

Innovative Islamic Hedging Products: Application of *Wa'd* in Malaysian Banks

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Abstract: The principle of *wa'd* or promise can be used to structure innovative *shari'ah* compliant hedging instruments. Conventional hedging products such as forward currency contracts and currency swaps are prohibited in Islamic finance principally due to the issue of *ri'ba* and to the violation of *bay al-sarf* rule which requires currency trading to be done on 'spot' basis only. The usage of *wa'd* has grown rapidly in recent years since it offers great flexibility and many of the world's first *shari'ah* compliant derivatives such as Islamic cross currency swaps and Islamic profit rate swaps have been developed by Malaysian banks using *wa'd*. This paper discusses and examines *wa'd* applications in seven selected Malaysian Islamic banks, specifically in its application as an Islamic hedging instrument. Based on a survey of the banks' official information disclosed to the public, the finding of this research indicates that all Islamic banks under study have used *wa'd* in structuring their Islamic hedging products. This paper represents a preliminary study of *wa'd* applications in the Malaysian banks; it shows that *wa'd* is a flexible mechanism and has the prospect of playing a vital role in facilitating Islamic financial institutions manage their business risks and liquidity effectively.

Keywords: Islamic hedging; *wa'd*, *shari'ah* compliant, Malaysia

JEL classification: F31, G20, P45

1. Introduction

Today, the Islamic finance industry is capable of providing complete banking solutions in fulfilling people's needs. For instance, the Islamic financial institutions in countries like Malaysia, Pakistan and the Middle East have successfully introduced and in some market segments replaced conventional home financing and conventional insurance with Islamic home financing and *takaful*. The industry has also introduced *sukuk* as an alternative to the conventional bond. Despite the tremendous growth in Islamic product development, the industry still lacks the availability and an array of choices for hedging mechanisms to mitigate risks faced by investors and people in business. The conventional derivatives

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used in hedging is prohibited since Islamic investors and Islamic financial institutions are not allowed to enter into forward currency contracts that involve the *ri'ba* element.

Traditionally, hedging is considered important in order to improve investor confidence in participating in international trade. As international trade involves the use of foreign currencies, people in business are exposed to foreign currency risks. Past decades have been associated with high volatility in foreign and domestic currency values across the world, leading at times (especially in 1998 and towards end of the last century) to severe currency crises in many countries. To improve business confidence, a good hedging mechanism is required to reduce the risks of currency exposure.

As Islamic finance grows, so has the need for hedging mechanisms since Islamic investors are also exposed to similar kinds of global risks including foreign currency risks. The use of conventional products for hedging has been controversial and most Islamic scholars consider them to be non *shari'ah* compliant for various reasons. The products which are financial derivatives have also been largely used for speculative purposes to gain profit rather than for hedging. The excessive use of these derivatives in recent years has in fact drawn much criticism not only by academics and *shari'ah* scholars but also among practitioners themselves because they contribute to financial market instability and lead to crises (Chapra 2008; Ahmed Habib 2009; Hassan 2009).

Does the Islamic finance industry need similar alternatives for hedging? Should Islamic products be structured so that the principle of minimising risks or hedging be embedded in product structuring so that separate products for hedging are not necessary? After all Islamic products are supposed to be free from interest rates and therefore 'theoretically' are not susceptible to changes and volatility in interest rates, thus reducing the need for hedging. This in itself can be a point of contention. However, in this paper, we argue that under current circumstances, appropriate instruments to manage risks which are in compliance with *shari'ah* principles are still crucial. Competing side by side with conventional finance, and facing similar global economic and financial uncertainties and risks, the Islamic finance industry's search for Islamic solutions to meet changing market needs must be a constant undertaking.

The objective of this study is to examine the principle of *wa'd* and the permissibility of structuring hedging products based on this principle. The paper also explores the application of *wa'd* as a form of hedging mechanism among Islamic banks in Malaysia. Through our preliminary search, we identified seven banks which are currently using *wa'd* as a hedging tool in Malaysia and they are CIMB Islamic, Bank Islam Malaysia, Bank Muamalat, Kuwait Finance House, RHB Islamic Bank, Standard Chartered Saadiq Bank, and Deutsche Bank Malaysia. The first part of this paper discusses the literature review on theory and application of *wa'd* in Islamic finance. This is followed by a discussion on the need for *shari'ah* compliant hedging mechanisms to meet the current needs of the market with a focus on the use of *wa'd* as a tool for hedging. The last part of the paper examines the use of *wa'd* in the Malaysian Islamic banks.

2. *Wa'd*: Theory and Application

The term *wa'd* which is also known as unilateral promise refers to a commitment made by one person to another to undertake a certain action or verbal disposal beneficial to the other party. Lehman and Phelps (2005) in the West's Encyclopedia of American Law (2008) define

the unilateral promise as a contract in which only one party makes an expressed promise, or undertakes a performance without first securing a reciprocal agreement from the other party. Many of the scholars believe that fulfilling a promise is a noble quality and its breach is reproachable in Islam. According to Mohamad Akram (2009), *wa'd* is a promise which affirms the positive meaning and negative meaning. But if the promise is to do something evil, then it is not obligatory to fulfil it.

Abu Ghuddah and Abdul Sattar (2006) differentiate between *wa'd* and *muwa'dah*. According to them, *muwa'adah* which is also known as bilateral promise refers to two reciprocal promises in which two parties agree to do the same acts. A simple example for *muwa'adah* is, a promise to sell a car to B and B promises to buy the car from A. The resolution of the Fiqh Academy of Jeddah (2006) decided that a bilateral promise, if binding on both parties is not allowed. With the definition of *muwa'adah*, AAOIFI (2008) ruled that binding *muwa'adah* is regarded as a contract. Even though *muwa'adah* is claimed as similar to a contract, Shamsiah and Rusnah (2009) opined that *muwa'adah* should not be deemed as a contract because it is only a bilateral promise to execute an agreement on a future date. However, all scholars agree that *wa'd* is different from a contract because in the case of a contract, both of the contracting parties are obliged to do or to deliver something to each other.

A promise is regarded seriously in Islam for fulfilling a promise is one of the characteristics of a true believer and a person who breaks his promise is considered as a *munafiq* or a hypocrite, "Four qualities denote a hypocrite: when he talks he lies; his promise he does not keep; his covenant he betrays; and when he argues he exceeds the limit" (Al-Bukhari, *Sahih Bukhari*, Kitab al-Iman). Allah S.W.T. has repeated the word *wa'd* more than 150 times in al-Qur'an to show its significance (Qarrah Daghi 2002).

Allah SWT said: يَا أَيُّهَا الَّذِينَ آمَنُوا أَوْفُوا بِالْعُقُودِ Meaning: "O you who believe, fulfil your promise" (al-Qur'an, al-Maidah: 1). This verse shows that Islam gives an order to fulfil the promise. Though Islam gives high emphasis to fulfilling a promise, jurists have different views as to whether the fulfilment of *wa'd* is legally binding. Scholars took three positions on this: (1) fulfilling a promise is praiseworthy but not obligatory; (2) fulfilling a promise is always obligatory; and (3) fulfilling a promise is basically obligatory but with conditions and exceptions (Mohammad Akram 2009). Hence, as a general principle, *wa'd* must be fulfilled for religious reasons only since it only creates moral obligation but cannot be enforced by the courts of law. Nevertheless, in the case the promisor may cause the promisee to incur some expenses or undertake some labour or liability on the basis of the promise, it is mandatory on the promisor to fulfil his promise for which he may be compelled by the courts.

The principle of *wa'd* has been practised in Islamic finance industry since its early days in the 1990s, but then the practice was concentrated on *murabahah* to purchase orderer (*murabahah lil amr bi al-syira'*). Later, the application of *wa'd* was extended to other financing and investment facilities which are structured based on sale (*bay'*), leasing (*ijarah*) and partnership (*syirkah*). The purpose of using *wa'd* in those contracts is mainly to ensure continuous *shari'ah* compliancy in every stage of the transaction, particularly to avoid the formation of two contracts in one or conditional contract which is impermissible in Islam (Nurdianawati 2008). In Islamic financing documents, *wa'd* is applied in a

supplementary document to the master agreement, or is commonly known as purchase undertaking.

According to Parker (2010), the concept of *wa'd* has gained prominence over the last few years as the Islamic finance industry has sought to innovate derivative products and in the context of proliferation of the global *sukuk* market, it is a very useful and flexible tool in structuring *shari'ah* compliant transactions. *Wa'd* also plays an important role in showing the parties' commitment to complete the transaction according to their ultimate intentions. *Wa'd mulzim* which is also known as binding unilateral promise has been structured to protect the interest of financial institutions, in which customers undertake to buy the leased asset in the event of default and extensive total loss of the asset.

The concept of *wa'd mulzim* has been applied in many Islamic banking products which are based on sale, leasing and partnership contracts. For example, in the contract of *murabahah* to purchase orderer, the customer will give his *wa'd* to purchase the asset that he has requested the bank to purchase from the supplier. The *wa'd* shall be separately executed prior to the execution of the *murabahah* contract. During the purchase requisition, the purchase order application shall contain the promise which must be duly signed by the purchase orderer. The bank will buy the asset from the supplier and sell it to the customer at a premium, typically payable in instalments. The premium is generally based on a benchmark rate, such as LIBOR, plus a margin, thus giving rise to the needs to hedge fluctuations in such a benchmark. In this situation, the customer has to fulfil his *wa'd* because the bank will have to incur some costs during purchasing of the asset as ordered by the customer. If the customer refuses to fulfil his *wa'd*, then he is liable for breach of *wa'd* and shall compensate for related actual costs incurred by the bank.

The principle of *wa'd* also has been used in the contract of *ijarah muntahia bi-tamleek* whereby the bank or customer makes a promise with the other party to sell or purchase the asset at the end of the lease period or transfer the ownership to the customer through gift (*hibah*) or sale of the leased asset (Muhammad Ayub 2007). The ownership of the leased asset shall be transferred to the lessee upon execution of a sale contract of the leased asset as stated in *wa'd* by the *lessor* at a mutually agreed consideration to be executed at the end of the lease period or at any time during the lease period. The *wa'd* by the lessee to lease the asset from the bank upon the latter's acquisition of the asset shall be binding on the lessee and shall be separately executed prior to the execution of the *ijarah* contract. The bank may require the customer to pay a security deposit as a guarantee which protects the bank from the risk of the customer not fulfilling the unilateral *wa'd* to lease the asset upon purchase by bank. If the customer breaks the *wa'd*, the bank may set-off the actual loss from the amount of security deposit. In a situation where there is no breach of promise, the security deposit may become part of the rental payment of the leased asset.

Apart from that, the *wa'd* can also become an alternative to the conventional put and call option. In order to disclose the element of *wa'd mulzim*, a purchase undertaking can replace the conventional put option while a sale undertaking can replace the conventional call option. Besides, *wa'd* is also applied in the disposal of goods purchased through *salam*. After executing the *salam* sale, a trader will give *wa'd* to the bank that he will buy the asset on stipulated terms and conditions. The bank also takes the *wa'd* from his customer to sell the bank's *salam* asset when received from his agent at any given price (Muhammad Ayub 2007). In the contract of diminishing *muharakah*, the customer uses *wa'd* to redeem

the bank's investment by purchasing the bank's share periodically. For redeemable preference shares (RPS), the ruling was made on the basis that the application to buy back is in diminishing *musharakah*. In order to conform with the *shari'ah* principles, the purchase price set at the time of issuance must be based on the principle of *wa'd*, in which the issuer promises to buy back the preference shares from the shareholders at a future date based on the purchase price promised at the date of issuance (Securities Commission of Malaysia 2006).

In addition, *wa'd* is adopted as an exit mechanism or *takharuj* of financing or investment. For instance, in the issue of *sukuk al-musharakah* by Sharjah Islamic Bank (SIB) a GCC institution, *wa'd* has been applied to redeem the *sukuk* on the final maturity, in which the issuer gives *wa'd* to buy the portion of the *sukuk* holders as *musharakah*, and the *wa'd* is binding only on the issuer. Similarly, *wa'd* also has been applied in *sukuk mudarabah* as a mechanism that allows the financier to complete the financing and exit from the financing. The *mudarib* will give *wa'd* to buy the *mudarabah* assets when the agreed situation occurs. Then, the financier also agrees to sell the *mudarabah* assets to the party if the conditions that were agreed upon actually prevail (Ahmad Suhaimi 2008). This means that *wa'd* is used as a guarantee to investors to receive an amount equal to their initial investment when their *sukuk* is redeemed. This also portrays that *wa'd* is very useful as an exit mechanism particularly in redeeming *sukuk* at maturity. All of the above-mentioned use of *wa'd* depict that the practice of *wa'd* has become widespread since almost all the contracts offered by Islamic banks in Malaysia adopt *wa'd* principles to facilitate their operations.

3. The Importance of Islamic Hedging Mechanism

Islamic hedging can be denoted as mitigating and minimising exposure to risk to protect real business activities using mechanisms which are consistent with *shari'ah* principles. Hedging with the aim to reduce and mitigate risk plays an important role in the Islamic finance industry as it protects the value of current or anticipated cash market or off-balance sheet positions from adverse changes in the exchange rate. With Islamic hedging mechanisms, any changes in the exchange rate would not give additional liability or reduce profit to the institutions or companies. Hedging is an important risk management tool for a wide range of interested parties including fund managers, corporate treasurers, individual businesses, portfolio managers, pension fund managers, and bank managers. Hedging is also needed for importers to hedge account payables and exporters to hedge account receivables which are denominated in foreign currency.

Thus, the Islamic hedging mechanism is vital in the Islamic finance industry in order to improve investor confidence in conducting cross-border business activities. By its nature, the hedging process is closely related to the financial derivatives market (Saadiah and Tabatabaei 2008). Financial derivatives are commonly regarded as one of the useful tools of risk management and are frequently used to reduce risks associated with movements in price and currency risk. Derivatives offer a variety of financial benefits and can act as insurance against commodity price fluctuations with the least cost. Moreover, the use of derivatives allows participants to realise economic gains from risk variability and to achieve price efficiency through hedging and low cost arbitrage opportunities. Hedging instruments such as swaps are perceived as more effective mechanisms to mitigate certain types of risks, which otherwise cannot be efficiently managed using other natural risk management

strategies like diversification and concentration (Asyraf Wajdi Dusuki 2009b). This shows that without having a proper risk management mechanism and hedging tools, even when a company makes profit in its investment, it could actually be making losses due to uncontrolled exposure to currency and exchange rate risk. Thus, derivatives can provide an opportunity for companies to focus on their core business without having to worry about price movements in the market (Hance 2008).

Though derivatives can mitigate risks effectively, its use is highly controversial from the Islamic perspective as it is speculative in nature. According to Obaidullah (1998), derivatives are independent contracts and may not be suitable forms of hedging for managing risk since they can be used for speculating on price movements that can generate an unearned income. In this contract, both counter values which are the good's payment and delivery are deferred to a future date. When both price and delivery are deferred, this falls under the category of selling a debt against a debt (*bay al-kali bi al-kali*) which is prohibited in Islam. This means that when an individual sells a commodity in the futures market, it is promised that the commodity will be delivered at a later date. Similarly, when the price is also deferred, then it makes the transaction into an exchange of debt for a debt. The commodity remains a debt which the seller owes to the purchaser whilst the price remains a debt upon the buyer. Exchanging a debt for a debt is not permissible in *shari'ah* based on a hadith narrated by Abdullah ibn Umar that : "the Messenger of Allah (S.A.W) prohibited the selling of a debt in return for a debt (*bay al-kali bi al-kali*)" j (al-Bayhaqi, Sunan Kubra, Sunan Darulqutni, Kitab al-Buyu^c, 3/71).

Forwards, futures and options which are some of the derivative instruments used conventionally contain the element of zero sum game since any changes in the price of the underlying goods means that one party gains and the other party loses. This is similar to misappropriation of the property of others and hence impermissible in Islam (al-Suwailem 2006). Under *shari'ah* principles, the hedging transaction must be strictly linked to underlying transactions and cannot be a transaction that has the sole purpose of making money from money. Usually, the market players enter into a derivatives market with the objective of gaining profit, not to buy, sell and actually take delivery of the commodities, rather to settle the differences of prices only. At times, prior to the specified date of delivery approaching, the commodity is transacted and sold further to another party, and they also sell it further and so on. And when the specified date of delivery appears, each party settles the difference between the buying and selling price, usually before the maturity date. The idea is to gain profit without having to actually take the burden of delivering the commodity.

Meanwhile the use of conventional derivatives such as currency forward and swap contain the element of *ri'ba* and does not apply the rule of *bay' al-sarf* which involves two different currencies to be transacted on a spot basis. *Bay al-Sarf* is a contract of exchange of money for money. This contract is tightly regulated under *Shari'ah* because it can be easily manipulated for the purpose of producing an interest-bearing loan, which is prohibited in Islam.

Ibn Rushd (n.d.) examines the three forms of sale that can arise in a market where goods and money are in existence:

"when two commodities are exchanged, one may serve as a currency and the other as a priced commodity, or both may be currencies. When a currency is exchanged for a currency, the sale is called *sarf*, and when a currency is exchanged for a priced

commodity, the transaction is sale proper (*bay*). This is similar to the sale of a priced commodity for another priced commodity (barter)."

One popular *hadith* of Prophet S.A.W regarding *bay al-sarf* is:

"Gold for gold, silver for silver, wheat for wheat, barley for barley, dates for dates, and salt for salt - like for like, equal for equal, and hand-to-hand; if the commodities differ, then you may sell as you wish, provided that the exchange is hand-to-hand." (Al-Tirmidhi, *Sunan Tirmidhi, Kitab al-Musaqat, Bab al-sarfi wa bay'i al-shahabi bi al-waraq* naqdan).

And in a similar *hadith*, the Prophet peace be upon him said

"Gold for gold, silver for silver, wheat for wheat, barley for barley, dates for dates, and salt for salt - like for like, and hand-to-hand. Whoever pays more or takes more has indulged in *ri'ba*. The taker and the giver are alike [in guilt]." (Muslim, *ibid*; and Musnad Ahmad).

And in another one,

"Do not sell gold for gold except when it is like for like, and do not increase one over the other; do not sell silver for silver except when it is like for like, and do not increase one over the other; and do not sell what is away [from among these] for what is ready." (Bukhari, *Kitab al-Buyu, Bab bay i al-fiddati bi al-fiddah*; also Muslim, Tirmidhi, an Nasa'i and Musnad Ahmad).

The above *hadiths* have been regarded as providing the basis for the requirement that currency trading must be done on a spot basis. To be *shari'ah* compliant, the simple rules of the *shari'ah* compliant model must be followed, in that any contract used must be free from *ri'ba* and excessive *gharar*. The issue of *ri'ba* arises when there is excess (inequality) or a delay in delivery as the case may be in any exchange of two *ribawi* (goods subject to *fiqh* rules on *ri'ba* in sales), items. Or if there is a delay in delivery in any exchange of dissimilar items, e.g., US dollar for ringgit. Since the practice of conventional currency trading and derivative products contradict with the above *hadith*, the conventional currency forward and swap is prohibited in Islam. The currency forward and swap transactions contain the element of *ri'ba* since the parties involved wish to exchange currency sometime in future but the rate is fixed today and therefore the contract is concluded today while the delivery of the currency occurs in the future (Asyraf Wajdi Dusuki 2009b).

While the debate concerning permissibility and usage of derivatives in Islamic finance for hedging purposes is ongoing, the need for hedging itself is not disputed. Islam recognises the concept of hedging and its importance particularly with respect to managing risk to protect wealth. One of the most important objectives of *shari'ah* (popularly known as *Maqasid al-Shari'ah*) is, in fact, to preserve and protect wealth from being exposed to harm and damage or loss. Many Quranic verses and *hadith* of the Prophet Muhammad (peace be upon him) have clearly indicated the importance of taking every strategic measure to curb and minimise anticipated risk that could be a detriment one's property. The jurists of both the past and the present have, however, consistently asserted that the instruments and mechanisms used to manage risk must not in any way violate any *Shari'ah* ruling (Asyraf Wajdi Dusuki 2010).

Islamic hedging mechanisms must be developed, so that risk can be mitigated effectively and at the same time comply to *maqasid al-shari'ah*. This shows that Islamic hedging solutions are an integral part of the risk management tools required by all parties involved, including the Islamic finance industry. Suhaimi Mohd Yusof (2008) states that the challenges faced by the industry is to provide a hedging mechanism that has value added and will give a positive impact on the economy. According to Gassner (2009), what is needed in Islamic finance today are hedging instruments which are at least tied to the real economy. This temporary solution is needed as a basis for producing more competitive and sophisticated hedging instruments which are in line with the *shari'ah*. Hence, instead of using conventional derivative products for hedging purposes, Islamic finance could look deeper into its own contracts. One of the most important principles which can be developed as a hedging tool is *wa'd* which is also known as unilateral undertaking or unilateral promise. *Wa'd* is the most recent and viable concept to be applied in Islamic finance.

4. Application of *Wa'd* in Islamic Hedging Mechanism

Nowadays, the *wa'd* principle is widely adopted in Islamic capital market products as a tool for liquidity payment and hedging purposes. Although *wa'd* is still criticised from a conceptual perspective, in practice this instrument has become a contractual promise as it offers great flexibility. *Wa'd* can be used as a risk mitigation technique to eliminate some unwanted risks such as price risk and exchange rate risk, in the event of default and total loss.

Shari'ah scholars are in agreement that market players are not allowed to enter into a foreign currency contract in which the concurrent possession of counter values by both parties do not take place. However, the *wa'd* principle can be adopted to facilitate *shari'ah* compliant transaction of import and export trading activities. This is because, the importers need to hedge their foreign exchange risk, but since forward contracts of gold, silver or any monetary units are prohibited in Islam, they can hedge against risk using the *wa'd* arrangement without involving the element of *ri'ba*. Thus, the importers or exporters can take foreign currency forward cover for genuine business activities on the basis of *wa'd* and simultaneously exchange the currencies at the agreed time (Muhammad Ayub 2007).

Wa'd which is used in FX option and currency forward aims to hedge uncertain currency cash flow as well as it allows the FX forward profile to be emulated (Hassoune and Carasse 2010). The party may make *wa'd* to buy or sell a particular amount of currency against another currency on a predetermined date and at a predetermined rate. Islamic FX forward refers to an agreement to enter into the exchange of two currencies at a future date with the rates agreed upfront. This contract is important since an importer has the obligation to make payment at a future date in a foreign currency, and is exposed to risks that the foreign currency might appreciate, forcing him to pay more in domestic currency. Similarly an exporter who has receivables at a future date in a foreign currency has risks of losses if the foreign currency depreciates in future as he would receive less in export revenue in domestic currency. Since conventional FX forward involves contract for future sale where both price and delivery are deferred, thus *wa'd* is adopted in Islamic FX forward arrangement. A customer can unilaterally make a promise to purchase a currency, say USD for RM at a future date at a present fixed price. This is in the form of a promise to purchase made by a customer to a bank and the bank will provide an acknowledgement. Then, at maturity, the

customer can make an offer to purchase the currency, for instance, USD for RM on a spot basis at the pre-agreed rate. Thereafter, the bank accepts the customer's offer and the currencies are exchanged. As the transaction is made on a 'spot' basis, this fulfils the *shari'ah* requirement that currency trading is done on spot, the 'promise element' only contains the promise to purchase and also the rate of exchange, that is, the price.

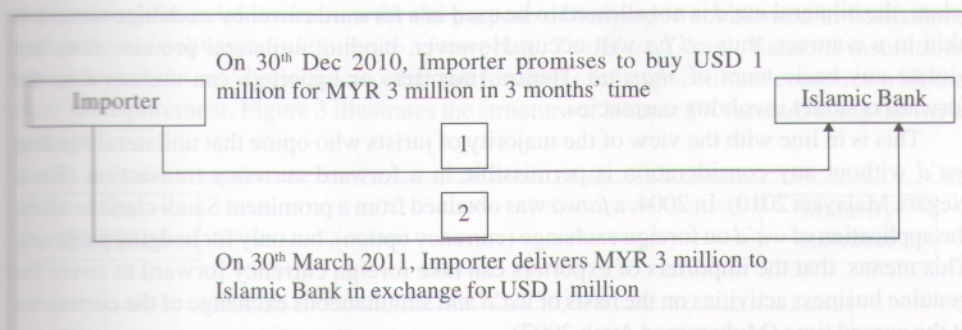


Figure 1. Islamic forward forex using *wa'd*

The illustration on how *wa'd* provides risk management is shown in the Figure 1

In recent years, the *wa'd* principle has been used by Islamic and conventional banks to replicate the conventional option mechanisms and to give investors a return, benchmarked against the performance of certain assets or indices. One of the uses of the *wa'd* concept has been as a 'swap replicator'. To date, there are three main instruments of Islamic swaps in Malaysia, the FX swap, cross currency swap and profit rate swap. Islamic FX swap is a contract that is designed as a hedging mechanism to minimise market participant's exposure to volatility and fluctuations in market currency exchange rates. The swap is a useful instrument that is frequently used to reduce the exposure associated with the variation in yield and currency risk, thereby restructuring the nature of liabilities. The two most popular forms of Islamic FX swaps are *wa'd* and *tawarruq* (Nazneen 2010).

The second type of Islamic swap is the Islamic profit rate swap, where only the cash flow is changed. This cash flow is in the same currency. Therefore, the exchange involved is to change the flow of the fixed profit rate with the flow of the floating profit rate. For example, assuming Company A has bought a building priced at USD100 million using *ijarah* financing. The rental that needs to be paid every half-year is based on LIBOR. Say today's LIBOR rate is 4.50 per cent. Due to the uncertain economy and market conditions, the company is worried that LIBOR will increase and wishes to change the financing based on a floating rental rate into fixed-rate financing. This is to ensure that the operating costs of Company A are controlled. The third type of Islamic swap, which is cross-currency swap is similar to Islamic FX Swap because it too involves dual exchange of foreign currency, at the beginning and at the expiry date (exchange and re-exchange of foreign currency). The difference is that, cross-currency swap not only involves the exchange of capital value at the beginning and at maturity, but also involves an exchange stream of cash flow during that period. Therefore, cross-currency swap usually involves a longer time period compared to FX Swap (Asyraf Wajdi Dusuki 2009b).

According to the *Shari'ah* Advisory Council (SAC) of Bank Negara Malaysia (2010), Islamic financial institutions are allowed to enter into a forward foreign currency transaction for hedging purposes based on *wa'd mulzim* which is binding on the promissory and the compensation for breaching of promise could be implemented. Nevertheless, no fee is allowed to be charged on the promisee because the upfront cash payment for forward currency transaction would lead to a bilateral *wa'd* which is not *shari'ah* compliant. In Islam, the bilateral *wa'd* is not allowed to be used in a forward currency exchange since it is akin to a contract, thus *ri'ba* will occur. However, binding unilateral promise does not violate any basic tenet of *shari'ah*. Hence, importers or exporters can use *wa'd* in the forward contract involving currencies.

This is in line with the view of the majority of jurists who opine that unilateral binding *wa'd* without any consideration is permissible in a forward currency transaction (Bank Negara Malaysia 2010). In 2004, a *fatwa* was obtained from a prominent Saudi cleric to allow the application of *wa'd* on foreign exchange (currency option), but only for hedging purposes. This means that the importers or exporters can take foreign currency forward to cover for genuine business activities on the basis of *wa'd* and simultaneous exchange of the currencies at the agreed time (Muhammad Ayub 2007).

The benefits of using *wa'd* in Islamic FX forward and swaps in fact are easy to understand as its uses and costs are similar to the conventional FX forward and swaps.

The Islamic FX swap based on *wa'd* structure involves exchange of currencies based on the principle of *bay' al-sarf* at the beginning. After that, it involves *wa'd* to carry out another *bay' al-sarf* at a future date based on the rate determined today. At the expiry date, the second *bay' al-sarf* will be implemented to get back to the original currency. Meaning that, at the beginning of the FX swap, the investor can sell USD to the bank on a spot basis to obtain RM. This complies with *bay' al-sarf* principles which require transactions to be done on spot. Thereafter the investor will enter into *wa'd* to enter into a contract of currency exchange based on the principle of *bay' al-sarf* at a future time. The future exchange of currencies will be based on an exchange rate that refers to today's rate. So at the future time, the investor will get back the USD without being exposed to the risks of currency fluctuation. The illustration of the transaction is shown in Figure 2.

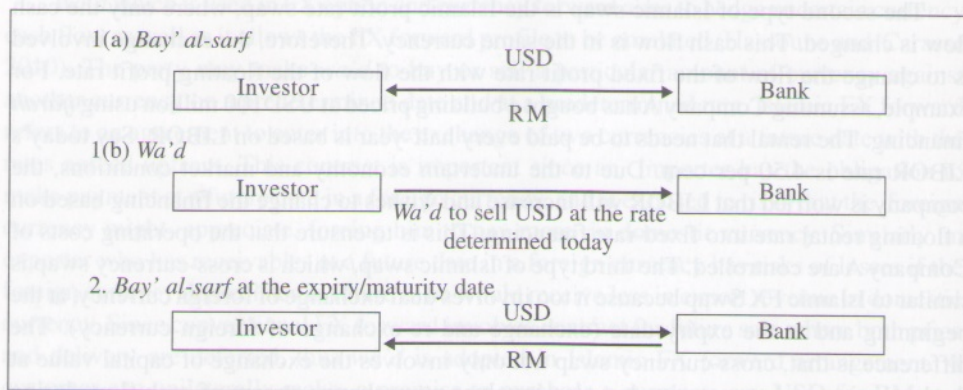


Figure 2. Islamic FX swap based on *wa'd*

Source: Asyraf Wajdi Dusuki (2009a; 2009b)

Under the *wa'd* structure, only one party promises to buy or sell as the case may be wherein the party is bound by that promise. The other party though not bound by that promise, has to proceed with the promise undertaken by the promissory. Since *wa'd mulzim* from only one party is not deemed under Islamic law as a contract, hence this can facilitate Islamic FX (Mohd Daud Bakar 2008).

As mentioned earlier, forward exchange contract which is commonly practised in conventional financial institutions for the purpose of hedging is not allowed in Islam since both price and delivery are deferred to a future date. Therefore, Islamic financial institutions have adopted the *wa'd* principle so that the forward exchange contract complies with the *shari'ah* requirement. Figure 3 illustrates the structure of Islamic FX forward using the *wa'd* principle.

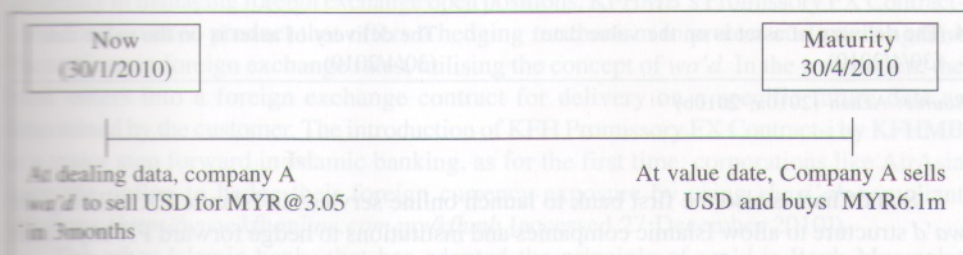


Figure 3. Islamic FX forward based on *Wa'd*

Suppose Company A, a Malaysian company expects to receive USD 2 million in 3 months time, and expects USD/MYR rates to strengthen and wants protection by locking in the rate now and the bank would offer the FX forward at 3.05. If company A accepts, then he and the bank are contracted to trade at that rate in 3 month's time. If the US dollar strengthens to 3.00, the exporter is protected as he will receive MYR 6.1million (USD 2.0m * 3.05) instead of MYR 6.0 million at the current rate.

The adaptation of the *wa'd* principle makes the transaction of FX forward comply with *shari'ah*. Table 1 shows the differences and similarities of the forward exchange contract and the Islamic FX forward which is also known as Promissory Forward Exchange contract.

5. *Wa'd* Application in Malaysian Islamic Banks

In April 2006, Standard Chartered (StanChart) was the first bank in Southeast Asia to launch a comprehensive Islamic derivatives solution based on a globally acceptable Islamic concept to ensure that customers have access to mechanisms to hedge profit rate risks while enhancing their balance sheet management. The Islamic derivatives solution comprises Islamic Profit Rate Swap, Islamic Cross Currency Swap and Islamic Forward Rate Agreement.

In July 2006, Standard Chartered Bank Malaysia Berhad executed USD10 million Islamic Cross Currency Swap with Bank Muamalat Malaysia Berhad, the first Islamic cross currency swap in Malaysia and probably in the world. The currency swap allows Bank Muamalat to hedge the currency and interest rate risks of its investment in foreign currency denominated assets. The facility allows the parties involved to exchange a series of profit-principled payments in one currency for another denominated in a different currency, based on a notional principal amount over an agreed period.

Table 1. Forward Exchange Contract and Promissory Forward Contract: a comparison

Forward Exchange Contract	Promissory Forward Exchange
1. Transaction between Company A and bank is fulfilled at the dealing date (30/1/2010)	On the dealing date (30/1/2010), the Company A only give <i>wa'd</i> to do the transaction on 30/4/2010
2. Transaction fulfilled on the dealing date is binding and can be enforceable	<i>Wa'd</i> on the dealing date is not binding and the parties can revoke the <i>wa'd</i> for acceptable reasons
3. Currency rate is fixed on the dealing date (30/1/2010)	Currency rate is fixed on the dealing date (30/1/2010)
4. The delivery of asset is on the value date (30/4/2010)	The delivery of asset is on the value date (30/4/2010)

Source: Aznan (2010a; 2010b)

StandChart is also the first bank to launch online services in Islamic FX utilising the *wa'd* structure to allow Islamic companies and institutions to hedge forward FX exposures under a *shari'ah*-compliant structure. Recently, in July 2008, the *shari'ah* compliant version of StandChart's Online Treasury (OLT) proprietary foreign exchange trading and hedging platform has been re-launched under the bank's global brand for Islamic products which is Standard Chartered Saadiq. OLT offers a customer instant access to liquidity to efficiently achieve FX management objectives (www.standardchartered.com.my [accessed 12 January 2011]).

In 2007, the CIMB Islamic Bank Berhad launched the Islamic Foreign Exchange with *Shari'ah*-Compliant Option Features or FXOP-i, Cross Currencies Profit Rate Swap (CCPRS-i) and Islamic Profit Rate Swap (PRS-i) that allow customers to hedge their foreign exchange risk. The CIMB Islamic Profit Rate Swap has been recognised as the world's first Islamic derivative product. In recognition of this innovation, the CIMB's Islamic Profit Rate Swap has been conferred the Islamic Finance Product of the year in 2005 by Euromoney. The product is basically an agreement to exchange profit rates between a fixed rate party and a floating party or vice versa implemented through the execution of a series of underlying contracts to trade certain assets under the *shari'ah* contracts (Azmi *et al.* 2008).

The FXOP-i by way of *wa'd* enables customers to lock in a foreign exchange rate in advance by engaging in a *shari'ah*-compliant financial transaction with CIMB Islamic. The net proceeds from this transaction which is similar to the premium paid for option instruments in conventional finance grants customers the right, but not the obligation, to exercise the option at the agreed rate on the maturity date. Hence, customers can protect the value of their future foreign currency proceeds, fix their hedging cost at the equivalent of the option 'premium' and even earn a profit if foreign exchange rates move in their favour (<http://www.cimbislamic.com/index.php?tpt=islamic> [accessed 2 January 2011]). This is done to replicate option.

In 2008, Kuwait Finance House Malaysia introduced its KFH Ijarah Rental Swap-i product. This is a *shari'ah*-compliant hedging contract suitable for corporate customers

who have *ijarah* financing arrangements which are subject to fluctuations of the reference rates such as costs of funds or fixed over the *ijarah* lease facility period. The product aims at protecting customers against profit rate volatility and can be used to hedge risks in any variable or fixed *ijarah* based facility such as *ijarah* contract financing, *ijarah* project financing, *ijarah* auto financing, *ijarah* asset acquisition financing or even *ijarah* based *murabahah*. Companies can convert either the fixed or floating rate commitments into a more manageable rate exposure thus minimising the occurrence of any negative impact on volatility and uncertainty in rate over a period of time (Azmi *et al.* 2008).

Kuwait Finance House (M) Berhad (KFHMB) has also applied Promissory FX Contract-i containing an unconditional promise to enter into an agreed foreign exchange contract with another party at a specified future date in order to mitigate the uncertainty and provide flexibility in managing foreign exchange open positions. KFHMB's Promissory FX Contract-i is a long awaited product that offers a hedging mechanism to protect customers against fluctuations in foreign exchange rates, utilising the concept of *wa'd*. In the transaction, the bank enters into a foreign exchange contract for delivery on a specific future date as determined by the customer. The introduction of KFH Promissory FX Contract-i by KFHMB is a major step forward in Islamic banking, as for the first time, corporations like AirAsia have the option to hedge their foreign currency exposure by using *shari'ah*-compliant solutions (<http://www.kfhonline.com.my/kfhmb> [accessed 27 December 2010]).

The other Islamic bank that has adopted the principle of *wa'd* is Bank Muamalat Malaysia Berhad, whereby the customers promise to enter into the contract aware of their obligations. Bank Muamalat has applied forward foreign exchange, that is a *wa'd* on trade date followed by *aqad* on the value date. The pricing to be negotiated with the dealers and the bank has the right to claim for mark to market (MTM) losses on the extension or cancellation of forward. This means that banks have the right to claim for actual losses on MTM on termination date (www.muamalat.com.my [accessed 29 December 2011]).

Bank Islam Malaysia Berhad (BIMB) also has its own innovative *shari'ah*-compliant hedging solution based on *wa'd* concept. Among the products offered by Bank Islam is *Wiqā'* Profit Rate Swap which is an agreement to exchange profit rates between two counterparties (normally consisting of a Fixed Rate Party and a Floating Rate Party). The other product is *Wiqā'* Cross Currency Swap (WCCS) which is an arrangement between two parties to exchange a series of profit and/or principal payments denominated in one currency, for another series of profit and/or principal payments denominated in another currency, based on a notional principal amount over an agreed period. Another hedging product offered by BIMB is *Ithe* Islamic Option (Commodity Undertaking-i) which provides the option buyer the right but not an obligation to enter into an underlying contract of exchange on a future date (<http://www.bimb.com.my> [accessed 24 December 2010]).

RHB Islamic Bank Berhad had also approved Islamic Promissory Forward Currency contract based on *wa'd mulzim*. In this contract, the customer will promise to buy foreign currency within a specific agreed period based on an agreed rate. Later, the bank will arrange for a *murabahah* contract (*tawarruq*) with a third party based on currency needed by the customer to do a mismatch arrangement (Ahmad Suhaimi Yahya 2008). The other hedging products using *wa'd* principle offered by RHB Islamic are Islamic FX forward, Islamic Profit Rate Swap and Islamic Cross Currency Swap (http://www.rhb.com.my/islamic_banking/main/main.html [accessed 27 December 2010]).

Deutsche Bank (DB)(Malaysia) Berhad has also adopted the *wa'd* principle in structuring an Islamic hedging mechanism. In the *wa'd* structure, the Islamic account gives *wa'd* to DB (*Wa'd* 1) to sell a number of shares selected from a basket at a predefined price while DB gives *wa'd* to the Islamic account (*Wa'd* 2) to buy the relevant shares at the settlement price. The purpose of these *wa'd* is to enable exchange, upon settlement of the securities, of the relevant shares for the cash amounts required to be paid to investors in respect of the securities at such time. *Wa'd* 1 and *Wa'd* 2 are mutually exclusive and independent of each other. Following receipt of the relevant notice to perform the obligations of either *Wa'd* 1 or *Wa'd* 2, the Islamic account and DB shall be deemed to enter into an agreement on the terms of the form of either the *Wa'd* Share Sale Agreement or the *Wa'd* Share Purchase Agreement (<http://www.db.com/malaysia> [accessed 25 December 2010]).

In structuring *shari'ah*-compliant Islamic derivatives like swaps and forward instruments, various contracts permissible in *shari'ah* could have been used in order for the products to be free from *ri-ba* (usury), *maysir* (gambling), *gharar* (excessive uncertainty) and *jahl* (ignorance). They are linked with asset backed transactions such as *ba'i*, *ba'i bithaman ajil*, *murabahah*, *ijarah* etc.

In Malaysia, most Islamic banks that have developed Islamic derivatives have also adopted the principle of *wa'd*, e.g., in forward FX instruments as a mechanism to hedge against foreign currency exposure. This instrument is vital to provide certainty in terms of price and foreign exchange transactions to the parties involved. In practice, only the customer (who may be an importer / exporter) will give *wa'd* to the bank to sell/ buy foreign currency to/ from the bank to set rates for the date specified in the foreseeable future. At maturity, the contract is carried out based on the principle of *bay al-sarf* (Shamsiah and Rusnah 2010). Islamic banks such as CIMB Islamic, BIMB and Bank Muamalat have made available spot trading and Islamic FX forward trading which uses the concept of *wa'd*, that is *wa'd* on the trading date and *wa'd* on the value date (Nazneen 2010).

Table 2 summarises the hedging products based on *wa'd* structure by seven Islamic banks in Malaysia under study.

6. Findings and Discussion

Wa'd, as mentioned before, is a unilateral promise made by one party which is known as a promisor to do certain acts in the future. The basic purpose of binding promise is to gain assurance that the promisor will fulfil his responsibilities, as stated in the promise, hence, the promisor is legally binding to fulfil it. Since the procedural aspects of conventional forward contract is not correct according to the *shari'ah* due to deferment of both counter values, *wa'd* is seen as the most suitable principle to be adopted in the forward contract. Hence, forward foreign exchange transaction may be done on a promise basis instead of a contract.

Under the *wa'd* structure, only one party promises to buy/ sell certain assets or currency in the future and is bound by that promise, while the other party will proceed with the promise undertaken by the promissory. Even though *wa'd* is binding upon the promissory, it is not deemed as contract under Islamic law. This is because a contract will bind both parties.

Islamic financial institutions can enter into forward foreign currency transactions for hedging purposes based on *wa'd* but no fee is to be charged on the promise. This is due to

Table 2. Hedging products based on *Wa'd* structure offered by Malaysian Islamic banks

Islamic Bank	Hedging product based on <i>wa'd</i>
Bank Islam Malaysia Berhad (BIMB)	<ul style="list-style-type: none"> a. <i>Wiqā'</i> Forward Rate Agreement b. <i>Wiqā'</i> Profit Rate Swap c. <i>Wiqā'</i> Cross Currency Swap (WCCS) d. Islamic Option (Commodity Undertaking-i)
Bank Muamalat Malaysia Berhad	a. Forward Foreign Exchange
CIMB Islamic Bank Berhad	<ul style="list-style-type: none"> a. Cross Currency Profit Rate Swap (CCPRS-i) b. Cross Currency Swap (CCS-i) c. Islamic Profit Rate Swap (PRS-i) d. Islamic Foreign Exchange with <i>Shari'ah</i>-Compliant e. Option Features (FXOP-i)
RHB Islamic Bank Berhad	<ul style="list-style-type: none"> a. Islamic Promissory Forward Currency Contract b. Islamic FX Forward c. Islamic Profit Rate Swap d. Islamic Cross Currency Swap
Kuwat Finance House (M) Berhad	<ul style="list-style-type: none"> a. Promissory FX Contract-i b. <i>Ijarah</i> Rental Swap-i
Standard Chartered Saadiq Bank Berhad	<ul style="list-style-type: none"> a. Islamic FX Forward b. Islamic Cross Currency Swap c. Islamic Forward Rate Agreement. d. Islamic Profit Rate Swap
Deutsche Bank Berhad	a. Two Unilateral Undertakings

Source: Authors' compilation (2010)

the fact that upfront cash payment for forward currency transaction would lead to a bilateral *wa'd* which is not *shari'ah*-compliant (Bank Negara Malaysia 2010). This is in line with the view of the majority of jurists who opine that unilateral-binding *wa'd* without any consideration is permissible in a forward currency transaction.

Since there are three different views regarding *wa'd* (i.e. opinion 1 says that fulfilling promise is noble, neither mandatory nor enforceable through court; opinion 2 says that fulfilling a promise is mandatory and promissory is under moral and legal obligation to honour his promise; opinion 3 says that promise is not binding under normal circumstances and it becomes binding if it cause some expenses), the mechanism used by banks to prevent losses in case a customer refuses to fulfil the promise is by imposing a certain 'clause'. The clause may consist of conditions that in case of non performance due to negligent or fraudulent misconduct, the bank can ask for compensation. The compensation must be based on the actual costs or loss incurred by the bank due to non fulfillment of promise. If the customer still refuses to pay the compensation, then it may be resolved through the courts.

Based on the case study above, it shows that Malaysian Islamic banks have adopted the *wa'd* principle in structuring various products particularly Islamic hedging products. The current practice in Malaysia is to use only the unilateral *wa'd* which is binding only on the promisor, not both parties involved in the transaction. If the *wa'd* binds both parties, then it is considered as a contract and a forward contract of currencies is not allowed in Islam due to prohibition of selling debt for a debt and involvement of the *ri'ba* element. In order to avoid *shari'ah* issues which are bilateral, *wa'd* may be equivalent to a contract; therefore, the transaction of forward currency exchange contract in Malaysia has only adopted unilateral binding *wa'd*.

This study also found that Malaysian Islamic banks may have adopted various terms and contracts in their product offerings, but essentially they adopted *wa'd* in structuring them, particularly in structuring Islamic hedging mechanisms. This is consistent with the AAOIFI *Shari'ah* Standards (2008) that a bilateral promise is prohibited in currency trading when it is binding upon both parties even when it is done for risk management and hedging purpose. Only a promise from one party is permissible even if the promise is binding.

7. Conclusion

Our research on the practice of Islamic hedging in Malaysian Banks indicates that *wa'd* is the preferred mechanism for hedging. Compared to other contracts such as *bay al-salam* which also has potential for becoming a risk management tool (Saadiyah and Tabatabaei 2008), *wa'd* seems to involve less *shari'ah* issues and can conform easily to requirements of *shari'ah* compliance and its structure is simple and easy to be understood by players. *Wa'd* also offers great flexibility in structuring products that can mimic conventional products.

Although in recent years there have been many criticisms on the Islamic finance industry's practice of imitating the conventional products in its product development process, the popular call for developing original *shari'ah* based rather than 'merely' *shari'ah*-compliant products, often underestimates the reality that Islamic finance has to compete side by side with the conventional system. If Islamic finance were to really offer a clear alternative then it must have products that meet the current needs of the market. Hence at least in the transition period until more *shari'ah* based products are developed, the Islamic financial services industry needs to offer similar sets of products to meet the requirements of the day and if there are Islamic contracts that can be used to turn useful conventional products into *shari'ah*-compliant products, this should be welcomed in itself. But perhaps what the market needs is a clear answer to the question "does *shari'ah* compliance in itself make any difference?" In this case, at least, whether *shari'ah* compliance in hedging mechanisms would make any difference to risk management practices. This would provide a clear case for embracing Islamic finance and pave the way for higher acceptance.

The discussion on the application of *wa'd* shows that *wa'd* can become a viable principle for Islamic hedging in facilitating Islamic financial institutions and Islamic investors to manage their business risk effectively. Since derivative products which are commonly used as hedging mechanisms are against *shari'ah* principles due to prohibition of *ri'ba*, the *wa'd* structure can be used as an alternative to offer *shari'ah*-compliant hedging products. The study on the seven Islamic banks in Malaysia which are CIMB Islamic, Bank Islam Malaysia Berhad, Bank Muamalat, Standard Chartered Saadiq, Kuwait Finance House (M) Berhad, RHB Islamic bank and Deutsche Bank Malaysia shows that practices and use of the

principle of *wa'd* is becoming widespread in the operations of Islamic banking and financial transactions. Almost all the contracts in Islamic banking in Malaysia have adopted the elements of *wa'd* so as to facilitate financial and banking operations. Even though all of these banks use different names for the hedging products based on *wa'd*, they use the same principle, which is the *wa'd* that is binding only on one party, not both parties involved in the transaction.

This paper is a preliminary overview on the application of *wa'd* in seven out of the total seventeen Islamic banks in Malaysia based on information from official websites. Future research will investigate the operation of *wa'd* in each Islamic bank in more detail, why its use is still limited and what are the challenges and prospects for greater acceptance by customers.

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