Developing Islamic derivatives as real hedging instruments

Derivatives are used by many large portfolios and funds as part of their investment management strategies to serve many purposes that include anticipating future cash flows, arbitrage, asset allocation change, hedging and speculation, with the last two being the main motives. The drive to make a larger return becomes an attraction of derivatives markets for investors. FAROUK ABDULLAH ALWYNI delves further.

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The main derivatives instruments are forwards, futures, options and swaps. They constitute the vast majority in derivatives markets. The gross market value of over-the-counter (OTC) derivatives amounted to US$15.5 trillion in the first half of 2020 from US$11.6 trillion in mid-2019 (Bank for International Settlement [BIS], 2020). Interest-rate derivatives mainly contributed to this surge going up by 32.95% to US$11.7 trillion from US$8.8 trillion in the first half of 2019. Central banks' response to the COVID-19-induced market turmoil in March 2020 through cutting rates contributed to this increase.

Among the world's largest derivatives exchanges in 2019 by number of contracts traded are the National Stock Exchange of India (US$5.9 trillion), the CME Group (US$4.8 trillion), the Brazilian Exchange B3 (US$3.9 trillion) and the US's Intercontinental Exchange (US$2.3 trillion) (statista.com).

While financial derivatives have become part of global conventional finance, they are still not widely used in the Islamic finance world. Fitch Ratings (2020) reported that 30% of Fitch-rated Islamic banks do not use derivatives, and most of the remaining 70% have somehow restricted the use of derivatives, and limit them to profit rate swaps and Islamic-currency forward contracts instruments. Fitch also pointed out in the same report that the derivatives market is still underdeveloped in countries where Islamic finance relatively plays a significant role. Using BIS data, Fitch stated that in April 2019, the total turnover (daily average) of the OTC interest-rate derivatives in Bahrain, Indonesia, Malaysia, Saudi Arabia, Turkey, and the UAE was only less than 1% of global OTC interest-rate derivatives turnover.

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The main reason that derivatives instruments still have not found a global acceptance within the Islamic finance circle is that there is still a controversy about the permissibility of their use. A majority of scholars including International Shariah standard-setters such as the OIC Fiqh Academy and AAOIFI have voiced objections to their use due to the involvement of Gharar, short-selling and interest. This is not to mention that most of those who enter into derivatives contracts do not really have an intention to execute the real transactions.

However, there are also scholars, especially those from Malaysia, who have different views on the aforementioned controversy. In fact, Malaysia's Islamic finance regulators have approved a number of derivatives instruments believed as Shariah compliant. These instruments are, among others, forward foreign exchange transactions based on unilateral Waad Mulzim (binding promise), Islamic profit rate swaps based on Bai Inah and forward foreign currency exchange transactions based on Bai Muajjal (deferred payment sale and options based on Waad and two independent Tawarruq transactions).

Some Islamic financial institutions in Dubai have also started using swaps and some foreign exchange forwards. This second group of Shariah scholars who came up with Shariah compliant derivatives instruments argue that a derivative instrument used for hedging is basically part of risk management in line with one objective of the Shariah, which is protecting wealth.

Other reasonings used normally include public interest and modern business requirements. Other Islamic alternatives proposed in place of conventional derivatives include Bai Salam, Bai Istisnah and Bai Arbun. The first two are suggested to be alternatives to conventional futures contracts, and the last one as an alternative to a conventional options contract.

Islamic financial institutions, like their conventional counterparts, indeed also need risk management instruments. However, learning from their conventional counterparts, Islamic derivatives instruments should not be abused as tools for speculation.

While Islamic finance should strive to meet the needs of the business community, and it should also become an ethical alternative in the financial world. The abuse of financial derivatives contributing to the financial debacle in 2008 should really serve as a lesson for the Islamic finance community, that the development of Shariah compliant derivatives needs to be based on real economic necessity that can contribute to a more stable financial system.