Islamic Hedging Products
IIFM Specialized Sessions on Islamic Finance
ISEF, Surabaya

- FX Forward – i
- Cross Currency Swap – i
- Profit Rate Swap – i

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Shariah-compliant FX and Hedging Solutions
Underlying Sharia concepts

- Three key Shariah concepts applied are:
  - **Bai Al-Sarf** -- sale of a monetary value for a different monetary value i.e. the exchange of different currencies for immediate delivery or settlement at the prevailing rate.
  - **Wa'ad** -- a promise for delivery or settlement at a future date i.e. allow for exchange of currencies for delivery in the future at a pre-agreed exchange rate.
  - **Murabahah --** the sale and purchase of an asset where the cost and profit margin are made known and agreed by parties involved.

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Mechanics of FX Forward – I (two waad structure)

- Suitability: clients who have a foreign currency cash flow that they would like to hedge and who are willing to accept an opportunity loss should the Fixing Price be below the Strike Price.
- Structure: Two unilateral FX waad
- Bank Waad: To sell client Foreign Currency
  - Condition: If the spot price is above the forward rate on the fixing date
  - Price: pre-agreed forward rate on the settlement date
- Customer waad: To buy foreign currency from the bank
  - Condition: If the spot price is at or below the forward rate on the fixing date
  - Price: pre-agreed forward rate on the settlement date

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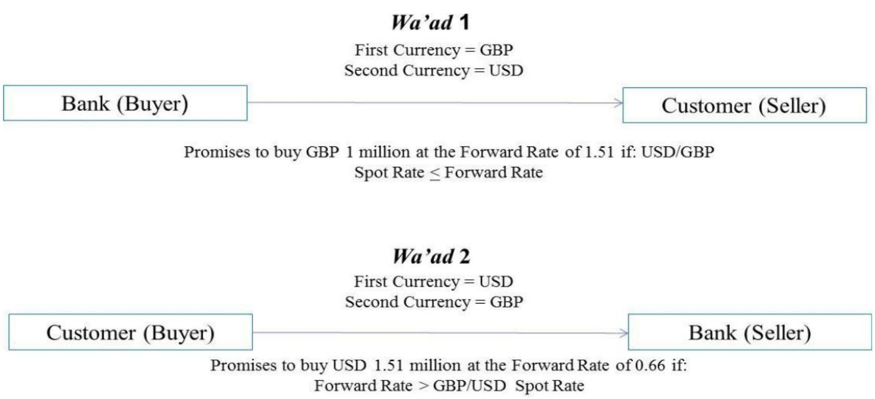
FX forward diagram



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Numerical example

- Forward rate: 1.51 USD/GBP
- Fixing date: Jan 1, 2018
- Notional value: 1,000,000 GBP
- Scenario 1:
  – on the Exercise Date if USD/GBP Spot Rate is < 1.51, the Customer exercises its rights under Wa'ad 1, so that on the Settlement Date, the Bank buys GBP 1 million in exchange for USD 1.51 million.
- Scenario 2:
  – on the Exercise Date, if USD/GBP Spot Rate is > 1.51 (i.e. Forward Rate of 0.66 > GBP/USD Spot Rate), the Bank exercises its rights under Wa'ad 2, so that on the Settlement Date, the Customer buys USD 1.51 million for GBP 1 million.

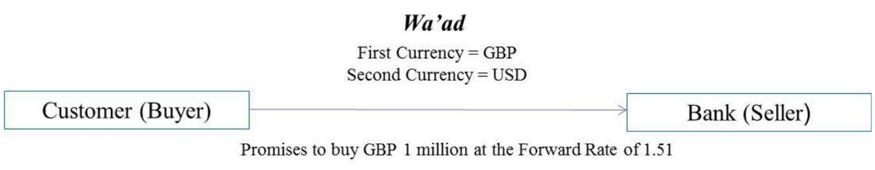
Documentation structure

1) TMA Master agreement
2) Schedule to TMA master agreement
3) Product documentation:
   1) Master terms and conditions for an Islamic FX forward (two unilateral waad based structure)
   2) Annex 1 – form of party A's undertaking
   3) Annex 2 – form of party B's undertaking
   4) Annex 3 – form of exercise notice
   5) Annex 4 – form of offer and acceptance

Mechanics of FX Forward – I (one waad structure)

- <u>Suitability</u>: clients who have a foreign currency cash flow that they would like to hedge and who are willing to accept an opportunity loss should the Fixing Price be below the Strike Price.
- <u>Structure</u>: One unilateral FX waad
- <u>Customer waad</u>: To buy foreign currency from the bank
  - Condition: If the spot price is at or below the forward rate on the fixing date
  - Price: pre-agreed forward rate on the settlement date
- <u>No bank waad</u>

FX Forward diagram (one waad)



On the Exercise Date, the Bank exercises its rights under the Wa'ad, so that the Customer buys GBP 1 million in exchange for USD 1.51 million. Although for Shari'ah related reasons the Bank is not strictly under an obligation to exercise its rights under the Wa'ad, given that this is an IFX Forward product the expectation is that it would do so.

Documentation structure

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Islamic Derivatives Solutions

- Islamic Cross Currency Profit Rate Swap (CCPRS)
- Islamic Profit Rate Swap (IPRS) – two sale / one sale structures

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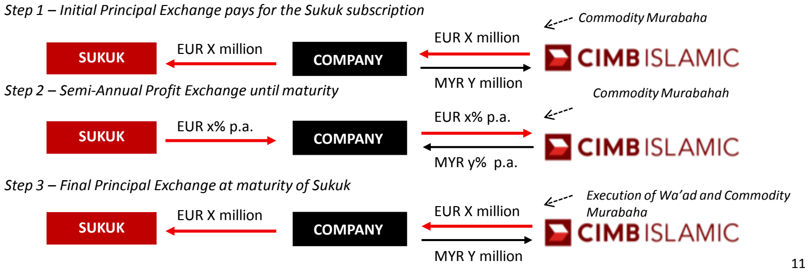
Islamic Cross Currency Profit Rate Swap (CCPRS)

- An Islamic Cross Currency Profit Rate Swap ("CCPRS") involves the exchange of principal and profit in one currency for the principal and profit in another currency.
  - Principals are exchanged at the start (optional) and end of the swap. This is done at a pre-determined exchange rate which eliminates any uncertainty due to foreign exchange movement
  - The CCPRS allows client to convert effectively a liability or an asset from one currency to another
  - The profit rates on both sides can be either fixed or float

Example: Converting EUR Fixed Returns from Sukuk into MYR Fixed Returns



Product Description

- Each party simultaneously grants to the other party a Wa'ad (undertaking) to purchase Shari'ah Compliant Assets from such other party on one or more specified future dates on the basis of Murabaha transactions to be entered into on each exercise of the Wa 'ad (undertaking)
- Where the purchase price payable in respect of each such Murabaha transaction is to be determined on the basis of the cost price of the purchased Shari 'ah Compliant Assets plus a profit amount, with the purchase price payable by one party being denominated in one of the two currencies the subject of such Islamic cross-currency swap and the purchase price payable by the other party being denominated in the other of the two currencies the subject of such Islamic cross-currency swap.
- This DFT Terms confirmation contains a Wa 'ad (undertaking) granted by Party A (as Buyer) to Party B (as Seller). Under a Related DFT Terms Agreement, Party B (as Buyer) grants a Wa 'ad (undertaking) to Party A (as Seller). This DFT Terms Agreement and the Related DFT Terms Agreement together form an Islamic Cross Currency Swap.

Worked Example

Party A will issue USD 10,000,000 Sukuk with a 12-month tenor on 1 February 2016:

• Sukuk pays out a capital (or principal) amount at one year maturity and periodic (monthly) floating profit amounts to investors over the course of its tenor.

• Party A's main operations are in Euro and Party A wishes to sell the USD it has raised under the Sukuk for Euro.

• Party A's main income is in fixed Euro and Party A is exposed to any changes in the currency exchange rates of Euro to USD and the profit rates in respect of USD.

• Party A wishes to hedge itself against the possibility that the exchange and profit rates used to calculate the USD floating amounts will increase. By entering into the ICRCS, it is looking to fix its exposure in relation to the Sukuk.

• Party A wishes to buy the USD it requires to repay the principal of the Sukuk on maturity.

The PRS enables Party A to hedge its USD exposure under the Sukuk by converting it into a Euro exposure (i.e. Party A knows that by paying an amount of Euro to Party B, Party A will receive from Party B the USD amount necessary to pay under the Sukuk). Party B was highly dependent on Euro income and through the PRS is able to convert some of that into USD income.

Hedging Transactions

Party A and Party B enter into ICRCS on 25 January 2016 (Trade Date), under which:

<u>Initial Exchange:</u>
• Party A will pay a USD capital amount (Profit Type 1) (being the amount raised under the sukuk) under one (First) leg of the ICRCS (and receive a Euro amount under the other leg).
• Party B will pay a Euro capital amount (Profit Type 1) under one (Second) leg of the ICRCS (and receive a USD amount under the other leg).

<u>Interim Exchanges</u>
• Party A will pay Euro fixed amounts (Profit Type 2 – Fixed Profit Rate) under one (First) leg of the ICRCS (and receive USD floating amounts under the other leg).
• Party B will pay USD floating amounts (Profit Type 2 – Floating Profit Rate) under one (Second) leg of the ICRCS (and receive the Euro fixed amounts under the other leg).

<u>Final Exchanges:</u>
• Party A will pay a Euro capital amount and fixed amount (Profit Type 1 + Profit Type 2 – Fixed Profit Rate) under one (First) leg of the ICRCS (and receive a USD amount under the other leg in order to repay the principal under the Sukuk).
• Party B will pay a USD capital amount and floating amounts (Profit Type 1 + Profit Type 2 – Floating Profit Rate) under one (Second) leg of the ICRCS (and receive the Euro amount under the other leg).

<u>**To achieve these payments, the parties will buy or sell Shari'ah compliant assets to each other pursuant to a Murabaha Sale to be entered into pursuant to a Wa'ad (or undertaking).**</u>

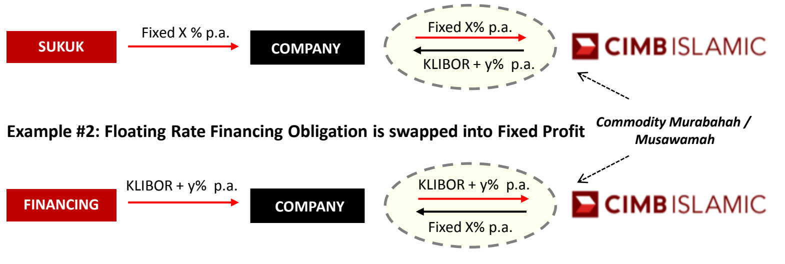
Documentation structure

1) TMA Master agreement
2) Schedule to TMA master agreement
3) DFT terms confirmation – first leg – Party A as buyer
    1) Annex 1 – form of exercise notice
    2) Annex 2 – form of Murabaha party A as buyer asset sale confirmation
4) DFT terms confirmation – first leg – Party A as buyer
    1) Annex 1 – form of exercise notice
    2) Annex 2 – form of Murabaha party A as buyer asset sale confirmation

Islamic Profit Rate Swap (IPRS)

- Islamic Profit Rate Swap modifies the profit rate index of a liability (or asset) without changing the characteristics of the underlying debt (or asset). An existing fixed profit rate exposure can be swapped into a floating profit rate exposure or vice versa.
    - Exchange of profit rate only
    - No exchange of principal
    - Can use one sale structure or two sale structure

Example #1: Fixed Profit received from Sukuk is swapped into Floating Profit



Mechanics of Profit Rate Swap (one sale structure)

- Suitability: clients who require to swap floating profit rate of existing Islamic financing to fixed profit rate to protect against profit rate movements until maturity.
- Structure: Two unilateral waad to enter into Murabaha
- Bank Waad: To buy commodities on Murabaha basis from client
  - Condition: If the floating rate is higher than the fixed rate on the fixing date
  - Price: cost price + profit ([floating rate – fixed rate] * notional value * days)
- Customer waad: To buy commodities on Murabaha basis from bank
  - Condition: If the fixed rate is higher than the floating rate on the fixing date
  - Price: cost price + profit ([fixed rate – floating rate] * notional value * days)
- Only one waad can be enforced due to the condition

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Numerical example

- Fixed rate: 5%
- Floating rate: 3 month LIBOR
- Fixing date: Jan 1, 2018
- Fixing frequency: 3 months
- Notional value: 1,000,000 USD
- Bank Waad: if floating (3M Libor) > fixed (5%) on fixing date, bank buys commodities from client on Murabaha with profit equal to 1,000,000 * (floating – fixed) * 90/360
- Client Waad: if fixed (5%) > floating (3M Libor) on fixing date, client buys commodities from bank on Murabaha with profit equal to 1,000,000 * (fixed – floating) * 90/360
- Scenarios:
  - Fixed > floating: bank exercises waad and client buys commodities from bank
  - Floating > fixed: client exercises waad and bank buys commodities from client

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Mechanics of Profit Rate Swap (two sale structure)

- Suitability: clients who require to swap floating profit rate of existing Islamic financing to fixed profit rate to protect against profit rate movements until maturity.
- Structure: Two unilateral waad to enter into Murabaha
- Bank Waad: To buy commodities on Murabaha basis from client
  - Price: cost price + profit (fixed - floating rate] * notional value * days)
- Customer waad: To buy commodities on Murabaha basis from bank
  - Price: cost price + profit (floating - fixed rate] * notional value * days)
- Both Waads are exercisable but practically, only one will be exercised at maturity

Numerical example

- Fixed rate: 5%
- Floating rate: 3 month LIBOR
- Fixing date: Jan 1, 2018
- Fixing frequency: 3 months
- Notional value: 1,000,000 USD
- Bank Waad: if floating (3M Libor) > fixed (5%) on fixing date, bank buys commodities from client on Murabaha with profit equal to 1,000,000 * (floating – fixed) * 90/360
- Client Waad: if fixed (5%) > floating (3M Libor) on fixing date, client buys commodities from bank on Murabaha with profit equal to 1,000,000 * (fixed – floating) * 90/360
- Scenarios:
  - Fixed > floating: bank exercises waad and client buys commodities from bank
  - Floating > fixed: client exercises waad and bank buys commodities from client

Documentation structure

1) TMA Master agreement
2) Schedule to TMA master agreement
3) DFT terms confirmation – first leg – Party A as buyer
    1) Annex 1 – form of exercise notice
    2) Annex 2 – form of Murabaha party A as buyer asset sale confirmation
4) DFT terms confirmation – first leg – Party A as buyer
    1) Annex 1 – form of exercise notice
    2) Annex 2 – form of Murabaha party A as buyer asset sale confirmation

Thank You

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