Use of W´ad and Tawarruq for Swaps in the framework of Islamic Finance

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This paper tries to analyse the use of w´ad (promise) and tawarruq for derivative products of swaps and its implications for Islamic finance. After briefly discussing the essential principles of Islamic finance and the evolution of derivatives in the conventional finance, the paper analyzes the sharī´ah status of w´ad and muwa´adah and how these are different from ´aqd (contract). Paper also discusses few famous swaps and hedging products based on w´ad with or without tawarruq and examines them specifically from the sharī´ah point of view. Sharī´ah view regarding tawarruq practices and Fatwa of OIC Islamic Fiqh Council have been discussed briefly. The objective of the paper is to reiterate that financial swaps are against the basic principles of Islamic finance; if the present practice of their increasing use is not discontinued; all hopes of gradual improvement in products and practices of the emerging discipline will be lost. Structured products not conforming to the fundamentals of Islamic finance have potential to cause a serious breakdown in the financial system as already experienced in the global financial crisis. For the bright future of Islamic Finance, due consideration must be given to substance and consequences of the products.

Key Words: Islamic swaps, *W´ad*, Commodity *Murabaha*, *Thaman-al mithl,* Speculation, *Maqāsid-al-sharī´ah.*

1. Introduction

Swaps and other derivatives were initially considered among the prohibited areas of Islamic finance. With increasing use in the conventional finance during late 1990s as hedging and speculation tools, they came into the grey area particularly after M. Hashim Kamali discussed the possibility of options and futures in Islamic Commercial Law in 1997 on the basis of *maslahah*, *ibāha* and the need for *ijtihād*[2]. Islamic finance practitioners tried to develop 'Islamic' derivatives during 2000-2007 on the basis of *salam*, *murabaha*, *wakalah*, *ibāha*, *maslahah*, *ba'i al 'arbun*, *ba'i al-khiyar* and ultimately *w´ad* along with *tawarruq* / commodity *murabaha*.[3] However, as the principles relating to *salam*, *ba'i al 'arbun* and *khiyar* had been clearly laid down in *Hadith* and classical *fiqh*, financial engineers could not develop any financial derivative structures acceptable to the overwhelming majority of the contemporary jurists. As detailed principles of application of *w´ad* in commercial transactions *were* laid down in recent years

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[2] Kamali, Mohammad Hashim; Islamic Commercial Law: An Analysis of Futures and Options; Islamic Texts Society, UK; 2000.

[3] Edwards, Waren, 2007; Edwardes is of the view that all banking products are built from four pillars: deposits, exchange, forwards and options. ….. as almost anything is permitted in conventional banking, Islamic banking is no different, merely a special case. Just as conventional products can be built from the four pillars so too can Islamic products be built using Islamic equivalents. … 'Instead of using back-to-back loans, Islamic products can be created using Islamic equivalents of back-to-back *murabaha*, back-to-back *ijara*, or back-to-back sukuk'.

around 1990s, they took liberty to transform the accessory nature of promises to the full-fledged contractual structures comprising complicated contracts and deals along with excessive use of *wakalah*. As a first step, hedge funds and short-selling mechanism were approved using the concept of promise. It was followed by the Islamic swaps and the *tahawwut* agreement jointly developed by IIFM and ISDA.

This paper is divided into six sections. Next section discusses the fundamental *sharī´ah* rules for business, risk and uncertainty in businesses and the need for hedging. Section three briefly discusses the swaps as a part of derivatives and hedging instruments in the conventional finance. Nature of swaps introduced recently in Islamic framework with focus on the use of *w´ad* and *tawarruq* is discussed in section four. Section five consists of aspects analyzed in the *sharī´ah* and procedural perspectives. Swaps permissibility on legal grounds and their implications for the Islamic finance movement have also been analyzed in this section. Summary of the findings and recommendations are covered in section six.

2 ***Sharī´ah* rules of business and risk**

By prohibiting *riba* and *gharar*, *sharī´ah* wants to ensure that no party should be allowed to get undue return or made to suffer any undue burden or loss to other party of a transaction. As risk and uncertainty are inalienable features of life, *sharī´ah* accepts them as genuine part of the business. But, while the normal business risk justifies the return, too much or too little risk incurs a ban, under the rules of *gharar* (Vogel & Hayes, 1998: 86; Elgari, 2003, P. 12).

The requirement of the *sharī´ah* that risk must not be separated from the real transactions is crucial, natural and conforms to economic reality (Al-Suwailem, 2006: 59; Ayub: 53, 81, 82). Vogel & Hayes (1998: 79) contend that Islamic law of prohibiting all risk free and chance free incomes is to prevent the occurrence of any exploitative and unfair situations. The ban on selling which one doesn't have or on selling before possession implies that consequent upon a sale agreement, delivery has to be given and possession taken – mere netting-off (*Muqassah*) to settle only the difference in prices, and every one transferring the business risk to others are not acceptable as per *sharī´ah* rules.

2.1 Risk categories and the need for hedging

Risk needs to be distinguished from the uncertainty deliberately injected at the inception of a contract that is technically termed as *gharar*, as happens in financial derivatives. The word "risk" is ordinarily used to refer to any sort of uncertainty viewed from the standpoint of the unfavourable contingency, while the term "uncertainty" is used with reference to the favourable outcome. Hence, we speak of the "risk" of loss; and "uncertainty" about gain or future profitability. Knight (Pp.233, 241, 242) distinguishes between the measurable and non-measurable uncertainties and contends that while the former relate to the risk, the latter pertains to the real uncertain situations. If responsibility of any of the parties with regard to finalization of a contract is vague, and the contract in question does not comprise the condition of *khiyar* as provided in Islamic law of contract, the contract would be void because of *gharar*. While measures can be taken to reduce the risks and make other people genuinely share it, business risk can neither be eliminated nor transferred to others separating it from the ownership (Al-Suwailem, 2006: 141). The risk which is prohibited is 'risk from the within' i.e. deliberate injection of avoidable uncertainty at inception of the transaction, regarding identification of the subject matter and the price because such uncertainty leads to *riba* and *gharar* and to injustice and inequity (Saleh, 1986: 64).

The amount of uncertainty can be reduced in the several ways; one way suggested by Knight is "by slowing up the march of progress" (Pp. 347, 348). It necessitates avoidance from too much risks – all games of chance and the derivates including futures, options and swaps that may generate high gains to promoters and the early birds, but ultimately lead to many vulnerabilities and serious socio-economic problems.

Hedging may be different from *gharar*/gambling and could be used as natural, economic and cooperative tool for risk management. But, financial derivatives make hedging and gambling undistinguishable. Hence, the main challenge before the scholars working on risk management by Islamic banks is to distinguish the essential risk taking from *gharar* and gambling like transactions (Al-Suwailem, 2006: 27-54, 84, 112-142). Similarly, according to Dr. Obaidullah (2005: 176), "The *sharīʹah* does not disapprove of hedging, since it brings in some *maslaha*. It is the zero-sum nature of the game that the *sharīʹah* finds objectionable, as in it lies the roots of social disharmony and discord."

El-Ashkar (1995) defines speculation as "the practice of (a) using available information to (b) anticipate future price movements of securities so that (c) an action of buying or selling securities may be taken with a view to (d) buying or selling securities in order to (e) realize capital gains and/or maximize the capitalized value of security-holdings." However, the speculative practices in the markets tend to prove that the act of seeking knowledge is not for any real business or getting the underlying assets, but for making money off its speculated growth in value which in the long run may lead to instability in the financial markets and negative impacts on the real sector businesses. Particularly, the facility of netting-of the payable / receivable value by any of the parties renders speculation a type of gambling in the light of the prohibition of gharar based sales. Hence gambling and speculation both may lead to loss to the competing parties which should not have been in the first place. Therefore, while speculation in the stocks trading may not be exactly similar to gambling, it has a number of ingredients that render it gambling in one way or the other. It has necessarily to be avoided in derivatives markets.

The above discussion reveals that hedging through financial derivatives could lead to even more risk by injecting excessive uncertainty in a contract at the inception that invokes prohibition due to being a type of gambling. This is further confirmed by the fact that even in conventional finance, only 2.7 per cent of the derivatives are used by the end users – remaining 97. 3 % are being used by the gamblers for speculation[4]. The position is further accentuated by the fact that fulfillment of relevant *sharīʹah* conditions for acceptable hedging process is almost impossible.

3. Swaps in the conventional framework

Swaps are the smartest of the structured derivatives excessively used by the conventional institutions over the last two decades[5]. A swap has been defined as a financial transaction in

[4] Dusuki, Asyraf Wajdi and Shabnam Mokhtar; ISRA Research Paper (No. 14/2010); The Concept and Operations of Swaps as a Hedging Mechanism for Islamic Financial Institutions; (p.48); Sami, Al-Suwailem; 2006, P 43.

[5] Although the world of derivatives comprises a wide variety of financial instruments, the most common derivatives fall into four categories: Swaps: Counterparties agree to exchange a series of cash flows at a future date; Options: Counterparties have the right, but not the obligation, to buy (or sell) an asset at a future date; Futures: Counterparties are bound by a standardised obligation to buy (or sell) an asset at a future date; and Forwards: Counterparties are bound by a non-standardised obligation to buy (or sell) an asset at a future date (Goldman Sachs Asset Management- A Pocket Guide to Derivatives). For evolution of derivative products, please see: Dusuki, 2009 and Al Swailum, 2006.

which two counter-parties agree to exchange streams of payments overtime according to a predetermined rule[6]. There are over a dozen types of financial swaps commonly used in conventional finance. The main types based on their relative importance are interest rate (IR) swaps, currency swaps, credit default swaps, commodity swaps and equity swaps.

Swaps objectives are stated to include hedging of financial risks, reducing financing costs, conducting large scale operations for more & more profits, access to new markets and, mostly, undertaking speculative activities to maximizing the gains[7]. Practically, however, swaps are being used as a tool of speculation for extraordinary benefits to innovators of the increasingly complicated synthetic products and the related market players. They provide the highest degree of leverage than any other categories of derivatives and could lead to insolvency of any big financial institution and even distort the whole system. Dr. Alfred Steinherr (1998: 200) cautioned in the following words: "Derivatives are Dynamite for financial crises and the fuse-wire of the international transmission at the same time. Unfortunately, the ignition trigger does not seem to be under control." [8] It was due to high speculative benefits that swaps deals increased exponentially; starting from 1981, the swap transactions reached approximately US $4.6 trillion by the end of 1992 and to more than US $ 415.2 trillion by the end of 2006[9]. According to ISDA Market survey, total IR, Currency and CDS outstandings amounted to US $ 457,177.71 billion as at the end of 2009.

SWAPS AND DERIVATIVES

Notional amounts outstanding at year-end, all surveyed contracts

(in billions of US dollars)

Year-end	Total Interest Rate and Currency Swaps outstandings	Total credit default swap outstandings	Total equity derivative outstandings
1987	865.60		
1990	3,450.30		
2000	63,009.00		
2001	69,207.30	918.87	
2002	101,318.49	2,191.57	2 ,455.29
2003	1 42,306.92	3,779.40	3 ,444.08
2004	1 83,583.27	8,422.26	4 ,151.29
2005	2 13,194.58	17,096.14	5 ,553.97
2006	285,728.14	34,422.80	7,178.48
2007	3 82,302.71	62,173.20	9 ,995.71
2008	4 03,072.81	38,563.82	8 ,733.03
2009	426,749.60	30,428.11	6 ,771.58

Source: CDS ISDA Market Survey annual data http://www.isda.org/statistics/pdf/ISDA-Market-Survey-annual-data.pdf

[6] Steinherr, Alfred, 2000; P. 292.
7 Dusuki and Shabnam, (Pp.6, 7), ISRA Paper No. 14 / 2010.
[8] Steinherr, Alfred; 2000; P. 194.
9 Based on the statistical reports issued by the Office of the Comptroller of the Currency (OCC), 97.3% of the total derivatives are used by dealers, i.e., speculators; Al-Suwailem (2006); P. 43.

4. Islamic Swaps

Incidentally, Islamic finance industry also developed fast with the dawn of 21st century when the financial engineers were able to develop "debt-based" *sukuk* and hedging instruments to replicate the conventional bonds and other products with addition of Islamic terms with regard to structuring, securitization and money market instruments including Islamic Forex swaps, Islamic Cross-Currency swaps, Islamic profit rate swaps, Islamic credit default swaps, Islamic repos, etc. Deutsche Bank (DB) published a white paper on the use of *w´ad* in January, 2007 (although, it had been structuring products in this way since 2005). In the specific mechanism outlined in the White Paper, the *w´ad* based Islamic swap is an agreement between the bank and the investor to swap the returns from two baskets of performing assets. When the assets are deposited with the bank, it agrees with the investor to hand over the return from the basket of haram assets at the due date, in return for the return from the basket of *sharī´ah* compliant assets. "The Investors will receive a profit or loss on their investment in the Securities based on the performance of the specified underlying reference asset or index (the "Reference Asset" or "Index") rather than the performance of the Shares in the Islamic Account". The Islamic investor takes the risk that the *sharī´ah* compliant assets he deposited with the bank could outperform the haram returns he will receive when the swap is conducted. Two promises are signed to ensure that both sides carry out their obligations on the due date. The transactions shall be deemed to take place as per promise to sell or purchase, as indicated in the Paper, "Following receipt of the relevant notice to perform the obligations of either Promise 1 or Promise 2 ... Islamic Account and DB shall be deemed to enter into an agreement on the terms of the form …" (P.3).

The need for Islamic CDS was emphasized after default of at least 10 *sukuk* issues in 2009. This call for Islamic CDS was made only months after the conventional CDS industry nearly brought down the entire international financial system. Mahmoud El-Gamal commented on the call in the following words, "*So, the most recent crisis has not taught the participants and experts of today's "Islamic finance" much (I use the quotation marks because they do Islam a great disservice by using it as a brand name to market their grossly inferior and poorly construed products for a profit). Will the customers at least finally see that this is not an infant industry that needs to grow*?" [10]

Although there could be some legal possibility to use CDS for genuine hedging, as long as there is some sort of direct link between the amount of the underlying assets held on creditors' books and the notional amount of the CDS; yet they certainly are open to manipulation as is currently happening in the derivatives markets. Further, the permission once granted, though limited, may lead to mass level unauthorized use by IFIs as experienced in case of organized *tawarruq*.

Some of the swaps structures introduced by IFIs are discussed below:

4.1 Islamic FX Swap

Islamic FX swaps are based on the structures of either *tawarruq* and /or *w´ad*. The *tawarruq* based structure normally involves two *tawarruq* transactions at the beginning and the end that

[10] http://elgamal.blogspot.com/2010/01/have-we-learned-nothing-here-come.html; the Blogspot of Dr. Mahmoud El-Gamal (January 03, 2010)

allows the same effect as achieved in FX swap. Problem arises when the parties involved want to exchange currency at some time in the future but fix a rate today when the contract is concluded. This contravenes the *ba´i-al-sarf* rule that it must be transacted on a spot basis. To avoid the prohibition, the concept of *w´ad* is used along with *tawarruq*. We briefly discuss the process adopted by the IFIs to fulfill the requirement of the *sharī´ah*. (The diagram and process flow, as explained by Dusuki and Shabnam can be seen in their paper – link given in the bibliography) Suppose an investor has Dollars and wants to invest in Euros; suppose the spot rate is USD1.45 for €1. The investor will buy a commodity worth USD14.5 million from broker A (through the bank) by cash. Then the investor will sell the commodity to the bank at the price USD14.501 million by credit with expiry date of one year. Bank will sell the commodity to Broker B by cash and obtain USD14.5 million. Thus, the Bank changes USD14.5 million to €10 million based on the spot rate. As Part- II of the process, bank will buy the commodity from Broker B worth €10 million by cash and sell the same to the investor at the price €10.141 million by credit. At the expiry date, the investor needs to pay the price of the commodity bought from the bank at €10,140,874. The bank also has to pay the investor $ 14,501,450 just now. The end result of the payments at the expiry date, is that both sides have converted $ and €at the forward rate.

The *w´ad* Structure of FX Swap involves *ba´i al sarf* at the beginning along with *w´ad* to carry out another *ba´i al sarf* at the future date. At the expiry period, the second *ba´i al sarf* is implemented to get back the original currency without being exposed to the risks of currency fluctuation[11].

4.2 Islamic Cross-Currency Swaps

Islamic Cross-Currency Swap involves a series of commodity *murabaha* transactions, not one as in case of FX swap, because it not only involves the principal value at the beginning and end, but also the stream of cash flow during the lifespan of the product. For example, a company has US Dollars; it makes investment in Euro denominated *sukuk* with quarterly paid yield. *Tawarruq* will be needed with receipt of every return so that the Euros received are exchanged with Dollars. In case of *sukuk* of 1.5 year duration, a series of six transactions will be executed. The investor company is asked to make *w´ad* to conduct a specified number of *tawarruq* transactions with the bank.

Thus, three stages of transactions need to be implemented by the both sides: i) Exchanging Dollars with Euros and making promise that the principal value will be changed back at the same rate on the expiry date; ii) *Tawarruq* transaction, on cash basis, between the Company and the bank each time the cash flow is received in Euros; and iii) At maturity, the investor company will sell Euro to obtain his Dollars back - execution of *ba´i al sarf* at the spot rate at the initiation.[12]

4.3 Profit-Rate Swaps

In profit-rate swap, cash flow from a floating rate is changed with a fixed rate. For example, a company has to pay rental based on LIBOR, which is, say 4.50 %; if it rises, the company will pay a higher rental every year. To make the rental payment a fixed obligation, it will buy from the bank a commodity valued at a fixed rate (5%, for instance). However, it must be noted that if the company enters into the profit-rate swap and LIBOR decreases to 4% for example, the company still needs to pay 5% as agreed. In other words, the bank will gain a profit from this

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[11] For details of the swap process, see Dusuki and Shabnam, ISRA Paper No. 14 / 2010; Pp. 31, 32.

[12] For flow diagram and details of the swap process, see Wajdi and Shabnam (2010); Pp. 32-36.

transaction. This means the investor company will usually forecast the floating rate before it enters into a profit-rate swap. In case the forecast is not accurate, he will not able to change his stance and cancel the said profit rate swap. If the company wishes to cancel the *w´ad*, it must pay compensation on the (actual) cost that is borne by the bank, if any. Hence, the company is again exposed to a risk for which it might not have a real need and against which it intended to hedge. It refers to the speculative nature of the transaction. No party pays the price of the commodity and only netting-off is made as happens in conventional profit rate swap. 'Actual' cost to the bank is nothing but the rate of differential and the speculative gain or the loss of expectation. To replicate the conventional profit rate swap, *muqāssah* (offset of net value) is made. Hence, on the transaction date neither party pays the real value. They only settle their respective obligations by *muqāssah*[13].

4.4 ***Sharī´ah*-compliant total return swap (TRS)**

The "*Sharī´ah*-compliant total return swap" works by using the concept of *w'ad* as in the case of profit-rate swap. As claimed by the developers, a client invests in *sharī´ah*-compliant assets, but the exposure is swapped for that of another asset that may be non- *sharī´ah* compliant. "Because the client's money is directly invested in *sharī´ah*-compliant assets, and the TRS is based on accepted Islamic principles, the investor is able to gain exposure to assets that, if invested in directly, would be forbidden". TRS opened the market to a whole array of underlyings that would otherwise be prohibited. It also offerd flexibility to product providers meaning that they can offer many of their existing products to Islamic clients simply by adding a total return swap. The process of *w´ad* based TRS has been technically termed as "*Sharī´ah* Conversion Technology". As explained by the bank that offered TRS product, the purpose was to provide Muslim investors access to funds that operate in a non-*sharī´ah* compliant manner by "reflecting their performance."[14] The bank claimed that the investor's money is used to purchase a principal protected note, structured by a multinational bank, which invests in simple *salam* or *murabaha* contracts. The contract includes an agreement, no more than a promise (a purchase undertaking), that if the returns from the *salam* are less than the returns from a particular index, or group of funds, then the structuring bank will pay the investor amounts equal to the returns from the index, or group of funds. To be more precise, if the designated index or fund outperforms the *salam* investment, the investor will earn returns that are better than the *salam* returns. Bank claims that since the bank will pay investors with its own money, the investors will not receive returns directly from the conventional index or group of funds (funds which may be using strategies that are non-*sharī´ah* compliant, investing in stocks that have never been screened, and selling securities that they borrowed but never owned, to say nothing of investing in interest-bearing bonds, futures, or any of a host of derivative instruments).

As analyzed by Shaykh DeLorenzo, "the Islamic client's investment in this product triggers a series of transactions, none of which is *sharī´ah*-compliant. Moreover, these produce fees and earnings for other than the *sharī´ah* investor. Can the *sharī´ah* board of the Islamic bank ignore all of this, and approve the entire transaction because the first link in the series is basically a *salam* or a *murabaha*? Or is the *sharī´ah* board compelled to consider the transaction in its

[13] Netting-off in transactions where subject matter on both sides do not exist is void (Fathul Bari, Beirut, 1379 H; Vol.4, P. 380-382); For details of this swap process, see Dusuki and Shabnam; pp. 37-39.

14 Cf: DeLorenzo; 2007. This, however, seems to be a misrepresentation of the truth. The term sheet for one such product states unequivocally that its purpose is to "wrap a non-Sharī´ah compliant underlying (asset) into a Sharī´ah compliant structure." http://www.dinarstandard.com/finance/DeLorenzo.pdf

entirety?" "…While giving details of the money trail in the TRS process; he has pointed out how the investor's money, even though it remains in *salam* contracts, is actually put to work in ways that are clearly not in compliance with *sharīʹah* rules[15].

DeLorenzo also observed: "It is a mistake to say that the haram basket is no more than a benchmark. As a mere benchmark it has nothing to do with the transaction. In a *wʹad* swap it is what creates the returns, and that is the problem. If you're going to swap returns of one basket of performing assets for another, then you must insist that the assets in both baskets are *halal*. Only then can you be sure of receiving returns that are *halal*." But the *sharīʹah* related objection was rejected by saying that "a difference of opinion by Islamic scholars is nothing unusual ... there are some scholars who do not accept even Commodity *murabaha*…". Sheikh Dr Hassan was reported to have claimed, "The *wʹad itself* is nothing new, and has been used in Islam in different ways, but the innovation is in the way the *wʹad* is put together with other contracts and features. As a result, we can offer payouts and exposure to asset classes in a way that had not been done before." In my humble opinion, however, it in no way seems to be acceptable if we keep in view the claim of the financial innovators, "One of the main innovations in the market has been the ability to ***benefit from conventional yields, like index products, whereby the underlying index need not necessarily be sharia-compliant***. It can be a hedge fund, for example, and the investment will still be *sharīʹah*-compliant if so approved by a scholar".[16]

5. Issues to be analyzed from *Sharīʹah* perspective

The swap structures discussed above involve a number of issues that need to be discussed in the light of the *sharīʹah* principles. The issues may include:

1) Separation of risk from ownership and trading in excessive risk;
2) Use of *wʹad* as alternative to *'aqd* (a full-fledged contract);
3) Use of organised *tawarruq* – the issue of validity of commodity *murabaha*;
4) Rules of *baʹi al sarf* and creating complications by combining of several contracts;
5) Swaps' use as a tool of hedging or speculation;
6) Letter verses substance - Swaps role in achieving *maqāsid*-al- *sharīʹah*

5.1 Separation of risk and trading in risk

A fundamental feature of derivatives including swaps is that risk is separated from ownership and separately traded as a commutative contract, while in Islamic finance risk, like reward, always remains with the ownership (*al-ghunm bil-ghurm*) (for details see El Gari, 2003, pp. 11-17). All types of swaps that we have discussed involve *gharar* and the most of them also involve *riba*. Involvement of *gharar* in commutative contracts renders such contracts invalid as almost all contemporary *sharīʹah* scholars believe as in case of conventional insurance - considered haram due to invalid transfer of risk to the insurer against payment of premium. Apparently trading is made a part of the swap structures, but no such trading actually takes place, as we will discuss in the part on commodity *murabaha*, and the net loss or gain is paid or received rendering the whole process a type of gambling. Uncertainty is created *ab initio* in the contract and, as a result, gain of the one is accompanied with loss of the other.

5.2 Use of *wʹad* as alternative to *'aqd*

Islam has divided the contracts into the categories of commutative and non-commutative and the jurists have framed well-established rules for the both categories. For example, while *ba'i* and

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[15] DeLorenzo; see the link: http://www.dinarstandard.com/finance/DeLorenzo.pdf

[16] Luma Saqqaf, head of the Dubai based Islamic finance group at law firm Linklaters: http://www.risk.net/risk-magazine/feature/1506267/structuring-sharia

ijarah are the means of business for earning profit, *qard* (loaning) and related activities like *hawalah* and *kafalah* are non-commutative and making them earning source is strictly prohibited. A *w´ad*, on the other hand, is simply an accessory activity and a committment, although extremely useful and important tool for conducting any prudent business, in addition to its role as a religious and moral norm. Below, we shall discuss various aspects of *w´ad* in some detail.

The words *w´ad* (promise) is considered as a necessary risk mitigation technique in *murabaha*, *ijarah* and diminishing *musharakah* and as a tactical part of the structured contracts like commodity *murabaha* and 'Islamic' derivatives like options and swaps. Promise could be unilateral or bilateral (called *muwa´adah*), although the latter is considered as a contract by majority of the *sharī´ah* scholars as also by the OIC Fiqh Academy and AAOIFI.

Although promise is morally and religiously binding according to the tenets of the *sharī´ah,* it was considered neither mandatory nor enforceable according to the majority of the classical jurists probably because it was not considered a customary contract. Liability / right was considered to be created only after a regular 'offer & acceptance'. For the Maliki school, fulfilling a promise is obligatory if the non-fulfillment entails difficulties or cost for the promisee. It implies that in case the promisee conducted any activity pursuant to the promise, and the promisor backs out, the latter needs to compensate the former. To Ibn Al-Arabi, Ibn Shubramah and some others, fulfilling a promise is obligatory and enforceable except where otherwise justified (provided it does not allow the prohibited things, and not prohibits the permissible things). Based on this approach, promise is considered legally enforceable to the extent that if the promisee has incurred some expenses or taken some liability as a result of the promise, he / she has a right to recover the loss occurring due to non-fulfillment of promise until and unless the promisor is not in a position to fulfill it on account of any *force majeure*. Consensus of the contemporary jurists is that if non fulfillment is due to any willful act of the promisor, he/she has to make good the loss occurring to the promisee[17]. Although, *w´ad* does not refer to a formal contract in the *sharī´ah* framework, some practitioners have transformed it from the category of voluntary offer and commitment to that of a full-fledged commutative binding contract (*´aqd*) in one way or the other (as discussed by Rafic Yunus al-Masri, as we will see in next sub-section).

In late 1970s and early 1980s, when Islamic banks started using banking *murabaha*, problems arose due to refusal to buy by the client after purchase of the asset by the banks as per the promise. Jurists issued *fatāwa* to resolve the issue. Sheikh Abdul Aziz bin Baz, the grand (late) Mufti of Saudi Arabia seemed to be more careful while decreeing that promises to sell are permissible provided that the goods that have been pledged are owned by those who made the promise[18]. The *sharī´ah* committee of the Kuwait Finance House (in 1979) and the Islamic Fiqh Academy of the OIC in its fifth meeting (1988) resolved that a unilateral promise is binding both morally and legally only upon the side that makes the promise. The resolution regarding promise, as involved in banking *murabaha*, is as follows:

[17] See for details: Vogel & Hayes, (1998), Pp. 125 – 128; Ayub, 2007, Chapter 5; Abdullah, Nurdian Irwani (2008)..

[18] Resolutions of the securities Commission *Sharī´ah* Advisory Council, p. 138, adapted from Mohamad Sulaiman Al-Asyqar, " Bay' al-Murabahah kamaTajrihi al-Bunuk al-Islamiyyah". Working paper presented at the 2nd Islamic Finance Convention in Kuwait on 21-23 march 1983.

> "A promise—unilaterally given by one party (either the [purchase] orderer or to whom the order [to purchase] is given) binds the promisor morally, unless there is a reasonable excuse. It is also legally binding if it is made conditional upon the realization of a condition, and if the promisee has incurred expenses as a result of the promise. The binding status of the promise in this situation implies that the promise must either be fulfilled, or the promisor must pay compensation based on the actual cost or losses incurred by the promisee as a result of the non-fulfillment of the promise without any reasonable excuse."

As per AAOIFI's *Sharīʹah* Standard, customer's promise to purchase and other related undertakings must not be integral to the *murabaha* transaction. Purchase undertakings are merely intended to provide an assurance that the customer will purchase the commodity after it has been acquired by the institution. Further, both parties can mutually agree to revise the terms of the promise in respect of the deferment of the payment, the mark-up etc. at any time before the execution of the *murabaha* transaction[19]. Any revision or amendment of terms with mutual consent of the promisor and the promisee is allowed because a promise is not a contract and no right is established merely by the promise. As such, any amendment to the profit margin in subsequent *murabaha* transaction and the duration will not amount to rescheduling of debt which is also prohibited by the *sharīʹah*. No such provision is made in promises made or taken in so-called Islamic swaps.

5.2.1 Bilateral Promises (*muwaʹada*)

Binding bilateral promises (*muwaʹadah*) (given reciprocally by both parties with the effect that each one is the promisor as well as promisee) are not valid as per the *sharīʹah* principles. The Islamic Fiqh Academy resolved in this regard:

> Bilateral promises (given by each party to one another) are permitted in murabaha sales with the condition that either / both parties have the option not to enter into the sale; however, if there is no such option, such a promise is not allowed because a binding bilateral promise in a murabaha sale is similar to the sale transaction itself, in which case the requisite condition is that the seller must be the owner of the commodity being sold so that the prohibition by the Holy Prophet (peace be upon him) for the people selling what they do not possess is not circumvented[20].

According to AAOIFI as well, bilateral promises are not permissible, unless the option to annul is granted to one or both parties. Keeping in view the verdicts of the top level standard setting institutions of Islamic finance, one would not expect that the both parties' promises in organized *tawarruq*, swaps and other structured transactions could be allowed by the *sharīʹah* committees or the scholars associated with IFIs. Dusuki and Shabnam (2010) have rightly observed in this respect:

> "Therefore, it is very important to ensure that *wʹad* execution is further refined so that there is no issue of *muwaʹadah*, where two parties make promises to one another, for this resembles a conditional sales agreement, which is prohibited. This is also to ensure that this *wʹad* is not misused for a wrong purpose which does not fulfill the demands and objectives of *sharīʹah*.[21]"

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[19] AAOIFI, Clauses 2/3/1 to 2/3/4 of the *sharīʹah* standard No. (8)

[20] Council of the Islamic Fiqh Academy, 'Resolutions and Recommendations' (1985-2000), IRTI, IDB, Jeddah, 2000; Pp: 86, 87 (Resolution 40 & 41 (2/5, 3/5).

[21] Dusuki and Shabnam Mokhtar; ISRA Research Paper (No. 14/2010); P. 53.

Practically, however, some institutions have developed a variety of swaps using "two unilateral independent promises" (that also involve organized *tawarruq* in the garb of *murabaha*). "*Amiri Capital*", as part of their effort to set up "*Sharī´ah-Compliant Hedge Funds"* and prime brokerage services, introduced a short-selling mechanism by use of the *w´ad* structure[22]. That short-selling method involved offsetting *w´ad* between the Islamic Investor (Islamic fund manager) and the bank/prime-broker. The transaction involved two *w´ad* for counterparties facing one another. The provision given in the suggested swap structure that only one promise is in effect at one time, does not serve the purpose due to the conditional nature for the both parties. It rather amounts to a full-fledged bilateral promise based contract designed to convert a non-*sharī´ah* compliant deal into a *sharī´ah* compliant transaction using some Islamic wrappers. One cannot understand how the two reciprocal promises are unilateral and independent when no party is given option for not entering into the contract, and if either party wishes to cancel, it has to pay on the basis of *muqāssah*.

The Deutsche Bank's Academic Paper offered a philosophical study regarding *w´ad* in Islamic business and finance. The study argued that promise must be legally binding and explained generally accepted view in the following words:

> "In Islamic law, a simple promise seems to be different from a contract in that a contract is always effective in the present, while the simple promise seems to involve the future. Nothing actual or tangible is fulfilled by the act of promising. Rather, an obligation to do arises on the part of the promisor at a purely moral level, as there is no object in actual existence at the time of promising. Thus, Islamic law does not recognize a contract which has as its object a future thing, or an agreement to agree, or the exchange of an obligation for an obligation (Bay'al-Dayn bi al-Dayn)"[23].

However, the study neither discussed whether *w´ad* could be used for prohibited transactions nor the crucial issue of consideration for *w´ad*. According to the generally accepted principle, consideration for *w´ad* is not permissible. As there is 'no object in actual existence' at the time of promise, there should be no consideration for making a promise. But, the way the swap products have been Islamized, promise involves consideration by any of the bilateral promisors as no 'actual' loss is incurred by the other party because none of them have invested any amount and there is only net settlement (*muqāssah*). *Islamic Finance Resources* blog commented on the swap structure using *w´ad* in the words: "Note that with this amazing swap, anything and everything is possible. As one Belgian banker said with excitement, "yes, it is possible to have *sharī´ah* compliant pork bellies (Astaghfirullah!)".[24]

Rafic Yunus al-Masri also made a candid study on the subject discussing the relevant decision of the OIC Fiqh Academy. Starting from the use of promise in *murabaha* operations, he has discussed *w´ad* use in derivatives. Having discussed the binding promise in *murabaha* he observed, "Had they stopped at that point, and had the unilateral promise (*w´ad*) remained non-binding, there would not have arisen any problems … but … they went a long way in elaborating, amplifying, dissecting, and subcategorizing, … so much so that the binding unilateral promise came to replace the contract which is proscribed by Islamic law".

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[22] http://islamic-finance-resources.blogspot.com/2009/03/shariah-compliant-short-selling.html

[23] Deutsche Bank Academic Paper, "Pioneering Innovative *Sharī´ah* Compliant solutions" http://www.deutsche-bank.de/presse/en/download/White_Paper.pdf

[24] http://islamic-finance-resources.blogspot.com/2009/06/shariah-compliant-swap-i-shariah.html

As observed by Al-Masri, binding promise is being used as an alternative to the proscribed contracts and this requires serious view by the *sharī´ah* scholars. Al-Masri is of the view that "The difference of opinion among jurists on the plain unilateral promise (*w´ad*) should not be extrapolated to the unilateral promise (*w´ad*) that substitutes for the contract, since in this case the unilateral promise (*w´ad*) may not be binding under any circumstances"[25].

Here we can particularly refer to the rule applicable to *ba´i al sarf* in which exchange of counter values from both sides has to be hand-to-hand. In such contracts even *khiyar al shart* is not valid. Similarly, in all non-commutative contracts that are binding for one, but not for the other party, like *waqf, hibah, qard*, *kafalah, rahn*, etc*, khiyar al shart* is not valid[26]. Then, how promise with the effect of a binding commitment could be regarded as valid and how the quasi agreement of promise could be allowed to transact currency business or Forex exchanges with the proviso of *muqāssah*. As discussed earlier with reference from *fathul bari*, *muqāssah* in such exchange is not valid where both counter value are absent or not yet due. The scholars in late 1990s had allowed forward cover in currencies on the basis of *w´ad* only for fulfilling the real exchange needs of the traders and not for making speculative gains in the Forex business. The *'Commission for Transformation of the Financial System'* established by the State Bank of Pakistan in 1999 in terms of the Judgment on *Riba* by the Supreme Court of Pakistan had specifically mentioned the following condition for forward cover that could be considered valid:

> "The amount of foreign currency is needed for genuine trade or payment transactions. The need will have to be supported by appropriate documents so as to prevent forward cover for speculative purposes." It means that a currency dealer would not be permitted to get a forward cover[27].

Hence, it seems that the concept of promise has been used only to synthesize the futures contracts that are otherwise disallowed. About the *sharī´ah* scholars who allowed such transactions, Shaykh DeLorenzo observed, "...they have made a serious mistake. So serious, in fact, that in my paper on the subject I have called their decision the Doomsday Fatwa... it is likely that those scholars fell into the trap of literalism". ...[28]

5.2.2 ISDA-IIFM *Tahawwut* Master Agreement

In the swap structure suggested by ISDA and IIFM jointly, institutions can transact Islamic hedging transactions such as profit rate swaps and currency swaps. The parties are made to understand that *"no interest shall be payable or receivable and no settlement based on valuation or without tangible assets is allowed; …though the structure of the document is similar to the conventional ISDA Master Agreement…, the key mechanisms and provisioning such as early termination events, closeout and netting are developed based on the Islamic sharī´ah principles"*. By incorporating the bilateral promise, the swap structure has been made too complicated to enter into any *gharar*-free deal leading to clear rights and liabilities of the parties. In the profit rate swap, for example, "bank enters into *w´ad* under which customer can, by

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[25] Al-Masri, Rafic Yunus; The Binding Unilateral Promise (wa´d) in Islamic Banking Operations: Is it Permissible for a Unilateral Promise (*w´ad*) to be Binding as an Alternative to a Proscribed Contract? J.KAU: Islamic Economics., Vol. 15, pp. 29-33 (1422 A.H / 2002 A.D).

[26] Ibne Qudama, Al- Mughni, Vol. 6, Pp 49, 50. In *khiyar al shart*, the buyer reserves an option for him to annul the sale within (3) days, after which the sale becomes finally effective. Also see: Al Jazeeri; Kitab al Fiqh…; Ulama Academy, Awqaf Department, Punjab, Lahore; November, 2006; Vol 2; P. 237.

[27] See: Ayub, 2007; Chapter. 14 (14.4.5)

[28] http://dinarstandard.com/finance/DeLorenzo.pdf; http://dinarstandard.com/finance/DeLorenzo012308.htm; (excessed on Sep 4, 2009).

exercising *w´ad*, require the bank to purchase (under *murabaha*) **Zinc** from the customer at the **fixed rate price** payable on the relevant quarterly settlement date". As a reciprocal, "customer enters into *w´ad* under which the bank can, by exercising *w´ad*, require the customer to purchase (under *murabaha*) **Aluminum** from the bank at the **floating rate price** payable on the relevant quarterly settlement date".[29] The crux of the matter is that the metals are being used only as a vehicle for speculation and the netting-out is an integral part of the whole structure indicating that there would be no actual exchange. The TMA primarily covers the risks relating to relationship framework like events of early termination, netting mechanisms and representations. It does not deal with usage and structure of hedges and the risks arising from assets / liabilities. *Murabaha, musawama* and *w´ad* based products are included in the structure framework[30], which implies that practitioners will ultimately be using organized *tawarruq*.

5.3 The issue of validity of *Tawarruq* in derivatives

In its crude form, which is considered permissible in acute individual needs by almost all jurists, *tawarruq* may be defined as purchase of commodity on deferred payment basis and selling it to any third party at lower price (in the market) on cash, thus getting liquidity by way of incurring return based debt that was the real purpose behind the trade transaction. But IFIs are using 'organised *tawarruq*' with involvement of brokers and the concept of *w´ad*, while the conditions of possession and ownership / risk transfer are hardly ever fulfilled. The designated assets are just an entry to the brokers' books and the legal documentation and legal framework indicate that there is no intention or even possibility of the parties to give or take delivery as required for a valid sale transaction. As a liquidity management instrument, this process serves the same purpose as inter-bank deposits serve in the conventional system. In some cases delivery Order (D.O) is issued as an evidence of sale to satisfy *sharī´ah* scholar. The D.O. is either without the option of taking delivery, or with option to take possession. The latter case is generally avoided because an additional price impact has to be borne in this regard.

The Islamic Fiqh Council of the OIC in its 19th Session held in April 2009 issued a *Fatwa* on 'organized *tawarruq*' and 'reverse *tawarruq*' declaring them non-*Sharī´ah*-compliant. "It is not permissible to execute both *tawarruq* (organized and reversed) because simultaneous transactions occur between the financier and the *mustawriq*, whether it is done explicitly or implicitly or based on common practice, in exchange for a financial obligation. This is considered a deception … in order to get the additional quick cash from the contract. ……….". The Council considered it as a ruse to circumvent the prohibition of *riba* and rejected its approval on the basis of *maslahah,* as contended by a few scholars. The Council described the process of organized *tawarruq*: "when a person (*mustawriq*) buys merchandise from a local or

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[29] http://www.iifm.net/default.asp?action=article&id=155**;** It is ironical to note that the IIFM's *sharī´ah* advisory panel has approved only the '*Tahawwut* Master Agreement' (TMA) and not the transactions made under this. TMA says, "No *sharī´ah* approval is given by the IIFM *sharī´ah* Advisory Panel with respect to any transactions, DFT term Agreements or credit support arrangements or any amendment to this ISDA IIFM TMA" (P. 1). It is more likely that in actual practice, real transaction, actual transfer of ownership of the real assets, real settlement and other *sharī´ah* related conditions, will seldom be observed as it happened in the case of Tawarruq, that in principle was allowed, but subsequently prohibited by the OIC Islamic Fiqh Council due to unwarranted use by the IFIs. Further, some loopholes have been left that could lead to non-performance by the parties as required by the Sharia rules. For example, any party has no obligation to make any payments or deliveries in case of even a **potential** event of default with respect to the other party (Section 2(a)).

[30] IIFM; link given in the Bibliography.

international market on a deferred price basis. The financier arranges the sale agreement either by himself or through his agent. Simultaneously, the *mustawriq* and the financier execute the transactions, usually at a lower spot price. Reverse *tawarruq* is similar to organized *tawarruq*, but in this case, the *mustawriq* is the financial institution, and it acts as a client, according to the document"[31]. The Council observed, "Islamic banking and financial institutions should avoid all dubious and prohibited financial techniques in order to conform to *sharī´ah* rules and to realize the *sharī´ah* objectives (*maqāsid-al-sharī´ah*). It will also ensure the development and realization of the socioeconomic objectives of the Muslim world. If the current situation is not rectified, the Muslim world would continue to face serious challenges and economic imbalances that will never end". Fiqh Academy of the Muslim World League, Makkah also discussed *tawarruq* as practiced by Islamic banks in its seventeenth session held in December 2003 and forbade it.[32]

Similarly, AAOIFI Standard on *Tawarruq* does not approve the fictitious trade transactions with cosmetic involvement of any third party. The Standard allows *tawarruq* transaction only if the client that has purchased the commodity from the bank sells it either himself or through its own / separate agent – meaning that bank or its agent should not sell on customer's behalf if the customer had initially bought that commodity from the bank. Particularly, Articles 4/5, 4/7, 4/8, 4/9 and 4/10 of the Standard highlight the divergence between the AAOIFI's permitted *tawarruq* and the currently practiced organized *tawarruq*. Reality is that fulfilling the conditions of AAOIFI or Fiqh Academy renders the *tawarruq* economically unfeasible. As such, the IFIs seemingly enter into a large number of separate transactions, but typically operate a netting facility between their storage facilities. They use and reuse the same stock many times during the same day in numerous consecutive sales – "rather than specifically identifying and subsequently 'releasing' the metal for each transaction, all the transactions for a certain day are carried out without such demarcation and hence even this minimal transfer of constructive ownership does not really happen in most cases. Daily net positions dictate the overall net stock balances, i.e. how much is encumbered and how much is free to be used for new *tawarruq* transactions"[33].

Quoting from Ibn Qayyim Al-Jawziyya, El-Gamal (2006:71) has indicated the *hanbali* denunciation of organized *tawarruq*. Ibn Taymiyya has been reported as saying, "The precise economic substance for which *riba* was forbidden is present in this contract, and transaction costs are increased through purchase and sale at a loss of some commodity. Sharī´ah would not forbid a smaller harm and permit a greater one".

Despite the verdict by the apex sharī´ah bodies, tawarruq is being used in covered drawings, in top-up facilities, in mezzanine financing, in liquidity management and in working capital finance (among other things)"[34]. More serious issue is that capital is provided through commodity *murabaha* generally to the conventional banks that, as agents for buying and selling, do not bother for quality, quantity of the goods or fulfilling the *sharī´ah* essentials of trading in general and *murabaha* / *musawamah* in particular. The end of the process is very simple and banks (mostly, conventional) get funds (pay interest) through a series of paper haggling. IFIs

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[31]Resolution 179 (19/5) in relation to Tawarruq; its meaning and types.
[32] Cf: Islamic Finance: Law, Economics and Practice; Cambridge University Press, 2006; P. 72
[33] Salman H. Khan; Organised Tawarruq in Practice: A Sharī´ah Non- compliant and Unjustified Transaction; NewHorizon, October-December, 2010.
34 Nikan Firoozye; Featured Structure: Tawarruq: *Sharī´ah* Risk or Banking Conundrum, Opalesque Islamic Finance intelligence; June 23, 2009;
http://www.opalesque.com/OIFI12/Featured_Structure_Tawarruq_Shariah_Risk_or_Banking438.html

undertaking this practice for arbitration, passing on a part of the return received from the conventional institutions to their depositors. Money deposited with IFIs for the purpose of *sharī΄ah* based banking is used to provide support to the conventional *riba* and *gharar* based financial system which causes serious reputational risk to Islamic finance.

In the view of this writer, there can be no disservice to the cause of Islamic finance greater than this. Umer Majid, director, Halal Investment Bank in UK, said in the Islamic Funds World conference held in Dubai in 2008, in which *w΄ad based* swap transaction was discussed, that British Muslim investors were becoming distrustful of *sharī΄ah* compliant investment products; "They feel they are being given conventional products with Islamic labels,". It has also stopped journey of financial system to real sector economy to help resolve serious problems facing global economy. Malaysian scholar Aznan Hasan has explained how the *sharī΄ah* auditors managed to uncover non-*sharī΄ah* practices by brokers on the LME. Hasan discovered the frequent overlapping ownership of underlying assets and exposed what he termed "Fictitious *Murabaha*" activities undertaken by some LME brokers. "After a *sharī΄ah* audit he illustrated how commodity broker (A) when selling a commodity, involved multiple and simultaneous ownership, meaning one particular commodity was sold to more than one buyer"[35].

Therefore, an overwhelming majority of the scholars is not in favour of allowing *tawarruq*. The AAOIFI and the scholars who allow limited use of *tawarruq* have placed a number of conditions for its permissibility. For example, Mufti M. Taqi Usmani, one of the scholars who allow it, has advised the following with regard to acceptable *tawarruq*[36]:

a) The use of organized *tawarruq* should be reduced because it might be deemed a stratagem, thus *sharī΄ah* advisors must monitor this.
b) If the bank appoints the *mutawarriq* as its agent to buy the commodity on behalf of the bank and later sell it to itself, this transaction is not valid.
c) Besides that, if after buying the commodity from the bank, the *mutawarriq* later appoints the bank as his agent to sell it in the market and this matter is stipulated in the contract, it makes the transaction invalid.
d) *Tawarruq* through the international commodity market such as bourses is not allowed, as actual sales do not happen.

It is not difficult to understand that fulfilling the above conditions is just impossible for any of the swaps and hedging type of structured products innovated during last few years. Mahmoud El-Gamal, while commenting on a few scholars' disapproval of the Fiqh Academy's Fatwa on organized *tawarruq*, observed, "….they seem to have paid little attention to whether or not conventional forms of secured lending (e.g. mortgage finance) are forbidden *riba*. Their own logic can be turned against them, especially since it seems that they would like for the customer who avoids a secured lending transaction such as mortgage instead to engage in buying aluminum on credit and selling it back for cash with which to buy (or refinance) the property at a higher cost. If the secured lending transaction was *ribawi*, then this "organized *tawarruq*" must be even more *ribawi*, because the cost is higher, and it is in fact closer to unsecured lending of cash at interest than the mortgage transaction where there is never any money-for-money loan".

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[35]Khnifer, Mohammed (2009); US$ 31 billion vaporised after Usmani *sukuk* comment, Aleqtisadiah newspaper;
36 Usmani, M. Taqi; (2009) Ahkam al-Tawarruq waTatbiqatuhu al-Masrafiyah; OIC Islamic Fiqh Academy, 26-30 April, 2009 cf: Wajdi and Shabnam, 2010, P. 51.

Tawarruq transactions do not provide any link with the real sector of the economy. The ban on the debt as a form of business is a unique feature of Islamic finance. But, *tawarruq* sabotages this ban as lending and borrowing against rent remains the real feature of the activity undertaken to circumvent the prohibition of *riba*. It makes easy to borrow and puts IFIs on par with conventional financial institutions to lend in order to make use of surplus liquidity. Dr. Nejatullah Siddiqi says about this aspect of *tawarruq*, " It is an unfair transfer of wealth; it is inefficient as it penalizes entrepreneurs and rewards rentiers; it leads to instability as it creates obligations irrespective of whether they can be met or not"[37].

There seems to be a quick competition in innovation of risk-free products without regard to the *sharī´ah* inspiration as they claimed about the product to be, "the world's first-ever standardized master agreement in Islamic finance." The IIFM launched its Master Agreement for Treasury Placement (MATP) in October 2008 for the use of over-the-counter (OTC) commodity *murabaha* transactions worldwide. Despite the Fatwa and AAOIFI's announcement that it would screen Islamic banking products for *sharī´ah* compliance to promote uniformity, banks are exceedingly using *tawarruq* for deposit mobilization, debt-based financing and hedging that may be speculation. In August 2009, the Association of Islamic Banking Institutions Malaysia (AIBIM) -- which comprises Bank Islam, CIMB Islamic and the Malaysian units of Kuwait Finance House and Al Rajhi, etc. launched a standardized *murabaha* deposit contract comprising 'Interbank Master *Murabaha* Agreement (IMMA)' and a Master Agency Agreement (MAA). It is ironical to note that according to their own estimate, "some 60 percent of the proceeds of the global commodity *murabaha* business are currently leaking into non-Islamic investments"[38].

5.4 Circumventing the rules of *ba´i al sarf* and complex nature of Contracts

The swaps' mechanisms, as discussed above, involve *ba´i al-sarf* and combination of promises and several contracts that are made integral part of the whole structure. Making a series of conditional contracts and binding promises integral part of any contract structure invokes prohibition due to involvement of *gharar* and *riba*. According to Islamic law, the contracts with different nature and objectives, as commutative and non-commutative contracts, and contracts with contradictory implications cannot be merged.

AAOIFI's Standard for Guarantees says with regard to providing guarantee by the manager (*mudarib*) as an agent, "It is unlawful to combine agency with a guarantee in a single transaction because to do so is contrary to the requirements of both. This is because to stipulate a guarantee by an investment agent transforms the operation into a loan with *ribawi* interest, guaranteeing [the return of] principal while offering returns from the investment"[39]. By analogy, one cannot become guarantor as a result of the commitment by way of promise; one has to be rather bound by way of regular guarantee contract.

The Holy Prophet (pbuh) instructed one of his Companions to sell low-quality dates first and then buy the high-quality dates he wanted, instead of resorting to exchange of a greater quantity of low quality dates for a lesser quantity of high-quality dates. Similarly, exchange of money and monetary units is subjected to hand to hand mutual delivery by the parties with the purpose of saving any of the parties from any undue possible loss. However, some contracts can be combined provided that each contract is permissible on its own and subject to observance of prescribed rules. According to AAOIFI, prior agreement for combining the contracts that

[37]Siddiqi; 2007:http://www.siddiqi.com/mns/Economics_of_Tawarruq.pdf
[38]Arab News: http://www.menafn.com/qn_news_story_s.asp?StoryId=1093244593
[39] AAOIFI Standard 5: Clause: 2.2.1 and 2.2.2.

contradict to or oppose each other is prohibited because it leads to performing an act that has been prohibited by the *sharī΄ah* [40]. AAOIFI has indicated following conditions for combining various contracts into one single transaction in its Standard No. 25:

1) Combining contracts should not include the cases that are explicitly banned by *sharī΄ah*. For example, contracts that combine a sale and a loan into one contract;
2) Combining contracts should not be used as a ploy to commit *riba*, such as an agreement between two parties to practice a sale and buyback transaction (*al-΄inah*) or *riba al fadl*.
3) Contract combining should not be used as an excuse for practicing *riba*. ….
4) Combined contracts should not reveal disparity or contradiction with regard to their underlying rulings and ultimate goals ...

Sharī΄ah Advisory Council of Kuwait Finance House in Meeting No. 23/2006 on 19th September 2006 in Kuwait, while evaluating the *ijarah* /Rental-Rate Swap based on unilateral binding promise in the *musawamah* and *tawarruq*, laid down four main conditions to ensure that the product complies with the *sharī΄ah*: i) The agreements in that structure are actual, not fictitious (*suri)*; ii) It has its normal effects, e.g. a sale agreement gives the effect of ownership transfer to the buyer (*milkiyyah taammah*); iii) The agreements are separate; and iv) The agreements are independently enforceable, not conditional (upon one another).[41]

5.5 Swaps' use as a tool of speculation

As indicated by Dusuki and Shabnam (2010), "almost all swap products applied by Islamic financial institutions have been approved by their respective *sharī΄ah* advisory bodies on the condition that they be used as a hedging mechanism in risk management. This means the products cannot be used for the purpose of conducting speculative trading activities meant to generate profit"[42]. ISDA-IIFM TMA also indicated following conditions for its use: i) Transactions entered into under the TMA should only be for the purpose of hedging actual risks of the relevant parts; ii) Transactions should not be entered into under the TMA which are for the purposes of Speculation and iii) Transactions must be real transactions, involving the actual transfer of ownership or real assets, actual risk and real settlement[43].

Although, the swaps technique may apparently be used for hedging to mitigate the risk, but practically it results in taking *gharar* related prohibited risk and the ground reality is that almost the same level of risk is faced by the investor even after the swap transaction. Dusuki and Shabnam, while explaining speculation in such swap transactions with an example, observe the following:

> "However, it must be reminded that if the company enters into the profit-rate swap and LIBOR, (that in the beginning was 4.75 % with the fixed rate of 5 %), decreases to 4% for example, the company still needs to pay 5% as agreed. In other words, the bank will gain a profit from this transaction. This means the investor will usually forecast the floating rate before he enters a profit-rate swap. In case the forecast is not accurate, he will not be able to change his stance and cancel the said profit rate swap (he will have to

[40] AAOIFI Standard No. 25; Clauses 4/4, 6/3/4
[41] Dusuki and Shabnam, ISRA, 14/2010; Cf: Ahmad Suhaimi Yahya (2008) Hedging Mechanism in Islamic Finance According to *Sharī΄ah* Perspective; Presented in the 3rd *Sharī΄ah* Advisors Islamic Finance Dialogue, organized by Centre for Research and Training (CERT). 17 November, 2008. Kuala Lumpur.
[42] For details see: Dusuki and Shabnam, op.cit. P. 47.
[43] IIFM; op.cit

> compensate for the actual loss to the bank). Notice that the investor benefits if the floating rate is higher than the fixed rate that was agreed upon (i.e. the investor gains a positive offset); however if the floating rate is lower than the agreed fixed rate (5%), the company needs to pay the bank. Nevertheless, this profit-rate swap gives certainty to the company. The company must choose, does it want certainty or is it willing to take the risk of fluctuations in the floating rate. If it wants certainty, it must forego the possibility of profiting from such fluctuations.[44]"

The question arises as to what certainty it gives to the company; and what type of 'actual cost' is (other than the loss of expected return on the underlying notional) against which investor has to compensate while no real transaction is involved and there is only netting off? The 'actual cost' is not covered under the analogy of *thaman-al mithl* or *'iwad-al mithl* as argued in the DB's white paper (P.20). The doctrine of *'iwad-al mithl* cannot be invoked for return on financing provided under *musharaka*, *mudaraba* or even under trade based debt creating modes wherein the buyer is obliged to pay only the price specified in the contract. The case of *fasid* (voidable) *mudaraba* also cannot be used for analogy for 'actual costs' in fictitious transactions like swaps. Another key question is why to enter into so complicated type of transaction if the risk is again there along with possibility of a series of transactions that are non-*sharī΄ah* compliant according to the majority of the scholars? A simple answer seems to be is that practitioners needed complete alternatives to each and every product that could be used by their conventional counterparts, which is made possible by invoking the concepts like *w'ad, organized tawarruq, 'maslaha', 'umoom-e-balwa'*, the sale of debt and *ba'i al inah*, etc[45].

Concerns regarding derivatives' effectiveness in 'risk-management' started arising in early 1990s when *Bankers Trust* traders were caught discussing the size of the "rip-off factor" on a Procter and Gamble derivatives deal. As the main motive is speculation, it surely triggers concern as to allowing hedging through swaps by *sharī΄ah* committee like that of IIFM and even by *sharī΄ah* scholars of global repute, leaving the aspect of *sharī΄ah* compliance to the practitioners themselves, who are paying no heed to the reservations expressed by the Islamic Fiqh Council or the AAOIFI. Hardly, any person can expect that in cross-currency swap with underlying asset of 1.5 year *ijarah sukuk* with quarterly payment of return, parties will accomplish a series of six transactions of *tawarruq* buying and selling each time specific currencies or metals in line with the rules of *sharī΄ah* on *ba΄i al sarf*, particularly in view of the fact that the parties have to do only the net settlement and "the neither party, i.e. the bank or the investor, will pay the real value, they will only settle their respective obligations by *muqāssah*, i.e.an offset of net value"[46].

The *sharī΄ah* Council of Kuwait Finance House in Meeting held in September 2006 in Kuwait, while evaluating the rental-rate swap based on unilateral binding promise and *tawarruq*, laid down following four main conditions to ensure that the product complies with the *sharī΄ah*: i) The agreements in that structure are actual, i.e., there is no fictitious contract; ii) It has its contractual effects. For example, a sales agreement gives the effect of ownership; there should not be any obstacle to exercising the complete rights of ownership. It is up to the buyer to either sell it or keep it and use it; iii) the agreements are separate, and iv) the agreements are not

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[44] Dusuki and Shabnam ,ISRA, 14/2010; P. 39.

[45] See for example: Khnifer, Mohammed; Maslahah and the Permissibility of Organized Tawarruq; Opalesque Islamic Finance Intelligence - Eighth Issue (30 4 2010)

[46] Dusuki and Shabnam ,ISRA, 14/2010; P. 38.

conditional (upon one another).[47] The main practical issue, however, in all synthetic products is that each and every part of the structure is made integral part of the overall arrangement invoking payment of liquidated damages to the counter party that comes under the purview of *riba*.

5.5.1 Distinguishing legitimate hedging from speculation – lack of disclosure

The contract law operative in the world has not been able to distinguish legitimate hedging from speculation. Courts today confront serious concerns with regard to various issues involved in trading in derivatives and the role of brokers and particularly the insiders. Roy Kreitner, in his article published in *Columbia Law Review* discussed the development of contract law when the question of gambling was eventually swallowed and internalized, as if the problem was solved. However, no analytic formula could distinguish gambling from risk allocation. Instead, the gambling question was subjected to a complex and indecisive cultural negotiation and displacement...[48]

Some structures of Islamic swaps have been approved by respective *sharī´ah* boards only for the purpose of genuine hedging and not for speculation. The ground reality on the other hand is that little part of derivatives is being used for genuine hedging. Risk management and gambling have been intermingled for "profit maximization". Speculative profits and windfall gains do not allow the strict regulation or fire-walls to be effective or useful in the long run. William Gamble, President of Emerging Market Strategies, observed the following in his posting on Net after the IIFM-ISDA coming up with the product:

> "…. One of the main causes of the 2008 financial collapse and the present strains in Europe is the lack of information. No one knows the extent of the inter connections, so without information markets can collapse. Derivatives increase the inter connections and decrease the information…..The end result may not be hedging risk, but creating more. The illusion that a specific investment is protected from loss may result in investors taking risks that they would not otherwise have taken. If they feel protected by the derivatives contract, there is less of an incentive to do more due diligence. This was proved recently when the holders of un-rated illiquid "asset-based" *sukuk* (Islamic bonds) realised that their investments were in fact not collateralized. ……The cross-border issue is also a problem for regulators. Which regulators are responsible for policing these transactions? We also have to assume that there are regulators, that they have jurisdiction and that …. Legal disincentives without enforcement by regulators or courts are worthless. So would be the value of derivatives as insurance"[49].

5.6 Achieving *maqāsid-al-sharī´ah*

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[20]Cf: Dusuki and Shabnam, 2010; P. 44

[48] Roy Kreitner; Columbia Law Review; Vol. 100, No. 4 (May, 2000); pp: 1096-1138; In a rare case, A US jury convicted a trio of Wall Street traders on charges they paid hefty bribes to coax confidential information. Prosecutors have called the probe the biggest ever into inside trading in the hedge fund industry. The convicted had engineered a plot to pay two attorneys nearly $100,000 for the inside tips on mergers and acquisitions that generated millions of dollars in illegal profits (http://ibnlive.in.com/news/us-jury-convicts-3-in-hedge-fund-trial/159078-2.html) (June 13, 2011). Similarly, a Hong Kong court jailed one of the city's highest profile businesswomen for engineering a HK$3.7 million ($475,000) stock scam. She hid from the Securities watchdog that she was "the real beneficial owner" of the Options and allowed Hong Kong's stock exchange to approve a prospectus which contained false information. http://www.channelnewsasia.com/stories/afp_asiapacific_business/view/1135375/1/.html

[49]http://www.moneylife.in/article/71/5302.html (May 11, 2010).

Sharī´ah allows to minimize or manage the risk in businesses, but the mechanisms, contracts or instruments to be used in managing this risk must be in line with *sharī´ah* principles and *maqāsid-al-sharī´ah*. The 28th Al-Barakah Symposium held in Jeddah in September, 2007 which specifically discussed the issue of hedging, resolved the following:

1. In Islamic financial activities, the pre-condition is that investors bear the risks. This is based on the principle of *al-ghunm bil-ghurm* which means that entitlement to return or profit is accompanied by responsibility for attendant expenses and possible loss; therefore, *any investment activities based on the separation between "al-ghunm" and "al-ghurm" or profit entitlement and liability of loss are not allowed. ….*[50]
2. Mitigating and avoiding risks are permissible if managed in line with *sharī´ah* mechanisms, contract and instruments, as long as they do not bring about matters that contravene the *sharī´ah* principles.

Dusuki and Shabnam observe with regard to the *murabaha-tawarruq* based swaps:

> "Although the implication and economic effects of the swap products introduced in the Islamic financial system seems to be very similar to those of conventional products, what is more important is that the substance of the structure must be in line with the principles and the (*maqāsid-al-shari´ah*). This is to avoid any kind of deviation or abusive use of this instrument for a purpose that is not allowed in *sharī´ah*"[51].

But with the huge potential of misuse (as evidenced in their own study - Pp. 5, 48), there could only be the circumventions of the basic principles of the *sharī´ah*, what to talk of the achievement of the *maqāsid-al-sharī´ah*.

Honorable Sheikh Husain Hamid Hassan has also emphasized that while performing risk management through hedging mechanism could be permissible, detailed attention must be given to the aspect of *sharī´ah* compliance and *maqāsid-al-sharī´ah*, so that no doubt (*shubhah*) could arise creating other, bigger problems.[52] Other scholars who are inclined to accept validity of some kinds of swaps in Islamic finance also agree that the substance of any swap structure must be in line with the principles and objectives of the *sharī´ah* to avoid any kind of deviation or abusive use of this instrument for a purpose that is not allowed in *sharī´ah* [53].

The above approach has to be applied carefully with regard to all structured products; permitting for "genuine hedging' or exceptional purposes could open a back-door of speculation which the *sharī´ah* experts did not intend to allow. The question arises, how to restrict the practitioners exploiting the permission granted by the *sharī´ah* boards for speculative or non-*sharī´ah* conforming uses? The practitioners trained in the conventional framework are developing instruments and products in the way they are familiar with to generate as much money as possible for them and their employers. They are evidently following failed 'conventional' synthetic products with potential 'Islamic' financial tools of mass destruction.

6. Conclusion

The core principle of Islamic finance is that in any business the owner of an asset has both risk and reward – risk should not be separated from real economic activities. The conventional derivatives, also including swaps, that separate risk from real economic activity and make it traded separately are against the philosophy of Islamic finance. They fuel financial market

[50] See for details: El Gari, 2003, pp. 11-17.
[51] Dusuki and Shabnam ,ISRA, 14/2010; P. 53.
52 Cf: Wajdi and Shabnam (p.20), ISRA Paper No. 14 / 2010
[53] Dusuki and Shabnam (p.53), ISRA Paper No. 14 / 2010

uncertainty and multiply the risks in the economy and only the speculators are better off, while real economic agents like producers and consumers, individuals as well as economies, are worse off. "Presently, the *sharī´ah* norms are being stretched to the limit to meet the demands of the conventional system. The ground realities are not being adapted to *sharī´ah* norms", concludes Dr. Zubair Hasan in a Paper[54].

All permissions so far for 'Islamic' swaps have been for the purpose of genuine hedging by observing relevant rules of Islamic business and trade. But limiting the practitioners to the permitted and *sharī´ah* conforming purpose is next to impossible because of the *tawarruq* and *w´ad* based complicated structures. It is more likely that with limited permission, IFIs' major activities would concentrate on synthesized products leading ultimately to derivative-driven system and contracts instead of the real sector business. This paper tends to emphasize following points to be taken care of in this regard:

1) Allowing series of organised *tawarruq* deals in one swap transaction and then expecting true observation of the *sharī´ah* trade rules by the market players, historically speculators, are two things apart;
2) Replacing the contracts of forbidden category by introducing the concept of reciprocal *w´ad* by the two parties (party not performing as per promise required to make up loss of the other) is over-stretched application of the this concept and the arrangement will be as proscribed as a proscribed contract itself;
3) *Gharar* is injected in the very beginning which renders the whole arrangement a *mayser* / *qimar* based activity. This 'risk from the within' is prohibited, as discussed by Sheikh Al-Dhareer (1997), because such uncertainty leads to *riba* and *gharar* and to injustice and inequity. All games of chance and the derivates including futures, options and swaps that may generate high gains to promoters and the early birds, but ultimately lead to vulnerabilities and serious socio-economic problems, should be in the negative list for IFIs.
4) The dichotomy between the established implications of the derivatives and economic effects of the "Islamic" swap products (*that they are very similar to those of conventional swaps*), and the requirement "*that the substance of the structure must be in line with the principles and objectives of the sharī´ah (maqāsid-al-sharī´ah)*" may be removed[55]. Otherwise, Islamic financial engineers will be using conventional products through legal stratagem without taking care of Islam's cardinal principles of economics and finance and the possibility of the achievement of *maqāsid-al-sharī´ah*.
5) Reducing risks, sharing of risks and transfer of risks are different concepts and have different *sharī´ah* prepositions and implications. Transfer of risk against premium payment is invalid. Guaranteeing payment of return, that too on the notional investments, on the basis of *w´ad,* does not conform to the principles of Islamic finance, and if stretched, on the basis of analogy, will demolish the whole configuration of Islamic finance.

[54] Zubair Hasan; Islamic Finance: The Structure-Objective Mismatch and Its Consequences; ISRA International Journal of Islamic Finance; Vol. 2; Issue 1, 2010.
[55] Dusuki and Shabnam, 2010, P. 53

6) Product innovation must not be at the cost of *sharī΄ah* compliance that is the *raison d'être* of Islamic finance. Otherwise, there would be no need to create a separate discipline in the world of finance.
7) If any product structure is *sharī΄ah* compliant in letter, consideration may also be given to achieving objectives of the *sharī΄ah* and to the possibility of fulfillment of the relevant essential requirements that make it acceptable, before allowing the practitioners to apply that structure.

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COMPETING INTERESTS

1. I, as a coauthor, am working for the preparation of an advanced text book on Islamic financial instruments and markets. The draft manuscript of the book is expected to be submitted to John Wiley & Sons in September-October 2012. The contents of this paper may also be used in various chapters of the book.
2. Riphah International University Islamabad to which I belong would like to publish the paper in its biannual Journal, “Journal of Islamic Business and Finance” in any issue of 2012. Hope, the conference organizer would allow it.

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