RISK MANAGEMENT IN ISLAMIC FINANCE: AN ANALYSIS FROM OBJECTIVES OF SHARI’AH PERSPECTIVE

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ABSTRACT
As Islamic finance industry grows 15 to 20 per cent annually, the need of hedging tools to mitigate certain risks in a volatile market increases. The broad perspective on risk and its management is embodied in the essential objectives of Shari'ah, which is wealth protection. However, in the light of Shari'ah legal maxim that states ‘al-ghurum bi al-ghunn’ (liability accompanies gain) and ‘al-kharaj bi al-daman’ (benefit goes with liability) risk cannot be isolated from economic affairs. The legitimacy of revenue generation requires that it has to be created based on real economic activities, which involve real business risk and liability. Thus the element of risk and liability is essential for the legitimacy of profit entitlement. On the other hand, exposing to excessive risk not only hinders investment, but also deters economic growth, which might be against the maqasid al-Shari’ah (objectives of Shari’ah). A few critical questions arise then; how to balance between these two ends? What kinds of risk are to be borne in order to be entitled to the revenue? What types of risk can be mitigated? Therefore, this paper attempts to address these issues and provides a crystal understanding on the concept of risk management in the light of the objectives of Shari’ah. This study employs qualitative method of research. Inductive approach is adopted to analyse financial risk management from Islamic perspective. The paper also adopts a deductive approach to derive legal provisions from Qur’an, Sunnah and Islamic juristic literature. It is observed that there are many supportive arguments and evidences in Islamic heritage showing the importance and necessity of risk management in financial transactions. It can be concluded that hedging business risk does not contravene with the legal maxim ‘al-ghurum bi al-ghunn’ (liability accompanies gain). Both concepts are congruent and consistent in their objective, which is to protect the wealth and to ensure justice and fairness to all contracting parties in their financial dealings. From Shari’ah perspective financial risk can be classified as forbidden risk, essential risk and tolerable risk. Forbidden risk must be avoided in order to make a financial transaction Shari’ah complaint. Islamic hedging strategies are only applicable to ‘tolerable financial risk’. This is because from an Islamic perspective essential business risk must be borne in order to earn legitimised profit. Subsequently, this research provides juristic justifications for the necessity of risk management with Shari’ah complaint hedging instruments for Islamic financial institutions.

Keywords: Risk Management, Hedging, Objectives of Shari’ah, Islamic Finance

Introduction
The possibility of an adverse outcome is the essential part of business activities. Uncertainty is a natural component of activities that involve the future as it traverses across different levels. The existence of uncertainty about future outcomes is defined as risk (Damodaran, 2007). Risk is often linked with undesirable event that produces negative outcome. Holton (2004) argues that uncertainty in regards to the potential outcomes of an experiment and that the outcomes have to matter in terms of providing utility are two essential components for the existence of risk.

Be that as it may, in finance risk is defined in terms of variability of actual returns on investment around an expected return, even if the returns represent positive outcomes (Damodaran, 2007). Risks in economics and finance are classified in various ways. One way is to distinguish between business risk and financial risk. Business risk is due to the uncertainty arising from the nature of a company’s or an individual’s business. It is related to factors affecting the product market, i.e. the uncertainty of the cost of inputs or the future sales. Financial risk is the uncertainty arising from possible losses in financial markets due to movements of financial variables, i.e. uncertainty of commodity prices, stock prices, exchange and interest rates (Jorion & Khoury, 1996).

On the other side, Muslim jurists used the word khatar and mukhatarah for business risk. Mukhatarah is defined as “possibility of unexpected outcomes” (Al-Sharbsi, 1981). Khatar and mukhatarah are interchangeably used with gharar (Uwaidah, 2010). According to Al-Mawsu’ah al-Fiqhiyyah Al-Kuwaytiyyah (1983-2006) mukhatarah is the doubtful status of a business transaction in which gain and loss are unknown. By analysing various definitions of khatar and mukhatarah from juristic perspective, Muhammad (2008) concludes that the concept of risk according to Muslim jurists is almost similar to what is defined by conventional economists.

Not only that, Islamic financial institutions (IFIs) being part of global financial industry, i.e. performing their business activities not in isolation from conventional counterparts, face mostly similar risks and for managing them IFIs apply mostly the same
Risk Management

Operating in a dynamic environment, every business entity requires an active risk management strategy to protect itself from unexpected results. Sound risk management is the key responsibility of the management and should be part and parcel of the overall corporate governance structure. An effective risk management system comprises of identifying, measuring, monitoring and limiting risks. These processes, in turn, depend on appropriate control and auditing procedures. In the following section, the concept of risk management will be deliberated briefly.

2.1. An Overview of Risk Management from Conventional Perspective

Risk management, according to Cumming and Hirtle (2001), is attributed to “the overall process that a financial institution follows to define a business strategy, to identify the risks to which it is exposed, to quantify those risks, and to understand and control the nature of risks it faces”. Damodaran (2007) distinguishes between risk management and risk reduction. Risk management refers to a strategy for an organisation’s advantage by seeking it out to exploit uncertainty and risks through various proactive policies to create value. Risk reduction, on the other hand, is a defensive process to protect organisation from risk by using insurance, hedging and derivatives. Examining the likelihood and impact of the risk can assess the implication of risk of outcomes. The likelihood can be termed in probability terms. The impact can be measured as the total loss or value of total assets lost. The goal of the risk management process is to take corrective actions to reduce the impact and possibility of loss so that the residual risks can be brought within the tolerable loss range. The impact can be reduced by controlling the sources from which they arise and instituting limits to the exposures. For example, credit risk can be reduced by controlling the exposure to such risk by doing due diligence to reduce the probability of default.

From a risk management perspective, risks faced by financial institutions (FIs) can be classified into three types, namely the risk, which can be eliminated, the risks transferable to others and the risks manageable by the institutions themselves. FIs as financial intermediaries tend to avoid particular risks taken by simple business practices. Moreover, FIs will not undertake activities imposing risks upon them. The practice of FIs is to undertake activities in which the risks can be either efficiently managed or transferred to others (Crouhy, Mark, & Galai, 2001).

Risk avoidance methods include amongst the standardisation of all business-related processes and activities, composition of a diversified portfolio and application of an incentive-compatible scheme with accountability of actions. Certain risks faced by banks can be decreased or eliminated by selling or transferring them in well-defined markets. Risk transferring methods include amongst changing borrowing terms, selling or buying of financial claims, use of derivatives for hedging, etc. There are certain risks that cannot be either transferred or eliminated and need to be absorbed by the banks. These risks are accepted by the FIs, as they are essential to their business and the banks are specialised in dealing with them. Examples of these risks are the market risks in the trading book activities of banks and the credit risk inherent in banking book activities (Kolb & Overdahl, 1997).

There are mainly four types of risks faced by FIs:

1) Credit Risk: It is the risk of failure of a company or individual to pay the contractual interest or principal on its debt obligations. This type of risk creates panic for investors who hold bonds and sukuk in their investment portfolio (Duffie & Singleton, 2012).

2) Liquidity risk: it is a risk when a business entity is not able to meet short term financial demands. This happens when a security or hard asset is unable to convert into cash without a loss of capital (Pastor & Stambaugh, 2003).

3) Market risk: The possibility for a company or bank to experience losses arising from movements in market prices. It is also called as ‘systematic risk’, this type of risk cannot be eliminated through diversification (Constantinides, 1978).

4) Operational risk: Basel Committee on Banking Supervision (2001) defines operational risk as “the risk of loss resulting from inadequate or failed internal processes, people and systems, or from external events”.

2.2. Risk Management from Maqasid al-Shari‘ah Perspective

The broad perspective on risk and its management are embodied in the objective of Shari‘ah which is to protect the wellbeing of mankind. Chapra (2008) quotes Al-Ghazali in defining maqasid al-Shari‘ah as “promotion of the well-being of the people, which lies in safeguarding their faith (dIn), their self (mAnaf), their intellect (‘Aql), their lineage (nasIl) and their wealth (mAl)”. Islam provides detailed instructions to manage various types of risks in a broader sense amongst others are criminal assault risk, illness risk, investment risk, business risk and etc. Interestingly, Islam also commands the adherents to manage spiritual types of risks such as to avoid fornication, idolatry, apostasy and other types of sins. However, the discussion on the risk management in this paper is focusing on risk in economic and financial transactions. A fundamental question needs to be addressed in this part is “what is the Islamic approach towards risk management in financial transactions?”. 
There are many supportive arguments and evidences in Islamic heritage showing the importance and necessity of risk management in all aspects of life. With this in background, the significance of risk management according to Qur’an and Sunnah (prophetic tradition) will be discussed in the following section.

1.2.1.1. Risk Management in Qur’an

There are many Qur’anic verses that guide mankind to have risk management in wealth and financial affairs. Those verses precisely show the significance of strategic planning to control and mitigate anticipated risks. The absence of efficient risk management will harm certain parties to the extent that the risk most likely endangers one’s life.

It is stated in surah Yusuf:

قَالَ تَزَوَّجُوا سَيْعَ سَيْعَ دَأْبًا فَمَا حَصَّنَتْ فَنَزِهَاء فِي سَيْبِهِ إِلَّا قَتْلًا مَا تَأْكُلُونَ (47) ثُمَّ بَيْنَاهُ مِنْ بَعْضِ شَيْءِ شَادَّ بَيْنَاكُمْ لِمَنْ إِلَّا قَتْلًا مَا تَأْكُلُونَ (48) ثُمَّ بَيْنَاهُ مِنْ بَعْضِ شَيْءِ شَادَّ بَيْنَاكُمْ لِمَنْ إِلَّا قَتْلًا مَا تَأْكُلُونَ (49)    

[Joseph] said, “You will plant for seven years consecutively, and what you harvest leave in its spikes, except a little from which you will eat. Then will come after that seven difficult [years], which will consume what you saved for them, except a little from which you will store. Then will come after that a year in which the people will be given rain and in which they will press [olives and grapes]” (Qur’an, 12:47-49).

In the above verses, prophet Yusuf (p.b.u.h.) interpreted the dream of the king of Egypt that Egyptian would face seven years of drought after seven years of prosperity. Hence, he advised the king to develop an economic strategy in order to overcome the upcoming catastrophe. To be precise, Egyptians had to implement the proposition by actively planting crops during the first seven years and store much of the proceeds as a preparation to face seven years of drought, as interpreted by prophet Yusuf. As recommendations implemented it resulted in the country surviving the seven years of drought (Ibn Kathir, 1988).

In the following Qur’anic verse, attestation by contracting parties in a financial transaction is required to manage risk, particularly the credit risk:

"O you, who have believed, when you contract a debt for a specified term, write it down. And let a scribe write [it] between you in justice. Let no scribe refuse to write as Allah has taught him. So let him write and let the one who has the obligation dictate. And let him fear Allah, his Lord, and not leave anything out of it." (Qur’an, 2:282).

Attestation is a basic requirement in Islamic commercial law, whether it is an ordinary documentation at an individual level or an official documentation at an entity level. The core objective of attestation is to mitigate the risk of any party denying what was agreed upon, which may lead to a loss of capital. In case the financial transaction that involves debt is performed during a journey Qur’an allows the creditor to receive collateral as the debt security. This is an example of risk management, i.e. mitigating credit risk due to the failure of the debtor in fulfilling his financial obligations. The aforementioned verse clearly gives an indication that if the trust of the counterparty is not sufficient an effective step must be taken to avoid fraudulence and unreasonable losses (Usmani M. S., 1978).

In financial matters and business dealings, there is always a possibility of disputes and differences of opinion over the mutually agreed conditions. There is a need that such kind of transactions involving money, land, rights, ownership, property and other articles of value should be recorded in the form of contract and signed by both parties in the presence of witnesses. A well-documented contract eliminates the risk of default and ensures to secure the rights of all concerned. Since evidence and witness are essential to reveal truth and justice, Allah commands people that they should not refuse to be witnesses when required:

ذلكم أقسط عند الله وأقوم للشهادة وأدنى ألا ترتابوا إلا أن تكون تجارة حاضرة تديرونها بينكم فليس عليكم جناح ألا تكتبوها وأنبئوا إذا تبايعتم (Qur’an, 12:49).

Interestingly, Islam does not only focus on reducing the risk of counter parties; it also ensures the safeguard of scribes and witnesses. The following Qur’anic verse prohibits causing harm to the scribe or witnesses:

‘Let no scribe be harmed or any witness. For if you do so, indeed, it is grave disobedience in you. And fear Allah. And Allah teaches you. And Allah knows of all things’ (Qur’an, 2:282).

1.2.2. Risk Management in Prophetic Tradition
The legality of the concept of risk management has its root and basis in the Sunnah as well. There is a well-known hadith on tying a camel, which is repeatedly quoted by the proponents of takaful. It was narrated by Anas bin Malik that an Arab Bedouin asked the Prophet (p.b.u.h.) in Medina:

"O the Messenger of Allah...Should I leave my camel untied and trust in Allah, or should I tie it?" The Holy Prophet (p.b.u.h.) replied: “Tie your camel and then trust in Allah” (Al-Tirmidhi, 1998).

Despite the fact that a Muslim must put his trust to Allah (s.w.t), the hadith proves that a Muslim should not be passive and fatalistic. The hadith does not only illustrate how a Muslim should deal with his fate, but it also instructs to manage the risk of calamities and losses. It is worth mentioning that risk management is not against the concept of tawakkul (trust in Allah). Tawakkul is to choose appropriate means toward achieving the goals first, then entrusting Allah for the better result (Usmani M. T., 1999).

It is also narrated by Anas bin Malik that the Prophet (p.b.u.h.) said:

"The money of the orphans, so it will not be eaten (decreased) by zakah” (Malik, 2004).

In this hadith the Prophet (p.b.u.h.) encourages the trustee on behalf of orphans to invest the wealth in a business that will yield a positive return. This is to avoid the risk of decrease in the wealth due to payment of zakah portion. One of the clear examples of risk management could be the business of Abbas ibn Abdul Mutallib (may Allah be pleased with him) as narrated by his son:

"Whenever Abbas ibn Abdul Mutallib (may Allah be pleased with him) handed over his assets [camels] for mudarabah to his partner, he stipulated that he should not take the assets across the sea, nor take them down to the bottom of a dry river bed, nor trade them for live animals. If he were to do any of these, he would have to bear the compensation. Word of al-Abbas stipulation reached Rasulullah (p.b.u.h.) and he allowed it" (Al-Daraquanti, 2004).

This hadith permits stipulating conditions in mudarabah business in order to prevent exposure to undue risks. Apart from that, this hadith also became as foundation for the ruling of restricted mudarabah where capital provider can put forward some restrictions on management where to invest the fund.

Risk in economics represents the probable loss of wealth, thereafter it is not desirable in itself. Nonetheless, risk is essential in economic activities and must be taken to create wealth and value. The presence of higher risk opens a higher opportunity for profit and reward. Though risk management is important, it is also argued that risk should not be eliminated in total by transferring to other contracting parties as it leads to injustice and unfairness. It is argued that obtaining profit without assuming business risk is not allowed. Total elimination of risk in financial transaction, which is ‘zero risk’ may result any income derived becomes illegitimate. The following subtopic of this paper will further discuss the principle of risk taking in financial transaction from the Shari’ah perspective and its connection with profit justification.

2. Risk Taking and Risk Sharing: Reconciliation

The notion of risk taking is an essential and a core principle in Islamic financial transactions. The principle of risk taking connotes that the contracting parties that are involved in a commercial transaction bear the fundamental business risk and liability. Risk taking principle is based on the principle of liability which outlines the legitimacy of receiving profit. It is derived from a fundamental legal maxim:

العلم بالغمر

"(Entitlement to) profit is accompanied by responsibility (for associated expenses and possible loss)”.

The profit is only legitimate if it assumes a proportionate risk and should not be created from risk free contract. The profit is acceptable if it is on the basis of taking liability and responsibility of bearing risk of loss. Any transaction must be based on risk and liability for justifying the return generated out of business effort, labour, skill and financial capital. There are three factors that justify the earned return. First, trading and entrepreneurial activities and utilisation of one’s asset. Second, effort and work taken for the transaction. And third, risks and liabilities assumed through possession as derived from the following fundamental legal maxim:

يستحق الربح اما بالمال اما بالعمل اما بالضمان.

"Profit is entitled for the (risk of) ownership, the (risk of) effort and (risk of) liability/responsibility”.

For instance, an investor who advances his capital to an entrepreneur based on trust to be invested in a business or investment activity becomes capital holder eventually sharing the investment risk and profit. In the event the investment generates income, the contracting parties enjoy the profit. However, when the enterprise suffers the loss, it is shared equitably (not equally) among
the contracting parties. Hence, the income generated is regarded as just and fair due to the risks that are borne by the contracting parties. Each party of the contract deserves to receive the equitable return, justifiable distribution and fair reward out of the risk that they assume.

The previous discussion on risk management concludes that Islam highly suggest management and minimisation of risk. However, in the discussion of principle of risk taking, it is found that there are some risks that must be borne and cannot be totally eliminated. Some risks are inherent in a business and become requirements of a contract. In this case the absence of such risks causes the contract to be void. For instance, in the case of musharakah, any stipulation that one partner has to guarantee the capital in the event of loss means that one partner transfer risk to another, which is similar to riba. In instance where riba occurs in a loan transaction, the lender does not bear any business risk while obtaining interest from the borrower no matter whether the borrower makes a profit or suffers a loss. Islam encourages managing risks, but it does not allow transferring the risk to other parties as it brings harm and create injustice.

According to International Shariah Research Academy for Islamic Finance (2012), Islam condemns two extremes behaviour related with risk, which are opposite to one another. The first extreme behaviour is total avoidance of risk such as in case of riba, whereby the lender making money without bearing business risk. The second extreme behaviour is extensive risk taking such as in case of maysin (gambling). Islam also prohibits transactions that involve elements of gharar fahish (excessive uncertainty about the commodity) and ghish (cheating).

The above-mentioned elements may invalidate the transaction. Therefore, it is important to understand what types of risks can be avoided and to what extent risks can be minimised. In line with the above discussion, Hassan (2009) identifies three types of risks from the Islamic perspective:

I. Essential risk

The essential risk is inherent in all business transactions. This business risk is necessary and must be undertaken to reap the associated reward or profit. Ibn Taymiyyah says:

“Risk falls into two categories commercial risk, where one would buy a commodity in order to sell it for profit, and rely on Allah for that. This risk is necessary for merchants, and although one might occasionally lose, but this is the nature of commerce. The other type of risk is that of gambling, which implies eating wealth for nothing (أكل المال بالباطل), This is what Allah and His Messenger (p.b.u.h) prohibited” (Ibn Taymiyyah, 1996).

Two legal maxims are associating returns to essential risks form the basis of Islamic economic transactions. The first maxim states “الغنم بالغرم”, “entitlement to profit is accompanied by responsibility for attendant expenses and possible loss” (Tyser, Demetriades, & Effendi, 2000). This maxim attaches the ‘entitlement of gain’ to the ‘responsibility of loss’. For instance, in a sale contract, before selling the commodity the owner has to bear all types of risks associated with the commodity. This risk will be transferred to the buyer when he will possess the commodity in the form of complete ownership. One of the basic requirements of a sale contract is transfer of complete ownership (milikiyah tammah), which cannot be acquired without transferring risks and liabilities. Any condition that effects the transfer of risks and responsibilities will result in the contract becoming unlawful. Furthermore, the aforesaid maxim is usually used to propose the preference for profit-and-loss-sharing (PLS) financing instruments like musharakah and mudarabah (International Shariah Research Academy for Islamic Finance, 2012).

The second maxim is derived from the Prophetic saying “[Entitlement to] profit is dependent on responsibility [for attendant expenses and possible loss and defects]” (Tyser, Demetriades, & Effendi, 2000). The maxim asserts that the party enjoying the full benefit of an asset should bear the risks of ownership of that asset. However, linking returns to risks of ownership does not necessarily relates to PLS contracts. The principle points out the risks related to ownership associated with sale and leasing transactions. For instance, the implication for a sale-based transaction is that the seller must bear all the risks associated with the object of the sale while concluding the contract and in a leasing contract, the lessor should be responsible for the asset leased out during the time of contract.

II. Forbidden risk

The second type of risk is the prohibited risk in the form of excessive gharar. Gharar is usually translated as uncertainty, risk or hazard, but it also implies ignorance, gambling, cheating and fraud (Al-Suwailim, 2006). Generally, gharar relates to the ambiguity and/or ignorance of either in the terms of the contract or in the object of the contract. Thus, a sale can be void due to gharar, due to risks of existence and taking possession of the object of sale on one hand, and uncertainty of the quantity, quality, price and time of payment on the other (Dusuki & Mokhtar, 2010). Thus, transactions having gambling-like features are forbidden due to excessive gharar. Jurists classify a number of aspects in which excessive gharar may occur:

- Risk or uncertainty associated with time of payment (غرر في الاجل) – for instance, unconfirmed date of payment in the case of a deferred sale (Al-Kasani, 2003).
- Risk or Uncertainty associated with existence of commodity (غرر في الوجود) – for instance, trading of an item that does not exist (Al-Kasani, 2003).
• Risk or Uncertainty associated with quality of commodity (غرر في الصنعة) – for instance, ambiguity happens in the specifications and features of the goods (Al-Sarakhsi, 1993).
• Risk or Uncertainty associated with quantity of commodity (غرر في المقدار) – for instance, selling something without specifying the price or quantity of the goods (Ibn Abidin, 1992).
• Uncertainty associated with possession of commodity (غرر في الحصول) – for instance, trading of birds in the sky or fish in the sea (Ibn Muflih, 1997).

III. Tolerable risk to be avoided

The final type of risk identified by Hassan is the permissible risk that does not fall in the above two categories. It includes the types of risk that are inevitable, insignificant and unintentional. Exposing to excessive risk not only hinders investment but also deters economic growth, which might be against the maqasid al-Shari’ah. Examples of these risks can be operational risks, liquidity risks, credit risk (Al-Suwailem, 2006).

Based on the above discussion, it is permissible from Shari’ah perspective to manage or minimise tolerable risk through a hedging strategy. According to Hassan (2009) an Islamic hedging approach toward risk management must fulfil the following conditions:

• The strategy adopted to manage tolerable risk must not contravene with Shari’ah principle of ‘al-ghurm bi al-ghurm’.
• The approach must be free from the elements of excessive gharar.
• The underlying contract must be based on Shari’ah principles.

Al-Suwailem (2006) adds one important condition that an Islamic hedging instrument must be free of zero-sum game features, where the net change of a wealth or benefit is equal to zero. In other words it is not allowed from Shari’ah perspective to use hedging tool in a financial transaction when gain of one party is equivalent to another’s loss, because it leads to “eating of wealth without any justification”.

Conclusion

The scope of this study was confined to structure a conceptual Shari’ah framework for risk management in Islamic Finance. In Islamic financial transaction the concept of risk management is based on the objective of Shari’ah, i.e. protection of wealth. This is to uphold the well-being of humanity and universal prosperity. Shari’ah promotes principle of justice and fairness in financial dealings and bans any acts that bring harm to any party. In this regard, Shari’ah condemns risk that brings harm and dangers to the society by prohibiting activities that involves elements of excessive risk such as zero-sum game. It also stresses the importance of transparency in business dealings and prohibits any elements of uncertainty and misrepresentation. The existence of those elements will invalidate the financial transaction. Those elements are condemned as they expose the contracting parties to manipulation and injustice. It implies consumption of wealth of other’s wrongfully.

With regard to essential and tolerable risk, Islam highly stresses on the importance of managing and minimising risk efficiently. The profound risk management is needed to maintain business stability and economic health. However, there are parameters that must be observed in managing the risk. The risks can be minimised but they cannot be totally eliminated. Total avoidance of essential risk is prohibited because it means the risk is shifted to the other contracting counterparty. It eventually results in injustice to that particular party. Any stipulations that change the nature of financial contracts to be free from essential risks make them fictitious. Any return derived from this activity is deemed to be a consumption of other’s wealth in wrongful manner, as the case of conventional loan contract.

The core objective of this study was to classify financial risk for the purpose of risk management from an Islamic perspective. We can conclude that treatment of risk in Islamic commercial law is unique. It is very much dependant on the type of risk respectively, i.e. forbidden risk, essential risk and tolerable risk. There are few risks that must be avoided, certain risks that cannot be removed and others that can be minimised. Having comprehension on the classification of risks is important to realise that concepts of risk management and risk taking are actually not in conflict. Both concepts are congruent and consistent in their objective, which is to protect the wealth and to ensure justice and fairness to all contracting parties in their financial dealings. Therefore, this study suggests policy makers and Shari’ah advisors of IFIs to structure hedging tools only for the purpose of mitigating tolerable risk not eliminating the essential business risk.

References


