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# ISLAMIC DERIVATIVES IN INDONESIA: A STUDY ON INDONESIAN ULAMA COUNCIL (MUI)'S FATWA ON TAHAWWUT (HEDGING)

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## ABSTRACT

In 2015, Indonesian Ulama Council (MUI) introduced a fatwa on tahawwut (hedging). This remarks the formal introduction of Islamic derivatives into the country's Islamic banking and finance industry. Islamic banks and conventional banks offering Islamic services are "religiously" and legally allowed to use forward contracts to hedge foreign currencies. Furthermore, the fatwa that depends largely on wa'ad (unilateral promise)-based structure has flexibilities and opportunities to be implemented into a wider derivative instrument such as foreign currency and profit rate swaps. Using qualitative research approach based on library and literature study, the researcher aims at examining the genesis and analytical scope of the fatwa, its opportunities, and challenges in the country.

***Keywords:*** fatwa, tahawwut (hedging), Islamic derivatives, forward contracts, and wa'ad (unilateral promise)

# ENDONEZYA'DA İSLAMİ SERMAYE PİYASASI TÜREV ARAÇLARI: ENDONEZYA ULEMA KONSEYİ ÜZERİNE BİR ARAŞTIRMA (MUI)'NIN TAAHHÜT'TE (DENGELEME) FETVASI

## ÖZ

2015 yılında, Endonezya Ulema Konseyi (MUI) taahhüt (dengeleme) üzerine bir fetva yayınladı. Bu, islami sermaye piyasası türev araçlarının ülkenin İslami bankacılık ve finans endüstrisine resmi olarak dahil edilmesine dair idi. Bu fetva sayesinde İslami bankalar ve İslami hizmetler sunan konvansiyonel bankalar, yabancı para birimlerini dengelemek için "dini bir şekilde" ve hukuki olarak vadeli sözleşmeler kullanma hususunda izne sahip oluyorlardı. Dahası, büyük ölçüde vaat (tek taraflı söz) temelli yapılanmaya bağlı olan fetva, döviz ve kar oranı takasları gibi daha geniş bir türev enstrümanına uygulanabilme esneklik ve fırsatına sahiptir. Kütüphane ve literatür araştırmasına dayalı nitel araştırma yaklaşımını kullanarak araştırmacı, fetva'nın doğuşu ve analitik kapsamı, ülkedeki fırsatları ve zorlukları incelemeyi amaçlamaktadır.

***Anahtar Kavramlar:*** fetva, taahhüt (dengeleme), islami sermaye piyasası türev araçları, vadeli sözleşme, ve vaat (tek taraflı söz)

Islamic financial industry that has been one of the fastest growing financial markets operates on the basis of Islamic law (*Shariah*). This means that financial transactions and products under such an industry including product designed for risk management, known as derivatives, are subject to *Shariah* requirements. These include the permissibility of managing risks as long as it involves real economic transactions, avoids uncertainty in structuring financial contracts (*gharar*), and forbids prohibited elements such as interest payment (*riba*), and speculation (*maysir*).

The growth of Islamic banking industry in Indonesia particularly in relation to growing number of international investments on domestic Islamic markets, international trading and service activities such as exports and imports, international remittances, and financing pilgrimage (*hajj*) to Mecca, has increased risk exposures to the industry mainly on adverse movements of foreign currencies. This has motivated some major Islamic banks to ask *fatwa*[1] to Indonesian Ulama Council (MUI) regarding hedging on foreign currencies (known as *tahawwut* in Arabic). Hedging can be used to eliminate the risk resulting from exposure to a risk factor that is foreign currency.

In 2015, the council issued *fatwa* number 96/MUI/III/2015 of Islamic version of hedging contract (*tahawwut*) based on *wa'ad* (unilateral promise). The *fatwa* includes three different types of hedging namely "simple hedging", "complex hedging", and "hedging based on Islamic commodity markets". These hedging products are considered financial derivatives since its values are derived from underlying variables namely foreign currency and or commodities. The *fatwa* on hedging also means that the MUI as Sharia standard setting in the industry officially recognises derivatives to be included as one of the country's Islamic financial instruments.

This paper discusses those hedging products based on that *fatwa*. All hedging products use the structure of a *wa'ad* (unilateral promise) leading to buying and purchasing contracts on an underlying variable. The *fatwa*

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[1] A *fatwa* declaration is an Islamic legal verdict issued by a qualified Shariah scholars or mufti. A *fatwa* consists of a question (*su'al, istifta*) addressed to a mufti, together with an answer (*jawab*) provided by that *mufti* (Hallaq, 1994: 31). Furthermore, a *fatwa* has become a crucial dimension of Islamic financial markets since the issuance of Islamic financial products needs to be preceded by a *fatwa*.

was initially formulated to provide a religious legitimation on foreign currencies' forward agreement described as "simple and complex hedging" between counterparties that include customers with Islamic banks, among Islamic banks, and conventional banks with Islamic banks. However, the flexibility of the third hedging product namely "hedging based on Islamic Commodities Markets" (*'Aqd al-Tahawwut fi Suq al-Silah*) means that a specified commodity market may facilitate trading and transactions between counterparties. Furthermore, this product can also be applied to a wider derivative instrument such as swap derivatives, and may open a wider use of derivative in Islamic financial industry. There are also some challenges on the implementation of this *fatwa* that includes lack of standard documentations or master agreement, Sharia harmonization, regulators' legitimacy, and counterparty risks.

This paper at first elaborates main principles of Islamic finance. This will guide into a state of the art of Islamic finance. At second, the paper highlights some global challenges of this Islamic-faith based system that will also give insight on what is happening in the industry. At third, the paper discusses conventional foreign currency forwards, and swaps contracts. And finally, the paper examines Islamic derivatives based on the *fatwa* of Indonesian Ulama Council (MUI), its scope, opportunities, and challenges.

## Main Principles of Islamic Finance

### *Prohibition of Riba (interest)*

*Riba* – explicitly derived from *Qur'an* and *hadits* (prophetic traditions of Muhammad) – is typically defined as increase or gain, but also associated with interest or usury (excessive compound interest) (Saleh, 1986: 121). There is a *hadits* that explains this type of *riba*. Mohammad (peace be upon him) said: "[p]rofit accompanies liability for loss (*al kharaj bi l dhaman*)" (Vogel in Khan and Porgio, 2010). Thus, profits (*al kharaj*) are lawful as long as the risks of loss (*dhaman*) are also part of the transaction (ibid). Charging interest on loans is unlawful (*haram*) because the lender is guaranteed his principal in return, plus additional guaranteed profit.

In such an interest-based lending, there is no risk sharing. This may result exploitation of the poor and the needy, and inequitable distribution of wealth. This lack of risk makes any profit the lender will gain unlawful –

he is only entitled to the repayment of his principle (ibid). This understanding offers one of the most penetrating insights into the inner logic of *fiqh* laws as to *riba* (Vogel and Hayes, 1998).

Furthermore, the prohibition of interest means that money cannot be traded from money, and all transactions should be based on real assets.[2] This prohibition is intended to help society through the creation of equality in creating wealth and jobs.

### *An Integration of Financial and Real Market Economy*

Sharia promotes the link between real sector and the financial sector to achieve balanced and sustainable economic development. This implies that money in the financial sector of an economy is not a commodity but rather a medium of exchange. This results that accumulation of money in the financial sector should a direct impact in the growing transactions in the real sector economy.

The important of close connection between financial and real economy has been praised by Islamic Financial Services Boards, Islamic Development Bank, and Islamic Research and Training Institute (2010) when they point out that the link between financial transactions and productive flows would prevent the Islamic financial industry from excessive risks due to uncontrolled leverage and speculative risk taking in the financial markets.

### *Risk Sharing Principles*

Theoretically, Islamic finance operates under risk sharing principles. This means that Islamic financial institutions should operate on active real

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[2] The *hadits* that is often referred to this interpretation is one which was reported by Abu Sa'id al-Khudari and 'Ubadah ibn al-Samit that the Prophet (peace be upon him) said:
"*Gold for gold in equal amounts, hand in hand, and any surplus is riba; silver for silver in equal amounts, hand in hand, and any surplus is riba; wheat for wheat in equal amounts, hand in hand, and any surplus is riba; barley for barley in equal amounts, hand in hand, and any surplus is riba; dry dates for dry dates in equal amounts, hand in hand, and any surplus is riba; salt for salt in equal amounts, hand in hand, and any surplus is riba".* See Wahba Al Zuhayli, "the Juridical Meaning of *Riba*" translated by Iman Abdul Rahim and Abdulkader Thomas in Abdulkader Thomas (ed), *Interest in Islamic Economics* (Routledge, 2006) 25, 30

economic transactions and involvement through the core principles of Islamic contracts namely profit and loss sharing mechanisms.

In Islamic banks, the intermediary model of the banks is developed on the basis of two-tier *mudharaba*. This means that Islamic banks serve as *mudharib* that receives funds from the surplus units and simultaneously supplies funds to various business projects. This model enables the banks to share risks either in asset sides as well as in liabilities sides.

### *Sharia Constraints on Business Activities*

There are some business activities that are deemed unlawful (*haram*) under the Shariah. *Fiqh* divides these activities under two broad categories: (1) *Haram lighoeri dzatihi* refers to an activities that lead to unlawful activities such as financial institutions that involve interest payment or receipt such as conventional banks, insurance firms; and (2) *Haram li dzatihi* refer to activities that involve unlawful goods such as the production, distribution, and/or profiting from alcohol, pornography, tobacco, gambling, weapons, music, entertainment, and processing pork or non-halal meat or commodities.[3]

### *Prohibition of Gharar*

The prohibition of *gharar* is closely related to derivatives discussion in Islamic law. Unlike *riba*, *Qur'an* does not literally mention *gharar* but *hadits* does. There are several *hadits* related to *gharar* (Vogel and Hayes, 1998).[4] *Gharar* is not only defined as excessive uncertainty or risk, it also has a broad meaning that could also mean the uncertainty of one or both parties regarding: (i) the existence of the exchanged counter-values; (ii) the characteristics of the exchanged counter-values of the identification of their

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[3] For further readings on how these requirements shape the product development in Islamic Capital Market, see Lahsasna and Hassan in Hassan and Mahlknecht (2011: 23)

[4] For example, *"do not buy fish in the sea, for it is gharar. The Prophet forbade sale of what is in the wombs, sale of the contents of the udders, sale of a slave when he is runaway.... The Messenger of God forbade the [sale of] the copulation of the stallion... He who purchases food shall not sell it until he [measures] it*." (Vogel and Hayes III, 1988: 88)

species or knowledge of their quantities or of the date of future performance if any, and (iii) control of the parties over the exchanged counter-values (Saleh, 1989: 115). Based on this, there are tripartite requirements (existence, ownership, and possession) in respects of Islamic contracts (*aqd*) in which denying on those could result on *gharar* (Oberoi and Khadem in Hassan and Mahlknecht, 2014).[5]

It is arguable that forwards and futures derivatives are violating those three partite requirements. Forwards and futures allow a buyer to purchase goods that are non-existence at the time of the actual contract, permit sellers to sell prior to holding property title to the contract object, and permit buyers to resell the contract object or to otherwise settle the contract obligation, prior to actual physical delivery/receipt of the object contract (ibid). However, there are alternative interpretations that allow derivatives under Islamic law. Kamali found that the *hadits* ("do not sell what is not with you") (Kamali in Iqbal and Khan 2005) – often used to argue the concept of ownership and existence of the contract object – has weaknesses especially on the *hadits* transmission (*isnad*) (ibid). This results open interpretations on: (1) total ban on selling what one does not own; (2) ban on selling only specified objects (*'ayn*) – and not fungibles – that are not owned; and (3) ban on selling what is not present and which the seller in unable to deliver. He concluded that the existence and ownership requirements apply only to sales involving specific objects (*'ayn*), not fungible goods, and are therefore applicable to derivatives such as forwards or futures. He further argues that possession requirements only apply to perishable goods as this inapplicable in derivatives markets (Ibid).

### *The Prohibition of Maysir*

*Maysir* often refers to speculative or gambling contracts, which are regarded as unlawful.[6] Its prohibition is explicitly found in the *Qur'an*.[7] In

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[5] These are: (i) existence of the object of sale at the time of contract, (ii) ownership of contract object at the time of the contract; and (iii) physical delivery of the object prior to resale or settlement.

[6] The word *Qimar* is also sometimes used and appears to have an identical meaning (Proctor, 2015: 49.19)

[7] For instance, Its verse 5:9 states "O you who believe, intoxicants, and gambling, and the altars of idols, and the games of chance are abominations of the devil; you

*hadits*, *maysir* could occur in the sale of goods. The sale of "the stroke of the diver (i.e. anything a diver may return with after a dive), of unexamined goods a buyer touches (a game played by merchants in Mohammed's time), and of the sale of goods determined by the throwing of a rock (another game)" (Vogel and Hayes, 1998: 88-89). Both parties involve in these sells transacting something of an unknown value (ibid). In defining *masyir* synonymous to gambling, Muslim scholars are often regarded *Maysir* to a zero-sum game (Al Suwailem, 2006). In game of chance, for instance, both parties have no control over the risks and the outcome of the events. It means the contractual parties' skills and familiarity of the game have no impact on the probability of the future events. *Maysir* is also often regarded as speculation that leads to be a zero-sum nature of a game that resembles gambling and *gharar*. Islam condemns speculation that purely transfers wealth form one to another without engaging into socio-economically productive activities (Khan, 1988).

## Main Challenges of Islamic Finance Globally

### *The Shift from Risk Sharing to Risk Transfer*

One of the major criticisms of Islamic finance is the minor application of partnership and equity-sharing financial assets (Askari, et al, 2012). Current Islamic finance preferred to utilize financing instruments based on debts such as *murabaha* products. One of the reasons is a lack of appetite for riskier assets, which in turn is due to Islamic banks trying to duplicate conventional commercial banks, whose chief objective is preservation of depositors' principal.

By emphasizing on *murabaha*-like instruments, Islamic banks are able to provide low risk and safe financing instruments. This mechanism also enables the banks to hold collaterals from the customers to mitigate default

shall avoid them, that you may succeed". Similarly, the verse 5:92 also states: "[t]he devil wants to provoke animosity and hatred among you through intoxicants and gambling, and to distract you from remembering God, and from observing the Contact Prayers (*salat*). Will you then refrain?". And also Qur'an verse 2:219 states, "They ask thee concerning wine and gambling. Say: "In them is great sin, and some profit, for men; but the sin is greater than the profit." They ask thee how much they are to spend; Say: "What is beyond your needs." Thus doth Allah Make clear to you His Signs: In order that ye may consider".

risks. In collateral-based finance, Islamic banks transfer default risk to customer itself rather than share the risks between contractual parties.

### *Adoption on Western Finance*

The seed of Islamic version of derivatives emerged when Deutsche Bank develops Islamic derivatives. Citigroup then designed Islamic version of currency swap for the Dubai Investment Group (DIB) to hedge the currency risk of DIB's investment in Bank Islamic Malaysia (Global Islamic Finance Report, 2010). This indicates the Western giants are in the frontline to shape the current development of Islamic financial instruments. Wigglesworth (2009a) believes that Western financial institutions currently dominate the Islamic finance industry. One of the reasons is that they are finding new distribution channels for their products and services by saving their time and cost by re-engineering conventional products into Islamic versions (ibid).

### *Financialization's Syndrom*

There have called for avoiding the financialization of the economy by strengthening links between Islamic finance and the real economy (Farooq, 2009). As explained elsewhere in this paper, Sharia promotes transferring wealth from one party to another by engaging into real economic activities. Shariah promotes integration between financial and real markets. Financializaiton syndrome that affects the massive money circulation in the financial markets without direct impact on real sector market is thus condemned in Islamic finance.

### *Standardization*

Islamic financial industry needs standardized regulation, legal frameworks, and harmonization of Sharia interpretations due to different level of Sharia strictness. Lack of these factors may hamper the healthy growth of the industry.

The absence of Sharia standards may slowdown innovation on one hand and creates loopholes that tend to be exploited by product designers on the other hand. Innovations will take place, so long as the basic standards are

set. But if the industry does not have such a standard, it will impede growth (Wigglesworth, 2009b).

### *The Issue of Fatwa Shopping*

The lack of *Sharia* standardization on Islamic financial products results an issue of *fatwa* shopping whereby financial institutions approach a number of Shariah scholars (simultaneously or consecutively) within the same or from different Islamic legal schools (*madhahib*) to provide religious opinions on financial contracts, products, and services.[8] Such procedure enables these institutions to receive a preferred *fatwa* based on their financial objectives (Malik et al, 2011). This practice plausibly occurs due to the weak governance arrangements of the Shariah Supervisory Board (SSB) at the institutional level. For example, Wafiq and Pellegrini argue that *fatwa* shopping is a result of conflict of interests in the process of Shariah supervision due to a dual relationship of the Shariah Supervisory Board's (SSB) position as the employee and as the supervisor or assessor (2006:9). Nienhaus (in Archer and Abdul Karim, 2007:395) and El-Gamal (2008: 199) agree adding that its implications may weaken the process of supervision and undermine a sound Shariah pronouncement on Islamic products and services. Fatwa shopping can also be categorized as operational risks and may create risk exposures that hamper development of Islamic finance[9].

In the case where centralised *Shariah* standard setting organisation is existed in a particular jurisdiction, the issue of *fatwa* shopping may be reduced. However, this issue may be more challenging in the case where such centralised organisation is non-existent. In Islamic derivatives markets

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[8] See Malik, M. Shaukat, Malik Ali, and Mustafa Waqas, 'Controversies that Make Islamic Banking Controversial: An Analysis of Issues and Challenges' (2011) 2(1) *American Journal of Social and Management Sciences* 41-46.

[9] When the external stakeholders such as the investors or consumers loss their confidence in Islamic banks due to the inconsistency in the work of Shariah supervisory boards when their decisions contradict each other (Malik et al, 2011: 14). See also, Abdul Karim Aldohni, *the Legal and Regulatory Aspects of Islamic Banking: A Comparative Look at the United Kingdom and Malaysia*, (Routledge, 2011) 107.

that include cross-border participants, this issue should be discussed widely in the lieu of Sharia governance and risk management perspective.

## What are Foreign Currency Forwards and Swap Contracts?

Forward contract is a contractual obligation between two parties to buy or to sell an asset at a specified future date at a price agreed upon today (Hull, 2009). The terms of agreement are fixed for the duration of the contract and include the price at maturity, contract size, quality, and delivery location and time (Culp, 2004, and Hull, 2009). The party that agrees to buy the asset in the future is called a long position party, and the party that agrees to sell the asset in the future is called a short position.

The purpose of this derivative is to hedge the volatility associated the commodity price or assets by locking the price in advance to be delivered later. The illustration of this contract as follows: an Indonesian exporter who is expecting to receive a payment of 100 thousand dollar after three months. Since he will need to convert these dollars into rupiah, there is exchange rate risk involved. The exporter enters into a forward contract to exchange 100 thousand dollars into rupiah after 3 months at a fixed exchange rate of one dollar is equivalent to 14.000 rupiah. Forward contract enables him to exchange his 100 thousand dollars for 1.4 billion rupiah after 3 months. If there is no currency forward contract, the amount will be fluctuated either higher or lower from the current price.

Forward contracts are not tradable in on exchange. Instead, there are traded in over-the-counter (OTC) market, usually between two financial institutions or a financial institution and one of its clients. These are the customized contracts since the contracting parties can negotiate the terms of the contracts by themselves.[10]

Meanwhile, swap contract is an agreement whereby buyer and seller exchange future cash flows (Hull, 2009).[11] This instrument allows financial institutions to manage their interest rate, foreign exchange, and credit risks. In interest rate swap, two parties deal to make payments in the future. One party called "fixed rate payer" agrees to make fixed rate interest payments while the other called "floating rate payer" agrees pay floating rate. This

[10] J. Hull, *Options, Futures and other Derivatives* (7th ed, Prentice Hall, 2009).
[11] J. Hull, *Options, Futures and other Derivatives* (7th ed, Prentice Hall, 2009).

agreement was usually settled by one party paying-off rather by both. The different in the rate it assess, one side becomes liable. For example, in one period where the floating rate is lower than the fixed rate, the fixed-rate payer will pay the different in rate to the floating-rate payer. If the other period shows that the fixed rate is lower than the floating, the floating will pay the different in rate to the fixed-rate payer.

## Islamic Derivatives in Indonesia: A Case Study

### *MUI's Fatwa on Hedging*

In Indonesia, National Shariah Council (DSN), as an institute or organizational entity within the Indonesian *Ulama* Council (MUI),[12] issues *fatwa*s pertaining to the practices of Islamic banking, Islamic insurance (*takaful*), capital market and other Islamic financial institutions in the country.

MUI plays a central role in the industry since the Central Bank of Indonesia (*Bank Indonesia*) adopts their *fatwas* and makes them as *Shariah* standards for all Islamic banking players. In 2008, the Central Bank of Indonesia issued a codification of Islamic Banking Products, including deposit funds, financing, and service products, for the purpose of creating consistency in *Shariah* rulings on various Islamic banking products by adopting the MUI's *fatwas*.[13]

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[12] MUI headed by a board of directors in the Jakarta's headquarter. It has more than 150 regional branches at the provincial and district levels. Its members consists of different Islamic organizational backgrounds such as *Nadhlatul Ulama* (NU), *Muhammadiyah,* Islamic United (*Persis*), and many others. The central headquarter does not have a clear relationship with all its branches including the complication of *fatwa*s produced by the central and local branches. In the area of Islamic economics, the role of this organization is very central in influencing public perceptions about Islamic banking industry, for instance, in January 2004, MUI issued a *fatwa* (No. 1/2004) restating the prohibition of interest of conventional banks and confirming that interest is part of *riba* in the Qur'ān, and defining the term broadly to mean any 'additional charges levied on the postponement of agreed payments'. See, Lindsey (2014)

[13] <http://www.bi.go.id/en/perbankan/syariah/Documents/CODIFICATIONOFISLAMICBANKINGPRODUCTS.pdf> (28 October 2014)

In 2015, MUI issued *fatwa* of 96/MUI/III/2015 on *tahawwut* (hedging). This *fatwa* consists of three different types of hedging structure: (1) simple hedging (*hedging sederhana*); (2) complex hedging (*hedging kompleks*); and (3) hedging based on Islamic commodities markets (*hedging berdasarkan bursa komoditas Syariah*). All types of hedging under the *fatwa* use a *wa'ad* (unilateral promise).

The use of *wa'ad* structure has been recognized widely. For instance, Accounting Auditing Organization for Islamic Financial Institutions (AAOIFI) Standard 1: Trading in currencies states "a bilateral promise is prohibited in currency trading when it is binding upon both parties, even when it is done to treat the risk of decline in a currency's value. As for a unilateral promise from one party, that is permissible, even if it is binding". The Shariah Advisory Council of Bank Negara Malaysia, furthermore, states that a forward foreign currency transaction based on unilateral binding promise (binding only on the promisor) is permissible. The permissibility is only applicable for the purpose of hedging transaction not speculation (ISRA, 2014).

### *The Rationale Behind the Hedging Fatwa*

Islamic banks and conventional banks offering Islamic services that facilitate international trading activities through various instruments such as credit line, letter of credit, and guarantee are exposed to foreign currency risks. This risk occurs due to time differences in the period between signing and exercising such a contract that creates foreign currency rate fluctuation that differs from the rate at the time of signing such a contract. In a worst scenario, when the foreign currency rate is higher than at the time of signing contract, Islamic financial institutions compensate the price differences, and thus get loss.

Meanwhile, Islamic banks cannot use conventional hedging instruments to mitigate such a foreign currency fluctuation risk due to Sharia requirements. There are three elements of conventional hedging instruments that are not considered as Sharia compliant. These are the use of interest rate mechanism, the requirement to state current rate of a foreign currency for future delivery, and trading of debt-instruments. These

prohibitions result a lack of hedging instruments in the market that prompt Islamic finance to be less competitive to its conventional counterparts.[14]

The existence of hedging based on Shariah also falls under the category of *maslahah* (public interest). Islamic finance markets have a wider opportunity to conduct financial transactions based on their religious aspirations. This also may facilitate further growth of Islamic financial industry.

### *Shariah Guidelines on Islamic Hedging*

The Shariah Advisory Council (DSN) – Indonesian Ulama Council (MUI) stated certain Sharia guidelines on hedging transactions in the country's Islamic banking and finance industry. These include:

1. The transactions of Islamic hedging should not be entered into for the purpose of speculation. Cash settlement should be related to underlying transactions.[15]
2. Forward agreement documents cannot be sold
3. The transaction value of Islamic hedging must not be more than the underlying transaction's nominal value stated in the document of the underlying transactions.
4. The duration of Islamic hedging transactions must not be more than the duration of underlying transactions stated in the underlying transaction documents
5. Settlements of Islamic hedging must involve in delivering the whole principal assets
6. Cancellation of Islamic hedging by one of the transacting parties must be followed by transferring the whole fund to the cancelled party

[14] In most cases, except in Iran and Sudan, Islamic financial industry co-exists with conventional industry.

[15] Underlying transaction means any transactions that involve: (1) trading of goods and services either domestically or internationally; and (2) various investments that include direct investments, portfolio investment, financing, capital, and other investments either domestically or internationally. In the Bank Indonesia's Explanation on Islamic Hedging (3/05/2016), http://www.bi.go.id/id/peraturan/moneter/Documents/faq_pbi_180216.pdf

***Simple Hedging (‘Aqd al-Tahawwut al-Basith)***

In simple hedging each party simultaneously grants to the other party a *wa’ad* (a unilateral promise or undertaking), either formally written or not, to undertake from such other party one spot or more transactions on specified dates in the future based on bay *al-sarf* (a currency exchange)[16]. The undertaking or promise consists of: (1) a predetermined foreign currency; (2) notional amount; (3) a predetermined exchange rate (forward rate); and (4) predetermined dates. Bank Indonesia has issued regulation PBI Number 18/2/PBI/2016 to regulate Islamic simple hedging.

The example of this arrangement is as follows: Party A grants a *wa’ad* (unilateral promise) on 1 April 2016, to buy USD 1 million from Party B on 1 May 2016 at the exchange rate 1 USD = 14.000 IDR, simultaneously Party B also grants a *wa’ad* to sell USD 1 million at the predetermined rate to Party A. On 1 May 2016, Party A exercises his promise to buy the USD from party B, thereafter Party B sells USD 1 million to Party A, and receives 14 billion IDR from the customer. The currency exchange is complete and Party A receives USD 1 million at the agreed exchange rate regardless of the market rate.

In the above simple hedging, one party may face losses due to the lack of hedging partners.[17] This obstacle is mainly addressed by the third type of hedging under the *fatwa* when both parties are able to exchange currencies on mechanism of *wa’ad* leading to *murabaha* in a commodity market.

***Complex Hedging” (‘Aqd al-Tahawwut al-Murakkab)***

The definition of complex hedging is similar with simple hedging whereby each party simultaneously grants to the other party a *wa’ad* (a

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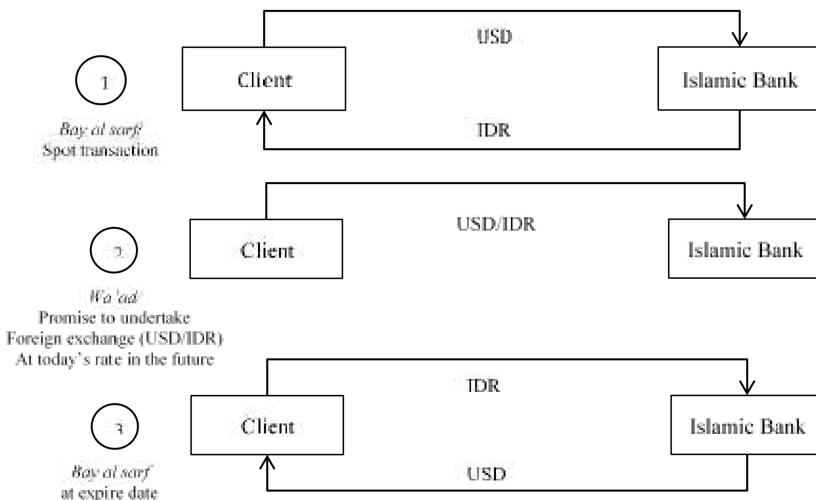
[16] Currency Exchange based on *bay al sarf* has been approved by the Indonesian Ulama Council (MUI) on a *fatwa* number 28/DSN-MUI/III/2002 on *bay al-sharf*. The *fatwa* states that currency exchange is allowed on the spot basis in which the deal settlement is expected to be completed within 2 days after contract has been concluded. This *fatwa* also prohibits currency forward transactions, currency swap transactions, and currency option transaction. Later on the fatwa allows currency forward contracts. However, it needs to be preceded by *wa’ad* (unilateral promise) as will be discussed in detail in this paper.

[17] Republika Online, “Hedging Syariah Kompleks Berpotensi Dikembangkan” [10/05/2016] http://www.republika.co.id/berita/koran/syariah-koran/16/05/10/o6yec63-hedging-syariah-kompleks-berpotensi-dikembangkan

unilateral promise or undertaking) to undertake spot transactions in the future. This promise comprises of a specified foreign currency, notional amount, a specified foreign currency rate, and an exercising date.

The different between simple and complex under the *fatwa* is that in complex hedging a spot transaction (based on *bay al sarf*) is taken place at the beginning followed by an undertaking (*wa'ad*) by the customer to enter into a currency exchange forward on a future date at today's exchange rate. On the future date, another spot transaction (*bay al sarf*) takes place at the rate that was promised at the earlier date. Diagram 1 illustrates this *fatwa* (Appendix 1). For example, in 1 April 2016, Party A that has USD 1 million sells this dollar to Party B on the spot basis (*bay al sarf*) to obtain IDR. Let assume the spot price is 1 USD = 14.000 IDR. At this stage, Party A exchanges USD 1 million with IDR 14 billion. Thereafter, Party A enters into *wa'ad* (unilateral promise or undertaking) to enter into another spot transaction (*bay al sarf*) in the future based on the today's price. At expire date 1 June 2016, Party A exercises his promise to get back his USD without being exposed to the adverse movements of currencies rate by buying USD 1 million at the rate 14.000 IDR.

**Figure 1.** *"Complex Hedging" based on MUI's Fatwa*



### *Hedging based on Islamic Commodities Markets (‘Aqd al-Tahawwut fi Suq al-Silah)*

In exercising hedging based on Islamic commodities markets, the market facilitates Islamic hedging on foreign currency transactions based on trading on several commodities deemed as Sharia compliant (*sil’ah*). Jakarta Future Exchange (JFX) facilitates such a transaction by establishing a special unit dedicated to Sharia compliant transactions. However, up to the writing of this paper, the Indonesia regulators such as Bank of Indonesia and Indonesian Financial Services Authority have not yet provided any regulation pertaining to this type of hedging.

The structure of hedging based on Islamic commodities markets contains *tawarruq* whereby party A purchases a commodity on deferred payment basis from party B and immediately sells the commodity at cash basis to party C at a lower price. In Indonesia, there is no specific *fatwa* on *tawarruq*, however, Indonesian Ulama Council (MUI) has stated that if there is a urgent need (*lil hajah*), then it is allowed to use *tawarruq*.[18] This contract is one of the controversial structures in Islamic finance. Unlike Malaysia that disallows *tawarruq* and prefers to utilize *bay al inah* (Party A sells a commodity at x price to B at cash, and then party A buys back that commodity from B at cost plus profit on deferred payment basis), Middle Eastern scholars mostly agree the use of *tawarruq* in Islamic finance products.

The *fatwa* on hedging based on Islamic commodity markets consists of two different mechanisms. Each mechanism consists of two different transactions.

First mechanism consists of two transactions as illustrated with example as follows:

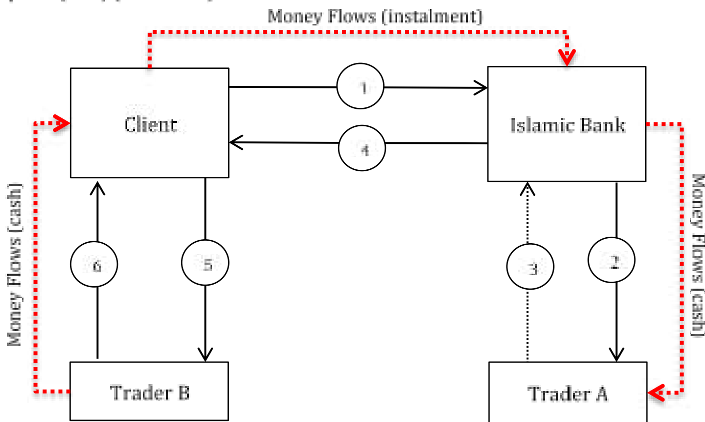
First transaction or first leg:

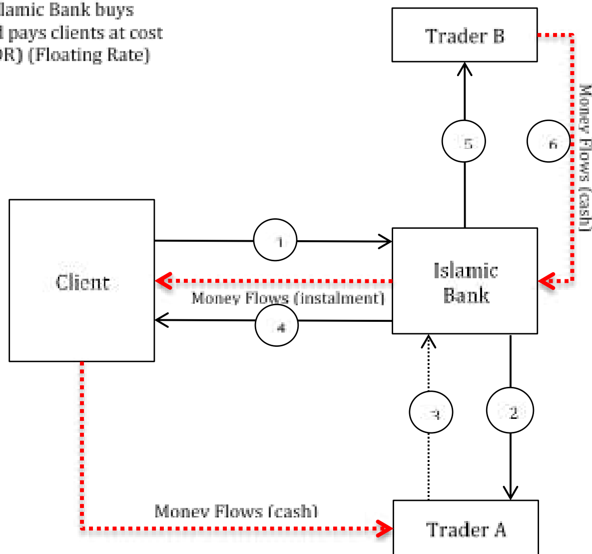
- Party A promises (*wa’ad*) buys a commodity through Party B from trader A for cash
- Party B buys a specified commodity from trader A for cash

[18] Republika Online, “Hedging Syariah Kompleks Berpotensi Dikembangkan” [10/05/2016] http://www.republika.co.id/berita/koran/syariah-koran/16/05/10/o6yec63-hedging-syariah-kompleks-berpotensi-dikembangkan

- Party B sells the commodity to Party A at cost + profit in a specified currency
- Party B assists Party A to sell off the commodity at cost at the commodity market

**Figure 2.** *Hedging based on Islamic Commodity Markets in the First Mechanism*



Second Transaction or second leg:

- Party A appoints Party B on the basis of wakala contract (agency contract) to buy a commodity from trader B for cash;
- Party B buys the commodity from Party A at cost + profit
- Party B sells off the commodity at cost

The second mechanism also consists of two different transactions. The process of the second mechanism is similar with the first one. It involves *wa'ad* (*promise*) by one party to the other party to buy a commodity on a specified price and date. If one party exercises his promise (*wa'ad*), the other party is required to purchase required commodity under *murabaha* contract.

The following illustrate these two sets of mechanism of hedging based on Islamic commodities markets to exchange USD with Euro.

First transaction:

1. The client who has USD promises (*wa'ad*) through the Islamic bank to buy the commodity worth USD 1.5 million by cash
2. The bank buys commodity from a vendor in the commodity market cost USD 1.5 million by cash
3. The client buys the commodity from the bank at USD 1.5 million plus bank's profit
4. The client sells the commodity to a vendor in the commodity market with the bank's assistance at USD 1.5 million

Second transaction:

1. The client who has USD appoints the bank (*wakala*/agency contract) to buy the commodity worth USD 1.5 million by cash
2. Thereafter, the client sells the commodity – that was bought – to the bank (based on forward rate) at the price of USD 1.501.000 by credit (USD 1000 additional profit compared to the cost price). The bank will make repayment after 12 months. This transaction gives the investor returns in USD. However, this transaction has not achieved the client's primary objective to get Euro. Then it goes to the next as follows.
3. The bank, that bought the commodity on deferred basis from the client, sells the commodity to other broker in the commodity

market at a lower price and obtains the same amount as earlier purchase which is USD 1.5 million cash

4. Now the bank needs Euro. Hence, the bank exchanges USD 1.5 million to Euro 1 million (based on today's rate, for instance). The bank buys the commodity from other broker cost Euro 10 million
5. The bank then sells the commodity to the client at cost plus profit say Euro 1.001.000 by credit on deferred basis within 12 months.
6. The client sells the commodity to other broker at a lower price and obtains Euro 1 million.

The above illustrates that the client has succeeded to exchange USD 1.5 million to Euro 1 million[19].

Unlike in conventional swaps where two legs transactions – one fixed and one floating – are treated as a single transaction and documentation, in Islamic hedging as illustrated above, these two legs are treated into two separate documents. Each document contains a *wa'ad* granted by one party to the other. The only *Shariah* reason for this separation is that each leg must be clear and distinct from each other (Clifford Chance, 2012).[20]

## *Wa'ad* (Unilateral Promise) in Islamic Derivatives Markets

*Wa'ad* has been the cornerstone in engineering Islamic financial products including Sharia compliant derivatives. The *wa'ad* is more flexible than a contract (*'aqd*) to replicate conventional financial Some *Shariah* restrictions on conventional finance such a predetermined price for future delivery, or the transfer of ownership in the future with the price paid today do not apply to a *wa'ad* (Atallah and Ghoul, 2011). Furthermore, a *wa'ad* is relevant to various aspects. At first, it shows parties' commitment to complete a transaction. For instance, Islamic banks may use *wa'ad* to request its customers to give a binding promise to the banks to purchase an asset under various financing products such as *murabaha* and *musharaka* products. In Islamic capital markets, a *wa'ad* is also used as a tool for liquidity payment

[19] This example is derived from Dusuki (2009), since the mechanism of hedging based on Islamic commodity markets as explained by the MUI's fatwa has similarities with Islamic swap transactions as discussed by Dusuki.

[20] Clifford Chance, "New Product Documentation for Islamic Cross Currency Swaps" November 2015

as an exit mechanism, i.e. to redeem a *sukuk* at maturity, and as an alternative to put option and call potion. In derivatives markets, a *wa'ad* is widely used as a purchase undertaking that is applied in a supplementary document to the master agreement (Wisham, Muneeza, and Hasan, 2011). For this reason, for instance, Cattelan (2011) argues that the combination of *wa'ad* (unilateral promise) can help to engineer many Islamic instruments to adopt various conventional finance instruments.

### *Wa'ad Under the Fatwa of Indonesian Ulama Council (MUI)*

MUI issued a *fatwa* Number 85/DSN-MUI/XII/2012 on Promise (*Wa'ad*) in Shariah financial and business transactions. One of most important features of the *fatwa* is that unilateral promise (*wa'ad*) is not only morally but also legally binding. The *fatwa* thus maintains that *wa'ad* is a promissory arrangement in which the promisee must suffer a cost for the promise to be enforceable. The *fatwa* refers to the term *mulzim* to indicate that the promisee can be enforced to exercise his or her promise by a legal authority.

As part of the punishment of not exercising promise, the MUI's *fatwa* allows the bank to execute *ta'widh* (compensation fee) on a defaulted promise. This *fatwa* provides the financial regulators including Bank of Indonesia with the power to impose a *ta'widh* to the defaulted promise[21].

MUI took similar view with the Islamic Fiqh Academy of Saudi Arabia that opined that the concept of *wa'ad* is "obligatory not only in the eyes of God but also in a court of law". This makes a *wa'ad* is judicially binding if it is made contingent upon a reason and if the *wa'ad* produces cost or expense in an effort to meet the promise (Wisham, Muneeza and Hasan, 2011).

### *Cross Currency Swaps and Profit Rate Swaps Based on Wa'ad Structure: Some Examples*

In 2012, International Islamic Financial Markets (IIFM) and International Swaps and Derivatives Association (ISDA) published Islamic

[21] See Bank Indonesia Regulation Number 18/2/PBI/2016, Article 5 point 2

Profit Rate Swap (IPRS) providing risk mitigation from the cash flows' fluctuation of Islamic financial institutions. IPRS templates were structured on two sets: (1) one set was designed using *wa'ad* involving a two-sale structure, and (2) the other one set based on *wa'ad* with a single sale structure. In November 2015, another product template was issued namely Islamic Cross Currency Swap (ICRCS). This product enables Islamic financial institutions managing risks in transactions exposed to fluctuations in currencies and rate-of-return mismatches based on *wa'ad* structure.

### Islamic Profit Rate Swaps

Islamic Profit Rate Swaps use a *wa'ad* structure leading to *murabaha* sale. A *wa'ad* is an undertaking or promise by one party (the buyer of the assets) to the other party (the seller of the assets) that, if required by the seller (usually called exercise of the undertaking or *wa'ad*), the buyer will fulfil its promise, in this case, to enter into a *murabaha* contract[22]. It means the buyer will buy using *murabaha* contract from the seller an agreed quantity of agreed *Shariah* compliant assets at an agreed price on a relevant exercising date (Clifford Chance, 2012). *Murabaha* is used in this agreement to generate fixed payments (comprising both a cost price and a fixed profit element) and a series of corresponding reverse *murabaha* contracts are used to generate the floating leg payments (the cost price element under each of these reverse *murabaha* contract is fixed but the profit element is floating) (Oberoi and Khadem, 2011).

### Islamic Cross Currency Swap based on Wa'ad

Islamic cross currency swap (ICRCS) is Sharia compliant derivative arrangement that uses *wa'ad* leading to reciprocal *murabaha* transactions (similar in some respects to the structure used for a profit rate swap, as discussed previously). This derivative contains *wa'ad* of two sales structure illustrated as follows: Bank A gives a *wa'ad* to Bank B in relation to each payment date under which Bank B may exercise Bank A's *wa'ad*, requiring Bank A to buy from Bank B, in cash in one of the two specified currencies

[22] *murabaha* refers to a sale contract whereby Islamic banks purchase an asset at x price from a vendor and sell it on x plus profit to a customer

(which may be different for different payment dates), Sharia compliant assets in respect of that payment date. Simultaneously, under different documentation, Bank B gives a *wa'ad* to Bank A (in relation to payment dates which will generally be the same as the payment date under this leg) under which Bank A may exercise Bank B's *wa 'ad*, requiring Bank B to buy from Bank A, in cash (in the other of the two specified currencies for the payment date under the second leg), different Shari 'ah compliant assets in respect of that payment date. Hence, this two-leg structure generates two sales per payment date, one by Bank A to Bank B and the other by Bank B to Bank A.[23]

## Some Challenges of Developing Islamic Derivatives in Indonesia

### *The Use of Commodity Murabahah (Tawarruq)*

Complex hedging as well as hedging based on commodity markets as the last two forms of Islamic derivatives based on the MUI's fatwa use *tawarruq* or *commodity murabahah* in their structures. Nowadays, *tawarruq* has been extensively used by Islamic financial markets as a vehicle for liquidity and risk management purposes. However, the widespread practice of *tawarruq* has been still disapproved by many contemporary scholars. More importantly, the International Islamic Fiqh Academy of the Organization of Islamic Cooperation, in its 19th session, held in Sharjah in 2009, resolved that the current *tawarruq* practice is against Islamic principles of contracts.[24] The resolution refers to an organized *tawarruq* whereby a buying and selling transaction in the market is a merely fictitious transaction as a way to circumvent the prohibition of *riba*.

There are two types of *tawarruq* namely a real *tawarruq (tawarruq fiqhi or haqiqi)* and organized *tawarruq* (*tawarruq munazzam*). The real *tawarruq* refers to a series of sale contracts whereby a buyer buys an asset from a seller for a

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[23] *Corporate Profile of IIFM* (11 May 2016), http://www.iifm.net/about_iifm/corporate-profile

[24] Resolution 179 (19/5) of Islamic Fiqh Academy of the Organization of Islamic Cooperation, [10/01/2017], https://zulkiflihasan.files.wordpress.com/2009/12/oic-fiqh-academy-recommendation-tawarruq-may2009.pdf

deferred payment and subsequently sells it to a third party for cash at a lower price for the purpose of obtaining cash (Zuhayli, 2009).[25] Jurists took different views on the permissibility of this transaction. Some jurists including the Shafii', Hanafi, and Hanbali argue that *tawarruq* in its traditional model is permissible, while some disagree[26]. Meanwhile, the organized *tawarruq* is deemed to be as synthetic and fictitious transaction whereby the financier arranges the sale agreement either by himself or through his agent. Simultaneously, the buyer and the financier executives the transactions. This kind of transaction may open the door to borrowing money on the basis of *riba* and without creating any real economic activity, as the same commodity or product might be sold to several borrowers.[27] Furthermore, the application of organized *tawarruq* raises some controversial issue including the issue of commodity, the issue of possession and delivery, the issue of pre-arrangement, and the issue of agency.[28] AAOIFI holds the position that a *tawarruq* should be practiced without an artificial transaction. In Its Sharia Standard No 30, Article 4/5, AAOIFI states that "the commodity (object of *tawarruq*) must be sold to a party other than the one from whom it was purchased on a deferred payment basis (third party), so as to avoid *inah*, which is strictly prohibited. Moreover, the commodity should not return back to the seller by virtue of prior agreement or collusion between the two parties, or according to tradition".[29]

Indonesian market faces the challenges on how to put this fatwa into practice. Recently, the Indonesian authorities including the Bank of Indonesia as well as the Financial Services Authority of Indonesia (OJK) have not yet issued any regulation pertaining to the application of the

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[25] See Asyraf Wajdi Dusuki, Mohammad Mahbubi Ali, and Yulizar D. Sanrego, "The Application of Commodity Murabahah in Bursa Suq Al-Sila' Malaysia vis-à-vis Jakarta Future Exchange Shariah Indonesia: A Comparative Analysis" (2013) 49 ISRA Research Paper, p.4

[26] Ibid, 12

[27] Zamir Iqbal and Abbas Mirakhor, *An Introduction to Islamic Finance: Theory and Practice* (2nd Edition, Wiley, 2011), p.86

[28] For further discussion on these issues see, Asyraf Wajdi Dusuki, Mohammad Mahbubi Ali, and Yulizar D. Sanrego, "The Application of Commodity Murabahah in Bursa Suq Al-Sila' Malaysia vis-à-vis Jakarta Future Exchange Shariah Indonesia: A Comparative Analysis" (2013) 49 ISRA Research Paper

[29] AAOIFI, *Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) Sharia Standards* (Bahrain, 2008)

complex hedging and hedging based on the commodity market. The application should be based on the practice of the real *tawarruq* to avoid the market from the Sharia risks that occur due to the application of an instrument that is deemed not Sharia compliant.

***Lack of Standard Documentations***

Since Islamic derivatives officially recognized by the Indonesian *Shariah* standard setting in 2015, its standard documentations need to be developed. Such standard is important since it may facilitate a benchmark for market players in developing derivative documentations, create efficiency and competitiveness since the negotiating parties may reduce costs and time committed to negotiations process, and help transparency since all materials economic and legal terms must be defined in the agreement.

In Malaysia, Bank Negara Malaysia, for instance, has introduced Islamic Derivatives Master Agreement (IDMA) in 2007[30]. In the global level, International Islamic Financial Markets (IIFM) and International Swap and Derivative Associations (ISDA) have developed the ISDA/IIFM *Tahawwut* (hedging) Master Agreement in 2010. The Introduction of this master agreement means that Islamic financial industry has benchmark to develop a standard documentation for Islamic derivative markets (see McMillen, 2010).

***Lack of Regulators' Approvals***

At present, Indonesian banking regulators mainly Bank Indonesia (BI) has approved two out of three Islamic hedging schemes under the *fatwa*. BI issued Bank Indonesia Regulation (PBI) number 18/2/PBI/2016 on simple hedging (*'Aqd al Tahawwuth al-Basith*) and complex hedging (*'Aqd al Tahawwut al-Murakkab*) as part of Islamic hedging based on *Shariah* principles. The regulation does not provide the last part of hedging under the *fatwa* namely hedging based on Islamic commodity markets (*'Aqd al-Tahawwut fi Suq al-Silah*).

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[30] Bank Negara Malaysia (20 March 2016) http://www.bnm.gov.my/index.php?ch=9&pg=15&ac=367&tpl_id=395, accessed 20 March 2016

In Indonesia, a *fatwa* issued by the MUI needs regulators' approval to give legal effects on the industry. Law No 21 of 2008 on Islamic banking requires the central bank to adopt the *fatwa* of the MUI in developing Islamic financial instruments (see Lindsey, 2012). However in the case of Islamic derivatives, Bank Indonesia seems in the position of "wait and see" to adopt the *fatwa* mainly on hedging based on Islamic commodity markets. As the paper mentioned elsewhere, the *fatwa* is flexible enough to be implemented into various derivative instruments. If the regulator did not careful in responding the *fatwa*, it would be a "main gate" for the boost of derivatives markets in the Islamic finance industry and would also lead to financialization syndrome in the industry.

### *The Issue of Counterparty Risk*

"Simple hedging" and "complex hedging" as defined in the MUI's *fatwa* are considered over-the-counter (OTC) derivatives because they are generally traded and negotiated between counterparties. In this mechanism, there is not clearing house to facilitate a selling and buying transactions of contracting parties. These parties can privately negotiate the transaction on their best preferences.

One of the main challenges of such a derivative is counterparty risk, the risk that one side in a derivative contract will fail to honor the contract (Stulz, 2003:131). For instance, bank A has a long position to buy foreign currency in a specified time in the future. The forward position makes money if the foreign currency at the end of the year higher the forward price, but only if the forward seller honors the terms of the contract at maturity. If the forward seller cannot deliver at maturity because of a lack of financial resources or other reasons, the forward contract is useless, and the gain the firm expected to make does not materialize.

In Islamic finance, the only one scenario to address the above issue is to make unilateral promise (*wa'ad*) becoming a binding agreement. The MUI has issued *fatwa* on this as discussed earlier. However, this will not be enough to address counterparty risks. In conventional scenarios, Stulz (2003) proposes two mechanisms on this. At first, the long position (forward buyer) enters the contract if the counterparty has a high debt rating indicating a low probability of default. At second, the short position

(forward seller) is required to post a bond to a third party that guarantees performance on the contract. This guarantee is a form of securities that is forfeited if the short does not deliver on the forward contract (ibid). There is a need to develop guarantee mechanism in the spirit of *Shariah* to address this counterparty risk.

### *Sharia Harmonization between Ideal and Realities*

Sharia harmonization is imperative especially Indonesia and other ASEAN countries have committed to enter ASEAN Economic Community (MEA). Under the treaty, Islamic banking players in the region can access foreign instruments including derivatives among member countries. In such a circumstance, Sharia harmonization is needed to provide a common standard on Sharia matters. If this happens, transfer of Islamic derivatives is more easily facilitated among industry players in the region. Furthermore, this could also enhance liquidity, since standard Sharia requirements consistently applied across Islamic derivatives transactions.

It is important to note that Islamic hedging based on Islamic commodity markets in Indonesia involves *tawarruq*, a mechanism that is not accepted widely in Malaysia and allowed in the Middle Eastern countries. *Tawarruq* is also viewed controversial in the country. The lack of Sharia harmonization on *tawarruq* structure could result the lack of market acceptance towards Islamic financial instruments that involve such a structure.

International Islamic Financial Markets (IIFM) that formed by Indonesia and Malaysia among others could lead the efforts of Sharia harmonization in the region. However, it is worth to notice that their effort is complicated since both Indonesia and Malaysia have ambitions to be the center of Islamic finance industry.

## CONCLUSION

This paper has discussed Islamic hedging based on the Indonesian Ulama Council (MUI)'s *fatwa*. The *fatwa* accommodates three different types of risk management instruments namely "simple hedging", "complex

hedging", and "hedging based on Islamic commodity markets" to mitigate risks faced by Islamic financial industry.

All the hedging products under the *fatwa* use the structure of *wa'ad* (unilateral promise) leading to purchasing and selling contracts of an underlying variable. The *wa'ad* structure is flexible to adopt various conventional derivatives instruments. As a result, the *fatwa* that was initially formulated to provide a religious legitimation on foreign currencies' forward agreement can be applied to a wider derivative instrument such as swap derivatives, and may open a wider use of derivative in Islamic financial industry. Up to present, the regulators just adopt one out of three types of hedging derivatives under the *fatwa*. The last two parts namely complex hedging and hedging based on commodity markets have not yet transformed into any regulations. One may argue that this was plausibly resulted from the use of *commodity murabahah* (*tawarruq*) in the last two types of Islamic hedging. The *tawarruq* itself has been at the center of criticism of the current application of Islamic financial industry worldwide. The regulators seemingly want to ensure that the application of these two types of Islamic hedging should be based on the real *tawarruq* to avoid the market from the Sharia risks that occur due to the application of an organized *tawarruq* that is deemed not Sharia compliant mainly by Fiqh Academy. Furthermore, the last type of hedging namely hedging based on commodity markets may open the "gate" of derivatives markets in the industry, and may also attract huge debates especially on how these derivatives should be in line with the spirit of Islamic finance.

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