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## *Sharī'ah* Evaluation of Financial Derivatives and Developing *Sharī'ah* Compliant Hedging Instruments

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# ***Sharī'ah* Evaluation of Financial Derivatives and Developing *Sharī'ah* Compliant Hedging Instruments**

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## **Abstract**

The use of financial derivatives is controversial in Islamic Finance. The commonly held opinion is that derivatives are not *Sharī'ah* compliant, so should not be used in Islamic Finance. The use of Islamic derivatives in some jurisdictions and not in others on the one hand and the lesser clarity regarding their *Sharī'ah* compliance on the other hand have created uncertainty and thus hindrance for the Islamic Financial Institutions (IFIs) in properly managing the associated risks. This study is an effort to address the said issue. It aims to analyze the forward, futures, options and swap contracts from a *Sharī'ah* perspective and intends to look for their *Sharī'ah* compliant alternatives to fill this viable gap, so that the IFIs may not find themselves in an unfavorable position. The current study adopted the qualitative research method to clarify and understand the relevant issues. The analysis showed that, in principle, the current application of derivative instruments is not *Sharī'ah* compliant due to a number of forbidden elements. Islamic contracts used as the bases or building blocks for developing derivatives conforming to the *Sharī'ah* principles include *Bai 'Salam*, *Murābahah*, *Wakalah* and *Wa 'ad* based arrangements. Based on these *Sharī'ah* concepts, alternatives to Short Selling, FX Forward contract, Profit Rate Swap and Cross-Currency Swap were examined which presumably minimize the gap and help the IFIs in the development and careful implementation of these structured products as per the fundamentals of Islamic Finance.

**Keywords:** financial derivatives, Islamic hedging instruments, *Sharī'ah* evaluation

## **Introduction**

In financial markets, the participants are frequently exposed to several risks including the most significant financial risks, that is, the uncertainty of interest and exchange rates and the fluctuation in stock and commodity prices. The means of dealing with these financial risks are called derivatives, which include forwards, futures, options and swaps (Chance, 2004). The popularity and growth rate of

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derivatives is very high due to their flexibility and easy usage. These instruments are frequently used for hedging, arbitrage and/or speculation apart from other purposes. Hedgers manage uncertainty and reduce financial risk through derivatives, whereas speculators and arbitrageurs bet on it to earn profit and to take advantage from speculation (Stoll, [1993](#)). While explaining the purpose of derivatives, (Tickell, [1999](#)) mentioned that the noble purpose of derivatives is to manage risk and to enable hedging; however, the irony is that these instruments are mostly used for arbitrage and speculation contrary to their intended objectives, which is the main reason behind the non-acceptance of these instruments in Islamic Finance.

Islamic jurists have expressed a number of concerns regarding the *Sharī'ah* compliance of these instruments, though their opinions and stated reasons for non-acceptance are varied and based on different grounds. In some instances, attempts have been made to offer justifications for the acceptability and adoptability of these instruments in Islamic Finance. These various opinions can broadly be classified into two approaches, that is, the modern approach and the traditional approach. Modernists appear relatively more liberal; indeed, they are of the view that these instruments can be aligned with Islamic norms subject to certain adjustments and by removing un-Islamic elements from their methods and usage. They base their reasoning on various grounds such as public interest, modern business requirements, objectives of the *Sharī'ah*, and on the provisions of *Malikī* and *Hanbalī* schools which appear relatively flexible as compared to *Hanafī* and *Shafī* schools. On the other hand, traditionalists are totally against the existing instruments, indeed some have denied their usefulness and need altogether. These diversified approaches along with the use of the so-called *Sharī'ah* compliant derivatives in some jurisdictions and not in others, as well as lesser clarity about the relevant *Sharī'ah* issues, has created uncertainty within the Islamic financial industry. This uncertainty reduces its ability to manage the associated risks and to enter into the areas openly available to conventional financial institutions. More significantly, excess liquidity of the IFIs requires the *Sharī'ah* compliant investment channels to survive and to compete in the financial sector. Keeping in view the expansion of the IFIs' activities well beyond their original jurisdictions all over the world, Sole and Jobst ([2012](#)) rightly stated that due to global diversification and public demand, the IFIs will definitely require the *Sharī'ah* compliant instruments to manage the associated currency and other risks. Likewise, Bacha ([1999](#)) stated that the objections of Islamic scholars on derivatives might need some

rethinking and reevaluation. Recently<sup>1</sup>, a survey questionnaire was circulated by IFSB with the objectives to capture the existing practices of Islamic hedging instruments and their *Sharī'ah* compliance as well as other concerns raised across jurisdictions. All these facts show that there exists a gap that needs to be addressed.

## Objectives

The current research has two key objectives:

- (1) To determine the actual status of conventional derivatives including forwards, futures, options and swaps from a *Sharī'ah* perspective in today's sophisticated business environment.
- (2) To analyze the *Sharī'ah* concepts which have derivative like features such as *Bai'Salam*, *Murābahah*, *Wakalah* and *Wa'ad* based arrangements that could be used as the bases or building blocks for Islamic derivatives to counter-balance the unfavorable position currently faced by the IFIs.

Thus, the current study critically analyzes the discourse of modern scholars regarding the relevant issues such as the application of “bay' al-kali bi al-kal,” that is, the sale of debt for debt, the sale of nonexistent things, and the sale prior to taking possession etc. The aim is to clarify and understand *Sharī'ah* objectives of these principles and their *Sharī'ah* compliance in the derivative instruments. Apart from apparent structures, substance and consequences of these transactions and lack thereof, the fundamentals of Islamic Finance are focused in the current study. It will definitely help the industry in the development of financial products and the execution of transactions based on these hybrid arrangements.

## Methodology

The basic aim of the current research is to critically analyze, explain and evaluate contemporary writings related to derivative instruments and to discover the possible *Sharī'ah* compliant avenues regarding these instruments. Thus, qualitative research method was adopted to investigate and understand the exact nature of the existing instruments from a *Sharī'ah* perspective. As suggested by Creswell (1994), if the study topic needs a deeper investigation then qualitative method is more suitable for research. Accordingly, for an in-depth understanding Richard (2009) preferred the qualitative method of inquiry. Strauss and Corbin (1998) proposed that qualitative method helps the researcher to find out what is not possible to discover through statistical tools. The current study relied on classical sources and the relevant study of Islamic law to prove or disprove the ideas discussed. It relied on

<sup>1</sup>Closing date was June 20<sup>th</sup>, 2019 via online at <https://ifsbwp13irschi.questionpro.com>

the work of major Sunni schools of Islamic law, namely the *Hanafī*, *Malikī*, *Shaf'īte*, *Hanbalī* and *Zahirī* schools and the writings of modern scholars. The study did not support the opinion of a specific school of Islamic law but adhered to the opinion of the majority. The opinion of international forums such as AAOIFI (Accounting and Auditing Organization for Islamic Financial Institutions) and the *fatawa* of International Fiqh Academy, which gives its opinion on the basis of *Collective Ijtihād* regarding modern issues in Islamic Finance, were preferred.

### Literature Review

The study of relevant literature revealed that classical sources have not discussed the subject in detail. With the gradual development of the Islamic financial market, the topic of derivatives in Islamic Finance has received considerable attention among scholars and various institutional and individual works have addressed this issue. The first institutional discussion was undertaken by the Makkah based *Fiqh Academy* and it acknowledged the benefits of forward and futures trading<sup>2</sup>. *Fiqh Academy* realized that various types of contracts need to be addressed separately. However, this is not reflected in its resolution. Further, the opinion of Islamic jurists regarding the possibility of “selling an item before taking possession” and the “deferment of the price of *Salam* for three days” as per the view of *Malikī* School was not examined and new alternatives were not provided, despite their benefits being recognized by the *Fiqh Academy*. Moreover, various papers in relation to Islamic derivative instruments were presented in the sessions of *Fiqh Academy* held in *Jeddah*, which reproduced the resolution of the *Makkah Academy* and called for further research in this area. Besides institutional work, many individual *Sharī'ah* scholars have also discussed the topic, such as Kamali (1996) rebutted the criticisms of Islamic scholars on futures trading and declared it to be valid on the basis of public interest or *maṣlahah*. Nevertheless, he did not address properly all the relevant *Sharī'ah* issues<sup>3</sup>. Another scholar Ahmad, (1995) discussed futures markets only, thereby limited the scope of his study. He looked for a pure and viable Islamic alternative and gave preference to *Bai' al-salam* as the building block of the intended Islamic alternative. Moreover, he expressed the need for an Islamic alternative of foreign currency futures but he did not elaborate on it. Likewise,

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<sup>2</sup>The Academy acknowledged the benefits in these words “*Forward and futures contracts provide opportunity for industrial and commercial institutions to finance their projects through the issuance and sale of stocks and financial instruments... forward and futures also provide a permanent venue for traders in commercial instruments and commodities.*” see ‘*AlQarārāt Majlis al-Majmā' al-Fiqhī al-Islāmī*’, seventh session, “*Sūq al-'Awraq al-Māliyyah wa al-Badā'i'i* (al-Būrsah)”, 163-165.

<sup>3</sup>*Sharī'ah* issues related to derivatives such as “sale prior to taking possession, debt trading, or *bay' al-dayn bi al-dayn*” have not been properly elaborated.

(Chance & Brooks, [2015](#)) and Al-Suwailem ([2006](#)) attempted to develop risk hedging strategies for the IFIs. However, a proper structure and a detailed mechanism were not laid down that fulfill the requirements of the IFIs. (El-Gari, [1993](#); Usmani, [1996](#); Ayub, [2003](#)) Vogel and Hayes ([1998](#)) upheld that futures contracts are impermissible in Islamic law, although a model for futures transaction can be based on various Islamic contracts such as *Salam*, *Istiṣnā*, *Wa'd and Bay' al-mu'ajjal* (deferred sale) etc. Unfortunately, they did not attempt to provide that how these contracts can be restructured for industry usage and recommended further research. Ayub ([2011](#)) discussed the structured swap products and critically examined them from a *Sharī'ah* perspective, while highlighting their various shortcomings and some loopholes in the ISDA/IIFM *Tahawwut* Master Agreement (TMA). However, he neither addressed these concerns nor presented any other viable solution. Bacha ([1999](#)) explained the evolution of derivatives, their benefits, and presented a case as to why they are needed. Moreover, he highlighted the consequences that would affect Islamic business activities if these instruments were ignored. Further, he discussed *Salam* and *Istijrār* contracts as having derivative like features. However, he limited the scope of his study and stated that the objective of his paper is neither to reevaluate these instruments in the light of *Sharī'ah*, nor is it intended as a critical examination of the juridical works of the *fuqahā'* (*Sharī'ah* scholars).

In spite of the fact that the majority of scholars recognize the benefits and needs of these instruments, yet they have also passed a prohibitive judgment and do not bother to propose any viable alternatives to secure the public interest. This stand definitely raises doubts in the minds of the people that *Sharī'ah* has not the capability to respond to contemporary issues and Muslim traders have to continue their trading according to the forbidden contracts without any Islamic input or alternative. Moreover, the *Sharī'ah* principles referred to by the scholars as the bases of the prohibition of financial derivatives, the motive behind these principles and their compliance in today's modern business environment have not been properly evaluated. The current study is undertaken to fill these gaps.

### ***Sharī'ah* Evaluation of Conventional Derivatives**

Hedging for the protection of wealth and investment is a higher objective of *Sharī'ah* and acceptable to all *Sharī'ah* scholars. However, there is disagreement among scholars regarding the acceptability and adaptability of financial derivatives as risk hedging instruments in Islamic Finance. In this section, the arguments and counter arguments presented by scholars regarding major *Sharī'ah* issues along with their basis and rationale are discussed and debated. The objective is to understand how

and why *Sharī'ah* scholars oppose financial derivatives and to analyze the compliance of the *Sharī'ah* principles or lack thereof in the current structured products mentioned in the subsequent section.

(i) Islamic scholars generally found that forward and futures contracts involve “exchange of one debt for another debt,” where the seller and buyer agree to defer the price payment and delivery of an item in/for the future. So, the deferment of both counter values is considered as “*Bay' al-kāli' bi al-kāli*” which, according to (Al-Zuhayli, [1997](#); Ibn Taymiyyah, [1960](#); Al-Jawziyyah, [1991](#)), is a means to *riba*, *gharar* and excessive risk and hence leads to conflict between the parties. Imam Ahmad ibn Hanbal ruled that “common consensus (*ijma al-nas*) has forbidden the sale of debts.” This is based on a *Hadith* which reports: “The Prophet prohibited *Bay' al-kāli' bi al-kāli*” (Al-Shawkāni, [1973](#); Obaidullah, [2002](#); Uddin, [2015](#)) declared that this constitutes selling of debt for debt which is prohibited in *Sharī'ah*.

On the other side, some modern scholars such as (Kamali, [1996](#); Ahmad, [1995](#); Al-Masri, [2007](#); Hamoud, [1976](#)) have argued against this objection/stance. Kamali ([1996](#)) stated that “the legal schools have recorded divergent rulings as to the definition of *Bay' al-kāli' bi al-kāli*.” Moreover, the above reported *Hadith* only appears in some collections and many prominent scholars such as Al-Albani (n.d), as quoted by Kamali ([1996](#)), consider it to be weak and unreliable. Thus, it cannot be used as an inference for prohibition and for judging contract and its effects. Giving further justification he stated that the futures contract, as traded in the clearing house, makes it a contract among the purchaser, the seller and the fully committed guarantor. Hence, no uncertainty is found regarding the fulfillment of obligation that takes place as repayment of debt by the debtor, so it is allowed in *Sharī'ah*. Ahmad ([1995](#)) is of the opinion that deferring both price and subject matter is accepted in the forward markets for the “underlying commodities” only, while for “financial securities” it is impermissible. Al-Masri ([2007](#)) gave the example of *Istisnā'* where deferring of both the price and the item is accepted and the International Islamic *Fiqh* Academy declared it as a permissible contract. This issue was addressed by Hamoud ([1976](#)) in the following words: “deferring both in exchange is accepted based on *muawadhah*. This type of contract which includes selling debt for debt meets the needs of traders and industrialists, so based on *hajah* (need) and *dharurah* (necessity), it can be used if it retains the legal standard. Deferring is accepted as long as it does not include foodstuff asset or any form of *gharar*.”

(ii) The second issue is that in futures and forward contracts, counter-values are non-existent at the time of the contract which is considered as the sale of *al-ma'adum* and is basically invalid due to *gharar*, as stated by Mahmassani<sup>4</sup> that “the non-existence of both counter-values of the contract in both futures and options amounts to unwarranted risk taking and *gharar* that creates massive uncertainty over the prospects of fulfillment.” Obaidullah (2001) and Al-Saati (2002) stated that the underlying asset in these contracts does not exist and is not in the seller’s ownership, which is against the principles of *Shari‘ah*. The Islamic Fiqh Academy in its Resolution No. 63 (7/1) passed in 7<sup>th</sup> session (9-14 May, 1992) also endorsed that “This contract is not permissible because of the deferment of both elements of the exchange. It may be amended to meet the well-known conditions of *Salam* (advanced payment). If that is done, it shall be permissible.” This is also in line with many other *fatawa*<sup>5</sup>. Usmani (1996) also found futures transactions impermissible because both the sale and purchase cannot be effective for a future date and these transactions also lead to excessive speculations. A study explained this by stating that “there are clear sayings of the Prophet (PBUH) that he who makes a *salaf* (forward sale) should do that for a specific quantity, specific weight, and for a specific period of time. Moreover, he states that the reason for accepting *salaf* is that the product is a public necessity and a payment is settled at the beginning of the contract. However, in the forward and futures markets, the payment is settled at the end of the contract. Thus, we argue that forward and futures violate the *Shari‘ah* rules.” These views are based on a number of *Ahadith*<sup>6</sup> and on the opinions of the classical *Fiqhī* jurists of the *Shaf‘ī*, *Hanbalī* and *Hanafi* schools. For example, Art. 197 of the *Mejelle* (the Ottoman Civil Code) stated that “the thing sold must be in existence” and Art. 205 further explained that “the sale of a thing, which is not in existence is void.” Classical scholars like Ibn-Qudamah (1960) and Al-Zuhayli (1997) have agreed that “the sale of non-existent objects

<sup>4</sup>Mahmassani as quoted in Kamali (1996), supra note 17 at 203-204.

<sup>5</sup>For instance the European Council for Fatwa and Research confirmed Decision 63 (7/1) taken by the OIC Islamic Fiqh Academy (2003) concerning options trading and dealing in Commodities, Currencies and Indices in Organized Markets.

<sup>6</sup>Sampling of *Ahadiths* which prohibits “the sale of nonexistent goods,” for instance, Jabir narrated in Sahih Muslim, (vol.1, 915) that “the Messenger of Allah (peace be upon him) forbade the sale of fruits until they ripen.” Another *hadith* on the authority of Ibn Abbas, when he was asked about selling of dates; he replied, “The Prophet (peace be upon him) forbade the sale of dates until they become fit for eating and can be weighed.” A man asked: “What does „to be weighed” [mean exactly]?” Another man sitting beside Ibn Abbas replied, “Until they can be estimated.” Further, in another *hadith*, Ibn Abbas reported: “The Messenger of Allah (peace be upon him) prohibited the sale of fruit before its quality is known, the sale of wool on the back of sheep, and the sale of milk in the udder.”



and objects that may cease to exist is not valid” due to the lack of ownership. The main reason behind the ruling of the invalidity of the sale of non-existent assets is indeterminacy (*jahalalah*) and the existence of *gharar*.

Contrary to the above, Imam Malik considered it lawful to sell a non-existent thing for a specified number of days (Al-Zuhayli, [1997](#)). According to (Ibn-Taymiyyah, [1960](#); & Al-Jawziyyah, [1991](#)), emphasis is not on ownership or possession, rather it is on the seller’s effective control and the ability to deliver. This approach proves that where “*jahalalah*” and “*gharar*” are minimized, the sale may be allowed though the items are non-existent at the time of the sale. In their view, the particular *Hadith* is related to the sale of what is not present and what the seller cannot deliver. They further suggested that on the basis of the freedom of contract, both the parties can postpone both the asset and its counter value. Jurists of the *Hanbalī* school also base their reasoning that no clear cut prohibition is available in the *Quran* or *Sunnah* and the particular *Ahādith* describe the situations of excessive risk and uncertainty, where the object may not be deliverable. Kamali ([1999](#)) maintained that the “sale does not own” applies only to assets in rem (*Bay‘al-a‘ayans*), not to fungible goods.

Zahraa and Mahmor ([2002](#)) also upheld that the prime concern is the safe delivery of the subject matter as per description, rather than its existence. SAC in its 11<sup>th</sup> meeting on 26 November, 1997 also resolved that “a futures contract on crude palm oil is permissible” and clarified that “*Bay‘al-madum* is prohibited because of the element of *gharar*, rather than the element of non-existence.”

(iii)The third issue is the selling of items prior to taking possession. In this respect, (El-Gari, [1993](#); Usmani, [1996](#)) stated that futures contracts include “selling items prior to taking possession” which invalidates these contracts. OIC Islamic *Fiqh* Academy in its 7<sup>th</sup> session held in 1412H (9-14 May, 1992) as well as all the leading classical jurists declared this kind of sale as prohibited in *Shari‘ah* and based their reasoning on the authority of the *Ahadith*<sup>7</sup> of the Holy

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<sup>7</sup>Ibn Abbas narrated that the Messenger of Allah (SAW) said: “*He who purchases food should not sell until he takes possession of it.*” Ibn Abbas said: “*Every sale is subjected to this condition*” and the *hadith* narrated by Abu Hurairah that “*the Messenger of Allah (SAW) forbade selling foodstuff unless received by the seller.*” And the *Hadith* “*Do not sell what you do not have*” Narrated by Abu-Dawud in his book (Kitab Al-Ijarah), Chapter: Regarding A Man Selling What He Does Not Possess: Narrated by Hakim Ibn Hizam: Hakim asked (the Prophet): Messenger of Allah, a man comes to me and wants me to sell him something which is not in my possession, I buy the goods for him from the market and then sell it to him. The Prophet replied: “*Do not sell what you do not possess.*”

Prophet (PBUH). Additionally, Al-Zuhayli (1997) stated that “the delivery of the item (underlying assets) in sales contracts is required and if the seller is unable to deliver it, the transaction would entail *gharar*, gambling and risk.”

Critics, on the other hand, stated that technically the word “*qabd*” refers to lawful custody and ownership which does not necessarily entail the material operation of holding. In this regard, Kamali (2007) quoted Ibn Rushd’s (n.d) view stating that “selling non-food items before taking possession is acceptable.” Moreover, the possession of real estate and non-weighted items is also not necessary prior to their selling. Youssuf (1987) stated that “the *ilah* (causality) of prohibition here is ‘*gharar*’ (dispute) due to the seller’s inability or failure to deliver the underlying assets, if the delivery is ensured then the existence or possession of the subject matter is no more an issue.” Further, (Hattab, 2007; Mañşūrī, 2001) also mentioned that selling non-existent items whose existence is certain in future is permissible. Hattab (2007) further stated that “food is excluded from that, must be possessed before selling, but if the food is a preserved type food, it can be sold before taking possession.”

(iv) The fourth issue is that futures contracts are generally not a genuine sale as no intention of making delivery or taking real possession or even real ownership is found and thus, these are not genuine contracts. Instead, these are speculative activities with the aim to exploit price fluctuations to achieve maximum gains as mentioned by Ayub (2011). Bacha (1999) mentioned that “this speculative behavior is no doubt prohibited by the *Sharī’ah* rules because it is similar to gambling.” As a result, the International Islamic Fiqh Academy (1992) and Islamic *Fiqh* Academy of Muslim World League (1984) identified that the ultimate goal of these contracts is to pay and receive price differences between sellers and buyers and thus they are considered as gambling and are, therefore, impermissible.

On the basis of the above discussion, we may conclude that the non-existence of the underlying asset may invalidate the contract in principle. However, it is not the non-existence of the asset per se which invalidates the contract; rather, it is the existence of excessive uncertainty and *gharar* that makes the contract invalid. If *gharar* can be removed, then the non-existence of the subject matter at the time of the contract does not invalidate the contract. Moreover, keeping in view today’s sophisticated nature of business executed in clearing houses, it is an undisputed fact that as per practice the clearing house acts as the seller to each buyer and the buyer to each seller in all futures transactions. So, each transaction is guaranteed by the clearing house. Moreover, the discussion shows that the emphasis is not on

ownership or possession, rather on the seller's effective control and ability to deliver which proves that where "*jahalah*" and "*gharar*" are minimized, the sale may be allowed based on *hajah* (need) and *dharurah* (necessity). With respect to the deferment of both counter values at the time of the contract, many contemporary scholars have admitted the legality of '*Istisnā*' where both counter values are deferred based on the *Hanafī* school's opinion and have put aside the opinion of all other schools due to the need for such an independent contract in the contemporary business world. Similarly, futures contracts have the same legal characteristics as '*Istisnā*' and they are needed today more than '*Istisnā*' itself. However, deferment may be accepted as long as it does not include foodstuff and no uncertainties over clearance and delivery are found. Moreover, the claim by some scholars that there is no need of such type of contracts is unjustified, as it is an established fact that these contracts are the backbone of contemporary international trade and no country or company can ignore their importance in managing its businesses. Sole and Jobst (2012) derivatives may be in line with *Sharī'ah* norms if they are employed to address genuine hedging, to avoid avertable uncertainty (*gharar*), and to build an equitable system based on public interest (*maslahah*). They further mentioned that the global diversification of Islamic Finance will definitely require new, more flexible and updated instruments to manage the associated currency and other risks.

### **Prospects of Islamic Contracts as *Sharī'ah* Compliant Derivatives**

As a complete code of life, *Sharī'ah* rules provide concepts and contracts that can be used as building blocks of risk management strategies in Islamic Finance. In this section, various hybrid structures based on these concepts such as *Salam* based Short Selling, FX Forward contract on *Wa'ad* basis and the execution of Profit Rate Swap and Cross Currency Swap using *Murābahah*, *Wakala* and *Wa'ad* based arrangements are examined along with their fundamental requirements as per *Sharī'ah* norms and their compliance with *Sharī'ah* or lack thereof as per existing practices, which needs proper deliberation by the scholars and careful implementation by the practitioners.

### ***Salam* Contract and its Possible Applications**

*Salam* sale is almost similar to the forward contract except the price behavior. In *Salam*, the entire amount is paid at the time when the contract is initiated with the objective to support farmers and small businessmen for the working capital financing. In this regard, *Salam* is more beneficial for the seller than for the buyer. However, the predetermined price is normally fixed lower than the spot price and is considered as a privilege to the buyer. As per classical sources, a *Salam* sale

should fulfill some mandatory conditions namely price payment at the time of the contract, specification of goods, a fixed period and place for the delivery of goods and fulfillment of the contract. All these conditions are agreed upon by the majority of the jurists and have been adopted by the Islamic *Fiqh* Academy (Jeddah). *Salam* is the closest alternative to a forward contract. Likewise, after a detailed discussion. Vogel and Hayes (1998) declared that it is possible to construct an Islamic contract which partially replicates the conventional futures contract via back-to-back *Salam* contracts. While commenting on the replication of short-selling, various scholars have preferred the *Salam* contract especially for equities.

### ***The Use of Salam as Hedging Instrument***

*Salam* based short-selling is implemented in jurisdictions like Malaysia as an alternative to conventional short-selling. The main differences between conventional short-selling and *Salam* based sale are as follows: (i) short-selling involves borrowing stocks at interest, while in *Salam* there is a sale so no borrowing is involved (ii) the dividends during the borrowing period belong to the lender in short-selling, while in *Salam* the dividends are estimated and included in the price.

Indeed, *Salam* based short selling is a simultaneous cash sale and *Salam* purchase of a stock can be executed in the following way: (i) selling of stock by the owner to a short-seller for cash (ii) simultaneous purchasing of the same amount of stock by the owner from the short-seller on *Salam* basis at an agreed price (iii) the credit purchase price includes the dividends and an amount equal to interest on the proceeds of shorted stocks (iv) to enable the short-seller to sell the stock onwards to a third party at market price, the ownership of the stock is transferred to the short-seller instead of the cash paid.

Here, we may refer to the Bursa Malaysia, where short selling is regulated through Securities Borrowing and Lending (SBL) and the Regulated Short-Selling (RSS) guidelines. In short-selling, the owner does not own the security he sells, instead he should first borrow the security to deliver the same to the purchaser. Otherwise, naked or uncovered short-selling occurs. Therefore, to ensure the ability of the seller to fulfill his part of the obligation it is mandatory that RSS must be supported by Securities Borrowing and Lending (SBL), due to which investors need to borrow the stocks from the Central Lending Agency (CLA).<sup>8</sup> After passing through various developmental phases, Malaysia has been upgraded to an

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<sup>8</sup>CLA is an agency managed by Bursa Clearing where all lending and borrowing take place. Investors cannot deal directly with CLA; they have to go through an approved Participating Organization (PO) (also known as Stock Broker, which is licensed to trade in Bursa Malaysia) or an investment bank.

“Advanced Emerging” market. On the other hand, short-selling and SBL are among the criteria set for “Developed” stock markets. Since Malaysia claims that the short-selling regulated under these rules is *Shari'ah* compliant, so we will discuss its procedure and will examine if its *Shari'ah* compliant.

### ***Shari'ah Analysis of Salam based Short Selling***

To determine the acceptability of *Salam* based structure as a *Shari'ah* compliant alternative, the core issues namely (a) '*bay`ma`dum`*' (selling what the seller does not own), (b) the eligibility of stock as the subject matter of a loan contract, and (c) benefiting from the loan contract need to be resolved. In short-selling, the owner does not own the stock he sells which is a violation of the sales contract as per the views of the majority of jurists based on the *Hadith* “Do not sell what you do not possess.” However, according to Ibn Taymiah and Ibn Qaiyyem, the rationale (*`illah*) for such prohibition is the occurrence of '*gharar`*' due to the inability of the seller to deliver the sold item. The above *Hadith*, therefore, means: “Do not sell things you are not able to deliver.” This *Hadith* only prohibits the sale where the object is undeliverable, regardless of the fact that it may or may not exist. The wisdom of the *Hadith* constitutes the prohibition of excessive risk and uncertainty (*gharar*) and not the existence of the object or lack thereof (Wahbah & Al-Muhandis, 1984). As claimed by SSC, with the inclusion of SBL in RSS the fulfillment of the contract in terms of delivery, settlement and payment is guaranteed and regulated by the exchange. As the seller first borrows the stock before selling it through the broker, he is mostly capable to deliver the stocks at any time which fulfills the condition of Ibn Taymiah and Ibn Qaiyyim. Thus, if *gharar* could be eliminated in RSS, then the issue of '*bay`ma`dum`*' is no longer significant<sup>9</sup> in short-selling transactions based on the following *fiqhi* maxim: “When an issue that impedes (the permissibility) is removed, then the activity which was initially forbidden becomes permissible” (Council, 2006).

The second important issue is whether stocks are eligible to be the subject matter of a loan contract. Juristic debate and ruling in this regard is based on how scholars view the stock, that is, as either fungible or non-fungible; as having a financial value or looking into the company's assets and dividing them into cash, tangible assets, debts and/or a combination of the three (cash, tangible assets, and debts). Most jurists except the *Hanafi* jurists are of the opinion that all goods, whether fungible (*mithli*) or non-fungible (*qimi*), which are eligible for forward sale (*Salam*) can be the subject matter of a loan contract (El-Gamal, 2006). *Hanafi* jurists also deem that stock should satisfy the homogeneity (*mithli*) which is an

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<sup>9</sup>As resolved by SAC in its 69<sup>th</sup> meeting held on 18 April 2006.

important criterion for objects to be eligible for lending. If the stock originally represents non-homogeneous properties (*mal qimi*), it breaches the *Hanafis'* conditions regarding the validity of lending stocks (Dusuki, 2008). The problem here is whether the delivered stock is similar to the sold stock, as homogeneity means that the things must be similar in terms of their value or shape. In short selling though the seller cannot deliver a similar stock in value, as the value of the asset is changing. However, the borrower returns a similar stock in shape. Moreover, SAC does not look into the assets of the company that represents the stock but considers the stock as a fungible and eligible item to be lent. They further argue that as long as shares are available in the market at the time of signing the *Salam* contract, it can be considered a *Salam* item. Moreover, RSS ensures the availability of the shares in the market which enables the seller to deliver the same to the buyer on the date of delivery. In RSS, it is a mandatory requirement to receive share availability confirmation from the approved securities for the borrowing and lending agents stating that the share is available or ready to be borrowed. If, for example, the share (*Salam* item) is not available in the market at delivery date for some reason, then the buyer has the option to terminate the contract or wait till the trading of shares is resumed.

As far as the third issue is concerned, even if we could adopt the opinion of some jurists such as Ibn Taymiyah and Ibn Qayyim and found solutions to the problem of the ownership of stocks in short selling and its validity as a subject matter of loan contract based on majority views, still there is another issue namely getting benefits from the charges imposed by the stocks' owner on lending his stocks in short selling, which is against the *Shari`ah* principles and needs to be overcome prior to fixing the legality of the transaction. Therefore, the permissibility ruled by SSC regarding RSS needs reconsideration and a careful standardized solution to the above mentioned issues is required prior to implementing this product in other regions.

### **The Concept of *Wa'ad* and its Application as a Hedging Instrument**

*Wa'ad* is a most flexible and useful concept. It is used almost in all products as mentioned by Vogel and Hayes (1998), who stated that the application of *Wa'ad* may not be confined to the *Murābahah* model only. *Wa'ad* is generally acknowledged as a unilateral promise which is defined by Ball et al. (2008) in the following words: "It is a commitment made by one person to another to undertake a certain action or verbal disposal beneficial to the other party." *Wa'ad* is different from *Muwa'adah* in the sense that in *Muwa'adah* the parties perform two unilateral promises on the same subject. Most Islamic jurists consider *Muwa'adah* less

favorably as compared to *Wa'ad*. The Islamic *Fiqh* Academy in its resolution No. 157, 2006 decided that “bilateral promises if binding on both parties are not allowed.” AAOIFI (1999) also ruled that “binding *Muwa'dah* is regarded as a contract.” Islamic *Fiqh* Academy in its Resolution No. 2 and Resolution No. 3 (1988-1989) resolved that a *Wa'ad* is morally binding and its fulfillment may be enforceable by a court of law, if caused some liabilities. This view is supported by various scholars. Even AAOIFI has endorsed that the ruling of IFA may be extended to currency exchange transactions carried out within an Islamic framework. Due to its inherent flexibility, *Wa'ad* is more helpful in the development of innovative structures. Indeed, modern jurists consider it to be a possible version of the forward contract. Thus, *Wa'ad* can be used in various structures such as FX Forward, Profit Rate Swap and Cross Currency Swap etc.

### ***How does Wa'ad Work in an Islamic FX Forward Contract?***

To edge the currency fluctuation risk, FX Forward contract is designed where both price and delivery are deferred. As mentioned above, FX Forward is an agreement to exchange a currency with another currency at a specified rate of exchange on a predetermined future date. This is particularly useful for clients involved in cross-border trade and exposed to a foreign currency' volatility risk, either in their payment of imports or in their receivables on the export of goods. However, this is not allowed in *Shari'ah* due to (i) the deferment of both counter values and (ii) the violation of the rule of *Bay'al-Sarf* which requires spot exchange of the currencies. In AAOIFI's *Shari'ah* Standard No. I -Trading in Currencies, Clause 2 mentions that it is permissible to trade in currencies provided that it is done in compliance with a set of conditions, including the condition that both parties must take possession of counter values upon concluding the contract. To make this *Shari'ah* compliant, single and dual *Wa'ad* (*Wa'adan*) based structures can be adopted. These structures along with their *Shari'ah* analyses can be described with the help of the following case study to be used as a reference for both the options, that is, single and dual *Wa'ad*.

Consider the case of Muslim Insaf Motors (MI Motors), a Pakistan based manufacturer which prepared a shipment amounting to US\$30(M) as per sales invoice for a 30-day credit. Let's suppose that the prevailing exchange rate USD/PKR is 2.000. Thus, MI Motors, after conversion of dollar into rupees, will record an expecting revenue of Rs.60(M). Therefore, MI Motors decides to enter into FX Forward with the IB to exchange US\$30(M) at the rate of 2.000 in a time period of 30 days. This purpose can be achieved through the following options:

**Single Wa'ad with Spot Exchange.** As the first step, MI Motors will undertake a promise to purchase Rs.60(M) on a *Wa'ad* basis from IB in a time period of 30 days (value date: June 30, 2018). As the second step, two days before maturity, that is, June 28, 2018, MI Motors will make an offer to purchase Rs.60(M) from IB in consideration of US\$30(M) and IB will accept the offer. The reason behind two days' gap, also known as spot date, is a norm in treasury operations which is allowed by AAOIFI and such a market practice is also acceptable to *Sharī'ah* scholars. The currency exchange takes place as the third step on maturity at the settlement date which is June 30, 2018. In its wake, MI Motors will deliver to IB US\$30(M), while IB will deliver to MI Motors Rs.60(M). Hence, the *Wa'ad* will end with a *Bay'al-Sarf*. In the case of default, the IB can recover the actual losses or may seek collateral as security to mitigate this risk.

***Sharī'ah Analysis of the above Mentioned Structure.*** The above mentioned FX structure is *Sharī'ah* compliant due to the following factors: (i) there is no binding contractual agreement at the first stage, rather it is concluded on the basis of single party promise. Modern jurists, including AAOIFI, regard the same as binding on the promisor and the promisee may recover the actual losses / expenses incurred as a result of the breaching of the promise (ii) in the above structure, the exchange of two currencies happens on the spot which satisfies the “*hand to hand*” rule specified in the Hadith. Thus, *Wa'ad* on deal date, in combination with spot exchange on maturity date, can provide solution for an Islamic FX Forward within the parameters of *Sharī'ah* compliance. *Sharī'ah* Advisory Council (SAC) of the Central Bank of Malaysia also passed the resolution in their meeting in April 2005 after a detailed deliberation in this regard.

**Dual Wa'ad (Wadaan) Combined with Spot Exchange.** Although the above mentioned structure fulfills the *Sharī'ah* requirements but the main problem with the single party *Wa'ad* is the imbalance in responsibilities between the parties since there is no check on the promisee (in the above mentioned case the IB) to fulfill its part of the transaction. Not only it results in reputational risk but it can also be seen as an unfair arrangement. Therefore, the alternative option is that of Dual *Wa'ad* combined with spot exchange to hold both the parties liable to their commercial obligations. In Dual *Wa'ad* structure, both the parties make independent and unrelated promises to each other. For example, referring to the above mentioned case wherein MI Motors, on June 01, 2018 (the deal date) promises to purchase Rs.60 (M) and agrees to pay an agreed price of US\$30 (M) to the IB on maturity. In dual *Wa'ad* structure, on deal date, that is June, 01, 2018 as of 2<sup>nd</sup> undertaking,



the IB promises to purchase US\$30(M) from MI Motors on June 30, 2018 and acknowledges that the delivery arrangement will be made accordingly. Moreover, both the promises made by the IB and the MI Motors will also include a clause that may be triggered by the promisor in case of favorable exchange rate. One of the two scenarios, that is, exchange rate may be higher or lower will take place, thus undertaking of the party in the money will be cancelled and the other party undertaking will be triggered.<sup>10</sup> The settlement of currency exchange will take place on maturity day. MI Motors will deliver to the IB US\$30(M), while the IB will deliver to MI Motors Rs.60 (M).

***Sharī'ah Analysis of the above Mentioned Structure.*** Analyzing the composition of the above mentioned structure from a *Sharī'ah* perspective, almost all the scholars agree that two inverse sets of promises on the same subject matter by the counter parties tantamount to a bilateral contract, as mentioned in AAOIFI *Sharī'ah* Standard of Commodities in Organized Markets; Clause 3/2/2. However, the above structure is carefully designed where both the parties make a promise to purchase, instead of one party promising to purchase and the other promising to sell to avoid bilateral contract of exchange for future delivery. To ensure proper compliance, the following conditions should be met: (i) both the promises should be independent and unrelated (ii) both parties should make a promise on a different condition (iii) on maturity, one promise will be effective and the other will be waived off or cancelled by mutual consent. The fulfillment of the above conditions will enable the formation of a *Sharī'ah* compliant alternative to the FX Forward contract.

### **Application of *Murābahah* as a Hedging Mechanism**

*Murābahah* is a sale transaction (also known as cost plus financing) which is commonly used as a *Sharī'ah* compliant financing technique, on the asset side of the bank's balance sheet. *Murābahah* can also play a vital role in the derivative market. Wilson (2007) stated that *Murābahah* is the foundation of over 70% of Islamic derivatives. Several of these instruments are based on the reverse engineering of multiple *Murābahah*, *Wakalah* and *Wa'ad* based arrangements, such as profit rate swap and/or cross-currency swap which are demonstrated below along with the *Sharī'ah* analysis of these transactions.

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<sup>10</sup>The logic behind the method of determining as to which promise will be triggered is that the party which is 'in the money' will always be allowed to trigger the undertaking of the counterparty. Therefore, in a situation where US Dollar trades above Rs.3.00, the Islamic bank is 'in the money'" (because USD has appreciated against Rupees), hence the Islamic bank will call upon the customer's undertaking.

### ***The Concept of Profit Rate Swap and the use of Murābahah***

In the conventional financial world, it is known as interest rate swap in which two parties agree to exchange or mutually transfer each other's debt payment streams without transferring the underlying debt. This is done through the use of synthetic loan agreements not allowed in the *Sharī'ah*. The best Islamic proxy aimed to resolve this misfit exchange payment could be the use of Commodity *Murābahah* combined with *Wakalah and Wa'ad*. In the proposed structure, two separate *Murābahah* transactions are involved. In the first *Murābahah* transaction, the client purchases the commodities from the commodity brokers and sells them to the bank for a price that is based on a fixed profit rate. Thus, the client appoints the bank as an agent for purchasing the underlying commodities from the commodity broker based on an undertaking. This leg, undertaken between the client and the bank is intended to facilitate the sale and purchase of the commodities, instead of directly dealing with the broker. In the second *Murābahah* transaction, the client purchases the commodities from the bank for a price that is based on a rate that is benchmarked against a floating rate benchmark. Therefore, on the basis of *Wa'ad*, the customer irrevocably undertakes to purchase the underlying commodities and also the payment of the deferred sale price at every occasion when the bank sells them the commodities. The reason behind the execution of this undertaking is to ensure that the customer is committed to the exchange of cash flows through the swap trade throughout the tenor. The clients will act through the bank as their agent to on-sell the underlying commodities to the commodity brokers. The bank will send a sale notice which will cover the detailed information of the asset and the price. After receiving the sale notice the clients will accept, on deferred sale price, the purchase of the underlying commodities. The bank will provide a similar undertaking for the purchasing of commodities and the payment of price to the client. Thus, two separate and distinct commodity *Murābahah* transactions will be executed by the counter parties. *Sharī'ah* analysis of this structure is given below along with the structure of ICCS.

### ***Structuring Islamic Cross-currency Swap***

Islamic Profit Rate Swap deals with a single currency, as both legs of the transaction are denominated in the same currency. Where as in Cross-Currency Swap (CCS), the interest liabilities in two currencies are exchanged and consist of three stages: (a) spot exchange of the principal of the two currencies (spot settlement is two business days after rate fixing) (b) a continuous exchange of interest payments during the swap's life, and (c) a re-exchange of principal at the maturity of the contract. CCS is a useful tool for both borrowers and investors to

take advantage of in different credit markets. It is also helpful for the investors or fund managers for the diversification of currency exposure in a portfolio management. A case study will be presented below as an example to demonstrate how CCS apparently works as a *Sharī'ah* compliant alternative.

As per approved strategy, Bank A decides to start a Medium Term Note (MTN) program of RS. 3 billion to diversify the source of funding. Bank B is appointed as the arranger and as the swap provider. Bank A issues the first *sukuk* of the size of RS. 500 million for 5 years, priced at 5% p.a. with the option of semi-annual payment of the coupon. Afterwards, the basic conditions are set by the swap provider, that is, Bank B for the currency swap. The substance of transaction is that Bank A will swap Rs.500(M) *sukuk* proceed to US dollar with the quoted exchange rate, such as US\$1.00 = Rs.3.00, which converts Rs.500(M) into US\$166.67(M). Stepwise procedure is the same as mentioned above for IPRS. The main difference between an ICCS and an IPRS is as follows: (i) in ICCS the exchange of principal amount occurs at the start and re-exchange at the maturity with the respective currency and (ii) two sets of cash flow streams are designated to be exchanged with two respective currencies during swap life. The three steps mentioned at the start of this section are thus transacted using the following *Sharī'ah* compliant analyses and mechanisms.

### ***Sharī'ah Analysis of the Transactions***

*Sharī'ah* analysis of the transaction is that at the first stage that is, spot exchange of the principal of the two currencies Bank A, after the issuance of *sukuk* and receiving the *sukuk* proceed, will enter into spot exchange on the basis of *Bay'al-Sarf*, whereby Bank A intends to exchange Rs.500 (M) for US\$166.67(M) based on the above mentioned assumption. Two undertakings as mentioned in IPRS, as part of the master agreement, will be signed between the parties. Thus, the exchange of two principal amounts of two different currencies is a distinctive feature of ICCS. At the second stage, the exchange of profit payments continues during the swap's life. As per term sheet, it follows that (i) the tenor of the transaction is 5 years with 6-month interval settlement (ii) both undertakings are exercised on each settlement date, thus two separate Commodity *Murābahah* transactions will be concluded for the respective undertakings (iii) Based on bank undertaking, Bank A will sell the commodities worth Rs.500(M) at a profit rate of 5% to Bank B, which will be paid to Bank A at every 6-month interval (iv) This profit amount will basically be paid by Bank A to *sukuk* holders as the *sukuk* profit. However, Bank B, based on client undertaking, will sell the commodities worth US\$166.67(M) to Bank A at a profit rate of 6-month KIBOR plus 100bps to be paid at each 6-month interval. Hence,

based on these *Wa'ad* based undertakings and using commodity *Murābahah* and *Wakalah* cash flows are exchanged. At maturity, which is stage three, the re-exchange of principal can be made either through another set of *Bay'al Sarf* or through two other sets of Commodity *Murābahah*. This time, the selling price of the respective *Murābahah* contracts will be paid in full by the parties which will ensure that the principal amounts are re-exchanged. Thus, upon receiving the principal amount, that is, Rs.500 (M), *sukuk* obligation will be settled by Bank A.

Finally, Islamic Cross-Currency Swap is based on the combination of *Wa'ad*, *Bay' al-Sarf*, *Wakalah* and *Murābahah*. The same mechanism is to be used, as explained under the Islamic Profit Rate Swap, for the periodic exchange of cash flows with the only difference that the exchange of the notional amounts can be affected by the use of a *Bay' al- Sarf* or even using Commodity *Murābahah* mechanism. The issue of the deferment of counter values has been addressed in the above mentioned transaction in such a way that counter values are exchanged on the spot basis through commodity *Murābahah*, thus no deferment occurs which is prohibited. Moreover, on the basis of *Wa'ad* undertaking both the parties are made liable to continue to enter into the series of exchange and to fulfill their commitment. Furthermore, to ensure the use of separate commodities as well as the availability of these commodities for the amount being exchanged, two commodity *Murābahah* transactions are executed.

## Conclusion and Recommendations

The discussion elucidates that the current application of conventional derivative is not *Sharī'ah* compliant due to a number of forbidden elements. In the current paper, various hybrid structures based on Islamic notions and having derivative like features were evaluated. These included the mechanism of *Salam* based short selling with special reference to Regulated Short Selling approved by the *Sharī'ah* Advisory Council (SAC) of Malaysia. The major shortcoming of this mechanism was identified which needs to be resolved. *Wa'ad* based arrangement was structured and measured and found to be the most suitable and flexible version of the forward contract. Hence, forward foreign exchange transaction may be carried out on the basis of a promise instead of a contract which needs careful implementation. Moreover, *Murābaha*, *Wakalah* and *Wa'ad* based structures for Profit Rate Swap and Cross-Currency Swap were examined. However, to remove the uncertainty and to ensure the *Sharī'ah* compliance of these structured products, the possession and delivery of the commodity needs to be ensured as per the requirement of a sale contract. Mere netting-off, that is, settlement of the difference in the amount of the two benchmarks will render speculative gain or loss based on

expectation as mentioned by Ayub (2011) that the parties only settle their respective obligations by *muqāssah* and neither party pays the actual cost of the commodity. As mentioned by (Al-Suwailem 2006; Ayub 2011), risk is the mandatory part of the real transaction based on the principle of *al-ghunm bil-ghurm*, thus it should be ensured that risk should not be separated from the ownership. Further, *Wa'ad* is frequently used in these hybrid structures which is merely an accessory activity and a commitment. Indeed, the majority of the *Sharī'ah* scholars including OIC *Fiqh* Academy and AAOIFI consider bilateral promise (*muwa'adah*) as a contract. Therefore, a careful execution of the same is necessary to maintain it as a promise and not a full-fledged contract. Moreover, the purpose of transactions and the relevant motivations of the parties should be taken into consideration, as these instruments should be allowed for genuine hedging to fulfill the needs of the traders and not for speculative gains. To prevent the speculative purposes of these transactions, measures should be taken to support the genuineness and actual need of these transactions.

At the end, to bring standardization and uniformity in these structured products across the globe, we recommend that there is an instant need of a legitimate database from the institutions of collective *Ijtihād* such as International *Fiqh* Academy, *Fatwa* Councils, IFSB, IIFM, AAOIFI etc. regarding the relevant issues in these structured products. Some institutions have taken initiative in this regard, such as IFSB collected information recently from the IFIs through a survey questionnaire about the products offered for hedging in the derivative market. The objective was to capture the existing practices in relation to the use of *Sharī'ah* compliant hedging instruments as well as the regulatory and *Sharī'ah* compliance concerns raised across jurisdictions for standardization which is appreciable.

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