

ISLAMIC FINANCE FORUM

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Shari'ah issues to be discussed

Preferred Stock (Preference Shares)

The model of limited liability company is a contemporary one. Only in Britain and the U.S.A such model was known earlier than twentieth century. In many Muslim countries, company laws in which such model is promulgated goes back to no earlier than the 1940's. Because of this, *Shari'ah* research on the subject of limited liability companies is quite recent. The *fatwa* that it is permissible to establish a limited liability company and to float shares goes back to the 1950's. Shaikh Ali Al-Khafeef (Egypt) and Shaikh Mohamed bin Ibrahim (the late grand mufti of Saudi Arabia) are among the earliest writers on the subject. However, their rulings were quite general only touching on the basic idea of a limited liability company and share floatation. It is only in the 1980's when the Islamic Jurisprudence Academy of the OIC started an effort to define the issues and refine rulings related to this model of company, that issues such as preferred stock transpired.

The time-honored *Shari'ah* literature includes many forms of company, famous among which is the *Musharakah* (formerly *shirkat Al enan*) and the *Mudarabah*, *Mazarah* and *Musaqah*. The books of Islamic law are rich, meticulously covering all aspects of these forms of companies and the classical jurists established clear rules particularly on the contractual relationships between the parties to these companies. It is, therefore, quite natural that contemporary *Shari'ah* research on the subject of “company” tried to make an analogy between this limited liability entity and the known forms of partnership in *Shari'ah*, in an attempt to reach the appropriate resolution on these issues.

One of the major *Shari'ah* requirements for the permissibility of any form of company is what is called the continuity of the sharing of profit between partners. So if the contract forming such company contains any condition which may result in the discontinuation of such profit sharing, such company is not permissible. For example, in a contract of *Mudarabah*, if it includes a condition that says the first \$ 1000 of profit goes to the financier and the rest goes to the *mudarib*, such *Mudarabah* is void even if the expectation is that the *Mudarabah* will

makes thousands of dollars of profit. This is because the mere possibility that profit will all go to the financier and hence no sharing of profit will take place is enough to invalidate the contract. It is believed that such contract does not serve the purpose of fairness which is prominent in the *Shari'ah* requirements.

If we look at the concept of preferred stock, we find the same problem. A preference share pay a fixed rate of dividend (and is given priority over ordinary shares in receiving dividend), and will have first claim on remaining assets in the winding up of the company (after debt is discharged). Although share holders are partners (otherwise it can't be called a company), they are members in a company that may result in some of them receiving profit, others not, some may redeem his investment others may not. Such form of company is not acceptable from *Shari'ah* point of view. The Islamic jurisprudence Academy of the OIC, ruled that preferred stock is not permissible, due to the reasons mentioned above.

Nevertheless, we know that there are situations where a preference share arrangement makes a lot of sense. Can we reconcile?

Leasing

We all know the importance of leasing, both as a mode of finance and an investment potential, the legal and tax aspects, types of lease contracts and the cash flow consequence of lease as compared to borrowing. At this juncture we will concentrate on the Shari'ah aspects of the lease contract.

We are concerned in this exposition about aspects of lease that have Shari'ah consequence.

Two elements to consider : The first is to do with the lease contract, i.e. the contractual relationship between the owner of the leased assets (lessor) and the lessee. The second is to do with the structure through which securitized lease investment may be rendered.

The lease contract:

Leasing, from Shari'ah point of view, is a sale contract where the sold items are the usufructs generated the leased asset. Naturally only assets that can produce such usufructs can be leased. Furthermore, at the time of lease, the leased equipment must be the ownership of the lessor and should remain so for the duration of the contract.

The relationship between the lessor and the lessee should be just that, i.e. lease (not lender-borrower). This means that insurance on the asset itself is the responsibility of the owner as well as any structural maintenance. Routine and preventive maintenance will be borne by the lessee.

Rental payments should be fixed for the whole duration of the contract. If a periodical adjustment is needed, the contract should state very clearly that the two parties are free to rescind the contract.

It goes with saying that only equipment used for permissible purposes can be subject to any Shari'ah acceptable lease contract.

If it is the desire of the two parties to transfer the ownership of the leased assets at one point of time to the lessee, this should be done in a separate contract.

Structured securitized lease

A pool of leased assets can be securitized. In such case, investors may purchase units of the pool. As long as each unit represents actual ownership of an indivisible portion of the pool, such securitization is acceptable from Shari'ah point of view.

In this case the relationship between the investors and the lessee's represent a lease contract and should exhibit all the consequences of ownership of the leased asset. These units are not a stream of cash flow but carry rights and responsibility on both parties.

It is also possible for these units to be traded in the market and may also be rated for the benefit of the investors. This may require the establishment of an SPV (as a servicer) and a trust (as issuer of investment units).

As long as the relationship between the investors and the equipment users remains that of lessor and lessee, an SPV, Trust as well as the trading the units in the open market, will not have any consequence on the Shari'ah permissibility.

Unfortunately we can't say the same about issuing different classes of units. Only in the case where the classes are on the same footing Vs profit and recovering their original investment such classes may be acceptable.

Debt Securitization

In its basic form, securitization is simply the repackaging of cash flows into securities. These cash flows can be derived from diverse underlying assets. Securitization of debt and receivable is what is talked about in most cases. This is due to the fact that the majority of assets of financial institutions in the west, where the idea of securitization originated, is of that nature.

If we are talking about a bank, or an installment sale company, securitization would generally mean the repackaging of mortgages, consumer loans or credit card receivables into securities that can be negotiable, or at least transferable in an organized manner.

Shari'ah's Approach to sale of debt:

Certainly the conventional methods of sale of debt are not acceptable from *Shari'ah* point of view. This, however, does not mean that *Shari'ah* do not have its own mechanism of desposing of and sale of

debt. Debt in *Shari'ah* represent any “obligation” either monetary or chattel. To sell such debt, there are 2 sets of conditions, one consists of the general *Shari'ah* rules of contract. The second is exclusively for sale of debt :-

- a) The first set of conditions include requirements like being clear of *gharar*, that the debtor is willfully and knowingly accepts this sale and that creditor has no malicious intent in his sale of the debtetc.

- b) Monetary debt from *Shari'ah* perspective can either be sold for money or for goods i.e. denominating the price in monetary or in commodity terms. If that monetary debt is to be sold for money, then it cannot be sold for less or more than the nominal value of that debt. This means, that time value of money has to be ignored. If the price of the debt is made in goods or commodities, then the two parties can agree on any “price”.

c) That the transactions does not include exchange of differed obligations or what is called in *Shari'ah* the sale of debt for debt. Whether monetary or commodity, consideration is not allowed to be differed for further payment.

It is important, to come to grips with the rationale of this position. Clearly *Shari'ah* permits the exchange and sale of debt. It, however, prohibits that sale in cases where the transaction becomes no more than making money out of money. This is because in Islamic economy there is no break-up between real and monetary sector. Money is only a medium of exchange, therefore it is not allowed to become itself a means for generating profit. Clearly, the object (in the legal sense) of the transaction are these payable dues. On the other hand if one is talking about for example, a leasing company securitization might be structured in a way that transfers not only the cash flow but also ownership of the leased assets to the holder of the security with all the risks and rewards involved. From the point of view of the theory of contract (both *Shari'ah* & positive law), there is a difference between securitization of cash flows drawn from real assets and those derived from purely financial

ones. While differentiating between the two is not customary in conventional writing on securitization, doing so affords us a number of insights into the Islamically acceptable ways of securitization.

Options

Financial and Investment activities don't depend only on primary exchange contracts, but also on derivatives. A derivative is an instrument produced (derived) from an already existing contractual relationship. The most important derivative securities are options.

An option is a contract granting the right and not the obligation to purchase or sell an asset during a specified period of time at an agreed upon price. In contemporary financial transaction an option is itself a contract. Hence an investor can buy an option contract in the stock market. This means that he will pay a price to another party to acquire the "right" to buy or sell an asset in the future for a pre-set price. The party that receives the price will be "obliged" to either buy (in case of put option) or sell (in the case of a call option) at the request of that buyer. An investor will opt to buy an option contract whenever she has expectations about the future market of the asset in question which are not that of the other party. Through the purchase of an option contract

(i.e. right to buy or sell), an investor can benefit from his expectations, yet protect his investment from adverse outcomes if such expectations didn't materialize. The option contract is independent of the future purchase or sale of the underlying asset.

Shari'ah does allow for many kinds of options. Some of them are there to guard against injustice between the two parties. For instance, if the buyer discovers that the seller didn't reveal his true cost in a Murabaha transaction then he automatically will have an option to repeal the contract and has a right to receive back his money. He need not exercise this option if he is satisfied, still, with that price. But if he is not, the seller is obliged to return or compensation. The same thing will be true if buyer discovers damage in the purchased goods. But *Shari'ah* also provides for generic options, where one party can hold the contract in suspense for a specific and short period of time. Hence two parties may engage in a sale contract and then one of the two parties requests an "option" in that sale contract. In this case he will have the right to either go through with the sale or decides to walk-out of it. The other party will then be obliged to accept the decision of the buyer. Both "call" and "put"

option can be included in any exchange contract. However, the option itself can never be a separate contract. Therefore, that option will not be separately priced. This is a major departure for the standard option pricing model, which means no market for options can be created in an Islamic environment. As a rule, Shari'ah only permits tangible objects to be subject of exchange contracts. Pure rights and obligations can't be sold.

One of the contracts of sale that generated a lot of controversy because of its “optional” aspect is what called “sale of *arboon*”. This kind of sale is not permitted by all schools of jurisprudence in Islam. However, the *Hanbali* school does permit it, and most contemporary scholars will be inclined to this view. Sale of *arboon* is in fact a call option. In this type of contract the buyer pays only a small percentage of the price of the purchased good or asset, and holds the sale contract in suspense for a predetermined period of time. If he decides to complete the purchase, the balance will be paid to the seller. The interesting thing is that if he decides not to go ahead with the purchase, then the paid

portion of the price will be kept by the seller as a consideration for
giving him the option.