SHARED RISK & REWARD

Issue 133 – January 27, 2012

Reading List

Use of derivatives as hedging instruments in Islamic finance (link)

Could trade finance provide a place for murabaha in "authentic" Islamic finance (Sharing Risk)

Malaysian banks, ITFC working to open up more Islamic trade finance (Sharing Risk)

Guide to ITFC financing (PDF)

Bank Negara says no fee for Wa'd currency hedging (link)

Blog Posts This Week

Is Islamic bank consolidation picking up the pace?

KFH's Alafco to consider listing on international exchange

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Linking Islamic derivatives to trade finance

There is a lot of criticism of the use of derivatives in Islamic finance because they are viewed as being speculative and the worst form of innovation by Islamic financial institutions. Some of the criticism is warranted, where derivatives are used for speculative purposes unrelated to some other economic activity. There is a legitimate concern that it is difficult in most cases to determine the underlying intent behind a derivatives transaction, which has made it hard to justify the use of derivatives at all.

On his blog, Humayon Dar describes a hypothetical wa'd based structure for a foreign currency swap used by a company importing soya beans from the U.S. The result of the transaction is that the importer is hedged within a small band (Rs. 99 and Rs. 100 per US#) against fluctuations in the PKR/USD exchange rate. The mechanics of the transaction involve two promises, one from the bank to exchange rupees at $0.01 per rupee and a promise by the importer to exchange rupees at Rs. 99 per $1. In terms of options, the transaction would be a collar (holding rupees equal to the purchase price payable in 30 days and being short a call option and long a put option). In the transaction, the exercise price of the wa'ds are different to fulfill the condition that "only unilateral promises (or two or more unequal and non-diagonal promises) are binding".

The mechanics of the transaction are not unique to the example given of an importer wanting to hedge the price of a commodity being imported, which makes it potentially used for speculation on the movements in the PKR/USD exchange rate. So what conditions could make this applicable as a hedge and not able to be used to speculate on the currency fluctuations?

One potential is to make the currency hedging contract available only to companies that are receiving trade financing from the International Islamic Trade Finance Corporation. That body, a part of the Islamic Development Bank group, provides trade finance to companies in the IDB member countries using murabaha, but only offers financing in US Dollars, Euro, British Pounds and Japanese Yen.

The International Islamic Trade Finance Corporation (ITFC) buys the asset that the company needs and, subject to some conditions (either a parent company guarantee, export credit insurance, or government guarantee) will sell it to the company with deferred payment. The asset is then shipped directly from the supplier to the company and the company pays the ITFC.

This type of trade finance is provided to larger companies directly and is of less applicability to small and medium sized businesses who are still in need of financing. The ITFC has a financing program tailored to SMEs where a domestic bank is placed in the middle of the transaction so that the financing is provided by the ITFC and the credit risk for the company remains with the domestic bank. However, from the ITFC brochure (PDF) it is not clear whether the currency terms are the same as the direct murabaha trade financing provided to larger companies, but it is likely to be restricted to those four currencies).

This is where the wa'd based currency hedge could be used to make the ITFC financing through domestic banks more useful for SMEs who are not likely to absorb currency risks themselves. The structure of the transaction is a two-tiered murabaha financing where the ITFC and the domestic bank enter into a murabaha transaction, as do the domestic bank and company. Both of these murabaha agreements would be in one of the four currencies the ITFC uses. The ITFC buys (and sends payment to the supplier) and resells the asset to the domestic bank deferred repayment, which then turns around and sells the asset on the company (to whom the asset is shipped). Then the domestic bank enters into a wa'd currency swap with the company to provide hedging against currency fluctuations.

This type of transaction could be criticized still for the use of two wa'd with only slightly different exchange rates which circumvents the idea that "two equal and diagonal promises are considered as a contract, and […] gives rise to a binding forward sale contract [which] is not in compliance with Shariah." However, it does limit the risk that the intent of the transaction was speculation on the exchange rate since it is offered to facilitate international trade in an asset the company needs. This is further supported since, in Malaysia for example, it is not permissible to charge a fee for the wa'd for currency hedging. The bank instead makes a spread between the cost charged by the ITFC and the cost paid by the company for the underlying asset.

Until next week,
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