Current trends in Islamic Finance and the development of Islamic hedge funds

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In 1975 the first Islamic bank was born. Certainly this was not the beginning of Islamic finance as Islamic finance started with the very birth of the religion of Islam over 14 hundred years ago. However, that was the beginning of the institutional set up of new financial organizations that are, while following Shari'ah injunctions they can fit into an already existing world class financial system. It is the process of re-engineering already tested structures of finance to be in line with Shari'ah requirements.

1975 witnessed a modest beginning where the basic lender-borrower based financial intermediary was redesigned to work on concepts like sale, lease and partnership rather than money for money in a contract of loan

The drive to “Islamize the system” did not stop there. Enlightened leaders knew that Muslim societies will be able to keep pace with the rest of the world without a financial system capable of meeting all their needs. To do that it is not required that we jump over Shari’ah rules. Shari'ah is never a hurdle and we are not incarcerated inside Shari’ah. On the contrary, we are emancipated by Shari'ah. However, we have to pay the effort and work very hard to understand these rules, comprehend Shari'ah aims and objectives and interpret the scripture in a manner that while not violating the established rules of interpretation, takes into consideration facts of our contemporary life. This approach always pays off. The more we apply it the more we discover the versatility and resourcefulness of Islamic Shari'ah.

In the last few years Shari'ah boards with the help of financial experts were able to really take the system to new level of modernity by designing substitutes that deliver the same economic outcome of some of the most sophisticated conventional products on a Shari'ah acceptable legal framework. This includes things like options, futures, profit (not interest) rate swaps; capital protected (not guaranteed) investments…etc. The area of Sukuk is by itself a witness to the almost unlimited potential for innovation within the Shari'ah permissibility.

Rating Intelligence is really blessed to have a Shari'ah board that, with the exception of the chairman, consists of exceptional scholars who are open minded and have remarkable abilities to research, revert to Shari'ah sources and discover amazing exemplars of the methodology of classical scholars in interpreting rules of Shari'ah in a way that proves that Islamic law is peerless in its adoptability to changing circumstances.

Marvelous innovations in the last few decades are not confined to genetic engineering, technological design and computer software. Some of the most important revolutions that reshaped our lives are taking place in the sphere of finance. Individuals and firms have always resorted to their ingenuity to reduce cost, circumvent inefficient government regulations and manage risks. This results in more growth and prosperity and welfare improvement for everybody. It is a forgone conclusion that Muslims should not ignore new advances in medicine and technology. By the same token, they must not be left out in the pursuit to renovate the system of economy. It is wrong to think that Shari'ah is a constraint that prohibits us from enjoying the fruits of scientific advances. In fact it is part of our Islamic belief that our *Shari'ah* is capable of accommodating all our legitimate needs. If we fail to catch up with others, it is due to lack of effort on our part to understand the principles, rules and objectives of Shari'ah. This can be said about Hedging technique. If these techniques satisfy a legitimate need, then rest assured that there must be a Shari'ah permissible way for hedging. Nevertheless, until very recently the area of derivatives is looked at as "taboo" from Shari'ah point of view. This is quite natural.

When futures contracts first launched in Chicago in 1860 they were considered a form of wagering and they were prohibited. However, the 19th century didn't close before laws prohibiting futures and option were repealed. When futures first launched in Chicago in 1860 they were considered a form of wagering and they were prohibited. The same thing happened in several states in the US. However, the 19th century didn't close before laws prohibiting futures and option were all repealed. This doesn't mean all derivatives all good and useful. Until this very day a lot of knowledgeable and wise people believe that derivatives are nothing but a game of cards played in gigantic casinos as Noble laureate economist Moris Allns once described derivative market. Like every thing in life, derivatives are a blend of good and bad, useful and harmful. Hence we have to be prudent enough to segregate the good from the bad and harmful. It is the area of risk management the holds most of potential utility and benefit.

Every business faces variety of risks. However, risk is like matter, it cannot be destroyed only moved from one place to another. It is not possible to eliminate risk but it can be managed. To do that we must recognize the existence and nature of risk we are facing and consciously take the amount of risk we want to take. In every market when a market player desires to take less risk, there should be another willing to assume more risk. Those who work to avoid certain type of risks are called hedgers. Those who assume more risk, for profit, are customarily called speculators. However, these are not two distinguishable groups of people. The only difference between hedgers and speculators is the fact that the latter have no commercial interest in the underlying asset. Such will not be a material difference that can be the basis of policy or special procedures toward each group. Hedging is a umbrella of structures and arrangements the purpose of which is to mange risk by allowing players to take only the amount of risk the feel they can manage.

The best way to understand hedging is to think of it as insurance. When you hedge you are insuring yourself against a negative event. In investment, hedging generally means using instruments in the market to off set risk of adverse price movement.

Clearly, the availability of a mechanism to transfer risks is quite valuable to individuals and companies. On a macro level a mechanism to transfer risk is a form of risk sharing.

Risk by itself is neither necessary nor preferable for any transaction to be Shari'ah acceptable. In fact it is more in line with Shari'ah to avoid risk, provided this is done through Shari'ah acceptable means. At the time of the Prophet (PBUH) a Bedouin getting off his camel asked the Prophet (PBUH) as a true believer should I just rely on Allah and leave my camel here unleashed. The Prophet (PBHU) said no you rely on Allah but also you leash your camel. Hence, managing risk is not contrary to true belief.

It is an established economic fact that risk sharing and intertemporal smoothing are essential elements of welfare in any society. It is also an established *Shari'ah* fact that the main objective of Islamic *Shari'ah* is the good and welfare of the Society. Therefore, it is unthinkable that *Shari'ah* will lack the ways and means to provide necessary facility for Muslims' legitimate needs to manage risks in the realm of finance and investment.

We know already that all the modes of partnership in *Shari'ah* are geared toward risk participation. Not only that risk sharing is the most important element in the idea of *Mudarabah* and *Musharakah*, but also that when the form of contract of such partnership is altered to shield one partner from risk, the contract becomes null and void for it no longer serves the basic purpose which is risk/reward sharing. In fact the main reason for prohibition of interest is the fact that loan contract shifts commercial risk of the profit generating venture to the borrower. Hence, the other party deserves to get no share of such profit which is essentially a reward for risk taking.

However, it is one thing to say that risk sharing is a legitimate objective, but another to say that risk *per se* can be the subject of an exchange contract. Speculators have no commercial interest in the commodities being exchanged in futures markets. Rather, they make money out of "purchase" and "sale" of risk. Unlike the need for hedging against risks, speculation is a deplorable activity. The point is how can we distinguish hedgers who have a legitimate need, and speculators? Unfortunately, there is no practical way for such end.

Intertemporal smoothing is a legitimate objective. It is a built-in component in every contract that bridges present to future. *Shari'ah* doesn't lack such a facility. As a matter of fact *Salam* itself is an intertemporal smoothing device.

The simplest way to hedge is to invest in two securities with negative correlation.