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TAWARRUQ AND WA'D AS MAIN INGREDIENTS OF ISLAMIC STRUCTURED INVESTMENT: FOOD FOR THOUGHT

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ABSTRACT

This article discusses in detail one example of an Islamic structured investment product. The said product is used as an illustration to highlight some issues deemed critical in the development of the wider Islamic finance space. The author humbly submits that convoluted structures, quite common in contemporary Islamic finance, are generally not healthy for the industry and its stakeholders. Opacity in financial dealings not only increases the cost of doing business, it makes risk assessment and management that much more challenging, to both transacting parties and regulators. Some additional perspectives related to the polemic on the practice of *tawarruq* are also offered. Finally, some thoughts on the widespread usage of *wa'd* as a somewhat indispensable tool in structuring contemporary Islamic financial instruments as well as the attitude towards risk inherent in structured products vis-à-vis a reasoned Islamic risk-return paradigm are deliberated upon.

JEL Classification: G21, G23

Key words: Islamic structure investment, Islamic finance, *Tawarruq*, *Wa'd*

1. INTRODUCTION

In financial parlance, structured products refer to a category of financial asset which involves some degree of financial engineering in order to synthesize a risk/return payoff structure to suit a particular risk profile of investors. The use of derivatives is common in structured products although not necessary. Structured products are

typically offered by financial institutions such as banks and hedge funds to high net worth individuals, pension funds and institutional investors.

The somewhat unique characteristic of structured products is that they seek to combine investment in "safe" products that essentially offer capital protection with higher risk (and presumably, higher return) investments. For example, suppose an investor invests $100. A significantly larger portion, say $85, is invested in a highly rated bond, which will pay $100 at maturity. The remaining $15 is invested in riskier assets such as stock options, commodity futures or currency swaps with the hope of generating handsome returns.

The usual end-result of this strategy is that the investor has the comfort of capital protection whilst retaining the potential to earn superior returns. In a sense, structured products introduce a third dimension in the risk-return spectrum. Very risk-averse investors tend to put their money in capital-guaranteed, fixed-return instruments like bonds and government securities. These investments typically offer very low yields. At the other end of the spectrum, investors with a great appetite for risk would invest in stocks and derivatives. While these offer much greater potential returns, they also carry much higher risks. Structured products allow the investor to position himself somewhere in-between these two ends of the risk-return spectrum.

Note that theoretically an investor could accomplish the above strategy on his own simply via a risk-weighted asset allocation exercise. However, in reality transaction costs and minimum volume requirements (particularly for certain derivative instruments) may be impediments or prove to be prohibitively costly. As such, structured products were created to meet specific needs that cannot be met from standardized financial instruments available in the market.

It can be said that Islamic structured investments generally seek to emulate the economic characteristics of conventional structured products. The objective is to provide investors with the comfort of capital protection whilst at the same time enabling investors to partake in enjoying higher returns. The main difference is that it is accomplished in a manner deemed to be *Sharīʿah* compliant. This covers both the financial asset invested in as well as the contractual relationships employed to create the structured product offering.

In this case study, we dwell in the details of a specific Islamic structured investment product. Various key aspects and features of

the product are discussed including how the product is structured, risk perspectives and selected contractual terms. The intention here is not to be merely descriptive and/or to discriminately scrutinize one particular product offering, but rather to highlight some issues of contention, using this example of an Islamic structure investment product as illustration. For this reason, the identity of the product and the institution (an Islamic bank) offering it are withheld.

2. PRODUCT FEATURES

2.1 ISLAMIC CONTRACTS AND CONCEPTS EMPLOYED

Given that Islamic structured products generally seek to replicate their conventional counterpart, one would presume that two sets of Islamic nominate contracts would be employed to put together an Islamic structured product – one would be of fixed income nature, thereby providing some degree of capital protection (for example, *sukūk*), and the other would be of variable return promising good profit potential (for example, stocks or *muḍārabah* investment).

However, at least in the case of the Islamic structured investment product for this Islamic bank, which is the subject of this case, another approach was taken. The primary instruments used to construct the Islamic structured investment in this case are *murābaḥah* and *wa'd*. In essence, the bank in structuring this product makes a notable distinction between (i) formalizing the contractual relationship between itself and the investor, and (ii) channelling the funds raised from the product to income-generating assets. In other words, the investor does not earn returns from the *murābaḥah*. Rather, it would be from investments in say *sukūk*, equity investments, and/or Islamic derivatives. The *murābaḥah* contract is merely used to structure the product. This will become clearer below when we elaborate on the product structure.

2.2 PRODUCT STRUCTURE OR SCHEME

The product can be split into three phases:

a. Initial *Murābaḥah* Phase or Process Phase
b. Investment Phase
c. Additional *Murābaḥah* Phase or Disbursement at Maturity

2.2.1 INITIAL MURĀBAḤAH PHASE

The purpose of this phase is to formalize contractual obligations of both parties and to agree on the scope of investment of the structured product. The following steps describe this phase.

Step 1: The bank's customer (investor) purchases a specified quantum of specified commodity from a trader or broker (either directly or via the bank acting as the investor's agent).

Step 2: The investor subsequently sells this commodity to the bank on deferred payment terms. The deferred payment period equals the tenor of the Islamic structured product.

Step 3: The bank then sells the same commodity back to the market (to another trader or broker) for cash.

The above three steps together describe a very common practice in contemporary Islamic finance known as Commodity *Murābaḥah* or *Tawarruq Munazzam* (organized *tawarruq*). The three steps are essentially executed in that order and are not independent of each other. They are amalgamated via a Master Facility Agreement which is legally binding. In Islamic finance today, commodity *murābaḥah* is commonly used to structure cash and unsecured financing, as well as a liquidity management instrument.

It is important to note that in the application of commodity *murābaḥah* here, in step 2, when the investor sells the commodity to the bank, only a nominal (very small) rate of profit is imposed. As alluded earlier, the purpose of the *murābaḥah* contract here is not to generate a profit for the investor. Rather, it is to create an obligation on the part of the bank, to the investor, which incidentally is the capital protection component of the structured product. To put it simply, the outcomes of the above three steps are:

a. The Investor: Pays money now, gets money back at the end of the product's tenor plus a negligible amount of profit.

b. The Bank: Gets money now, obligated to pay the money back at tenor end plus negligible amount of profit, as agreed.

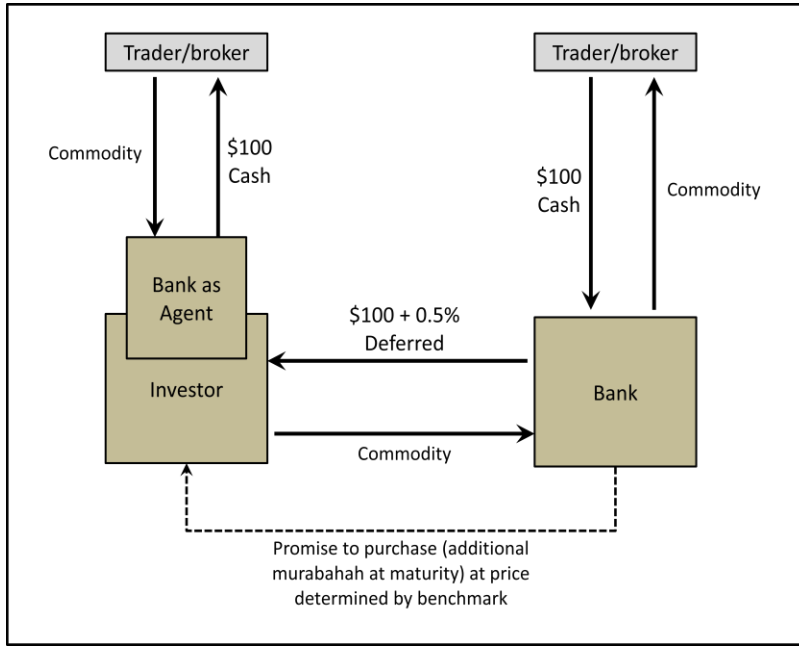
Step 4: The bank issues a binding unilateral promise (*wa'd*) to purchase a specified commodity at a price determined with reference to a specific benchmark or index. By virtue of this binding promise, the discretion is on the part of the

investor as to whether or not a second or additional (commodity) *murābaḥah* is executed at maturity.

In short, while steps 1 through 3 provide the investor with capital protection of invested funds, step 4 is the investment that the investor hopes will yield good returns.

The diagram below illustrates this phase.

FIGURE 1
Illustration of Initial *Murābaḥah* Phase



2.2.2 INVESTMENT PHASE

Once the bank has obtained funds (indirectly from the investor) it would make two kinds of investment. Firstly, the bulk of the monies will be invested in safe, very low risk, fixed return *Sharīʿah*-compliant instruments such as sovereign *sukūk*, highly-rated corporate *sukūk* or *Sharīʿah* compliant government securities. The proportion to be invested in this category of investment would depend primarily on the rate of return of these low-risk instruments.

The higher the rate of return, the lesser is the proportion that will be invested here. This is because the bank will only invest *just enough* funds here in order to be able to pay its obligation to the investor at maturity (as per the Initial *Murābaḥah*). Also, the fixed income instruments referred to above would typically be zero coupon securities (that is, purchased at a discount to face or maturity value with no interim cash flows). This matching of cash flows is a form of risk mitigation.

Secondly, the balance remaining after having made investments in instruments to ensure capital protection for the investor will be invested in higher-return securities. In most cases, the investor would select and decide the chosen instrument or asset type. This can range from *Sharīʿah*-compliant stocks or stock indices to synthetic Islamic derivatives (cross currency swaps, profit rate swaps, forward rate agreements, etc.). This choice will be reflected in the master facility agreement and in the unilateral binding promise (*wa'd*). The promise to purchase makes reference to a benchmark rate which could be any of the following (as examples):

a. The prevailing stock price of a particular stock or basket of stocks.
b. An index of *Sharīʿah*-compliant stocks (for example, FBM *Sharīʿah*, Dow Jones Islamic Market, etc.).
c. The prevailing (market) exchange rate for a particular currency
d. The market price of a particular commonly-traded commodity
e. The prevailing Islamic benchmark profit rate (for example, Islamic inter-bank rate)

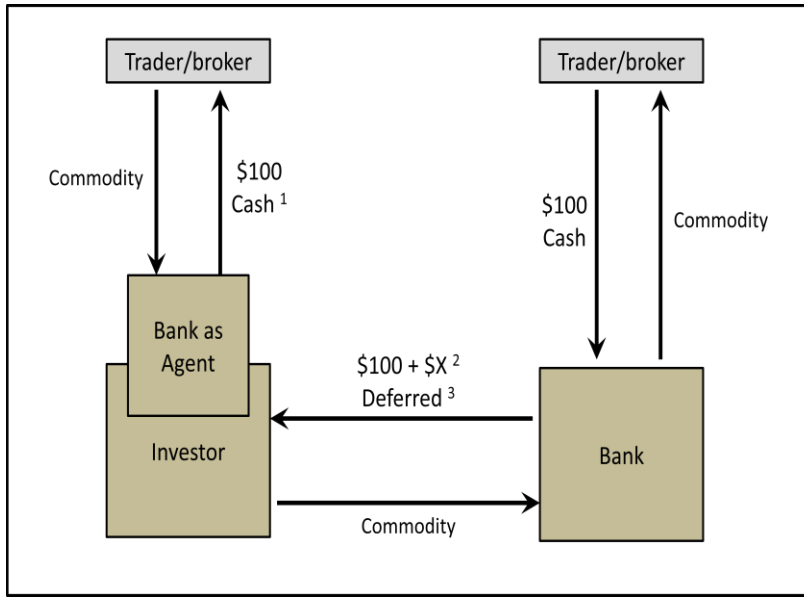
The bank would endeavour to ensure that the tenor of both categories of investments mentioned above matches, as closest as is possible, that of the tenor of the Islamic structured investment arranged for the investor.

2.2.3 ADDITIONAL *MURĀBAḤAH* PHASE

This occurs at maturity, at the end of the agreed tenor of the Islamic structured investment (typically 3 to 5 years). Here, the investor will receive two cash flows. Firstly, the investor's capital will be returned (as per the obligation of the bank to the investor in the Initial *Murābaḥah*). Secondly, the investor can potentially receive cash flow as a result of fruitful investment in the chosen (higher-risk)

asset or investment. Here, the determinant would be the agreed benchmark. Suppose the bank and investor had agreed that funds should be invested in *Sharīʿah*-compliant Malaysian equities, and that the benchmark would be the prevailing FBM *Sharīʿah* Index. Assume also that during the course of the tenor of the Islamic structured investment, the said index rose substantially. This would mean that the promise to purchase would be "in the money" for the investor. The investor would then exercise his right to enforce the binding *wa'd*. A second commodity *murābaḥah* transaction will be carried out in order to pay the investor what is due to him (returns from the equity investment). The diagram below illustrates this.

FIGURE 2
Illustration of Additional *Murābaḥah* Phase



The following notations refer to the diagram above.

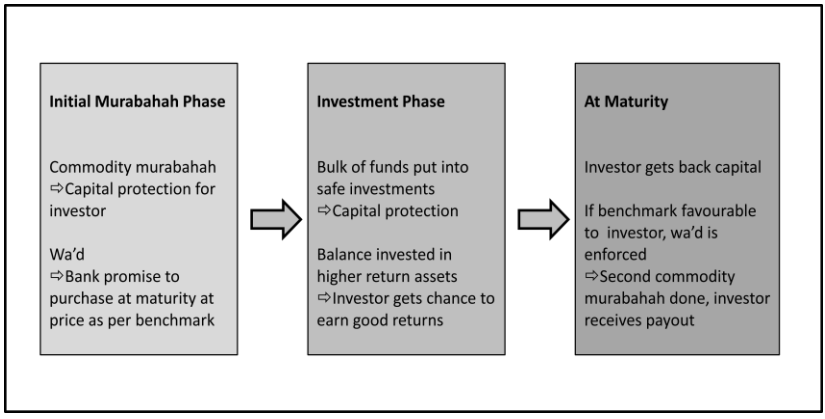
1. Additional money need not be raised to purchase the commodity. Money from the Initial *Murābaḥah* is used here.
2. $X is the profit due to the investor, resulting from the investment in equities.

3. Deferred payment here is only for a short duration, typically 5 to 7 days.

Of course, one possible scenario is that the investment went awry. Using the same example, the stock index could have dropped instead. In this case, the promise to purchase is "out of the money" and the investor would not exercise. The second (additional) *murābaḥah* transaction will not be carried out and the investor merely gets back his capital (plus the small, negligible return).

To summarize, the above arrangement seeks to replicate the economic features of a conventional structured product, using means deemed to be *Sharīʿah* compliant. The commodity *murābaḥah* mechanism is used to effect cash flow movement while actual funds are invested in *Sharīʿah* compliant assets and investments. The diagram below illustrates the essence of this product.

FIGURE 3
Illustration of Product Phases



2.3 RISK PERSPECTIVES

2.3.1 FROM INVESTOR'S PERSPECTIVE

By virtue of the manner in which the above Islamic structured investment is constructed, it is important to note that the investor is facing the credit risk of the bank, and not that of the issuer of the fixed income security underlying the structured investment. This is contrary to the typical conventional structured product whereby the investor takes on the risks inherent in the fixed income security itself,

instead of the bank structuring and offering the structured product. In conventional structured products, suppose the fixed income (capital protection) component is invested in bonds, then the credit risk that investors face is the credit risk of the issuer of those bonds. However, in our case of this particular Islamic structured investment, suppose that the banks invest the capital protection component in a *Ṣukūk* and subsequently that *sukūk* defaults, the bank is still obligated to return the investor's money, as per the Initial *Murābaḥah*. This means that insofar as this Islamic structured product is concerned, it is the credit risk of the structuring bank that should be the object of risk assessment.

Thus, the author considers it somewhat paradoxical that the Securities Commission of Malaysia, the governing authority for this product, stipulates that this instrument is an "investment" instead of a deposit. In the author's humble view, this product comprises a form of capital guarantee and not merely capital protection, despite both the bank and regulator professing the latter label. Of course, the true acid test is, in the event that the *sukūk* invested in defaults, will the bank still honour its Initial *Murābaḥah* obligation and return the investor's capital? If the answer to this question is in the affirmative, then the author is more inclined to label this arrangement as a form of capital guarantee.

2.3.2 FROM BANK'S PERSPECTIVE

After carefully perusing the documents and structure, the author concludes that in actual fact, there are two ways in which the bank can handle the proceeds from the Islamic structured investment – (a) as investment agent of the investor, and (b) as a source of funds.

a. Bank as Investment Agent of Investor -The way we have described this product thus far, assumes this model –the bank is merely acting as an agent of the investor by investing the investor's money in two components – one that provides capital protection and another that provides profit potential. Interpreted in this manner, the proceeds from the structured investment do not count as a source of funds. The bank would not use these monies to finance its financing operations on the asset side of the balance sheet. It is merely providing a service of investment to its customers. Thus the accounting of such a transaction is likely to be off-balance-sheet, much similarly to

the case of specific investment accounts (SIA). However, recall from the previous section that in the event of *sukūk* default, for example, the bank is still obligated to pay the investor his capital. The bank is exposed to the credit risk of the chosen fixed income instrument. In our example, it is the risk of default of the *sukūk* in question. Hence in this scenario, the capital repayable to the investors would appear as a liability on the books of the bank. The corresponding asset entry would be the *sukūk* invested in. In computing capital adequacy, the appropriate risk weight should be assigned based on the credit rating of the *sukūk* in question.

b. Islamic Structured Investment as a Source of Funds - Upon articulating the product's documentation, it appears that only the Initial *Murābaḥah* phase and the Additional *Murābaḥah* phase are documented in the facility's agreement clauses. The Investment phase, although described in the marketing kit, is not captured in legal documents. This implies that it is at the bank's sole discretion how to handle the proceeds. The bank could opt to simply becoming the investor's investment agent as described above. Alternatively, the bank could treat the proceeds of this product as funds to finance its asset-side. Instead of investing in *sukūk*, the bank could channel the money to higher-yielding assets such as home financing or personal financing. If and when the bank does this, the risk profile changes, as far as the bank is concerned. The bank is no longer purely an investment agent to the investors. The proceeds of the Islamic structured investment become a source of funds, to be utilized in any manner deemed appropriate by the bank. The capital to be repaid to investors is a liability to the bank. Risk weight for assets would depend on the chosen asset. These funds procured from the Islamic structured investment product have a cost. Its calculation will be briefly looked at below.

2.4 PRICING

In the model where the bank acts as an investment agent, the bank is not at will to dictate the manner of utilization of proceeds. Hence, financial remuneration to the bank will be in the form of structuring and/or agency fees. The bank is merely serving the investors by channelling the investor's money to appropriate investment assets, in the right proportions, so as to realize the investment strategy chosen

by the investor. For this service, the bank charges a fee. Competitive market forces would dictate the quantum of this fee, in addition to overhead costs (structuring fees, profit margin, incidentals, legal fees, etc.).

When effective capital guarantee is in place, an additional cost component has to be built-in, that is, the credit risk premium pertaining to the fixed income instrument employed.

On the other hand, in the model where the proceeds are treated as a source of funds, financial return to the bank would be in the form of margin differential between the cost of funds obtained from this Islamic structured investment and the rate of return of the chosen asset financed with these funds. The former can, and should, be computed to facilitate transaction-level decision making. We provide a simple illustration below of how the cost of funds from the Islamic structured investment can be calculated.

FIGURE 4
Illustration of Cost of Funds Computation

Suppose an investor invests $100m in an Islamic Structured Investment with a tenor of five years.

Under the "bank as investment agent" scenario, the bank would proceed to identify a suitable zero-coupon *sukūk* for the capital protection component. Assume that this *sukūk*, with a face value of $1,000, will mature in 5 years' time and is currently selling at $812.12. The implied (annual) discount rate or yield-to-maturity is computed to be 4.25%.

The bank would then invest $81.212m of the investor's money in this *sukūk*. The balance of $18.788m will be channelled to higher-return assets as per the investor's preference.

The bank is not liable for any specific return performance of this $18.788m component. Even if all this money is lost, that will be borne by the investor.

However, the bank is responsible for the $81.212m component. More specifically, the bank is obligated to pay the investor the expected future value of $81.212m, which is $100m. In other words, the bank

must return the investor's original capital.

Hence, in the "proceeds as source of funds" model, the bank must ensure that \$81.212m will accumulate to \$100m in 5 years' time. Failure to do this may result in the bank being unable to meet its obligation to the investor. From our calculation above, this means that the bank must invest the \$81.212m in an instrument that yields at least 4.25% per annum. Thus, this is the cost of funds for the Islamic Structured Investment. Of course, any asset financed using proceeds from the Islamic Structured Investment should have a return much higher than 4.25% as there are other cost components (credit risk premium, overheads, capital charge, etc.) in addition to the profit margin.

TABLE 1
Summary of Risk Exposure, Accounting Treatment and Pricing

Model & Assumption		Risk Exposure		Accounting		Pricing
		Investor	Bank	Asset	Liability	
Bank as Investment Agent	No capital guarantee	Credit risk of bank	No financial risk	Off balance sheet		Agency fees
	Capital guarantee	Credit risk of bank	Credit risk of fixed income instrument	Fixed income instrument	Capital repayable	Agency fees plus credit
Proceeds as Source of Funds		Credit risk of bank	Risk of chosen asset	Chosen asset	Capital repayable	Cost of funds is implied discount rate of fixed

2.5 LEGAL DOCUMENTATION AND ISSUES

Two documents are used to formalize the contractual obligations of parties in this Islamic Structured Investment, namely the Master *Murābaḥah* Agreement and the Master Agency Agreement.

The Master *Murābaḥah* Agreement essentially covers the Initial *Murābaḥah* transaction, the unilateral promise to purchase (*wa'd*) and the Additional *Murābaḥah* transaction. In addition, this document also incorporates clauses typical in a financing legal

document such as those relating to representations and warranties, indemnities, confidentiality clauses, disclosures, tax liability, contractual currency, and governing law and jurisdiction.

The Master Agency Agreement essentially empowers the bank to act on behalf of the investor in making necessary commodity purchases from traders or brokers as part of the commodity *murābaḥah* arrangements.

One *fiqh*-related matter may arise in analyzing this product's structure. The issue is whether the unilateral promise to purchase (*wa'd*), made by the bank in favour of the investor, is to be construed as a benefit (*manfa'ah*). If this is the case, then the order of execution is imperative so as to avoid implications of *ribā'*. After execution of the (Initial) commodity *murābaḥah* transaction, there is a debtor-creditor relationship between the bank and the investor. More specifically, the investor is the bank's creditor. Any benefits accorded to the investor, by the bank, may implicate *ribā'*. This includes unilateral promises that are potentially of financial value to the investor (at maturity, if the benchmark or index is favourable to the investor, the investor stands to gain a payout from the bank). In order to resolve this matter, it was advocated that the *wa'd* be executed first, followed by the *murābaḥah* commodity transactions.

2.5.1 LATE PAYMENT

Surprisingly, the author was not able to locate any clauses in the legal documents pertaining to this product that address the issue of late payment and the legal remedies, recourses or repercussions related thereto. In relating to this, it is important to note that with this product, upon execution of the Initial *Murābaḥah,* and once proceeds have been received by the bank from the investor, payments are due only from one party, that is the bank. Thus, late payment would only be a transgression committed by the bank, and not the investor. Given the absence of any specific legal clauses making reference to late payment, the author humbly offers two explanations.

Firstly, it appears that the legal documents pertaining to this financial instrument were prepared primarily with the interest of the bank in mind, that is, to protect the financial interest of the bank. Secondly, it is assumed that in general, if any delinquency in payment is to happen, it would be on the part of the customer, and not the bank. It is argued that the bank's reputational risk serves to

protect the investor against event of late payment by the bank. In other words, a late payment clause is not necessary because the bank would not want to risk damaging its reputation of being a good paymaster. In addition, the investor has the comfort of oversight and enforcement powers of the regulatory authority.

2.5.2 DEFAULT, RECOVERY AND RESTRUCTURING

Similarly, there are no specific legal clauses that address event of default and legal processes that ensue as a result thereof (such as recovery and restructuring). Again, this is because the bank considers this event as remote and its occurrence would mean financial distress or insolvency of the bank. Such an event would trigger a separate set of legal processes and would typically attract intervention from regulatory authorities.

2.5.3 EARLY TERMINATION OR UPLIFTMENT

The bank clearly communicates to the investor that this product offers capital protection only if it is held to maturity. Thus, early termination of this structured investment (that is, withdrawal of funds by the investor before the stipulated maturity) could result in diminution of the investor's capital.

The investor is also protected against event of early termination by virtue of a legal clause that states that early termination can only be done by mutual agreement of both parties.

The legal documents are silent as to the exact mechanics or procedures for early termination. Given the lack of documentation that stipulates what exactly happens when there is early upliftment; one can only assume that the bank handles this event on a case to case basis. From common practice, the following are some ways to handle early termination:

a. A debt discount is given to hasten payment based on the principle of *dha' wa ta ajjal*.
b. A rebate (*ibra'*) on the selling price is awarded.
c. Rescission (*iqalah*) of the earlier *murābaḥah* and execution of a new *murābaḥah*.

In order to determine the quantum of the discount or rebate, or to determine the new selling price of the new *murābaḥah*, a "marking-to-market" exercise is undertaken. Based on variables such as

prevailing profit rates and lapsed duration of investment, the market value of the investment funds is computed.

Among the three options mentioned above, the most likely mechanism to be employed by the bank is the third one – rescinding the earlier *murābaḥah* and executing a new one. However, the author was made to understand that the bank is more inclined to cancel the earlier *murābaḥah*, and in its place, a *musawamah* sale agreement will be transacted. The author finds the reason offered as to why a *musawamah* sale is done instead of another *murābaḥah* sale somewhat disturbing. The reason is – in *musawamah* (sale by bargaining), *Sharīʿah* precepts do not require disclosure of the mechanics of the computation of the selling price. In arriving at the selling price via a marking-to-market exercise, elements of *ribā'* are somewhat inadvertently invoked. By resorting to *musawamah*, this aspect is "hidden" or relegated to the "internal processes" bin, and not incorporated in any legal documents.

3. CRITICAL APPRAISAL

In this last section, the author shares some of his humble observations with respect to the product discussed above.

3.1 USE OF *MURĀBAḤAH* TO STRUCTURE THE PRODUCT

Initially, the author was perplexed as to why commodity *murābaḥah* was the chosen mechanism to operationalize this financial arrangement. To his mind, it makes the structure unnecessarily complicated and opaque. Instead of using commodity *murābaḥah*, the bank could simply work out an agency agreement whereby the bank would invest the investor's money, proportioned appropriately between safe and higher-return investments so as to match the investor's risk preference. This would be more straight-forward, transparent and hence, in the author's humble opinion, more in line with the spirit of the *Sharīʿah*. The author subsequently deduced that the reason why the bank has opted for this structure is perhaps so that they can have their options open as to how to use the proceeds from the Islamic structured investment. In other words, recalling the discussions above, the bank can decide whether to go with the "bank as investment agent" model or the "source of funds" model, depending on market conditions and/or its operating strategy.

Nonetheless, the author humbly submits that such convoluted structures, quite common in contemporary Islamic finance, are generally not healthy for the industry and its stakeholders. Opacity in financial dealings not only increases the cost of doing business (requiring more voluminous legal documentation and substantially more man-hours to structure, explain and understand), it makes risk assessment and management that much more challenging, to both transacting parties and regulators. If there is a lesson to be learned from the recent subprime financial crisis, it is that overly complex financial instruments both conceal dishonest motives and hinder prudent supervision. In the aftermath of the crisis, even the highly-paid, Ivy League-trained financial engineers that designed instruments like Collateralized Debt Obligations (CDOs) and Credit Default Swaps (CDS) admitted that they did not fully understand the workings of those instruments, particularly their aggregate effects on the financial system and economy. The author's humble submission is that if Islamic banking and finance is to avoid straying down that same path, a premium must be accorded to transparency and simplicity.

3.2 COMMODITY *MURĀBAḤAH* ISSUES

Commodity *Murābaḥah* (*tawarruq munazzam*) is very commonly used in Islamic banking and finance today. Its application can be found from the structuring of home financing, vehicle financing and personal financing to constructing Islamic deposits, money market instruments, Islamic derivatives and even *sukūk*. Its widespread and often indiscriminate proliferation has been criticized by *Sharīʿah* scholars, academicians and the public alike, in recent times. In some *Sharīʿah* circles, *tawarruq munazzam* has been outlawed outright. It is not difficult to make sense of the reasons as to why commodity *murābaḥah* has received much flak. The primary contention is that once the dust of legal terminologies and pure technicalities settles, what is left is a money loan, pure and simple. In other words, *tawarruq munazzam* is accused of being a legal stratagem to circumvent the prohibition of *ribā'*, much in the same way as the once controversial *bay' al-'inah*.

It is not the author's intention to reproduce the common arguments surrounding the polemic on *tawarruq*. Rather, the author would like to share some additional facts that perhaps can shed more light on this debate. It is often argued by proponents of commodity

murābaḥah that the profit earned is justified from a *Shari'ah* perspective because parties in the transaction carry commodity price risk (albeit minimal). However, upon closer inspection, this point of differentiation between profit earned on commodity *murābaḥah* and interest earned on a *ribā'* loan slowly but surely evaporates. Consider the following facts:

a. Many *Sharīʿah* committees require that the trader from which the customer buys a commodity and the trader to whom the bank sells that same commodity to be two different traders. However, in reality, the bank receives simultaneous offers from both traders (the other on behalf of the customer) prior to executing the commodity *murābaḥah* series of sales.
b. In fact, not only do both traders know each other, there is a pre-arrangement between both traders, for the trader that bought the commodity to sell back that commodity to the first trader who sold the commodity in the first place. In other words, the commodity would make one full circle, ownership of the commodity changing hands only on paper and for a very short duration. The real movement is that of money and debt.
c. Commodity price quotes received by the bank from both traders are valid for 24 hours. This means that if the commodity *murābaḥah* transactions are concluded within a 24 hour period (as they typically are), there is virtually no commodity price risk.
d. If this is not enough, an agreement is struck between the bank and the brokers (Broker's Agreement) such that the bank has the option to cancel the initial commodity purchase if the bank is subsequently unable to dispose the commodity. This is accomplished via a purchase undertaking made by the broker to buy back the commodity at cost, at the discretion of the bank (bank essentially has a put option on the commodity, exercise price being the original cost of the commodity). Thus, hypothetically, suppose the bank buys the commodity (in its own capacity or on behalf of the customer) from Trader 1, and before the bank is able to sell the same commodity to Trader 2, Trader 2 becomes insolvent and is not able to buy the commodity from the bank, the bank is able to exercise the put option and sell the commodity back to Trader 1, at no additional cost.

It is clear from the above discussion that the bank has gone to great lengths to minimize, if not totally eliminate, any commodity price risk. With such knowledge, the author finds the argument of commodity price risk-taking as a means to justify commodity *murābaḥah*, unpalatable.

Some other proponents of commodity *murābaḥah* argue that *tawarruq* should be allowed because it is the lesser of two evils, that its benefits outweigh its harms. Given the current absence of other viable and available options, *tawarruq* despite its issues is better than *ribā'*-based conventional loans. The author would like to offer his humble views in response to this line of argument. The author can think of at least three problems with the above argument of justifying commodity *murābaḥah*.

Firstly, it is argued that *tawarruq*, despite its controversies, is at most "*syubhah*", while *ribā'*-based loans are clearly prohibited. The problem with this line of reasoning is that we have precluded a third (or more) option. Many bankers have conveniently painted the picture that it is either *tawarruq* or *ribā'*, when in reality, there are other options. Take the case of home financing. There are other alternative options such as true sale *murābaḥah*/BBA and joint venture between property developer and financier; and let us not forget that there is always the option of renting. A home or dwelling is the basic necessity that Islam advocates and protects, not necessarily the ownership thereof. Studies have shown that in many developed European nations like Sweden and Germany, as much as 40% of their population live in rented homes. Are we saying that these Europeans have been deprived of a basic necessity? Many scholars turn a blind eye to *Sharīʿah* issues in Islamic home financing instruments by arguing permissibility on the basis of "*dharurah*". If that were the case, the author would imagine that Islamic home financing should be limited to low and medium cost housing only. It is difficult to see how someone can buy a 7-bedroom bungalow in prime suburbia and finance the purchase using an Islamic home financing instrument, on the basis of "*dharurah*". The point is, before we can appropriately argue that *tawarruq* is the lesser or least of evils, we need to consider all the options.

The second problem is related to the first one. When we unconditionally allow practices like commodity *murābaḥah*, it stifles innovation and search for more genuine and wholesome alternatives to *ribā'*. There is no doubt that options like true sale *murābaḥah* and rental markets have their fair share of problems and issues. But these can be overcome given the right amount of research and

development work. Unfortunately, commodity *murābaḥah* is the bane of these potential solutions. Why bother coming up with workable alternatives when commodity *murābaḥah* is allowed and convenient?

Thirdly, in weighing the benefits and harms pertaining to a particular financial instrument, we should not leave out the important dimension of the public's perception. If instruments like commodity *murābaḥah* are viewed as legitimate or labeled as being categorically *Shari'ah* compliant, on the basis that in form, it is merely a succession of sale contracts, albeit the fact that in substance, it is almost indistinguishable from a conventional money loan, this might give the undesirable impression that the Islamic law of commercial transactions is one that is primarily driven by pure technicalities and legal jargon. Terminologies used and explicit legal lingoes employed determine the nature of the transaction, rather than the actual nature of the contract itself. There is the danger of having *fiqh muamalah* being reduced to, in the eyes of the discerning public, a set of laws seeking legitimacy of presence and implementation on the basis of mere technicalities. *Fiqh muamalah* should not be seen as Islam's version of conventional banking and finance, differentiating itself purely on the basis of language and nomenclature. It should be known by all, non-Muslims and Muslims alike, that *fiqh muamalah* carries with it the spirit of the *Shari'ah* which amongst other things, seeks to institutionalize distributive justice in the economy and society. The author is not contending that *Shari'ah* compliance be judged in the court of public opinion. Rather, societal perception should be made an important input in deciding the *Sharīʿah* compliance of financial instruments.

3.3 SCEPTICISM SURROUNDING THE USE OF *WA'D*

The author would like to express his humble opinion that the widespread usage of *wa'd* as a somewhat indispensable tool in structuring contemporary Islamic financial instruments is something that should warrant concern. It appears that the role of *wa'd* has unfortunately been reduced to as a tool of legal stratagem or *hilah*. The author humbly submits that in many cases, the binding unilateral promise (*wa'd*) is being used as a convenient *Sharīʿah* compliant replacement or substitute for an otherwise prohibited contract or contractual arrangement. When too much emphasis is placed on

contractual form and legal definitions whilst neglecting economic consequences, higher order *Sharīʿah* objectives take a back seat. When contracts used in combination are assessed individually and in isolation, without regards to the aggregate or final effect, *Sharīʿah* tenets could be in compromise. The author respectfully calls for *Sharīʿah* scholars the world over to exercise greater caution; scepticism even, when the use of *wa'd* is present. The pertinent question should be, why must we resort to the use of *wa'd*? Why are established Islamic nominate contracts inadequate? Why do we need to employ a stratagem or legal manoeuvring, and more importantly, what are the economic consequences of a particular product or structure?

3.4 ATTITUDE TOWARDS RISK INHERENT IN STRUCTURED PRODUCTS

It is said that necessity is the mother of invention. However, at times, it is greed for higher returns at lower risks that motivate the engineering of new financial instruments. Not happy with existing risk-return payoffs of existing instruments, the market has devised ingenious ways of augmenting investment instruments. Such is the case for structured products, and the Islamic finance space has not been spared. In this pursuit for superior returns, the author feels that tenets of the *Sharīʿah* may have been compromised.

To the best of the author's limited understanding, the prohibition of *ribā'* implies the following dictum – that in Islam, profit or gain is only justified when accompanied with risk-taking and/or effort. Islamic legal maxims like "*al ghorm bil ghunm*" (with risk comes profit) and "*al kharaj bil daman*" (profit is accompanied with responsibility) underscore this message. The author cannot help but feel that the spirit of risk-taking or risk acceptance is absent in products such as the Islamic structured investment discussed above. The underlying paradigm of the above product is how to get as much return or profit whilst simultaneously ensuring capital is not at jeopardy. This, to the author's mind, runs contrary to Islam's perspective on risk. In order to justify returns, capital must be at risk. By this, we do not mean recklessness. Investors should exercise prudence, diligence and judiciousness in assessing and mitigating risk. However, good investment acumen and shrewdness should not be confused with exploitative *ribā'*-based practices.

Certain risks (such as outcome of investment and result of commercial endeavours) cannot be eliminated. These risks can only

be transferred or shared. Someone has to bear them. The *Sharīʿah* dictates that in order for justice and fairness to prevail, the party that bears the risk is accorded the benefit of potentially earning a profit associated with that risk. *Ribā'* is repugnant in the eyes of the *Sharīʿah* because the creditor obtains a benefit (interest dues) without taking on any of the economic risks. With that philosophy in mind, it is not difficult to see how structured products in general may invite objection from *Sharīʿah* scholarly circles. This is more acute in the case of the Islamic structured investment discussed here, as capital is essentially "guaranteed" and not just "protected". The basic rhetorical premise is, how could an instrument that effectively preserves capital while at the same time provides positive expected returns be considered to be in line with the spirit of the *Sharīʿah*?

It is not the author's place to question the *Shari'ah* compliance of Islamic financial products available in the market today, including the structure discussed above. However, the author humbly submits that in order for Islamic finance to develop in a manner that would receive the blessings of Allāh ʿ*azza wa jalla*, Islamic finance should not just be about *fatwa*, but also about *taqwā*.

DISCUSSION QUESTIONS:

1. In your opinion, do Islamic financial institutions face higher costs of doing business?

2. Notwithstanding your response to question 1, what strategy should be adopted by Islamic financial institutions to remain competitive in the financial marketplace?

3. There is claim that Islamic finance is less risky compared to mainstream finance. The fact that Islamic financial markets and institutions better weathered the 2008 Global Financial Crisis is offered as evidence to substantiate such an assertion. Discuss this in light of salient points raised in this article.

4. The issue of *Sharīʿah* non-compliance risk has been receiving more attention in recent times. How do you think practices highlighted in this case would contribute to the matter?