The Shariah Advisory Council of Bank Negara Malaysia (SAC) Ruling on Anticipatory Hedging

234th SAC Meeting dated 25 September 2023

Part I: SAC Ruling, Its Effective Date and Applicability

The SAC recognised that anticipatory hedging is a practice to mitigate risk exposure from projected or anticipated transactions based on previous track record and/or relevant documents. Pursuant to section 52 of the Central Bank of Malaysia Act 2009, the SAC ruled that anticipatory hedging is allowed based on the high probability that the actual exposure will materialise at a future time. The allowable application of anticipatory hedging is limited to managing risk exposures. Any elements of gambling, speculation, and significant ambiguity (*gharar fahish*) must be avoided.

1.1. This ruling is effective on its publication date on the Bank Negara Malaysia's website and is applicable to the following Islamic financial institutions (IFIs):

(a) licensed IFIs under the Islamic Financial Services Act 2013 (IFSA);
(b) licensed banks and licensed investment banks approved under section 15(1) of the Financial Services Act 2013 (FSA) to carry on Islamic banking business; and
(c) prescribed institutions approved under section 33B(1) of the Development Financial Institutions Act 2002 (DFIA) to carry on Islamic financial business.

1.2. In line with sections 28(1) and (2) IFSA and sections 33D(1) and (2) DFIA, as the case may be, IFIs are required to comply with this ruling as compliance with any ruling of the SAC in respect of any particular aim and operation, business, affair or activity of the IFIs shall be deemed to be in compliance with Shariah.

Part II: Background

2.1. As part of industry initiative to enhance secondary market activity of interbank Islamic derivative transactions and grow the Islamic financial market, the industry has proposed to expand the application of hedging to include anticipatory hedging which will allow IFIs to hedge projected exposures. Therefore, clarity is needed on the permissibility of anticipatory hedging application from Shariah perspective to help boost the market activities.

2.2. Hedging[1] or firm hedging in finance involves using market instruments to offset risks in investments and liabilities. The instruments used for hedging are derivatives. Thus, to hedge investments means strategically using instruments, such as derivatives, to offset the risk of any adverse price movements.[2] Anticipatory hedging, on the other hand, is a transaction aimed at hedging against risks from a projected future transaction.

[1] For the purpose of this statement, hedging will be referred to as "firm hedging" to differentiate its nature from anticipatory hedging.
[2] The International Shari'ah Research Academy for Islamic Finance (ISRA), *Islamic Capital Markets: Principles and Practices* (2nd Edition), 2023, p. 756.

2.3. Use cases of anticipatory hedging in Islamic financial business are as follows:

i) Hedging the exposures arising from repetitive business/client activities
Example: an importer typically purchases USD 10 million worth of raw materials on quarterly basis and invoices are also issued on a quarterly basis. When the market level and budgeted spot rate are right, the importer wishes to lock in the cost of imported materials for the whole year to ensure his cost of final goods and final price to clients are not negatively impacted. Hedging for the import of raw materials for the 2nd until 4th quarter are therefore anticipatory for the importer's normal course of business since the documentation is not yet available at the inception of the hedging transaction.

ii) Hedging the exposure of profit rate risk from an anticipated transaction
Example: a foreign currency floating rate financing has been finalised but pending final documentation and drawdown. However, the customer wishes to lock in the fixed price of his financing to provide better cash flow planning as the level is within his budgeted rate. A Cross Currency Profit Rate Swap (CCPRS) can be entered into prior to financing disbursement and finalisation of all relevant documentations.

iii) Pre-hedge the transaction due to size or market constraints
Example: a large disbursement of a financing facility is to take place soon and the customer wishes to hedge the profit rate risk. The IFIs may need to pre-hedge the transaction because the exposure is too big for market to absorb at one time, hence the need to responsibly execute the transaction over a period of time to obtain best pricing for the customer and to manage the large exposure risk effectively.

2.4. In general, anticipatory hedging applies the same Shariah principles as firm hedging namely promise (*wa`d*), bilateral promise (*muwa`adah*), currency exchange (*bai` al-sarf*) and *tawarruq*. The applicability of these Shariah principles for various hedging instruments were deliberated and approved by the SAC.

2.5. The scope of this proposal covers the application of anticipatory hedging for foreign exchange and other derivatives which may involve underlying exposures such as foreign currency exchange (FX), profit rates, commodities and any other hedgeable exposures.

Shariah issue

2.6. The SAC discussed the key Shariah considerations on permissibility of anticipatory hedging particularly on whether the implementation of anticipatory hedging may give rise to the issue of gambling, speculation and significant ambiguity in its application.

Part III: Key Discussion

Ensuring Shariah compliance in the application of anticipatory hedging: avoidance of gambling, speculation and significant ambiguity

3.1. Based on the above explanation and use cases, exposures involved in anticipatory hedging may be considered as an actual risk if the amount of transaction is justifiable, quantifiable and the timing of payment can be ascertained.

3.2. Preventive measures are important to avoid any element of gambling, speculation, and significant ambiguity in a hedging transaction. Based on the presentation by the industry, the following measures may be undertaken by the management of IFIs prior to the implementation of anticipatory hedging:

i) Implementing a robust Know-Your-Customer (KYC) practice and customer due diligence to understand clients' conduct of business and typical repetitive exposures;
ii) Pre-determining anticipatory hedging ratio to avoid over-hedging. In this regard, the hedging ratio should be less than the total expected exposure. In determining the hedging ratio, IFIs may take into consideration several factors including prevailing market condition and probability of impending underlying transaction;
iii) Establishing parameters in ensuring the probability of the transaction materialising e.g. timing, exposure amount, cashflow cycle etc.;
iv) Establishing risk control limits such as open position and tenure limits; and
v) Establishing a mechanism to monitor the hedges in the following manners, including but not limited to:
    a) unwinding any anticipatory hedges in the event of order cancellation or not meeting requirements (supported by evidence);
    b) any termination is accompanied by client declaration with a solid justification; and
    c) conducting a post-deal ad hoc periodic check.

3.3. If the anticipated or underlying exposure ceases to exist, it is mandatory to cancel the hedging transaction. Upon cancellation, mark-to-market (MTM) valuation may be performed as per the documentation agreed upon by the contracting parties.

3.4. To ensure high standards of integrity, market conduct and fair dealing, Bank Negara Malaysia as the authority may determine the appropriate regulatory policy or guideline on the implementation of anticipatory hedging within the Islamic finance industry in Malaysia.

Rules of Firm Hedging Applicable to Anticipatory Hedging

3.5. *Wa`d* serves as the main Shariah principle for structuring derivative instruments in the industry.

3.6. For derivative instruments related to foreign exchange, *Wa`d* Policy Document stipulates that the arrangement of *wa`d* and *muwa`adah* shall only be structured for the purpose of hedging.[3]

[3] The permissibility of the application of *wa`d* and *muwa`adah* in *bai` al-sarf* transaction is based on the justification that they are not tantamount to a contract since the contract is yet to be entered into during the *wa`d* or *muwa`adah* period.

3.7. Given that anticipatory hedging also applies *wa`d* as the main underlying Shariah principle, and the consistency in terms of its objective and characteristic with the firm hedging, particularly in managing risk exposure, any SAC ruling regarding hedging practices is also applicable to anticipatory hedging.

Part IV: Basis of Ruling

The anticipatory hedging transaction is concluded based on mutual agreement of the contracting parties

4.1. The nature of the transaction is based on the principle of mutual agreement *(taradhi).* In this context, both parties must have a mutual understanding on the requirements of the anticipatory hedging and the consequences of the transaction. This is in line with the following *fiqh* maxim:

المواعيد بصور التعاليق تكون لازمة[4]

"Conditional promises are binding."

4.2. Such approach is also consistent with the following *fiqh* maxim:

الأصل رضا المتعاقدين ونتيجته ما التزماه بالتعاقد[5]

"The original ruling for a contract is the consent of the contracting parties and its effect is based on what have become the rights and duties as agreed in the contract."

The permissibility of the anticipatory hedging is based on the high probability that the transaction will materialise in the future

4.3. The implementation of anticipatory hedging to reduce risk exposure is based on customers' recurring and projected transactions (supported by historical information, previous financial track records or relevant documents), thus indicating the certainty and high probability of future exposure to materialise.

4.4. The permissibility to apply the principle of high probability in Islamic finance is based on the following *fiqh* maxims:

الظن الغالب يُنزل منزلة اليقين[6]

"High probability is considered to have reached the level of certainty."

العبرة للغالب الشائع لا للنادر[7]

"Consideration is based on the prevailing practice and not on the isolated cases."

[4] Muhammad Mustafa al-Zuhaily, *al-Qawaid al-Fiqhiyyah wa Tatbiqatuha fi al-Mazahib al-Arba`ah,* Dar al-Fikr, 2006, v. 1, p. 533.
[5] Ahmad al-Zarqa', *Sharh al-Qawa`id al-Fiqhiyyah*, Dar al-Qalam, 1989, p. 482.
[6] Ali Haidar, *Durar al-Hukkam fi Sharh Majallah al-Ahkam*, Dar al-Jayl, 1991, v. 1, p. 22.
[7] Ahmad al-Zarqa', *Sharh al-Qawa`id al-Fiqhiyyah*, Dar al-Qalam, 1989, p. 235.

4.5. The anticipatory hedging has similarity with the firm hedging in terms of the high probability of the exposure to be materialised in the future and the Shariah contract applied in the transaction. Thus, the principle of similarities takes the same ruling can be applied for anticipatory hedging's implementation. This is based on the following *fiqh* maxim:

ما قارب الشيء يعطى حكمه[8]

"Whatever resembles something it would take the same ruling."

Part V: Implication of the SAC Ruling

5.1. The SAC Ruling provides clarity on the key Shariah considerations that must be fulfilled by IFIs that wish to offer anticipatory hedging. The considerations as set out in Part I of this Shariah Ruling will ensure an end-to-end Shariah-compliant for the transaction.

[8] Ali Ahmad al-Nadwi, *Jamharah al-Qawa`id al-Fiqhiyyah fi al-Mu`amalat al-Maliyyah*, 2000, v. 1, p. 468.