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# An Overview on the Practice and Issues of Hedging in Islamic Finance

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## Abstract:

In terms of Islamic banking, which relies on three main pillar of prohibiting Riba, Gharar& Maysir, risk management is still not sufficiently developed. Indeed, Islamic use traditional types of risk management instruments used by conventional banks. Despite Islamic banking has a specific characteristic related essentially to the Profit & Loss Sharing (PLS) principle in Mudarabah & Musharakah contracts. Such instruments change the classic concept of risk in comparison with conventional banks adding new types of risk such as Commodity/Asset price risk and Bundled risk along with neutralizing other type of risks like the liquidity risk.

Nevertheless, the rigidity of some Sharia'a scholars has impeded some financial instruments that try to match the real risk management demands by business entities in the global Islamic finance industry. Indeed, it has been widely acknowledged by many observers that the Islamic finance industry will not be able to sustainably continue on this growth trajectory, and may even regress, without a proper market risk management framework that can effectively deal with the complex risks that exist in today's globalized economy (Chapra& Khan, 2000; Moody's, 2010).The present research article is an attempt to analyze hedging instruments from an Islamic finance perspective. It will approach different fiqhi ruling on them along with the applicability of these instruments in the reality.

**Key Words:** Risk Management, Islamic Finance, Hedging, Futures.

## Résumé :

En ce qui concerne la finance islamique, qui se base sur trois piliers principaux à savoir la prohibition du riba, gharar & maysir, la gestion des risques n'est pas encore efficacement développée. En effet, les banques islamiques font appel aux instruments financiers utilisés par les banques traditionnelles. Sachant que les banques islamiques ont un caractère spécifique liée au principe du partage des profits et des pertes dans les contrats mudarabah et musharakah. Ce principe change, en effet, la définition usuelle du risque connue jusqu'à présent dans le secteur conventionnel, ce qui peut ajouter d'autres types de risques liés aux risque d'actifs mais aussi ceci peut permettre de neutraliser d'autres risques comme celui lié à la liquidité.

Pourtant, la rigidité de certains spécialistes de la shari'ah à entraver l'essor des instruments de couverture contre les risques qui essayent de répondre à la demande des acteurs de la finance islamique. Par

conséquent, la majorité des instruments de couverture conventionnels ont été bannis même si ils ont pour but une couverture contre des risques réels et n'ont pas pour la spéculation.

Beaucoup d'observateurs ont conclu que la finance islamique ne saura pas garder un niveau croissant de développement sans avoir un marché d'instruments dérivés compatibles à la shari'ah qui peuvent répondre au caractère complexe du risque sur les marchés au risque de voir l'industrie régresser (Chapra & Khan, 2000 ; Moody's, 2010). Le rapport suivant est une tentative d'analyser la pratique de couverture des risques financiers en finance islamique et plus précisément les contrats Futures liés au huile du palmier brut. Ce dernier va aborder les différents points de vue d'un point de vue shari'ah et de l'efficacité économique de ces contrats et leur retombés sur l'économie réelle ce qui peut soutenir ou réfuter les points de vue actuel sur le sujet.

**Mots Clés :** Gestion des risques, Finance islamique, Futures, couverture.

## **Introduction:**

The globalization of financial markets since the 80s, the emergence on new financial institutions and the development of new information technologies have amplified the risks endured by institutions and precisely banks for the reason that risk is in the main component of the value creation to the shareholders. Historically speaking, Modigliani-Miller theorem have consisted that the value of a firm is independent of its risk structure; firm should simply maximize expected profit, regardless of the risk entailed; the value creation is simply generated through optimal allocation of resources. However, the variety of markets' biases cause the M&M theorem to fail and create a role for risk management. The dictionary of Financial Terms defines Risk as the possibility you'll lose money if an investment you make provides a disappointing return. All investments carry a certain level of risk, since investment return is not guaranteed, it may be resumed as the uncertainty regarding future incomes. Thus, risk management takes a central role in banks daily work and they need to have some process of risk management.

Islamic finance is a rapidly growing part of the financial sector in the world. Moreover, Islamic finance industry has overtaken interest outside Muslim world. More recently, conventional financial markets seem to show keen interest in IF. Its stability and resilience during the 08 financial crisis have provided a safe alternative for many investors.

The impressive growth track of Islamic banking over the last few years has created high expectations in the stake-holders and has compelled the major players of the banking industry, investors as well as regulators and government to view it as a separate segment in the banking industry. In addition to that, we count more than 700 Islamic Financial Institutions are

operating across the globe with around US\$1.2 trillion<sup>1</sup> assets under management in more than 85 countries essentially the nine core markets (Bahrain, Qatar, Indonesia, Saudi Arabia, Malaysia, United Arab Emirates, Turkey, Kuwait and Pakistan). Together, they account for 93% of industry assets, estimated to exceed US\$920 billion<sup>2</sup> in 2015. Financial Institutions from Middle East, Far East, US and Europe to Africa, South and Central Asian republics are offering Islamic banking services. The industry is growing at a rate of roughly 15-20<sup>3</sup> percent per year, and could serve 40 to 50 percent of the world's Muslim population within a decade. According to a recent estimate by Standards & Poors the market potential for Islamic banks is estimated at \$ 4 trillion.

During the last two decades, Islamic banks created many creative profit-sharing instruments that enabled them to compete with their counterparts. However, this attempt to maximize their Return on Assets (ROA), Islamic financial institutions is exposed to risks. Indeed, The annual reports of Islamic banks worldwide for the period between 2004 and 2011 on 65 full-fledge Islamic banks across the globe concluded that credit risk and interaction between credit risk and rate of interest risk have significant negative impact on the return on assets (ROA) which is a main indicators of banks' profitability. Consequently, the implementation of a risk management process in the Islamic banks is linked directly to their performance. Also, Bank Negara Malaysia stated that International Regulators must pay put effort in studying risk affecting the banking industry. To

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<sup>1</sup> Ahmed Ali Siddiqui, Executive Vice President, Product Development & Shariah Compliance, Meezan Bank Limited

<sup>2</sup> World Islamic Banking Competitiveness Report 2016

<sup>3</sup> fourth edition of the Islamic Financial Services Board's (IFSB) Islamic Financial Services Industry Stability Report

quote “An increase in interest rate would trigger credit risk as it leads to an increase in the number of loan defaults, the increase in interest rate could also lead to liquidity problems.”

As hedging provides protection for economic agents, it would not seem surprising that it should fall into one Maqasid Al-shari’ah which is the preservation of wealth. Hence, Islamic finance offers various instruments for hedging purposes as the complexity of international markets give rise to new typology of risk. Obaidullah (2005) rightly notes, “The provision of hedging facility is hardly an adequate rationale for tolerating Qimar and Maysir. The Shari’ah does not disapprove of hedging, since it brings in some It is the zero-sum nature of the game that the Shari’ah finds objectionable, as in it lie the roots of social disharmony and discord.” Thus, the necessity of hedging is crucial to protect the wealth as it falls into Maqasid Al-shari’ah. However, conventional instruments, mainly derivatives, cannot separate hedging from speculation.

This paper will try to approach the concept of hedging in Islamic finance along with presenting the different instruments offered to mitigate risk. For that, the first part of this paper will emphasize on the notion of risk in Islam then, it will be question of presenting the available tool of hedging on the market along with the main shari’ah issues around them.

### **The Notion of Risk in Islam:**

The necessity to take risk is in the core of value creation in any nation. In fact, on one hand experts and specialists agree that no economic growth can take place without taking risks. “Nothing ventured nothing gained” is the first principle of investment. (Al-Suwailem, 2006b). Hence, Islam put risk in the core of its concern by emphasizing and insisting on equity-based financing to simulate growth and prosperity.

Muslim jurists use both khatar (Risk) and mukhatarah (Risk taking) for business risk. Mukhatarah is defined as “possibility of unexpected outcomes” (Al-Sharbasi, 1981). Khatar and mukhatarah are interchangeably used with gharar (Uwaidah, 2010). (Al-Amine, 2008) concludes that the concept of risk according to Muslim jurists is almost similar to what is defined by conventional economists. However, some might argue that there is a distinction between the concept of risk as khatar and the concept of gharar. The response to that from

Islamic finance perspective is that the first notion refers to a tolerated level of gharar which exist in every commercial transaction. While gharar as that element of uncertainty in exchange transactions in case spotted in a contract make it void from Shari’ah point of view is the excessive type to which hedging does not apply.

Risk is an essential component of all Islamic transaction as no one can claim any compensation without bearing risk. Indeed, under the rules of shari’ah, return is directly linked to the exposure of an ex ante investment risks according to the fiqhi rule “al-ghounmu bil al-ghourm”. Also, returns assume liability “Al-kharaju bi Daman” meaning that any profit occurs after a liability. As for the typology of risk, Ibn Taymiah (728H – 1328G) cited that risk falls into two categories: commercial risk, where one would buy a commodity in order to sell it for profit, and rely on Allah for that. This risk is necessary for merchants, and although the probability of loss exists, but this is the nature of commerce. The other type of risk is that of gambling, which implies eating wealth for nothing. This is what Allah and his Messenger (peace be upon him) have prohibited.

If we define risk as possibility of loss, then it becomes clear from an Islamic perspective that risk as such is not desirable as Islam through Maqasid Al-shari’ah (Supreme goals of Islam) clearly call for the preservation and development of wealth. Exposing wealth to loss cannot be a goal in itself. In fact, al-Qarafi clearly states that i.e. protection of wealth, is desirable for rational agents (Al-Suwailem, 2006a).

The legal maxims that frame the notion of risk in Islamic law can be presented as follow:

Islamic scholars have come up with three legal maxims that frame the practice of risk management within IFIs. In this section three legal maxims are discussed with reference to its application in the industry.

- Harm is to be eliminated (الضرر يزال)

This maxim provided by the lawgiver is either to secure benefit or to prevent harm. The element that brings harm to the community should be eliminated. The word darar means danger and injury. Thus, this maxim aims to secure public benefit and flexibility and avoids rigidity and complexity. As risk matches the definition of harm and danger, it is encouraged to managed by the mean of risk sharing not risk shifting.

- Benefit goes with liability (الخروج بالزمان)

Linguistically in the Arabic language, *kharaj* means yield and return and *Daman* refers to liability and responsibility<sup>4</sup> with different other meaning in Islamic fiqh. However, in this case, its meaning is the liability of the asset in case it is damage or destroyed. As liability comes always with risk, mitigating it is an important element based on this maxim. Additionally, Islamic law links return and liability which falls into most of commercial transaction as no one can claim any compensation without taking any risk.

- Liability accompanies gain (الغرم بالغنم)

This maxim can be considered as an inverse or extension of the previous maxim. The general meaning of this maxim is that the owner should bear all risks and costs that attend ownership of the asset since he is entitled to enjoy any benefit resulting from it (Abdallah, Hassan, & McClelland, 2015).

### **Hedging in Islamic Finance:**

A hedge is a position established in one market usually in the context of one's commercial activity, in an attempt to offset exposure to the price risk of an equal but opposite obligation or position in another market (Zahan, S. Kenett, 2011). Hence, the practice of hedging aims to protect an investment against the risk of a probable loss due to the markets fluctuations. Varieties of these instruments are traded both in the conventional as well as in Islamic financial markets such as SWAPs, Futures, Islamic FX forward and Islamic profit rate SWAP. Despite the fact that the majority of Shari'ah standard-setting authorities agree on the need of hedging, divergences still remain concerning the legality and Shari'ah compliance of certain Islamic hedging instruments.

This reserve is relatively justified for the reason that hedging instruments are the main reason behind the 08 financial collapses. Indeed, the practice of hedging caused the 2008 financial crisis amplifying the risk in the financial markets. The risk taking of hedge funds was more dangerous than other financial institutions because they used the mechanism leverage using sophisticated derivatives to borrow money. That created higher returns in a good market and greater losses in a bad one. As a result, the impact of any downturn was enormous. In fact, low interest rates meant bonds delivered lower results

to pension fund managers. They were desperate to earn enough to cover their expected future payments. As a result, massive amounts of money poured into hedge funds. Consequently, the choc was big and general.

Hedging is acceptable in condition that it matches with a number of Islamic contracts that aimed at minimizing risks and unwanted circumstances and aligns with one of the general objective of Shari'ah which is the protection of Wealth.

Indeed, the IFSB insisted on its 1<sup>st</sup> IFSB on the primordial necessity to implement a Risk Management Process within Islamic Banks (IB). To quote "IFS shall have in place a comprehensive risk management and reporting process, including appropriate board and senior management oversight, to identify, measure, monitor, report and control relevant categories of risks and, where appropriate, to hold adequate capital against these risks. The process shall take into account appropriate steps to comply with Shari'ah rules and principles and to ensure the adequacy of relevant risk reporting to the supervisory authority".

Dallah Al-Baraka (2002) in its Resolution 6/27 describes the practice of hedging as "an agreement where parties agreed to enter into a contract in the future for the protection of the buyer and seller as a safeguard against fluctuations of the market rates". Bases on this definition, we can say that the definition of hedging in Islamic finance is quiet similar to its definition in conventional finance which implies the existence of a general consensus among shari'ah scholars to the necessity of hedging.

However, the question that arises is on which ground the practical framework of Islamic hedging instruments should come from. The reason to ask this question is that current hedging instruments in conventional finance mainly "derivatives" are based on a model of risk transfer that creates more risk in the system. In the case of risk transfer and shifting model, risk is commoditize through its separation from the original transaction. This process of commoditization of risk leads to its proliferation in the system. The normal result of this situation is more instability and therefore, more recurrent crisis.

Consequently to that, Muslim scholars have created a new category of tolerated risk which shall be hedge against it. It is mainly based on risk sharing or, technically speaking, on a zero-sum

<sup>4</sup> Hans Wehr : 546.

game where the outcomes benefit to both counterparties and the element of excessive gharar is neutralized.

**Islamic Hedging Instruments:**

**Islamic Options:**

The first type of instrument to be presented will be based on the existing structure of Option contracts. A conventional financial option is often traded as a separate contract in itself. The contract involves a right to purchase or sell an underlying asset at a stipulated price within or at the end of a specified time period (Obaidullah, 1998). In such contracts, the possibility of conflicts between the parties because of their abrupt, irrational and wrong decisions is minimized because of the period between the entering into the contract and the settlement date. Another important reason may be that under conditions of excessive Gharar or uncertainty regarding the article of exchange, price etc., options for the parties are provided to reduce Gharar and bring it within Islamically acceptable limits (Obaidullah, 1998).

Options are often unacceptable in the Sharia'ah. However, there is no consensus regarding the specific objections to options.

Some contemporary scholars, such as, (Abu Sulayman, 1992), (Kamali, 1995), who have attempted an evaluation of such contracts, have used a generic term, al-ikhtiyarat, a variant of the term al-khiyar, which normally is the classical Fiqh concept for various kinds of embedded options, as mentioned above. (Abu Sulayman, 1992) uses the terms ikhtiyar al-talab, ikhtiyar al-daf, and fatrah at-ikhtiyar for describing call options, put options, and option period respectively. Furthermore, the view of some Shari'ah scholars is that an option is a promise to sell or purchase a thing at a specific price within a stipulated time and such a promise in itself permissible. The promise is also binding on the promisor. However, this promise cannot be the subject matter of a sale or purchase.

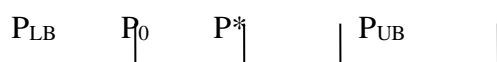
The problematic issue about the use of options in Islamic Finance includes prohibition of gambling (Maysir), unnecessary risk taking (Gharar), and of transactions based on ignorance (Jahl), trading in permitted (Halal) products only, presence of mutual consent for entering into or canceling contracts and the nature of the underlying asset (mal).

As the options are not an interest based product on itself, their use should not defer form conventional banks to Islamic banks. Hence, two main applications can be deduced in the existing literature: Bay' Al-urbun & Al-istijrar.

**Al-istijrar:**

It involves two parties, a buyer which could be a company seeking financing to purchase the underlying asset and a financial institution. The contract has embedded options that could be triggered in the underlying asset's price exceed certain bounds. The contract is complicated as it constitutes a combination of options, average prices and Murabahah or cots plus financing. A typical Istijrar transaction could be as follows; a company seeking short term working capital to finance the purchase of a commodity approaches a bank. The bank purchases the commodity at the current price ( $P_0$ ), and resells it to the company for payment to be made at a mutually agreed upon date in the future. The price at which settlement occurs on maturity is contingent on the underlying asset's price movement from  $t_0$  to  $t_n$ . Where  $t_0$  is the day the contract was initiated and  $t_n$  is the  $n^{th}$  day which would be the maturity day. Unlike a typical Murabahah contracts where  $P^* = P_0 (1+r)$  with  $P^*$  is the price on maturity and  $r$  is the profit rates, the  $P^*$  in Istijrar contract could be  $P^*$  cited above or an average price  $P$  of the commodity between  $P_0$  and  $P_n$ . The embedded option is the right to choose to fix the price at which the settlement will occur at any time before maturity.

The different prices are shown below:



Where:  $P_0$ : Purchasing price of the commodity

$P^*$ : Murabahah price

$P_{LB}$ : The lower bound price

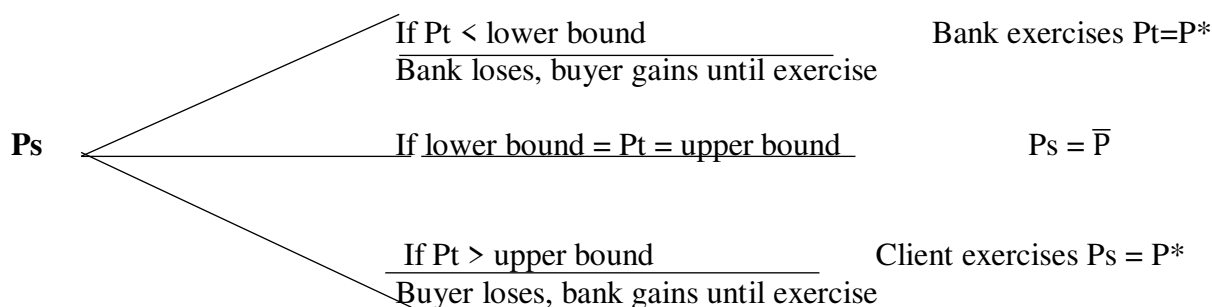
$P_{UB}$ : The upper bound price

The settlement price ( $P_s$ ) at  $t_n$  would be:

$P_s = P$  the average price of the commodity during the period if the price remained within the bounds

$P_s = P^*$  if the price exceeded the bounds.

Accordingly, the payoffs of the contracts are as shown below:



**Fig.1. the Payoffs of Istijrar Contract**

**Source:** Financial Derivatives: Markets & Applications in Malaysia, Bacha (2012), p392

Consequently, the exercise price of the option is based on the expectation of both counterparties on the fluctuation of the price of the assets during the period of the contract. However, in the case of an Islamic regulation sphere, the hedging instrument is no longer a zero-sum game as both parties get benefits from the contract from the sharing of risk in which the settlement price brings always benefit for both of them.

**Bay’ Al-urbun:**

Some scholars have justified the permissibility to options by drawing a parallel with Bay’ Al-urbun. Urbun refers to a sale in which the buyer deposits earnest money with the seller as a part payment of the price in advance but agrees that if he fails to ratify the contract he will forfeit the deposit money which the seller can keep.

We can assimilate this Bay’ Al-urbun to a call option in the sense that the seller does not return the premium or advance payment to the buyer. The accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI, 2008) in standard 1, trading in currencies, has pointed out the impermissibility of options in Shari’ah but has instead approved the use of Urbun. Moreover, the Shari’ah Advisory Council (SAC) concluded that the concept of bay`urbun is permissible and can be developed as an instrument in the Malaysian Islamic capital market. It has been a common practice in any society to pay a deposit in a business transaction so that the parties involved will not lose their rights within a certain given period. This does not contradict Shari’ah

principles because it is `urfsahih to ensure the smooth running of a mu`amalah. Bay`urbun is permissible because the hadith of the Prophet s.a.w. which indicates the prohibition is weak.

The pricing of Bay’ Al-urbun will be defined by the famous formula of Black & Scholes. Many similitude can be spotted between bay` Al-urbun and a call option. However, there is two main differences between the two instruments:

- The deposit in the case of Bay’ Al-urbun is a part of the global price in the opposite of the premium paid which is a non-refundable payment;
- During the transaction, the bank should detain the underlying assets as Shari’ah forbids intangible financial transactions.

The model will allow calculating the amount of urbun based on the possible outcomes of the underlying asset up to maturity under the assumption that prices follow a normal distribution with a Gaussian curve. Thus, the price of the deposit will be determined as the mean of the possible intrinsic values weighted by their probabilities.

**IslamicFX Forward Contract:**

The basic mechanism for the application of this type as it is the only one offered by Islamic bank is the concept of wa`ad. Al-Wa`ad means promise which connotes an expression of willingness of a person or a group of persons on a particular subject matter. In a commercial transaction, a promise has a dual meaning. This is because, in a unilateral contract, the offer of the offeror is

known as promise, while in a bilateral contract, the acceptance of the offeree is known as promise as well (Salwani, 2008). This definition opens the door for multiple application of wa'ad within the framework of Islamic risk management especially in FX contract. In fact, a forward contract in the Forex market locks in the price at which an entity can buy or sell a currency on a future date. It is also known as "outright forward currency transaction", "forward outright" or "FX forward". Before detailing the use of wa'ad in FX contract, we must refer to the Malikis' opinion on this issue. Indeed, Malikis' scholar of thought does not permit promise done in currency transaction except on the spot or immediately. This is in parallel to the hadith of the prophet, Bello & Hassan (2013). This opinion is justified by the hadith of the prophet "gold for gold, silver for silver, wheat for wheat, barley for barley, dates for dates, salt for salt, like for like, equal for equal, and hand-to-hand (spot); if the commodities differ, then you may sell as you wish, provided that the exchange is hand-to-hand or spot transaction"<sup>5</sup>. However, Imam Shafi'i permit promise of sale and purchase of currency as stated in Kitab al- Umm, "If two persons promise on currency there is no restriction for them to buy dirham, then both of them agree upon one of the price until they execute the sale and purchase agreement" (Bello & Hassan, 2013).

Shari'ah council of AAOIFI had explained that the original hukum for currency transaction is permissible, because it includes in the general provision of shari'ah which allow currency transaction. It is one of the sources of income as long as it is not contrary to Shari'ah. However, Shari'ah council of AAOIFI also decided that the promise in currency exchange which is mulzim in nature is prohibited as proclaimed by the consensus opinion of jurists. This is because the promise which is mulzim in nature by both parties is just like a formal contract. Should the promise is done by one party; it is permissible though it is mulzim in nature.

As for those who recognized al-wa'ad in currency exchange, the delivery of the exchange can be made within three days after the dealing which is still considered as spot according to the view of Imam Malik, who made an analogy with Salam

contract. Any time longer than that will amount to riba as the principle stated before. Therefore to avoid such thing and having a longer period with the fluctuation of the market price, here al-wa'ad will come into the picture where it will take effect from the time the dealing is made without concluding any contract, until the delivery day.(Bello & Hassan, 2013).

FX forward contracts based Islamic wa'dan is needed as it seeks to meet hajiyyahmaslahah of people. The hajiyyah is more prominent when it involves a larger organization such as a large investment bank or multinational companies seeking to hedge. The principle of wa'danalso required to make a hedging product that is comparable to conventional (Ahmad, Yaacob, & Mat Zain, 2014).

In order to illustrate the concept of FX Forwards in IF, let us suppose a customer-IFI relation. The customer promises on the 1<sup>st</sup> of June 2017 to buy USD10 million from the IFI on the 1<sup>st</sup> of July 2017 at the exchange rate of 9.95 MAD/USD. The customer is bound by the unilateral promise.

On the 1<sup>st</sup> July 2017, the IFI pays USD10 million to the customer and receives MAD99.7 million from him.

The currency exchange is complete and the customer receives USD10 million with the agreed exchange rate regardless of the market rate.

### **Futures:**

The only tradable Future contract with shari'ah compliance is Crude Palm Oil Future (CPOF) in Malaysia. In spite of the existence of many shari'ah rulings against the use of futures<sup>6</sup>, the Shari'ah Advisory Council (SAC) in Malaysia in its eleventh meeting, on November 26, 1997, resolved that the Crude Palm Oil Futures (CPOF) is in accordance with shari'ah principles. The

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<sup>6</sup>The ruling of the Islamic Fiqh Academy of the Muslim World League IFA-MWA in 1985 (as cited in Al-amine, 2008: 14). The IFA-OIC in 1992 resolved for relatively the same reasons advanced by the IFA-MWL that commodity future contract are prohibited as both payment and delivery take place in the future. The AAOIFI issued a ruling in 2004 that categorically prohibit commodity future contract. Indeed, the organization confirmed that futures are prohibited neither forming them nor trading them. The basis for this ruling if the verse in *surat Al-nisa'* (4:29).

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<sup>5</sup>Mishkat, on the authority of Bukhari's "Tarik", and Ibn Taymiyyah's "Al Muntaqa" translation by M. 'UmerChapra. See also Sunnah al-Bayhaqi, Kitab al-Buyu", translation by 'UmerChapra.



SAC ruled that CPOF are free from elements of Gharar and Maysir; and even if such elements exist, the trading regulations have overcome them (Securities Commission, 2006: 75).

On the issue of delivery date, the SAC argued that there is no element of gharar in the crude palm oil futures contract as, when the contract is offered, specifications such as its quantity, type, price and delivery date are made known to market players. However looking into the crude palm oil contract specification, it only provides for the delivery or tender period to be on the 1st business day to the 20th business day of the delivery month; or if the 20th is a non-market day, then the next preceding business day (Securities Industry Development Corporation, 2007). Hence, the question is whether this tender period could amount to gharar. On the issue of the sale of a non-existent or non-possessed crude palm oil, the SAC argued that this issue is not relevant. According to the SAC, the prohibition of bay' ma'dum (buying something that does not exist) is due to the element of uncertainty in handing over the sold goods and not due to the non-existence of the object at the time when the contract is being made. In support of this proposition, the SAC refers to salam and istisna'. In the contract of istisna' the subject matter of istisna' is definitely non-existent at the time of the contract while the subject matter of salam may be non-existent (Securities Commission, 2006). Furthermore, the SAC argued that there is no element of gharar as the contract can be settled in cash before the maturity date or by delivery on the maturity date. The SAC supported their argument with the existence of the Clearing House which ensures the delivery and settlement of crude palm oil futures contracts. Even if there is gharar, it is eliminated by the crude palm oil futures contract trading regulation which provides for surveillance and insurance against any cheating (Securities Commission, 2006).

The main point of divergences between the different rulings could be summed up as follows:

- The deferment of both counter-values
- The sale of a non-existent CPO
- The sale of debt.

The main opinions expressed below belong to Dr Hashim Kamali and Abdul Rahim Assaati (2002) whereby they promote a shari'ah-compliant version of Futures.

The general trend of the scholars who adhere to a permit the use of Futures can be resumed as follows: Azzam, al Khatib and Abd al Qadir share

the view that the registration and clearance procedures, as well as the guarantee functions of the clearinghouse, are precise and that trading futures are conducted by trained professionals in a highly centralized and controlled market. The and its related procedures are such that the prospects of uncertainty and gharar were virtually eliminated. Thus, the conclusion is drawn that futures contracts are valid from the Shari'ah perspective (Kamali, 1996).

However, the argument advanced previously on trading without actual transfer of the commodity or stock to the buyer, which is explicitly prohibited by the Prophet.<sup>7</sup> The Hadith cited in support addressed a companion, Hakim ibn Hizam, to "sell not what is not with you" can be further analyzed.

Al Khatib records the view that this Hadith conveys moral guidance (irshad) rather than a prohibition per se.<sup>8</sup>

Imam al Shafi'i has ruled that one may sell what one does not own provided that it is not a specific object, for delivery of a specific item cannot be guaranteed if the seller does not own it.<sup>9</sup> In essence, this prohibition seeks to prevent gharar in sales that consists of uncertainty over delivery.<sup>10</sup>

#### ○ **The Sale of Non-possessed Crude Palm Oil:**

According to the Hanafis, qabd is not an essential requirement (rukun) of sale but rather a subsidiary condition, namely, that of effectiveness (shart al nifadh). This ruling led al-Kasani to point out that a valid sale can be concluded prior to the seller's taking possession but that it will remain in abeyance until qabd has taken place<sup>11</sup>. Qabd is therefore, not a prerequisite of a valid contract, and it is perfectly lawful to postpone it to a later date. Ibn Rushd confirmed this and stated, "There is no disagreement in the Maliki School that only food grains (mainly wheat and barley) cannot be sold prior to qabd."

<sup>7</sup> Muhammad Akram Khan, "Commodity Exchange and Stock Exchange in an Islamic Economy," *The American Journal of Islamic Social Sciences* 5, no. 1 (Spring 1988): 91.

<sup>8</sup> Al Khatib, *al Siyasa al Maliyah*, 176, note 29.

<sup>9</sup> Muhammad ibn Idris al Shafi'i, *al Risalah*, ed. Ahmad Muhammad Shakir (Cairo: Mustafa al Babi al Halabi, 1940), 337.

<sup>10</sup> Al Khattabi, *Ma'alim al Sunan*, 5:143, note 29; see also al Qaradawi, *Bay' al Murabahah*, 56, note 22.

<sup>11</sup> Al-Kasani, *Bada'ih*, note 38, 5:156.

○ **The Sale of Debt:**

A debt is normally created by a trader who enters the market either as buyer or seller without any physical exchange of values. The debt so originated may become the subject of an offset/reverse transaction which will trigger a series of sales and purchases essentially of the sale of debts. The offsetting transaction in futures can also consist of offsetting a debt that one party owes to another. In this case, the settlement is done through the modality of sale and purchase. Bay' al-dayn (sale of debt) basically envisaged sale over an unpaid debt involving either two, or in some cases, three parties. The reason of its prohibition was over uncertainty in its repayment. However, the situation is very different in the futures market now where all transactions are concluded over guaranteed debts.

Ibn Qayyim's examination of the source evidence on bay' al-dayn also led him to the conclusion that "there is neither explicit nor implicit text in the Shari'ah on its prohibition. On the contrary the principles of Shari'ah indicate its permissibility."<sup>12</sup>

○ **Deferment of both counter-values:**

Rafiq al-Misri has argued that there is no extra gharar in deferring both counter values compared to the deferment of one of them only. If one of the counter values has been delivered while the other is deferred to a future date, or when both are so deferred, the level of risk would be the same and no additional gharar is likely when both are deferred. Suppose that the buyer in a deferred payment sale receives the commodity but defers the payment of price, it is possible that the price fluctuates during the interval, and one of the parties suffers the consequences. It could be the seller if the spot price goes up or the buyer if it goes down. It should be noted that in the case of salam sale, the risk will be about the same even if both counter values were deferred. Of course, in the case of deferment of one counter value one of the parties to the contract will benefit from the receipt of the commodity. If both counter values were deferred, both parties will share the risk and the expected gharar would be about the same. Thus there is no ground for the claim that gharar would be greater if both counter values are

deferred. Misri added that the Hadith of al-kali bil-kali is actually not authentic.<sup>13</sup>

○ **Uncertainties over Commodity Future Market:**

Existing data do not confirm the suspicion that future trading is dominated by large speculators. Data may vary from market to market, but, regardless of market, the total holdings of large speculators' long and short positions are less than 20 percent of the total holdings of small traders. Large speculators probably constitute less than 2 percent of the total futures trading population<sup>14</sup>. Major Price movements are usually caused by basic changes in the supply or demand for a given item and only rarely by a group of speculators creating a self-fulfilling prophecy. Evidence obtained from considerable research suggests that "speculation probably does more to smooth price fluctuation than to increase it"<sup>15</sup>. Research on the behavior pattern of such goods as onions and live beef cattle before and after the institution of futures markets have supported, on the whole, the conclusion that future trading has not increased price fluctuation in the cash market<sup>16</sup>. Statistical analysis shows that the volatility of futures prices is approximately the same as that of equity prices<sup>17</sup>.

Eventually, the discussion on the permissibility of Future contract in general is still a hot spot among shari'ah scholars. However, we should not ignore that it is widely recognized that commodity futures markets allow commercial hedgers such as farmers and producers to hedge their commodity price risk, as emphasized by the longstanding hedging pressure theory of commodity futures prices (e.g., Keynes, 1930; Hicks, 1939; Hirshleifer, 1988). There is little doubt that futures markets for agricultural commodities provide important economic benefits. Trading standardized agricultural commodities for future delivery on organized exchanges permits an efficient mechanism for hedging and provides a

<sup>13</sup>Rafiq al-Misri, *al-Jami' fi Usul al-Riba*, Damascus: Dar al-Qalam, 1991, p. 339f, as quoted in al-Amine, "Futures Trading", p. 79.

<sup>14</sup>Teweles, *Commodity Futures*, note 11, p. 31; Courtney, *Investor's Guide*, note 97, p. 53.

<sup>15</sup>Teweles, *Commodity Futures*, n. 11, p. 13; Courtney, *Investor's Guide*, n. 97, p. 52.

<sup>16</sup> Courtney, *Investor's Guide*, 51.

<sup>17</sup> For details on these studies, see Frank K. Relly, *Investment Analysis and Portfolio Management* (Chicago: the Dryden Press, 1985, pp. 792-793.

<sup>12</sup> Ibn Qayyim al-Jawziyya, *Illam al-Muwaqqiin*, Beirut: Dar al-Kutub al-Ilmiyya, 1991, Vol. II, p. 9.

forum for establishing and disseminating price information. These so-called risk-transfer and price-discovery functions of futures markets are the main benefit which multiple studies, (Kristoufek & Vosvrda, 2014) show that future market leads to more economic efficiency in a way that such instruments improve the farmers' competitiveness. Moreover, the informational role of future markets is due to the lack of centralized trading in spot markets for commodities, centralized futures markets serve as an important platform for aggregating dispersed information regarding supply and demand of commodities. Consequently, in the case of Malaysia, future market could help farmers and government, as it relies on this sector for its budget income, to stabilize the prices and provide an efficient for forecasts.

### Conclusion:

The main challenge that impedes the development of a risk management industry within Islamic finance is the behavior of relying on existing conventional instruments. These instruments are not the best model draw from because their core conception is based on interest and excessive risk taking which both do not comply with shari'ah guidance. Hence, the necessity for establishing a proper instrument to Islamic finance should be a high priority for practitioners and scholars. The process of engineering such instrument must exclusively be based on a risk sharing model. Protection of one property is an essential pillar of Maqasid al-shari'ah, thus hedging would be for no harm to Muslim community. Furthermore, the nature of the current economic trends and business, pushes to more effort in Islamic Risk Management to offset the extremely volatile market. Also, the basic norm of Shari'ah is prohibition (al-hazar) in the field of 'ibadat (worship matters) and it is permissibility (ibahah) in mu'amalat and commercial transactions. Nothing in this latter area must be declared forbidden without decisive and indisputable evidence. Consequently, in the light of the argument advanced, there is no decisive evidence on the prohibition of hedging, it is then permissible in Shari'ah. A transaction is valid from the Shari'ah perspective when it does not include riba, and it does not partake in excessive gharar. The instruments advance above would fall under the basic principle of permissibility, with the condition to undertake in a continuous process

to establish vigilance and develop more refined safeguards against abuse, excessive speculation, and gharar.

Consequently, the issue of hedging instruments should be approached from another perspective away from the common fiqhi discussion about uncertainties and gambling. Research should be conducted in order to measure the real impact of such instruments on the real economy and the lost incurred in case hedging is not practiced. The logic that should frame these researches is a balance to find the right path to integrate futures among our financial system.

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