

Islamic Hedging Standards

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1.

Hedging as Risk Management Instrument in Islamic Perspective

Risk in Islamic Perspective

- Risk generally means a measurement of unpredictability or uncertainty of future events.
- In finance it can be taken as the amount one potentially stands to lose by a transaction or the probabilities of each possible outcome being known.
- In an Arabic Islamic finance lexicon, the common term used to denote risk is *mukhatarah*.
- The word *mukhatarah* itself derived from an Arabic root word 'khata', which implies several meanings such as exposure and fear or destruct, or an exalted position.

1. Permissible Risk

- Inevitable risk relates to **mundane economic** activities involving transactions which have added-value in order to generate returns.
- Taking that risk is part of requirement for profit entitlement:
 - ◇ (الغنم بالغرم) “entitlement to profit is accompanied by responsibility for taking risk.”
 - ◇ (الخراج بالضمان) “Entitlement to profit is dependent on responsibility attendant expenses and possible loss”
- The jurists, in accordance with those maxims, almost unanimous in allowing returns and profits which are commensurate by the added or counter-values in any of the following forms;
 - ◇ Utilization of one's property through investment or trading activities;
 - ◇ Effort taken to conduct the transaction; and
 - ◇ Risk or liabilities assumed through ownership.

2. Non-Permissible risk

- Avoidable risk in a transaction, but the contracting parties opted not to eliminate it, but use it to gain profit.
- Risk that would lead to unjust consumption of property or '*aklu al-maali bi al-batil*'.
- For example,
 - ◇ Risk in gambling transaction or zero sum game (*maysir*)
 - ◇ Risk in excessive uncertainty (*gharar fahish*), such as:
 - Uncertainty or risk related to existence (*gharar fi al-wujud*), e.g. *bay' al-ma'dum*
 - Uncertainty or risk related to taking ownership (*gharar fi al-husul*), e.g. *sale of loss camel*
 - Uncertainty or risk related to quantity (*gharar fi al-miqdar*), e.g. *sale of unspecified price or quantity*
 - Uncertainty or risk related to quality (*gharar fi al-sifah*), e.g. *sale of unspecified type or characteristics of a product*
 - Uncertainty or risk related to the time of payment (*gharar fi al-ajal*), e.g. *deferred sale but with unspecified date*

3. Tolerable and Manageable Risk

- Tolerable risk in a transaction and avoidable/manageable.
- But, At times, it becomes necessary to protect against this type of risk. Hence, some risk management steps need to be taken.
- Dr Hussein Hamid Hassan outlines three pre-conditions for managing this type of risk:
 - ◇ The instrument or approach used to manage risk of this category must not contravene the Shari'ah principle of *al-ghunm bil-ghurm*.
 - ◇ The instrument employed to manage this risk does not involve excessive ambiguity (*gharar fahish*).
 - ◇ The instrument or approach to be used must comply with Shari'ah principles and only be used to avoid or manage risk allowed by Shari'ah.

Risk Management in Islamic Finance

- Islamic financial institutions, like their conventional counterparts are exposed to wide array of risks.

1	Financial risk
• Credit, MARKET and Liquidity risk	
2	Business risk
• Management risk and Strategic risk	
3	Operational risk
• people, processes, systems and several other factors	

- MARKET RISK is the risk of losses arising from adverse movements in market prices, such as:
 - ◇ Foreign exchange risk (unanticipated movements in exchange rates)
 - ◇ Profit rate risks (changes in the net profit income as a result of changes in profits and shifts in composition of assets and liabilities).

The need for hedging against investment and finance risks

- Hedging is one strategy for managing and minimizing risk in an economic activity, such as business or investment.
- Islamic finance has prescribed certain measures to manage and minimize risk in line with the spirit of preservation of wealth in the *maqasid al-Shari'ah*.
- In various legal maxims, it becomes principle that avoiding harms (which can be through risk management) is required.
 - ◇ 'la darara wa la dirara' (harm should neither be initiated nor reciprocated).
 - ◇ 'al-darar yuzal' (Harm must be eliminated).
 - ◇ 'al-darar yuzal bi qadril imkan' (Harm must be eliminated as much as Possible).
 - ◇ 'Daf' ul-madarrah muqaddamun 'ala jalbil-manfa'ah' (Repelling harm takes priority over seeking benefit).

The need for hedging against investment and finance risks

- Islamic Banks retail portfolio mostly consist of fixed profit rate assets on a Murabaha basis while liabilities to corporate customers are on floating rate benchmarks.
 - ◇ Rate of Return mismatch in Assets & Liabilities require protection against steep rise or fall in reference rates of return.
- Islamic Banks' foreign currency exposures such as deposits, import & export L/C's, Sukuk etc.,
 - ◇ The foreign currency exposures need to be managed to avoid loss due to volatility in the international currency markets.

Islamic Hedging Instrument

- Hedging, **can be one of the instruments** in managing risk in Islamic finance.
- Hedging should be used **for managing risk purposes** and not be leading to speculation as in zero sum games that threaten financial system stability.
- Dallah Barakah Resolution No. 2/28, 28th Barakah Symposium, Jeddah, 16 Sept 2007 issued resolutions:
 - ◇ In Islamic financial activities, the pre-condition is that investors bear the risks. This is based on the principle of “*al-ghunmu bi al-ghurmi*” which means that entitlement to profit is accompanied by responsibility for attendant expenses and possible loss. Therefore, any investment activities based on the separation between “*al-ghunm*” (profit) and “*al-ghurm*” (losses), where investors are qualified to receive profits without bearing “*daman*” (responsibility for losses or risks), are not allowed.
 - ◇ Managing risk through hedging (*tahawwut*) is allowed if it is in line with Shariah mechanisms, contract and instruments and as long as they do not bring about matters that contravene Shariah principles.

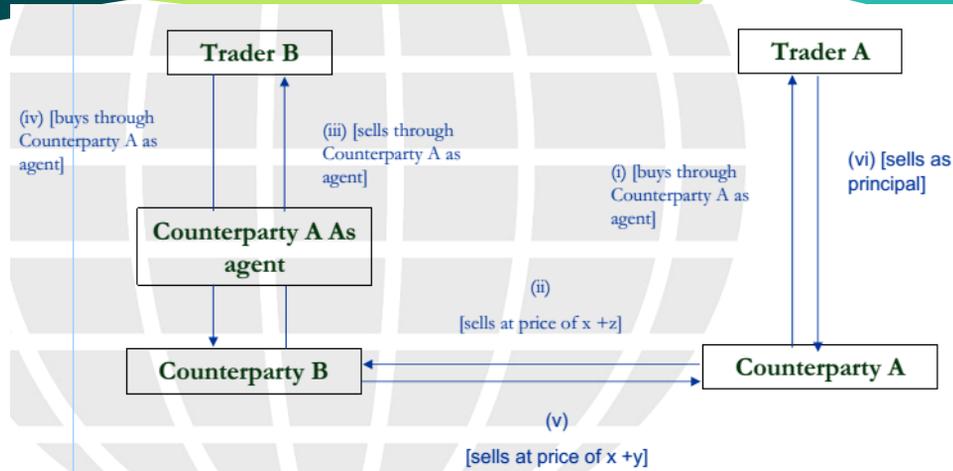
Islamic Hedging Instrument

- Islamic banking and financial institutions have **modified the existing conventional hedging instruments** using Islamic contract for hedging purposes.
- The product of hedging such as the following:
 - ◇ Islamic Profit Rate Swap (IPRS)
 - ◇ Islamic Cross Currency Profit Rate Swap (ICCS)
 - ◇ Islamic Forward Rate Agreement (IFRA)

Islamic Profit Rate Swap (IPRS)

- An Islamic profit rate swap (*Mubadalatul arbaah*) is an agreement to exchange profit rates between a Fixed Rate Party and a Floating Rate Party, or vice versa, implemented through the execution of a series of underlying Shariah contracts.
- Purpose: to manage exposure to interest rate and profit rate movements.
- It is designed to protect financial institutions from fluctuations in borrowing rates and to provide a risk control mechanism.
- *Wa'ad* contract is being utilised so as to ensure the swap reaches maturity.
- Before each commodity *murabahah* stage and reverse *murabaha* stage in the following structure, a *wa'ad* is given by each counterparty respectively.
- The *wa'ad* ensures that the promisee undertakes to enter into that relevant commodity *murabaha* or reverse commodity *murabaha* trade.
- This will continue until the swap expires

Islamic Profit Rate Swap (IPRS) - *Tawarruq*



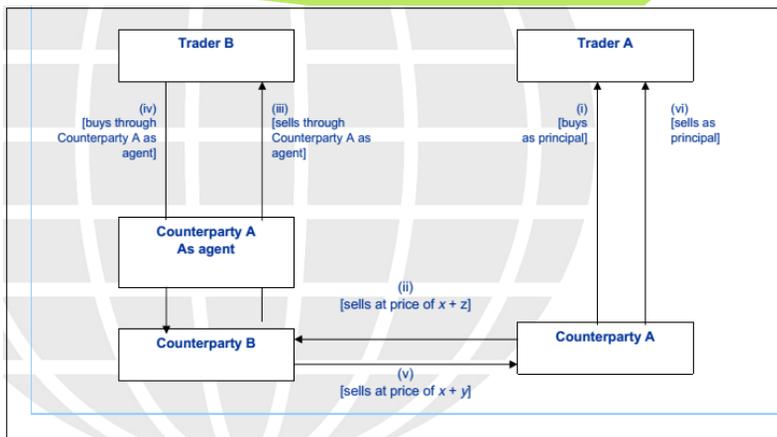
Islamic Cross Currency Swap (ICCS)

- Islamic Cross Currency Swap (ICCS) is an agreement to exchange profit rates between a Fixed Rate party and a Floating Rate Party or vice versa implemented through the execution of a series of underlying contracts to trade certain assets.
- In addition to transaction of assets, there is element of spot foreign exchange contract, applying the Shariah concept of *Sarf* (foreign exchange).
- ICCS enables counter-party to switch their asset or liability from one currency to another to :
 - ◇ Hedge currency risk
 - ◇ Profit rate risk

Islamic Cross Currency Swap (ICCS)

- ICCS Implementation is by the execution of a series of underlying Murabahah contracts on commodities.
- ICCS is structured based on three (3) acceptable Shariah concepts:
 - ◇ Spot Foreign Exchange (Sarf)
 - ◇ Tawarruq (Commodity Murabahah/Musawamah). The difference between Murabahah and Musawamah is that Musawamah is a general and regular kind of sale in which price of the commodity to be traded is bargained between seller and the buyer without any reference to the price paid or cost incurred by the former while in Murabahah there is a need to refer to the price paid or cost incurred by the seller
 - ◇ Promissory Foreign Exchange

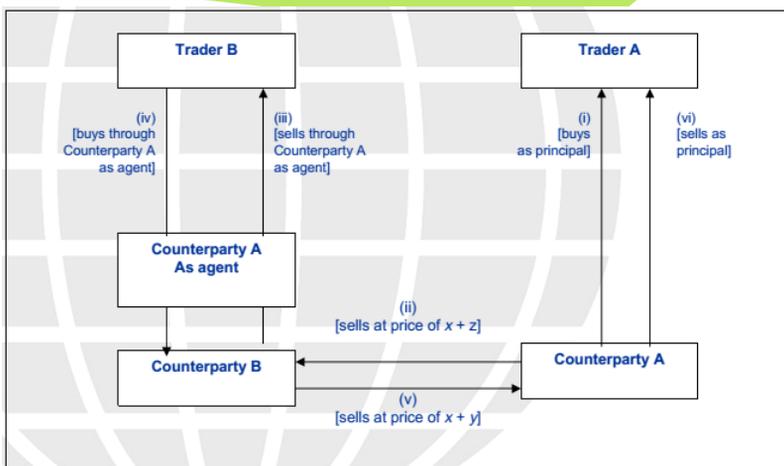
Islamic Cross Currency Swap (ICCS) – case study Commodity Murabahah



Islamic Forward Rate Agreement (IFRA)

- Islamic Forward Rate Agreement (IFRA) is an agreement between two (2) parties to exchange one payment of profit denominated in a single currency for another payment of profit denominated in the same currency, based on a notional principal amount, at single specified period.
- IFRA differs from Islamic Profit Rate Swap (IPRS) as in IFRA, only one payment of profit is exchanged while in IPRS, it involves a series of profit payments.
- IFRA can be structured using the Shariah concepts of *Tawarruq* (tri-partite sale) (Commodity Murabahah)
- Implementation is by the execution of a single Murabahah contracts on commodities

Islamic Forward Rate Agreement (IFRA)



3.

Shariah Issues in Hedging Instruments

Shariah Issues in Hedging Instrument

1. GHARAR

- Islamic contract require clarification and specification of products, price and time delivery.
- Selling and buying could only be done if the products is exist and in the possession of seller.
- Issue of *gharar* in Swap, forward and future contract, is term:
 - ◇ Delivery of goods and payment of price in the future,
 - ◇ Certainty and ability of contracting parties to fulfil their contractual obligations.
- A plausible answer for *gharar* issues currently is that an organized, liquid and highly regulated futures exchanges and markets alleviates much of that risk, hence *gharar* can be eliminated.

Shariah Issues in Hedging Instrument

2. Combination of several contracts/agreement in Islamic hedging instrument

- AAOIFI's Council of Shariah Advisors in its Resolution No.25 has prescribed that combining more than one contract is permitted, provided that:
 - ◇ Contracts' combining should not include the cases that are explicitly banned by Shariah. For example, contracts that combines sales and lending into one contract.
 - ◇ Contracts' combining should not be used as a trick for committing usury (*riba*).
 - ◇ Each contract itself is permitted in Shariah and each contract must stand independently, that is, without binding one another (*uqud mustaqillah*).
 - ◇ Each contract cannot in anyway indicate of having any condition between one contract with another contract.
 - ◇ Combined contracts should not reveal disparity or contradiction with regard to their underlying rulings and ultimate goals.

Shariah Issues in Hedging Instrument

3. WA'AD ARRANGEMENT

- In Islamic Swap and forward arrangement, wa'd (promise) has been instilled in the arrangement.
- A wa'd is a binding unilateral promise and is binding one way only.
- Before each commodity *murabahah* stage and reverse *murabahah* stage in the following structure, a wa'd is given by each counterparty respectively.
- The wa'd ensures that the promisee undertakes to enter into that relevant commodity *murabahah* or reverse commodity *murabahah* trade.
- This will continue until the swap expires.
- The Islamic Fiqh Academy has decided that the wa'd 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.

Shariah Issues in Hedging Instrument

3. WA'AD ARRANGEMENT

- 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-aqad*) and not at the time of the *wa'd*.
- The promisee also has the possibility to claim actual damages from the promissor, if the latter backs out on a *wa'd*.
- *Wa'dan* (two unilateral promises) has also been arranged in the transaction.
- This is allowed if the effect of the promise will not take place at the same time as in bilateral promise (*mu'awadah*).
- For bilateral promise (*mu'awadah*), AAOIFI in its Shariah Standard No.1 on Trading Currencies clearly mentioned that: "A bilateral promise is prohibited in currency trading when it is binding upon both parties, even when it is done to treat the risk of decline in a currency's value. As for a unilateral promise from one party only, that is permissible, even if it is binding".

Shariah Issues in Hedging Instrument

4. BAY' SARF

- The transaction that involves exchange of two currencies is regulated in *bay' al-sarf* contract.
- The problem with the conventional FX forward structure arises when the parties involved want to exchange the currency sometime in the future but have already fixed a rate today while the contract is also sealed today.
- This contravenes to the basic Shariah rules governing the exchange of currency (*bay' al-sarf*).
- In *bay' al-sarf*, it is a requirement for an exchange which involves two different currencies to be transacted on spot basis.
- This is based on the Hadith:

الدَّهَبُ بِالذَّهَبِ، وَالْفِضَّةُ بِالْفِضَّةِ، وَالْبُرُّ بِالْبُرِّ، وَالشَّعِيرُ بِالشَّعِيرِ، وَالشَّرُّ بِالشَّرِّ، وَالْمِلْحُ بِالْمِلْحِ،

Shariah Issues in Hedging Instrument

5. BAY' TAWARRUQ

- *Tawarruq* in swap and forward arrangement take place in the form of series of *murabahah* sales transactions.
- *Tawarruq* is a three-party or four party transaction whereby a person buys an asset from a seller on deferred payment terms- on credit and later on he sells the asset to a third party buyer or to the market at large, on cash basis.
- The result he gets cash, but indebted to the first seller.
- It is allowed on the basis that it is like a normal sale transaction if real ownership is really taking place.
- Nevertheless, there is a concern on organized *tawarruq* (*tawarruq munazzam*) which is claimed to be a *hilah* for ribawi transaction and brought similar effect .

Shariah Issues in Hedging Instrument

6. BAY' ARBUN

- The practice of hedging, especially in call options uses bay' al-*arbun* as a contract that would legitimate its practice.
- *Urbun*: the right to buy based on the partial payment on the price of goods. *Bay al-Urbun* is a sale involving *urbun* i.e the earnest money. The seller does not return the *urbun* in case the latter does not confirm the contract.
- The arrangement is as follows:
 - ◇ The buyer deposits earnest money with the seller.
 - ◇ If the buyer proceeds to purchase the goods, the earnest money is considered as part payment of the price.
 - ◇ If the buyer does not proceed to purchase the goods, the buyer forfeits the earnest money deposit.

- Hanbali scholars find *al-urbun* permissible:
 - ◇ Practice of Caliph Umar: Nafi bin al-Harith, Caliph Umar's officer, purchased a house (for conversion into a prison) from Safwan bin Umayya on condition that if the Caliph approved of it, the deal would go through, otherwise Safwan could keep the *urbun* of 400 dirhams.
 - ◇ All other fiqh schools (Malikiyah, Hanafiyah, Shafi'iyah) find *al-urbun* unacceptable based on a Hadith narrated by Amru' Ibn Syu'aib that "The Prophet (Peace Be upon Him) forbade (us) from the sale of urban" (Abu Daud).
 - ◇ They also consider the retention of earnest money by the seller akin to misappropriation of the property of others (*akl amwal al-nas bi al-batil*).
- OIC fiqh Academy in their 8th Seminar, 1-7 Muharram 1414H, in Brunei Darussalam issued resolutions:
 - ◇ The time frame of the contract should be predetermined.
 - ◇ The *urbun* deposit is considered as part of the selling price if the purchase is carried through.
 - ◇ It is not applicable in the sales which stipulate the reception of either of the two elements of exchange in the contract setting i.e. the *salam* sale; or the reception of the two elements of exchange in the contract setting i.e. money and currencies exchange.

- A call option can be considered near to *Bay' al 'Arbun* in the sense that the seller does not return the premium or advance payment to the buyer if the latter does not exercise the purchase option and the buyer loses the option premium even if the option is exercised and the contract is confirmed.
- In the case of *Bay' al 'Arbun*, however, the option premium is adjusted in the sale price when the contract is confirmed.
- But a call option is different from *bay al-urbun* when in the former the buyer loses the option even though the option is exercised and the contract is confirmed.

THANK YOU VERY MUCH

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