Derivatives in Islamic finance –
A case for Profit rate swaps

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Abstract

“Derivatives are financial weapons of mass destruction”- Mr. Warren Buffet, Chairman Berkshire Hathaway

Islamic finance has been well established for over thirty years. Some financial commentators have opined that Islamic finance’s approach could be the future of global finance given the fallout from the global financial crisis.

What about derivatives in this brave new world? Derivatives are a long established part of the global financial markets and are heavily traded in the financial markets. What about the Islamic world? The Qur’an’s prohibition on excessive risk, gharar, would prima facie seem to denote derivatives a prohibited class of investment. Is that really true? Forward contracts of sale, bai al salam and arbun, options, are permitted. This article takes a fundamental look at whether there can be any place for financial derivatives in Islamic finance through the lens of a particular derivative - the interest rate swap.

This article starts off with an overview of Islamic finance from its roots in the classical texts of Islamic law including the Qur’an, Sunnah and the hadith. It will highlight and identify similarities and differences between the four major schools where appropriate. Chapter 4, critically analyses from first principles the Islamic texts to review whether there is any indication that derivatives in general, and interest rate swaps in particular could be permitted under fiqh.

The key findings are:

• Synthetic interest rate swaps have been created that follow the form of Sharia law, and
• Islamic legal arbitrage allows interest rate swaps to be created in substance.

Introduction

Islamic finance is broadly defined as all financial activities in which Muslims engage. One of the objectives of Islamic finance is to replicate the efficient structures, deals and products in traditional western financial markets using techniques or structures that comply with both the letter and the spirit of the

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principles of Sharia. In this paper I will explore the fundamental textual sources of the Qur’an and the Sunnah to establish the legal basis for derivatives in general and interest rate swaps in particular. I will critically discuss whether there can be interest rate swaps in substance, which conform to the form and principles of Sharia law. The central question in any analysis of Islamic finance is whether the form or substance or both of the structure must be “Islamic”. I will explore this question in detail.

As I do not speak Arabic, I apologize for not using the original texts and relying on translations. Any misunderstanding caused by the translations is solely due to me.

**Textual Sources of Islamic financial Law**

“There is not just one Islamic law. There are many different Islamic laws and different schools, time period and countries”

_Vikor, Between God and the Sultan: A History of Islamic Law_

The starting point for all legal matters in the Muslim world is the Qur’an and the Sunnah. The Qur’an is believed by Muslims to be the word of God and the Sunnah is the record of the sayings and deeds of the prophet Mohammed.

Indeed, Henry Corbin once said that the Qur’an posses a hidden depth containing both an exoteric and esoteric meaning³. Corbin went on to say, that each meaning contains another, in the same way that an onion conceals further levels beneath. Corbin called these “seven depths of hidden depths”. This theme is a central issue in the primary sources in Islamic law, because when it seems that the guidance is clear, it may be that one meaning has a secondary meaning. Different interpretations have sprung up and they are often differentiated by reference to a madh’hab or school. During this paper, I will focus on the four major schools of Sunni Islam which are the Hanafi, Maliki, Shafi’i and Hanbali. The majority of Muslims consider hadith to be essential supplements to and clarifications of the Qur’an. Hadith scholarship and interpretation have become crucial in the world of Islamic finance for finding some justification for the structures and instruments created. A central tension in Islamic finance is the form versus substance debate. There may be words in the hadith which permit a particular type of financial instrument, but the instrument itself would seem to violate what is perceived to be the ethical purpose of Islam. I will address some of these issues in detail.

Key principles of Sharia and Islamic Finance

Islamic Finance is seen in the west as a negatively established system. What I mean is that in the western financial markets everything is permitted except what is not prohibited by law. In reality, Sharia legal scholars say that laws fit into three boxes. Those that are expressly prohibited by the Islamic texts, those permitted and those that are neither and therefore can be reasoned either way by analogy. The practice of asking Sharia committees what one can and cannot do is a cornerstone of the Islamic financial markets. Ibn Taymiyyah is well known for supporting an almost laissez-faire attitude to freedom of contract. His views were certainly more in favor of the “if it isn’t prohibited, allow it” school of thought. This view is broadly supported by Sharur who also took a more realist approach to Sharia.

I will now outline the key Sharia principles that are relevant for my analysis of interest rate swaps.

Riba

Riba is commonly described as the prohibition of the payment or receipt of interest. Sharia prohibits riba, but it does not prohibit trade or making a profit as part of that trade\(^4\). The Qur’an forbids usury, interest, and the Sunnah prohibits exchanges of unequal commodities. In verse 2:275\(^5\) the Qur’an states that trade is like usury, but trade is permitted and usury not. Again in verse 3:130\(^6\), we are told not to devour usury but fear God. In verse 4:161\(^7\), the verse states that those who took usury devoured men’s substance wrongfully. Verse 30:39\(^8\) states that increasing through the property of other people will have no increase with God, but those that embrace charity will get recompense multiplied.

In a number of hadith, riba is also mentioned. Allah’s Messenger has been quoted as cursing the acceptor of usury\(^9\); exchange of bad dates for good dates is a kind of usury\(^10\). Some commentators such as Siddiqi suggest that if riba can produce stability

\(^4\) Qur’an (2:275) Al Baqarah  
\(^5\) Qur’an (2:275) Al Baqarah  
\(^6\) Qur’an (3:130) Al-‘Imran  
\(^7\) Qur’an (4:161) Al-Nisa  
\(^8\) Qur’an (30:39) Ar-rum  
\(^9\) Sahih Muslim, Book 010, Number 3881  
\(^10\) Sahih Bukhari, Volume 3, Book 034, Number 294, Number 344 and Number 379
and efficiency in the economy, an increase in justice and fairness, and is conducive to growth it should be allowed\textsuperscript{11}.

According to ul Hassan, one of the objectives of Islam is to establish justice between financier and entrepreneur\textsuperscript{12}. In my view, the prohibition on exchanging products which appear to be the same, but are not, seems reasonable. Sharia wants parties to take shared risk in the venture. Therefore, there needs to be an actual asset involved. The fact, however, that a financier is taking two types of risk seems to be overlooked. On the one hand the money lender is taking credit risk on the borrower. On the other the Qur’an and hadith expressly state that a creditor should not only be lenient on a borrower but should in some cases forgive the debt entirely\textsuperscript{13}. In my view the prohibition of interest may just be on a financier taking someone else’s money unjustly.

\textit{Maisir – speculation}\textsuperscript{14}

Sharia prohibits gambling, excessive speculation or transactions based on chance. Commercial risk taking, like opening a shoe shop, is allowed under the Sharia. The prohibition seems to focus on transactions that have the manipulation of risk as their sole or primary purpose as tantamount to gambling. Some commentators say that the prohibition of maisir is why futures, options and swaps are prohibited.

\textit{Uncertainty – gharar}\textsuperscript{15}

Risk and uncertainty are usually differentiated. Al-Suwailem says that the word gharar in Arabic means a risk that implies delusion and deception\textsuperscript{14}. Risks can normally be measured. Uncertainty cannot. The Hanafi and Hanbali schools define gharar as “that with hidden consequences”. Whereas the Shafi‘i school describes it as “that whose nature and consequences are unknown”. Uncertainty, however, in Islamic law will render a contract void in the same way as under Anglo-

\textsuperscript{11} Siddiqi, M N, Riba, Bank Interest and the Rationale of its Prohibition, Islamic Development Bank Islamic Research and Training Institute, Jeddah, Saudi Arabia, p. 35
\textsuperscript{12} An Explanation of Rationale behind the Prohibition of Riba in the Doctrines of three major religions: with special reference to Islam by Mehboob ul Hassan; Ph. D. Candidate, Post Graduate School of Economics, Nagoya City University, 1. Yamanohata Campus, Mizuho-Ku Nagoya City, Japan. E-mail : mhassanjp@yahoo.co.jp
\textsuperscript{13} Qur’an 64:14 Al Taghabun. See also Narrated Abu Huraira: Allah’s Apostle said, ”A man used to give loans to the people and used to say to his servant, 'If the debtor is poor, forgive him, so that Allah may forgive us.' So when he met Allah (after his death), Allah forgave him.” (Book #56, Hadith #687)
\textsuperscript{14} TOWARDS AN OBJECTIVE MEASURE OF GHARAR IN EXCHANGE, SAMI AL-SUWAILEM; Islamic Economic Studies, Vol. 7, Nos. 1 & 2, Oct. ’99, Apr. 2000 at 66
American law\textsuperscript{15}. In modern financial transactions, gharar applies to contracts where the subject matter of the contract is not in possession of one of the parties, and there is uncertainty about its future possession\textsuperscript{16}. Generally Sharia law recognizes that there is a risk in most commercial enterprises. This does not appear to be the same thing as uncertainty, because I can calculate the risk. Looking at risk and uncertainty in the context of financial derivatives, it may be that if gharar is defined as consequences, then mathematically all outcomes can be calculated. This then would mean that no consequences are hidden and there is therefore an absence of gharar. There is still risk, but all possible outcomes are known. It is only which precise outcome that is “uncertain”. If uncertainty is prohibited, but I can take risks provided that they are in a trading context, then possibly, there may be scope for derivatives.

\textit{Unfair exploitation}

Sharia has a sort of inbuilt consumer protection doctrine\textsuperscript{17} to prevent one party from benefiting at another party’s loss. The critique of this, however, is that in cost plus sales, there is nothing stopping the parties from agreeing to a 60\% interest rate for a one week transaction. Under Sharia law the parties have freedom to contract and the contract would be held valid if the parties agreed all the terms including the interest rate.

\textbf{Discussion - Interest rate swaps}

"Interest is the price of time and time belongs to God".

\textit{Aristotle}

There is no express mention of interest rate swaps in the Qur’an or the Sunnah. Therefore there can be no question that they are not required (wajib), recommended

\textsuperscript{15} Classic examples of contracts that are prohibited due to gharar include sale of fish in the sea, and birds in the sky.
(mandub), or discouraged (makruh) according to the textual sources. The only question is whether they do not breach any of the other prohibitions. If not, can they be permitted (mubah)?

I will analyze from first principles whether the Sharia’s prohibition on interest rate swaps is valid or not.

A financial derivative is an agreement between two parties that has a value determined by the future price of an underlying asset or commodity. Swaps are a derivative in which two counterparties exchange cash flows referenced to one parties underlying asset for those of the other parties. Swaps are amongst the most heavily traded instruments in the world. According to the International Swaps and Derivatives Association, the total amount of notional outstanding at the end of June 2009 was $414.09 trillion. This is a mind boggling figure as it 29 times the annual GDP of the USA.

An interest rate swap is where one counterparty exchanges fixed interest payments on a loan for floating interest rate payments on a separate loan.

![Diagram of Interest Rate Swap]

The notional principle amount is not usually exchanged between the parties. By entering into an interest rate swap, the net result is that each party can 'swap' their existing obligation for their desired obligation. In return for matching the two parties together, the bank takes a spread from the swap payments.

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20 Plain vanilla interest rate swap with a bank counterparty. See http://en.wikipedia.org/wiki/File:Vanilla_interest_rate_swap_with_bank.png
Usury

In my view usury has two sides. Firstly, interest is forbidden and secondly, no exchange of unequal products. We will focus on the first to see whether in fact the Qur’ān is internally consistent in this regard. The mudarabah or cost plus financing is a classic Sharia compliant business transaction. The plus component normally equates exactly to an interest rate charged in the western world. The underlying form versus substance debate certainly sides with form, because it appears to me that cost plus financing is exactly the same as charging interest in substance. Therefore, if interest, all be it hidden in a mudarabah contract, is permitted then it appears that interest can be charged for borrowing.

Al-Maisir – gambling

There is a strict prohibition on gambling in the Sharia. The word literally means game of chance and is derived from various roots. One of which is Yusr which means convenience and is a means of earning without toil and exertion. This is a common theme within Islamic law in that there is a general dislike of someone who free rides or gets something for nothing. Maisir seems to be a prohibition on getting something for free by just gambling. As far as interest rate swaps go, there doesn’t seem to be any gambling at all. The typical fixed rate payer believes that interest rates will rise or has a debt that has a floating rate of interest, whereas the floating rate payer believes that floating interest rates will fall. Is this a gamble? No more of a gamble than the farmer who decides to wait until harvest before selling his crop rather than entering into a bai al salam contract now and selling his future crop today. In the bai al salam example, the farmer thinks future prices will fall or needs cash now, but the buyer today thinks future prices will probably rise. By analogy, if forward contracts do not breach maisir because they are not seen as gambling then I would argue that, interest rate swaps should not be deemed to breach maisir also. In my view as far as interest rate swaps are concerned the only item that is not certain is the future floating interest rates which will affect the payments under the floating legs of the deal.

Uncertainty – gharar

Is an interest rate swap uncertain and if so how? The terms of the contract are fixed at outset. Apart from the credit risk of the counterparties defaulting, the uncertainty
mostly stems around the future floating interest rate. Sharia obviously doesn’t prohibit running a business or owning an asset and the inherent uncertainty that goes along with that. Sharia seems to allow those examples of uncertainty because the person who is liable to the risk owns a tangible asset. In the interest rate swap example, there is only this concept of notional. In effect a theoretical or mathematical number designed to allow the fixed and floating rate payers to calculate the cash flows in the swap. I concede that in this regard, the analogy between a farmer who owns an asset, for example a head of cattle and a swap counterparty breaks down. The farmer owns a tangible asset. If it goes down in value he still has the object itself. For swaps though the situation is different. The counterparty doesn’t own an asset perse. He merely owns the right to a series of cash flows under the contract, and I would argue that the general dislike of transactions whereby there is no actual movement of real property can cause difficulty for the Islamic perception of transactions as a general rule. If there is no asset movement, then the transaction is void under Sharia.

There is some disagreement amongst schools regarding financial products. Some Sharia requirements, however, may have received acceptance by most schools. Sharik, which means risk sharing, is the principle that risk should be shared by all participants and linked to returns. In an interest rate swap this could be satisfied because the fixed rate payer is liable to overpay if interest rates fall in the market place and the floating rate payer would benefit. If interest rates rose the opposite would be true. Therefore, it would appear that both parties have a chance of profiting and therefore both seem to share in the risk of winning or losing in the venture.

Arbun

The Arbun contract is a Sharia compliant conditional purchase contract. Under a Arbun contract the buyer pays a deposit, a small percentage of the purchase price to the seller. The contract stipulates that if the buyer proceeds with the transaction, then the buyer will pay the purchase price less the deposit. If the buyer decides not to proceed, then the buyer forfeits the deposit to the seller. This is almost identical to the option in traditional western finance. The key difference is that in an option contract, the premium paid for the option is not deducted from the sale price if the option is exercised. Under an Arbun contract it is. The net result, however, is the same. The buyer can pay a little bit now for the right to buy the asset at a later time. In my view, Sharia law clearly permits derivatives, because the arbun is not an asset sale but is permitted under Sharia. In the event that the buyer does not proceed, the seller keeps

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22 Islamic finance and banking: The Challenge and Prospects by Khurshid Ahmad, Review of Islamic Economics, No. 9, 2000, 57-82 at 63
the premium and property in the asset remains vested in the seller. This transaction clearly has the element of uncertainty. Reasoning by analogy, if a buyer can be allowed to pay a premium for the right to buy an asset, in an interest rate swap deal can a counterparty who is paying fixed not buy the right to receive a floating rate of payment? The main objection could be that under an arbun contract if the transaction proceeds then an asset will change hands. In an interest rate swap transaction no asset typically changes hands as the notional is precisely that.

Three madh’hab’s and a hadith declare arbun to be void. The Hanbali school, however, accepts the arbun contract based on hadith. The OIC Fiqh Academy has also endorsed ‘Arbun’ but only if time limit is specified\(^\text{23}\). Ibn Rushd, the renowned jurist of the Maliki School, says, “The majority of scholars have forbidden arbun because it involves gharar, risk-taking, and the taking of money without any consideration in return”.

**Profit Rate Swap**

Interest rates swaps as I have shown above will probably violate riba, maisir and gharar. There is a case, however, for arguing the contrary. The profit rate swap seeks to achieve Sharia compliance by using a series of murabaha transactions. The primary murabaha contract will see a floating rate payer buy a commodity from broker 1, and immediately sell the commodity to the fixed rate payer. The fixed rate payer will immediately sell the commodity to broker 2 to generate cash. Fixed rate payer will then repay floating rate payer on a deferred basis in installments on pre-agreed payment dates.

Sharia law would traditionally argue that the floating rate payer paying a variable amount would not be Sharia-compliant due to the uncertainty of the amount to be paid. One argument that would counter this is that the arbun contract should also fall foul of gharar as it is not certain that the buyer will actually complete the transaction. The arbun appears to me to be a far more risky situation because of the forfeit of the premium that the buyer will lose. In an interest rate swap by comparison, it can be argued that the uncertainty of interim payment amounts is not material to the floating rate payer. What is important is that the floating rate payer agrees to pay an amount

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\(^{23}\) Ayub, Understanding Islamic Finance; John Wiley & Sons, 2007; Pp. 209-211
on a fixed day and with reference to a fixed reference, i.e. LIBOR. If Sharia requires these interim steps to be agreed and fixed at outset then an interest rate swap, by definition can never be Sharia compliant. What about if the floating rate payer agreed to make a series of payments of fixed amounts and then would add more if the floating equivalent was higher and would receive a refund if the floating payment due on that date was lower? If these stipulations were agreed in the contract would this be Sharia compliant? Essentially you would now have two fixed payers, but both parties would agree that fixed payer B will either pay an additional amount or receive an additional amount based on the floating interest rate at the time of payment in the market. In my view, this may also fall foul of the Sharia’s prohibition on uncertainty as the additional payments would also be uncertain at the time of the contract.

The profit cost swap seeks to address this issue using a series of sequential Secondary Reverse Murabaha Contracts. In brief, the fixed rate payer buys commodities every three months, sells them to the floating rate payer who onward sells them immediately and pays the fixed rate payer the cost of the commodities plus the fixed rate payers profit on the sale, which is linked to a floating rate formula. Pausing there for a moment, this is where the substance versus form critics would throw their arms in the air. These sequence of murabaha contracts comprise an element of uncertainty. The amount of the fixed rate payers profit is uncertain as it is linked to LIBOR. Therefore, how come these contracts are allowed? Is it simply because a physical commodity changes hands? The fact that there has to be purchase and sales of commodities every 3 months means that what looks like separate and distinct commodity transactions are all probably agreed in the original contract. Therefore, if one looks closely at this transaction overall, the floating rate payer will pay interest based on LIBOR which is clearly uncertain. Why does Sharia look the other way and let these transactions pass as Sharia compliant? My only explanation can be that there is a commodity changing hands, and it looks on first blush as a plain vanilla murabaha transaction. There is, however, the uncertainty of the profit paid to the fixed rate payer. In my view, this uncertainty is exactly the same as that contained in an interest rate swap contract and therefore, there is a case for arguing that those contracts should not fail for lack of gharar. Interest rate swaps could fail for lack of an underlying asset changing hands, but as I mentioned in the arbun contract above, these contracts are permitted by the Hanbali school, so why not interest rate swaps?

The floating rate payer can make a wa’ad under a murabaha to pay the cost of the commodities plus a profit linked to LIBOR and this is Sharia compliant. The commodity bought and sold to allow this transaction to happen is transferred from buyer to seller within seconds. This means that the risk of owning the commodity,
which in my view is the key to why the transaction is allowed under Sharia, is effectively irrelevant. This is due to the fact that no sooner has the fixed rate payer bought the asset; it is sold to the floating rate payer and onto the floating rate payer’s agents. The buyer has no interest in the commodity at all. In reality, you would probably find that the broker for the fixed rate payer acts as agent for the fixed rate payer too, and transfers the commodities to the floating rate payer’s agent, broker 2. Therefore, there is probably no ownership risk on the commodities at all as the transaction takes seconds. If the commodities are already in the custody of broker 2 or are held in a central repository or a third party custodian, then the commodity probably never leaves its actual physical site at all during the entire transaction. In which case, the whole thing smacks of form and not substance. Provided you fulfill what the fatwa says then the transaction is Sharia compliant. In substance the interest rate swap achieves exactly the same objectives, but is declared non-Shariah compliant because a commodity doesn’t change hands, and there is too much risk due to the unknown amount of floating rate interest that will be paid. The profit cost swap in my view, has the exact same interest rate uncertainty, but is deemed Sharia compliant. The commodity bought and sold by both parties is the same physical amount and needs to be for the same agreed price so that the cash flows add up. In substance under the profit swap, all that is essentially happening is that a floating rate payer is paying LIBOR and a fixed rate payer is paying a fixed amount. That is it.

Speculation is definitely prohibited under Sharia law. There is a difference in objective between hedging and speculation. Hedging is the process whereby a party seeks to reduce risk, which according to maslaha can be a public good as it reduces overall risk. Interest rate swaps can be used by parties to balance their cash flow requirements. It would make sense for a company to swap its fixed rate receipts in exchange for floating ones so that it can better match up its income with its liabilities. This looks like good risk management. In the Qur’an, the prohibition of riba but allowance of trade24 must be taken in context with the other verses. If a company entered into an interest rate swap as a normal part of its business, does this constitute trade? Could it be allowed on this basis? There is also a prohibition under the Sharia for combining more than one contract under an agreement if the contracts are mutually dependent on one another. Presumably the profit swap circumvents this by

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24 Qur’an 2:275 Al Baqarah.
not making each subsequent sale and purchase by the fixed rate payer dependent on the other 3 monthly transactions. I am not sure how the parties will structure their agreement any other way without specifying these periodic transactions so that the swap will work. By definition, the initial murabaha, has built in payment dates which are deferred. Therefore, the sequential murabaha contracts designed to fulfill these deferred payment dates must be specified in the original agreement. This seems to be another area where Sharia law has allowed a rule, prohibition of collateral contracts, to be stretched if not broken!

There is a Qur’anic verse that mentions buyers of food grain not selling it until the food grain is in the possession of the seller\(^{25}\). Some commentators have opined that this would prohibit forward or other derivative transactions until the seller is in actual possession of the products. In my view this cannot be the correct reading of this verse for three reasons. Firstly, the bai salam contracts expressly permits forward selling of products that my not yet be reduced from the fields or be in the possession of the seller. Secondly, the arbun contract, may allow the seller to acquire actual possession of the goods at a later time than he enters into the contract and receives the upfront payment from the buyer. Thirdly, the verse expressly mentions food grain and I would argue should be read narrowly to only apply to contracts which involve food products for human consumption. If this grain is for human consumption, then it would be right and proper not to let sellers of food grain take the money from people without actual possession of the grain. Individuals need food grain to live and survive. Therefore, this is probably one of the few commodities where only spot trades should be allowed to prevent individuals from passing their money for food to an individual who either absconds, squanders the proceeds or is not able to obtain the grain. I would argue that this narrow reading of this verse does not forbid any type of derivative contract based on no physical possession at the time of contract.

Another factor that is worthy of mention is that when an interest rate swap is priced, the present value of the floating rate payments is equal to the present value of the fixed rate payments. This means that from the outset, both parties do not win or lose. There is an inherent risk sharing because it could go either way. Therefore I would argue that both parties share the risk of making or losing money because they start off in an equal position. Secondly, both parties are fully aware that the equation could go

\(^{25}\) Sharia compliant swaps and hedging to mitigate risk in Sharia compliant investments, by Mian mohammad Nazi, SVP, of Dar Al Sharia – Dubai Islamic Bank, 18th International Islamic Finance Forum, 18-21 January 2010, See also the hadith, “sell not what is not with you”.
in their favor or against them. Therefore, there is no unjust exploitation. There is as I have mentioned, uncertainty about which one will end up in profit or in deficit, but this is no different to a normal trading business.

On the issue of primacy of the texts and abrogation, Shafi’i would opine that the Qur’an and Sunnah are broadly equal in status. Conversely al-Shatibi would state that the Qur’an can abrogate the Sunnah. Therefore, there can be no express prohibition of financial derivatives in the Qur’an because they were not thought of at the time. If my preceding analysis is correct with regards to interest rate swaps not being a zero-sum game, and both parties are in trading businesses, then they can both benefit. If there is no violation of the other parts of the Qur’an then maybe interest rate swaps are Sharia compliant. On the other hand if Shatibi’s thesis is more closely followed, then the hadith that permit options can be abrogated by the Qur’an’s prohibition of gharar, which may prevent any expansion of derivatives apart from the arbun contract acknowledged by the Hanbali madh’hab.

Conclusions

Interest rate swaps can be used for both hedging and speculation. Sharia compliant profit rate swaps require a commodity to be bought and sold, and the “profit” paid by the floating rate payer can be linked to LIBOR or some other floating and hence uncertain reference data. Therefore, in my view, if one looks at the form of interest rate and profit swaps, one is left thinking that they are different. One involves a commodity sale, the other doesn’t. If one looks at the substance, one sees that the net cash flows for the counterparties are identical. I have shown that the conditional sale contract, arbun, is Sharia compliant according to the Hanbali school. All schools allow the murabaha.

Warde recently noted selling of exotic derivatives is off limits to Islamic institutions. In the detail of Islamic finance, however, one finds contradictions. The arbun and the bai salem contract both rely on the future which is uncertain. Islamic law seems to allow these transactions for a variety of reasons including a sharing of risk. I would argue that in an interest rate swap both parties are sharing the risk and a

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case can be made for allowing interest rate swaps to be Sharia compliant without resorting to buying and selling assets. Indeed, given the Islamic principle of permissibility (ibahah), which renders all commercial transactions Sharia compliant in the absence of a clear and specific prohibition, I would argue that interest rate swaps could form a valid part of Islamic finance notwithstanding the prohibitions that I have mentioned. As another idea, could interest rate swaps based on the exchange of a small amount of a commodity at outset, but with interest payments linked to a larger notional amount specified in the contract be Sharia compliant? Just a thought.

For the wa’ad and profit swap structures, the very fact that an asset and not a notional must be used could be the important factor to their Shairah compliant status. Does the asset under a profit swap have to be equal to the notional under an interest rate swap? Is it possible to have a peppercorn asset specified in the interest rate swap contract? Indeed in English law, the courts will look to the substance and not the form of a contract to view its true meaning27.

In Islamic finance, derivatives are not readily accepted due to their lack of transfer of a real asset and the uncertainty of the contract. I would agree with Al-Suwailem’s view that elimination of zero-sum contracts is a central theme of Islamic principles. This is because in a zero-sum game there is a winner and a loser. The winner wins at the loser’s expense. If, however, the structure of the payoffs can be understood to not be a zero-sum game, or win-win then maybe derivatives in general and interest rate swaps in particular would not breach gharar rules at all28. I have argued that there are similar Sharia compliant investments, such as the arbun, that have the same setbacks. Arbun contracts are accepted by Islamic investors. Moreover a contractual requirement for an asset transfer, where in reality the asset does not physically move at all, implies that in substance the Sharia compliant transaction could be seen as exactly the same as an interest rate swap. As Mr. Keat said, Islamic finance needs to continue to develop instruments that help to mitigate risks29 and the interest rate swap would be a good start.

27 Re Watson, ex p Official Receiver in Bankruptcy (1890) 25 QBD 27, CA.
29 Remarks by Mr. Heng Swee Keat, Managing Director, Monetary Authority of Singapore at Inaugural Plenary Session, World Islamic Banking Conference, Bahrain, 24th November 2008
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