Secondary trading in Shariah compliant instruments

Secondary market trading in conventional finance is a well-trodden path for conventional banks seeking to reduce their exposure to distressed credits, but can this be replicated in the world of Islamic finance? BARRY COSGRAVE explores.

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Trading in Shariah compliant instruments has caused many headaches within the secondary trading community. Many of the issues raised concerns of a perceived difference between the rights to which Shariah compliant financiers benefit versus those of conventional creditors, together with a general misconception that trading in financial obligations is not permitted under Shariah. As financial markets enter into uncertain territory, many financial institutions are seeking to rationalize their exposures by reducing the finance provided to certain sectors or even individual names.

Secondary traders, in the form of trading desks and private funds, are increasingly focused on the Middle East as a source of interesting opportunities, many of which come from Islamic banks. But how can the circle be squared between Shariah compliant banking and the need for Islamic banks to undertake the important steps in terms of corporate governance?

Rights of financiers

To the purchasing entity, the main area of concern is typically whether the rights conferred on an Islamic bank translate equally to the rights that a conventional lender would expect to see. The reality of Shariah compliant debt instruments is that they contain the same rights and obligations that a conventional bank would expect to see albeit in a Shariah compliant manner. The reason for this is that there is nothing in Shariah that permits any party from seeking to disclaim its obligations under a contract freely entered into.

It would also be commercially unacceptable for a banking entity to grant special rights to an entity that did not make commercial sense. While certain entities have sought to use Shariah compliance (or a claim for lack thereof) as a cloak to discard obligations, such attempts have almost universally been rejected out of hand on the basis of contract law. It should be noted that Shariah respects freedom of contract provided that the terms are not onerous — a principle that is in line with most legal statutes throughout the world.

Trading obligations

How then can an Islamic bank trade away its right to receive payment from an entity and can this be done at a discount? Trading of financial obligations in the secondary market is almost always undertaken at a discount for commercial reasons. This raises some issues in the Islamic finance market. The majority of Islamic finance instruments tend to utilize either a Murabahah or an Ijarah structure.

The Ijarah structure is most common in the Sukuk market but there are also many examples in the bank finance market. However, Murabahah is by far the most common structure used in bank finance. There are of course other structures used in Islamic finance transactions but these are not discussed for the purposes of this article.

Ijarah

Ijarah structures, whether they are bank financings or Sukuk, are straightforward to trade in the secondary market. Ijarah represents ownership by the provider of the finance (whether they are a bank or a Sukukholder) of the asset underlying the transaction. That asset is real and present throughout the duration of the instrument. As a result, any trade in an Ijarah transaction represents a trade in an asset which can be undertaken at any price to which the contracting parties agree. As such, trading at a discount is permitted and straightforward to complete.

Murabahah

The situation with Murabahah-based financings is somewhat more complex. The issue at play is the relative short duration of time for which the assets in a Murabahah transaction form the basis of that sale and purchase. The obligation to pay the deferred purchase price (or similar contractual definition) is an absolute one and represents a monetary obligation.

Monetary obligations that are due under Islamic instruments cannot be traded for cash other than at par, the reason being that the delta between the deferred purchase price due and the purchase price paid for that obligation would constitute Riba. The majority of Murabahah instruments that seek to be traded are in entities from whom a payment obligation is due and which are in financial distress: naturally this requires a more complicated solution. Instead of paying cash for the financial obligation, purchasers of Murabahah finance instruments are required instead to deliver commodities of a certain value as consideration for the acquisition of the right to receive the deferred purchase price.

This structure can raise complications where non-Shariah compliant entities are seeking to acquire payment streams from Islamic banks but the reality is that little differentiates the economics of the transaction from a conventional trade other than the need to use commodities rather than cash. In terms of documentation, typically a Loan Market Association trade confirmation will be entered into but will be supplemented by a Shariah compliant purchase agreement that documents the trade of commodities as consideration for the purchase.

While still in its relative infancy, there is a definite increase in the volume of Shariah compliant instruments being traded in the secondary market. This trading activity is set to rise and is already witnessing year-on-year growth. The challenge for market participants is to ensure that all parties are comfortable from a due diligence and trading perspective that what they are trading represents obligations that are enforceable both from a Shariah perspective and from what would be expected on a conventional basis.

However, the opportunity is to create a secondary market in Shariah compliant instruments that is as efficient as its conventional equivalent, enabling Islamic banks to manage their exposure while simultaneously allowing secondary traders to enter a market in need of trading solutions.