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THE PRACTICAL MODEL OF HEDGING IN ISLAMIC FINANCIAL MARKETS

Ehab Injadat
Independent Researcher, Ajloun, Jordon
drehab@hotmail.com

Abstract

The Islamic law disapproved using the current conventional hedging instruments that are used in current derivatives markets although these instruments are considered the effective tools used to protect from systematic risks in global financial markets. However, the evaluation in Islamic finance and also the expanding nature of the industry of the Islamic finance should be taken into account. As such, the hedging product becomes vital in Islamic finance and a similar demand will also be facing the market. This is a call for the formulation of Islamic hedging model to provide services of Islamic hedging. In this context various opinions of hedging model show that the concept of hedging is not fully unify and is frequently out of offer hedging services. Consequently, this study has tried to develop model of Islamic hedging. Therefore, the Islamic law perspective, conditions and requirements for applying this model as protection tool from systematic risks will be presented in this section. The methodology used in this study is qualitative research method of document analysis, through highlights the literature materials such as academic research's relating to hedging including contemporary and classic jurisprudence scriptures. This study finds that the perception of hedging according to Islamic law is different from the conventional hedging. The Islamic model of hedging in the financial markets must be used to manage& reduce risks, involves real activity, applied by Shari'ah compliant instrument, and conduct on Halal products.

Keywords: Hedging, Risk Management, Speculation, Islamic Finance

INTRODUCTION

Hedging is a process of undertaking the procedures and measures for protection from harms. Hedging is also an art of managing risks. Generally, Islam allows hedging because the basic goal of hedging is to protect and avoid probable risks. Thus, it is in line with the concept of *Maqassid al-Shari'ah* (Islamic purposes). In fact, this was what Islamic law has originally prescribed in keeping and protecting the money from damage and loss. The following is a clarification of the concept of hedging by the Islamic *Shari'ah* scholars. By hedging, the loss from risk that continuously occurs in the financial market can be minimized (Ahmad & Halim, 2014). Nevertheless, in the context of conventional market, hedging involves the use of derivative instruments that Islam views as controversial. Ayub (2011) & Smolarski*et al.* (2006) stated that hedging could be different from *gharar* and gambling, and it could be used as economic and cooperative instruments for risk management where the returns are justified by taking risks (*al-ghunmbil-ghurm*). Risk reduction purposes appears to be permissible under *Shari'ah*. So, there is no room for doubt that hedging is in line with the goal and principles of Islam, but there is a difference in terms of the method to be used to achieve the goals.

Dusuki (2010) concluded that risk management is important, and strategic actions must be taken to handle risk efficiently and promptly. Hattab (2010) declared that hedging is important to protect Muslims from the financial crises and major risks. Therefore, hedging must be taken into account. He also added that the hedging instrument is a one of the most complex contemporary tools invented by the human mind in the modern era and some of these tools are forbidden by the OIC Figh Academy.

Obaidullah (2002) stated that hedging is consistent with the Islamic rationality, but hedging with current conventional derivatives is fraught with serious dangers. In addition, Razif*et al.* (2012) further said that hedging in general is accepted by *Shari'ah* as long as it fulfills the objective of *Shari'ah* in protecting property.

Humans require properties to live a better life, and Islam is assured of managing property and wealth. In this sense, Islam permits hedging as it will bring *maslahah* and fulfills the principle of *maqassid Shari'ah*. However, hedging depends on the hedging method, which must be within the framework permitted by *Shari'ah*. *Shari'ah* admits hedging and its importance, and the tools and procedures taken to achieve this are encouraged as long as they do not contradict with the *Shari'ah* norms (el-Gari, 2008). Even though *al-Shari'ah* indicates maintaining wealth as a form of benefit to avoid harm, the activities that are undertaken to manage risk must be from accepted instruments not including prohibited elements by *Shari'ah*. (Abu Ghuddah, 2007).

Al-Ghoul (2008) stated that *Shari'ah* does not object the opinion of reducing risk by hedging, provided that certain conditions are met. In an attempt to be compliant with *Shari'ah*, the risk in hedging should be inevitable, insignificant, unintentional, and the probability of a failure should be less than the possibility of success.

Three conditions have been outlined by al-Suwailem, (2007) and Dusuki (2010) in order to manage risk in accordance with the *Shari'ah* provisions: the instrument must be in line with the *Shari'ah* law (*al-ghunmbil-ghurm*), the instrument does not contain ambiguity (*gharar*) or *riba* or gambling, and the instrument is in compliant with the *Shari'ah* principles and is used merely for risk avoidance and management, as stipulated by *Shari'ah.* The grounds for Islamic hedging must be the *hadith* of *al-kharaj bi al-daman* and the *al-ghunm bi al-ghurm* principle. As summarized by Aboziad (2014) & Ahmad & Halim (2014) Islamic hedging must fulfill the followings, the instruments are permissible, the purpose is hedging and hedging only, and the process includes actual buy and sell. Islamic hedging to reduce risks must be associated with genuine economic activities only.

Meanwhile, Some suggested hedging is purchasing assurance policy to transfer risk. (Obaidullah, 2004; Kolb & Overdahl, 2006). Besides, hedging is as investment activities intended to reduce and avoid risks by using current hedging contract in the financial markets (Kamali, 2002, Obaidullah, 2004). In hedging activity gain is vital in the sense that the profits made will offset against any future price fluctuations (Abu Bakar, 2010).

Based on the above, there are numerous opinions of hedging model show that the hedging in Islamic law is not fully unify and may involve speculation activities. Even though the main objective of hedging is to reduce the risk of loss, the questions arise whether the concept of hedging can be used to avoid risks, or eliminate risks, or gains and trade, or perhaps simply to reduce risks alone. The inconclusiveness in applying hedging instruments causes the business to be tainted from risk protection by those who want to make easy profits and speculation. Therefore, this study tries to develop *Shari'ah*-compliant hedging model, where hedging model should be compliant with Islamic law.

RESEARCH METHODOLOGY

This study follows qualitative research namely contents analysis method of document analysis, Amongst the main publications and document' that cover hedging conception. Consequently, it has been highlighted on literature materials such as books including the contemporary and classical *fiqh* scriptures, recent publications, and seminar working papers. Data analysis method that used in this study is inductive approach to develop the Islamic hedging model after scrutinizing and interpreting the overall information about hedging.

FINDINGS

Islamic hedging Model

The conditions for hedging from the perspectives of *Shari'ah* as reported by Islamic finance researchers' opinions and recent publications about hedging are presented in Table 1.

Table 1: *Shari'ah* Compliant Hedging Model

Hedging Case / Researcher	Conduct on Acceptable Underlying Asset	Manage & Reduce Risks	Instrument is in line with Islamic law	Involves Economic Activity	Risk Transfer & Insurance	For Speculation and Profit	Eliminate Risk
Obiyathulla (2002; 2004)		✓			✓	✓	✓
Kamali (2002, 2006)		✓				✓	
Smolarski*et al.* (2006)		✓					
Al-Suwailem (2007)	✓	✓	✓	✓			
Kolb &Overdahl (2006)		✓					
Abu Ghuddah (2007)	✓		✓				
Saadiah& Ali (2008)		✓					
Al-Ghoul (2008)	✓	✓	✓				
El-Gari (2008)		✓	✓				✓
Arbouna (2008)	✓		✓	✓			
Metzger (2009)					✓		
Dusuki (2009)		✓	✓	✓			
Hattab (2010)	✓	✓					
Ayub (2011)		✓	✓	✓			
Razif *et al*. (2012)		✓	✓				
Zahan&Kenett (2012)		✓			✓	✓	
Ahmad & Halim (2014)	✓	✓	✓	✓			
Aboziad (2014)		✓	✓	✓			
Oubdi & Raghibi (2017)	✓	✓		✓			
Total	**7**	**16**	**10**	**7**	**3**	**3**	**2**

From Table 1 it is clear that hedging itself is permissible in Islamic law. However, in order for hedging activities to comply with Islamic law, and avoid misusing prohibited purposes as what happened in conventional derivatives markets, four conditions must be met in using any derivative contract for hedging in Islam.

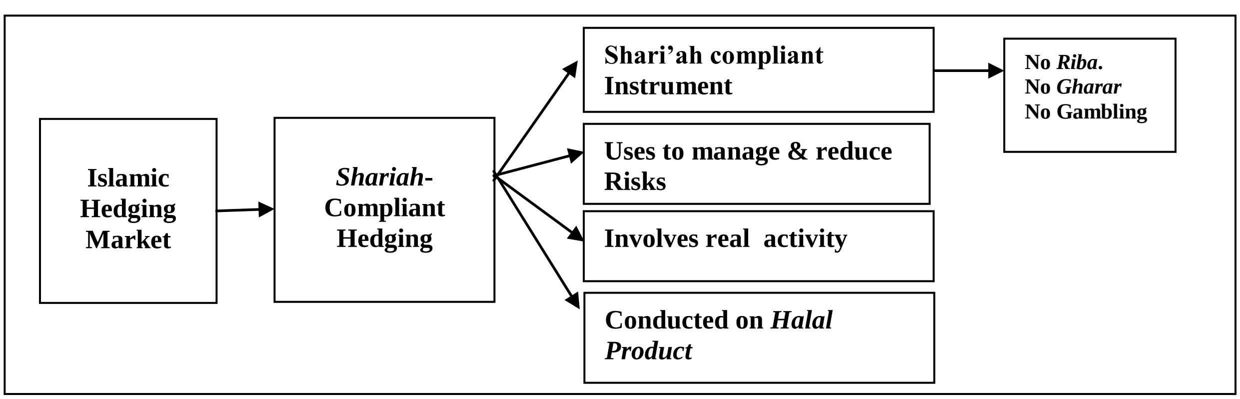
Firstly, hedging process must be done only for the purpose of managing and reducing the expected risks in the financial market. Meanwhile, hedging are not allowed to transfer risk or eliminate risk, the rule of investment in Islamic law does not permit the risk to be eliminated in totality As well as not allowed to be used for speculation and arbitrage. So designing hedging market will be only to offer hedging without speculation activities. the hedging process includes taking a relatively limited amount of risk where the possibility of a gain outweighs that of a loss; its ultimate goal is to reduce the risk of a loss.

Secondly, the hedging instrument must be compliant with Islamic law, the hedging instrument should not contain any prohibited elements as those found in conventional derivatives instruments such as *riba*, *gharar*, and gambling.

Thirdly, the hedging activity must be through economic contract linked with real activity such as actual buy and sale guided by Islamic rules (*al-ghunmbil-ghurm*), embedded in the hedging feature. Where accepted risks that can be hedged these include the risks that are inherent in real activity which generate. It's clear in prohibiting the getting of returns and profits without bearing the responsibility of economic activity. Instead, Islamic law stipulates taking the responsibility for real activity carried out through the ownership of properties and benefits which generates the wealth with an emphasis on risk reduction or cancellation, and yet that last one is impossible. Therefore, the best way to control the risk is by linking it with the real activity which generates wealth which in turn will cover and compensate the risks, and consequently traders will achieve two purposes at the same time: generate profit (wealth) and control risk

Lastly, the underlying assets in hedging contract must be compliant assets with Islamic law. Hedging will not be valid if the hedging instrument used contradicts with any of the conditions mentioned. As such, all efforts in establishing the *Shari'ah*-compliant derivatives market will be focusing on providing the services of Islamic hedging that are fully *Shari'ah* compliant as presented in Figure 1. Figure 1 illustrates the four conditions for hedging provided by derivatives market from the perspective of *Shari'ah*.

Figure 1. *Shari'ah* Compliant Hedging Model



CONCLUSION

Hedging itself is permissible in Islamic law. However, in order for hedging activities to comply with Islamic law, and avoid misusing prohibited purposes as what happened in conventional derivatives markets, four conditions must be met in using any derivative contract for hedging in Islam, hedging process must be used only for the purpose of managing and reducing the expected risks in the financial market, hedging must be applied by *Shari'ah* compliant instrument, hedging activity must be involve economic activity linked with real activity, and the underlying assets in hedging contract must be compliant assets with Islamic law (*halal* product). Further studies are recommended regarding to developing Islamic hedging through the use of Islamic contracts or the development of conventional hedging contracts.

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