CROSS CURRENCY SWAP

By: Richard Tredgett, Partner, Allen & Overy
Priya Uberoi, Senior Associate, Allen & Overy
Nick Evans, Trainee, Allen & Overy

Over the next five years it is anticipated that the market for Sharia-compliant financing products will grow at a rate of 15-20% per annum. This builds upon already impressive growth in recent years which has seen significant breakthroughs in Sukuk, Securitisation and general Islamic banking and moves from the UK government to develop London as a world centre for Islamic finance. These developments have allowed more and more entities the opportunity to structure their finances in a Sharia-compliant manner, which in turn has created a burgeoning interest in Sharia-compliant hedging products to allow institutions to effectively manage their risk in a manner that does not offend Sharia principles. In this article we will explore briefly the difficulties that arise with conventional derivative products from a Sharia perspective as well as exploring a case study of a Sharia-compliant Cross-Currency Swap structure to demonstrate how innovative application of Sharia-compliant financing techniques and products can replicate the cash flows of a conventional currency swap.

SHARIA LAW FUNDAMENTALS

Sharia (Islamic law) 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 law 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 scholars) that allow further rules to be extracted from the primary sources and applied to a modern context.

There are five classical schools of thought (***madhab***), each loosely associated with a particular geographic region. These schools are broadly similar but some differences in legal interpretation between schools could mean that even if a structure has received approval from scholars affiliated with one school of jurisprudence, this will not automatically guarantee acceptance by other scholars from another madhab.

SHARIA LAW AND CONVENTIONAL DERIVATIVE PRODUCTS

As further discussed in Andreas Alexander Jobst's "Derivatives In Islamic Finance" Learning Curve article (May 5, 2008), when structuring derivatives products, four main difficulties arise with respect to compatibility with Sharia law, namely the Sharia prohibitions on (i) ***Riba*** – the receipt and payment of interest, (ii) ***Gharar*** - Sharia does not recognise the validity of a contract if its principal terms are uncertain (for example price, quantity or material characteristics of any asset sold) 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) and (iv) debt exchange.

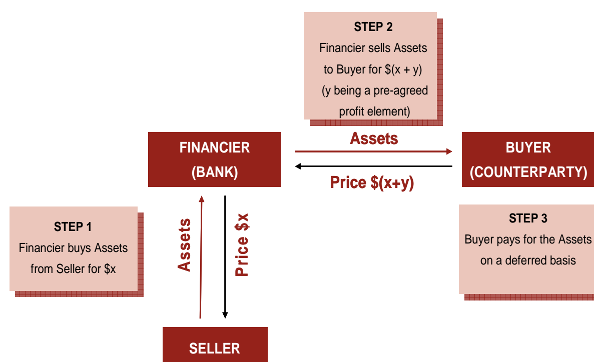
A conventional currency swap usually consists of three stages, (i) a spot exchange of principal, (ii) a continuing exchange of interest payments during the swap's life (essentially a series of FX forward trades) and (iii) a re-exchange of principal at the maturity of the contract (normally at the same spot rates used at the start). Clearly, given the Sharia prohibitions discussed above (ie. *riba*, *gharar* and *maisir*), such a transaction structured conventionally would not be Sharia-compliant.

SHARIA-COMPLIANT DERIVATIVES - THE CROSS-CURRENCY SWAP

The challenge when structuring Sharia-compliant derivatives is to generate cash flows which are similar to conventional derivative products but using established Sharia-compliant financing techniques. In the context of this Cross-Currency Swap two simultaneous *murabaha* transactions, a term and reverse *murabaha*, are used to generate cash flows similar to a conventional currency swap (as detailed above).

A ***murabaha*** is a sale arrangement whereby a financier purchases goods from a supplier 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 Murabaha Structure



As such, under the term and reverse *murabahas*, the parties agree to sell Sharia-compliant assets (often London Metal Exchange approved metals) to each other for immediate delivery but on deferred payment terms in different currencies (ie. use two parallel *murabahas* to generate corresponding deferred inter-party cash flows in the swapped currencies (**Currencies A and B**)). This structure, in effect, is not dissimilar to the "parallel loans" structure that was used by institutions in the earliest examples of conventional currency swaps.

The Primary (Term) Murabaha (Diagram 2)

Under this transaction the Bank sells commodities (sourced from a commodity broker for the purpose of entering into the murabaha (**step 1**)) to the swap counterparty (the **Counterparty**) (**step 2**). The value of commodities bought and on-sold (the **Cost Price**) will be denominated in Currency A. The commodities are delivered on the date on which the transaction is entered into. On receipt of the commodities purchased the Counterparty (or its agent) will on-sell those commodities immediately to a different commodity broker (**step 3**) to generate a Currency B payment. Payment by the Counterparty for the commodities purchased under the Primary Murabaha is on a deferred basis in instalments payable on pre-agreed payment dates in Currency A (**step 4**). Each instalment will represent a portion of the pre-agreed profit element, except that the final instalment will also include payment in full of the Cost Price (**Step 5**).

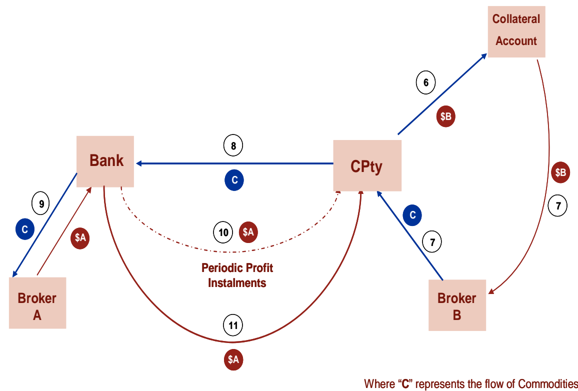
The Secondary (Reverse) Murabaha (Diagram 3)

On the giving of initial notification (by either party) that it wishes to enter into a cross-currency transaction, the Counterparty will deposit an amount in Currency B (equivalent in value to the Currency A Cost Price amount) into a collateral account (such monies, once deposited, to be managed by a pre-appointed collateral manager) (**step 6**). To instigate the Secondary Murabaha, the Collateral Manager uses that Currency B amount to purchase commodities from its commodity broker (**step 7**) (The intention is that the commodities sold under the Secondary Murabaha should have

the same value as those purchased under the Primary Murabaha).

The Collateral Manager (acting as agent of the Counterparty) immediately on-sells these commodities to the Bank for immediate delivery (**step 8**) and the Bank then immediately on-sells such commodities to the original commodity broker (**step 9**) to generate a Currency A payment. Payment by the Bank is on a deferred basis in instalments in Currency B, such instalments to represent a portion of the pre-agreed Secondary Murabaha profit element (**Step 10**) (with the exception of the final instalment which will also include payment in full of the Currency B equivalent of the Cost Price (**step 11**)). Instalment payment dates under the Secondary Murabaha will mirror those under the Primary Murabaha, such that on every date during the transaction cycle that a Primary Murabaha Currency A payment is due a corresponding Secondary Murabaha Currency B payment will also be due.

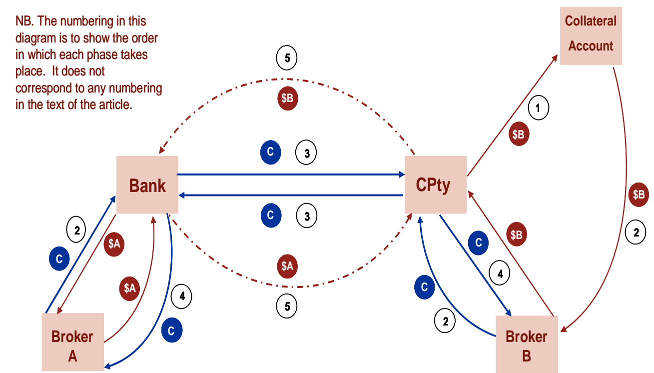
Diagram 3 - Secondary (Reverse) Murabaha



Revisiting the cash flows under a conventional currency swap, (i) the broker payments received by each of the Counterparty and the Bank (**Steps 3 and 9**) can be analogised to the initial principal exchange, (ii) the interim instalment payments (**Steps 4 and 10**) can be analogised to the interest payments and (iii) the repayment of Cost Price or equivalent thereof (as applicable) (**Steps 5 and 11**) as part of the final instalment can be analogised to the final re-exchange.

From a documentation perspective, the currency 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 to otherwise 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.

Diagram 4 - Full Cross Currency Swap Structure



CONCLUSION

This structure is a good example of how well-established Islamic financing techniques are being used to create innovative structures which allow Islamic banks and corporates to effectively hedge their risks in a Sharia-compliant manner. A number of other such structures, including profit rate swaps (analogous to interest rate swaps), total return swaps and fund/index linked derivatives, have also been pioneered and are being used both in OTC transactions and embedded into larger structures. As the market develops, liquidity should further increase ensuring that its impressive growth rate continues.

Further information

Visit: www.allenovery.com/islamicfinance

This article first appeared in the 16 June edition of Derivatives Week.