

Introduction to Islamic Financial Risk Management Products

Introduction: the main features of Islamic finance

To consider the basics of Islamic financial risk management products, it is helpful to summarise the Islamic principles and jurisprudence on which Islamic finance is based.

Speculation

Contracts which involve speculation (*maysir*) are not permissible (*haram*) and are considered void. Islamic law does not prohibit general commercial speculation, but it does prohibit speculation which is akin to gambling, i.e. gaining something by chance rather than productive effort.

Unjust enrichment

Contracts where one party gains unjustly at the expense of another are considered void.

Interest

The payment and receipt of interest (*riba*) are prohibited, and any obligation to pay interest is considered void. Islamic principles require that any return on funds provided by the lender be earned by

way of profit derived from a commercial risk taken by that lender.

Uncertainty

Contracts which contain uncertainty (*ghara'*), particularly when there is uncertainty as to the fundamental terms of the contract, such as the subject matter, price, and time for delivery, are considered void.

To ensure adherence to these underlying principles, most banks that sell Islamic products have a board of Shari'a scholars (or will appoint a Shari'a scholar on a product-by-product basis) to ensure the bank's (or product's) compliance with the Islamic precepts.

On the whole, Shari'a scholars in the financial field hold the view that financial risk management products (commonly referred to as hedging arrangements) in the conventional finance space fall into the category of speculation (*maysir*) and uncertainty (*ghara'*), both of which are prohibited under the Shari'a and cannot therefore be marketed as Shari'a compliant products or used in conjunction with Islamic financing.

With the rise in sophistication of Islamic finance in recent years, however, a school of thought has emerged among pre-eminent Shari'a scholars that Islamic investors should be able to enter into hedging arrangements, provided that the financial risk management product is itself structured in a Shari'a compliant

Executive Summary

- The main features of Islamic finance and Shari'a scholars are introduced.
- Conventional financial risk management products are viewed as non-Shari'a compliant, which means that such products are not available to Islamic investors.
- The popularity of Islamic finance has given rise to a demand for Shari'a compliant financial risk management products for underlying Islamic investments.
- A number of structures of Shari'a compliant financial risk management products are available in the marketplace, all based around a *murabaha* sale structure.
- The rising popularity of the *wa'ad* structure is discussed.
- The article concludes with a brief summary of the future of Shari'a compliant financial risk management products including an introduction to the ISDA/IIFM Tahawwut Master Agreement.

manner and that there is genuine underlying risk arising from an Islamic investment.

The conventional financial risk management products have become an intrinsic part of the mechanics of banking finance and are, to a large part, documented by standard documentation and negotiated without recourse to lawyers. Any Shari'a compliant financial risk products have to strike the balance of being faithful to the principles of Shari'a while maintaining the user-friendly structure of their conventional counterparts.

The conventional products

Financial risk management products in the conventional world are, in their basic form, a derivative, and each product is based on the principles that a derivative is a financial instrument whose value derives from that of an underlying asset, and the underlying asset must be capable of being ascribed a market value.

The number of "assets" that can be ascribed a market value and from which, therefore, a derivative can be derived has resulted in a variety of financial risk management products. The commonly known structures are those based on interest and currency rates: i.e. interest rate swaps, cross-currency swaps, and foreign exchange forwards. There are also commodity derivatives based on gold, steel, and other metals. More recently, products known as "exotics" based on the weather and carbon emissions have appeared in the market in response to the requirements of a changing environmental as well as financial climate.

How a Shari'a compliant product is structured

The starting point in structuring an Islamic financial risk management product should be an understanding of the commercial purpose of its conventional counterpart. For example, when structuring an Islamic compliant "profit rate swap", one must examine the use and structure of its equivalent in the conventional space: the basic interest rate swap. The interest rate swap is a hedging arrangement that is used to limit exposure to possible losses of expected income due to interest rate movements, and there is a similar demand for Shari'a compliant products to limit exposure in Islamic investments where the profit, rent, or commission payable is linked in part to interest rate movements.

One must also consider the non-Shari'a aspects of a conventional financial risk management product and address the same in the Islamic structure. As noted in the introduction, a principle of Islamic finance is that any profit must be earned through trade and taking a risk in a transaction. A common reason why hedging arrangements are seen as non-compliant is that although a financial risk management product is linked to the value of an asset, it does not always require ownership risk in the asset itself and any profit earned is earned independently of trade, ownership, or investment in such an asset.

Conventional risk management products are structured along the lines of a synthetic trade that occurs on each payment date. The elements of this synthetic trade are that:

- a party will be obliged to carry out an action (such as the delivery of an asset or the payment of a price) on a certain date; and
- the obligation to carry out such action will vary in accordance with the value of the underlying asset.

This structure has provided the framework for Shari'a compliant financial risk management products by replacing the synthetic trade with an actual commodity (or any other asset) trade structured along the lines of a *murabaha*. This is a common Islamic structure under which assets can be sold for a determined profit and the payment can be deferred.

By using commodity trades, the banks and the counterparty expose themselves to ownership, if only briefly, of an underlying asset. The value of the traded commodity represents the principal amount of the underlying Islamic investment (the "cost price") and is sold at a profit, which is calculated by reference to an interest rate and, if applicable, a margin or spread (the "profit"). As the bank has taken ownership in the underlying asset, it is permitted to on-sell this at the profit, the calculation of which must be agreed upfront.

A number of structures of Shari'a compliant products all based on the *murabaha* have appeared in the marketplace with varying degrees of success. A description of the main structures, using the example of a profit (interest) rate swap, are set out below, together with the advantages and disadvantages of each.

Profit rate swap structure one

As in a conventional trade the parties, namely the "bank" and the "counterparty," agree the commercial terms of the future transaction i.e. the trade dates, the fixed rate, the floating rate, the assets to be traded, and the notional cost price. On each trade date, the bank and counterparty will enter into two *murabaha* agreements.

Under the first *murabaha* agreement (the "floating leg"):

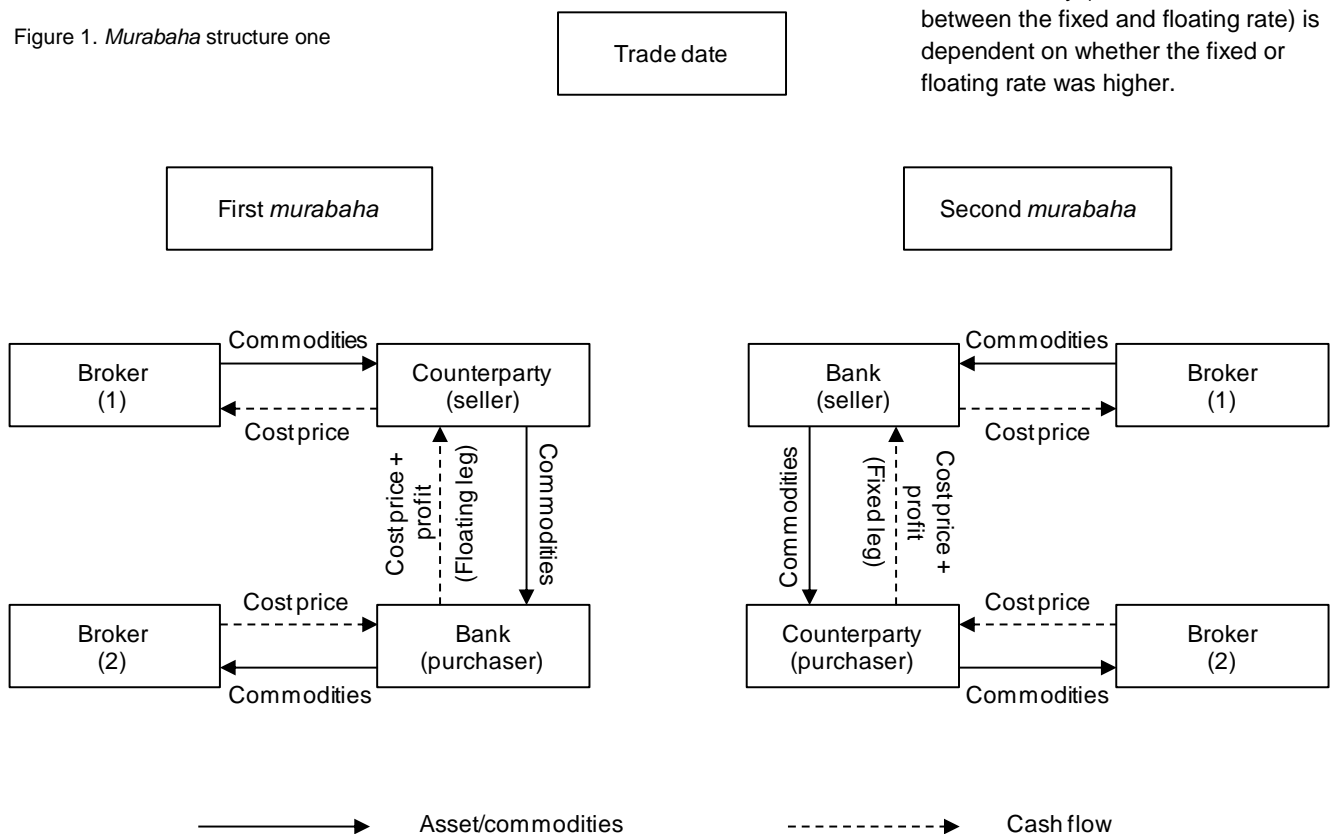
- the counterparty will sell to the bank an amount of commodities, the value of which will be the notional cost price;
- the sale price for these commodities will be cost price + profit;
- the profit element will represent the floating rate (calculated against the notional cost price).

Under the second *murabaha* agreement (the "fixed leg"):

- the bank will sell to the counterparty an amount of commodities the value of which will be the notional cost price;
- the sale price for these commodities, will be cost price + profit;
- the profit element will represent the fixed rate (calculated against the notional cost price).

The structure is shown in Figure 1. The net result of these trades is that on each trade date: the amount of commodities sold under each *murabaha* will be the same and the cost price will be the same, and these will effectively be netted off by way of on-sales to a third-party broker; only the profit element will differ; and, as in a conventional interest rate swap, the net beneficiary (of the difference between the fixed and floating rate) is dependent on whether the fixed or floating rate was higher.

Figure 1. *Murabaha* structure one



The risks associated with this *murabaha* structure are as follows:

- **Commodity risk.** This arises from the bank's and the counterparty's ownership of the commodity. To mitigate this risk, although the ownership lasts for a short period only, many banks require the counterparty to indemnify them against any losses incurred due to ownership of the commodity. Some Islamic institutions see this as undermining the principles of *Shari'a*, which require that full ownership risk is taken.
- **Execution risk.** This arises due to the fact that, under Islamic principles, parties cannot agree to a future sale (where delivery of the asset and payment of the price are both deferred to a later date). Therefore, the delivery of a commodity must occur on the same day that the *murabaha* contract is concluded. The result of this "parallel *murabaha*" structure depends on both parties' willingness to enter into the *murabaha* agreements on each trade date (whether or not they are the net beneficiary).
- **Costs.** These costs arise from the fact that two new *murabahas* are entered into at the beginning of each "profit" period (with deferred payment provisions) or on the trade date itself (with immediate delivery and payment provisions), throughout the term of the profit rate swap. This exposes each party not only to ownership risk, but also to the brokerage costs associated with a commodity trade (normally the brokerage fees are the liability of the counterparty, who would then be liable for two sets of brokerage fees on each trade date)

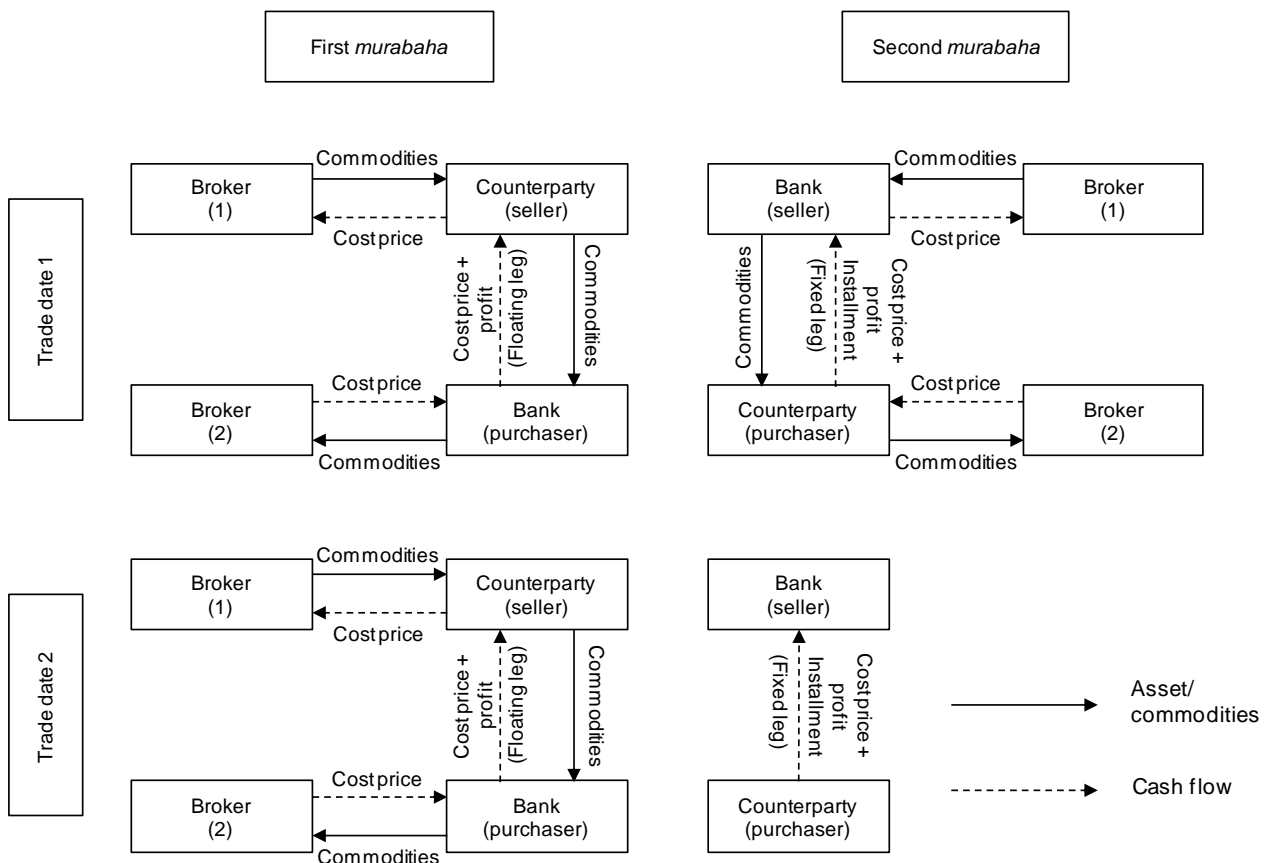
Profit rate swap structure two

In recognition of the risks set out above, the "parallel *murabaha*" structure has been developed in such a way as to limit the bank's and the counterparty's exposure to these risks, the key of which is that the fixed-leg *murabaha* is only entered into on day one and runs for the life of the profit rate swap, with "fixed" profit under the day-one *murabaha* being paid in instalments over a number of deferred payment dates (with no need for further commodity trades to take place or *murabaha* agreements to be entered into).

The deferred payment dates under the fixed-leg *murabaha* will match the trade dates of each floating-leg *murabaha*. Because the floating-leg *murabaha* resets the profit rate a number of times, it has to be re-executed in relation to each trade date in order to give the parties certainty of the cost price + profit, which results in a commodity trade being carried out. The way that structure two operates is illustrated in Figure 2.

This structure reduces the ownership risk (by reducing the number of commodity trades that are carried out) and the associated costs. It also reduces the execution risk as one half of the trade is entered into on day one. The parties are, however, still exposed to some execution risk: for example, a party not benefiting from a trade could walk away from the trade and the bank would remain liable to pay out under the fixed-leg *murabaha*.

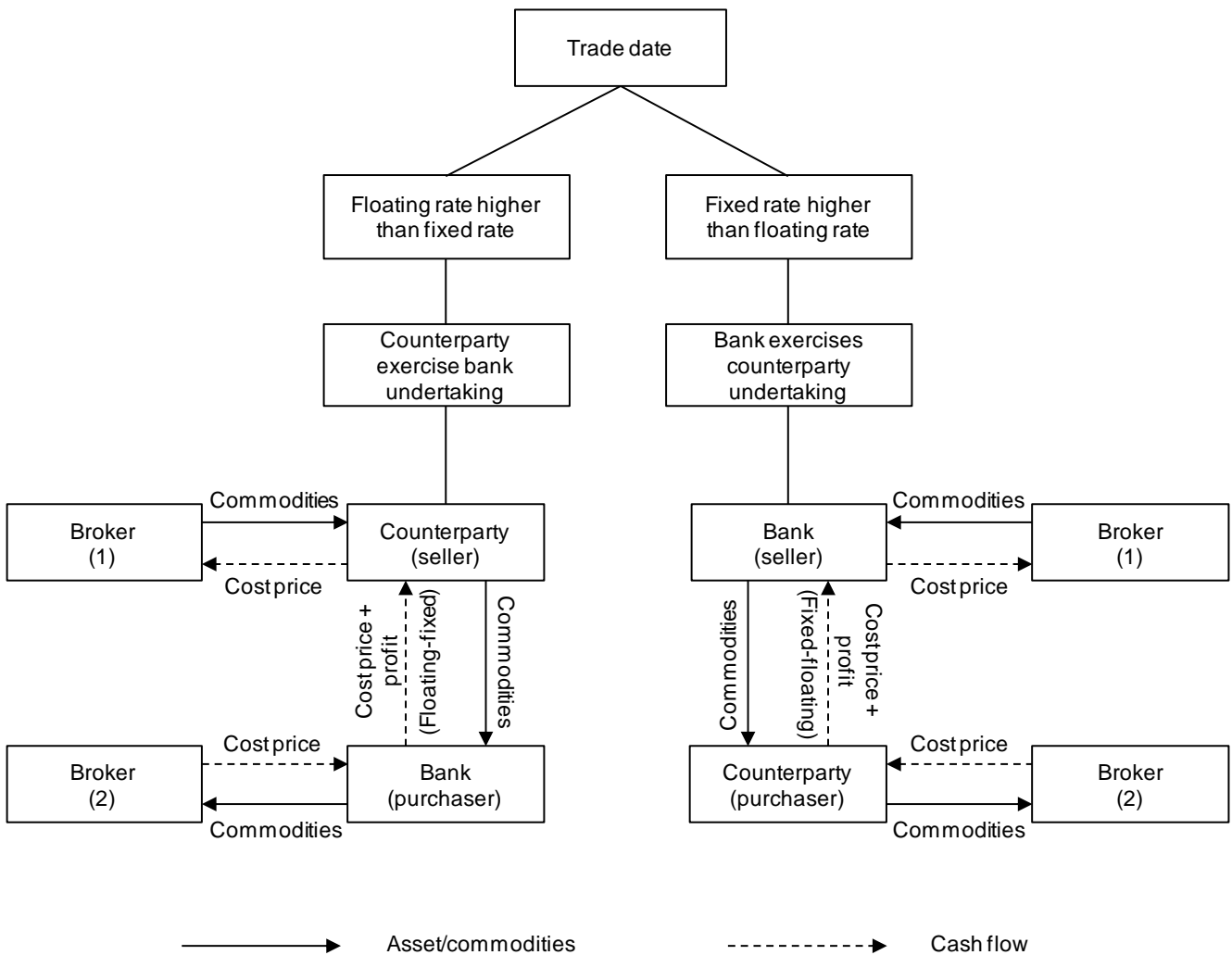
Figure 2. *Murabaha* structure two



Profit rate swap structure three

A structure that addresses the execution risk associated with structures one and two (and mitigates the ownership risk associated with structure one) has been adopted in the market with great success and is known as the *wa'ad* structure (Figure 3).

Figure 3. The *wa'ad* structure three



Wa'ad is the Arabic word for promise. A promise, though commonly thought of as a moral obligation, is in most legal systems also a legal one. The *wa'ad* structure is based on each

party (as promisor) granting the other (as promisee) a unilateral and irrevocable promise to enter into a trade on certain dates for a certain price in the future. It is effectively a

put option. The trade that takes place on a trade date is, as in structures one and two, a *murabaha* trade of commodities (or other assets), whereas the promise to enter into the

trade is documented by way of a purchase undertaking (or put option).

These two purchase undertakings are documented separately so that each 'promise' is a standalone unilateral obligation of the promisor, but they can and do contain similar terms such as the trade dates and the commodities to be purchased. So that when read together, they represent the two sides of a profit rate swap. The only main difference is the price, which consists of cost price and profit (which will be calculated to reflect the difference between the fixed and floating rates).

The main aspect of the purchase undertaking is the conditions attached to its exercise by the beneficiary, the promisee. The conditions attached to the exercise mirror those in the conventional hedge that determine which party benefits on a trade date. In an interest rate swap, this would be whether the fixed rate or the floating rate were higher. Depending on which is higher, only one party is able to exercise the purchase undertaking under which they are promisee and require the promisor to carry out a trade, purchase commodities, and pay the promisee the cost price + profit. The net result of the trade mirrors that of the structures one and two in that the cash flows are gained through the purchase and on-sale of commodities, but also that of a conventional trade, where there is only one cash flow representing the difference in the profit.

As is the case with structure two, the benefits are that there is only one trade on any trade date, which lowers

the ownership risk and associated costs. The real advantage, however, is that it resolves the issue of execution risk as the party in the money is in "control" of the trade, and once the promise is exercised by the promisee, the contractual obligation to purchase the commodities and pay the cost price + profit arises without need for further execution.

The flexibility of the *wa'ad* structure makes it suitable for a number of products beyond profit rate swaps, as it can be adapted as a foreign exchange forward (with only one purchase undertaking) or cross-currency swap. It can also be drafted as a master agreement together with purchase undertakings, bringing it in line with its conventional counterparts.

The future

The Islamic financial risk management products market has gathered such momentum in recent years that the favoured structures are constantly under review and revision. Satisfied that the Islamic structure allows payments that mirror those of the conventional trades, bankers are now looking at the other International Swaps and Derivatives Association (ISDA)-style provisions, such as right to terminate, termination events, tax events, and calculation of close-out amounts, and they are demanding the same level of sophistication in the Islamic financial risk management products.

In March 2010, ISDA and the International Islamic Financial Market (IIFM) launched the ISDA/IIFM Tahawwut Master Agreement. Taking an approach similar to that of the ISDA 2002 Master Agreement (a market standard agreement used for conventional financial risk management products), the Tahawwut Master Agreement is a framework agreement under which a range of Shari'a compliant financial risk management products, such as the profit rate swap, can be documented. As well as containing "master terms" such as tax, representations, events of default and termination events, the ISDA/IIFM Tahawwut Master Agreement contains a Shari'a compliant method of close out which can be used across product groups.

In 2012, ISDA and IIFM released the first template product documentation designed to be used with the ISDA/IIFM Tahawwut Master Agreement which was for the profit rate swap. The templates known as the *Mubadalatul Arbaah* used the *wa'ad* structure documented by way of purchase undertakings, though the ISDA/IIFM Tahawwut Master Agreement is designed to be used with other types of structures such as *murabaha*.

It is hoped that the ISDA/IIFM Tahawwut Master Agreement and its related documentation will be adopted by the market as industry standard documentation for Islamic financial risk management products.

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