

CHAPTER 14

Islamic Derivatives: Theory and Practice

14.1. Introducing derivatives

Derivatives are financial contracts - the inherent values of which are derived from, and exist by reference to, independently existing underlying(s). The underlying(s) for a derivative contract can be an asset or a pool of assets, an index or any other item to which the parties may choose to link their derivative contract. For example, credit derivatives, equity derivatives, index-linked derivatives and property derivatives are some of the popular types of derivative instruments. In addition to these, there can be 'exotic' derivatives instruments, such as inflation derivatives, weather derivatives and mortality derivatives.

The first record of organized trading in derivative instruments can be traced back to 17th century Japan. Feudal Japanese landlords would ship surplus rice to storage warehouses in the cities and then issue tickets promising future delivery of the rice at a specified price. These tickets (representing a rudimentary form of forward contract), which were traded on the Dojima rice market near Osaka, allowed landlords and merchants to lock the prices at which rice was bought and sold, consequently reducing the risk they faced.⁷⁰

In the 19th century, Chicago was central to the development of derivatives in the United States. As in Japan, the seasonal nature of agricultural production was the main impetus behind the development of these financial instruments, culminating in the establishment of the Chicago Board of Trade in 1848. Other early exchanges involved in futures trading in the US included the New York Cotton Exchange (estd. 1870), and the New York Coffee Exchange (estd. 1885).⁷¹

In terms of standardised documentation for derivative

contracts, the formation of the International Swaps and Derivatives Association (ISDA) in 1985 was a major milestone. In 1987, ISDA published the Interest Rate and Currency Exchange Agreement and the Interest Rate Swap Agreement, which were the first standardised derivative contracts to find wide acceptance globally. These were followed by the 1992 ISDA Master Agreement (Multicurrency - Cross Border) and the 1992 ISDA Master Agreement (Local Currency - Single Jurisdiction). The 2002 ISDA Master Agreement (Multicurrency-Cross Border) was ISDA's response to market developments since 1992, and sought to consolidate the available market practice till that date. With the growing sophistication of derivative instruments, category specific standardised documents, such as the 2003 ISDA Credit Derivatives Definitions and related updates have been published by ISDA and have now gained wide acceptance.

Derivative instruments rely on specific embedded contracts to serve the required commercial ends. The most commonly used types of derivative contracts are forwards, futures, options and swaps, and these tend to be the building blocks for more complex derivative instruments. Derivatives can be either bilateral over-the-counter (OTC) instruments, or exchange-traded instruments (traded on exchanges such as NYSE Liffe, NASDAQ Dubai, Eurex or CME) and can be used for hedging (risk management), arbitrage and speculation.

(a) Use of conventional derivative instruments for risk management (hedging)

Risk management is the process of identifying, assessing and minimising risk in any commercial operation⁷².

Banks, financial institutions, corporate houses and individuals face diverse risks in commercial operations including interest rate risk, currency risk and counterparty credit risk. The process of risk management aims to reduce (or, as the case may be, eliminate) risks by managing cash-flows efficiently, with a view to ensuring that there is no mismatch at any material point of time, between the cash-flows to an entity and the cash-flows from that entity.⁷³

Using conventional derivatives for risk management constitutes at least 10% of the OTC derivatives market, and can be illustrated by way of the following example. Let us assume that at the beginning of a crop season (e.g. 11 January 2009 (T1)), a wheat farmer (F) and a miller (M) enter into a contract whereby M agrees to buy and F agrees to sell 100 bushels of wheat at the price of £2 per bushel at the time of harvest (e.g. 11 June 2009 (T2)). By entering into this contract, both F and M have managed (hedged) their respective risks in the following manner:

(i) F knows (on T1) the price at which he will be able to sell the wheat (on T2) and can accordingly (i) make investments in fertilizers, seeds, etc.; and (ii) plan future profits; and

(ii) M knows (on T1) what price he shall be able to buy wheat at (on T2) and can accordingly plan ahead in terms of pricing and marketing activities.

The contract described above is a basic example of a type of derivative contract known as a **forward contract**. If the same arrangement was mirrored through a clearing house or exchange (C) (whereby C buys the wheat from F and M buys the wheat from C), it would give rise to a **futures contract**. An exchange minimises the possibility of a default by either party by requiring the payment of an initial 'margin' and regular posting of the 'margin' based on marked to market calculations⁷⁴. Through this process, losses are recognised as they occur and the party which is out-of-the-money (i.e. the party with the losing position) is required to top-up its existing margin whenever a 'margin call' is made by C. Over the years, with increased sophistication among market-players, the concepts of 'marked to market' and 'margin call' have, along with other related concepts, evolved substantially.

Another type of derivative contract is the options contract. In the example above, if M paid a premium to F on T1 and acquired the right (but not the obligation) to buy 100 bushels of wheat at the price of £2 per bushel on T2, the contract would be regarded as an **options contract** whereby M has purchased a **call option** from F. M's decision whether or not to exercise the option on T2 would depend upon the spot price of wheat in the market on or about T2. For example, M would (i) exercise the option if the spot price was £2.50 on or about T2 (M's option would then be regarded as being **in-the-money**); and (ii) not exercise the option if the spot price was £1.50 on or about T2 (M's option would then be regarded as being **out-of-the-money**).

In the above example, M knows that he needs to pay £200 to F on T2. Let us assume that M's income source is in US Dollars (US\$). In such a situation, M might want to enter into a contract with a bank (B), whereby on T2,

(i) B agrees to pay M £200, and (ii) M agrees to pay B US\$ 300. This would be a **swap contract**, by which M hedges its foreign exchange risk.

(b) Use of derivative instruments for arbitrage

Arbitrage is the practice of taking advantage of a price differential between two or more markets - i.e. striking a combination of matching deals that capitalize upon the imbalance, with the resulting profit being the difference between the market prices. Arbitrageurs closely follow the quoted prices of the same assets / instruments in different markets and if the prices are significantly divergent, to make a profit (taking into account any applicable transaction costs), enter into an arbitrage transaction whereby they buy the asset from the market having the lower quoted price and immediately thereafter, sell the same asset in the market where it has a higher quoted price.⁷⁵ This type of use of derivative instruments requires substantial investments in global networking and telecommunication technologies, with a view to exploit potential arbitrage opportunities.

Arbitrageurs may also look to take advantage of a market situation where the current buying price of an asset is lower than the sale price of that asset in a futures contract. Unlike speculative transactions (described in paragraph (c) below), arbitrage transactions are not 'zero sum games' (as a gain by the arbitrageur is not directly linked to some other market player's loss) and can be used to harmonise and regulate international prices.

(c) Use of derivative instruments for speculation

In the example in paragraph (a) above, M had a genuine trade interest guiding his decision to enter into derivative contracts. However, the same types of contracts (i.e. forwards, futures, options and swaps) can be entered into purely with an objective of making a speculative gain. For example, a speculator (X) can enter into a forward contract with F to purchase 100 bushels of wheat at £2 per bushel on T2. This would be based on X's belief (fuelled by market intelligence and investment analysis) that the price of wheat will not be less than £2 per bushel on T2. On T2, (i) if the price of wheat is £1.50 per bushel, X pays £50 to F ((£2 - £1.50) × 100); or (ii) if the price of wheat is £2.50 per bushel, F pays £50 to X ((£2.50 - £2) × 100). Unlike derivative contracts for trade hedging purposes, in derivative instruments used for speculation, there is typically no actual delivery of goods (e.g. wheat, in the above example) from one party to the other, as participants in such contracts take market positions without taking off-setting positions under corresponding derivative contracts.

(d) Benefits of conventional derivative instruments

In today's sophisticated global financial markets, derivative instruments can, if used prudently, contribute significantly to the welfare of all market participants in the following ways:⁷⁶

(i) The use of derivative instruments for hedging purposes contributes to risk management and enables such users to formulate more accurate business plans by reducing uncertainties;

(ii) Derivatives are crucially important to facilitate

⁷³ Dennis W. Cox, *Frontiers of risk management*, Euromoney Books, p. 274.

⁷⁴ Advantages and Alternatives of Using Exchange-Traded Derivatives in Portfolio Management, available at http://hedgeweek.com/articles/detail.jsp?content_id=12889

⁷⁵ Mike Moffat, *Arbitrage examined*, available at <http://economics.about.com/cs/finance/a/arbitrage.htm>

⁷⁶ Andreas A. Jobst, *Derivatives in Islamic finance*, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1015615; CFA Level 1: Purposes and benefits of derivatives, available at <http://www.investopedia.com/study-guide/cfa-exam/level-1/derivatives/cfa9.asp>; Derivatives increase liquidity, available at http://www.asx.com.au/professionals/companies/derivatives_increase_liquidity.htm.

⁷⁰ D.R. Capasso, *Trading on the Seattle Merc* (1995).

⁷¹ The origins of derivative instruments, available at <http://people.brandeis.edu/~cecchett/Textbook%20inserts/The%20Origin%20of%20Derivatives.htm>

⁷² Minimize risk and maximize success: Therapeutic risk management, available at <http://209.85.229.132/search?q=cache:F-6e58vs7vAJ:www.rtihealth-solutions.org/request/index.cfm%3Ffuseaction%3Ddisplay%26PID%3D5198+risk+management+identify+assess+minimize+risk&cd=2&hl=en&ct=clnk&gl=uk>

price discovery, as futures market prices depend on a continuous flow of information from around the world and require a high degree of transparency. This flow of information reduces distortionary effects of government regulations and other externalities and facilitates the proper re-alignment of prices;

(iii) Increased trading volumes lead to lower transaction costs, leading to an increased 'value-for-money' for market participants;

(iv) Derivative instruments help to channelize more institutional money to emerging markets, as such instruments can be effectively used to manage market, credit and interest rate risks in underdeveloped local capital markets;

(v) The availability of derivatives increases liquidity in underlying cash markets, since market makers inject substantial liquidity into (i) the options and warrants markets; and (ii) the underlying stocks that they trade in; to hedge their market making activities in the derivative markets; and

(vi) Since the returns generated from derivative instruments are not correlated to more traditional instruments, derivatives contribute significantly to portfolio diversification and effective portfolio management.

14.2. Islamic derivatives – introduction and legitimacy

Islamic derivatives are financial products which seek to generate a similar economic profile to comparable conventional derivative instruments, albeit through a *Shari'a* compliant structure. Under *Shari'a*, all financial instruments and transactions must be free of at least the following five elements: (i) *riba* (interest), (ii) *rishwah* (corruption), (iii) *maisir* (gambling), (iv) *gharar* (unnecessary risk) and (v) *jahl* (ignorance). The prohibitions on interest and on taking 'unnecessary' risks become especially relevant in the context of derivative instruments.

In this context, it is important to note that while *Shari'a* prohibits *riba*, it does not prohibit trade or the making of profits as part of such trade(s). In fact, the Quran expressly alludes to the distinction between trade and *riba* in the following verse (2:275):

Those who eat riba do not stand except as stands one whom Shaytan has by the touch thrown into confusion. That is because they say: "Sale is like riba". God has permitted trade and forbidden riba.

The prohibition on *riba* stems from the *Shari'a* tenet that money, by itself, should not be recognised as a commodity and consequently, there should be no reward for its use. Under *Shari'a*, money is perceived only as a medium of exchange and a unit of measurement. Islamic derivative products must therefore be based on underlying transactions in tangible commodities as opposed to merely superficial cash-flows.

Furthermore, *Shari'a*-compliant financial instruments

must adhere to *daman* – the principle of risk-sharing among all participants and the linking of risk to returns. In this regard, the widely held view is that one cannot profit from a venture in which one does not share the risk. Islamic derivatives therefore need to have an inherent risk-sharing mechanism in order to be *Shari'a*-compliant.

There is a wide spectrum of views on the legality of Islamic derivatives, ranging from the staunchly unfavourable to the vocally supportive. For example, Mufti Taqi Usmani of the Fiqh Academy of Jeddah argued (in 1996) that futures contracts are invalid under *Shari'a* because:

*"Firstly, it is a well recognized principle of the Shari'a that purchase or sale cannot be effected for a future date. Therefore, all forward and futures contracts are invalid in Shari'a; secondly, because in most futures transactions delivery of the commodities or their possession is not intended. In most cases the transactions end up with the settlement of the difference in price only, which is not allowed in the Shari'a."*⁷⁷

Conversely Fahim Khan states that:

*"We should realize that even in the modern degenerated form of futures trading, some of the underlying basics concepts as well as some of the conditions for such trading are exactly the same as were laid down by the Prophet"*⁷⁸

Further, Sheikh Nizam Yaquby is reported to have said (as reported in an article published in 2008):

*"there are a few instruments which have been 'tamed' and designed to be alternatives (to) conventional derivatives. These are relatively new and we have to look into them."*⁷⁹

It could be argued that there is a general convergence of views for most Islamic derivative products, although there may also be divergences based on jurisdictions, madhabs and the perceptions of individual scholars.

A few Sharia tenets have, however, gained almost universal acceptance. These include the following:

(i) *maslaha* (i.e. the public good), towards which all commercial transactions should be geared (reduction in *gharar* is generally viewed as contributing to *maslaha*); and

(ii) *ibaha* (i.e. permissiveness), which is generally taken to mean that if anything is not expressly prohibited under Sharia, it is deemed to be permitted.

In structuring Sharia-compliant products, one must therefore have regard, among other concepts, to *daman*, *maslaha* and *ibaha*.

14.2.1. Key issues

Since the inception of Islamic derivatives, the lack of liquidity in Islamic money markets and doubts regarding the credibility of such products (as a realistic alternative to conventional derivative products) have been the key issues relating thereto.

(a) Liquidity

The value of cash as a strategic asset is widely acknowl-

edged in both the conventional and the Islamic finance industries. In a conventional banking system, the treasury manages the bank's cash flow to maximise the profit generating potential and to safeguard both the bank's balance sheet and its profit-and-loss statement against liquidity risk. Conventional banks manage their excess liquidity mainly in four ways:

- (i) lending any surplus in the inter-bank network,
- (ii) investing in government securities,
- (iii) lending to corporate customers, and
- (iv) keeping the excess funds at 0% return

Methods (i), (ii) and (iii) outlined above involve *riba* and hence, cannot be used by Islamic banks, while method (iv) does not yield any return to the bank.

To resolve this dilemma, the International Islamic Financial Market (IIFM) launched the IIFM Master Agreement for Treasury Placement (MATP) in October 2008, which enables financial institutions globally to enter into OTC commodity murabaha transactions. The MATP documentation covers the following two separate structures:

(a) where the depositor/client acts as buying agent (either disclosed or undisclosed) of the financial institution; and

(b) where the depositor/client and financial institution act as principals with no agency relationship

The MATP documentation consists of a master Murabaha agreement, a master agency agreement and a commodity purchase letter of understanding,⁸⁰ and has already been widely used in several jurisdictions such as the GCC region, Malaysia, Kuala Lumpur and Singapore. Even outside the MATP framework, commodity murabaha is currently the most widely used product in the Islamic money market and is used by several financial institutions (particularly in the GCC region) to manage their liquidity risk⁸¹. Further development of the global Islamic money market will help banks manage their liquidity risks more efficiently.⁸²

(b) Credibility

For the development of the Islamic finance industry, it is important that *Shari'a*-compliant financing techniques are regarded as credible alternatives to their conventional counterparts. The lack of a central regulatory body, divergent views relating to the same product / financing technique aired by different *Shari'a* scholars and the general practice of not disclosing fatwa (for OTC derivatives only) leading to reduced transparency in the market could hamper the credibility of *Shari'a*-compliant products. Similar to the issues highlighted in the Turner Report (relating to the conventional finance sector), a more uniform approach, greater transparency and stronger regulation are also necessary prerequisites for the sustainable growth of Islamic finance.

Recently, the Malaysian legislature passed the Bank Negara Malaysia Bill 2009, under which decisions of the Islamic Finance Syariah Advisory Council (the **Council**) will be binding on the court which referred the relevant matter to the Council.⁸³ In another recent development, the UK Budget 2009 (the **Budget**) provides relief from stamp duty land tax in respect of transactions undertaken as part of the issue of alternative finance prop-

erty investment bonds.⁸⁴ Along with other favourable provisions in the Budget, this provision places Islamic financing structures such as the *sukuk* on a level playing field (from a tax treatment perspective) as compared to conventional bonds. The above initiatives serve as good examples of concrete legislative/regulatory measure which should lead to greater uniformity and renewed investor confidence in *Shari'a*-compliant products, resulting in a boost to the credibility of such products.

14.3. The global development of Islamic finance

Over the past 30 years, Islamic finance has expanded to become a distinctive and fast-growing segment of the international banking and capital markets today. The origins of modern Islamic finance can possibly be traced to a savings bank based on profit-sharing established by Ahmed Elnaggar in the Egyptian town of Mit Ghamr in 1963.⁸⁵ In 1972, the Mit Ghamr Savings project became a part of the Nasr Social Bank which still continues in business in Egypt. Subsequently, in the 1970s, oil-related wealth provided the capital resources for the establishment of several Islamic banks – notably the Islamic Development Bank (1974), the Dubai Islamic Bank (1975), the Kuwait Finance House (1977), the Faisal Islamic Bank of Egypt (1977) and the Bahrain Islamic Bank (1979).⁸⁶

In the 1990s, HSBC and Citigroup established global Islamic finance divisions. These banks started out offering primarily a few mutual funds to suit Sharia investors. Today, both the Islamic finance divisions of conventional banks and stand-alone Islamic banks are creating instruments that parallel many of the Western world's financial products, from consumer loans to bonds. With the passage of time and the global development of Islamic finance, investors' appetite for complex Islamic products has also grown significantly and market players predict that there is strong potential for further growth in Islamic derivatives.⁸⁷

14.3.1. Key jurisdictions

(a) Malaysia

Over the past decade, Malaysia has made a concerted effort to promote itself as an Islamic finance hub. It is presently (i) the world's largest Islamic banking and financial market, with Islamic banking assets totaling US\$ 30.9 billion and (ii) the world's largest Islamic private domestic market in debt securities, estimated at approximately US\$ 34 billion. Malaysia also has a critical mass of market players in the Islamic finance industry and an active Islamic money market which channels approximately RM 30 billion monthly.⁸⁸ The above factors, combined with the growing popularity of the Labuan International Offshore Financial Centre located just off the Malaysian coast, make Malaysia an inviting choice for prospective investors in Islamic finance.⁸⁹

(b) The Gulf Co-operation Council (GCC) countries

Saudi Arabia, Kuwait, Bahrain, Qatar, the United Arab Emirates and Oman together constitute the GCC. The historical linkage of Islamic finance to oil-related wealth

⁸⁰ IIFM Master Agreements for Treasury Placement, available at <http://www.cpfinancial.net/v2/News.aspx?v=1&aid=1181&sec=Islamic%20Finance>

⁸¹ IIFM launches first-ever standardised Master Murabaha and Agency Agreements, 08 October 2008, available at <http://www.iifm.net/IIFMLaunchesMurabaha/tabid/173/Default.aspx>

⁸² Islamic banking – managing liquidity risk, available at <http://www.continuitycentral.com/feature0126.htm>

⁸³ Bank Negara Malaysia Bill 2009 Approved, Bemama, 01 July 2009.

⁸⁴ The UK Budget 2009 and Islamic finance, 22 April 2009, available at <http://www.nortonrose.com/knowledge/publications/2009/pub20766.aspx?lang=en-gb>

⁸⁵ Mahmoud, el Gamal, Islamic Finance – Law, Economics, Cambridge University Press, p.193

⁸⁶ M. Kabir Hassan (ed.), Handbook of Islamic Banking, Edward Elgar Publishing Limited, p. 12.

⁸⁷ Richard Barley, StanChart sees Islamic Derivative Growth, available at <http://www.reuters.com/article/summitNews/idUS-DIS54866520080205>.

⁸⁸ <http://www.pwc.com/extweb/indissue.nsf/docid/1D681D874F24FDA7CA25720A00158BFD>

⁸⁹ Sponsored Report: Labuan IBFC, Islamic Finance Asia (Oct/Nov 2008), available at http://www.islamicfinanceasia.com/2_spon_libfc.php.

⁷⁷ New Horizon, June 1996, pp 10-11.

⁷⁸ (Islamic Futures and their Markets, Research Paper No.32, Islamic Research and Training Institute, Islamic Development Bank, Jeddah, Saudi Arabia, 1996, p.12)

⁷⁹ Islamic Scholar Urges Financial Regulators To Adopt Standards, 18 November 2008, available at <http://www.zawya.com/printstory.cfm?storyid=ZW2008111800087&l=113459081118>.

continues to be important even today, with the DIFC being a major Islamic finance hub in the region. Related initiatives, which are currently in various stages of implementation, include setting up the DIFC Shari'a Centre, an Islamic hedge funds platform, an Islamic finance portal, a commodity murabaha exchange and the creation of a judicial academy and research centre.⁹⁰ The presence of the head offices of many Islamic banks in the GCC region contributes significantly to its importance as a principal driver in Islamic finance.

14.4. The building blocks – key concepts used in Islamic derivatives structures

There are a number of key traditional Islamic products that can be used to create the building blocks of Islamic derivatives - i.e. *murabaha*, *wa'ad*, *arbutun* and *salam*.

14.4.1. Murahaba

Murabaha (also known as cost-plus financing) is a particular type of *Shari'a* compliant financing technique, which forms the foundation of almost 70% of all Islamic derivative products. Under such a structure, typically the bank (B) (i) purchases commodities from a third party broker, Broker 1 (T) at a particular price (X) (Step 1) and (ii) on-sells these commodities to the counterparty (C) at a price which includes B's cost price (X) and some profit / mark-up (Δ), which B discloses to C. Thus, C's cost price is equal to X plus Δ (Y) (Step 2).

Typically, Y is payable by C in instalments, but it can also be paid as a one-time bullet payment on a specified date in the future (similar to the 'sale and deferred payment' model in conventional financing) (Step 3). Having purchased the commodities from B, C on-sells these to another third-party broker, Broker 2 (P) at a price equal to X (Step 4).

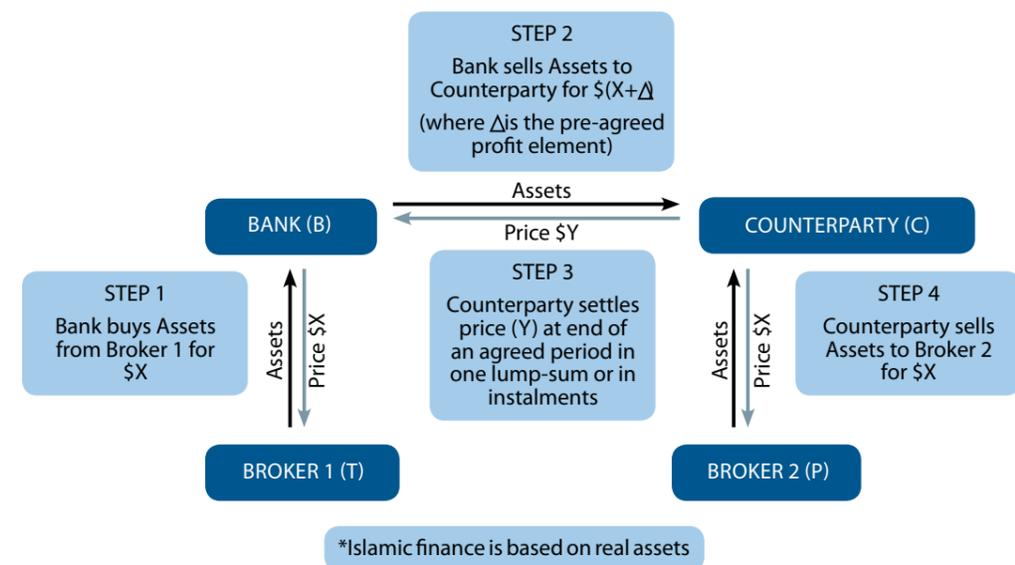


Figure 83: Murabaha – cost plus financing structure

The above structure is *Shari'a* compliant because (i) no interest is being charged by B (rather, B is making a profit, which is justifiable since B bears the risk, for however short a period, of not being able to on-sell the commodities to C); and (ii) the financial transaction is backed by underlying transactions in tangible goods. It is important to maintain the severance between the following three parts of a *murabaha* as separate transactions:

- (a) the purchase of goods by B from T;
- (b) the sale of goods by B to C; and
- (c) the sale of goods by C to P.

Murabaha is a particularly popular as a financing technique in the realms of consumer finance and asset finance. Notably, *murabaha* can also be used in a *Shari'a* compliant profit-rate swap and/or a cross-currency swap (see Sections 14.5.2 and 14.5.1 below).

14.4.2. Wa'ad

Wa'ad is a traditional Islamic product which, in the context of commercial dealings, is generally accepted to mean that of a unilateral promise.⁹¹ According to a fatwa issued by the Islamic Fiqh Academy (the IFA) at its Fifth Conference held in Kuwait (1988-1989), a *wa'ad*, in the context of a classic *murabaha* sale is morally binding, and additionally, its fulfilment may be enforceable at court, if: (a) the promise is a unilateral promise binding only one of the parties to the *murabaha*; and (b) the promise has caused the promisee to incur some liabilities.⁹² Since then, this view has attracted widespread scholarly support.⁹³ It is however debatable whether the IFA's fatwa extends to Islamic finance structures other than *murabaha*-related *wa'ad* transactions. The Accounting and Auditing Organization of Islamic Financial Institutions (AAOIFI) has endorsed the extension of the IFA fatwa to currency exchange transactions within an Islamic framework,⁹⁴ thereby suggesting that the application of *wa'ad* may not need be confined to the classic *murabaha* model. However, such extension of the IFA's fatwa has been criticized by certain authors.⁹⁵

Since the *wa'ad* is a unilateral promise, it does not have to satisfy the requirements of a bilateral contract (*aq'd*) under *Shari'a* (i.e. (i) knowledge of the price and (ii) possession or ownership of the subject matter of the contract). This inherent flexibility of the *wa'ad* renders it particularly helpful in developing several innovative *Shari'a*-compliant structures, such as an FX option (refer: Section 14.5.1 below) or a total return swap (see Section 14.5.4 below).

14.4.3. Arbutun

Arbutun (literally translating into 'earnest money contract') is a conditional purchase contract, which is permissible under *Shari'a*. Under an *arbutun* contract, the buyer (B) concludes a purchase and makes an advance of some sum (X) which is less than the purchase price (Y) to the seller (S). The contract stipulates that if B decides to proceed with the transaction, he will pay S the purchase price minus the initial deposit (Y minus X = Z). If B decides not to proceed with the transaction, he forfeits the deposit in favour of S.

Arbutun offers a close analogy to a conventional option, although it cannot be regarded as identical to an option (because, unlike an *arbutun* contract, the premium paid under a conventional option is not deducted from the purchase price if the buyer chooses to exercise the option).

Several madhabs declare *arbutun* to be a void contract, since it makes a gift (the initial deposit) conditional upon a sale, and therefore allegedly offends the *Shari'a* principle of non-combination of gratuitous contracts with onerous ones. However, the Hanbali school accepts the *arbutun* as a valid form of contract, based upon *hadith*.⁹⁶ The OIC Academy has also endorsed *arbutun*, but only if a time limit is specified for exercising the option.⁹⁷

14.4.4. Salam

Salam (also known as *bai salam*) is similar to a conventional forward contract whereby the price of an asset is paid up-front at the time of the contract, for the asset to be delivered later (similar to a 'deferred delivery' model in conventional finance).

The legitimacy of *salam* is rooted in the sunna, whereby the Prophet Muhammad is believed to have observed the practice of people paying in advance the price of dates to be delivered within one, two or three years in Madina. The sale, however, did not specify the quality, measure or weight of the dates at the start of the contract. The Prophet Muhammad ordained that:

"Whoever pays money in advance (for fruits) (to be delivered later) should pay it for a known quality, specified measure and weight (of dates or fruit) along with the price and time of delivery" (reported by Imam Bukhari and others)⁹⁸

Consequently, when using *salam* in structuring today, scholars prescribe several strict conditions, including the following:

- (a) the seller must undertake to supply a specific asset at a future date in exchange for full spot payment (in advance) at the start of the contract;

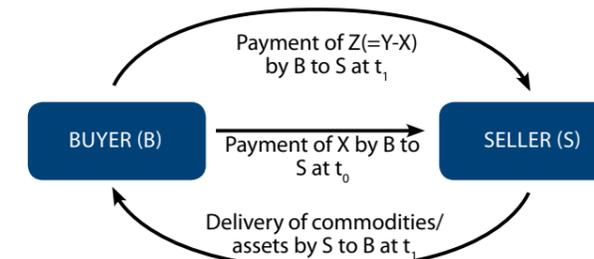
- (b) before delivery of the asset, the risks on the asset lies with the seller and upon delivery, the risks are transferred to the buyer; and

- (c) the buyer can enter into a similar contract with a third party in a parallel *salam*. This parallel contract would be independent of the first *salam* contract.

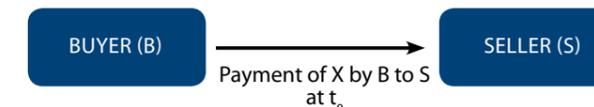
While writers such as Mohammed Obaidullah have preferred concepts such as *khiyar al-shart* (option as a stipulated condition), *khiyar al-ayb* (option to reject an object based on a defect therein), *khiyar al-ruyat* (option after inspection) and *khiyar al-tayeen* (option of determination or choice),⁹⁹ these are relatively complicated products that are yet to be fully synchronised with conventional financing.

The *salam* is a popular technique for generating working capital. It can also be used in a *Shari'a*-compliant structure which mirrors the cash-flows generated by a conventional short-selling structure.

- (i) If B chooses to proceed with the purchase contract at t_1 ,

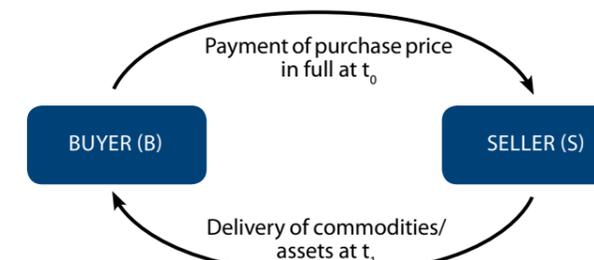


- (ii) If B chooses not to proceed with the purchase contract at t_1 ,



- Notes: 1. t_0 must be earlier in point of time than t_1 .
2. X must be less than Y

Figure 84: Arbutun – Partial payment up front with the option to conclude the transaction at a later date



- Notes: t_0 must be earlier in point of time than t_1 . The commodities/asset to be delivered at t_1 must be specified at t_0

Figure 85: Salam – Full payment up-front and deferred delivery

⁹⁰ Shakir Husain, DIFC will be Islamic finance hub, 25 January 2008, available at http://www.gulfnews.com/BUSINESS/Banking_and_Finance/10184666.html.

⁹¹ Rafic Yunus Al-Masri, The binding unilateral promise (*wa'd*) in Islamic Banking operations: Is it possible for a Unilateral Promise to be binding as an Alternative to a Proscribed Contract?, J.KAU: Islamic Econ., Vol. 15, page 29, available at http://islamiccenter.kaau.edu.sa/arabic/Magallah/Pdf/15/15_RAFIC.pdf.

⁹² Resolution numbers 2 and 3 of the Fifth Conference of the Islamic Fiqh Academy (Kuwait), as cited in Deutsche Bank Academic Paper, Pioneering Innovative *Shari'a*-Compliant Solutions, available at http://www.db.com/press/en/download/White_Paper.pdf.

⁹³ Liao Y-Sing, Waad is legally binding for compensations – scholar, 1 April 2009, available at <http://www.forexpros.com/news/general-news/interview-waad-is-legally-binding-for-compensation-scholar-41406>.

⁹⁴ Muhammad Al Bashir Al Amine, Risk Management in Islamic Finance: An analysis of derivatives instruments in commodity markets, Brill's Arab & Islamic Laws series (2008).

⁹⁵ Frank E. Vogel and Samuel L. Hayes, Islamic Law and Finance: Religion, Risk, and Return (Arab and Islamic Laws, Vol. 16) (Arab and Islamic Laws Series); The journey towards absolute return, The Banker, 10 March 2009, available at http://www.thebanker.com/news/full-story.php/aid/6467?current_page=NO_PAGE.

⁹⁶ Frank E. Vogel and Samuel L. Hayes, Islamic Law and Finance: Risk, Religion and Return, Kluwer, page 157.

⁹⁷ Eighth session (1994), Fiqh Academy Journal 1:794.

⁹⁸ <http://islamicbankers.wordpress.com/focus/in-focus-bai-salam/>

⁹⁹ Mohammed Obaidullah, Comments on Stakeholder Model of Governance in Islamic Economic System, available at <http://islamic-center.kaau.edu.sa/7iecon/Ahdath/Con05/5th%20conf%20ppr%20com-ments%20for%20Bahrain/Comillions%20on%20Stakeholders%20Model...%20by%20Mohammed%20Obaidullah.doc>

14.5. Shari'a compliant derivative products

In this section, we analyse several products such as Shari'a-compliant cross-currency swaps, profit rate swaps and FX options that are commonly used in the Islamic derivatives markets. We also discuss how these products use the building blocks of *murabaha*, *wa'ad*, *arbut* and *salam*, as discussed above.

14.5.1. Cross-currency swap

(a) Structure and cash-flows in a conventional cross-currency swap

A conventional cross-currency swap usually consists of three stages: (i) a spot exchange of principal at the outset (Initial Exchange), (ii) a continuing exchange of interest payments during the swap's life (essentially a series of FX forward trades) (Interim Amounts) and (iii) a re-exchange of principal at the maturity of the contract (normally at the same spot rates as those used at the start) (Final Amount). Clearly, the prohibitions on *riba*, *maisir* and *gharar* would render such a structure untenable under *Shari'a*.

(b) Structure and cash-flows in a Shari'a-compliant cross-currency swap

The challenge, therefore, is to generate cash flows which are similar to a conventional currency swap, but within a *Shari'a*-compliant framework. To this end, one can use reciprocal *murabaha* transactions, whereby the parties enter into *murabaha* contracts (a Primary (Term) *Murabaha* and a Secondary (Reverse) *Murabaha*) to sell *Shari'a*-compliant assets (often London Metal Exchange traded metals, such as palladium and aluminium) to each other for immediate delivery but on deferred payment terms.¹⁰⁰

(i) The Primary (Term) *Murabaha*

Under this transaction the Bank (i) sources commodities from a commodity broker (**Broker A**) at Cost Price (step 1, in the diagram below); and (ii) on-sells these commodities to the swap counterparty (the **Counterparty**) (step 2). The value of commodities bought and on-sold (in steps 1 and 2 respectively) are both denominated in Currency A (MYR).

Payment by the Counterparty for the commodities purchased under the Primary *Murabaha* is on a deferred

¹⁰⁰ Richard Tredgett and Priya Uberoi, Islamic Derivatives case study: a Cross Currency Swap, Derivatives Week, 16 June 2008.

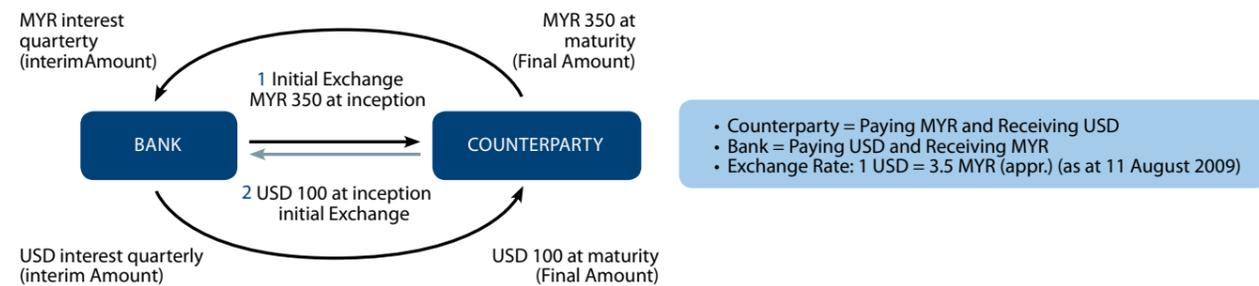


Figure 86: Conventional cross-currency swap (MYR/US\$)

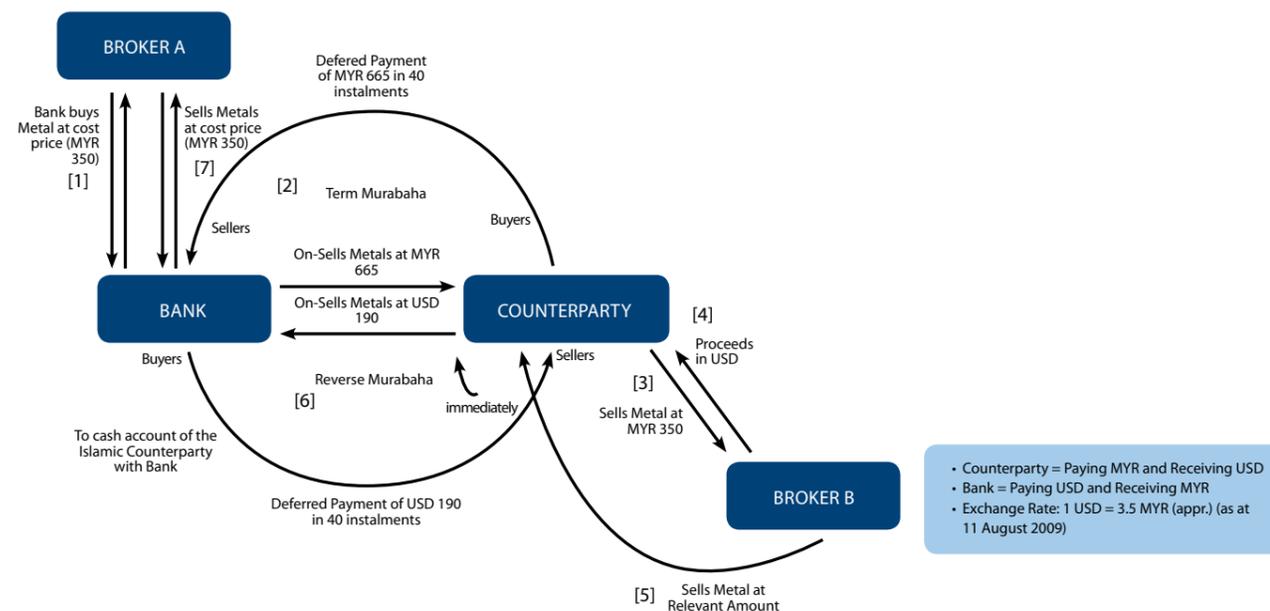


Figure 87: Islamic cross-currency swap (MYR/US\$)

basis, in instalments payable on pre-agreed payment dates (each a **Deferred Payment Date**). Each instalment represents a portion of the pre-agreed profit element, with the exception of the final instalment, which also includes payment in full of the Cost Price.

(ii) The Secondary (Reverse) *Murabaha*

To initiate the Secondary *Murabaha*, the Counterparty (i) purchases commodities from Broker B and makes payment in Currency B (step 5), and (ii) immediately on-sells these commodities to the Bank for immediate delivery (step 6). **The commodities sold under the Secondary *Murabaha* should have the same value as those purchased under the Primary *Murabaha* (the Currency B equivalent of the Cost Price being the Relevant Amount, in the diagram below).**

Payment by the Bank is on a deferred basis in instalments in Currency B, such instalments to represent a portion of the pre-agreed Secondary *Murabaha* profit element (with the exception of the final instalment, which also includes payment in full of the Currency B equivalent of the Cost Price). Instalment payment dates under the Secondary *Murabaha* mirror those under the Primary *Murabaha* (i.e. on each Deferred Payment Date, a payment shall be due (i) from the Bank to the Counterparty in Currency B; and (ii) from the Counterparty to the Bank in Currency A).

Upon receipt of the commodities the Bank immediately on-sells these to Broker A (step 7) to generate a Currency A payment.

(c) Industry Usage

In October 2006, Citigroup designed a currency swap for the Dubai Investment Group (**DIB**) to hedge the currency risk on DIB's RM 828 million (approximately £119 million) investment in Bank Islam Malaysia.¹⁰¹ Standard Chartered Saadiq, Al Hilal Bank and Calyon

also market products based on *Shari'a*-compliant cross-currency swaps.¹⁰²

14.5.2. Profit Rate swap

(a) Structure and Cash-flows

A profit rate swap is best analogised to a conventional interest rate swap, under which the parties agree to exchange periodic fixed and floating payments by reference to a pre-agreed notional amount. As with many conventional derivative products, a conventional interest rate swap is problematic from a *Shari'a* perspective as it potentially contravenes the *Shari'a* prohibitions on *riba*, *maisir* and *gharar*.

The profit rate swap seeks to achieve *Shari'a* compliance by using reciprocal *murabaha* transactions (similar in some respects to the structure used for a cross-currency swap, as discussed above). A term *murabaha* is used to generate fixed payments (comprising both a cost price and a fixed profit element) and a series of corresponding reverse *murabaha* contracts are used to generate the floating leg payments (the cost price element under each of these reverse *murabaha* contracts is fixed but the profit element is floating).¹⁰³

(i) The Primary (Term) *Murabaha*

The process is initiated by the **floating rate payer** (the Floating Rate Payer) (i) sourcing commodities from a commodity broker (**Broker 1**) (step 1, in the diagram below); and (ii) on-selling these commodities to the swap counterparty (the **Fixed Rate Payer**) (step 2). The value of commodities bought and on-sold is the pre-agreed Cost Price for the transaction and the commodities are delivered on the date on which the transaction is entered into.

On receipt of the commodities purchased, the Fixed Rate Payer (or its agent) on-sells those commodities immediately to a different commodity broker (**Broker 2**) (step 3) to generate cash. The Fixed Rate Payer pays for the commodities purchased under the Term *Murabaha* on a deferred basis, in instalments payable on a series of pre-agreed payment dates (each a **Deferred Payment Date**) (step 4). Each instalment comprises both a Cost Price element (a repayment of a set percentage of the

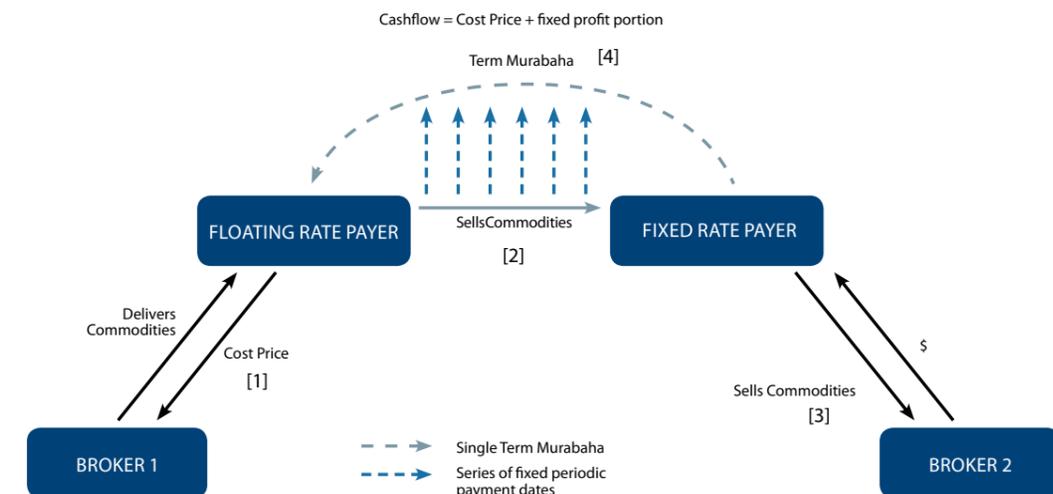


Figure 88: Primary Term murabaha

¹⁰¹ Mark Bendeich, Islamic Commodities: what would Mohammed do?, December 8, 2006, available at <http://www.gata.org/node/4587>

¹⁰² <http://www.standard-chartered.com.my/islamic-banking/wholesale-banking/treasury-products/en/>; <http://www.calyon.com/business-lines/calyon-at-the-heart-of-the-development-of-islamic-banking.htm>; <http://www.alhilalbank.ae/web/?page=treasuryunit>

¹⁰³ Priya Uberoi and Nick Evans, Islamic Finance: Profit Rate Swap, PFI, October 2008.

Cost Price) and a fixed profit portion (paying a portion of the Floating Rate Payer's profit on the transaction).

(ii) The series of sequential Secondary Reverse Murabaha Contracts (SRMCs)

An agreement by which the Floating Rate Payer simply agrees to pay a variable amount (linked, for example, to LIBOR) to the Fixed Rate Payer on certain pre-specified dates would not be *Shari'a*-compliant due to the uncertainty (gharar) associated with such a structure. SRMCs help us resolve this problem, as each floating rate payment is linked to an underlying purchase and sale of commodities.

The first SRMC (SRMC1) is entered into on the date of entry into the Primary Murabaha transaction and is initiated by the Fixed Rate Payer purchasing commodities from Broker 2 (step 5, in the diagram below). For the purpose of SRMC1, the Fixed Rate Payer uses only that portion of the Cost Price which is due to be repaid to it on the first Deferred Payment Date as capital for purchasing commodities from its broker.

The Fixed Rate Payer immediately on-sells these commodities to the Floating Rate Payer for immediate de-

livery (step 6), and the Floating Rate Payer immediately on-sells such commodities to Broker 1 (step 7) to generate cash. Payment by the Floating Rate Payer is on a deferred basis by a single bullet payment comprising (i) the full value of the commodities purchased under the relevant SRMC plus (ii) the Fixed Rate Payer's profit (such profit being calculated by reference to a floating rate formula (e.g. linked to LIBOR) and thus generating the floating rate element) (step 8). Each such payment is due on the next Deferred Payment Date under the Primary Murabaha (at a frequency of every three months, in the illustrative diagram below).

(b) Industry Usage

In October 2006, Standard Chartered Saadiq entered into a US\$ 150 million three-year profit rate swap with Kuwait-based Aref Investment Group S.A.K. Commenting on the deal, Dr. Ali Al Zumai, Chairman and Managing Director of Kuwait-based Aref Investment, said:

*"The swap is a significant development in broadening capital market instruments. It gives us the flexibility to hedge through a Shari'a compliant solution."*¹⁰⁴

BNP Paribas, Al Hilal Bank and Calyon have also de-

veloped products based on *Shari'a*-compliant profit rate swaps.¹⁰⁵

14.5.3. FX Option

(a) Structure and Cash-flows

A conventional option gives the buyer of the option the right, but not the obligation, to enter into a certain transaction (i) on a future date (European option), or (ii) on any of certain specified future dates (Bermudan option), or (iii) within a specified period, till the expiration of the option (American option).

The *wa'ad* can be used to structure a *Shari'a*-compliant FX (i.e. currency) option. In this regard, *Shari'a* distinguishes between the **creation** of an option and the **trading** of an option. The creation of an option (and the subsequent exercise or cancellation of the same) for **genuine trade hedging purposes** is broadly viewed as permissible, as it reduces gharar and is therefore regarded as contributing towards *maslaha*.¹⁰⁶ However, the trading of an option without any accompanying purchase/sale of underlying tangibles, **undertaken solely with the objective of making a speculative gain** (akin to gambling, i.e. *maisir*, which is prohibited under *Shari'a*), is regarded as impermissible by several *Shari'a* scholars, as this is looked upon as increasing gharar.¹⁰⁷

Under one application of this structure, (i) the Client promises the Bank (the date of such promise being the **Trade Date**) to sell a particular amount of a currency (Currency B) against another currency (Currency A) on a pre-determined date (**Settlement Date**) and at a pre-determined rate; (ii) the Bank acknowledges the Client's promise but makes no promise to the Client; and (iii) the Bank pays a non-refundable fee (premium) to the Client, regardless of whether the Bank chooses to exercise the call option by enforcing the *wa'ad* (the Bank's decision whether or not to exercise the option being dependent upon whether the option is in-the-money on or about the Settlement Date). The Bank, therefore, has a right to accept the promise (and thereby exercise

the *wa'ad*-based option) or cancel the promise by sending a cancellation notice.

In the context of a similar *wa'ad*-based FX option developed by a multinational bank, the relevant *Shari'a* Board stated that the concerned product is "*for hedging or cost reduction purposes only and not for speculation*".¹⁰⁸

Cash-flows

(b) Industry Usage

In February 2009, the Gulf Finance House (GFH) announced a partnership with Deutsche Bank in a first-of-its-kind foreign exchange hedging deal worth over Euro 30 million (US\$ 39.4 million). The deal utilises a *Shari'a*-compliant FX-option developed by Deutsche Bank and approved (for the purposes of the above deal) by the Secretary General and member of GFH *Shari'a* Board, Dr. Fareed Hadi. Commenting on the deal, Mr. Abdul Rahman Al Jasmii, Deputy Chief Executive Officer, GFH said:

*"We are proud to be the first bank to utilize the Islamic FX Option provided by Deutsche Bank. This pioneering product will help GFH to eliminate foreign exchange risks and as such we are pleased to be able to add this type of promissory note or option to our inventory of risk management tools."*¹⁰⁹ (emphasis supplied).

Calyon, Al Hilal Bank and the State Bank of Pakistan have also developed products based on *Shari'a*-compliant options.¹¹⁰

14.5.4. Total Return Swap

(a) Structure and Cash-flows

The underlying economic reasons for entering into a conventional total return swap are that, (i) it allows investors to gain exposure to an asset which it does not necessarily need to hold on its balance sheet, and (ii) pay-offs can be structured so that the other party can

¹⁰⁵ <http://www.calyon.com/business-lines/calyon-at-the-heart-of-the-development-of-islamic-banking.htm>; <http://www.alhilalbank.ae/web/?page=treasurysunit>; Abdulkader S. Thomas, Stella Cox, Bryan Kraty, Structuring Islamic Finance Transactions, p. 197.

¹⁰⁶ Dr. Mohammed Obaidullah, Islamic Financial Options, available at <http://vlib.unitar-kjlj1.edu.my/htm/islamfin.htm>; Sami al Suwailem, Hedging in Islamic Finance, available at www.iritpms.org/OpenSave.asp?pub=217.pdf.

¹⁰⁷ Id.

¹⁰⁸ Calyon at the heart of Islamic banking, available at <http://www.calyon.com/business-lines/calyon-at-the-heart-of-the-development-of-islamic-banking.htm>.

¹⁰⁹ GFH partners with Deutsche Bank with Historic *Shari'a* Compliant 'Islamic FX Option', available at <http://tyo.ca/islambank.community/modules.php?op=modload&name=News&file=article&id=2471>

¹¹⁰ www.calyon.com/business-lines/calyon-at-the-heart-of-the-development-of-islamic-banking.htm; www.alhilalbank.ae/web/?page=treasurysunit;

¹⁰⁴ AME Info, Standard Chartered executes Profit Rate Swap deal with Aref Investment, 04 November 2006, available at <http://www.ameinfo.com/100675.html>

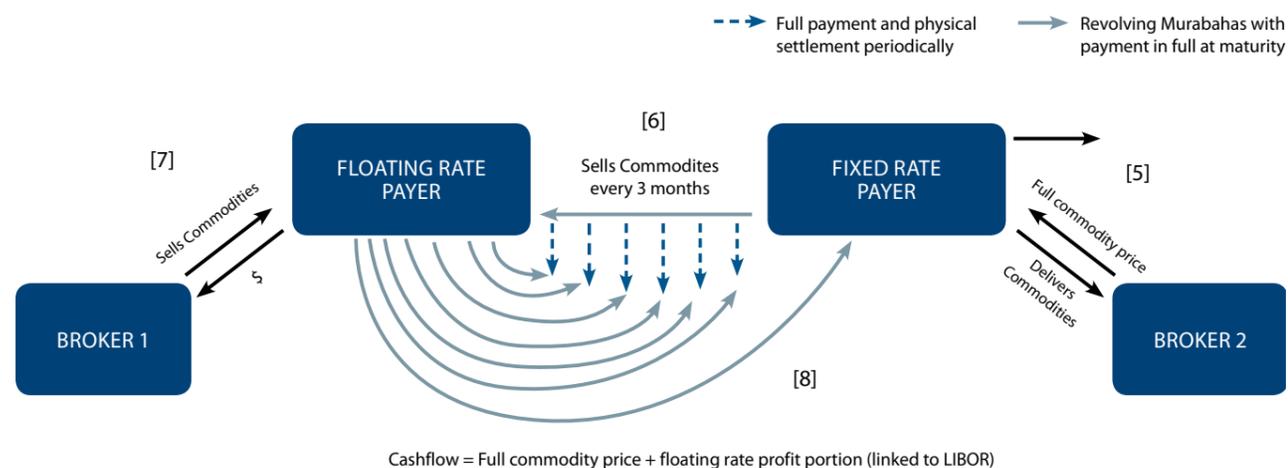


Figure 89: Secondary reverse murabaha contracts

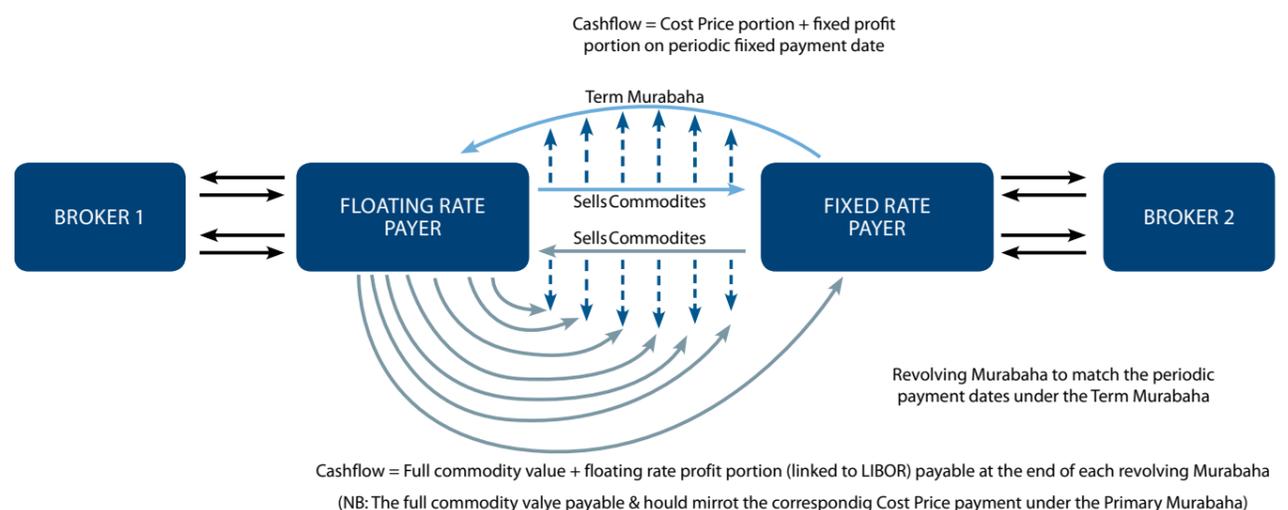
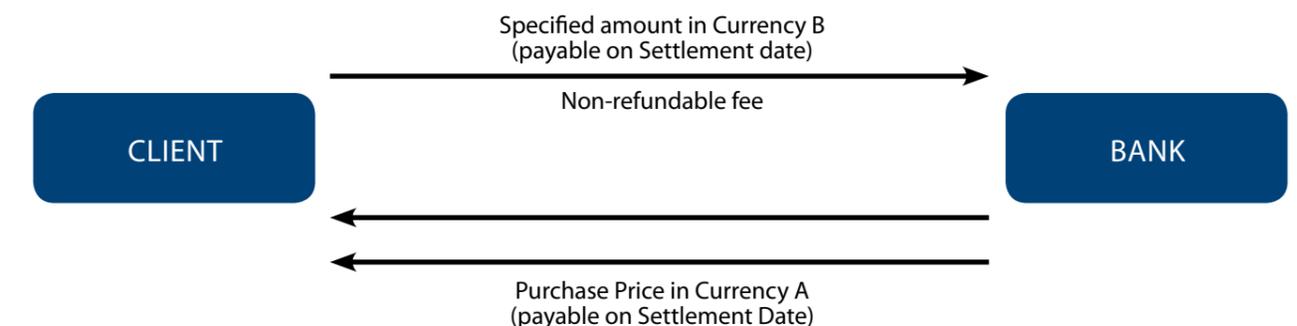
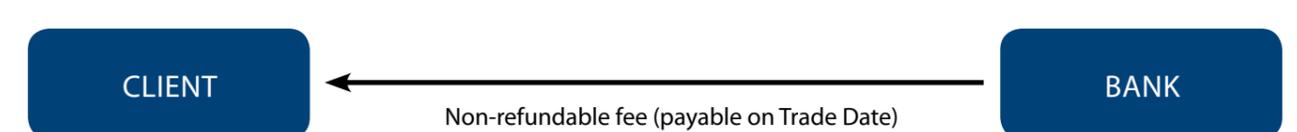


Figure 90: Full profit swap structure

Scenario (A) If the Bank exercises the option (i.e. if the Bank does not send a cancellation notice to the Client):



Scenario (B) If the Bank sends a cancellation notice to the Client and therefore, does not exercise the option:



(Note: In the above example, the Client is the 'Seller' and the Bank is the 'Buyer' of the option)

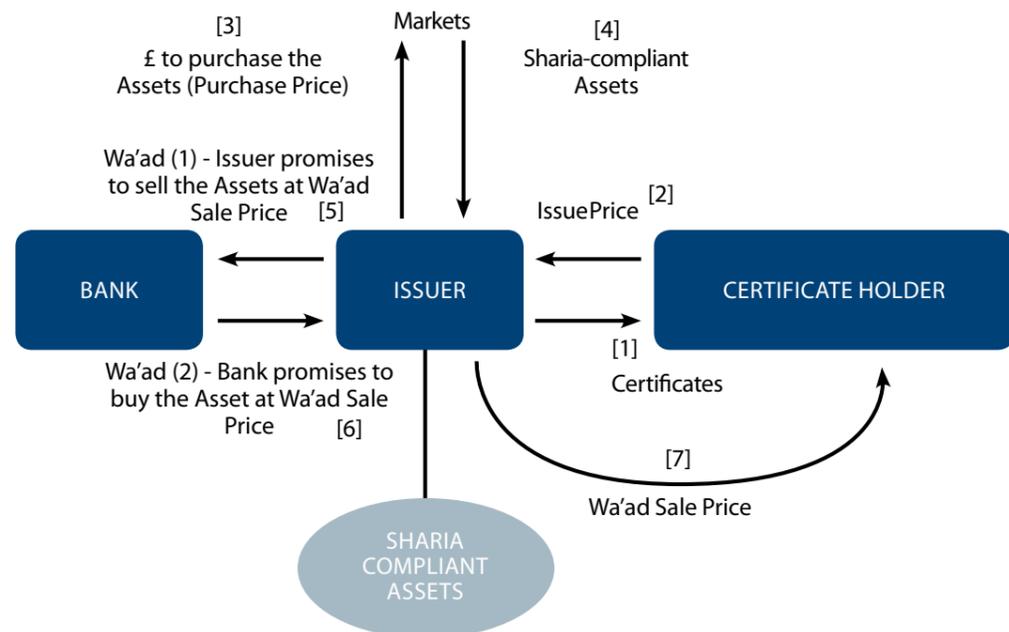


Figure 91: Total Return swap structure

hedge against the upside or downside related to that particular asset or class of assets. Under Shari'a, a similar economic profile can be generated by using a double *wa'ad* structure.

Under this structure, an SPV Issuer issues Certificates to investors in return for the issue price (steps 1 and 2, in the diagram below). The Issuer then uses the issue price to acquire a pool of *Shari'a-compliant Assets* from the market (*Shari'a-compliant Assets*) (steps 3 and 4). These *Shari'a-compliant Assets* could, for example, be shares listed on the Dow Jones Islamic Market Indexes (DJIMI).

The investors (holders of the Certificates) gain exposure to an underlying index or assets (the **Underlying**) based on two mutually exclusive *wa'ads* between the Issuer and the Bank. Under one *wa'ad* (**Wa'ad 1**), the Issuer promises to sell the *Shari'a-compliant Assets* to the Bank at a particular price (which is linked to the performance of the Underlying) (**Wa'ad Sale Price**) (step 5), while under the other *wa'ad* (**Wa'ad 2**), the Bank promises to buy the *Shari'a-compliant Assets* from the Issuer at the **Wa'ad Sale Price** (step 6). Out of these two *wa'ads*, only one shall ever be enforced.

(Numbers in the diagram above denote chronology of events. Either 5 or 6 will occur (but never both, as explained above)).

At maturity, the Bank will calculate how the *Shari'a-compliant Assets* have performed relative to the Underlying, and (i) if the **Wa'ad Sale Price** is greater than the market value of the *Shari'a-compliant Assets*, then the Issuer shall enforce **Wa'ad 2** (similar to a conventional put option), or (ii) if the **Wa'ad Sale Price** is less than the market value of the *Shari'a-compliant Assets*, then the Bank shall enforce **Wa'ad 1** (similar to a conventional call option).

The commercial significance of this structure lies in the

fact that, similar to a conventional total return swap, it offers Islamic investors the opportunity to potentially swap the returns in one basket (as generated from the *Shari'a-compliant Assets*) with the returns in another basket (the **Wa'ad Sale Price**, as calculated with reference to the Underlying).

The total return swap mechanism has been criticised by Sheikh Yusuf Talal DeLorenzo (a prominent *Shari'a* scholar) on the basis that it was devised with a view to "wrap up a non-*Shari'a* compliant underlying into a *Shari'a* compliant structure." Sheikh de Lorenzo argues that such a structure is not *Shari'a* compliant because:

(i) the returns, under such structures (overall, termed '*Shari'a* Conversion Technology'), are determined by the performance of funds which are not *Shari'a*-compliant and which could invest in *haram* securities;

(ii) a *qiya* (analogy) cannot be drawn between the use of LIBOR for pricing (which is generally considered to be permissible) and the use of the performance of non-*Shari'a*-compliant assets for pricing; since while the former is used to **indicate** the return, the latter is used to **deliver** the return; and

(iii) the cash-flows in a total return swap based on a double *wa'ad* indicate that the investment by an Islamic investor operates as a trigger for a series of transactions which are not necessarily *Shari'a*-compliant.

However, Hussein Hassan, Head of Islamic finance and structuring for the Middle East and North Africa at Deutsche Bank, claims that in the Deutsche Bank structure using the double *wa'ad* mechanism, Deutsche Bank kept Islamic investors' investments isolated from *haram* assets, as demonstrated by the *Shari'a* audits carried out by the bank.¹¹¹ It is further argued by supporters of the double *wa'ad* structure that the use of the Underlying as a point of reference is no different from issuing a *sukuk*

benchmarked against LIBOR.¹¹²

(c) Industry Usage

The double *wa'ad* structure has been used by Deutsche Bank in relation to a total return swap. This derivative product was approved by the Shari'a Board of Dar Al Istithmar (*Shari'a* Advisor to Deutsche Bank), consisting of five of the world's leading *Shari'a* scholars: Dr. Hussein Hamed Hassan, Dr. Ali AlQaradaghi, Dr. Abdul Sattar Abu Ghuddah, Dr. Mohamed Ali Elgari and Dr. Mohamed Daud Bakar.

According to Hussein Hassan, "Driven by investor demand, the technique has been instrumental in opening up investment in asset classes that have previously been closed to Islamic investors".¹¹³

14.5.5. Short-selling

Conventional short-selling involves selling a borrowed security (generally a stock or a share) that the seller does not own. There is, therefore, a separation of ownership and risk in any conventional short-selling mechanism. The short-seller essentially takes a chance on the security in question decreasing in value, which would enable the short-seller to buy that security back from the market at a later date (for a lower price) and make a speculative gain in the process.

Under *Shari'a*, according to Hadith, one cannot sell what one does not own and ownership cannot be divorced from risk.¹¹⁴ The *arbut* or the *salam* can be used to emulate the economics of a conventional short-sale in a *Shari'a*-compliant structure, whereby the seller actually owns the securities which form the basis of the transaction.

Our understanding in this regard is based solely on publicly available materials, although it is not implausible that such *Shari'a*-compliant structures incorporate the creation of alpha, to ensure that the returns are synonymous with a conventional short-selling arrangement.

(a) Short-selling using *arbut*

(i) Structure and Cash-flows

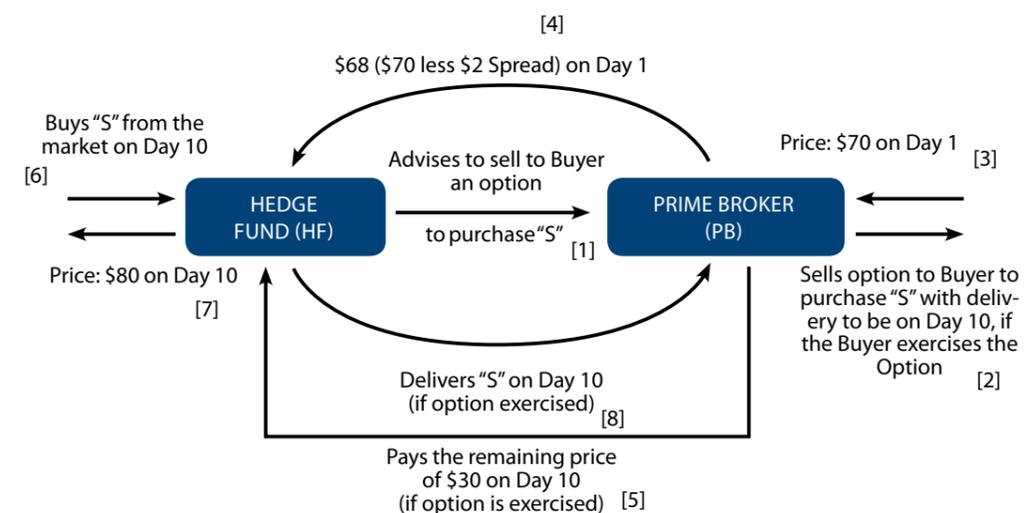


Figure 92: Short selling using *arbut*

In this structure, a hedge fund (**HF**) advises the prime broker (**PB**) to sell an option to purchase shares (**S**) in a particular entity at a specified price (US\$ 100 in the illustrative diagram below (**ID**)), with delivery to take place on a specified date in the future (Day 10 in the **ID**) (step 1, in the diagram below). **PB** then sells this option to the Buyer and receives an initial payment of US\$ 70 from the Buyer (steps 2 and 3). In the present example, (i) the Buyer takes a 'long' position on **S** – i.e. the Buyer expects the market value of **S** on Day 10 to be greater than US\$ 70; and (ii) **HF** takes a 'short' position on **S** – i.e. **HF** expects the market value of **S** on Day 10 to be less than US\$ 70.

Simultaneously with steps 2 and 3, **PB** enters into an *arbut* contract with **HF**, whereby **PB** pays **HF** US\$ 68 (US\$ 70 minus **PB**'s spread of US\$ 2), with **HF** obliged to deliver **S** on Day 10 (step 4).

On Day 10, if the Buyer chooses to exercise the option to buy **S** and proceeds with the transaction, the Buyer pays **PB** the remainder of the purchase price (US\$ 30) (the **Remainder**). The exercise of the option by the Buyer triggers the legally binding obligations between the parties. Therefore, following payment of the **Remainder** by the Buyer, **HF** will be under an obligation to purchase the stocks and deliver them to **PB**, who will pass them on to the Buyer. **PB** therefore pays **HF** US\$ 30 (step 5), following which **HF** purchases **S** from the market on Day 10 (steps 6 and 7) and delivers it to **PB**. (step 8). **PB** then passes **S** on to the Buyer.

It should be noted that the higher the initial deposit payment the lower is the risk for **HF**, since the return is higher (in the event the Buyer chooses not to exercise its option). The deposit payment on Day 1 should therefore represent at least a third of the total purchase price; a "minority" as per the sayings of the Hadith, to contribute to the *Shari'a*-compliance of such a structure.

(ii) Industry Usage

In June 2008, Barclays Capital and the Dubai Multi Commodities Centre Authority (DMCC) announced the first *Shari'a* compliant hedge funds to be launched on the Al Safi Trust alternative investment platform. DMCC has

¹¹¹ Daniel Stanton, Don't fear the riba, 24 January 2008 available at www.arabianbusiness.com/509145-dont-fear-the-riba.

¹¹² Id.

¹¹³ Meeting all tastes, Risk, September 2008, available at <http://www.risk.net/public/showPage.html?page=813157>.

¹¹⁴ Prohibitions on riba and gharar, available at http://www.witness-pioneer.org/vil/Books/MG_CIBF/chapter_1.htm.

committed seed capital of US\$ 50 million to each of four commodity hedge fund managers on the Al Safi platform, for a *Shari'a* compliant 'fund of funds' product to be offered under the Dubai *Shari'a* Asset Management (DSAM) brand.¹¹⁵ The Al-Safi fund utilises the *ar-bun* structure in order to replicate the economic effects of short-selling.¹¹⁶

(b) Short-selling using *Salam*

(i) Structure and Cash-flows

In this structure, a hedge fund (HF) advises the prime broker (PB) to sell shares (S) in a particular entity at a specified price (US\$ 100 in the illustrative diagram below (ID)) on Day 1 (step 1, in the diagram below). Once PB has sold S to the Buyer (with delivery to the Buyer to be on Day 10) and received US\$ 100 (steps 2 and 3), PB enters into a *Salam* contract with HF whereby PB pays US\$ 98 on Day 1 (US\$ 100 minus PB's spread of US\$ 2) (step 4) and HF undertakes to deliver S on Day 10.

In the present example, HF takes a 'short' position on S – i.e. HF expects the market value of S on Day 10 (X) to be less than US\$ 70.

On Day 10, HF buys S from the market (Seller) (steps 5 and 6) for X (US\$ 80 in ID) and delivers S to PB (step 7).

(ii) Industry usage

Newedge, a brokerage jointly owned by Calyon and Societe Generale, uses *Salam* contracts to enable hedge funds on its platform (launched in October 2005) to replicate the mechanics of conventional short-selling. Commenting on this structure, Teilhard de Chardin, global head of prime brokerage at Newedge in London says:

"Although different solutions seem more acceptable for different regions, many Saudi scholars prefer the *Salam* contract for equities, which is why we have taken this route."¹¹⁷

14.6. Legal and regulatory concerns

The tremendous growth of the Islamic finance industry in recent years has prompted several commentators to question the existence and effectiveness (or lack thereof) of central/regional regulatory bodies.¹¹⁸ The efforts of AAOIFI, IIFM and the Islamic Financial Services Board (IFSB) to produce guidance notes and/or *Shari'a* standards (as the case may be) – while commendable, have not yet achieved the desired level of harmonisation. The resulting lack of uniformity is compounded by the absence of a codified body of laws governing *Shari'a*-compliant transactions/products.

Regulation is carried out mostly at the micro level, with banks appointing their own *Shari'a* Boards (comprised of *Shari'a* scholars) who examine the *Shari'a* compliance of new products (and often, also monitor the ongoing compliance of these products). Divergence of opinions among different *Shari'a* Boards adds to the lack of uniformity mentioned above.

Such divergences of opinion in the Islamic finance industry was highlighted in the aftermath of a declaration made by Sheikh Taqi Usmani (a respected *Shari'a* scholar) in 2007 that up to 85% of the *sukuk*-based products in the market at that date were not *Shari'a*-compliant and hence, unenforceable. The *sukuk* market was thrown into turmoil overnight and relative stability was restored only after a statement on the boundaries of permissibility in relation to *sukuk* was issued by the AAOIFI in February 2008.

In recent times, complicated *Shari'a*-compliant financial structures and derivative products have been criticised by certain commentators such as Sheikh Yusuf Talal de Lorenzo (please see Section 14.5.4 above) on the ground that in the process of financial decision-making (based on profit maximisation), *Shari'a* tenets are being eroded. Such commentators argue that *Shari'a*-wrapping – i.e. the tendency of certain *Shari'a* Boards

to approve financial products that are delivered by ostensibly halal means (even if the actual return delivered by those products is ultimately derived from non-compliant investments) is threatening to obscure and override *Shari'a*-based products – i.e. products which are rooted in the *Shari'a*, rather than being merely superficially compliant.

The above discussion is indicative of the lack of uniformity of opinions, which sometimes plagues specific products within the Islamic finance industry. Such divergences also take shape on a cross-jurisdictional basis. For example, the bai bithaman ajil contract is viewed as *Shari'a* compliant in South-East Asia, but its validity is not recognised in the GCC region.

The growth of the Islamic finance industry is contingent upon the development of investor confidence in this regard, which in turn rests upon a greater measure of uniformity of opinion and practice in relation to *Shari'a*-compliant products. A centralised regulatory regime could reconcile divergent opinions in the industry and produce industry-standard guidelines which would be very useful to all market players in the Islamic finance industry.

14.7. Conclusion: through the looking glass – the way forward

14.7.1. The need for greater uniformity

As discussed above, the lack of a central regulatory body is perceived as an obstacle to the growth of investor confidence in Islamic finance. A good starting point to address this concern would be the MATP project (reference: Section 14.2.1(a)).

The MATP project was a natural forerunner to a joint initiative between ISDA and IIFM to produce a Master Agreement under which *Shari'a*-compliant hedging transactions can be documented. The ISDA/IIFM *Tahawwut* Master Agreement was launched on the 1st March in Bahrain after 4 years of hard work. Based in form and structure on the ISDA 2002 Master Agreement, it is very much hoped that it will bring liquidity, confidence and a convergence in pricing to the Islamic derivatives market.

Essentially the ISDA/IIFM *Tahawwut* Master Agreement is a multiproduct agreement on which all *murabaha*, *musawama* and *wa'ad* based Islamic products can be documented on. More analysis needs to be done to conclude whether *salam* and *ar-bun* based products can be documented on the ISDA/IIFM *Tahawwut* Master Agreement. It is pan-jurisdictional i.e. it can be used by all market participants regardless of their nexus to a particular madhab. At present the ISDA/IIFM *Tahawwut* Master Agreement sits outside the ISDA modular library e.g. it cannot be used with the Credit Definitions or Equity Definitions however, this is something that ISDA members will be discussing in the near future.

The most important concept within the ISDA/IIFM *Tahawwut* Master Agreement is the dichotomy between Transactions (*concluded transaction*) and Designated

Future Transactions (*non-concluded transactions*). The appreciation of this concept lies at the heart of the agreement and forms the cornerstone of the Islamic close-out mechanism.

Next steps include drafting template confirmations and working with ISDA to try and elicit enforceable netting opinions in the relevant jurisdictions.

The ISDA-IIFM *Tahawwut* Master Agreement (together with an Explanatory Memorandum) can be downloaded from both the ISDA website (www.isda.org) or at IIFM's website (www.iifm.net).

Initiatives, such as the above, definitely illustrate progress towards achieving greater uniformity in Islamic derivatives.

14.7.2. Innovation is the order of the day

As with any industry in its nascency, innovation could play a determining role in the growth of Islamic finance. With an increase in the number of *Shari'a*-compliant products in the market which can achieve a similar economic profile to comparable conventional products, the investor base is likely to increase. The following recent developments illustrate the recognition, by industry players, of the importance of innovation:

1. Bursa Malaysia has announced its intention to launch:

(i) a palm-oil based commodity spot trading platform later this year (Commodity Murabaha House);¹¹⁹ and

(ii) a *Shari'a*-compliant short-selling platform.¹²⁰

2. The Dubai Multi Commodities Centre (DMCC), in association with NASDAQ Dubai and the World Gold Council, launched Dubai Gold Securities (DGS) in March 2009. DGS offers investors exposure to the price of gold. The securities are backed by physical reserves of gold held by HSBC (as custodian).¹²¹

3. In Bahrain, the total value of Islamic assets increased from US\$ 1.9 billion in 2000 to US\$ 16.4 billion in early 2008.¹²² The introduction of a comprehensive prudential and reporting framework by the Central Bank of Bahrain has helped generate investor confidence and the market share of Islamic assets (as compared to total banking assets in Bahrain) increased from 1.8% in 2000 to 6.5% in early 2008.¹²³

4. DIB recently bought back US\$ 50.62 million of the five-year US\$ 750 million *sukuk* issued by DIB *Sukuk*-Company Limited in 2007, at a 12% discount to the face value. This was the first-ever *sukuk* buy-back.¹²⁴

14.7.3. Islamic finance and the credit crunch: new challenges and new opportunities

Based on the principle of risk-sharing that is inherent to *Shari'a*-compliant financing techniques, Islamic banks have broadly been better placed than their conventional counterparts to combat the effects of the credit crunch. While the Dow Jones Islamic Market World Emerging Markets Price Index rose 6.43% in the period from 01 October 2008 to 11 August 2009, the S&P 500 Composite Price Index and the FTSE 100 Price Index fell 14.36% and 5.82% respectively, over the same period.¹²⁵

¹¹⁹ Malaysian bourse to launch Islamic platform in June, available at <http://www.reuters.com/article/rbssFinancialServicesAndRealEstateNews/idUSKLR45196220090305>

¹²⁰ Malaysian bourse plans shari'a short selling platform, available at <http://in.reuters.com/article/rbssFinancialServicesAndRealEstateNews/idNLKLR15672820090330>

¹²¹ Dubai launches Islamic gold backed security, available at <http://in.reuters.com/article/domesticNews/idINL212041620090302>

¹²² Lionel Laurent, Capitals of Islamic Finance, 21 April 2008, available at http://www.forbes.com/2008/04/21/islamic-investment-dubai-cx_11_islamicfinance08_0421cities_tearsheet_3.html

¹²³ <http://www.bahrainifs.com/FSInBahrainIslamicFinance.aspx>

¹²⁴ Lovells advises on first ever *sukuk* "buy back", available at <http://www.lovells.com/Lovells/MediaCentre/PressReleases/Lovells+advises+on+first+ever+sukuk+buy+back.htm>

¹²⁵ Datastream (Thomson Reuters).

¹¹⁵ DMCC Seeds Al Safi Trust, 19 June 2008, available at <http://www.investegate.co.uk/Article.aspx?id=200806190700030291X>

¹¹⁶ Dean Naumowicz and Uzma Khan, Symptoms of compliance, available at <http://www.cpifinancial.net/v2/print.aspx?pg=magazine&aid=1782>

¹¹⁷ Meeting all tastes, September 2008 – RISK, available at <http://www.risk.net/public/showPage.html?page=813157>

¹¹⁸ Frank Kane, The West's bankers may learn from their Islamic brothers, <http://www.thenational.ae/apps/pbcs.dll/article?AID=/20090307/BUSINESS/448194510/1005>

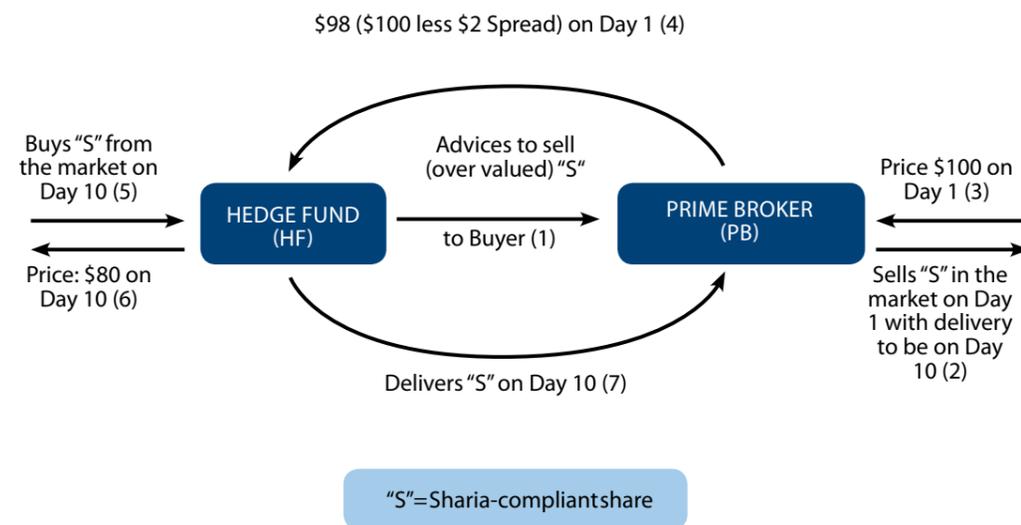


Figure 93: Short selling using salaam

Commenting on the difference in operational mechanics between Islamic and conventional banks, Abdel Bassat al-Shibi, managing director of Qatar International Islamic Bank, has stated that “Islamic banks don’t buy credit but manage concrete assets which shelter them from the difficulties that American and European banks are experiencing.”¹²⁶

While it may be too early to analyse the effects of the credit crunch on Islamic finance, it is worth noting that even in the current economic climate, there is appetite for *Shari’a*-compliant products, as evidenced by:

(i) the Government of Bahrain’s recent *sukuk* being eight times oversubscribed;¹²⁷ and

(ii) the Republic of Indonesia’s inaugural US\$ 650 million *sukuk* being several times oversubscribed.

However, Islamic financial institutions are not completely insulated from the effects of the credit crunch. Several *sukuk* issuances and launches of innovative derivative products have been presently placed in a holding pattern, till the markets indicate definite signs of recovery.

14.7.4. A growing market with significant potential

Today, it is estimated that there are *Shari’a*-compliant assets worth at least US\$ 750 billion globally, with this figure expected to reach US\$ 1.5 trillion by the end of 2010. A recent report suggests that Islamic banking has expanded by more than 10% annually over the past decade,¹²⁸ with daily turnover in *Shari’a*-compliant transactions possibly running into billions of dollars.¹²⁹ Islamic finance has the potential to be the new star on the investment horizon. Already, its appeal is spreading fast beyond the shores of conventional hubs such as the GCC region and Malaysia, as is apparent from the following developments:

(a) The Islamic Bank of Thailand (IBT) plans to raise between US\$ 70 million to US\$ 200 million through the issue of *sukuk* in Malaysia and the Middle East by the end of 2009;¹³⁰

(b) VTB Capital plans to develop *Shari’a*-compliant products and market these in Russia and the Commonwealth of Independent States (CIS);¹³¹

(c) The Law Governing the Operation of Islamic Banks by the Central Bank of Nigeria was enacted in March 2009. This creates a level playing field for Islamic financial institutions and conventional banks in Nigeria. Diamond Bank is one of the major players in the Islamic finance space in Nigeria. 65 % of Nigeria’s estimated 150 million population is Muslim;¹³²

(d) South Korean government officials have issued several public statements advocating a greater role for Islamic finance in the country’s financial system. Korea Development Bank and the Abu Dhabi Investment Corporation are presently holding talks with a view to identifying investment opportunities in South Korea;¹³³ and

(e) BTA Bank, Kazakhstan’s second-biggest bank by assets, is considering opening an Islamic banking unit, in collaboration with Dubai-based Emirates Islamic Bank. Kazakhstan has also promulgated a new law (The Islamic Finance Law 2009) which amends several aspects of the

existing legal framework (including the Law on Banks and Banking Activity in the Republic of Kazakhstan, 1995), and is intended to broaden the range of finance options available to Kazakhstani companies.¹³⁴

While only time will tell to what extent the above initiatives are successful, it is certain that with sustained innovation and greater uniformity in application, Islamic finance will continue to appeal to a wide class of investors. The global markets are gradually reviving themselves and amidst the green shoots, Islamic finance appears to be a very promising bud.

¹²⁶ Faisal Baatout, Credit Crunch may spur Islamic finance, 28 October 2008, available at <http://news.theage.com.au/business/credit-crunch-may-spur-islamic-finance-20081028-5ab3.html>

¹²⁷ Central Bank of Bahrain announces maturity of 9th issue, 01 July 2009, available at http://www.sukuk.net/news/articles/2/Sukuk.net_Central_Bank_of_Bahrain_announces_matur.html

¹²⁸ Elisabeth Eaves (Forbes), The rise of Islamic finance, available at <http://www.ameinfo.com/157243.html>.

¹²⁹ Mark Bendeich, Islamic Commodities: what would Mohammed do?, December 8, 2006, available at <http://www.gata.org/node/4587>

¹³⁰ Islamic Bank of Thailand to issue *sukuk* bonds, 27 March 2009, available at <http://www.newser.com/archive-business-news/1G1-196424126/islamic-bank-of-thailand-to-issue-sukuk-bonds.html>

¹³¹ VTB Capital to move into Islamic finance, 22 June 2009, available at <http://www.cpifinancial.net/v2/News.aspx?v=1&aid=2648&sec=Islamic%20Finance>

¹³² Mushtak Parker, Nigeria opens market for Islamic finance, 13 April 2009, available at <http://www.ara.billionews.com/?page=6§ion=0&article=121487&d=13&m=4&y=2009>

¹³³ South Korea gears up for Islamic finance initiative, 02 February 2009, available at http://www.menafn.com/qn_news_story.asp?StoryId=1093231531

¹³⁴ SRI, Islamic Finance comes to Kazakhstan, 07 May 2009, available at http://www.menafn.com/qn_news_story.asp?StoryId=1093231531