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# Islamic Justifications of Foreign Exchange Options Contract as a Tool of Risk Management

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**Abstract:** Foreign Exchange options contract (FX options) is known as an agreement in which a seller (writer) conveys to a buyer (holder) the right but not the obligation to buy or sell a specific quantity of a currency at a specified price on or before a specified date. This should be considered as an efficient contract as it can help to eliminate the risk of fluctuating exchange rates by fixing a rate on the date of the contract for a transaction that will take place in the future. Although, FX options provides facility of risk management, some shariah issues arise, such as issue of riba, gambling, trading of promise and many more. In addition, FX options contract gives the parties an opportunity to gain leverage which is not allowed in Islam. Thus, the aim of this study is to examine Islamic justifications of FX options contract as a tool of risk management. This study finds that, some shariah principles such as bay' al-urbun, bay'al-inah, wa'd and bay' al-sarf can be developed to avoid the issue of riba. In order to avoid gambling and leveraging activites, this study suggests that FX option contract should be allowed in the first phase only in a static manner. Consequently, this contract should not be allowed to be practiced in the secondary market as currency trading is clearly prohibited in Islam. In order to make sure that this contract is comply with Shari'ah, this contract must strictly be used only in conjunction with real trades in goods and services.

**Key words:** Gambling, leveraging activites, issue of riba, obligation, Malaysia

## INTRODUCTION

Since the early 1970s, the use of derivatives contractas a risk management tool has mushroomed. It has grown rapidly in recent years due to improvements in computer technology and innovations in financial theory. The increasing need to manage risks arising from volatility in the interest and currency exchange rates also contribute to the popularity of derivatives. Derivatives contract that consist of forward, futures, options and swaps are essentially developed for the purpose of fulfilling two requirements, namely to reduce risk and to obtain maximum returns. Meaning that derivatives contract not only used for hedging but it provides institutional investors, corporate treasury departments and bank risk management departments with many benefits over trading the underlying assets.

The simplest form of derivatives is forward contract. It is a contract between two parties to exchange something on a future date at a price agreed upon today. Forward contract is privately negotiated Over the Counter (OTC) and not easily transferred or canceled. Thus, they are not liquid. Due to lack of liquidity in forward contract, futures contract was designed to solve the shortcomings in the forward contract. Both forward and futures contract have some similar features, except that futures contract trades on organized exchanges and subject to daily settlement procedures. Thereafter, as a result of financial innovation, options emerged as an added value to the futures contract. Options contract is more flexible and able take advantage of favorable price movements. Options is the same as futures, except that in options contract, only the grantor of options should pays the margin.

Among underlying assets of options are currencies, equities, rates and index. As options is a type of derivatives that derives its value depend on the value of its underlying, thus the underlying asset for foreign exchange option is currency. A Foreign exchange option is a contract giving the option purchaser (the buyer) the right but not the obligation, to buy or sell a fixed amount

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of Foreign exchange at a fixed priceper unit for a specified time period. An option buyer is not obliged to fulfill the option contract and its loss is limited to the premium paid. Due to its flexibility in nature, options are widely used for speculative activities that can equate to gambling and hence run contrary to the principles of Islam.

Therefore, this study tends to give clearer picture about options contract, particularly FX option as well as shariah issues concerning the contract. This study is non empirical in nature and it use descriptive method in order to discuss and gives a clearer picture about option contract in Islamic perspectives. It will begins with an explanation options contract and description of conventional FX options in managing risk followed by shariah issues arising from the contract, then lastly Islamic FX options contract will be discussed.

## OVERVIEW OF OPTIONS CONTRACT

The first extensive application of options in market is when the Dutch developed a large market of tulip bulb options. Dealers and growers of tulips were involved incall and put options to manage their risk exposure. The market was completely unregulated and unorganized, thus make easy for speculators to take advantage from the imperfection in the market (Gonzalez, 1992).

Contract of option is defines as a right without obligation to purchase or sell an underlying asset at a stipulated price within or at the end of a specified time period. A conventional financial option is often traded as a separate contract in itself (Obaidullah, 1999; Kolb and Overdahl, 2003). However, option seller are obligated to sell or purchase whenever option holder decides to exercise the contract, either to sell or buy (Bakar, 2008). Meaning that the option seller (writer or grantor) in exchange for the premium received must fulfill the option contract if the buyer decides to do so.

There are two types of options, namely put and call option. Put option gives the holder the right but not the obligation to sell an asset at a certain price within a specific period of time. While call option gives the holder the right but not obligation to buy an asset at a certain price within a specific period of time. The price in option contract is known as exercise price or strike price. A decision of choosing either to exercise the contract or let the contract expires is depending on the expectected gain. For call options, the option is said to be in the money if the market price of the underlying asset above the strike price. While a put option is in-the-money when the market price of the underlying asset is below the strike price. In order for the option buyer to make a profit, the price must increase above (call option) or decrease below (put option) the option's strike price by the amount of the premium paid.

Options differ from both futures and forward contracts in that a party to the options contract exercises its right only if the value of the underlying asset reaches a specific amount (strike price). Therefore, a payoff from purchasing an option occurs only when the price either drops or rises to the specific strike price, depending upon the type of the options contract. When a speculator uses futures, the potential loss as well as the potential gain is large. In contrast by using options, no matter how bad things go, the speculator's loss is limited to the amount paid for the options.

Any investor who does not has enough fund is able to do leverage using option contract as premium option is costing only a small fraction of the price. This allows option traders to control the profits on the same number of shares at a much lower cost. Example of illustration of option leverage is by asuming an individual A has $ 1000 and wish to invest in shares of Company X. Company X is trading at $50 while it's $50 strike price call options are asking for $2.00. In this case, A could simply buy shares of X company with all his money and own 20 shares or he can buy 5 contracts of $50 strike call options on X company shares which controls 500 shares. With the same amount of money, A can control 25 times more shares of X company than A normally can by buying shares (http://www.optiontradingpedia.com).

## FX OPTION IN RISK MANAGEMENT

An option is merely a contract that deals with an underlying asset. For this reason, options are called derivatives which means an option derives its value from something else. To hedge against Foreign currency risk, currency option or Foreign exchange option is required. Foreign exchange option, commonly shortened to just FX option is a derivative financial instrument that gives the owner the right but not the obligation to exchange money denominated in one currency into another currency at a pre-agreed exchange rate on a specified date. For this right, a premium is paid to the broker which will vary depending on the number of contracts purchased (http://www.investopedia.com/terms/c/currencyoption.asp).

FX call option is a right but not an obligation to buy currency during a specified time period at a specified price. Meanwhile, FX currency put option is a right but not an obligation to sell currency during a specified time period at a specified price. Since, the holder of a FX option has the right but not the obligation to trade currency, it is beneficial to use options to hedge potential transactions. Similar to the other types of option contract,

the exercise/strike price for FX option and the premium price together will determine the floor or ceiling established for the potential transaction.

FX option is one of the best ways for corporations or individuals to hedge against adverse movements in exchange rates. Hedgerscan enter into FX option contract in order to reduce the risk that they face from potential future currency movements in a market variable. FX options are relatively cheap because they effectively operate on leverage. Until the maturity date of the contract, hedgers/investors only need to pay a small fraction of the value of the currency in the form of margin (Tickell, 2000). If the market moves in their favor, they can exercises the option and buy the currency and then sell them at a profit. If the market price move unfavorably, then they do not exercise and forfeit the premium. Thus, any loss is limited to the upfront premium being paid (Bahrain Financial Exchange Handbook nd).

FX option have gain acceptance as invaluable tools in managing foreign exchange risk for a minimal cost. By buying a put option, the investor can hedge his risk by limiting his possible losses to amount of premium he pays. Meaning that customer is able to benefit on the underlying position without having his profit reduced by the hedging instruments except for a small deduction due to the premium (Iqbal *et al*., 2012).

FX options can be a useful hedging device as it can protects financial company from potential negative impacts of currency rate fluctuations. However, by trading the FX option, it provides investor with tremendous versatility including a wide range of strike prices and expiration months available for trading (Kotze, 2011). FX option is a security that allows currency traders to realize gains without having to purchase the underlying currency pair. By incorporating leverage, FX options magnify returns and provide a set downside risk. Alternatively, currency trading options can be held alongside the underlying forex pair to lock in profits or minimize risk. In this case, limiting the upside potential is usually necessary for capping the downside as well.

Investors can hedge against foreign currency risk by purchasing a currency option put or call. For example, assume that an investor believes that the USD/EUR rate is going to increase from 0.80-0.90 (meaning that it will become more expensive for a European investor to buy US Dollars). In this case, the investor would want to buy a call option on USD/EUR so that he could gain from an increase in the exchange rate (or the USD rise). If the holder of the option decides to exercise then, this option becomes a simple FX contract. Normally, the holder of the option will only exercise when the market is in his favour, otherwise the option contract expires worthless (Kotze, 2011).

The other advantage of trading FX option is that only the sellers of options have to pay the margin price. As a consequence, producers in countries with non-convertible currencies who are contemplating a hedging strategy can by buying options to sell their products, simultaneously they can avoid the possible problems caused by the need for foreign exchange to meet the margin deposits or maintenance margins. Moreover, the parties of FX option contract are granted a reassessment or cooling off period over which they can rationalize their decision or reverse the same. Thus, the possibility of conflicts between parties and wrong decision can be minimized (Obaidullah, 1999).

## SHARIAH ISSUES OF FX OPTIONS CONTRACT

Based on the discussion above, it cannot be denied that FX options plays an important role in risk management. Thus, to think that options have no benefit at all is to deny an internationally recognized reality (Al-Amine, 2008). Despite its benefit as hedging tool, there are significants number of contemporary shariah scholars have ruled that conventional FX options contract impermissible. Among the shariah isses that need to be addressed are given below:

**Leverage activity:** Based on a dictionary of Islamic Finance by Khorshid (2011), leverage means magnifying one's buying power to make a purchase for example, by borrowing money to buy more assets than could otherwise be afforded in the hope that they can be sold for a greater profit. Once the loan and interest is paid back, the profit will be graeter than the cost.

According to El-Gamal (1999), option is no doubt is a leveraging device used for trading in risk. It is because this technique allow investor to use only a small amount of money to make much larger profit. In that way, leverage gives them significant financial power. Though, FX option magnifies gain but if the currency rate moves against the investors, their loss is much greater than it would have been if the investment had been made with cash. If their expectation is correct, FX option would magnifies return. This type of return is clearly contradict with shariah principle. The degree of leverage that are afforded by options contract can be, so high that large unpredictable market moves in underlying prices may one day lead to insolvency of major financial institutions (Obaidullah, 1998).

The institutions dealing in derivatives claim that diversify of hedging products protects their client against market volatility and provide a larger spectrum of risk management to the benefit of society. On the other hand,

the fact that volatility is caused by their activities when they trade-in derivative as part of rip-off factor and the clients are sold nothing for something, that is protection against a danger that never needed to exist in the first place (Ayub, 2007).

Apart from that, there is a famous hadith asserted that: al-kharaj bi al-dhaman which means that any entitlement to the return on an asset relates to the risk of ownership. Based on this hadith, Muslim jurists developed a legal maxim which is al-ghurm bi al-ghunm which means that gain is justified with risk. Both the hadith and legal maxim imply that the entitlement to a return is related to the liability of risk (Ahmad and Halim, 2014). Simply put in Islam if there is no risk, there will be no gain. Therefore, in order to get lawful earning in any economic venture, people should take risk and liability, not to get easy money by way of leveraging.

**Speculation and gambling:** Creation of option for fulfilling genuine hedging need is permissible in Islam because it is in accordance with preservation of wealth and is considered part of maqasid al-shariah. Nevertheless, trading of option without accompanying any real asset is prohibited as it is akin to gambling. Speculators use option to bet on the future direction of a market variable. They wish to bet on future movements in the price of an asset. Due to leveraging activity in option trading, the possibility of risk and returns are magnified, the gains of the buyer being equal to the losses of the seller and viceversa. Thus, the purchase and sale of options is a risky zero-sum game (Obaidullah, 1999). Zero sum game is similar to gambling as one will win at the expense of the other. The gain are, therefore, in the nature of maysir and maysir cannot exist without the existence of excessive gharar (Iqbal *et al.*, 2012).

Trading in option has become popular because options can be bought for a fraction of money. The purpose is profit making through sales that are more akin to gambling. Gambling involves creation of risk for the sake of risk. The gambler chooses to seek out risks that were not there before. Even if they had been there before, they had not concerned him personally and no social good is accomplished by gambling. Gambling activity is clearly different to investment as investment consists of committing capital to an enterprise in the hope of earning a profit (Kamali, 2005). According to Usmani (1996), profit from options may be unearned gains. He views that the objection of option is due to gambling and unearned gain because profit earned from options is through cash transactions as there is no physical delivery.

Although, the main purpose of FX option is to manage currency risk but majority of the market participants do not enter into the contract for the purpose of reducing risk rather for making huge profits in speculative activities which are prohibited in Islam. Speculators use options to bet on the futures direction of a market variable. The function of options contract as a risk transfer mechanism to another willing party to accept has resulted in the vigorous participation of the hedgers and speculators in the particular market (Engku Rabiah Adawiah, 2010). Ultimately, many market participants are profit driven speculators whose interest is only to maximize profits rather than the genuine hedgers with the real purpose only to protect their real assets.

Derivative securities are attractive to speculators because they have a great deal of leverage. With only a small initial outlay, speculators can take a futures position that has the same returns of buying 30 times the same amount of the underlying asset. According to the Office of the Comptroller of the Currency (OCC), only 2.7% of the total derivatives contracts are used for hedging purposes whilst 97.3% are used for speculative purposes. This depicts that speculators are dominant in the market and they can make a lot of money with little risk by trading in option.

The issue of option trading should be taken serious attention as it might give negative impact to the economy. Therefore, trading of option in the secondary level should be totally ban. In order to fulfil a genuine need of hedging, only the initial level of FX option should be allowed. The secondary level is prohibited because hedging by real investor no longer exist, instead they are speculator and gambler who are betting to gain easy, quick and maximum return.

**Trading of right:** Majority jurists view that option sale is a mere right to buy or sell. In Islam, the right cannot be traded. Charging fee for this is not permissible. Al-Zuhayli, al-Salami, Abu Ghuddah and Accounting and Auditing Organisation for Islamic Financial Institution (AAOIFI) do not allow option contract due to right is not fall under the category of wealth. Thus, the right cannot be a subject matter of contract.

According to Usmani (1996), an option is a promise to sell or purchase a thing on aspecific price within a specified period. Such a promise in itself is permissible and is normally binding on the promisor. However, this promise cannot be the subject matter of a sale or purchase. Therefore, the promisor cannot charge the promisee a fee for making such a promise. This ruling applies to all kinds to options, no matter whether they are call options or put options. Elgari (1993) opines that "the right does not have a tangible or material quality but it is indeed intangible that may not be sold or brought,

considering it is not a property. It is similar to preemptive right (right of custody) all of which while allowed in shariah are intangible rights that are not allowed to be sold or relinguished against monetary compensation".

On the other hand, a few scholars would prefer to include any kind of benefit or manfaahin the definition of maal. Since options involve a benefit (a right without obligation) for the purchaser, trading of such benefit is observed to be permissible (Obaidullah, 1999). According to Iqbal *et al.* (2012) when an option is stand alone and can be traded independently, the premium paid for it is impermissible. However, when the option is embedded in larger transaction, it is similar to 'urbun. Thus, a fee paid for it is permissible.

Salehabadi and Aram (2002) compare option contracts with insurance contracts under Islam and found that option is similar to insurance because of presence of a seller and a buyer and a premium in the case of option and insurer, insured and insurance premium in the other case. They also opined that transfer of risk from insured to insurer is exchange for a fee in insurance transactions and transfer of risk from buyer to seller in exchange for premium.

**Riba:** In conventional practice, the issue of riba (usury) arises in the Foreign exchange option contract when the parties involvoled will fix a rate on the day contract is concluded but the exchange of currency will happen in the future. This activity clearly involves riba as it does not fulfil the rule of sarf contract which is the exchange of two different currencies must be done on a spot basis. The element of riba exist in the presence of interest rate when two financial institutions or any other financial institution with their corporate clients trading the options over the counter and the exchange of transaction is not done on the spot basis (Suhaimi and Salleh, 2012). Therefore, FX options involves riba and it is impermissible in Islam as a fundamental condition of the currency exchange contract is the absence of any deferement, otherwise the contract will be defective (IBFIM, 2008).

Riba also will incur when a buyer pays the option premium in the form of money and the option buyer expecting a profit from a margin between the exercise and the market price. Since, the margin is in the form of money, the issue of riba arise especially if the margin is higher or lower than premium paid. Any increase in the value of money or currency exchange is categorized in riba al-fadhl which is prohibitted in Islam.

According to MGCF (2010), there is a difference between option and trading in option. If the option is backed by asset delivery, it falls within the Islamic paradigms of permissibility. However, when an option is converted into a monetary asset as a result of trading, it falls into the rank of riba because the rights cannot be traded at a price. Hence, the contract is invalid.

## ISLAMIC FX OPTIONS CONTRACT

Given current volatility in the market, producers, consumers, counterparties and scholars are more aware of the need of hedging market risk. Hence, there is growing number of Islamic financial institution develop Islamic FX option contract in order to fulfil the need of hedging as the demand for such products is growing accordingly. However, it should be noted that any contract in Islamic finance should not violate the basic principles of Shariah Law such as riba, excessive gharar, speculation, gambling and so on.

Islamic financial institution are challenged by limited range of instruments, insufficient credit and market risk management and underdeveloped nature of Islamic money market. If these challenges are overlooked, they can hinder the growth that IFI needs to achieve in order to compete with conventional financial counterparts (MGCF, 2010). Currently, Islamic FX option is not widely used in Islamic financial institutions. Not all banks offering Islamic FX option contract as they must get approval from their Shariah Advisory Board. This is due to trading right in currency option is not recognized by all Islamic scholars.

Since, leverage activity using conventional options is not possible, at least from global perspectives, Islamic solution can bring about the same economic implication. Islamic finance need to develop financial innovation in the market as to enable them to efficiently compete with conventional banking and finance. So far, wa'd and'urbun are the most used instruments to replicate the conventional options.

Most Islamic jurists opined that 'urbun can become a basis for developing shariah compliant option contract. 'Urbun is a sale agreement where the purchaser commits to buy from seller a certain quantity of reference asset at predetermined price at a given future date. The purchaser pays to the seller at the inception on the contract a deposit and the purchaser has right to revoke his commitment at any moment.

Islamic Fiqh Academy (2000) in its resolution no 72/3/8 resolves that al-'urbun contract is permissible if the time frame of the contract is set and the down payement is considered as part of the selling price if the purchase is carried through and is the property of the seller if the buyer desists. Similar to conventional FX option, Islamic FX option contract also requires a buyer to pay a premium to seller in order to get a right to buy currency on a specified rate based on the mutually agreed rate.

Based on the aforementioned concept of al 'urbun, it can be said that the difference beween 'urbun and option is that the 'urbun price is part and parcel of the price of the sold items. On the other hand, the premium of financial options is not considered part of price. Rather it is a consideration for granting an option to buy or sell (Arbouna, 2004). Table 1 shows the differences of Islamic option and conventional option.

Based on Table 1, some scholars of Islamic finance have suggested the concept of al-urbunto replicate conventional option in shariah compliant manner. By concluding al-urbun contract, the buyer must pays a deposit to the seller in advance but commodity delivery will not be executed until after the payment of the price in full, either during the option period or when it expires. However, it is not possible for Islamic financial institutions to exploit 'urbun except in the case of purchase as they cannot use it to sell anything before the good is possessed by them (Bakar, 2008). Hence, concept of al-urbun is suitable only for the right to purchase not the right to sell. Therefore, Aznan views that structuring of al-'urbun to replicate the conventional call option is complicated and may contradict shariah principles if it not considered carefully.

Apart from that the other shariah principle that can be adopted in structuring Islamic FX option is wa'd which is also known as undertaking. Wa'd refers to a unilateral promise by one party to another to do something in the future such as a promise to sell and a promise to buy also can become an alternative to conventional put and call option (Bakar, 2008). In order to disclose the element of wa'd mulzim, purchase undertaking can replace conventional put option while sale undertaking can replace conventional call option.

Although, Islamic FX option is not widely offered by Islamic financial institutions but some Islamic banks such as CIMB had offered it for risk management and investment purposes. In 2007, CIMB Islamic Bank Berhad launched the Islamic Foreign Exchange with Shari'a-Compliant Option Features or FXOP-i. The FXOP-i by way of wa'd enables customers to lock in a foreign exchange rate in advance by engaging in a shariah-compliant financial transaction with CIMB Islamic. The net proceeds from this transaction which is similar to the premium paid for option instruments in conventional finance grants customers the right but not the obligation, to exercise the option at the agreed rate on the maturity date. Hence, customers can protect the value of their future foreign currency proceeds, fix their hedging cost at premium even earn a profit if foreign exchange rates move in their favour (http://www.cimbislamic.com/index.php?tpt=islamic 2 January 2011).

Table 1: Differences between Islamic and conventional option

| Islamic option | Conventional option |
|---|---|
| Option is deemed as earnest money | Premium-cost to buy the option |
| Option is not tradable (international shariah standards) | Option is tradable |
| Underlying asset must be compliant | Underlying assets must not necessarily be compliantSchedule |

(Bakar, 2007)

FXOP-i is based on several Islamic finance concepts namely tawarruq by way of commodity murabahah (sale at cost plus), bay' al-'inah, wa'd and bay' al-sarf. An exciting feature of FXOP-i is that customers can choose to undertake the transaction using either the commodity murabahah or bay'-al'inah concepts, thus making it an attractive solution to a wider range of customers (http://www.cimbislamic.com/index.php?tpt=islamic 2 January 2011).

FXOP-i which is offered by CIMB Islamic in Malaysia consists of two different transactions and legs. The transactions are done by promisor who sell the option and promisee who buy the option as depicted in Fig. 1.

At the first stage, both buyer and seller will exercise al-'inah or commodity murabahah contract in order to get option premium. For al-'inah contract, the Mudarabah Interbank Investment (MII) or any other suitable asset is used. On the other hand, commodity murabahah contract uses commodity such as Crude Palm Oil (CPO) or London Metal Exchange (LME).

Figure 2 shows an example of al-inah contract in order to get option premium. Bank sell MII at par price, RM1000. Then, the bank buys back MII at discount price which is RM900. The other way to get option premium is by doing commodity murabahah contract:

- Payment of premium RM100 from client to bank
- Bank sells CPO to the client on deferred basis
- Client appoint bank as an agent to sell CPO on cash basis
- Bank sells CPO to third party (investor B) by cash
- Cash is given to investor A

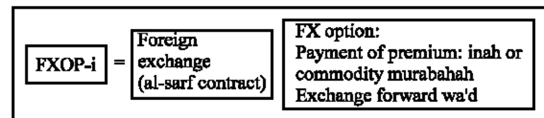


Fig. 1: Composition of FXOP-i

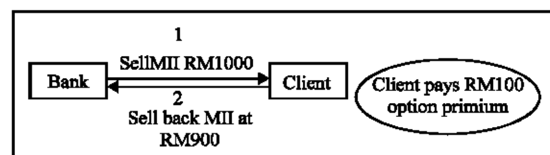


Fig. 2: Contract al-inah to get premium

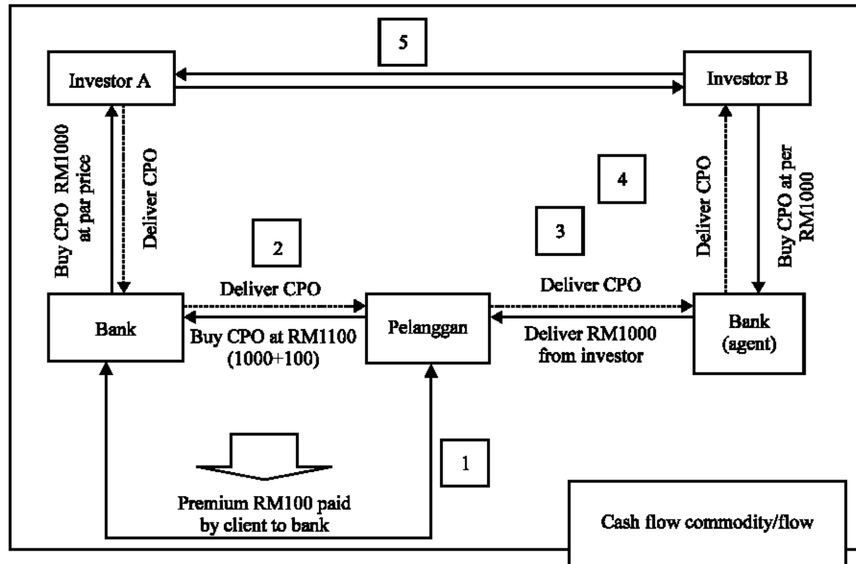


Fig. 3: Commodity murabahah transaction to get premium

At second stage, after getting option premium, the client will gives wa'd to exchange currencyon a future date by way of sarf. The undertaking is done separately with inah/commodity murabahah, so wa'd is independent with premium payment. This transaction is in accordance with resolution by Shariah Advisory Council (SAC) of Bank Negara Malaysia which states that no fees for wa'd currency hedging. The SAC warns that no consideration (or fee) is allowed to be charged on the promisee in view of the fact that upfront cash payment for forward currency transactions would lead to a bilateral wa'd which is not allowed by the Shariah. Only wa'd without any consideration is permissible in a forward currency transaction (Parker, 2010) (Fig. 3).

At the maturity date, the exchange of currency contract is done by spot basis (sarf). The price depending on which position is in-the-money. This transaction allows client to ento into option contract in order to manage currency risk associated with investment. This contract allows client (investor) who hold currency 1 and need to invest in currency 2 in shariah compliance.

## CONCLUSION

To conclude, it cannot be denied that option contract plays an important role in risk management as it can provides a flexible hedging tool to hedge risk. As Islamic finance exposed to the risk of market volatility and fluctuation in the currency rate market, thus FX option contract is a dire need in order to hedge against risk of fluctuation in currency exchange rate risk. Because of its flexibility, the contract has given many benefits to some particular group of people. However, Islamic financial transaction is bound by strict rules and regulation of Islamic Law. Any Islamic Financial Transaction must be free from riba, no gharar involved, no gambling features and must be fair and just to the parties to the contract. In contrast, conventional FX option is impermissible as it involves the element of leverage, gambling, trading of right and riba. All these elements are totally prohitted in Islam. Therefore, altering and modifying conventional product is required in the current market in order to fulfil the need of hedging.

This study also found that the conventional practice of FX option contract magnifies return by way of leveraging which is clearly againt principles of Islamic risk management. Option trading is the most important element that can lead to insolvency of major financial institutions and consequently would outburst economic crisis. This is because in secondary level of trading, people will only speculate and they have no real underlying asset. They just do buying and selling out of nothing in order to get easy and quick return. This activity is totally contradict with shariah principles. Hence, this study suggest that the option contract is only permitted at initial level only as hedging of real asset may accur. On the other hand, secondary level which is trading of promise should not be allowed to be practiced as currency trading is clearly prohibited in Islam. This is based on Islamic law principle that money is just a medium of exchange and not a commodity by itself.

As Islamic banks and financial institutions are now highly aware of the need for a rigorous approach to risk management, thus hedging products such as Islamic FX option based on principle of wa'd, al-urbun, commodity

murabahah had been developed. The development of Islamic FX optionis merely to provide an innovative sharia-compliant risk management tool against currency risks. Although, Islamic FX option gives similar economic effect of FX option conventional, the contract must strictly be used only for hedging when there is a clear underlying transaction.

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