Repurchase Agreements and their Sharia Complaint Alternatives: An Analytical Perspective within Liquidity Management Context

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Abstract
This paper aims to analyze the repurchase agreement (Repo) in the light of Islamic Shari’ah principles, legally and financially. After clarifying the liquidity issue and its relation to the repo agreement, the study begins with examining the legal aspects of such agreement. Then, the analysis financially explores issues relating to sharia-compliant repurchase agreement substitutes. The current paper shows that the repo is not a loan contract. As the article clarified that, the repo differs from the mortgage of financial securities. Modification of these agreements should be done to be appropriate for Islamic financial institutions. Particular care should be given to some contracts that illegitimate from Islamic Sharia point of view. Contracts such as reciprocal loans, SBBA, Organized Tawarruq should be revised before using. Some issues should be considered such as capacity risk, governing rules, and mixed funds for initiating Wakala investment contract. As sharia-compliant Repo research is limited, the authors confronted a challenge with the conceptual base of Islamic alternatives and their real application in banking transactions. The paper contains challenges and implications for the future developments of sharia-compliant liquidity risk management instruments. This article provides the sharia-compliant perspective of managing liquidity risk through alternatives to repurchase agreements, where the current knowledge and application are very limited.

Keywords: Islamic banks, Repurchase agreement, Liquidity management, sharia-compliant, Reciprocal Loans, Tawarruq, Wakala investment, Sell and Buy Back Agreement, Reciprocal Deposits.
1. Introduction

Banks transform deposits into illiquid loans. This necessary intermediation role of banks relies on a maturity mismatch between assets and liabilities exposing a bank to funding liquidity risk. Islamic financial institutions may face difficulties in issuing and getting short-term loans to facilitate their emergency needs in call money market or repo because, these instruments contain interests.

The shortage of such tools is becoming problematic for Islamic finance as the industry grows. Some scholars who fear that these devices might replicate conventional financial products without addressing a real economic need try to debate purposefully and discuss the Islamic repo deeply. Repurchase agreements in the view of Islamic law, alternatives to the classic repo, and their application in Islamic institutions may clarify the reality of such agreements (Bonfim & Kim, 2014, p. 2).

Recently, Islamic banks have achieved a significant progress because of the confidence given by customers of those banks. Because of such confidence, the size of the deposits and investment accounts have been increased; which in turn led to increased cash inflows over cash outflows resulting in the problem of optimal liquidity management. On the other hand, some Islamic banks were unable to attract customers because of poor experience and little return on investment projects resulting in a shortage of cash. In Islamic banks, the cash liquidity means the ability of a bank to meet its liabilities to ensure that the investment activities are accordance with the provisions and principles of the Islamic Sharia.

Obviously, a surplus or deficit is unwelcome at banks in general. In the first case, excess cash may result in a substantial loss of revenue or profits that a bank could achieve if invested this money in massive projects of the Islamic banks. In the second case, a deficit may have an impact on the financing of investment projects. At the same time, these banks may face the issue of emergency withdrawals that lead to problems with the Central Bank to ensure the liquidity needs (Shehata, 2010, p. 13–).

The central banks occupy an extremely central status among different government financial institutions in various States to implement their financial, economic, and social policies. The Central Bank achieves the economic stability of the State through managing of monetary policy and monitoring of credits for various financial institutions. Thus, Central Bank performs functions and tasks assigned to meet the goals and fiscal and monetary policies of the
State (Fahmi, 2006, p. 9).

This paper aims to analyse twofold points regarding the repurchase agreement. First, the repurchase agreement is legally discussed to shed light on its particular nature as a unique sale contract. Second, this research scrutinizes the sharia-complaint alternatives to repurchase agreements. In order to achieve such goals, the rest of the paper is organized as follows. The second section deals with the repurchase agreements. Particularly, the concentration will be on legal aspects, elements, characteristics, and the contracts included in the repo. The second section handles the alternatives to repurchase agreements focusing on the concepts and Islamic sharia provisions of such instruments.

2. Repurchase Agreements

Repurchase agreements include the concurrent sale and repurchase of an asset, typically a security. The seller buys back the asset, hypothetically at the same price at which he sold it. However, the seller pays the original buyer interest on the implied loan created by the transaction, on the buy-back date (Al-Shobili, n.d.; Fleming & Garbade, 2003, p. 1; Norris, 2011). Likewise, Bateel clarifies that the repurchase agreement is a contract including the sale of securities with the commitment to repurchase them from the buyer at a particular date and a predetermined price for the purpose of liquidity management (Bateel, n.d., p. 37). The legal aspects of such transactions seem to be blurred in the previous studies. Therefore, the legal and financial characteristics of the repurchase agreement, which differentiate it from other agreements, should be analysed.

3. Analysis of the Repurchase Agreement (Repo) Legally

Repurchase agreement includes a set of contracts governing mechanism of the Agreement. It is an agreement with a promise by the seller to purchase a financial security back from the buyer at a stated price at a particular future date.

In the Repo, the seller aims at getting cash where he sells financial securities to obtain its cash value from the buyer. Then, he recovers these securities at a price higher than the sale price. The difference between the sale price and the purchase price is the cost of financing that borne by the seller. This cost is called the return of the repo.

For the purchaser, he performs a reverse repo where he purchases financial securities at
cash price, and then he resells them to the original seller at a higher price than the purchase price. The difference concerning the two prices is the return of the reverse repo. The purchaser has surplus cash and is in the position of the financier who invests his money in the repo instead of the speculation in the stock market. The repo agreement is secured and has a short-term maturity as well as less risk than investing in financial securities market.

Thus, the reverse repo can be defined as a purchase of financial securities at a particular price at a specific date. It implies a commitment to selling the same securities to the original seller at a later time at a certain price in the agreement (Al-Shobili, n.d., p. 4).

4. The Substance Elements of the Repo Contract

Initially, the signature on a repurchase agreement is a legal act. Therefore, it must meet the actualelements of any legal action in terms of the availability of legal consent, entity, and reason according to the General rules in the theory of obligation.

The consent must be valid and free from any defect of the well: a mistake, a fraud, a coercion, and an exploitation. If the consent has any defect, the commitment will be void because it affects an element of the repurchase agreement. In addition, the consent must be originated by an entirely eligible party since the signing of the contract of the repurchase agreement is a business.

The entity will be transferring the ownership of sold securities from the seller to the buyer in return for paying cash amount as a price for such securities. The object of the commitment should be legally valid and possible. The reason for commitment must legally exist and valid according to general discipline, unless the contrary is approved.

5. The Contracts Included in Repurchase Agreement

The repurchase agreement consists of two contracts. First, the essential contract of securities implies selling of financial securities that represent its consideration. The seller is obliged to transfer the securities to the buyer for a particular price. It includes terms that make it distinct from other contracts, and focus on intangible effects. For example, it determines the repurchase duration of securities by the same seller and fixes the purchase price. Despite the transfer of ownership of the securities to the buyer under the contract, the buyer has no right to the profits or proceeds resulting from the convention. , and must be transferred to the seller.
The second is the promise of sale and purchase contract. It is an agreement whereby a seller commits to selling specific something at a particular price if the other party wanted to buy it for a certain period. The repurchase contract is a mutual commitment from two sides: the seller and the purchaser. The seller obligates to repurchase the securities that he sold to the buyer at a certain time with a certain price. At the same time, the purchaser promises to sell these securities to the same original seller with such conditions. The promise of sale is considered a consensual contract, but not a final sale contract. It is only a promise of sale distinguished from a contract of sale upon which the seller and the buyer immediately obligate at the contract conclusion.

6. Elements of the Repo:

Repo agreement components include its formulation, the seller, the buyer, the financial securities, the term, and the return. First, regarding the formulation, Repurchase agreement starts by a contract by which one party sells securities to another. It is implemented simultaneously with another contract to buy them at an agreed price later in the near future. The wording of the agreement will include a pledge to purchase in the case of a repo, and to sell in the event of a reverse repo sale.

The second element is the seller who sells for cash and buys on credit. The third is the buyer who buys for cash and then sells on credit. The fourth is the financial assets that represent a guarantee of the agreement. The most prominent assets used in the operations of repo and reverse repo are Government bonds, Treasury bills, certificates of deposit, and securities backed by mortgages. The fifth element is the term where it is often for a short-term maturity for either one day or more. In addition, it may be for a medium-term, or long-term period in accordance with the agreement of the parties. The last component is the return (the repo rate) which is the margin of the repurchase agreement and paid by the seller of the assets or securities.

Central banks are resorting to the repo as a tool to control monetary policy. It is like a flexible way to control the size of the loans and liquidity to tackle inflation and deflation. Moreover, the repo provides a mechanism to arrange for immediate liquidity to the private banks (Al-Shobili, n.d., p. 4).

7. General Characteristics of the Repo

Repo contract has unique features and benefits. The repo is one from consensual contracts
held by consensus two wills: the will of borrower and lender. However, it is not a formal contract, where the law does not require a particular form of the conclusion of the contract. The contracting parties can guarantee the contract terms and conditions agreed upon by contract. In addition, repo is not one of the official contracts that require documentation of formal bodies in the front of an officer.

The repo is one of the netting contracts where the contract can achieve a benefit or financial compensation for both parties. The compensation of the lender is the benefit obtained from the difference between the sale price and the purchase price of the securities, called repo. At the same time as the borrower then brings offsetting through financial liquidity obtained through financing in the form of a secured loan.

The repo is one of the contracts binding the two sides where the contract carries out obligations facing both parties. Obligations of the seller (the lender) imply that the seller, according to the buy-back contract has two key commitments. The first is the obligation to transfer the securities to the buyer (borrower) at a given date and a particular price. The second is the commitment to repurchase the securities sold to the purchaser in fixed time and at a predetermined price.

Likewise, obligations of the buyer (borrower) include two fundamental commitments. The first one is the requirement to buy the securities from the seller. The contract determines aspecific cash price that represents the total amount minus an agreed profit. Such profit is the spread between the sale price and the repurchase price (called Repo Fees) at a particular future date. The second commitment is the obligation to resell the securities purchased from the seller to the latter for a total value plus a specified (Repo Fees) and an agreed date in the contract (Shrar, 2012).

8. The Unique Features of the Repo

In accordance with international accounting standards, one may argue that the repo is a secured loan. However, this agreement cannot be adapted as a loan because the loan contract linked to private guarantee, which called the possessory pledge in the civil law, gives the creditor the right of preference. This power makes him preferred before the other creditors in getting their rights from the values of such things. In addition, the creditor has the right to trace the mortgaged thing in any hand.
On the other side, the right of the possessory pledge does not include the transfer of the money pledged to the creditor. It needs a permission of the Court for execution on mortgaged property. Because the inability of the seller to repurchase the securities sold to the buyer, the buyer has the right to sell it without referring to the Court or the seller to meet his rights. However, the private guarantee in the repurchase agreement is very similar to the possessory pledge with respect to fruits of the thing pledged. That is; the mortgagee creditor has no right in any profits or proceeds of the mortgaged thing during the period of the mortgage. As well as in the repurchase agreement, the profits or proceeds worth of securities should be transferred to the seller by the buyer according to the repo.

Consequently, the repo is not a loan with a private guarantee and that the legal adaptation of the repurchase agreement is a contract for the sale of securities. Moreover, it has a unique nature because the seller commits to repurchase securities sold in a short-term and at a predetermined price. The buyer should transfer profits and returns of securities to the same seller during this period. By this, it is approaching to the agreement of lending securities with a fundamental difference between them. This difference is related to the repurchase agreement where the seller should transfer the securities to the buyer with the previously mentioned restrictions (Al-Fzia, 2015, pp. 9–10; Shrar, 2012).

Even though, the conventional repo has precise nature legally, its compliance with the Islamic sharia should be considered. Notably, a number of alternatives appear to be employed in the real banking situations. Thus, the following section tries to elucidate these alternatives in the light of Islamic provisions.

9. Alternatives to Repurchase Agreements

Alternatively, Islamic banks may bring about their liquidity using some options to conventional repurchase agreements. For instance, interbank Wakalah investment contract, Sell, and Buy Back Agreement of financial securities, Islamic interbank lending market, Islamic interbank depositing market, and Al-Tawarruq are models of these alternatives.

10. Interbank Wakalah Investment Contract

Wakalah investment is one of the applicable liquidity management instruments. Wakalah investment contract is an agency contract in which the investment account holder appoints the
institution offering Islamic financial services to carry out the investment on behalf of the principal (Boumediene, 2011, p. 23). For example, Kuwait Finance House (KFH) concluded a contract between a KFH as an agent and a customer as an investor. Along with this contract, the investor’s investments are managed by KFH based on the agreed conditions. The conditions include the period, the currency, and renewal of investment. Investment terms include (KFH, 2015).

Merits of Wakala investment accounts involve coupling stable periodic income and capital steady appreciation. In addition to the regular resource of income, the principal amount of investment is confidently paid at maturities. Moreover, the appointed agent bank should employ the money of the principal investor in sharia-compliant transactions. Furthermore, both the principal and the agent share in the profit and loss of investment. Nonetheless, in compliance with sharia, no guarantee is found on minimum return of investment. For calculating the expected return, LIBOR (London interbank offered rate) is the benchmark or a guidance for calculating such return.

Debatable matters such as capacity risk, governing rules, and mixed funds enter into consideration when initiating Wakala investment contract. When an agent has a lack of capacity, its obligations will be in trouble. For example, Blom Bank litigated TID, the Kuwait-based company, in the High Court of Justice in London to recover 10.7 million US dollar investment with TID in 2007. TID promised a 5% return in the terms of the wakala. However, TID rejected to pay, arguing that the transaction was not compliant with Islamic Sharia. The 5% return is a usury that is prohibited in Islam, and TID’s charter prohibited it from entering into non-Islamic transactions. TID argued it was acting ultra vires. However, TID’s Sharia board issued a fatwa affirming that the wakala was a permissible Islamic contract. This case underlined the problem of capacity risk and has caused Islamic finance institutions to come under assessment by rating agencies (U.A.E, 2015).

Another issue is the conflict between governing laws and Sharia principles. The governing rules are fixed whereas fatwas declared by Sharia scholars handle a specific deal and may differ from one Sharia Board to another and from one deal to another.

Likewise, the invested money of the agency contract is usually mixed with the agent’s funds. If the agent becomes bankrupt, the principal’s money will be combined with the agent’s other money. The liquidator may treat the wakala money as part of the agent’s liquidation assets.
This risk should be considered when investing funds under wakala contract.

Mainly, Islamic Sharia allows wakalah investment contract that could be a musharakah, a mudarabah, or a wakalahby al-ujr (the agency with fee). Musharakah occurs between two parties that jointly contribute capital, in agreed percentages, and possibly perform work on the agreement that they will proportionately share profit and loss according to their share in capital. This contract is a Sharikat Al'Anan. If one party does not contribute to the capital, the contract is a mudarabah.

Mudarabah refers to a mechanism whereby a deficit party can obtain investment from a surplus party based on profit sharing principle. The profit sharing ratio is negotiable between both parties. The investor party at the time of negotiation would not know what the return would be. That is because the actual yield will be preserved towards the end of the investment period (Shaikh, 2009, pp. 8–9).

The third form of wakalah investment contract is the wakalah by al-ujr (an agency with fee). It is an investment management contract whereby the investor agrees to provide the investor’s agent with funds to invest in different assets. The investor’s agent is paid a service-based fee (Hanif & Sheikh, 2009, p. 5). Thus, the musharakah, the mudarabah, the wakalah by al-ujr are three allowable forms of wakalah investment contract in the Islamic law. Islamic banks could apply these types with each other (interbank) and with their regular clients.

11. Sell and Buy Back Agreement (SBBA) of Financial Securities

Sell and buy back agreement seems to be as replication of the conventional Repo. It is a bilateral agreement in which the seller first sells assets to a buyer at an agreed price. Consequently, both parties enter into a separate agreement in which the buyer promises to sell back the asset to the seller at an agreed price (Bacha, 2008). The possibilities of selling could be with par value in addition to a determined return calculated on an annual base, or with the market value at the time of execution. The difference between such SBBA and conventional Repo is the actual transferring of possession from the seller to the buyer with all associated privileges.

Islamic Sharia ruling on SBBA differs according to the value of buying back; par value or market value. If the promise of obtaining back is by par value, it has two situations: par value without return or par value with a determined return. Par value without return seems to be
as "bay al-Wafa" which is a debt guarantee sale. In such selling, one party agrees to sell an asset to another for a cash price. However, the seller reserves the right to repurchase such asset at its original price from the purchaser for a particular period (Hegazy, 2007, p. 35). Bay al-Wafa is a fake practice of Riba and is considered unreliable by the majority of Islamic scholars (Billah, 2015).

The second case is to sell the asset at its par value plus a particular return on an annual base. This transaction is similar to the reverse of Bay Al-Inah (Razali, 2012). Ijma or agreement holds that Bay Al Inah is an illegal contract from the Islamic point of view. However, if the promising of selling was at market value; nothing appears to prevent such trading according to Islamic Sharia law. Approving on the second contract, the price of an asset may increase or decrease with the time. Such time is required to allow a change in the features of the sold things; hence, Islamic law allows such kind of selling.

To summarize, the alternatives SBBA should fulfill some conditions. First, the sale should be real and bear all the rights and responsibilities of the buyer as an owner in the beginning. Second, the promise of selling or buying should be at the market value of financial securities. Third, the two parties should allow enough periods between the first selling and the second, to be sure that the assets that support these securities were changed. Finally, the promise should not be compulsory for both parties. As a suggested instrument for activating this alternative, Central Banks may issue short-term Islamic bonds, which are similar to Treasury bills, in order to execute SBBA transactions.

12. Reciprocal Loans

Mutual loans indicate that in return for a loan for a particular period, the lender receives an amount equal to the loan for a similar period. In other words, the borrower receives a certain loan for a particular period and returns the same amount for a similar period to the lender. The contract may explicitly tie the two loans, or not (AL-LIHYANI, 2002).

In considering the views of Islamic jurists, most of them argue that mutual loans are illegitimate. If the mutual loans are untied, one can argue that they are legitimate. However, it is hard to avoid such dependency relationship. Binding could occur in terms of a promise or a memo of understanding. Such binding is an illegitimate trick around a legal contracting because what is illegal in the contract is prohibited in complicity (AL-MASRI, 2002).
13. Reciprocal Deposits without Interests

Another alternative to conventional repo is the reciprocal deposits without interests. Reciprocal deposits mean that two banks agree to open a current deposit account at the other. Each bank should decide on not calculating interests neither credit balance nor debit balance. The difference between the reciprocal deposits and the mutual loans is that there is no agreement on lending in the reciprocal deposits. The owner of debit balance is not required to lend the owner of credit balance; only, they agree on dropping interests.

Al-Shubili states that there is no legislative prohibition regarding interest-free reciprocal deposits. He comments: “the Islamic banks require this transaction in its relation with other banks. Although the reciprocal deposits are a loan from Islamic law point of view, they are not conditional mutual loans. The bank, which has an overdrawn account, is not obligated to lend the other bank. Dropping the interests is only required condition. The legality standards and the eighth symposium of Al-Baraka have undertaken these opinions.

14. Tawarruq and Reverse Tawarruq with Mortgaging Financial Securities

Tawarruq is buying a product from a party on a deferred basis. Then, the buyer sells it to a third party at a lower price on a cash basis to obtain money (Nasrun Mohamad & Asmak Ab Rahman, 2014). Unlike inah, which consists of two individuals and leads to riba, Tawarruq involves three parties: the seller, the buyer and the third party (Dabu, 2007).

Islamic banks run two types of Tawarruq contracts, which are real Tawarruq and Organized Tawarruq (Dabu, 2007). The real Tawarruq happens when a person buys a commodity from a bank on a deferred basis and sells it to another person or bank for cash. However, Organized Tawarruq occurs when a person purchases a product from an Islamic bank on credit, then he makes the bank his agent to sell this product for him, which he has not received.

Reverse Tawarruq is the purchasing of a product in cash then selling it on credit to a third party. For instance, a depositor appoints a bank as his agent to buy a particular product and pays the price to the bank. Such bank will purchase the product on credit, with a marginal profit that will be agreed upon (Dabu, 2007).

The majority of past and present jurists allow real Tawarruq. It is free from riba, and it does not contain any form of inah contracts. However, most of the contemporary juristic
councils prohibit the Organized Tawarruq because of its usury. Organized Tawarruq is a loan with interest from the bank to the customer, and commodity that exists in the contract is a means of deception to reflect that the contract is sharia-compliant. This agreement leads to triple inah, which is prohibited by the majority of the scholars (Dabu, 2007).

Reverse Tawarruq is also a prohibited transaction because (prohibited Organized Tawarruq) includes this deal (Dabu, 2007). Concisely, it is permissible to execute the repo through Tawarruq or reverse Tawarruq contracts if some considerations taken into account. First, the contract should be on a certain commodity in order to avoid bay’ alkali’bil- kali’ (sale the debt with debt). Second, the buyer of the product should not sell it before possessing and receiving it according to Islamic law. Third, after purchasing and before selling, the purchaser should guarantee the commodity to avoid “earning what he does not guarantee” which is forbidden by Prophet may peace be upon him. Fourth, the product should not be sold to the first supplier to avoid bay’ al inah. Finally, the purchaser himself should sell the commodity to the bank in the reverse Tawarruq in order to avoid the unreality in the contract if the bank were the two parties at the same time.

15. Conclusion

Legally, the analysis shows that the repo consists of a group of contracts that organize it. It is found that this agreement is a guaranteed sale contract with unique nature. It differs from the regular contract of selling financial securities. It implies a promise of selling and buying from the two parties. It has special conditions that only exist in the repo. Although the common use of the repo at financial institutions, the national laws do not organize this contract as they do with the lending agreement of financial securities. However, some of the scholars argue that the repo is a loan contract. The current paper shows that the repo is not a loan contract. As the article clarified that, the repo differs from the mortgage of financial securities.

Financially, conventional repurchase agreements seem to be a crucial instrument for managing the liquidity of the financial institutions. Modification of these agreements should be done to be appropriate for Islamic financial institutions. These firms can employ several alternatives such as Wakala investment, reciprocal loans, mutual deposits, sell and buy back agreements, and Tawarruq. However, special care should be given to some contracts that illegitimate from Islamic Sharia point of view. Contracts such as reciprocal loans, SBBA,
Organized Tawarruq should be revised before employing. Future research should deliberately examine some issues like capacity risk, prevailing rules, and mixed funds for initiating Wakala investment contract.

Furthermore, the paper recommends organizing the repo within national laws of the financial securities market and issuing rules of the repo activities. Moreover, the paper suggests creating a distinctive model for the repo to secure the rights and obligations of the whole parties in the agreement.

References


