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Challenging the Parameters of Permissible Hedging in Islamic Finance: Rationale and Implementation of Recent *Shari'a* Rulings

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Hedging Under *Shari'a* in the Context of the Financial Crisis

The recent crisis of the international financial markets, which is still ongoing, initially began in late summer 2007,[1] with U.S. subprime markets crashing. Suddenly, huge volumes of residential mortgage backed securities (RMBS) lost their valuess at a high pace due to mass defaults of the home owners owing the underlying loans. A second major blow came with the collapse of the century-old institution of Lehman Brothers in September 2008,[2] which caused major damage to both institutional and private investors, demonstrating the power and dynamics of systemic risk.

Ironically, those financial instruments originally designed to shift risk or manage risk, such as Credit Default Swaps (CDS) and Asset Backed Securities (ABS), stood at crucial points of the financial turmoil. These instruments were meant to improve risk profiles by protecting market participants against the default of others or by providing secured cash flows for one while improving the balance sheet of another. Both instruments were used to trade, transform and ultimately shift risks from one market participant to another, in short: contemporary financial risk management. Eventually, such risk management instruments spiraled out of control and caused major damage.

Interestingly both crashes, be it the US-RMBS market in 2007 or the collapse of Lehman in 2008, were followed by confessions of affected investors that they had neither fully understood the inherent risks of the financial instrument involved nor the instrument itself.[3]

Initially, Islamic finance proved somewhat resilient to the first shock waves of the still ongoing economic turmoil due to its underlying precepts and an overall reduced exposure to the more risky edge of the crumbling

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markets. However, as time passed, it appeared that Islamic financial institutions, as an inseparable part of the international financial markets, were by and large as equally affected as their conventional players. A traditionally and geographically significant exposure to crumbling real estate markets, especially in the G.C.C. and the U.S., quickly neutralized the benefits that some Islamic investors had yielded from not having invested in the massively depreciated stock of conventional financial institutions.

In bad weather everybody looks for shelter. In financial terminology, this is called hedging. In the context of the current turmoil, existing protection mechanisms are put under scrutiny while new and more efficient models of risk avoidance, risk reduction and risk shifting are sought.

Islamic finance, unlike its conventional counterpart, has to observe a number of additional requirements according to its specifications—in its overall business in general but more specifically when it comes to risk management and hedging. Among these more specific requirements are the prohibition of *riba*, *gharar* and *maysar* as the most prominent precepts.

From this perspective it is evident that conventional RMBS could not pass any *shari'a* screening as they rely on the trading of debt and would be impermissible under the ban on *riba*. Likewise, CDS are non-investable as these insurance-type transactions involve the shifting of risks against payment of a premium, which, from a *shari'a* perspective, is tantamount to gambling or *maysar*. Therefore *shari'a*-compliant market participants were hedged against direct investments in these instruments, based on their beliefs.

RMBS and CDS aside, risks are to be managed under Islamic precepts as they are under conventional rule. Sophistication in structuring does not necessarily mean better protection. In fact, RMBS and CDS were precisely the most sophisticated risk shifting and hedging instruments present at the epicenter of the current economic crisis. This was a painful lesson on how carefully risk management instruments have to be designed.

With this in mind, Islamic finance more than ever needs to develop efficient, understandable and reliable hedging instruments and mechanisms. As Islamic finance is an industry based on ethics, it is crucial to carefully align proposed hedging methods and hedging products to *shari'a* requirements. Recently, a number of players in the industry, among them predominantly conventional international banks with an Islamic outlet ("window"), have developed highly engineered hedging solutions that some people dispute are not *shari'a* compliant. The debate regarding *shari'a* acceptable and efficient hedging instruments, including these new products, is far from settled.

Lately, Islamic finance standard setting boards have issued various rulings on how the precepts of Islamic finance shall effectively be implemented (AAOIFI *Sukuk* statement, February 2008 and the Resolution 179 [19/5] of

the International Council of the OIC Fiqh Academy on organized *Tawarruq*, April 2009). This means testing various solutions and methods proposed by the industry.

The following discussion will look into prevalent *shari'a* parameters on hedging and discuss the current status of *shari'a*-compliant hedging techniques before elaborating on the recent landmark rulings issued by *shari'a* standard setting bodies and discussing their possible impacts. This paper seeks to demarcate the limits of permissible hedging in Islamic finance according to recent *shari'a* rulings, while recommending implementation of key considerations in recent *shari'a* rulings and existing standards (e.g., AAOIFI *shari'a* Standard on *Tawarruq*). Technical aspects of how such key considerations can be reflected in legal documentation will conclude the paper. In this context the paper argues in favor of relying on the parties' intention (*niyyah*) in order to distinguish hedging from speculation. It advocates *shari'a* boards having a more material involvement in the depth and duration of *shari'a* monitoring.

Prevalent *Shari'a* Parameters Regarding Hedging

Hedging can be described as risk management by protecting an investment against a specific type of risk by neutralizing this risk. As such, hedging is an essential part of any investment activity and is vital for any business that has to deal with fluctuations or expected fluctuations in prices, currency rates, markets, a counterparty's ability to cope with payment obligations, etc.

Because *shari'a* is adverse to excessive risk taking (*gharar*, *qimar*, *maysar* and *riba)*, this prohibits some of the most common ways of hedging in conventional finance, e.g., most forms of derivatives.

Ways of Hedging under Shari'a

Natural hedge/asset-liability-balancing

The most basic *shari'a*-compliant hedge is the balancing of assets and liabilities. This on-balance-sheet hedge can be considered a "natural hedge." Along with risk pooling models (see below) this has been one of the more prominent ways to hedge out risks in a *shari'a*-compliant manner. Some have favored the "natural hedge" in the debate on *shari'a*-compliant derivatives.[4] A number of authors have raised the question whether derivatives, by nature susceptible to speculation, would therefore be needed at all.

However, hedging by using a natural hedge-like asset-liability balancing requires a certain structure of financials. Market participants may or may not have such financials at hand. Practically, they are more likely not to always meet the natural asset-liability equilibrium. Therefore risk pooling as a tool for containing and hedging out risks has been discussed as another option.

Risk pooling

The concept of risk pooling stems from the idea of collective risk sharing and collective risk balancing; each participant brings its specific risk but also its resources that may be used in case a member of the community incurs relevant damage. In this case all pool members would shoulder the burden of such relevant damage rather than the single pool members. For instance, risk pooling solutions have been discussed in terms of portfolio insurance for the benefit of investors in an Islamic mutual fund[5] or as cooperative, not-for-profit mutual arrangements.[6]

The growing sector of *takaful* is a prominent and successful example of such a risk pooling approach, where a decidedly large number of participants with a relatively smaller and less volatile risk profile (compared to, for instance, international financial institutions) are seeking and finding sufficient protection.

Due to structural reasons, risk pooling solutions seem to be less viable for complex risk portfolios. Thus, pooling solutions appear to be confined to "real economy"-linked small-cap or mid-cap businesses or to hedging solutions for individuals. Such reasons can be found in the dynamics of international capital markets, the sophisticated risk profiles of the players involved and also the rather limited number of participants (at least compared to the mass market of common risk pooling markets like *takaful*).

Risk shifting

If risk can neither be canceled out on the individual level, nor shouldered by a larger number of entities through risk pooling, the only way of doing away with excessive risk is to shift it to a third party. While this is conventionally achieved through derivatives, Islamic finance has not been comfortable with such derivatives and has resorted to financially engineered solutions instead.

Risk shifting solutions based on contractual arrangements (arbun, khiyar ash-shart)

It is worth recalling the most prominent reasons why the majority of scholars consider most derivatives non-compliant to *shari'a*. These are:

- the objection of enabling speculation and resulting in win-lose probabilities akin to gambling;[7]
- the perceived lack of physical assets in the reality of today's options contracts, supported by the fact that the overwhelming majority of contracts on the derivative markets are eventually cash settled rather than physically delivered;[8]
- the character of derivatives serving indistinctly genuine hedging needs but also speculative purposes;[9]

- the lack of classical *fiqhi* contracts validly apt to accommodate contractual arrangements similar to conventional derivatives.[10]

On each of the above objections there has been a vivid discussion without reaching any consensus. This can be illustrated in the various opinions pertaining to the objection that none of the classical *fiqhi* contracts could serve as a base case for universally modeling *shari'a*-compliant derivative contracts. Regarding *shari'a*-compliant options, the majority argued that *arbun* could not be used to replicate an Islamic option. Unlike in conventional options, there would be a valid reason for the *arbun*-seller to retain the down payment in case the contract is not fulfilled, while a conventional option would bear a premium akin to unjustly consuming the wealth of others.[11]

Likewise, regarding the application of a stipulated option (*khiyar ash-shart*), some argued such a stipulated option would not be extendable beyond three days maximum, while conventional options contracts require far longer maturities.[12] In contrast, the proponents of permissibility argued as per *khiyar ash-shart* that some *madhhab* indeed allow the stipulation of a longer option period than three days and supported their view with further, more systematic reasons[13]:

- if used for genuine hedging purposes, derivatives would not increase but would limit business risk and therefore be of direct benefit for real underlying economic activities;
- the pricing of an option would not be equal to unjust enrichment but could be justified by using exact formulae including the market price of the underlying reference asset;
- the non-use of derivatives for (genuine) hedging purposes more than its use would be detrimental for the respective party's business and create even more risk instead of reducing it.

The larger debate on the permissibility of derivatives under *shari'a*, however fervent, could not turn away the market's needs for risk managing and hedging solutions. The persistent debates centered around the numerous *fiqhi* requirements on contracts involving a future element like *arbun*, *salam* and *khiyar ash-shart* encouraged the rise of another legal instrument of classical *fiqh,* in this context, *wa'ad*. *Wa'ad* is the unilateral promise, legally binding to the majority of scholars, when employed under a *murabaha* scheme.[14] The requirements on *wa'ad* are far less restrictive than contracts like arbun and salam and helped the industry to employ *wa'ad*-based structures without caring too much whether the trade-offs would bring Islamic hedging products close to conventional hedging products. The industry interpreted as flexibility the apparent absence of cumbersome *fiqhi* requirements on *wa'ad*.

Promise-based (*wa'ad*-based) solutions

Instead of a bilateral contract but a unilateral promise, solutions for Islamic hedging could be designed with financial engineering replicating conventional derivatives not explicitly (i.e., by using *arbun* or *khiyar ash-shart* contracts for replacing, for instance, an options contract) but implicitly by engineering the pay-off of any derivative contract through mutual unilateral promises.

One of the earliest publicly available descriptions of such a *wa'ad*-based financially engineered structure has been documented in a Deutsche Bank Academic Paper in February 2007.[15] Since then the markets have used *wa'ad* more widely to replicate all types of derivates, including FX options, total return swaps and even short selling mechanisms.[16]

An example for a relatively simple transaction is an FX call option in favor of a bank against its client using *wa'ad*:

> Promise to sell a pre-determined amount of currency B for a pre-determined amount of currency A upon Settlement Date; Bank pays non-refundable fee to Client upon Trade Date.
>
> *Bank* ◄——————————————————— *Client*

The Client will receive a non-refundable fee from the Bank when issuing the promise (Trade Date). The Bank may decide at its full discretion, according to the respective exchange rate upon Settlement Date, whether to hold the Client to its promise and ask for the specified amount of currency B for the pre-determined amount of currency A. Obviously, the Bank will decide so in case the exchange rate allows the Bank to realize a gain on the currency transaction equal or above the fee paid upfront to the Client. Otherwise the Bank will not exercise the Client's promise but rather send a Cancellation Notice to the Client. In this case the Client will end up with the non-refundable fee.

This structure avoids the above discussions on *arbun*, *bay'al-salam* or *khiyar ash-shart* through the use of the unilateral promise or *wa'ad.* Based on *wa'ad,* the transaction can be structured in a "clean" way from a *shari'a* perspective as neither the maturity beyond three days (objection regarding *khiyar ash-shart*) nor the fee paid the Bank (objectionable when applied under the precepts of *arbun* for such transaction) raise concern under *fiqhi* requirements on *wa'ad.*

By taking a glance at the above-summarized objections against derivatives in Islamic finance we observe that the use of *wa'ad*, although a flexible and overall less regulated instrument in the universe of *fiqh*, has helped to largely overcome at least the more formal, legalistic debate on hedging solutions

offered by the use of *arbun*, *bay‘ al-salam* or *khiyar ash-shart*. For the most part these difficulties stem from the fact that classical *fiqh* is several hundreds of years older than modern (Islamic) finance and cannot easily accommodate modern financial markets' needs.

However, systematic objections also remain under such application of *wa'ad*. The most prominent systematic objection is the absence of a mathematical or economic measure to distinguish an instrument's use for genuine hedging on the one hand and speculation on the other hand—an objection that alredy accounts for conventional derivatives and led some authors to abandon altogether the concept of derivatives under Islamic finance precepts.[17]

While theoretically there is consensus that hedging shall be allowed and speculation banned, even a summary analysis of theory and practice of hedging shows the incoherency of such a presumption.

Theory and Practice

Various proponents of derivative use under Islamic finance precepts argue that their use for genuine hedging shall be permissible whilst their use for speculation shall be prescribed.[18] Put to the test, this idea lacks clarity of definition and further contradicts market practice.

Such a proposal lacks clarity in definition because it remains fuzzy how genuine hedging purposes could be separated from speculation. Most authors proposing the permissibility of derivative use for "genuine" hedging purposes simply use this term without offering a definition or objective measure for determining such genuineness.[19] Jobst, for instance, suggests the formula "employed to address genuine hedging demand on asset performance associated with direct ownership interest,"[20] without further elaborating on how this could be applied in practice.

Consequently, other authors and scholars have dropped the issue of hedging by derivative use in Islamic finance exactly for this reason. Suwailem convincingly argues that "derivatives make hedging and gambling undistinguishable"[21] and concludes,"The difference between arbitrage, that improves efficiency of the market, and gambling, which destroys market fundamentals, was and still is, a subject of prolonged debate. Although it is easy to agree on the two opposite extremes, no 'analytical formula' is developed to filter out the two in the vast majority of mixed situations in between."[22]

Further, the assumption of a differential treatment of hedgers and speculators is in direct contradiction with market practice. In conventional markets we see a minority of hedgers facing a vast majority of speculators. Relevant publications quote more than 97 percent speculators facing less than 3 percent hedgers in conventional derivative markets.[23]

Apart from the still unsolved matter of how to distinguish hedgers from speculators in theory, there is no reason why in practice the above ratio would significantly differ in Islamic derivative markets. Derivative markets are markets driven by an overwhelming majority of speculators and a minuscule minority of hedgers. In this context it appears even more dramatic, that a majority of speculators is needed in order to provide necessary liquidity to the market. Any derivatives market, be it conventional or Islamic, cannot refrain from allowing speculators to enter the market provided that the market shall be sufficiently liquid in order to allow efficient allocation of risks and accurate pricing.

Eventually, the way primary hedging markets (derivatives markets) function explains the ratio of speculators in these markets. There, every hedger indeed needs its speculator: The existence of complementary hedging needs of maturity, quality and quantity would appear far too rarely to keep a derivative market going. Only in very rare occasions will we see two parties taking part in a derivative transaction with both intending to genuinely hedge their underlying business needs (e.g., a palm oil producer and a company running a power plant with this palm oil, both intending to hedge themselves against price fluctuations occurring until the next harvest season).

That said, we can assume that if an exact "analytical formula" existed that enabled us to determine the fine line between hedging and speculation, its strict application would lead to the prescription of nearly all such transactions in a *shari'a*-compliant derivative market, thereby only exempt in rare cases of complimentary matching hedging needs. This is a scenario that, by lack of sufficient market liquidity, would render Islamic derivative markets impracticable. After all, the beauty of derivatives lies within their flexibility. It is this flexibility that entails their potential for genuine hedging purposes as well as for speculation.

A preliminary finding can be established regarding prevalent *shari'a* parameters and permissible hedging techniques, their theoretical background and the practical challenges they face: the objective parameters of a given transaction do not show whether a party seeks risk reduction or (even leveraged) speculative gains. Hedging can neither be separated from speculation by applying a mathematical or economic formula, nor by circumventing *fiqhi* objections using promised-based structures (*wa'ad*) rather than contract based schemes (e.g., *arbun*, *bay' al-salam* or *khiyar ash-shart*). In the absence of objective measures (of overriding importance from a legal draftsperson's perspective), we have to look at subjective measures to distinguish hedging from speculation: the intention or the *niyyah* of the parties involved.[24]

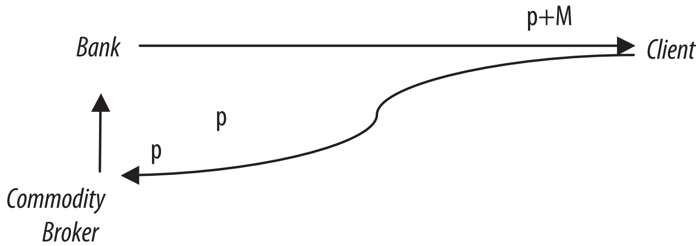
Before elaborating on this, we will glance at how recent landmark rulings of *shari'a* standard setting bodies like the OIC *Fiqh* Council may influence

the permissibility of structured hedging solutions, be them promised-based (*wa'ad*) or contract based schemes (e.g., *arbun*, *bay' al-salam* or *khiyar ash-shart*).

The New Approach of Recent Landmark Rulings

OIC *Fiqh* Council Resolution 179 (19/5): A blow to organized *Tawarruq*?

Reportedly, a certain number of Islamic risk management products, such as profit-rate swaps, rely on commodity *murabaha* transactions for structuring the cash flows between the parties involved.[25] Any such commodity *murabaha*/on-sale transaction will take the following format (arrows indicate asset transfer at market price (p) or at market price plus profit margin (p+M)):



Note: Bank will arrange all dealings with Commodity Broker. Bank will buy the commodities on its own behalf, subsequently sell these same commodities to Client against deferred payment by Client on the amount of p+M. As Client is not interested in the commodities but in the cash, Bank will immediately on-sell the commodities to the market and forward the cash proceeds to Client.

The above transactions, according to AAOIFI *shari'a* Standard No. (30), would have to be classified as Monetization or *tawarruq* as the underlying commodity does not remain with the mark-up paying party (here the Client) but is immediately on-sold to the market in order to obtain cash rather than the commodity itself. Therefore the party paying the mark-up qualifies as *mustawriq*. According to AAOIFI *shari'a* Standard No. (30) 3/1, "Monetization refers to the process of purchasing a commodity for a deferred price determined through *musawama* (bargaining) or *murabaha* (mark-up sale), and selling it to a third party for a spot price so as to obtain cash."

The existence of a standard, here AAOIFI *shari'a* Standard No. (30), indicates substantial practice. Otherwise this standard would not have been issued. The permissibility of such practice certainly has to follow the rules, notably (without the following requirements being an exhaustive list):

- real asset transfer requirement: there should be a real commodity that the seller owns before selling it (3/1);
- operationally the identifying documents for the commodity shall be made available (4/2) and the commodity must be sold to a party other than the one from whom it was purchased on deferred payment terms (4/5);
- documentation-wise the contract for purchasing the commodity on deferred payment terms and the contract for selling it for a spot price to the market afterwards shall not be linked together in a form preempting the *mustawriq*'s right to actually obtain the commodity and get it physically delivered (4/6);
- the *mustawriq* shall sell the commodity by himself or through his agent but not through the Bank (4/9).

Importantly, it has to be noted that AAOIFI *shari'a* Standard No. (30) perceives Monetization or *tawarruq* as an exceptional instrument, with a restricted use in situations of established need (5/1). According to No. 30, "Monetization is not a mode of investment of financing. (...) The institution should resort to monetization only when it faces the danger of a liquidity shortage that could interrupt the flow of its operations and cause losses for its clients." In light of these rules it is doubtful whether transactions akin to *tawarruq* would be permissible under *shari'a* without such established need and under less than exceptional circumstances (5/1), even if the further requirements (4/1 to 4/9) were observed.

Market practice from time to time does not even seem to comply with basic requirements as set out in AAOIFI *shari'a* Standard No. (30) 4/1 to 4/9. Therefore the above discussion on whether or not a qualified need in terms of (5/1) could be established or not is often obsolete. Since cash flow modeling in contemporary Islamic finance heavily relies on Monetization arrangements, it currently does not seem feasible to abandon *tawarruq* in general by dropping the matter as a whole. However, the obvious non-compliance to AAOIFI *tawarruq* requirements by a number of market participants may have led the *Council of the OIC Fiqh Academy*, Jeddah, to issue in April 2009 the Resolution 179 (19/5) pertaining to the permissibility of certain forms of "organized" *tawarruq*. The *Council of the OIC Fiqh Academy* deliberately pursues, with this resolution, the goal of "ensuring the actualization of *shari'a* principles (*maqasid al shari'a*)."[26] The Resolution 179 (19/5) approaches its subject by firstly defining what shall be labeled "organized" *tawarruq*:

> Types of *tawarruq* and its juristic rulings: Technically, according to the Fiqh jurists, *tawarruq* can be defined as: a person (*mustawriq*)

> who buys a merchandise at a deferred price, in order to sell it in cash at a lower price. Usually, he sells the merchandise to a third party, with the aim to obtain cash. This is the classical *tawarruq*, which is permissible, provided that it complies with the *shari'a* requirements on sale (*bay'*). The contemporary definition on organized *tawarruq* is: when a person (*mustawriq*) buys a merchandise from a local or international market on deferred price basis. The financier arranges the sale agreement either himself or through his agent. Simultaneously, the *mustawriq* and the financier execute the transactions, usually at a lower spot price. Reverse *tawarruq*: it is similar to organized *tawarruq*, but in this case, the (*mustawriq*) is the financial institution, and it acts as a client.[27]

Whereas forms of *tawarruq* deemed "classical" shall be allowed, the Resolution 179 (19/5) further elaborates on the rationale of the prescription of what is deemed "organized" or "reverse" *tawarruq*, mentioning that, "it is not permissible to execute both *tawarruq* (organized and reversed) because simultaneous transaction occurs between the financier and the *mustawriq*, whether it is done explicitly or implicitly or based on common practice, in exchange for a financial obligation. This is considered a deception, i.e., in order to get the additional quick cash from the contract. Hence, the transaction is considered as containing the element of *riba*."[28]

Applied to the above example of a simple commodity *murabaha*/on-sale arrangement, we can state the following: As the commodity purchase by the Client/ *mustawriq* from the Bank and the commodity on-sale by the Client/*mustawriq* (through the Bank acting as Client/*mustawriq*'s agent) will take place in a very short period of time, while the on-sale price (p) reflecting the market price of the commodity is lower than the deferred price (p+M) to be paid at maturity by the Client/*mustawriq* to the Bank, the first requirements of the OIC ruling ("simultaneous transaction between the financier and the *mustawriq*") seems to apply. Also, the transaction, if performed as described above, seems indeed to create a financial obligation upon the Client/*mustawriq* toward the Bank while the underlying commodity deal is simply reversed. It can be argued that it would be in fact the financial obligation of deferred payment in the amount (p+M) that remains as sole effect from the above transaction. Therefore the second requirement ("*in exchange for a financial obligation*") also seems to be met.

However, OIC Resolution 179 (19/5) is more in line with AAOIFI *shari'a* Standard No. (30) rather than extending AAOIFI's requirements. AAOIFI *shari'a* Standard No. (30) aptly draws the fine line between permitted classical *tawarruq* and forbidden organized monetization. Still, those requirements

must be implemented thoroughly. Therefore important points to be observed are the real asset transfer requirement, the observance of non-identity of commodity supplier and on-sale purchaser and overall the separation of the *murabaha* transaction and the on-sale transaction (including the respective agency Client/*mustawriq*-Bank).

Several players in the market may not pass the requirements of AAOIFI and OIC in how they effectively implement their *tawarruq* transactions. However, the crucial point is not primarily the lack of more *shari'a*-compliant alternatives to such non-compliant market practice in commodity *murabaha*/on-sale transactions, but it is the thorough application of existing required rules. This can be ensured by appropriate legal documentation keeping the *murabaha* transaction clearly separate from the on-sale transaction (including the agency appointment by the *mustawriq*). Further, the above requirements on real asset transfer and the safeguard of the *mustawriq*'s option to ask for physical delivery of the underlying commodity must be properly documented. Eventually, operational implementation is needed instead of reducing vital *shari'a* requirements to mere paperwork.

In conclusion there are two aspects to be learned from OIC Resolution 179 (19/5).

The first aspect is of concrete documentary and transactional dimension: Legally and operationally, AAOIFI *shari'a* Standard No. (30) must be applied in its strictest possible sense.

Current practice of market participants must be scrutinized according to this benchmark. The demand side itself, i.e., the clients, plays an important role in testing and verifying such a benchmark. The *shari'a* supervisory boards involved play a crucial role in this regard. Therefore the clients should insist upon their respective counterparties on full disclosure of documentary and operational details of how a given transaction is conceived and will be implemented.

Secondly, OIC Resolution 179 (19/5) labels organized *tawarruq* as "deception" and recommends to "ensure the actualization of *shari'a* objectives (*maqasid al shari'a*)." In doing so, OIC points to a larger context: the importance of "substance over form" considerations in Islamic finance.

In this context it has to be noted that AAOIFI also uses the same rationale, an example of which is found in *shari'a* Standard No. (25) on Contracts Combining (4/1&2):

> Contracts' Combining should not include the cases that are explicitly banned by *shari'a* like combining sale and lending in one contract.
>
> It should not be used as a trick for combining *riba* such as agreement between two parties to practice *bai'ul eina* or *riba al-fadhl.*

The above illustrates the general effort of AAOIFI to ensure the actual implementation of overriding *shariʿa* principles—not only from a formal point of view but also in substance. In the case of *tawarruq*, both AAOIFI *shariʿa* Standard No. (30) and the Resolution 179 (19/5) issued by the Council of the OIC Fiqh Academy strive to put a limit to the misuse of this classical *fiqhi* instrument for financing techniques tantamount to *riba*.

The principle of "*substance over form*" or the effective implementation of *shariʿa* precepts seemed to be of lesser importance during the first years of the booming Islamic finance niche market. The widespread use of so-called *shariʿa arbitrage*, i.e., mimicking conventional products and transaction by use of classical *fiqhi* contracts, led some to speak of this phenomenon as a "*shariʿa conversion technology.*"[29]

In this respect the OIC Resolution 179 (19/5) indeed appears as a severe blow to a widespread practice in the international Islamic finance industry applying set rules (i.e., AAOIFI *shariʿa* Standard No. (30)) in a far too lax manner. Therefore, players who have been using non-compliant techniques have heard OIC's call and will therefore expedite strengthening their transaction structures, including bettering documentation and resolving operational issues. As Islamic finance is coming of age, the challenge should be to let Islamic finance blossom in its own right based on *shariʿa* and *fiqh*, and to work on truly *shariʿa*-based financing techniques and investment instruments.

"*Substance over form*" is a concept closely related to another aspect of recent landmark statements: the demand for actualization of *shariʿa* precepts and the quality of *shariʿa* monitoring, which will be discussed in the following section with regard to the 2008 AAOIFI statement on *sukuk*.

AAOIFI Sukuk *Statement (2008): Raising the Bar for Effective* Shariʿa-*Compliance*

The 2008 AAOIFI *Sukuk* statement[30] has been thoroughly discussed in Islamic Finance literature and is well-known. This paper will focus on the AAOIFI *Sukuk* statement's impact on general concepts of *shariʿa* in contemporary Islamic finance. From this perspective it is interesting to take a close look at two core aspects of the 2008 AAOIFI *Sukuk* statement: the question of actualization of *shariʿa* precepts and the quality of *shariʿa*-monitoring with respect to its depth and duration.

Actualization of *shariʿa* precepts

The 2008 AAOIFI *Sukuk* ruling set forth detailed requirements pertaining to ownership rights and repurchase values in equity-type *sukuk* structures (i.e., *sukuk al musharaka, sukuk al mudaraba,* etc.). In such structures, according to AAOIFI, *sukuk* holders must fully assume the risks of the

underlying assets in which the *sukuk* certificates represent undivided ownership. The ruling stresses the importance of strict adherence to the requirements of the underlying equity-type structure, be it a *musharaka* or a *mudaraba*. Under these schemes, as per Islamic law requirements, the investment party (i.e., *rabb al mal* and *sharik*) takes a direct equity risk and shall remain invariably exposed to this equity risk over the lifetime of the investment. Therefore, AAOIFI ruled, it shall not be permissible for the *sukuk* issuer to hedge such equity-type *sukuk* holders against the asset price risk by guaranteeing a pre-agreed repurchase value with respect to the underlying asset instead of leaving it to the investors to realize a certain re-sale value at the market conditions upon maturity. In the words of AAOIFI:

> It is not permissible for the *mudarib* (investment manager), *sharik* (partner), or *wakil* (agent) to undertake {now} to re-purchase the assets from *sukuk* holders or from one who holds them, for its nominal is, however, permissible to undertake the purchase on the basis of the net value of assets, its market value, fair value or a price to be agreed, at the time of their actual purchase, in accordance with Article (3/1/6/2) of AAOIFI *shari'a* Standard (12) on *sharika* (*musharaka*) and Modern Corporations, and Articles (2/2/1) and (2/2/2) of the AAOIFI *shari'a* Standard (5) on Guarantees.[31]

Here again, we note the concern to ensure overriding Islamic law requirements beyond the technicalities of structuring fine print and business considerations obviously stemming from conventional finance habits rather than from *shari'a* concepts underlying the transaction.

Depth and duration of *shari'a* monitoring

AAOIFI, in its 2008 *Sukuk* statement, seems to be aware of the importance of effective implementation of *shari'a* rules. Strengthening the rules to be more *shari'a*-compliant in substance is one aspect (and has been outlined above). Another equally important aspect is the existence of appropriate monitoring of an investment from inception until maturity. The duty of any *shari'a* supervisory board involved in a transaction therefore is to "review **all** contracts and documentation related to the actual transaction"—an obligation clearly pertaining to the depth of *shari'a* monitoring—but also to "oversee the ways that these are implemented in order to be certain that the operation complies at every stage with *shari'a* guidelines and requirements as specified in the *shari'a* Standards."[32] The latter is a call for ensuring ongoing and effective monitoring of the investment over its lifetime.

Enhancing substantial *shari'a* compliance instead of merely requiring formal adherence to *shari'a* precepts is a challenge considering the current

status of *shari'a arbitrage*. Requiring effective operational implementation of what has been legally documented, not only upon inception but also over the lifetime of an investment, sets up a new standard in Islamic finance. However, such considerations are crucial if Islamic banking shall be in the position to differentiate itself from conventional finance in the long run.

For the time being, the 2008 AAOIFI statement applies only to *sukuk*. However, given the overriding importance and the weight of the concerns raised, one could interpret this statement as being of larger significance in the standards of *shari'a* compliance in the future.

Recent landmark statements of *shari'a* ruling bodies point toward a new approach in *shari'a* compliance that essentially consists of two aspects. Firstly, there is a need for compliance to *shari'a* precepts in substance (i.e., documentation-wise as well as operationally) rather than only formally. This entails respecting the larger framework of classical *fiqhi* instruments involved in a specific structure (see OIC Resolution 179 (19/5) and 2008 AAOIFI *Sukuk* statement). Secondly, there is a call for enhanced scrutiny in terms of certification and monitoring of *shari'a* precepts for any product or transaction from inception through the entire life of the investment (2008 AAOIFI *Sukuk* statement). The challenge to transform this new approach into practice remains huge.

Apart from more technical issues still to be resolved (we will look into this from a legal draftsperson perspective in the following sections), there remains the problem that there are currently far too few reputable scholars burdened with certifying too many transactions and products. It is unlikely that a small group of people would be able to effectively monitor on an ongoing basis the fast growing universe of *shari'a*-compliant investments. This shortcoming may force increased efforts for the establishment of appropriate *shari'a* compliance mechanisms and human resourcing similar to the organizational framework conventional finance displays in the field of legal and compliance.

Impact of the New Approach on the Permissibility of Current Hedging Techniques

Impact on hedging instruments based on *Tawarruq*

We have seen that current hedging techniques, specifically *shari'a*-compliant derivatives, frequently rely on *tawarruq* transactions enabling the modeling of cash flows upon settlement events. This accounts specifically for Islamic profit-rate swaps (*wa'ad*-based or not) relying on commodity *murabaha* transactions for structuring the cash flows between the parties involved.[33]

As argued above, OIC Resolution 179 (19/5) requires one to stay clear of what is deemed "organized *tawarruq*," since "organized *tawarruq*" transgresses the permitted boundaries of classical *tawarruq*. In this respect, OIC

Resolution 179 (19/5) recalls the requirements of existing *shari'a* standards rather than setting up new requirements. The requirements for classical and thus permissible *tawarruq* are clearly outlined in AAOIFI *shari'a* Standard No. (30). While a number of requirements are to be observed, in the context of current hedging techniques, there are specifically two requirements lacking in what OIC deems "organized *tawarruq*": the lack of real and documented asset transfer and the missing link between *murabaha* transaction and on-sale transaction. Therefore "organized" *tawarruq*, according to OIC, is characterized by a "simultaneous transaction between the financier and the *mustawriq,*" resulting in an exchange of financial obligations at the detriment of the Client/*mustawriq* but in favor of the financier—a transaction tantamount to *riba*.[34] OIC considers such a transaction nothing more than a deception.

Henceforth, market participants will have to take AAOIFI *shari'a* Standard No. (30) seriously, specifically in effectively implementing the requirements of real asset transfer between the parties involved (3/1); availability of the identifying documents for the commodity (4/2) and the third-party requirement regarding the on-sale buyer (4/5); ensuring the *mustawriq*'s right to actually obtain the commodity and get it physically delivered (4/6); and the role of the bank as *mustawriq*'s agent in the on-sale transaction (4/9).

As AAOIFI *shari'a* Standard No. (30) considers *tawarruq* as confined to situations of established need, more research and discussions will be needed regarding the permissibility of large-scale *tawarruq*, even if complying with the above transactional requirements. AAOIFI clearly states,"Monetization is not a mode of investment of financing . . ." and cites a concrete situation of such established need, notably that, "the institution should resort to monetization only when it faces the danger of a liquidity shortage that could interrupt the flow of its operations and cause losses for its clients." From this point of view, it would be hard to accept any general consideration stemming from *maslaha* for a large-scale application of *tawarruq* for the use of hedging, as some authors have argued in the past.[35]

The dimensions of *maslaha* are numerous. This topic should be studied more thoroughly than simply using the term and assuming the existence of such public need.[36] Here, practitioners and researchers may benefit immensely from our *shari'a* scholars, who are able to share their wealth of knowledge in order to balance the dilemma between obviously needed *shari'a*-compliant hedging techniques and fundamental *fiqhi* requirements.

In summary, current modes of hedging, as they rely on *tawarruq* schemes, are put to the test by recent landmark statements of OIC and AAOIFI. Specifically the apparent contradiction between an obvious need in the market for flexible and available hedging instruments and the AAOIFI

requirement for a specific (not only general) situation of established need (see AAOIFI *shari'a* Standard No. (30) (5/1)) requires further research by the scholars and by the Islamic finance community. In this context OIC Resolution 179 (19/5) may be seen as an initial, but severe, blow to a practice that has pushed the boundaries of *shari'a* compliance. It also may encourage the development of genuine *shari'a* products for hedging purposes rather than continuing to rely on *shari'a* arbitrage striving to rebuild conventional hedging instruments in a *shari'a*-compliant fashion through the use of highly engineered solutions.

Depth and Duration of Shari'a-*Compliance: Structuring Issues, Legal Documentation and Operational Implementation*

While OIC specifically elaborates on *tawarruq* and therefore the OIC Resolution 179 (19/5) applies only to *tawarruq*-based hedging solutions, the 2008 AAOIFI statement seems at first to apply only to *Sukuk* structures. However, it has been argued above that the rationale of the 2008 AAOIFI statement reflects what has been laid down earlier in terms of AAOIFI *shari'a* Standards and therefore is of larger importance.

It has been argued that regarding the more fundamental aspects of the AAOIFI ruling, we can identify a call for enhanced scrutiny in terms of certification and monitoring of *shari'a* precepts for any product or transaction from inception through the entire life of the investment. Notably the actualization of *shari'a* precepts in a more substance-oriented assessment of overriding *fiqhi* requirements will impact current Islamic hedging solutions. The same applies to the required depth and duration of *shari'a* monitoring.

As an example we may again resort to the commodity *murabaha* in the form of a *tawarruq* transaction, used for settlement purposes in a modern derivative hedging solution. The rationale of the named 2008 AAOIFI ruling will henceforth require the market participants to meticulously comply to what has been laid down in AAOIFI *shari'a* Standard No. (30) in terms of structuring, legal documentation and operational implementation.

AAOIFI has exemplified, in the case of equity-based *sukuk* structures, that the principles of the underlying *fiqhi* instruments (in this case *musharaka, mudaraba,* etc.) are to be observed also when these *fiqhi* instruments are used in another structure (here, a *sukuk* structure). Applying the same rationale, it is evident that regarding *tawarruq*, the requirements must be met not only for AAOIFI *shari'a* Standard No. (30) but also the requirements pertaining to *murabaha* and *murabaha on purchase order*. AAOIFI *shari'a* Standard No. (30) supports this view in (4/1), wherein it states that, "the requirements of the contract for purchasing the commodity on deferred payment basis should be fulfilled, for both *musawama* and *murabaha* transactions, with due

consideration to AAOIFI *shari'a* Standard No. (8) on *murabaha* and on *murabaha on purchase order*." While in practice, *tawarruq* transactions often only fulfill the rudimentary requirements of AAOIFI *shari'a* Standard No. (30), future certifications of such transactions will require the involved *shari'a* boards to take a much closer look into structure, legal documentation and operational execution of any such transaction.

An important challenge emanating from the 2008 AAOIFI statement will be the establishment and resourcing of procedures capable of ensuring a high level of ongoing monitoring over the lifetime of a transaction, enabling the parties to "review **all** contracts and documentation related to the actual transaction" and to "oversee the ways that these are implemented in order to be certain that the operation complies at every stage with *shari'a* guidelines and requirements as specified in the *shari'a* Standards."

Such approach significantly increases the burden on players in the international Islamic financial markets to care about in-depth *shari'a*-compliance, in terms of structuring efforts, legal documentation and their execution in the operational workflow. Given the scope if this paper, the focus will be on the second aspect: the implementation of the above findings and requirements in terms of legal documentation.

Implementation of the New Approach in Legal Practice

Choice of governing law

Practice shows that a majority of international financial market transactions, be them *shari'a*-compliant or conventional, are governed by English law. It is difficult to choose *shari'a* as the governing law of a contract or as an additional source regarding the interpretation of a contract. In conventional and Islamic financial markets, players tend to prefer the English law as the governing law. The acceptance of any local law, e.g., Saudi law or Kuwaiti law, will not satisfy the legal advisors of the transacting parties due to insecurities about what could happen in case of serious litigation on the matter. The expertise of international law practitioners along with the relative reliability of English courts contribute to the preference of using English law for Islamic transactions. International conventional banks featuring an Islamic window operate under English law, as most of them are even headquartered in London.

When documenting an Islamic transaction under English law, it is crucial to remember the basic considerations pertaining to *shari'a.* The most prominent feature in this regard is the recommendation not to include *shari'a* in the governing law clause. English courts have issued several landmark rulings in this respect. One of the most prominent is the case of *Shamil Bank of Bahrain vs. Beximco Pharmaceuticals Ltd.*[37] In this case,

despite the parties stipulating in the respective governing law clause that the agreement would be "subject to the principles of the *shari'a,*" the Court of Appeals declared such choice of law invalid and held that:

> the general reference in the clauses to principles of the *shari'a* afforded no reference to, or identification of, those aspects of *shari'a* law which were intended to be incorporated into the contract and stood unqualified as a reference to the body of *shari'a* law generally, which was repugnant to the choice of English law as the law of the contract and rendered the contract self-contradictory and meaningless; that the references to *shari'a* law were intended merely to reflect the Islamic religious principles according to which the bank held itself out as doing business and were inadequate to incorporate the principles of *shari'a* law, or any part of *shari'a* law, into the agreements; that, therefore, the validity of the agreements and the defendant's obligations thereunder were to be decided according to English law.[38]

In legal documentation, parties will often prefer English law, even in a transaction that is *shari'a*-compliant, without any additional mentioning of *shari'a* as choice of law, provided the parties intend to stick to an English forum.

Operationally, there is an additional reason why, with respect to the above-discussed commodity *murabaha* transactions/*tawarruq* transactions, the practice of choosing English law appears appropriate. According to market practice, the commodities trades underlying such transactions are executed at the London Metal Stock Exchange (LME).

Besides its location in a well-functioning jurisdiction, this exchange offers various advantages for transaction-intensive, *shari'a*-compliant structures. Firstly, LME commodities are fully *shari'a*-compliant even for trading under a deferred-payment scenario. In short, LME traded commodities do not fall into the category of *ribawi* goods. Goods considered *ribawi* (e.g., gold) would not be admissible for a deferred payment structure such as *murabaha*. A sale on *ribawi* goods would be considered a form of *riba al nasi'a*. A second reason for such preference is the fact that LME trades are tax-neutral since the commodities are stored in bonded warehouses outside the European Union. This avoids triggering EU taxes on sale transactions.

For market practice, operational reasons and requirements emanating from recent landmark judgments, English law appears an appropriate choice of law. Even though *shari'a* is at the core of any Islamic finance transaction, it will preferably be expressed through the structure and the parties' rights and obligations in the body of the agreement.

Accurate Documentation of Shari'a-specific Transactional Requirements
Regarding the discussed commodity *murabaha/ tawarruq* transactions, AAOIFI *shari'a* Standard No. (30) (4/6) provides a practical example of concrete practical relevance:

> The contract for purchasing the commodity on deferred payment basis, and the contract for selling it for a spot price should not be linked together in such a way that the client looses his right to receive the commodity. Such linking of the two contracts is prohibited whether it is made through stipulation in the documents, acceptance as a normal tradition, or incorporation in the procedures.

From a legal draftsperson's point of view the problem lies in contradicting requirements from a *shari'a* perspective on the one hand and the financial institution's risk considerations on the other hand. Whereas *shari'a* obviously requires the draftsperson to clearly stipulate the client's right to effectively receive the commodity upon request, any financial institution involved in such transaction would prefer not to be exposed to a client's potential request of physical delivery. Firstly, this is because physical delivery may be operationally cumbersome and thus beyond pricing considerations on which a specific transaction was based. Secondly, the brokers involved, though specialized in facilitating the implementation of commodity *murabaha* transactions, may not necessarily be experts in international commodity shipping and delivery.

The above operational considerations show that there are numerous implications to be taken into account when drafting a specific transaction agreement. Eventually, such considerations cannot blur the goal of obtaining a set of documents in line with precise *shari'a* requirements, here AAOIFI *shari'a* Standard No. (30) (4/6). Similar considerations will guide a legal draftsperson in the implementation of other requirements of AAOIFI *shari'a* Standard No. (30), which would be beyond the scope of this paper.

The precise documentation of all operational requirements is vital to ensure full *shari'a* compliance. A general reference of submitting an agreement to the "principles of *shari'a*," as in the case of *Shamil Bank of Bahrain vs. Beximco Pharmaceuticals Ltc.*, will not replace such detailed drafting. It will essentially be the role of the involved *shari'a* boards to effectively monitor the requirements and ask for their strict implementation, a point that will be expanded upon later.

The Investment's Use for Hedging or Speculation: A Case for Niyyah (Intention)
Despite the *shari'a* ban on speculation and excessive risk taking, notably by reason of contravening the prescriptions of *gharar*, *qimar* and *maysar*, the

case of derivatives, conventional and *shari'a*-compliant, shows that their markets rely heavily on participants aiming solely on speculation. This is supported already by the fact that without a majority of speculators in derivatives markets, these markets would lack essential liquidity. Technically, as derivatives always entail win-lose distribution of pay-offs between the parties involved in a specific transaction, and given the rarity of fully complementary hedging needs, the equation of "hedging party" vs. "speculating party" appears to remain a cornerstone of the vast majority of hedging transactions in the market.

As argued earlier in this paper, it does not seem possible to apply an objective measure or a mathematical formula to distinguish between a financial transaction's purpose for hedging or for speculation. However, in the interest of material *shari'a*-compliance one cannot suggest that transacting for addressing "genuine hedging"[39] shall be allowed, without elaborating further on how such 'genuine hedging' could be identified. It has been argued that, in the absence of an objective measure pertaining to the distinction of hedging from speculation, the essential difference could validly be established by taking into account the parties' intention (*niyyah*).

Intention in *shari'a* is a prominent concept in the field of *'ibadat* (rules pertaining to worship and ritual matters) as well as in the field of *mu'amalat* (rules pertaining to social and economic matters including trade). In the field of Islamic contract law, there are several concepts of intent, and a thorough discussion would be beyond the scope and focus of this paper.[40] The goal of this paper is not to re-assess *fiqhi* theory regarding the formation of commercial contracts and the role of intent in this framework. The goal is much more practical: to find, from a draftsperson perspective under English law, a practical proposition on how to document a party's intention to enter into a transaction for hedging purposes rather than for speculation.

Several considerations must be observed in such legal drafting: no party can validly assess nor guarantee a counterparty's intention to enter into a transaction for speculation or for hedging purposes; in the case of fraudulent or deliberately untrue statements it will not affect the validity of the contract but rather trigger the obligation upon the misrepresenting party to purify amounts obtained from such speculative activity.

In a contractual framework under English law, such commitment most suitably would be inserted in the representations and warranties section and could be worded as follows:

> The Client represents and warrants to the Bank that it has entered into this Agreement and any other documentation relating to this Agreement to which it is a party solely with the intention of hedging in compliance with *shari'a* principles.

> The Client confirms to the Bank that it will monitor the existence of such hedging purpose over the lifetime of this Agreement. Further, the Client commits to purify amounts obtained from any speculative purpose in the framework if this Agreement as being advised upon by the Client's *shari'a* supervisory board.

This clause being drafted as self-commitment of the Client will not be invocable by the Bank and thus will only work in the direction of ensuring enhanced *shari'a* compliance without granting a right to the counterparty to assess any misrepresentation in this respect or raise an objection on these grounds.

Obviously, such stipulation will work perfectly in the case of two counterparties displaying complementary hedging needs. In case such complementary hedging needs do not exist, such drafting could result in a party deliberately lying about their intention—without any effect. Admittedly this is an inherent drawback of self-committing clauses, their non-invocability by a third party, i.e., by any counterparty to a transaction. However, also a mere self-commitment is likely to put pressure on the parties engaged in a hedging transaction. Therefore, the respective parties' *shari'a* board's work is crucial in guaranteeing effective adherence to *shari'a* principles.

The Role of Shari'a *Boards*

AAOIFI in its 2008 *Sukuk* statement is very clear about depth and duration of certification and monitoring tasks to be accomplished by a *shari'a* board of a financial institution. In contrast, AAOIFI defines the scope of work for its own *shari'a* board as follows:

(1) Achieving harmonization and convergence in the concepts and application among the *shari'a* supervisory boards of Islamic financial institutions to avoid contradiction or inconsistency between the *fatwas* and applications by these institutions, thereby providing a pro-active role for the *shari'a* supervisory boards of Islamic financial institutions and central banks.

(2) Helping in the development of *shari'a* approved instruments, thereby enabling Islamic financial institutions to cope with the developments taking place in instruments and formulas in fields of finance, investment and other banking services.

(3) Examining any inquiries referred to the *shari'a* board from Islamic financial institutions or from their *shari'a* supervisory boards, either to give the *shari'a* opinion in matters requiring collective *ijtihad* (reasoning), or to settle divergent points of view, or to act as an arbitrator.

(4) Reviewing the standards that AAOIFI issues in accounting, auditing and code of ethics and related statements throughout the various stages of the due process, to ensure that these issues are in compliance with the rules and principles of Islamic *shari'a*.[41]

Obviously, the scope of required monitoring is dependent on the activities of an organization. To date there is no binding description available of which tasks a *shari'a* board must assume, nor which *madhhab* it has to follow. However, AAOIFI, as one of the most prominent standardization organizations in Islamic finance, certainly is a voice to be heard in the international financial markets. AAOIFI took the stance to require that the *shari'a* board of a financial institution ensure ongoing and in-depth monitoring and full review of transactions and product documentation in order to safeguard the adherence to *shari'a* in form and substance:

> *Shari'a* supervisory boards must not consider their responsibility to be over when they issue a fatwa on the structure of *sukuk*. Rather, they must review all contracts and documentation related to the actual transaction, and then oversee the ways that these are implemented in order to be certain that the operation complies at every stage with *shari'a* guidelines and requirements as specified in the *shari'a* Standards, and that the investment of *sukuk* proceeds and what those proceeds are converted to takes place in accordance with one [or another] of the approved *shari'a* methods of investment as stated in *shari'a* Standard (17) on the subject of Investment *Sukuk*, Article (5/1/8/5).[42]

The required depth and duration of certification and monitoring reflects the current status of Islamic finance where, on the one hand, standardization already exists in the form of acknowledged standards (e.g., the AAOIFI *shari'a* Standards), but where, on the other hand, an internationally accepted *shari'a* judiciary is beyond imagination.

In the absence of comprehensive standardization and in view of the absence of an internationally accepted *shari'a* judiciary, the *shari'a* boards still benefit from a significant amount of discretion. Moreover, the lack of an internationally accepted *shari'a* judiciary means that the parties of the transaction and the respective *shari'a* boards involved are the ones who must assess whether a transaction, its documentation and its operational implementation satisfy *shari'a* requirements over its entire lifetime.

Certainly the burden of AAOIFI's *Sukuk* statement is huge, considering the already immense workload of *shari'a* boards of international financial institutions. Adding the duty of in-depth monitoring to the task of thorough

assessment upon certification may not be practical without putting in place appropriate mechanisms of *shari'a* compliance similar to what exists in conventional finance under the terms of Legal and Compliance. The standards are there but human resourcing and appropriate procedures must be conceptualized and implemented so that the practice does not return to the way it was before the February 2008 AAOIFI statement. In this context, *shari'a* boards of counterparties in a financial transaction may also benefit from one another in receiving each other's input on the *shari'a*-compliance of a certain structure. Transacting parties and their *shari'a* boards should take their tasks seriously and thoroughly scrutinize the documents, flow charts, test trades, fatwas, etc., presented to them. The fact that under current Islamic finance transactions the obligation of in-depth *shari'a*-compliance will be more of a self-binding representation rather than a warranty by the counterparty (see above) shall not lead the parties to refrain from scrutinizing the transactions into which they intend to venture.

Particularly with respect to the current, ongoing crisis, the players involved must be familiar with all details of a transaction, including the structure and its legal and economic implications, to avoid the legal and economic disasters that befell the conventional finance market.

Conclusion

Natural hedges and risk pooling arrangements, though preferable over a stricter *shari'a* perspective, do not seem to fit the purposes of most players in international financial markets. Therefore, more flexible solutions in the form of risk-shifting arrangements have been recently developed. These heavily engineered financial solutions use classical *fiqhi* contracts and instruments (i.e., *arbun, bay' al-salam*, *khiyar ash-shart* or *wa'ad*). These solutions in their very nature serve genuine hedging needs and speculation alike; it has been argued that in the absence of a mathematical formula a legal draftsperson has to resort to the parties' intention (*niyyah*).[43]

From a *shari'a* perspective, such engineered solutions are further put under scrutiny as they help circumvent general *shari'a* principles (*gharar, maysar,* etc.) and aheavily rely on commodity *murabaha/tawarruq* transactions for modeling the payment streams upon maturity. Recent landmark statements by *shari'a* standard setting bodies have tackled these issues, notably the April 2009 *OIC Fiqh Academy* Resolution 179 (19/5) and the February 2008 AAOIFI *Sukuk* Statement. These statements can be interpreted as a new approach on *shari'a*-compliance, notably by calling for documentation-wise and operational implementation of *shari'a* precepts in substance rather than only formally, in line with the *maqasid al shari'a,* as

well as enhanced scrutiny in terms of certification and monitoring of *shari'a* over the entire life of an investment.

The transfer of the above findings in the process of legal documentation is, as far as current international financial market transactions are concerned, largely a matter of English law due to its customary use in such transactions and trading practice in the underlying commodity trades. In terms of governing law, recourse to the principles of the *shari'a* appears not to be a viable choice in an English forum due to applicable case law (e.g., Shamil Bank of Bahrain vs. Beximco Pharmaceuticals Ltd., 2004). Instead, transactional *shari'a* requirements have to be interwoven in the fine print of the documentation wherever necessary in order to ensure *shari'a*-compliance in substance.

With respect to *murabaha/tawarruq* transactions occurring under engineered risk-shifting arrangements, the strict observance of OIC and AAOIFI *shari'a* Standards, notably AAOIFI *shari'a* Standard No. (30), must be ensured in its various aspects (e.g., real asset transfer, operational requirements, de-linking of contracts). Other parameters still may need further discussion (e.g., regarding the exceptionality of *tawarruq* transactions according to AAOIFI *shari'a* Standard No. (30) (5/1)). Regarding the equation of speculation and hedging, and in the absence of a objective measure, a legal draftsperson may resort to the parties' intentions (*niyyah*) by inserting appropriate legal language in the representations and warranties, as suggested further above. Given the early stage of drafting hedging arrangements under *shari'a*, this suggestion is a mere proposal. Eventually, the wording and use of such clauses may and will evolve before a market practice will be established.

Legal documentation is always bound by its subject matter. Documenting a party's intention presents the challenge of legally documenting what is ultimately beyond control from the draftsperson's perspective (and any counterparty's perspective to a transaction). For this reason the *shari'a* supervisory boards will henceforth play an even more vital role in ensuring that a transaction and the institutions involved comply to *shari'a* requirements.

The recently cited statements of leading *shari'a* standard setting bodies put a double burden on the *shari'a* supervisory boards: first, the obligation of scrutinizing a transaction thoroughly according to the full set of legal and transactional documents as well as per its effective implementation over the entire life of the investment; secondly, the obligation to apply the same level of scrutiny to the institution supervised and its economic goals pursued—some sort of *shari'a* self-regulation or permanent *shari'a* self-control. Such self-regulation may rely on approved standards. Recent landmark

statements have greatly impacted the question of how to align market practice with core *shari'a* principles and have proven that standardization is already a reality. What is lacking is strict implementation in substance rather than in mere form and the means and procedures to thoroughly accomplish this task.

Until *shari'a c*ompliance procedures are implemented in order to take the immense workload off *shari'a* supervisory boards, markets are likely to receive reminders by *shari'a* standard setting bodies to what has been laid down as their benchmark. Likewise, until such *shari'a c*ompliance procedures are common practice, a legal draftsperson will have to do piecemeal work in order to ensure in-depth transactional *shari'a* compliance through the fine print of the transaction documents.

An effective documentary distinction between speculation and hedging entails a commitment by the parties to uphold the goals of *shari'a* and to refrain from pursuing what has—for valid reasons in light of the current crisis—been discussed.

Endnotes

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33. Uberoi and Evans, "Profit Rate Swap."
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36. For a detailed assessment of the matter, see Dusuki and Abdullah, "*Maqasid al-shari'ah, Maslaha,* and Corporate Social Responsibility," 25–33, avilable at www.isra.my/index.php?option=com_content&view=article&id=266&Itemid=157.
37. CA (Civ Div) Court of Appeals rendered judgment on Jan. 28, 2004.
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