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RESEARCH ARTICLE

A COMPARATIVE STUDY BETWEEN FOREIGN EXCHANGE FORWARD CONTRACTS AND ISLAMIC FOREIGN EXCHANGE FORWARD CONTRACTS

*Dr. Ehab Mohammad Mustafa Injadat

Jordan

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ABSTRACT

This paper presents an analysis of foreign exchange forward hedging and risk management applied in both conventional and Islamic financial markets. This paper compare the hedging mechanism and Islamic law perspective for both instruments based on data from different documents, books and websites to recognize distinguishing aspects of these two hedging instruments and the related risk protection. This study show that hedging and risk management mechanism and goals in these two foreign exchange forward instruments are actually not similar, foreign exchange forward is based on binding promise while the Islamic foreign exchange forward is based on the concept of dual non-binding and independent promise to avoid the Islamic law criticisms of conventional FX forward. However both instruments are slightly similar in their respective business activities and its risk protection efficiency in foreign exchange markets and international trade.

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INTRODUCTION

Exchange Forward contract is one of financial derivatives family, Commonly used in financial markets for hedging and speculation, the following sections entailed and an overview of foreign exchange forward contract, Islamic perspective of forward contact and foreign exchange forward contract, Islamic foreign exchange forward contact, and finally the conclusion.

Foreign Exchange Forward Contract: Foreign exchange Forward contract is a non-standardized binding agreement to buy and sell foreign currencies where the parties are obligate to the execution of the contract on the expiration day, the contract traded only in over-the-counter market like through the banks, and it does not follow daily settlement procedures like future contract. There are two users of foreign exchange forward contract, these are hedgers and speculators, where hedgers seek to keep their revenues or fix the expenses against unfavorable exchange rate. While speculators use the forward as tool to place bets on which approach prices and exchange rates will go. With respect to hedging foreign exchange forward contact used to protect form unfavorable exchange rate and price fluctuations either up or down when especially when commercial is done between traders from countries that use different currencies or contracts that have been made in foreign exchange market. Subsequently, foreign exchange forward can used to protect traders from market, price, and exchange rate risk where the Importers (Exporters) can avoid exchange risks, by buying foreign exchange forward contract for trade currencies with the financial institutions at any time. At on delivery, cash is exchanged for the underlying asset. So, it can say the economic advantage of foreign exchange forward contract represented in being a vital hedging instrument especially in foreign exchange market and international trade.

For example : Suppose JISC which is a Jordanian company specialized in steel trading, imports a Iron steel from china in order to sell it to retailers. When the JOD/CNY spot exchange rate is CNY 9.7906 = 1JOD. JISC agrees to import an steel valuation CYN10 Million (JOD 1,021,387) with payment being due in 120 days' time. JISC sells the iron to a retailers contractor for, suppose, JOD1,050,000. In 120 days of time, if JOD 1 still equals CNY 9.7906,J ISC will buy CNY 10 Million for JOD 1,021,387, so making an overall profit of JOD28,613. However, in 120 days' time the JOD/CNY exchange rate could be changed. If say JOD 1= CNY 9.5000, then CYN 1 Million will cost ISC JOD 1052631 so overall instead of making the expected JOD 28,613 it actually loses JOD 2,631. JISC can avoid this foreign exchange risk via a foreign exchange forward contract with an international Bank. JISC and Bank sign a contract currently under which JISC promises that in 120 days' time it will buy (and Bank promises to sell) CYN 10 million from Bank at a fixed price of, say, JOD 1,023,000.

Corresponding author: **Dr. Ehab Mohammad Mustafa Injadat,**
Jordan.

The implied rate of JOD1=CYN 9.7751 is called the forward rate.. It is set by taking into account 120 days' time discount rate and interest rates in Jordan dinar and China yuan). This implies JISC will undertake fixed cost of JOD 1613 to hedge itself against opposite exchange rate fluctuation, while also giving up the chance to gain from a positive exchange rate movement. Next section covers the Islamic law perspective from current using of forward and forward foreign exchange contracts in financial markets.

Prohibition of Foreign Exchange Forward Contract: Islamic law allows hedging because the basic goal of hedging is to protect and avoid probable risks. Thus, it is compliant with the concept of *Maqassid al-Shari'ah* (*Shari'ah* purposes). In fact, this was what *Shari'ah* has originally prescribed in keeping and protecting the money from damage and loss. In this context although of forwards importance and role to hedge and protect trades, importers and exporters from systematic risk and price fluctuations, it consider impermissible tool from the perspective of the Islamic law. This is because they involve a *gharar riba*, and gambling (IFA-MWL, 1984; OIC Fiqh Academy, 1992; AAOIFI, 2010). Many scholars suggested that these contracts contain the sale of what you don't have (*gharar*) (AAOIFI, 2010). Prior to that, IFA-MWL (1984) & OIC Fiqh Academy (1992) concluded that the forward contracts are prohibited because they entail the sale of assets that the seller does not own or possess.

Foreign exchange forward contract is a form of prohibited usury, the postponement exchange subject matter and price to the future date is not allowed in Islamic law (IFA-MWL, 1984; OIC Fiqh Academy (a), 1992). Where the contract considers a type of prohibited sales of debts (*riba*) does not entail the contract effects when they initiated. OIC Fiqh Academy: considered bilateral promise to trade currencies is prohibited if the promise is binding, even for the intention for protecting against currencies fluctuations. IFA-MWL (1984) and OIC Fiqh Academy (1992) prohibit buying and selling currencies in current forward contracts style because it is a form on *Nasiah* usury (*riba al-nasiah)*. Forward contracts are commonly used for speculation purposes, where majority of these contracts are not planned to be settled by delivery and; thus, they are not genuine contracts. Al-Suwailem (2007) confirmed that based on the office of the comptroller of currency (OCC), only 2 % of forward contracts used for actual exchange and trade, while the common is used for speculation only for cash exchange (there is no real trade at all) . IFA-MWL (1984) and OIC Fiqh Academy (1992a) determined that the final purpose for using forward contracts is gambling, where the contracts are not proposed to be settled by delivery, consequently, the agreement are prohibited.

Shariah Compliant Foreign Exchange Forwards Contracts: Islamic law disapproves the current forward contract although these contracts are considered effective tools used to hedge from systematic risks in global financial markets and foreign exchange markets. However, the evaluation of Islamic finance the expanding nature of the industry of the Islamic finance also the expansion of international trade should be taken into account. As such, the hedging product becomes vital in Islamic finance and a similar demand will also be facing the market. This is a call for the formulation of new Islamic contracts to provide services of forward hedging contracts. Therefore, the following *Shariah* compliant foreign exchange forward contracts that can be used as a instruments for hedging from foreign exchange markets risks will be presented in this section.

Islamic Foreign Exchange Forwards: International Swaps and Derivatives Association (ISDA) and the International Islamic Financial Market (IIFM) designed two standards for Islamic forward foreign exchange products for use as hedging instruments and to be used under the ISDA/IIFM *Tahawwut* Master Agreement. The formation of both instruments is to decrease the traders, investors and Islamic banks exposure to foreign exchange rate fluctuations in Islamic market. The agreements can be used to diminish currency risk associated with capital markets instruments, as well as trade finance and banking activities. The first stander is solo *Wa'ad* Structure, involve a single promise where the buyer who grants the promise in favor of the seller. (ISDA, 2016). Meanwhile the second standard which is the importance the Dual Wa'ad Structure that can be alternative of conventional foreign exchange forward contract, where both parties offer a unilateral and independent promise in favor of the other party, and a party's right to exercise the other party's (ISDA, 2016). Promise is subject to an exercise terms being satisfied on the maturity date. Consequently it contains two independent unilateral promises, so each promise carries a different trigger terms and therefore does not constitute a contract, Both parties enter into one (long) contract between them, and then enter into short contract for specific transactions (hedging).

Party A, send a promise to party B to purchase the relevant currency amount if the forward rate is more or equivalent to exercise rate on the exercise date then party B accept the promise, on other hand party B, send a promise to party A to sell the relevant currency amount if forward rate is less than or equivalent to the exercise rate on the exercise date then party A accept the promise. However, IIFM *Shari'ah* Board members required the following conditions in foreign exchange forward to be *Sh'ariah* compliant : first the contract should be only for the purpose of hedging not for speculation, second the contract should be free from any form of interest, third the exchange of different currencies should be on spot basis hand to hand if the currencies are different and hand to hand with equal to equal if the currencies are same. Fourth the contract shall not include any conditional option. Finally each promise should be independent and separate from the other (IIFM, 2019). For example, JISC promises that if in 120 days' time, the spot value of JOD 1 more than, or equal to, CNY 9.7900 it will buy CNY 1M from Bank for a fixed price of JOD 1,030,927. Meanwhile China Bank independently promises JISC that if, in 120 days' time, the spot value of JOD 1 is less than CNY9.7900, it will sell CNY 1M for a fixed price of JOD 1,030,927. By using IFXF only one of these conditions will be fulfilled, however JISC will get the CYN 1M it wants for JOD 1,030,927. Consequently JISC protect itself from fluctuations in JOD/CNY forward exchange rate. IFXF can protect against foreign exchange fluctuations while remaining compliant with the Islamic law.

Conclusion

Conventional foreign forward contract is effective tool to hedge from exchange rate and price fluctuations and can be used as speculative instruments, meanwhile the Islamic law considered the contract unlawful for many reasons such as sale what you don't have (*gharar*), selling currencies not on spot basis (*riba*), bilateral promise in currencies also not allowed,

and finally the major uses is for speculation rather than hedging. While Islamic foreign forward consider *shariah* compliant contract which can give the same conventional foreign exchange forward performance with concerning hedging in financial markets where parties in Islamic foreign forward contract can also protect from currency, price, exchange rate. nevertheless the Islamic foreign forewarned agreement involve two independent unilateral promises, each one carries a different trigger condition such that only one of the promises can be exercised on the maturity with no further obligations arising under the other promise. Nevertheless the Islamic law stipulated the following terms to be fully compliant with Islamic law, the agreement only for hedging purposes; based on spot exchange, free form any form of interest, the contract shall not contain any conditional option. Finally, each promise should be independent and separate from the other.

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