intended to make must be in compliance with the basic principles of *Sharia* outlined above, i.e. in particular the principle of *Haram*.

**Structured Products**

Against the background of the principle of *Maisir* (cf. above, BASIC PRINCIPLES), the issue of *Sharia* compliant conventional structured products is difficult and many questions have not been answered yet.

One of the major difficulties is that structured products have to comply with the *Sharia* in three ways: (i) the underlying, (ii) the investment strategy or trading mechanism, respectively, and (iii) the structure itself must be in compliance with the *Sharia*. Many of the components used in conventional structured products cannot be used for *Sharia* compliant structured products.

In order to achieve a common understanding of *Sharia* compliant structured products, the International Swaps and Derivatives Association (ISDA) has analyzed the major principles of *Sharia* and drafted certain documents relating to *Sharia* compliant derivatives which are currently under discussion.

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