The evolution of Islamic derivatives

Despite its widespread use as a Shariah compliant structure in Saudi Arabia, Murabahah is not widely accepted when used to facilitate an Islamic derivatives transaction within the kingdom. MARTIN FOSTER-JONES discusses.

There is a popular misconception in the GCC region, particularly in Saudi Arabia, that the sole purpose of derivatives is founded upon speculative principles. The aversion to the use of derivatives within the region is not only due to the evident intrinsic failure of a number of international structured products following the collapse of Lehman Brothers in 2008, but also due to a negative over-simplified interpretation of derivative instruments.

There is a certain degree of irony in this simplification, as the most straightforward derivatives are actually of unquestionable benefit in traditional structured finance and accordingly the question remains as to whether such derivatives, if adhering to Shariah principles, can be utilized more pervasively in the GCC region and, more particularly, in Saudi Arabia.

Business case

In their most basic form, derivatives have an important commercial function in mitigating investor exposure to market fluctuations, reducing transaction costs and providing investors with accessibility to new markets. As things currently stand, some Islamic institutions and investors from the GCC region are more exposed than their western counterparts to changes in market conditions. For example, in the GCC region, currencies are (for the most part) pegged to the US dollar. In highly structured transactions, these currencies will have exposure to both non-US currency fluctuations and the possibility of a future de-pegging from the US dollar. Currency exposures of this nature could more easily be averted through the use of Islamic derivatives.

From a competition perspective, it is important for the Islamic finance sector in the region to have access to Islamic derivative products. The availability of these products is fairly widespread. However, their acceptability is still met with significant resistance. A greater acceptance of Islamic derivatives instruments in the region will ensure the further development of the Islamic financial services sector within the GCC.

Derivative documentation

On the 1st March 2010, the International Swaps & Derivatives Association (ISDA) and the International Islamic Financial Market (IIFM) formally launched the ISDA/IIFM Tahawwut Master Agreement in Bahrain. The ISDA/IIFM Tahawwut Master Agreement is a proforma agreement which can potentially provide a framework from which all Murabahah, Musawwamah and Waad-based Islamic derivatives can be negotiated and documented.

An example of how an Islamic cross-currency swap has been used within the Murabahah context outside of the GCC can be found in charts 1 and 2.

The Islamic cross-currency swap outlined benefits from the reduced funding costs of both parties through the ability to raise currency cheaply with the assistance of a counterparty rather than converting funds on the international foreign exchange. The rejection of this form of Islamic derivative in the GCC derives from the fact that the intention is to exchange money which, in itself, is not recognized as a tradable asset from an Islamic finance perspective.

Compatibility of derivatives with Shariah principles

There are a number of conceptual difficulties in creating Islamic derivatives, some of which can be associated with the inherent nature of traditional derivatives, and others (such as credit-linked notes) as a byproduct of their evolution into complex structured instruments in traditional financial markets.

One of the key problematic issues with traditional derivatives pertains to the set-off and netting settlement provisions common to most derivative contracts.

The agreement is of significant importance to the evolution of Islamic derivatives as it is the first international standardized document of its kind. As such, and with the appropriate support and development, the agreement could potentially lead to the creation of an international Shariah compliant intra-bank derivatives market.

Islamic derivatives in practice

Murabahah is a particularly widespread form of Shariah compliant structured finance used within the GCC and specifically in Saudi Arabia. The Murabahah form of structuring can also be used as a means to facilitate a number of Islamic derivatives.

Despite its widespread use as a Shariah compliant structure in the kingdom, Murabahah is not widely accepted when used to facilitate an Islamic derivatives transaction. The rationale behind this lies in the intended use of the instrument. Shariah scholars have stated that the Murabahah structure is intended for use in trade finance and consequently it should not be amended for use in derivative transactions. Those working within the Islamic financial services industry are being encouraged to create innovative structures and techniques which diverge from the Murabahah structure so as not to abuse its intended use.

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Traditional derivative contracts are often settled in cash following a reverse of the initial transaction. From an Islamic perspective this essentially means there is no genuine sale and as a direct result of this the transaction is void.

Besides the lack of asset ownership at the time of sale, other areas of concern shared by Islamic scholars have centered on the excessive uncertainty or speculation associated with derivative transactions and the fact that they often reference assets that are not in existence at the time of entering the contract.

In order to adhere to Shariah principles, derivative transactions in the GCC should be provided in response to a genuine market need, pertain to the direct ownership of an underlying asset, avoid reference of non-existent assets at the point of contract execution and avoid any unnecessary risk or speculation. If these criteria are met with a view to creating an equitable system, such an approach could potentially be interpreted as being in the interest of the public.

**Going forward**

There is currently a broad spectrum of interpretation in respect of the Shariah compliance of certain Islamic derivative structures. This divergence of jurisprudence is largely motivated by the differing schools of thought, individual interpretation of Shariah and varying levels of knowledge about the mechanics of derivative structures.

It is difficult to envision a convergence of views and the formation of a definitive consensus with respect to Islamic derivative use in the near future. This being said, the combined efforts of the AAOIFI, the IIFM and the Islamic Financial Services Board (IFSB) to create the ISDA/IIFM Tahawwut Master Agreement have certainly been encouraging.

In order to continue moving forward, it is important to accept the existence of a divergence of opinion and work within these parameters. The current misconceptions in the market can be negated through the continual engagement of Shariah scholars in the Islamic derivative discussion, as well as the de-mystifying of certain aspects of those Islamic derivatives that are already in existence. With this approach in mind, there is a greater possibility that the use and acceptability of Islamic derivatives will become more pervasive in the GCC.

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