

SHARIA COMPLAINT SWAPS AND HEDGING TO MITIGATE RISK IN SHARIA COMPLIANT INVESTMENTS



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TOPIC – A

CONVENTIONAL DERIVATIVES & THEIR POSITION UNDER SHARIA

1. Understanding conventional derivatives

- A financial arrangement, the value of which is derived from another financial instrument, Index or measure or economic value.
- Exchange of cash or delivery flow between two parties each of which flow is, in the eyes of the respective parties, equal to the other at the start of the agreement; a financial arrangement involving mutuality and valued by reference to current market rates, price and levels.
- A contract in which the party only pretends to do something and allocate the risk and benefits between themselves as if they had done that something.

1. Understanding conventional derivatives

- Categories of conventional derivatives – 3 Categories
 - Customized, privately negotiated derivatives known as over-the-counter (OTC) derivatives).
 - Standardized, exchange-traded derivatives, known generically as ETD.
 - Debt obligations, hybrid securities and securitized derivatives.

1. Understanding conventional derivatives

- Types of Derivatives
 - Forward
 - Futures
 - Options
 - Swaps
 - Interest rate swaps
 - Currency swaps
 - Credit swaps
 - Commodity swaps
 - Equity swaps

2. Sharia position on conventional derivatives

- Prohibitions under Sharia
 - *Riba* (Interest) – Underlying considerations is interest based.
 - *Gharar* (uncertainty) and *Jehala* (ignorance) - Sale of an uncertain asset or an asset, which one does not own.
 - *Maysir* (speculation) and *Qimar* (gambling) – Purpose is to speculate on the basis of certain incidents and determine the entitlements accordingly.
 - Subject matter does not qualify the conditions, which makes the assets sellable or investable under Sharia.

2. Sharia position on conventional derivatives

- Prohibitions under Sharia
 - Prohibition with regard to form and substance;
 - a. Lack of delivery and possession.
 - b. Deferred transaction in respect of currency/commodities.
 - c. Form of derivatives - Are binding promises that are converted into a sale contract on the future date without an offer and acceptance.
 - d. Deferment of the counter-values.
 - e. No actual exchange of counter-values (usually on notional basis).
 - f. Conditionality of Sale.

2. Sharia position on conventional derivatives

- Sharia Rulings on prohibition
 - On futures and forwards
 - As per Item 5/1/2 of AAOIFI Sharia Standards No: 20 (In respect of Sale of Commodities in Organized Markets), Futures are not permitted either with respect to their formation or with regard to their trading.
 - On options
 - As per Item 5/2/2 of AAOIFI Sharia Standards No: 20 (In respect of Sale of Commodities in Organized Markets), Option contracts are not permitted either with respect to their formation or with regard to their trading.
 - On swaps
 - As per Item 5/4/2 of AAOIFI Sharia Standards No: 20 (In respect of Sale of Commodities in Organized Markets), Swaps are not permitted either with respect to their formation or with regard to their trading.

TOPIC – B

SHARIA BASIS FOR PERMISSIBILITY OF INSTRUMENTS

1. Norms under Sharia for Sale and Trade

- Allah has permitted Trade and forbidden Riba (2:275 – Holy Quran).
- "O ye who believe, fulfill your contracts,"(5:1 – Holy Quran) with the proviso "except what legalizes the prohibited and prohibits what is legal"
- "Muslims abide by their conditions, except for a condition that legalizes the prohibited or prohibits the lawful"
- "He who buys food grain should not sell it until he has taken possession of it".

2. Prohibition of Riba (interest)

- An instrument/contract is considered Sharia repugnant if it is based, promotes or comprises of elements of Riba (interest). Instruments which vitiate the principles of Sharia on counts of Riba (Interest) are:
 - i. Direct interest based aspects like lending, borrowing or instruments providing for interest.
 - ii. Contracts involving sale and purchase of currency (including foreign exchange, gold and silver) in violation of “**hand to hand (spot) and equal in amount and quantity rule**” if the underlying commodities are of the same species and considerations.

2. Prohibition of Riba (interest)

iii. Other instruments of Riba including the following:

- ***Bai–Al–Einah*** :
 - When the bank purchases a commodity from its client on a spot basis and sells it back to the client at a cost-plus price and on a deferred basis.
- ***Bai–Al–Wafa*** :
 - Under this contract one party sells an asset to another for a price on condition that the asset would revert back to the seller when he returns the price on a future date;
- ***Bai-Al-Dayn*** :
 - Sale of receivables or debt.
- ***Riba-Al-FadhI*** :
 - This is selling one type of item for the same type of item that is better in quantity.
- ***Riba-An-Nasiyah*** :
 - One form of this type is to receive compensation for providing or deferring the debt.
- **Conditional Sale** :

3. Prohibition of Gharar & Jihala

i. Description

An instrument/contract is considered Sharia repugnant on the grounds of *Gharar* (Uncertainty) or on the basis of *Jihala* (Ignorance) since it results in any or combination of the following:

- Injustice in any form to any of the parties;
- Hazard or peril leading to uncertainty in any business;
- Deceit;
- Fraud;
- Undue advantage;
- No Real-time transaction.

3. Prohibition of Gharar & Jihala

- ii. Following are broad forms of *Gharar* and *Jihala* :
 - a. Subject Matter – reasons could be attributed to any or all of the following:
 - Description of the subject matter;
 - Non-existence of the subject matter or lack of possession or delivery;
 - The considerations for the sale should be known, fully ascertainable and their identity should not be subject matter of uncertainty, misinterpretation or vagueness
 - Deferment of both the consideration would make the instrument Sharia repugnant on counts of uncertainty of consideration.

4. Prohibition of Gambling (Al Qimar) and Speculation (Al Maysir)

- An instrument/contract is considered Sharia repugnant if it is based, promotes or comprises of elements of Gambling (*Al Qimar*) and Speculation (*Al Maysir*).
- The *Holy Quran* and the traditions of the Prophet (pbuh) explicitly prohibit gains made from games of chance (gambling), which involve unearned income (*Al Maysir*).

5. Justification of revenue on the basis of risk

a. Sharia basis

- Permissibility of return attributable to the assumption of risk , there cannot be profit if there is no ownership risk involved.

b. Types of Risks

- Impermissible risks: These vitiate the contract, including the following:
 - Combining elements of hedging under the instrument.
 - Exclusion of ownership risk & Investment risk;
 - Stipulating or trading only in profit or margin in currencies;
 - Trading based on performance of indices, exchange rate difference or contract values.
- Permissible risks:

Certain risks can be mitigated and excluded by adopting permissible Sharia structures either by a party to the transaction or by external third parties. The form of the exclusion and conditions for such mitigation depend on the party's capacity, the Sharia instrument and the nature of the underlying risk.

6. Considerations pertaining to instruments

i. Form and content:

Due deference should also be given to the form and content of the subject matter instrument.

ii. Pre-agreement:

Sharia does not permit the parties to pre-agree and fix the terms of their contract (i.e. as can be evinced from the form of an agreement to sell, etc).

iii. Combination of contracts:

Sharia does not permit the parties to combine more than one contract under an instrument if the contracts are mutually dependent on each other.

iv. Compliance to Sharia rules:

Sharia permits certain structures to be based on promise (for example), due consideration should be given to follow the Sharia rules in adopting such structures (i.e, no pre-arrangement (oral or written) to be made, promise should not be bilateral, etc).

TOPIC – C

RISK MANAGEMENT THROUGH SHARIA COMPLIANT DERIVATIVES

1. Derivatives based on Wa'ad (Unilateral Undertakings)

a. Wa'ad Structure

Wa'ad structure has been used to mitigate profit and currency related risks with the following features:

- Should be asset based except for currency units;
- If the structure envisages promises to be obtained from both the parties then same should be mutually exclusive (including on counts of subject matter, conditionality, price, etc);
- Should be based on actual performance and must result in actual trading and should not be on notional basis.
- For profit swap, asset must be used.
- For currencies, either promise for sale or purchase of currencies only or sale and purchase of assets at agreed benchmark or fixed rate.

1. Derivatives based on Wa'ad (Unilateral Undertakings)

b. Application of Wa'ad in mitigating risk

- Sharia compliant options and hedging;
 - Profit related risk (Asset based);
 - Currency related risk (Asset based and Currency based);
 - Providing conditions of exercise to achieve;
 - Sharia compliant cap mechanism;
 - Sharia compliant floor mechanism;
 - Sharia compliant collar mechanism.
- Sharia compliant mitigation of Asset Disposal Risk, Commercial Risk and Legal and Regulatory Risk.
 - Exercise of Option through Purchase Undertaking;
 - Exercise of Option through Sale Undertaking.

1. Derivatives based on Wa'ad (Unilateral Undertakings)

b. Application of Wa'ad in mitigating risk

- Examples
 - i. Structure and Process Flow of a Profit Rate Swap
 - ii. Structure and Process Flow of a Currency Swap
 - iii. Structure and Process Flow of a Currency Hedge

2. Derivatives based on Master Murabaha Agreement

Pursuant to the Murabaha Contract the seller shall sell the underlying goods to the buyer on a cost-plus profit basis. The exact cost price, profit (mark-up) and the settlement date are specified in a subsequently formed Murabaha Contract, however, the mechanism for price determination is set out in the Master Murabaha Agreement.

3. Derivatives based on Salam and Master Salam Agreement

Pursuant to the Salam Contract the seller shall sell the described (by weight, type and measure) fungible commodity to the buyer in exchange for immediate payment

4. Derivatives based on Bai- Al-Urbun

Under this sale the buyer pays earnest money (the "**Urbun**") to the seller as a part payment of the price with an option to rescind the contract on the condition that if it rescinds the contract the Seller shall forfeit the down payment.

Can be used for options.

Islamic *Fiqh* Academy Resolution

TOPIC – D

CHALLENGES AND ISSUES IN STRUCTURING SHARI'AH COMPLIANT HEDGING

1. Scope and enforceability of instruments

- i. Independent and mutually exclusive promises;
- ii. Taxation considerations in certain jurisdictions;
- iii. Performance based considerations;
- iv. Governing law considerations where Sharia law is not recognized as a source of law;
- v. Enforcement considerations before local courts having difficulty comprehending Sharia niceties;

2. Performance or delivery under the relevant structure

- Requirement of delivery under the underlying structures
 - Actual delivery
 - Constructive delivery
- Sharia position of delivery (AAOIFI Sharia Standards)
 - Item 3/2/3 - Sharia Standard No: 8 (Murabaha)
 - Item 5/1 - Sharia Standard No: 10 (Salam)

3. Acceleration, close out, calculation of termination amount and compensation

- Need for replacement
 - Rating downgrade
 - Change of requirements

- Determination of default
 - How default in paying installments under a concluded contract is different from default under one promise or one transaction of a master arrangement.
 - Refusal of delivery
 - Item 4/11 - Sharia Standard No: 8 (Murabaha)

3. Acceleration, close out, calculation of termination amount and compensation

- Sharia position on replacement
 - Replacement of counterparty
 - No consensus but general Ijtihad by certain Sharia scholars.
 - Replacement of assets
 - Salam contracts
 - Item 4/2 - Sharia Standard No: 10 (Salam)

3. Acceleration, close out, calculation of termination amount and compensation

- Position of Sharia scholars
 - Consensus on entitlement to receive compensation to recover actual damages (AAOIFI Sharia Standards)
 - Some Sharia scholars allow the determination of the termination amount by third parties and arbitrators.
 - Need for detailed basis to be provided.