Shariah Parameters on Islamic Foreign Exchange Swap as Hedging Mechanism in Islamic Finance

By:
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Abstract

Islamic Foreign Exchange Swap (hereafter Islamic FX Swap) is a contract that is designed as a hedging mechanism to minimize market participants' exposure to market currency exchange rate which is volatile and fluctuating. Although Islamic FX Swap functions almost similarly as its conventional counterpart, its structure must not contravene with the principles of *Shariah*. In other words, Islamic FX Swap structure should be free from any elements prohibited by Islam like usury (*riba*), gambling (*maysir*) and excessive ambiguity (*gharar*). These prohibitions are mainly to promote justice and provide a level playing field in order to protect the interest and circumvent harms of all parties involved in market transactions, which is transpired in the objectives of *Shariah* (*maqasid al-Shariah*). This paper, therefore aims to review the structure and mechanism of Islamic FX Swap as currently offered by many Islamic financial institutions worldwide. Specifically the paper highlights the *Shariah* parameters and guidelines in structuring Islamic FX Swap. As will be evident in this paper, this instrument has its own advantage as risk management tool which appeals to Islamic financial institutions which are constrained with instruments to hedge against currency exchange market rate volatility.

1. Introduction

A conventional swap contract is essentially a derivative contract where one set of cash flows is exchanged, or swapped, for another. In conventional practice, swap is mainly used for the purpose of hedging or minimizing risk faced by an institution or financial organisation by protecting the value of the asset from being exposed to the volitility and fluctuation of a market. The aforementioned market includes interest rate market and currency rate market. The former is usually managed by institution through swap instrument known as interest rate swaps while the

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potential fluctuation in the value of currencies is managed through currency swaps. This paper focuses on the currency swap also known as FX swap.

Essentially Islamic finance is not immune from being exposed to the risks of market volatility and fluctuation either in currency rate market or interest rate market. In the absence of alternative profit-related rate as a benchmark, Islamic banks are constrained to use the interest rate-related benchmark such as London Inter-Bank Offer Rate (LIBOR) or Base Lending Rate (BLR) in their financing operations. Undoubtedly, this link automatically exposes their income and expenditure flows as well as the value of their assets to the interest rate risk. Therefore, the issue of risk management to mitigate or minimize both risks is relevant to Islamic financial institutions in order to ensure their competitiveness, viability and sustainability.

Consequently Islamic swap is structured to deal specifically as a hedging mechanism in Islamic finance. Islamic swap is a hybrid contract that is designed to achieve the objectives of the conventional swap contract. More importantly the contract is structured to be in conformity with the Islamic commercial jurisprudence principles, which means that the essence and the object of the contract must satisfy the *Shariah* requirement. This implies the need to ensure that the contract is free from *riba* (usury), *gharar* (excessive ambiguity) and any element of gambling in the transactions.

This paper reviews the concept and operation of the Islamic FX Swap instrument as a hedging mechanism in the Islamic financial system. The main objective of this paper is to provide a clear parameter on how Islamic FX swap should be structured and executed according to the principles and contracts in *Shariah*. The structure of the paper is as follows: Section 2 introduces swap as one of the risk management instruments particularly to hedge against interest rate risk and currency rate risk in conventional finance. This is followed by reviewing the common structure of Islamic alternative to conventional FX swap in Section 3. The product is discussed in the light of *Shariah* principles and contracts that form the basis of structuring Islamic swaps. Section 4 highlights on a number of *Shariah* issues concerning the swap contract, in view of setting a parameter for its structuring and operation.

2. Swap as a Hedging Mechanism

The swap appears to be one of the earliest derivative products introduced compared to other derivative products. Exclusively, the currency swap product was offered in the United States market as early as 1970s and was followed with the interest rate swap in 1981 (Marshall and Kapner, 1990, p.xvii)[1]. These swap products were very well received by the public to the extent that the total swap transctions increased to more than USD700 billion in 1989 and the total outstanding swap touched approximately USD4.6 trillion at the end of 1992 (Das, 1994, p.3)[2]. According to the Bank of International Settlements, the swap transactions in the global swaps market had reached more than USD415.2 trillion at the end of 2006, which appeared to be 8.5 times more than the rate of Gross National Product of the world for the year 2006 and was more than other transactions in derivative market. This entire figure further accentuates the importance of hedging instruments in current financial markets.

Companies, banks, the insurance industry, international organisations and local financial institutions benefit a lot from swaps. The volatility of financial markets, especially interest rate and currency market, has become a serious threat to therse market participants. Hence, the wide usage of swap product is closely tied to its important function which is to hedge againts the market risks namely interest rate and currency rate fluctuations in the open market. In fact swap instrument appears to be one of the most important risk management instruments particularly for hedging purposes. Hedging instruments like swap are perceived as more effective mechanism to mitigate certain types of risks, which otherwise cannot be efficiently managed using other natural risk management strategies like diversification and concentration (Wardrep and Buck, 1982)[3].

Technical Definition of Swap

[1] Marshal, John and Kenneth Kapner (1990) *The Swaps Handbook*, New York: New York Institute of Finance.

[2] Das, Satyajit (1994) *Swaps and Financial Derivatives: The Global Reference to Products, Pricing, Applications, and Markets*, 2nd ed. Sydney: The Law Book Company.

[3] Wardrep, B. N. and J. F. Buck, "The Efficacy of Hedging with Financial Futures: An Historical Perspective," *Journal of Futures Markets*, vol.2, no.2, pp.243-254

A swap can be defined as a bilateral contractual agreement in which both parties agree to simultaneously make periodic payments in exchange of two different streams of cash flows. This payment is refered to as the legs or sides of the swap and is determined based on hypothetical values of underlying assets called notionals. The swap agreement can be done by exchanging an asset or liability in the same or different currencies or a floating interest rate stream with another of fixed rate or vise versa.

There are several types of financial swaps that are commonly used in the conventional financial system. The main types of swap instruments are briefly explained below, based on their relative individual importance respectively:

- ✓ **Interest rate swap:** This is the most common type of swaps involving an exchange of interest rate payments on a notional amount of principal. Typically done by exchanging a fixed interest rate payment on the principal with a floating rate that is adjusted periodically.
- ✓ **Currency swap:** This type of swap includes exchange of interest payment but with payment of interest on a notional amount of principal denoted in different currencies.
- ✓ **Commodity Swap**: This swap is applied based on the average price of an underlying commodity (i.e. oil, gas, or other natural resources) where the parties exchange payment of fixed price over the commodity with another floating price.
- ✓ **Equity Swap:** This swap involves exchanging a stream of payments based on the performance of an underlying quantity of equity shares or an equity share index (Coyle, 2001, pp.2)[4]

Main Objectives of Swaps

Generally, the main purpose of swaps are as follows:

- **Hedging from financial risks:** Compared to other derivative instruments, swap can be used more effectively as hedging mechanism against risks which are related to interest

[4] Coyle, Bryan (2001) *Interest Rate Swap*, United Kingdom: Financial World Publishing, 2001

rate or currency exchange markets. This instrument is also considered to be more suitable for hedging risks of long term nature ranging from 1 to 10 years and sometimes can even run considerably longer period of time (Kapner and Marshall, 1990, pp.268)[5]. Hedging can be achieved using swaps through sculpting an existing cash flow to a desired structure that maximizes profit.

- **Reducing financing cost:** The imperfect nature of capital markets often trigger the phenomenon of what is known as comparative borrowing advantage. What happens is that the fund of capital flow between one country and another country is usually restrained by various forms of control and regulatory requirements such as law, high taxation, levies and operating costs. These constraints may result in higher cost of capital borrowing between one market with another market due to the market imperfection condition (Kapner and Marshall, 1990, 267)[6]. Swap finance can lower the borrowing cost for both counterparties by using the simple generic/plain vanilla structure.
- **Operation at a larger scale:** The use of swap as a hedging mechanism, especially against risks from fluctuations of costs, enables institutions to trade and operate on a larger scale. Even though the cost of using the hedging instrument is fairly high, however usually profits from operations of large scale (economies of scale) will be higher than operation without any hedging instrument.
- **Access to new markets:** The use of swaps helps in providing access to markets which are usually difficult to penetrate. For example, institutions which are rated low often find it difficult to obtain loans for long term period. However by swaping their debt which is based on floating-rate with a debt enables them to acquire larger capital to penetrate new markets (Vantakesh and Vantakesh, 1994, pp.19-20)[7].

✓ **Speculative activities to maximise profits:** Speculation is common in derivative markets and swap is of no exception. Essencially, using swaps as means of hedging includes an

[5] Marshal, John and Kenneth Kapner (1990) *The Swaps Handbook*, New York: New York Institute of Finance.
[6] Ibid, p.267.
[7] Vantakesh, Raj and Vijaya Vantakesh (1994), Interest *Rate and Currency Swaps: The Market Products and Application*, Chicago: Probus Publishing, pp.19-20

element of speculation as it is based on projection of increase or decrease in interest-rates. There is always an element of uncertainty that our expectations may not be met and thus losses will be harvested instead. Greenspan (1999) reiterates that derivatives are zero-sum game, whereby the loss of one party is the gain of the other. For example, if Company A speculates that interest rates is rising, then it will take advantage of this conditions by arranging a swap transaction by entering as a fixed rate payer and, consequently, as a floating-rate receiver. Through this swap, Company A will benefit from the rising payment of the floating-rate while it only pays a fixed amount throughout the swap transaction period.

3. Structuring Swap that Complies with *Shariah* (Islamic Swap)

The following sections explain in detail the application of *Shariah* principles on the mechanism of swap as a hedging instrument in Islamic finance. To date, there are three main instruments of Islamic swap that have been structured in a manner that complies with *Shariah* principles, namely - FX Swap, Cross Currency Swap, and Profit Rate Swap. This paper only focuses on Islamic FX swap.

To begin with, the section starts by briefly discussing the mechanism of conventional FX Swap in view of assessing whether it is compatible to Shariah principles or otherwise. Indeed, the examination of the swap structure from Islamic viewpoint is very crucial to ensure that the transaction does not contravene to *Shariah* principles. Subsequently, the discussion of Islamic alternative structure to conventional FX swap is offered to provide better comparative understanding on how the instrument is developed to achieve the same result as its conventional counterpart.

Shariah Perspectives on FX Swap

FX Swap is a derivative instrument that has a specific objective to hedge against risk of fluctuation in currency exchange rate risk. In conventional structure of FX Swap, normally it involves two foreign currency monetary exchanges; at the beginning and at the expiry date (FX

Swap involves exchange and re-exchange of foreign currency). The dual exchange makes this FX Swap different from a forward contract. In the forward contract, the exchange only takes place once. For instance, one side wants to change US dollar currency (USD) to Malaysia ringgit currency (MYR). After the exchange between USD to MYR, the forward contract will expire. MYR will not be changed back to USD in a forward contract.

Unlike FX forward as described above, FX swap involves two stages exchange. At the beginning when the first currency exchange takes place, USD is coverted to MYR based on spot rate. On the same day, both sides will seal a forward contract to exchange MYR back to USD at a forward rate. Thus this FX Swap can also be seen as a combination of contracts between spot and forward contract. FX SWAP is usually sealed for a short term period; less than a year.

As an illustration for FX swap, say Bank A which is based in United States intends to invest in Malaysia thus converting USD100 million to MYR350 million based on today's spot rate. On the maturity date, the MYR will be converted back to USD based on a forward rate that was agreed upon at the beginning of the contract.

From the *Shariah* viewpoint, the problem with the conventional FX Swap structure arises when the parties involved want to exchange currency sometime in future but already fixing a rate which is fixed today while the contract is sealed today. This contravenes to the basic *Shariah* rules governing the exchange of currency *(bay` al-sarf)*. In *bay` al-sarf*, it is a requrement for an exchange which involves two different currencies to be transacted on spot basis[8]. Hence it is prohibited to enter into forward currency contracts whereby the execution of a deferred contract in which the concurrent possession of both the countervalues by both parties does not take place. This rules applies in the case of FX swap since the contract of exchanging two foreign currencies

[8] There are many hadith which govern the rules regarding the exchange of currencies. The best known hadith is the one reported on the authority of 'Ubaydah Ibn al-Samit, to the effect that the Prophet (peace be upon him) said: "Gold for gold, silver for silver – until he said – equal for equal, like for like, hand to hand, if the kinds of assets differ, you may sell them as you wish provided it is hand to hand. (Reported by Muslim in his Sahih). Here the reference made to gold and silver are analogous to paper and coin money as a medium of exchange in today's world. The currency of each country is considered as being of a kind that is different from that of other countries as they are 'constructive money' according to the decision of the International Islamic Fiqh Academy. Refer to AAOIFI (2008).

is done on forward basis where the contract is sealed today but exchanges actually happen in future (on the date of maturity).

Consequently, Islamic FX Swap is structured based on *Shariah* principles and contracts to achieve the same objectives of its conventional counterpart which is to hedge against currency rate fluctuation risks. For the Islamic FX Swap, there are two structures are commonly offered in the market. One structure is based on the contract *bay` al-tawarruq*[9] and the other adopt the concept of *wa'ad* (promise/undertaking).

a. Islamic FX Swap based on Tawarruq Structure

For the structure that is based on *tawarruq*, usually, it is structured with the application of two sets of *tawarruq* (at the beginning) to enable the same effect as FX Swap to be achieved. As an illustration, say an investor has USD14.5 million. He wants to invest in the currency Euro (€) but does not want to be exposed to fluctuation in the currency market. This product FX Swap aims to protect the investor from currency rate fluctuation risks. Supposing in the example above, today's rate (spot rate) USD/€ is USD1.45 amounts to €1.

If the investor exchanges USD to €, he would get €10 million on the first day. He invests this money and after one year, that is, when he wants to exchange it back to USD, let say the rate of currency stated above has changed to 1.40. Then, he may only receive back USD14 million and hence suffering a loss of USD 0.5 million compared to his original position. Nevertheless, this depends on the currency rate. If after a period of a year, the USD/€ rate is 1.50, then the investor obtains USD15 million, which is a profit of USD 0.5 million compared to original position. If the investor applies FX Swap, he would fix the forward rate and may not be exposed to any loss or profit. This is what is meant by hedging.

[9] *Bai` al-tawarruq* is set of sales contracts which involve transaction of buying a commodity on deferred payment basis and then selling it on cash basis to a person other than the first seller, i.e. at a lower price.

To understand the process and mechanism which is used in the Islamic version of FX Swap that complies with *Shariah*, Diagram 1(a)-1(b) gives a complete illustration on the mechanism of FX Swap that complies with *Shariah*.

Diagram 1(a): Islamic FX Swap – First Part

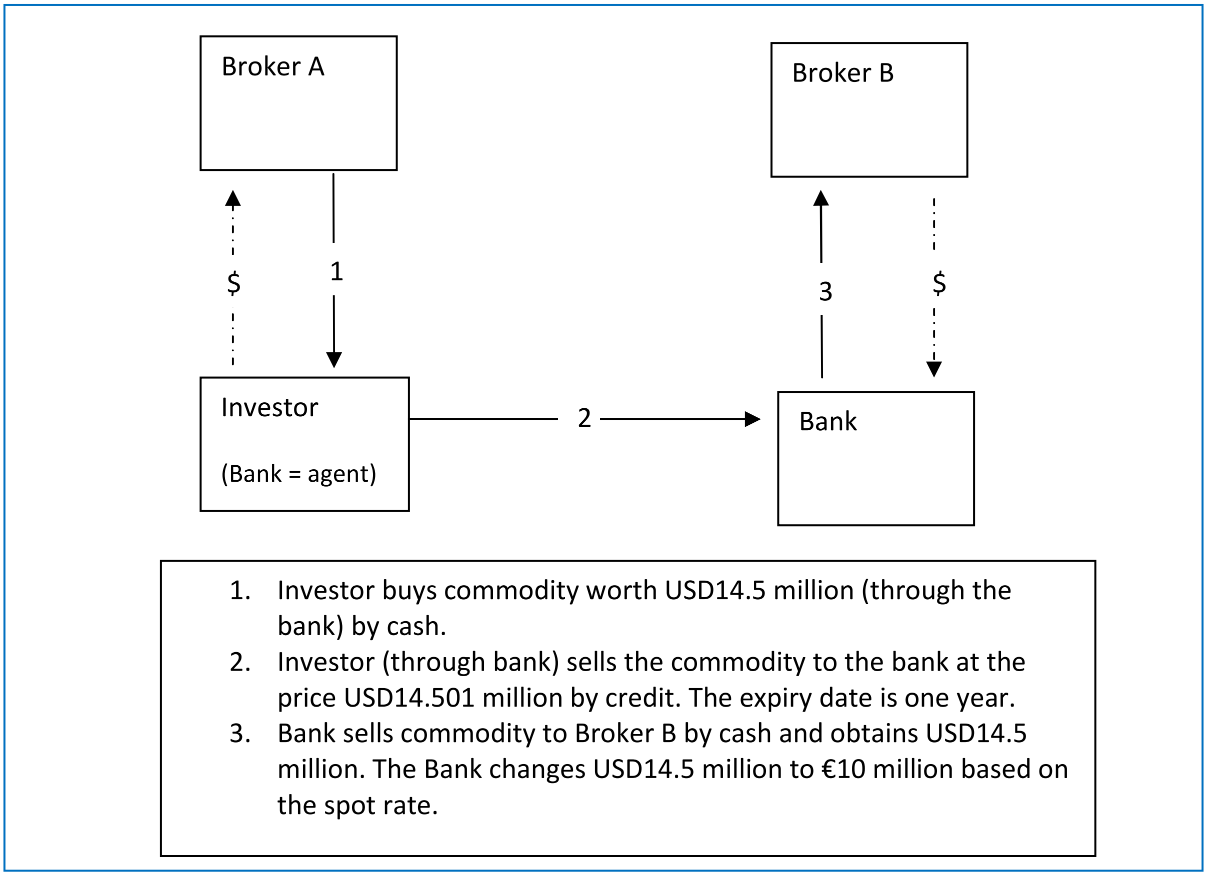
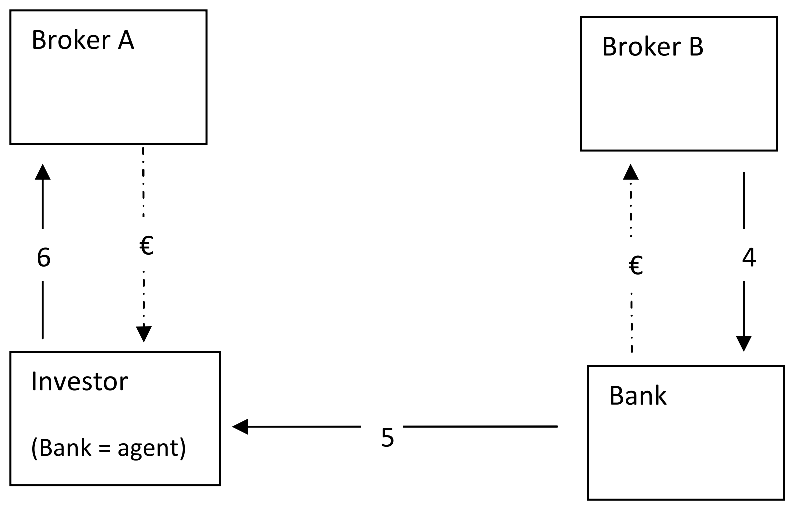


Diagram 1(b): Islamic FX Swap – Second Part



4. Bank buys the commodity from Broker B worth €10 million by cash.
5. Bank now sells the commodity worth €10 million to the investor at the price of €10.141 million by credit. Expiry date is also one year.
6. Investor sells (through bank) the commodity to Broker A and obtains €10 million.

The dicussion based on the Diagram 1 (a) and (b) are as follows:

1. The investor who has the USD will buy the commodity (through the bank who is the agent) worth USD14.5 million by cash.

2. Thereafter, he will sell the commodity that was bought, to the bank (based on the forward rate) at the price of USD14,501,450 by credit (USD1,450 additional profit compared to the cost price). The bank makes the payment after one year. This transaction gives the investor returns in USD. However, this still has not achieved the investor's objective of wanting to invest in €.

3. The bank that bought the commodity earlier will now sell the commodity to another broker and obtain USD14.5 million by cash.

4. Now the bank needs €. So, the bank changes USD14.5 million to €10 million (based on today's rate). With this money, the bank will buy the commodity from broker B at the value of €10 million.

5. After owning the commodity, the bank then sells it to the investor at the price of €10,140,874 by credit. Payment will be made after a year.

6. The investor will sell the commodity to Broker A and obtain €10 million.

The economic implication of the above transaction is that the investor has succeeded in exchanging USD14.5 million to €10 million. He can also invest this €10 million for one year. At the end of the expiry of one year, the investor needs to pay the price of the commodity that was bought from the bank (refer to transaction 5) totalled at €10,140,874. The bank also has to pay the investor USD14,501,450 the result of the transaction (refer to transaction 2) just now. The end result of the payments at the expiry date, is that both sides have converted USD and € at a forward rate.

The transactions exemplified in Diagram 1(a) and 1(b) above is known as *tawarruq,* which are conducted only at the beginning of FX Swap. There will not be any other tawarruq transactions during the duration of FX Swap because the objective of it is to exchange foreign currency at the beginning and at the end only and not in between. Table 3 shows the cash flow in a FX Swap.

Table 3: Cash flow in FX Swap

				Cash Flow of Investor		**Cash Flow of Bank**	
	Return	Buying Price	Selling Price	Beginning	End	Beginning	End
Tawarruq USD	1bp	14,500,000	14,501,450	(14,500,000)	14,501,450	14,500,000	(14,501,450)
Tawarruq EUR	1.40874%	10,000,000	10,140,874	10,000,000	(10,140,874)	(10,000,000)	10,140,874

Exchange Rate		1.45	1.43				

Islamic FX Swap Based on *Wa`ad* Structure

The second structure in a FX Swap is based on the concept of *wa'ad.* The wa`ad is an Arabic word which literally means "a promise". The value of the wa`ad in Shariah is similar to the value of a social promise in Common Law. The promise may have moral force in that breaking it may provoke opprobrium (social blame) but it does not entail legal obligations or legal sanctions. Under Civil Law, the Wa`ad can be binding or non-binding depending on the intention of the party who is giving the promise.

The Islamic Fiqh Academy (based on the Kingdom of Saudi Arabia) has decided that the Wa`ad is "obligatory not only in the eyes of God but also in a court of law" when: it is made in commercial transactions; it is a unilateral promise; and it has caused the promissee to incur liabilities. Also it is a requirement that the actual sale – if the promissee was in respect of selling a certain asset – to be concluded at the time of exchange of the offer and the acceptance (known in Arabic as Majlis al-Aqd) and not at the time of the Wa`ad. The promissee also has the possibility to claim actual damages from the promissory, if the latter backs out on a Wa`ad.[10]

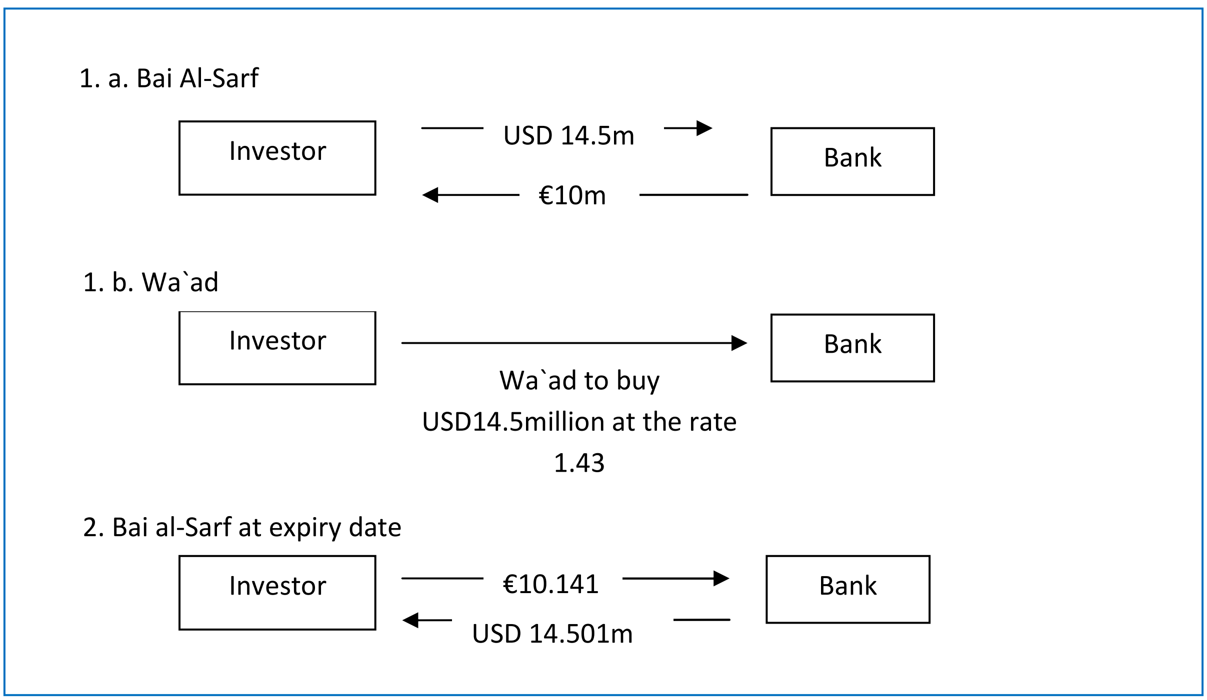
The Islamic FX based on Wa`ad structure involves exchange of currencies (*bay` al-sarf*) at the beginning, and promise or undertaking (*wa'ad*) to carry out another *bay` al-sarf* at the future date based on the rate determined today. At the expiry date, the second *bay` al-sarf* will be implemented to get back the original currency.

[10] See Resolution No.2 and 3 of the 5th Conference of the Islamic Fiqh Academy, Kuwait 1409H, published in the Majallah Majma` al-Fiqh al-Islami, No.5, Vol.2, p.1599.

To illustrate how Wa`ad is used in structuring Islamic FX swap, lets take the same example as discussed previously. At the beginning of FX swap, the investor that has USD14.5 million can sell this USD to the bank on spot basis to obtain €. This complies to bay` *al-sarf* principles which requires transaction to be on spot. Thereafter the investor will enter into *wa'ad* or undertakes to enter into a contract of currency exchange based on the principle of *bay` al-sarf* at a future time. The future exchange of currencies will be based on an exchange rate that is referred to today's rate. So at the future time, the investor will get back the USD without being exposed to the risks of currency fluctuation.

Diagram 2 below gives an illustration of the mechanism:

Diagram 2: Islamic FX Swap based on *wa`ad*



4. *Shariah* Parameters on Islamic FX Swap

Based on the explanation of the two Islamic FX swap structures above, it is possible to summarise that most of the swap products that comply with *Shariah* have similar objective as their conventional counterpart. Nevertheless, what is more important is that the means to achieve the stated objective *Shariah* principles. In Islam, making a comparison by only looking at the name alone is not sufficient. More importantly is to evaluate the structure and its essence based on the underlying contract used and *Shariah* principles adopted. This is in line with the following *Fiqh* maxim:

العبرة بالمسميات لا بالأسماء

"Comparison with the same should not be based on the name alone".[11]

The above maxim is also consistent with another maxim taken from the *Majallah al-Ahkam al-'Adliyyah* (the Civil Code of the Ottoman Empire)[12]. Clause 3 of the Majallah provides that:

العبرة في العقود للمقاصد والمعاني لا للألفاظ والمباني

"The real reason of contracts is for the objectives and not for the literal wordings"

Thus, the following sections identify several potential *Shariah* issues that need to be addressed particularly in structuring and executing Islamic swap. This is paramount to ensure this product is free from elements that are not in congruent with the spirit and objective of *Shariah*.

[11] Fatawa Al Azhar, (chap) juz 10 p. 177; in **http://www.islamic-council.com** . Fatawa Al Islam Su'aal wa Jawaab, Bab 47651 Al Bunuk Al Islamiyyah, juz 1 p. 4707 under the supervision of Sheikh Muhammad Soleh Al Munjid; in **www.islam-qa.com**.

[12] The Majallah is the Civil Code of the Ottoman Government promulgated in 1876. The compilation of the civil code is based on Shariah principles. Although it is comprehensive in delineating certain Islamic jurisprudence principles, the Majjalah, however, does not contain all the provisions of civil law (e.g. one branch of law pertaining to family law was left out). The very purpose of compiling this code is aimed at preparing a book on juridicial transactions which would be correct, easy to understand, free from contradictions, embodying the selected opinion of the jurists and easily readable for everyone. Among the subjects covered include sale (bay'), hire (ijārah), guarantee (kafālah), transfer of debt (hiwālah), pledges (rahn), trust and trusteeship, gifts (hībah) etc. See Bakar (2000) and Majallah-al-Ahkam (2001).

Parameters on Combining Several Agreements (الجمع بين العقود)

Apparently the Islamic swap mechanism as discussed above involves combination of several contracts in one transaction. This somehow triggers some *Shariah* issues in the context of prohibition made by the Prophet s.a.w against amalgamation of two contracts, as stated:

" نهى النبى (ص) عن بيع و سلف[13], وعن بيعتين في بيعة[14] , وعن صفقتين في صفقة[15] "

"The Prophet s.a.w. banned combining between contracts of sale and debt; and combining two sales contracts into one contract; and combining two transactions into one transaction."

Most Muslim jurists agree that combining a sales with a loan is prohibited because of the difference in the nature of the sales agreement (*bay`*) and the loan agreement (*salaf*). The sales (*bay`*) is an exchange contract (*muawadat)* while a loan (*salaf*) is a charitable contract (*tabarruat*). The sale (*bay`*) and loan (*salaf*) contracts are also different from the angle of time period. While the former has a certain period and time limits, loan contract has no time limits. This is because sale contract involves an exchange while loan is benevolent. Besides that, sale is a binding contract, while loan is not binding because it is considered an act of charitable from one party to another (unilateral) . Therefore combining two contracts which are diametrically opposed in nature is deemed as impermissible.[16]

[13] Al-Tirmizi stated that this hadith is the same status as hasan sahih (Al-Muwatta 2/657; Mukhtasar Sunan Abi Dawood, Al-Munziri 5/144; Al-Musnad, Ahmad 2178; Al-Aridhah, Al-Ahwezi 5/249; Al-Sunan, An-Nasai 7/295; Neilul Awtar 179/5.

[14] Ibnu Arabi explained that this appears to be a true command from the Prophet s.a.w. himself (Al-Qabas 2/842; Mukhtasar Sunan Abu Dawood, Al-Munziri 5/98; Al-Muwatta' 2/663; Al-Aridhah, Al-Ahwezi 5/239; Al-Sunan, Al-Nisai 7/295; Neilul Awtar 5/152).

[15] Al-Musnad, Ahmad 1/198; Neilul Awtar 5/152.

[16] Refer to Kitab al-Muntaqa Syarah Al-Muwatta' (435/3). An example of a combination of a sale-purchase agreement and loan is: A seller stated 'lend me this shirt and sell this to me me at the price of RM10' or 'sell me your shirt if you want to loan my money'.

However, Islamic scholars differ in their opinions with respect to combining few contracts into one.[17] Eventhough based on the hadith quoted earlier, the Prophet s.a.w prohibits amalgamation of several contracts, there are views allowing it but with certain conditions.

Among them is the story of Umar bin Al-Khattab while dispatchingYa'la bin Munyah to Yemen and his order was generally on distribution of land.

> **أن عمر أجاز المعاملة بالجزء وقد استشكل هذا الصنيع بأنه يقتضى جواز بيعتين في بيعة لأن ظاهره وقوع العقد على إحدى الصورتين من غير تعيين ويحتمل أن يراد بذلك التنويع والتخيير قبل العقد ثم يقع العقد على أحد الأمرين**
>
> "Umar has partly allowed this transaction (muamalah) and has raised questions because these deeds cause the truth of the two contracts in one contract because the original agreement occurs between both of them without knowing which one. It has possibly already been made clear and chosen before the agreement takes place between them."[18]

Hence AAOIFI's Council of *Shariah* Advisors in its Resolution No.25 has prescribed that combining more than one contract is permitted, provided that each contract itself is permitted in *Shariah* and each contract must stand independently, that is, without binding one another (*uqud mustaqillah* (العقود المستقلة). At the same time, each contract cannot in anyway indicate of having any condition between one contract with another contract.

According to AAOIFI (2007), the guidelines and conditions for combining several contracts into one single transaction are as follows:

[17] Imam Syafi'e explained **بيعتين في بيعة** occurs when one agreement puts a condition which influences another agreement. As an example Syafi`e gave two interpretations. The first one 'I sell to you RM2000 deferred or RM1000 cash. Choose which one you want. It is sale-purchase which is Fasid because of uncertainty. The second 'I sell my slave with the condition you sell your horse'. (Refer to Al-San'ani, Subul al-Salam, Maktabah Al-Halabi, 4th Edition, 1960M (12/5)).
Imam Malik also had a similar opinion when he explained "the meaning of two sale-purchase in one sale-purchase is an agreement which is binding against the purchase of one of the goods. Like selling this shirt with 1 Dinar, and that shirt with 2 Dinar and the purchaser chooses either one of the shirts he likes but decides to buy it. (Refer to Kitab al-Muntaqa Syarh Al-Muwatta' (435/3)). Syeikhul Islam Ibn Taimiyyah and Ibn Qayyim instead interpreted this hadith as regarding the agreement *bay`inah* which is banned in *Shariah*. (See Al-Bassam, Taysir al-Allam Syarh Umdatul Ahkam (473/1))

[18] Ibnu Hajar al-Asqalani, Fathul Bari Syarh Sahih al-Bukhari, Dar Ma'rifah, Beirut (p.12:5)

1. Contracts' combining should not include the cases that are explicitly banned by *Shariah*. For example, contracts that combines sales and lending into one contract.

2. Contracts' combining should not be used as a trick for committing usury (riba) such as agreement between two parties to practice sale and buyback transaction (bay` al-`inah) or riba al-fadl[19].

3. It should not be used as an excuse for practicing riba. The two parties could misuse, for instance, contracts' combining when they conclude a lending contract that, at the same time, facilitates some other compensatory gains to them. For example, they could stipulate in the contract that the borrower should offer accommodation in his house to the lender, or grant him a present. Contracts' combining could also be misused by imposing excess repayment in terms of quantity or quality on the borrower.

4. Combined contracts should not reveal disparity or contradiction with regard to their underlying rulings and ultimate goals. Examples of contradictory contracts include granting an asset to somebody as gift and selling/lending it to him simulataneously, or combining Mudarabah (profit sharing contract) with lending the Mudarabah capital to the Mudarib, or currency exchange with Jualah, or Salam with Jualah for the same contract value or leasing with selling (i.e. hirepurchase in its traditional form).

In relation to this, most of *Shariah* advisory councils of Islamic financial institutions like Kuwait Finance House, Calyon Global Islamic bank, HSBC, RHB Islamic bank and many others make decisions in the same spirit when approving swap products that contain combination of more than one contract. For example, the *Shariah* Advisory Council of Kuwait House in a meeting No.23/2006 on the 19 September 2006 in Kuwait, when evaluating the product Ijarah Rental Swap based on *wa`ad mulzim min taraf wahid* (unilateral binding promise) in the *musawamah*

[19] It has been reported that the Prophet (peace be upon him) instructed one of his employees to sell his low-quality dates first and then buy the high-guality dates he wanted, instead of resorting to exchange of more quantity of low-quality dates for less quantity of high quality dates. (Narrated by Abu Dawood, Al-Tirmizi, An-Nasai, Ibn Majah, Ahmad, Al-Shafie and Malik).

transaction and *tawarruq*, laid down four main conditions to ensure that this product complied with *Shariah*. The conditions include:[20]

1. The agreements in that structure is actual (not a fictitious contract (*suriyah*)).
2. Each agreement has its own effect (*atharuha*). For example, sales agreement gives the effect of ownership. There should not be any obstacle on ownership (*milkiah tammah*). It is up to the buyer whether he wants to sell it, or keep it and use it.
3. The agreements are separate.
4. The agreements are unconditional (between one another).

In addittion to the above, other *Shariah* guidelines that need to be adhered to include the following:

5. For exchange contracts (*'uqud al-mu'awadhat*), the pillars and conditions of the said contracts must be complied with. The contract must be clear and a real transaction must occur, and must be proven;
6. The sequence of each contract to be executed must be followed accordingly as to ensure that all these contracts are independent and separate from one another (*mustaqillah*).

Parameters for Hedging

Most of the swap products that have been approved by the respective *Shariah* committees of each financial inntitutions put a condition Islamic swaps are exclusively for hedging purposes. It means that swap can only be used as an insurance activity aimed to protect an asset from adverse change, which can be an enexpected and undesirable change in the value of an asset, at the lowest cost. This also implies that Islamic swap cannot be used for funding and trading activity by mean of speculation to generate profit as widely practiced in conventional finance.

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[20] See Ahmad Suhaimi Yahya (2008) Mekanisme Lindung Nilai Dalam Kewangan Islam Menurut Perspektif Syariah. Presented in Muzakarah Penasihat Syariah Kewangan Islam Kali Ke-3, anjuran Centre for Research and Training (CERT). 17 November 2008. Kuala Lumpur.

For example the *Shariah* advisory body of Calyon Global Islamic Bank whose members constitutes of Dr Abdulsattar Abu Ghuddah, Sheikh Nizam Yaquby and Sheikh Dr Mohammed Elgari approved some swap products, including Islamic FX Swap, Cross Currency Swap, Islamic Profit Rate Swap (*murabahah* and *musawamah*) by outlining clear conditions that these products can only be applied for hedging and cost reduction purposes. While speculative investment activity using Islamic swap instrument is prohibited. This view is shared by many other *Shariah* internal committees of other financial institutions offering swap products which comply with *Shariah* such as Kuwait Finance House, CIMB Islamic, Standard Chartered Saadiq and others.

The question is, what method should be used to ensure that this decision does not infringe the purpose of attracting profit by mere peculation? Based on statistical reports that is issued by the Office of the Comptroller of Currency (OCC), only 2.7 % from the total of derivatives are used by end users, that means transactions that aim to hedge only achieve the percentage stated, while the majority, 97.3 % is used by dealers, or in other words by speculators (Al-Suwailem, 2006, p.43).

These statistics will surely trigger concern as to what extent the Islamic swap product is really free from any speculative activity that is not allowed in *Shariah*. Thus, a more detailed guidelines or parameters (*dhawabit*) is necessary to make sure that this product is used solely for the purpose of hedging and not for speculative activities.

Some financial institutions give a written representation to get a guarantee and declaration from the counterparty subscribing the swap product making sure that the swap is only used for the purpose of hedging and not speculation.For some other financial institutions, the swap is only used for hedging when there is a clear underlying transaction and contract, for example the *ijarah* contract. This is to ensure that the underlying asset or asset foundation for the swap instrument is based on entirely actual and real economic activity and not a fictitious one,.

Apart from that, the *Shariah* monitoring body also have to ensure that every swap operation which is operated must be based on certain underlying asset which is legitimate and the transfer of ownership is complete on that asset. This could prevent any speculative activity which occurs when no perfect ownership occurs on an asset (for example in the case of short-selling transaction).

7. Conclusion

This paper has examined the concept and mechanism of the *Shariah* compliant FX Swap. The paper begins by reviewing swap instrument as implemented in conventional finance. Initially swap is used as hedging instrument to extend or match cashflows with the physical delivery of imports or exports. Eventually FX swaps have come to be used also as a funding mechanism against short-term borrowings or by the professional market players to speculate on interest-rate movements.

Apparently the swap practised in the conventional system is not *Shari'ah*-compliant, due to the existence of the following elements; *riba* (usury); gharar (excessive ambiguity); and *qimar* (gambling). The swap introduced by Islamic banks (*'uqud al-mubadalat*), based on concepts such as *Wa`d, Murabahah, Musawamah* and *Tawarruq* is deemed by scholars as permissible as long as it is free from elements that contravene the *Shari'ah*, and for the purpose of fulfilling the need for hedging. Thus, Islamic swap depart from conventional swap in two respects. First, the structure of Islamic swap is based entirely on the principles, values and objectives of *Shariah*. Second, the purposes of Islamic swap have been clearly defined as an instrument that can only be used for hedging and not for speculative trading activities.

As evident in the paper, although the final implication and economic effect for both parties in the Islamic financial system and the conventional financial system seems to be very similar, however what is more important is that the substance of the structure must be in line with the principles of *Shariah* contract and the objectives of *Shariah* (*maqasid al-Shariah).*

Therefore *Shariah* parameters in structuring and executing swap are very important to ensure market pratitioners truly fulfil and adhere to the requirement outlined by *Shariah*. Two broad categories of *Shariah* parameters on Islamic FX Swap are suggested, namely the guidelines on combining various contracts in one single transaction and the other is on guidelines of how to demarcate Islamic swap purposes either to hedge or to speculate.

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