Explicit Derivative for Islamic Hedging: A Strategy for Reconsideration

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ABSTRACT

Nowadays, market is witnessing increasing involvements of Islamic Institutions worldwide in international trades that include both retail and corporate segments, across diverse geographies. Even though the Islamic Banking and finance (IBF) industry has shown relative resilience during the recent market events, but statistics have shown that IBF are not fully immune to the turbulence in global markets. Thus, it has increased awareness regarding the need for a proper risk management mechanisms including hedging and it has become prominently important for Islamic finance practitioners to have access to hedging solutions in order to compete in this fast moving and volatile marketplace. As in Malaysia, in order to meet the demand, accompanied by the resolution by the both Shari‘ah Advisor Council of Bank Negara and Securities Commission that approve hedging products such as forwards, futures, swaps and options as Shari‘ah compliant, considerable efforts has been taken place by the Islamic financial institutions in formulating Shari‘ah-compliant derivatives. However, Islamic hedging solutions within the Shari‘ah parameters are not easily developed and without criticisms. This article aims to explore the issues and challenges using explicit derivatives as hedging tools in Islamic Financial Institutions in Malaysia.

1.0 INTRODUCTION

Some countries have taken a firm stand to totally ban the use of derivatives due to varying scholarly opinions on the legitimacy of traditional derivatives, but other countries has allowed their actual implementation on a limited scale or through complicated structures. Despite its controversial nature in the Islamic finance industry, both scholars and practitioners believed that derivatives and hedging products remains a necessity for a sound risk management system. They seem to have a consensus “on the rationale behind the desire
for the relative safety of hedging rather than speculating on the movements of the financial markets with unhedged market risk exposures” (Ayoub, 2013).

In practice, Islamic financial institutions and corporate have been left with limited choices to meet the urgent demand to hedge their risk exposure. The limited availability of suitable Shari’ah-compliant risk management mechanisms has denied Islamic financial institutions of the advantages of derivatives. Currently, they have either resorted to existing conventional derivatives or developed specific shari’ah-compliant and customized hedging solutions so called Islamic Derivatives to manage risks (Jobst & Sole, 2012).

1.1 Derivative in Islamic Finance

The terms ‘Hedging’ in conventional finance is directly related to derivatives products such as futures, options and swap and after the devastating 2008 global financial crisis, the word ‘derivative’ itself keeps reminding us of its highly speculative nature. Meanwhile, in light of Islamic finance, Jobst & Sole (2012) have offered a different perspective of derivatives by dividing them into three groups that are implicit derivative, legacy derivative and explicit derivative. The first group that is ‘Implicit’ derivative is evidence that the main Islamic contracts (murabaha, musharakah, mudarabah and ijara) already contain derivative-like elements to ensure definite performance and equitable risk sharing between borrowers and lenders. Meanwhile, ‘legacy derivatives’ is another reflection of Islamic finance is rich with elaborated contracts such as the contracts of salam, istisna’, khiyar al-shart, and ar bun that enable transaction to be done with different installment rates and delayed repayment for the survival of business entities.

Finally is ‘explicit derivatives’ and this explicit use of derivatives is the one that remains highly controversial because for most scholars, separate products for hedging are not necessary because the principle of minimizing risks or hedging should be embedded in product structuring itself (Al-Suwailem, 2006; Malkawi, 2014). Due to this category of derivatives, there are scholars who are not comfortable with the label ‘Islamic’ derivatives as if the label is used solely to demonstrate that Islamic finance also has instruments that can replicate the effects of conventional instruments and some said it is inappropriate because of the derivatives’ characteristic in conventional finance is mainly used for speculation or investment while ‘Islamic derivatives’ is created for risk mitigation purpose only (Rizky et al., 2016).

<table>
<thead>
<tr>
<th>Table 1: Classifications Scheme of Derivatives in Islamic Finance</th>
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<tbody>
<tr>
<td>Type of Derivative</td>
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<td>---------------------</td>
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<tr>
<td>Forward</td>
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<tr>
<td>Option</td>
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<tr>
<td>Swap</td>
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Source: Jobst & Sole, 2012
1.2 Islamic Hedging Product Structure: Issues and Challenges

Even though the Islamic industry has been in dire need of risk management tools and solutions to complement investment, project financing and capital raising requirements, however, within the framework of Shari’ah, Islamic hedging solutions are not easily developed. (A. Aziz, 2007) has discussed the evolution of Islamic hedging products particularly in Malaysia and South East Asia. Coincidentally, Islamic hedging solutions have been introduced in Malaysia using the familiar framework of Commodity Murabahah with their well known products; commodity Murabahah deposit and financing solutions. These commodity Murabahah products were originally introduced to the Malaysian market with the aspiration of offering alternative solutions plus a noble intention of attracting more customers towards choosing Islamic Banking. In addition, in most regions and countries, the commodity Murabahah modus operandi meets Shari’ah acceptable standards. However, Tawarruq (commodity Murabahah), while it is a well accepted jurisdiction in Malaysia, it was ruled out in the Middle East in 2009 by the OIC Fiqh Academy after much debate on the concept that are considered circumventing the prohibition of riba with the real purpose of getting a quick cash from the contract. Furthermore, the principle of tawarruq seems to contradict with the objectives of the Shari’ah (maqasid al-Shari’ah) since the objective of tawarruq is to provide liquidity and the customer eventually gets cash in exchange for a debt of a larger magnitude. It therefore ends in pure debt financing. Obviously, in terms of ‘substance’, tawarruq serves simply the same objective of riba (Al-Suwailem, 2006).

Most of the Islamic hedging products available in today’s market such as Islamic profit rate swaps, profit currency swaps or Islamic forwards are based on principles which are controversial in nature such as Tawarruq. In regards to the use of Commodity Murabaha in so called innovative structuring of Islamic swaps through multiple sales contracts of non-precious commodities, Ayoub (2013) & A.S. Gundogdu (2016) stressed out that there are no recognition by the Shari’ah scholars, legal experts and practitioners on the economic reality of the transactions. The activity is phrased as ‘artificial/ forced use of commodity’ because there is no connection between precious metal contract and physical metal stock as it should be if there is a true purchase and sale transaction in the future along with the associated ownership risks by the parties actually take place. Since there are no genuine purchase and sale, the parties involved in this transaction do not facilitate economic activity but actually create debt out of a thin air. Similar issue has been highlighted by Kasri et al, 2016 due to the artificial use of commodity murabahah/tawarruq to facilitate the mark to market gain or loss in hedging practice in Malaysia.

In a similar view, A.S. Gundogdu and E. Dogan, 2014, argued that the principal condition that distinguish Islamic Finance from its counterpart in “creating debt through sale or lease of real assets by financing modes such as Murabaha would be a genuine trade transaction with full intention of giving and taking delivery”, which is obviously missing with commodity Murabaha. To make the problem worse in the view of Shari’ah is when Siddiqi (2007).

concluded that the practice of commodity Murabaha cannot be accepted as Shari’ah compliant as its consequences will bring more Mafasid (harm) than Masalih (benefit) to the
Following that controversial issue, the usage of the principle of *wa’ad* in structuring Islamic hedging products has grown rapidly since it offers great flexibility and many of the world’s first *Shari’ah*-compliant derivatives such as Islamic cross currency swaps and Islamic profit rate swaps have been developed by Malaysian banks using *wa’ad*. In recent years, many Islamic Financial Institutions have shifted to the *wa’ad* structure which offer great flexibility and less controversy (Bakar, 2008; Mohamad et al., 2011). Referring to Nurdianawati Irwani Abdullah (2008), the earliest ruling on the application of *wa’ad* was limited to the *Murabahah* sale to purchase orderer facility. Later, its application was extended to other financing and investment facilities which are structured based on sale (*bay’*), leasing (*ijarah*) and partnership (*shirkah*) contracts. The use of *wa’ad* in such facilities is necessary as a risk mitigation tool to show the parties’ commitment to perform their contracts as mutually intended completely. Most importantly, its ultimate purpose is to ensure continuous *Shari’ah* compliancy in every stage of the transaction, particularly to avoid the formation of two contracts in one or pre-conditioned contract (conditional contract). However, the usage of the principle of *wa’ad* in structuring Islamic profit rate swap and foreign currency exchanges is not without criticism as it is deemed as a flawed structure because of “having features of *bay’al-kali’* *bil-kali*” (Sakti et al., 2016). Furthermore, Islamic profit rate swap (IPRS) is deemed the most controversial products due to *wa’dan* concept in product structure.

### 1.3 Tahawwut Master Agreement: Issues and Challenges

The growth in usage of Islamic swap for risk management of exchange rate and profit rate risk has led to the efforts to develop *Tahawwut* Master Agreement (TMA) to match the call from the industry for a market benchmark for *Shari’ah*-compliant hedging transactions. TMA uses *Murabaha* contractual form along with *Wa’ad* concept to develop a framework that consist of a single agreement, governing law, representations, flawed assets and conditionality, and close out mechanism and netting. Hence, coupled with both recent local and international initiatives especially the introduction of the long awaited Tahawwut Master Agreement in 2010, it has been seen as the catalyst for a more convergent market practices, consolidated and unified *shari’ah* approval process and reduce the legal risk issue associated to lack of standardized documentation based on universal comprehensible terms. Since the agreement is originate from the ISDA Master Agreement, the differences between the two lies in three distinct aspects (Ayoub, 2013).

1. The requirement of an underlying asset that is religiously permissible (mainly Zinc and aluminium)
2. The contract is for hedging purposes only
3. Interest cannot be chargeable in the transaction and in the event that interest is granted as part of court proceedings, it must be promptly given to the charity

While Ayoub (2013) is in agreement that TMA structure has served its purpose to cater the real need of hedging, he argues that IFIs in practical becoming more diverge in terms of

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1. The sale of one debt to another
2. Jeddah-based OIC Islamic Fiqh Academy has ruled that a ‘unilateral’ promise is binding while a bilateral binding promise (*wa’dan*) is not allowed because it amounts to an ‘*Aqd*’ (IRTI, 2000)
hedging practices as IFIs are increasingly using documentation based on the conventional architecture due to the confusion led by Tahawwut Master Agreement that uses Murabaha contractual form along with Wa’ad concept. IFIs perceived Tahawwut Master Agreement that is supposed to reduce legal risk associated to the lack of standardized documentation based on universal comprehensible terms has actually work the other way around as it includes a wide array of unilateral promises between hedgers, commodity brokers, and banks on multiple date which in the event of default, are expected to be enforceable in a court of law that originally prohibits bilateral binding commitments as it is equal to ‘Aqd’ according to Islamic jurisprudence. Furthermore, another component of TMA which seems to increase the legal risk in the event of default is the obligation to take the interest granted as part of court proceedings (an integral part of cost of carry valuation model) but it must be promptly given to charity afterwards. Kasri et al, 2016 also voice out a similar issue on the permissibility of using the conventional formula in determining the close-out amount in Islamic profit rate swap.

In addition to that, since TMA used the concept of Tawarruq and Wa’ad as underlying contract thus Islamic hedging products developed alongside are not well received in countries with different jurisdictions such as Indonesia and Middle East (Rizky, 2016). It is most likely due to the ultimate focus of the pre modern Islamic contracts is to seek for a quick and familiar solution to satisfy the market demands by attempting to ‘generate a similar economic profile to comparable conventional derivatives instrument through a Shari’ah compliant structure’ without considering much on the substance of the transactions. These Shari’ah issues identified can be seen as verification that the incremental adjustments to the pre modern contracts as discussed by Ayoub (2013) have arguably increased the controversy rather than reduced it.

TMA also seems to violate the purpose of consolidating and unifying shari’ah approval process as it is evidenced when Kasri et al (2016) have highlighted various Shari’ah issues related to the practice of hedging on the ground using derivatives such as forwards, futures, swaps and options despite they have been resolved as Shari’ah compliant by the SAC-SC and SAC- BNM. The issues identified are:

1) A hedger cannot be allowed to profit on the basis of an external factor that is uncertain at the time of entering into the contract, for example, future interest rates or future currency exchange rates.
2) It also finds that the execution of promises and commodity murābāḥah/tawarruq to facilitate mark-to-market gain/ loss does not represent a genuine exchange in the Shari’ah; thus, the resultant profit could not be considered a lawful gain.
3) Moreover, the Shari’ah does not allow one party to gain when the amount of gain is given not on the basis of holding a commodity but on the basis of mark-to-market, as this would trigger the element of gambling.
4) In addition, the compensation or damage paid by the party that breaches the wa’d in an Islamic profit rate swap, which is in the form of the close-out amount, is to be based on actual loss. Thus, the party that incurs a loss due to the breach is allowed to be compensated but not the party which breaches the wa’d.

3 Jeddah-based OIC Islamic Fiqh Academy ruled that a ‘unilateral’ promise (wa’ad) is binding while a bilateral binding promise (wa’idan) is not allowed because it amounts to an ‘Aqd (IRTI, 2000)
5) Similarly, the mark-to-market gain or loss imposed due to the termination or extension of *waʿd* in an FX forward is considered to be borne by the party which breaches the *waʿd* and not otherwise. The charges imposed must also be based on actual loss and not on opportunity loss.

### 1.4 Low demand of Islamic hedging instruments

Given the strong support by the government and regulators, European and Malaysian banks have gone further than most in developing various Islamic hedging products. Despite the literatures that favored the permissibility of options, forwards, and futures in Islamic finance added with recent innovation in this area that has similar focus (mostly on highly customized option contracts as well as commodity hedges), however, swap contracts such as cross-currency swaps and profit rate swaps become the most widely accepted forms of newly established *Shariʿah*-compliant derivatives which were deemed quite useful for the management of foreign currency and profit rates (i.e., interest rates) risk exposures faced by commercial and financial institutions that are increasingly being connected to the global financial markets (Jobst & Sole, 2012; Ayoub, 2013).

However, it is surprising when leading Islamic asset management companies and Islamic investment banking arms of major banks in Malaysia barely have any Islamic derivative offerings for their clients (S. S. Ahmed, 2013). It is evidence when leading Islamic financial institutions such as Aberdeen Asset Management, CIMB-Principal Islamic, RHB Islamic Asset Management, OSK-UOB Islamic Fund Management, Hong Leong Islamic Investment Bank and Amanah Raya Investment Management confirmed to Islamic Finance news that they do not make use of Islamic derivative products in their transactions. Nik Ahmad Zaki, a senior portfolio manager at CIMB-Principal Islamic Asset Management, opined that the lack of demand is due to significant market transparency aided by robust regulations and surveillance by the regulators thus very few market players feel the need to hedge their portfolio positions, investors are not product savvy and the absence of substantial volatility in the interest (profit) rates in the market which may not prompt the use of derivatives. Furthermore, since derivatives are not totally independent financial instruments and rely on the value of the underlying assets, their potential depends on the growth of the underlying sector, hence, the use of derivative instruments may be linked to the vibrancy in the economic conditions. On the other hand, Ayoub (2013), opined that the confusion created by the acceptability of these products along with the lack of consensus by their proponents on which contractual forms to use (Khiyar Al-Shart, Urbun, Salam, Istisna’a, etc.) may have been a contributing factor for this lack of response.

Saadiah et al, 2014 have identified two challenges in promoting the use of Islamic hedging instruments which may cause the low demand. The first challenge is Islamic hedging has limited hedging purposes (risk management only) whereas conventional hedging can be used for speculation. Hence, due to this, the demand for Islamic hedging instruments is limited compared with the speculative conventional instruments where many of the products do not really serve the purpose of hedging but rather used as tools to gain huge returns. Secondly is conventional hedging is more established whereas Islamic hedging is more recent. The challenge is there because one of the reasons why a company chooses conventional rather than Islamic is because conventional hedging market exists longer than Islamic hedging.
market hence the clients have more confident with conventional hedging instruments. Rizky et al, 2016 further add the challenge in Islamic hedging is for the time being, it is difficult to operate shari’ah-compliant derivatives because of the small size of Islamic banks.

2.0 CONCLUSION

The future of Islamic derivatives lies in the hand of both practitioners and Islamic finance scholars, either to allow it to flourish as an investment products or to limit it to hedging based on necessity as it is primarily permitted. To commemorate sustainable development goals (SDGs), it is at best to structure or develop the hedging products within Islamic space in a less controversial manner and avoiding at all cost the use of wa’ad or commodity murabaha. The initiative should be prolong with the coming of new talents from dedicated institutions for Islamic finance such as INCEIF in Malaysia and other universities worldwide offering Islamic finance program.
REFERENCES


