Hedging Instruments in Islamic Finance

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by

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In the Name of Allah, the Beneficent, the Merciful

1.0 INTRODUCTION AND PRELIMINARY CONCEPTS

All praise is due to Allah, the Lord of the Universe. May peace and blessings be upon the master of all Muslims, our Prophet Muḥammad (SAW), his household and all his companions.

1.0.1 –Islamic finance is predicated upon the avoidance of either lending or borrowing money on interest because any loan that brings a benefit to the lender in money or in kind is regarded as a type of the ribā that was prohibited in the statement of Prophet Muḥammad (peace be upon him), “Any loan that leads to benefit [for the lender] is ribā.”

As for conventional finance, it relies primarily on the system of interest, especially in the banking sector, for depositors lend to the bank for a certain amount of interest, while the bank, on the other hand, extends loans to customers at an interest rate higher than the interest rate at which its depositors lent to it. The difference between the interest the bank pays to the depositor and that which it takes from the customer is the bank’s profit from the process.

Apart from managing the difference between the interest rate at which the bank takes from the customer and that which it pays to the depositor, [the risk exposure of] a conventional bank is [primarily] restricted to the credit risk of the debtor in terms of his ability to repay the debt at the agreed-upon time.

Furthermore, the interest rate in a conventional bank may be stable or floating. The latter may constitute a challenge to the conventional bank, requiring it to hedge the risks of guaranteeing the assets and liabilities of the bank. That is because the interest rate for deposits is fixed while the interest rate for financing is generally linked to the cost of interest-based borrowing; e.g., LIBOR (London Interbank Offered Rate).
A conventional bank needs to hedge against the possible incompatibility that would result from a reduction in the interest rate. Would Islamic financial institutions face the same need?

From a theoretical point of view, it is possible that Islamic financial institutions would face the same situation if there is a difference in the nature of the Islamic financial institution’s two co-parties, the depositor and the borrower. Take the case of a floating deposit [rate] (on the basis of a muḍārabah contract) while the [profit rate for] financing is fixed through the use of contracts like murābaḥah, or ijārah, or istiṣnā’, etc. Any possible discrepancy may require Islamic financial institutions to procure external financing, possibly at a higher relative rate, so as to be able to pay the profits due to the investment account owners, if the total return for the fixed-rate finance is less than the prevailing return in the market. There is no need for any hedging or exchange from the point of view of the Sharī‘ah in this situation, but the failure to alleviate these risks may drive the owners of the Islamic deposits to withdraw their deposits/investment accounts as result of the lower profit rate. Whenever that happens, it will have a negative impact on the long-term financial abilities of the Islamic financial institutions, to the extent that they will not be able to finance customers’ projects, which may lead to a decrease in productivity as a result of the drop in financial activity. Alternatively, these institutions could resort to searching for finance from sources other than deposits; however, such finance will be expensive. These additional finance costs will have a negative effect on the prices of Islamic financial products.

In order to avoid dealing with the interest-based system, Islamic financial institutions resort to real commercial activities through sale and lease contracts. It is possible that both the customer and the Islamic financial institution may be exposed to currency risks if the sale and the purchase involve different currencies, especially if the payment for either the sale or the purchase or the lease is done with different currencies in the future. The value of that foreign currency may change in the future in a way that harms or benefits either the seller or the buyer, according to the particular circumstances.

For example, the seller sells a commodity to the buyer in a currency different from the local currency of the seller. Let’s say the costs of producing the commodity are
calculated in *dirhams* while the price of the sale is calculated in dollars in the future. It would benefit the seller if the exchange rate between dollars and *dirhams* is sufficient to cover the costs of production and realize a margin of profit. If not, the seller will definitely lose. In this context, currency hedging will be a matter of the highest importance to guard against a loss in genuine commercial activity due to external factors dictated by circumstances beyond the control of both the seller and the buyer. In addition to possible problems that may arise from a discrepancy between assets and liabilities and from currency risks, Islamic finance may also face the problem of a drop in the market price of the commodity specified in the sale contract. An Islamic finance investor may buy some assets, such as shares, commodities, etc., for investment, paying cash, but this contract faces certain risks, e.g. a plummeting price for that asset, which would negatively affect the anticipated profit from the purchase. Can Islamic financial institutions permit investors to buy things in the future by allowing deferred delivery of both the commodity and its counter-value in the future or by partial payment of the price in advance to secure the payer’s right to purchase a specific commodity in the future?

Conventional finance has, for this purpose, adopted forward and futures contracts, options and swaps. Should Islamic finance adopt the same method of hedging for market risks, or should it have its own special method for that?

### 2.0 WHY ARE HEDGING INSTRUMENTS USED IN FINANCE?

There are many causes behind the development of hedging instruments in conventional finance. Among these causes are: hedging against the risks of market price, or the present prevalent price, or the cost at the time of the contract. It has been said that without hedging for investments the contracting parties may be subjected to such [levels of] market price risk that the capital may be exposed to total loss. It is believed that hedging can limit those risks to a specific level which can prevent damage to any investment.

How can that be realized?
If we undertake a comprehensive, careful study of the whole range of hedging instruments, including forwards, futures contracts, options and swaps, we see that all of them refer to a single important theory or formula: setting the price. That simply means that the price of each commodity in the future will be stable and guaranteed from the first day. Neither of the contracting parties will face any situation of instability or change in the prices because the asset price has been fixed from the first day. Likewise, the market risks of future operations will be significantly limited because current market values will have no effect on the future price for any transaction. The investments in these instruments will never be subordinate to the existing market value because the price has been fixed before the contract.

If we examine the history of forward contracts we notice that the main objective of the contracting parties for entering into a forward contract is to guarantee the price of commodities that will be delivered in the future. The producer and the buyer both realize that the price of any commodity will change in the future, and that may harm them. Based upon these anticipations, the two sides agree to the sale and purchase of a specific commodity—like wheat, for example—at a specific price, on the condition that the commodity be delivered and the counter-value paid on the same date in the future.

Fixing the price will realize a benefit for both of them, irrespective of the market situation. In addition to the benefit of fixing the price, the two contracting parties are assured that each of them will have someone with whom to sell and buy, so there is no cause to fear the lack of a supplier or buyer in this transaction.

Despite the fact that forward contracts may realize the benefit of fixing the price, they involve many difficulties and administrative issues. They require that the objectives of the two contracting parties coincide on all particulars: they must both be interested in the same commodity at the same price and with the same delivery date. Such a coinciding of interests may hardly ever be realized in the real market. That is the cause that led to the establishment of futures markets.

These markets play a role that also allows a fixed price with delivery and payment in the future, but a futures market also provides a mechanism that allows sales and purchases without having to know the other party. The board that supervises the
market is responsible for regulating and organizing all matters connected with the sale and purchase operations. That includes standardized quantities, a formula for setting the future price, and mechanisms for delivery, settlement and margins paid in advance as a guarantee, etc. Adherence and commitment to all the requirements are incumbent upon all the participants. Moreover, if the seller fails to deliver the asset at the time fixed in contract, then the offset room in the futures market undertakes to deliver to the buyer the agreed-upon quantity of the commodity at the agreed-upon quality, and it will then seek compensation from the seller later. This process is thus more organized and regulated than forward contracts.

Despite the fact that both forward and futures contracts can guarantee the price, neither of them allows the buyer to sell, for a higher price, his commitment to purchase. That is because the buyer in both types of contract, simply by agreeing to the contract, is obligated to execute it immediately upon the arrival of the fixed future date, and he is not able to sell his purchase commitment to a third party for a specific price. Against the backdrop of this issue, the instrument known as an option emerged. An option is simply a product that entitles the buyer to purchase a specific asset at an agreed-upon fixed price at a future date. It also gives him the right to sell his commitment to the future purchase to a third party. Thus, if an investor pays five dollars for this right, it means that the price of the right is five dollars, and it is then possible to sell it, for example, for six dollars, and by doing so the investor will make a dollar of profit.

The last hedging instrument is a swap, which is an exchange of two assets—like cash flows or currency exchange prices or anything else—as a precautionary measure against the risks which the participants or investors may face. In the conventional system, financial institutions fix the interest rate on deposits while the interest rate on loans is floating, and this may lead to inconsistency between a bank’s assets and liabilities. Swaps are the preferred hedging instrument for this type of risk.
3.0 THE SHARĪ‘AH VIEW ON HEDGING AGAINST MARKET AND CURRENCY RISKS

It is clear from the above that there are two basic issues which are in need of a Sharī‘ah legal view:

First of all, currency and market risks are real problems in the market. Fluctuations in the market price for goods and fluctuations in the value of one currency against another are inevitable occurrences of real markets. The price of a certain share may be ten dollars today, but in the future it may be a dollar less or a dollar more. The same is true for currency values; the dirham, for instance, may drop or rise against another currency in the future. An increase or decrease in market or currency risks may have strong effects with negative consequences for the concerned parties.

The second issue is related to setting a price, from which everyone who attempts to reduce his exposure to risks or losses will benefit. Although locking in a price may not guarantee the achievement of significant profits, it will still limit the risk of loss due to market and currency risks. The question here is: Will the parties involved actually hedge against market and currency risks or not?

It is worth stating that a party in need of hedging against these risks may have a genuine and legitimate reason for employing these instruments.

However, there are other parties that may employ hedging instruments for speculative purposes in order to earn profits from market discrepancies.

This paper will not discuss the second group because they are speculators more than hedgers, and there are no acceptable reasons motivating them to use hedging instruments. The first group is different. It has a legitimate need of hedging to protect real investments, and centers of investment and profit.

Taking into consideration the functions of conventional futures and forward contracts, it is clear that the salam contract may effectively treat market risks, as it fixes the price of the sale from the very beginning, irrespective of the market price in the future. And the seller and buyer have nothing to fear from fluctuation of the market
price; each of them can plan on the basis of the production process because the cost has been locked in.

In contrast to both forward and futures contracts, the buyer in the salam contract must pay the full price in advance. In the prospective contracts of conventional finance the buyer must only pay an advance amount determined by the terms and conditions of the contract. The margin paid may expose the buyer to either profit or loss.

The achievement of either profit or loss is calculated on practically a daily basis, according to the future market price compared to the sale price agreed upon in the contract. This may be considered as a kind of gambling; or at the least, gharar (ambiguity) has entered into it.

If the parties in the financial market need to lock in a price for a specific commodity without paying the whole price in advance, as is required in salam, it is possible in this case to use the mechanism of wa’d (promise) to accomplish that. Either of the two contracting parties may make a pledge—let’s say it’s the buyer, who promises to buy a specific commodity from the seller in the future, at a price agreed upon at the time of the promise. This is legally permissible because the promise to purchase has emanated from one party. The promisee in this situation must pay a margin (hāmish al-jiddiyah) to guarantee that the buyer will indeed fulfill the promise. It is also lawful for the price of the margin to float in accord with the actual market price for the future price. But it is unlawful from a Shari’ah perspective to create any account for the calculation of profit or loss on the margin; rather, its purpose is restricted to guaranteeing the financial ability of the buyer to make the future payment.

Finally, we have no suggestions based on the Shari’ah to reverse-engineer the characteristics of either the forward or futures contracts. The suggested Shari’ah solutions are confined to producing a solution to the issues of market risk, fixing a price and the requirements of the margin through the necessary administrative arrangements for it; however, it is legally prohibited to sell the margin.

There is another issue related to these derivative contracts: immediate cash settlement instead of the actual delivery of the commodity that is called for. This means that the seller in a derivative contract may either deliver the goods to the buyer at the agreed time or choose to close out the transaction by payment of an amount of money to the
buyer without consideration of the commodity’s current market value. This procedure requires juristic consideration because the immediate cash settlement is a new deal for the Islamic market. Some Islamic funds have sanctioned the sale of an asset at the time of delivery or before that by appointing the seller as an agent to sell the goods to a third party after the buyer has actually or constructively possessed them, and any income generated will be for the buyer.

With regard to hedging against currency risks, the scholars of Islamic finance have approved hedging strategies by means of a promise or commodity murābahah or tawarruq with an appended promise. The promise structure is considered easier than the commodity murābahah structure because the party that needs to hedge the value of his currency will make a pledge to purchase or sell his currency for another currency at the price he expects to get, and the rate of exchange will be fixed from the first day, based on the principle of a promise. However, the actual currency exchange will be executed in the future at the agreed-upon exchange rate. This provides the characteristic of price stability in currency exchange. Although these formulas are acceptable in the Sharī‘ah, they are surrounded with risks because the promisee may decide not to sell or buy, for the promise is binding only upon the promisor.

Some scholars perceived these possible risks, so they suggested that a delayed currency exchange be executed through a formula of commodity murābahah or by tawarruq instead of a promise to buy or sell the currency in the future. It is necessary that the two parties make mutual promises to sell and buy different commodities from each other in the future using different currencies (the currencies that are in need of hedging) but with the price of exchange fixed at the time the promises are issued. This will not just accomplish the price-fixing feature; it will also oblige the two parties to fulfill their commitments.

Options are also regarded as one of a number of instruments for hedging against market risk and limiting possible losses. Some scholars of Islamic finance have suggested that the concept of the ‘urbūn contract can play the role that options play in conventional finance; however, the concept of ‘urbūn is suitable only for the right to purchase, not the right to sell. By this arrangement, the buyer pays a deposit to the seller in advance; the contract of sale is concluded, but commodity delivery will not be executed until after the payment of the price in full, either during the option period
or when it expires. However, it is not possible for Islamic financial institutions to exploit ‘urbūn except in the case of purchase as they cannot use it to sell anything before the good is possessed by them.

The price of an Islamic option is a part of the total price, while the premium of the conventional call option is considered a price paid for the right to purchase a specific asset. If the buyer or the investor determines to purchase an asset offered for sale at a price of USD 10,000, for example, and pays USD 1,000 as ‘urbūn (down payment), he will later pay the remaining USD 9,000, according to Islamic finance; while according to the rules for options in conventional finance, he will have to pay USD 10,000. The USD 1,000 will be considered a premium that may be circulated in the secondary market.

But Islamic finance does not allow the circulation of the advanced payment because it is a part of the sale price which has already been paid to the seller. Despite the fact that ‘urbūn gives its payer the right to buy that specific asset, the sale of this right is not allowed in the Sharī‘ah because it is not a valid asset for sale and purchase.

There is a need for swaps in Islamic finance, as there is in conventional finance as long as there is a possibility of an imbalance between assets and liabilities of the Islamic financial service providers. Islamic financial institutions accept deposits on the basis of a muḍārabah contract, for which the profit return will be set based on the performance of financial products offered by the Islamic financial institutions. Most Islamic financial products, if not all, have a fixed profit rate; for example, murābaḥah, istiṣnā‘ and ijārah. At the same time, the profit rate for the deposit accounts is floating, while for the financer it is fixed. In this circumstance, Islamic financial institutions must resort to swaps of their commitments or liabilities for floating assets. Likewise, they must swap their fixed assets for fixed liabilities. This is the main goal intended from swaps.

Swaps in the modern era are made feasible through a contract of commodity murābaḥah or tawarruq with the added condition of a promise to periodically enter into murābaḥah contracts.
4.0 THE CHALLENGES AND HOW TO OVERCOME THEM

It is clear that market and currency risks are real risks which cannot be overlooked, so it is compulsory for Islamic finance to effectively tackle these two types of risk; not just as they apply to the buyer or the investor, but rather, as they apply to Islamic finance institutions subject to the capital adequacy standards and requirements of risk management issued by the Islamic Financial Services Board.

In addition to market and currency risks, there are also investment risks. Options or ‘urbūn are viewed as effective instruments for providing some protection against those risks. Another possible instrument is wa’d (promise), which has been designed specifically for this purpose; more specifically, two unilateral promises (wa’dān) to reduce investment risks. The final aim of two unilateral promises is to guarantee that the investor will not in any circumstances be exposed to any loss, i.e., to completely insulate him from market conditions. Thus, all investment risks would be hedged against in all situations.

After all this, the following issues may be presented for discussion:

a- Does the Islamic hedging system support alleviation of risks; not just market and currency risks, but also investment risks?

b- How can we distinguish between market risks and investment risks, which appear to be intermingled?

c- To what extent should the prohibition of selling what is not possessed be applicable in financial transactions?

d- To what extent should the prohibition of delaying the exchange of the two counter-values be applied to financial transactions?

e- There are few fatwās specifically on Islamic hedging, and they are limited to hedging against the risks of market price and currency value. Will there be a need for hedging against credit risks associated with murābaḥah or ijārah or istiṣna’ by transferring these risks to investors in derivatives, or should Islamic
financial institutions avoid involvement in such arrangements for transferring credit risk?

f- How shall Islamic financial institutions deal with the standards laid down by the Islamic Financial Services Board?

And our final prayer is praise of Almighty Allah, the Lord of the Universe.