

Sharia-compliant structured products

As other financial contracts in conformity with the Sharia code, Sharia-compliant structured products follow investment directives which observe the Islamic faith. Accordingly, transactions must relate to material assets and may not be inferred from monetary assets. In addition, the way in which risk is spread between the contract parties restricts the use of conventional derivatives. However, there are solutions which theoretically achieve similar results as conventional products.

As opposed to conventional European and Anglo-Saxon structures, when structuring financial products according to Islamic law, not only must the desired payout profiles with their risk/return features be optimised, but strict care must be taken to ensure that the tripartite harmony with Sharia law is observed. This means that the following three elements must all conform with Sharia code:

1. underlying
2. trading mechanism or investment strategy
3. packaging structure

What is Sharia-conform?

Just as for conventional derivatives and structures, framework contracts are also drafted for Sharia-conform products. The difficulty in constituting these contracts is that the different schools of thought or “Sharia Boards” have no uniform understanding of what is admissible as a financial transaction and what is not. Due to this heterogeneity, the *International Swaps and Derivatives Association* (ISDA) is currently analysing the fundamental legal issues of Islamic law. The objective is to find a more homogeneous interpretation and implementation for derivatives business and to create Sharia-conform ISDA documentations which can be used in different jurisdictions. These endeavours are centred on the United Arab Emirates (Dubai and Abu Dhabi), Bahrain, Saudi Arabia, Kuwait and Qatar, but there is also an ongoing coordination with interpretations in Asia-Pacific.

Underlyings and indexes

The following five investment classes have been used until now as underlyings for structured retail products:

- Sharia-conform savings plans
- Shares or share portfolios, including private equity structures
- Currencies
- Commodities
- Real estate

Until now most retail products have been packaged as investment funds; the first products for retail customers used Sharia-

conform funds as underlyings. But indexes or products similar to indexes are now increasingly used, although exclusively on shares. Compliant share indexes exist for various world regions. Such share indexes are dynamic in their composition. The components must be regularly scrutinised for their Sharia-conformity. Indexes on *Sukuk* (plural of *sakk*, “legal instrument, deed, check”, is the Arabic name for a financial certificate but can be seen as an Islamic equivalent of bond) or *Murabahas* (is defined as a particular kind of sale, compliant with Sharia, where the seller expressly mentions the cost he has incurred on the commodities to be sold and sells it to another person by adding some profit or mark-up thereon which is known to the buyer) as a substitute for bond indexes are still lacking. Products with underlyings such as salt, gold or

silver are not admissible because these are considered to be substitutes for money. Because currencies are also considered as a money substitute in certain cases, hedging foreign currency positions with derivatives is not so easily possible, but there are already solutions emerging for this issue.

Trading mechanisms and investment strategy

Conventional structured products are frequently put

together with options or borrowed capital through trading mechanisms for leverage purposes. These may not be used. Most elements from the derivatives range known today still cannot be described as Sharia-conform. For instance, there is no substitute for put options, genuine forwards and futures, and there is also no alternative for levered products. But whether *Mudarabas*, a form of dormant participation, can be used as a lever in structures cannot be definitely clarified. A distribution of profits over two contract parties is theoretically possible in this form. One party contributes know-how and the other the capital for a specific business purpose. There are indications that structures are already traded on the market which use a form of lever. However, the described leverage effect, it can be supposed, is not as efficient as conventional borrowed capital financing.

But there are *Salam* and *Arboun*. *Salam* is a precisely defined future transaction in which a bank buys goods in the buyer’s name and delivers them to the buyer at a later point in time at a price agreed beforehand. The *Arboun* is a kind of

“For constituting structured products, not only the ingredients (underlyings), but also the trading mechanism and the packaging must be Sharia-conform.”

Sharia-compliant call option and can be compared to a future transaction that can be terminated. The prepayment of the option money is forfeit if the option is not exercised.

The Salam structure offers opportunities for Sharia-conform swaps. These are customary with French issuers. In addition, *Range Accruals* (standard products for interest derivatives) are technically feasible.

The first investment funds can already replicate the short sale of shares without offending against Islamic laws. It must still be worked out whether such funds can substitute the effective short sale necessary for delta hedging of options and useful for hedging derivative structures.

Packaging structure

Frequently used standard structures, such as *Collateralised Debt Obligations* in credit derivatives, cannot simply be put together in a Sharia-conform way because of their segmentation into interest instruments and equity capital portion. Not only is it mandatory that such a product is based on conform underlyings, but the assets must also be traded in a compliant way and the resulting cash flows properly distributed. Otherwise, the entire vehicle is not considered as Sharia-conform.

Capital protection

Many plain vanilla and exotic structures may – for the time being – not be used. Fully excluded at the moment are structured products with digital options because they contain a bet (gambling) element. Then again, the first capital-protected bonds with diversified investment portfolios have been issued. As no borrowed capital may be applied for leverage purposes, it is not surprising that these notes are diversified over three to four investment classes to ensure that the corresponding volatilities of the underlying basis fund are kept as low as possible. It is well known that low volatility leads to lower setbacks, which in fact is a form of capital protection.

Whereas traditional option payout structures offend against many Sharia rules (interest prohibition, prohibition of uncertainty at contract conclusion, and prohibition of speculation or gambling), some *Constant Proportion Portfolio Insurances* (CPPIs) and coupon-paying structures can be structured to conform to the Sharia: There are structures with income-based coupon payments, *look back* and *profit lock* in elements. The former mostly depend on the highest or lowest prices reached by the underlying during the product's term, whereas the latter secure already distributed profits during the term. Murabahas are used as a risk-free investment.

Other than CPPIs, capital protection products can also be put together with an Arboun and a Murabaha. The Arboun replicates the purchase of a call option and the Murabahas represent the risk-free investment.

The rapid growth for Sharia-conform financial investment solutions over recent years shows that structured products are increasingly demanded by Islamic clients. However, also in the future it will still not be possible to replicate all conventional derivative products in a Sharia-compliant way. Instead, we should focus on designing additional Sharia-conform products that are not comparable with conventional

structures. Creativity is the decisive factor to successfully realise this objective.

“The difficulty is that the different Sharia boards have no uniform understanding of what instruments are admissible.”



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