The Development of Salam as Hedging Instrument

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Abstract: The current derivatives markets, undoubtedly, provide many important advantages for the participants in the financial markets, namely the hedging services. However, the current derivatives contracts are prohibited by Islamic law, because they include many prohibited elements: gambling, gharar, and riba. On other hand, the financial markets in Islamic countries are witnessing steady growth in the trading volume, number of participants, investors, and size of Islamic financial institutions, which show an increasing demand on the Islamic products. Consequently, it is usual that there will also be an increase in the size of the exposure to various risks, and thus generates the need to use hedging instruments that are compatible with the Islamic law and provide the means of protection and risk prevention in the financial markets of Islamic countries. Therefore, this paper attempt to develop effective hedging instrument based on the structure of salam contract, compatible with Islamic law and appropriate to provide hedging alternative of using conventional derivatives. This study follows the qualitative research, involves using in-depth interviews with experts and scholars in hedging, finance and Islamic finance. This study concluded the ability of using salam to offer hedging on tangible commodities, nevertheless the original salam has some obstacles in offering hedging. This study also found other two instruments derived from the original salam can offer better performance in offering Shari’ah compliant hedging and overcome the obstacles existed in original salam, the first instrument is separately parallel salam SPS and second instrument salam with right to sell.

Keywords: Development of Salam, Hedging Instrument

1. Introduction

The current financial markets in Islamic countries nowadays, which are a part of the financial markets, are witnessing a tremendous In addition, Rushdi Siddiqui, who is the global head of services Islamic finance “Thomson Reuters”, during the Middle East, North Africa and South Asia Forum (MENASA) on The Challenges of Islamic Finance, said that “The Islamic finance industry took 40 years to reach one trillion dollars, but within the next five years it is expected to increase its value to reach two trillion dollars, growth in assets size, trading volumes, and numbers of participants. This would increase the demand for the risk management. KFH (2014) declared that the total Islamic assets were amounted USD1.8 trillion at the end of 2013 and will exceed USD2 trillion barrier.

Against the backdrop of this in the same forum, Afaq Khan, a CEO in a “Standard Chartered Bank group – honest,” addressed the unity of the Islamic transactions in the Standard Chartered Bank. He stressed the importance of strengthening the risk management while growing the sector to provide a wider range of Islamic products and services to customers in both existing and new markets for more than 1.2 billion Muslims. The increased risks should be dealt with proactively (DIFC, 2010).

Russell (2010) reported in order to achieve fully Islamic finance industry must create instruments to hedge against the risks inherent to the physical assets such as commodities and property. Khalid Hamad, the executive director of banking supervision at central bank of Bahrain, also said, “Given the development of the Islamic finance, the Islamic institutions can no longer afford to leave their positions un-hedged,” (Russell, 2010).

The derivatives market is one of the requirements that must be taken into consideration in terms of their use in the financial markets. However, the current contract of conventional derivatives markets is prohibited by Islamic law. It is contradicted with the principles of the Islamic religion. Therefore, it is an impermissible contract. The Islamic law requires all Muslim to avoid dealing with any contract that includes any prohibited element, or any element that is incompatible with the provisions and principles of Shari’ah. In relation to this, the current conventional derivatives markets in financial markets turn out to be invalid and prohibited by the Islamic law, as they include some of the forbidden elements, such as riba, gharar and gambling (IFAA-MWL, 1984; OIC Fiqh Academy (a), 1992; AAOIF, 2010). Consequently, the needs for using Islamic derivatives contracts that are in line with Shari’ah in the financial markets of Islamic countries are essential and a necessary (Bacha, 2007; al-Ghoul, 2008; Dusuki, 2010; Zahan & Kenett, 2012).

Pertaining to this field, experts and scholars of the Islamic finance have indicated that there are several fully Islamic contracts that are permissible by Shari’ah by Ijma (consensuses), as they are accepted by Islamic fiqh academies to be used as Shari’ah compliant derivatives contracts, and to act...
as a substitution to the conventional derivatives instruments. The *salam*, contract is example. These contracts can replace the impermissible future and forward contracts as instruments of risk management (al-Amin, 2005; Hattab, 2005; Bacha, 2007; Kamali, 2007; Muhammad & Chong, 2007; Kunhibava, 2010; Heliar & al-Sahlawi, 2011; Asif, 2012; Jobst & Sole, 2012; Zahan & Kenett, 2012; Bacha & Mirakhor, 2013). Based on above, this study tried to determine the ability of developing *salam* from financing contract to be hedging instrument alternative of use future and forward contracts, highlight the main challenges, and try to solve it.

The paper is divided into seventh sections, It is structured as followed: section 1 introduction, section 2 the needing for Islamic hedging in the financial markets of Islamic countries, section 3 overview of conventional derivatives from Islamic perspective view, section 4 overview of *salam*, section 5 methodology that has been used in this study, section 6 Study findings (development of *salam*), and finally section 7 study conclusion.

2. Financial Derivatives from Islamic Perspective View

Derivatives contract is most effective instruments that can be used for hedging from systematic risks in the financial market as well as enhancing the financial market. However, derivatives contracts like any other new financial products need to be previewed by Muslim jurists to ascertain its validity and readiness for use by Muslim investors. The following are the main criticisms of derivatives contracts namely futures and forwards contracts:

The derivatives contracts that are currently being traded in the financial market are impermissible from the perspective of the major Muslim experts. This is because they involve a high risk and *gharar* that results from the sale of what you don’t have, or an asset that is not in the possession of the seller, or debt by debt sale and gambling (IFA-MWL, 1984; OIC Fiqh Academy, 1992, 2005; Hattab, 2005; Radhwan, 2005; Abu al-Nasr, 2006; al-Salous, 2006; al-Zuhailly, 2006; al-Suwailem, 2007; Dawabah, 2007; el-Gamal, 2008; el-Shatnawi, 2009; AAOIFI, 2010; Jobst & Sole, 2012; Nasbah, 2013; Abozaid, 2014).

Future and forward contracts include the sale of what you don’t have. Many scholars suggest that these contracts contain *gharar*, where the underlying asset does not exist on their ground or they include the sale of what you don’t have and not in the possession as well, (Radhwan, 2005; Abu al-Nasr, 2006; Dawabah, 2007; AAOIFI, 2010; Abozaid, 2014). The deferment of both the final payment and item delivery is another criticism for future and forward contracts (IFA-MWL, 1984; OIC Fiqh Academy, 1992; al-Sulayman, 2005; Jobst & Sole, 2012; Abozaid, 2014). This is due to the fact that these contracts include *bav’ al-kali bil kali* (sale of debts).

Al-Sulayman (2005) points out that stocks-trading on the basis of future credit sale is prohibited, because stocks are *a’yan*, which are not permitted for selling on a deferring base, and the postponement of delivery of stocks has no valid purpose. Furthermore, the underlying stocks are not accepted in future markets on credit sale. The prohibition occurs on these contracts when the underlying asset is money (currencies), such as future and forward currencies contracts; since currencies are not considered as a commodity for selling and buying, but rather it is a method for trading. The contracts on hypothetical assets such as future and forward index are prohibited and considered the same as gambling (OIC Fiqh Academy, 1992).

Future and forward contracts are used for speculation and gambling purposes where many of these contracts are not intended to be settled by delivery or by making real possession or even real ownership and; thus, they are not genuine contracts. Bacha (1999) stated that the trading volume of futures is often much larger than the underlying assets and this is due to the speculating activity and gambling in derivatives. Al-Suwailem (2007) stated that based on the office of the comptroller of currency (OCC), only 2.7 % of derivatives transactions used by end users for hedging ended by actual delivery, while the majority, 97.3 %, is used for speculation by speculators and dealers and it ended by cash settlement. Furthermore, IFA-MWL (1984) and OIC Fiqh Academy (1992) resolute that the ultimate goal for using financial derivatives is gambling, which is prohibited, where the contracts are not intended to be settled by delivery, and thus, the contracts are impermissible.

Another criticism is the availability of offsetting sales and purchases in the future markets as whole. IFA-MWL (1984) considers the sale of underlying asset in *salam* contract prior to possessing it as prohibited.

This view is also backed up by the facts of the negative role played by the misuse derivatives in financial markets which worsened the financial crises in 2008, sovereign debt crises in Europe and collapse of many financial institutions. This is especially relevant since the trading volume of derivatives market (more than USD690 trillion) continues to increase compared to the total GDP of the world (USD77 trillion) in 2014.
Thus, it is of no doubt that the current conventional derivatives in the financial market is fully prohibited and forbidden contracts in Shari’ah. However, the financial markets especially in Islamic countries in need of using these instruments such as futures and options to protect from systematic risks, next section will highlight the need of using Islamic hedging instruments in the financial markets.

3. The Need for Hedging

Financial market in Islamic market witnessed a tremendous growth in capital markets where these Islamic capital markets are positively correlated to the hedging instruments. Thus, in order to keep that growth, the industry must create instruments to hedge against the risks inherent to the physical assets such as commodities and property. Khalid Hamad, the executive director of banking supervision at central bank of Bahrain, said, “Given the development of the Islamic finance, the Islamic institutions can no longer afford to leave their positions un-hedged,” (Russell, 2010). Ghannadian & Penovska (2011) stated that by 2009, the Shari’ah Islamic fund assets had grown to be around USD400 billion. This indicated that the demand for managing risk instruments has risen these days. Financial market suffer from lack of suitable Islamic instruments that can offer hedging and of risk management for either customers or the banks themselves or both.

In this context, Al-Suwailim (2007) stressed on the importance of a risk management approach so as to ensure economic efficiency and meet the need of Islamic institutions for hedging. Jobst et al. (2008) also pointed out that the demand for religiously valid risk management, after the total assets lodged in Islamic financial institutions and capital markets reached USD1 trillion, has become inescapable. Further Saadiah et al. (2011) reported that, although the Islamic finance industry has been greatly expanded; with respect to reducing risks, the market still lacks in terms of accessibility and choices of hedging instruments. While the Islamic finance continues to expand speedily, the increasing opportunity cost of limited Shari’ah-compliant risk transfer mechanisms has raised (Jobst, 2013); especially, since the scarcity of Islamic derivatives instruments for hedging comes at a very critical time where many Islamic financial institutions achieved significant growth in their economic and financial activities as they expand their business well beyond their original jurisdictions (Sole, 2008).

Badlisyah Ghani, the chief executive of Malaysia’s CIMB as cited in Russell (2010), suggested that it is compulsory under the Shari’ah law to have derivatives products in order to manage risk and protect customers (Russell, 2010). Belazzouz (2012) confirmed that the Islamic financial industry is facing a wide range of challenges, most notably the absence of risk management tools to meet the Shari’ah requirements on the one hand, and check the advantage of economic efficiency on the other. So, it is important to look for innovative and creative Islamic risk management instruments and perhaps one of those entrances: Islamic financial engineering.

The recent global financial crisis in 2008 revealed that the loss in the Arab countries balances is around 2.5 trillion. It is of no doubt that the absence of the hedging instruments (derivatives contracts) has led to these losses. As such, hedging would be effective enough to avoid these losses, and the proof is that the global hedge funds have emerged from the global crisis with minimal losses and still dominate the markets in the world (Hattab, 2010). Apart from that, the Arab Monetary Fund (AMF) estimated the losses in 2008 in the Arab stock at about USD367 billion after its market value fell to USD769.5 billion from USD1.13 trillion in 2007, due to the sharp decline recorded by the markets as a result of fall out from the global financial crisis. All of these increase the demand for the use of hedging tools, particularly the Islamic derivatives instruments such as salam alternative of using futures contracts. Belazzouz (2012) concluded that it is clear that there is a great shortage of risk management tools in the Islamic financial industry, and with the globalization of capital markets and increase in the size of the risk, price fluctuations and severity and speed of transmission, the need to create Islamic derivatives seems evident. Increases pressure on to develop Shari’ah-compliant derivatives market in order to meet the increase in the demand of Islamic hedging. Therefore, it is necessary to have Shari’ah-compliant derivatives market in the financial markets to provide protection and hedging services, or at least mitigation of losses in the financial markets of Islamic countries, exactly protection from systematic risk which involves fluctuations in prices either up or down.

In this regard, many previous studies indicated the existence of some Shari’ah-compliant contracts originating from its principles can be used as Islamic derivatives instruments, as alternative of conventional derivatives, to be the nucleus for creating risk management market under the principles of Shari’ah such as salam, contracts to serve as the building blocks for Shari’ah-compliant derivatives. Next section overviews the structure of salam contract.
4. Overview of Salam

Al-Salam or Salam sale or bay ‘al-Salam contract is defined as the sale of a subject matter that will be delivered at a given future date although the price is paid immediately during the session of the contract. This contract also refers to the transactions of sale or purchase of deferred underlying asset for spot price paid.

Hamzah (2008) states that Salam contract is a sale described in dhimmah (self). Thus, from the definitions, it is a contract or agreement between two parties and it includes spot or immediate cash payment and deferment of the delivery of underlying item that is fully described. Bay salam is accepted. Bay salam contract is similar to a forward and future contract but there is a substantial difference; in salam contract, the buyer pays the full payment of subject matter (underlying asset) on spot price (front payment) to the seller at the initiation of the contract, in the contract place or meeting place (Heliiar & al-Sahlawi, 2011).

Salam contracts can be used for risk management tools as a basis for derivatives contracts (Bacha, 2007; Kunhibava, 2010; Heliiar & al-Sahlawi 2011; Guendouz, 2012; Zahan & Kenet, 2012; Bacha & Mirakhhor, 2013) and alternative of futures and forward contracts in the financial markets (al-Amin, 2005; al-Gaoul, 2008).

Khan (1998) has suggested the use of bay’ al-salam as the basis for any Islamic futures market, and he also proposed to develop an Islamic future market that is suitable for agricultural commodities and raw materials. This market can offer solutions to reduce farmers’ debt. Al-Amin (2005) and Al-Gaoul (2008) also assured that salam contract is a Shari‘ah-compliant contract like forward contracts. Not only that, al-Suwailem (2007) saw the possibility of using salam contract as an alternative of future contract with regard to risk management and hedging, as well as price discovery, as it helps in detecting traders’ expectations. Bay-salam is one of Islamic contracts that can be considered as a basis for derivative contracts (Bacha, 2007; Heliiar & al-Sahlawi, 2011; Asif, 2012; Bacha & Mirakhhor, 2013; Injadat, 2016). In contrast, the trading of salam contract as Islamic derivatives are not traded yet on an exchange market. Kunhibava (2010) assured that many Islamic contracts can be used for hedging still not fully used such as salam contract. Thus, the next step is to formulate the exchange-traded Islamic derivatives that are strongly governed and monitored by the regulating body (Kunhibava, 2010; Belazzouz, 2012; Injadat, 2016).

This study, therefore, furthers the related to the field of Islamic hedging. In particular, this study tries to develop salam contract as hedging instrument in the financial markets to provide hedging from systematic risks alternative of using conventional derivatives. For this purpose this study tried in the development of salam make sure the contract in line and fully committed to Islamic rules through avoiding the main criticisms of conventional derivatives as explained in section 2 as well as make sure the efficiency in providing hedging activities to compete the conventional instruments and meet the need of hedging in financial markets of Islamic countries as explained in section 3.

5. Methodology

This study tries to develop and design accepted salam contracts to be hedging instrument, accordingly, this study followed qualitative methodology, which is an inductive approach that involves a process of observing specific phenomena through which the researcher arrives at a general conclusion (Sekaran & Bougie, 2009). Further, qualitative research is suitable for the markets research and for developing new products in the market.

This study uses in-depth interviews to collect the primary data for the advantage of gaining qualitative data pertaining to the participants’ experiences in risks management, finance and financial markets. The in-depth interviews were with experts and scholars in hedging, finance and Islamic finance by applying non-probability-expert sampling. The interviewees were experts hold PhD degrees in finance and Islamic finance, and members of Shari‘ah advisors in Islamic financial institution to develop salam instrument in line with islamic rule and able to provide hedging. The total number of interviews in this study was twenty two respondents.

To ensure the quality of qualitative data collected for this study. The method of data quality that was used in this study is environmental triangulation, which involves the use of different locations of interviews; consequently, the interviews were with experts from Malasyia and from Jordan. Finally, this study used Nvivo version 9 program, for analyzing the data that have been collected through in-depth interviews.

6. Findings: Developing and Designing Salam Products

The Islamic hedging contracts are one of the main and core issues in the financial markets as mentioned in this study. This part explains the development of salam products that can be used as Islamic hedging instrument as alternative to conventional future and forward contracts and its
mechanism in offering hedging in the financial markets. Salam mechanism is similar to that in the ordinary use or practice, where the salam contract is a salam of buying and selling commodities. However, the difference in this market is that the contracts (instruments) are applied under hedging market system (financial market) to offer hedging from risk in line with Shari’ah rules.

“In using salam contract, what are the requirements to fulfill salam contract? So basically the legal requirements follow how the contract is used based on Shari’ah supervising.” (Interview #3)

This study, tries to develop and add some enhancement to this contract to make it increasingly suitable and flexible in hedging for the participants’ benefits under the Shari’ah provisions.

“Salam contract is clear. It can be applied as it is or with some adjustments in some cases for example, the parallel salam. If the risk occurs to the buyer when the price is decreased, to protect him from the loss, let him sell it during the contract period under the Shari’ah supervising.” (Interview #9)

The majority of respondents (86%) assure that salam contract is an Islamic product and can be used as derivative instrument for hedging. Although salam is used for financing, particularly for financing the seller (farmer or manufacturer), it can also be used as a hedging and risk management tool. The area of hedging in this contract is represented through providing the hedging activities when the underlying assets are commodities. They are tangible goods that are accepted in Shari’ah such as wheat, corn, cotton, oil, palm oil, clothes, woods, aluminum, iron, and many other commodities.

These underlying assets are considered as essential assets in Islamic countries, whether main exports or imports to or from Islamic countries. All these items can be described accurately to avoid gharar, and this aspect applies to all of types of this contract, as the issuer of salam, the buyer and seller can issue in the market where the buyer can issue a contract (standardized or non-standardized) to buy commodities at a fixed price during the specified period. The seller can also issue a contract to sell the commodities at a fixed price during the specified period.

Salam contracts have existed in previous studies. However, this study considers that some types (forms) of this contract were developed; each one differs from the other in offering hedging and risk management, in order to enhance the hedging feature to become more effective and flexible as follows:

6.1. Original Salam

The original salam is a contract similar to any salam in the ordinary markets in which the two parties are the buyer and the seller. The buyer pays the full price in advance to the seller, and asset settlement (delivery) is performed in the future at the execution date. The mechanism starts when the buyer (issuer) sends an order to the market either directly or through a certified brokerage firm to issue salam to buy oil.

The order involves the initial conditions such as the item or product characteristics, type, date of settlement, quantity, quality, price, place of settlements, cargo cost, and everything related to the product (underlying asset), as the buyer desires. After the order is sent, the market management in accordance with the Shari’ah board lists the order in the market system (market screen) after it has been accepted, and the seller (farmer or producer) can execute it (or negotiate if the contract not standardize). The buyer pays the full price in advance to the seller according to the salam’s conditions, and the seller receives the price and offers the required guarantees to ensure the fulfillment of the sale. Thereafter, the contract becomes pending until the execution date (monitoring). When the execution of the contract fails, the Islamic derivatives market expressed by the clearinghouse grants and the sale process will protect the buyer.

On the execution day, if the contract is executed correctly, the buyer will receive the underlying asset that conforms to all the contract specifications. Following that, the seller retrieves the guarantees. The contract process, afterwards, is accomplished successfully.

Using the previous example, we suppose that the wheat (underlying) price in salam is USD250 (one ton) and at the maturity, the market price of wheat is USD252. Therefore, the buyer will save USD2 for each ton, whereas the seller will lose USD2 for each ton. However, this loss is relative because the seller receives the price in advance and takes advantage of the finance (time value of money). For example, if one borrows the amount of USD250 from a bank at an interest rate or murabaha of 6% for three months (salam maturity), then the bank will pay USD3.75 as the amount of the cost of borrowing. However, if the market price is USD248, then the buyer will incur a loss of USD2 while the seller saves USD2 in addition to the financing advantages.

On other hand, the nature of hedging in the original contract is limited to offer hedging for the
commodities. The consensus scholars prohibit selling stocks on credit sale such as sale of stocks by salam. Where the accepted underlying asset in salam is only for the stereotyped goods (quantity and quality) that have active demand, storables, and have a value compared to their size, such as agricultural crops and minerals. Furthermore, when the underlying asset is money (currencies), such as future and forward currencies contracts not allowed and prohibited, where that currencies must be traded on spot rather than deferment basis. In this context, salam that are conducted also on prohibited underlying assets are definitely considered as impermissible, such as those underlying assets is interest and hypothetical assets as index and considered the same as gambling.

In fact the main obstacle and weakness of using original salam in hedging is limited to offer hedging from the increase of the prices of commodities. Therefore, with this nature, the buyer in this contract who wants to hedge from a price increase will incur loss (risk) if the market price of the underlying asset continues to decline at end of the of maturity. This hedging may double the buyer’s loss when he sells the underlying asset at a low price. This inability to offset the contract before the maturity also consider liquidity problem in which the conventional contract buyer can sell the contract before the expiration date, especially when the contract situation is not in his favor. Whether the underlying assets’ prices increase or decrease, the user can sell the contract and liquidate the asset. In Islamic contracts, one cannot sell the contract or the underlying assets before possessing it at the expiration day and may therefore lose the opportunity to sell the goods (higher price) or lose as a result of decreasing market price less than the strike price in salam.

“The main difficulty is right to sell the product before expiration; this is strong obstacle in Islamic hedging, especially if the price moved up or down contrary to hedger’s expectation.” (Interview #10)

Another, vital criticism for original salam the problem of capital (paying price in advance), if you want to hedge you should pay the full price in advance unlike the future and forwards, which make the contract uncompetitive to lake of leverage feature. Therefore, the problem with using salam is that one needs to pay the full capital in advance because the philosophy of this contract is based on financing the seller. This contract requires the buyer (hedger), whether he is a farmer or a merchant who wants to protect himself in this case, to pay the full price of the underlying assets in advance to protect himself from the price fluctuation contrary to the case of conventional derivatives.

“Paying the price in front is problem, how much money you have to pay in front, you must remember the capital is not unlimited; there is cost of fund.” (Interview #14)

The decision makers or the derivative market users in the current conventional derivatives have leverage feature, and the market becomes increasingly competitive and less costly. In salam, paying the money (capital) in advance is costly, based on the time value of money. The capital is limited, thereby creating problems for the derivatives users when they use such contract for hedging.

“If you talk about salam as hedging; salam can only work if you have the sphere of Islamic finance which in a way to have people banks provide salam capital, because it helps the firms to produce.” (Interview #11)

As a user of derivatives, one will prefer to have a hedging contract that does not need capital in advance, offer fully hedging from price fluctuations prevents him from losing in the worst-case scenario, liquid instrument, and less costly (leverage). This preference is basically what is lacking in original salam when used as risk management, and is taken from the perspective of the conventional derivatives users.

6.2. Separately Parallel Salam

Another form of salam is the separately parallel salam SPS. It is considered an important instrument that can be used as derivative instrument for hedging. This contract is accepted by scholars but it should be executed in two separate contracts to avoid gharar (two contracts in one contract): the first is salam to buy and the second is salam to sell or vice versa the first is to sell and the second is to buy.

However, with separate contracts, this type is the development of the original salam in hedging in which it can overcome some of the criticisms of the original, particularly with regard to the hedging nature (protection from price fluctuations), offsetting contract, capital paid in advance.

“Murabaha, the enhancement is the murabaha to purchase order; musharakh, the enhancement is the musharakh mintalih biltamlik. In derivatives market we have salam
and the enhancement is parallel \textit{salam} and for \textit{istisna}, the enhancement is parallel \textit{istisna}” (Interview #6).

The underlying assets in this contract are similar to those in the original \textit{salam} in which the assets must be tangible commodities. This contract can be issued by buyers, sellers, trader, and farmers.

ABC Company is an import company that wants to hedge from oil prices’ fluctuations. For this purpose, the ABC Company can issue SPS (two \textit{salam}); the first is to buy 1,000,000 barrel of oil from a foreign country (oil exporter) at a fixed price of USD100,000,000 (USD 100 each). At the same time, as an importer, the company wants to sell these oils at a reasonable price of USD101,000,000 (USD101 each). Therefore, the company issue another (second) set of standardized \textit{salam} contracts (10 \textit{salam} contracts; each contract is issued for 100,000 barrel that include the same characteristics of the oil in the previous (first) contracts. In this case, separate contracts are necessary to avoid the prohibited picture of \textit{gharar}; the two contracts in one contract and achieve hedging from price fluctuations.

“Often \textit{salam} contract in Malaysia is used for financing so, we need the bank to pay the price in front in order to get the product later for the buyer in parallel \textit{salam}.” (Interview #14)

The hedging nature in this contract, from the previous example, the ABC Company receives 1,000,000 barrel of oil from the first contract at the price of USD100 for each barrel, paying a total cost of USD100,000,000 (regardless of the oil price in the market). Thereafter, the company sells the products in another 10 \textit{salam} contracts to the retailers, setting a price of USD101 for each ton with a total revenue of USD101,000,000 and a save of USD1,000,000 regardless of the oil price in the market.

In this contract, the hedges can protect themselves from the increase and decrease of commodities price. Particularly, fixes the buying and selling prices regardless of the underlying prices in the market go up or down. The first \textit{salam} is used for buying and the price is less than that in the second (selling). While if the first \textit{salam} is used for selling, then its price must be greater than that in the second (buying). In addition to that, the original seller can protect himself from the price decrease, and the final buyer can protect himself from price increase.

“In \textit{salam} contract there are some restriction rules; to pay money in advance that one can’t comply with. In this regard, as constrains. So this is why parallel \textit{salam} is wanted because you see, if you have customers, financial initiations and suppliers. So basically in normal \textit{salam} the customer must pay money (100 percent) in advance but in case of parallel \textit{salam} you just undertake only and who pays the 100 percent of the money is the financial institution. The financial institution’s help is sound, because it can pay the money in advance while the customer may not be able to because of the liquidity and capital issues. So, this is the main reason that parallel \textit{salam} contract was created; in order to help manage risk in the markets.” (Interview #6)

SPS contract is among the best instruments that can be used for Islamic derivatives to offer hedging in the commodities markets (\textit{Shari’ah} approved commodities).

“Parallel \textit{salam} and parallel \textit{istisna} and \textit{arabun}; these are the main instruments that can be used in hedging. I think these are the best instruments that can be used for hedging in financial markets” (Interview #21); “For manufacturing, we use parallel \textit{istisna}; for tangible products, we use parallel \textit{salam}. Then, \textit{arabun} can be used for trading of stocks and portfolio managing.” (Interview #17)

SPS a preferred instrument because it can overcome also the problem of capital (paying price in advance, where the first \textit{salam} require pay price in advance (buying) USD 100,000,000 can be financed from the second that require receive the price in advance 101,000,000 (selling). In addition, this by the second can overcome the problem of buyer protection in the case of price lowering; it also offers protection from increasing and decreasing prices.

“I hope in the future to have Islamic hedging system like parallel as the solution for this point, for protecting from price fluctuations, both increasing and decreasing and I am sure of that.” (Interview #16)
6.3. Salam with the Right to Sell

The last form of salam SRS includes the original salam with right to sell the underlying assets before possessing them. The selling of underlying assets in salam before possessing them is unacceptable. However, in this case, this undertaking is accepted because the underlying price is reduced, and the buyer is exposed to the risk of low price. This study determined that the buyer can sell the underlying assets before possessing them to avoid losses, but he must do so under the Shari’ah supervision.

“The Salam contract with right to sell the underlying assets during the salam maturity, in order to push the damage and protect the hedger from the decreasing price.” (Interview #22)

SRS contract is powerful in hedging from price increase and limits the loss if the price decreases. So, SRS better than the original salam in hedging market because it gives the hedger choice in making decisions and protecting his interests when the price declines as well as flexibility in liquidate the contract before maturity.

“The Maliki has a different view, where if the salam is food, yes, it is required in transaction as there is hadith on possessing the foods, but if the salam is not food, then the Maliki allowed selling before possessing where the Maliki views that it contains the qabd (possession) required in food transaction. So if you apply the Maliki view, the salam contract becomes flexible because the buyer can sell it before possessing; view of Maliki.” (Interview #1)

The mechanism of this contract supposes that the investor, who expects that the price of cotton will increase with the likelihood that it may decrease, can buy a salam contract with the right to sell the cotton if the price decreases. We suppose that the market price of one ton of cotton is USD300 and USD290 in salam and that the market price during the first month of the period begins to decline to USD296 and in the second month continued to decrease to USD291. During this time, the investor can ask the market (Shari’ah board) to sell the cotton or, according to the terms, he can automatically sell at this price whether in the commodities market or in the real market through the documents in his possession, that is, if he wants to sell the cotton to avoid loss. According to the hedging nature of this contract at its maturity date, if the market price of the cotton decreases to less than the salam price of USD288, then the buyer can protect himself from losing USD2 for each ton of cotton. The buyer can be protected from the increase of price to avoid the loss if the price decreases in salam with the right to sell. The investor who wants to hedge has miscellaneous instruments of salam, and he can use one of them to hedge from the systematic risk when the underlying assets are commodities.

Salam products can be effective instruments for hedging, namely the development salam such as SPS and SRS, the following table summarize the strengths and weaknesses of each instrument:

<table>
<thead>
<tr>
<th>Salam Products</th>
<th>Islamic Acceptance</th>
<th>Hedge from Price Rising</th>
<th>Hedge from Price Declining</th>
<th>Overcome the Problem of Capital</th>
<th>Overcome the Problem of Liquidity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Original Salam</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>SPS</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>SRS</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
<td>Yes</td>
</tr>
</tbody>
</table>

7. Conclusion

This study was embraced with the aim of developing salam contract to be Islamic hedging instrument that is compliant with the Shari’ah principles, and ascertaining of its suitability in the offering hedging. In order to accomplish this broad aim, it has been utilized to clarify the current conventional derivatives, as well as the important need of having Islamic risk management instrument represented by utilizing the salam to offer hedging activities in the Islamic finance industry.

This study found the ability of using salam to offer hedging on tangible commodities, however the original salam has some obstacles in offering hedging taken from the perspective of the conventional derivatives users, namely it suffer from inability to protect buyers from price declining and limited to protect him from price rising, lack of liquidity during the contracting period, and the lack of leverage, where the capital should be paid in advance. On other hand this study found other two instruments driven from the original salam can offer better performance in
offering hedging. The first instrument is SPS which can overcome all the obstacles that exist in original; it can protect the hedger from price rising and declining alike, and go beyond the problems of liquidity and leverage. The second instrument is SRS which also can offer better performance of hedging than original and offer hedging from price rising and declining, as well as overcome the liquidity problem.

**References**


