

دار  
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SHARIYAH  
REVIEW BUREAU

NAVIGATING  
NON-COMPLIANCE  
IN CROSS CURRENCY  
SWAPS

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SHARIA ADVISOR LICENSED BY  
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# INTRODUCTION

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 'notionals'. 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. In the most basic (usually called 'plain vanilla') of swap contracts, the interest-rate swap, one party to the contract pays a fixed rate of interest, and 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 liquid and easily valued<sup>1</sup>.

A swap is a method for reducing financial risks. Generally, one party has a fixed-rate obligation and the other a floating-rate obligation, or one has an obligation denominated in one currency and the other in another currency. 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 U.S. Treasury bond. Interest rate, currency, and equity swaps are futures contracts. The motivations for swaps are claimed to range from economic reasons, comparative advantage, and hedging purposes<sup>2</sup>.

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<sup>1</sup> NAPF (2015), Swaps Made Simple, National Association of Pension Funds

<sup>2</sup> Krichene, N. (2012), Islamic Capital Markets Theory and Practice, Wiley

## HISTORY OF SWAPS

Swap agreements originated from agreements created in Great Britain in the 1970s to circumvent foreign exchange controls adopted by the British government. The first swaps were variations on currency swaps. The British government had a policy of taxing foreign exchange transactions that involved the British pound. This made it more difficult for capital to leave the country, thereby increasing domestic investment.

Swaps were originally conceived as back-to-back loans. Two companies located in different countries would mutually swap loans in the currency of their respective countries. This arrangement allowed each company to have access to the foreign exchange of the other country and avoid paying any foreign currency taxes.



IBM and the World Bank entered into the first formalized swap agreement in 1981. The World Bank needed to borrow German marks and Swiss francs to finance its operations, but the governments of those countries prohibited it from borrowing activities. IBM, on the other hand, had already borrowed large amounts of those currencies, but needed U.S. dollars when interest rates were high for corporate borrowers. Salomon Brothers came up with the idea for the two parties to swap their debts. IBM swapped its borrowed francs and marks for the World Bank's dollars. IBM further managed its currency exposure with the mark and franc. This swaps market has since grown exponentially to trillions of dollars a year in size.

The swap product was very well received by the public, to the extent that the total swap transactions increased by more than USD700 billion in 1989, and the total outstanding swap reached approximately USD 4.6 trillion by the end of 1992. According to the Bank of International Settlements, swap transactions in the global swaps market had reached more than USD 415.2 trillion by the end of 2006. This was 8.5 times more than the total Gross National Products of the world for the year 2006 and was more than any other transaction in the derivatives market<sup>3</sup>.

The history of swaps wrote another chapter during the 2008 financial crisis when credit default swaps on mortgage backed securities (MBS) were cited as one of the contributing factors to the massive economic downturn. Credit default swaps were supposed to provide protection for the non-payment of mortgages, but when the market started to crumble, parties to those agreements defaulted and were unable to make payments. This has led to substantial financial reforms of how swaps are traded and how information on swap trading is disseminated. Swaps were historically traded over the counter, but they are now moving to trading on centralized exchanges<sup>4</sup>.

<sup>3</sup> Dusuki, A. & Mokhtar, S. (2010), The Concept and Operations of Swap as a Hedging Mechanism for Islamic Financial Institutions, ISRA

<sup>4</sup> Investopedia, When was the first swap agreement and why were swaps created?, Available from: <https://www.investopedia.com/ask/answers/051115/when-was-first-swap-agreement-and-why-were-swaps-created.asp>

## DIFFERENT TYPES OF SWAPS

A plain vanilla swap is one of the simplest financial instruments contracted in the over-the-counter market between two private parties, both of which are usually firms or financial institutions. While there are several types of plain vanilla swaps, including an interest rate swap, commodity swap and a foreign currency swap, the term is most commonly used to describe an interest rate swap in which a floating interest rate is exchanged for a fixed rate or vice versa.

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 commonly transacted swap in the present market. It involves the exchange of a fixed rate payment for a floating rate that is adjusted periodically. A plain vanilla interest rate swap is often done to hedge a floating rate exposure, although it can also be done to take advantage of a declining rate environment by moving from a fixed to a floating rate. Both legs of the swap are denominated in the same currency, and interest payments are netted. The notional principal does not change during the life of the swap, and there are no embedded options<sup>5</sup>.

### 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 index<sup>6</sup>.



<sup>5</sup> Investopedia (2018). Plain Vanilla Swap. Retrieved online from: <https://www.investopedia.com/terms/p/plain-vanilla-swap.asp>

<sup>6</sup> Dusuki, A. & Mokhtar, S. (2010), The Concept and Operations of Swap as a Hedging Mechanism for Islamic Financial Institutions, ISRA

## CROSS-CURRENCY SWAP

In a cross-currency swap, the parties involved agree under contract to exchange the following: the principal amount of a loan in one currency and the interest applicable on it during a specified period of time for a corresponding amount and applicable interest in a second currency. Currency swaps are off-balance sheet transactions in which two parties exchange principal and interest in different currencies. A currency swap is similar to an interest rate swap, except that in a currency swap, there is often an exchange of principal, while in an interest rate swap, the principal does not change hands. In currency swaps, on the trade date, the counter parties exchange notional amounts in the two currencies. For example, one party receives \$10 million British pounds (GBP), while the other receives \$14 million U.S. dollars (USD). This implies a GBP/USD exchange rate of 1.4. At the end of the agreement, they will swap again using the same exchange rate, closing out the deal.

Since swaps can last for a long time, depending on the individual agreement, the exchange rate in the market place (not on the swap) can change dramatically over time. This is one of the reasons institutions use these currency swaps. They know exactly how much money they will receive and have to pay back in the future. During the term of the agreement, each party pays interest periodically, in the same currency as the principal received, to the other party. There are number of ways interest can be paid. It can be paid at a fixed rate, floating rate, or one party may pay a floating while the other pays a fixed, or they could both pay floating or fixed rates. On the maturity date, the parties exchange the initial principal amounts, reversing the initial exchange at the same exchange rate<sup>7</sup>.

Currency swaps are often used to exchange fixed-interest rate payments on debt for floating-rate payments; that is, debt in which payments can vary with the upward or downward movement of interest rates. However, they can also be used for fixed rate-for-fixed rate and floating rate-for-floating rate transactions<sup>8</sup>. A Currency Swap is considered by conventional markets as one of the best way to fully hedge a loan transaction as the terms can be structured to exactly mirror the underlying loan. It is also flexible in that it can be structured to fully hedge a fixed rate loan with a combined currency and interest rate hedge via a fixed- floating cross currency swap<sup>9</sup>.



<sup>7</sup> Investopedia, How do cross currency swaps work?. Retrieved online: <https://www.investopedia.com/ask/answers/042315/how-do-currency-swaps-work.asp>

<sup>8</sup> FXCM. How Do Currency Swaps Work?. Retrieved online: <https://www.fxcm.com/insights/how-do-currency-swaps-work/>

<sup>9</sup> MFX. Understanding Cross Currency Swaps. Retrieved online: <http://www.microrate.com/media/docs/investment/VI-Guide-to-Cross-Currency-Swaps.pdf>

## CROSS-CURRENCY SWAP EXAMPLE

Investopedia gives an example of a cross-currency swap in the following manner:

1. Company A wants to transform \$100 million USD floating rate debt into a fixed rate GBP loan. On trade date, Company A exchanges \$100 million USD with Company B in return for 74 million pounds. This is an exchange rate of 0.74 USD/GBP (equivalent to 1.35 GBP/USD).
2. During the life of the transaction, Company A pays a fixed rate in GBP to Company B in return for USD six-month LIBOR.
3. The USD interest is calculated on \$100 million USD, while the GBP interest payments are computed on the 74 million pounds amount.
4. At maturity, the notional dollar amounts are exchanged again. Company A receives their original \$100 million USD and Company B receives 74 million pounds.

Company A and B might engage in such a deal for a number of reasons:

1. The company with US Dollars needs British pounds to fund a new operation in Britain, and the British company needs funds for an operation in the US. The two firms seek each other and come to an agreement where they both get the cash they want without having to go to a bank to get loan, which would increase their debt load. As mentioned, currency swaps don't need to appear on a company's balance sheet, whereas taking a loan would.
2. Having the exchange rate locked-in lets both parties know what they will receive and what they will pay back at the end of the agreement. While both parties agree to this, one may end up better off. Assume in the scenario above that shortly after the agreement the USD starts to fall to a rate of 0.65 USD/GBP. In this case, Company B would have been able to receive \$100 million USD for only \$65 million GBP had they waited a bit longer on making an agreement, but instead they locked in at \$74 million GBP.

While the notional amounts are locked-in between the parties and are not subject to exchange rate risk, the parties are still subject to opportunity costs/gains in that ever-changing exchange rates (or interest rates, in the case of a floating rate) could mean one party is paying more or less than they need to based on current market rates.



## SHARIAH REVIEW OF CROSS-CURRENCY SWAPS

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

1. *Riba*
2. Forward Currency Contract
3. *Gharar*

### 1. *Riba*

Swaps and especially cross-currency swaps incorporate *Riba* in their contracts. In cross-currency swaps, the contracting parties exchange interest rates in different currencies at different intervals across the life of the transaction. This results in currency exchanges with cash flows at different periods resulting in *Riba al-Nasi'ah*, which refers to delay and deferring in currencies. *Riba* is categorically prohibited in the Qur'an

The Qur'an 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.”**

[Qur'an 2:278-279]

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. Forward currency contract

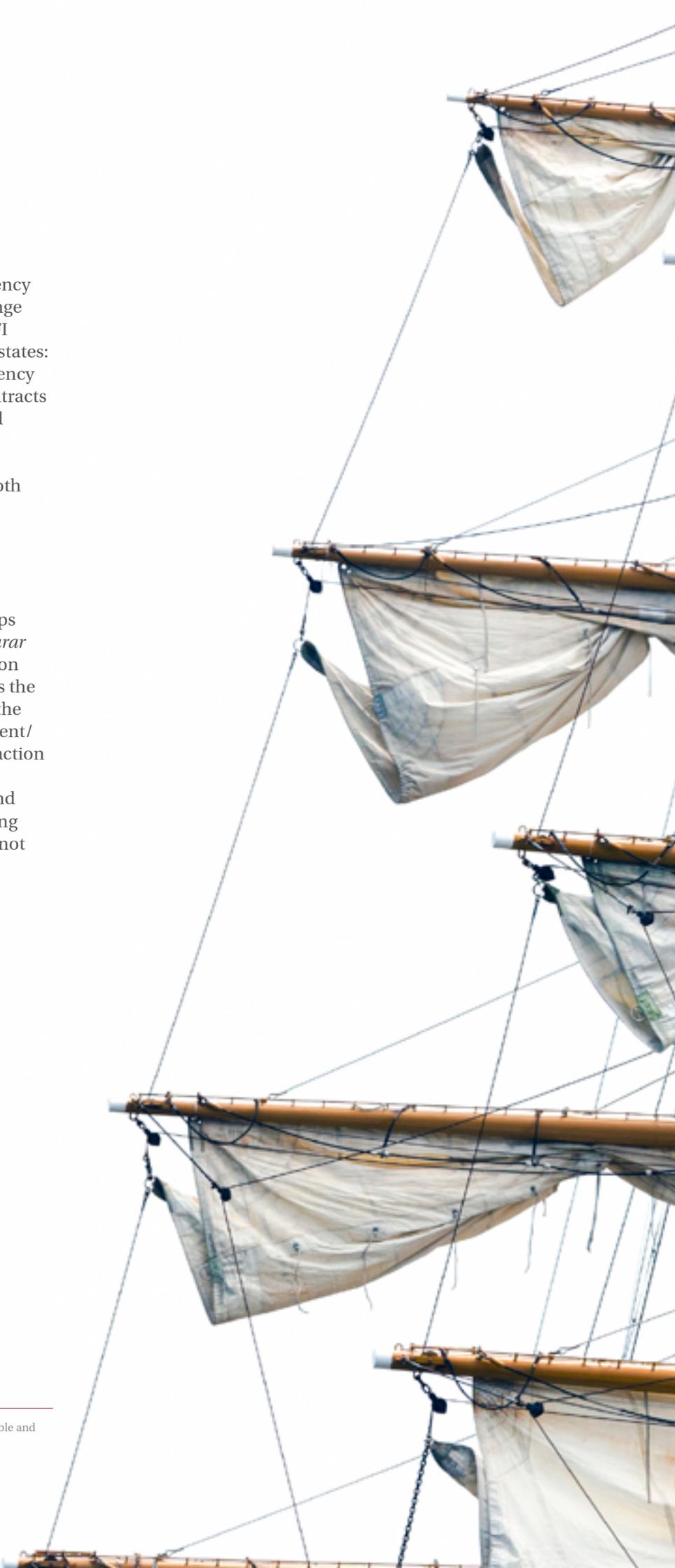
Another non-compliance issue in cross-currency swaps is the contractual agreement to exchange the notional amounts at maturity. The AAOIFI Sharia Standard No.1 on Trading Currencies states: 2/2 It is prohibited to enter into forward currency contracts. This rule applies whether such contracts are effected through the exchange of deferred transfers of debt or through the execution of a deferred contract in which the concurrent possession of both of the countervalues by both parties does not take place.

## 3. *Gharar* (uncertainty)

Another prohibitive element in currency swaps is the existence of *Gharar* or uncertainty. *Gharar* refers to an essential element of the transaction being uncertain, which significantly increases the probability of dispute in the future. Hence if the selling price, the subject matters or the payment/delivery dates are ambiguous, then the transaction is not Shariah compliant due to the presence of *Gharar*. In currency swaps, the outcome and amount that is to be paid from the party paying a floating rate is unknown, and therefore are not Shariah compliant<sup>10</sup>.

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<sup>10</sup> Jakhura, S. (2006), What makes conventional insurance impermissible and Takaful permissible?, CIEFSA.



## SHARIAH PRINCIPLES OF TRADING AND EXCHANGING CURRENCIES

Before considering Shariah compliant alternatives to conventional cross currency swaps, it is pertinent to understand the different views held by Shariah scholars regarding the principles of exchanging fiat currencies.

The AAOIFI considers fiat currencies to be a new breed of currencies which are in the same category as gold, silver. Fiat money is deemed to be *Thaman Haqiqi* (real money) and as a result, shares the same rulings as commodity money such as gold and silver. This is because free-floating fiat currencies have replaced gold and silver as a medium of exchange and are considered to be money today. As a result, the rulings of *Sarf* (money exchange) applies to fiat money also.

Another opinion argues that despite fiat currencies being a new breed of currencies, they are not in the ruling of gold and silver, instead, they share similar properties to *Fulus* (copper coins). As a result, they are not natural forms of money like gold and silver, rather, they are based on custom and can be activated/deactivated as currency based on practice. Based on this, not all the rulings of *Sarf* apply to fiat currency exchange. This group of scholars restrict the rulings of *Sarf* to gold and silver exchange. In respect to fiat currencies, the rulings of trading *Fulus* and *Riba* apply in certain scenarios. This opinion is predominantly held by Hanafi scholars in the Indian subcontinent and Southern Africa. Mufti Muhammad Taqi Uthmani (may Allah preserve him) is considered to be among the pioneers of this analysis<sup>11</sup>.



<sup>11</sup> Uthmani, M.T. (2012), *Fiqh al-Buyu*, Maktabah Maariful Quran: Karachi

## Currency trading laws in the AAOIFI Standards

It is permissible to trade in currencies, provided that it is done in compliance with the following Shari'a rules and precepts.

- Both parties must take possession of the counter values before dispersing, such possession being either actual or constructive.
- The counter values of the same currency must be of equal amount, even if one of them is in paper money and the other is in coin of the same country, like a note of one pound for a coin of one pound.
- The contract shall not contain any conditional option or deferment clause regarding the delivery of one or both counter values.

## Currency trading laws according to opinion 2

It is permissible to trade in currencies, provided that it is done in compliance with the following Shari'a rules and precepts.

- One party must take possession in the trading session, being either actual or constructive.
- The counter values of the same currency must be of equal amount, even if one of them is in paper money and the other is in coin of the same country, like a note of one pound for a coin of one pound.

Based on the Hanafi school of Islamic thought, the '*illa* (legal causative factor) of *Riba* are homogeneity of the counter-values and both counter-values being weighable or measurable<sup>12</sup>.

These two '*illa* do not apply when exchanging different fiat currencies. Each country's currency is regarded as a separate genus. Neither are fiat currencies weighable or measureable, instead, they are countable. However, possession by one party is required for *Ta'yin* (specifying a counter-exchange in a contract) according to the Hanafi jurists, as a legal principle states that money is not specified by specification prior to possession and receipt; money is only specified by *Qabd* (possession).



<sup>12</sup> The amount of the counter-values must be in excess of half Sa' for the '*illa* of *Riba* to apply. The Hanafi jurists argue that anything under half Sa' is not subject to *Riba*. This is based on the fact that the lowest measurement in Shariah is half Sa'. Anything below half Sa' does not fall under any valid measurement in Shariah to have a legal consequence.

## SHARIAH COMPLIANT ALTERNATIVE

A conventional cross-currency swap usually consists of three stages:

1. a spot exchange of principal at the outset (Initial Exchange),
2. a continuing exchange of interest payments during the swap's life (essentially a series of FX forward trades) (Interim Amounts) and
3. a re-exchange of principal at the maturity of the contract (normally at the same spot rates as those used at the start) (Final Amount).

Shariah scholars have proposed an alternative structure to generate cash flows which are similar to a conventional currency swap, but within a Shariah compliant framework. The Global Islamic Finance Report 2010 has proposed a structure is to use reciprocal *Murabahah* transactions, whereby the parties enter into *Murabahah* contracts using a Primary (Term) *Murabahah* and a Secondary (Reverse) *Murabahah* to sell Shariah compliant assets to each other for immediate delivery but on deferred payment terms<sup>13</sup>.

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<sup>13</sup> GIFR (2010), Chapter 14 Islamic Derivatives: Theory and Practice, Global Islamic Finance Report

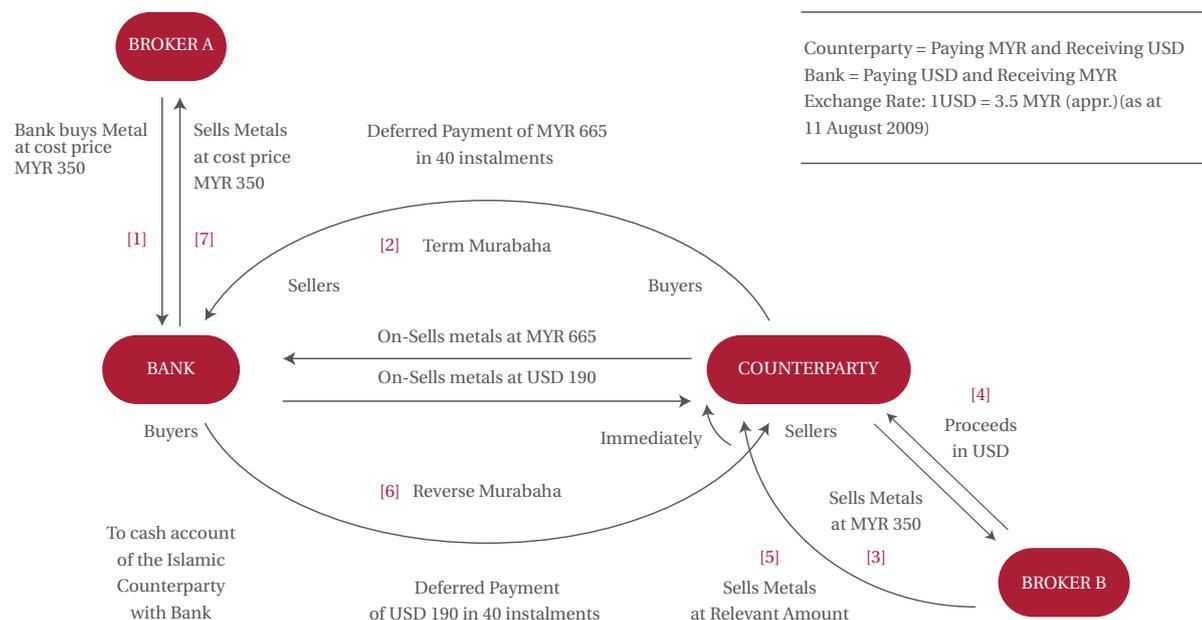
## The Primary (Term) *Murabahah*

Under this transaction the Bank sources commodities from a commodity broker (Broker A) at Cost Price (step 1, in the diagram below); and (ii) sells on these commodities to the swap counterparty (the Counterparty) (step 2). The value of commodities bought and sold-on (in steps 1 and 2 respectively) are both denominated in Currency A (MYR). Payment by the Counterparty for the commodities purchased under the Primary *Murabahah* is on a deferred basis, in instalments payable on pre-agreed payment dates (each a Deferred Payment Date). Each instalment represents a portion of the pre-agreed profit element, with the exception of the final instalment, which also includes payment in full of the Cost Price. The commodities are delivered on the date on which the transaction is entered into. On receipt of the commodities, the Counterparty (or its agent) promptly sells the commodities to a different commodity broker (Broker B) to generate a Currency B (US\$) payment (steps 3 and 4).

## The Secondary (Reverse) *Murabahah*

To initiate the Secondary *Murabahah*, the Counterparty

(i) purchases commodities from Broker B and makes payment in Currency B (step 5), and (ii) immediately sells these commodities to the Bank for immediate delivery (step 6). The commodities sold under the Secondary *Murabahah* should have the same value as those purchased under the Primary *Murabahah* (the Currency B equivalent of the Cost Price being the Relevant Amount, in the diagram below). Payment by the Bank is on a deferred basis in instalments in Currency B, such instalments to represent a portion of the pre-agreed Secondary *Murabahah* profit element (with the exception of the final instalment, which also includes payment in full of the Currency B equivalent of the Cost Price). Instalment payment dates under the Secondary *Murabahah* mirror those under the Primary *Murabahah* (i.e. on each Deferred Payment Date, a payment shall be due (i) from the Bank to the Counterparty in Currency B; and (ii) from the Counterparty to the Bank in Currency A). Upon receipt of the commodities the Bank immediately on-sells these to Broker A (step 7) to generate a Currency A payment.



## Conclusion

Cross currency swaps involve parties exchanging the principal amounts of a loan in one currency and the interest applicable on it during a specified period of time for a corresponding amount and applicable interest in a second currency. Currency swaps are often used to exchange fixed-interest rate payments on debt for floating-rate payments. From a Shariah compliance perspective, cross-currency swaps are non-compliant with Shariah due to the presence of *Riba* as interest rates are exchanged through the life cycle of the transaction. Furthermore, cross-currency swaps violate the Shariah principles of exchanging currencies as there is a forward agreement in the swap to trade the notionals upon maturity.

Shariah scholars have proposed the use of two reciprocal *Murabahah* to engineer cash flows similar to that of a cross-currency swap but within a Shariah compliant framework.

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The future of Sharia Advisory and Audit is exciting and we are very lucky to be a part of this business!

## ABOUT OUR PEOPLE

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#### 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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