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SHARIA RULING ON FINANCIAL RISK MANAGEMENT IN THE CONTEXT OF CURRENCY SWAP

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Abstract

Currency swaps are a common financial tool, but because they might involve interest payments and exchange rate changes, there are some doubts regarding whether they adhere to Sharia law. Islamic finance is governed by Sharia law, which forbids engaging in speculative activities and charging or paying interest (Riba). This has sparked a discussion among experts over whether currency swaps are permissible in Islamic finance and if they comply with Sharia law. Some academics are wary of using currency swaps in Islamic banking, but others contend that they can be set up in a way that complies with Sharia law. To establish Sharia-compliant alternatives to conventional currency swaps, new products such as Wa'ad-based currency swaps, Salam-based currency swaps, Bai al Sarf-based currency swaps, and *Mudaraba*-based currency swaps have been created. These goods enable Islamic financial institutions to conduct currency exchange business while upholding Sharia law's fundamental precepts. The creation of these alternative products demonstrates how Islamic banking may be modified to satisfy the demands of the contemporary financial industry while upholding Sharia law's tenets. It is anticipated that the usage of Sharia-compliant currency swaps and other financial instruments will become more significant in Islamic finance as the global financial sector continues to develop.

Keywords: derivative, swap, currency swap, risk management, Sharia alternates

Introduction:

Financial contracts called "swaps" are made between two parties to trade future cash flows. These contracts can be used as a risk management tool or as a tool for market speculation. The notional amount, or fictitious sum used to calculate the cash flows, is the basis on which the parties agree to exchange cash flows in a swap agreement (Fabozzi, & Markowitz, 2002).

Interest rate swaps are a typical sort of financial swap in which one party consents to paying the other party a fixed interest rate in return for a variable interest rate based on an underlying reference rate, such as LIBOR. A currency swap is another sort of swap in which two parties trade interest payments made in several currencies (Hull, 2018).

Financial swaps have developed into a crucial tool in contemporary finance, enabling investors to control risk and develop more intricate investment plans. But, they can also be intricate and include considerable risks, so it's crucial to fully comprehend the terms and circumstances of any swap deal (Mello, & Parsons, 2000).

Literature review (Currency Swap)

A financial arrangement between two parties to exchange principal and interest payments made in several currencies is known as a currency swap. This derivative contract is used to access international capital markets, lower borrowing costs, and control currency risk. Usually, multinational enterprises, financial institutions, or sovereign governments are the parties to a currency swap.

The two parties to a currency swap agree to exchange cash flows based on a predetermined notional value, which serves as the swap's principal, according to Madura and Fox (2018). While the cash flows based on the notional amount are normally exchanged on an ongoing basis throughout the duration of the swap, the notional amount is often only exchanged at its beginning and termination. The London Interbank Offered Rate (LIBOR) or other benchmark rates are often utilized as the basis for the interest rates used to compute the cash flows.

A currency swap has the benefit of enabling businesses to borrow in a currency that matches their revenue stream, so lowering the risk of exchange rate changes. For instance, a US-based business with income in euros can utilize a currency swap to convert US dollars into euros, enabling it to borrow money in the Eurozone at a reduced rate of interest.

In recent years, currency swaps have grown in popularity, especially among developing market nations looking to lessen their exposure to unpredictable exchange rates. The global market for currency swaps increased from \$1.8 trillion in 2001 to \$4.7 trillion in 2013, according to Chinn and Ito (2015), with the majority of activity occurring in the over-the-counter (OTC) market.

Features of Currency Swap

The principal and interest payments of a loan denominated in one currency are exchanged for comparable payments in another currency in a currency swap between two parties. At the moment the contract is signed, the exchange rate to be utilized in the swap is established, and payments are still exchanged during the term of the agreement (Madura, 2015).

The following are some characteristics of currency swaps:

Hedging currency risk:

A financial technique known as hedging can be utilized to lessen the chance that an asset or investment will experience unfavourable price changes. In the context of currency risk, the practice of taking precautions to protect oneself against the possibility of negative changes in the exchange rate is referred to as hedging.

Currency hedging can be especially useful for companies and investors who engage in international trade or who have exposure to the markets of other countries currencies. Hedging is a strategy that can assist reduce the risks associated with fluctuations in exchange rates, which can have a major negative impact on profitability and investment returns.

Currency risk can be mitigated by the employment of several different measures, including the following:

Forward contracts: A forward contract is an agreement to purchase or sell a currency at a predetermined exchange rate at a certain future date. These transactions are carried out by a forward contract. Businesses and investors can lock in a particular exchange rate as a result of this, which helps to reduce the risk of unfavourable changes in the currency markets (Investopedia, 2021).

Options contracts: Options contracts give the buyer the right, but not the responsibility, to purchase or sell a currency at a certain exchange rate at a later period. But the buyer is not required to exercise this right. As a result, this offers the buyer more flexibility than forward contracts do, as they can pick. whether or not to exercise the option depending on market conditions.

Currency swaps: It is possible to engage in a currency swap, which entails swapping one currency for another at a mutually agreed-upon exchange rate, with the understanding that the transaction will be reversed at a later time. Over a longer length of time, this can assist companies and investors in managing the risk associated with currency fluctuations (Bank for International Settlements, 2016).

Natural hedging: The process of matching cash inflows and outflows in multiple currencies is an example of natural hedging. For instance, a company is said to have a natural hedge against fluctuations in the exchange rate if it generates income in a foreign currency and pays its expenses in the same currency (The Balance, 2021).

It is essential to keep in mind that hedging does not come without expenses, even though it may be an efficient method for managing currency risk. The practice of hedging often entails making payments of fees or premiums to financial institutions, and there is always the possibility that the hedging approach may not be effective in limiting the impact of unfavourable exchange rate swings.

Flexible in term

Currency swaps can be flexible in many ways, one of which is the term of the contract. Currency swaps can be designed to have a relatively short-term length, such as one year, or a relatively long-term duration, such as ten years or more. Both options are possible. The duration of the contract can be adjusted to better meet the requirements of the parties involved in the transaction.

Currency swaps can also be variable in terms of the size of the cash flows that are transferred between the two parties. Depending on the requirements of the many parties involved, currency swaps may entail substantial or inconsequential sums of money. For instance, a multinational organization might participate in a currency swap to protect itself against the risk of foreign exchange on a substantial investment, but an individual investor might utilize a currency swap to manage currency risk on a more modest investment (Investopedia, 2021).

Currency swaps may also provide some leeway in terms of the exchange rate that is applied when calculating cash flows. Depending on the requirements of the many parties involved, the exchange rate can either be fixed, allowed to float freely, or a combination of the two. It is possible to adjust the exchange rate that is applied during a currency swap so that it accurately reflects the risk and volatility of the currencies that are being traded.

Currency swaps, as a final point of consideration, might be flexible in terms of the particular terms and conditions of the contract. The parties that are participating in a currency swap can negotiate a wide range of parameters, such as the frequency of payments, the amount of collateral that is required, and the termination provisions

(International Swaps and Derivatives Association. (ISDA, 2021).

Currency swaps, as a whole, are capable of providing a significant degree of flexibility in the management of currency risk. Parties are in a better position to properly hedge against the risk of foreign exchange and control their exposure to currency fluctuations if the terms of the contract are tailored to meet their requirements (BIS, 2016).

Counterparty risks

A financial product known as a currency swap is characterized by the exchange of a notional main amount denominated in one currency for an equivalent amount denominated in another currency, together with an agreement to exchange the principal amounts back at a predetermined period in the future. Currency swaps are a common tool utilized by multinational firms, banks, and other financial institutions to mitigate the risk associated with fluctuations in the value of foreign currencies (FINCAD, 2021).

The possibility that one of the parties involved in a financial transaction may fail to fulfil their obligations constitutes the counterparty risk. When it comes to currency swaps, counterparty risk refers to the possibility that one of the parties involved will not fulfil its duties to fulfil the swap contract by exchanging the agreed-upon principal amounts or interest payments as required by the contract (Eun, & Resnick, 2014).

For instance, if a company enters into a currency swap with a bank to exchange a notional principal amount in USD for an equivalent amount in EUR, the company opens itself up to the possibility of counterparty risk if the bank fails to live up to its obligation to pay the EUR principal amount by the date that was previously agreed upon (Investopedia, 2021).

It is possible to reduce the risk posed by a counterparty by adopting measures such as performing background research on the counterparty, securing the swap with collateral, or asking the counterparty to produce a credit rating or a guarantee from a third-party guarantor.

Even though these precautions have been taken, there is still a possibility of experiencing losses due to counterparty risk. This is an essential point to keep in mind. For example, the financial crisis of 2008 showed that even highly rated and seemingly secure counterparties could default, which resulted in large losses for investors and counterparties (IMF, 2016).

In conclusion, currency swaps do involve a risk posed by the counterparty, and it is essential for market players to be aware of this risk and to take the right steps to manage it.

Access to more affordable financing

A currency swap is a type of financial instrument that facilitates the exchange of a predetermined quantity of one currency for another currency between two parties. Currency swaps are often utilized by corporations and governments to control their exposure to foreign currencies, lower the risk associated with fluctuating exchange rates, and gain access to finance on more favourable terms.

When two parties agree to engage in a currency swap, it means that in addition to exchanging the principal amount of the loan, they also agree to exchange the interest payments that are linked with the loan. This allows both parties to benefit from the interest rates that are offered in the currency markets of the other, which are frequently more advantageous than the rates that are offered in their respective currency markets.

Consider, for instance, a corporation established in the United States that must obtain loans denominated in Japanese yen to support its activities in that country. If the company were to borrow money directly from the yen market, it would very certainly be required to pay an interest rate that was greater than the rate that a Japanese company would pay to borrow money in dollars directly from the American market.

Nevertheless, if the American firm enters into a currency swap with a Japanese company, it will be able to convert its dollars into yen and then utilize those yen to finance its activities in Japan. The currency swap will take place between the two companies. The Japanese corporation can put the dollars it is paid in the US towards the financing of its activities in that country. When this is done, both parties can acquire funding at interest rates that are more favourable than what they would be able to achieve in the currency markets of their respective countries.

Banks and other types of financial organizations frequently act as the middlemen in currency swaps. These institutions play the role of middlemen, bringing together different companies whose requirements for foreign currency borrowing are complimentary to one another. Currency swaps can assist businesses and governments in better managing their foreign currency exposure and decreasing their foreign exchange risk. In addition to giving access to funding at more cheap rates, currency swaps can also help businesses and governments gain more affordable financing (Investopedia, 2021).

Currency swaps, in general, have the potential to be an efficient and successful method for businesses and governments to gain access to more affordable borrowing in the international currency markets. By exchanging currencies as well as interest payments, the two parties can take advantage of the more advantageous interest rates that are available in the currency markets of each other's country. This can contribute to a reduction in the cost of borrowing money and an improvement in the financial performance of the parties concerned.

Types of Currency Swap

Contracts involving the exchange of principal and interest payments made in two distinct currencies are known as currency swaps. Currency swaps come in a variety of forms, each with special characteristics and advantages.

The following are some examples of frequent **currency swaps:**

1. Fixed-to-fixed currency swaps are one sort of swap in which both parties consent to exchange fixed interest rate payments in two different currencies. Companies that have fixed-rate debt in one currency and wish to hedge their currency risk generally employ this form of swap (Madura, 2015).
2. Fixed-to-floating currency swaps: In this kind of swap, one party consents to pay an interest rate that is fixed in one currency while the other party consents to paying an interest rate that is floating in a different currency. Companies that seek to benefit from lower floating interest rates in one currency while hedging against currency risk sometimes employ this form of exchange (Eun, & Resnick, 2014).
3. Swaps between floating-to-floating currencies: In these swaps, both parties consent to exchange payments with floating interest rates in two separate currencies. Companies that have floating-rate debt in one currency and want to insure against currency risk generally employ this kind of exchange.
4. Cross-currency basis swaps: In this sort of swap, the parties trade payments with floating interest rates denominated in two distinct currencies, but the payments are based on various interest rate benchmarks. To account for the variance between the two benchmarks, the exchange rate used in the swap is modified. Companies that want to benefit from interest rate differences between two currencies frequently employ this form of exchange (Hull, 2018).

Benefits of currency swap

Currency swaps are a helpful instrument for reducing borrowing costs, controlling currency risk, and improving a company's capital structure. The following are some advantages of currency swaps:

1. Hedging currency risk: By converting payments made in one currency into payments made in another, currency swaps enable businesses to hedge against currency risk. For businesses that operate internationally and are subject to currency rate swings, this might be very helpful (Madura, 2015).
2. Access to more affordable financing: By using currency swaps, businesses can raise money at a lower cost by borrowing in a currency that has lower borrowing costs than their home currency (Eun, & Resnick, 2014).
3. Capital structure optimization: By aligning the currency of a company's debt with the currency of its cash flows, currency swaps can be utilised to improve a company's capital structure. This may aid in lowering borrowing costs and reducing currency risk.
4. Flexible terms: The duration of the contract, the currencies involved, and the exchange rate utilised can all be altered to suit the individual requirements of the parties.
5. Diversity of funding sources: By gaining access to capital markets in several currencies, currency swaps can assist businesses in diversifying their funding sources (Hull, 2018).

Discussion: Impacts of currency swap

Currency swaps can have a big impact on the businesses and investors engaged in the transaction. The following are some of the main effects of currency swaps:

1. Lessened currency risk: Companies and investors can benefit from currency swaps by swapping payments made in one currency for payments made in another. This might be crucial for businesses that operate internationally and are subject to exchange rate changes (Eun, & Resnick, 2014).
2. Better financing options: By using currency swaps, businesses can have access to financing in other currencies, lowering their borrowing rates and diversifying their funding sources.
3. Variations in interest rate differentials: The cost of financing and investment returns can be affected by changes in interest rate differentials between two currencies.
4. Counterparty risk: Currency swaps are subject to counterparty risk, which is the possibility that one party will break the terms of the agreement. For both parties, this risk may have considerable financial ramifications.
5. Regulatory adjustments: Changes to the rules governing currency swaps may affect the accessibility and pricing of these contracts for businesses and investors (Bao, & Wang, 2018).

Sharia ruling on currency swap

Currency swaps are a type of financial instrument that may involve interest payments and changes in exchange rates, which raises concerns regarding whether they are permissible under Islamic law. Islamic finance is governed by Sharia law, which forbids engaging in speculative activities and charging or paying interest (Riba).

Scholars disagree on whether or not currency swaps are compliant with Sharia law, and there is a discussion about their usage in Islamic finance. While some academics contend that currency swaps can be used in a way that complies with Sharia law, others are more hesitant.

Using the idea of *Musharaka*, which entails splitting profits and losses between the parties, is one method for organising currency swaps by Sharia law. By this arrangement, the parties would sign into a joint venture agreement, where each would contribute money in their currencies and split the profits and losses (Iqbal, & Mirakhor, 2012).

Using the idea of wa'ad, which is a unilateral pledge to buy or sell a currency at a later time, is an additional strategy. Under this arrangement, one party would make a future promise to buy or sell a currency at a certain exchange rate, and the other party would have the option to accept or reject the offer (Obaidullah, 2010).

Islamic alternative product of currency swap

To replace traditional currency swaps, the field of Islamic finance has created a variety of alternative products that are consistent with Sharia law. Here are a few of these items:

1. Wa'ad-based currency swap: Wa'ad is the unidirectional commitment to purchase or sell a currency at a later time, as was previously indicated. Wa'ad-based currency swaps provide the flexibility to be set up to convert currencies at a predefined rate at a later time without requiring interest payments (El-Gamal, & Inanoglu, 2016).
2. Salam-based currency swap: Salam is a contract for postponed delivery of commodities in which the buyer pays the price in advance and receives the products at a later date. Salam-based currency swaps can be set up such that currencies are exchanged at a later time, with one side paying the agreed-upon sum in advance and the other providing the money at a later time.
3. Exchange of currencies based on *Bai al Sarf: Bai al Sarf* is the selling of one currency for another at a spot rate. This may be used to organize currency swaps by exchanging currencies at the spot rate and agreeing on a future delivery date for each party (Iqbal, & Mirakhor, 2012).
4. Mudaraba-based currency swap: Mudaraba is a profit-sharing partnership in which one side contributes the cash and the other contributes the knowledge to manage the funds. Mudaraba-based currency swaps can be designed to entail the exchange of currencies, with each partner participating in the gains or losses depending on their contributions (Hasan, 2011).

Summary

Currency swaps entail interest payments and exchange rate swaps, which raise concerns about whether they adhere to Sharia law. Islamic finance functions according to the guidelines of Sharia law, which forbids engaging in speculative operations and collecting or paying interest (Riba).

Scholars disagree on whether or not currency swaps are under the purview of Sharia law, and there is discussion over their application in Islamic finance. Yet, several alternatives to traditional currency swaps are consistent with Sharia law. These commodity swaps are based on *wa'ad, salam, bai al Sarf, and mudaraba*.

These alternative products can be used to exchange currencies without engaging in speculative activities or charging or paying interest because they are designed by Sharia law. They give Islamic financial institutions a Sharia-compliant substitute for traditional currency swaps and permit them to conduct currency exchange operations while abiding by the rules of Sharia law.

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