ISLAMIC HEDGING MECHANISM: EMERGING TREND

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Shariah Perspective on Economics of Hedging

- Principles of capital protection, risk management and risk hedging are essentially acceptable to general principles of Islamic law as long as they are free from:
  (a) Taking and paying interest
  (b) Uncertainty in pricing, subject matter and other relevant aspects in a contract (*gharar*)
  (c) Any element/clause/practice which contradicts the very purpose of an underlying contract (e.g. capital guarantee in investment contract).
- Although the Shariah may find these economic objectives acceptable, the mechanism to achieve that desired objective must be equally compliant.

Islamic Solutions Methodology

- Having endorsed the importance of risk management, Islamic finance must take a different "route" to arrive at the same destination.
- Examples of this methodology

  (a) House financing: Term loan vs. *murabahah/ijarah/musharakah mutanaqisah*

  (b) Insurance: Purchase of protection for a premium vs. mutual help of donation (*tabarru')*

  (c) Fixed income instruments: Fixed deposit/Bonds vs. *Tawarruq/murabahah* product and Islamic *Sukuk al-Ijarah*.
- Can we apply the same to issues of forward, future and swap?

- Islamic option which is deemed as “earnest money” is good example to replicate the conventional option except that the Islamic option cannot be traded (according to International Shariah Standards)

- This aspect of risk management or hedging instrument can be illustrated in Equity Linked Notes.

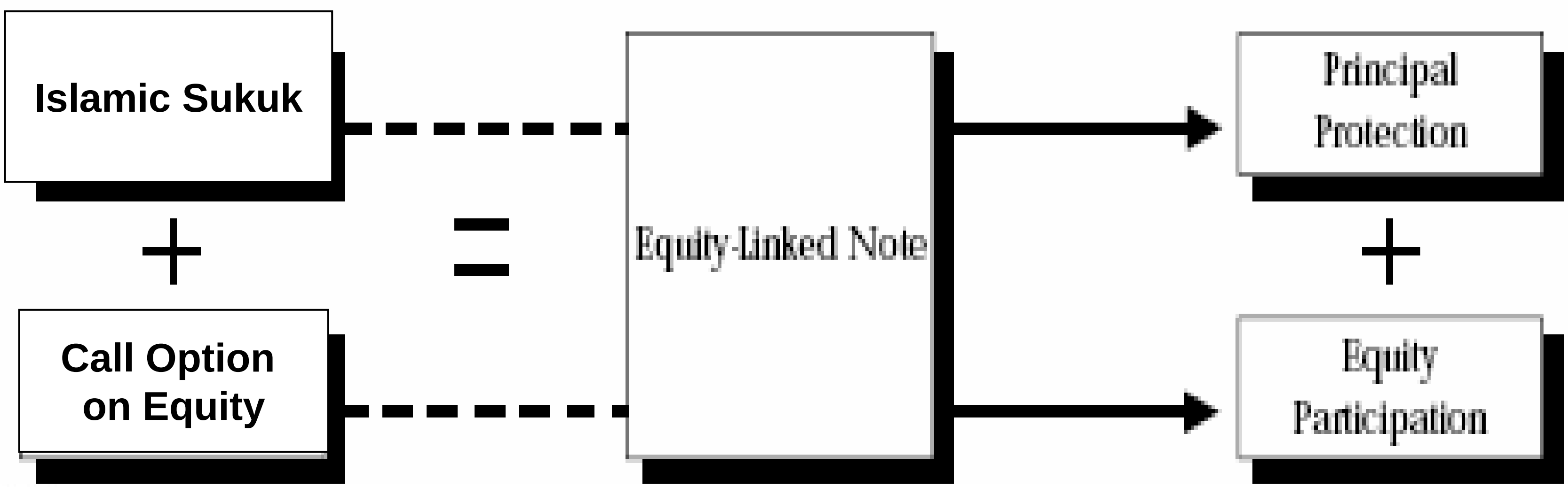
Equity Linked Notes (ELN)

- **ELN is an instrument that provides investors fixed income like principal protection together with equity market upside exposure.**
- **An ELN is structured by combining the economics of a long call option on equity with a long discount bond position. As for Islamic Equity Linked Notes, two requirements are to be met:**
  - **Equity must be Shari'ah compliant**
  - **Option must be structured under the 'urbun concept i.e. down payment, earnest money.**

- The investment structure generally provides 100% Capital Principle Protection. The coupon or final payment at maturity is determined by the appreciation of the underlying equity.
- The instrument is appropriate for conservative equity investors or fixed income investors who desire equity exposure with controlled risk.

Equity Linked Notes (ELN)

Figure 1: Structure of an Equity-Linked Note



SHARI'AH ISSUES IN FINANCIAL STRUCTURING (THE THEORY OF CHANGE AND INNOVATION)

- Islamic law deals with permanent (*al-thawabit*) and changeable (*al-mutaghayyarat*) aspects of legal issues differently.

- As for permanent part of issues, no alternation is permissible though its refinement, extension and reaffirment is encouraged (example: prohibition of riba, obligation to fulfill the contract)

- However, Islamic law allows rooms for reasoning and reinterpretation in areas of law which are changeable and progressive in character. (example: standard of delivery, standard of certainty in pricing, and underlying asset, standard in settlement of obligation).

- While riba is a fixed prohibition in terms of definition and application, gharar (lack of knowledge that could be detrimental to parties to contract) is not. Gharar changes with the change of technologies, legal framework, customary practice, market or society tolerance etc,

Micro-Shari’ah Issues in Hedging

- The pricing standard: Certainty and benchmark.
- Time and method of delivery with regard to both ribawi items and non-ribawi items.
- Time and method of payment with regard to both ribawi items and non-ribawi items.
- Marked to market.
- Perception [e.g. Salam sale to replicate the economics of Short-sale].

Product Structuring for Islamic Hedging Products

- Freedom of contract is acceptable provided it is free from riba and gharar.

- Riba takes place if there is an excess (inequality) or a delay in delivery, as the case may be, in any exchange of two similar ribawi items. Or, if there is a delay in delivery in any exchange of two dissimilar ribawi items (e.g. USD for RM).

- Gharar-free transactions imply transactions which are void of lack of knowledge that could bring detriment to one or the other party in a contract. Lack of knowledge may be due to uncertainty of item, price, etc.
- Islamic financial structuring, therefore must be free from both riba (when it involves exchange of two similar or dissimilar ribawi items) and gharar (when it involves non-ribawi items).
- Issues of riba confine to either excess (inequality) or delay in delivery on payment or both.
- Issues of gharar centre around uncertainty, inability to deliver, unavailability, etc. Here, lies the product development and innovation.

Are Islamic Hedging Instruments A Need?

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- Some scholars argue that Islamic hedging instruments are not in tandem with Islamic philosophy because they are, *inter alia*:
  - (a) artificial products
  - (b) they are created to suit conventional products which are based on either interest or speculation
- Some other scholars argue that "Islamic Hedging" is needed for protecting real business activities and not just for speculation purposes/undertakings
  - (a) Forward currency or currency swap to protect real import and export activities involving two different currencies
  - (b) Profit rate swap to manage real asset and liability potential mis-match of a financial institution.
- Would there be any limits to the usage of Islamic Hedging?
  - (a) Investment fund
  - (b) Synthetic products

Islamic Potential Contracts/Principles For Islamic Hedging Products

- Earnest money or *‘urbun*
- *Salam* Sale
- Unilateral binding promise (*wa’d*)
- *Istijrar* – purchasing an asset the price of which is to be determined later.
- *Murabahah/Tawarruq* contract
- Fixed and floating contracts
- Short sale??

Shariah Issues For Deliberation

- Deferment of both counter values in future market.
- Margin account and marked to market.
- Enforcement of unilateral binding promise.
- Fees for guarantee/protection (CPPI)
- Third party guarantee
- Separate legal entity in *murabahah/tawarruq* and in *wa'd* structure
- Unilateral binding promise (*wa'd*)

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