



Islamic Shorting: Trend or Hype?

*Michael Mahlknecht, Director
Delta Hedge*

While short-selling is not permitted by the Shariah, more and more Islamic institutions and hedge funds claim to offer Shariah-compliant shorting solutions. Islamic short-selling is often being presented as if it were a major innovation or a significant breakthrough for Islamic finance. In reality, however, basically every contract can be 'Islamised' using concepts from modern financial engineering. The question is rather how high the transaction costs are, and, especially, whether one regards such mechanics as Shariah-compliant, or as just an undesirable ploy, which strikes at the foundations of the objectives of Islamic finance.

This article briefly reviews the characteristics of conventional shorting, before outlining three approaches based on Salam, Arbutun and Wa'd, and discussing the pros and cons of each one of them.

The Mechanics of Conventional Shorting

Conventional shorting is usually comprised of the following steps:

1. The investor instructs his broker to short a specific asset for him.
2. The broker checks whether any of his other clients is holding the respective asset in his portfolio.
3. If this is the case, the broker borrows the asset from that client and sells it in the market in the usual way for the investor.
4. At some indefinite future date, the investor closes out his short position by purchasing the asset on the market.
5. The broker replaces the purchased asset in the account of the client from whom the asset was borrowed.

In practice, there are several issues and risks connected with conventional shorting:

- If at any time the broker runs out of shares to borrow, the investor is forced to close out his short position immediately, even if that leads to financial losses for him.
- The lender of the asset incurs a credit exposure to the borrower and will thus seek collateral in the form of the cash received by the borrower from the sale of the asset.
- As the asset's price is likely to fluctuate, usually a collateral amount exceeding the value of the asset, the so-called hair-cut, is asked for, meaning that the full proceeds of the short sale may not be available to the investor.
- Usually assets can be borrowed only for short periods of time, ranging from overnight to a few weeks, with costs increasing sharply with the borrowing length.
- Equally, the costs of borrowing can rise strongly when the demand for borrowing an asset exceeds its supply.

Salam-based Shorting

With the Salam contract, Islamic finance offers a natural possibility to sell assets for a price to be paid upfront for an asset to be delivered later. Salam, which is often compared to forward contracts, differs in important aspects from short-selling:

1. Salam contracts do not entail borrowing the underlying asset from another party. It is likewise not identical to naked shorting, which is usually restricted to a T+3 delivery.



2. The underlying of a Salam contract can be a single asset or a basket of securities.
3. Salam is an individual contract between two parties, which does not affect any third parties.
4. Salam is a fixed-term contract.
5. As a consequence, the investor has no risk of being 'short squeezed' at some stage in the future.
6. The price paid in a Salam is usually lower than the asset's market price, with the discount accounting for counterparty credit risk.
7. Estimated dividends and interest, as well as brokerage fees, just as for short-selling, have to be considered when fixing the price of the Salam.

Arbun-based Shorting

Arbun may be used in several ways to mimic the economical effects of short-selling:

1. The selling party accepts a down payment for an asset, just like writing a call option. If the down payment is set on a very high level, close to its market price, the similarity to short-selling is increased, as the buyer is economically forced to execute the option even with falling prices, in order to minimise his losses. However, such a high down payment level would be tantamount to paying an excessive option premium, or to a combination of Salam and a forward contract, which makes it unattractive for many counterparties.
2. Alternatively, the selling party could receive a down payment from a counterparty, combined with a subsequent binding promise, or Wa'd, by the counterparty to purchase the asset even in case of the market price being below the pre-agreed price at maturity. Again, the selling party cashes in on falling prices, even though this structure is not equivalent to short-selling.

Wa'd-based Shorting

Binding unilateral promises, Wa'd, can be used efficiently in combination with Murabaha, or deferred payment transactions to replicate short-selling. For this purpose, party A first purchases an asset from party B through a Murabaha, for the Murabaha price X, and then sells it on to another party for the spot market price. In addition to that, party B gives a unilateral promise to party A to buy back the asset at some future date at a pre-agreed price Y. Conversely, party A promises to sell the asset to party B at that date for that price Y.

Such a combination of two, unilateral, promises is equivalent to a forward position on the asset. Now, if the price Y is set equal to the Murabaha price X, the combined payoff of the Murabaha transaction and the forward position at maturity is zero. Only the 'borrowed' asset is 'given back', which party A must purchase on the market, at some indefinite future date before, or at maturity, making the whole structure an exact Islamic replication of short-selling. In practice, the forward price Y agreed on would be lower than the Murabaha price X, to create an incentive for the counterparty, and to realistically account for expected dividend yields, brokerage fees and other borrowing costs.

As for conventional short-selling, with such an approach, important issues have to be considered:

- If the Murabaha, and the forward repurchase through Wa'd, is carried out with the owner of the asset directly; it is necessary that this party is holding a sufficient amount of the needed asset, and that it does not want to retain flexibility in regards to the time when it sell its assets in the future, as the transaction is fixed-term for the borrower. In this case, Wakala fees would have to be paid by the shorting party to its broker, who has arranged the transactions on behalf of this party.
- If, however, the Murabaha, and the forward repurchase through Wa'd, takes place with the shorting party's prime-broker, who does not own the asset himself; the broker himself must get into transactions with one of his other clients, who owns a sufficient amount of the needed asset. In that



case, the remuneration for the broker would increase and only be the difference between price X and price Y. Such an approach requires extremely careful structuring, in order for the broker to avoid undesirable market risks.

- If all parts of the structure, the Murabaha transaction, as well as the Wa'd promises, are conducted with merely one counterparty; the whole process may be regarded as constructing a dummy transaction with the only purpose to enable Shariah non-compliant short-selling.

The fact that this kind of Wa'd-based short-selling solution is fixed-term for the lending party, may increase transaction costs and shorten the length of the transaction, compared to conventional short-selling mechanisms.

An important advantage of such an approach is that procedural complexity is left with the prime broker, while fund managers do not have to care about formal requirements. By this, experienced conventional fund managers can easily be mandated to manage Islamic funds, without being familiar to the specifics of, for example, Salam or Arbun contracts.

Conclusion

To profit from declining markets, Islamic finance offers a range of possibilities other than just replicating conventional short-selling. Besides other Islamic derivatives and hedging methods, strategies based on Salam, Arbun and Wa'd provide investors with the necessary flexibility in this context. The focus, thus, should not be on marketing Islamic short-selling concepts, but on choosing and structuring the most adequate strategies to cash in on the respective market expectations.

Michael Mahlnecht is director consulting at software provider Delta Hedge.



This article first appeared in www.cpifinancial.net on 2 July 2008.