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# MALEZYA'NIN YAPILANDIRILMŞ ÜRÜNLERİNDE İSLAMİ GÖMÜLÜ OPSİYONLAR: SORUNLAR VE ZORLUKLAR

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## ÖZ

Yapılandırılmış Ürünler, getirinin vade tarihi, kupon tarihi, sermaye koruma seviyesi (SMR Varlık Yönetimi) gibi önceden tanımlanmış özelliklere sahip bir dayanak varlık ile bağlantılı olduğu tasarruf veya yatırım ürünleri olarak tanımlanabilir. İslami yapılandırılmış ürünler aslında İslam hukukuna uyumlu yapılandırılmış ürünlerdir. Bu ürünler amaç, ekonomik faydalar ve temel yapısal özellikler açısından geleneksel ürünlere benzerlik taşırlar. Aralarındaki fark, İslami yapılandırılmış ürünlerin riba (faiz), gharar (belirsizlik), zulm (adaletsizlik)'den kaçınarak İslam hukuku ilkelerine bağlı kalması ve bu ilkelerle uyumlu şekilde bir bütün olarak çalışmasıdır. Bu, yatırımı yapılandırmak için Malezya Merkez Bankası Şer'i Danışma Kurulu tarafından onaylanan İslam hukuku sözleşmelerinin kullanılmasını ve İslam hukuku tarafından izin verilen dayanak varlıkları içerir. Kurulduğu günden bu zamana kadar sektöre kazandırılmasına rağmen, İslami yapılandırılmış ürünlerin uygulamalarının birçok İslam hukuku sorunu var. Bu çalışma Malezya'daki İslami bankalarda yapılandırılmış ürünler için hem literatürün hem de çeşitli vaka çalışmalarının derinlemesine analizlerini kullanarak bu ürünlerin İslam hukuku açısından en önemli sorunlarının analizini ve değerlendirmesini yapmaktadır. Çalışmanın bulguları, Malezya'da kullanılan yapılandırılmış ürünlerin mevcut uygulamasının İslam hukuku açısından bir dizi sorununa sahip olduğunu, bu ürünlerin piyasada İslam hukukuna tamamen uyumlu şekilde faaliyete göstermesi için mevcut sorunların hem bankalar hem de endüstri tarafından düzeltilmesi gerekliliğini ortaya koymaktadır.

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# ISLAMIC EMBEDDED OPTIONS IN STRUCTURED PRODUCTS OF MALAYSIA: ISSUES AND CHALLENGES

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**ABSTRACT**

Structured Products could be defined as savings or investment products in which the return is linked to an underlying asset with pre-defined features such as the maturity date, coupon date, capital protection level (SMR Wealth Management). Islamic structured products are essentially Shariah-compliant structured products. They bear similarities to conventional products in terms of purpose, economic benefits and basic structural features. The difference being that Islamic structured products adhere to Shariah principles by avoiding riba (usury), gharar (uncertainty), zulm (injustice), and operate holistically in a Shariah-compliant manner. This includes utilizing Shariah contracts approved by the Shariah Advisory Council of the Central Bank of Malaysia to structure the investment and contains underlying assets that are permissible by Shariah. Despite having been introduced into the industry since its establishment, implementing Islamic structured products have many Shariah issues. Using in-depth analyses of both the literature and several case studies for structured products in Islamic banks in Malaysia, this paper analyzes and assesses the most important Shariah issues surrounding Islamic structured products in Malaysia. Our findings confirm that the current implementation of Malaysian structured products continues to possess a number of Shariah issues, which need to be corrected by both the banks and the industry in order to have fully Shariah-compliant structured products to be operational in the market.

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The routes of structured products emerged in the 1970s. It was, however, only in the 1990s that the first equity-linked, capital protected structured product began to be introduced on a large scale. Since becoming an identifiable asset class in the 1980s with the development of financial derivatives, structured products have become a mainstream investment tool for both retail and institutional investors. Although structured products have been associated with some of the most widely publicized financial of the 1980s[5], including the collapse or near-collapse of Enron, Parmalat, AIG and Bear Stearns, the market for structured products has only continued to expand. The popularity of structured products accelerated in the mid-2000s. Since the 2008 crisis, the structured products market has once again accelerated the market. In 2011 alone, the global issuance of new retail structured products was estimated to be over US$400 billion. It is no secret that *Shariah*-compliant products have universally weathered the 2008 global financial crisis. Following the crisis, the perception that *Shariah*-compliant structured products and investment products are both more ethical and more transparent than conventional structured products has attracted many investors and, interestingly, the demand for Islamic investment products to be gaining more popularity than conventional products in 2009 and much of 2010.

Structured products are relatively new in the Malaysian capital market. It was on 10th December 2003 that the Securities Commission (SC) first released the 'Guidelines on the Offering of Structured Products'. The purpose of this guideline is to facilitate universal brokers, merchant banks, conventional and Islamic commercial banks, performance-guaranteed special purpose vehicles (SPV) established by any of the above-mentioned institutions to issue "structured products" tailored to the needs of sophisticated investors. Thus, since 2004, Malaysian financial institutions have been actively offering structured products to investors. From 2004 until June of 2009, the SC has approved RM 236.85 billion worth of structured products, including RM 22.8 billion of Islamic structured products. This remains relatively small in comparison to the market share of conventional structured products.

Some of the main targets for Islamic structured products are Islamic institutional investors and high-net-worth (HNW) families due to their preference for high returns. Islamic structured products are also preferred because the principal amount is protected, which is useful when the market trends are downwards. A further reason for its popularity is that it shows Islamic banks' natural progression of advancement from offering only *Mudarabah*-based unrestricted Profit Sharing Investment Accounts (PSIA), which are similar to

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5 SRP Academy – History of structured products
https://www.structuredretailproducts.com/srp-academy/structured-products-history

Islamic structured products. It is offering structured products in the form of restricted PSIA (depositors' money is used for specific projects and investments) and structured retail products offered in the form of structured deposits.

Structured products are usually made with several embedded features including risk mitigation, risk transfer, principal protection (usually provided if the investment is held until maturity), the profit margin dictated by the performance of the underlying or reference asset, and the potential return may exceed average investment returns. In addition, with the growing demand for *Shariah*-compliant investments from increasingly wealthy areas of the world, it has naturally attracted the attention of large Western banks, and in response, these banks have all developed their own Islamic finance capabilities. They have focused much of their attention on developing the fixed income side of the Islamic capital market. Western banks have done so largely by treating Islamic finance as a type of structured product, applying the same skills, and, in many cases, the same staff used in the structured products field to create *Shariah*-compliant, fixed income instruments. In other words, many Western banks are creating Islamic fixed income securities that are essentially a new type of structured product[6].

## Definition

To begin with, there is no standard definition of structured products. Therefore, it is necessary to look at some of the definitions of structure products that are currently being used. Professor Campbell R. Harvey of Duke University defines structured products as "investment vehicles based on a basket of underlying securities, such as derivatives, equities, debt issuance, commodities, indices, currencies, or any combination thereof." [7]

*The Q Finance dictionary* sees structured products as a customized financial contract, legally binding between a client and an investment bank, designed to meet a client's specific needs and stating the specific terms that have been agreed.[8]

The Financial Industry Regulatory Authority (FINRA) defines structured products as "securities derived from or based on a single security, a basket of securities, an index, a commodity, a debt issuance and/or a foreign currency". Based on (important information about structured products by Robert W. Baird & Co "They are a hybrid between two asset classes typically issued in the form of a corporate bond or a certificate of deposit, but instead of having

6 http://www5.austlii.edu.au/au/journals/JlLawFinMgmt/2011/2.pdf

7 Structured Product: Farlex Financial Dictionary - The Free Dictionary by Farlex

8 Definition of Structured Product: QFinance Dictionary

a predetermined rate of interest, the return is linked to the performance of an underlying asset class."

As may be seen from the three definitions provided above, it is difficult to find an exact definition that can be agreed upon. However, for the purpose of this paper, the definition provided by the SC of Malaysia will be utilized. SC defines structured products as "any investment product that falls within the definition of securities that provides the holder with an economic, legal, or other interest in another asset (the underlying asset) and derives its value by reference to the price or value of the underlying asset." The SC notes that the 'underlying asset' refers to any security, index currency, commodity, or other assets, or a combination of such assets. It goes on to say that securities are in reference to debentures, stocks or bonds issued by any government, shares in or debentures of a body incorporated or unincorporated, unit trusts, prescribed investments, and includes an option or interest in respect thereof.

**Types of Structured Products**

**Table 1.** *Types of structured products*

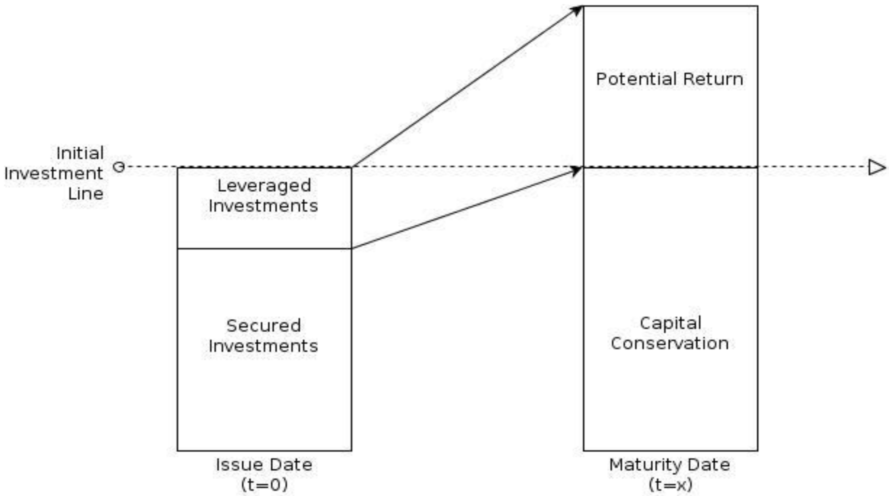
| | | | |
|---|---|---|---|
| Equity-Linked Notes | Bond-Linked Notes | Credit-Linked Notes | Commodities-Linked Notes |
| Index-Linked Notes | Currency-Linked Notes | Hybrid-Linked Notes | Interest Rate-Linked Notes |

**Source:** Authors.

The most important characteristic of structured products is that the securities involved are structured with derivative instruments. There are many types of derivative instruments available, and options are some of the most common instruments used. An option is an instrument that provides the option holder with the right, but not the obligation, to buy or sell an asset at a specified future date. As a result, it has become a popular ingredient applied in structured products as a 'peace of mind' feature by limiting the liabilities; at the same time, options also limit the potential benefits of the investment.

Figure 1 gives an illustrative example of how general structured product works. Let us imagine that RM100 is invested into this structured product. The initial investment is then divided into two separate portfolios. The first portfolio is a secured investment that provides a guaranteed return at the maturity date. The second portfolio is the leveraged investment that is expected to provide an excess return if it performs as anticipated at the maturity date. However, if the second portfolio does not perform to how the issuers had planned, the investors will at least get back the original amount of capital invested into the structured product.

**Figure 1.** *An example of structured products*




**Source:** www.investopedia.com

## Islamic Structured Products

Islamic structured products are essentially *Shariah-compliant* structured products. They perform in a similar manner to conventional ones in terms of purpose, economic benefits and basic structural features. The difference being that Islamic structured products adhere to *Shariah* principles, avoiding *riba* (usury), *gharar* (uncertainty), *zulm* (injustice), and operates holistically in a *Shariah-compliant* manner. This includes utilizing *Shariah* contracts approved by the *Shariah* Advisory Council (SAC) to structure the investment and contains underlying assets that are permissible in *Shariah*.

Islamic structured products are currently being offered in three different forms: structured deposits, structured notes and certificates, as well as hedging solutions. Structured deposits are usually offered to banks' premier clients (corporate and HNW). Structured notes are sold as over-the-counter securities or through exchanges. Moreover, with the recent introduction of Islamic derivatives market in Malaysia, the tradeability of Islamic structured products is bound for improvements in the future. Islamic hedging solutions are offered by some Western investment banks in the form of profit rate swaps, currency swaps, and other Islamic derivatives.

**Table 2.** *Shariah contracts used in building structured products*

| ***Shariah* Concepts and Principles Approved by *Shariah* Advisory Council (SAC)** | |
|---|---|
| **Primary *Shariah* Principles** | **Supplementary *Shariah* Principles** |
| • *Bai` Bithaman Ajil* (BBA) (Deferred-Payment Sale)<br>• *Bai` Inah* (Sale with Immediate Repurchase)<br>• *Bai' Istijrar* (Supply Sale)<br>• *Bai` Salam* (Advance Purchase)<br>• *Bai' Wafa'* (Sale and Repurchase)<br>• *Ijarah* (Leasing)<br>• *Ijarah Thumma Bai* (Lease to Purchase)<br>• *Istisna'* (Purchase Order)<br>• *Mudarabah* (Profit-Sharing)<br>• *Murabahah* (Cost-Plus Sale)<br>• *Musharakah* (Profit and Loss Sharing)<br>• *Qard Hasan* (Benevolent Loan) | • *Bai` Dayn* (Debt Trading)<br>• *Bai` Muzayadah* (Open-Bidding Trading)<br>• *Kafalah* (Guarantee)<br>• *Hak Tamalluk* (Ownership Right)<br>• *Hibah* (Gift)<br>• *Hiwalah* (Remittance)<br>• *Ibra'* (Rebate)<br>• *Ittifaq Dhimni* (Pre-Agreed Contract)<br>• *Rahnu* (Collateral)<br>• *Sukuk* (Securities)<br>• *Ujrah* (Fee)<br>• *Wakalah* (Agency) |

**Source:** Authors

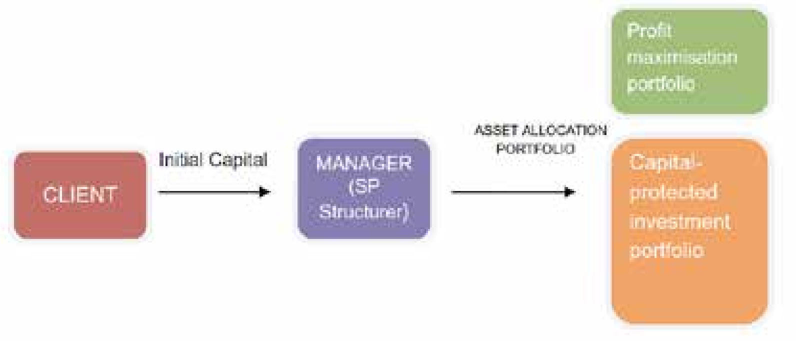
Islamic structured products in Malaysia are required to contain only the *Shariah* concepts and principles that have been approved by the SAC, as shown in a non-exhaustive list above. The structure provider must also observe the nature of the contracts (*Muqtada al-Aqad*) used in creating Islamic structured products. Unlike conventional structured products that are specification driven, Islamic structured products are contract-driven. If the structured product utilizes sale-based contracts such as *Murabahah* and *Tawarruq*, the contract's structures must contain sale-based contractual features. Hence, it must be built with complete pillars of contracts including *Mawdu' al-Aqd* (subject matter of the contract), *al-Aqidan* (the two contracting parties), and *Sighah* (statement of contract). Additionally, the returns must be based on the sale price (purchase price plus profit). If the structure utilizes participatory contract such as *Mudarabah* or *Musharakah*, the contract's structures must contain the nature of a participatory contract. In this case, the returns must be based on a profit-sharing ratio, contribution determined for *Musharakah*, and mutually agreed for *Mudarabah*. If the structure utilizes a *Wakalah bi al-Istithmar* contract, it must contain service-based features, and the financial institution will determine the amount of fixed fee the customer shall pay upfront.

Earlier, we mentioned several common types of structured products. However, it is necessary to revisit the list and re-evaluate what types of structured products are compliant with the *Shariah*. Interest-linked notes are not accepted because they contain *riba*. Bond-, currency-, and credit-linked notes are also generally disapproved due to the existence of *riba* elements. Equity- and index-linked notes may be acceptable if the underlying equities and indices are *Shariah*-compliant. This is enforceable because there are many *Shariah*-compliant equities and *Shariah*-compliant indices available in the market. Commodity-linked notes are also accepted as long as the commodity and its derivative contracts are *Shariah*-compliant. Hybrid-linked notes can be accepted as long as the foundations within the hybrid securities comply with the *Shariah* principles. Most successful Islamic structured products offerings are exposed to the commodity market, and it began with Deutsche Bank commodity-linked Islamic structured product with reference to platinum, aluminum, and crude oil by Abu Dhabi Commercial Bank. Due to the excellent performance of commodities futures during economic downturns, commodity-linked Islamic structured product becomes an attraction to the Islamic investors.

The underlying securities of the structured products must be *Shariah*-compliant top to bottom. It should not be securities that are involved in *riba*, *gharar*, *zulm*, *qimar* (gambling), *maysir* (speculation), and any form of activities that renders the asset *haram* (prohibited). To ensure that the underlying securities are *Shariah*-compliant, it is normally certified upon issuance by *Shariah* advisors. For equity stocks and indices, there are bodies that apply Islamic stock screening criteria to ensure that the stocks are *Shariah*-compliant. A *Shariah*-compliant structured product must also go through a two-tier regulatory requirement: First, the rating requirement that is necessary for all types of structured products. Second, to the approved by *Shariah* concept and principles that are only applicable to Islamic structured products.

However, there are two broad types of Islamic structured products: First is the fully *Shariah*-compliant structured product, which contains a *Shariah*-compliant structure and underlying asset. This is commonly produced by fully-fledged Islamic banks and subsidiary Islamic banks due to the preference of purer products. The second is the *Shariah* bridged products which contain a *Shariah*-compliant structure but non-*Shariah compliant* underlying asset. This type of structured products is currently offered by Western banks.

**Figure 2.** *Example of Islamic structured products*

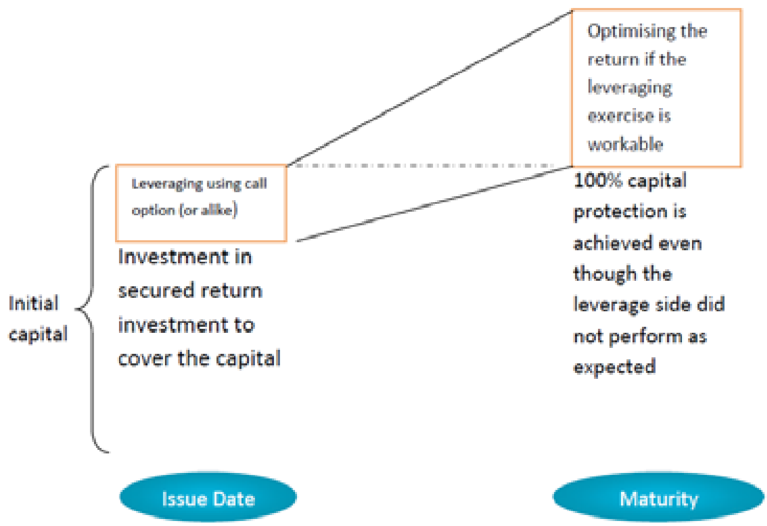



**Source:** Securities Industry Development Corporation (SIDC).

Figure 2 shows the most common structure of an Islamic structured product. The client provides the principal or initial capital to the structured product manager to be invested in a particular portfolio of investments. The clients of structured products are individuals (usually HNW), institutional investors, and even banks which resell the structured notes to their clients. The relationship between the client and the structured product manager is usually based on the *Mudarabah* or *Wakalah* contract. However, in no way does this affect how the asset allocation portfolio is managed. Instead, it only affects the manner in which the profits are to be distributed by the manager. For instance, in a *Wakalah* contract, the manager will take the upfront fee regardless of the performance of the structured product in the future. However, if the *Mudarabah* contract is used, the manager is only entitled to the profit-sharing ratio, and he will earn only if the structured product manages to generate a positive return at maturity.

*Figure 3* demonstrates how the portfolio is created and distributed in equity-linked Islamic structured products. The initial capital provided by the client will be divided into two portfolios. The larger portion will be invested in a relatively secured investment which will cover the principal capital regardless of the performance of the leveraging instrument. This ensures that the capital invested is protected if the structured product fails to perform as anticipated at maturity. The smaller portion of the capital is used to 'buy' an Islamic option that is used to optimize the return on the investment. It can generate high profits if the option performs well. But if it does not perform as expected, the investor will lose all the money invested in this portfolio. However, their principal capital is already protected by the first portfolio, which provides enough returns to cover the initial capital.

**Figure 3.** *Equity-linked Islamic structured product*




**Source:** Dhiraj et al, 2019.

The most important aspect that needs to be monitored within the Islamic structured products is the embedded Islamic options. The reason for this is that leveraging an Islamic structured product using a conventional option is not possible under the current global view of *Shariah* rulings on options. It bears no similarities to the conventional options, nor is it a mere copy. However, the purpose of embedded Islamic options is to mitigate risks present within the structured product, and the principles present in the embedded Islamic option must be *Shariah*-compliant. Normally, an *Urbun* (downpayment) contract is utilized to create a *Shariah*-compliant call option. *Wa'ad* (promise) may, however, also be used to achieve a similar effect. *Wa'ad* can also be used for a *Shariah*-compliant forward.

The reason why Islamic options need to be embedded lies within the scope of option creation and trading. Creating an option (including the exercise and cancellation of that option) solely for hedging purposes is viewed as permissible by most scholars as it reduces *gharar* (contractual uncertainty) and is therefore regarded as a *maslahah* (contribution to the public interest).[9] However, the trading of an option that is not accompanied by the trading of its underlying asset, with the intention to make a speculative gain (similar to gambling which

[9] Mohammed Obaidullah, Islamic financial options; Sami al Suwailem, Hedging in Islamic finance.

is prohibited in *Shariah*) is regarded as impermissible by many scholars as it increases the *gharar*.

***Urbun***

*Urbun* is one of the principles used as an embedded Islamic option. In its literal translation, *Urbun* means to pay or to receive in advance. In *Urbun*, the deposited advance payment made to the seller is considered part of the purchase price if the buyer decides to continue with the contract. So, if the buyer decides to continue, he will only have to pay the remaining purchase price (the full purchase price minus the *Urbun* amount).

*Urbun* might, at first glance, appear to be much the same as a regular option contract; however, there are fundamental differences between *Urbun* and a regular option contract. First, the *Urbun* serves as a collateral or a guarantee that the potential buyer has the intention of purchasing the commodity. The *Urbun* also acts as a security for the seller if the buyer later wishes to withdraw from the purchase. Secondly, the *Urbun* of the commodity is considered to be part of the total price of the commodity, whereas, in the options contract, the premium is paid by the buyer to obtain the option to purchase the underlying at a fixed price and a fixed term in the future. As a result, when the option holder makes the decision to continue with the contract, he is still obligated to pay the full purchase price of the underlying asset.

Thirdly, in *Urbun*, both parties share the risk of transaction because the seller may not sell the item, and the buyer may reclaim back his downpayment. But in a conventional option, the option holder bears the entire risk while the financial institution is safe from any risk because of the secured premium paid to him. Here, the financial institution acts only as an option provider and has no concerns on the results of the client's forecast at all. A scenario such as this is not permissible in *Shariah* contracts because it lays down the risk of transaction solely to one individual, whereby *Shariah* recommends that the risk present in contracts should be borne by the parties in a just manner. Fourth, the purpose of an *Urbun* contract is to secure a future purchase of commodity with a total price known by all parties. If the client decides to proceed with the contract, a transfer of ownership is made for the underlying item in the contract. As such, the client does not bet on the future price of the underlying; he already knew the price when he entered into the contract.

Some writers have made the case that *Urbun* can be viewed as a 'real option'. In the *Urbun* context, the decision to exercise the option depends on real variables affecting the buyer's total utility rather than just the asset price. An option, however, is bought to monitor the price of the underlying asset where it will only be exercised if the underlying asset's price appreciates.

One of the virtues of the *Urbun* contract is that the *Urbun* holder is the owner of the securities during the holding period, thus entitling the *Urbun* holder to dividends generated from the securities during the holding period. This is because once the *Urbun* contract is enforced, the right and liability of the subject matter are transferred to the buyer. This is one of the primary reasons why the *Urbun* contract is suitable as an embedded option for a structured product, particularly equity-linked notes.

To illustrate how *Urbun* operates as an embedded option, we will look at the example of Islamic equity-linked structured product that is explained by Prof. Dr.Azmi Omar (Mahmud, Foziah, 2018) as:

1. The investor places the capital in an equity-linked structured product.
2. The bank will invest most of the capital (e.g. 85%) in a *Shariah*-compliant fixed income investment that provides a fixed amount of returns sufficient to protect the initial capital/principal investment.
3. The remaining portion of the capital (e.g. 15%) is invested in a "call option" using an *Urbun* contract.
4. The "call option" will benefit the investor if the equity price referred is in-the-money.
5. Alternatively, if the "call option" is out-of-the-money, the investor will only suffer a limited loss of the *Urbun* that will not affect the portion of the capital that is protected by the fixed income investment.

So far, there are several structured products that have been introduced which contain the concept of *Urbun*. CIMB's first equity-linked structured product 'Islamic All Stars Global' is a *Mudarabah Muqayyadah* (restricted *Mudarabah*) and *Urbun* based structured investment. The majority of the principal is invested into *Shariah*-compliant debt instruments for a minimum period of five years which will provide capital protection if held until maturity. The balance of the principal is invested into an *Urbun* contract which refers to the performance of the Islamic All Stars Index that consists of 20 global blue-chip multinational companies. It won the most innovative *Shariah*-compliant structured product in Asia, the best-guaranteed fund in Malaysia, and best local currency structured product in Malaysia in the Asset Mid-Year 2007 Triple A Derivatives and Structured Products award. Moreover, it was the first structured product offered in Malaysian Ringgit and Singaporean Dollar.

Bank Islam's first structured investment product, An-Najah NID-i is the first Islamic structured investment focused on healthcare. It invests into Islamic Negotiable Instruments (INI) structured along with the *Shariah* contract of *Mudarabah Muqayyadah*, and Baraka Aging Population Index options under the

*Shariah* contract of *Bai al-Urbun*. The structured product is managed by Societe Generale Asset Management. HSBC Amanah Islamic Equity-Linked Structured Investment-i is based on *Wakalah fi al-Istithmar* and also contains *Urbun* contracts.

### *Wa'ad*

For a *Shariah* contract to be enforceable, it needs to fulfil three pillars of contract: *Mawdu al- Aqd* (the subject matter of the contract), *al-Aqidan* (the two contracting parties), and *Sighah* (the statement of the contract). *Wa'ad* is not obliged to strictly adhere to these pillars due to its unilateral nature, thus making it an attractive *Shariah* principle to be used in contracts. Due to its flexibility, *Wa'ad* has gained a great deal of exposure in the Islamic Finance market for several years now.

Three divergent views on the enforceability of *Wa'ad* are in existence which needs to be addressed. Based on special report derivatives (The Waad on the street) First, *Wa'ad* is legally enforceable because of the moral and legal obligation to honour the promise. This view is endorsed by Samura bin Jundab, Umar bin 'Abd al-Aziz, Hasan al-Basri, Said bin al-Ashwa, Ishaw bin Rahayawh, Ibn Shubrumah, Imam Bukhari, Ibn Arabi, Ibn al-Shat and al-Ghazzali[10]; Second, *Wa'ad* is enforceable, but despite the fact that fulfilling a promise is noble, it is neither enforceable nor mandatory through the court of law. This view is endorsed by Imam Abu Hanifah, Imam Al-Shafai', Imam Ahmad and several Maliki jurists[11]. Third, *Wa'ad* in the context of *Murabahah* sale is morally binding. Its fulfilment may be enforceable in court if the unilateral pledge binding only on one of the parties in the *Murabahah*, and the promise has caused the promise to incur some cost[12]. The Islamic Fiqh Academy (IFA) issued a *fatwa* supporting this view in December 1988, which resulted in more scholars coming out in support of this viewpoint[13].

The Accounting and Auditing Organization of Islamic Financial Institution (AAOIFI) has also endorsed the IFA's *fatwa* to currency exchange transactions within the Islamic framework[14], thus no longer confining *Wa'ad* solely to

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[10] Sheikh Mustafa Al-Zarqa, Introduction to Jurisprudence (Al-Madkhal Al-Fiqhi), Vol II, page 1,032; Islamic Banking and Finance Institute Malaysia, Islamic Finance Bulletin, July-September 2008, issue 21.

[11] Al-Ghamrawi, al-Siraj al-Wahhaj Ala Matn al-Minhaj li al-Nawawi, page 243; C. Chehata, Le concept de contrat endroit musalman, 13 Archives de Philosophie du Droit (1968), page 129; Nurdianawati Irwani Abdullah, The status of promise (wa'ad) and its implications in contemporary Islamic banking, page 3, ISRA Islamic Finance Seminar, November 11 2008.

[12] Resolution number 2 and 3 of the Fifth Conference of the Islamic Fiqh Academy (Kuwait).

[13] Liau Y-Sing, Waad is legally binding for compensations - scholar, April 1, 2009.

[14] Muhammad Al Bashir Al Amine, Risk Management in Islamic Finance: an analysis of

*Murabahah*. Some scholars have, however, criticized the extension of the IFA's *fatwa*[15].

Due to the development of Islamic finance, scholars find that the concept of *Wa'ad* is suitable to act as a derivative instrument which is *Shariah*-compliant. Unlike conventional derivative instruments used for speculation, *Wa'ad* is used strictly to mitigate profit and currency related risks. In other words, it is used for hedging purposes only. As a derivative instrument, *Wa'ad* has several interesting features such as being asset-based (with the exception of the currency unit), requiring *Wa'ad* made by both parties to be mutually exclusive, based on actual performance and must result in actual trading and should not be on notional basis, and assets must be used for profit swap.

*The Wa'ad*-based derivative has been applied in various different ways in order to mitigate risks. One such way is by providing *Shariah*-compliant options and hedging for profit-related risk (asset-based), currency-related risk (asset-based and currency-based), and providing conditions of exercise to achieve (*Shariah*-compliant cap, floor, or collar mechanism). It has also been used as *Shariah*-compliant mitigation of asset disposal risk, commercial risk, legal and regulatory risk by exercising the *Wa'ad* option through purchase-undertaking or even sales-undertaking.

To see how *Wa'ad* is used as an embedded option in a structured product, we will demonstrate with the example of a Rolling *Murabahah* structured product as shown by (Firoozye 2009):

1. We enter into a 5-Year *Murabahah* which matures at a value of RM 100 (the principal protection component). The prevailing 5-Year swap rates will be around 5%, thus costing the *Murabahah* only RM 75.
2. The bank offers the investor a unilateral undertaking (*Wa'ad*) to enter into a subsequent *Murabahah* starting in Year 5 for the duration of one (1) month. The cost of this *Wa'ad* is RM 25. This second *Murabahah* will have a markup of (LIBOR + Spread) x Number x RM 100 where the markup is determined from today until Year 5 at which point it is fixed.
3. If the markup is less than or equal to zero (0), the investor receives RM 100 in Year 5 and chooses not to roll into the second *Murabahah*.

derivatives instruments in commodity markets, Brill's Arab & Islamic Laws series (2008).

[15] Frank E Vogel and Samuel L Hayes, Islamic Law and Finance: Religion, Risk, and Return (Arab and Islamic Laws, Volume 16) (Arab and Islamic Laws Series); The journey towards absolute return, The Banker, March 10, 2009.B

4. If the markup is positive, the investor will choose to exercise the *Wa'ad* and roll into the second *Murabahah*, thus receiving RM 100 + (LIBOR + Spread) x Number x RM 100 in 5 years and one (1) month.

In this example, the investor had successfully obtained a promise, namely the *Wa'ad*. Also, the second *Murabahah* is not based on a one month LIBOR, but some odd range-accrual linked cash flow. Note that the rolled *Murabahah* is not transferrable by selling it to a third party or resold back to the bank because it would be considered as *Bay' al-Dayn* (a sale of debt).

*Wa'ad* is also used in structuring a forex option since it is conceptually accepted by many scholars. The option's promisor may also receive a fee for facilitating the transaction. The objective of a *Wa'ad* forex option is to simply emulate the cash flow of a conventional forex cash flow. In this type of option, the majority of Muslim jurists have concluded that it can only be used for hedging and cost reduction purposes, not for speculation.

An example of some structured products which explicitly mentions that it contains *Wa'ad* is Maybank Structured Islamic Deposit (STRIDE-i) which is a commodity-linked note that is based on BBA-*Murabahah* and *Wa'ad*. It is wrapped as *Shariah*-compliant Negotiable Islamic Debt Certificate. It invests on wheat and copper due to demand that is driven from emerging economic giants such as India and China. It invests on copper futures on London Metal Exchange (LME) and wheat futures on the Chicago Board of Trade (CBOT). The investments in the futures are made using a *Wa'ad* arrangement. Majority of the principal is invested into Negotiable Islamic Debt Certificates which are held until maturity for capital protection.

CIMB Islamic Bank's 'Greater China and Commodities Income Protected Plus-i' is a *Shariah*-compliant credit-linked note that combines commodity and equity investments with protection referenced to CIMB Islamic Bank Tier 2 Junior Sukuk. It is based on the *Shariah* concepts of restricted *Mudarabah*, *Wa'ad*, and *Bai' al-Inah*. The upside of the investment is that it capitalizes on global recovery via Greater China equities and commodities market and uses the MSCI Taiwan Index, Hang Seng China Enterprise Index, and the S&P GSCI Excess Return Index as its reference indices. The principal is protected by CIMB's Tier 2 Junior Sukuk with an AA rating from Malaysian Rating Corporation Berhad.

Hong Leong Tokyo Marine Takaful introduced the Capital Protection Investment-Linked Fund (CPIL) Scheme. It is a three-year *Shariah-compliant* principal-protected *Takaful plan* investment using the concepts of *Murabahah* and *Wa'ad*. Its returns in the maturity are benchmarked against the best performing basket of investment based on real estate related indices (the

European Public Real Estate Index and Tokyo Stock Exchange REIT Index) and commodities (oil, copper, and zinc). Citibank was the structure provider while HLTM Takaful managed this scheme. It received an award from *The Asset* magazine the Most Innovative *Shariah* Compliant Structured Product in the 2008 Asia Pacific Structured Product and Derivatives Award.

HSBC Amanah Dual Currency Structured Investment is a liquidity management product that allows investors to earn a profit return on short-term surplus funds. It is based on the *Shariah* concepts of Commodity *Murabaha-i* and *Wa'ad*. It was also the first-ever Islamic structured product that was approved under the SC's 'Guidelines on the Offering of Structured Product' back in 2006. The *Wa'ad* component allows the investor to provide the bank with a unilateral promise to exchange currencies in which the amount of currencies to be exchanged is specified in the unilateral promise.

## SHARIAH ISSUES

The most notable *Shariah* issues concerning the approval process of structured products are the SC which regulates issuing and offering private debt securities (PDS) in Malaysia cover the evaluation of three (3) different types of PDS at different periods.

The SC states that the approval period for corporate proposals involving the issuing/offering of conventional private debt securities and Islamic securities is within 14 working days from the date of submission, while the approval period for corporate proposals involving asset-backed securitization (ABS) is within 28 working days from the date of submission. Both cases are subject to full and complete information received. However, proposals involving the issuing/offering of PDS by multilateral institutions and quasi-sovereign institutions and the issuance of "structured products" by eligible issuers are treated as "being deemed approved upon the receipt of complete submission of the relevant proposals to the SC". The SC also assures that any issuances/offers of Islamic securities are *Shariah*-compliant and consistent with the principles approved by the *Shariah* Advisory Council. Despite this, the structured product issuers are not obliged to do a pre-submission consultation to the SC.[16]

This raises the issue of misusing the regulations for the advantage of structured product issuers. The issuers can send all the proposals of structured products all at once. The immediate approval actually presents the issue that the proposal might not be vetted through correctly. This is further amplified as the structured product issuers are not obliged to do a pre-submission

[16] Approval Process of Private Debt Securities in Malaysia: Securities Commission Website

consultation on *Shariah* matters before sending the proposals for approval. All this indicates that there are significant loopholes in the approval process of structured products.

A further issue relating to Islamic structured product is the amalgamation of two or more contracts in one deal. This issue is raised because the level of recognition given by *Shariah* in the amalgamation of contracts remains questionable. However, the practice of adjoining several different contracts into a product is a norm in the Islamic finance industry today.

Regardless of the current practice, some scholars oppose this structural type because it weakens the integrity of the contractual principles involved and is representative of techniques that are used to bypass the prohibition of *Usury* in Islam.[17] The scholars argue that Islamic banks are using such techniques as a means by which to practice interest-based financing in the manner of conventional banks concealed under Islamic banking nomenclature. This has led to accusations that Islamic financial practices are simply mimicking the practices of conventional banks. It seems that the scholars are indirectly suggesting that Islamic banks should adopt the straightforward Islamic contracts instead of mimicking the unhealthy practices of conventional banks, which leads to an outcome similar to interest-bearing products.

Other scholars, however, have argued that as long as the contracts do not lead to the overt circumvention of a prohibition and are made and amalgamated with the fullest consideration and adherence to *Shariah* guidelines, and structured within the necessary limitations and boundaries, that these contracts should not be invalidated. Since contracts such as these are designed to be independent, its application is permissible and reflects the *Muwatah* (existence of understanding) between the bank and the client to exercise their contractual relationship in such manner.

In terms of regulations, structured products are one of the least regulated instruments in the Islamic capital market. The myriad of ways in which to create a structured product is one reason why it is far less regulated. Regulators can place limitations and barriers in creating a structured product, but due to the open landscape of structured products creation, structured product creators can bypass the restrictions in a variety of different ways and therefore render the limitations and barriers created as insignificant. If such a scenario was to happen, the market would assume that regulators failed to rectify the issues of the structured product.

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[17] Tarek El Diwany, 'Travelling the wrong road patiently', in Banker Middle East, September 2003.

A further reason is the still relatively small size of the combined conventional and Islamic structured product market. The market is still in its infancy, having been introduced only in the past decade.

Structured products also face criticism for the lack of information disclosed by the issuer regarding the risk and returns of the structured products offered to customers. Because most structured products are handled by the treasury department of financial institutions, and because their customers are usually loyal HNW individuals and institutions, the issuers somehow believe that they do not have to disclose the risk and returns. When it comes to offering any products, the provider or seller is obliged to disclose the relevant information, especially regarding risks and returns. What worries the market is that these issuers might only disclose information that would attract potential customers to invest in structured products. They can even use marketing channels to attract potential investors without disclosing sufficient information. In some ways, this is a more serious issue for Islamic structured products, particularly because it violates one of the pillars in *Shariah* contracts, namely the *Mawdu' al-Aqd* (subject matter of the contract). One of the requirements of *Mawdu' al-Aqd* is that the specification of the product must be known to both parties in which they must view the similar object, and the object is identified by the description. If the description of the product is purposely or even unintentionally made to be incomplete, it would render the contract void and will create a lot of issues if such cases are discovered.

There are also issues on the operations of the structured product where insufficient steps are taken by the financial institutions to ensure that their staff are sufficiently trained to handle the complexities of structured products. As structured products are relatively new to the financial market, many people are still unfamiliar with how to handle their operations. It only becomes more challenging when it comes to Islamic structured products where there are still fewer people that have the necessary knowledge of both structured products and *Shariah* contracts. As a result, some financial institutions outsource the management of their structured products to institutions who are experienced in such matters. For example, Societe Generale Asset Management is responsible for managing Maybank Baraka Structured Deposit and Bank Islam's An-Najah NID-i Structured Investment. Such arrangements attempt to solve the issue regarding the competency of staff in handling the operations of structured products. In the case of Islamic structured products, there are concerns that conventional structured product managers will not adhere to the *Shariah* contracts as they should be.

Some scholars argue that Islamic derivatives, in general, are not *Shariah*-compliant because they are an artificial product and created with the intent to replicate the conventional products that are usually based on either interest or speculation. At the same time, other scholars make the case that Islamic derivatives are necessary in order to protect real business activities and transactions, and not for speculation purposes. For example, it can be used in the form of currency forward or currency swap to protect real import and export activities involving two different countries. It can also be used to manage the potential mismatch of real asset and liability through the usage of profit rate swap.

(El-Gamal 2003) stated that there is nothing wrong with financial engineering, but the misuses of the derivatives are to be blamed similar to the argument of gun control which says that 'guns don't kill people, people do'. He continues by stating that there will be a misuse of financial instruments which are made for hedging, but which are in fact instruments of gambling.

### Issues on *Urbun*

One of the issues regarding *Urbun* is the ownership of the security during the holding period. For a conventional option, the securities still belong to their seller during the holding period. However, the virtue of *Urbun* contracts indicates that the *Urbun* holder, in fact, is the owner of the securities. The concern regarding this issue is whether the application of *Urbun* in the real transaction is similar to the *Urbun* stipulated in the contract. This is because to replicate *Urbun* as a conventional call option is complicated, especially regarding the ownership because it has become a norm in the conventional market to avoid owning the underlying asset when trading the option. Majority of the scholars rejected such practices, and AAOIFI stresses that holding the ownership of any subject matter is required before selling it to somebody else. But, if this criterion is not properly executed, *Shariah* rulings relating to ownership and liability in the contract will be violated.

### Issues on *Wa'ad*

Looking back at the example of the Rolling *Murabahah*, the second *Murabahah* contains markup linked to a possibly non-*Shariah* compliant underlying. Thus, if the Muslim investor obtains this Rolling *Murabahah* structured product, he is investing in a non-*Shariah* compliant product. Even when the *Wa'ad* mentioned is about buying the promise to enter into a second *Murabahah*, it essentially allows the bank to hedge using non-*Shariah* compliant derivatives. This is one of the reasons why Sheikh Yusuf Talal DeLorenzo objects to *Shariah* Conversion Technology (DeLorenzo 2010). However, if the second *Murabahah* has a markup linked to a *halal* underlying, Sheikh Yusuf's objection does not apply.

Continuing with the Rolling *Murabahah* example, the structure involves buying a *Wa'ad* to enter into a second *Murabahah*. *Wa'ad* itself is a unilateral promise that has no considerations at all. So the issue is whether *Wa'ad* is purchased. Most scholars would say no. This is because the promise is an intangible that cannot be owned and cannot be the subject matter of sale in Islamic contracts. We can see that even usufruct cannot be sold in Islam, let alone promises. But within the industry, banks specify that they are charging an 'upfront fee' to offset expenses in offering *Wa'ad*; but a fee itself is a consideration.

### Futures and Forwards

Since *Wa'ad* has also been used in the form of futures (e.g. Maybank STRIDE-i), we will look at the *Shariah* jurisdiction on both futures and forwards. Majma' al-Fiqh al-Islamiy states that forward and futures contracts are not permissible. Index trading is not permissible, because the subject matter is *khayal* (not real) and does not exist (Zakaria, Islamic structured products[18]). Such trading is tantamount to *muqamarah* (gambling). Majma' al-Fiqh al- Islamiy also recommends that futures should follow *Salam* contract or other nominate contracts such as *Sarf*, *Wa'ad* and *Istisna'* to buy or sell at a future date, which require full payment of purchase price at the time of the contract[19].

## CONCLUSION

Despite having been introduced into Islamic finance industry since its establishment, the Islamic structured products still have many *Shariah* issues and debates between scholars. Islamic wealth managers have wider social agendas for structured products. Islamic structured products are regarded as a screened investment since they must be *Shariah*-compliant, ethically based, and socially responsible. Conventionally, it is similar to the terminology used in global investments as Socially Responsible Investment (SRI). An Islamic structured product should always comply with the objectives of *Shariah* in order to be a *Shariah*-compliant product. It can be argued that the issue of Islamic option embedded in structured products will fall under the preservation of wealth of the *Maqasid al-Shariah* (objectives of *Shariah*). Wealth is given a considerable amount of attention, in which it is evident as many of the Qur'anic verses and the Prophetic traditions touches on the aspect of wealth, as Allah SWT has stated in the Holy Qur'an: "*Fair in the eyes of men is the love of things they covet: women and sons; heaped-up hoards of gold and silver…*" [3:14].

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18 https://www.utar.edu.my/fbf/file/ICM04-Islamic%20Structured%20Products.pdf
19 https://www.coursehero.com/file/p3saat7a/Index-trading-is-not-permissible-because-the-subject-matter-is-not-real-khayal/

By obtaining wealth, it will indeed lead to a better quality of life in the society, especially in its civilization development, by which it is possible only when it is being properly distributed amongst the people.

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