ICIB

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Organized By:

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RIPHAH CENTRE OF ISLAMIC BUSINESS

Collaborators:

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ISRA الأكاديمية العالمية للبحوث الشرعية International Shari'ah Research Academy for Islamic Finance

Islamic Economics, Finance, Entrepreneurial Development & Public Policy for the Ummah's Socio-economic Wellbeing

Under the above theme, the speakers / paper presenters will discuss the vision of Islamic economics, business and finance, public policy for entrepreneurial development and to enhance social inclusion and good governance, meaning how to develop Islamic countries' economies giving fair opportunity to all segments of the society and provide them not only suitable jobs / employment but also dignity and respect in the society and falah in this world and the Hereafter. As it is possible only through application of the principles of the Shariah, in letter and spirit, in all socio-economic disciplines and business and finance affairs, Shariah compliance of all institutions, products and activities would also be covered in the Theme of the ICIB-2016 event.

Conference Secretariat:

Riphah Centre of Islamic Business (RCIB)
Riphah International University, 274-Peshawar Road, Rawalpindi.
Mr. Ikram Ullah Khan (Ikramullah.khan@riphah.edu.pk; +92 (333) 5949 907)
Mr. Ehtesham Rashid (ehtesham.rashid@riphah.edu.pk; +92 (345) 2569 620)

Issues in FOREX Trading in the Light of Islamic Law of Contracts

DR. MUHAMMAD QASEEM

ICIB 2016

FAISAL MASJID

FX Market – An Introduction

- Generally undertaken to cater to the needs of
  - Importers who have to pay in FX; or
  - Exporters who realize the sale proceeds in FX and sell the same in the market
- Forward FX contracts are used for speculation and hedging.
- Hedgers generally fall into three categories:
  - **Risk averse corporate and retail clients**, who want a fixed future revenue stream from international transactions. E.G. fixing the FV of USD receivable in 30 days by entering into a forward FX deal with a bank to sell it USD at a pre-agreed rate.
  - **International portfolio managers** who may use forward FX to secure the value of future investment returns.
  - **Banks** which use forward FX contracts mainly for liquidity management.

FX in Conventional Banking

- **Value Today**: Deals can be settled for cash (T + 0), as counter-values are exchanged on the transaction date.
- **Value Tomorrow**: Counter-values are exchanged one business day after the transaction date.
- **Spot**: Counter-values exchanged two business days (T + 2) after the transaction date.
  - Deal Date : on which the parties enter into the transaction,
  - Value/Maturity Date : on which the funds are remitted and delivered by the parties.

  The banks prefer Spot FX transactions as in many cases the counter parties may have to arrange the currencies that they are required to deliver.
- **Forwards**: Any transaction beyond spot (T+2), that are settled beyond (T+2).

SHARI'A RULES ON FX

Nature of Currency Exchange Contract

- No explicit instructions with regard to sale and purchase of paper currencies.
- However, the Prophet SAW gave clear instructions for sale and purchase of currency of his time – the Dinar and Dirham.
- Expressly prohibited sale of gold for gold or silver for silver, unless both the counter-values are delivered simultaneously, are of the same genre, and are equal in number and weight also.
- Therefore, it is prohibited to exchange gold for gold, be it in any form or shape, with one of the counter-values being more in quantity/weight or by deferring the delivery of one of them.

Is Currency the Equivalent of Gold & Silver?

- **Most jurists' opinion**: the reason for the prohibition of the exchange of gold for more gold or deferred silver is that gold, and silver are natural currencies. Therefore, any item which is considered as currency is subject to rules of *Bai' ul Sarf*.
- Some have opined that paper currency is not gold, nor does it represent gold, but represents a number of goods and services receivable from the national economy or the issuer; and some consider it as a commodity which can be sold by way of Salam

Cont.

- The above opinions are considered flawed by the majority.
- Paper money has replaced gold and silver as a natural currency, prices are measured by it, wealth is preserved in it and any debt paid in paper currency absolves the debtor from his liability.
- Therefore, currency exchange is subject to the rules of Aqd us Sarf.
- In a contract of Sarf, exchange of the counter-values is an integral part of the offer and acceptance between two present parties, without which the transaction is not valid.

Cont.

- It is not permissible for any party to enter into an FX transaction on a particular date and stipulate a settlement date/time later than the Majlisul Aqd.
- Therefore, for an exchange of currency to be a valid transaction the contracting parties must exchange the currencies subject of sale and purchase before dispersing or terminating the Majlisul Aqd.

AAOIFI Standards

- This means that both the parties must take possession of the counter-values before dispersing.
- The contract shall not contain any conditional option or deferment clause regarding the delivery of one or both counter-values.
- Currency transactions shall not be carried out on the forward or futures market.

Rules Related to Possession

- Constructive possession is deemed to have taken place by the seller enabling the other party to take its delivery and dispose of it, even if there is no physical possession. Among other forms are the following:
  - To credit money to the customer’s account in the following situations:
    - Directly or through bank transfer
    - When the customer enters into a spot contract with the institution, against a currency already deposited in his account

إذا عقد العميل عقد صرف ناجز بينه وبين المؤسسة في حال شراء عملة بعملة أخرى لحساب العميل.

    - A delay in making the transfer is allowed to the institution, according to prevailing business practice. However, the payee is not entitled to dispose of the currency during the transfer period.

Delivery in case of Cross border Transactions

- If contracting parties are not present in the same place, funds should be remitted, with a maximum of two days allowed for actual delivery.
- Allowed on the basis of necessity due to time difference and likely closure of banks, provided the currencies are transferred by the parties in the same sitting at the time of conclusion of the transaction without any delay.
- If a party/Islamic bank wants to purchase a currency which is intended to be delivered after one or two days, it can give a Promise to Purchase or get from the counterparty a Promise to Sell the required currency at an agreed rate on the intended date.

Rules Cont.

- English translation of the AAOIFI Standard is not correct as it has translated an immediate FX transaction (عقد ناجز) as a ***Spot*** transaction (T+2 FX).
- Caused confusion, as Treasuries of Islamic Banks have assumed that the Shari'a Standard has allowed spot FX transactions as practiced by them.
- Many Shari'a boards of Islamic banks have approved Spot Transactions assuming that a Spot Transaction is a ready/immediate transaction.
- Probably the technical definition of the Spot Transaction has not been provided to these Shari'a boards; otherwise they would not have allowed the same as it would be in direct conflict with a very explicit Hadith, and hence it is not a subject of Ijtihad.

Treasuries' Challenge

- Based on the above rules, certain Islamic banks have been stopped from dealing in these transactions; instead, they are using the Promise format.
- The Treasuries of these banks have requested for a solution by the regulator and the Shari'a scholars and have given the following information:
  - Spot (T+2) is a normal convention worldwide. Since a large volume of the banking sector is dealing spot with trade customers the position that is generated is basically in Spot value. To cover this position generated by customers all the banks in the market expect to and actually deal in spot in large volumes.

Treasuries' Challenge cont.

- No banks can deviate from the market standard practice of Ready, Tom (T+1) and Spot (T+2). This is because a bank that has sold in spot cannot cover in ready value because it will have excess USD left in its account and will be short in PKR account. Similarly a bank that has bought in spot value cannot cover in ready value because then it will be short in the USD account and will have surplus PKR.
- A ready transaction has to be covered in ready, a tom transaction has to be covered in tom and a spot transaction has to be covered in spot.

Treasuries' Challenge cont.

- For cross border transactions it is very improbable to convince a foreign bank to deal spot in the promise format.
- No bank in the market has agreed to deal spot on the basis of the unilateral promise structure. Even the full-fledged Islamic banks are not dealing spot in the promise structure.
- As far as we know, most central banks have not so far approved the promise structure for the FX transaction of Islamic banks.
- If an IBI is stopped from spot FX, it will lose its market share. Eventually, this would portray these Islamic banks as failing to cater to the requirements of their customers.

جزاك الله خيراً