Globally financial institutions are experiencing the aftereffects of the financial crisis and the severe liquidity squeeze. The Islamic finance industry, although initially seen as relatively insulated, is not immune from the crises and is also feeling the threats.

As such, players in this industry are searching for new products to cater for changing investor attitudes; in times of crises, Islamic financial institutions and investors seem to have one of the following attitudes:
1. Reluctantly going back to basics, avoiding complex structures and focusing on traditional straightforward investments
2. Creating a new generation of Islamic financial products and structures which can provide investors with safer and more conservative investments
3. Comparing the costs of structuring Islamic financial products against those of conventional products and squeezing any premium placed on top from our perspective, we strongly believe that the Sharia’-compliant concepts have great flexibility and greater potential for developing new products which are yet to be uncovered. One example of these concepts is the ‘Wa’ad’ and its variations.

The ‘Wa’ad’
The ‘Wa’ad’ is an Arabic word which literally means “a promise”. With the growth of Islamic finance, ‘Wa’ad’ has turned out to be a very flexible tool which can be used in conjunction with other Sharia’-compliant products to achieve a desirable economic effect.

The ‘ Wa’ad’ concept is found in a large number of modern Islamic financial products. Below are some examples:
- Musharaba, where the purchaser promises the seller to buy a certain asset from the seller in the event the seller buys this asset from a third party (for more details about the Musharaba to the purchase orderer please refer to Standard No 8 of the AAOIFI Sharia’ Standards).
- Islamic project financing relies heavily on the concept of ‘Wa’ad’. The project financing structures based on Diminishing Musharakah (Diminishing partnership) where the project company and the financier co-own the project use the concept of ‘Wa’ad’ to allow the project to acquire the ‘share’ of the financier in the project. ‘Wa’ad’ is also used in project finance when the structure is a combination of finance’s Islamic manufacturing and ‘Sharah’ (Islamic lease).
- The most apparent use of ‘Wa’ad’ is in Sukuk structures, where the Sukukholders are promised by the relevant entity to buy their Sukuk for a certain price (usually the nominal value of the Sukuk). Effectively, in certain Sukuk structures, the ‘Wa’ad’ is used as a guarantee to investors (Sukukholders) to receive an amount equal to their initial investment when their Sukuk are redeemed. The extensive use of ‘Wa’ad’ as a guaranteed promissor in the AAOIFI to issue their Islamic trust certificate on Sukuk in February 2008 (the full text of the statement can be read on the AAOIFI website, www.aaoifi.com).

As a reminder, the above-mentioned AAOIFI statement has ruled that it is prohibited for the originator to grant the Sukukholders of Musharakah, Musharabah or Wa’ad Sukuk a purchase undertaking to repurchase the Sukuk from the Sukukholders at their nominal value. The repurchase price of the Sukuk should be equal to the market value of the Sukuk underlying assets at the time of exercise of the purchase undertaking. According to the AAOIFI Statement, the purchase undertaking to repurchase the Sukuk at their nominal value remained permissible in ‘Sharah’ (Islamic lease).

The popularity of ‘Wa’ad’ based structures is increasing due to the flexibility of the ‘Wa’ad’ and its ability to accommodate the needs of modern Islamic financing. However, from a prudential point of view and risk management perspective, it is important to understand the value of ‘Wa’ad’ in Sharia’. This issue has given rise to interesting legal and Sharia’ discussions which have repercussions on structures that use the ‘Wa’ad’ concept.

The value of the ‘Wa’ad’ in Sharia’ is similar to the value of a social promise in Common Law. The promise may have moral force in that breaking it may provoke opprobrium (social blame) but it does not entail legal obligations or legal sanctions.

Under Civil Law, the ‘Wa’ad’ can be binding or non-binding depending on the intention of the party who is giving the promise.

The Islamic Fiqh Academy (based in the Kingdom of Saudi Arabia) has decided that the ‘Wa’ad’ is “obligatory not only in the eyes of God but also in a court of law”:
- it is made in commercial transactions;
- it is a unilateral promise; and
- it has caused the promissore to incur liabilities;

Also, it is a requirement that the actual sale - if the promise was in respect of selling a certain asset - to be concluded at the time of exchange of the offer and the acceptance (Known in Arabic as ‘Aqada Al Aqya) and not at the time of the ‘Wa’ad’.

The promissore also has the possibility to claim actual damages from the promissor, if the promissor backs out on a ‘Wa’ad’.

Therefore, some versions of ‘Wa’ad’ remain voluntary while others are obligatory.

The AAOIFI have not issued a standard governing the ‘Wa’ad’, nevertheless, it was referred to in many of the Standards (see for example paragraph 8 of standard No 9 of the AAOIFI Sharia’ Standards).

Some forms of ‘Wa’ad’ are prohibited. The AAOIFI provides some guidelines, below are a few:

- a bilateral promise to purchase and sell currencies is forbidden if the promise is binding ...


Paragraph 2/9 of Standard N 1 of the AAOIFI Sharia’ Standards - (Bilateral promise to purchase and sell currencies). Also, paragraph 8/2 of standard No 9 of the AAOIFI Sharia’ Standards brings further clarifications to the bilateral promise mechanism ...

a binding promise is binding on one party only, while the other party must have the option not to proceed ...

The rationale behind the prohibition is that the bilateral promises between the same parties in respect of the same asset are equivalent to a contract, where both countervalues are deferred. Such contract is prohibited under Sharia’.

Standard No 8 (Musharaba to the purchase orderer) of the AAOIFI Sharia’ Standards, provides further clarifications on how a ‘Wa’ad’ can operate. The main points of the following:

- the bilateral promise is permissible whenever it includes an option to cancel the promise. This option may be given to both parties or to one of them (Paragraph 2/3 of Standard No 8 of the AAOIFI Sharia’ Standards);
- it is possible to change the terms of the promise if both parties agree to such change. No party can solely change the terms of the promise. However, such a change cannot be effected if the parties have executed their obligations under the ‘Wa’ad’ (or the relevant agreement) (Paragraph 2/34 of Standard No 8 of the AAOIFI Sharia’ Standards).

This means that changes to the ‘Wa’ad’ are only valid as long as the parties did not enter into the agreement referred to in the ‘Wa’ad’. However, if one of the parties insists on changing the terms of the promise, then the changes will constitute a new promise granted by this party to the other.

- the ‘Wa’ad’ is a standalone agreement. It is not supposed to be embedded in any other underlying agreement. For example paragraph 8 of standard No 9 or 9.1
- the AAOIFI Sharia’ Standards (‘Jarah and ‘Jarah Muntiaha Billamaa) states that “...the method transferring the asset to the lessee must be evidenced in a document separate from the ‘Ijarah contract documents…” and that “…the separate document evidencing a promise should be independent of the contract of ‘Ijarah Billamaa and cannot be taken as an integral part of the contract of ‘Ijarah”. (See also paragraph 2/32 of Standard No 8 of the AAOIFI Sharia’ Standards).

It should be noted that a ‘Wa’ad’ cannot be used as a mechanism to circumvent Sharia’ prohibitions. Scholars do not lack the means of prohibiting such structures where each agreement taken separately is Sharia’-compliant but when read jointly the structure seems to be less Sharia’-compliant.

PRACTICAL ASPECTS OF TRANSITION INTO IFRS AND GAAP (US GAAP)
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1 Resolution no. 2 and 3 of the 5th Conference of the Islamic Fiqh Academy, Kuwait 1409 H., no. 5, vol. 2, p. 15998.

Modern uses of ‘Wa’ad’
In recent years, the ‘Wa’ad’ concept has been used by Islamic and conventional banks to replicate the conventional options mechanisms and to give investors a return benchmarked to the performance of certain assets or indices. One of the modern uses of the ‘Wa’ad’ concept has been used as an “replicator”. ‘Wa’ad’ has been widely used to give investors a return linked to a wide range of asset

Zaher Barakat and Allen Youssef Merhej explore the structure and use of the ever more prevalent but still controversial ‘Wa’ad’ in Islamic Finance products. This is the first part of our coverage of the major Islamic Finance products.

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classes such as indices, commodities, funds etc. This has been achieved by swapping a Shari’a-compliant return with a non-Shari’a-compliant return in order to give Shari’a-compliant investors exposure to certain non-Shari’a-compliant assets.

Some of these structures have been criticized by the Scholars. See for example the article published by Sheikh Yusuf Talal De Lorenzo on The Total Returns Swap and the ‘Sharia Conversion Technology’ (Stratagem, in which he critiqued a stratagem using a Wa’ad structure which he labels as ’Sharia Conversion Technology’ the purpose of which is to affect a total returns swap to “Wrap a non-Sharia-compliant underlying into a Sharia compliant structure.” In this article Sheikh De Lorenzo says that: “the means of delivery, a Wa’ad or promise, is widely seen to comply with Sharia norms. Since it is compliant, at least to the letter of the law, some Sharia scholars have approved products that use a Wa’ad to deliver returns from non-compliant investments. By doing so, however, they have failed to consider the purpose of the transaction, they have failed to consider the movement of the cash and, most importantly, they have failed to consider the ramifications for the industry as a whole.”

On the other hand, the Wa’ad has been used by financial institutions – both Islamic and conventional to replicate the conventional options mechanisms. In addition, though not without its controversies, the Wa’ad has also been used to give investors a return benchmarked to the performance of certain non-Halal assets including indices, commodities, funds etc. This has been achieved by swapping a Shari’a-compliant return with a non-Shari’a-compliant return in order to give Shari’a-compliant investors exposure to certain non-Shari’a-compliant assets. There has been much research conducted on this subject and many articles written. This has served as a catalyst that has encouraged market evolution and growth. Below is a brief description of one of the controversial Wa’ad structures:

A financial institution (Islamic or conventional) issues securities to the investor upon receipt of their commitment amount. Below is a brief description of one of the controversial Wa’ad structures:

1. If the value of the reference Sharia Compliant Equities held in the Islamic Investment Account increases by more than the performance of the Index or Underlying

Reference Asset, then Wa’ad 1 (in the above diagram) will be exercised and Wa’ad 2 will not.

2. However, if the value of the shares in the Islamic Investment Account goes up by less than the performance of the Index or Underlying Reference Asset, then Wa’ad 2 will be exercised and Wa’ad 1 will not.

Both outcomes serve to allow Islamic investors to achieve exposure to assets that they were not able to in the past. In both cases, the sale of the relevant shares takes place in return for the settlement price determined as the basis of performance of an index or the underlying reference asset.

This structure has been criticized by Sheikh Yusuf De Lorenzo and defended by Dr. Husain Hamid Hassan during the Islamic Funds World Conference which was held in 2008 in Dubai. Dr Hassan mentioned that the Islamic investor takes the risk that the Shari’a-compliant assets he deposited with the bank could underperform the ‘haram’ returns he will receive when the swap is conducted.

The difference in points of view and Shari’a interpretations is normal and it is has allowed Shari’a as a body of rules to evolve within the time.

Conclusion

As attitudes of Islamic financial institutions and investors change, there seems to be a greater need for new product development. The Wa’ad and its variations are examples of this process. However, as the market is constantly evolving, some observers argue that the evolution path is at times too close to that of conventional finance. As such, industry players and activists should involve financial institutions as well as investors in product creation. Furthermore, various regulators should strive to create an institutional framework and supervision system to encourage standardisation, nurture financial diversification without limiting experimentation and new product development.

Zaher Barakat is the Head of Middle East Financial Products at Royal Bank of Canada. He is a visiting lecturer on Islamic Banking and Finance for the Executive MBA program at Cass Business School. Mr Barakat has over 12 years of investment Banking experience. He previously worked at Morgan Stanley and prior to that at ABN AMRO where he started his career in 1997.

Allen Youssif Merhej has a legal and financial qualification; Allen is a certified Shari’a advisor and auditor from the Accounting & Auditing Organization for Islamic Financial Institutions (AAOIFI). He is also an Islamic finance lawyer.