Exchanges and Islamic finance

Michael Saleh Gassner
Michael Gassner Consultancy Ltd

The peninsula region where the prophet Muhammad spent his life was well experienced in international trade. Commodities were sourced from as far away as China with partnerships being founded to execute such long distance trade. In Islam trade is encouraged, but exchanging money for money in a different amount is categorised as impermissible. This prohibition still influences the Islamic understanding of modern day banking interest as a grievous sin.

The Quran sura Al Baqara, verse 275, states that our creator allowed trade but prohibited *Riba*, which is typically translated as interest. While trade transactions allow for deferred payment and rent is permissible, the understanding of *Riba* is close to the differentiation between banking interest based on loans and economic interest charged for real capital. The latter could at least be structured in an Islamically acceptable way, though many scholars emphasise profit and loss sharing partnerships as a preferable financing alternative. A substantial cultural difference is apparent in the understanding of trade; in Europe, the gods for trade and thieves were the same: Mercury for the Romans, Hermes for the Greeks. In Islam, trade is recommended for Muslims, while lending money against money is a sin.

Where were goods exchanged in the Islamic history? We can still see the model today, in the old bazaars or suqs of Istanbul, Damascus, Cairo or Tunis and many other Middle Eastern cities. The spice bazaar contains all retailers of spices; household goods are in another area; clothes sellers congregate in yet another area. This clustering of traders is a typical and common phenomenon of market regulation throughout Islamic history – very much like modern day exchanges, they bring supply and demand to a single point in order to increase competition and achieve a proper equilibrium price. The understanding of this issue was remarkably advanced among Islamic jurists.

What else does Islamic finance focus on? Basically it condemns a number of industry sectors as unethical; to name but a few: alcohol, pork-related products, conventional banking and insurance, gambling, certain entertainment, pornography, and in general everything harmful to individuals or society. Above all mankind is understood to be simply the custodian of the achievements of the creator, and hence individuals should be careful in their usage of the wealth given to them. This principle leads to considerations familiar to the Socially Responsible Investment movement and to the concept of sustainability.

Wealth also results in an obligation towards the poor, called *Zakat*. This obligatory social tax, calculated as 2.5% of an individual's wealth, is one of the five pillars of Islam that each Muslim must uphold. At the same time *Zakat* leads to mobilisation of idle savings in investments, as non-invested money would decrease by 2.5% annually if there were no returns to cover this tax. This stimulation to avoid hoarding of resources and instead mobilise them in investment or consumption helps to avoid one of the causes of recessions, which is hoarding money fearing an economic downturn.

While trade is encouraged, gambling (*Maysir*) and excessive uncertainty in contracts (*Gharar*) are both prohibited. Additionally, forward contracts are considered impermissible on the basis of the rule 'do not sell what you do not own'. This prohibition has important implications for modern day exchange markets, especially regarding the use of derivatives by practising Muslims. In the remainder of this article we will review the issues involved regarding stock markets, commodity markets, and bond markets and derivative markets.

Stock markets

Although many will assume that stock markets in the Muslim world have to follow Islamic rules, this is not in fact the case. Only Sudan (around USD1.0bn annual turnover) and Iran (turnover ca. USD4.9bn in 2006) have stock markets defined as Islamic-only by state law. Other markets do not assess whether or not the stocks listed comply with the requirements of Islamic law; only modern commercial law is applied, partly influenced by both Islamic and Western concepts. In addition to the two stock markets mentioned only one other has opted to operate under Islamic rules supervised by an external independent Sharia Supervisory Board: the Dubai Financial Market, which is the stock exchange for the local shares of Dubai. (The newly established Dubai International Financial Exchange (DIFX) is a different entity and operates conventionally.) An Islamic exchange monitors its listed companies against the activities and debt criteria set by the Sharia Board. Those companies which do not comply with the rules can not be listed and traded. It may be expected that other exchanges will turn Islamic over the next couple of years, following the example of the Dubai Financial Market.

2006 turnover at selected exchanges

Exchange	Volume (shares)	Value (USD)
Sudan (Islamic)	7.6bn	1.0bn
Iran (Islamic)	10.9bn	4.9bn
Dubai Financial Market (Islamic)	39.6bn	67.4bn
Saudi Arabia (Conventional)	54.4bn	1,403.7bn
NYSE (Conventional)	588.1bn	21,789.5bn

What are the rules applied to identify a stock as Sharia-compliant or not? There are different opinions and ongoing debate. But the best known and most widely accepted rules are defined by the Sharia Supervisory Board of Dow Jones Islamic Market Indexes and laid out in their rulebook:

Industry Type: Excluded are companies that represent the following lines of business: alcohol, tobacco, pork-related products, financial services, defence/weapons and entertainment.

Financial Ratios: Excluded are companies whose:
- Total debt divided by trailing 12-month average market capitalisation is 33% or more.
- Cash plus interest-bearing securities divided by trailing 12-month average market capitalisation is 33% or more.
- Accounts receivables divided by 12-month average market capitalisation is 33% or more.

Articles

The rules are designed to exclude forbidden activities for Muslims, minimising the impact of interest received and paid, and avoiding the trading of debt. Unintended impermissible income should be forwarded to a charity – a matter of pragmatic compromise. There is no requirement that the companies are managed by Muslims, or are situated in Muslim countries. Interestingly, initial empirical analysis suggests that there is no cost for following ethical rules in terms of returns. Higher performance has even been observed at some times and the future will tell us whether this is significant – Enron, as a famous example, was screened out because of increasing debt levels. However, underperformance can of course occur when a prohibited sector like finance is doing well.

As Western stock markets are much larger they also provide the majority of the market capitalisation of the leading Dow Jones Islamic Market Index, which nevertheless increasingly includes areas not covered by other providers such as Malaysia and Sri Lanka. For major Western markets, Dow Jones has some competition as an Islamic index provider from FTSE and, in 2006, from Standard & Poors. As a matter of fact, the majority of Islamic funds will still be invested in Western markets, as the size and trading volume of Muslim stock markets is not yet well advanced. A number qualify as emerging markets, some as frontier markets, and many are much too small to accommodate with any substantial funds.

An ongoing debate among Muslims about all exchanges is whether speculation on them is permissible or not. Speculation in the Western meaning can be of two kinds: investing, with the aim of being a partner with the company invested in; and gambling, buying the same company for price differentials. In the latter case there is fierce debate as to when speculating on price differentials constitutes gambling and when it does not. Obviously a grey zone exists. The legal contract for buying and selling shares is always to be upheld and enforceable, but what about the intention, the major criterion at the day of judgement – is it about gambling or investing? If price bubbles go high there is often not much doubt left about the intention; the person who sells his house to fund his speculation is no longer a reasonable investor but a gambler.

Derivatives

A similar debate surrounds derivatives. Technically we have to differentiate two conventional derivative contracts:

- The forward purchase
- The right to buy or sell

The forward purchase is not considered to be permissible as it contravenes the general rule 'do not sell what you do not own', an established principle of Islamic jurisprudence. Therefore the normal contract for shorting shares is impermissible under Sharia rules.

Nor can the right to buy or sell be the subject of a valid contract. A similar right evolves if one party gives a unilateral promise for another to buy or sell, but, there is no compensation for it. This restriction is hindering Islamic financial institutions from participating in the deeper derivate markets in the Western world, even for transactions which have a real business concern as their motivation.

Nevertheless, contracts allowing the hedging of risk were known in Islamic law from the earliest times. *Salam* or *Salaf* is the name of one of these contracts, for a sale by description of a homogenous good. The delivery is postponed, but the price is paid today. It allows individuals to benefit from falling prices, for example by enabling a farmer to secure the future price of his harvest. A major condition is that delivery needs to be done even if the harvest is not as expected. The Hanbali school, prevalent in Saudi Arabia, allows an even more liberal stance, with *Arbun*, a downpayment with revocation option. While in a Salam contract full payment needs to be made today, *Arbun* allows the purchaser to pay only a part, the downpayment. If markets change the buyer can revoke the contract and leave the downpayment with the seller. With a high downpayment *Arbun* functions similarly to a *Salam* contract, while a small downpayment can be compared with either an American option, where execution can be done during the agreed-upon time, or with an European option, where execution could be done only at a given date. Among academics there is also a discussion as to whether master agreements (*Istijrar*) can be used to replicate barrier and Asian options. Last but not least, Deutsche Bank published an academic paper presenting their *Wa'd* structure, two promises functioning like a forward contract at a price referenced to any index. More and more hedging tools are being discussed, but at a very early stage. The International Islamic Financial Market in Bahrain works together with ISDA to define template contracts for Islamic quasi-derivatives.

Forex markets

Foreign exchange is restricted by Sharia by the rules of exchange of currencies (*Sarf*), requiring spot transactions. In addition, there is a widespread distrust regarding fiat/paper money among Muslims; some groups go as far as requesting a return to a gold standard. In early Islam six commodities were used as monies: gold, silver, wheat, barley, dates and salt – a multiple currency environment.

In the Gulf Cooperation Council countries (Saudi Arabia, Qatar, Kuwait, Bahrain, UAE, Oman) there is an intense debate about creating a single currency, like the euro in Europe. All individual currencies are currently pegged to the US dollar. This is likely to persist, although the high US dollar surplus from oil and the rising import costs from Europe and Asia do not represent a proper exchange rate any longer; a devaluation of the US dollar is getting more likely.

Forex hedging transactions for future dates are rather difficult to offer for an Islamic financial institution. A forward contract is not permissible. Likewise *Arbun* and *Salam* are not applicable. Hence, only a unilateral promise can form an instrument in some cases – but there is no compensation embedded in the first place.

Islamic bond markets

Conventional bonds are based on interest-bearing loans and consequently prohibited in Islamic finance. An alternative instrument which came into prominence over the last five years is called by its Arabic name '*Sukuk*'. A *Sukuk*, the plural of *Sakk* (the origin of the English word 'cheque'), is a certificate representing partial ownership in certain assets accepted by Sharia. A structure that has been popular for some time is based on a sale and leaseback with purchase undertaking. A company wishes to sell its headquarter and leases it back. A Special Purpose Vehicle collects the funds from the investors to buy the property. After the maturity date the purchase undertaking, a unilateral promise, is executed and the company buys the headquarter back at principal. During the rental period the cash flow consists of the rents paid to the landlord, in many cases benchmarked to LIBOR.

Sukuk are being listed in Bahrain, at the Dubai International Financial Exchange, Kuala Lumpur, Ireland, London and Luxembourg. Both London and Luxembourg recently increased their efforts to attract these listings; the UK even gave an assurance that *Sukuk* can be used by UK corporates with the same tax treatment as conventional bonds. In April 2007, a UK finance minister announced that the government was considering borrowing money via bonds that were Sharia-compliant.

Secondary market trading of *Sukuk* is increasing slowly and is still on a very low level. As bonds are mostly traded OTC and not on an exchange, some *Sukuk* desks have been set up; a major dealer is the Liquidity Management Centre in Bahrain.

Commodity markets

Commodity markets are strongly used for a transaction called *Tawarruq*. This is the purchase of a commodity on credit and the sale to a third party at spot for a lower price – two sales contracts replicating exactly a conventional loan. Treasuries of Islamic financial institutions in particular rely on this method to manage their assets and liabilities. The approach is highly disliked among academics and practitioners but Islamic finance still lacks an elegant solution to meet this necessity. So some scholars see an advantage in upholding a legal form, even if the substance is no different from an interest-bearing transaction. The commodity bought and sold for this large transactions is typically platinum or aluminium, any commodity considered permissible and not money in Sharia. The London Metal Exchange is a traditional harbour for this business, Tokyo looked into it, Malaysia is using palm oil, and scholars are starting to push Islamic financial institutions to use local traders rather than international exchanges.

Vision

Islamic finance and exchanges is a theme with many facets. And we will see an increasing relevance for the exchanges of the world as the market share of Islamic finance increases steadily in the core markets of the Gulf and beyond. For commodity trades, the relevance of local traders will increase; for investments a move towards China and India is ongoing, following the demand for oil; and at least some Islamic-only exchanges will be built to serve the pious Muslim's financial needs and contribute to the wider economic development of Muslim societies.

Michael Gassner can be contacted at gassner@islamicfinance.de or via www.islamicwealthmanagement.com.