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 on a pool of assets in one or more other items 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’ derivative 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.

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 motivating factor in the development of derivatives in the United States. As early as 1850, the Chicago Board of Trade in 1848. Other early exchanges also emerged.

The Origin of the Textbook inserts/Global Islamic Finance Report (GIFR 2010)

The use of derivative instruments for financial hedging (risk management), arbitrage and speculation. 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), it would give rise to a futures contract. An exchange minimizes the possibility of a default by either party by requiring the payment of an initial margin and regular posting of the margin. Based on the market calculations.

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Arbitrage is the practice of taking advantage of a price difference between two or more markets — i.e. striking a combination of matching deals that capitalizes upon the imbalances, 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 significantly diverge, to make a profit (taking into account any applicable transaction costs), enter into an arbitrage transaction whereby they buy the asset from the market offering lower quoted price and immediately thereafter, sell the same asset in the market where it has a higher quoted price. 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 paragraphs (b) and (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 harmonize and regulate international prices.

Christopher Plummer Points, p. 274


Mike Mufli, Arbitrage examined, available at http://economics.about.com/cs/finance/a/arbitrage.htm


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Islamic derivatives: theory and practice

Islamic derivatives are financial products which seek to provide a similar economic profile to comparable conventional derivative instruments, albeit through a Sharia compliant structure. Under Sharia, all financial instruments and transactions must be free of at least the following five elements: (i) riba (interest), (ii) mubahah (corruption), (iii) musta (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 Sharia prohibits riba, it does not prohibit trade or the making of gains from 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 do not agree with you stand out separately from you. They say: ‘We also do not agree with them’. God has permitted trade and forbidden riba.

The prohibition on riba stems from the Sharia’s tenet that money, by itself, should not be recognised as a medium of exchange and a unit of measurement. Consequently, there should be no reappearance of usury and on taking ‘unnecessary’ risks become especially relevant in the context of derivative instruments.

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 Taj Ul-Umar from the Fiqh Academy of Jeddah argued in 1996 that futures contracts are invalid under Sharia because:

“Firstly, it is a well-received principle of the Sharia that purchase or sale cannot take place on speculation (i.e. for a future date). Therefore, all forward and futures contracts are invalid under Sharia, 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 Sharia.”

Conversely, Fathi Khan states that:

“We should realize that even in the modern degenerated form of futures trading, some of the underlying basic concepts as well as some of the conditions for such trading are exactly the same as laid down by the Prophet.”

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 termed and designed to be alternatives (to) conventional derivatives. These are relatively new and we have to look into them.”

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

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

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

(ii) hukma (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 damaan, modhio and ghari.

14.2.1. Key issues

Since the inception of Islamic money markets and doubts regarding the credibility of such products (as a realistic alternative to conventional Sharia Advisory Council (the Council) will be on the court which referred the relevant matter to the Council. In another recent development, the Bank Negara Malaysia Bil 2009, under which decisions of the Islamic Finance Advisory Council (the Council) will be on the court which referred the relevant matter to the Council. In another recent development, the Bank Negara Malaysia Bil 2009, under which decisions of the Islamic Finance Advisory Council (the Council) will be on the court which referred the relevant matter to the Council. In another recent development, the Bank Negara Malaysia Bil 2009, under which decisions of the Islamic Finance Advisory Council (the Council) will be on the court which referred the relevant matter to the Council. In another recent development, the Bank Negara Malaysia Bil 2009, under which decisions of the Islamic Finance Advisory Council (the Council) will be on the court which referred the relevant matter to the Council.

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, dated back to the demand from the Muslim community for an alternative to a savings bank based on profit-sharing established by Ahmed Ennaguy in the Egyptian town of Mqur in 1961.77 In 1972, the Mqur Savings project became a part of the Nair 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 (1975), the Islamic Bank (1975), the Kuwait Finance House (1977), the Islamic Bank of Egypt (1977) and the Bahrain Islamic Bank (1979).

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 financial products from consumer loans to bonds. With the passage of time and the global development of Islamic finance, investors’ appetites for complex Islamic products has also grown significantly and market players predict that there is strong potential for further growth in Islamic derivatives.

14.3. The global development of Islamic finance

Over the past decade, Malaysia has made a concerted effort to promote itself as the premier Islamic finance centre in the world by developing the following initiatives:

(i) the world’s largest Islamic banking and financial market, with Islamic banking assets totaling USD 30.9 billion and (ii) the world’s largest Islamic private domestic market in debt securities, estimated at approximately USD 3.4 billion. Malaysia also has a critical mass of market players in the Islamic finance sector, with an active Islamic finance market which channels approximately RM 30 billion monthly. The above factors, combined with the growing presence of international Islamic banks and the International Offshore Financial Centre located just off the Malaysian coast, make Malaysia an inviting choice for prospective investors in Islamic finance.

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

Recently, the Malaysian legislature passed the Bank Negara Malaysia Bil 2009, under which decisions of the Islamic Finance Advisory Council (the Council) will be on the court which referred the relevant matter to the Council. In another recent development, the Bank Negara Malaysia Bil 2009, under which decisions of the Islamic Finance Advisory Council (the Council) will be on the court which referred the relevant matter to the Council. In another recent development, the Bank Negara Malaysia Bil 2009, under which decisions of the Islamic Finance Advisory Council (the Council) will be on the court which referred the relevant matter to the Council. In another recent development, the Bank Negara Malaysia Bil 2009, under which decisions of the Islamic Finance Advisory Council (the Council) will be on the court which referred the relevant matter to the Council.

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...
14.4.1. Murabaha

Murabaha (also known as cost-plus financing) is a particular type of Sharīʿa-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) 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 (Step 2). Typically, Y is payable by C in instalments, but it can be paid at once as a time-bill payment on a specified date in the future (similar to a ‘sale and deferred payment’ finance technique). Having purchased the commodities from Broker 1, B on-sells these to another third-party broker, Broker 2 (P), at a price equal to C’s cost price plus Δ (Step 4).

Since the wa‘ad is a unilateral promise, it does not have to satisfy the requirements of a bilateral contract (qiṣāṣ) under Sharīʿa (i.e., knowledge of the price and (i) 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 Sharīʿa-compliant structures, such as an FX option (refer section 14.4.5 below) or a total return swap (see Section 14.4.5 below).

14.4.2. Wa‘ad

A ‘wa‘ad (arabic word for ‘promise’) is a traditional Islamic product which, in the context of commercial dealings, is generally accepted to mean a unilateral promise.94 According to a fatwa issued by the Islamic Fiqh Academy (the IFA) at its Fifth Conference held in Kuwait (1988-1989), a ‘wa‘ad is 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.95 Since then, this view has attracted widespread scholarly support.96 Several madhabs declare the murabaha to constitute a contract, the premium paid in accordance with the IFA fatwa extends to Islamic finance structures, other than murabaha-related wa‘ad transactions. The Academy and Auditing Organization of Islamic Financial Institutions (AOAOFI) has endorsed the extension of the IFA fatwa to currency exchange transactions within an Islamic framework,97 thereby suggesting that the application of ‘wa‘ad may not need to be confined to the classic murabaha model. However, such extension of the IFA’s fatwa has been criticized by certain authors.98

14.4.3. Arbun

Arbun is generally defined as a common practice found in the Muslim world, whereby the seller (B) (i) promises a price (Y) at end of the date of sale (similar to the ‘sale and deferred payment’ finance technique) and (ii) on-sells the commodities to the counterparty (C); and (iii) on-sells these to another third-party broker, broker 2 (P), at a price equal to (C’s cost price + Δ) (Step 4).

Notes:
1. t₀ must be earlier in point of time than t₁.
2. X must be less than Y.
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, waslād, qīsāl and sālim, as discussed above.

14.5.1. 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 re-exchange of interest payments during the swap’s life (essentially a series of FX forward trades) (Interim Amounts) and (iii) a final exchange of interest payments at maturity (Final Amount).

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 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 includes payment in full of the Cost Price.

The commodities are delivered on the date on which the transaction is entered into. On receipt of the commodities, the Counterparty (or its agent) promptly on-sells the commodities to a different commodity broker (Broker B) to generate a Currency B (USD) payment (steps 3 and 4).

(i) The Primary (Term) Murabaha

To initiate the Secondary Murabaha, the Counterparty (ii) purchases commodities from Broker B and makes payment in Currency B (step 5), and (iii) immediately on-sells the 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). Installment 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 (DIG) to hedge the currency risk on DIBS RM 828 million (approximately €119 million) investment in Bank Islam Malaysia. Standard Chartered Saadiq, Al Hilal Bank and Calyon also market products based on Shari’a-compliant cross-currency swaps.

I4.5.2. Profit rate swap

(i) Structure and Cash-Flows

A profit rate swap is best Analysed 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 ribā, mārsī and gharār.

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).

(ii) The Primary (Term) Murabaha

The process is initiated by the floating rate payer (the Floating Rate Payor) (i) sourcing commodities from a commodity broker (Broker 1) (step 1), in the diagram below; and (ii) on-sells these commodities to the swap counterparty (the Fixed Rate Payor) (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 Payor (or its agent) on-sells those commodities immediately to a different commodity broker (Broker 2) (step 3) to generate cash. The Fixed Rate Payor 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
The Fixed Rate Payer immediately on-sells these commodities to its broker.

(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) within a specified period, to expire the option (American option).

The swap is used to structure a Shari’a-compliant FX trade (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) is regarded as contributing towards maslaha. However, the trading of an option without any accompanying purchase/sale of underlying tangible, undertaken solely with the objective of making a speculative gain (akin to gambling, i.e. misr), is prohibited under Shari’a, is regarded as impermissible by several scholars, as it is looked upon as increasing gharar.107

Under one application of this structure, (i) the Bank 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), 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 wá‘ad (the Bank’s decision whether or not to exercise the option being dependent upon whether the option is in-the-money or not on or about the Settlement Date). The Bank, therefore, has a right to accept the promise (and thereby exercise the wá‘ad-based option) or cancel the promise by sending a cancellation notice.

In the context of a similar wá‘ad-based FX option developed by a multinational bank, the relevant Shari’ah Board stated that the concerned product is “for hedging or cost reduction purposes only and not for speculation”.108

Cash-flows

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’s Shari’a Board, Dr. Fareed Hadi. Commenting on the deal, Mr. Abdul Rahman Al Jasmi, Deputy Chief Executive Officer, GFH said:

“We are proud to be the first bank to utilise 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 add this type of permission, rate or option to our inventory of risk management tools.”109 (emphasis supplied).

Calyon, Al Hilal Bank and Calyon have also developed products based on Shari’a-compliant profit rate swaps.110

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

Specified amount in Currency B (payable on Settlement date)

Specified amount in Currency A (payable on Settlement date)

Non-refundable fee

Purchase Price in Currency A

Specified amount in Currency B (payable on Settlement date)

Non-refundable fee

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)
Islamic Derivatives: Theory and Practice

Figure 91: Total Return swap structure

hedge against the upside or downside related to that particular asset or class of assets. Under Sharia’s, 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 Sharia-compliant assets from the market (Sharia-compliant Assets, steps 3 and 4). These Sharia-compliant Assets could, for example, be shares listed on the Dow Jones Islamic Market Indexes (DJIM). 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 Sharia-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 Sharia-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 Sharia-compliant Assets have performed relative to the Underlying, and if the Wa’ad Sale Price is greater than the market value of the Sharia-compliant Assets, then the Issuer shall enforce Wa’ad 1 (similar to a conventional put option), or if the Wa’ad Sale Price is less than the market value of the Sharia-compliant Assets, then the Bank shall enforce Wa’ad 2 (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 Sharia-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 Sharia scholar) on the basis that it was devised with a view to “swap a non-Sharia-compliant underlying into a Sharia-compliant structure.” Sheikh De Lorenzo argues that such a structure is not Sharia-compliant because:

(i) the returns, under such structures (generally termed ‘Sharia Conversion Technologie’), are determined by the performance of funds which are not Sharia-compliant and which could invest in haram securities;

(ii) a qiyas (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-Sharia-compliant assets for pricing; since while the former is used to indicate the return, the latter is used to deliver the return; and

(ii) 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 Sharia-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 the double wa’ad mechanism, Deutsche Bank kept Islamic investors’ investments isolated from haram assets, as demonstrated by the Shen’s audits carried out by the bank.” 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.113 114

(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 Sharia’s Board of Dar Al Itha’thmar (Shari’a Advisor to Deutsche Bank), consisting of five of the world’s leading Shari’a scholars: Dr. Hussein Hassan, Dr. Ali AlQahtani, Dr. Abdulfattah Abu Ghuddah, Dr. Mohamed Ali Elgindy 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.”115

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, there is, therefore, a separation of ownership and risk in a 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 (a lower price) and make a speculative gain in the process.

Under Sharia’s, according to Hadith, one cannot sell what one does not own and ownership cannot be divorced from risk.116 The arba’i or the salim can be used to emulate a conventional short-sale in a Sharia-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 Sharia-compliant structures incorporate the creation of a partnership, to ensure that the returns are synonymous with a conventional short-selling arrangement.

(a) Short-selling using arba’i

(i) Structure and Cash-flows

$68 ($70 less $2 Spread) on Day 1

Bucks “S” from the market on Day 10

Advises to sell to Buyer an option

Price: $70 on Day 1

Prime broker (PB) 

Sells option to Buyer to purchase “S” with delivery to be on Day 10, if the Buyer exercises the Option.

Buys “S” from the market on Day 10

Advise to sell to Buyer an option

Price: $100 on Day 10

Pays the remaining price of $30 on Day 10

Delivers “S” on Day 10 (if option exercised)

Heads fund (HF) 

Sells an option to purchase shares (S) in a particular entity at a specified price ($US 100 in the illustrative diagram below), 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 arbot 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 $US 10 (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 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 represent at least a third of the total purchase price; a “minority” as per the sayings of the Hadith, to contribute to the Share’s-compliance of such a structure.

(ii) Industry Usage

In June 2008, Barclays Capital and the Dubai Multi Commodities Centre Authority (DMCC) announced the first Sharia-compliant hedge funds to be launched on the Al Salt Alternative investment platform. DMCC has

Figure 92: Short selling using arba’i

113 Id.


115 Id.

committed seed capital of US$ 50 million to each of four commodity hedge fund managers on the Al Saif platform, for a Shari'a compliant ‘fund of funds’ product to be sold under the Dubai Shari’a Asset Manage-
ment (DSAM) brand. The Al Saif Fund utilises the ar-
ban structure in order to replicate the economic effects of short-selling.12

(b) Short-selling using Salim

(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 ($US 100 in the illustrative diagram below) on Day 1 (step 1, in the diagram below). Once PB has sold S to the Buyer (with delivery to the Buyer to be on Day 10) and received US$ 100 (steps 2 and 3), PB enters into a Salim 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 on 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$ 78. On Day 10, HF buys S from the market (Seller) (steps 5 and 6) for $X (US$ 80 in this example) and delivers S to PB (step 7).

(ii) Industry usage
Newedge, a brokerage jointly owned by Calyon and Soci-
ete Generale, uses Salim contracts to enable hedge funds on its platform (launched in October 2005) to replicate the positions of companies engaged in short-selling. Comment-
ing on this structure, Teilhard de Chardin, global head of
Newedge in Suzhou, China, global head of prime brokerage at Newedge in London says:

“Although different solutions seem more acceptable for dif-
erent regions, many Saudi scholars prefer the Salim con-
tract 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/regulatory bodies.13 The efforts of AAOIFI, IFM and the Islamic Financial Services Board (IFSB) to produce guidance notes based on Shari’a stan-
dards (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). Divergences of opinions among different Shari’a Boards adds to the lack of uni-
formity mentioned above.

Such divergences of opinion in the Islamic finance in-
dustry was highlighted in the aftermath of a declara-
tion made by Sheikh Taji 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 derivatives have been created 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 be-
ing 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 deliv-
ered by those products is ultimately derived from non-
compliant investments) — is threatening to obscure the Shari’a-based products — i.e. products which are rooted in the Shari’a, rather than being merely su-

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 inves-
tor 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 SDAI and IFM to produce a Mas-
er Agreement under which Shari’a-compliant hedg-
ing transactions can be documented. The SDAI/IFM 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 Agree-
ment, it is very much hoped that it will bring liquidity, confidence and a convergence in pricing to the Islamic derivatives market.

Essentially the SDAI/IFM Tahawwut Master Agreement is a multiproduct agreement on which all sukuk, musawama and waqf based Islamic products can be documented on. More analysis needs to be done to conclude on the salim and aston based transactions can be documented on the SDAI/IFM Tahawwut Mas-
ter Agreement. It is a pan-jurisdictional in so far as it can be used by all market participants regardless of their nexus to a particular madhab. At present the SDAI/IFM Tahawwut Master Agreement sits outside the ISDA modular rlg. e.g. it cannot be used with the Credit Defini-
tions or Equity Definitions however, this is something that SDAI members will be discussing in the near future.

The most important concept within the SDAI/IFM 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 get enforceable netting provisions in the relevant jurisdictions.

The SDAI/IFM Tahawwut Master Agreement (together with an Explanatory Memorandum) can be downloaded from both the SDAI website (www.sdai.org) or at IFM’s website (www.ifmfn.org).

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

14.7.2. Innovation is the order of the day

As with any industry in its nascent, 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 eco-

118 DIFC Seeks Al Saif Trust, 19 June 2008, avail-
able at http://www.invest-
mentuk.com/ArticleDeta-
ils/20080619070039291X

119 Daew Naumovicz and Umma Khan, Symptoms of com-
.net/u/3ptm/asp.aspx?c-
magazineid=178

net/public/showPage.
html?page=11/31 57

121 Frank Kane, The West’s brokers may learn from their
Islamic brothers, http://www..
financialtimes.com/mtarticle.
artid=2000610371
BUSINESS/4181451/410505

$98 ($100 less $2 Spread) on Day 1 (4)

Buy S” from the market on Day 10 (5)

Price: $80 on Day 10 (6)

Delivers “S” in the market on Day 10 with delivery on Day 10 (2)

Advices to sell (over valued) “S”

PRIME BROKER (HF)

Price $100 on Day 1 (3)

Sells “S” in the market on Day 1 with delivery on Day 10 (2)

HEDGE FUND (HF)

$100 less $2 Spread

Figure 93: Short selling using salamara

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

122  Lionel Laurent, Capital’s
investment in Dubai: A Summary of
the 2008 ISDA/IIFM Commodity
Market Report, 24 March 2009, avail-
able at http://www.mayer
brown.com/files/ISDA/2008
ISDAIIFM_2009_commodity
market_report.pdf


124 Lovells advises on first ever
sukuk “buy back”, available at
http://www.lovells.com/Lovells/
reuters/articles/sukuk_buyback.
tearsheet_3.html

125 Islamic Derivatives: Theory and Practice

14.7.3. Islamic finance and the credit crunch:

For example, the bai bithaman ajil contract is viewed as

142 Global Islamic Finance Report (GIFR 2010)

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 get enforceable netting provisions in the relevant jurisdictions.

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143 Islamic Derivatives: Theory and Practice

142 Global Islamic Finance Report (GIFR 2010)

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Initiatives, such as the above, definitely illustrate progress towards achieving greater uniformity in Islamic deriv-
atives.
Commenting on the difference in operational mechanics between Islamic and conventional banks, Abdel Bassat al-Shib, 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 bonds, 27 March 2009, available at http://www. ibbank.co.th/eng/eng/announcements_matur.html

(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 in Malaysia promulgates a new law (The Islamic Bank Act 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.