Capital Markets

Islamic finance embraces derivatives

Robin Wigglesworth in Abu Dhabi MAY 4, 2010

Few took notice outside certain coteries of specialist bankers and lawyers, but the launch of a 42 page master documentation for derivatives that comply with Muslim religious principles could have a far-reaching impact on the Islamic finance industry.

The International Islamic Financial Market (IIFM), a Bahrain-based Islamic capital markets body, and the International Swaps and Derivatives Association (ISDA) have for the past four years been working on standardised documentation for derivative instruments that comply with sharia, or Islamic law.

On March 1 the two industry bodies finally presented their "Tahawwut Master Agreement " and are now embarking upon a series of workshops to encourage Islamic banks to adopt its standardised documentation.

If widely adopted, the new standards could encourage more Islamic banks to hedge more of their risk, and thereby help the Islamic finance industry meet its potential, bankers say.

Islamic institutions that operate across country borders - such as Saudi Arabia's Al Rajhi Bank, which also operates in Malaysia - will benefit from easier currency hedging and all could gain from better risk management on credit exposures and interest rate movements.

The Tahawwut documentation has been drafted to closely resemble existing standardised documentation for derivatives used widely in western markets which was drafted by ISDA in 1992, according to Priya Uberoi, head of Islamic derivatives at Clifford Chance, who worked on the Islamic version for ISDA.

The new sharia compliant master agreement should therefore appeal to conventional banks with Islamic arms, such as HSBC, Citigroup and Standard Chartered.

The launch of the sharia compliant master agreement is timely. The Islamic finance industry has continued to grow despite the financial crisis - to about $950bn last year according to Moody's - but its increasing size and maturity means that risk management is becoming more pressing.

While conventional banks can easily hedge themselves against an array of risks, Islamic banks have often been prevented from doing the same, due to the reluctance of clerics to approve derivatives that could contravene religious bans on interest, gambling and unnecessary risk.

Many sharia scholars have moderated their position in recent years. While using Islamic derivatives to "speculate" or enhance returns is forbidden, sharia-compliant financial institutions are now allowed to hedge against currency moves, credit exposures, interest rate movements, and even sukuk bonds through "Islamic credit default swaps".

"Blending Islamic principles with derivatives only started four to five years ago, but a lot is going on now," says Ms Uberoi. "The recent turmoil has made many people in Islamic finance realise the value of risk management tools. For the industry to develop further we need these products."

Islamic investors are already able to mimic the effects of conventional derivatives by using a complex combination of existing Islamic contracts and concepts.

The most common products used are wa'ad, a type of unilateral promise, and murabaha, comparable to a conventional 'sale and deferred payment' structure. But products such as arbun and bai salaam can also be used. Arbun is similar to a conventional option, and bai salaam resembles forward contracts.

However, the development of such instruments has been piecemeal and fragmented, and each bank often uses its own structures and documentation, hampering their usage by increasing the complexity and cost.

The potential for Islamic derivatives is significant, particularly in the Middle East, where Islamic finance is relatively less developed than in Malaysia.

"In theory, the potential market size is several billion dollars per annum of structured investment products and hedging instruments, but we're barely scratching the surface today," says Harris Irfan, head of Islamic products at Barclays Capital.

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