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ASIM KHAN

DAR AL ISTITHMAR

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- Launched in 2004, Dar Al Istithmar is a venture between Russell Wood and Oxford Islamic Finance
- Independent from its shareholders, Dar Al Istithmar offers:
 - **Shari'a Consultancy Services**
 - **Shari'a Monitoring / Purification Services**
 - **Shari'a Compliance Reviews**
 - **Islamic Finance Arranging and Advising ***
- Dar Al Istithmar's Shari'a Supervisory Board comprises world renown scholars
- Dar Al Istithmar won the Euromoney awards for the “Best Islamic Assurance and Advisory Services” for two consecutive years.

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Shari'a Compliant Derivative Equivalents

Asim Khan

Executive Director | Dar Al Istithmar

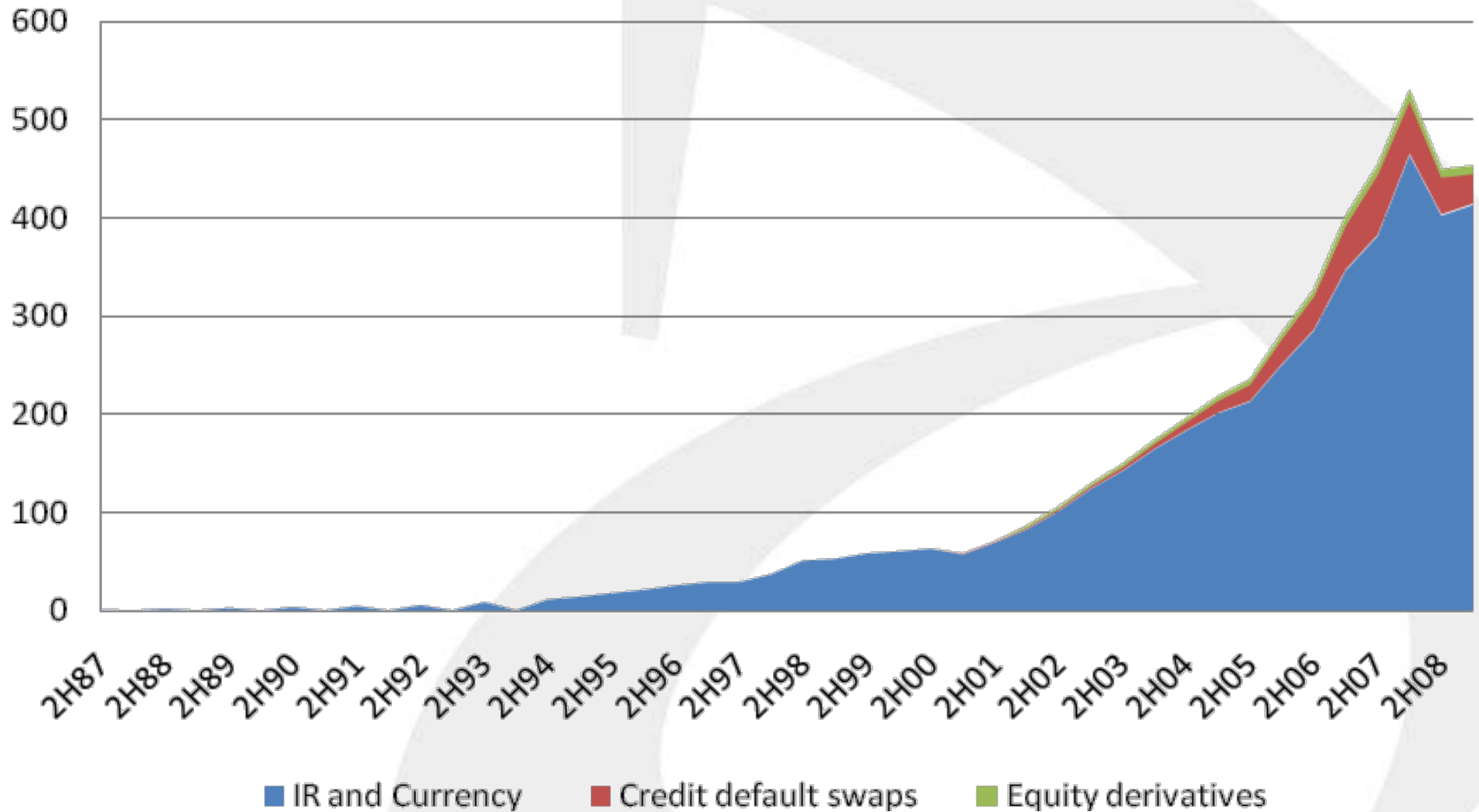
Intelligent

*Islamic Finance Advisory: Creating Innovative
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Best Islamic Assurance and Advisory Services - 2006
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Value of Conventional Derivatives



Source: ISDA

	Topic
1	Principles from Qur'an and Hadith
2	Primary Prohibitions affecting Financial Transactions
3	Subsidiary Prohibitions affecting Conventional Derivatives
4	Permissibility of Derivative Equivalents
5	Structural Shari'a Compliance Issues
6	Cases of Shari'a compliant derivatives
7	Frontiers of Innovation in Shari'a Compliant Derivative Equivalents
8	Challenges
9	Future of Derivatives
10	Conclusion

- ✓ **All transactions are assumed permissible unless otherwise deemed impermissible**
 - “Allah has made trade lawful” – Holy Qur'an 2:275
 - “O ye who believe, fulfill your contracts” – Holy Qur'an 5:1
 - “O you who believe! Do not devour your wealth among yourselves falsely, except that it be trading by your mutual consent” - Holy Qur'an 4:29
 - “Muslims abide by their conditions, except for a condition that legalises the prohibited or prohibits the lawful” – Traditions of the Holy Prophet, Ahmad, Vol. 1, p 312
- ✓ **Ownership and possession of assets key requirement for trading of goods**
 - “He who buys food grain should not sell it until he has taken possession of it” – Ibn Abbas reporting Holy Prophet (pbuh)
- ✓ **Riba explicitly prohibited**
 - O ye who believe! Fear Allah, and give up what remains of your demand for usury, if ye are indeed believers. – Holy Qur'an 2:276

× Riba (Usury)

All forms of direct or indirect forms of interest (usury) are considered impermissible. These include:

- × *Riba Al-Naseea*: Direct interest from deferment of loan.
- × *Riba Al-Fadl*: Contracts for sale and purchase of same asset but different quality for deferred or spot payment
- × *Bai al-Inah*: Deferred payment sale and then spot payment repurchase of the same asset.
- × *Bai al-dayn*: Sale of debt at discount or premium
- × *Combination of contracts*: Combining a loan with one of gift (in case the gift is a form of riba) or Combining a loan with a contract of sale (in case the sale is a form of riba)

× Gharar (Ambiguity) or Jahala (Ignorance)

Sale of probable items whose existence or characteristics are not certain, due to the risky nature which makes the trade similar to gambling

× Maysir (Gambling) and Qimar (Speculation)

Games of chance / Zero sum games where one party wins everything at the expense of the other

× **Asset must be valuable in Shari'a; Pure Rights cannot be sold or traded**

Only a tangible commodity or usufruct may be bought and sold in Islamic law. Pure rights cannot be bought and sold

× **Delivery and Possession**

Hakim ibn Hazam said: "I asked the Prophet: 'O Messenger of God. A man comes to me and asks me to sell him what is not with me. I sell him (what he wants) and then buy the goods for him in the market.' The Prophet replied: '**Sell not what is not with you**' - Tradition of the Holy Prophet (PBUH)

× **Deferred currency transaction**

"Gold for gold, silver for silver, wheat for wheat, barley for barley, dates for dates, salt for salt, like for like, in equal weights, from hand to hand. If these species differ, then sell as you like, as long as it is from hand to hand"

× **Mutual deferment of countervalues/ bilateral promises**

"bay al-kali bil kali" Islamic maxim approved through consensus (ijma)

× **Conditional sale OR twin sales**

"The Prophet has disallowed back-to-back sales of the same object between the same contracting parties, switching roles in each sale, the second sale being contingent upon the first" - Tradition of the Holy Prophet (PBUH)

✓ **Overwhelming need for protection/genuine hedging risk**

Shari'a scholars consider derivatives permissible only when there is an overwhelming need (darrura) for protection from a permissible risk:

"He has only forbidden you what dies of itself, and blood, and flesh of swine, and that over which any other (name) than (that of) Allah has been invoked; but whoever is driven to necessity, not desiring, nor exceeding the limit, no sin shall be upon him; surely Allah is Forgiving, Merciful." Holy Qur'an, 2:173

✓ **Critical to define types of permissible risk protection**

Cannot remove risk altogether such as ownership risk or investment risk, since there can be no profit without the assumption of risk, **BUT** can take steps to mitigate such risks. Permissible risks include:

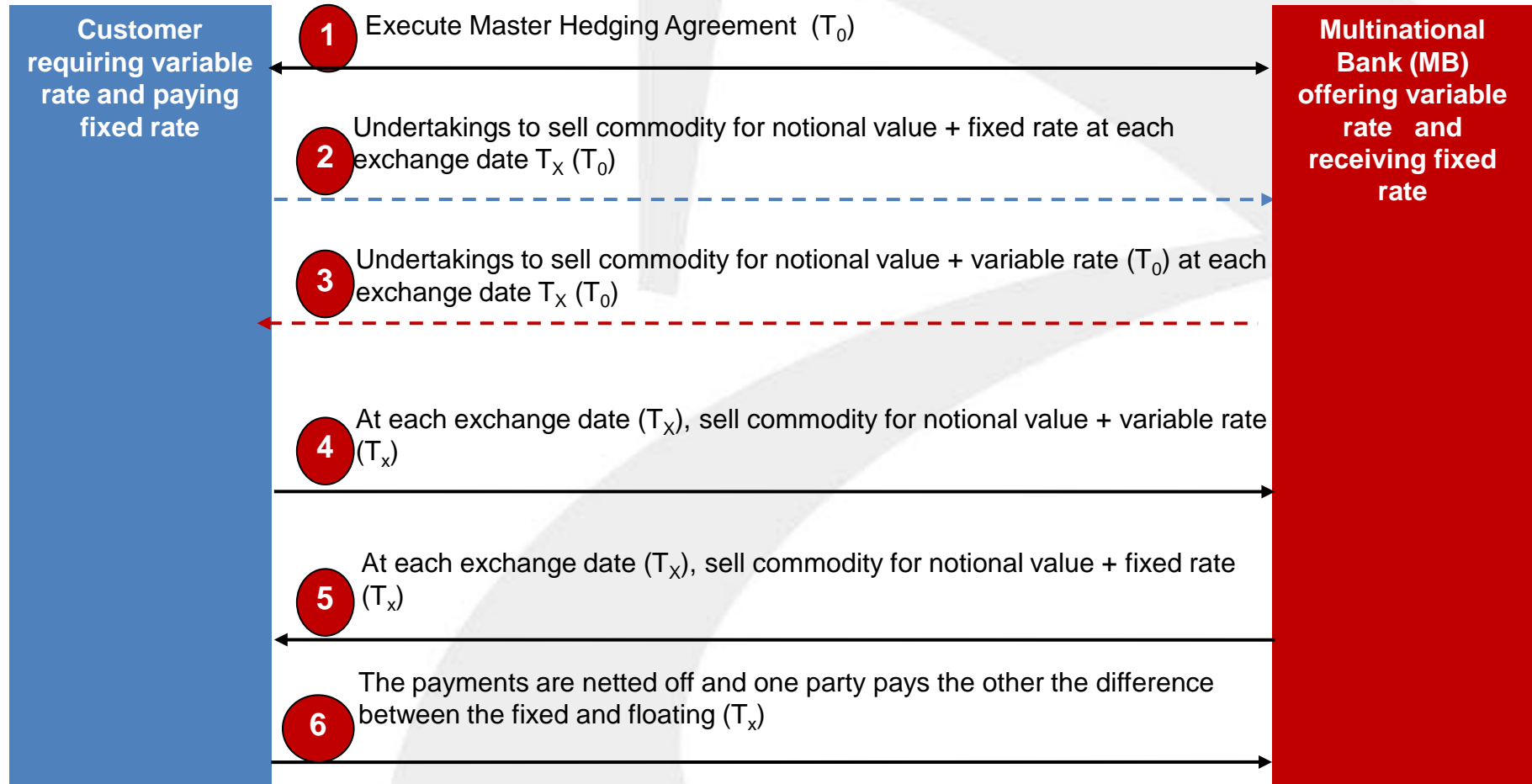
- **Currency Risk:** Risk of devaluation of investment as a result of changes in FX rates
- **Profit Rate Risk:** Risk of loss as a result of changes in profit rates.
- **Commodity Risk:** Risk that commodity prices will change
- **Counterparty Risk:** Risk that the counterparty will not perform its contractual obligations
- **Equity Investment Risk:** Risk that the investment value will decline

✓ **Structure must nevertheless be Shari'a compliant**

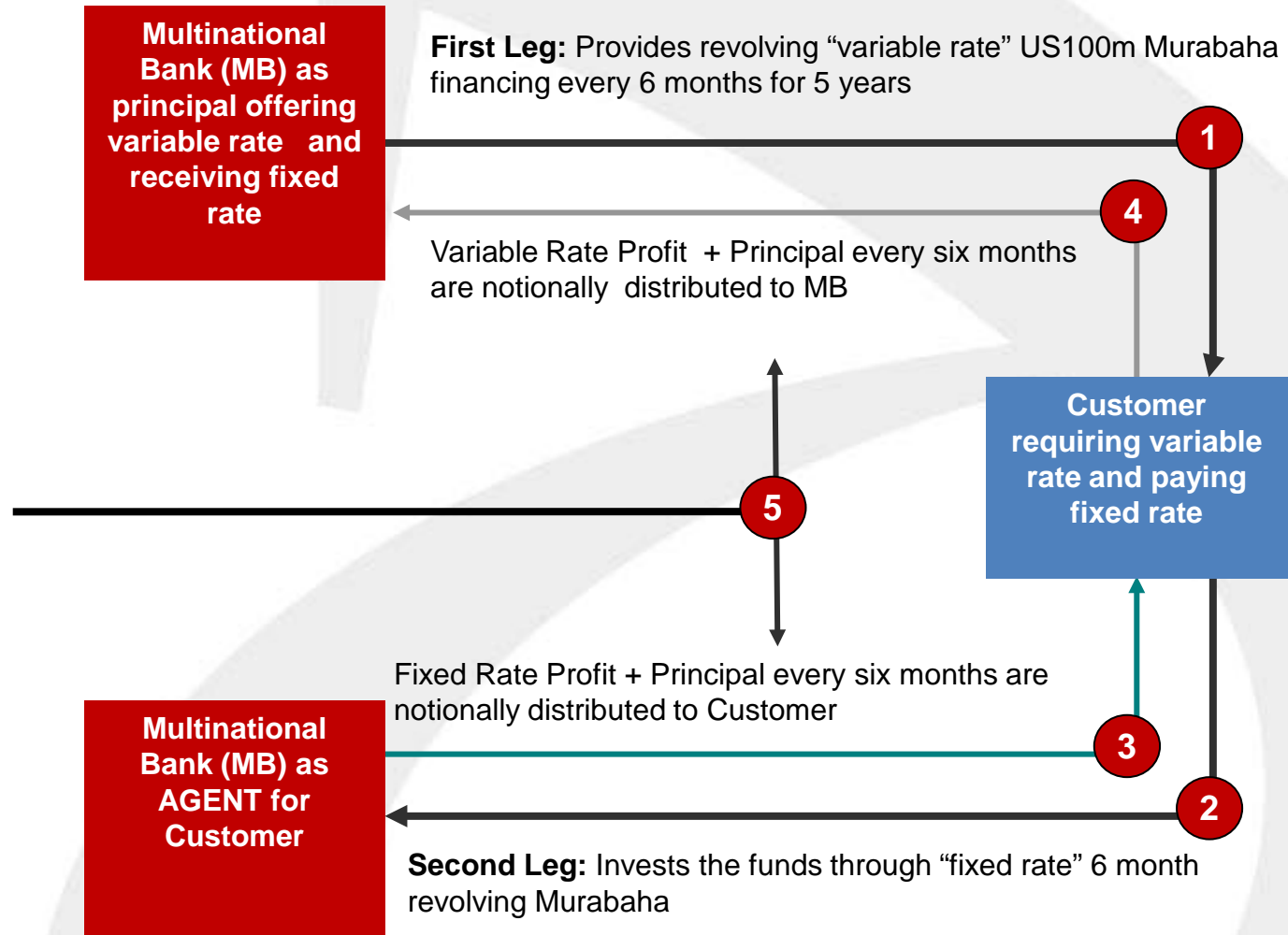
Steps to mitigate risk must nevertheless be compliant in form and structure

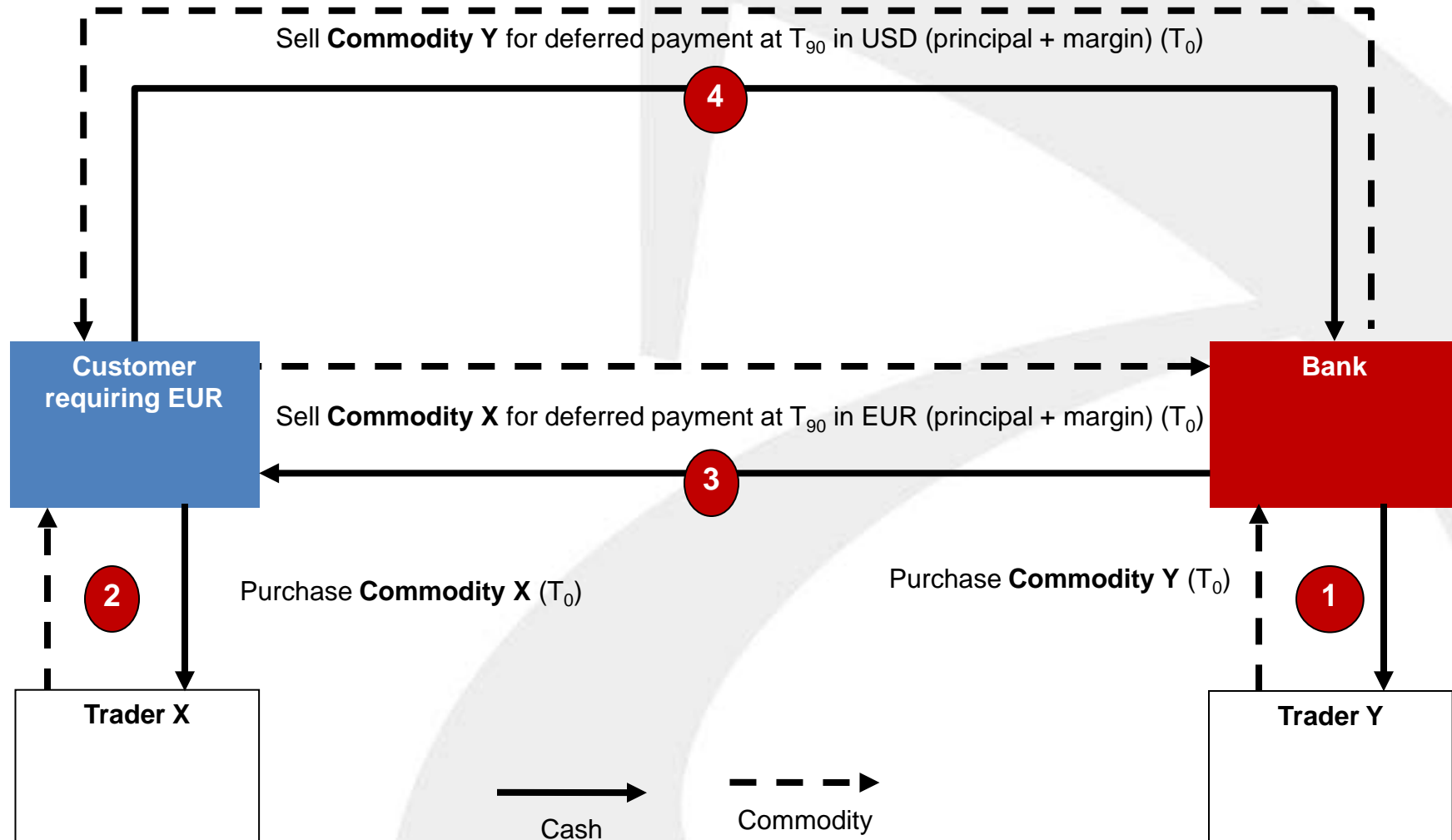
To replicate the effect of conventional derivatives, the structure must conform to Shari'a compliance requirements:

- ✓ Real trade or investment based instrument, i.e. Musawama or Murabaha
- ✓ Avoidance of any implicit or explicit application of interest i.e. penalties etc
- ✓ Avoidance of any ambiguity in determination of termination amount and close out netting
- ✓ Promises should not be bilateral or unilateral promises must not result in a bilateral contract (where applicable)




Net-off: Difference between Variable rate and fixed rate (3-4) are netted off and counterparty pays /receives the difference between variable and fixed

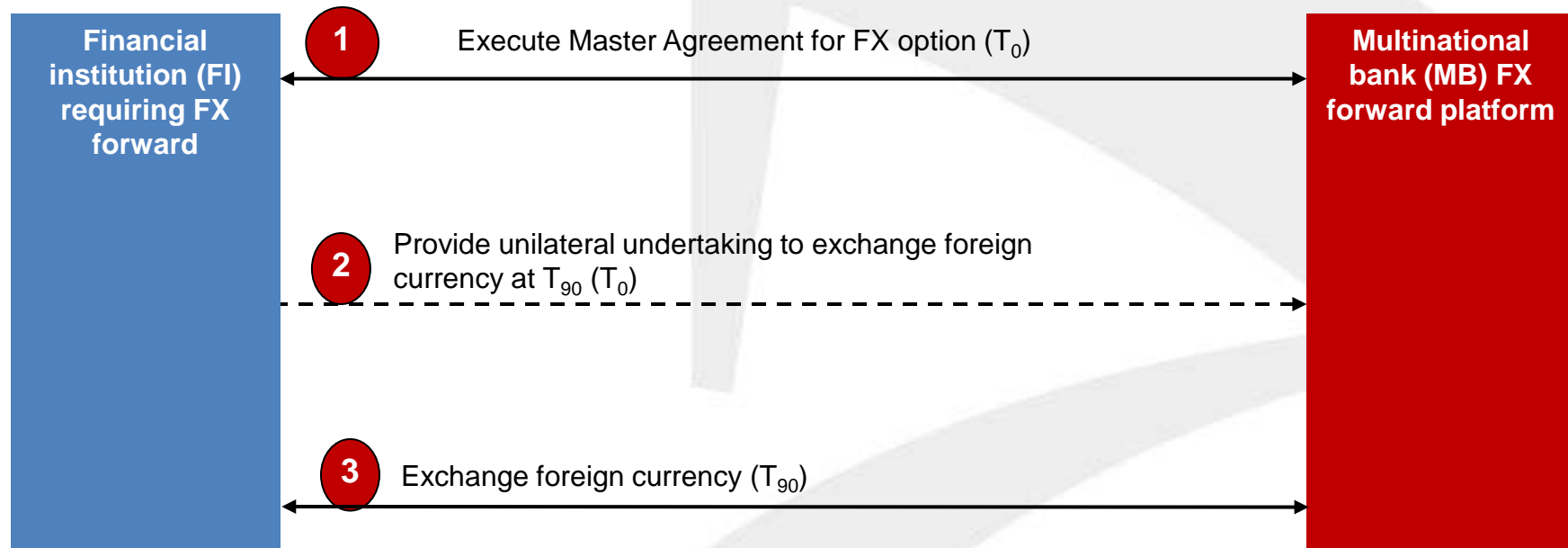




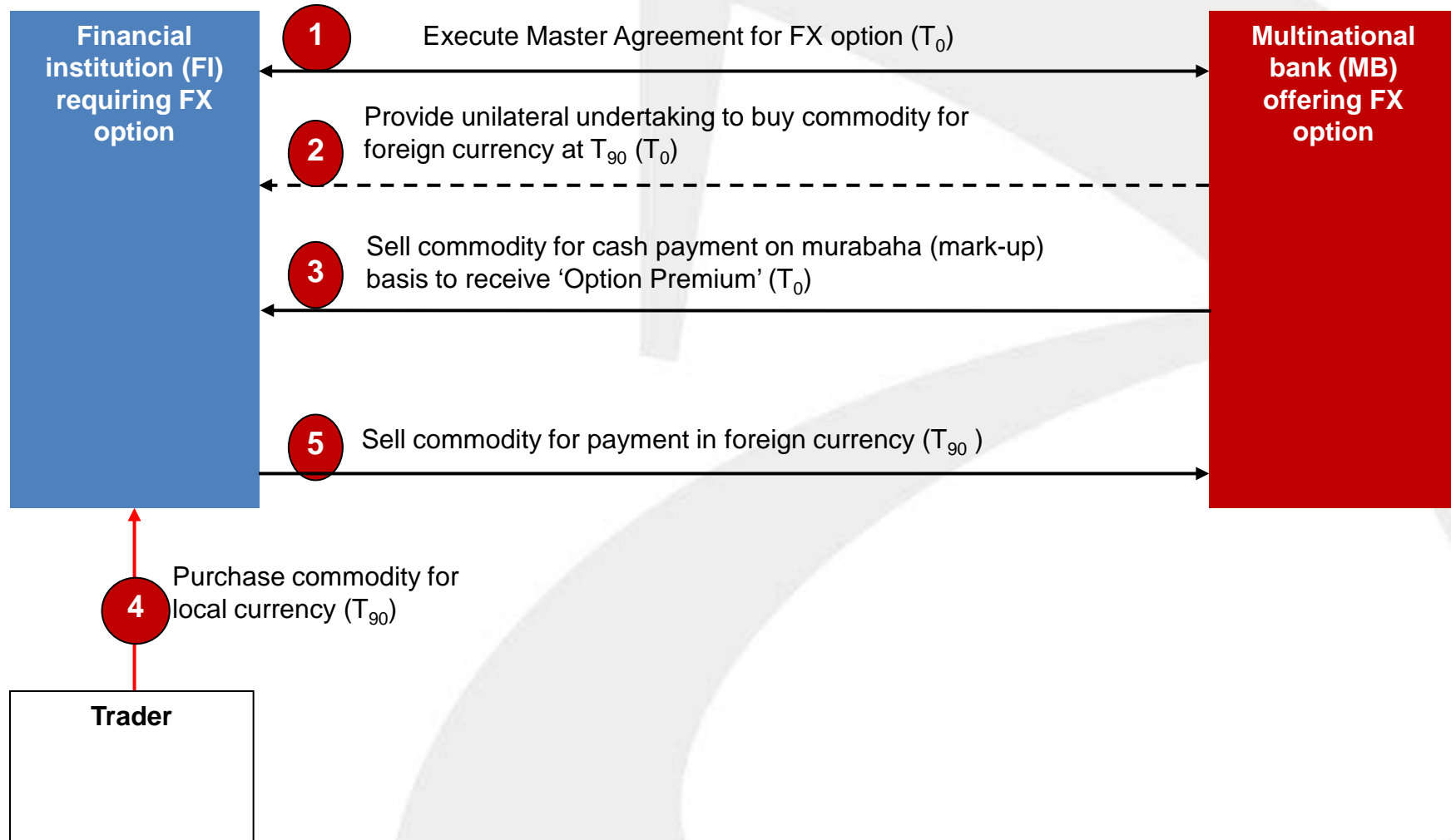
Shari'a Compliant Forward Hedging Contracts

Wa'd (Unilateral promise)	Bai' al-Arboun Sale with down-payment	Bai' al-Salam Advance payment with deferred delivery
		
<ul style="list-style-type: none"> • Built-in optionality for one party. • Can be structured along with additional contracts to synthesise paid optionality • Can be utilised for all asset classes • Enforceability dependent on loss incurred based on reliance on promise. 	<ul style="list-style-type: none"> • One party has the option to exercise sale • Premium can be embedded as down-payment for a sale contract. • Can be utilised for all assets other than currencies • Valid and enforceable contract 	<ul style="list-style-type: none"> • Both parties have to execute their obligations • Discount for advance purchase • Can only be utilised for fungible commodities (excluding currencies, gold and silver) • Valid and enforceable contract

Unilateral Wa'd FX Forward Platform Mechanics



Binding on FI but not binding on MB to execute.



- A credit default protection (CDP) products stands on stronger ground than a PRS contract, even though PRS has gained more acceptability in recent years.
- ✓ Genuine mutual risk protection mechanism as opposed to protection from rate fluctuations (part of interest rate system)
- A shari'a compliant CDP would require:
 - Exposure to **ACTUAL** credit risk exposure of a counterparty (i.e. insurable interest)
 - **Structured according to acceptable Shari'a norms:**
 - Wa'd and Musawama transactions combined,
 - OR
 - Mutual protection (Takaful) fund with donations (tabarru) and default claims.

- **Diversity of Shari'a opinion and absence of *stare decisis***

Even where a group of accepted Scholars find a Shari'a compliant derivative to be compliant, it may be deemed impermissible by the judges in a Shari'a court or a civil court interpreting Shari'a law in its own discretion.

- **Enforcement of early termination provisions and legal recognition**

Institutions in jurisdictions which do not recognise derivatives or consider them to fall under the legal ambit of gambling laws will find it difficult to enforce the terms of an ISDA/IIFM Master Agreement in the event that they need to early terminate.

PROFIT RATE EXPOSURE

Profit Rate Swaps will continue to be a significant driver of derivative activity

- Total IF assets: \$600 bln
- Financing/Asset Ratio: 60%
- Hedging requirements: 50% (conservative)

Total market: \$180 bln or 1200 transactions (avg size \$150 mln)

FX EXPOSURE

External positions in countries with Islamic finance assets will require significant hedging

- March 2009 total external position: \$1.2 trillion
- 31% of total require Shari'a compliance: \$375 billion
- Last ten years of growth: 14% for assets and 12% for liabilities

2013 Shari'a compliant demand for hedging: \$628 bln

"I am very pleased by the thoroughness and professionalism of Dar Al Istithmar's management team. I am sure that with their innovative and responsive approach, Dar Al Istithmar will go a long way in serving the Islamic Financial industry."

Dr. Hussein Hamed Hassan, Chairman, Dar Al Istithmar Supervisory Board



"We have found Dar Al Istithmar management team to be very approachable, responsive and committed".

Dimitris Melas, MSCI Barra.



"We are very impressed by Dar Al Istithmar's management team's knowledge on Shari'a related matters, their efforts to understand the client needs and, their dedication and helpful attitude throughout. With their approach, Dar Al Istithmar made us feel that they are more like partners to us rather than merely a service provider."

Richard Ellis, Partner, Amiri Capital



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