

# The Evolution of Islamic Hedging Solutions

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## Introduction of commodity Murabahah products

Commodity Murabahah products were introduced to the Malaysian market with the aspiration of offering alternative solutions and to attract more customers. The emergence of these products has meant that customers have greater choice of Shariah compliant products, enabling them to participate and to be competitive in the global banking industry. In addition, the commodity Murabahah modus operandi meets Shariah acceptable standards in most regions and countries.

The development of commodity Murabahah products, particularly in Malaysia and South-East Asia, started with the introduction of commodity Murabahah deposit and financing solutions. Using a similar framework and mechanism, Islamic hedging solutions were then introduced. The Islamic industry has been in dire need of risk management tools and solutions to complement investment, project financing and capital raising requirements. A number of institutions have been trying out different structures and mechanisms to create viable solutions and the development is still ongoing.

This article is written with the intention of sharing information on commodity Murabahah products, including the deposit, financing and Islamic hedging solutions.

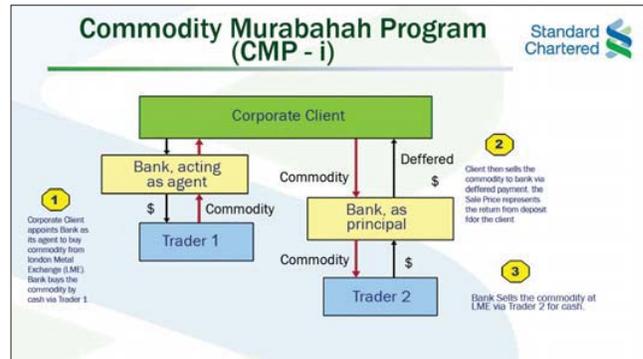
### Commodity Murabahah Program-i (CMP)

CMP-i serves as an alternative deposit product for corporate and institutional clients, based on a globally acceptable Islamic structure. Unlike a deposit or loan contract involving a borrower and a lender, the CMP-i product is based on a sale and buy-back contract which complies with the Shariah principles of Murabahah. The product offers features such as fixed return with an unlimited deposit size. The Murabahah transaction involves the purchase and sale of metal commodities such as aluminum, zinc, tin or copper as the underlying assets. The current arrangement is via metal traders based in London. There is no commodity price risk to clients. The modus operandi or the mechanism of the transaction is shown below (see figure 1).

CMP-i documentation required is as follows:

- a. Master agency agreement.
- b. Schedules of offer and sale.
- c. Cost-traders commission.

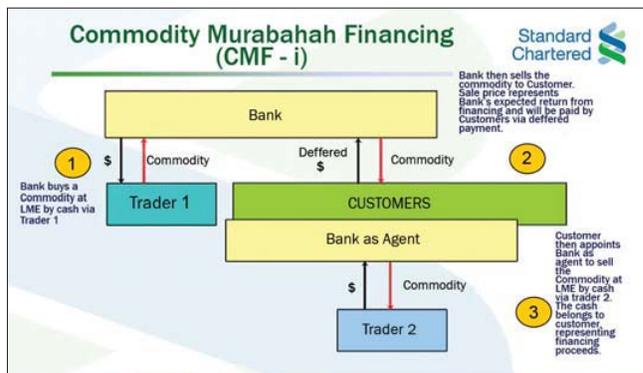
Figure 1



### Commodity Murabahah Financing-i (CMF)

CMF-i serves as an alternative financing product for corporate and institutional clients. The product mechanism is basically the reverse of the CMP-i (please see figure 2). This product will provide working capital financing for corporate clients without the client having to have ready assets. Documentation requirements for this product are very much similar to the CMP product.

Figure 2



## Islamic hedging solutions

### IPRS, ICCS and IFRA

The Islamic Profit Rate Swap (IPRS) was introduced to assist in the management of profit rate risks, thus enhancing cash flows. Profit rate swap is a mechanism structured to allow bilateral exchange of profit streams using two parallel and back-to-back Islamic marked-up sale transactions (Murabahah). It comprises of three possible structures, namely the IPRS, Islamic Cross-Currency Swap (ICCS) and Islamic Forward Rate Agreement (IFRA).

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## The Evolution of Islamic Hedging Solutions *(continued...)*

In IPRS, a series of Murabahah sale and purchases are conducted, allowing parties to swap or exchange profit rates from fixed to floating rate or vice versa (see figure 3 below).

In ICCS, the same mechanism can also be applied for the purpose of cross-currency swaps. The Murabahah sale and purchase will be transacted involving one currency in exchange for another. The objective is for the parties to exchange one income stream of currency with another, for example Malaysian ringgit to US dollar.

The IFRA is similar to the IPRS, where there is an agreement between two parties to conduct a Murabahah transaction in a single specified profit period.

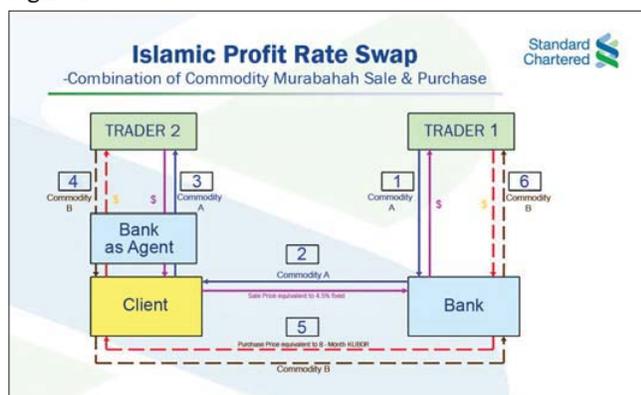
The pricing of all these Islamic hedging solutions depends on the rate of profit, which will be agreed upon by the bank and the client. The period of the swap ranges from one to five years.

Documentation required includes the following:

- Master agreement between the bank and the clients.
- Murabahah purchase agreement and Murabahah sale agreement.
- Murabahah terms and conditions.
- Agency agreement.
- Letter of framework.

The products above were designed to have minimal balance sheet implication.

Figure 3



- Step 1: Bank (as principal) buys Commodity A from trader 1.  
 Step 2: Bank sells Commodity A to customer for a price of “P + SFR.”  
 Step 3: Customer sells Commodity A to trader 2 (through bank as its agent).  
 Step 4: Customer buys Commodity B from trader 2 (through bank as its agent).

Step 5: Bank buys Commodity B from customer for a price of “P + LIBOR.”

Step 6: Bank sells Commodity B to trader 2.

**“The availability of hedging products is imperative for the industry to compete with its conventional counterparts, especially in the corporate and institutional markets”**

### Issues and challenges

Islamic hedging solutions are not easy to structure within the framework of Shariah. However, we have seen positive developments among the industry players, and the Shariah scholars have been playing a vital role in providing support and guidance towards the development of these products. In addition, the regulators have been supporting the initiative and have been instrumental in providing direction, supervision and approval for products.

Familiarization and adaptation are another issue faced by all parties, including the bank and the clients. Time was required by all parties involved to understand the product, the processes and procedures. In many instances, parties may have to organize meetings involving personnel from treasury, legal, Shariah and others.

Legal documentation and standardization are also key issues that industry players have to manage and comprehend. Efforts are being made to provide a common platform for the industry to rely on, especially regarding legal agreements.

### Conclusion

Islamic banking and finance is still in dynamic mode. The availability of hedging products is imperative for the industry to compete with its conventional counterparts, especially in the corporate and institutional markets. In the case of Islamic hedging, there have been encouraging developments by industry players in introducing different structures with different mechanisms, resulting in global perspective for the industry.



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