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Islamic electronic trading platform on organized exchange

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Abstract

Today Islamic finance industry is under severe criticism, particularly, concerning liquidity management practices of treasury departments. Since cash lending is not possible under Islamic *Shari'ah*, Islamic banks tend to use securitized asset related schemes which are by no means neither acceptable under Islamic finance jurisprudence nor compliant with *Maqasiq Al-Shari'ah*. *Maqasid Al-Shariah* oversees economic activities which produce wealth and prosperity for all members of society to empower any member with certain level of belongings to bestow freedom while condemning inequality. Under this wider aim of *Maqasid Al-Shari'ah*, this paper presents alternative state-of-art *Shari'ah* compliant products, which is used in international trade finance, to be migrated to electronic trading platform under organized exchange in pursuit of replacing controversial liquidity management products. Besides, this paper introduces Islamic Commodity Future Contract, derived from asset backed *Murabaha*, with physical delivery as an alternative liquidity management tool for Islamic FIs and hedging tool for companies.

JEL classification: G15; G29; G30

Keywords: Islamic finance; Islamic exchange; Islamic treasury practices; Islamic trade finance; Liquidity management; Islamic Commodity Future Contract

1. Introduction

Islamic finance industry has substantially grown since its early infant phase in 70s. Demographic boost and increased oil prices supported growth of Islamic finance industry alongside the economic growth of OIC countries. With increased complexity and products of conventional finance, Islamic banks, may be unnecessarily, felt to provide Islamic alternative of any product offered by conventional peers. Coupled with difficulty in liquidity management for treasury function, this put Islamic finance under some criticism. Islamic scholars evaluated several cases for treasury function and some of them from *Maqasid Al'Ahariah* point of view issued temporary *Fatwa* until *Shari'ah* compliant alternative found.[1] The most prominent case is *Tawarruq*, as Islamic FIs would have negative carry and fail in the long-term, some Islamic Scholar allowed *Tawarruq* for temporary base. However, not much solid work done to provide *Shari'ah* compliant alternative solutions. Once accept for short-term solution stayed as fine financial product. Today Islamic banks can be deemed in the course of conventional banks as they have some practices, which would literally convert Islamic banks to conventional.

Regardless of the criticism, traditional Islamic finance contracts: *Murabaha*, *Mudaraba*, *Musharaka*, *Ijara*, *Istisna* presents strong potential to serve *Maqasid Al-Shari'ah* with stronger credit management features as embedded in lending process itself. However, in some instances criticism on Islamic banks can not be very much substantiated. For example, Islamic banks are criticized on extensive reliance on *Murabaha* sale (Yousef, 2004). This critic very often ignores the nature of

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[1] *Al-Maqasid Al-Shari'ah*; as per Chapra Human Development and Well-Being to be realized by ensuring the enrichment of: *Nafs* (Human self), *Mal* (Wealth), *Nasl* (Posterity), *Aql* (Intellect) and *Din* (Faith).

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Islamic Finance. Islamic finance is reflection of real economy. If in an economy 90 percent of transaction relates to trade finance, then naturally 90 percent of contract used for trade finance shall be based on *Murabaha* while remaining shall be subject of project finance or *Sukuk*, hence, *Istisna* and *Ijara*. Besides, while putting Islamic FIs under the spot light one should also take decision making process of loan seekers who prefer *Murabaha* sale if the deal is profitable and less risky while criticizing Islamic FIs not engage in profit-loss-sharing, in case of less profitable and high risk deals. Most of the controversial discussion in Islamic finance today has more intricate than it appears.

In order to address the problem with strong underpinning, in the next section, controversial novelty in Islamic finance is to be introduced. Any new Islamic finance product should avoid these to have strong *Shari'ah* foundations.

2. Usual suspects

The evaluation of any Islamic finance product should start with:

1 Checking Compliance with *Maqasid Al-Shari'ah*.
2 Ensuring facilitation/financing real economic transaction.

Hence, one should start with benefit of the product for social welfare. In many instances, a product may comply with Islamic finance principle, yet, undermine *Maqasid Al-Shari'ah*: financing arms through *Murabaha* sale, piling household debt with seductive consumption loans and creating cash loan balloons not connected to real economy. Keeping this in mind, today most controversial contemporary Islamic finance products, such as *Sukuk*, treasury liquidity management products and hedging tools, developed based on three types of novelty:

2.1. Bai Al-Inah

Rosly and Sanusi (1999) identifies *Bai Al-Inah* as extensively used contract type employed for designing of, particularly, *Sukuk*. In its most basic form, it is a two party differed sale transaction. Loan seekers sells to the fund owner some object, gets cash and buys simultaneously back the same object, as-is without any change, for a greater amount to be paid in a future date. Majority of Islamic scholar finds *Bai Al-Inah* unacceptable since it is a circumvention for cash loan, hence, *Riba*.[2] The stance of Islamic scholar would not change even if buy back is not simultaneous end after an *Ijara*, from creditor to debtor, to finish automatically with transfer of ownership back to loan seeker/debtor. The gist is to focus on a real sale: two sales in chain among third party supplier of the product, loan seeker/debtor and financier/creditor. The third party supplier is missing in any cases, hence, causes a red flag. The evolved versions of basic *Bai Al-Inah* is akin to "Sale and Lease-back" structures, which is very often preferred by companies for taxation purposes, offered by conventional leasing companies.

2.2. Islamic discounting/factoring (Bai Al-Dayn)

> *"Those who consume interest cannot stand [on the Day of Resurrection] except as one stands who is being beaten by Satan into insanity. That is because they say, "Trade is [just] like interest." But Allah has permitted trade and has forbidden interest. So whoever has received an admonition from his Lord and desists may have what is past, and his affair rests with Allah. But whoever returns to [dealing in interest or usury] — those are the companions of the Fire; they will abide eternally therein"* (2:275)

Very often bill discounting or factoring is proposed as similar to *Murabaha* and hence *Shari'ah* compliant alternatives in trade finance. There are certain features of *Murabaha* which makes it a good omen for trade finance and protect economy from systematic risk created by conventional finance methods:

1 In case of *Murabaha*, fund disbursement is done to the account of supplier. This feature gives better credit risk assessment opportunity for banks and impede debtor to use funds for unproductive and/or speculative causes instead of real business.
2 At the date of disbursement, repayment date and sale price is determined. In case of delay in repayments, financier cannot accrue late payment charges to her account. Accordingly, financier should better evaluate credit worthiness of debtor and direct loans to credit worthy ones.
3 Since *Murabaha* finances/facilitate bono-fide transaction, it would less likely to give rise to credit bubble.

Islamic finance gets most closes to factoring or discounting in Export financing, yet, even in this case there is a serious difference: recourse to loan seekers. In Islamic export finance based on *Murabaha*, financier can not recourse to loan seeker (exporter) and needs to wait to be repaid back from importer, takes the risk of final buyer. In case of discounting/factoring financier can recourse to loan seeker (exporter).[3] With all these feature, unlike debt trading, Islamic finance would by no means loss its connection with real economy, hence, should not led to credit bubble.

2.3. Commodity Murabaha based on organized Tawarruq

Today most of Islamic banks' *Murabaha* syndications, inter-bank lending and hedging tools such as Islamic SWAPS are based on organized *Tawarruq*. *Tawarruq* became panacea for treasury department of Islamic FIs. The issue is widely discussed by Gundogdu (2014a) as Loan-seeker (Resource

[2] For more details on the issue, one may refer to work of Rosly and Sanusi (1999).

[3] Please refer to Gundogdu (2016) for more details.

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