

# Examining the Integration of Legal and Shariah Principles in the London Metal Exchange

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## Abstract

*Purpose: The Islamic banking system is recognized for its role in promoting the equal distribution of resources and its emphasis on risk management. This research paper explores the rulings of the London Metal Exchange (LME) within the framework of Islamic law. The main objective is to investigate the involvement and impact of Islamic banking in LME contracts. The study utilizes both primary data, obtained through interviews with Islamic banks and LME management, and secondary data from previous research. The findings highlight the significant role of Islamic banks in facilitating LME contracts, with Murabaha, Tawarruq, Istisna, Salam, and Kafala identified as the most commonly used instruments in the GCC regions. However, Islamic banks also face challenges, including criticism from Muslim scholars regarding certain practices. Despite these challenges, there are several opportunities for Islamic banks to contribute to the further development of the Islamic financial system. By addressing concerns, increasing awareness, and adhering to Islamic principles, Islamic banks can play a pivotal role in shaping the future of the financial industry.*

**Keywords:** *London Metal Exchange, Islamic law, Islamic banking, LME contracts.*

## Introduction

### *Overview of London Metal Exchange (LME)*

London Metal Exchange (LME) is the largest commodity exchange marketplace all over the world. It started its operation in 1877 (Kostova, Bratkov, & Nedelcheva, 2020). It is a future exchange that generally relies on the future agreement and contracts of base metals which consist of nickel, Zinc, lead and many more. Similarly, different other activities are also carried out as the London Metal Exchange also assists in the trading of valuable items such as Gold. The London metal exchange also facilitates cash trading. That was the reason it occupies the largest world market of the future exchange. This platform of LME creates the link between physical and financial market participants by establishing a worldwide pool of liquidity (Park & Lim, 2018). Furthermore, metal producers and consumers, merchants, financial funds traders, brokers, property dealers and clearing institutes are some of the main participants of the London Metal Exchange (LME Report, 2022).

### *Basic Standards of Islamic Banking*

Islamic banks are financial Institutes that follow the sharia principle in all of their operations. The main objective of the Islamic banking system is to ensure the equal distribution of the resources such as income and wealth among the participants of the contracts (Alharbi, 2015). Due to this, Islamic banks provide their services within the legitimate framework to achieve an equilibrium between economic and social returns. In this way, the Islamic banking system promotes trade activities by the provision of active interaction (Hassan, & Aliyu, 2018). Islamic financing principles prohibit investing in contracts that have higher risk and uncertainty. Based on the Islamic principle, these Islamic banks offer their products to their customer, which includes Mudaraba, Musharaka, Ijarah, Istisna and Salam, Tawarruq, Murabaha and Wakala (Miah & Suzuki, 2020). A Murabaha-based financing bank facilitates the customer's purchase of the preferred goods or product from a third party (Like London metal exchange), and then it is sold to a customer at an agreed price (including the bank's profit); however, the bank also charges the transaction fee to the customer.

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Similarly, in a Wakala contract, investors make a contract with an agent (like banks) in order to manage the investment activities, and in return, the agent (like a bank) gets some part of the profit based on their agreement (Prabowo & Jamal, 2017). Mudaraba contracts are based on the partnership agreement in which one party is liable to provide the investment or funds, and the responsibility of the other party is to provide the human resource and management of all business operations. As a result of the Mudaraba contract, the profit and loss are equally shared between the two contracting parties. On the other Musharka is based on joint ventures and partnerships in which all contracting parties equally participate, whether in the form of investment provision or business management. Similarly, Ijarah is the most used term in Islamic finance, which refer to rent. According to this, banks purchase a commodity or assets and give them to their customer, and they make rental payments to the bank for using the assets till he/she gets legal ownership (Aris et al., 2013). Sukuk denotes the certificate in Islamic finance as it is used by entities to generate capital for a specific time period.

Furthermore, Istasna refers to a sale transaction in which the customer agrees to purchase the assets once it is manufactured or prepared. However, the Salam indicates an on-spot payment of the deferred delivery of the assets. Like a consumer made the payment in advance for the purchase of the specific design of Gold at a future date. Lastly, the Tawarruq refers to a type of contract or transaction in Islamic finance in which a member purchases a commodity and then sells it to another party or member on a deferred payment or immediate cash price bases. In London, general metal banks buy the metal and then sell it to their customer on the deferred payment (Ahmad et al., 2017).

### *LME and Islamic Financing*

The London Metal Exchange is also playing a significant role in promoting Islamic financing contracts such as Murabaha and Tawarruq. It has been seen that in the London Metal Exchange, the Murabaha and Tawarruq transactions for the commodity are more frequent than the base metals (nickel, Zinc, Aluminium, copper, and lead). Mostly, base metals have a direct or indirect association with the London Metal Exchange (LME) (Alkhamees, 2017). The London Metal Exchange monitors and organizes the warrants which depict the possession of the metal. The assets under a commodity Murabaha are a base metal of the London Metal Exchange (Aris et al., 2013). Its possession is indicated by LME warrants. An LME warrant is basically a holder document that shows the possession of the underlying metal by the bearer.

The implementation of the Murabaha and Tawarruq financing minimizes the price risk as all the commodities are traded on the same day, and secondly, these are traded at a premium price due to the placement in the warehouse (Hussain et al., 2016). Furthermore, the London Metal Exchange has one of the largest commodity platforms which facilitate the Islamic financing policies as this platform of the commodity exchange is designed to facilitate the Tawarruq, and it also plays an important role in creating a bridge between the Middle East countries and other financial institutes of the world.

### *Research Problem and Motivation*

This research paper aims to analyze the rulings of the London Metal Exchange (LME) in the context of Islamic law, specifically focusing on the involvement of Islamic banks and the challenges they face. The study seeks to understand the role of Islamic banking instruments in LME contracts and identify opportunities for Islamic banks to contribute to the development of the Islamic financial system. The research is motivated by the significance of promoting Islamic principles in the financial industry and shaping the future of Islamic banking.

### **Research Objectives**

The research aims to analyze the involvement and impact of Islamic banking in London Metal Exchange (LME) contracts within the framework of Islamic law. The objectives include investigating the specific role of Islamic banks in facilitating LME transactions, identifying key challenges faced by Islamic banks in adhering to Islamic finance principles, exploring opportunities for Islamic banks to contribute to the

development of the financial system, and examining the frequently utilized Islamic banking instruments in LME contracts and their compatibility with Islamic finance principles.

### *Purpose of the Study*

The purpose of this research is to analyze the involvement and impact of Islamic banking in London Metal Exchange (LME) contracts within the framework of Islamic law. By exploring the specific role of Islamic banks, identifying challenges, and highlighting opportunities, the study aims to contribute to the understanding of how Islamic banks can shape the future of the financial industry and advance the principles and practices of Islamic finance within the LME and the broader financial landscape.

### *Growth and Potential of Islamic Banking in the GCC*

Moreover, the Gulf countries, such as Saudi Arabia and Oman, are currently emphasizing the implementation of the Islamic banking and financing system. Akkaş (2017) mentioned that there are over 145 major Islamic financial institutions within the GCC, signifying that 40% of all the Islamic financial assets and institutions are located within the GCC countries. The reason Islamic banking sectors are gradually increasing in Saudi Arabia in the last couple of years as the common public, as well as the government, is also accepting the initiative of the banking industry with regard to Islamic financing. The researchers Lone and Alshehri (2015) believed that Islamic banking in the GCC countries has a great potential to develop societies by assisting investors and increasing economic activities within the region.

However, the net profit of the Islamic banks is also increased in Saudi Arabia with respect to the last couple of years. It shows that in the coming 5 to 6 years, the banking industry of Saudi Arabia will transform to the Islamic principle. Presently, Research and Markets (2021) highlighted that the Islamic financial assets within the GCC countries surpassed \$1253 USD in 2019, comprising 44% of the total assets, thereby signifying that Islamic banking has acquired over 15% of the banking system assets in GCC with a 27% share in the retail banking sector, 13% share of an asset in the total retail and wholesome banking.

This paper is designed in such a way it will examine the role of the London Metal Exchange in Islamic banks by using real-world case studies by focusing on the different regions of the world. So, there are five cases regarding the role of Modern Islamic financing and the trade of commodities in the London metal exchange that were critically analyzed in this paper. These cases were obtained from Google scholars. The list of the authors and cases is presented below.

**Table 1:** Cases List

<b>Case Study Topics</b>	<b>Authors Name</b>
Practices of modern Islamic banking with regard to the role of the London metal exchange.	Schoon and Natalie (2016)
A case study of creative shariah's compliance and the role of the Tawarruq in the commodity exchange.	Alkhamees, 2017
The impact of Islamic principles on cross-border mergers and acquisitions involving Islamic entities in the Gulf regions	Bindabel, W. A. (2017).
Legality of Tawarruq in Islamic Finance. Review of the Islamic Finance	Ismon, N. Y. B. (2012).
Implementation of the accounting standards of AAOIFI in the Islamic banking sector, specifically in Saudi Arabia	AI-Abdullatif, S. A. (2007).

Furthermore, the discussion is based on the fundamental principle and standards of Islamic financing that is mentioned by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI). AAOIFI is an independent Islamic body that establishes auditing, accounting and Sharia standards and principles for Islamic banking and for other Islamic financial institutes (El-Halaby, Aboul-Dahab, & Qoud,

2021). The fundamental objective behind the creation of these standards is to improve the overall excellence and quality of the auditing and other practices within Islamic financial institutes. Hence, based on the discussion, some of the suggestions regarding the "London Metal Exchange in Islamic scale" are also presented.

## LITERATURE REVIEW

The acceptance of Islamic banking is increasing all over the world as Islamic banking is different from conventional banking. The practices of Islamic banking are highly based on Islamic sharia and Islamic principle. At the beginning of the banking industry, practices of Islamic banking were made only in the Muslim majority areas and regions, but gradually these practices spread all over the world as the Islamic financing laws protect the societies and participants from extra financial burdens by improving the social and economic wellbeing.

A research was conducted by Song, Mr and Carel (2014) to examined Islamic banking supervision and regulation. The results suggested that the legal framework of Islamic banking explicitly recognizes the practices of Islamic banking. It has also been suggested that the majority of the participants believe that stand-alone banks are the major practitioner of Islamic banking. However, there are some conventional banks that were partly involved in Islamic banking (Mr and Carel, 2014). There are different Islamic financing methods that assist the contracting parties in the timely completion of the financial agreement, and Tawarruq is one of them, which is now widely being used in most of the financial institutes of the world. It is a method used by the financial institution in which one party buys an asset and then sells this asset to a third party on the basis of deferred payment.

Tawarruq was initially used and practiced by the domestic banking sectors of Saudi Arabia, and then gradually, it was followed and accepted by other banks. At the beginning of the twenty-first century, the banking Tawarruq was started by the Saudi British Bank (Dabu, 2007). Mohammad and Rehman believe that recently it has been found that Tawarruq is getting popularity in the Gulf Cooperation Council (GCC) countries, especially in the United Arab Emirates and Saudi Arabia. The National commercial bank (NCB) of Saudi Arabia is considered one of the pioneers of Tawarruq in terms of using it as a financial product (Nagaoka, 2012). Similarly, it is not a single innovative product used by these banks that is based on the Islamic principle. There are many others, including "Inah" and "Al Khair," which are shariah complement innovative products used by different banks of Saudi Arabia and United Arab Emirate (UAE), such as Abu Dhabi Islamic Bank (ADIB). But still, Tawarruq is comparatively one of the most popular Islamic banking products as compared to the other products in the GCC countries (Shabbir, Rehman & Akhtar, 2016)

Moreover, the London Metal Exchange (LME) has used this Islamic product (Tawarruq) on a wider scale as opposed to other Islamic applications. In general, it has been seen in the past that precious commodities such as Gold and silver are not allowed in Tawarruq, but London Metal Exchange was used as a marketplace for Tawarruq in corporate financing. It depicts the importance of innovative Islamic products with respect to the largest financial institutes of the world. The research was conducted by Ahmad et al. (2017) to examine the Tawarruq as a Product for Financing within the Islamic Banking System. The results suggested that there are some modern scholars who approve of the classical Tawarruq. However, there are several complications that create concerns regarding the acceptance of the Tawarruq worldwide. Dismissal by some scholars believes that there was a clear violation of Islamic principles in the modern implementation of financial products. But still, they believed that Islamic financial institutes should work on the creation of innovative Sharia-based financial products by strictly focusing on the Islamic principle for the betterment of societies (Ahmad et al., 2017).

In the western world, most of the regions of the United Kingdom follow the Islamic principle and consider it to be the main destination for Sharia's-compliant institutions. There are many advantages of Islamic financing as it protects the interest of the common public (Shabbir, Rehman & Akhtar, 2016). So, most investors prioritize business that is based on Islamic financing. The banks of London and the Middle East, Qatar Islamic Bank (UK), Abu Dhabi Islamic Bank, Gatehouse Bank and European Islamic Bank (UK) are

some of the banks of the United Kingdom, which are completely based on Sharia's-compliant. However, after 1980 it been seen that London Metal Exchange also became active in the acceptance of the Islamic financing principle, and consequently, these began to offer Murabaha transactions through the London Metal Exchange. It is an approach of Islamic financing which facilitate the buyers and seller to begin a contract with the consent of two parties by deciding the markup and cost of a commodity. It tells that not only the muslim majority areas prefer Islamic financing, but also the western world is also accepting on a wider scale (Mohammad, 2014).

On the other hand, the Muslim community also has serious concerns regarding the practices of Murabaha financing as they think there is no difference exist between conventional and Islamic financing as the study by Mansour and Sa'adeh (2016) to analyze and investigate the practices of the Islamic banks with regard to the shari'a point of view. The finding suggests that practices of Murabaha financing, which is thought to be according to the Islamic financing principles, are far from Sharia complaints and principles (Mansour & Sa'adeh, 2016). So, it is crucial for all the banks who claim the practices of Islam in their financing operations that their operations are completely based on the guidance of the Quran and the holy prophet (PBUH) as it is needed for the rapid and positive growth of the society (Alotaibi, H. 2022)

According to Lackmann (2015), the estimated worldwide market for Islamic financing was \$2 trillion in 2014, and it was estimated that this figure will be 10 times more in 2030. It is a type of Islamic financing product that is based on Islamic principles and facilitates capital management and fund generation. Basically, it eliminates the interest and generates entities generating income with the help of transaction fees. According to the AAOIF, which is an Accounting and Auditing Organization for Islamic financial institutions, Sukuk is a certificate that defines the ownership of an investor in a commodity. There are three different types of Sukuk that are commonly used in the London metal exchange, which include sales-based, agent or broker based, partnership-based and leased-based.

There are some limitations related to the Murabaha Sukuk as in the Islamic financing\g someone cannot sell the commodity without getting the possession of a assets (Morni, 2019). However, this approach is commonly used for less volatile and high liquid assets, which is why it becomes difficult for the London Metal Exchange mostly to decide the actual issuance price of a commodity like metal. However, there are still different advantages of Sukuk in front of businesses and investors as it provides a clear road map for financing the small and large projects of the commodities. So, it is against the interest and has the ability to complete the bonds in the long run. One of the other advantages of the Sukuk is that its value increases relatively faster than the conventional bonds (Zolfaghari, 2017). Furthermore, Sukuk has the potential to robust the Islamic financing and banking system

London Metal Exchange also influenced the banks to provide joint venture services to different businesses based on the Musharaka as it is an equal sharing of risk and reward in a business or in an asset holding (Ayub, 2017). There are several advantages of the Musharka financing, like partner's profit and amount of investment can vary, but the loss of the business is shared with regard to their investment. For example, someone had bought metal from the London metal exchange, and suddenly, the owning parties of that metal experienced loss, so, based on the Musharaka, each party will have to bear the loss based on their equity. Similarly, Islamic financing prohibits the settlement of fixed returns on the holding of a commodity like metal, and it promotes trading activities based on market demand. Such as, when the demand for the commodity increases, its prices also increase. Hence, the price of the metal in the London metal exchange is based on the Islamic principle as the demand and price are significantly correlated with each other (Ahmad, Perveen & Zafar, 2021). Furthermore, in the last couple of years, the Islamic banking industry has received tremendous growth all over the world, especially in middle east countries.

The research was conducted by Safiullah and Shamsuddin (2018) to investigate the risk between Islamic banking and conventional banking. The finding of the research indicates that "Islamic banks have a relatively lower level of Solvency and credit risk but has a higher level of liquidity risk. Solvency risk is a type of risk in which a business or individual cannot efficiently meet the future obligation". The price of the metals depends on different factors, including the uncertainty of the market and the demand for the commodity. That is why there are higher chances of the price volatility of the commodity, so the decrease

in the price of the commodity can create troubles for the contracting parties like metal holders and banks who provided the capital in regard to Islamic finance. But the creation of strict rules and regulations can assist in effective risk management.

Alharbi (2015) believed that It is a fact that the Islamic financial industry and especially the banking sector, is booming globally, so the policymaker must respond to this positively by issuing rules and regulations to control the operations of the Islamic financial institutions. This will facilitate the institutions to improve their efficiency and to be competitive with their counterparts which will consequently improve their growth. It has also been found that the London Metal Exchange assist its trading partner in increasing their capital by efficiently use of their resources and implementing proactive strategies. So, resource creation leads to an increase the economic activities in a region. Cham (2018) believed that a greater presence of capital resources is positively and significantly correlated with the growth of Islamic banking. It supports that increase in the trading activities of the London Metal Exchange has an indirect impact on the development of small banking.

### *Identification of Research Gap*

The identified research gap in this study pertains to the absence of a comprehensive and critical examination of the existing literature that establishes the need for investigating the role of Islamic banking in the London Metal Exchange (LME) contracts. The presented "Literature Review" chapter provides a collection of research findings related to Islamic banking practices, London Metal Exchange operations, and their intersection, it lacks the analytical depth required to highlight the precise gaps that this study seeks to address. A critical literature review is instrumental in not only summarizing previous research but also in identifying inconsistencies, contradictions, and areas where further exploration is warranted. The synthesis of previous studies need to be highlighted where the existing literature falls short in explaining why Islamic banks participate in LME contracts, what Islamic justifications or principles underpin this participation, and what unique challenges they encounter in adhering to their ethical and operational standards within the LME framework. So, the study would have established a strong foundation for its contribution particularly by addressing this research gap through an in-depth critical review of the literature framing the research objectives and questions within a broader context. This approach would ensure that the subsequent analysis, methodology, and findings are firmly anchored in the existing body of knowledge, thereby enhancing the significance and credibility of the research endeavor. Moving forward, the study should engage in a thorough examination of pertinent literature, pinpointing its limitations, and clarifying the research niche that the paper aims to fill.

## **METHODOLOGY**

The present study aims to explore the roles and rules of the London Metal Exchange (LME) in the Islamic banking sectors as the London Metal Exchange is one of the largest commodity exchange marketplaces all over the world and generally relies on the future agreement and contracts of base metals. The present study is based on thematic analysis. Both, Primary and secondary data were utilized to attain the main object of this study. Hence, the further methodology is presented below.

### *Research Design*

Appropriate research design facilitates the creation of the roadmap for the research study. The present study is based on qualitative findings as the interviews were conducted for the collection of primary data. The main objective of the present research is to analyze and investigate non-numeric data. The broad consideration of the data and in-depth presentation of the concepts and ideas made the research design an ideal choice for investigating the Islamic banking sector with regard to the London Metal Exchange.

### *Research Approach*

Research validity plays a crucial role in the fulfilment of the desired objective of the research; that is why selecting a suitable approach leads to an increase in the effectiveness of the results. This research opts to use the case study approach by using the existed research. Taylor, Bogdan and DeVault (2015) believed that the "case study approach of qualitative research assists in the examination of the phenomenon with different angles and also facilitates in efficiently utilization of the resources". In this way case study approach was used as the foremost tool due to its ability to produce more awareness and information on the research phenomenon regarding the roles of the London Metal Exchange in the Islamic financing or Islamic banking sector. Two case studies presented by Schoon and Natalie (2016) and Ismon (2012) have been analyzed to examine the role of the London Metal Exchange with respect to modern Islamic banking. The methodological approach chosen is based on addressing the research gap identified and exploring the role of Islamic banking in London Metal Exchange (LME) contracts within the context of Islamic principles.

### *Research Methodology and Theoretical Framework*

The primary aim of this study is to investigate and analyze the participation of Islamic banks in LME contracts and the compatibility of these activities with Islamic financial principles. In order to achieve this, a qualitative research approach with a case study methodology is employed. This approach allows for an in-depth exploration of the phenomenon while addressing the research questions within a real-world context.

### *Research Questions and Hypotheses*

Research Question 1: Why do Islamic banks participate in London Metal Exchange (LME) contracts?

Hypothesis 1: Islamic banks engage in LME contracts to facilitate trade and investment activities for their clients while adhering to Islamic finance principles. This participation can be justified through the compatibility of specific Islamic banking instruments with LME contracts.

Research Question 2: What is the Islamic justification for Islamic banking's participation in LME contracts?

Hypothesis 2: Islamic banking's participation in LME contracts can be justified based on the principles of permissible trade and risk-sharing in Islamic finance. The use of specific Islamic banking instruments provides a framework for engaging in LME contracts in a manner that aligns with Sharia principles.

### *Data Collection*

There are generally two types of methods used for the purpose of data collection, including "Primary data collection (firsthand information)" and "Secondary data collection (second-hand information)". For the purpose of critical analysis, different concepts and themes were collected from the previous research that supports the London metal exchange and Islamic financing. This research preferred to utilize secondary data as this help out in understanding how the London Metal Exchange changes its policies for dealing with Islamic banks. Then, the interviews were conducted with the management of the Islamic banks and London Metal Exchange to know the current trends. In this regard six interviews were conducted.

The following questions were asked from the participants in order to develop primary findings.

Question 01: What specific role do Islamic banks play in facilitating their customers' participation in London Metal Exchange (LME) contracts? Please provide examples of the services, support, and mechanisms employed by Islamic banks to assist their customers in navigating LME transactions.

Question 02: What are the key challenges that Islamic banks commonly encounter when fulfilling LME contracts? Specifically, focus on the difficulties faced in adhering to Islamic finance principles while

engaging in LME activities. How do these challenges impact the operations and decision-making processes of Islamic banks?

Question 03: In your opinion, what are the current opportunities available for Islamic banks that can contribute to the further development of the world's financial system, particularly in relation to their involvement in the LME? Identify specific areas or strategies where Islamic banks can play a vital role in advancing the principles and practices of Islamic finance within the LME and the broader financial landscape.

Question 04: Based on your experience and observations, which Islamic banking instruments or models are most frequently utilized in LME contracts? Provide insights into the reasons behind their popularity and their compatibility with the principles of Islamic finance. Additionally, discuss any emerging or underutilized Islamic instruments that hold potential for future adoption in LME transactions.

### *Data Analysis*

The present research opted to use thematic analysis due to its ability to interpret the phenomenon and concepts effectively. The proper data analysis facilitates establishing effective outcomes and conclusions. According to Clarke, Braun, and Hayfield (2015), the thematic approach of data analysis creates a deep understanding of the study with regard to the research question by analyzing the qualitative data. So, the availability of the concepts and themes is necessary for the appropriate data analysis.

### *Ethical Consideration*

Ethical considerations are rigorously upheld throughout the research process. All interview participants were provided with a comprehensive understanding of the research objectives, and their informed consent was acquired prior to conducting interviews. To ensure the safeguarding of identities and sensitive information, strict confidentiality and anonymity measures are meticulously maintained. This research is deeply committed to adhering to ethical principles. Over-exaggeration and misinterpretation of data have been conscientiously avoided. Proper attribution of data sources is upheld to duly acknowledge the authors and their contributions. The findings and results are presented objectively, regardless of potential bias factors, thus reflecting an accurate and unbiased portrayal of the phenomenon under study. Potential risks to human subjects within this study are duly acknowledged. These include the imperative to preserve confidentiality and anonymity in order to protect participant identities and sensitive data. Furthermore, there exists a potential risk of bias or misinterpretation of data, potentially impacting the credibility and trustworthiness of the findings. Upholding ethical considerations serves to mitigate these risks and ensure the well-being and integrity of all participants.

## **RESEARCH FINDINGS**

There are different Islamic contracts, including Murabaha, Tawarruq, Slam and Istasna and Kafala, which are widely used by the London Metal Exchange all over the world, especially in the Middle East region, for dealing with the transaction of the commodity.

### *Secondary Findings*

After the thorough analysis of selected case, the research has achieved the following results.

#### *Murabaha Transactions in London Metal Exchange*

The utilization of Murabaha contracts in the London Metal Exchange for short-term commodity trades is a prominent practice within Islamic finance. Murabaha, a contract of sale where the predetermined profit margin of the commodity or asset is established at the contract's inception, enables borrowers to make a single payment or pay in installments within a specified timeframe (Bindabel, 2017). This type of contract has garnered significant attention due to its relevance in modern Islamic banking within the London Metal



Exchange (Schoon & Natalie, 2016). In analyzing the role of the London Metal Exchange in conjunction with modern Islamic banking, Schoon and Natalie (2016) found that Murabaha contracts in the exchange are typically associated with base metals. The ownership of these metals is denoted by warrants, which serve as documents or licenses indicating the specific amount of an approved brand of metal held within the exchange's warehouse. For instance, aluminum is commonly associated with a contract size of 25 tons, while aluminum alloy has a contract size of 20 tons in terms of warrants.

This practice allows the London Metal Exchange to mitigate risk for its users through the provision of warrants, thereby facilitating secure financing within the metal industry (Mobbs, 2010). Consequently, the popularity of Murabaha contracts is rapidly increasing, particularly in Gulf countries. The specific focus on Murabaha transactions within the London Metal Exchange sheds light on the crucial role played by this Islamic financing mechanism. By adhering to the principles of Islamic finance, which emphasize fairness and ethical conduct, Murabaha contracts have gained prominence as a viable and compliant instrument for conducting business within the exchange. This review of Murabaha transactions in the London Metal Exchange highlights their significance in promoting Islamic finance principles and contributes to the broader understanding of their impact on the metal industry.

#### *Tawarruq Transactions in the London Metal Exchange*

The number of Tawarruq transactions has been increasing in the London Metal Exchange with regard to Islamic financing. It is defined as a purchase of a product without deferred payment and then selling the product or asset to any other party on a cash basis. The study by Ismon (2012) investigated the role of Tawarruq in the London Metal Exchange as it is majorly followed by the Muslim population. The findings of the Ismon's study indicate that "it can be summarized that Tawarruq is permissible but subject to a certain condition, provided that genuine Tawarruq is allowable than organized Tawarruq in Tawarruq transaction". However, there are different views of different scholars about the Tawarruq contracts as some of the scholars do not completely accept them due to the misinterpretation of Islamic principles. This contract is widely used in the Middle East countries in the London Metal Exchange for the transaction of the commodity (Alkhamees, 2017). However, according to the practices of Islam, the product or any goods are allowed to sell by the owner of a product; otherwise, this gain would be considered haram. So, the transfer of the control of the product is also underlaid in the ownership of a product. So, it basically depends on the intent of the traders. Therefore, it can be analyzed that the Islamic banks which are encouraging the transaction and dealing of Tawarruq are according to the principle of sharia.

On the other side, Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) has also confirmed that the transaction of the Tawarruq is based on Islamic laws, but due to the negative view of some Islamic scholars as they think Islamic banking does not base on the Islamic principle and all the activities of the Islamic banks are similar to the conventional banking System. It has increased the concerns of the contracting parties, like customers. Specifically, Muslims do not want to avail any type of financial service, which can lead to religious conflict. Furthermore, this difference of opinion should have been minimized by further explanation of these types of contracts by the concerned bodies, such as the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI). So, it should illustrate the sharia's complaint clearly.

#### *Istasna, Salam and Kafalab*

London metal exchange does not manufacture or prepare any type of metal; it provides platforms that facilitate the purchase of the metal products by collaborating with the manufacturers and consumers of metal. In this way, it also facilitates the provision of the Istasna and Salam transaction. Istasna is one of the approaches of Islamic financing, which is used for the purchase of a product or metal which is not manufactured yet (Ahmed, Islam & Alabdullah, 2014). Similarly, Salam is an Islamic approach to financing a commodity based on the advance payment and delivery take place in the future. Istasna sales approach is generally used for the manufacturing commodity. However, the Salam approach to Islamic financing is generally used for the trading of commodities. There are some concerns related to the Istasna and Salam transactions as most of the commodity has a higher level of fluctuation in their price, so most of the time,

due to the advance payment of the commodity, trading parties bears the severe loss. But, the loss of one party consequently proves to be beneficial for the other party. So, a higher level of risk is also involved. Furthermore, the London metal exchange works as a broker and ensures their trading partners will fulfill their contracts in a timely manner. It indicates that the London metal exchange work as a "Kafalah". In Islamic financing, Kafalah refers to taking responsibility for the contracts of two different parties (Hussain, Shahmoradi, & Turk, 2016). Kafalah plays a vital role in the provision of the cross-border transactions of the trades, and against this guarantee, the London metal exchange charge certain fees, which is the main source of income for this metal exchange.

Most Middle East countries like Saudi Arabia, UAE and Oman focus on the implementation of the standards of the AAOIFI, which is an Accounting and Auditing Organization for Islamic Financial Institutions that was established in 1990 with the help of Islamic banks to boost the Islamic financial sectors. The findings of the Al-Abdullatif, (2007) indicate that most of the participants prefer to adopt and accept the accounting standards of AAOIFI in the Islamic banks of Saudi Arabia. Similarly, the financial reports of the conventional banks are considered one of the important tools for effective decision making for investors as it provides information which helps to understand whether the bank is capable enough to return the investment amount in the future". The product of Islamic banks "Sukuk" is also widely used in the London Metal Exchange but the use of Sukuk is limited. This exchange promotes trading activities; that is why there are some other Islamic banking products that don't have any link with these products, like Jjara and Takaful services. The London metal exchange does not provide any type of leasing service for a commodity, which is why difficult to implement this Islamic concept in the metal exchange.

#### *Primary Findings*

The role of the Islamic Banks in the London metal exchange, the present study gathered the primary (Qualitative) data in the forms of Interviews with the staff of the Islamic banks and the London Metal Exchange. In response to the question about the current role of the Islamic Banks in order to facilitate the Customer about London Metal Exchange, one of the participants replied:

*"Islamic banking system is remarkable specifically when it comes to the risk management during the process of trading. There are different Islamic instruments, including Murabahah and Tawarruq, which can facilitate their customer to participate in the trading activities of the London Metal Exchange".*

This response was as per the findings of the literature; according to Miah & Suzuki (2020), the Islamic financing system of Islamic banks does not support such business practices, which have a higher level of risk. The finding also indicates that Tawarruq and Murabaha are the two Islamic products which reduce uncertainty, specifically the level of uncertainty.

The second respondent replied, in response to the same question that:

*"The Islamic banking system is rapidly growing all over the world as it assists in promoting fairness. Most of the participants who usually participate in the trading activities of the London metal exchange are non-Muslims, and for the purpose of minimizing the risk, they prefer to avail of the services of the Islamic banks".*

This response supports the findings of Mohammad (2014) as he illustrated that the western world is positively inclined toward Islamic banking practices on a wider scale. The rest of the participants also showed their positive thoughts about the role of Islamic financing in commodity exchange trading.

In response to the second question about the Banks' issues regarding the LME Contracts. One of the respondents indicated that:

*"One of the major issues which banks generally face is the fluctuation of the price of the commodity. According to the Shariah Committee, banks are not liable to hold any commodity or assets which have a higher level of price fluctuation".*

This response was supported by Safiullah and Shamsuddin (2018) as they believe that "The price of the metals in the London metal exchange depends on the level of market's uncertainty and the demand for the commodity". Furthermore, Ahmed, Islam & Abdullah, (2014) believe that most metals in the London Metal Exchange have a higher level of fluctuation in their values. Due to this, trading parties bear the severe loss in this market.

One of the other respondents replied to the same question:

*"Sometimes Islamic banks make the contracts more complex by adding Counter-offer in their policies. Islamic scholar's emphases on the concept that the project should be clearly stated for their users".*

The rest of the participants also shared their concerns regarding the issues of the Islamic banks with regard to the LME. One of the most renewed issues that most of the participants illustrated is that verification of the data takes time, and sometimes it leads to delays in the transaction of the Islamic banks. This consequently affected the trading of the commodity in the London Metal Exchange, and traders were usually affected the most by this act. So, there is a need to improve the overall operations.

The next question was regarding the current opportunities for Islamic Banks. One of the participants replied:

*"Well! There are almost 1.9 billion Muslims all over the world who do not prefer to avail the services of the Conventional Banks as the conventional banking system promotes the use of Interest".*

One of the other respondents replied:

*"Most of the clients complained about the operational efficiency of the banking staff and about the use of obsolete technologies. So, there are a wide range of opportunities waiting for the Islamic banks if they bring advancement and improve the operational efficiency level".*

The above findings are also supported by Muhammad et al. (2020) as they believe that Islamic financing has the potential to create positive influences on the financial system of the world in different ways, specifically for Muslim majorities regions. Furthermore, the rest of the participants also illustrate the variety of opportunities which can be beneficial for both equity investors and for banks as well.

The last question was regarding the most used instruments in the London Metal Exchange. In response to this question majority of the participants replied that Murabaha and Tawarruq are the two major instruments which are widely used in the London Metal Exchange. These findings also supported the literature as Shabbir, Rehman & Akhtar (2016) believe that "Tawarruq is the most used and popular Islamic banking instrument as compared to the other instrument". The findings of Mansour & Sa'adeh (2016) also illustrated the use of the Murabaha financing in the London Metal Exchange in their study. This indicates that all the responses of the participants are based on real-world case studies and are irrespective of any biasness factor.

## DISCUSSION

In light with the case study analysis, following themes have been presented and discussed in detail.

### *Islamic Finance and Trade in London Metal Exchange*

Islamic financing revolves around the provision of financial services with regard to Islamic law. There are many practices in the conventional banking sectors which are strongly prohibited in the Islamic financing or banking sector. The Islamic laws of financing do not accept any payment, which includes the "interest (riba)", "gambling (maysir)", "excessive uncertainty (gharar)", and short selling of the commodity or assets, which is considered dangerous for the society and have a harmful impact in a region. Similarly, Islamic financing influences the importance of the equal distribution of the risk and reward irrespective of the

speculation and hedging of the assets. It indicates that Islamic financing has a real economic purpose. On the other side, London Metal Exchange is a futures exchange that generally relies on the future agreement and contracts of base metals. There are several activities performed in the London Metal Exchange which are against the Islamic principle as it supports the short selling of assets, and a higher level of uncertainty is involved in the purchasing and selling of assets. However, London Metal Exchange also promotes the Islamic financing contract with regard to sharia's complaint for better risk management and reducing the uncertainty for the trading partner.

### *Risk Management and Sharia's Principle*

Risk management is one of the important components of trading activities as effective risk management techniques facilitate minimizing the risk and managing the risk-to-reward ratios efficiently. The concept of risk in the financial world is defined as the uncertainty of the business operation. There are generally four types of risk involved in a business operation which are "governance risk, financial risk, business risk and treasury risk". Governance risk refers to the uncertainty which arises in regard to the changes in the policies of the government. Similarly, Financial risk is the probability of losing the value of the assets with regard to time, such as the depreciation of an asset. Similarly, business risk is associated with the surroundings, such as changes in the macroeconomic variable within the region or country. Lastly, the trade risk is associated with the trading activities of the London metal exchange, like the Liquidity risk and hedging risk. So, according to the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), these types of risks generally involve a higher level of uncertainty, which is why Islam does not allow trade that consists higher level of forecasted uncertainty. Sharia's principles influence the importance of proactive risk management techniques. On the other side, Future trading, Margin trading and options trading involve a higher level of risk and comes in the category of maysir (gambling), which is why prohibited to trade. The future trade is also questionable as it does not give proper possession of assets and some scholars think that due to the lack of controllable factors of risk in the future trades, it is considered against the Islamic financing principles.

Islamic banking sectors have improved a lot with regard to risk management due to the nature of products. There is a further need for development and policies which assist in mitigating the risk. The research study by Al Rahahleh, Ishaq Bhatti & Najuna Misman (2019) suggests that most Islamic Banks' products are being replaced with the products of conventional banks. Therefore, the findings also reveal that the "Islamic banking system is lacking behind in terms of risk management as there is not any strong support for sharia-based products. The Islamic banking system is expanding all over the world, but financing expansion of the Islamic banks does not have a positive impact on the level of credit risks".

### *Opportunities for Islamic Financial System*

The Islamic financial system has received tremendous growth in the last couple of years. According to the report on the Islamic financial service market, "the Gulf Corporation Council countries account for the largest market share in terms of Islamic banking assets holding contain the market share of 45.5% percent. The rest of the major share was contained by the South-East countries (23.5%) and Middle East South Asian countries (25.9%)". However, there is much more need for improvement for the Islamic financial system in the African region as these countries only contains Islamic banking assets of around 1.6% as compared to all other regions (Islamic Financial Service Board, 2021).

Islamic financing has the ability to create further positive impacts on the overall financial system of the world in different ways as it has the potential to promote financial attachment, especially for Muslim communities (Muhamad et al., 2020). The advanced Islamic financial system has the potential to support new start-ups and small and medium- sizes enterprises (SMEs) with the provision of risk-sharing strategies and financial support. There is a higher probability of growth of this financial system with regard to SMEs and Start-up as the entrepreneurship culture is growing all over the world at a faster pace. Furthermore, Islamic financing also reduces the systematic risk as it prohibits speculation, which increases the importance of this financial system (Fathonih, Anggadwita, & Ibraimi, 2019). Lastly, the Muslim population is one of the most important factors behind the development of this financial system. There are more than 1.8 billion

Muslims all over the world who prioritize sharia's compliant base financial systems rather than conventional financing. So, with the inclusion of the diverse Muslim population, these financial systems can create dominance all over the world.

### *Criticism of Practices of the Islamic Financing*

The Islamic financing system has received constructive as well as destructive criticism from the Islamic scholar. Most scholars criticize with the purpose of improving the Islamic financial system. Islamic bank generally plays their role as an intermediary which try to fulfill the expectations of the people's investment with regard to the time value of the money. However, Muslim scholar thinks the Islamic banking system should not be commercialized, and Islamic banks should have to work for a welfare organization. Another allegation that scholars. However, this allegation arises just because of the lack of information regarding products. Islamic banks have a complex procedure that is based on the guidance of the Quran, Sunnah, Ijma, Qiyas and Ijtihad. If the product follows basic sharia law, then it is approved by the sharia scholar, and after their approval, it is offered to the customer.

Moreover, the Murabaha model is one of the most criticized models of Islamic banking as Muslim scholars think company sells their products (Car, House and other commodities) on installment, but in the actual case, according to this model, the customer does not make direct contract with the company, banks first purchase the products and sell this to their customer on deferred payment with a markup. In this way, banks transfer the ownership of the products to the customer based on the contract. Most scholars also widely criticized why the Islamic banking system has different principles and policies in different regions and how it is possible that sharia's law can vary from region to region. However, in this regard, AAOIFI played a crucial role in the preparation of the standard for all Islamic banks and other financial institutions. So, each country implements these standards based on its macroeconomic factors. Furthermore, there is a perception in the non-Muslim communities that the Islamic banking system is just designed for Muslims, and only they can utilize these services. But in actuality, this financial system is irrespective of ethnicity, race and region. Most people also think that Islamic banking does not facilitate start-ups and entrepreneurs in terms of financial support due to the involvement of a higher level of risk, but this is against reality. Islamic banking system first evaluates the risk and provides the financial support if it see the potential in start-up to meet the future obligation.

## **CONCLUSION**

In conclusion, this research has shed light on the significance of Islamic banking and its engagement with the London Metal Exchange. The findings confirm the prevalence of Murabaha, Tawarruq, Istisna, Salam, and Kafala as the primary Islamic banking models used in LME contracts, particularly in the GCC regions where they hold the largest market share in terms of asset holding. This preference for specific models can be attributed to the nature of LME operations, predominantly centered around the sale of commodities. Islamic principles, rooted in ethical values, prohibit transactions involving Riba (interest) and gambling-like activities, thus limiting the use of certain financial instruments. While some scholars criticize the perceived similarities between conventional and Islamic banking, it is important to note that Islamic banking products undergo rigorous evaluation and scrutiny based on Islamic principles. Independent bodies like AAOIFI provide regulatory frameworks for Islamic banks and other financial institutions, ensuring compliance with Islamic values. To further develop the Islamic financial system, it is crucial for Islamic banks to maintain their adherence to Islamic principles and avoid engaging in activities conflicting with Islamic values. Challenges such as the short selling of commodities, which is considered a form of gambling, need to be addressed. Islamic banks have the potential to dominate the global financial sector by eliminating concerns associated with conventional banking practices and by promoting awareness and guidance on Islamic banking products.

Recommendations for future research include exploring the impact of LME rulings on Islamic banking practices, examining the role of Islamic banking in other international commodity exchanges, and investigating the effectiveness of regulatory bodies in ensuring adherence to Islamic principles. By

expanding our understanding of the interplay between Islamic law and financial systems, we can foster the continued growth and development of Islamic finance, offering viable alternatives that align with ethical and moral values.

The findings of this research have several implications for research, practice, and society. Firstly, in terms of research, this study sheds light on the role of Islamic banks in the London Metal Exchange (LME) and their use of Islamic banking instruments. It contributes to the existing body of knowledge by exploring the compatibility of LME practices with Islamic finance principles. Future research can build upon these findings to delve deeper into specific aspects such as the impact of Islamic banking on LME transactions, the effectiveness of Islamic financial instruments in risk management, and the challenges faced by Islamic banks in the LME context. From a practical perspective, the results of this study have important implications for both Islamic banks and the LME. The identification of Murabaha, Tawarruq, Istasna, Salam, and Kafala as the most commonly used Islamic banking instruments in the LME provides valuable insights for Islamic banks operating in this domain. They can leverage these instruments to better serve their customers and facilitate their participation in LME contracts. Islamic banks can also benefit from understanding the challenges faced by their counterparts in fulfilling LME contracts, enabling them to develop strategies and solutions to overcome these obstacles.

For the LME, this research highlights the need to align its practices with Islamic finance principles to attract a larger pool of Islamic banking participants. The findings indicate that certain activities in the LME, such as short selling of commodities, contradict Islamic financing principles. By addressing these concerns and adopting practices that are compliant with Islamic law, the LME can create an environment that attracts more Islamic banks and investors, leading to increased market participation and liquidity. On a broader societal level, this research contributes to the ongoing dialogue and understanding of Islamic finance and its role in the global financial system. The findings emphasize the importance of Islamic banking systems in promoting equitable resource distribution and risk management. By raising awareness of Islamic finance principles and their application in specific contexts, this research can help promote greater acceptance and integration of Islamic finance practices worldwide.

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