

PROFIT RATE SWAP

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The market for Sharia-compliant derivatives products is at a fascinating juncture and we are witnessing the embryonic stages of an OTC derivatives market. Growth in demand for Islamic financing products generally has been prolific in recent years and the prospects for further impressive growth appear strong. Innovation in the finance sector has allowed more entities the opportunity to structure their finances in a Sharia-compliant manner. It is estimated that Islamic banking assets globally total approximately US\$700-900 billion and McKinsey predicts that Islamic banking assets and assets under management will reach US\$1 trillion by 2010.

As the Islamic finance market in general has grown and financing structures have become ever more sophisticated, a corresponding demand has arisen for complementary derivatives products. Specialist derivatives practitioners are now facing both an exciting opportunity and an interesting challenge, namely to produce products which provide parties with the unquestioned benefits of conventional derivatives (particularly with respect to effective hedging and general risk management) whilst also adhering to and respecting the core tenets of Sharia.

At Allen & Overy, with a world leading derivatives practice in London and a well-respected presence in the GCC region (spread over three offices and with over 30 years experience on the ground) we have been well placed to lead the development in this field. This article will begin by examining key principles of Sharia and how the use of conventional derivatives products could be seen to run contrary to such principles. It will then, in considering the example of a Sharia-compliant profit rate swap, explore how the combination of well-established commercial and financial arrangements and innovative structuring is helping to meet the growing demand for risk management products whilst also seeking to abide by the tenets of Sharia.

SHARIA FUNDAMENTALS

Islamic law, or Sharia, governs social, political and economic relationships and institutions. Sharia is not a codified body of law but a principles-based legal system that is capable of development and subject to interpretation. The legal principles underlying Sharia are derived from a series of primary and secondary sources.

The primary sources for Sharia are the *Qur'an* (scripture), *Sunnah* (practices and traditions of the Prophet Muhammad) and *Ahadith* (accounts of the sayings and deeds of the Prophet Muhammad). The secondary sources of Islamic law are, essentially, a series of methods (eg, analogical reasoning, or consensus of Sharia scholars) that allow further rules to be extracted from the primary sources and applied to a modern context.

There are five classical schools or bodies of jurisprudence (called *madhab*) within Sharia, each named after its founding jurist and associated with a particular geographic region. These schools are more similar than they are different, but their differences account for some of the variation in financing techniques deemed permissible by Sharia scholars.

SHARIA AND A CONVENTIONAL INTEREST RATE SWAP

A profit rate swap is best analogised to a conventional interest rate swap. Under a conventional interest rate swap the parties agree to exchange periodic fixed and floating payments by reference to a pre-agreed notional amount. As with many conventional derivatives products, a conventional

interest rate swap, is problematic from a Sharia perspective as it potentially contravenes three key Sharia prohibitions, the prohibitions on (i) *Riba* – the receipt and payment of interest (the effective exchange of interest payments being fundamental to an interest rate swap); (ii) *Gharar* - uncertainty in the principal terms of a contract (for example price, quantity or material characteristics of any asset sold and hence under a conventional interest rate swap the agreement to make future payments linked to a floating rate); and (iii) *Maisir* - gambling or speculation in contracts (and accordingly, conventional contracts of insurance and particular futures and options contracts viewed as akin to gambling are prohibited) – the debate arising from this being reminiscent of the struggle that some secular legal systems have had with whether derivatives contracts should fall within gambling prohibitions.

WORKING TOWARDS SHARIA-COMPLIANT DERIVATIVES

Considering, the above tenets, the challenge when structuring Sharia-compliant derivatives is, therefore, to arrange the transaction such that the parties gain the benefit of the positive risk sharing/management solutions that derivatives can offer (effective risk management itself arguably being something seen as worthy of encouragement under Sharia) but without breaching the fundamental prohibitions as discussed above. Andreas Alexander Jobst (an economist at the International Monetary Fund) has argued¹ that derivatives are not necessarily in principle incompatible with Sharia, provided that they:

"(a) are employed to address genuine hedging demand associated with effective and intended ownership interest (*qabd*) in a specific asset or venture;

(b) disavow mutual deferment of contractual obligations without actual and direct transfer of a physical asset as the object of an unconditional sale;

(c) maintain collateralised payment for the use of the contractual asset but rule out provisions aimed at generating unilateral gains from interim price changes of the underlying asset beyond the scope of shared business risk; and

(d) eschew activities deemed similar to speculation (*gharar*) through clearly stated object characteristics and/or delivery results – and other prohibited sinful activity (*haram*)."

In addition, Jobst argues that "derivatives must also be employed without risk of exploitation in a bid to create an equitable system of distributive justice in consideration of the public interest (*maslahah*)."

If his contentions are correct, we can see that Sharia scholars may look to more than simply the structuring and return profile in their consideration of a transaction's Sharia compliance and that the *purpose of the transaction* and the *relative motivations of the parties* may also be significant. Certainly, the application of Sharia in the area of derivatives remains varied and there is continued debate and concern surrounding the application of derivatives due to varying interpretation of Sharia by the different schools of thought. That said, the use of Islamic derivative transactions has been readily accepted in Malaysia where the Shafi'i school is dominant, for instance in November 2006, Bank Islam Berhad and Bank Muamalat Malaysia Berhad agreed to execute a pro-forma derivative master agreement for the documentation of Islamic derivative transactions. The establishment in 2006 of the International Swaps and Derivatives Association (ISDA) and International Islamic Financial Market (IIFM) joint working group, with the aim of creating a pro-forma Sharia compliant Master Agreement for derivatives transactions has also helped focus the

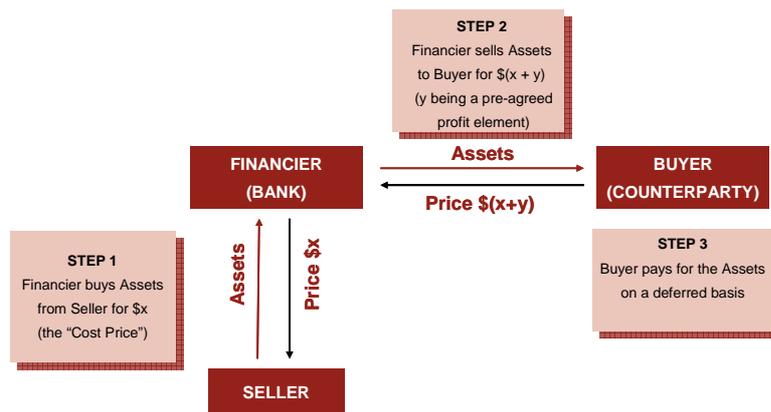
¹ "Learning Curve – Derivatives in Islamic Finance", Derivatives Week, 5 May 2008.

debate and catalyse the process of market standardisation.

THE PROFIT RATE SWAP

The Profit Rate Swap seeks to achieve Sharia-compliance by using reciprocal *murabaha* transactions: commercial arrangements long accepted by Sharia scholars. The *murabaha* is a sale arrangement whereby a financier purchases goods from a supplier (at the cost price) and then on-sells them to a counterparty at a deferred price that is marked-up to include the financier's profit margin. This profit margin is deemed justified since the financier takes title to the goods, albeit possibly only briefly, and hence accepts the commercial risk of their ownership.

Diagram 1 – The Basic Murabaha Structure



Under this profit rate swap, the parties enter into *murabaha* contracts to sell Sharia-compliant assets (often London Metal Exchange traded metals) to each other for immediate delivery but on deferred payment terms. 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 these reverse *murabaha* contracts is fixed but the profit element is floating, as further explained below). This structure, in effect, is not dissimilar to the "parallel loans" structure that was used by institutions in the earliest examples of conventional swap transactions.

It should be noted that a profit rate swap may also be structured as a series of Wa'ads (unilateral promises) whereby each party undertakes to the other to "swap" relevant fixed and floating rate payments at some particular point of time in the future.

The Primary (Term) Murabaha (Diagram 2)

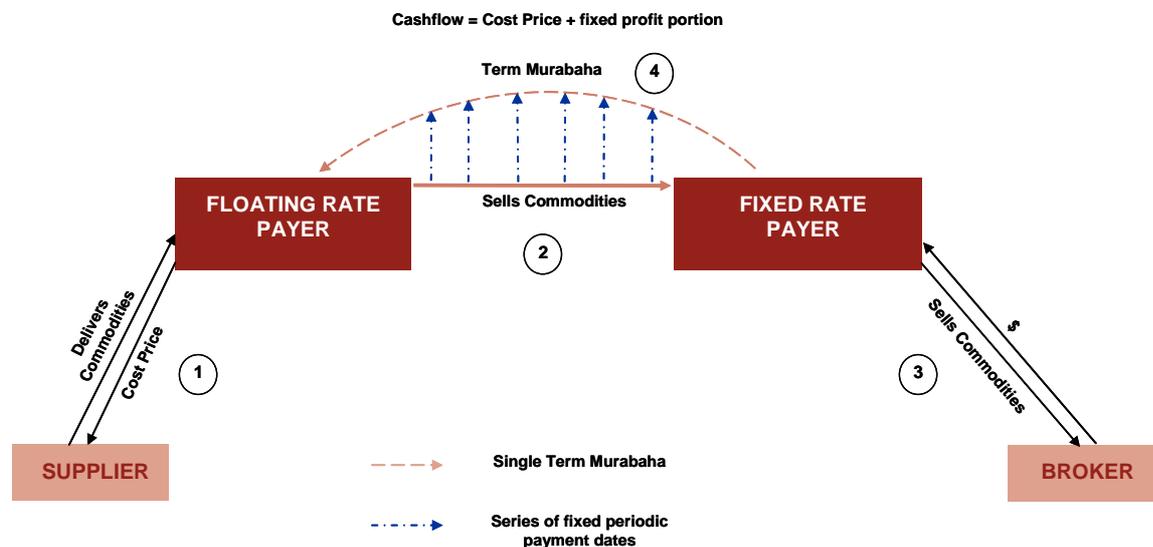
Under this structure the floating rate payer (which could be a bank or a corporate, the **Floating Rate Payer**) sells commodities (sourced from a commodity broker for the purpose of entering into the murabaha (**step 1**)) to the swap counterparty (the **Fixed Rate Payer** - which again could be a bank or a corporate) (**step 2**). The value of commodities bought and on-sold will be the pre-agreed **Cost Price** sum for the transaction. 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) will on-sell those commodities immediately to a different commodity broker (**step 3**) to generate cash.

Payment by the Fixed Rate Payer for the commodities purchased under the Primary Murabaha is on a deferred basis in instalments payable on a series of pre-agreed payment dates (**step 4**). Each

instalment will comprise both a Cost Price element (a repayment of a set percentage of the Cost Price) and a fixed profit element (paying a portion of the Floating Rate Payer's profit on the transaction).

Diagram 2 - Primary Murabaha (Fixed leg)



The series of sequential Secondary Reverse Murabaha Contracts (Diagram 3)

The more complex limb to this transaction is that generating the floating leg payments. An agreement to simply make a series of payments linked to a floating rate (e.g. to make payments linked to LIBOR) on a series of future dates would not be Sharia-compliant as the rate of LIBOR by reference to which these future payments will be calculated is uncertain (i.e. *Gharar*). This uncertainty is mitigated by instead entering into a series of sequential Secondary Reverse Murabaha Contracts (SRMC's).

The initial SRMC

The first SRMC is entered into on day one (i.e. the date of entry into the Primary Murabaha) by the Fixed Rate Payer utilising an amount equal to the Cost Price element due to be paid to it by the Floating Rate Payer on the next due deferred payment date under the Primary Murabaha to purchase commodities from its commodity broker (**step 5**) (Note that consequently, the commodities sold under each SRMC represent only a portion of the value of the commodities purchased under the Primary Murabaha).

The Fixed Rate Payer immediately on-sells these commodities to the Floating Rate Payer for immediate delivery (**step 6**) and the Floating Rate Payer then immediately on-sells such commodities to the original commodity broker (**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, as discussed above, being calculated by reference to a floating rate formula (e.g. LIBOR) and thus generating the floating rate element) (**step 8**). Such payment is due on the next due deferred payment date under the Primary Murabaha (effectively also the Termination Date for that particular SRMC), whereupon that SRMC is settled in full and discharged and a new SRMC is entered into (see "Subsequent sequential SRMC's" below). (Note

that the floating rate element is calculated and fixed prior to entry into the relevant SRMC to ensure that uncertainty is minimised thus preventing the transaction falling foul of the *Gharar tenet*.)

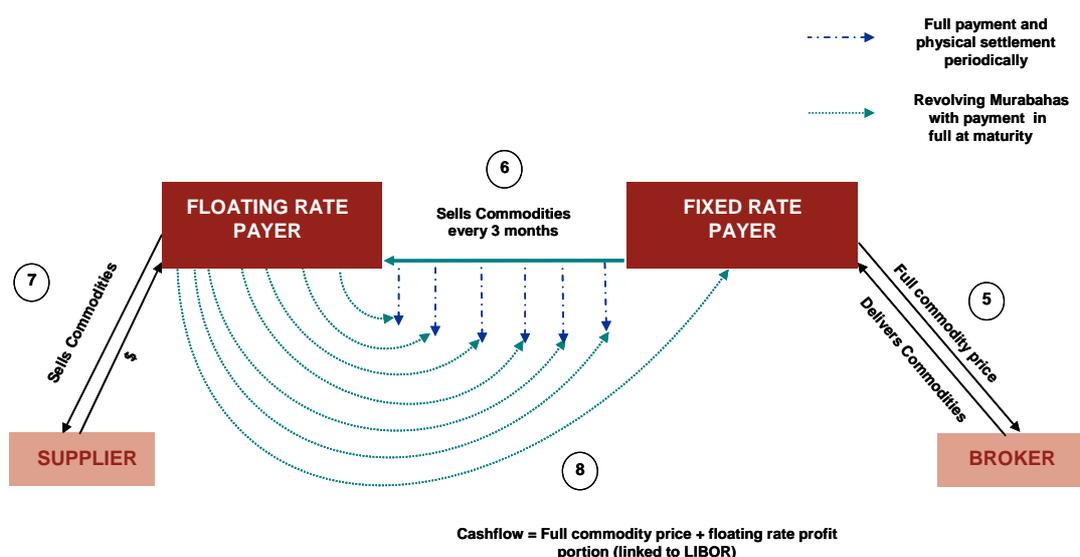
From a Sharia-compliance perspective, Sheikh De Lorenzo has confirmed² that, "The use of LIBOR as a benchmark of pricing in no way means that interest has entered the transaction. This is because LIBOR is a notional rate". To this extent, whilst an interest rate benchmark is, amongst other elements, used to indicate the level of return received under the SRMC's (i.e. the floating rate profit element is linked to LIBOR), the return itself will not be considered an interest payment and therefore not in contravention of the Sharia prohibition of *riba*.

Subsequent sequential SRMC's

Each subsequent SRMC will have a term which runs from the Termination Date of the preceding SRMC and ends on the next due deferred payment date under the Primary Murabaha. As with the initial SRMC, at the end of that term the Floating Rate Payer will make payment in full (in respect of that SRMC) and the next subsequent SRMC will be entered into. In this way, each deferred payment date under the Primary Murabaha will also be (i) the Termination Date (and thus payment date) under a corresponding SRMC and (ii) the start date for the next SRMC (ensuring that the SRMC's are sequential). The final SRMC will terminate on the final deferred payment date under the Primary Murabaha.

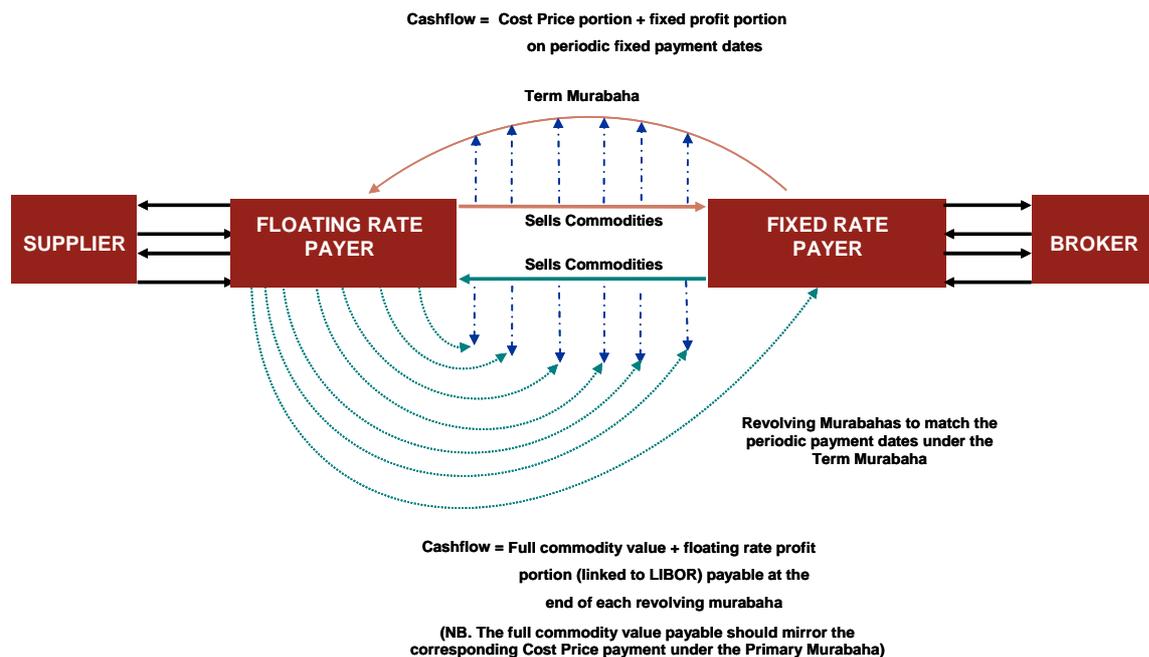
Consequently, on each date that a payment is made by the Fixed Rate Payer to the Floating Rate Payer under the Primary Murabaha, a corresponding SRMC will generate a reciprocal payment under which the element payable in respect of commodities purchased (the Cost Price element in the case of the Primary Murabaha payment and the full commodity value payable in respect of the relevant SRMC) is identical. However, the profit elements payable will vary, the profit element under the Primary Murabaha being calculated by reference to a fixed rate and the profit element under the SRMC by reference to a floating rate, thus generating cash flows that are generated in a Sharia-compliant manner but are similar in nature to the cash flows under a conventional interest rate swap.

Diagram 3 - Series of Secondary (Reverse) Murabahas (Floating leg)



² Yusuf De Lorenzo, "The Total Returns Swap and the 'Shariah Conversion Technology' Strategem".

Diagram 4 – Full Profit Rate Swap structure



DOCUMENTING THE TRANSACTION

From a documentation perspective, the profit rate swap is documented under a bespoke master agreement which, for Sharia adherence, will not incorporate debt exchange, interest payments or indemnities. This requires further innovative technology to address knock-on effects on otherwise market standard provisions (for example, calculation of compensation amounts on late/deferred payment), addressing how to calculate an Early Termination Amount and new representations addressing the issue of Sharia-compliance. The calculation of any payment due on an early termination of the swap (the "Section 6(e) payment" under the conventional ISDA Master Agreement) is particularly complex given the need to provide a mechanism by which to give value to (and effectively enforce) the future non-concluded Secondary Murabahas in a close-out situation. This is compounded by the fact that the standard "Net Present Value" calculation used in conventional derivatives transactions when calculating such a payment incorporates a deduction attributable to the "time value of money" (which on the strictest interpretations is contrary to Sharia principles). How best to overcome these difficulties remains the subject of scholarly debate (we have seen a number of approaches adopted in the market) but concerted efforts on behalf of ISDA and the IIFM to arrive at a market standard solution see negotiations now at an advanced stage.

CONCLUSION

Islamic banks and corporates are increasingly looking for ways in which to hedge their exposures (e.g. mismatches between underlying portfolio payments and payments due from an originator, lender or project company) in securitisations, loan structures and project financings. The development of a Sharia-compliant OTC derivatives market, including a profit rate swap, does just this, addressing such mismatches in order to address "genuine hedging demands". Along with the development of Sharia-compliant profit rate swaps, cross-currency swaps, total return swaps and fund/index-linked derivatives have also been pioneered, again using a combination of traditional, well-established Islamic commercial and financial arrangements and innovative structuring to meet

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clients' demand. And whilst debate (and in some cases controversy) continues to surround the use of certain new structures, the establishment of and progress made by the ISDA/IIFM working group developing a standardised pro-forma Sharia-compliant Master Agreement for derivatives transactions shows both a real belief in and strong commitment to the further development of this market. Such debate and standardisation, with the increased conformity, certainty and liquidity it will bring, promises much for the future and should ensure the firm establishment of a robust Islamic derivatives market with strong growth for years to come.

Further information

Visit: www.allenoverly.com/islamicfinance

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