Istijrar - How does it really work?

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The Background

Although technically Istijrar is just a repeat sale or ‘supply’ arrangement, (see reference link), it is both a very sophisticated contract and in the form most quoted can have elements resembling ‘Asianing’ in options (i.e., average price), and barrier options. Although note that it is not really an Asian option, but a series of barrier options. Further reference is given in ‘Structuring Islamic Finance Transactions’ (pp 71-2) by Thomas, Cox and Kraty (see reference link).

The modern use of the contract was begun by Mufti Taqi Usmani and this interesting payoff is described in some detail in papers by Obiyathulla I. Bacha’s ‘Istijrar: A Product of Islamic Financial Engineering’ (see reference link) and Dr Mohammed Obaidullah (New Horizon, no 68, Oct 1997). While it is not possible to reproduce this latter article in electronic format as IIBI has not yet finished scanning their back issues.

It is also mentioned in some detail in Obaidullah’s online textbook (see reference link, p 48), as well as in this lecture note by O.I. Bacha, ‘Derivatives in Islamic Finance - An Overview’ (see reference link, p 21) and his paper ‘Derivative Instruments and Islamic Finance: Some Thoughts for a Reconsideration’ (see reference link, p 23).

The Structure

The details of the arrangement are as follows (according supposedly to Dr. Muhammad Imran Ashraf Usmani), based on Meezan Bank’s Guide to Islamic Finance (see reference link, section 19). Please note that although this is a sale, after the execution of the Master Murabaha, no offer or acceptance is issued and sale is concluded merely by possession (bay al-ta’ati or al-mu’atah).

A Master Murabaha facility or Istijrar facility agreement is signed between the bank and its client under which various Sub-Murabahas would be extended:
Featured Structure

At Time T0:

The Master Murabaha agreement will describe the following formula for the price range and the Murabaha price $P^*$:

1. The upper and lower range around the cost price $P_0$ is determined. This price range may be linked to a benchmark such as LIBOR+margin. Hence the price bound would change when the benchmark shifts.
2. The Murabaha price $P^*$ or the exercise price is set. This is the price which may be applied if the market price of the asset goes above or below the price range during time $T_0$-$T_90$.

The period during which the above two call options shall be valid is $T_0$-$T_90$.

At T90:

1. When the Sub-Murabaha or ‘Declaration’ is signed at $T_90$, the sale is executed.
2. The settlement price $P_s$ is determined at this time.

Settlement price $P_s$ may be one of the following two:

* Avg price of asset during $T_0$-$T_90$
* Exercise price fixed by either party after the market price of asset during time $T_0$-$T_90$ has gone out of the price range. This exercise price may be the murabaha price $P^*$ or some other price fixed by either bank or customer.

At Ts: On the settlement date, the settlement price $P_s$ is paid as set at time $T_90$.

* If a number of Sub-Murabahas have been executed under the Master Murabaha Agreement, then each will be settled according to its own settlement price on the settlement date.
* In order to decrease the price volatility between Declaration Date and the Settlement Date, the duration may be reduced.

Terms Used:
- $T_0$ - Time when Master Murabaha agreement or Istijrar agreement is signed.
- $T_90$ - Time when declaration is signed
- $Ts$ - Settlement Date $P_0$ - Cost price
- $P^*$ - Murabaha Price
- $P_s$ - Settlement price
- Declaration -- Offer and Acceptance between Customer and Bank to sell the asset back to customer.

Key Points:

* Murabaha Price $P^*$ is to be determined at the time of extending the Sub-Murabaha.
* The Murabaha Price $P^*$ cannot be fixed as the settlement price $P_s$ by the Bank or the Customer during the tenor of the sub-Murabaha $T_0$-$T_90$
* $P_s$-settlement price may be the prevailing market price of an average of the price during the Istijrar period.
* The price on the settlement date cannot be changed by either party even if the market price has gone out of the price range during the tenor of the sub Murabaha.

Process Flow:

1. Master Murabaha Agreement/Istijrar agreement is signed at $T_0$
2. Agency agreement is signed (if required) at $T_0$. 

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3. When the bank purchases the commodity the Declaration (Sub Murabaha) is signed at T90.
4. Ps-the Settlement Price [Contract Price] is paid on the Settlement Date.

**Short Discussion**

While the features of this derivative contract/arrangement are described in some detail in these papers, the technicalities and legalities and Shariah aspects are less easily found. But the amazing thing is that this arrangement is merely a set of sales.

Islamic Law of sale is such that Istijrar is not considered a set of strange options, no wa’ad is necessary, no khiyar is needed (although they can apparently also be used). In sale contracts there is flexibility according to the payment and settlement of price. Bay’ bi Sirr al-Suqq or payment at market-determined price (see reference link) is the subject of relatively rich discussion, this is one area of fiqh which touches upon Istijrar. The fact that Istijrar is a repeat sale makes many scholars feel that this flexibility (delay of payment and price set according to market average) should be afforded to this arrangement. Moreover, the embedded derivative elements help to reduce the risk, reducing the gharar of the arrangement to something considered to be ‘acceptable’.

Please note as well that Istijrar is extremely flexible and can be used for many other types of contracts (e.g., ijara, and mudaraba, supposedly) and can probably allow for a great many other payoff profiles. This usage of Islamic Law of Sale is something that has not been explored to its fullest in Islamic Finance, and we should probably expect much more future innovation in Islamic Finance using Istijrar.

A future topic of discussion remains the notion of sale at market-determined price (see reference link) as well as the more conventional delay in payments and conclusion of sale without offer/acceptance. Undoubtedly, Istijrar is one of the hidden gems of Islamic Finance.

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