Structured derivatives in Islamic finance: keeping one step ahead of ibaha, or providing valuable protection?

The mention of 'structured derivatives' often arouses connotations of wild excesses of risk taking and of high volatility, whereas the actuality is that these products were originally developed to provide low-cost protection, or hedging, against unwanted market trends. To find out how these products can fit into Islamic finance, Don Brownlow, NewHorizon's contributing editor, spoke to Warren Edwardes, CEO of London-based Delphi Risk Management and author of 'Key Financial Instruments: understanding and innovating in the world of derivatives'.

Should the Islamic finance industry be scurrying around trying to replicate each and every complex derivative rather than focus on what is actually needed?

In the conventional banking world, banks are able to use an array of derivative products to manage risk – often to reduce risk, but sometimes to generate risk so that they can benefit from the increased returns that risk brings. Islamic financial institutions (IFI) also need to manage risk, not only in terms of the institutions' own treasury management but also to create products that allow their customers to do the same, for example, in order to reduce an individual's or corporation's exposure to currency risk.

Edwardes thinks that derivatives have gained a reputation for being dangerous gambling instruments following the debacles at Procter & Gamble, Bankers Trust and the widely publicised excesses of Nick Leeson at the defunct Baring Brothers. IFIs, in order to remain Shari'ah-compliant, must qualify their products and strategies through the scholars that provide supervisory authority.

There are various prohibitions in Islam regarding banking that must be abided by and in this regard the Shari'ah prohibits uncertainty (gharar) and gambling (quimar). As a result, many of the structures that have been created to provide the characteristics of conventional derivatives while still maintaining Shari'ah compliance are proprietary and are often not generally openly available. But, according to Edwardes, 'there is the concept of ibaha which means that if something is not banned then it is permitted'. Under this principle, he cautions that 'because something appears to be similar to something that is banned, then don't assume that it too is banned'. He points out that 'looking at some of the financial products on the market, it seems that everything is possible using murabaha. Who am I to disagree, bearing in mind the principle of ibaha?'

He points out that using 'murabaha an investor can "invest" in an "arm's length Special Purpose Vehicle" [a specially formed company] that in turn could create "trades" in anything – from options to futures to warrants'.

In any event, he argues that derivatives can be seen as permitted by saying 'murabaha and salam could be regarded as derivatives: one is buying or selling something with deferred payment [murabaha], the other is buying or selling something for deferred delivery [salam]. They are derivatives because one is buying/selling for future payment and the other is buying/selling for future delivery – forward payment or forward delivery. So derivatives are permitted because murabaha and salam are permitted.' These instruments can be regarded as 'forwards' in the conventional market. Forwards were one of the first derivative types to be developed for the conventional markets back in the mid-1980s.

Additionally, there are two other concepts that Edwardes believes are relevant – those of arboun and wakala. Arboun is a concept of down-payment for something; wakala is an agency agreement where an agent is paid a fee for performing a management function or a management service.

The IIBI defines arboun as a down-payment for the delivery of a specified quantity of a commodity on a pre-determined date. This can be regarded as having similar properties to that of an option in the conventional market. Edwardes comments that 'it is a down-payment that provides a right – similar to an option, but why use terms that are provocative?'

Under wakala a management company may be paid a fee to provide 'dynamic delta hedging', for example, to manage foreign currency risk. (The 'delta' is a measure of volatility so, for example, if the market is as likely to go up as go down then the future is 50:50, or 50 per cent likelihood of movement so it has a delta of 0.5.)

In his book, Edwardes examines the concept that all banking products are built from four pillars: deposits, exchange, forwards and options. He thinks that, 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. He suggests that 'to create Islamic derivatives without getting close to the edge, go back to first principles, to when derivatives were first created'.

Back in the 1970s, US and UK companies made back-to-back loans to hedge foreign currency exposures – a forerunner of currency swaps. 'Instead of using back-to-back loans, Islamic products can be created using Islamic equivalents of back-to-back

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murabaha, back-to-back ijara, or back-to-back sukuk,' says Edwardes.

There is a major problem facing IFIs in terms of 'the lack of tools available for risk management and risk profile alteration', he thinks. The need to address asset liability management and the yield curve management in IFIs should be met and catered for. Edwardes asks: 'Should the Islamic finance industry be scurrying around trying to replicate each and every complex derivative rather than focus on what is actually needed?

'Maybe the way ahead is not to talk about structuring Islamic derivatives with all of the connotations of gambling and uncertainty; let's focus on financial takaful,' he suggests. Going back to basics and addressing the problems that derivatives were originally designed to address may be the way forward. Islamic banks would then have Shari'ah-compliant tools that would help solve the real asset/liability and risk management issues faced by Islamic institutions, both financial and commercial.

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