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THE SHARIA DYNAMICS OF TOTAL RETURN SWAP

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SHARIA ADVISOR LICENSED BY
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Introduction

Credit risk is arguably one of the most significant forms of risk capital market participants face. It is often unmanaged, or at best poorly managed, and not well understood. It tends to be situation-specific, and it does not fit easily in the paradigm of modern portfolio theory. And yet, it is an important consideration in most business and financial transactions. Managing credit risk exposure more effectively is crucial to improving capital market liquidity and efficiency. One of the common methods to manage such risk is through swaps.

A swap is a credit derivative which aims to reduce financial risks. Generally, one party has a fixed-rate obligation and the other a floating-rate obligation. This paper looks at the dynamics of total return swap in light of Shariah precepts. Initially, the notion of credit derivatives is discussed. Thereafter, total return swaps are introduced and analysed in some depth. This is followed by a Shariah analysis of the compliance of total return swaps. The paper concludes by presenting a Shariah compliant alternative to total return swaps.

INTRODUCTION TO CREDIT DERIVATIVES

Credit derivatives emerged in the 1990s as a risk management tool. They enable market participants to separate credit risk from other types of risk and to manage their credit exposure by selectively transferring unwanted credit risk to others. This uncoupling of credit risk from other types of risk has created new products for both hedging and investing¹.

A derivative contract, or derivative for short, is a bilateral contract whose value derives from the value of some underlying security, such as a stock or a bond. Suppose the underlying security is a bond. A bond's value depends on a variety of factors, including its coupon, maturity, sinking fund schedule (if there is one), optional redemption features (if the issuer or investors have the right to force early redemption), and credit risk. Credit risk refers to the risk that a security will lose value because of a reduction in the issuer's capacity to make payments of interest and principal. Default risk refers to the likelihood that the issuer will actually fail to make timely payments of principal and interest. Default risk is a form of credit risk in which the reduction in the capacity to pay is so serious that a scheduled payment is delayed or missed altogether. The payment may ultimately be made, but default risk is still a concern because the delay in receiving payments is costly.

A credit derivative is a privately negotiated contract, the value of which is derived from the credit risk of a bond, a bank loan, or some other credit instrument. Market participants can use credit derivatives to separate default risk from other forms of risk, such as currency risk or interest rate risk.

The value of a credit derivative is linked to the change in credit quality of some underlying fixed-income security, usually a bond, a note, or a bank loan. As credit quality changes, so does the value of a fixed-income security. A deterioration (improvement) in credit quality raises (lowers) the yield investors require and reduces (increases) the price of the bond, other factors remaining the same. A credit derivative can be used to hedge this risk. For example, a bank can use credit derivatives to reduce its exposure to the risk of a customer defaulting on his loan. It can transfer this risk to other parties, for a fee, while keeping the loan of the customer on its books. The extent of protection the hedge affords depends on the nature of the derivative selected.

Credit derivatives are generally short-term in nature, typically having an expiration time to of one and three years. As the credit derivatives market develops, longer-dated instruments may become more readily available. Similar developments have taken place in the interest rate swap and currency swap markets.

¹ Finnerty, H., The PricewaterhouseCoopers Credit Derivatives Primer, PwC
Tavakoli, J., Introduction to Total Return Swaps, Available from:
<https://www.tavakolistructuredfinance.com/trs/>

Three Basic Structures

There are three basic ways to structure a credit derivative:

1. Link a stream of payments to the total return on a specified asset. A total return swap is an example of such a structure. The total return receiver also gets the credit risk exposure from the underlying asset because this risk exposure is embodied in the underlying payment stream.
2. Base the payoff on a specified credit event, such as a bond default or a bond rating downgrade. A credit swap is an example of such a structure. The payer serves as an insurer and bears the credit risk associated with the specified event.
3. Tie the payoff to the credit spread on a specified bank loan or bond. Credit spread options are an example of such a structure. The writer of a credit spread uses a “Put” option facility which acts like an insurer and bears the risk that the credit quality of the underlying asset might deteriorate and cause the specified credit spread to widen.



WHAT ARE SWAPS?

As mentioned earlier, swaps are a type of credit derivative. Swaps are contractual agreements between two parties to exchange future cash flows on pre-determined dates over a specified period (i.e. until the swap matures). Technically, a swap can be defined as a bilateral contractual agreement in which both parties agree to simultaneously make periodic payments in exchange for two different streams of cash flow. This payment is referred to as the legs or sides of the swap and is determined based on hypothetical values of underlying assets called notional. The swap agreement can be executed by exchanging an asset or liability in the same or different currencies or a floating interest-rate stream with another of fixed rate or vice versa. In the most basic (usually called 'plain vanilla') of swap contracts is the interest-rate swap, where one party to the contract pays a fixed rate of interest, while the other pays a floating rate of interest.

Swaps are specifically tailored to the needs of both parties entering into them. As such, they are not traded on an exchange, but instead are traded 'over the counter' (OTC). Brokers – either independent or divisions of investment banks – provide live, tradable price quotes for a wide range of swaps. Additionally, brokers provide liquidity to the market by acting as intermediaries between investors wanting to take different positions. Swaps are extremely flexible instruments. Unlike a bond, where the details are set in stone at the time of issuance, the various details of a swap can be amended, upon mutual agreement, at any time. However, even with this flexibility, each swap remains eminently liquid and easily valued².

Most swaps today involve interest payments or currencies, but just about anything can be swapped, including equity swaps, credit spread swaps, and commodity swaps. In an equity swap, the cash flow based on an equity index is swapped for some other cash flow, typically a fixed-rate cash flow. In a commodity swap, the swapped cash flow is based on commodity prices. In a credit swap, the cash flow usually is based on the spread between a risky bond and a Treasury bond. The motivations for swaps include economic reasons, comparative advantage, and hedging purposes. The comparative advantage notion shows that two companies gain when each borrows in the market where it has comparative advantage and enters into a swap with the other company. The hedging purpose shows that swaps are used to hedge interest and exchange rate risks and to immunize portfolios against interest rate risk³.

² NAPF (2015), Swaps Made Simple, National Association of Pension Funds

³ Krichene, N. (2012), Islamic Capital Markets Theory and Practice, Wiley

DIFFERENT TYPES OF SWAPS

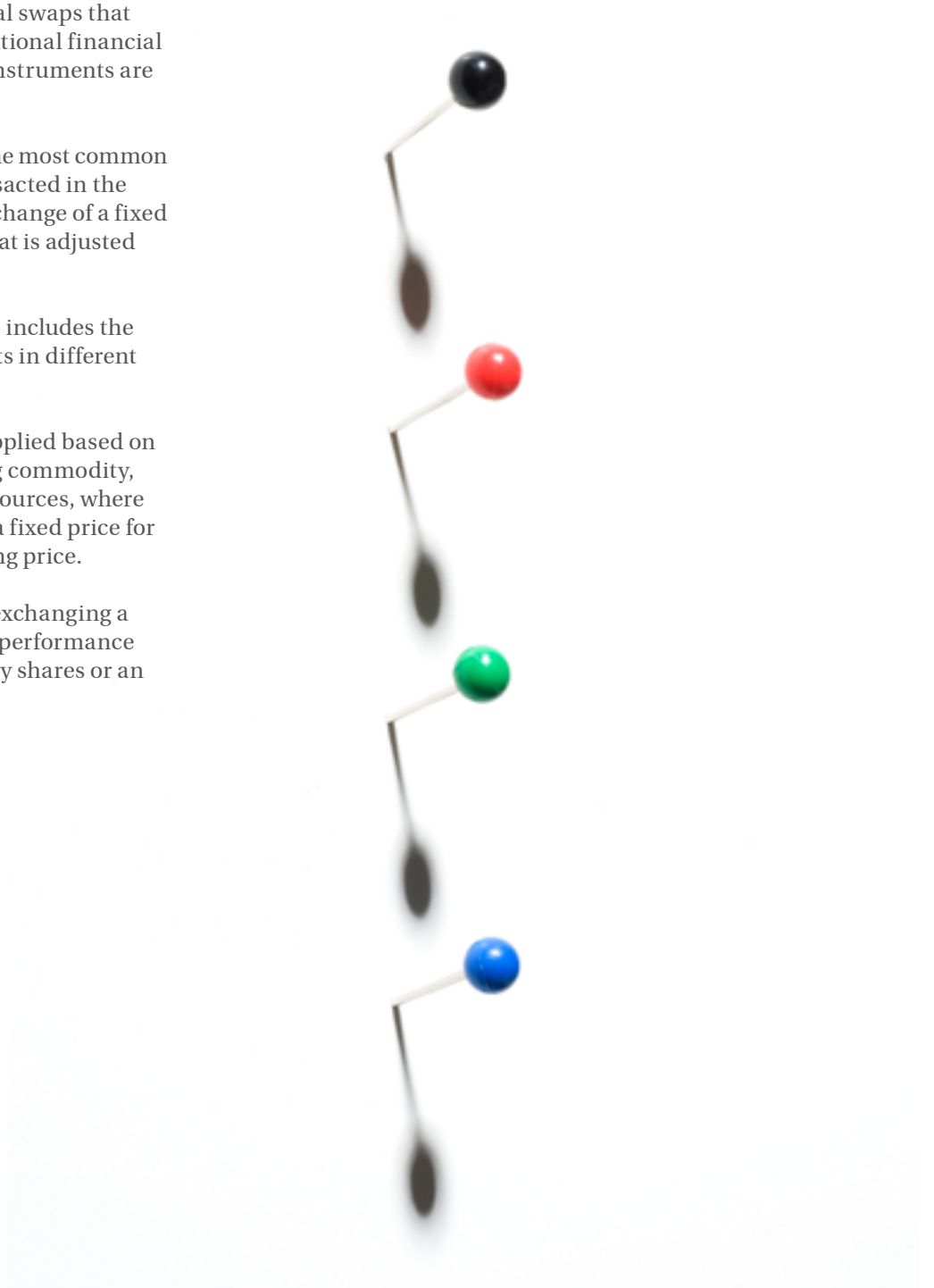
There are several types of financial swaps that are commonly used in the conventional financial system. The main types of swap instruments are briefly explained below:

Interest-rate swap: This swap is the most common type of swap and is the most transacted in the present market. It involves the exchange of a fixed rate payment for a floating rate that is adjusted periodically.

Currency swap: This type of swap includes the exchange of interest-rate payments in different currencies.

Commodity swap: This swap is applied based on the average price of an underlying commodity, such as petrol or other natural resources, where the parties exchange payment of a fixed price for the commodity for another floating price.

Equity swap: This swap involves exchanging a stream of payments based on the performance of an underlying quantity of equity shares or an equity-share index⁴.



⁴ Dusuki, A. & Mokhtar, S. (2010), The Concept and Operations of Swap as a Hedging Mechanism for Islamic Financial Institutions, ISRA

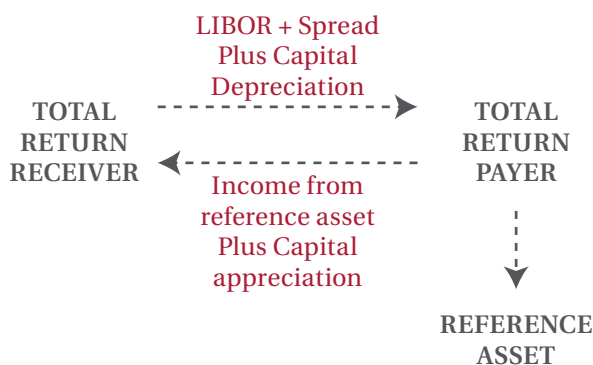
AN ANALYSIS OF TOTAL RETURN SWAPS

Credit derivatives include total return swaps (TRS). Although this is a less common type of credit derivative, it is an important off-balance sheet tool, particularly for hedge funds and for banks seeking additional fee income.

A Total Return Swap is a financial derivative which requires one party to make fixed rate payments in order to receive payments based on the performance of a certain asset, index, bond etc. The reference assets can be indices, bonds (emerging market, sovereign, bank debt, mortgage-backed securities, corporate), loans (term or revolver), equities, real estate receivables, lease receivables, or commodities.

Essentially, it allows an investor to gain exposure to a class of asset without having to own the asset, merely paying someone else a fixed rate to hold the asset. The objective of a TRS is to transfer the total economic exposure (market and credit risk) of the reference asset without having to purchase or sell it⁵. A TRS allows an investor to enjoy all of the cash flow benefits of a security without actually owning the security. The investor receives the total rate of return. At the end of the TRS (or at pre-arranged interim periods), the investor, the receiver of the TRS, must pay any decline in price to the TRS Payer. If there is no decline in price, the investor does not make a payment.

If the security appreciates in price, the investor gets the difference between the original price and the new higher price. For all of this, the investor makes ongoing payments to the TRS Payer. In the credit derivatives market, this payment is referred to as the floating rate payment, the financing cost, or the funding cost of the investor⁶.



A TRS is commonly used by large institutional investors. Investors and a large financial institution (the “counterparty”) typically agree to exchange (or “swap”) their capital, which is held as cash in a custodial account, for the total return delivered by another asset such as a stock market index. Suppose an investor wants to purchase a 5-year BBB-rated bond issued by XYZ Corporation but does not want to bear the out-of-pocket cost (and possibly inconvenience) of arranging financing, actually buying the bond, and taking delivery. Suppose also that a bank owns the same bond and would like to extend a loan to XYZ Corporation but its loans to XYZ and investments in XYZ debt instruments have fully exhausted its capacity to lend to XYZ. A total return swap will allow the investor to receive the total economic return on this bond without actually buying it.

It will allow the bank to reduce its risk exposure to XYZ Corporation as if it had sold the bond without actually selling it. If the two entities enter into a total return swap structured around this bond’s total return stream, the investor will be synthetically “long” the 5-year bond, and the bank will be synthetically “short” the same bond.

The total return payer makes payments equal to the interim cash flows (interest payments on a bond) plus any capital appreciation on the reference asset. Usually the total return receiver pays a floating interest rate, generally one of the LIBOR (London Interbank Offered Rate) rates, plus any capital depreciation on the reference asset. The total return payer realises the same series of returns as if it had sold the reference asset short; while the total return receiver realises the same stream of returns as if it owned the reference asset. But the total return receiver avoids having to take custody of the bond. Since it is also obligated to make a series of specified payments, the investment in the bond is leveraged. For example, suppose the total return recipient pays 3-month LIBOR. It effectively finances its investments in the reference bond by borrowing at 3-month LIBOR.

⁵ Deloitte (2016), Introduction to Derivative Instruments, Available from: <https://www2.deloitte.com/content/dam/Deloitte/ie/Documents/pdf>

⁶ Tavakoli, J., Introduction to Total Return Swaps, Available from: <https://www.tavakolistructuredfinance.com/trs/>

FEATURES OF A TRS

The Total Return of a reference asset includes all cash flows that stream from it as well as the capital appreciation or depreciation of the reference asset.

The Floating Rate is a reference interest rate, e.g. the London Inter-bank Offered Rate (LIBOR) plus or minus a spread.

The Total Return Receiver (TRR) is the party that agrees to make the floating rate payments and receive the total return. The TRRs are usually aggressive hedge funds, specialty asset managers and collateralised loan obligation special purpose vehicles (SPVs), who accumulate leveraged credit spreads and sell off tranches to investors.

The Total Return Payer (TRP) is the party that agrees to receive the floating rate payments and pay the total return. The TRPs are usually large institutions such as investment banks, commercial banks, mutual funds, securities dealers and insurance companies.

Other market participants in a TRS include:

Fund of Funds, Private Equity Funds, Pension Funds, Credit Card lenders, University Endowments, Governments, Non-Governmental Organisations and special purpose vehicles such as Collateralised Debt Obligations and Real Estate Investment Trusts.

TRS requires a certain amount of risk for both parties:

- The owner of the TRS is assuming that the returns on the underlying asset will exceed the rate he has to pay
- The issuer of the TRS is assuming that the rates he receives from the investor will be higher than the return on the asset⁷



⁷ WSO, What is a Total Return Swap, Available from: <https://www.wallstreetoasis.com/finance-dictionary/>

STRUCTURE OF A TRS TRANSACTION

In order to purchase the reference asset, the TRP must borrow capital. The dealer will raise cash from the capital market at a funding cost (usually linked to the inter-bank offered rate) and this cash will flow right out again to purchase the reference asset. The asset provides both interest income and capital gains or losses, depending on its price fluctuations.

A TRS has two payment legs between the payer (TRP) and receiver (TRR); the reference asset or a basket of assets exists on the “total return leg” and the interest payment, linked to the inter-bank offered rate, exists on the “funding leg”. The cash flow payment stream exists on the funding leg. The Return Leg is generally made up of two components: cash flows and capital appreciation of the reference asset(s). The Funding Leg also has two components: floating coupons based on LIBOR +/- a spread and payments to offset any capital depreciation of the reference asset(s).

On the “total return leg”, the payer has a long position in the reference asset, holding it on its balance sheet, so it buys protection on the asset and agrees to pay the receiver all the future returns of the reference asset plus any appreciation in its value. In exchange, on the “funding leg”, the receiver seeks exposure to the returns of the reference asset or basket of assets, but does not want to acquire or hold in its balance sheet. The receiver will sell protection on the reference asset by taking a synthetic long position in the asset, agreeing to make regular floating cash flow payments to the payer (inter-bank offered rate +/- a spread) including any depreciation in the value of the asset and compensation for any default losses⁸.

A TRS is similar to a plain vanilla swap except the deal is structured such that the total return (cash flows plus capital appreciation/depreciation) is exchanged, rather than just the cash flows⁹.

Low cost borrowers with large global balance sheets are naturally advantaged as payers in TRS. Synthetic assets are created in the process. Higher cost borrowers, such as hedge funds, enjoy the financing and leverage of the total return transaction. The total rate of return payer is the legal owner of the reference asset. The total rate of return payer holds the reference asset on its balance sheet. For the period of the transaction, the total rate of return payer has created a short position in the market risk (depreciation of the car) and a short position in the credit risk (potential “damage”) of the reference asset¹⁰.

The total rate of return receiver, the investor, is not the legal owner of the reference asset. The TRS is an off-balance sheet transaction and the reference asset does not appear on the balance sheet of the receiver. For the period of the transaction only, the total rate of return receiver has a synthetic long position in the market risk and a synthetic long position in the credit risk (damage) of the reference asset. At the maturity of the transaction, the total rate of return receiver may choose, but is not obligated, to purchase the reference asset at the then prevailing market price. In the event of default of the reference asset prior to the maturity date of the TRS, the TRS usually terminates, but it need not necessarily terminate.

⁸ Business Day (2015), An Introduction to Total Return Swaps, Available from: <http://www.businessdayonline.com/business-economy/investor/>

¹⁰ Tavakoli, J., Introduction to Total Return Swaps, Available from: <https://www.tavakolistructuredfinance.com/trs/>

⁹ Deloitte (2015), Introduction to Derivative Instruments, Available from: <https://www2.deloitte.com/content/dam/Deloitte/ie/Documents/pdf>

In most cases of default, the TRS does terminate. The total rate of return receiver bears the risk in the event of default in either case. If the TRS terminates due to a default, the total rate of return receiver, the investor, makes the total rate of return payer “whole” for the market risk and credit risk of the reference asset meaning the investor may make a net payment of the difference between the price of the reference security at the beginning of the transaction and the price of the reference security at the time of default. Alternatively, the investor may agree to take delivery of the defaulted reference asset and pay the initial price of the reference asset to the total rate of return payer. Once this has occurred, neither the payer nor the receiver has any additional obligation to the other party and the TRS terminates¹¹.

The TRS is initially structured so the Net Present Value (NPV) to both parties is at or close to zero. As time progresses, the TRS gains or loses value on each leg so that one of the counterparties obtains a profit.

Payments Received by Total Return Receiver:

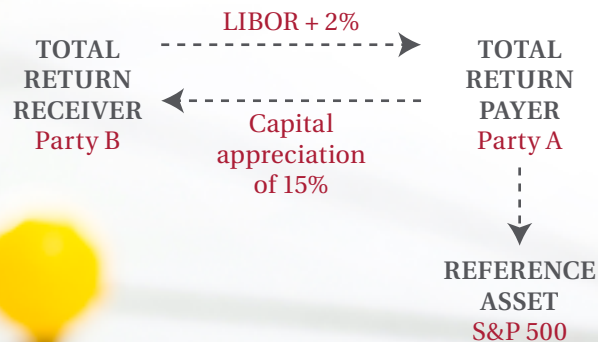
- If reference asset is a bond, the bond coupon
- The price appreciation, if any, of the reference asset since the last fixing date
- If the reference asset is a bond that defaulted since the last fixing date, the recovery value of the bond

Payments Received by the Total Return Payer:

- The periodic floating payment (usually LIBOR+/-a spread)
- The price depreciation, if any, of the reference asset since the last fixing date
- If the reference asset is a bond that defaulted since the last fixing date, the par value of the bond

The following is an example of a TRS:

Two parties may enter into a one-year total return swap where Party A receives LIBOR + fixed margin (2%) and Party B receives the total return of the S&P 500 on a principal amount of \$1 million. If LIBOR is 3.5% and the S&P 500 appreciates by 15%, Party A will pay Party B 15% and will receive 5.5%. The payment will be netted at the end of the swap with Party B receiving a payment of \$95,000 ($\$1 \text{ million} \times 15\% - 5.5\%$)¹².



¹¹ Tavakoli, J., Introduction to Total Return Swaps, Available from: <https://www.tavakolistructuredfinance.com/trs/>

¹² Deloitte (2015), Introduction to Derivative Instruments, Available from: <https://www2.deloitte.com/content/dam/Deloitte/ie/Documents/pdf>

ADVANTAGES AND DISADVANTAGES OF TRS

A TRS has the following advantages and disadvantages¹³:

Advantages

Leverage: The parties do not transfer actual ownership of the assets which allows for reduced up-front capital to execute a valuable trade. This makes TRS very popular with hedge funds.

Operational Efficiency: all settlements, interest collections, payment calculations, consent requests, reporting, and tracking associated with transferring ownership of an asset can be avoided. Asset administration is left to the Total Return Payer so the Total Return Receiver never has to deal with these issues.

Flexible: a TRS can be based on virtually any asset or series of assets. Furthermore, the life of a TRS contract and its payment dates are up to the parties, and need not match the payment or expiration dates of the reference asset(s).

Disadvantages

Investment Return Risk: is borne by the Total Return Receiver in a TRS. While the Total Return Payer retains the reference asset(s) on its balance sheet, the Total Return Receiver assumes the risk of capital losses by making guarantee payments to the Total Return Payer that offset any drop in asset value.

Counterparty Risk: many hedge funds (Total Return Receivers) take leveraged risk to generate greater returns. If a hedge fund makes multiple TRS investments in similar assets, any significant drop in the value of those assets would leave the fund in a position of making ongoing coupon payments plus capital loss payments against reduced or terminated returns from the asset(s). Since most swaps are executed on large notional amounts between \$10 million and \$100 million, this could put the Total Return Payer (typically a commercial or investment bank) at risk of a hedge fund's default if the fund is not sufficiently capitalized. Counterparty risk may be reduced by shortening the maturity of the TRS, increasing collateral required, or third party balance sheet auditing and verification.



¹³ Deloitte (2015), Introduction to Derivative Instruments, Available from: <https://www2.deloitte.com/content/dam/Deloitte/ie/Documents/pdf>

NON-COMPLIANCE OF TRS WITH SHARIAH

There are multiple issues with TRS which breach Shariah principles and make TRS non-compliant financial instruments:

1. *Riba* (Interest or usury)
2. *Qimar* (Gambling) like activity
3. Separating risk and reward
4. *Gharar* (uncertainty)
5. Trading an impermissible subject matter

1. *Riba*

TRS have an element of *Riba* in the contracts. A Total Return Swap exchanges two streams of cash flows. A total return leg that pays cash flows corresponding to the total return on the period of a specified asset (including any capital appreciation/depreciation and interest/coupon payments). A premium leg that pays cash flows indexed on a fixed rate or floating rate index. Thus, TRS are bilateral commercial transactions, i.e. there is an exchange of money from both parties to the transaction in the case of a claim, and this exchange of monies is generally unequal, resulting in *Riba*. Unequal payments in homogenous currencies are tantamount to *Riba al-Fadhl*. *Riba al-Fadhl* (known as *Riba* due to surplus and excess) originates when a *Riba* item is exchanged for the same item in an unequal amount. In the case of TRS, the *Riba* item is money.

The exchange of cash flows in different periods results in another type of *Riba* known as *Riba al-Nasi'ah*, which refers to delay and deferring an exchange of two homogenous items. *Riba* is categorically prohibited in the Qur'an.

The Quran says,

“ O you who believe! Remain conscious of Allah, and give up all outstanding gains from usury, if you are [truly] believers; for if you do it not, then know that you are at war with Allah and His Messenger. But if you repent, then you shall be entitled to [the return of] your principal. You will do no wrong, and neither will you be wronged.” [Surat Al-Baqarah, 278-279]

Prophet Muhammad (peace be upon him) said:

“ Cursed is the one who takes interest, and the one who pays it, the one who records it, and the two who (accept to be the) witnesses for signing it.” (Muslim)

2. *Qimar* like activity

Qimar or Gambling refers to a contract in which payment and staking of wealth from one of the parties to the contract is definite whereas the liability/payment of the other party to the contract is indefinite and contingent upon chance. One party will definitely win at the expense of another's loss.

In TRS, both parties stake their wealth and assume a position. The owner of the TRS is assuming that the returns on the underlying asset will exceed the rate he has to pay. The issuer of the TRS is assuming that the rates he receives from the investor will be higher than the return on the asset¹⁴. Although TRS is not literally gambling, the structure and positions assumed by either party make them akin to gambling wherein any of the two parties involved may win a sum of money from the other party. Thus, it has a very strong semblance to gambling.

¹⁴ WSO, What is a Total Return Swap, Available from:
<https://www.wallstreetoasis.com/finance-dictionary/>

3. Separating risk and reward

A TRS essentially allows an investor to gain exposure to a class of asset without having to own the asset, merely paying someone else a fixed rate to hold the asset. According to Islamic principles, risk and reward cannot be separated. An investor cannot be rewarded with profit or a return without bearing the risk. The Islamic legal maxim states:

“Al-Kharāj bi al-damān” (profits come with liability)

“Al-ghunm bi al-ghurm” (reward comes with risk)

Thus, a TRS breaches core legal maxims of Islamic finance, making them non-compliant with Shariah.

4. *Gharar* (uncertainty)

Another element in TRS which makes it impermissible from the Shariah perspective is the aspect of *Gharar* or uncertainty. *Gharar* or uncertainty in commercial transactions has been prohibited by the Shariah and thus commercial transactions, in which an essential element of the transaction remains uncertain, and could thus be the cause of dispute in the future, are rendered impermissible by Shariah. Hence if the selling price, the item being sold or the payment/delivery dates are ambiguous the transaction would have an element of *Gharar* and thus be impermissible. It is for this reason that sale transactions that are contingent on an event that is to occur in the future are impermissible. Shariah scholars explain that there are four types of uncertainty¹⁵.

These are;

1. Al-Gharar fil wujud

This refers to the uncertainty that arises with regards to the existence of the subject of the transaction. The example quoted by the jurists for this type of *Gharar* is the example of the impermissibility of selling a horse or camel that has run away, this is because the existence of the horse or camel at the time of the sale is uncertain.

2. Al-Gharar fil husool

This refers to the uncertainty that arises with regards to the acquisition of the subject of the contract. For example, a person is not allowed to sell a fish that has not yet been caught in a huge and unrestricted body of water as there is an element of uncertainty with regards to his acquisition of the fish.

3. Al-Gharar fil miqdar

This refers to the element of uncertainty that arises with regards to the amount of the subject of the contract.

4. Al-Gharar fil ‘ajal

This type of *Gharar* refers to the element of uncertainty that would arise with regards to the time frame of the delivery of the subject of the contract. Hence the selling of the child that is to be born to the foetus of an animal is considered impermissible.

There is *Gharar fil Husool* and *Gharar fil Miqdar* in a TRS as a return from the underlying asset is uncertain. Likewise, the quantum and amount is uncertain and not fixed.

5. Trading an impermissible subject matter

The objective of a TRS is to transfer the total economic exposure (market and credit risk) of the reference asset without having to purchase or sell it. The Prophet Muhammad (peace be upon him) prohibited *bay’ al-Gharar* (uncertainty) (Sahih Muslim). The scholars of hadith state that this narration refers to trades harnessing major uncertainty as well as the actual trading and transfer of risk¹⁶. Risk is not a tradable commodity or an act that contributes to the value of output. Thus, the Prophet (peace be upon him) clearly prohibited trading and exchanging risk. In prohibiting *Gharar*, the Shariah has also prohibited the trading of risks, and thereby, prohibiting derivative instruments designed to transfer risk from one party to another. Therefore, a TRS is non-compliant as it entails the transfer of economic exposure and risk in lieu of cash flow.

¹⁵ Jakhura, S. (2006), What makes conventional insurance impermissible and Takaful permissible?, CIEFSA,

¹⁶ Al-Maghribi (1119 AH), al-Badr al-Tamam Sharh Bulugh al-Maram, Dar Hijr

SHARIAH ALTERNATIVE FOR TOTAL RETURN SWAP

The underlying economic reasons for entering into a conventional total return swap are as follows,

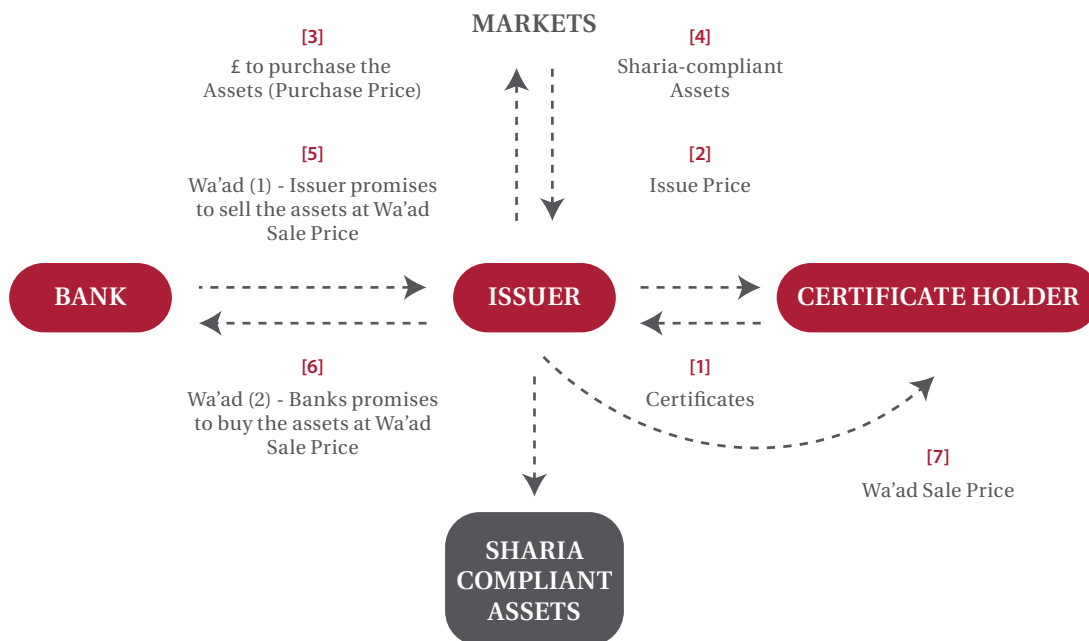
- (i) it allows investors to gain exposure to an asset which it does not necessarily need to hold on its balance sheet; and
- (ii) pay-offs can be structured so that the other party can hedge against the upside or downside related to that particular asset or class of assets.

Under Shariah, a similar economic profile can be generated by using a double wa'ad structure. Under this structure, an SPV issuer issues certificates to investors in return for the issue price (steps 1 and 2, in the diagram below). The Issuer then uses the issue price to acquire a pool of Shariah-compliant assets from the market (steps 3 and 4). These assets could, for example, be shares listed on the Dow Jones Islamic Market Indexes (DJIMI).

The investors (holders of the Certificates) gain exposure to an underlying index or assets (the Underlying) based on two mutually exclusive wa'ad between the Issuer and the Bank. Under one wa'ad (Wa'ad 1), the Issuer promises to

sell the Shariah-compliant Assets to the Bank at a particular price (which is linked to the performance of the Underlying) (Wa'ad Sale Price) (step 5), while under the other wa'ad (Wa'ad 2), the Bank promises to buy the Shariah-compliant Assets from the Issuer at the Wa'ad Sale Price (step 6). Out of these two wa'ads, only one shall ever be enforced. (Numbers in the diagram denote chronology of events. Either 5 or 6 will occur (but never both)). At maturity, the Bank will calculate how the Assets have performed relative to the Underlying, and (i) if the Wa'ad Sale Price is greater than the market value of the Assets, then the Issuer shall enforce Wa'ad 2 (similar to a conventional put option), or (ii) if the Wa'ad Sale Price is less than the market value of the Assets, then the Bank shall enforce Wa'ad 1 (similar to a conventional call option).

The commercial significance of this structure lies in the fact that, similar to a conventional total return swap, it offers Islamic investors the opportunity to potentially swap the returns in one basket (as generated from the Shariah-compliant Assets) with the returns in another basket (the Wa'ad Sale Price, as calculated with reference to the Underlying).



This alternative to a conventional TRS has received a mixed response from Shariah scholars. Whilst some have favoured this product, others have raised concerns. One concern raised was that this product was devised with a view to “wrap up a non-Shariah compliant underlying into a Shariah compliant structure.” Such scholars argue that this product is not Shariah compliant because:

(i) the returns, under such structures (overall, termed ‘Shariah Conversion Technology’), are determined by the performance of funds which are not Shariah-compliant and which could invest in impermissible securities;

(ii) a Qiyas (analogy) cannot be drawn between the use of LIBOR for pricing (which is generally considered to be permissible) and the use of the performance of non-Shariah-compliant assets for pricing; since while the former is used to indicate the return, the latter is used to deliver the return; and

(iii) the cash-flows in a total return swap based on a double wa’ad indicate that the investment by an Islamic investor operates as a trigger for a series of transactions which are not necessarily Shariah-compliant.

A response to the above could be that in the Deutsche Bank structure using the double wa’ad mechanism, Deutsche Bank kept Islamic investors’ investments isolated from non-Shariah compliant assets, as demonstrated by the Shariah audits carried out by the bank. It is further argued by supporters of the double wa’ad structure that the use of the Underlying as a point of reference is no different from issuing a Sukuk benchmarked against LIBOR.

The double wa’ad structure has been used by Deutsche Bank in relation to a total return swap. This derivative product was approved by the Shariah Board of Dar Al Istithmar (Shari’a Advisor to Deutsche Bank), consisting of five of the world’s leading Shariah scholars: Dr. Hussein Hamed Hassan, Dr. Ali AlQaradaghi, Dr. Abdul Sattar Abu Ghuddah, Dr. Mohamed Ali Elgari and Dr. Mohamed Daud Bakar. According to Hussein Hassan, “Driven by investor demand, the technique has been instrumental in opening up investment in asset classes that have previously been closed to Islamic investors”¹⁷.



Conclusion

A Total Return Swap is a financial derivative which requires one party to make set rate payments in order to receive payments based on the performance of a certain asset, index, bond etc. Essentially, it allows an investor to gain exposure to a class of asset without having to own the asset, merely paying someone else a fixed rate to hold the asset. The objective of a TRS is to transfer the total economic exposure (market and credit risk) of the reference asset without having to purchase or sell it. TRS has proven to be a popular conventional instrument among hedge funds due to its leveragability. TRS offer operational efficiency as all settlements, interest collections, payment calculations, consent requests, reporting, and tracking associated with transferring ownership of an asset can be avoided. TRS are also flexible as it can be based on virtually any asset. Despite this, a TRS is non-Shariah compliant and is plagued with a number of prohibited elements. A TRS is a *Riba* transaction as it involves an exchange of two streams of unequal cash flows. TRS have a resemblance to *Qimar* as both parties stake their wealth, assume a position and a certain amount of risk for: The owner of the TRS is assuming that the returns on the underlying asset will exceed the rate he has to pay. The issuer of the TRS is assuming that the rates he receives from the investor will be higher than the return on the asset. A TRS also violates one of the axioms of Islamic finance as it essentially separates risk from reward by allowing an investor to gain exposure to a class of asset without having to own the asset, merely paying someone else a fixed rate to hold the asset. A Shariah compliant alternative proposed by Shariah scholars is the double-wa'ad product which offers Islamic investors the opportunity to potentially swap the returns in one basket (as generated from the Shariah-compliant Assets) with the returns in another basket (the Wa'ad Sale Price, as calculated with reference to the Underlying).

ABOUT SRB

Since our humble beginnings more than 13 years ago we've grown to include more than 100 companies across a host of industries, thousands of transactional programs, multi-disciplinary teams and a combined scholarly workforce of 35 Sharia Scholars from 19 countries. And we're not done yet: our Sharia Advisory and Sharia Audit services will continue to improve—serving local and international businesses to help them maintain and manage Shari'a compliance.

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ABOUT OUR PEOPLE



RESEARCH AUTHOR

MUFTI FARAZ ADAM

SHARIAH CONSULTANT AT SRB

- > Completed his Islamic studies in the six-year Alimiyyah degree at Darul Uloom Leicester.
 - > Specialised in Islamic law and graduated as a Mufti in South Africa at Darul Iftaa Mahmudiyyah, Durban.
 - > Accredited with: Masters of Arts in Islamic Theology with specialisation in Juristic verdicts (Iftaa) and a Diploma in Islamic Finance.
 - > Completed a Master's Degree in Islamic Finance, Banking and Management at Newman University in 2017.
-



PEER REVIEWER

SHAIKH MUHAMMAD AHMAD SULTAN

SHARIAH ADVISOR AT SRB

- > Over 10 years of experience as a Shari'a consultant and academic in various parts of Islamic finance.
 - > Worked predominantly in the financial services along with retail and investment banking and has expertise in corporate advisory and real-estate funds.
 - > He procured his Masters (A'alamiyah) in Fiqh and Usool ul Fiqh from Jami'ah Ahsan Ul Uloom and procured Bachelors in Islamic sciences from Jamia Dar-ul-Uloom.
-



PEER REVIEWER

SHAIKH OSAMA

SHARIAH CONSULTANT AT SRB

- > Member of the Shari'a supervisory Board of Ithmaar Bank
 - > Member of the Shari'a supervisory Board of International Investment Bank IIB
 - > Shari'a Adviser for Bahrain Bourse
 - > Member of the Shari'a supervisory Board for Family Bank
 - > Member of the Shari'a supervisory Board for Solidarity Group Islamic Insurance
 - > Shari'a adviser for Gulf Islamic Investment Company in Dubai
-

Disclaimer

This is a preliminary Shariah research and is by no means a definitive conclusion or fatwa on the aforementioned subject. This paper was written to develop knowledge and research on this complex subject from a Shariah perspective. We hope that this paper will prompt and engage global Islamic finance bodies, Shariah scholars and Muslim economists to analyze, comment and build upon the arguments expressed.

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