



SHARIYAH
REVIEW BUREAU



HEDGING CURRENCY RISK:
RESTORING BALANCE
WITH SHARIA VALUES

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The Two Types of Exchange Rates

There are two types of exchange rates: flexible and fixed. Flexible exchange rates change constantly, while fixed exchange rates rarely change.

Flexible

Most currency exchange rates are determined by the foreign exchange market, or forex. Such rates are called flexible exchange rates. For this reason, exchange rates fluctuate continuously. American dollars, Mexican pesos, Canadian dollars, European euros, British pounds, and Japanese yen are all examples of flexible exchange rates.

Fixed

Other currencies, like the Saudi Arabian riyal, rarely changes its rate. This is because its rates is pegged to the U.S. Dollar. Their central bank has enough U.S. Dollar and other foreign currency reserves to control the value of their currency. If the value of the local currency falls, the bank sells its dollars for local currency. That reduces the supply in the marketplace, boosting its currency's value. It also increases the supply of dollars, sending its value down. If demand for its currency rises, it does the opposite.

The Causes of Fluctuation in Currencies

The majority of the world's currencies are bought and sold based on flexible exchange rates, meaning their prices fluctuate based on the supply and demand in the foreign exchange market. Increased demand for a particular currency or a shortage in its availability will result in a price increase. A decreased demand or an influx in supply will lower its price. The supply and demand of currency are connected to several interrelated factors, including, but not limited to monetary policy, inflation rates and the conditions of the political and economic environment¹.

1. Monetary Policy

Central banks attempt to control the demand for currencies by increasing or decreasing the money supply and/or benchmark interest rates. The money supply refers to the amount of money in circulation within a country. As money supply increases and accessibility to a currency rises, the cost of borrowing money decreases. If there's a higher amount of a currency floating around, the value of that currency will decrease against foreign currencies and the exchange rate will dip. High money supply is also linked to low interest rates (because a larger supply means lower demand). The interest rate is the price at which money can be borrowed. With low-interest rates, people and businesses are more willing and able to borrow money. With more money being borrowed and ultimately spent, the economy begins to grow. However, if the amount of money in the economy is too high and the supply of goods and services do not match, prices of these goods and services may begin to inflate.

2. Inflation Rates

Another factor which has a huge bearing on the fluctuations of currencies is the rate of inflation. The inflation rate is defined as 'the rate at which the general price of goods and services is increasing.' Too much of an increase in the inflation rate can cause the economy to become unstable, leading to depreciation and decline in the value of a currency.

The interest and inflation rates of a country have a huge influence on a country's economy. If the inflation rate gets too high, the central bank may counteract the issue by increasing interest rates. This is expected

to encourage people to spend less and save more. This is also said to attract foreign investment and increase the amount of capital entering the marketplace, which results in an increased demand for the currency. Therefore, an increase in interest rates can lead to an increase in the value of a currency. Similarly, a decrease in interest rates can result in a reduction in the value of a currency.

Lower interest rates, in turn, also tend to make a currency drop in value – because people are expected to borrow more and spend more, which in theory should make the economy grow².

3. The Political & Economic Environment

The political and economic environment of a country is another factor that can impact fluctuations of currency. This is why currencies from countries that are politically stable and have a solid economy tend to have a higher demand, which results in higher exchange rates.

Markets are constantly monitoring the current and predicted economic conditions of a country. Political conditions also have a resounding impact on the value of a currency. If a country is in the middle of political unrest or global tensions, the currencies of that country become less attractive and demand falls.

1 Universal Partners FX, Why do Currencies Fluctuate.

2 Azimo (2020). What Causes Currency Fluctuations?

4. Government Debt

Countries will engage in large-scale deficit financing to pay for public sector projects and governmental funding. While such activity stimulates the domestic economy, nations with large public deficits and debts are less attractive to foreign investors. This is because a large debt encourages inflation, and if inflation is high, the debt will be serviced with cheaper dollars in the future. In the worst-case scenario, a government may print money to pay part of a large debt, but increasing the money supply is said to inevitably cause inflation. Moreover, if a government is not able to service its deficit through domestic means (selling domestic bonds, increasing the money supply), then it must increase the supply of securities for sale to foreigners, thereby lowering their prices. Finally, a large debt may prove worrisome to foreigners if they believe the country risks defaulting on its obligations. Foreigners will be less willing to own securities denominated in that currency if the risk of default is great. For this reason, the country's debt rating is a crucial determinant of its exchange rate.

5. Country's Current Account / Balance of Payments

The current account is the balance of trade between a country and its trading partners, reflecting all payments between countries for goods, services, interest, and dividends. A deficit in the current account shows the country is spending more on foreign trade than it is earning, and that it is borrowing capital from foreign sources to make up the deficit. In other words, the country requires more foreign currency than it receives through sales of exports, and it supplies more of its own currency than foreigners demand for its products.

6. Terms of Trade

A ratio comparing export prices to import prices, the terms of trade is related to current accounts and the balance of payments. If a country's exports rise compared to its imports, its terms of trade have favourably improved. Increasing terms of trade shows greater demand for the country's exports. This, in turn, results in rising revenues from exports, which provides increased demand for the country's currency (and an increase in the currency's value). If the price of exports rises by a smaller rate than that of its imports, the currency's value will decrease in relation to its trading partners³.

7. Recession

When a country experiences a recession, its interest rates are likely to fall, decreasing its chances to acquire foreign capital. As a result, its currency weakens in comparison to that of other countries, therefore lowering the exchange rate.

8. Speculation

If a country's currency value is expected to rise, investors will demand more of that currency in order to make a profit in the near future. As a result, the value of the currency will rise due to the increase in demand. With this increase in currency value comes a rise in the exchange rate as well.



³ <https://www.investopedia.com/trading/factors-influence-exchange-rates/>

What is FX risk?

Foreign exchange risk, also known as exchange rate risk, is the risk of financial impact due to exchange rate fluctuations. In simpler terms, foreign exchange risk is a risk that the financial performance or financial position of a company may be impacted by changes and fluctuations in the exchange rates between currencies.

Foreign exchange risk for a business can arise from a number of sources, including:

- Where the business imports or exports.
- Where other costs, such as capital expenditure, are denominated in foreign currency.
- Where revenue from exports is received in foreign currency.
- Where other income, such as royalties, interest, dividends etc, is received in foreign currency where the business's loans are denominated (and therefore payable) in foreign currency.
- Where the business has offshore assets such as operations or subsidiaries that are valued in a foreign currency, or foreign currency deposits.

A falling domestic exchange rate can have the following effects:

- It can increase costs for importers, thus potentially reducing their profitability. This can lead to decreased dividends, which in turn can lead to a fall in the market value of the business.
- Domestically produced products can become more competitive against imported products.
- It can increase the cost of capital expenditure where such expenditure requires, for example, importation of capital equipment.
- The cost of servicing foreign currency debt increases.
- The cost of investing overseas could increase.

A rising domestic exchange rate can have the following effects:

- Exports can be less competitive, thus reducing the profitability of exporters. This can lead to decreased dividends, which in turn can lead to a fall in the market value of the business.
- The cost of foreign goods may decrease, thus giving importers a competitive advantage over domestic producers.
- The value of foreign currency liabilities will fall. Hence the cost of servicing these liabilities decreases.
- The cost of capital expenditure will decrease if it is for the importation of capital equipment.
- The cost of investing overseas may decrease.



Types of Foreign Exchange Risk

Fundamentally, there are three types of foreign exchange exposure companies face⁴:

1. Transaction exposure

2. Translation exposure

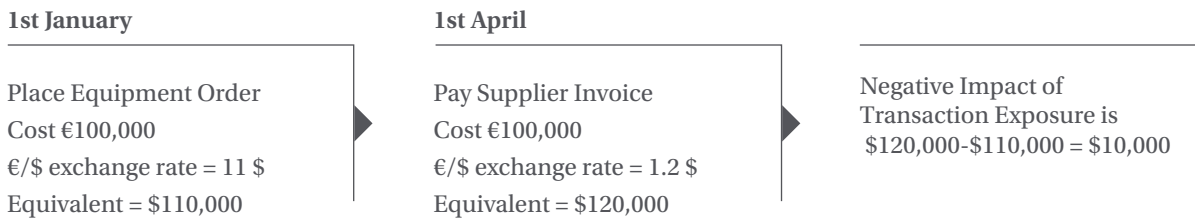
3. Economic (or operating) exposure

1. Transaction Exposure

This is the simplest kind of foreign currency exposure which arises due to a business transaction taking place in a foreign currency. The exposure occurs, for example, due to the time difference between an entitlement to receive cash from a customer and the actual physical receipt of the cash or, in the case of a payable, the time between placing the purchase order and settlement of the invoice.

Example: A US company wishes to purchase a piece of equipment from a company in Germany. The equipment costs €100,000 and at the time of placing the order the €/ \$ exchange rate is 1.1, meaning that cost to the company in USD is \$110,000. Three months later, when the invoice is due for payment, the \$ has weakened and the €/ \$ exchange rate is now 1.2. The cost to the company to settle the same €100,000 payable is now \$120,000. Transaction exposure has resulted in an additional unexpected cost of \$10,000.

⁴ Efinancemanagement (n.d.). Types of Foreign Exchange (currency) Exposure. Available from: <https://efinancemanagement.com/international-financial-management/types-of-foreign-exchange-currency-exposure>



2. Translation Exposure

This is the translation or conversion of the financial statements (such as P&L or balance sheet) of a foreign subsidiary from its local currency into the reporting currency where the parent company is established. This arises because the parent company has reporting obligations to shareholders and regulators which require it to provide a consolidated set of accounts in its reporting currency for all its subsidiaries.

For example, a US company decides to set up a subsidiary in France to manufacture equipment. The subsidiary will report its financials in Euros and the US parent will translate those statements into USD.

The example below shows the financial performance of the subsidiary in its local currency of Euro. Between years one and two, it has grown revenue by 10% and achieved some productivity to keep cost increases to only 6%. This results in an impressive 25% increase in net income.

However, because of the impact of exchange rate movements, the financial performance looks very different in the parent company’s reporting currency of USD. Over the two year period, in this example, the dollar has strengthened and the €/ \$ exchange rate has dropped from an average of 1.2 in Year 1 to 1.05 in Year 2. The financial performance in USD looks a lot worse. Revenue is reported as falling by 4% and net income, while still showing growth, is only up by 9% rather than 25%.

German Subsidiary

	Local Currency P&L			Translated into \$US		
	Year 1	Year 2	% Variance	Year 1	Year 2	% Variance
	Euro	Euro	Yr2 v Yr1	\$	\$	Yr2 v Yr1
Revenue	1,000,000	1,100,000	10%	1,200,000	1,155,000	-4%
Cost	800,000	850,000	6%	960,000	892,000	-7%
Net Income	200,000	250,000	25%	240,000	262,500	9%

The opposite effect can of course occur, which is why, when reporting financial performance, some companies quote both a “reported” and “local currency” number for some of its key metrics such as revenue.

3. Economic (or Operating) Exposure

This final type of foreign exchange exposure is caused by the effect of unexpected and unavoidable currency fluctuations on a company’s future cash flows and market value, and is long-term in nature. This type of exposure can impact longer-term strategic decisions such as where to invest in manufacturing capacity.

How FX Risk is Managed by Conventional Institutions

Foreign exchange risk can be managed through two primary methods: without financial instruments and with financial instruments.

1. Without financial instruments:

a. Transact in Your Own Currency:

Companies in a strong competitive position selling a product or service with an exceptional brand may be able to transact in only one currency. For example, a US company may insist on invoicing and payments to be made in USD even when operating abroad. This arrangement passes the exchange risk onto the local customer/supplier⁵. In practice, this may be difficult since there are certain costs that must be paid in local currency, such as taxes and salaries, but it may be possible for a company whose business is primarily done online.

b. Build Protection into Commercial Relationships/Contracts:

Many companies managing large infrastructure projects, such as those in the oil and gas, energy, or mining industries are often subject to long-term contracts which may involve a significant foreign currency element. These contracts may last many years and the exchange rates may fluctuate and jeopardize profitability. It may be possible to build foreign exchange clauses into the contract that allow revenue to be recouped in the event that exchange rates deviate more than an agreed amount. This arrangement allows the passing of foreign exchange risk onto the customer/supplier.

This may be an effective way of protecting against foreign exchange volatility. These clauses also require that a regular review rigor be implemented by the finance and commercial teams to ensure that once an exchange rate clause is triggered the necessary process to recoup the loss is actioned.

c. Natural Foreign Exchange Hedging:

A natural foreign exchange hedge occurs when a company is able to match revenues and costs in foreign currencies such that the net exposure is minimized or eliminated. For example, a US company operating in Europe and generating income in Euros may look at sourcing product(s) from Europe for supply into its domestic US business in order to utilize the Euros it has previously earned.

⁵ Ainsworth, P. (n.d.), A Guide to Managing Foreign Exchange Risk. Available at: <https://www.toptal.com/finance/interim-cfos/foreign-exchange-risk>

2. With financial instruments:

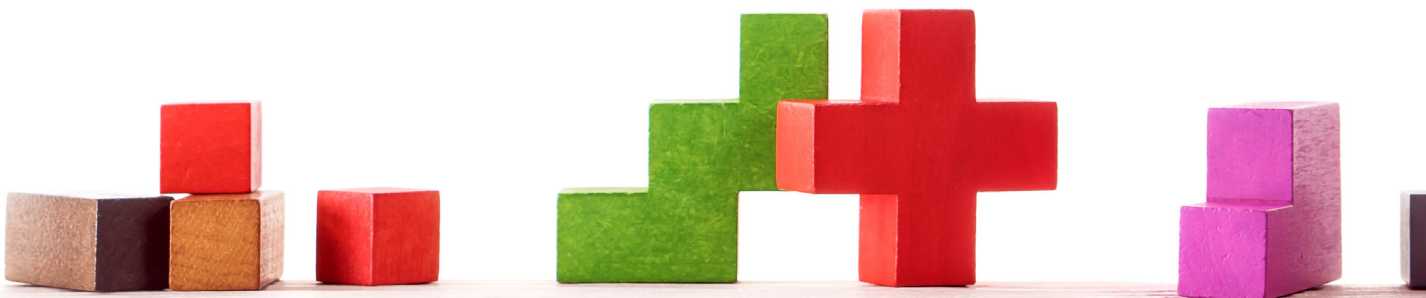
The two primary methods of hedging with financial instruments are through a forward contract or a currency option.

1. Forward exchange contracts:

A forward exchange contract is an agreement under which a business agrees to buy or sell a certain amount of foreign currency on a specific future date. By entering into this contract with a third party (typically a bank or a financial institution), the business is potentially considered to be protected from subsequent fluctuations in a foreign currency's exchange rate.

The intent of this contract is to hedge a foreign exchange position in order to avoid a loss on a specific transaction. In the equipment transaction example (used earlier in this paper), the company can purchase a foreign currency hedge that locks in the €/€ rate of 1.1 at the time of sale. The cost of the hedge includes a transaction fee payable to the third party and an adjustment to reflect the interest rate differential between the two currencies. Hedges can generally be taken for up to 12 months in advance although some of the major currency pairs can be hedged over a longer timeframe. The benefits of the protection only materialize if transactions (customer receipts or supplier payments) take place on the expected date. There needs to be close alignment between the treasury function and the cash collection/ accounts payable teams to ensure this happens.

This enables the business to protect itself from adverse movements in exchange rates by locking in a fixed exchange rate on a mutually agreed future date. The transaction is deliverable on the agreed date. The problem with this method is that the business is locked into the contract price, even when the rate movement is disadvantageous to it. For example, if a business purchasing capital equipment wanted certainty in terms of the local currency costs, it would buy US dollars (and sell local currency) at the time the contract was signed, with a forward rate agreement. This would lock in the local currency cost, ensuring that the cost paid for the equipment will equal the original cost used to determine the internal rate of return of the project



2. Currency options:

Currency options give a right, but not an obligation, to buy or sell a currency at a specific rate on or before a specific date. They are similar to forward contracts, but the company is not forced to complete the transaction when the contract's expiration date arrives. Therefore, if the option's exchange rate is more favourable than the current spot market rate, the investor would exercise the option and benefit from the contract. If the spot market rate was less favourable, then the investor would let the option expire and conduct the foreign exchange trade in the spot market. This flexibility is not free and the company will need to pay a premium.

For example, if a company wishes to take an option instead of a forward contract with a premium of \$5,000.

If the USD weakens from €/\$ 1.1 to 1.2, then the company would exercise the option and avoid the exchange loss of \$10,000 (although it would still suffer the option cost of \$5,000).

In a scenario where the USD strengthens from €/\$ 1.1 to 0.95, then the company would let the option expire and bank the exchange gain of \$15,000, leaving a net gain of \$10,000 after accounting for the cost of the option.

	01 Jan Exchange Rate €/\$=1.10	01 April Exchange Rate €/\$=1.20	01 April Exchange Rate €/\$=0.95
Equipment Cost (Cost in Euros is 100,000)	\$110,000	\$120,000	\$95,000
Option Cost		\$5,000	\$5,000
Exchange Gain/(Loss)		(\$10,000)	(\$15,000)
Exercise Option		(\$10,000)	-
Let Option Expire		-	-
Net Gain/(Loss)		\$5,000	\$10,000



Shariah Review of Conventional FX Risk Management

Conventional instruments have

1. Forward currency exchange contracts

Forward currency exchange contracts create a legal obligation to exchange at a future date. This violates the Shariah principles mentioned in the AAOIFI Sharia Standard No.1 of taking possession in the contractual session when trading currencies. The Sharia Standard states the conditions of exchanging currencies as follows:

- 1/ Both parties must take possession of the countervalues before dispersing, such possession being either actual or constructive.
- 2/ The contract shall not contain any conditional option or deferment clause regarding the delivery of one or both countervalues.
- 3/ Currency transactions shall not be carried out on the forward or futures market.”

The AAOIFI Shariah Standard explicitly states the status of forward currency contracts as follows:

- 4/ It is prohibited to enter into forward currency contracts. This rule applies whether such contracts are effected through the exchange of deferred transfers of debt or through the execution of a deferred contract in which the concurrent possession of both of the countervalues by both parties does not take place.
- 5/ It is also prohibited to deal in the forward currency market even if the purpose is hedging to avoid a loss of profit on a particular transaction effected in a currency whose value is expected to decline.”

The majority of Shariah scholars are of the view that conventional Futures and Forward contracts are not Shariah compliant. This was the resolution of the International Islamic Fiqh Academy as well as the Islamic Fiqh Academy of Muslim World League⁶. The AAOIFI Standard No.20 also states:

5/1 Futures

5/1/1 A contract that is binding under law. It is concluded on the trading floor of the exchange for the sale and purchase of commodities or financial instruments for a period linked to the near future. The transaction is arranged with the mentioning of the quantity, type and category along with the statement of the date and place of delivery. As for the price, it is the sole element that varies, and it is ascertained in the trading hall.

5/1/2 The Shari’ah rule for futures contracts It is not permitted according to the Shari’ah to undertake futures contracts either through their formation or trading.”

6 International Islamic Fiqh Academy. (1992a). Qararat al-Majma', Seventh Session, Resolution 1 Financial Markets. Jeddah: International Islamic Fiqh Academy.
International Islamic Fiqh Academy. (1992b). Qararat al-Majma', Seventh Session, Resolution 3 Istisna contract. Jeddah: International Islamic Fiqh Academy.
Islamic Fiqh Academy of Muslim World league. 1984. Fatawa al-Majma, Seventh Session-Financial Securities and Commodities Market. Mecca: Islamic Fiqh Academy of Muslim World League.

The Shariah scholars object to Forwards and Futures contracts due to the following reasons:

a. Trading before possession

The majority of buyers and sellers in futures and options transactions reverse out of their position before delivery or maturity. This means that physical delivery hardly ever takes place in futures and options; for example, 99% of all futures contracts are settled before maturity. This feature of derivative trading, i.e., sale before delivery is made or selling something one does not possess, has been subject to intense criticism by Islamic scholars. A primary objection to this feature is that a number of intermediaries make money without adding any form of utility to the commodity, i.e., they earn money without giving anything in recompense. Actual physical delivery of the commodity is good because it creates jobs from storage, transport and packaging⁷.

b. Qimar activity

Shaykh DeLorenzo argues that futures are part of zero-sum markets where gains result from corresponding losses. He opines that this sort of economic activity is clearly forbidden under Shariah. He adds that, while proponents of futures market may argue that such activities function to stabilise prices and regulate risk, as far as the Shariah is concerned such markets produce nothing of value. He concludes that futures amount to bets on the direction the market is moving in. Obviously, the ethics of this market are unacceptable⁸.

c. Sale of debt for debt

The exchange of debt for debt also known as *Bay' al Dayn bil Dayn* or *Bay' al-Kali bil Kali*. The AAOIFI Shariah Standard No.10 on Salam states:

“Any delay in payment of the capital and dispersal of the parties renders the transaction a sale of debt for debt which is prohibited, and the scholars agreed on its prohibition. Ibn Rushd said: “As for sale of debt for debt, Muslim scholars are unanimous regarding its prohibition.”

This general prohibition has been prescribed to futures, where it is concluded that the sale of futures contracts, where the parties can offset their transactions by selling the ‘debts’ owed to other parties before the delivery of the underlying asset, will amount to a sale of a debt and is therefore prohibited.⁹



7 Sherin Kunhibava and Balachandran Shanmugam, ‘Shariah and Conventional Law Objections to Derivatives: A Comparison’, *Arab Law Quarterly* 24, no. 4 (1 January 2010): 319–60, <https://doi.org/10.1163/157302510X531764>

8 Ibid

9 Ibid

2. Currency options

Currency options violate Shariah principles and are deemed as non-compliant according to AAOIFI Shariah Standard No.20: Sale of Commodities in Organized Markets which states:

“5/2/1 A contract by means of which a right is bestowed -but not an obligation- for the purchase or sale of an identified item (like shares, commodities, currencies, indexes or debts) at a determined price and for a determined period. There is no obligation in this contract except on the person selling this right.

The AAOIFI Shariah Standards describe the underlying reason for this prohibition as follows: “The basis for the impermissibility of options is that the subject-matter of the contract in them is not wealth that can be deemed compensation according to the Shari’ah”. The subject matter is problematic. An option represents the power, the right to choose. When you own an option, you can choose whether to buy an asset or not, or (with different type of options) whether to sell an asset or not. When you own an option, you have the right to buy or sell, but not the obligation. You only do what is favourable for you at that moment. Options are essentially a choice which you are purchasing. The ‘ability to choose’ is the subject matter. There are two choices a person buys: transact or not to transact. A choice is inherently results in unknown and uncertain outcomes, and as a subject matter, it attracts *Gharar* in the subject matter. A choice is not something for which consideration can be given. Selling ‘choices to transact’ is invalid as a choice does not conform to *Mal* (property), *Manfa’ah* (usufruct) nor a valid *Haqq* (right) in Shariah. In an option contract, one is trading this choice, which is a contract, to hedge against the risk. The choice incorporates risk. When the underlying asset is in one’s favour, the option contract is exercised. When the underlying asset exposes one to loss, the option contract is not exercised. Thus, the contract is being traded to hedge against the risk exposure in the underlying asset.

In an option contract, the right to buy (or sell) an underlying asset at a predetermined strike price requires payment of a fee. According to Mufti Muhammad Taqi Uthmani, an option is a ‘promise’ which in itself permissible and “normally binding on the promisor”. However, the fact that an option transaction requires payment of a fee on the promise invalidates this type of derivative under Shariah¹⁰. He opines that this ruling applies to all types of options, whether they be calls or puts, because options are rights, not physical assets, and therefore cannot be bought or sold. The ‘right to buy’ is a commitment, pledge and promise to transact. Let alone being lawful commodities, promises are not even assets. Promises are merely an expression of imposing a task on one’s personal liability. Mufti Taqi Uthmani further states that a premium is paid without any transfer of property, benefits or rights. Hence, when there is no counter-exchange being transferred, a premium is unwarranted. As a consequence, the premiums paid for options fall under *Rishwa* (bribe) and are prohibited. *Rishwa* refers to taking consideration for something which does not warrant a premium or consideration¹¹.

In respect to options, the OIC Islamic Fiqh Academy states that:

“Option contracts as currently applied in the world financial markets are a new type of contracts which do not come under any one of the Shariah nominated contracts. Since the object of the contract is neither a sum of money nor a utility or a financial right which may be waived, then the contract is not permissible in Shariah.^{12”}

10 Uthmani, M.T. (2014), *Fiqh al-Buyu*, Karachi: Maktaba Ma’arif al-Qur’an

11 Uthmani, M.T. (2014), *Fiqh al-Buyu*, Karachi: Maktaba Ma’arif al-Qur’an

12 OIC Islamic Fiqh Academy, “Resolution and Recommendations of the Council of the Islamic Fiqh Academy 1985-2000”, 2000

Shariah Compliant Methods to Hedge Currency Risk

1. Back-to-back loans

The AAOIFI Shariah Standard No.1 Trading Currencies proposes the following solution:

2/4 It is permissible for the Institution to hedge against the future devaluation of the currency by recourse to the following:

2/4/1 To execute back-to-back interest free loans using different currencies without receiving or giving any extra benefit, provided these two loans are not contractually connected to each other.”

This is a very simple approach through the execution of two back-to-back, interest-free loans of different currencies. The loans do not carry any interest or any other benefit. The agreements are separate and neither one cross references the other. This is a very simplistic FX hedge, and does not conform to the conventional FX hedging, as the conventional hedging mechanism takes into account the forward FX rates, the tenor etc. This simplistic method has been used in day-to-day dealings between local traders and in small amounts.

When two companies in different countries need to access money in each others currency for the purpose of offsetting a bill or trading on the currency market, a back-to-back loan is used. Since the value of currencies differ, companies engage in this type of loan as a hedge against currency risk. Also, if a company takes a loan in another currency for the purpose of making a payment, it can minimise the expense the company would have accrued if it had paid in its own currency.

Example 1:

An American company that desires to open an office in China and a Chinese company seeking to establish its presence in the US can both engage in back-to-back loan. In the type of loan, the American company can lend the Chinese company \$2 million to open an office in America while the Chinese company would also lend an equivalent of \$2 million (in the Chinese Yuan) to the American company. Due to the fact that both loans are made in their distinguished currencies, both companies will be able to hedge currency risk. However, both loans will have the same maturity date, they will be paid back on the same day.

Example 2:

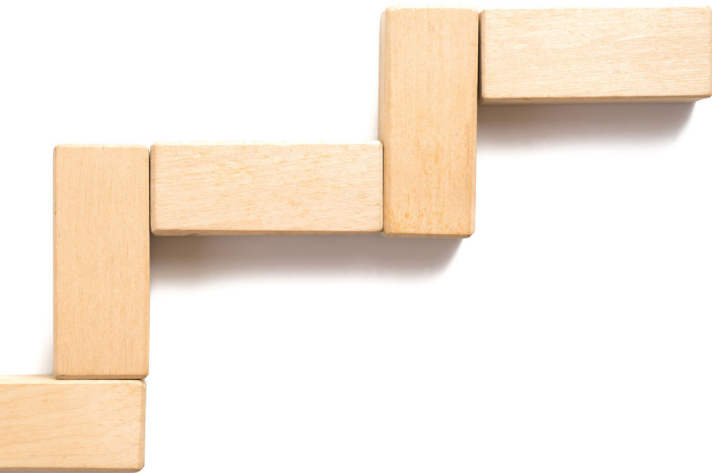
Company XYZ based in the US is concerned about the value of the dollar changing relative to the euro.

To mitigate this concern, Company XYZ and Bank ABC structure a back-to-back loan, whereby Company XYZ deposits \$1 million with Bank ABC, and Bank ABC (using the deposit as security) lends Company XYZ \$1 million worth of euros. The current exchange rate between American dollars and euros is 1:0.50 (that is, \$1 buys half a euro).

The bank and Company XYZ agree to a one-year term on the loan. When the loan term ends, Company XYZ repays the loan, thereby insuring against currency risk during the term of the loan.

There are a number of risks that can be attributed to back-to-back loans. The major risk is that the two currencies in this type of loan have the tendency of being uneven in terms of loss attributable to them. This is called asymmetrical liability, except in cases where there is provision or coverage for asymmetrical liability is clearly stated in the back-to-back loan agreement. Another risk of back-to-back loan is that if one of the companies or parties defaults on loan payments, the other party is not relieved of their responsibility for repayment¹³.

13 Gordon, J. (2020). Back-to-back Loan.



2. Trading in foreign currency

The AAOIFI Shariah Standards mention another method to manage foreign currency risk as follows:

“Where the exposure is in respect of an account payable, to sell goods on credit or by Murabahah in the currency of the exposure.”

An account payable is money owed by a business to its suppliers shown as a liability on a company's balance sheet. In this instance, an institution can reduce its exposure to this account payable in a foreign currency by creating an account receivable in that foreign currency. This receivable can take place through a Murabahah sale, whereby the fixed mark-up adds additional capital to minimise the FX exchange variance.

3. Settling in foreign currency

Another method stated by the AAOIFI Shariah Standards is settling in a foreign currency. The Standard states:

“It is permissible for the Institution and the customer to agree, at the time of settlement of the instalments of a credit transaction (such as a Murabahah), that the payment shall be made in another currency applying the spot exchange rate on the day of payment.”

4. Commodity Murabaha

Another option is based on Commodity Murabaha, defined in Islamic finance as a tri-lateral sale arrangement whereby a financier or intermediary purchases goods from a supplier and sells them to an end-user at a deferred price that is marked-up to include the intermediary's profit margin.

In this scenario, the customer and the bank enter into separate murabaha transactions to facilitate the FX forward contract. The customer will buy a commodity for spot value and sell it to the bank for the purchase price plus agreed profit, the basis point in a conventional FX forward deal, payable on a deferred basis.

To address the other side of the FX forward deal, the bank will buy another commodity and sell it to the customer, again for the purchase price plus agreed profit, on a deferred basis. Both the customer and the bank typically will sell the commodity back into the market to recover their initial investment. However, the cost associated with incorporating a commodity in the transaction has given the impetus for Islamic institutions to seek alternative methods of hedging their FX exposures.



5. The Single Wa'd Structure

Another common mechanism is based on the concept of Wa'd (meaning promise). Typically, Party A, who is looking for a hedge, will provide an undertaking to buy a currency from Party B in the future. The essential elements of the promise include the purchase price of the currency and the delivery date. The promise must not be conditional on any event. Party A is normally bound to fulfil its promise to Party B. However, Party B is not under any obligation to act on the transaction when an offer to purchase is submitted. A unilateral and binding promise is provided by one party to another on the trade date and a spot FX transaction takes place on the settlement date for the exchange of currencies. The promise cannot be conditional on any event and will have details of the amount of the currency to be purchased along with the future date of purchase. The Wa'd structure is most common in hedging in Islamic transactions.

The International Islamic Financial Market (IIFM) have developed the Islamic FX Forward product and the legal documents to facilitate hedging using the single Wa'd structure.

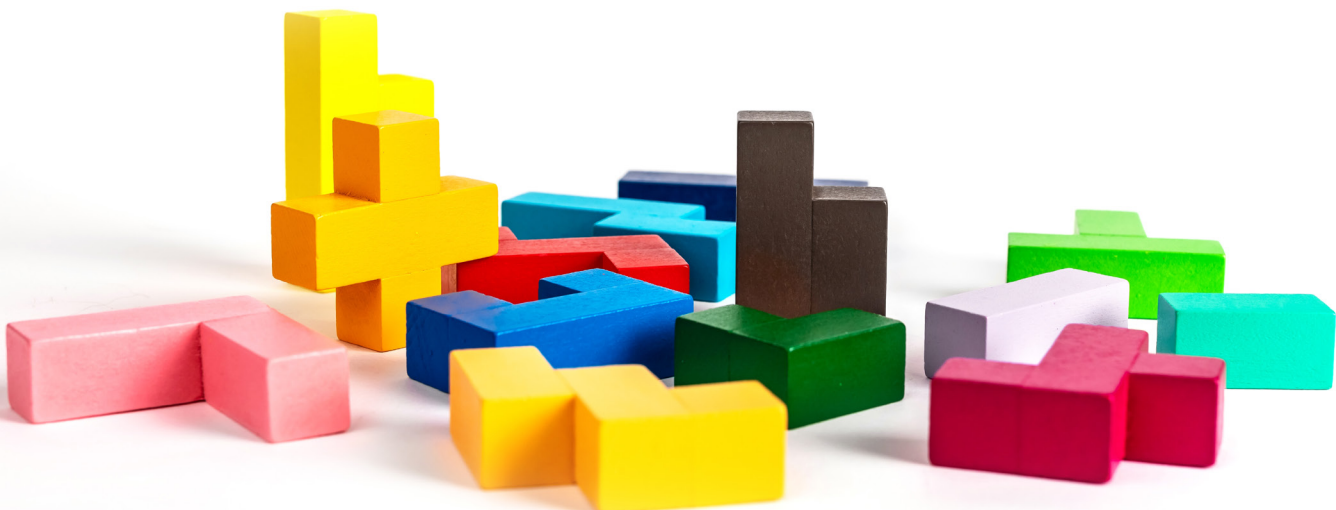
Illustration in relation to the Single Wa'ad Structure

Wa'ad / First Currency GBP / Second Currency=USD




Promises to buy GBP 1 million at the Forward Rate of 1.51

On the Exercise Date, the Bank exercises its rights under the Wa'ad, so that the Customer buys GBP 1 million in exchange for USD 1.51 million. Although for Shari'ah related reasons the Bank is not strictly under an obligation to exercise its rights under the Wa'ad, given that this is an IFX Forward product the expectation is that it would do so.



Conclusion



Foreign exchange risk is the risk of financial impact and financial loss due to exchange rate fluctuations. These variations in currencies take place for several reasons such as the domestic monetary policy, inflation rates, political and economic environment, government trade, public deficit, recession and speculation as well as other factors. Fundamentally, there are three types of foreign exchange exposures: transaction exposure, translation exposure, and economic (or operating) exposure. Transaction exposure arises due to an actual business transaction taking place in foreign currency. Translation exposure is the translation or conversion of the financial statements (such as P&L or balance sheet) of a foreign subsidiary from its local currency into the reporting currency of the parent. Economic exposure is caused by the effect of unexpected and unavoidable currency fluctuations on a company's future cash flows and market value. FX risk is managed in two primary ways: without financial instruments and with financial instruments. Transacting in one's own currency, building protection in commercial contracts and natural foreign exchange hedging are common methods of hedging without the use of financial instruments. Conventional methods using financial instruments include forward exchange contracts and currency options. Both of these financial instruments are not Shariah compliant. They violate Shariah principles of currency exchange, violate the principles of possession, have an element of Qimar (gambling) activity and are a sale of debt for debt. Shariah compliant methods to hedge currency risk include back-to-back loans, trading in foreign currency, settling in foreign currency, using commodity Murabaha and using Wa'd. The single Wa'd and double Wa'd are the most common structures used in Islamic FX hedging.

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Disclaimer

This is a preliminary Shariah research and is by no means a definitive conclusion or fatwa on the aforementioned subject. This paper was written to develop knowledge and research on this complex subject from a Shariah perspective. We hope that this paper will prompt and engage global Islamic finance bodies, Shariah scholars and Muslim economists to analyze, comment and build upon the arguments expressed.

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