

## 5

Derivative-Like Sales: *Salam*, *Istisna'*, and *'Urbun*

As we indicated in the previous chapter, existence of some property as the object of sale is generally a condition for contract validity. However, there are two notable exceptions that allow sales of nonexistent objects. The first is an ancient contract that predates Islam, called *salam* in the Hijaz area of western Arabia, wherein the Prophet lived, and *salaf* in Iraq, both terms meaning “prepayment.” This contract was primarily used for financing agricultural production and was legalized by the Prophetic traditions cited below. A similar contract, called *istisna'*, meaning “commission to manufacture,” was legalized in later centuries, likewise to assist financing of nonagricultural (e.g., manufacturing) production.

In recent years Islamic financial practitioners have adapted the classical forms of *salam* and *istisna'* and combined them with other transactions to generate approximations of conventional financial transactions, including interest-bearing loans, interest-bearing bills and bonds, build-operate-transfer and build-operate-own infrastructure and other project financing, etc. We start this chapter by reviewing the classical rules on *salam* and *istisna'* and the innovative uses of those contracts that have been approved in recent years (not entirely without controversy) by various juristic bodies.

### 5.1 Prepaid Forward Sale (*Salam*)

All six major compilers of Prophetic tradition narrated on the authority of Ibn 'Abbas that when the Prophet migrated to Madina (formerly known as the city of Yathrib), he found its inhabitants engaging in one-to-three-year forward sales of fruits, with prices being prepaid at contract inception (which gives *salam* = “prepayment sale” its name). He then narrated that the Prophet said, “Whosoever engages in a *salam* contract, let him specify a volume or weight for the object of sale, and a definitive term of deferment.” Thus, jurists of all schools considered the forward sale of fungible commodities (measured by weight, volume, length/size,

or number of homogeneous units), with full prepayment of the price, to be a valid contract. As in all forward and futures contracts, jurists stipulated that the object of sale should be specified in genus, type, and quality, as well as quantity, however measured. In this regard, they agreed that the *salam* contract constituted an exception to the general prohibition of sale of nonexistent properties, as well as the prohibition of sale of properties that are not in the seller's possession at the time of sale.<sup>1</sup>

Classical jurists recognized the economic need for this contract primarily to allow farmers access to capital (price of *salam*), with which they can buy seeds, fertilizer, and other materials to grow their crops. However, they also recognized that the contract includes an element of speculation, since the *salam* seller benefits if the spot price at delivery time is lower, and the buyer benefits if it is higher. They also recognized that *salam* includes price discounting for time, that is, an element of interest, since the prepaid *salam* price will be generally lower than the expected spot price at time of delivery. This recognition prompted classical jurists to stipulate numerous conditions on *salam* contracts, to minimize elements of *gharar* and eliminate elements of *riba* therein.

In their efforts to avoid the abuse of *salam* contracts to synthesize *riba*-like transactions, classical jurists imposed strict conditions on delivery and settlement options for the *salam*-short (seller).<sup>2</sup> On the other hand, it is clear – as we shall argue later – that conditions on immediate or near-immediate delivery of the price, which distinguish *salam* contracts from contemporary forwards, are rendered immaterial if the *salam*-long can simultaneously obtain a credit line (e.g., through *tawarruq* or *murabaha*) for the present value of the desired forward price. Hence, we shall focus on the delivery restrictions, which are generally observed today and which have given rise to legal stratagems such as parallel *salam*.

#### *Revocation and Settlement of Long Position*

If the *salam*-long wishes to take part in a *salam* contract for purely financial purposes, without intent of taking delivery of the *salam* object, he can theoretically attempt to achieve his goal in one of two simple ways: (1) settle the position with the *salam*-short in cash or some other commodity (based on spot prices on the delivery date, or some other formula), or (2) sell the *salam*-long position to a third party, which is tantamount to selling the *salam* object prior to receiving it. In their efforts to restrict *salam* contracts to genuinely needed economic activities, such as the original financing of agricultural production, premodern jurists generally forbade both avenues. However, as we shall see in the next two sections, contemporary jurists have utilized some minority opinions, as well as the permissibility of debt transfers for *salam* objects, to synthesize purely monetary financial transactions from the *salam* contract.

A third way to settle a *salam* financially would be to revoke the contract shortly before delivery, whereby the *salam*-long may accept a different price from the one he paid (reflecting the difference between the prepaid price and spot price at time of revocation, known by the Arabic name *iqala*). However, although revocation of *salam* sales is permissible, jurists did not allow settlement in cash either directly or through revocation. In that context, classical jurists, starting with Abu Hanifa and his associates Abu Yusuf and Al-Shaybani, relied on a Prophetic tradition: “Whosoever engages in a *salam* contract, let him not take any replacement for the contract’s specified price or object.”<sup>3</sup> This Prophetic tradition disallows the long from accepting a replacement for the object of *salam* (e.g., financial equivalent at spot price) or from revoking the contract and receiving a replacement for the price refund reflecting that financial equivalent at spot price. In other words, this canonical text appears directly to address the remaining ways in which financial engineers might try to convert the *salam* contract into a purely financial tool.

However, a minority opinion in the Maliki school allowed sale of the object of *salam* prior to its receipt, provided that the object was not foodstuffs. In this regard, if the object is sold to the original *salam*-short, they allowed the sale subject to the condition that the price does not exceed the initial prepaid price. Indeed, in that case, one could characterize the second sale as a partial revocation of the original sale (which is generally not accepted in the Maliki school, but accepted in other schools),<sup>4</sup> together with an exoneration of the *salam*-short’s remaining liability.<sup>5</sup> Moreover, the Malikis permitted sale of the *salam* object prior to its receipt to a third party at any price, provided that the price is paid in a different genus, and the *salam* object was not a foodstuff. Those opinions also meant that Malikis allowed settling the long position with the *salam*-short for an equal or smaller amount.<sup>6</sup>

### *Parallel Salam*

Since the Maliki school of jurisprudence does not have a significant following in the areas where Islamic finance has witnessed its greatest growth, selling *salam* objects to third parties was not the first method contemplated to utilize *salam* as a pure financial tool. However, bankers and jurists found another juristic opening for such utilization based on characterization of the *salam*-short position as debt for the fungible *salam* object. Once it is characterized as debt for fungibles, the short position may thus be forwarded to a third party, possibly within the context of mutual debt clearance (*maqassa*). The most practical procedure devised along those lines by Islamic bankers came to be known as “parallel *salam*.”

This structure has allowed banks to use *salam* contracts to synthesize debts with fixed or variable interest rates as follows: Party A wishes to borrow \$1,000,000 for

three months at LIBOR + 200 basis points, and party B is willing to lend him at that rate. Party A may take a short position to sell platinum, deliverable in six months to party B at a specified location, collecting the prepaid *salam* price of \$1,000,000. Three months later, the two parties may engage in a second and opposite *salam* contract, usually through a third-party intermediary to ensure separation from the initial contract (as we have described in the case of *tawarruq*), for delivery of the same amount of platinum at the same location, with the prepaid price being  $\$1,000,000 \times (1 + \text{LIBOR} + 0.02)$ . Then both parties have liabilities toward one another for delivery of the same amount of platinum at the same location, and the two liabilities may be canceled against one another according to the rules of debt clearance (*maqassa*).

There are two main contemporary *fatawa* that pertain to this practice of parallel *salam*.<sup>7</sup> Notice the wording of requests for *fatwa* in the two cases. The questioner in the first *fatwa* asked directly about the permissibility of using this particular financial transaction (parallel *salam*) essentially as an institutionalized method for conventional banking practice. In this case, jurists ruled that, in fact, while the practice was permissible on an individual basis in their opinion, it is not permissible to turn it into a business mode. However, that prohibition was promptly diluted by the following appeal to considerations of competitiveness tantamount to necessity. Cleverly, the posers of the second *fatwa* question omitted asking about making the practice a business mode. Also, the jurists in that second *fatwa* conveniently did not go out of their way to rule on the issue of systematic use, about which they were not asked.<sup>8</sup>

The first *fatwa* that we quote on parallel *salam* was the second *fatwa* of the second Dalla Al-Baraka Symposium:

**Question:**

Is it permissible to sell the object of *salam* prior to its receipt?

If that is not allowed, is it permissible for the *salam*-long to take a *salam*-short position in the same genus, based on his long position, but without linking the two contracts for what he is eligible to receive and what he is responsible to deliver?

Is it permissible for the *salam*-long to make this a systematic trade?

**Answer:**

1. It is not permissible to sell the object of *salam* prior to its receipt.
2. However, it is permissible for the *salam*-long to take a *salam*-short position of the same genus, without tying the first *salam*-long position by virtue of the first contract to the *salam*-short liability of the second contract.
3. It is not permissible to use this type of transaction [which was allowed in the second paragraph of the answer] as a systematic mode of business. This is due to the fact

that *salam* was permitted as an exception to general legal rules, based on the needs of producers that can be met through *salam* in individual cases, without turning the latter into a systematic trade. On the other hand, if economic conditions in some Islamic countries, and major benefit considerations, dictate using this methodology as a systematic business mode in special cases, to minimize the effect of existing injustice, then it may be permitted based on that major benefit, as determined by *fatwa* and Shari'a supervisory boards.

The general prohibition of using this structure to synthesize interest-based debt instruments in paragraph (3) was diluted substantially in the last sentence of that paragraph. A second *fatwa* by the Shari'a Board of Al-Rajhi Investment Corporation (*fatwa* #41) indirectly appealed to that window of opportunity by invoking the need for Islamic banks to be competitive with their conventional counterparts in extending credit and being compensated accordingly. In the text of that Rajhi *fatwa*, given below, the questioners tried to be less specific about their intent, but the Shari'a board in fact addressed the issue of synthesizing conventional bank loans in this manner, by appealing to the aforementioned need:

**Question:**

Please inform us of the religious legal opinion regarding the Corporation's purchase of commodities (such as crude oil, various metals, etc.) through *salam* contracts, with the price being paid immediately, and delivery scheduled for a future date, knowing that the Corporation may sell that commodity through a *salam* contract, by receiving the price at the time of the [second] sale, with delivery scheduled for a future date.

**Answer:**

The main characteristic of the *salam* contract is that its object is a fungible liability measured by volume, weight, size, or numbers of homogeneous commodities, including agricultural products such as grains, oils, and milk, industrial products such as iron, cement, automobiles, and airplanes, and raw or semiprocessed materials such as crude and refined petroleum.

It is permissible for the *salam*-long (buyer) after the inception of the contract and prior to the delivery date to act as a *salam*-short (seller) for a similar commodity, with similar conditions to the existing contract, or with different conditions. As described, the *salam* contract is a highly efficient tool to meet the needs of an Islamic bank, recognizing that the main task of a bank is to extend credit, and its revenues rely primarily on the compensation it receives for time value.

...

Since dealings in credit markets of advanced countries require facing severe and critical competition, and since those countries provide a great deal of flexibility for competition, but put impediments for other tools of investment, this tool [*salam* contract] is considered a vital and important one to allow safe access to markets with flexible and wide competition, while providing protection against customary risks in those markets, such as political and inflation risks.

The Rajhi Shari'a board then proceeded to list five examples of using *salam* contracts to finance trading in a variety of commodities, in most cases emphasizing the real transaction aspect of *salam*. The Shari'a board also listed the generally accepted Hanbali position to be permission of pawning or use of mortgaged collateral (*rahn*) and guaranty (*kafala*) in lieu of liability for the *salam* objects.

Those provisions allow Islamic financiers to use *salam* contracts to synthesize interest-based debt. In fact, applications of *salam*, for example, by the government of Bahrain in issuing short-term bonds known as *sukuk al-salam*, cut more corners in settling the first *salam* for cash, as we shall see in Chapter 6. Those short-term debt instruments (similar to treasury bills) pay a declared interest rates, and they are backed by the full faith and credit of the issuing government. While those *salam*-based *sukuk* represented debt, and therefore were initially nontradable and meant to be held to maturity, repurchase facilities were recently announced to enhance liquidity management of Islamic banks that are the primary buyers of those instruments. Details on how this repurchase facility worked are not readily available, but it is clear how one could be constructed through the parallel *salam* vehicle described earlier.

### ***Conventional and Synthesized Forwards***

Classical jurists of all schools of jurisprudence forbade conventional forward contracts, wherein both price payment and delivery of sale object are stipulated as future liabilities.<sup>9</sup> The primary reason they gave for the prohibition is *gharar*, citing in particular ignorance about the state of the object of sale at the specified future date. Thus, they argued, the price to be paid in the future is known, but the future quality of the specified object of sale is unknown, which is a source of ignorance and uncertainty conducive to disputation. Recently Malaysian jurists, led by Dr. M. Hashim Kamali, have argued that legal and institutional advances, especially in organized futures exchanges, eliminate all excessive *gharar* from futures contracts by specifying in standardized contracts the characteristics of objects of sale, as well as compensation formulas for various delivery options given to the futures-short.<sup>10</sup> Consequently, they have allowed trading in Islamic futures, where the only Islamic constraints pertain to, for example, the objects of sale or margin trading rules.

In contrast, most jurists outside Malaysia remain opposed to forward and futures trading.<sup>11</sup> Some refer to the insistence of classical jurists of all schools that the price of *salam* must be paid in full at contract inception. Classical jurists argued that prepayment of the price (which gives *salam* its name) is the essence of permissibility of the contract, to give farmers access to capital with which to buy necessary inputs and sustain themselves until harvest. In addition, when the

price of *salam* is also fungible (e.g., monetary), those classical jurists argued that deferment of the price, while the object of *salam* is obviously deferred, would classify the transaction in an explicitly forbidden category of exchanging one deferred liability for another (called *bay' al-kali 'i bi-l-kali* ).<sup>12</sup> However, Malaysian and some other jurists questioned the authenticity of traditions forbidding this type of trade, many of them citing Al-Shafi'i's report that scholars of tradition considered its chain of narration weak. Nevertheless, most scholars continue to reject forward and futures trading, and many of them continue to quote that tradition as proof – especially those influenced by the Hanbali preference of traditions with weak chains of narration over any reasoning by analogy.

Thus, most jurists and Islamic finance practitioners outside of Malaysia ruled that deferment of the price alone (in credit or installment sale) is permissible, as is deferment of the object of sale alone (in *salam* sale), but deferment of both (conventional forward sale) is not permissible. This collection of rulings creates another Shari'a arbitrage opportunity for synthesizing forbidden conventional forward contracts from the *salam* and credit sale contracts that jurists permitted.

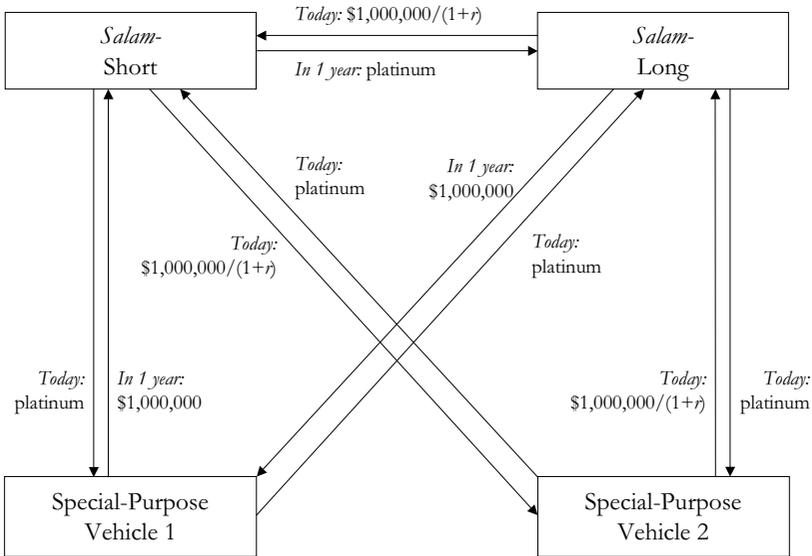


Fig. 5.1. Forward Synthesized from Salam and Credit Sales

Figure 5.1 illustrates one possible structure for synthesizing a forward contract from *salam* and a credit facility for its price (characterized variously as *murabaha*, *tawarruq*, etc., depending on banker and jurist preferences). The combination allows the *salam*-long to prepay the present value of the desired forward price.

For instance, if the desired contract was to pay \$1,000,000 in one year for some amount of platinum, one could always convert it into a *salam* contract by paying  $\$1,000,000/(1+r)$  at contract inception, where  $r$  is the appropriate interest rate. In this regard, the *salam*-short may extend a credit facility to the *salam*-long, perhaps using *tawarruq* with the same platinum serving as the underlying commodity, whereby the *salam*-long will obtain  $\$1,000,000/(1+r)$  today (with which to pay the *salam* price), for which he would have to pay the deferred price of \$1,000,000 in one year (at the time he originally desired to make that forward price payment).

The detailed procedure can be implemented as follows, utilizing two special-purpose vehicles, to ensure that no two parties ever engage in more than one trade of platinum with each other – thus minimizing concerns based on the prohibition of *'ina* sales:

1. *Salam*-short sells platinum to SPV1 on credit, for \$1,000,000 payable in one year. This is a standard credit sale transaction.
2. SPV1 sells platinum to *Salam*-long on credit, for \$1,000,000 payable in one year. This is also a standard credit sale transaction.
3. *Salam*-long sells platinum to SPV2, for a cash price of  $\$1,000,000/(1+r)$ . This is a standard spot sale.
4. SPV2 sells platinum to *Salam*-short for a price of  $\$1,000,000/(1+r)$ . This is also a standard spot sale.

The net result of steps 1–4 is a *tawarruq* facility whereby *Salam*-long receives  $\$1,000,000/(1+r)$  today (through SPV1) and owes *Salam*-short \$1,000,000 in one year (through SPV2). Finally,

5. *Salam*-long uses the  $\$1,000,000/(1+r)$  as a prepaid *salam* price, which he pays to *Salam*-short.

As a result of this *salam* contract, *Salam*-short owes *Salam*-long platinum deliverable in one year. In the meantime, *Salam*-long owes *Salam*-short \$1,000,000 to be paid in one year. This is the forward contract we wished to synthesize.

This structure ensures that each entity does one and only one transaction with each other entity, hence avoiding any problems with same-item sale-repurchase (*'ina*). This separation also allows the long and short to gain approval from Shari'a boards for all components separately, thus avoiding potential prejudice against synthesizing a forward position. Depending on the Shari'a board or boards of the short and long, transaction costs can be further reduced, according to the *tawarruq* conditions imposed by those boards, which determine transactions costs

of that component of our structure. In Chapter 10 we shall discuss the use of similar synthetic forwards to synthesize options, short positions, and the like.

It might appear that this proposed structure merely replicates classical forms of Islamic financial transactions, while adding no contribution to substance. Of course, based on the track record of Islamic finance, that would be the most likely utilization for this and similar contrived structures. In fact, however, the same “marking to market” logic utilized in Chapter 4 can ensure that the suggested structure – at least as a counterfactual that is not in fact implemented – adds substance. In this regard, arbitrage pricing of forwards, as taught in all finance textbooks, will force forward participants who contemplate using the *salam* contract to engage in a beneficial calculation. The arbitrage pricing logic for forwards proceeds as follows:

- Consider two portfolios: (1) a long forward contract plus the present value of the specified forward price (discounted at the riskless interest rate  $r$ ), and (2) a long position for goods to be delivered at the same future date specified in the forward contract.
- Notice that the second portfolio is precisely the liability on *Salam*-short toward *Salam*-long after full payment of the *salam* price at contract inception.
- Obviously, one can invest the present value of the forward price at the riskless rate (e.g., in treasury bills), thus converting the first portfolio into the second. In other words, if there are no other risks, the two portfolios must have equal values at delivery time.
- Since no risk is being taken between contract inception and delivery time, and since the two portfolios are equal in value at delivery time, they must also be equal in value at contract inception time. In other words, the *salam* price will be correct if and only if it is equal to the present value of the forward price: A higher *salam* price would unjustly favor the seller and vice versa.

Consequently, as we argued in the case of property purchase financing, the calculus imposed by our structure forces the parties through a “marking to market” exercise, which in turn ensures that trading will not take place at unfair prices. Needless to say, performing the calculations to ensure proper pricing does not require actually engaging in multiple inefficient trades. This structure may be used merely as a legal fiction to ensure proper pricing, without actually realizing the efficiency losses associated with multiple trades and corresponding transaction costs.

### 5.2 Commission to Manufacture (*Istisna'*)

Classical jurists approved another contract to purchase some item that is generally not owned by the seller at contract time, and that may never have existed prior to the contract. Under this contract, generally known as *istisna'* or commission to manufacture, the buyer (known as *mustasni'* or commissioner to manufacture) pays the price either in one or multiple installments, and a liability is established on the worker/seller (known as *sani'* or manufacturer) to deliver the object of sale as described in the contract at some future date.

Thus, *istisna'* shared with *salam* the function of financing the production of nonexistent items, which are established as liabilities on the sellers. However, *istisna'* differed from *salam* in a few main respects: First, jurists did not require price in *istisna'* to be fully paid at contract inception, to facilitate the financing of multistage manufacturing or construction projects, wherein the buyer may pay for each phase separately. Second, the term of deferment in *salam* is prespecified, and the seller must therefore acquire the object of sale at the specified delivery time on the spot market if he fails to produce it – prompting jurists to list a *salam* condition of general availability of the object of sale at delivery time. In contrast, the object of *istisna'* may never come into existence except by virtue of the *istisna'* contract. Hence, the term of deferment in *istisna'* need not be fixed at the inception of the contract.

Third, although the object of a *salam* sale is fungible (e.g., metals or grains), the object of an *istisna'* sale is typically nonfungible (e.g., a freeway or building). Fourth, *salam* contracts are binding on both parties and thus may be voided only by mutual consent. In contrast, *istisna'* contracts were deemed nonbinding on either party by early classical jurists. However, later jurists made the contract binding on both parties, and that opinion was codified in the Hanafi *Majalla* and adopted in the AAOIFI standard.<sup>13</sup> That standard also chose a minority opinion that requires the term of deferment in *istisna'* to be specified, provided that a mutually agreeable term is selected, allowing sufficient time for the necessary work to be done.

Some classical jurists debated whether the object of an *istisna'* contract is the object to be manufactured or the manufacturer's labor/effort. If the contract is merely the sale of an object to be delivered in the future, it would be no different from *salam*. Conversely, if the contract was merely over the manufacturer's labor, it would be an employment or hire contract, as discussed under the rules of *ijara* contracts in Chapter 6. Either characterization by itself would deem the contract impermissible based on analogy, since sales of nonexistent properties are generally forbidden (*salam* being an exception), and hiring contracts require that the employer must provide raw materials.<sup>14</sup>

Jurists of the various schools finally reached a compromise characterization of the contract, stipulating that the object of *istisna'* is the sold object, but that the contract requires the one commissioned to manufacture that object of sale to exert effort in its production. Moreover, contemporary jurists stipulated that if the contract did not require the commissioned party in *istisna'* to do the work himself, he may subcontract the work to another through a second *istisna'* contract. This practice of the commissioned agent engaging in a second *istisna'* contract came to be known as parallel *istisna'*. In parallel *istisna'* there is no direct liability on the final worker toward the initial commissioner/buyer, thus keeping the two contracts separate.<sup>15</sup>

The *istisna'* contract is most commonly used in conjunction with a lease (*ijara*) contract, thus giving rise to a BOT (build, operate, transfer) structure for financing infrastructure development and similar large projects. The Islamic Development Bank has been particularly active in utilizing this contract for financing infrastructure projects in various member countries. Because of the specific nature of this contract, it has not easily lent itself to pure financial applications, thus remaining a tool for real project financing. On the other hand, some advances in securitization have expanded its uses in synthesizing Islamic *sukuk*, as discussed in Chapter 6. In general, project finance structures based on *istisna'* differ very little from their conventional counterparts.

### 5.3 Down-Payment Sale ('*Urbun*)

In its classical manifestation, '*urbun* was a down payment from a potential buyer to a potential seller toward the purchase of a particular property.<sup>16</sup> If the buyer decided to complete the sale, the '*urbun* counted toward the total price. Otherwise, if the buyer did not execute the sale, he forfeited the down payment, which was thus considered a gift to the seller. Naturally, contemporary jurists and Islamic financial practitioners contemplated the similarity of this arrangement to a call option, which is likewise binding on the seller but not on the buyer. Indeed, some classical Hanbali jurists had even contemplated that the option period should be fixed (making the transaction somewhat similar to an American call option), otherwise the seller may have to wait indefinitely for the potential buyer to decide whether or not to exercise his right.<sup>17</sup>

Classical jurists differed over the legal status of this contract, most of them forbidding it based on a Prophetic tradition (which referred to the transaction under the name *bay' al-'urban*). Although that tradition was deemed nonauthoritative, because of missing links in its chain of narration, most classical jurists still deemed the contract forbidden, because of *gharar*, since the seller does not know whether or not the buyer will conclude the sale. Moreover, they argued, the potential seller

gives the potential buyer in this contract an option (in contemporary parlance: a call option), but if the buyer proceeds to exercise that option, the down payment counts toward the price, and the seller would thus not have been compensated for the option.<sup>18</sup>

This argument is particularly interesting, since classical jurists (and most contemporary ones) forbid the sale of naked options (because of *gharar*, according to the same logic as before), and since most of them do not consider mere legal rights (e.g., to exercise an option) to be valid objects of sale. However, those same classical jurists clearly felt that an embedded option (as in the case of *'urbun*) should be properly compensated. It is in this regard that they ruled that the seller is compensated only if the buyer did not exercise his right, and even that may not be sufficient compensation for the time he had to wait, during which he was not able to sell the property and benefit from its price.

In contrast to the majority of jurists of his time, Ahmad ibn Hanbal deemed the practice of down-payment sales permissible. He relied on a Prophetic tradition: "The Messenger of God was asked about down-payment sale (*al-'urban*), and permitted it."<sup>19</sup> Interestingly, scholars of tradition consider this also a tradition with a weak chain of narration. However, this narration was further supported by another weak narration that 'Umar ibn Al-Khattab allowed down payment toward the purchase of a jailhouse. Moreover, classical Hanbali and contemporary jurists of most schools argued that down-payment sales had become very common and provided some compensation to the seller for waiting, in case the buyer decides not to execute the sale. Moreover, contemporary jurists argued, there are weak Prophetic traditions that provide support either for permission or for prohibition. Hence, the Fiqh Academy of the Organization of Islamic Conference (the most prestigious international juristic body) ruled at its eighth session in Brunei in 1993 that down-payment sales are permissible.

### *'Urbun as Call Option*

Most analysts of the differences between the down-payment sale (*'urbun*) and contemporary call options concluded that the latter cannot be synthesized from the former.<sup>20</sup> On the other hand, a number of institutions have been in fact using call options under the name *'urbun*, ignoring some of the finer legal differences between the two contracts. For instance, if a seller wishes to write (sell) a call option to a potential buyer, giving him the right to buy within the specified time window at a strike price of \$100, and sell that call option to the potential buyer for \$*c*, one may call \$*c* a "down payment" and inflate the agreed-upon price in the down-payment sale to \$100+*c*. Thus, if the option holder decides not to exercise the option, he would have paid the premium \$*c*, and if he does exercise

it, he would buy at the desired price of  $\$100 + c - c$  (the down payment counting toward the price) =  $\$100$ . Thus, the juristic and legal differences between the classical '*urbun* contract and the contemporary call options are ignored, and the latter is used under the Arabic name of the former.

*Case Study 1: Al-Abli International Secured Fund*

In 2000 National Commercial Bank (NCB of Saudi Arabia) launched a protected-principal fund that utilized sophisticated derivative strategies without explicitly trading in options.<sup>21</sup> The declared goal of the fund was to generate capital gains at various participation rates (e.g., 37.5 percent of underlying index, capped at 11 percent, depending on subscription dates) in a weighted basket of global equities that met certain "Shari'a-compliance" criteria (we shall discuss mutual fund screens in Chapter 7). The main marketing feature of the fund was its principal protection (albeit without guarantee from NCB, to avoid giving returns while guaranteeing the principal, which would be deemed *riba* by most jurists).

The fund generated the desired return profile as a two-year process. In the first year, investors received fixed returns from a closed-end *murabaha* fund (see Chapter 6 for further discussion of *murabaha* securitization). In this structure the investor was exposed only to credit risk, but the provider did not directly guarantee the principal. In the second year, the provider kept roughly 95 percent of the original capital in the *murabaha* fund, thus continuing to protect the principal. The remaining 5 percent of the original capital plus profits from the first year were invested in call options, characterized as '*urbun*, as described above. Of course, if the index declined in value, the call options were not exercised. If it increased in value, investors received a gross return equal to the maximum of return based on the promised participation, and the cap rate for their particular subscription date.<sup>22</sup>

An investment bank was selected as an advisor, which managed the indexed portfolio of stocks and structured the product. That advisor was paid a "performance fee" equal to the actual returns on the portfolio above the cap rate. In other words, the advisor's fee was in fact a call option at the appropriate participation rate, with a strike price equal to the index value at the beginning of the year plus cap profits. Of course, the advisor (a conventional investment bank) would turn around and sell that call option to collect a flat fee (shown in the left panel of Figure 5.2). Hence, ignoring NCB's own management fee (then set at 1.5 percent of gross assets), payoffs to fund investors looked like a classical "bullish spread," with principal protected at 100 percent, and participation rate of 37.5 percent in index capital gains, capped at 11 percent (shown in the right panel of Figure 5.2).

A classical bullish spread could normally be structured by buying a call at the desired protection level and selling a call at the cap level. In this case, the long

call position at the low end was manufactured through (1) *murabaha* investment for one year, and (2) using the profits from the first year and anticipated profits from the second year to buy call options in the form of '*urbun* (down-payment) purchase of the participation position. The short call position would have been

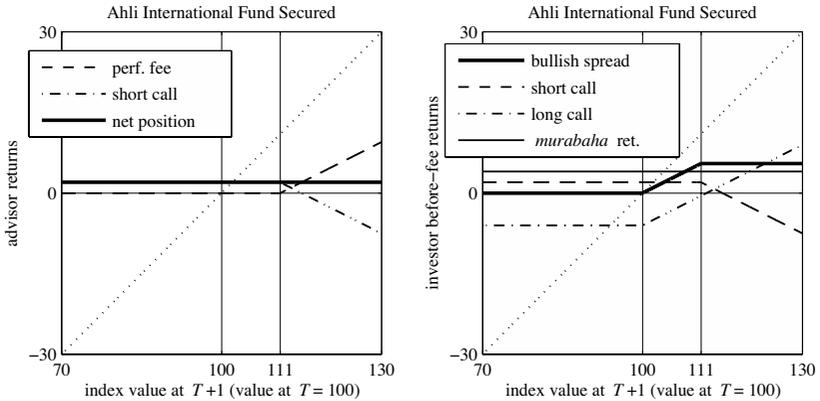


Fig. 5.2. Al-Ahli Secured Fund Returns

more difficult to manufacture, since the investors would own the index participation only if they recognize capital gains and exercise their option. In other words, investors do not own the participation position (even in constructed form) at contract time and thus could not write a call option in the form of down-payment sale of that which they do not own. By constructing the short call position as a gift to the "advisor," the latter can sell the long call he receives thus (to collect his fees), without the Islamic financial provider itself engaging in options trading, which has not (yet) been approved by the Fiqh Academy of the Organization of Islamic Conference or other widely respected juristic councils.

#### Case Study 2: Al-Rajhi Aman Fund

The direct use of '*urbun* was not necessary for obtaining principal protection. This is illustrated by contrasting the NCB protected fund structure with that of Al-Rajhi's Aman-1 Fund, which was introduced roughly at the same time. Instead of providing complete principal protection, Al-Rajhi chose to provide partial protection, thus alleviating investors' concerns about suspicion of *riba* without resorting to arguments regarding the difference between "guaranteed principal" and "protected principal." In this regard, Al-Rajhi's structure also employed payment with implicit options, which allowed a "partner" to trade those options without implicating the Islamic financial provider.<sup>23</sup> Naturally, the fund was structured

with a partner that was in fact an investment bank. The partner was assigned an unspecified share in the fund portfolio, without owning any shares in the actual mutual fund. Thus, that partner was not bound to adhere to Islamic principles as envisioned by Al-Rajhi's Shari'a board.

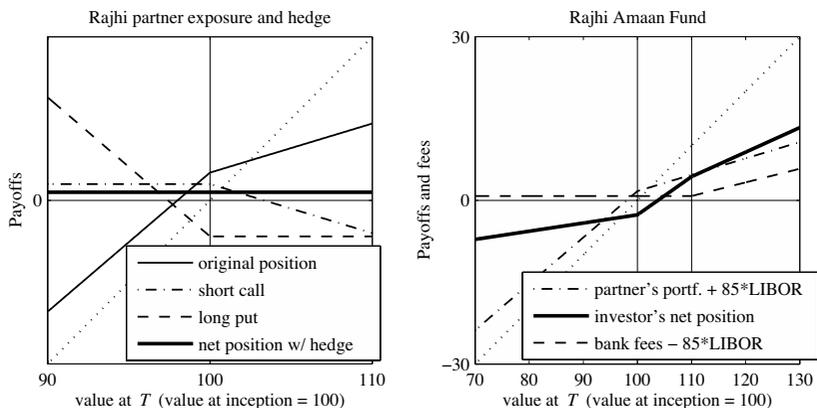


Fig. 5.3. Al-Rajhi Aman 1 Fund Returns

The partner bought 85 percent of the portfolio, at a deferred price equal to the market price at inception. In this way the partner was implicitly paid the interest on that 85 percent share. In return, the partner was entitled to 30 percent of profits, but bore 85 percent of potential losses. This obeys the Islamic rules of partnership (discussed in Chapter 7), whereby profits may be shared according to any agreed-upon percentages, but losses must be borne in proportion to invested capital. Of course, the partner (a conventional investment bank) converted the risky position (30 percent of gains and 85 percent of losses) into a flat fee by selling a call to give up the 30 percent gains, while buying a put to protect it against the 85 percent losses (left panel of Figure 5.3). In the meantime, investors in the fund had the benefit of substantially reduced loss rates without having directly to trade in options (right panel of Figure 5.3).

The use of advisors (in the case of NCB) and partners (in the case of Al-Rajhi) to insulate investors from options trading notwithstanding, Islamic investors have been largely restricted in using derivative-based strategies. In other words, those trading parties or investment advisors served as degrees of separation between the Islamic financial providers and forbidden derivatives trading. One could argue, on the one hand, that making conventional investment banks trade in derivatives in place of the Islamic providers makes economic sense, since those investment bankers have a decided comparative advantage in pricing derivatives and executing

trades. On the other hand, the addition of trading parties as buffers between Islamic financial institutions and transactions deemed to be forbidden (interest-based loans, option and future trading, etc.) must be seen fundamentally as a means of exploiting Shari'a arbitrage opportunities.