The Wa’o-Based Total Return Swap

Questions of Compliancy with Islamic Finance and Implications on the Islamic Derivatives Markets

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What is Islamic Finance?
Islamic Finance is a form of finance that follows the rules as given by Islamic law (Shariah).

Some salient restrictions include, but are not limited to:
• Eschewing interest (riba)
• No speculation
• No excessive risk-taking (gharar)
• Must be connected to a real economy, must have an underlying asset
• Prohibition of investments in certain sectors; alcohol, tobacco, banks, hotels, pork industries

Why is this important?
Islamic finance has grown into a $2 trillion industry, increasing in market size by 17% year over year from 2008-2012. Alongside the Gulf states and Malaysia, countries like Japan, Germany, South Africa, and Singapore have also taken interest in developing this nascent form of finance.

Islamic finance has an underdeveloped derivatives market, making it difficult for investors to hedge and diversify their risk. Recognizing this issue, a gamut of scholars, bankers, and lawyers have initiated debates on whether derivatives could ever be consistent with Islamic Finance.

What is a wa’o-based Total Return Swap (TRS)?
A wa’o-basedTRS enables a Muslim investor to gain exposure to non-halal assets without having to own the underlying asset itself by the usage of two unilateral promises (wa’d).

Mechanisms:
1) A Muslim investor buys a note from a Specialized Purpose Vehicle (SPV).
2) The SPV, now with the Muslim’s investor money, provides a loan to a fund manager.
3) The fund manager goes and buys a Shariah-compliant, or halal, asset.
4) The fund manager passes on the asset to the SPV. In legal terms, the SPV now owns the underlying asset.
5) During this stage, the SPV enters into two unilateral promises with the bank.

• The first promise is one in which the bank promises to buy the halal asset from the SPV at a price that is linked to a non-halal benchmark at maturity.
• The second promise is one in which the SPV promises to sell the bank the halal asset at a price that is linked to a non-halal benchmark at maturity.

Theoretical Underpinnings
Cycle of formal rationalization: rules and norms are officiated to further clarify what makes Islamic finance “Islamic”

Following the letter but not the spirit: exercise in semantics, bilateral promises are disguised by using two unilateral promises

Boundaries of formal rationalization: financial products going too blatantly against spirit of law, i.e. legitimizing forbidden returns

Emphasis on Connection to the Real Economy: How is this linked to the real economy? Are there truly compliant underlying assets behind this transaction?

Gambling? Will this financial product open the floodgates to legitimized speculation, or will it be primarily used for hedging?

Criticisms of the TRS
• Disguising a bilateral promise by using two unilateral promises: Binding bilateral promises are considered invalid under Shariah precepts. A binding bilateral promise is too similar to a conditional sales agreement, which is not allowed because it is similar to selling an asset that one does not have. Bankers have cleverly required two unilateral promises rather than one bilateral promise. Islamic scholars, however, find contention with this condition; requiring two unilateral promises still situates the investor as both the promisor and the promisee, which is explicitly prohibited under Shariah law.
• Blocking Ostensibly Legitimate Means to Illegitimate Ends: There were concerns by the Islamic banking community that the usage of wa’d-based TRS would allow for Muslim investors access to forbidden sources of revenue. “Whatever leads to involvement in the unlawful will either lead to the unlawful as a certainty or lead to the unlawful as a possibility.”
• Real Economies and Underlying Asset: “Because the benchmark has no gambling, no actual market value of the (underlying halal) shares, it’s as if I promised to sell my house to you in a year’s time proportionate to the rise in gas prices, even though gas prices have little to do with house prices.”
• Speculation vs. Hedging: Atallah and Ghoul believe that this TRS is inherently speculative in nature, and would not be used for hedging purposes. They contend that by swapping the return of the two basket of assets, the Muslim investor is essentially betting on the outperformance of the non-halal asset over the halal asset, which is inherently speculative.