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Structured Thoughts

News for the financial services community.

Sharia-Compliant Structured Products

The same features that continue to attract investors to structured products have recently garnered the interest of Islamic investors. Structured products provide retail investors with access to sophisticated payout structures and allow exposure to particular underlying securities in which a direct investment may be impossible or prohibitively expensive. As the international securities markets begin to show signs of renewed life, issuers will likely position themselves to take advantage of the largely untapped market of Sharia-compliant structured products. In this issue of *Structured Thoughts*, we explore some Sharia-compliant mechanisms that issuers can synthesize into Sharia-compliant structured products.

Background

There are three broad principles that underlie the majority of the rules of Islamic finance. First, Sharia prohibits *riba*, which is generally considered to be equivalent to loan interest (this particular type of *riba* is also called *riba-al-naseeyah*). The restrictions of *riba*, however, are arguably broad enough to include any practice where one party profits without assuming any risk. For example, the exchange of a certain amount of a commodity for a different amount of the same commodity is prohibited as a form of *riba* called *riba-al-fadl*.

The second prohibition lies on the other end of the risk-taking spectrum. Specifically, Islam prohibits the practice of *gharar*, which roughly translates to "uncertainty" or excessive risk taking. Under this principle, Sharia prohibits speculative practices and practices where at least one party to a contract is excessively uncertain of the outcome of the contract. The uncertainty can relate to any part of the contract, including consideration, payout, and tenure.

The third and most straightforward rule prohibits investment in companies that engage in *haram* (i.e., forbidden) activities. *Haram* is a broad term that includes dealing in pork-related foods, alcohol, gambling, and pornography. A company's capital structure is also relevant in that the company may not derive a substantial portion of its revenue from practicing *riba*, nor can it rely heavily on interest-bearing loans to maintain its operations. Investors commonly employ an equity screen to comply with this rule. For example, Dow Jones Islamic Market Indexes^{SM} (DJIM) applies the following exclusionary screens: [1]

[1] Dow Jones Islamic Markets, "Dow Jones Islamic Market Indexes^{SM} World Measures with a New Perspective," http://djdharmaindexes.com/mdsidx/downloads/brochure_info/Islamic_broch.pdf.

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Industry Screens	Financial Ratio Screens
— Alcohol — Pork-related products — Conventional financial services — Entertainment — Tobacco — Weapons and defense	None of the following may exceed 33%: — Total debt divided by trailing 12-month average market capitalization — The sum of a company's cash and interest-bearing securities divided by trailing 12-month average market capitalization — Accounts receivables divided by trailing 12-month average market capitalization

While the above screen may prohibit investments that are in, or linked to, bank holding companies that operate conventional banking subsidiaries, it does not necessarily bar investments in securities issued by an Islamic subsidiary of a bank holding company. Sharia scholars generally agree that it is permissible for bank holding companies to offer Islamic banking services through wholly owned Islamic subsidiaries.[2]

Principal Protection

Although principal protection seemingly violates the prohibition of risk-free profit, the economic effect of principal protection can be achieved by combining different Sharia-compliant structures. Here, we describe a principal-protected structured note that could be linked to a single stock, a stock basket, or a commodity (the "underlying"), and is based on combining a *murabaha* contract with a *arbun* sale.

Murabaha: A *murabaha* contract is a sale with a markup. Commonly, *murabaha* contracts are used in purchase financing arrangements where the financier agrees to purchase an item at the market price, then sells the item to its client at a markup on a deferred payment basis. In this example, the issuer of the notes (the "SPV") will be the financier and will sell a commodity to an Islamic bank on a deferred payment basis.

Arbun: A *arbun* payment is equivalent to a down payment towards the purchase of a specified item at a specified price, and within a specified time frame. If the buyer decides not to purchase the item, or if the specified time lapses, the seller may keep the *arbun*. The buyer, however, may decide to purchase the item at the pre-specified price at any time during the specified period.[3] *Arbun* sales have been used to synthesize call option behavior since conventional options generally fail the *gharar* test described above.

[2] *See, e.g.*, About HSBC Amanah, http://www.hsbcamanah.com/amanah/about-amanah/; About Citi Islamic, http://www.citibank.com/ciib/homepage/aboutus/intro.htm.
[3] *See* Decision number 72(3/8) Regarding Arbun Sale (June 27, 1993), Islamic Fiqh Academy. (Decision available in Arabic at http://www.fiqhacademy.org.sa/qrarat/8-3.htm).

Figures 1.1 & 1.2: Principal-Protected Structured Product

At time t=0 (Settlement)

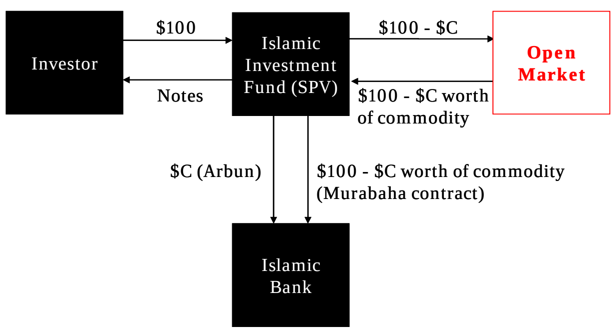

Figure 1.1

At time t=T (Maturity), if P>K

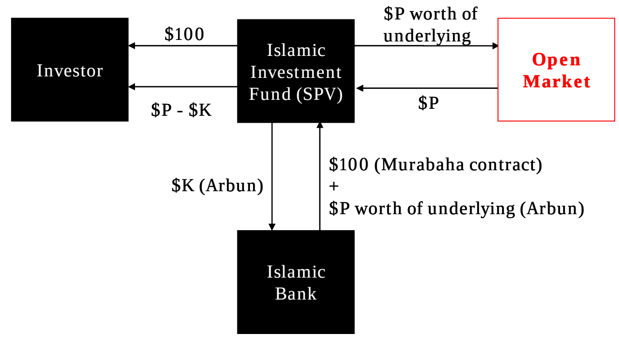

Figure 1.2

$C= *Arbun* (down payment/call premium) amount
$K=Agreed upon price of underlying in *Arbun* contract (strike)
$P= Spot price of underlying at maturity (t=T)

As described in Figure 1.1 above, an Islamic investment fund (or SPV) will enter into two agreements with an Islamic investment bank at settlement. The first is a *murabaha* contract in which the SPV sells $100-$C worth of a commodity to the bank in exchange for $100 at maturity. The SPV will purchase the commodity used in the *murabaha* contract from the open market at spot. The second is a *arbun* contract granting the SPV the right to purchase the underlying at maturity for $K (the strike price). The price of the underlying at maturity ("P") determines the payout to the investor as follows:

Scenario 1: $P is greater than $K: As shown in Figure 1.2, if P is greater than K at maturity, the SPV will choose to complete the *arbun* sale and will receive the underlying security at K. The SPV will subsequently sell the underlying in the open market for P and remit $P - $K to the investor. The SPV will also receive $100 in *murabaha* proceeds from the Islamic bank, which it will also remit to the investor.

Scenario 2: $P is less than or equal to $K: Here, the SPV will not complete the *arbun* sale forfeiting $C. The SPV will, however, still receive $100 in *murabaha* proceeds, and will remit that amount to the investor.

Therefore, the payout to an investor, as shown in Figure 2, is identical to the payout on a conventional uncapped, unleveraged, principal-protected note. Figure 2 assumes the strike price ($K) to be equal to the spot price of the underlying at settlement.

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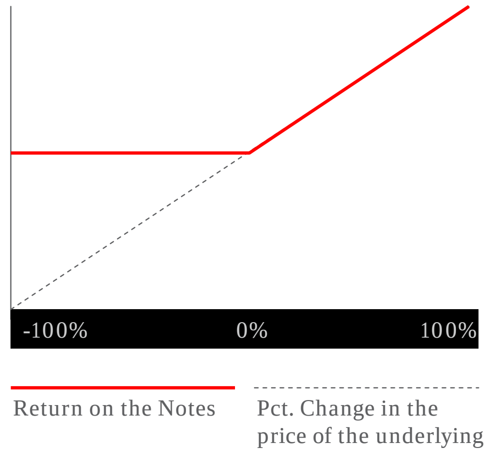
Figure 2: Payout on a Principal-Protected Sharia-compliant note



Choice of Market Measure

While the principal-protected structure described above is applicable to structured notes linked to a market measure that can be easily exchanged through a *arbun* contract, investors are likely to seek exposure to a wider range of market measures, such as foreign exchange rates, fund shares, or economic indicators. The structure described below provides this exposure by using two mutually exclusive bilateral promises (each a *wa'd*) between the issuer and an Islamic investment fund.

Figures 3.1 & 3.2: Dual *Wa'd*-Based Structured Product

At time t=0 (Settlement)

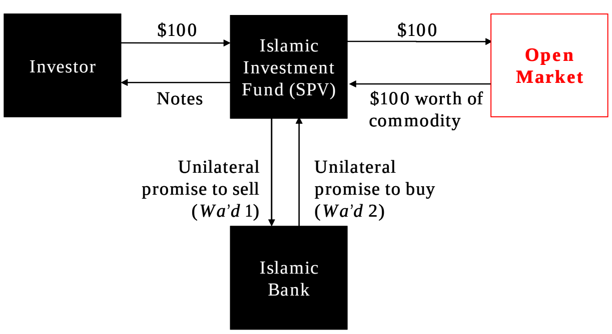


Figure 3.1

At time t=T (Maturity)

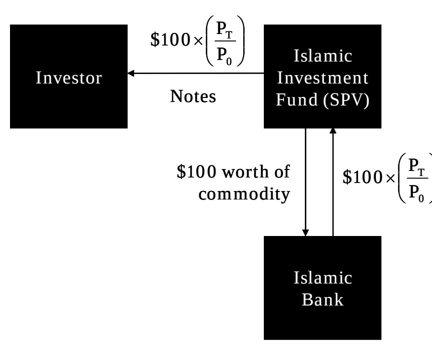


Figure 3.2

$\$P_0$= Spot price of underlying at pricing (t=0)
$\$P_T$= Spot price of underlying at maturity (t=T)

In this structure, the SPV purchases a commodity from the open market using the proceeds from the sale of the notes. At the same time, the SPV unilaterally promises to the sell the commodity to the Islamic Bank at the settlement price, and the Islamic Bank unilaterally promises to purchase the commodity for the same settlement price. The parties will agree to calculate the settlement price at maturity as a function of the change in the value of the underlying market measure.

At maturity, the Islamic Bank will purchase the commodity from the SPV at the settlement price since it will be profitable for one of the parties to enforce the other's unilateral promise regardless of the then market value of the commodity. More specifically, if the price of the underlying increases from pricing to maturity, the SPV will hold the bank to its promise to purchase the commodity. Conversely, if the price of the underlying decreases from pricing to maturity, the bank will hold the SPV to its promise. Given that the Islamic Bank will own the commodity at maturity, the choice of commodity could be critical, since it could provide a built-in hedge for the bank.

The dual *wa'd* structure is employed here because Sharia prohibits sales contracts in which the price is not fixed when the parties enter into the contract. Some Sharia scholars hold that unilateral promises, however, are not subject to the same restrictions as sales contracts, and allow for a greater degree of uncertainty. For a more detailed discussion of the Sharia concerns related to this structure, please see Deutsche Bank's academic paper discussing the subject.[4]

The effectiveness of this structure depends heavily on the enforceability of unilateral promises, and the Islamic finance community has not yet reached a consensus on this issue. Some jurists hold that enforcing dual unilateral promises amounts to an impermissible forward contract; others will enforce a promise only if the promisee reasonably relied on the promise to their detriment; and some will enforce dual promises as long as no other part of the agreement is impermissible.

Conclusion

It is important to note that the Islamic finance industry is in a state of flux, and that prevailing jurist opinions may differ substantially across jurisdictions. It is advisable, therefore, to remain attuned to the publications of the Islamic Financial Services Board (IFSB), the Islamic Fiqh Academy, and the Accounting and Auditing Organization for Islamic Finance Institutions (AAOIFI).

Written by

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[4] Press Release, Deutsche Bank AG, "Deutsche Bank publishes White Paper to increase supply of Sharia compliant alternative investments" (January 30, 2007), http://www.db.com/presse/en/content/press_releases_2007_3347.htm

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