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Islamic Hedging: Gambling or Risk Management?

2. Primary Author

Saadiah Mohamad

3. Co-Authors (separate with comma)

Ali Tabatabaei

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Islamic Hedging:
Gambling or Risk Management?

Saadiah Mohamad
Faculty of Business Management/UiTM International Centre
Universiti Teknologi MARA,
40450 Shah Alam, Malaysia
saadiah228@salam.uitm.edu.my

Ali Tabatabaei
Faculty of Business Management
Universiti Teknologi MARA,
40450 Shah Alam, Malaysia
ali@tabatabaei.net

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Islamic Hedging:
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1.0 Introduction:

Hedging is one of the new instruments which have been designed to fulfill modern financial needs of both individuals and businesses. It is an approach to risk management that uses financial instruments to neutralize the systematic risks of price changes or cash flows (Cusatis and Thomas 2005). Hedges are investments made to minimize or remove the risk of another investment. It is used to minimize exposure to business risks, at the same time allowing a business to gain profit from investment activities. Hedging is closely associated with the use of derivatives as financial instruments to minimize losses of a financial or business investment. A Derivative is simply a financial instrument or asset that derives its value from the value of an underlying asset. The most common instruments are forwards, futures and options.

In recent years the growth of Islamic Banking and Finance has been phenomenal and has outstripped the growth of conventional banking. According to Ford and Marks (the Banker 2007) the Islamic share of the USD 11 billion for the GCC and Malaysian investment banking revenue pool is estimated to be between 10% to 20%. The Banker also reports that there is a rapid growth in the number of Muslims (now stands at 1.5 billion) and by 2020 it is estimated that there will be 2.5 billion Muslims, comprising 30 % of the world's population. In the next eight to ten years, Islamic banks will account for 40%-50% of total savings for the Muslim population (The Banker 2007).

According to a report by the General Council for Islamic Banks and Financial Institutions (GCIBFI) in 2008 the estimated number of Islamic banks around the world has reached 396 in 53 countries and that according to Moody's report, the total volume of funds

managed by the Islamic banking industry stands at approximately US $700 billion globally with an average annual growth rate of 15 per cent (Al Nasser 2008).

The rapid increase in Muslim population and their financial activities, the global awareness and interest on Islamic banking and Finance and the availability of huge liquidity surpluses in the form of petrodollar from the Gulf have all contributed to this phenomenal growth.

Investors for Islamic investments can be divided into three groups. The first is the shariah-compliant investors who would only put their money in investments that comply with Islamic law. The second is the "shariah-compliant preferred investors" who would invest in both conventional and Islamic but would always have preference for shariah-compliant products and the third group is the returns sensitive performance who would take up Islamic investments if their returns are better than other investments. The first and second group of investors could be influenced by religious or ethical beliefs while the third are purely guided by returns and performance and regard Islamic investments as just another asset class. The good track record of performance for many of the Islamic asset classes and their superior risk bearing features especially during the economic downside have attracted not only the "faith based" investors who now feel less of a trade off between ethics and returns, but also those who are purely returns sensitive.

As Islamic investments grow, so do the need to protect and hedge such investments and Islamic financial instruments would have to be as good as if not better than their conventional counterparts if they were to really attract more "performance sensitive" investors. Global hubs for Islamic banking and finance like Kuala Lumpur, Dubai and Kuwait are witnessing phenomenal growth in the industry and this is accompanied by the need for more sophisticated products to meet the demands of the modern financial world including tools for risk management. But the shariah issues and the differing interpretations on what can be considered as permissible according to shariah or Islamic law remains a big challenge.

Hedge funds have been put at the heart of a serious argument among Islamic scholars over whether their practices – particularly short-selling – can be complied with prohibitions on *riba* or paying interest and on *gharar* (uncertainty) sales and excessive speculation. It is difficult to separete hedge funds from speculation and while many scholars accept the need for risk management and hedging, the financial tools applied are often the same. The challenge is for scholars to assess the shariah compliance of the strategy—is hedge funds investing for profit and hedging or is it pure speculation and gambling? (Mackintosh & Oakley 2008). Given the enthusiasm on Islamic finance, some financiers are keen on developing shariah-compliant funds by borrowing rules originally used by traders in order to duplicate the effect of short-selling, that is borrowing shares to sell with the intention of making profit from a fall in the price later. However, shariah scholars, bankers and investors are divided over whether Islamic versions of hedge funds can repeat the success of other products, given that based on Islamic laws, pure speculation is tantamount to gambling and is prohibited.

2.0 The Case for Hedging

All businesses and financial investments carry risks. For example, the nature of some businesses expose participants to price or currency volatility that may result in higher costs, reduced revenue, reduced profits and even losses. Hedging is a strategy to offset investment risk so it is often regarded as essential to businesses to use it as a strategy to eliminate or reduce these risks.

2.1 Hedging and the derivatives market

Hedging is an investment that is taken up specifically to reduce or cancel out the risk in another investment. It is a strategy to minimize exposure to an unwanted business risk, while still allowing the business to profit from an investment activity. By reducing risk exposure, hedging allows companies to focus on their core businesses. Hedging is an important risk management tool for a wide range of interested parties including fund

managers, corporate treasurers, individual businesses, portfolio managers, pension fund managers, and bank managers.

By its nature, the hedging process is closely related to the financial derivatives market. A derivative instrument is simply a financial instrument or asset that derives its value from the value of an underlying asset. A forward contract is a contract between two parties to undertake sale and purchase of an asset and to complete the transaction at a future date but at a price determined today. The development of a forward market came more as a result of necessity in business and trading for example to secure future supply of commodity as well as the need to lock in price amidst the possibility of price fluctuations. As such, it first evolved as a hedging tool. Later, some of the problems and weaknesses with the forward market gave rise to other types of instruments as we see today: futures, options and swaps and these are not only used for hedging purposes but with the development of hedge funds, derivative instruments are used as tools in financial investments to give good returns to investors.

2.2 Do Hedge Funds Involve in Hedging?

Are hedge funds and hedging the same thing? The first hedge fund was set up by Alfred Jones in 1949. It was first started as a way to eliminate a part of market risk by short-selling. He was the first to use short sales, leverage and incentive fees. By 1966 the Jones' fund had outperformed all the mutual funds even net of a hefty 20% incentive fee. The first rush into hedge funds followed and the number of hedge funds increased to over a hundred in that year. Originally hedge fund was to offer plays against the markets, using short selling, futures and other derivative products. But today funds using "hedge fund" appellation follow all kinds of strategies and structure. So hedge funds cannot be considered as a homogeneous asset class as some are highly leveraged; others are not, some engage in hedging activities; others do not, some focus on macroeconomics bets on commodities, currencies, interest rates while others are "technical" taking advantage of mispricing of some securities in their markets and so on. There are currently more than

8000 hedge funds available from nearly 3,000 managers.[1] Of the total hedge funds globally, 66 % are located in the US, 25 % in Europe and 9 % in Asia.[2]

2.3 Hedgers Vs Speculators

Undoubtedly, derivatives as instruments of hedging are important risk management tools, but they can also be used by speculators to speculate. While a hedger uses derivatives to reduce his exposure to risks, a speculator uses the same instruments to expose himself to risks to make profit. Thus the use of derivatives in recent years have been popular for a wide range of interested parties including: fund managers, corporate treasurers, speculators, individual businesses, portfolio managers, pension fund managers and bank managers. Are the activities from the players in the derivatives market useful from the industry and the societal point of view?

Hedging is undoubtedly useful. Apart from enabling businesses to plan better, the reduction in price and revenue fluctuation would lower costs and this can be passed on to consumers in terms of lower prices. On the other hand, speculative activities tend to have a bad name. This has been well documented especially in relation to the financial and exchange rate crises of the last century for example the role associated to big speculators like George Soros in the 1997-98 Asian financial crisis. But according to Obiyathullah Bacha (1999), the benefits of speculation includes 1) increased trading volume reduces transaction costs thereby making it cheaper for genuine hedgers to hedge 2) hedging increases liquidity. Market becomes deeper and broader thereby reducing execution risks. 3) Speculators are willing to take risks which allow hedgers to have someone to pass on their risks.

3.0 Shariah Issues in Hedging

[1] Van Hedge Fund Advisors International and www.hedgefund.net accessed 25 August 2008

[2] Dow Jones News Wires 14 September 2006

Basically scholars agree that hedging in order to reduce risk or protect investment is allowed in Islam, but most scholars are uncomfortable about the use of derivatives to make speculative gains as are commonly used by hedge fund managers. The conventional derivative instruments of forwards, futures, swaps and options in their present form are not considered as shariah-compliant.[3]

Even hedging provides some complications for shariah scholars. Hedging is used by investors and in some cases by traders --importers and exporters-- to reduce risk of exchange rate exposure. Hedgers hedge in order to reduce risk as opposed to speculators who expose themselves to risk in order to gain profit which according to some scholars tantamount to gambling. Shariah scholars argue that hedging is allowed if the sole purpose is to hedge (protect) against loss of value as a result of for instance currency fluctuation in the transaction of real assets. But speculation is disallowed because speculators go into the market not for "real" transactions but for speculative reasons which are divorced from real business activities. Speculation also may contain elements of riba, gharar, and maysir which are prohibited in Islam.

The problem is when hedgers enter the market they certainly do business with the speculators. For example a Malaysian exporter sells Malaysian products and quotes price at US$ 10 million but expects to get paid in 6 months. If currently the exchange rate is RM 3.5/US$, his export earnings in ringgit would be RM 35 million. However if ringgit is expected to appreciate to RM 3.0/US$ in 6 months' time he might just get RM 30 million, a loss of total RM 5 million simply because of currency value changes of which he does not have control. In order to protect against this loss he could enter a forward market now by buying ringgit at say RM 3.5/US$, for US 10 million. In 6 months if his guess is correct and ringgit does appreciate to RM 3.00 to a dollar, he uses 1 dollar to buy RM 3.5 in the forward market. He would then sell ringgit to get US dollars. For every 1 dollar, he gets a profit of RM 0.5, for 10 million dollars, he gets RM 5 million, enough to cover him for the loss of RM 5 million from his export earnings.

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[3] See for example the decisions by shariahh panel of advisors of Accounting and Auditing Organization for Islamic Institutions (AAOIFI shariah standard).

However his involvement in the forward market necessarily involve the other party the speculators, who speculate otherwise –who would sell ringgit because he speculates ringgit to depreciate. Without the speculators, and only the traders who want to do forward trading, the derivatives market is impaired (Saadiah Mohamad 2007). Obiyathullah Bacha (1999) argues that speculators play an important role in risk dissipation (risk sharing).

Khan (1991) discusses the different types of transaction in a currency derivative market that involves spot, forward, futures, and swaps and concludes that the conventional system in the forward, futures and swaps are not in line with Islamic principles. The spot market is allowed and is clear based on the hadith of the prophet.

> *Gold for gold, silver for silver, wheat for wheat, barley for barley, dates for dates, salt for salt, like for like, equal for equal, hand to hand. If these types differ, then sell them as you wish, if it is hand to hand (Muslim)*

This has been taken to mean that when commodity money is exchanged (like gold and silver) they should be of equal amount and the transaction should be completed on the spot. The exchange of different units of one specie for another as in the case for eg, of gold for silver is allowed as long as the transaction takes place on the spot.

There seems to be a consensus that speculation using the derivatives market through the forward, futures, swaps and options transactions are not in line with shariah principles as they involve elements of *gharar* (uncertainty) and *maysir* (gambling or game of chance).
In addition, because speculation in the derivatives market is done in view of profit and not to facilitate trading or a real business activity, the actual delivery of the underlying asset seldom occur. This kind of speculation can be highly destabilizing and the danger of excessive speculation has been well documented for example in relation to currency and financial crises and recently in the oil price hike. The danger is caused by the fact that speculative activities may no longer be tied to real economic activities and may distort the demand and supply conditions of the real economy.

Shariah scholars also point to the highly leveraged derivatives market, and that the fact that the trading volume of derivatives is much larger than the underlying asset volume, signifying the highly speculative nature of the market. The leveraging strategy involves sale of debt and promises (which is prohibited in Islam) many times over and this has contributed to the creation of many layers of leverage activities which expose investors to very high risks.

4.0 Derivatives and Hedge Funds

Investors who demand shariah-compliant financial products could not invest in hedge funds nor hedge using the conventional methods using forwards, futures and options because these are not endorsed by shariah scholars to be shariah-compliant. This is because most if not all strategies used by hedge funds have shariah issues that include:

1. Short selling-involves selling something you do not own
2. *Ba'i dayn bi –dayn* , involves sale of debt or promises
3. May involve elements of *gharar* or uncertainty and *Maysir* or game of chance
4. Leverage involves element of interest or *riba*

While issues such as gharar and maysir are a matter of degree and are still debated among shariah scholars and industry practioners, the prohibition on riba is clear and therefore structuring a shariah compliant instrument would clearly have to avoid the interest element. This means also that conventional hedge funds which use short sale and leverage cannot be used for Islamic investment as loans involve riba.

Another problem is that it would be very difficult to find any hedge funds exactly compatible with all Islamic rules. Islam prohibits selling what you do not own so short-selling is not permited. Furthermore in Shariah law making money through debt and interest payments is not acceptable, so fixed income funds and convertible funds are not allowed. Islamic rule also forbids investments in companies in which their activities are

related to tobacco, gambling, and alcohol, and most media and entertainment are also not allowed. Sectors that are clearly acceptable include healthcare, science and technology, oil and gas, consumer products, and basic industries.

4.1 Scholars' Opinions on Options Contract

Derivatives are generally non shariah-compliant because of the issue of gharar and ba'i dayn bi-dayn ie. selling dayn (debt or obligation) for debt or money is prohibited. An option is generally considered not acceptable because it is not an obligation (a right but not an obligation) and that the payment is for some "right" not a property. If it was a promise to buy or sell then it is not a problem, the crux of the matter is it is the buying or selling of a "right" not a property. Further, a right and not an obligation makes it dependent upon future events and thus introduces an element of gharar or uncertainty and maysir (gambling or game of chance). A forward could be acceptable but its non payment in full creates the problem of selling promises similar to ba'i dayn bi-dayn.

However, the views of scholars could vary and depend on which perspective or angle they take. Some have examined the validity under the doctorine of al-khiyarat or contractual stipulations while others have drawn parallels between options and bai-al-urbun. Urbun is a transaction in which a buyer places an initial good faith deposit with the seller (very much like the down payment), if the buyer decides to proceed with transaction then it is deducted from the total payment, otherwise it is forfeited. In another case Abu Sulayman (1992)[4] views options as totally detached from the underlying asset.

When viewed separately as a promise to buy or sell an asset at a predetermined price within a stipulated period, Obiyathullah Bacha (1999) noted that shariah scholars find nothing objectional with options. However it is in the trading of this promise and the charging of premiums that objections are raised. Ahmad Muhayyuddin Hassan[5] objects option on two grounds, first that the maturity beyond three days as per khiyar-al-shart (stipulated option for a fixed period) is unacceptable and second, that the buyer of an

[4] see Mohammad Hashim Kamali pp39-41
[5] see Mohammad Hashim Kamali pp. 37-38

option is granted much more benefits than the seller and this he considers as an "oppression and injustice". Thus Abu Sulayman (1992), Taqi Usmani (1996) and Ahmad Muhayyudin Hassan (1986)[6] have not approved of option contracts in the form that exist in the market today.

Obiyathullah Bacha (1999) points out that arguments that regard conventional options not permissible on the grounds of gharar and maysir because they are primarily transacted for speculative gains can be rejected. Gharar does not have a consensus definition and may be the result of *jahl* (ignorance), inadequate information or lack of transparency. He notes that modern derivatives market with standardised contract specifications and controls by regulators may render these argument invalid. And to argue that gains in this transactions are unearned and thus involve elements of maysir or gambling ignores the fact that both the buyer and seller take on risks and that the buyer also has at stake the premium he has paid.

In an in depth analysis on this matter, Mohammad Hashim Kamali (1995) examines the practice of modern day options trading in the light of Islamic Commercial Law; including issues related to the basic option contract, and the validity of parameters such as premiums, time to maturity and delivery. He concludes "that there is nothing inherently objectional in granting an option, exercising it over a period of time or charging a fee for it and that options trading like other varieties of trade is permissible mubah and as such it is simply an extension of the basic liberty that the Quran has granted (Hashim Kamali 1995).

4.2 Shariah Scholars' Opinions on Futures Contract

Obiyathullah Bacha (1999) notes some inconsistencies in arguments among scholars concerning forwards and futures contracts. Mufti Taqi Usmani (Islamic Fiqh Academy

[6] See Obiyathullah Bacha (1999)

Jeddah)[7] states that modern day futures contracts are invalid for two reasons. First, according to shariah sale or purchase cannot be affected for a future date. Therefore all forward and futures transactions are invalid in shariah. Second, future delivery of the commodities or their possession is not intended, most end up with price differential settlements only, and this he argues is not allowed in Islam. Yet Fahim Khan (1995)[8] notes that even in the modern forms of futures trading, some of the underlying basic concepts as well as the conditions for such trading are exactly the same as were laid down by the Prophet for forward trading. For example the prophet has been reported to say that he who makes a salaf (forward trade) should do that for a specific quantity, specific weight and for a specific period of time. This according to Fahim Khan is something that modern contemporary futures market trading pays particular attention to.

The Shariah Advisory Council of the Securities Commission of Malaysia has endorsed that futures trading of commodities is approved as long as the underlying asset is halal. Thus CPO futures are approved for trading. For the stock Index Futures, while the concept is approved, since KLCI has non halal stock, it is therefore not considered as a shariah-compliant instrument. This is supported by the view from Ustaz Ahmad Allam from the Islamic Fiqh Academy of Jeddah who certifies that the stock index futures is not compliant since some of the underlying stocks are not halal stocks.

5.0 Islamic Alternatives to short selling

The issues discussed so far very much centre around the conventional method of the use of short sale used in hedging as well as in hedge funds. A short sale is generally a sale of a security by an investor who does not actually own the stock. In order to deliver the stock the seller will borrow the security. The short seller will later buy the security on the open market (at a cheaper price if he is to realize expected /speculated profits) and return to lender. A short sale therefore involves loans which typically includes element of interest and if the stock the short seller borrows is a stock that pays dividends, then the short seller

[7] See Obiyathullah Bacha 1999
[8] See Obiyathullah Bacha 1999

also has to pay dividends to the person or firm making the loan. In general short selling is utilized to profit from an expected downward price movement, to provide liquidity in response to buyer demand or to hedge the risk of a long position in the same or related security.

Some shariah concepts or contracts that can be used as alternatives to conventional short selling includes:

1. Khiyaral-shart or stipulated option

   This stipulated options are legitimized in several hadiths (sayings of the prophet) and involves an unconstrained right to rescind an otherwise binding contract for a fixed duration.

2. Ba'i Al Arbun or Down payment

   In this case a buyer concludes a purchase and makes an advance of a sum of payment less than the purchase price. If he decides not to take the good and pays the rest of payment then the seller keeps the advance. Of all the Islamic contracts this offers the closest anlogy to the option contract.

3. Ba'i Al salam or Full Payment for Deferred Delivery

   This is the sale of goods for delivery at a later date but full payment is made immediately. The goods are usually agricultural goods but the principle can be extended to other assets.

6.0 Salam Sale- An alternative to Short Selling

The shariah has not prohibited all forward transactions. It has allowed the forward purchase and sale of agricultural commodities (salam) or manufactured goods (istisna).

Forward transactions in real goods and services with the intention of taking and giving delivery perform an important economic function. They make an allowance for the time period it takes to produce goods and thus provide producers and users with the assurance that they can sell the goods produced and for buyers to get the assurance of the supply of the goods. (Iqbal and Llewellyn 2002). In a salam sale a seller sells a commodity to a buyer against immediate full payment for delivery of commodity at a future date. Shariah scholars now agree that the salam sale contract can now be extended to be used to structure an Islamic derivative instrument as alternative to short selling. The existence of the goods at the contract time is not required and this represents an exception to the general rule. An investor in stocks can hedge part of his exposure to cover downside risk by selling stock as Salam.

E.g. We own 1000 shares of XYZ, current price $10/share

- Contract to sell at $9.90/share for delivery in six months. We receive $9,900 today. (Placed in a Murabaha a/c)

After six months:

If the Share price goes down to $9.50/share - Profit $400

If the share price increases to $10.30/share - Loss $400

In the case of conventional short selling there are two distinct transactions: “borrowing” of stock at interest and selling the stock. In Salam, there is a *sale* but no borrowing of the stock. In a salam sale, the sale price may incorporate the time value of money (financing cost) but early delivery of good will not reduce the price as the full price is paid upfront. For short selling, dividend even during the borrowing period, belongs to the lender. In Salam, it needs to be estimated and factored into the price. Since there is full payment, a salam sale is clearly advantageous to the seller, hence the price is normally lower then the prevailing spot price, this is in contrast with futures contract where futures prices is normally higher than spot by the amount of carrying cost. The lower price is a compensation given by the seller to the buyer for the privilege given to him in terms of getting the full payment even before delivery of the security.

Even though a short sale and salam sale are similar in many ways, they differ in terms of philosophy. A salam sale contract is slanted towards hedging or reduction of risk exposure to volatility or drop in equity market whereas a short sale is usually used as an aggressive implementation of a bear view on a stock. At the operational level, both sellers are exposed to the unlimited upside in price of the underlying and both are similar in terms of default risk (in salam, buyer bears risk for sellers' non delivery and in short sale, lender bears risk for borrower's default) and hence, the need for collateral. A salam sale has an added advantage because compared to a short sale that involves two different transactions, a salam sale is a "pure" contract between two parties with a pre-agreed delivery sale. However, a salam sale may be more expensive as it involves structuring and brokerage costs, net financing costs and estimated dividend. As costs are paid upfront, early delivery is not advantageous.

Overall, one key feature of the salam sale is that because the shariah prohibits the sale of debt and due to the requirement of tying one derivative instrument to one real asset, this prevents the creation of the many layers of leverage common in the conventional short selling practices of hedge funds and the derivatives market. Since Islamic products generally are closely tied to real economic activities, investors are less exposed to the dangers and instabilities caused by excessive speculation and the many layers of leverage activities. This feature of the Islamic derivative instrument would be a key factor for value add in the financial risk management.

7.0 Conclusion

The paper has outlined the debate among shariah scholars surrounding the use of derivatives in hedge funds and as a risk management tool. There is clear consensus on the need for hedging to protect investment but there is considerable debate regarding the kind of instruments that can be used for hedging which meet the requirements of shariah. Generally scholars seem to agree that the practice of short selling in the derivatives market using forwards, futures and options contracts either for hedging or for speculative gains in hedge funds are not permissible because of the many shariah issues surrounding them.

Even if the gharar and maysir arguments can be rejected, there is still the issue of riba involved when loans are made to facilitate short selling of securities that is not owned by the short seller.

With this conclusion Islamic financiers have to resort to structuring their own shariah compliant hedging instruments as risk management tools as well as those products that can mimic conventional short sale so that huge petrodollar funds from the Gulf and the rest of global funds seeking for Islamic investments can be put to work and compete with the other hedge funds. But innovative products can only be structured if the industry can cope with the many shariah issues facing it. Some conservative scholars prefer to play safe and avoid innovations and this tends to hold back the industry. Certainly shariah principles need not be compromised, but scholars need to consider Islamic law in the light of modern day requirements and that there is considerable potential welfare loss due to incompetencies and slow shariah responses to today's financial demands and problems.

This paper has also discussed one of the alternatives to short sale ie the Bai salam contract. As in all Islamic products, instruments involving salam contracts should embody all the principles and requirements both in form and spirit of the shariah. Thus, shariah screening, rather than being viewed as extra risk, is to act as impediments to bad investment decisions and hence provide investors with a more superior set of risk management tools.

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