



Wa'ad

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.

Global financial institutions are experiencing the aftershocks 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 crisis, 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 Shari'a-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 Shari'a-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:

- *Murabaha*, 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 *Murabaha* to the purchase orderer please refer to Standard No 8 of the AAOIFI Shari'a 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 *Istisna'a* (Islamic manufacturing) and *Ijarah* (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 guarantee has led the AAOIFI to issue their famous statement on *Sukuk* in February 2008 (the full text of the statement can be read on the AAOIFI website, www.aaofii.com).

As a reminder, the above-mentioned AAOIFI statement has ruled that it is prohibited for the originator to grant the Sukukholders of *Musharakah*, *Mudarabah* or *Wakala 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 remains permissible in *Ijarah Sukuk*.

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 Shari'a. This issue has given rise to interesting legal and Shari'a discussions which have repercussions on structures that use the Wa'ad concept.

Binding value of Wa'ad

Nowadays it is widely agreed that a Wa'ad related to a commercial transaction is binding under Shari'a. However, this was not the case for the traditional Islamic jurists.

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

The value of the Wa'ad in Shari'a 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" when:

- it is made in commercial transactions;
- it is a unilateral promise; and
- it has caused the promisee 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 *Majlis Al Aqd*) and not at the time of the Wa'ad.

The promisee also has the possibility to claim actual damages from the promisor, if the promisor 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 Shari'a Standards - *Ijarah and Ijarah Muntahiyah Bittamleek*).

Also, 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 Shari'a Standards - Bilateral promise to purchase and sell currencies). Also, paragraph 8/2 of standard No 9 of the AAOIFI Shari'a 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 countervales are deferred. Such contract is prohibited under Shari'a.

- Standard No 8 (*Murabaha* to the purchase orderer) of the AAOIFI Shari'a Standards, provides further clarifications on how a Wa'ad can operate. The main points are the following:

- a- 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 2/3/3 of Standard No 8 of the AAOIFI Shari'a Standards;
- b- 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 *Murabaha* (or the relevant agreement) (Paragraph 2/3/4 of Standard No 8 of the AAOIFI Shari'a 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 underlying agreement. For example paragraph 8 of standard No 9 of

the AAOIFI Shari'a Standards (*Ijarah and Ijarah Muntahiyah Bittamleek*) 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". (See also paragraph 2/3/2 of Standard No 8 of the AAOIFI Shari'a Standards).

It should be noted that a Wa'ad cannot be used as a mechanism to circumvent Shari'a prohibitions. Scholars do not lack the means of prohibiting such structures where each agreement taken separately is Shari'a-compliant but when read jointly the structure seems to be less Shari'a-compliant. Clause 3 of *Majalat Al Ahkam Al Adliyah* (the Shari'a Codification by the Ottomans) provides that "the real reason of

contracts is for the objectives and not for the literal wordings" (in Arabic it says: *Al Ibra Fi Al Oukoud Lil Makasid Wal Ma'ani la lil Alfaz wal Mabani*).

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 uses of the Wa'ad concept has been as a "swap replicator". Wa'ad has been widely used to give investors a return linked to a wide range of asset

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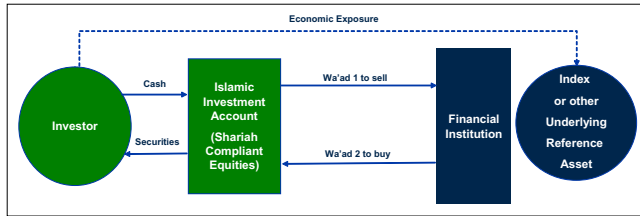
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1 Resolution no. 2 and 3 of the 5th Conference of the Islamic Fiqh Academy, Kuwait 1409 H., published in the *Majalat Majma' al-Fiqh al-Islami*, no. 5, vol. 2, p. 15998.



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 criticised by the Scholars. See for example the article published by Sheikh Yusuf Talal De Lorenzo on The Total Returns Swap and the "Shari'a Conversion Technology" Stratagem, in which he criticized a stratagem using a Wa'ad structure which he labels as "Shari'a Conversion Technology" the purpose of which is to affect a total returns swap or to "Wrap a non-Shari'a compliant underlying into a Shari'a compliant structure." In his article Sheikh De Lorenzo says that: "the means of delivery, a Wa'ad or promise, is widely seen to comply with Shari'a norms. Since it is compliant, at least to the letter of the law, some Shari'a 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 structures².

A financial institution (Islamic or conventional) issues securities to the investor upon receipt of their commitment amount (the amount the investor intends to invest). The financial institution credits this commitment amount into a separate account, the Islamic Investment Account. This account and

assets held within the account have to be completely segregated from the financial institution's accounts and assets, and all the rights to this account should be held by the investor.

This commitment amount is then used to purchase Shari'a compliant assets at market prices. There has been several assets used for this purpose, however, in the majority of cases, the assets are Shari'a compliant shares selected from an Islamic index such as the Dow Jones index or in some instances using screening agencies.



The Wa'ad has been used by financial institutions to replicate the conventional options mechanisms. It has also been used to give investors a return benchmarked to the performance of certain non-Halal assets.

At the same time, the financial institution enters into a series of unilateral undertakings with the Islamic Investment Account to buy the shares at a predefined sale price. The investor will realise a profit or a loss on their investment based on the performance of the Index or other specified underlying reference asset instead of the performance of the shares in the Islamic Investment Account.

There are two possible outcomes of this structure.

1. If the value of the reference Shari'a 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 as determined on 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. Hussein 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 outperform 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.

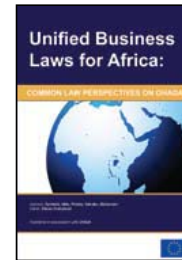
Conclusion

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.

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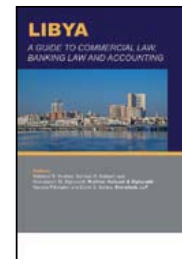
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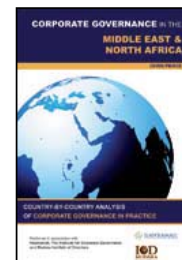
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² The Description is based on the Deutsche Bank Academic Paper on Wa'ad