

PRINCIPLES OF ISLAMIC ETHICS IN THE ISLAMIC FOREIGN EXCHANGE SWAP IN ISLAMIC BANKING MALAYSIA

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ABSTRACT

Islamic FX swap is one of the hedging mechanisms that will help financial institutions minimize foreign exchange risk as well as protects the value of assets from the market exposure. However, the Islamic Fx swaps is claimed to mimic conventional FX Swap structure which is to some degree is incompatible with Islamic financial ethics. This paper aims to analyze the application of the principles of Islamic ethics in the Islamic Foreign Exchange Swap (Islamic FX Swap) within the Islamic banking institutions in Malaysia. This study used content analysis method of the qualitative approach. This paper concludes that in Malaysia, the Islamic FX Swap operation in Islamic banking institutions runs based on the principles of Islamic ethics. There are four principles of Islamic ethics in the implementation of Islamic FX Swap, which are the absent of *riba*, the absent of *gharar*, the prohibition of excessive speculation and the prohibition of gambling. The implementation of Islamic FX Swap requires these ethical principles to ensure its operation complies with the Shariah.

Key words: Islamic ethics, Islamic FX swap, Islamic banking

1. Introduction

Ethics (*akhlaq*) is one of the main branches of Islam after belief (*aqidah*) and Islamic law (Shariah). Belief is fundamental for Muslims because it relates all matters of life to Allah SWT as Allah is the One God and the only Creator that humankind must worship. Islamic law is the rules and regulations that govern Muslims' life and conduct in the realization of the Divine will (Laldin, 2006). Meanwhile, ethics is an integral element that co-exists alongside the implementation of Islamic belief and Shariah. Islamic ethics covers all aspects of life, including social, politics, economics, behaviors, interactions, and management. Islamic finance and ethical finance are two important subjects discussed widely in the global financial market crisis to ensure the sustainability of financial development goals ([Tariqullah & Mohomed, 2017](#), [Kamran, & Zhao, 2016](#)). Routinely, the description of Islamic finance centers on it being ethical due to the prohibition of *riba*, *gharar*, and *maysir* in the products. The establishment of Islamic banking and finance system aiming to fulfill the socio-economic objectives and the creation of a just, fair, and balanced society.

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Foreign Exchange Swap (FX Swap) is one of the swap products categorized under derivative products. The purpose of this product is as a hedging mechanism that will help financial institutions minimize the foreign exchange risk. FX Swap protects the value of assets from the market fluctuation exposure ([Alshannag, Basah, & Khairi, 2017](#), [Fadahunsi & Barake, 2018](#), [Moles, 2016](#)). The instability of financial markets such as the currency market and interest rate affect creditors and debtors with different risk stages and uncertainty. Therefore, the international market uses the conventional FX Swap as hedging, arbitrage, and speculative mechanisms ([Al-Amine, 2008](#); [Al-Suwailem 2006](#); [Boris, & Sergey, 2018](#), [Obiyathullah, 1999](#)). [Vo et al. \(2019\)](#) state, the development of the derivatives instruments such as forwards, futures, options, and swaps had a positive result on economic growth in the short term, as showed in, India, Japan, and the U.S.

The contemporary Islamic finance scholars have begun discussing the derivative contract and its operation as early as in the 80s and 90s. Most scholars such as [Ahmad Muhayyuddin Hasan \(1986\)](#), Abu Sulayman (1996) and [Taqi Usmani \(1999\)](#) rejected the obligations of the conventional derivative market due to the existence of Shariah issues such as uncertainty (*gharar*), gambling (*maysir*), usury (*riba*) and short selling. Hence, in April 2006, the collaboration between Standard Chartered Saadiq Bank and Bank Muamalat Malaysia introduced the first Shariah-compliant swap instrument by launching two products named Islamic Foreign Exchange Swap and Islamic Cross Currencies Swap.

Despite the introduction of the new products for Islamic FX Swap instrument, they are still prone to criticisms by the scholars. The criticisms center on their operation for not fulfilling the Shariah requirements as they appear as a close copy or a replication of a conventional swap ([Ahmed, 2014](#); [Hamoudi, 2007](#); [Yusuf Talal, 2007](#)). Furthermore, they also claim that the existing practice of Islamic banking products has not been able to achieve its goals, which is to be based on Islamic moral values ([Mansour, Khoutem, & Majdoub, 2015](#)).

This paper aims to study the application of the principles of Islamic ethics in the Islamic Foreign Exchange Swap (Islamic FX Swap). This study is critical because it paves the way in ensuring whether the Islamic FX Swap products operate based on moral principles or not, which marks the difference from the conventional products. The first section of the paper presents the overview of Islamic FX Swap and its function. The second section discusses the Shariah issues related to it. The third section presents the principles of Islamic ethics in the Islamic FX Swap, and the fourth section concludes the entire discussion.

2. FX Swap Overview

FX Swap is an agreement between counterparties to exchange a currency for another, at a predetermined time, without incurring foreign exchange risk ([Barkbu & Ong, 2010](#)). The FX Swap concept has certain similarities with the forward contract concept due to the exchange of

two different currencies. The FX Swap involves dual exchange while forward contract involves a single exchange ([Asyraf Wajdi & Shabnam, 2010](#)).

Figure 1 illustrates the operation of an FX Swap contract. In the figure, Bank A, located in the United States, intends to convert USD100 million to MYR400 million. The second party, Bank B, located in Malaysia, wishes to have USD100 million for investment purposes in the States. Thus, Bank A and Bank B sign the FX Swap agreement to exchange their currencies based on today's spot basis and agree upon a forward date and rate. On the maturity date, the parties reconverted the currencies into the original currency on a forward rate. Both parties have agreed on a rate fixed on the day at the beginning of the contract.

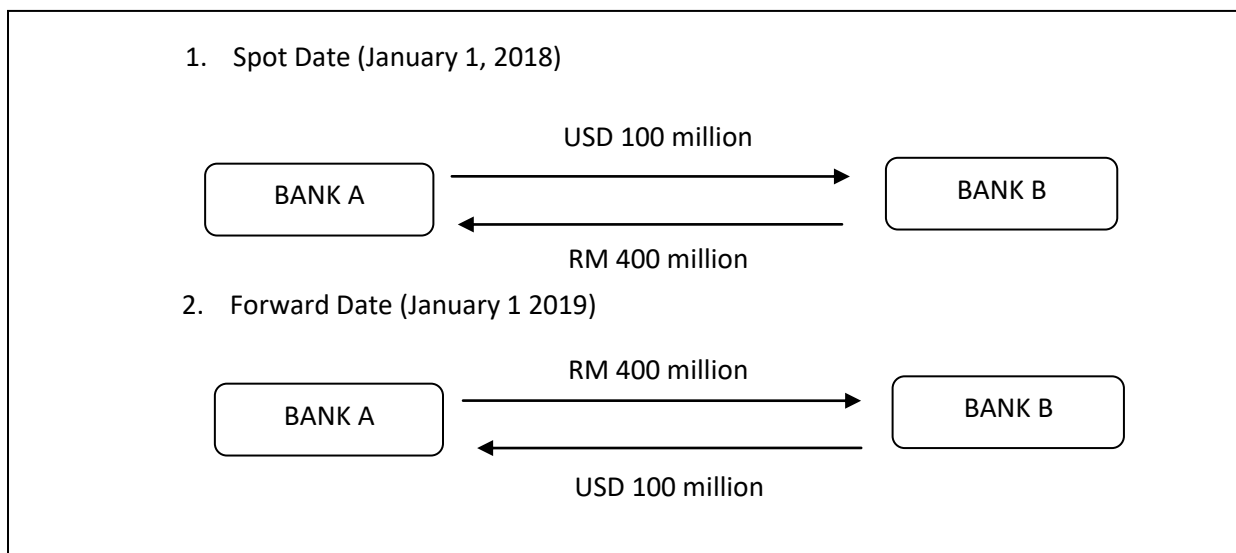


Figure 1: Operation of an FX Swap contract

2.1. FX swap function

Banks and other financial institutions use FX Swap widely to manage liquidity. Bank or financial institution that does not fully utilize its foreign currency deposits may face risk liquidity when there are any changes in the foreign currency exchange rate ([Barkbu & Ong, 2010](#)). By entering the FX Swap contract, any changes in the foreign exchange rates will not affect the financial institution or bank as it does not keep the currency by moving it temporarily to other parties. At the same time, the other parties may benefit the foreign currency exchange for their business purposes. For example, client A has Malaysian Ringgit currency, while client B has the US Dollar currency. Both parties enter the Islamic FX Swap transaction by converting both currencies on the spot and promise to reconvert the currencies into the original currency during a forward date. As a result, client A can use the US Dollar for his or her business purposes as well as client B, who is utilizing the Malaysian Ringgit temporarily. Therefore, both parties are not at risk of exchange rates while the unused foreign currencies can benefit other parties ([Shamah,](#)

2003). Meanwhile, the FX Swap instrument is an alternative for companies that are seeking foreign currency financing for businesses, asset purchases, and investments in a country. Likewise, financing companies can also minimize the lending cost of foreign currency by using the FX Swap instrument due to the lending cost is higher compared to the cost of FX Swap instrument (Shamah, 2003).

3. The Shariah Issues on FX Swap

The conventional FX Swap structure to some degree is incompatible with Islamic financial ethics due to the Shariah issues such as usury, uncertainty, gambling, and excessive speculations. Among the Shariah issues that need to be addressed are:

3.1. Shariah issue 1: Riba

The main Shariah issue about the FX Swap contract structure is *riba*. It arises when both parties have fixed the forward currency exchange rate on the agreement date (spot date) (Asyraf Wajdi, 2009; Khan, 1988; Sakti, Syahid, Tareq, & Mahdzir, 2016). Therefore, this contract contradicts the Shariah principles governing currency (*bay' al-sarf*) and the principles of Islamic ethics that emphasize the value of fairness in transactions. According to *bay' al-sarf* concept, any transaction that involves different currencies is required to be exchanged on a spot basis. On the contrary, the FX Swap structure involves the element of *riba* in the payment. As debt contract (*al-qard*) serves as the basis in FX Swap debt contract transactions (Obaidullah, 1999), therefore, a client who is using FX Swap contract becomes a debtor and shall repay the future debt with an additional cost. The FX Swap contract structure itself involves *riba* in the payment (Oubdi & Raghibi, 2017). Some Islamic financial scholars have supported this point of view, claiming that the transactions involve the sale of debt for a debt (*bay al-dayn bilyayn*) (Usmani, 1999). Basically, *bay' al-dayn* may be imagined as a sale over an unpaid debt involving either two or three parties. Shariah does not recognize this type of sale due to the element of uncertainty in its repayment and contains the exchange of deferred forms of wealth (Oubdi & Raghibi, 2017).

3.2. Shariah issue 2: Gharar

The second issue that violates the principles of Islamic financial ethics is the existence of *gharar*. *Gharar* is one of the most strictly prohibited elements in Islamic financial transactions and contracts. *Gharar* can be defined as misrepresentation, fraud, uncertainty, risky or hazard that might lead to damage or loss (Nehad & Khanfar, 2016). Two conditions that lead to *gharar* are the subject of a contract does not exist during the conclusion of the contract, and there is a deferment of goods and prices (Fahim 1995; Kamali 1996; Khan, 1988; Obaidullah 1998; Usmani 1999). In short, the items or assets in FX Swap do not exist, and the actual exchange does not happen. Khan (1988) states that, if a transaction takes place, it will happen without any party having an asset. This transaction resembles the one mentioned in the hadith of the Prophet SAW regarding the ban of *bay al-ma 'dum*, which is the sale of items that the sellers do not own. Other than that,

gharar exists in FX Swap when the agreed rate (forward rate) could not be expected in the future. This situation affects both of the contracting parties, and they may cancel the contract in the future if the agreed rate does not favor one of the contracting parties. If the agreed exchange rate exceeds the current exchange rate, one party may not exercise the obligation. Both parties are also exposed to credit risk when either party defaults. According to [Nordin and Asmak \(2011\)](#), this situation is due to the reason that there is no particular authority can regulate the transactions as the clearinghouse supervises the future contracts. This clearinghouse exists to prevent uncertainty and *gharar* over the fulfillment of the contracts ([Kamali, 1999](#)). Each transaction is guaranteed because the clearinghouse acts as the seller for each buyer and the buyer for each seller in all future transactions ([Kunhibava, 2010](#)).

3.3. *Shariah issue 3: Maysir*

Maysir or gambling refers to the easy acquisition of wealth by probabilities, whether or not it deprives the other's rights. [Al-Suwailem \(2000\)](#) and [Fahimah and Azlin \(2008\)](#) conclude that there are three characteristics of gambling that luck acts as the sole basis of the profitability where the winners get the losers' part. Therefore, investors expose themselves to high risks conditions, and those risks do not add value to the country's economy. One of the characteristics of gambling is a zero-sum game, which is one party gets profit based on the loss of the other party. [Obaidullah \(1998\)](#), [Al-Suwailem \(2006\)](#) and [Daud Bakar \(2008\)](#) explain that gambling happens when one of the contracting party face the risk of a loss while the other party will gain a profit. In the FX Swap operation, both parties will set an exchange rate in the future, and that will expose them to profit and loss risks. If the exchange rate at the forward time exceeds the rate of the spot time, the client gains profit while the bank suffers losses. If the opposite happens, the forward exchange rate is lower than the spot rate; then the bank earns profits while the client losses. This situation resembles betting for fate as it happens due to the dependence on market prices.

3.4. *Shariah issue 4: Speculation*

Speculation activity is an unethical act. Historically, financial crises around the globe have proven that speculation is one of the culprits. Speculation may define as an act of buying and selling of commodity in the market, with knowledge of its volatility and the risk involved therein, for the purpose of making a capital gain. It can be understood that speculation occurs when participants in the market intend to get a profit by buying shares at a lower price and sell to others at a higher price ([Habib, 2017](#); [Salamon, 2015](#)). According to [Rafikov and Saiti \(2017\)](#), there are six important elements in speculation namely: asset; buying; knowledge of market volatility; assumption of risk when waiting for positive or negative price change in the market; selling of the commodity; and intention of capital gain.

The noble purpose behind the creation of FX Swap is to enable hedging and managing speculation risk. However, ironically, this instrument has become the most popular financial

instrument used for speculation, which opposes its original purpose. [Abdul Rahman \(2003\)](#), [Fahim \(1997\)](#), [Obaidullah \(1998\)](#), and [Tamer \(2005\)](#) state that the elements of speculation take place in derivative markets when speculators are only interested in the market price changes. These speculators will terminate contracts before the maturity period, whether they are already profitable or to avoid losses, and most of the contracts also do not involve any physical delivery of the asset. [Obaidullah \(1998\)](#) and [Usmani \(1999\)](#) argue that this kind of transaction can be considered as excessive speculation as they place expectations on the market prices' fate, meanwhile, the speculators, their motive is to take advantage from the market price changes. Basically, the act of investors is based on their philosophical, religious or moral convictions of individual or collective investors ([Anas & Mounira, 2009](#)). According to [Al-Suwailem \(2006\)](#), dealers used 97.3% of the total amount of derivatives and, the end users used 2.7% of total derivatives. The percentages show that dealers who are real speculators will dominate the derivative market while hedgers are the minority. Most of the users entering a derivative contract intend to speculate instead of pursuing real businesses ([Saadiyah Mohamad & Tabatabaei, 2008](#)).

4. Principles of Islamic Ethics in Islamic FX Swap

In general, Islam and other divine religions invite humankind to follow moral and ethical principles in every possible condition. Therefore, it predominantly implies that the financial instrument and transactions to be disassociated directly or indirectly from corrupted businesses like gambling, human trafficking, drugs, arms and ammunition, pornography and other activities that fall under the grey areas when ethically and morally screened ([Rizvi, Arshad, & Lahsasna, 2014](#)). Other than that, in Islam, there are numbers of criteria for financial instrument and transactions to be permissible and ethical. In terms of the principles, all derivative instrument and transactions must be free from *riba*, *rishwah* (corruption), *maysir*, *gharar*, excessive speculation and *jahl* (ignorance) ([Fahim, 1997](#); [Muhammad, 1997](#); [Obiyathullah, 1999](#)).

The development of Islamic finance and banking products has introduced a new chapter in initiating Islamic derivative products. As a public necessity, many academics, Islamic finance practitioners, and Shariah scholars have advocated for the use of such products and devices treating it as a necessity (*hajah*) for risk hedging based on benefits (*maslahah*) ([Ayub & Paldi, 2016](#)). The emergence of Islamic swap products has solved many Shariah-related issues such as usury, uncertainty, gambling, and speculations. In general, there are five criteria must be met in order to avoid any misusing of Islamic derivative instruments as what happened in conventional derivatives markets: (i) the derivative instrument and its underlying commodities are Shariah compliant; (ii) the objective of derivative instrument is for real hedging; (iii) the transaction is based on real investment and real risk that contribute value to the real economy; (iv) the method and practice involved in risk hedging does not sever the risk from its underlying commodities; (iiv) The contract must be in accordance with the Shariah standards as well as its objectives (*maqasid al-shariah*) ([Kasri & Rahman, 2016](#); [Injadat, 2018](#); [Nordin et al., 2019](#), [Antara, Musa, Hassan, 2016](#)).

4.1. Ethical principle 1: RibaFree

The element of *riba* within FX Swap occurs when the exchange of two foreign currencies does not occur on the spot, and it may be fixed by using *wa'd* contract. A *wa'd* contract may define such exchange as a unilateral promise or undertaking that refers to an expression of commitment given by one party to another to perform a particular action(s) in the future (*Concept paper of Wa'd*, 2016). The *wa'd* application in the Islamic FX Swap contract can be illustrated in the following figure:

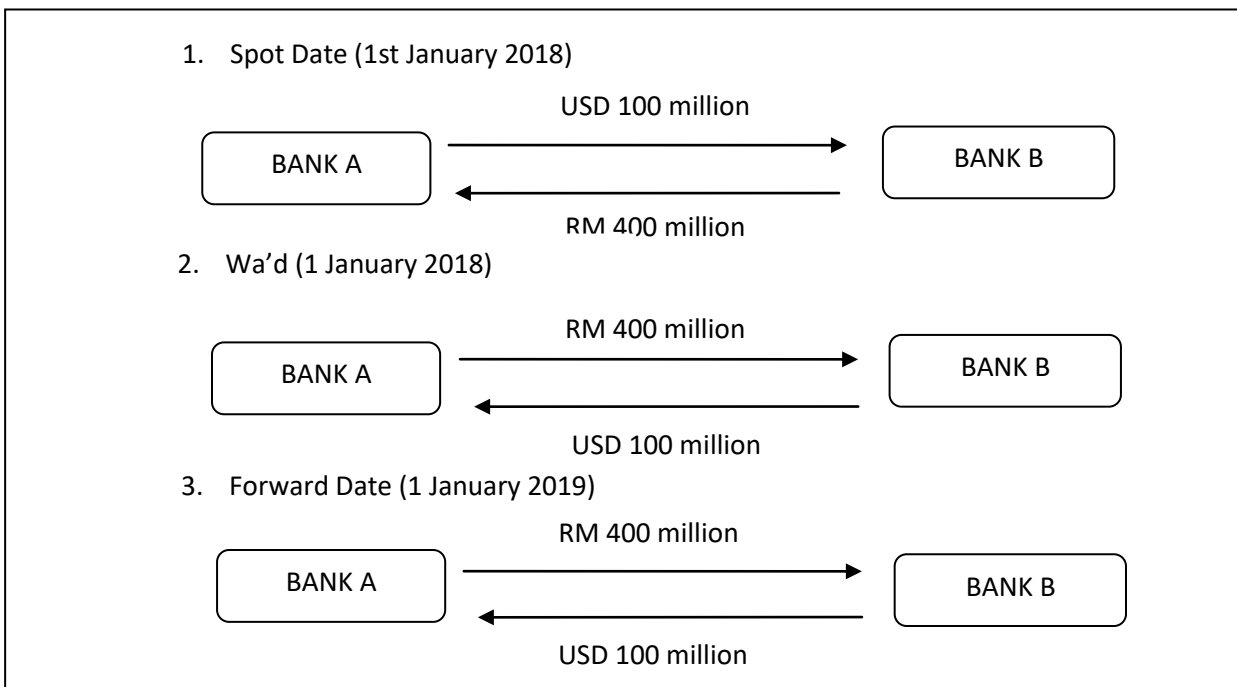


Figure 2: Wa'd application in the Islamic FX Swap contract

On January 1, 2018, an investor intended to convert his RM400 million to USD100 million. The exchange rate at that time is USD1.00 equivalent to RM4.00. Afterward, the investor and the bank carried out the exchange process. At the first stage, both parties executed the contract following *al-sarf* sales method because the exchange took place at the time the contract was sealed. At the same time, the investor and the bank entered into a *wa'd* agreement to execute the foreign currency exchange again at the agreed date (January 1, 2019) and the exchange rate (USD 1.00 = RM 4.00). On January 1, 2019, the foreign currency swaps were executed based on the agreement made on January 1, 2018.

In the current Islamic banking practice, the *wa'd* structure allows the achievement of the foreign exchange contract function without contradicting the principles of Shariah prohibitions, which is *riba* (Azizu, Abdullah, & Jubri, 2018; Azlin Alisa, Edawati, & Noor, 2014). Besides, the *wa'd* concept is a reapplication of the traditional contract in Islam in the contemporary Islamic banking and finance products to resolve the *riba* issue in FX Swap. This innovation receives

support from the Shariah Advisory Council of [Bank Negara Malaysia \(2010\)](#) where it has decided that Islamic financial institutions must execute their derivative instrument such as futures contract, forward contract, option contract and swap based on *wa'd*. Apart from that, the application of *wa'd* in FX Swap is in line with the Shariah objectives (*maqasid al-shariah*) that emphasize the preservation of wealth (*hifz al-mal*). It also coincides with the principle of Islamic ethics, which is protecting the interest (*maslahah*) of both contracting parties.

4.2. Ethical principle 2: Gharar Free

The element of *gharar* in FX Swap occurs due to the non-existence asset in FX Swap, and the actual exchange does not take place. The resolution to this issue is by requiring an underlying asset in FX Swap transactions. Since the FX Swap depends on the foreign exchange currency, *atawarruq* contract may be applied. *Tawarruq* contract involves an asset as an underlying subject of the contract in a transaction ([Ahmad et al., 2017](#)). Thus, the FX Swap transaction takes place based on the transaction of a commodity that eliminates the element of *gharar*. There are specific requirements set by the scholars on the underlying assets to ensure the transactions comply with the Shariah. Firstly, the asset must be permissible (*halal*). Secondly, the commodity must currently exist in its physical form. Thirdly, the seller should have legal ownership of the asset in its final form ([Obiyathullah, 1999](#)).

4.3. Ethical principle 3: Prohibition of excessive speculation

Another issue in the conventional FX Swap practice is speculation activity. According to [Fahim \(1995\)](#), not all kind of speculations is unethical due to the vital role of speculators who dare shift risks from others to them. Speculation is permissible when it is helping the market shifts risks from the producers who are unable to bear the risks to parties who can. This permissible speculation is a requirement in the actual economic activities. Therefore, the implementation of Islamic FX Swap still requires the elements of permissible speculation to avoid mismatches from occurring in risk management. In Islamic economics, it prohibits speculations that do not occur in the actual economic activities; moreover, when it is damaging the financial market. In order to ensure such speculations do not take place in Islamic FX Swap transactions, several Islamic financial institutions provide a declarative document to obtain a guarantee from the counterparties subscribing to the product to ensure the use of the derivative instrument is only for hedging purposes not speculation ([Asyraf Wajdi, 2009](#); [Zahan & Kenett, 2012](#)). The aim behind the use of the application of hedging and Islamic derivatives should strictly center on risk management. Even though financial institutions can control the speculators, they are still unable to control speculation activities when it comes to the international market ([Saadiyah Mohamad & Tabatabaei, 2008](#)). However, most of the Islamic banking practices reject this view because of the Islamic Banks that act as an intermediary institution will ensure clients who subscribe to their Islamic FX Swap are real hedgers. The following figure shows the practice of Islamic FX Swap:

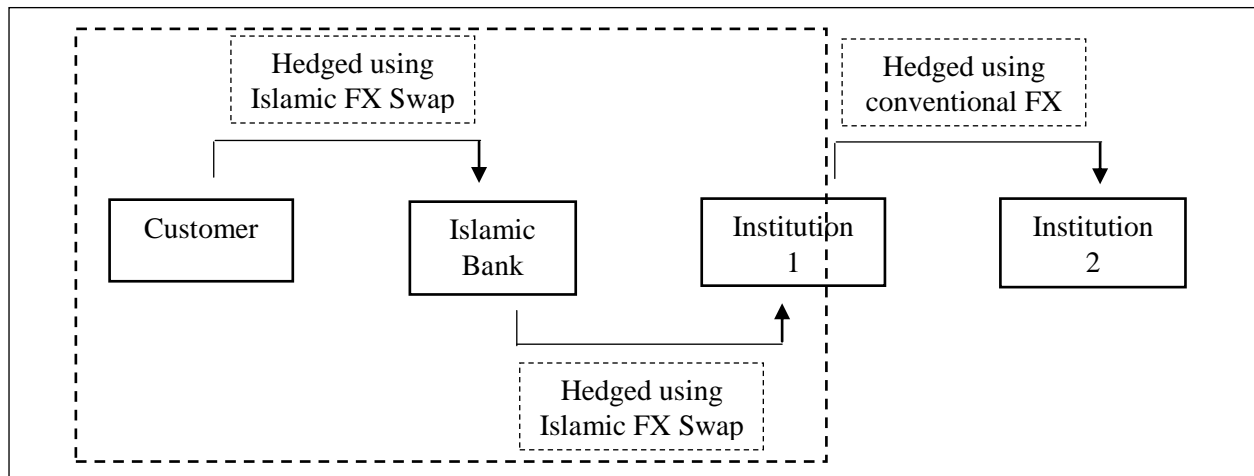


Figure 3: Islamic FX Swap

As Figure 3 shows, customer hedged his/her liability by using Islamic FX Swap from the Islamic bank. If the Islamic bank is unable to find the same risk that in line with its clients, it is necessary for the bank to swap the risk to another party that needs a real hedger. If the second party is also unable to bear the risk, it will transfer the risk to another party include Islamic or conventional institution. The Islamic banks will ensure that their clients and the second party who are dealing with them are real hedgers, while for the next parties, it is beyond the banks' responsibility. To ensure this speculative element can be minimized, the Islamic financial institution itself needs to strengthen their enforcement and monitoring body to control the operation of Islamic FX Swap. An ethical aspects in the regulatory framework are also necessary in addition to prudent and sound controls. Through regulatory body in Islamic finance institution, it's provide an upper hand to Shariah scholars to implement their authorities and make efforts for Shariah compliance (Ullah, Harwood, & Jamali, 2018).

4.4. Ethical principle 4: Prohibition of gambling elements

The elements of gambling will cease with the resolution of speculation issues as they are the worst form of gambling. According to Obiyathullah (1999), the price change in the market is a result of the price of the underlying assets and not just based on chances. Apart from having the real assets by using *tawarruq* contract, the exchange rates have also been fixed on the spot date, and that denies the elements of gambling in Islamic FX Swap.

5. Conclusion

This paper has reviewed the application of the principles of Islamic ethics of the Islamic Foreign Exchange Swap. The study of the conventional practice of FX Swap in financial institutions found that there are numbers of unethical issues in the implementation of FX Swap such as *riba*, *gharar*, gambling, and speculation. *Riba* occurs when the contracting parties fix the forward currency exchange rate on the agreement date (spot date). Gambling exists in FX Swap when the

subject of a contract does not exist, and the actual exchange does not occur. The elements of gambling occur in FX Swap when one of the contracting parties prone to a loss while another party gain a profit. Price fluctuation in the market causes speculators to take advantage of it. All in all, the implementation of the new contract innovation such as *wa'd*, *tawarruq* and monitoring efforts from financial institutions may eliminate the elements of *riba*, *gharar*, gambling and speculation in the Islamic FX Swap structure.

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