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Permissibility of Hedging in Islamic Finance

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Abstract: The case for hedging solutions has been strengthened in recent years as Islamic financial institutions aim to serve both retail and corporate segments and expand across geographies, resulting in a global perspective for the industry. Hedging generally is an effort to protect or minimize the risk of loss on an investment or depreciation in the value of an asset. Thus, using the hedging method, a person or a company not only can reduce the exposure to risk but at the same time the level of losses incurred can be controlled and reduced. The question is whether this hedging method in accordance with the nature of Islamic *mu`amalat*. This is because the use of current hedging has been misunderstood for profit purposes only. This paper, therefore aims to review the evidence from the Quran and the Hadith (the prophetic tradition) in relation to permissibility of hedging while taking into account the views of classical and contemporary jurists in this regard. This paper concludes that hedging in general is permitted by the Shariah as it fulfils the objective of Shariah itself which is the protection of property.

Key words: Islamic Finance · Risk Management · Hedging · Objective of Shariah

INTRODUCTION

Risks and commerce are two inter-related matters that are closely related since risk-taking is inevitable in carrying a business. In fact, the higher the risk, the more return one can gain and vice-versa. The issue of risk is one of the challenges faced by the conventional and Islamic finance industries. There are many types of risk management and one of them is hedging.

Generally, hedging is an act of protecting an asset or investment from the uncertain market, the individual engaged in the act of hedging is called the hedger. Hedger is a person who enters the market not for the purpose of gaining profits from the price change but rather to manage risks to the minimum [1]. In the futures market for example, hedger could be farmers, manufacturers, importers or exporters. Hedger will buy or sell in the futures trade market in order to balance the risks that he has to shoulder due to price fluctuation in the cash market. This is a method that could help the hedger in minimising the risk of price changes [2].

Definition of Hedging: In the Arabic language, the term hedging is known as *tahawwut* (تحوّط) which origins from the word *hata* (حاط). The linguistic meaning of the word *hiyatah* includes precaution, protection, attention and/or patronage [3]. The technical meaning of the word *tahawwut* in the field of finance is: the adoption of processes and arrangements and the selection of contractual formats that guarantee the reduction of risks to a minimum while maintaining good possibilities for return on investment [4].

The Position of Hedging in Risk Management: Risks are uncertain phenomenon that involves losses for investment portfolios or the decrease of values of certain assets. Risk taking in activities that will bring return is a norm. However, excessive risk will prevent investment and affect growth. Therefore the main challenge for those involved in money transaction, especially investors or traders, in managing economic activities is finding balance between taking risk and extreme risk in a smart manner. One of the ways of managing and minimising risks is hedging.

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Such as been mentioned above, hedging is a method in managing and reducing risk in economic activities business and investment. It does not mean complete eradication or elimination of risks. This aligns with the current understanding towards the function of risk existence. Therefore, with the hedging method, an individual or a company not only will able to reduce risk, but at the same time control and reduce the level of anticipated loss. The question being posed is, whether the hedging method is suitable with the nature of Islamic *mu`amalat*? To find the answer, elaboration of the legitimisation of hedging must be done by examining the *dalil* (proof) that permits hedging, as well as taking into account the view of contemporary *fuqaha*' (Muslim jurists) of this matter.

The Ruling of Hedging from Quranic Perspective: Hedging is a part of risk management process. Based on the above understanding, hedging is not something that violates the interest of Shariah, since Islam prohibit its followers from exposing themselves to any form of calamity or catastrophe on the self or the property, even if the calamity or catastrophe is something in the future and undetermined. Therefore Islam not only recognises the existence of risks, but proposes that the Muslims take steps of precaution in order to prevent or minimise loss due to certain risks. This is evident from the proofs of Quran, Hadith and *fiqh* literature that touches upon the activities of hedging either directly or indirectly. In the Quran, the verses 282-283 of the second chapter al-Baqarah, it had been stated *"O you who believe! When you contract a debt for a stated term, put it down in writing. Have a scribe write it down justly between you. No scribe should refuse to write; let him write as Allah has taught him, let the debtor dictate and let him fear Allah, his Lord and not diminish what he owes. If the debtor is feebleminded, weak, or unable himself to dictate, let his guardian dictate justly. Call in two men as witnesses. If two men are not there, then call a man and two women out of those you approve as witnesses, so that if one of the two women errs, the other can remind her. The witnesses should not refuse when they are called on for evidence. Do not disdain to write the debt down, be it large or small, along with the time it falls due. This way is more equitable in the sight of Allah, more reliable as evidence and more likely to prevent doubts arising between you. But if the merchandise is there and you hand it over, there is no blame on you if you do not write it down. Have witnesses present whenever you make a commercial contract; and let no harm be done to either scribe or witness, for if you did cause them harm, it would be a crime on your part. Be mindful of Allah and He will teach you. Allah has full knowledge of everything. If you are on a journey and cannot find a scribe, something should be handed over as security.*

The above verses explain that Allah recommends the Muslims to record any transaction activities that involve debt and to have just witnesses for the transaction [5]. These two matters can be used as reliable evidences if a dispute was to take place between the two parties involved. Islam also provides the guidelines in the appointment of a scribe and witnesses so that the transparency of the debt affairs is secured. Even if the transaction takes place during a journey, Allah gives permission that collateral is provided as guarantee for the creditor [6]. Although the term hedging is not found in the verses, its element can be seen from the preventive steps in managing debts from unwanted risks.

In the 12th chapter of the Quran, verses 47-49, Prophet Yusuf answered: *"You shall sow for seven consecutive years as usual. Store all that you reap, left in the ear, apart from the little you eat. After that will come seven years of hardship which will consume all but a little of what you stored up for them. After that will come a year in which the people will have abundant water and will press (products from grapes, olives etc.)*". From the verses we can see how Prophet Yusuf suggested to the Egyptians to cultivate their plantation for the fertile seven years and to stoke a majority part of their produce as a preparation for a more critical time, which was the draught season in the following seven years. As a result, Egypt was able to survive when the dry season hit for seven years and the risk of famine was reduced since a big portion of food was stored during the first seven prosperous years. This is clear evidence that strategic steps were taken in order to prevent and reduce expected risks, since a risk that is not well-managed can bring harm to certain parties. Although the above verses are mostly directed to the benefits of saving for the future, but it is also linked to the idea of the future being uncertain. Risks are also part of the uncertain future. Therefore it is best to take a proactive step by protecting the uncertain by managing and minimising it. One of the ways this can be done is through saving or the hedging method.

This matter is furthered strengthen with the clear commandment from Allah in the second chapter, verse 195: *"Spend in the cause of Allah; do not contribute to your destruction with your own hands, but do good, for*

Allah loves those who do good". In this particular verse humanity are commanded not to expose them to destruction. Destruction here refers to damage to the self, family members or properties [5]. In general this verse may emphasise spending on the path of Allah and to not be miserly to the point that it will bring harm. However this meaning can also be applied in the hedging practice. This this because the hedging method also requires a person or a corporate entity to pay a particular cost for purchasing financial instruments that can be used in hedging investments or commerce from unforeseen risks [6]. In other words, if an individual refuses to pay for the cost of hedging for his investment or asset, there is a high degree of possibility that he will be facing risk of loss in the future.

The Ruling of Hedging According to the Hadith: The concept of hedging has a strong basis in the Hadith. The proof can be obtained from the many Hadith that illustrate the importance of managing risks. One of them is on a Bedouin Arab who asked the Prophet Muhammad on which is better; to leave his camel untied and ask for the protection of Allah for his camel, or to tie it. The Prophet told him to tie his camel first and then have *tawakkal* (trust and dependence) to Allah [7, 8]. This Hadith explains that *tawakkal* that is preceded by effort is compulsory. Although Muslims have been told to have *tawakkal* to Allah in Surah al-Ma'idah in verse 23, the actual concept of *tawakkal* is not to leave things entirely to Allah without making any effort. This is because Islam teaches us to always be ready in facing any unexpectedness. Without prior preparation, we may have to face even worse risks. Therefore, these risks must be managed wisely so that its negative effects can be reduced. In this matter, the concept of hedging is an accepted risk management method in order to lessen losses. There are a number of Hadith in which the Prophet proposes the Ummah to strive and reach their objectives and at the same time to avoid harm.

Abu Hurairah narrated that the Prophet (peace be upon him) said, "A strong believer is better and dearer to Allah than a weak believer and there is good in all [believers]. Be intent upon what benefits you, seek help from Allah and do not lose heart. And if any [trouble] happens to you, don't say, 'If only I had done [such-and-such], it would have been different.' Rather, you should say, '[It was] the decree of Allah, Who did what He willed,' for [saying] 'if only' opens the [door] for Satan to work [on your mind]" [9, 10].

The above Hadith illustrates that vigour and enthusiasm is required from the believer. Although this Hadith of Imam Nawawi explains enthusiasm in terms of spiritual strength that can be bring about success in managing worldly affairs and the affairs of worship, but its scope of meaning can be extended to strength of the physical, economy, property and others [11]. This is because the basis of a believer's strength is not only through a strong faith, but also a healthy physical and a stable economy. Thus, a trader or investor should plan and take the step of protection through the application of hedging since it gives benefits to him when a risk is well managed.

Apart from that, risk management has existed in the time of Prophet Muhammad and he approved of it. The evidence is from an incident narrated by Ibnu `Abbas: When al-`Abbas bin Abdul Mutalib handed over his assets [camels] for *mudarabah* to his partner, he stipulated that he should not take the assets across the sea, nor take them down to the bottom of a dry river bed, nor trade them for live animals. If he were to do any of these, he would have to bear the compensation. Word of al-`Abbas's stipulation reached Rasulullah (peace be upon him) and he allowed it [8, 12].

Through the above Hadith it can be understood that the conditions that al-`Abbas stipulated in participating in *mudarabah* contract aims to reduce exposure to risks such as risks of theft, loss, damage and other risks that normally exist in financial affairs. The recognition of the Prophet Muhammad of the conditions indirectly gives us the picture that Islam does not prevent any effort in managing risk, as long as the effort does not violate *mu`amalat* principles.

The Ruling of Hedging According to *FUQAHA'* Perspective: In general, the *fuqaha*' has agreed in permitting the contracts that guarantee the safety of capital, debt or property such as collateral contract (*al-rahn*) [13-16], guarantee (*kafalah* and *daman*) and third party's guarantee on capital [17-19]. Islam also allows takaful (Islamic insurance) for the purpose of minimising financial risk due to accidents or tragedy [20]. All of these contracts are permitted for the convenience of contracting parties and at the same time protect them from plausible loss that may occur. This shows that hedging can also be permissible since its objective is similar, which is protection on the capital, value or price.

During the sixth conference of Dallah al-Baraka in Algeria on 2nd until 6th of March 1990, the Shariah Council reached the consensus that hedging activities are not prohibited in Islam as long as the *mahal al-`aqd* (the object of contract) is something that is permissible [21]. During its 28th conference in Jeddah, on 16-17 September 2007 [22] has formulated that risks are inseparable from any form of Islamic finance. This is based on the Hadith *al-kharaj bi al-daman* [9] and legal maxim *al-ghunm bi al-ghurm* [23].Therefore, managing risk by minimising it is permissible if the mechanism or contract used to attain the objective does not violate principles of Shariah.

Managing risk or the effort to minimise risk of loss is then required. This is based on the verse in the Quran [8] and Hadith [12, 13], on the prohibition of putting oneself in harm and the call to attain goodness and to leave anything that is bad. In fact, co-operating in the effort of alleviating risks and its disadvantages is much encouraged as had been permitted through the concept of *al-`aqilah* in undeliberate criminal cases and in the takaful system. Therefore hedging is considered in accordance with the concept of *maslahah* (public interest) and *maqasid al-shari`ah* (objective of Shariah), which stresses the protecting of property. It is an undeniable fact that the Shariah of Islam for mankind is to produce good for them and to reject evil.

The fact remains that Islam greatly emphasises the security of property starting from the process of obtaining the property, its custody and the way it is used in the halal and safe way. For example, Islam decrees the guidelines for the management of debt, the management of a deceased's property [22] and will [26]. There are also prohibitions on intrusion of the properties' of others such as theft, consuming the wealth of others' unjustly, the prohibition of being involved in transactions that include *riba* [27], the prohibition of appointing someone who does not fulfil the qualifications for financial matters, such as an insane person, children and a person who cannot manage wealth and likes to squander. In fact Islam also provides various means to develop properties and to use it, such as business activities, investments and others. Apart from that, the recommendation to saving and managing money can be detected indirectly through acts of worship outlined by Islam such as zakat, *hajj*, charity and *waqf* [27].

All the above explanation shows the emphasis that Islam put on the processes of obtaining wealth, its safekeeping and its spending in the *halal* (permitted) and safe ways. In fact, if we are to look at the weight that Islam put on the requirements of a person involved in a transaction, it clearly indicates that protection of property or wealth is indeed important. This is because the abandonment of this integral component can lead to loss of wealth and its destruction, which is a risk that must be avoided. The practice of hedging where its objective is to reduce exposure to risk of loss in investments and commerce is commended since the practice aligns with Islamic recommendation to protect wealth and to expand it, which is in accordance with the concept of *maqasid al-shari`ah* [4].

Islam's recommendation to safeguard wealth has indirectly shows the importance of avoiding harm. In this discussion of hedging practice for example, the harm here refers to unwanted risks. This is because extreme exposure to risks can result in loss in investment and business. Therefore, the effort to safeguard wealth and increase it must go together with the act of preventing anything that harms the wealth. In addition, there are various legal maxim that stress the importance of averting harm such as: *la darar wala dirar* (Harm should neither be initiated nor reciprocated), *al-darar yuzal* (harm must be eliminated), *al-darar yuzal bi qadr al-imkan* (harm must be eliminated as much as possible), *al-darar al-asyad yuzal bi al-darar al-akhaf* (severe injury is removed by lesser injury) and *dar al-mafasid muqaddam `ala jalb al-masalih* (repelling harm takes priority over seeking benefit).

All the above legal maxims have nearly equivalent meanings and mutually support each other in the sense that that rejecting harm is important. There are many other legal maxims that support the effort of managing risks and avoiding harm to the religion, soul, wealth and others. Thus, hedging is recommended by Islam as a means of preventing harm.

Based on the evidences from the Quran and the Hadith discussed above, the importance of managing risk has been clearly illustrated in general. Furthermore, the contemporary fatwas issued by most *fuqaha'* based on the concept of hedging explains that they do not reject the concept, but acknowledge its importance in the Islamic finance market. However their views differ in regard to the hedging instruments that comply with the Shariah that should be developed. In fact, the hedging concept that has been agreed upon is only a means to reduce risk and not to eliminate risk totally. Therefore, there is no barrier in Islamic finance activities in fulfilling the current essentials towards the need for hedging, as long as the methods used satisfy the criteria of Islamic transaction.

CONCLUSION

Hedging in general is permitted by the Shariah as it fulfils the objective of Shariah itself which is the protection of property. The reality of life shows that humans require properties in order to live a better life. Therefore, Islam recommends that we manage property or wealth since it is part of our life. Rationally, all the individuals or institutions who are involved in the financial industry will try their best to maximise profits and minimise the risks of losses. Hence, Islam permits hedging as it will bring *maslahah* and fulfils the principle of *maqasid al-shariah*. The effort to develop the instruments in achieving the objective of hedging is encouraged as long as it is within the framework permitted by the Shariah.

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