Hedging Transactions in Islamic Financial Institutions

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In the Name of Allāh,

the Entirely Merciful, the Especially Merciful

Praise is due to Allāh, Lord of the worlds, may the blessings and peace be upon our master Muḥammad, the last of prophets, on his family, and all his companions.

Resolution No. 238 (9/24)

Hedging Transactions in Islamic Financial Institutions

The Council of the International Islamic Fiqh Academy of the Organization of Islamic Cooperation, holding its 24th session in Dubai, United Arab Emirates, on 7-9 Rabīʿ al-Awwal 1440h (4-6 November 2019),

Having reviewed the recommendations of the scientific seminar on Hedging Transactions in Islamic Financial Institutions, organized by the Academy in Jeddah, Kingdom of Saudi Arabia, in cooperation with the Iqra Waqf for Development and Employment, on 24-25 Rajab 1440 (31 March - 1 April 2019),

Having listened to the in-depth discussions on the subject,

Resolves

First: confirming the resolutions of the Academy concerning hedging in financial transactions; in particular, resolution no. 224 (8/23) on *Hedging in Financial Transactions, Regulations and Rulings*, adopted at its 23rd session in al-Madinah al-Munawarah on 19-23 Ṣafar 1440 (28 October - 1 November 2018), including all its paragraphs, as follows:

1. Concept of hedging
2. Concept of risk.
3. Concept of
4. Shariah position towards risks
5. Shariah rules for hedging formulas and methods.

Second: Hedging (protection) transactions in their general meaning:

There is a range of transactions that can generally serve as a basis for hedging and protection formulas. They are in actual practice in financial institutions and they are permissible under Shariah, in particular:

1. Economic hedging: It consists of a diversity of assets, investment port- folios and formulas. It is required, according to Shariah, in order to achieve good resources management.
2. Cooperative hedging: It is based on takaful formulas by concluding

takaful insurance contracts to compensate for damages and losses that the Islamic financial institution may face. This formula is not objected by Shariah due to the lawfulness of

cooperative insurance on projects and physical and financial assets. Hence, the Academy resolutions no. 9 (9/2) and no. 200 (21/6) confirmed the lawfulness of cooperative insurance and its different formulas.

3. Parallel Contractual Hedging: It is undertaking a contract parallel to the original contract, with the same terms and specifications, whereby the financial institution protects itself against the risks of the original contract, such as *salam* (advance payment sale) and *salam muwazi* (par- allel salam), *istisna* (manufacturing) and *istina muwazi* (parallel istisna). This is as stated in the recommendations of Academy resolution no. 224 (8/23) on

One of the most important Shariah rules regarding the lawfulness of parallel contracts is not to connect the first contract with the second con- tract; instead, each contract should remain independent from the other in all its rights and commitments.

4. Combined Contracts: By combining contracts to hedge risks by ways of making the contract side by side, neither as a necessary condition nor incorporating one contract within E.g. the combination between a sale and a binding promise between *wakalah* (agency) and *Murābaḥah*. The following are some of the most important combination modes:

   1. The combination of *Murābaḥah* and *Mushārakah*: by dividing the investment portfolio into two parts: the first part is allocated to *Murābaḥah(s)* with creditworthy entities, at a fixed profit; and the second part is invested in a *Mushārakah* contract, such as trading stocks or real estate shares, and so on. Therefore, capital hedging is achieved through the *Murābaḥah* contract, with the possibility of loss for the second part.
   2. The combination of *Ijārah* and *Mushārakah*: hedging mechanism in this mode is similar to the previous However, hedging is applied with an *Ijārah* contract instead of a *Murābaḥah* contract, such as investing a part of the investment portfolio in the purchase of *ṣukūk al-Ijārah* with an income sufficient enough to protect all the capital, and the remaining amount shall be invested in *Musharaka* contracts.
   3. The combination of *Murābaḥah* and *Bay' al Urbun* (earnest money): The manager divides the capital in two parts: the first part is placed

in *Murābaḥah* contracts with solvent companies at a definite profit, while the second part is used as *Urbun* for the purchase of shares. If shares' price increases, the manager would proceed with purchasing them, take delivery of the shares and sell them, and of course pay the remainder of the contracted price to the seller, and the portfolio realizes profits for the funds. However, if shares prices do not increase, the manager does not proceed with the Urbun sale contract and loses the earnest money, but the capital remains already protected by the Murābaḥah contract.

In this process, it is compulsory to comply with Shariah rules of *bay' al urbun*, which includes keeping the subject matter of the *urbun* sale (in the hands of seller) intact without any disposition from the moment the contract was signed until the settlement between the two parties and avoidance of trading the *urbun* itself.

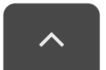
5. Hedging using *Khayar al-Sharṭ* (conditional options) to cover against the client's default:

For example; In *Murābaḥah*, and *Ijārah* ending with ownership contracts, the Academy resolutions on mutual promises confirm that they are per- missible provided conditional options are made available one or both par- ties, but without this condition, the mutual promises are not permissible.

It should be noted, in this regard, that in the resolutions in which the Academy allowed "binding undertaking" by one of the parties, regarding it as a hedge against the default of the client, and protection of the finan- cial institution against any losses, still maintain the right to opt-out for the other party.

6. Hedging using guarantees to protect the investment capital: There are diverse mechanisms which are included within the guarantee modes to cover risks arising from loss or non-profit in investment projects that the Academy resolutions confirmed their permissibility of which are the follows:

   1. Third-party guarantee: It is a natural or legal person independent from both parties of the contract if he/it undertakes to donate the guarantee in a specified project. The Academy resolution no. 30 (5/4) confirmed that this guarantee is permissible if the guarantor is independent in his/its personality and financial entity from both parties of the The third-party commits to donating a contribution, without any benefit to



him/itself to compensate for the loss of a specific project provided that it is a commitment made

independently.

1. Charging the *muḍārib* the burden of proof if a loss is claimed: the Academy stressed in its resolution no. 212 (8/22) that transferring the burden of proving the loss to the bank (being the *muḍārib*) as contrary to general principles provided that there are indirect evidences contrary to its claim of non-violation.

Third: hedging transactions that are, in the general sense, prohibited in Shariah include: Hedging through conditional mutual loans in two different currencies:

This formula is used to cover against exchange rate fluctuations and over- draft of correspondent accounts. If a financial institution has a surplus of a particular currency, it lends it to another institution provided that the latter lends the former another currency that it needs, whether this condition is explicit, implicit or customary. It is a kind of lending a loan against getting another loan, which is not permissible in Shariah, based on a consensus of all fiqh schools, because of the association between two loans (i.e. give me a loan and I give you a loan in return) whether the due dates of the two loans are same or different.

Hedges to Secure Capital in Shares and Ṣukūk: There are a few hedges, con- ditions and commitments usually incorporated in Ṣukūk issuance prospectuses which are incompatible with Shariah rules and with the Academy resolution no. 30 (5/4) of 1988 on *Muqāraḍah Bonds and Investment Certificates*; and no. 188 (3/20) on the *Pursuit of Research on Islamic Ṣukūk*, notably:

1. Guaranteeing the nominal value by the issuer (mudarib, managing part- ner, investment agent).
2. The *Muḍārib* undertaking to lend the *ṣukūk* portfolio to guarantee a cer-tain rate in the distribution of dividends.
3. Requiring that *ṣukūk* holders shall not have the ability to control the leased assets, e. no resort to dispose of the leased assets in case of install- ments payment default.
4. Non-transfer of *ṣukūk* assets ownership to investors or to *ṣukūk* holders which means that assets are not under their liability and are consequently not entitled to the assets' return

as they do not bear the liability against deserving the return. This is indicated by the fact that these assets often remain on the balance sheet of the

5. Requiring the inclusion in the issuance prospectus a commitment by the manager to lend the *ṣukūk* holders in case the actual profits fall below

a given percentage. This requirement is often backed by another that if the profit exceeds this percentage, the excess shall fully be granted to the manager as an incentive.

Fourth: Alternative hedging instruments for financial derivatives and their Shariah rulings: These instruments can be divided into three essential types:

Type I: Hedging against the risk of future exchange rate fluctuations

Among its most significant transactions are:

1. Binding mutual commitments between the two parties to enter into a currency exchange contract in the future:

Formula: Both parties make binding commitments one to the other to enter into a currency exchange contract on a specified future day and at a pre-determined exchange rate.

Shariah Ruling:

1. It is not permissible to utilize the binding mutual commitment as a hedging mode for currency exchange contracts. The Academy resolution no. 102 (5/11) on trading currencies stated that it is not permissible to sell currencies on deferred payment. Mutual binding promises on future currency exchange contracts are also not This is because the binding mutual commitment are similar to the contract as stated in the Academy resolution no. 40 (2/5) on fulfilling promises and the Murābaḥah to the purchase orderer, which stated that the binding mutual commitments to sell are equivalent to the sale itself.
2. This formula is not included in the exceptional cases mentioned in the Academy resolution 157 (17/6), on binding mutual commitments and collusion to make contracts; which allowed binding mutual commitments in exceptional cases while confirming that in such exceptional cases, binding mutual commitments should not have any *ribā*.

2. The two commitments, one against the other (a binding commitment with specific conditions, against a binding commitment with different conditions on a future currency exchange contract).

Formula: The first party shall make a binding commitment to the sec- ond party to sell an amount of a currency at a fixed rate at a specified time if the exchange rate direction is not in favor of the promise. But if

the exchange rate is in the latter's favor, the commitment becomes null. The second party shall also make a binding commitment to purchase the same amount of same currency, at the same fixed rate, at the same specified time if the exchange rate direction is not in favor of the promise. However, if it is in his favor, the promise becomes null.

Shariah Ruling:

Mutual commitments are not allowed to hedge against exchange rate fluctuations, as their reality is similar to binding mutual commitments to make a currency exchange contract that is prohibited in Shariah, by virtue of the Academy resolutions above.

3. An offer extended for a fixed period binding the offeror to enter into a currency exchange contract.

Formula: The first party issues an offer, extended until a given day, in which a currency exchange contract is concluded by selling the currency at a fixed rate and amount. The other party makes a binding or non-bind- ing undertaking to issue its consent within the agreed deadline.

Shariah ruling:

4. It is not permissible to apply the principle of an extended offer to the currency exchange contract due to the existence of the condition of *taqabud* (i.e. to take delivery of the object of sale and to pay its price) in the contract meeting; whether or not it is faced with a binding commitment on behalf of the other party, as stated in the Academy resolution 52 (3/6) on concluding contracts by modern communication devices. See article 4.
5. If the extended and binding offer is faced with binding commitment from the other party, it is then similar to the binding commitment, but even worse due to the existence of an

offer, regarded as one of the two pillars of the contract.

4. Execution of two mutual tawaruq transactions (*tawaruq mutaqabil*): Formula: The execution of *structured tawaruq* resulting in the confirma- tion of debt with the amount of the first currency required to be paid, then a *reverse tawaruq* transaction is carried out to result in a debt with the amount of the second currency required to be This will result in two mutual debts on both sides of the transaction, each in a different currency.

Shariah ruling:

It is prohibited because it is based in its structure on *Tawaruq* which

Shariah prohibits. The Academy resolution no. 179 (5/19) on *tawaruq* and its types confirmed that both types of *tawaruq*(structured or reverse) are prohibited, as there is explicit, or implicit, or customary collusion between the financier and the mustawriq (tawaruq beneficiary), to de- ceitfully collect at present money against a larger amount as future debt, and that is *riba*.

5. The bilateral binding commitment to conclude a *Murābaḥah* transaction or a future sale with loss, whose profit or loss is based on an agreed Formula: This transaction is executed through a binding bilateral com- mitment by both parties to *make a Murābaḥah/sale with loss* transaction, from the first party to the second party or from the second party to the first party on a given future day. The profit or loss of this transaction is calculated based on the positive/negative variance in a future day agreed upon for the calculation index.

Shariah ruling:

1. The principle is that it is not permissible to make bilateral binding commitments between the two parties, in accordance with the Academy resolution 40 (2/5).
2. This formula is not included in exempted cases allowed by the Academy resolution (157), stated above, in paragraph (4), article 1/1/A.

6. Two mutual commitments (a binding commitment with specific condi- tions against a binding commitment with different conditions, to execute Murābaḥah/sale with loss transaction in the future).

Formula: The first party makes to the second party a binding commit- ment to execute a *Murābaḥah/*sale with loss transaction at a specified mo- ment if the direction of the currency exchange rate index moves not in fa- vor of the other party. However, if the direction of the currency exchange rate index moves in his favor, the promise is null. The second party shall also issue a promise to execute a *Murābaḥah/sale with loss* transaction at the same specified moment if the direction of the currency exchange rate index is contrary to promise benefit. However, if the exchange rate index is favorable to his interest, the commitment becomes null. The profit or loss of the sale is calculated based on the agreed index.

Shariah ruling:

The two mutual commitments are not permissible as their real form re- sembles a binding mutual commitment that is prohibited by Shariah

according to the above mentioned paragraph (4) article (5).

Type II: Hedging against fluctuations in interest-rate indices which affect profit rates in Islamic formulas

1. Binding mutual commitment of both parties to enter into a future *Murābaḥah* or sale with loss contract, whose profit or loss will be calcu- lated on basis of an agreed index.

Formula: This transaction is made with binding mutual commitments by the two parties to carry out a series of Murābaḥah/sale with loss trans- actions from the first party to the second party or from the second party to the first party in a series of days in the future. The profit or loss of these sale transactions is made to equal with the positive or negative var- iance in each of the coming days agreed for the index's calculation.

Shariah ruling:

1. It is not permissible to utilize the bilateral binding commitments as a hedging mode to exchange fixed and floating interest rates because the mode of bilateral binding commitments is similar to the concluding a contract, as stated in the Academy resolution

40 (2/5) on fulfillment of promises and *Murābaḥah* to the purchase orderer. Binding mutual commitments to make a sale is similar to the sale itself.

2. This mode is not included in the exempted cases allowed by the Academy resolution no. 157, as described above in paragraph (4) article 1/1/A.

2. Two mutual commitments (a binding commitment with specified terms against a binding commitment with different conditions to execute a future *Murābaḥah/sale with loss* transaction).

Formula: The first party makes a binding promise to the second party to undertake a series of *Murābaḥah*/sale with loss transactions at a specified time if the direction of the interest rate index is not in favor of the second party. But if the direction of the interest rate index is in the latter's favor, the promise is annulled.

The second party also undertakes to execute a series of *Murābaḥah/sale with loss* transactions at the same specified times if the direction of the interest rate index is not to his interests, but if the direction of the interest rate index is to his interests, the commitment becomes null. The profit in *Murābaḥah* or the sale with loss is calculated based on the changes in the

agreed index.

Shariah ruling:

It is not permissible to make two mutual commitments, as their reality is equivalent to the bilateral binding commitments prohibited in Shariah, according to paragraph (4) mentioned above.

3. Execution of *mutual tawaruq transactions*:

Formula: Executing a *structured tawaruq* transaction resulting in confir- mation of indebtedness at the required fixed interest rate. Then proceed- ing to a reverse tawaruq transaction resulting in the affirmation of indebt- edness at variable interest rates. This will allow the two debts to be offset against each other on each day up to their deadlines. Compensation is then made by paying only the difference. There are three methods usually utilized to calculate the variable interest rate in this *tawaruq* transaction:

1. Contracting variable-rate *tawaruq*.
2. Contracting fixed-rate *tawaruq* with a commitment to discount any excesses in interest rate index for each future installment
3. *Cyclical tawaruq* by executing a series of short-term *tawaruq* transactions, each at a fixed price to create, at the end, a floating rate debt.

Shariah ruling:

It is not permissible because the transaction is based on a mode prohib- ited by Shariah (*tawaruq*), as stated in section (4), paragraph 4.

Type III: One-party binding commitment as an alternative to options transaction

Formula: Issuance of a binding commitment by one party to execute a *Murābaḥah* transaction with the second party for the amount of the positive variance, on an agreed day or within an agreed period, when the second party requests.

This binding commitment is sold at a given price which shall be paid in the beginning. The first party who issues the binding commitment shall become the option seller, and the second party who has the right to enforce fulfillment of the binding commitment shall be the option purchaser.

Shariah Ruling:

It is not permissible to pay for a binding commitment.

The Academy resolution no. (63) on financial markets stated the following:

Second: Options

1. Options contracts: The meaning of options contracts is to pay for the undertaking to sell or purchase a specific item at a given price, within a given period, either directly or through an authority guaranteeing the rights of both parties.

2. Shariah ruling: Options contracts, as currently traded in the international financial markets, are new contracts that do not fall under any Shariah-nominate contracts. Since the subject matter of the contract is neither property nor a benefit, nor a financial right that can be paid for, this contract is therefore not permissible in Shariah. Furthermore, since these contracts are initially not permissible to create, their trading is not permissible either.

The International Islamic Fiqh Academy also issued resolution no. (224) on hedging that contains regulations of Shariah-permitted hedging. It stated that: "Hedging formulas/modes should not lead to the sale of purely abstract rights, such as the sales of options which the Academy affirmed their prohibition by resolution no. 63 (1/7), paragraph (2-B). They should also not lead to paying for undertakings, such as payment for the guarantee, which the Academy prohibited in resolution no. 12 (12/2)."

Recommendations

1. Shariah Councils, Fatwa and Shariah Supervisory Boards, scholars and researchers shall reconcile between compliance with the fundamental ob- jectives of Shariah and its specific rules and regulations of individual con- tracts when practicing Ijtihad in structuring Islamic financial products in general and in drafting hedging contracts in particular. Also, to consider the outcomes of these contracts and their effects because the considera- tion of outcomes is a fundamental principle in Shariah.
2. Investment and treasury departments at the micro-institutional level, as well as authorities in charge of drafting monetary and financial policies at the macro-states level, shall ensure a balance between commitments and debts on the one hand, and wealth and actual economic activities on the other, and to avoid sinking in debts which negatively affects economic activity in general.

Indeed, Allāh is All-Knowing.