Monetary and Banking Research Institute
Central Bank of the Islamic Republic of Iran

The formation of a currency derivative market under Shariah in the Iranian financial system

Hossein Meisamy, Fereshteh Mollakarimi

Policy Report
www.mbri.ac.ir

MBRI PR-9901

November 2020

Monetary and Banking Research Institute
Central Bank of the Islamic Republic of Iran

Monetary and Banking Research Institute (MBRI) published the Policy Report on " The formation of a currency derivative market under Shariah in the Iranian financial system"

Monetary and Banking Research Institute

Central Bank of the Islamic Republic of Iran

No.10, Africa Ave., Argentina Sq.,

Tehran.Iran.P.O.box:16765-1654

www.mbri.ac.ir

Monetary and Banking Research Institute
Central Bank of the Islamic Republic of Iran

The formation of a currency derivative market under Shariah in the Iranian financial system

Introduction

The formation of a **"Currency Derivatives Market"** is one method used in different countries (especially developing countries) to manage exchange rate fluctuations. This market's importance is that sudden fluctuations in exchange rates have many adverse effects on production activities, trade, and in particular, the attraction of foreign capital and is one of the most critical obstacles in this regard.

According to the Bank of International Settlements (BIS), in 2018, about half of the derivative transactions in developing countries' financial markets were related to foreign exchange derivatives; while in developed countries, this ratio has been less than a quarter. This ratio is much higher in "Over-the-Counter (OTC)" transactions in developing countries, accounting for about 90% of all derivative transactions.

In the country's financial system, the currency derivatives market has not been implemented so far. This issue creates many challenges at the macro level for policymakers to manage the foreign exchange market to create foreign exchange stability. At the micro-level, the lack of a transparent market to cover the risk of exchange rate fluctuations poses severe challenges to the plans of producers, traders, and economic actors. Specifically, one of the main problems of investment and production in the country's economy is exchange rate fluctuations. Investors and traders are always worried about future exchange rate fluctuations because of the uncertainty of future exchange rates and the fact that investment decisions (and imports and exports) are often time-consuming. And this poses serious challenges to investment (domestic and mostly foreign), trade, and production. In particular, a review of the historical trend of the exchange rate in the last three decades shows that in some periods, the exchange rate has faced significant shocks and jumps and has caused great damages to producers and economic actors. In other words, the currency derivatives market is practically in charge of **"Exchange Rate Fluctuation Insurance,"** and in its absence, it will not be possible to cover the risk in a proper way for economic actors.

In recent years, however, the legislature has tried to somehow pave the way for the formation of a currency derivatives market, but unfortunately, these efforts have so far failed. Specifically, in July 2010, the "Executive Regulations on Foreign Exchange Futures Transactions" were prepared and published by the Central Bank Export Office, which was practically never implemented.

Besides, Note 3 of Article 20 of the Law on the Elimination of Barriers to Competitive Production and the Improvement of the Country's Financial System (approved by the Parliament on 21/April/2015) has considered the issue of covering exchange rate fluctuations. This legal article states: "The Ministry of Economic Affairs and Finance is obliged to prepare a bylaw on exchange rate fluctuations within three months after the approval of this law in cooperation with the Central Bank of the Islamic Republic of Iran, the Stock Exchange and Securities Organization and the Central Insurance of the Islamic Republic of Iran, and submit them to the Cabinet for approval. " However, the legal obligation has not been implemented yet.

The question that arises here is why, despite all the efforts made to form a currency derivatives market, the idea has not yet been made operational? It seems that the most critical drawback in this regard is the dominance of the micro view on the issue of currency derivatives. The models that have been proposed so far for the formation of the currency derivatives market have considered most of the foreign exchange as other primary assets and, based on a micro view of it, have proposed the formation of the currency derivatives market. In contrast, the exchange rate is a macroeconomic variable that has far-reaching effects on the entire economy. For this reason, it is necessary to consider the concerns of monetary policymakers (macro view in the direction of financial stability) in addition to a micro view of the issue.

This study tries to consider the currency derivatives market's discussion from this perspective and, therefore, has added value compared to previous research in this field. In this study, in addition to the capital market watchdog, the concerns and challenges of the money market watchdog (Central Bank) have been considered, and scientific solutions were provided.

Accordingly, the questions that are answered in the present study are:

A- What is the operational model of forming a currency derivatives market under Shariah in the country, and what are its characteristics?

B- From the point of view of compliance with Shariah, what are the most important points that need to be considered in relation to the currency derivatives market as well as the tools used in it?

C- Does considering currency as a primary asset in the derivative market create different jurisprudence considerations than other basic assets (such as stocks)?

D. What are the operational challenges and barriers to launching a foreign exchange derivatives market under Shariah in the country? How can appropriate measures be taken to address these challenges by using the theoretical foundations and experiences of countries?

Summary and Conclusion

This study tries to introduce the idea of forming a currency derivatives market in its financial system and discuss its necessity, dimensions, and details. It also tries to discuss the importance of launching the mentioned market in creating more stability in the country's foreign exchange market. This study's findings show that the currency derivatives market is one of the missing institutions in the country's financial market, the absence of which has created various costs for economic stakeholders and the general public. Accordingly, it seems that planning to launch the derivatives market at the macro and micro levels is a complementary step to manage the foreign exchange market better and pave the way for strengthening currency stability.

In practice, the currency derivatives market can be formed in three stages: foreign exchange wholesale cash market (organized foreign exchange market), foreign exchange derivatives wholesale market, and foreign exchange derivatives retail market. The most important purpose of forming a foreign exchange wholesale cash market is to extract the cash rate in major transactions that can be used as a basis or platform for derivative transactions. After this stage, wholesale transactions of foreign exchange derivatives can be formed under the supervision of the Central Bank and the main market stakeholders such as banks, exchange offices, importers, exporters, producers, etc.

Finally, the formation of a "foreign exchange derivatives retail" market on the commodity exchange can be put on the agenda so that speculative foreign exchange transactions can also be directed from the informal market to a structured, regular and supervised framework. It is also possible to buy and sell risk between risk-taking and risk-averse people at the micro-level. Based on the research findings, the following points can also be emphasized:

1. In the currency derivatives market, various types of derivative contracts are traded on a specific underlying asset (currency). In fact, stakeholders enter the market with different goals and motivations and try to achieve their goals in the best way by adopting the right buying and selling strategies. While central banks enter the market to stabilize the currency at the macro level and policymaking, speculators and investors enter the market to profit from their forecasts (in the short and medium-term) and traders and producers to hedge the risk.

2. Economic theories and experiences of different countries show well that the currency derivative market has certain functions, some of the most important of which are: policymaking to stabilize the currency, produce information and improve policymaker approximation, cover exchange rate risk, transfer Informal derivatives transactions to the formal market, reduce pressure on the cash foreign exchange market and clarify the future direction of the exchange rate.

3. Currency derivatives market stakeholders enter into these transactions with a variety of motives, some of the most important of which are: central bank policy at the macro level, risk coverage at the micro-level (by producers and traders, foreign investors, and foreign currency debtors) and speculation to gain profit in the short term.

4. Due to the important functions of the currency derivatives market in attracting foreign investment, major developed countries and many developing countries have taken action to establish currency derivatives

markets. For example, Argentina in 2001, Brazil in 2002, Turkey and the UAE in 2005, South Korea in 2006, and India in 2008 launched currency derivatives markets.

5. If the currency derivatives market wants to be launched in the country, besides economic functions, the dimensions of compliance with Shariah need to be considered. In general, the most important principles that need to be considered in designing the currency derivatives market in the Islamic context are: acceptance of the general nature of the derivatives market within the framework of Shariah, acceptance of speculative transactions within a regulated framework, the necessity of possibility of delivery of basic assets, incorrectness the design of derivative contracts on indices and necessity of observing general rules of contracts.

6. In addition to paying attention to Shariah's general principles, it is necessary that the legal nature of the instruments used in the currency derivatives market under Shariah (including futures, options, and clearing) be compatible with the Islamic jurisprudence.

7. Legally, a foreign exchange futures contract can be designed in the legal form of a "future sales commitment" or a "contract of compromise." In the first form, under the contract, the prospective seller of the currency undertakes to sell a certain amount of a currency at the present specified price, at maturity. In return, the currency's prospective buyer undertakes to purchase the said currency with the specified specifications. In the second legal form (contract of compromise), the futures seller of the currency, according to the compromise contract, gives a certain amount of a currency to the currency's prospective buyer for a certain price.

8. The option contract can also be designed in the form of an obligation. It means that the seller of the option undertakes to sell a certain amount of currency at a certain price at the customer's request, and in return for this obligation, he receives a sum from the customer, which is called the option price.

9. In the conventional currency swap, the interest element is remarkably present, and this interest is not due to the real economy's activities. However, because in the framework of Islamic Shariah, the opportunity cost of money is not accepted without connection to the real sector of the economy, so the exchange of interest is faced with the challenge of usury, and it cannot be justified within the framework of Shariah. This argument is valid either in the case where the principal of currencies is exchanged between the parties in addition to interest or in the case where only interest is swapped. The solution that can be suggested to solve this problem is to eliminate interest rates during the contract period. That is, a Shariah-compliant foreign exchange swap can be considered a new legal contract under Article 10 of the Civil Code, which includes the sale of cash at present and the obligation to sell cash in reverse in the future. At time zero, the parties sell their currency to each other and commit to a reverse transaction at maturity.

10. Although Shariah-compliant foreign exchange swap contracts based on the proposed legal framework (as opposed to foreign exchange futures and Shariah-compliant foreign exchange transactions) cannot meet all the

economic functions of conventional foreign exchange swaps, it responds to at least some of the needs of Islamic derivatives market stakeholders with its clearing tools.

Policy Recommendations

In this research, an attempt was made to study the issue of forming a currency derivatives market both from a theoretical and scientific point of view and from an operational and practical point of view (taking into account the specific features of the foreign exchange market in the country's financial system). Also, the dimensions of Shariah compliance concerning the market as a whole, as well as its main tools, were examined. Based on the subject matter and the findings of this study, the following policy recommendations can be made to policymakers:

1. As noted, the currency derivatives market in all countries has certain functions (such as covering the risk of future exchange rate fluctuations), and the country's economy is in dire need of such a market at present. Because if the Central Bank makes the foreign exchange market policy through the currency derivatives market, the costs will be lower than the current situation (extensive policymaker intervention in the foreign exchange cash market) and, based on the analyzes provided (and the experiences of countries), are even more effective**. Accordingly, it is recommended that the formation of a currency derivatives market be put on the agenda based on the stage model presented in this research and taking into account the mentioned considerations.** Doing so is expected to increase the Central Bank's maneuverability in managing exchange rate fluctuations.

2. From the point of view of compliance with Shariah, it is possible to form a currency derivatives market in the country using three main tools: foreign exchange futures, foreign exchange trading options, and foreign exchange clearing. However, both in relation to the market as a whole and in terms of the tools used, some considerations (including the possibility of delivering physical currency) need to be well-thought-out. Therefore, it is recommended to pay attention to Shariah's issue from the beginning in implementing the currency derivatives market. In this regard, the maximum use of the Jurisprudential Council of the Central Bank's capacity to approve the general framework and tools used in this market is recommended.

3. As mentioned, the prerequisite for forming a currency derivatives market is the existence of a market to discover the cash exchange rate. Because the presence of cash rates has a key role in the success of the derivatives market and the pricing of foreign exchange derivatives. Fortunately, however, the formation of an organized foreign exchange market to regulate cash foreign exchange wholesale transactions and the discovery of the rate of this market is now on the agenda of the Central Bank of the country. Accordingly, it is recommended that after the formation of the organized foreign exchange market, gradually and taking into account the considerations raised in this research, the field of wholesale transactions of currency derivatives as a new option in the organized foreign exchange market should be on the agenda.

4. It is recommended that currency derivatives wholesale market transactions be done by agreement of Over-the-Counter (OTC) based on bargaining between suppliers and demanders. Also, all three tools of futures, options, and clearing can be used in this market.

5. Establishment of currency derivatives market at the micro-level in the commodity exchange is the last step in launching the currency derivatives market. Because currency as a basic asset has certain effects on the macro level of the economy and cannot be compared with other basic assets that are based on the futures market (for example, saffron), accordingly, it is necessary first to raise a derivatives market formation at the macro and wholesale levels. Then the construction of a derivatives retail market in the commodity exchange should be on the agenda. Based on this, it is recommended that policymakers consider the logical course of forming the currency derivatives market with a macro approach towards the micro approach.

Monetary and Banking Research Institute

Central Bank of the Islamic Republic of Iran

No.10, Africa Ave., Argentina Sq.,
Tehran.Iran.P.O.box:16765-1654

www.mbri.ac.ir