UK banks

Derivatives: 'In need of robust architecture'

Robin Wigglesworth in Abu Dhabi MAY 12, 2010

Structuring derivatives that comply with the principles of *sharia* has long been one of the most complex niches of Islamic finance. But it is an increasingly important one, as the industry continues to grow and risk management becomes vital.

Sharia scholars, who have to bless all products and services offered by Islamic banks, have often been reluctant to approve derivatives, because of Islam's bans on interest, speculation and unnecessary risk – *riba*, *maisir* and *gharar* in Arabic – and the requirement for real assets to underlie all transactions.

"The varying scholarly opinions in the world of Islamic jurisprudence on the legitimacy of derivatives has so far translated into a total ban on these instruments in some countries and actual implementation – albeit on a limited scale – in others," Moody's, the rating agency, noted in a recent report.

Nonetheless, while innovation has slowed in the wake of the international financial crisis and clerical criticism of some high-profile instruments, the structuring and use of Islamic derivatives is gradually gaining ground, experts say.

"There was a time when 'derivatives' was a dirty word for scholars, but they've come round to accepting them, as long as they are for hedging and not speculation," says Harris Irfan, head of Islamic products at Barclays Capital.

"They're still in their infancy, but we're starting to see them used more and more."

The most common Islamic product used to structure *sharia*-compliant derivatives are *wa'ad*, a type of unilateral promise, and *murabaha*, one of the most popular, which can be likened to a conventional "sale and deferred payment" structure.

"You use Islamic finance products such as *murabaha* and *wa'ad* like Lego to build derivative instruments that comply with *sharia*," says Priya Uberoi, director of Islamic derivatives at Clifford Chance.

"About half of Islamic derivatives use *murabaha*, and the rest are based on *wa'ad*, but there are other products out there that can be used. They just haven't been tapped yet."

Other products include *arbun*, which is similar to a conventional option, and *bai salaam*, which resembles forward contracts.

Existing types of Islamic derivatives include cross-currency swaps, foreign exchange options, total return swaps and profit rate swaps, the Islamic equivalent to an interest rate swap.

Lawyers, bankers and scholars have even managed to engineer Islamic credit default swaps, a *sharia*-compliant version of the popular conventional fixed income insurance product.

Islamic banks are banned from speculating in a credit default, but can in theory protect themselves against an Islamic bond failure.

Ms Uberoi says: "Islamic CDSs are still controversial, and the structures aren't perfect, but you can, with innovative thinking, probably replicate most conventional derivative structures."

However, the complexity, cost and disparate standards of Islamic derivatives – almost every industry institution uses its own structures and documentation – hampers their frequent use, experts say.

To stimulate the use of Islamic derivatives, the International Islamic Financial Market (IIFM), a Bahrain-based Islamic capital markets industry body, and the International Swaps and Derivatives Association (ISDA), recently drafted a "Tahawwut Master Agreement" with standardised documentation for Islamic derivatives.

In Malaysia, Bank Islam and Bank Mumalat Malaysia executed a pro-forma derivative master agreement for documentation of Islamic derivatives in 2006.

But Asian *sharia* standards are often seen as too lax for Middle East clerics, and the IIFM and ISDA hope their new documentation can be more widely adopted.

The Tahawwut Master Agreement has been blessed by the IIFM's board of *sharia* scholars, which includes some of the industry's most prominent and widely respected clerics.

These include Sheikh Nizam of Bahrain and Sheikh Hussein Hamid Hassan from Egypt.

"The ISDA-IIFM documentation will bring more rigorous and robust architecture to the development of Islamic derivatives," says Ms Uberoi.

"It's a very new development, but a lot of Islamic banks are looking at how they can tailor their existing derivatives platform to fit with the master agreement," she says.

Bankers warn that it will take time before the Tahawwut documentation is widely adopted, as most banks have already spent a lot of time and effort on their own agreements and structures.

Hussein Hassan, head of Islamic finance at Deutsche Bank, explains: "If lot of banks move over to the IIFM-ISDA standards, it will help us toward some standardisation, but there will have to be a lot of effort on getting banks to use it."

Nonetheless, the implications of more widespread use of Islamic derivatives could be significant, experts say.

Sharia-compliant institutions would be able to hedge against currency movements, credit exposures, interest rate movements or even commodity inflation – all risk management tools that conventional banks take for granted.

"The golden principle of the *sharia* in human dealings is that all is permissible except that which is specifically prohibited," says Muddassir Siddiqui, a *sharia* scholar and head of Islamic finance at Denton Wilde Sapte, the law firm.

"There is a need for these products, and God would not give us a need without a way to fulfil it."