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Shari'a Compliant Derivative Equivalents

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Intelligent

*Islamic Finance Advisory: Creating Innovative
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- ❖ Guidance from Qur'an and Hadith
- ❖ Primary Prohibitions
- ❖ Subsidiary Prohibitions Impacting Conventional Derivatives
- ❖ Permissibility of Derivative Equivalents
- ❖ Shari'a Compliance – Structural Considerations
- ❖ Examples:
 1. Profit Rate Swap (Wa'd Application)
 2. Profit Rate Swap (Murabaha Application)
 3. FX Forward (Murabaha Application)
- ❖ Innovation in Derivative Equivalents
- ❖ Key Challenges
- ❖ Future of Derivatives

✓ **All transactions are assumed permissible unless otherwise deemed impermissible**

“Allah has made trade lawful” – Holy Qur'an 2:275

“O ye who believe, fulfill your contracts” – Holy Qur'an 5:1

“O you who believe! Do not devour your wealth among yourselves falsely, except that it be trading by your mutual consent” - Holy Qur'an 4:29

“Muslims abide by their conditions, except for a condition that legalises the prohibited or prohibits the lawful” – Traditions of the Holy Prophet (PBUH), Ahmad, Vol. 1, p 312

✓ **Ownership and possession of assets key requirement for trading of goods**

“He who buys food grain should not sell it until he has taken possession of it” – Ibn Abbas reporting Holy Prophet (pbuh)

✓ **Riba explicitly prohibited**

O ye who believe! Fear Allah, and give up what remains of your demand for usury, if ye are indeed believers. – Holy Qur'an 2:276

✘ Riba (Usury)

All forms of direct or indirect forms of interest (usury) are considered impermissible. These include:

- ✘ *Riba Al-Naseea*: Direct interest from deferment of loan.
- ✘ *Riba Al- Fadl*: Contracts for sale and purchase of same asset but different quality for deferred or spot payment
- ✘ *'Bai al-Inah*: Deferred payment sale and then spot payment repurchase of the same asset.
- ✘ *'Bai al-dayn*: Sale of debt at discount or premium
- ✘ *Combination of contracts*: Combining a loan with a gift (i.e. gift is a form of riba) or combining a loan with a sale contract (i.e. sale contract is a form of riba)

✘ Gharar (Ambiguity) or Jahala (Ignorance)

Sale of probable items whose existence or characteristics are not certain, due to the risky nature which makes the trade similar to gambling

✘ Maysir (Gambling) and Qimar (Speculation)

Games of chance / Zero sum games where one party wins everything at the expense of the other

- ✘ **Asset must be valuable in Shari'a; Pure Rights cannot be sold or traded**
Only a tangible commodity or usufruct may be bought and sold in Islamic law. Pure rights cannot be bought and sold
- ✘ **Delivery and Possession**
Hakim ibn Hazam said: "I asked the Prophet: 'O Messenger of God. A man comes to me and asks me to sell him what is not with me. I sell him (what he wants) and then buy the goods for him in the market.' The Prophet replied: '**Sell not what is not with you**' - Tradition of the Holy Prophet (PBUH)
- ✘ **Deferred currency transaction**
"Gold for gold, silver for silver, wheat for wheat, barley for barley, dates for dates, salt for salt, like for like, in equal weights, from hand to hand. If these species differ, then sell as you like, as long as it is from hand to hand"
- ✘ **Mutual deferment of counter values/ bilateral promises**
"bay al-kali bil kali" Islamic maxim approved through consensus (ijma)
- ✘ **Conditional sale OR twin sales**
"The Prophet (PBUH) disallowed back-to-back sales of the same object between the same contracting parties, switching roles in each sale, the second sale being contingent upon the first" - Tradition of the Holy Prophet (PBUH)

✓ **Overwhelming need for protection/genuine hedging risk**

Shari'a scholars consider derivatives permissible only when there is an overwhelming need (darrura) for protection from a permissible risk:

"..... but whoever is driven to necessity, not desiring, nor exceeding the limit, no sin shall be upon him; surely Allah is Forgiving, Merciful." Holy Qur'an, Extract from 2:173

✓ **Critical to define types of permissible risk protection**

Cannot remove risk altogether such as ownership risk or investment risk, since there can be no profit without the assumption of risk, **BUT** can take steps to mitigate such risks. Permissible risks include:

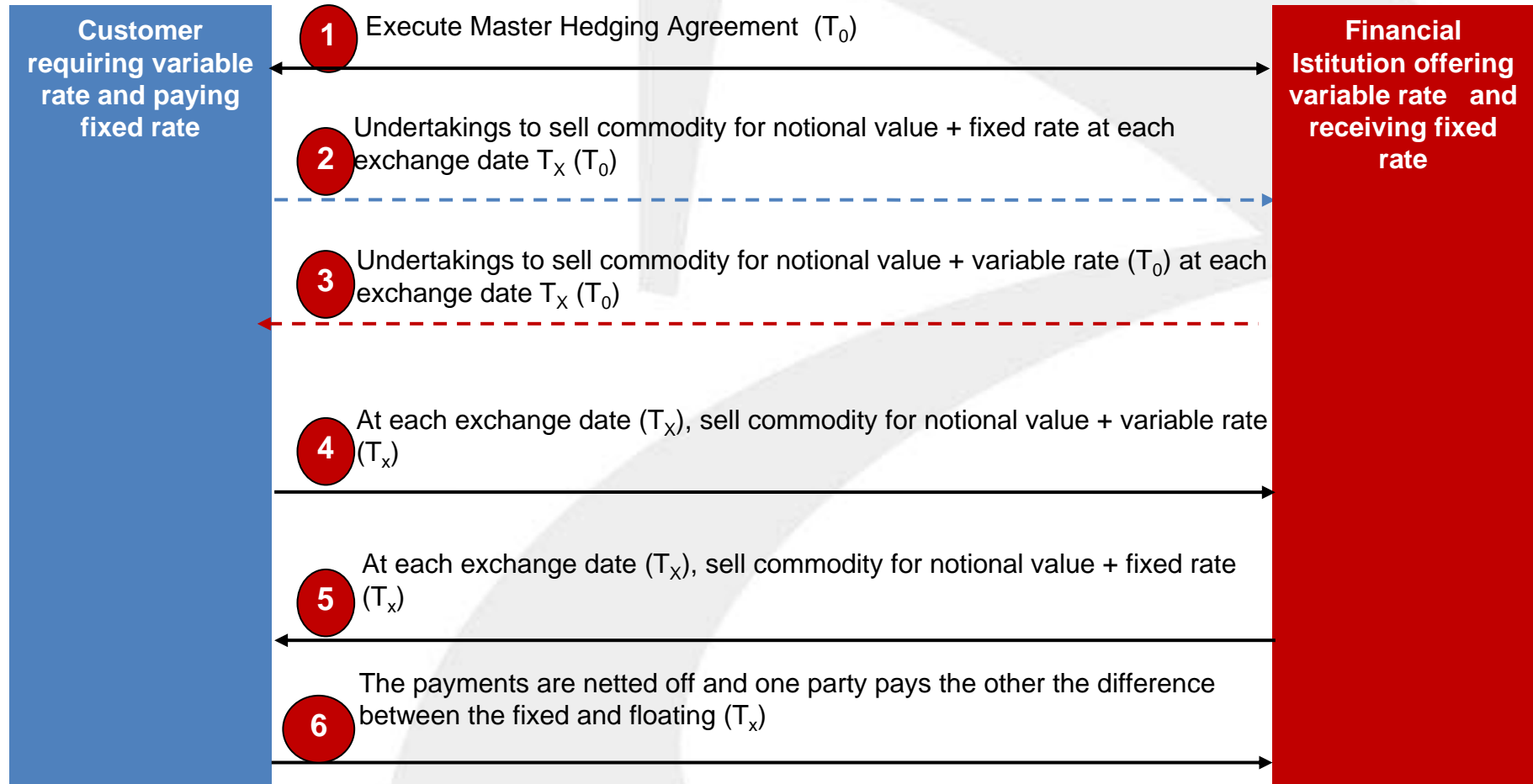
- **Currency Risk:** Risk of devaluation of investment as a result of changes in FX rates
- **Profit Rate Risk:** Risk of loss as a result of changes in profit rates.
- **Commodity Risk:** Risk that commodity prices will change
- **Counterparty Risk:** Risk that the counterparty will not perform its contractual obligations
- **Equity Investment Risk:** Risk that the investment value will decline

✓ **Structure must nevertheless be Shari'a compliant**

Steps to mitigate risk must nevertheless be compliant in form and structure

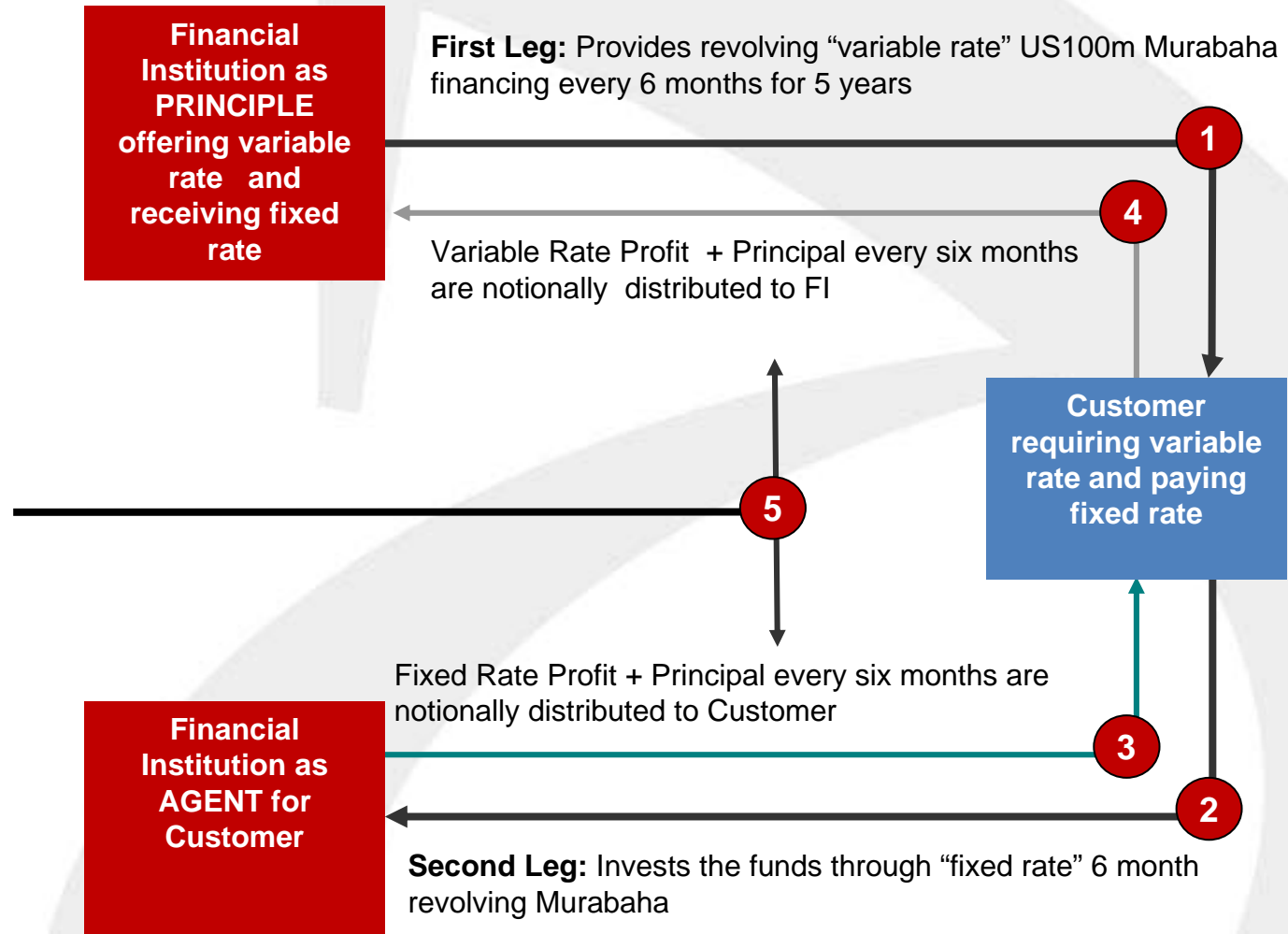
To develop a Shari'a compliant structure to replicate the effect of conventional derivatives:

- ✓ Real trade or investment based instrument
- ✓ Avoidance of any implicit or explicit application of interest
- ✓ Avoidance of any ambiguity in determination of termination amount and close out netting
- ✓ Promises (if any) should be unilateral and not bilateral

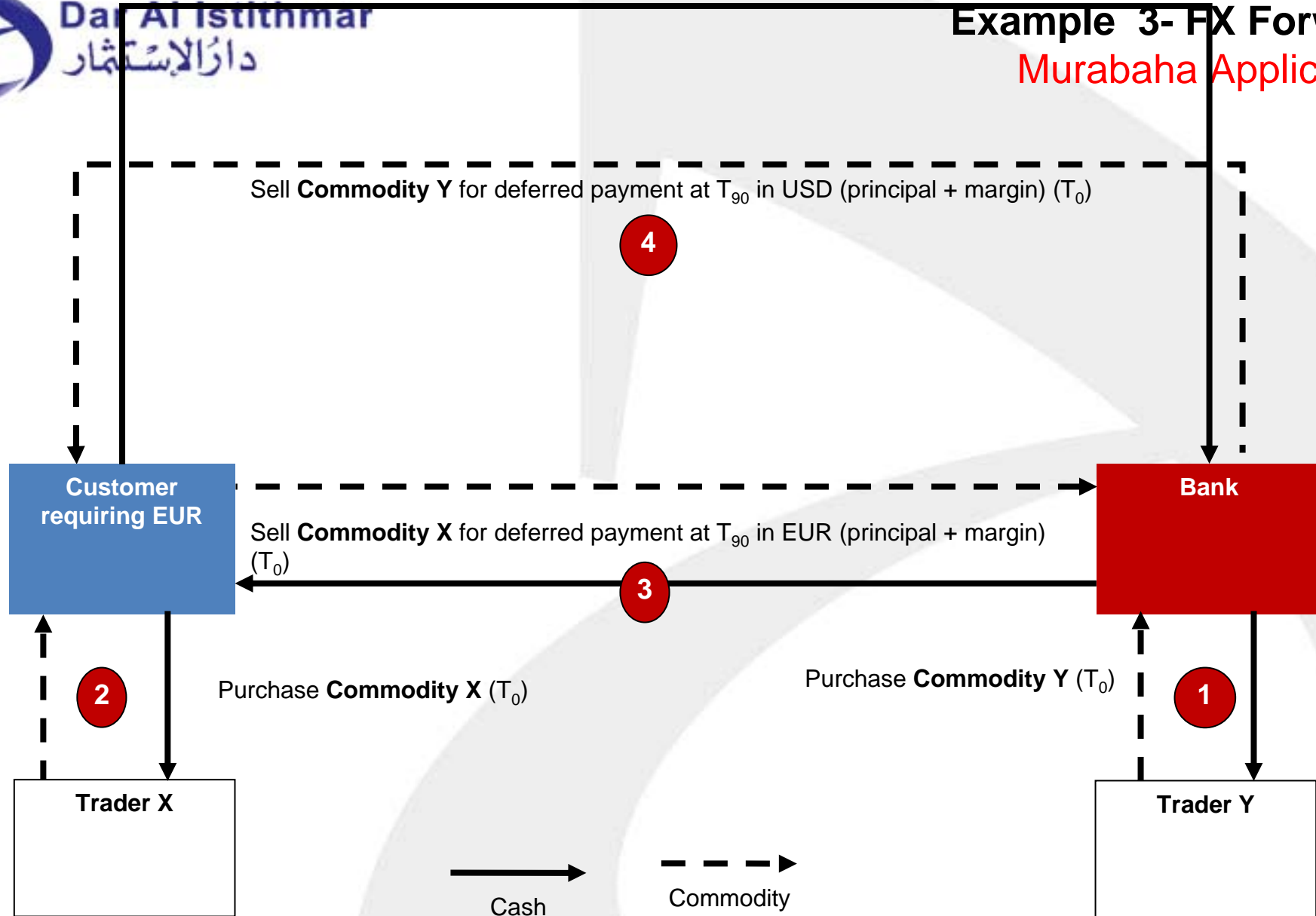


Example 2- Profit Rate Swap Murabaha Application


Net-off: Difference between Variable rate and fixed rate (3-4) are netted off and counterparty pays /receives the difference between variable and fixed



Example 3- FX Forward Murabaha Application



Shari'a Compliant Forward Hedging Mechanism

Wa'd (Unilateral promise)	Bai' al-Arboun (Sale with down-payment)	Bai' al-Salam (Advance payment with deferred delivery)
		
<ul style="list-style-type: none"> •Built-in optionality for one party. •Can be structured along with additional contracts to synthesise paid optionality •Can be utilised for all asset classes •Enforceability dependent on loss incurred based on reliance on promise. 	<ul style="list-style-type: none"> •One party has the option to exercise sale •Premium can be embedded as down-payment for a sale contract. •Can be utilised for all assets (except currencies) •Valid and enforceable contract 	<ul style="list-style-type: none"> •Both parties have to execute their obligations •Discount for advance purchase •Can only be utilised for fungible commodities (excluding currencies, gold and silver) •Valid and enforceable contract

- A credit default protection (CDP) products stands on stronger ground than a PRS contract, even though PRS has gained more acceptability in recent years.
- ✓ **Genuine mutual risk protection mechanism as opposed to protection from rate fluctuations (part of interest rate system)**
- A Shari'a compliant CDP would require:
 - **Exposure to ACTUAL credit risk exposure of a counterparty (i.e. insurable interest)**
 - **Structured according to acceptable Shari'a norms:**
 - **Wa'd and Musawama transactions combined,**
 - OR**
 - **Mutual protection (Takaful) fund with donations (tabarru) and default claims.**

- **Diversity of Shari'a opinion and absence of *stare decisis***

Even where a group of Scholars accept a derivative equivalent of a Shari'a compliant, it may be deemed impermissible by the judges in a Shari'a court or a civil court interpreting Shari'a law in its own discretion.

- **Enforcement of early termination provisions and legal recognition**

Institutions in jurisdictions which do not recognize derivatives or consider them to fall under the legal ambit of gambling laws will find it difficult to enforce the terms of an ISDA/IIFM Master Agreement in the event that they need to early terminate.

The future of Shari'a compliant equivalent of derivatives remain bright:

PROFIT RATE EXPOSURE

Profit Rate Swaps will continue to be a significant driver of derivative activity

- Total IF assets: \$600 bln
- Financing/Asset Ratio: 60%
- Hedging requirements: 50% (conservative)

Total market: \$180 bln or 1200 transactions (avg size \$150 mln)

FX EXPOSURE

External positions in countries with Islamic finance assets will require significant hedging

- March 2009 total external position: \$1.2 trillion
- 31% (estimated share of IFI's) of total external position : \$375 billion
- Last ten years of growth: 14% for assets and 12% for liabilities

2013 Shari'a compliant demand for FX hedging: \$628 bln

Thank you

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“Those who know, they do not know that to know is to know what they do not know” - Ibn Sina (Avicenna)

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