The Viability Hedging Instruments in Current Application

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Abstract: Hedging method is often associated with derivatives contract. However, the application of derivatives in hedging is facing some arguments and disputes among the jumhur fuqaha (majority Islamic jurists). Therefore, various alternative methods of hedging recommendations have been given by the islamic scholars. Despite these recommendations not all of them can be applied in the current financial industry. Therefore under this study, these recommendations will be divided into 2 categories, the proposed hedging method that is difficult to be applied and the proposed hedging method that can be applied. The study found that among various tools of hedging proposed, the principle of wa’d is one of the most relevant and suitable method to be adopted due to its flexibility and easy application in hedging products.

Keywords: Hedging method, derivatives, industry, wa’d, jumhur fuqaha

INTRODUCTION

Islam recognizes that risk is part of life. However, Islam is against the two forms of extreme risk taking attitude which is to avoid all risks by means of making profits without incurring any risk, such as the practice of usury and the excessive risk taking as in gambling related activities. Islam encourages risk taking that has been analyzed and weighed (calculated risk) in profit making.

Some of the risk management methods that have been discussed and permissible by the Islamic scholars are to limit the scope and level of risk to be taken in investments, diversification of investment instruments and 3rd party guarantees.

Since, the concept of hedging and its importance is recognized in Islam, the instruments and measures to achieve it is encouraged, as long as it is within the legal scope that is permissible by the shari’a (Ahmad and Halim, 2014; Elgari, 2009). Although shari’a promotes preservation of property, as a form of maslahah to avoid from harm and destitute, the effort of managing risk must beseech instruments allowed by the shari’a.

This study will examine hedging instruments proposed by the earlier Islamic scholars. These proposals can be divided into 2, the proposed hedging instruments that are difficult to apply and the proposed hedging instruments that can be applied.

HEDGING INSTRUMENTS THAT ARE DIFFICULT TO APPLY

Amongst the hedging instruments difficult to apply are Bay’ al-salam, Bay’ al-istijarar, Bay’ al-ji’alah, gold dinar and mutual borrowings.

Bay’ al-salam and istisna’: Khan (1995), Al-Darir (1997), Iqbal (1998), Vogel and Hayes (1998), Kamali (2000) and Ayyash (2005) view that the contract closest to forward contract is Bay’ al-salam (according to the schools of Shafi’i and Hanbali). Bay’ al-salam is a contract that is deferred and is a debt and payment is received while he was in the contract. Maliki school defines it, as a sale and purchase of capital paid in advance while the delivery of goods is within the time agreed upon while Hanafi says that Bay’ al-salam is a delayed purchase of a product with payment due immediately. However Vogel and Hayes (1998), views that al-salam contract is not a perfect substitute to the conventional forward contracts while al-istisna’ contract has some of the characteristics that belong to the conventional forward contracts. A legalized buying and selling of salam brings multiple benefits to humanity because of the ease of getting what one needed while allowing another to raise capital. In fact, this method also paves the way for money to be used, as a platform for people to achieve their life goals.

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Salam literally means an advance payment (capital)
Bay' al-salam is permissible and exempted from the
method of buying something that does not yet exist
(ma'dum) in order to uphold the economic maslahah and
to create flexibility to the market and meet the needs of the
people. This contract is also important to the Islamic
financial institutions in order to reduce the risk of extreme
price fluctuations of commodities from the time of delivery
until it is time to sell in the market. In addition, it also
benefits both the seller and the buyer because the seller
can acquire cash as capital while buyers can eliminate the
risk of future price volatility (Khan, 1995; Iqbal and
Mirakhor, 2007).

Moreover, the industrialist producers, such as
in agriculture, manufacturing and so forth practice
Bay' al-salam, especially when they lack capital. Through
Bay' al-salam, they can sell agricultural or manufactured
products in advance with deferred deliveries and acquire
financial capital. With this they could incur expenses
awaiting production and the harvest of crops, such as
the purchase of seeds, equipment or machinery. When the
manufactured product has been completed or the crop has
been harvested, they will submit an agreed rate to the
buyer at the time stated in the contract. With this price
fixing, the farmer's only concern of price fluctuation
(falling) will be protected. Thus by doing Bay' al-salam, a
buyer and a seller can avoid the risk of loss due to future
price changes. Bay' al-salam is more practical than a
futures contract in helping the farmers and producers and
facilitate transactions. This is because:

- It can protect farmers from price volatility and market
  risk, especially when it is time for harvest
- It provides liquidity to enable farmers to receive
  payment in advance and delay shipment of goods
- Acceptance of cash money will help farmers to meet
  costs and expenses required to purchase raw
  materials
- By requiring early payment, traders will not have the
  opportunity to make speculation

In fact, the conditions in Bay' al-salam, such as the
statement of goods specification clearly avoids the
element of ghurar. In other words, Bay' al-salam brings
benefit to the 2 contracting parties of which the
welfare of the seller is an advanced price determination
and to the buyer is the lower price. This indicates
that the permissibility of Bay' al-salam is in accordance
with the principle of upholding maslahah and refutes
mafsadah.

However, the problem of getting mutual requirements
simultaneously, also occurs in Bay' al-salam as in
future contracts. Thus, some of the problems that occur
in forward contracts, such as mutual requirements,
price negotiation and counter party risk can exist in
Bay' al-salam (Bacha, 2007). In addition, the risk of
default in a contract is also present in both of these
contracts.

The only difference is that in Bay' al-salam, the
default risk is only on the buyer who has already made a
full payment on goods to be delivered in the future.
Whereas in the futures contract, both parties face the
risk of default because both the goods and the price have yet
to be specified. So, the risk of default is higher in futures
contracts than Bay' al-salam.

In addition while Bay' al-salam can be in
accompany with future contracts, it cannot be used
for speculation and monopoly, instead it can only be used
as an exchange for real goods. With this, the contract will
not escalate the speculative activity and will only benefit
the producers and traders involved in real trading (Khan,
1995; Ayyash, 2008). Bay' al-salam, closely resembles the
conventional forward contracts for delayed delivery of
goods into the future. The only thing that differentiates
between the 2 contracts is the price must be paid in
full in Bay' al-salam whilst in futures contracts, price
will be paid upon the delivery of goods (Al-Suwailem,
2006) is also suitable, as an instrument of hedging activity in futures
contracts due to the observed conditions in Bay' al-salam
that is not too stringent and can accept changes and
modifications.

Al-Suwailem (2006), suggests for the value based
salam of Bay' al-salam to reduce the risk of price
movements in which the value is the quantity specified at
the beginning. Here, the value referred to is the quantity
multiplied by price. For example, the buyer pays the initial
RM10,000 to buy oil. The value here refers to the quantity
times the unit price or the number of barrels multiplied by
the price of a barrel. Buyers may be protected from the risk
of price volatility because even though prices at the
maturity date falls, the total quantity delivered will
increase to replace the fall in price. Vice versa if the price
on the maturity date goes up, the total quantity will fall in
place of the rising prices. The proposal is viewed as quite
appealing for application but Al-Suwailem (2006) provides
no details for this proposal. Thus, this method deems
difficult to apply because there is no in depth analysis
done to see the suitability of its use. In fact, there are also
issues to be resolved, such as whether the relevance of
value based salam is limited only to commodities
hedging? How value based salam can be applied to hedge
the risk of foreign currency rate movements?

In fact, the application of value based salam in the
current market for hedging purposes is deemed difficult
because the contract itself has its own risks. Bay' al-salam
has a risk where goods delivered are not the same as
required. This is because payment has been made in full at the beginning of the contract. In fact, the goods to be delivered in the near future has the possibility to be dissimilar with the one as required by the buyer or the seller cannot possibly provide the goods as required and agreed in the contract. Furthermore, the full advance payment condition in Bay'al-salam has made it impractical for the current reality whilst market players prefer to pay only a deposit in the beginning of the contract. Bay'al-salam is not liquid and this makes the market less competitive. In fact, this contract is limited and only confines to commodities.

Tag El-Din (2004), also contradicts the view of the Islamic scholars who say that Bay'al-salam could be an alternative to futures contracts. According to him, Bay'al-salam is a method of hedging specific to the capital provider not the manufacturer. Moreover the function of Bay'al-salam, as a discounted futures price makes it unsuitable for future prices prediction. Therefore, Tag El-Din (2005) views Bay'al-istisna' as a suitable alternative to the Islamic futures market as both subjects, akad (contract) and price may be deferred (this study combines the Bay'al-istisna' discussion in the topic of Bay'al-salam because majority of the Islamic scholars discuss istisna' as a topic under al-salam. The discussion of Bay'al-istisna', as a topic under Bay'al-salam is because the schools of Malikii, Shafi'i and Hanbali are with the view that both of these contracts involve of goods ordered not in existence or not yet manufactured or not yet in the hands of the seller. For example, the Malikii discusses it under a small subject under the topic of manufacturing of al-salam. Shafi'i and Hanbali, also put it under the heading of salam but did not provide specific definition. However, Bay'al-istisna' is specifically only for items that will be manufactured or constructed based on order, rather than items that are already in the market). Bay'al-istisna' or a manufacturing/construction contract order is a contract of sale of specified items to be manufactured or constructed with an obligation on the part of the manufacturer or contractor to deliver them to the customer upon completion. This manufacturing/construction contract order closely resembles the contract order items (salam) based on these circumstances, the contract of istisna' in terms of qyas is similar to salam which is not permissible because it is a buying and selling of a goods that is not yet in existence, since a contract on something that is not yet in existence is not allowed. However, the Hanafi school permits it based on the principles of istishin because people have practiced it since ancient time without any objection, it is hereby found to be consensus. Meanwhile, the schools of Malikii, Shafi'i and Hanbali permit the contract of istisna' based on the concept of salam and because it has been long practiced by the society. With this, they require for all the terms and conditions of salam contract to be adhered to in istisna' (al-Kasani, al-Bada'i, al-Zuhayli, al-Fiqh al-Islami, al-Khin, al-Fiqh al-mahajji) because it is also a buying and selling of a non existence goods which becomes an obligation to the manufacturer (seller) once the contract is sealed. It differs from the order of goods in the aspect that it does not need for an advance payment to be made and the period of work and date for delivery are not specified. The goods ordered also does not necessarily be the same as seen in the shops.

Tag El-Din, also explains that Bay'al-istisna' appropriates, as a means for hedging because there is no element of the sale of debt in this contract. In addition, the function of Bay'al-istisna', as a fixed rate mode will be replaced by a function of hedging in the Islamic financing. However, Tag El-Din's proposal for Bay'al-istisna' to be used for hedging purposes seemed to be impractical. This is because the Bay'al-istisna' permissible by Islam is only in manufactured goods whilst the hedging activities are not limited to manufactured goods only but also in foreign exchange activities, stock buying and selling, etc. Moreover, although Bay'al-istisna' is seen as more likely to resemble a futures contract for goods and payment of the price is delayed (unlike Bay'al-salam that requires full payment), Bay'al-istisna' is not suitable to be implemented in commodity trading already existed in the market (Al-Amine, 2001, 2008). Based on the discussed earlier, Table 1 concludes the strengths and weaknesses of Bay'al-salam as a method of hedging.

**Bay'al-istisna':** According to Ibn Abidin and Amin, istisna' means to extract from time to time in different

### Table 1: Strengths and weaknesses of Bay'al-salam and Bay'al-istisna' in hedging

<table>
<thead>
<tr>
<th>Strengths</th>
<th>Weaknesses</th>
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<tr>
<td>Control risk of price fluctuation</td>
<td>Counterparty risks</td>
</tr>
<tr>
<td>Prevent speculative activities</td>
<td>High cost</td>
</tr>
<tr>
<td>No element of gharar clear contract terms</td>
<td>Difficult to apply</td>
</tr>
<tr>
<td>Involve real economic activities</td>
<td>Difficult to determine price</td>
</tr>
<tr>
<td>Standard underlying assets, therefore easier to specify quantity and quality</td>
<td>Difficult to meet simultaneous mutual requirement. Advantage is more on the seller</td>
</tr>
<tr>
<td>Protect seller’s right in the aspect of full payment at the beginning of contract</td>
<td>Suitable on for commodities, cannot be used for currency underlying assets. For Bay'al-istisna' cannot be used on goods that is already in existence</td>
</tr>
</tbody>
</table>
quantities. Bai' al-istijjarar is a form of contract between the customer and the vendor to supply for materials at regular intervals such as daily, weekly or monthly with the price and method of payment as specified. This contract allows the buyer to purchase the required goods from the seller with payment made later it may occur, if there is a bid for offer and acceptance and may also occur, if there is a bid for acceptance and offer and shall apply, if there is taking and giving without bids and acceptance (El-Muhammady, 2008). Obaidullah (2004) and Bacha (2007), suggest for the use of Bai' al-istijjarar, as an alternative to futures contracts for under Bai' al-istijjarar, payment is made in the future and delivery of goods can be done in piece meal from time to time.

According to Bacha (2007), the use of Bai' al-istijjar in hedging is complex because it contains a combination of option contracts, average price and murabahah (cost price plus financing). Normally, this contract involves two parties, namely the buyer, i.e., the company who is seeking financing and the bank. The bank will buy commodity and then sell it back to the company at a certain price to be paid at a certain time at a future date. The actual price on the date is dependent on the movement of commodity prices (underlying asset) beginning from the commencement of contract to maturity. The contract, also involves the upper-bound option and the lower-bound option, whereby the contracting parties may choose to set a settlement price at any time before maturity date (Bacha, 2007; Kunhibava, 2010).

According to Obaidullah (2004), the use of Bai' al-istijjar avoids price movements speculation. The contract is also required being a necessity and it is an ‘urf of the community to ease their living in meeting daily needs (El-Muhammady, 2008). This reflects the nature of Bai' al-istijjar, as being flexible and adaptable in many other Islamic financial products. However, the use of Bai' al-istijjar given is too broad and not focused. The use of Bai' al-istijjar, also has evidenced some disadvantages such as illiquidity, thus inapplicability and inflexibility since it is only good for certain commodities (Table 2).

Bay’ al-jī’alāh: Al-jī’alāh is a promise of gifts or reward/gratuity and assertion. It is a contract that promises certain benefits for a specific job whether specified or majhul or difficult to determine. Khan (1995), Salehabadi and Aram (2002), Bacha (2007) and Kunhibava (2010) suggest for the use of Bay’ al-jī’alāh in lieu of a futures contract. Kunhibava (2010), states that Bay’ al-jī’alāh appropriates to be adapted in the Islamic derivatives compared to Bay’ al-salam for the delivery of goods and payment can be deferred.

For example, Ahmad who is a rice farmer who will harvest the crop in 6 month time, Ahmad plans to export up to 3 ton of crop in the next 6 months time and want to fix the price now. An intermediary accepts the offer and promises to pay a gratuity after the delivery of goods is done, thus Bay’ al-jī’alāh is formed.

Whilst Ali who needs to acquire rice yield in the next 6 months time, promises payment upon the delivery of yield. Price to be paid is based on the market price of rice. In this situation, the delivery of goods and payment will be arranged by an intermediary (clearing house).

Kunhibava (2010), concludes that Bay’ al-jī’alāh can be used, as a solution to the futures contract because:

- Jī’alāh allows delivery and payment of goods on a deferred basis
- No issue of sales before ownership because the agent will take possession prior to submission to the clearing houses
- It does not involve the sale of a debt with a debt, since it involves services
- It does not involve speculation and gambling, as players enter the market with intention to hedge

However this contract has its weaknesses, especially when the parties involved do not fulfill their promises. These weaknesses make this contract generally unacceptable to be used, as a method of hedging and poses risks to the contract (Table 3).

Gold dinar: Meera (2004) has discussed, the reliability of gold dinar system in increasing market efficiency and reducing cost compared to derivatives. The cost incurred in the trade transactions using gold dinar is lower than derivatives because only the accounting record is required. This means that the accounting of gold stored, through the central bank’s intermediation and
only net difference between the countries would be resolved on a regular basis. For example, Malaysia exported 50 gold bullion to Indonesia and imported 30 gold bullion from Indonesia. Price settlement can be done without incurring any physical transfer, instead based on the surplus which is 50-30 = 20. So, Indonesia will only pay 20 gold bullion to Malaysia. This transaction, also requires only a small cost because it can be done via an electronic medium.

Meera (2004) and Salmy Edawati and Ab. Mumin are also of the view that because gold has an intrinsic value and is stable, gold dinar could eliminate exchange rate risk if price is determined based on the value of gold. So, the application of gold dinar does not require the use of forward contracts, futures contracts or options. The application of gold dinar could also reduce the occurrence of arbitrage activities and currency speculation. This is because gold dinar prevents manipulation and currency speculation.

If any 3 countries agreed to use gold in their payment system, the 3 forms of currencies of the 3 countries will become one. In fact, the union of the 3 forms of currencies in the form of gold dinar facilitates diversification. This is because the 3 forms of currencies each poses different currency risks that is unique based on their respective countries. Thus with the currency union, the unique risk can be reduced. In addition, the application of gold dinar also has advantages because it does not require speculators, as in the derivatives contracts which requires the presence of speculators to boost liquidity.

Although, the proposed reapplication of gold dinar in the monetary system seems interesting enough, it is not feasible in the context of current economy for the recommendations given is of a general nature. In fact, so far gold dinar has not been used as a hedging mechanism thus this proposal deemed to be inapplicable (Table 4).

**Mutual borrowings:** Islamic banking and investors can hedge with the activity of mutual borrowings by exchanging the same amount of money to borrow the same amount in another currency at a specified period. The method of mutual borrowings is carried out without involving any interest or usury. Thus, the method of mutual borrowings is commonly known as tabadul qard al-hasan (Al-Amine, 2008). This type of borrowings is necessary because at times, there is the possibility of Islamic banks who are in urgent need of funds to finance large loan applications from customers. However, funding of this sort is difficult to carry out due to the maximum funding limit or single limit policy or other reasons related to risk and affordability. Thus, tabadul qard al-hasan is carried out in such a way that Islamic banks will provide a form of understanding to borrow without interest from the conventional banks now and the Islamic banks will lend money to the conventional banks in the future under similar term and amount.

In addition according to Ahmad Subaiami, the Shari’a Committee of the Islamic Development Bank is of the view that mutual borrowings between 2 institutions based on different currencies can be used, as a solution to hedge against currency depreciation. For example, if Bank A does not have the opportunity to invest in Yen currency, it may lend to Bank B in Yen. Next, Bank B will lend money to Bank A in other currency (e.g., dollar) as required. Both loans are interest free. At the end of the loan term, Yen will be returned to Bank A and dollar will be returned to Bank B. To achieve this purpose, banks would enter into a bilateral Memorandum of Understanding (MOU) for mutual assistance in relation to liquidity through mutual interest free loans to each other by using different currencies and thus can be used, as a solution to the issue of hedging against currency depreciation. This mechanism is regularly practiced by the Islamic financial institutions in the Middle East.

This means that any profit earned from investment of this method is not accounted for in hedging activities (Al-Amine, 2008). While Wan Mansor, suggests for hedging by borrowing money from other currency markets, such as the Euro or the Asian currency markets. Despite that the mutual interest-free loan is a good hedging method, it requires high cost and is difficult to apply (Hassoune and Carasse, 2010) (Table 5).

**HEDGING INSTRUMENT THAT CAN BE APPLIED**

Amongst the proposed hedging methods that can be applied currently is the Bay’ al-‘urban, wa’d commodity murabahah.

**Commodity murabahah:** Commodity murabahah is the transaction of buying and selling of commodities with deferred price with cost and sales profit have been prior agreed. The purpose of its application is for liquidity
management, risk management and to provide investors with greater liquidity of lower risk. In other words, commodity murabahah is a cash deposit product based on the Islamic concept, i.e., a commodity based transaction that is globally received to facilitate liquidity management and investment. This product involves the transaction of buying and selling of metal commodities in the London Metal Exchange (LME) based on the principle of murabahah of a fixed profit rate. The shari’a basis for murabahah are:

- Commodity must exist
- It has a physical or constructive possession of commodities
- The purchase price shall be made known and without conditions of any future events
- The price cannot be changed after it has been fixed

At present, commodity murabahah is widely used in London Metal Exchange to facilitate liquidity requirements. In Malaysia, commodity murabahah is known to have adopted crude palm oil, as the underlying asset and transactions are carried out based on the concept of murabahah and tawarruq. The concept of tawarruq involves sales contracts whereby the buyer will purchase an asset from the seller on credit and then the buyer then sells the same asset to a 3rd party, at a lesser value for the purpose of getting cash. At present, tawarruq is widely used, as a tool for liquidity and has obtained approval from the shari’a advisory council of the Bank Negara Malaysia and Securities Commission of Malaysia based on maslahah.

However, murabahah contract incurs delivery cost of the commodity. In addition, there is a shari’a issue in the identification of commodities, commodity ownership before sales, charges for the delivery of goods and fee payment to relevant parties. In fact according to Siddiqi (2007), the use of tawarruq based commodity murabahah brings more harm than good. Siddiqi (2007), also states that tawarruq lies outside the contract of shari’a compliant.

Sultan (2008), revealed that the commodity murabahah was very useful in hedging, being flexible and can easily be adapted in hedging products, such as the Islamic FX forward, Islamic option, IPRS dan ICCS. In the use of commodity murabahah in Islamic FX forward, a customer and the bank will normally enter into 2 separate murabahah contracts to perform forward FX transactions. Customers will buy the commodity on the spot and then sell it to the bank with cost plus profit which will be paid on deferred basis. In addition, customers who wish for hedging instruments on a forward

<table>
<thead>
<tr>
<th>Strengths</th>
<th>Weaknesses</th>
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<tr>
<td>Flexible contact</td>
<td>Shari’a issue in tawarruq</td>
</tr>
<tr>
<td>Provide liquidity facility</td>
<td>Commodity ownership is before sales is made</td>
</tr>
<tr>
<td>Easy to apply</td>
<td>Additional cost on commodity delivery</td>
</tr>
<tr>
<td></td>
<td>Problem in commodity identification</td>
</tr>
</tbody>
</table>

Table 6: Strengths and weaknesses of commodity murabahah in hedging

foreign currency exchange transaction can also provide a way to the bank to buy some amount of commodities from the bank and then appoint the bank to sell the commodity to a 3rd party. On the agreed date, tawarruq transactions will be carried out through the buying and selling of the commodities with direct payment delivery (Bank Negara Malaysia, 2010) (Table 6).

**Bay’ al-‘urbun:** Bay’ al-‘urbun is a contract where the buyer will make an advance payment with a calculation that if he continues to go ahead with the asad (contract) then the advance payment becomes part of the price of goods. However, if the buyer does not wish to continue with the contract, the deposit will be forfeited and become the property of the seller. Maliki and Shafi’i schools prohibit this type of transaction. Hanafi school on the other hand prohibits Bay’ al-‘urbun because of the 2 flaws, i.e., the condition of hibah and the condition for the return of money under the assumption that the seller is not selling due to the condition of nonreplacement. But if there is no precondition of the sort, the seller then can ask for the buyer to pay a portion of the goods price, as an advance deposit to secure the contract. The seller also cannot take the deposit if the contract is canceled and void except with the consent of the buyer.

Although, there are differences in opinions on the permissibility of this contract, the Shariah Advisory Council established the permissibility of Bay’ al-‘urbun ruling (Securities Commission, 2006). At present, Bay’ al-‘urbun is the foundation that binds businesses which provides a guarantee and promise to indemnify the loss of another person due to the long waiting before the contract is completed. This indicates that Bay’ al-‘urbun is valid and has already become the practice of many. It is customary for the people of today to pay an upfront deposit in any business transactions for protection of all contracting parties against the inability of 1 party to fulfil the contract. In other words, Bay’ al-‘urbun is permissible because it does not contradict with the shari’a principles that accepted ‘uruf sahih.

The Islamic Fiqh Academy in its resolution no 72/3/8 in 1993 has also decided that Bay’ al-‘urbun is permissible if the buyers were given a set period of time to make decisions whilst the advance deposit is treated, as part of the purchase price if the contract were carried out and the deposit will be the property of the seller if the buyer cancels the purchase (Islamic Fiqh Academy, 2000).
Bay' al-'urbun has a common similarity with option contract in terms of premium payment aspect that is charged, as a sign of promise (Elgarni, 1993; Bacha, 2007; Kamali, 2002). A payment given in advance is to enable the buyer to have options whether to continue or cancel the contract is a suitable alternative for the conventional option contract. The buyer will lose money al-'urbun, if he cancels the contract. Examples of the use of Bay' al-'urbun in investment: An investor has purchased a number of shari'a compliant shares worth RM100,000 and expects the market will fall in the future. However, prices in the future stock market has fallen to RM90,000. The investor has suffered a loss of RM10,000. However by using the al-'urbun contracts, the investor can limit the loss that may be encountered. Suppose the investor has to pay ‘urbun money of RM2,000 and within a month then the market price falls, thus by not continuing with the contract, losses can be controlled and limited to the amount of the urbun, i.e., RM2,000. If the market rises, investors will exercise their rights to purchase and only pay the balance of the share price which is RM98,000 and may sell the shares at the market price of RM120,000. This is similar in option contracts in which the buyers too will lose their options money when making a decision to discontinue the contract (Vogel and Hayes, 1998). Bay’ al-'urbun, also allows investors to benefit from the positive equity price movements and if the price movement is just the opposite, the investors can choose to not to implement ‘urbun and only bear a controlled minimum loss.

However, Bay’ al-'urbun is different than options for in options, the advance deposit is not included in the price irrespective of whether the contract is carried out or not. In Bay’ al-'urbun, if the buyer wanted to continue with the contract, the payment Bay’ al-'urbun will be included in the price and if he did not continue to purchase, then the money becomes the property of the seller.

Bay’ al-'urbun basically laden both the contracting parties with maslahah because the requirement of minimal deposit payment gives the buyer the opportunity to have options whether to continue with the contract or to choose otherwise. If the buyer intended to continue with the contract, the deposit money is considered, as part of the purchase price. Conversely if the buyer were to decide otherwise, the deposit cannot be reclaimed. This is because the money now belongs to the seller, as the right owner of the money and as a compensation for the risk of waiting and losing another potential buyers.

Although, the proposed use of Bay’ al-'urbun is somewhat more flexible than other methods, it incurs a cost for the deposit needs to be paid in advance. This method is also not suitable to be applied in other underlying assets such as currency, index and so on. As long as, there is an issue of inapplicability for many underlying assets other than commodity, its use remains limited and is not generally accepted. In addition, there are also arguments about the extent to which the application of the principles of Bay’ al-'urbun is appropriate in hedging, especially when it involves goods that have not been in inception, thus raising another issue of Bay’ al-ma’dum. This is because basically Bay’ al-'urbun involves the transactions of buying and selling of something that has already in existence (Table 7).

<table>
<thead>
<tr>
<th>Table 7: Strengths and weaknesses of Bay’ al-'urbun in hedging</th>
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<tbody>
<tr>
<td><strong>Strengths</strong></td>
</tr>
<tr>
<td>Flexible delivery of goods and payment</td>
</tr>
<tr>
<td>is deferred</td>
</tr>
<tr>
<td>Controls price fluctuation</td>
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<td>No element of gharar clear contract terms</td>
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<td>Disallow speculations</td>
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**Waad**: Wa'd gives the meaning of a promise in the Malay language. In Arabic, the term is usually referred to as ‘ahd and wa’d. Wa’d literally means a promise of something good or bad. However, wa’d is usually associated with good promises. Wa’d would literally mean a promise to each other in matters of good while wa’d would mean bad things, such as a threat or warning forcing one to make the promise. In terms of the Islamic law, wa’d would mean a commitment to do something good in the future.

In general, the term wa’d literally refers to a promise to do something that relates to good deeds, thus indirectly differentiates it with wa’d which refers to bad or immoral deeds. There are also differences between wa’d and ‘ahd. ‘Ahad literally means an affirmation or oath, a promise and a guarantee. ‘Ahad is the pledge or promise of nearness to God in terms of religion and anyone who rejects it will suffer loss in property and woe to the soul which would bring many more harms. While wa’d focuses more on relationships and rights of mankind. So, those who oppose it deemed to be unworthy and neglectful. Wa’d is not exposed to so much harm as ‘ahd. In addition, if someone breaks a promise (‘ahd) or breaks his oath to God, he is deemed to have committed a sinful act tantamount to destruction. Whilst the result of a breach of a wa’d, though is a sinful act does not tantamount to cause a perish or an offence of shirk. Thus if the promise wa’d is for a bad or an immoral deed, it is not compulsory to proceed. With this, the Islamic jurists have adopted the same literal interpretation of wa’d that is a notification to a person to do something good in the future. Hasan (2008) views that wa’d refers to a unilateral promise by 1 party to another to do something in the future, such as a promise to sell and a promise to buy.
According to Razali (2008), a promise should be binding but the law only recognizes certain types of promises which involves an exchange. A promise without giving something back in return for a promise is called an appreciative promise and is not carried out in the eyes of the law. Even the jumhar fuqaha classified wa’d, as a contract of tabarru’. Although, the fuqaha are of the view that wa’d is binding only in terms of religion alone, wa’d is also binding in terms of the law in order to ensure the maslahah on the part of the party receiving such promise. Therefore, the MPS of the securities commission adopted wa’d which is binding from both aspects including religion and legislations in order to ensure stability of transactions.

In the conventional foreign currency forward contracts, bankers and customers will do a contract today for a future exchange of currency with the exchange rate determined today. This conflicts with the shari’a requirement and raises the issue of usury as both contracting parties will make an exchange in the future at the rate agreed upon today. Thus, the application of wa’d principles allows permissibility of the foreign currency futures contract to be carried out based on the shari’a requirement and thus eliminates the issue of usury.

In other words in the currency transactions, such as the Islamic foreign currency forward contracts, ICCS and the Islamic FX swaps, the element of usury is eliminated first with the application of wa’d and then the actual contract takes place, i.e., after there is an exchange of currency which is done on the spot. The use of wa’d in the Islamic foreign currency forward contracts for example, must begin with a promise first and then only the actual contract is valid to be carried out on the date the currency promised to be delivered, executed by both the contracting parties. Thus, the application of wa’d has affected for the Islamic foreign currency forward contracts to be in accordance with the Islamic shari’a, as al-taqabud has taken place and fulfilled the requirement of al-sarf contract.

The principles of wa’d adopted in the Islamic financial transactions, such as foreign currency forward contract is considered as a wa’d mulzim. The use of wa’d which is of mulzim nature is very suitable to ensure the economic stability and the transactions stability (Ahmad et al., 2012). In addition, the application of wa’d does not only make the contract become shari’a-compliance but the principle of wa’d is deemed to be more flexible and easy to apply. This means that in addition to its shari’a compliance, the application of the wa’d principle provides ease does not involve complicated transactions and requires no additional cost compared with other shari’a principles. If the application and process is transparent, thus the transactions of the application of the Islamic hedging product will increase (Table 8).

Based on the analysis made on all the hedging instruments given, the study found that only wa’d application has an advantage over other methods. Although, there are other hedging instruments that are flexible, they require high cost. While the application of wa’d is not only flexible, it also does not require for any additional cost and is very easy to apply. Therefore, the advantages of wa’d have made it become popular in terms of its application in the Islamic hedging products today.

CONCLUSION

Hedging derivatives are closely related derivatives because derivatives are basically designed to realize the objective of hedging. However, due to the arguments and disputes from the majority Islamic jurists on the application of derivatives due to its shari’a noncompliance, various alternatives hedging methods have been proposed. This study divides the proposals into 2 which are the hedging instruments that are difficult to apply and the ones that can be applied. Among the hedging instruments that are difficult to apply are Bay’ al-salam, Bay’ al-istijarar, Bay’ al-ji’alah, gold dinar and mutual borrowings. While the hedging instruments which can and have already been applied is the commodity murabahah, Bay’ al-urubun and wa’d. Based on the analysis of all these instruments, it was found that wa’d is of the most relevance for application in the current practice. The flexibility nature of wa’d without incurring any cost makes it most popular for adaptation of hedging products offered by the Islamic financing institutions in Malaysia.

REFERENCES


