Fatwa and Shari'a Supervisory Board

DFM
سوق دبي المالي

Dubai Financial Market Standards on Shari’a-Compliance

Standard No. 3

Hedging Against Investment and Finance Risks

CONTENTS

INTRODUCTION

All praise is due to Allah, Lord of the Worlds; and Allah's peace and blessings be upon his last Messenger, his family, his noble Companions, and all those who follow them with righteousness until the Day of Judgment.

The need for hedging within Islamic banks and financial institutions stems from their commitment to adhere to the general objectives of the Islamic Shari'a (the Shari'a), which include the protection of wealth. In fact, the administrators of these institutions realize that they receive, through the contracts of *Wakala* or *Mudaraba*, the funds of both the shareholders as well as the investment fund managers for the purpose of making profits. Besides, the administration of funds is implemented on a trust basis and therefore, fund managers cannot be held liable for the loss, if any, unless in the cases of misconduct, negligence or breach of the investment agreement. However, if safeguarding funds is one of the fund managers' duties, the means to achieve this, which is through hedging, becomes a duty in itself.

In the context of Dubai Financial Market (DFM) playing an effective role in providing normative frameworks consistent with the provisions of Islamic Shari'a, being the first financial market operating with Shari'a principles on a global scale since 2007, and its tireless efforts to consolidate Dubai's position as an international capital for the Islamic economy, as well as the increasing importance of hedging and its significance for economic activities, the DFM has issued its own standard on hedging so that it may form a point of reference for Islamic banks and financial institutions to safeguard their funds without violating the rules of Shari'a. Following the DFM Fatwa and Shari'a Supervisory Board study and examination of all hedging-related standards and reliable Fatwas, the new Standard was prepared and developed, and is in fact the latest in a series of DFM standards issued including the DFM Standards on Sukuk and Shares.

The DFM Fatwa and Shari'a Supervisory Board presents this Standard to all Islamic Finance stakeholders to help achieve further progress, development and support of the following:

- Transactions of Islamic banks and Islamic financial institutions
- Investment and leasing companies
- Takaful and re-Takaful insurance companies
- Sukuk, Islamic funds and investment portfolios
- Financial studies, particularly those related to risk management
- Legislations compatible with the provisions and principles of Islamic Shari'a

The DFM Standard for hedging defines all types of risks according to their relevance and nature. The Standard also sets parameters for valid hedging instruments, it explains these instruments and places a special emphasis on their underlying contracts. Additionally, the Standard details the relevant provisions, undertakings and direct hedging instruments. Furthermore, it defines possible Shari'a substitutes to conventional derivatives-based hedging instruments, assets-based hedging applications, hedging in currency exchanges, in addition to the hedging instruments used to manage liquidity or protect against fluctuations on indices-based returns.

Perhaps the best outcome this unprecedented Standard could achieve is clarifying the prevailing misunderstanding about the ability of Islamic banks and financial institutions to exercise hedging. In fact, it is the duty of Islamic banks and financial institutions to manage their risks efficiently and effectively. Moreover, the Standard introduces hedging instruments and mechanisms which would not compromise Shari'a rules and Shari'a objectives. Thus by all accounts, it is an important step towards the further development and success of Islamic Finance.

The Standard also helps and encourages conventional banks and corporates to safely convert and become Shari'a-compliant by providing these institutions with convenient yet permissible services and instruments to hedge or manage their risks through.

Our intentions are known to Allah, and Allah alone is the source of our success.

INTRODUCTORY DATA

A. The Significance of Hedging:

Shari'a is well known for its assertion of evolution, development and production growth, it requires commitment and therefore calls for participation in all activities expected to yield profits. In fact, Islamic Shari'a provides a well-balanced and just financial system which, if well-followed and its lawful requirements are satisfactorily fulfilled, can form a mechanism for a natural reduction of risks whereby the risks are shared by all partners.

Hedging is a means to mitigate risks, which makes it necessary to first analyze the investment risks in an attempt to identify their types and evaluate their magnitude. Secondly, it is essential to employ the appropriate mechanism that would reduce risks to the minimum level possible. In fact, this is the process that financial experts call "risk management".

In general, hedging is permitted provided that the related risks are not necessitated by the nature of the transactions. Risk management shall be conducted in conformity with the Shari'a methods and contracts with the aim of mitigating risks that fall outside the nature of the transaction, whilst not to eliminate these risks or isolate them from their related assets in order to convert them eventually into financial products used for risk trading.

In fact, the presence of relative risks in some transactions is indispensable for the legitimacy of these transactions which is demonstrated in the evidence shown in two Fiqh maxims: "Profits and risk-taking are interdependent" (*al-kharaj bi-al-daman*), therefore one who bears the risk of loss of a transaction reaps its potential profits, and profit accompanies risk of loss" (*al-ghunm bi al-ghurm*). These two maxims, in fact, establish one of the fundamental principles of Shari'a in financial transactions, namely that one must accept the risk of loss to earn legitimate profits.

Although these risks are basically attached to all transactions, it is possible for these risks to be of varying degrees following the nature of the transaction or the contract in question. Of course, some risks shall in principle be entirely excluded; otherwise, the related transaction would be invalid, like the risks associated with excessive uncertainty (*gharar kabeer*), major ambiguity (*jahalah fahishah*) or usury (*riba*).

B. Hedging-Related Standards:

The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) issued two Shari'a standards related to hedging; No. (5) on "Guarantees" and No. (45) on "Capital and Investment Protection". Likewise, the Islamic Financial Services Board (IFSB) refers in its rules (especially par. 249 of the amended standard on "Capital Adequacy") to hedging through the Shari'a-compliant methods. In essence, the nature of investment in Islamic banks involves risk-taking since this comes as a standard implementation of the principles of *al-ghunm bi al-ghurm* and *al-kharaj bi-al-daman*; however, the profit normally earned by Islamic banks make up for these risks.

In fact, despite the firmly embedded relationship between the Shari'a-compliant investment and risk-taking (liability for the total/partial loss or the depreciation in the assets value), this kind of concomitance does not prohibit taking lawful measures and using permissible hedging instruments to mitigate risks.

C. The Need for Hedging Against Investment and Finance Risks:

It is known that the transactions of Islamic banks may include deferring some payable sums resulting from credit sales, deferred *Murabaha*, *Istisna'*, lease whose installments are deferred, Mudaraba or Musharaka.

Possibly, delinquency and default in debt repayment may hamper the creditor's investment plans, prevent him from meeting his financial needs or even cause him to lose some of his capital.

Accordingly, some collateral contracts exist to protect the rights of the creditors. These include contracts such as *Kafalah*, *Rahn*, *Hawalah* whereby the debtor transfers the creditor to the former's debtor or the creditor transfers his right to claim a debt to another person. This is because *Kafalah* secures debts as being owed by two persons instead of one, whereas mortgages provide the creditor with an asset as a security for his rights prior to all other ordinary creditors, when it is impossible for the debtor to make the necessary repayments.

Under *Hawalah* however, the right of the creditor is transferred from the insolvent debtor to another solvent one, and the referred creditor may charge to others his debts from the *muhal alayhi* (the one who replaces the debtor in the payment of debt).

D. The Difference Between Protecting Capital Through Hedging and Capital Guarantee:
The protection of the capital refers to taking the necessary measures to reduce the possibility of its loss, but such measures may eventually fail. For example, theft and damage cause losses to one's wealth despite all efforts to safeguard it.

Guarantee, on the other hand, refers to the bearing of losses instead of the guarantee seeker. It is associated with the effect of loss regardless of its causes and regardless of the effectiveness of the means and methods taken by the guarantor or the guarantee seeker to prevent it.

Within investments, although Islamic Shari'a requests the investment manager (the fund manager in *Mudaraba*, the managing partner in *Musharaka* or the investment agent in *Wakala bil Istithmar*) to use hedging and protect the invested funds, it relieves him from guaranteeing these funds except in cases of his misconduct, negligence or breach of the agreement.

Hence, Islamic financial institutions use the term "protection" and not "guarantee" in trust-based transactions; namely, *Musharaka*, *Mudaraba* and agency in fund management (*Wakala bil Istithmar*).

THE STANDARD

1. **Standard Scope:** The Standard addresses hedging from the risks involved in the operations of the Islamic banking and financial institutions, and also the permitted hedging instruments which do not lead or result in direct guarantee.

2. **Hedging: Rules, Mechanisms, Contracts and Requirements:**

2.1 Hedging: Rules of Lawful Instruments:

2.1.1 They shall involve risk distribution among partners pursuant to their shares in the capital.

2.1.2 The purpose shall not be to make the investment manager a guarantor in cases other than misconduct, negligence or breach of the agreement.

2.1.3 The instrument used shall neither be through an unlawful contract, nor a pretext to violate the Shari'a rulings.

2.1.4 If the hedging instrument involves Murabaha then it shall meet the following rules:

2.1.4.1 The purchase/sale of commodities must be genuine involving actual or constructive possession of the commodity. This is to avoid fictitious sale of commodities.

2.1.4.2 The seller must have processed the asset either actually or constructively, so the ability to deliver the asset, as a condition, is fulfilled, and the transaction does not involve the sale of what one has not owned or possessed.

2.1.4.3 The bank (the buyer of the asset of Murabaha who is seeking to sell) must be the party handling the sale itself or by delegating others, excluding the supplier, to sell on its behalf.

2.1.4.4 It must be ascertained that the buyer of the asset is neither its original supplier nor a party owning more than half of the asset. This is to avoid eina sale.

2.1.4.5 The bank is advised to follow the policy of not entering into transactions that would incur future liabilities in a currency other than the currency of the investment. This is in order to mitigate the risk of currency exchange-rate fluctuations.

2.1.5 If the transaction comprises several contracts they must be neither associated with one another in the same contract, nor interdependent or contingent on one another. This is in order to avoid the revocation of them all as a result of the revocation of one as forbidden by the Shari'a.

2.1.6 If the purchase undertaker (the promisor) defaults on his promise after the other party (the promised) has made some contractual arrangements, the former party shall be liable for all actual costs and losses the latter has suffered. He shall also be liable to compensate him for the actual loss resulting from selling the asset to others for lesser than the cost, together with any actual fees incurred as a result of the promise.

2.1.7 Taking into consideration the contents of the DFM Standard No. 1 for Issuing, Acquiring and Trading Shares (sub-paragraph 2.2.17) which prohibits the investment in companies which include activities that harm the environment, and therefore, any investment funds which finance such projects that cause harm to the environment become prohibited accordingly.

2.2 Hedging: Lawful Instruments and Mechanisms:

2.2.1 Personal guarantees: These may either be through combining liabilities like in the case of *kafalah*, letter of credit and documentary credit; or through the transfer of debt from one party to another (*Hawalat al-Dayn*) and the transfer of the right of demanding the debt so that one creditor replaces another, according to the rules of Shari'a (*Hawalat al-Haq*).

2.2.2 In-kind guarantees, such as collaterals (*Rahn*) and holding the asset sold in cash sales until payment is effective.

2.2.3 Guarantees as in pledges of debt securities and rights, such as debt bonds, checks, promissory notes, assets freezing and merchandise documents.

2.2.4 Independent guarantees, such as a security provided by a third party, Islamic Takaful insurance against nonpayment of debt and the creation of an investment-risk reserve.

2.2.5 Contractual guarantees, such as stipulating early settlement of future debts and the revocation of the contract in case of default/delay in the installments payment.

2.2.6 Compound mechanisms of hedging (alternatives to conventional derivatives), such as the use of long-term *Murabaha* with multiple *Murabaha* and the use of bilateral promises with different suppliers.

2.3 Risk-Hedging: Special Contracts and Procedures:

2.3.1 **Mortgage:** Keeping a property owned by the debtor or others as a security for the creditor's right, whereby the creditor can take his right entirely or partly thereof. It includes the mortgage of physical assets, such as real estates and cash assets (various types of accounts) as well as the mortgage of debts, benefits and financial assets. The right of the one who possesses the mortgage comes prior to the rights of other ordinary creditors, and he shall be given the right to pursue the debtor's mortgaged assets in possession of others.
Cases of this mortgage include:

2.3.1.1 Mortgage of durable physical assets, such as real estates, cars, aircrafts, steamers and durable equipment.

2.3.1.2 Mortgage of the assets and goods represented by the financial instruments and the supporting merchandise documents.

2.3.1.3 Mortgage of securities, promissory notes and other debt instruments.

2.3.1.4 Mortgage of cash balances by freezing accounts without denying the debtor his right to profits (profits can be agreed to be added as mortgage to the original amounts).

2.3.2 The preference rights, admitted by the Shari'a or the Shari'a-compliant laws, for some permitted benefits, such as the entitlements of the public treasury and the right to restore one's sold object when found in the property of the bankrupt, as well as the rights of the liquidator and the official receiver.

2.3.3 **Holding the Sold Object:** Refraining from delivering it when the cash payment of the price is immediately required but not yet paid to the seller, until it is actually paid.

2.3.4 **Kafalah:** refers to adding the liability of the guarantor(s) to the original liability of the debtor so that all liabilities become the same. It includes the right to recourse upon the request of the debtor, with or without his knowledge. It may also be unrestricted, but yet limited to the same debt amount originally secured by the mortgage, or restricted to a certain debt owed by the debtor to a third party. It may be hierarchal or non-hierarchal; if hierarchal, the creditor shall demand his debt from the debtor first and then from the guarantor, but if non-hierarchal, the creditor can demand his debt from both, the principal and the guarantor, or either of them.

2.3.5 **Huwalat Alhaq:** The transfer of the right to demand a debt from one creditor to another, so it involves the replacement of one creditor by another. It also enables the creditor to obtain the payable entitlements due to the debtor on others, such as salaries and compensations, e.g. the Takaful compensations.

2.3.6 **Huwalat Aldain, Debt Transfer[1]:** The transfer of a debt from one liability to another, mostly to a more solvent one so that the creditor may be able to collect his debt.

2.3.7 Entering into contracts after stipulating some of the hedging contractual options, such as:

2.3.7.1 **Khiyar al-Shart:** An option conditioned in the contract giving one party or both parties the right to terminate the contract within a certain period of time determined in the option.

2.3.7.2 **Khiyar al-Naqd:** An option given to the seller, upon his stipulation, to terminate the contract if the buyer fails to pay the price during a fixed period determined in the option.

2.3.7.3 **Khiyar of Sale with Urbun:** The option given to the buyer, upon his stipulation, to reserve the right to cancel the contract within a certain period of time in return for making a down payment of the price. This down payment shall belong to the seller in case of termination and shall be deemed as part of the price if the contract is implemented.

[1] Unlike laws that allow the sale of one's right to another (the sale of debt) unconditionally, Shari'a permits the sale of debt only if for equal value and with immediate payment of the two counter values.

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2.4 Risk-Hedging: Conditions and Undertakings:

2.4.1 **Stipulating that the total remaining debt installments shall become due:** following the failure to pay one or more due installments. This must be implemented with full consideration of the number of installments set by the condition, and the debtor shall be notified of the procedure within an appropriate period of time. If no payment is made during this period, the installments shall become due. However, the creditor shall not receive more than the due debt amount. For example, it the debt has resulted from Ijarah financing and the failure to pay the due installments occurs before the completion of the Ijarah period, the creditor shall be entitled only to the amount of debt corresponding to the period of Ijarah actually utilized by the debtor, and the rest, if any, shall be returned to the debtor.

2.4.2 **Stipulating the revocation of the agreement should the price or the rent not be paid within the scheduled time:** In this regard, it makes no difference whether the price is immediate or deferred so long as it is unpaid within its due time. This kind of stipulation is called "*Khiyar alNaqd*" (cash option), and pursuant to the dominant custom or the prevailing law, the seller may still cancel the contract even if such a condition is not stipulated in the agreement.

2.4.3 **Penalty Clause:** It is basically valid to stipulate a penalty clause in all financial contracts save debt-based contracts. A penalty clause refers to an agreed-upon sum of money payable in recompense for the postponement of delivery beyond the scheduled time. It is permitted in "*Istisna*" supply contracts and labor-lease contracts. The sum must be fair and the postponement should not have resulted from any compelling or uncontrollable factors.

2.4.4 **The letter of guarantee:** A commitment issued by a bank upon the request of the client (the instructor) to pay a specific or a specifiable sum in cash upon the request of the beneficiary within a specific duration of time. Despite the time limitation of this commitment, it may be extended before the expiry of the original period upon the consent of the client. If, however, the beneficiary's request to renew (extend) the letter of guarantee was declined (due to the refusal of the issuing bank or the client) the beneficiary shall have the right over the issuing bank to pay the guarantee amount or the due amount thereof (to execute the letter of guarantee).

2.4.5 **Documentary credit:** A written commitment issued by a bank (issuer) to the seller's bank (beneficiary's bank) upon the request of the buyer (instructor) pursuant to his instructions. It may also be issued by the bank in its own capacity with the aim of securing the payment of money up to a certain limit and within a certain period of time provided the documents representing the merchandise are delivered as per instructions. In brief, it is a banking commitment to a payment of money conditioned with the conformity of documents with instructions.

2.5 Direct Forms of Hedging:

2.5.1 **Establishing an investment-risk reserve:** This is possible through a partial deduction from the investors' profits only after allocating and deducting the amount due to the fund manager (whether it is a share in the profit or a fixed agency commission), so that the fund manager does not partake in any form of capital or profit guarantee. It is through this reserve that the loss of the invested capital may be reimbursed. If this reserve builds up significantly, it may cover any possible overall loss. The Accounting Standard no. (11) on "Provisions and Reserves", issued by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), regulates this type of reserve.

2.5.2 **Third-Party Guarantee (a voluntary commitment to bear a loss through donation):**
A third-party may commit to bear the loss in partnerships, *Mudaraba* and agency in investment. The third-party guarantee is the guarantee provided by a party who is not the fund manager in either of the above-mentioned contracts to compensate the loss suffered by a partner or a fund provider. This guarantor, however, shall have no right of recourse to the fund manager for repayment.
A resolution affirming this guarantee was issued by the International Fiqh Academy adding a further condition that there shall be no linkage between this guarantee and the contract of partnership or *Mudaraba*. In other words, the beneficiary, based on this guarantee, has no right to raise any claims of guarantee against the fund manager in case the third-party guarantee turned ineffective. In fact, this sort of so-called guarantee is not a real guarantee per se; rather, it is a commitment to donate money whose sum would cover the loss if any. This analysis is actually necessitated by the fact that any invested money is not a debt and as such, it cannot be "guaranteed" under Shari'a rules.

2.5.3 **Transferring the burden of evidence to the trusted fund manager:** (i.e. the *Mudareb*, the managing partner or the investment agent). This may take place if the fund manager makes a claim to the occurrence of damage or loss of the invested assets for reasons beyond his control while the fund provider rejects such a claim. Actually, the fund manager is merely entrusted with the management of the fund, but here he claims something that is abnormal and against the prevailing commercial custom and as such, he may bear the burden of evidence.

2.5.4 **The promise to purchase the assets of *Mudaraba*, partnership or agency in investment at fair value:** It is the promise to purchase the above assets at fair value, the net value or the market value so long as the assets remain unchanged from their initial state at the time of the promise.

2.5.5 **Guarantee in case of misconduct or negligence:** It refers to hedging through stipulating in the agreement that the fund manager shall be liable for any loss in the capital or the actual undistributed profits in cases of proven misconduct, negligence or breach of the agreement. This type of hedging provides that the trusted fund manager shall be the guarantor of the assets in his trust if they are destroyed, damaged or lost following the change of his possession of the assets from a trust-based possession to a liability-based possession. In this case the fund manager becomes an usurper for not returning the assets of *Mudaraba*, partnership or agency in investment on the time agreed-upon in the contract. In this case, he becomes liable for the price or the value of these assets on the very day when his possession has changed from trust to usurpation.

Such provision in the contract of *Mudaraba*, partnership or agency in investment triggers the fund manager's liability for the capital invested.

However, if the capital is not exposed to losses resulting from the fund manager's misconduct, then the fund manager will be liable for returning the investment assets equivalent or their value, even if considerably higher, as long as the damage of the assets is attributable to the manager's misconduct, negligence or violation of the contract's conditions. The value of the assets, in this regard, shall include any capital growth resulting from an increase to the capital, be it attached to the original assets or detached, or from an appreciation in the market value of assets. This rule remains applicable regardless of whether the increase to the capital is considered as belonging to the *Mudaraba* business as a whole or specifically to the fund provider.

2.6 Takaful Insurance:

It is the agreement of a group of people, who may face certain risks, to avert any harm resulting from these risks by payment of donation-based contributions. The Takaful fund is established from the collection of these contributions, and it shall enjoy a legal personality and an independent financial entity. The Takaful fund assets are invested in Shari'a-compliant modes of investment, and the fund along with its proceeds will be utilized to cover the financial losses befalling the Takaful participants.

2.7 Conventional Hedging and Related Shari'a-Compliant Alternatives:

2.7.1 Derivatives and related Shari'a-compliant alternatives:

Conventional banks and Shari'a-incompliant businesses mostly use derivatives for their hedging. AAOIFI has issued a Shari'a Standard No. (20) pertinent to derivatives under the title "The Sale of Commodities in Organized Markets", and Article No. (5) of this standard refers particularly to this issue. In fact, there are several conventional derivatives, the most important of which are futures, options and swaps.

2.7.1.1 Futures and related Shari'a-compliant alternatives:

Futures refers to the contracts in which the effect takes place on a specific future date, and they often end with clearance of credit and debit balances among the parties involved, cash payments or inverse contracts but rarely do they end with actual delivery of assets. According to Shari'a, conventional futures are unlawful contracts to initiate or trade.

Shari'a alternatives to futures include the credit sale in which the sold object is delivered in advance while the price is postponed to a future date. Herein, the seller may increase the deferred price above the spot price provided that the increase is not made after concluding the contract. Salam sale may function as another alternative to futures where the price is paid in advance and the delivery of the well-described merchandise is postponed to an exact future date.

2.7.1.2 Options and related Shari'a-compliant alternatives:

These are contracts that give a contracting party in exchange of it paying a certain sum of money, which is not part of the price, the right and not the obligation to buy or sell a certain object, such as shares, goods, currencies, indexes and debts for a certain price within a specific timeframe. This right is sold by one contracting party to another so that the seller of the right becomes bound by the choice of the buyer. According to Shari'a, these options are impermissible to initiate or to trade.

Shari'a alternatives to conventional options include *Urbun* sale, which refers to the sale of some lawful items whereby the buyer makes a down payment of the price

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to reserve the right to cancel the sale within a certain period of time. If, however, he chooses to cancel the sale, the down payment will belong to the seller. This right of the buyer can be transferred to others only once. They also include the sale contract with the option of stipulation (*Khiyar al-Shart*), which refers to a sale contract of some lawful items with the buyer or the seller or both contractors stipulating for themselves the right to cancel the sale during a specified period of time. This option is non-negotiable. Additionally, they include the binding promise to sale by the owner of some asset, and the binding promise to purchase by some potential buyer. This promise, however, has to be free of charge and non-negotiable.

2.7.1.3 **Swaps and related Shari'a-compliant alternatives:**

Conventional swaps refer to the agreements made between two parties on the temporary exchange of a certain amount of some financial or in-kind assets or interest rates. Swaps may involve a credit resale of the same asset back to the original seller (*eina*) or to a third-party but with no actual exchange of the asset. They may also involve giving against some value a contractor the right to conclude or cancel a contract. Swaps transactions as conducted in commodity markets are impermissible.

Shari'a alternatives to swaps transactions include the issuance of bilateral promises by the two parties to a transaction; one promise to purchase some goods on a *Murabaha* basis and in a certain currency, and the other promise to buy goods in a different currency. Also, one may promise to buy some goods at cost plus a fixed profit margin and the other promises to buy goods at cost plus a variable profit.

2.7.2 **Indices and related Shari'a-compliant alternatives:**

Indices refer to indicators calculated in a statistical manner using data on the prices of a selected group of stocks and goods traded in some organized, non-organized or mixed markets. The said prices are given weights based on the values of their trading volumes, and then their aggregate weighted value is divided by the total weights used. However, various types of indices are derived using different statistical and calculation methods.

2.7.2.1 **Unlawful uses of indices for hedging:**

A. It is not permitted to use indices in trading through sales and purchases based on the change in their figures in the stock markets, even if such trading is for the sake of hedging against some risks. In other words, it is not permitted to pay or receive money for the mere change in some index figure in the market, without any actual exchange of any commodities or of the commodities represented by the index.
B. It is not permitted to conclude options contracts on indices or on the multiplier of indices' contracts.
C. It is not permitted to suspend the contracts which do not admit suspension, such as the contract of sale, conditional to the value of a certain index.
D. It is not permitted to link the value of monetary debts, at the time of the debt initiation, to some price index so as to hedge against a possible change in the value of the debt currency.

2.7.2.2 **Lawful uses of indices for hedging:**

A. It is permitted to use indices to measure the change of some values in a certain market. It is also permitted to use these indices, being valid measuring tools, to measure and evaluate the performance of professional managers by matching the profits they manage to achieve on some indices. Indices may also be used to envisage the performance of a portfolio and evaluate its regular risks instead of observing the performance and risks of each stock independently. Furthermore, they can also be used to predict the market future and explore its probable changes. These kinds of uses of indices as future indicators in real transactions are permitted under the Shari'a.
B. It is permitted to use the indices as a basis for comparison (a benchmark) in investment funds and Sukuk, and to accordingly determine the fund managers' incentive in a contract like an investment agency or *Mudaraba*.
C. It is permitted to use financial indices, such as LIBOR, or a prices index of stocks or commodities, as a basis for determining the profit in the *Murabaha*-based promise provided that the profit ultimately stated in the contract of *Murabaha* is determined and never affected by changes on these indices. It is unpermitted, however, to rely on indices used in non-finance related and gambling-like businesses or activities.
D. It is permitted to use the index as a basis for determining the variable rent component representing the profit in lease contracts. (Applicable to this are the

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rules outlined in the Shari'a Standard No. (9) on *Ijarah* and *Ijarah Muntahia Bittamlik*, Article 5/2/3).

E. It is permitted to restrict the actions of the managing partner, the *Mudareb* or the investment agent by a certain index so that if the index reaches a certain rate, he will have to sell the investment assets at the market rate price or buy a certain amount of goods at the market rate price.

F. It is permissible to relate the execution of the binding promise to sell or buy an asset at a certain financial index rate of increase/decrease, over or below the price of the asset at a given time, so that any increase in the index rate will be reflected in the price of the asset.

G. It is permitted to relate to some financial index the amount of charity payable to a charitable fund, on a self-commitment basis, in case of default in meeting any financial obligation by the self-committed donator.

2.7.2.3 **The Shari'a parameters for an Islamic Index:**

A. The index should reflect the projected results of the Islamic investments at different maturities.

B. Fulfillment of all Shari'a requirements in addition to the technical requirements in terms of the index components and usages.

C. The existence of a Shari'a Supervisory Board to ensure compliance of the index components and usages with the Shari'a rules.

D. The index has to be annually reviewed and a Shari'a-compliance report issued.

2.8 Hedging in Extant Assets and its Applications:

2.8.1 Hedging in currencies:

2.8.1.1 Conventional hedging in currencies and the Shari'a alternatives:

A. It is unlawful according to Shari'a rules on money exchange to sell or purchase a currency without immediate delivery of both counter values[2].
Therefore, the only possible way to execute foreign exchange transactions under Shari'a rules is through spot payment of both counter values[3].

B. Converting the debt currency into another currency before the debt maturity is unlawful for this involves money exchanged without spot payment of both values, since the debt is still an unsettled liability.
The Shari'a alternative is to extinguish the debts by actual repayment or set-off. In case of partial discharge of a debt, the transaction is only permissible on this part and impermissible on the remaining unpaid or unset-of part.

C. It is not permitted for a bank to take interest-based loans in a certain currency, for example, Euros converted into US dollars, if it requires dollars to invest the dollars. In such a case, the bank shall repay the loan in Euros and such interest-based loan is impermissible.
The Shari'a alternative is that the bank purchases merchandise on credit (deferred payment) with Euros from A and then sells them for US dollars to B on the same maturity date of the first transaction, as detailed earlier.

D. If they have a future commitment to make payments in a specific currency (for example, in Euros), or if they receive future payments in a foreign currency (for example, in US dollars), conventional banks tend to hedge their position through executing future money exchange, which is impermissible.
The Shari'a alternative is that the bank, after purchasing a commodity for a deferred price from a supplier in US dollars, can seek a promise from a *Murabaha* customer to buy it in Euros at an exchange rate agreed as promised. As such, the bank may receive Euros, and not US dollars, on the payment due date, hedging thus from any increase in the Euro price from the date of export to the date of price payment.

2.8.1. Other forms of lawful hedging in currencies:

A. In the case of having a grace period (probably up to six-months) for the repayment of a debt (a deferred price) in a currency that is different from the currency of the importer (the bank's client), there appears the need to avoid the risk of currency exchange rate fluctuations. As an alternative, the bank after purchasing a commodity from a supplier for a deferred price in Euros, payable after six months

[2] When the two counter values are not delivered spot, the contract is called "Forward".

[3] This means that currency exchange has to be through the exchange of offer and acceptance and delivery of both counter values in the contracting session (spot) so long as both contracting parties are physically present in one place. If, however, they were in different places like one being in Dubai and the other in Japan, then exchange of the currencies must be reflected in the accounts within two working days, otherwise the contract is invalid since it breaches a Sunna report (hand to hand), while tolerating the delay of two days is a matter of necessity.

for instance, can proceed in selling the same in the local currency, UAE dirhams for instance, to its *Murabaha* customer, and here the bank has to refer to the exchange rate quoted on the day of the Murabaha sale. However, the bank may afterwards use the *Murabaha* sale proceeds (UAE dirhams) to buy a commodity for the purpose of selling it through a different *Murabaha* to possibly a different client in Euros, but payable on the date matching the date of paying the Euros to the supplier in the first transaction. Doing so, the bank will have hedged its position against an unfavorable change in the Euro-Dirham exchange rate during the first transaction.

B. Another form of a lawful hedging is to seek to obtain a unilateral binding promise to exchange two currencies, US dollars for Euros for example as per the bank's need, at a certain exchange rate determined in the promise or within a certain period. Then, at the request of the beneficiary, the bank concludes the contract of exchange with the one who made the promise through the exchange of offer and acceptance and effecting the exchange in the two currencies on the spot in the same contracting session. If they were not in the same location, then the actual exchange of currency shall take place as soon as possible, but not exceeding three days from the date of contracting.

C. The bank may buy a certain commodity in US dollars from a certain party, possess the commodity physically or constructively, then sell it at a deferred price (for example, in Euros) for the same term of the first sale and deliver it to its buyer, so that the latter can possess it physically or constructively. The bank may repeat this transaction whenever it has sums of certain currencies and needs another currency, so long as buying this currency at its payment due date exposes the bank to the risk of exchange rate appreciation.

D. Hedging by (exchange of deposits and loans): A bank may deposit the currency for which it has no investment opportunity, for example, in Yen, in a bank that desires to obtain this currency and has plans for some good investment opportunity. The latter bank, in return, may have the same problem with some currency and so agrees with the former bank to do the same. Each of the two banks can invest the currency deposited by the other bank and consequently achieve some investment returns. When the deposit reaches its maturity date, each bank shall return the principal deposit to the other bank.

E. The bank may ask the client to conclude a *Murabaha* deal in the same currency used by the bank to purchase the commodity on credit from its supplier. Alternatively, if the currencies are different then the bank may increase the profit margin to cater for the possible appreciation in the currency payable by the bank to the supplier. As such, it is the client that actually bears the risk of exchange rate fluctuations, and the bank will not have to engage in any future currency exchange. Should the client refuse to conclude the *Murabaha* deal in the same currency or accept a higher profit margin, the bank in this case may now buy the currency payable later to the supplier and invest it until its payment due date.

F. The bank that has purchased a commodity on credit in a foreign currency to sell to its *Murabaha* client in a local currency may agree with the client to take into account, while determining the *Murabaha* profit, the possible change in the foreign currency rate and determine the profit margin in view of the two currencies overall exchange rate average. In this case, the bank will not have to engage in any future currency exchange to protect its position.

2.8.1.3 **Liquidity hedging instruments:**

A. Using *Salam* sale to obtain the price in advance and deliver the goods in the future.

B. The sale of assets for an immediate price and then renting them against future rentals through Ijarah Muntahia Bittamlik (lease ending with transfer of ownership) spanning a minimum of one year since its start.

C. Leasing assets on a forward-lease basis and claiming the rentals upfront.

D. Forming a portfolio whose tangible assets correspond to no less than 10% of the total assets, the rest being *Istisna'* and *Murabaha* debts, so that its units can be sold to obtain liquidity.

2.8.1.4 **Hedging mechanisms against fluctuations of an index-based interest rate:**
Hedging against interest rate fluctuations shall be in conformity with the Shari'a rulings; an agreement of profit exchange[4] is held with two promises, one from the bank to its client and the other from the client to the bank as follows:

4 Profit Rate Swap

A. The bank issues a unilateral binding promise to enter into a Murabaha transaction/ transactions with the client. In return, the client gives a promise to the bank to conclude the *Murabaha* transaction / transactions with the bank. Here, the promised party shall have the option to enter into *Murabaha* in the future and shall not be bound to do so lest the transaction involves binding bilateral promises. However, since only one promise is executable during this transaction, it cannot be said that the promises are bilateral.
B. The profit margin in *Murabaha* can be fixed, variable or linked to a certain index depending on the *Murabaha* sum or the profit agreed to be paid on a certain future date. The targeted revenue shall be determined, be it invariable or variable.
C. The implementation of the promise can be made contingent upon a certain condition, so that if the condition is fulfilled the promise becomes executable.
D. The two parties must exchange an offer and acceptance when executing the *Murabaha*, in which the contract shall state the price payable by the buyer.
E. The two parties shall agree that the debtor is free from having to fulfill his promise, pursuant to the terms of each transaction, and terminate the agreement unilaterally after the lapse of a certain period. Consequently, the two parties become free from any liabilities related to the agreement.
F. The party reneging on his promise shall compensate the promised party for any actual loss incurred.
G. If the fixed-rate of return tends to soar, the bank may make use of that by investing its assets for a short period at a variable-rate return that is agreed upon in the contract.

APPENDICES

3. Definitions

3.1. **Risks:**

3.1.1 **Risk / exposure:**

3.1.1.1 **Risk:** probable exposure to losses due to the occurrence of unexpected and unplanned incidents.

3.1.1.2 **Exposure:** The exposure to probable incidents, which may incur pre-measurable or immeasurable losses.

3.1.1.3 **Calculated risks:** The exposure to probable incidents that would result in losses which are normally pre-measurable and prepared for.

3.1.1.4 **Uncalculated risks:** The exposure to probable incidents without the ability to calculate their losses, or the failure to assess their losses, so that no measure can be taken to confront them.

3.2 **Risk Management:**

A process aimed to confront the negative effects of the incidents that would normally lead to losses by taking the necessary measures to avoid or mitigate these effects. This process involves the following:

3.2.1 **Risk analysis,** which includes the following:

3.2.1.1 Risk measurement.

3.2.1.2 Risks assessment to identify their nature and the way to mitigate or reduce their effects.

3.2.1.3 Developing risk management strategies with the aim of avoiding or mitigating the risk effects.

3.3 **Hedging:**

Literally, it denotes preservation, maintenance and commitment.

Technically, it refers to the prevention or protection from risks.

It is also a synonym of the term "capital and funding protection"; in other words, it means the protection of capital and funding by using the available means for protection from loss, deficiency and damage in order to eliminate these risks, mitigate or transfer them.

3.4 **Hedge fund:**

A fund raised through contributions to make profit via speculation on shares, bonds and derivatives. The raised fund shall be used to facilitate speculation on different financial instruments in order to achieve higher rates of profits, which normally involve high risk profiles.

3.5 **Currency risks or exchange rate risks:**

3.5.1 These risks materialize when the currency of the investment in assets differs from the currency of the funds originally raised by the bank or the financial institution for investment.

3.5.2 When uncertainty exists as to the value of revenues, costs and receivables due on others or for others, upon their reception or delivery in foreign currencies during the repayment period.

3.5.3 As a result of the risks accompanying the transfer of fixed income into a variable income or vice versa.

3.5.4 Return risks refer to the inability of the bank or the Islamic financial institution to distribute a competitive return to their depositors as a result of its failure to achieve the expected returns from the investment or its failure to achieve profits in partnerships and *Mudaraba*.

3.6 **Risk types as to their source:**

The risks of extant objects (the assets, including debts, to which the capital is converted) are also called "investment risks" and they include the following:

3.6.1 Non or low-performing assets.

3.6.2 Difficult liquidation of assets when necessary.

3.6.3 Fluctuations in the assets prices to the degree of uncertainty as to the possibility of liquidating them at a specific value.

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4. **Risk Types According to their Nature:**

4.1 **Credit risks**, which refer to:

4.1.1 The probability of failure to repay the debt or to fulfill any financial commitment on time, including the delay in debt repayment in case of (temporary) insolvency and the willful abstention from repayment in case of procrastination.

4.2 **Market risks** including the following risks:
Dubai Financial Market Standards on Shari'a-Compliance | Standard No. 3 | Hedging Against Investment and Finance Risks

4.2.1 Price fluctuations (downward in case of assets price decline and upward in case of inflation).

4.2.2 Exchange rate fluctuations affecting the instruments and the assets traded in the market (assets and currencies).

4.3 **Contract drafting risks:**

4.3.1 Arising from the possible loopholes in contract drafting, which may lead to a partial loss of some rights of the Islamic bank or financial institution. Sometimes, they are associated with the characteristics of the contract as follows:

4.3.1.1 Information asymmetry between the bank and the client, as in the case of *Mudaraba* or investment agency.

4.3.1.2 The validity of the assets as securities to guarantee the repayment, as in the case of sales or lease contracts.

4.4 **Inflation risks:**

4.4.1 Resulting from the decline in the purchasing power of the cash holdings.

4.4.2 Inflation risks appear upon the recovery of the invested capitals in the long-term or mid-term types of investment.

4.5 **The risks of moral hazards:**

These risks materialize when assets are invested on behalf of others in contracts involving information asymmetry between the bank and the client.
For example:

4.5.1 When the *Mudareb* or the investment agent risks the assets of the fund providers contrary to their expectations.

4.5.2 When those necessary to be trusted turn out to be untrustworthy. These risks become more probable in the contracts of *Mudaraba* and investment agency.

4.5.3 Ownership risks are legitimate and have to be borne, for Shari'a rules dictate that only owners have to bear the risks of their own properties. However, Shari'a validates using hedging instruments like Takaful, diversification of investments and all other valid means.

4.6 **Operational risks, which come as a result of:**

4.6.1 Bad or weak management.

4.6.2 Failure to realize profits.

4.6.3 The risk of non-abidance by the Shari'a requirements, which is the most serious risk of all, for it discourages clients from active participation and damages the institution's reputation.

4.6.4 Shari'a incompliance risk. This refers to the risk resulting from disregarding the Shari'a rules or resolutions of the Shari'a committee, which may in turn lead to the invalidation of contracts and the disposal of the profit earned by channeling it to charity.

4.7 **Finance risks:**

They refer to the risks resulting from failure to adopt the appropriate methods to measure the risk involved in each financing instrument.

4.8 **Capital investment risks:**

They refer to the risks resulting from failure to follow proper strategies and applying the right measures for risk management, appropriate assessment and exiting from the investment when necessary.

4.9 **Credit-receiving risks:**
Refers to the risks of not laying down the proper foundations to identify the invested funds, their revenues, costs and profits in a manner commensurate with the responsibility of the institution's shareholders towards the investment account holders. This risk is also called "movable risks" due to the need to support the profits of investment accounts.

4.10 **Economic risks:**
Refers to the risks rising from the change in the overall economic conditions, which usually affect the foreign investment in any country, such as:
4.10.1 Exchange rate changes
4.10.2 Changes in State control rules.
4.10.3 Political instability.
Since these changes do not respond easily to the activities of investment managers, the mitigation of the economic risks necessitates adoption of investment diversifying policies in terms of geography, sectors, maturities, assets types and so forth.

4.11 **Legal risks:**
Refers to the risks resulting from the change of laws, such as banning what used to be lawful or imposing higher taxes on economic activities related to the investment.

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