A Short Term Financial Instrument based on the Salam Contract.

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Introduction:

There are certain facts and realities in our modern life that need to be reckoned with from *Shariah* point of view. They may be too obvious to us today that we don't even think about them, but they represent a momentous departure, structurally and institutionally, from a few centuries ago one of these facts is the institutionalization of financial intermediation in the form of banks, organized capital and money markets which are so important in our contemporary economic life. Another is the fact that every country is a "nation-state" with a government. That people in that country look to their government as a source of many valuable goods and services, such as health, education and welfare as well as economic development. These "good things" need finance, the source of which can only be "the citizens" of today or tomorrow through intergenerational transfer.

Even if the government finances are well managed, or that she is privileged with steady source of income, disposing of her economic duties can rarely be done without resorting to borrowing, if only for "smoothing" the budget process.

A non-Islamic government will have no problem as it can always resort to interest-bearing credit. However, a government of the people who are keen to remain within the realms of *Shariah* needs an alternate. It is part of our faith that Islam is suitable for every time and every place, because it is the final message for all humanity. It is only because of lack of effort on our part that solutions are not found. The present papers explores the possibilities of the *Salam* contract for designing a financial instrument for government short term finance.

Furthermore, money market instruments are very important for the efficient operation of any banking system. This because it provides a means to invest banks short term liquidity in an instrument that is liquid, profitable, and with tolerable degree of riskness. Excess liquidity then can find Islamically acceptable investment opportunities.

What is *Salam*?

Salam is a sale contract. Unlike standard sale contracts, the price is paid at the time of contracting while the sold goods are delivered at a future

date. *Salam* is therefore, a forward contract. However, its different from the commodity forward contracts that are known in commodity markets.

Salam was known at the time of the prophet (PBUH). It was always looked at as a “means of finance." This is because farmers use it to procure the seeds and fertilizers by selling their future harvest at the time of planting. *Salam* based transactions, however, are not confined to wheat and barley and the rest of the agricultural products. Rather it can be used for any fungible[1] goods. This is because the seller in *Salam* is not allowed to sell a “particular” good or one from a “particular” source. He sells a “well-described” standard one.

Because it is intended to be a “mode of finance” not a means of speculation, it is a requirement, for validity of *Salam,* to pay the whole price at the time of contracting. *Salam*, though it had been neglected for too long by contemporary economists, offers, in our view a tremendous potential.

We believe that *Salam* can be piloted into a *Shariah* substitute for conventional debt instruments.

There is no shortage in modern Islamic finance for modes that are based on profit sharing. Nor that procurement of goods on differed payment basis is not allowed in the Islamic system. However, both classes of financing modes don't avail them selves to government(and the private sector's) short term needs for cash. This is because profit sharing based modes of finance are generally long term and, more importantly, tied to a specific uses of funds. Murabaha and *Istisna'a* are useful, but they remain procurement and project financing techniques. Our present proposal, on the other hand, opens possibilities for money-market, negotiable instrument that remarkably substitute treasury bills. Yet, it is designed to be in line with *Shariah* injunctions and within the boundaries of permissibility.

A *Salam* based financial Instrument:

When an Islamic government (or any economic agent) needs money to acquire goods, they can buy them through Murabaha. If they need funds to

build a road for example, they can use *Istisna'a* or Musharakah. But what if the government needs cash (to pay salaries, or buy services not goods),

and needs it now. The options available, so far, is borrowing from the public or the banking sector at interest. It is no accident that, while great advances had been made in the Islamization of the "private" financial transactions in many Muslim countries, very little has been done in the public sector. Almost all Islamic governments borrow on interest.

In the present paper we are trying to develop the *Salam* contract into achieving the purpose of performing the function of short term money market instrument.

This instrument we are suggesting can be structured as follows:

a) The government which needs for example 500 million dinar, can issue *Salam* certificates equaling that amount, with small denominations, say 100 dinar each.

b) Each certificate represent a *Salam* contract, the seller is the government and the buyer is the holder of that certificate who paid its nominal value.

c) Each certificate promises that at maturity, 90 days for example, the government will deliver to the holder a specified quantity (1/2 ton) of the underlying commodity, which is described fully on the back of the certificate[1], or in a prospectus.

d) Once the government receives the cash, (via a process similar to bond floating) it can use it for any purpose, including short term deficit financing.

e) At maturity, the government will be due to deliver the sold goods in kind. For this purpose the government will, certainly, buy from the open market and deliver to the certificate holder. If the government produces the underlying commodity it is not permissible to put a condition in the contract that the sold good will be from government production except in cases where a large number of production facilities are owned by the government.

Goods suitable for this instrument:

There is some restrictions in *Shariah*, on the kind of goods that can be an object of *Salam*. They can only be fungible-like commodities. This is what is called in *Shariah* “Mithly”.

A Mithly, is a good who is standardized into substitutable or identical units, and whose utility can only be derived through consumption or the changing of its basic form. It is the type of product which has no important characteristics that identify it as coming from a particular supplier. Wheat, rice, barley and other grains are of this type. Oil, iron, copper are also “mithlys”. A building, an aircraft, an automobile and power generator are not mithlys, and hence can not be subjects of *Salam*. However, electricity measured in kilowatt could be considered a mithly. Seats in air flights can also be mithly’s.

Payments of price in *Salam*:

Salam may look like regular forward contract. Forward contracts however represent agreements between buyers and sellers to deliver something in the future. No payment is made but only a settlement on the agreed date. However, *Salam* is not permissible without the full payment

of price at the time of contracting. Delay (over 3 days), partial payment or advances in the form of anything other than money (like letters of guarantee....etc.) but money casts the contract null and void from *Shariah* point of view.

In our example, as the government flouts these *Salam* certificates (each of which represents a *Salam* contract), it is a *Shariah* requirement that it receives immediately the face value of each certificate in cash. This is a plus point for this instrument.

Liquidity:

The above mentioned structure is within the "standard" *Salam* contract, i.e. one that almost all *Shariah* scholars will agree on. In that so called standard *Salam* contract, the purchased goods are not supposed to be sold before actual possesment at maturity. Prior to delivery, certificate holder is not allowed to dispose of his certificate by sale for this purports to selling the underlying commodity before actual possession. Certainly this renders our *Salam* instrument impracticable. This is because, liquidity is one of the most important aspect of short term investment, second only to

profitability. A money market instrument that is not negotiable will not be very useful.

Is it possible, from *Shariah* point of view, to introduce "negotiability" into the *Salam* certificate? This is our main contribution to the subject.

In other words allowing the certificate holder to sell his certificate before maturity? If this can be done it means that an investor will buy such certificate if he expect prices of the underlying commodity to he higher at maturity. But if his exceptions changes before that date he can unload his investment and dispose of his certificate. Furthermore, when an investor knows that resale is possible at any time before maturity through an organized market, more and more people will invest in this instrument and subscribe in this venture.

It is quite clear, from contractual point of view, that sale of *Salam* certificate, is actually a sale of the underlying good or commodity. This is because as one exchanges such certificates for money, he is actually giving the buyer the right to receive, at maturity, the specified amount of that good. Hence, negotiability, to be acceptable from *Shariah* point of view, needs a proof that *Shariah* does allow sale of the *Salam* goods

before this actual receipt. The standard jurisprudence rule is that such thing is not permissible. Never the less we present in an appendix to this paper that the Maliki school clearly stands opposite to this stand allowing such sale. This is the only deviation we are taking away from the standard model of *Salam* in *Shariah*.

Guidelines and Restrictions:

We have shown in the appendix that the sale of the *Salam* goods before actual receipt is permitted in the Maliki school. Furthermore, with introduction of the following conditions and guidelines, we are actually placing our model even with the span of permissibility which extends to more than just Maliki school. These guidelines are as follows:

1- That the *Salam* goods are not food or food stuffs, because this contradicts an authentic narration from the prophet (PBUH), which made it a requirement that food is only sold after being in the actual possession of the seller. Commodities other than food can be sold before actual possession. These commodities like iron, copper & petroleum.... etc.

2- That the government (or issuer in general) never buys-back, at profit (i.e. paying more than the face value of the certificate), *Salam* certificates. In our scheme of *Salam* certificates, the government is selling a commodity on *Salam* basis. It is required, therefore, to actually deliver, at maturity, the quantity of the sold good. Through-out the duration of the *Salam* contract, there is a lender-borrower relationship between the government and the holder of the certificate. If government buys back the certificate, this, from contractual stand point means that the government is actually selling its obligation (debt) to the creditor. This is not impermissible in *Shariah*. It is a *Shariah* requirement however that it is sold at par value (face value of the certificate) or at a lower value, but not at profit. It is possible, furthermore, for the government to liquidate its position through parallel *Salam* an idea which needs to be further investigated.

3- The government must be a bonafide *Salam* seller and does not deals only in monetary debts:

This means that the government must be ready to deliver the sold goods to all the holders of these certificates at maturity. This scheme must include stringent conditions and penalties on the

government if more certificates are issued than government's ability to deliver.

This may be the most important monetary difference between *Salam*
certificates and conventional Treasury bills i.e. having a self restraining mechanism that forbids the government from over issuance of these debt instrument. Certainly the government can always buy from the open market at maturity and deliver to holder. However, there has to be some automatic penalties if government over-issue these certificates. Operationlization of these checks is not easy, one possibility could be in form of automatic increase in the value of the certificate over and above the market price of the underlying asset. Without such mechanism, the government obligation will be inflated way beyond its ability to deliver which will make the whole scheme a failure since it will end-up a conventional debt instrument. Clearly our suggestion of penalty goes against the basic *Shariah* rule of *Salam*. It is not permitted that the seller, in case of failure to deliver, compensate the creditor for any thing above the nominal value. But if this is adopted, it will create an incentive on the part of government to always fail to

deliver. This penalty is essential to the successful operation of the scheme.

On the other hand, an amount over and above the nominal value is *riba*. To mitigate this two possible solution may be adopted:

- The amount, though is higher in value, is paid in different commodity but not in money. (see appendix 3).

- The amount over and above the nominal value is clearly distinguished and paid to a charity. It will not be very effective if this is done by the government. Hence the scheme should include mechanisms to effectively enforce this.

4- The commodities which are subject of this instrument ought to be internationally traded goods. This is not a *Shariah* requirement but it is a restriction introduced to make sure that no exploitation is exercised by any of the parties involved through manipulation of prices. This will not be difficult because the eligible goods for *Salam* contracts are only fungibles. The price of these goods is international by nature. Except in closed economics, the world

price of Oil, Steel, Aluminum imposes itself on the local markets. This will introduce the organizational aspect of the market and the flow of information about expected prices in the future which are very important in this regard.

(A) Holders appoint an agent to sell their goods:

Like any other money market, investors are interested in profit not in the actual delivery of the underlying commodities. Although this profit has, for *Shariah* purpose, to be generated from genuine commercial transaction via the purchase and resale of a commodity, there is nothing in *Shariah* that requires the buyer to, himself, exercise the sale of these goods. This scheme will be more successful and a whole lot more efficient, if a general agent is appointed to receive, on behalf of all or some holders of these certificates, delivery from the government and sell, for the benefit of these holders, in the open market at going prices. This agent may charge a percentage of the nominal value of each certificate. This agent (or agents) can also take care of channeling the amount which is due to charitable purposes which was mentioned in part above.

(B) *Salam* instrument can be a source for interest free loans:

We have shown above that it is permissible in *Shariah* to liquidate the *Salam* obligation by the seller (i.e. holder of the *Salam* certificate) at nominal (or lower) price. The government, therefore, can stand ready to buy back these certificates at face value anytime before or on the date of delivery. This is based on the concept of "iqalah". Time in *Salam* contracts is the ownership of the buyer. It is, therefore, not acceptable for the seller to ask the buyer for "iqalah", i.e. making an earlier cash settlement, for this means that time for which he paid a price will be lost. Holders of certificates can, therefore, redeem the nominal value of their certificates rather than sell at profit. The seller in *Salam* (the government) is not required, from *Shariah* point of view, to buy back when ever the creditor asks it to do so. Rather, it is only an option. Certainly this option will not be effective as long as an active market for these certificates exists. Except in the case where the certificate is traded in the market at lower than face value, holders will have no

incentive to sell back to government. For this reason it may be a good idea to make it a rule that government buys only at face value or market price which ever is lower.

(C) The *Salam* Instrument can be a "bench-mark" for an Islamic economy:

In any capital market or money market capital pricing cannot be effective unless you have a bench-mark. In conventional market's this bench mark is a riskless security such as government bonds or interbank money market. Such indexes cannot be used in an Islamic economy because they both are based on interest. Our *Salam* instrument can function on a bench-mark because it represent the closet thing to a riskless money market instrument. It is then quite possible that yield on the *Salam* instrument can be used as a substitute for LIBOR.

Difference's between *Salam* Certificate and Conventional Treasury bills:

Clearly our *Salam* has a lot of similarities with the standard short term debt instruments which are based on interest. These

similarities make *Salam* certificates a perfect substitute for that essential instrument of public finance. However, the difference's are abound. These differences draw the line of *Shariah* permissibility.

These can be summarized in the following:

- Treasury bills are purely monetary instruments creating a financial lender-borrower relationship. They imply a contract the subject of which is just money. The profit to the holder (return on investment) is based and related only to "time".

The subject of the contract, in *Salam* is a commodity not money. It is a buyer-seller relationship. The profit is generated through the fluctuations in price of the commodity which is subject to *Salam* and sale price is based on the expectations of the two parties about the future. Certainly, time is involved in the profit making which may make us think that this is nothing but a time-value-of-money type of transaction. Nevertheless, it is an established fact that *Shariah* eliminated that time value only in cases of purely monetary transactions[1].

This is clearly the fundamental difference between the two instruments. It is not difficult to note that most of the *Shariah* restrictions imposed on *Salam* transactions are there to protect against *Salam* becoming a purely monetary transaction[2].

Appendix

Shariah Aspects of the *Salam* Instrument:

The classical position of the majority of *Shariah* scholars is that sold goods in a *Salam* contract remains an obligation, similar to debt, until date of delivery when the debt is settled. Hence, these goods cannot be sold before they actually become in the possession of the buyer. If we apply this to our proposed instrument, then the liquidity feature, which is the most important of this instrument is no longer attainable.

Nevertheless, we have to look at this issue from 2 perspectives; one dealing with the general *Shariah* stand on possession as a requirement for resale of any purchased commodity. The other, is the special case of *Salam*, and the possibilities of sale of *Salam* goods prior to actual possession. Clearly the second issue is, a subset, or just a variant of the first one and usually treated so.

Resale before actual possession:

Shariah distinguishes ownership from possession. While in most other legal systems it is sufficient, for purpose of resale, that one establishes ownership, *Shariah* require that actual possession takes place before such action. Hence delivery of the sold items most take place before resale. While ownership, in *Shariah*, is established once the contract is concluded, establishing possession in the form that permits resale may not be simple. Let us firstly, discuss the grounds for this requirement and the nature of possession before we go into dealing with the relevance of such to our proposal.

8 hadiths on prohibition of sale before possession:

Prohibition of what is called in books of figh “Sale before possession” is, without doubt, the consensus of the majority of Islamic scholars. Possession is a requirement for the lawfulness of resale. However, this is where the consensus ends, because defining the meaning of possession turns to be very problematic.

While the basic idea of the prohibition finds its roots in 8 *hadiths*, which are always sighted as evidence for such stand, a careful look at these hadiths may reveal a lot of *insight:*

a) Only six of these are authentic to the point that they can be basis for prohibition[1]. Certainly six is too many. The problem, however, is that they are all stating the prohibition of sale before possession of food items no mention of other general merchandise are there. It has been narrated that Abdullah Ibn Abbas (RAA) says that he thought everything else is like food[2]. Not only that this is the view if Ibn Abbas and not the Prophet, but it also reveals that there was at the time of Ibn Abbas a debate about the generality of this ruling. It is a well known fact that "food" had been given in *Sharia* a special status. Many rulings are modified when the subject of the transaction is food[3]. One would be in clear violation of Hadith if the subject of resale is food stuffs. For the rest of the goods that can be subject of sale, there is always two views about the matter. Certainly the one the requires possession is stronger, but other elements considered this rather less formidable view gains strength. In the instrument we are proposing we specified in the guide lines that it don't involve food.

b) It is important to note that in the second sale of the *Salam* goods (Secondary market) goods are not sold for immediate delivery. They are sold for differed delivery. Certainly prohibition of sale of things not in one's possession do not include sale on differed delivery basis.

c) Like the majority of the *Shariah* rulings, the prohibition of sale before possession have explicit reasoning (illah). In the above case several suggestions are being advised by scholars. Like other rulings of *Shariah*, where ever that illa is not present, the ruling changed from prohibition to permissibility. This case is no exception. Clearly, if we compile all these probable *illas*, and made sure that non is present in the model we are proposing, it would be safe to say that the liquidity feature of the proposed instrument is not in disagreement with the basic rules of *Shariah*. Below, we will trace the main grounds for prohibiting sale before possession to show that non is pertinent to the proposals we are advancing.

Riba (usury)

Riba is a ground for the prohibition of sale of the *Salam* goods before their possession by the buyer. However, *riba* does not emerge in every case of sale before delivery. Rather, only if the purchased goods (which are a form of debt) are sold back to the seller (before possession) at a profit that riba occurs. Effectively, this will be similar to lending at interest, which is not permitted. In the model we are proposing, and the guidelines we are suggesting the sold goods are never sold back to the seller (government), hence no possibility of *riba* can exist.

<u>Gharar</u>

To be lawful from *Shariah* point of view, contracts must be based on certainty not uncertainty or Gharar. Gharar deals with contractual uncertainty not unknown factors in real life. This *Shariah* requirement is, by no means, an attempt to eliminate natural disasters and unforeseen events. Rather, it is a restriction designed to prohibit people from engaging in gambling-like transactions where the outcome of the contract is just a chance. Sale before possession (and the sub set of sale of the *Salam* goods before possession) can involve, in certain cases, gharar. It is an established *Shariah* rule that whenever gharar is present in an

exchange contract, that contract becomes null and void. Nevertheless, the case at hand is different. We will present below the main cases to show that our proposal is not vulnerable to such likelihood.

a) The gharar eminating from rescindment of the first contract due to the annihilation of the sold goods:

If goods are sold before possession and delivery then they were delivered then sale before delivery will not have much effect on the size of gharar in this contract. But what if these goods, were destroyed before such delivery can take place?. Not only that first contract is void but also the first one is. In such case scholars thought that sale before possession is not permissible. In cases where such eventuality is not likely, such as sale contract involving real estate, scholars, did allow such sale. In our proposal, certainly the fact that what is being sold is fungible, not a particular good, means that such destruction before delivery is just not possible.

b) The gharar eminating from denial of the first seller:

If there is a possibility that the first seller denies obligation and refuses to deliver because of such denial then gharar is present in the second sale contract, i.e. one done before actual possession. In this case sale before possession certainly leads to gharar that voids the contract. In our case, however, the deal is made with the government which has no incentive to deny its obligation. Furthermore, it is a well documented deal to the point that such possibility is most unlikely.

c) Gharar eminating from impossibility of delivery:

This is like the case of selling “a bird in the air”, or a “fish in the sea, or a camel that is a runaway......etc. In all these cases gharar is so sizable that the contract is void. But then these are gambling-type contracts. Certainly this is not relevant to our case.

d) Gharar eminating from ignorance of the buyer:

This is like selling what is in a locked box or at a price that is unknown at the time of contracting to one or both parties. Both cases are not relevant to our proposal.

From all of the above one can say that non of the normally cited cases of gharar are relevant to our proposal.

Making risk-free profit:

Profit without risk is one more aspect that may void an exchange contract. If the holder of the certificate sells at a profit before actual delivery, then he may be making profit from the good without carrying any risk, since the risk of the goods are borne by the original seller (government) up to the time of delivery to the second buyer. Two points needs to be clarified here:

i- That to many scholars what really counts in as much as this point is concerned is that goods must be "deliverable" not actually delivered, ours is certainly is. Therefore, scholars permitted sale of ripe fruit on the trees although their risk is borne by the seller.

ii- To many scholars, such restriction is only for food stuffs not general merchandise. In our guidelines we have restricted the *Salam* instrument to only non-food items.