Social and Human Sciences Review, Batna 1 university Volume:27 N 01(June, 2026) pp 335-358
ISSN: 1111-5149, EISSN: 2588 – 2430

Financial Hedging Between Economic Efficiency and Sharīʿah Compliance: A Comparative Study

التحوّط المالي بين الكفاءة الاقتصادية والامتثال الشرعي: دراسة مقارنة

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Received in	28-03-2026	accepted in	02-06-2026

Abstract

This study addresses financial hedging as a central mechanism for risk management in a highly volatile and uncertain financial environment, through a comparative analytical approach between conventional and Islamic financial systems. It begins by deconstructing the conceptual framework of hedging while exploring its underlying motivations and foundations of legitimacy, before analyzing its forms and instruments in both systems, with particular attention to the jurisprudential constraints governing conventional tools and the resulting Sharīʿah-related reservations.

The study offers a critical analysis of hedging instruments and their role in balancing economic efficiency with financial risk mitigation. It also examines the influence of intellectual and Sharia-based frameworks on their structural design and the implications for financial stability, with the aim of contributing to a renewed conceptualization of more flexible and effective Islamic hedging tools grounded in sound jurisprudential principles. The findings indicate that conventional hedging instruments, while highly efficient and flexible in the short term, may entail speculative risks that undermine financial stability. In contrast, Islamic hedging instruments tend to be more conservative and secure, with lower exposure to systemic risk, thereby supporting long-term stability and strengthening confidence in the investment environment.

Keywords: Financial Hedging; Risk Management; Financial Instruments and Sharīʿah Compliance; Economic Efficiency and Financial Stability.

ملخّص

يُعالج البحث إشكالية التحوّط المالي بوصفه أداةً مركزية لإدارة المخاطر في بيئة مالية تتسم بحدة التقلب وعدم اليقين، وذلك من خلال مقاربة تحليلية مقارنة بين النظامين الماليين التقليدي والإسلامي، وينطلق من تفكيك الإطار المفاهيمي للتحوّط مع استجلاء دوافعه وأسس مشروعيته، ثم ينتقل إلى تحليل صوره وأدواته في كلا النظامين مع الوقوف على محددات التوظيف الفقهي للأدوات التقليدية وما يثيره ذلك من تحفظات شرعية.

ويقدّم البحث قراءةً نقديةً لكفاءة أدوات التحوّط في تحقيق التوازن بين تعظيم الفاعلية الاقتصادية والحدّ من المخاطر المالية، مع إبراز أثر المرجعيات الفكرية والشرعية في تشكيل بنيتها التصميمية وما يترتب على ذلك من انعكاسات على الاستقرار المالي، وذلك بهدف إثراء النقاش حول تصورٍ تجديدي لأدوات تحوّط إسلامية أكثر مرونة وفعالية تستند إلى تأصيلٍ فقهيّ دقيق. وتُبيّن أهم النتائج المتوصّل إليها أن أدوات التحوّط في النظام المالي التقليدي، رغم اتسامها بمرونة وكفاءة مرتفعة على المدى القصير، قد تنطوي على مخاطر مضاربية تؤثر سلبًا في الاستقرار المالي، وفي المقابل تتميّز أدوات التحوّط في النظام المالي الإسلامي بطابعٍ أكثر تحفظًا وأمانًا مع انخفاض مستوى التعرّض للمخاطر النظامية، وهو ما يسهم في تعزيز الاستقرار المالي على المدى الطويل وترسيخ الثقة في البيئة الاستثمارية.

الكلمات المفتاحية: التحوّط المالي؛ إدارة المخاطر؛ الأدوات المالية والضوابط الشرعية؛ الكفاءة الاقتصادية والاستقرار المالي.

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Introduction

In contemporary financial practice, hedging has become an undeniable necessity due to market volatility and the multiplicity of risks that can undermine the stability of returns and the continuity of investments. Risk management is no longer a peripheral concern; it has assumed the status of a foundational principle for safeguarding financial operations and protecting institutions and individuals from unexpected losses. The accelerating pace of economic change, coupled with globalization and the interdependence of financial markets, has heightened the need for mechanisms that reconcile the pursuit of legitimate profit with the imperative of minimizing potential risks. Within this context, hedging stands out as a pivotal instrument of modern finance.

From an analytical perspective, two distinct paradigms of hedging have emerged. The first is the conventional paradigm, which relies heavily on derivative instruments that provide liquidity and flexibility but are often diverted into speculative activities that amplify systemic vulnerabilities. The second is the Islamic paradigm, which seeks to address the same economic needs within the normative framework of Sharīʿah. This approach aims to harmonize risk management with the higher objectives of Islamic law (maqāṣid al-sharīʿah), thereby integrating economic efficiency with principles of justice, fairness, and ethical sustainability. It is in this context that the present study acquires its significance: by investigating hedging not merely as a financial technique but as a locus where economic exigencies intersect with moral and legal commitments, and by comparing the conventional and Islamic approaches to uncover the strengths and limitations of each.

RESEARCH PROBLEM

The divergence in intellectual and legal foundations between the conventional and Islamic financial systems has resulted in distinct approaches to hedging. The conventional framework is primarily grounded in pragmatic considerations that prioritize efficiency and liquidity, whereas the Islamic framework seeks to reconcile the demands of economic effectiveness with adherence to Sharīʿah principles. This divergence gives rise to a central question: **How does the divergence in foundational references between the conventional and Islamic financial systems shape the design of hedging instruments, and to what extent can these instruments balance economic efficiency, Sharīʿah compliance, and financial stability?**

From this central problem, several subsidiary questions arise:

1. What is meant by hedging in the financial system, and upon which foundational references do the two systems—the conventional and the Islamic—rely in addressing the issue of hedging?
2. How has the divergence in these foundational references influenced the nature and design of hedging instruments in both systems?
3. To what extent do Islamic hedging instruments succeed in reconciling Sharīʿah compliance with the achievement of economic objectives?

4. What are the implications of adopting hedging instruments in both systems for financial stability and their respective capacities to withstand market volatility?

SIGNIFICANCE OF THE STUDY

The significance of this study lies in its engagement with a fundamental issue in contemporary finance: hedging as a principal mechanism for risk management and the protection of investments amid market volatility. The comparative analysis of conventional and Islamic approaches allows for the identification of their respective strengths and limitations and clarifies the extent to which Islamic financial instruments can balance the requirements of economic efficiency with adherence to Sharīʿah principles. From this perspective, the study contributes to enriching the academic discourse on the development of alternative hedging instruments that are more equitable and sustainable, while also providing practical pathways for Islamic financial institutions to enhance their role within the global financial system.

OBJECTIVES OF THE STUDY

This study aims to:

1. Define financial hedging and distinguish it from risk-taking.
2. Examine the motives and theoretical and practical foundations of hedging, with particular attention to its Sharīʿah legitimacy.
3. Assess Sharīʿah rulings on conventional instruments and their implications for Islamic financial practice.
4. Evaluate the efficiency of hedging instruments in both systems in terms of economic objectives and risk management.

RESEARCH METHODOLOGY

This study adopts a descriptive–analytical approach, examining the key concepts of financial hedging, its underlying motives, and its Sharīʿah justifications, drawing on both classical jurisprudential sources and contemporary financial literature. It also employs a comparative perspective to highlight the similarities and differences between conventional and Islamic hedging instruments, with attention to their respective normative foundations. In addition, a critical–evaluative method is used to assess the effectiveness of these instruments in achieving economic objectives and managing financial risks within Sharīʿah constraints and the broader framework of financial stability.

I- THE CONCEPTUAL FRAMEWORK OF HEDGING IN FINANCIAL TRANSACTIONS

1) The Concept of Hedging/

1. Definition of Hedging in Language and Terminology:

1.1 Linguistic Definition:

The term *"hedging"* in Arabic (**التحوّط**) comes from the root **(ح و ط)**, which conveys the meanings of: (Ibn Manẓūr, 1993, p 279)

- Taking precautions,
- Being cautious,

- Seeking protection or safety.

In Arabic usage :

- *"Tahawwata al-rajul"* means "the man took precautions."

"Ihtāta li-amrin" means "he took measures to avoid harm." (Ibn Manẓūr, 1993, p 279)

- Thus, linguistically, **hedging refers to preservation, caution, and adopting protective measures.**

1.2 Terminological Definition

The meaning of hedging varies according to the context, whether in Islamic jurisprudence, economics, or finance:

1.2.1 in Islamic Jurisprudence

In Islamic legal terminology, the concept of *taḥawwut* (precaution) revolves around acting with caution and adopting the more reliable course in words or deeds, so as to avoid falling into what is prohibited or to avert harm and excessive uncertainty (*gharar*). Among jurists, *taḥawwut* is often used to mean safeguarding religion and transactions by adhering to what distances the legally responsible person (*mukallaf*) from suspicion or risk.

Al-Nawawī defines precaution as: *"To do that which, if omitted, would entail sin; or to refrain from that which, if committed, would entail sin; or to perform an act subject to juristic disagreement". (Al Nawawī, 1996, p 82)*

Similarly, the scholar Ibn Nujaym states: "Precaution is required by Sharīʿah, provided that it does not lead to obsessive misgivings (waswasah) or excessive hardship". (Ibn Nujaym, 1999, p 87)

This implies that hedging in juristic terminology is grounded in adhering to what ensures soundness in religion and transactions, while avoiding matters that involve suspicion or potential prohibition.

In the contemporary Islamic financial context, however, this notion has been adapted to the field of risk management, where financial hedging serves as a mechanism for loss prevention while remaining compliant with Sharīʿah injunctions and avoiding what it prohibits.

In this regard, the International Islamic Fiqh Academy defines hedging as:

"Taking measures that reduce risks resulting from fluctuations in prices, interest rates, exchange rates, or others, in a manner that does not conflict with the rulings of Sharīʿah." (International Islamic Fiqh Academy, 2018, p 224)

It is also defined as: "A set of Sharīʿah-based means employed by institutions or individuals to reduce exposure to financial risks, without falling into prohibited practices, and in a way that fulfills the objectives of Sharīʿah in safeguarding wealth and avoiding harm." (Kahf, 2012, p 44)

This means that hedging is a mechanism of safeguarding and protection against risks to the greatest possible extent, by eliminating the adverse effects arising from unfavorable developments in financial assets and fair values, through the adoption

of specific arrangements and procedures implemented within the framework of Sharīʿah principles.

1.2.2 in the context of Economics and Finance

Within the fields of finance and conventional economics, the notion of hedging has been articulated through numerous definitions, which, despite their variations, ultimately converge upon a unified general concept, as follows:

"Hedging is the practice of taking positions in financial instruments or markets to reduce or eliminate the risk of adverse price movements in an asset or liability." (Hull, 2018, p 5)

"A hedge is an investment to reduce the risk of adverse price movements in an asset, typically by taking an offsetting position in a related security." (Bodie, Kane & Marcus, 2014, p 332)

"Hedging is the use of financial strategies and derivative instruments, such as futures and options, to reduce or manage the risks associated with fluctuations in asset prices, interest rates, or exchange rates, with the objective of protecting the value of the investment." (Fabozzi, 2015, p 289)

From these definitions, it can be concluded that the concept of hedging primarily revolves around the use of financial strategies and instruments—particularly derivatives such as futures and options—to manage or mitigate risks arising from fluctuations in asset prices, interest rates, or exchange rates. Despite variations in phrasing, all definitions converge on the protective function of hedging, namely preserving the value of investments and stabilizing returns against market volatility.

2. The difference between risk and hedging

Risk is an inherent phenomenon associated with various aspects of human activity; however, it manifests most clearly within the financial domain. The concept of risk has garnered significant attention across multiple academic disciplines, including sociology, psychology, economics, finance, and insurance, making it one of the most extensively explored topics both theoretically and practically. Managing risk has long been a priority due to its critical role in maintaining economic and social stability. With the evolution of modern societies and the emergence of contemporary institutional structures, risk management has developed into a distinct scientific discipline and an applied field characterized by methodological rigor. It has become an essential function in all types of institutions, both public and private. (Naoulo, 2018, p 45)

In the financial context specifically, risk refers to the possibility of a discrepancy between the expected return from a particular investment and the actual return realized, which may lead to a partial or total loss of the invested capital. One of the notable definitions of risk states that it is: *a state of uncertainty regarding the receipt, amount, timing, regularity, or a combination of these aspects of return* (Hammad, 2003, p 71). From a legal standpoint, risk is defined as: *the probability of a future incident occurring, or the realization of an uncertain event beyond the control of the contracting parties, which may result in the destruction of property or the occurrence of damage* (Abu Muheimid, 2008, p 57).

This definition highlights the distinction between hedging and risk in terms of their concepts and functions within the financial domain. Risk refers to the possibility of incurring a loss or deviation from expected outcomes due to uncertain conditions, such as market volatility, interest rate fluctuations, or debtor defaults. It represents a potential threat that must be managed cautiously. In contrast, hedging is a strategy employed to manage such risk, aiming to mitigate or prevent potential losses through the use of financial tools and techniques, such as derivative contracts. In essence, risk constitutes the potential problem, whereas hedging represents the proactive approach taken to address or minimize the impact of that problem.

2) The Motivations for Hedging in Financial Transactions and Its Legitimacy

1. The Motivations for Hedging in Financial Transactions

The motivations for hedging in financial transactions vary based on the objectives that investors or companies seek to achieve in a volatile market environment, and they can be categorized as follows:

1.1. Risk Avoidance

In finance and business, economic activities are inherently exposed to risks arising from exchange rate fluctuations, interest rate changes, and global market disruptions, which may lead to unexpected losses and weakened institutional performance. In this context, hedging serves as a preventive financial strategy aimed at reducing a firm's exposure to such risks (Hull, 2021, p 63–70, paraphrased). For instance, firms reliant on imported inputs can mitigate currency risk by using financial contracts such as forwards or futures to lock in exchange rates. While hedging does not entirely eliminate risk, it reduces uncertainty and supports more stable and strategic planning.

1.2. Minimizing Earnings Volatility

One of the primary concerns for business owners and investors is the instability of earnings across different periods, as significant fluctuations in financial returns undermine forecasting accuracy and weaken confidence in the effectiveness of financial management. In this regard, hedging plays a critical role as a risk management strategy aimed at reducing earnings volatility. By mitigating exposure to market uncertainties, hedging allows earnings to achieve a relative degree of stability, thereby enabling firms to engage in long-term planning and to implement growth strategies with greater assurance (Hull, 2021, p 65–70, paraphrased from). For example, an exporting firm may enter into forward contracts to sell its products at predetermined prices, regardless of market fluctuations. By employing such financial hedging instruments, the firm can protect itself against sudden changes in prices or demand. This approach contributes to more stable profit levels, as the financial balance achieved through hedging enhances overall institutional stability and, consequently, increases the firm's attractiveness to current and potential investors.

1.3. Ensuring Financial Stability

Financial stability is widely regarded as a fundamental requirement for institutional survival in volatile environments rather than a mere objective. Firms

that fail to maintain stable cash flows often face difficulties in meeting essential obligations such as salaries, debt servicing, and operational costs. In this context, hedging acts as a key safeguard, reducing the impact of external shocks on performance. By adopting effective hedging strategies, companies can better withstand financial disruptions and manage crises without resorting to costly emergency measures. Thus, hedging represents an essential element of prudent financial management, enabling firms to anticipate and prepare for potential risks (Syawal, 2023, p 3–6).

We conclude from the discussion of these motivations that financial hedging is not merely a technical procedure, but rather a financial mindset grounded in foresight, careful planning, and prudence. It reflects a strategic awareness aimed at safeguarding an institution's financial interests and ensuring its continuity in an ever-changing environment. For this reason, institutions that cultivate a culture of hedging tend to be more resilient, more attractive to investors, and better equipped to navigate future challenges.

2. The Legitimacy of Hedging

Hedging is recognized as one of the contemporary financial concepts that has generated significant juristic and economic debate, due to its direct connection with risk management across various financial activities. Scholarly and expert opinions have varied, depending on the nature of the instruments employed in hedging, the legal framework governing its practice, and the extent to which it aligns with ethical standards and Sharīʿahh principles that regulate financial transactions, particularly within Islamic financial systems.

In its fundamental sense—aimed at reducing risk and neutralizing adverse impacts—hedging closely aligns with the objectives of Islamic law (Maqasid al-Sharīʿahh), particularly in safeguarding wealth, directing its investment prudently, and managing it efficiently to generate benefit while avoiding negligence or extravagance.

From an Islamic jurisprudential perspective, financial responsibility is comprehensive, encompassing four primary dimensions: the responsibility of acquiring wealth, the responsibility of investing and developing it, the responsibility of preserving and protecting it, and the responsibility of spending it through legitimate channels.

Consequently, the preservation of wealth is regarded as one of the essential objectives of Sharīʿahh, as wealth constitutes one of the five fundamental necessities (al-daruriyyat al-khams) that Islamic law seeks to safeguard alongside religion, life, intellect, and lineage. This underscores the central role that wealth occupies within the moral and social framework of Islam. An illustrative example of this principle is found in the Qur'anic verse: **"And test the orphans [in their abilities] until they reach marriageable age. Then if you perceive in them sound judgement, release their property to them"** [An-Nisa: 6]. this verse emphasizes the importance of assessing minors' capacity to manage wealth before entrusting them with their financial assets, highlighting the principle of due diligence in financial transactions

to ensure the proper preservation and responsible use of wealth. (Ibn Ashour, 1984, p 283)

It has been reported from ʿUrwah ibn al-Zubayr and others that Ḥakīm ibn Ḥizām (may Allah be pleased with him), a Companion of the Messenger of Allah (Peace and blessings be upon him), used to stipulate conditions upon the person to whom he entrusted his property in al-Muqaradah (to trade with, and the profit being shared between them), that: **"You should not trade with my property in living beings, and do not transport it by sea, and do not settle with it at the bottom of a river-bed; and if you do any of the aforesaid acts you should then guarantee my property"** (Al-Dāraqutnī, n.d., vol. 3, p. 63, ḥadīth no. 3033, narrators are reliable [thiqah]).

This narration falls within the context of muḍārabah, one of the well-known contracts in Islamic jurisprudence, in which the capital owner (rabb al-māl) entrusts his wealth to an agent (muḍārib) for trade, on the basis that profits are shared according to the agreed terms, while losses are borne by the capital, unless the agent acts negligently or transgressively.

Ḥakīm ibn Ḥizām (may Allah be pleased with him) stipulated three conditions in the contract: (Al-Dāraqutnī, n.d., p 63)

i. *"You should not trade with my property in living beings"*: That is, do not use my wealth to purchase animals (such as camels, sheep, or cattle), as they are living beings subject to death or disease, thereby involving a high degree of risk.
ii. *"Do not transport it by sea"*: i.e., avoid maritime trade or shipping, due to the inherent risks of drowning, sinking, or loss.
iii. *"do not settle with it at the bottom of a river-bed (baṭn masīl)"*: i.e., do not store the merchandise in places prone to flooding, since such locations expose the wealth to a clear risk of destruction.

The consequent stipulation was: *"if you do any of the aforesaid acts you should then guarantee my property"* This means that if the agent disregards these conditions and the wealth is lost or destroyed, he would be held liable, because he deliberately exposed the wealth to risks not authorized by the capital owner.

The Significance of the Hadith in the Context of Risk Mitigation:

- This narration illustrates the Companions' concern with risk mitigation (taḥawwut) in investment contracts, by limiting the scope of the agent's activities and directing them toward less hazardous avenues.
- It also establishes a foundational principle: the capital owner has the right to impose conditions in a muḍārabah contract that serve the preservation of capital and protection of interests—a principle later endorsed by jurists, provided that such conditions do not contradict the essence of the contract.

In light of these principles, financial hedging does not conflict with the objectives of Islamic law; rather, it can be regarded as a legitimate means of safeguarding wealth, provided that it is implemented in accordance with Sharīʿahh guidelines. The legitimacy of hedging is determined not by the concept itself, but by the mechanisms and methods employed and the extent to which they align with Sharīʿahh objectives—particularly when they serve to protect wealth or prevent its loss—so

long as they do not involve prohibited transactions or instruments that violate Islamic legal rulings.

II- FORMS OF HEDGING IN TRADITIONAL AND ISLAMIC FINANCIAL TRANSACTIONS

1) Forms of Hedging in Traditional Finance

In the traditional financial system, institutions rely on derivative instruments to hedge against market volatility. Financial derivatives are contracts whose value is derived from underlying assets such as stocks, bonds, commodities, currencies, and interest rates, with gains and losses linked to price movements. Rather than being assets themselves, they function as tools for managing or transferring risk and typically do not involve the physical exchange of the underlying asset, but are based on agreements reflecting expectations of future price changes. The most common of these instruments include: (Jarrow & Turnbull, 2000, p 21–145, 201–230, paraphrased from)

1. Futures Contracts

Futures contracts are agreements to buy or sell an asset at a fixed price on a future date, and are widely used as a key hedging tool to protect institutions from price fluctuations. Their main goal is not to profit from market volatility but to secure price stability for planning purposes. Traded in organized markets and backed by legal and regulatory frameworks, they involve daily settlements that reduce default risk. Although they do not always lead to the actual delivery of the asset, their core function is to minimize exposure to future price risks, thereby supporting effective risk management and financial stability (Jarrow & Turnbull, 2000, p 27–45).

However, a notable drawback of these contracts is that, in many cases, the primary objective of the contracting parties is speculation on market prices rather than genuine hedging. Consequently, these contracts often do not result in the actual exchange of the underlying asset, but rather conclude with the payment of price differentials upon the contract's maturity. The losing party pays the difference to the winning party through clearinghouses, which facilitate the transaction using accumulated margin deposits. This mechanism effectively transforms the contract from a genuine sale into a speculative arrangement that terminates in financial settlements, bearing a practical resemblance to gambling. (Razif, Mohamad & Samsulkamal, 2018, p 21–29)

2. Forward Contracts

Forward contracts are financial agreements entered into directly between two parties outside the scope of organized markets, whereby the parties agree to buy or sell a specific asset at a predetermined future date for a price established at the time of contracting. These contracts are characterized by a high degree of flexibility in their terms and specifications, as the parties can tailor the contract's details to suit their particular needs without adhering to the standardized conditions imposed by formal exchanges. However, this flexibility comes at the cost of increased risk, particularly with respect to credit and settlement risk, due to the absence of a central clearing entity to guarantee performance. Forward contracts are commonly

employed by financial institutions and large corporations as a hedging tool against price volatility, although they may also be used for speculative purposes. Consequently, they constitute financial instruments that combine the advantages of customization with the elevated risks associated with unregulated markets. (Hull, 2021, p 73–103)

3. Options Contracts

Options contracts are derivative financial instruments that grant the holder the right, but not the obligation to buy or sell a specific asset at a predetermined price—known as the strike price—either within a specified period or on a fixed future date. These contracts are broadly categorized into two main types: call options, which confer the right to purchase the asset, and put options, which confer the right to sell it. Options are considered flexible tools in risk management, as they allow investors to hedge against price volatility while maintaining the potential to benefit from favorable market movements. They are also employed in speculative strategies to enhance expected returns.

The significance of options lies in their ability to define the maximum potential loss for the buyer, since the buyer is not obligated to exercise the contract if it is not in their interest. This characteristic enables more precise risk management compared to certain other derivative instruments. However, the seller remains exposed to higher levels of risk, particularly when the contract is uncovered by the underlying asset, necessitating a thorough understanding of market dynamics and accurate pricing mechanisms to ensure effective utilization. (Hull, 2021, p 209–218)

4. SWAPS CONTRACTS

Swaps contracts are derivative financial instruments through which two parties agree to exchange a series of future cash flows based on predefined terms. These cash flows are often linked to financial benchmarks, such as interest rates or exchange rates. Swaps are widely employed in risk management, particularly to address interest rate fluctuations or hedge against currency risk, as they enable financial institutions and corporations to restructure their obligations in alignment with their funding strategies.

Swaps contracts take various forms, most notably interest rate swaps, in which fixed interest payments are exchanged for floating payments, and currency swaps, which involve the exchange of assets and cash flows denominated in different currencies. The significance of these contracts lies in their ability to provide flexible solutions for managing financial risk without necessitating the direct exchange of the underlying asset. However, their execution outside organized markets exposes them to elevated credit risk. (Hull, 2021, p 209–218)

2) Forms of Hedging in Islamic Finance

The concept of hedging in Islamic finance is grounded in Sharīʿah principles that prohibit riba, maysir, and excessive gharar, which restrict the use of many conventional derivative instruments. Consequently, alternative Sharīʿah-compliant structures have been developed to achieve similar hedging objectives while maintaining a balance between economic goals and ethical requirements. These

forms of hedging constitute a distinct area that requires careful evaluation in terms of their efficiency and legitimacy compared to conventional instruments. The following are selected models in this context:

1. Hedging through Documentation (Writing, etc.)

Writing in Islamic financial transactions constitutes one of the fundamental pillars of legitimate hedging. It is not merely an administrative or literary form of documentation, but rather a practical mechanism that contributes to the preservation of rights, the stability of financial dealings, and the establishment of a balanced financial system grounded in the principles of trust and justice. Islamic legislation preceded modern financial systems in emphasizing the importance of documentation and regulating contractual relationships, reflecting the depth of the Sharīʿah's preventive vision in mitigating risk and safeguarding wealth.

This principle is clearly established in the Qur'anic verse: **"O you who have believed, when you contract a debt for a specified term, write it down"** [al-Baqarah: 282], which (affirms the legitimacy of documenting contracts and debts, and explicitly commands the practice of writing in financial transactions). This verse serves as a foundational legal basis in Islamic jurisprudence for the documentation of obligations, as numerous classical exegetes—including al-Ṭabarī (d. 310 AH) and Ibn Kathīr (d. 774 AH)—affirmed that it constitutes a directive aimed at preserving rights and preventing future disputes, particularly in financial dealings.

As al-Ṭabarī explains: "The command to write is for safeguarding debts and clarifying obligations, so that no injustice or forgetfulness occurs between the parties" (Al-Ṭabarī, n.d., p 65). Similarly, Ibn Kathīr remarks: "This verse represents the longest in the Qur'an and deals entirely with financial rights and contractual obligations. It highlights the importance of documentation in securing financial interactions." (Ibn Kathīr, n.d, p 718)

This divine injunction not only mandates writing in financial transactions but also ensures contractual security by providing a clear record of obligations that prevents disputes and misunderstandings. It reduces ambiguity, strengthens trust, and preserves rights, thereby stabilizing financial dealings within a Sharīʿah-compliant framework. As emphasized by classical scholars such as al-Ṭabarī and Ibn Kathīr, documentation is not merely administrative; it is a practical mechanism for mitigating risk, safeguarding wealth, and promoting fairness and accountability in all Islamic financial transactions.

2. Hedging through Risk-Sharing Mechanisms

Risk-sharing constitutes a foundational principle of legitimate hedging in Islamic finance. Partnership-based contracts, such as mushārakah and muḍārabah, embody this principle by distributing financial risk among the contracting parties—unlike conventional contracts, which often place the entire burden of risk on a single party, thereby undermining contractual equity. In contrast, these Islamic contracts demonstrate a participatory and precautionary character, making them effective instruments for mitigating financial risk within a balanced, Sharīʿah-compliant framework.

The **mushārakah** contract, in particular, achieves hedging by distributing risk among partners. Each party contributes a portion of the capital and agrees on a profit-sharing ratio in advance, while losses are allocated in proportion to their respective capital contributions. This structure minimizes individual financial exposure and fosters collective responsebility (Al-Ṭarāblusī, 1992, p 117 , Al-Harari, 2018, p 120–124). Moreover, the presence of mutual oversight among partners promotes financial discipline. The contract may also incorporate valid Sharīʿah-based stipulations aimed at mitigating risks—such as decision-making protocols, restrictions on unilateral management, and requirements for periodic reporting. These safeguards help prevent mismanagement and ensure that the contract operates in alignment with the higher objectives (maqāṣid) of Sharīʿah, particularly the protection of wealth (ḥifẓ al-māl).

As for **muḍārabah**, it facilitates legitimate hedging by dividing roles and risks between the capital provider (rabb al-māl) and the entrepreneur (muḍārib), who manages the investment in exchange for an agreed share of the profit (Ibn Qudāmah, 1997, p 17, 29, 38, Ibn Rushd al-Hafid, 1996, p 237). The hedging function is achieved by limiting financial loss to the capital provider alone—provided that the muḍārib has not acted negligently or wrongfully. This structure encourages prudent management while ensuring fairness in the distribution of outcomes. The contract can further enhance hedging through lawful conditions, such as restricting the scope of investment activities, setting spending limits, or defining geographic boundaries. Additional stipulations may include requiring the muḍārib to demonstrate specific expertise or securing a guarantor in certain cases. These features underscore the flexibility of muḍārabah in managing risk without violating the principles and higher objectives (maqāṣid) of Islamic law.

3. Hedging through Liquidity Management (Ijarah Sukuk, Murabaha, etc.)

3.1 Ijarah Sukuk (See note no. 1) are regarded as effective hedging instruments in Islamic finance due to their structure, which is based on tangible, income-generating leased assets. These assets produce regular and predictable returns, contributing to financial stability and mitigating risks associated with market volatility or insolvency—risks typically more pronounced in instruments based on debt or speculative activities. The hedging strength of Ijarah Sukuk lies in their foundation on real asset ownership, which is leasable, thereby reducing credit risk and offering investors a higher degree of financial security.

Moreover, Ijarah Sukuk enable portfolio diversification by financing a wide range of assets across various sectors. Their compliance with Sharīʿahh—through the absence of interest-based (riba) transactions—makes them a legitimate risk-mitigation tool that shields investors from usurious risks and unethical market fluctuations. These sukuk can also be structured flexibly to include additional features, such as takaful (Islamic insurance) coverage or early redemption options, which enhance their effectiveness in risk management within a framework that aligns with *Maqasid al-Sharīʿahh* (the higher objectives of Islamic law) in preserving wealth and ensuring economic stability. (Saeed et al., 2021, p 629–640)

3.2 The **murābaḥah** contract to purchase upon request is a financing arrangement whereby a client requests a financial institution to acquire a specific commodity that meets predefined specifications. The institution first purchases the asset for its own account and subsequently sells it to the client at a predetermined price, which includes both the acquisition cost and a known profit margin—typically to be paid on a deferred basis. (AAOIFI, 2010)

This contract is regarded as one of the most prominent instruments of financial hedging within Islamic banking, serving both the financier and the client. It is structured such that the financial institution assumes ownership of the commodity prior to its resale to the client, and the profit margin is agreed upon in advance. From the financier's perspective, risk mitigation is achieved through a set of measures that include assessing the client's creditworthiness before entering the contract, obtaining a binding or non-binding purchase promise (depending on the juristic view), and requiring legitimate forms of security, such as collateral or a guarantor.

Additionally, financial institutions often employ what is known as khiyār al-sharṭ (option of condition) when acquiring the commodity from the original supplier. Under this arrangement, the institution enters into a purchase contract that includes a conditional, time-bound option—for example, a three-day period—during which it may rescind the transaction if the client fails to fulfill the purchase commitment or if unforeseen complications arise. This mechanism is firmly grounded in classical Islamic jurisprudence, recognized by all four major schools of law, and serves as an effective safeguard against operational and market-related risks. In doing so, it provides the institution with provisional protection before it assumes full ownership, reflecting the flexibility and prudence inherent in Islamic contractual structures for risk management within the bounds of Sharīʿah. (Ṣāliḥ & al-Hājirī, 2017, p 448–460)

In the same context, the promise to purchase in murābaḥah may be regarded as a complementary hedging mechanism, as it provides the financial institution with a degree of assurance prior to acquiring the asset by reducing the likelihood of client default. This mechanism helps mitigate price volatility risk and reduces the operational burden associated with holding unsold assets. Despite juristic disagreement regarding the binding nature of such a promise, most contemporary Sharīʿah boards and professional standards, including AAOIFI, have adopted a regulated form of binding promise in murābaḥah to the purchase orderer, particularly where non-fulfillment results in actual harm to the financial institution. This approach aims to preserve transactional stability while remaining consistent with Sharīʿah objectives of risk management (AAOIFI, 2017, p Standard No. 8).

From the client's perspective, murābaḥah provides a reliable means of protection against price volatility and the uncertainties of conventional (interest-based) financing. The predetermined total cost, including the profit component, ensures clarity and transparency, enabling the client to plan future cash flows with confidence. Moreover, the structure guarantees that the financing remains fully Sharīʿah-compliant, free from interest and exploitative terms often associated with

conventional lending. This contributes to both financial stability and contractual security for the client.

4. Hedging in Forward and Future Contracts

4.1 Hedging through the Salam Contract

The **Salam contract** is a recognized Islamic financial instrument that permits the purchaser to pay the full price in advance for goods to be delivered at a specified future date, with clearly defined specifications (Malik ibn Anas, n.d., Vol. 11, p. 211, Abdel Halim Omar, 2004, p24). It serves as a legitimate mechanism for both parties -buyer and seller- to hedge against anticipated price increases in commodities or raw materials.

.4.11. Hedging for the Buyer:

For the buyer, the Salam contract offers a practical tool to guard against future price volatility, particularly in markets prone to cyclical fluctuations or where there are credible expectations of rising prices. By fixing the purchase price at the outset, the buyer is able to:

- Secure essential goods at a predetermined cost, thus avoiding sudden market shocks.
- Plan expenditures with precision, as the cost of procurement remains constant.
- Protect against inflationary trends or shifts in supply and demand by anchoring the transaction in a present-day, fixed price.

Through this structure, the buyer attains a measure of economic stability and contractual certainty without resorting to interest-based hedging instruments that violate Islamic legal principles.

.4.12. Hedging for the Seller:

From the seller's perspective, the Salam arrangement provides a viable means of obtaining immediate liquidity to support production, agriculture, or manufacturing, without relying on interest-bearing loans or conventional credit facilities. It allows the seller to hedge against various risks, including:

- Securing a guaranteed sale prior to production, thereby minimizing exposure to potential market saturation or inability to offload inventory.
- Benefiting from early access to working capital, which can be used to acquire raw materials or meet operational costs.
- Locking in the sale price in advance, offering protection against future price declines and market instability.

Thus, the Salam contract represents a mutually beneficial arrangement aligned with the objectives of Islamic law, particularly the removal of hardship and the promotion of financial stability. It offers a lawful alternative to prohibited forward contracts that involve the sale of non-owned goods, deferred exchanges of both countervalues, and transactions tainted by uncertainty (gharar) or interest (riba).

4.2 Hedging through the Istisnā ‘Contract

The *Istisnāʿ* contract is a binding agreement between two parties, in which one party commissions the manufacture of a specific item according to agreed-upon specifications, and the other undertakes to produce and deliver it at a future date. Payment under this arrangement may be made in full at the outset, deferred in its entirety, or settled in installments. This contract stands out as a flexible and Sharīʿah-compliant mechanism that facilitates hedging against fluctuations in prices or shifts in the cost of raw materials—for both the purchaser (the commissioning party) and the manufacturer. (Al-Zarqa, 1420H, p 20)

From the buyer’s perspective, Istisnāʿ allows the price of the requested item to be fixed in advance, thereby protecting the purchaser from potential future price surges. It also facilitates more accurate financial planning by locking in costs prior to production. From the seller’s perspective, the contract provides assurance of a committed order, which reduces the risk of unsold inventory and grants access to funds—either partially or in full—that can be allocated toward procuring raw materials or covering production-related expenses.

In this way, the Istisnāʿ contract serves as a legitimate hedging tool, mitigating exposure to market volatility and supply chain uncertainty. It provides a viable alternative to contracts prohibited due to interest or the sale of goods not yet owned, while fully adhering to the essential legal requirements of Islamic commercial law—namely, clarity in specifications, price, and delivery terms.

III- SHARĪʿAH RESERVATIONS ON CONVENTIONAL HEDGING INSTRUMENTS

1) The Position of Islamic Jurisprudence On Conventional Hedging Instruments and The Reasons for Caution

Islamic jurisprudence adopts a systematic and critical perspective on a range of hedging instruments commonly used in the conventional financial system, especially those based on forward transactions involving the exchange of money or commodities without immediate possession, or those structurally reliant on interest and usurious financial derivatives. This position is grounded in well-established Sharīʿah principles drawn from the Qur’an and the Sunnah, and is further guided by the higher objectives of Islamic law, which aim to cleanse financial transactions of usury (ribā), excessive uncertainty (gharar), and injustice, in order to achieve equity and balance in economic activity.

1. Usury in Conventional Hedging Contracts

Many conventional hedging instruments—such as currency forward contracts and interest-based financial derivatives like swaps—are fundamentally structured around the deferred exchange of monetary values or money for debt, in which one or both countervalues are postponed (Fabozzi & Mann, 2010, p 417–450). This structure falls under the prohibition of ribā al-nasīʾah (usury involving delay), which is explicitly forbidden in Islamic law.

This prohibition is clearly stated in the Qur’an, where Allah says: **"O you who believe! Do not consume usury, doubled and multiplied, but fear Allah so that**

you may be successful." (Sūrat Āl ʿImrān, 3, p130), And in another verse: **"Allah has permitted trade and forbidden usury."** (Sūrat al-Baqarah, 2;p275)

The Sunnah also affirms this ruling. In the ḥadīth of ʿUbādah ibn al-Ṣāmit (may Allah be pleased with him), the Prophet Muhammad (Peace and blessings be upon him), said: **" Gold is to be paid for by gold, silver by silver, wheat by wheat, barley by barley, dates by dates, and salt by salt, like for like and equal for equal, payment being made hand to hand. If these classes differ, then sell as you wish if payment is made hand to hand"** (Muslim, n.d., vol. 3, p. 1418, ḥadīth no. 1587, Authentication: [Sahih]), This ḥadīth serves as a foundational text establishing the requirement of immediate possession (taqābuḍ) in monetary exchanges and the prohibition of deferring either countervalue.

Any delay or unequal exchange in ribā-based transactions undermines justice and disrupts economic balance, contributing to financial instability rooted in exploitation and speculation rather than legitimate exchange. To prevent this, Prophetic guidance requires equivalence and immediate possession to ensure fairness and avoid unjust enrichment. Thus, the prohibition of ribā serves broader objectives, including the protection of wealth, the promotion of trust, and the establishment of stability and balance in economic activity. Scholars such as Al-Nawawi and Ibn Hajar al-Asqalani emphasize that these rulings act as preventive measures to block all forms of ribā and uphold justice in financial dealings (Al-Nawawī, 1392H: vol.11, 9; Ibn Ḥajar al-ʿAsqalānī, 1379H, p 364).

2. Gharar and Gambling in Financial Derivatives

Many conventional hedging instruments - particularly forward contracts and financial derivatives such as options - exhibit significant elements of **gharar**, a term in Islamic jurisprudence denoting excessive uncertainty or ambiguity regarding the countervalue or subject matter of a contract (Malik, 1992, Vol. 3, p. 452). The primary concern arises when one party enters into the contract based on speculation about uncertain future price movements, while the other assumes a fixed financial obligation. Such an imbalance places the transaction squarely within the scope of prohibited financial gambling.

The explicit prohibition of this type of transaction is found in the ḥadīth of Abū Hurayrah (may Allah be pleased with him), who reported that "**The Messenger of Allah (Peace and blessings be upon him) prohibited the Gharar sale, and the Hasah sale**." (al-Tirmidhī, n.d., vol. 3, p. 532, ḥadīth no. 1230, Authentication: [Sahih]). This legal directive underscores the gravity of gharar in financial contracts, as excessive uncertainty or undue risk undermines the principle of transparency, potentially leading to future disputes or the exploitation of one party by another. Such consequences pose a serious threat to the stability of transactions and weaken contractual justice. This concern is particularly evident in a number of uncovered derivative hedging instruments, where gharar manifests in practice, causing harm to one party and eroding trust within the financial environment.

Therefore, the gharar inherent in conventional hedging instruments is not merely a formal defect; rather, it fundamentally undermines the balance of contractual fairness and leads to the erosion of rights. This is in clear contradiction

with the foundational principles of Islamic jurisprudence regarding contracts, which are based on clarity, justice, and mutual consent. (Abadah & Rababa‘ah, 2016, p 744–748)

3. Incompatibility with the Objectives of Islamic Law (Maqāṣid al-Sharīʿah)

Islamic law accords great importance to achieving higher objectives (maqāṣid) in the field of financial transactions. Chief among these objectives are the establishment of justice in economic exchange, the prevention of injustice and exploitation, and the imperative to link money to real economic activity that serves the public interest and contributes to wealth creation—rather than its hoarding or its circulation within a narrow circle of speculators. In Islamic economic thought, money is not viewed as a commodity to be traded in and of itself, detached from its functional and social context. Rather, it is regarded as a means of financing real production and fulfilling legitimate human needs. (Ibn Ashur, 2004, p 139–147)

However, many conventional hedging instruments—particularly financial derivatives such as forwards, options, and swaps—are primarily structured around pure speculation on price fluctuations, without resulting in the actual exchange of goods or the provision of tangible services. Their primary objective is to generate profit from anticipated price differences, rather than to facilitate genuine buying or selling transactions. This leads to the emergence of a “virtual economy” disconnected from real production and resource distribution.

Such a paradigm directly contradicts the objectives of Islamic law in several critical respects:

a) It fosters a financial environment characterized by excessive risk-taking and speculative behavior, rather than by stability and cooperative value creation.

b) It leads to the concentration of wealth in the hands of a minority engaged in financial speculation, without contributing to the financing of productive projects or the provision of goods and services to society.

c) It has adverse implications for economic justice, as wealth becomes vulnerable to volatility and loss through unreal financial wagers, thereby deepening the divide between those who possess financial instruments and those engaged in the real economy.

Accordingly, hedging instruments based on this model lack the necessary Sharīʿahh foundation that links wealth to labor or utility. They stand in clear opposition to the economic objectives of Islamic law, which aim to establish balance, protect rights, and promote the fair and productive circulation of wealth.

2) The Stance of Sharīʿah Supervisory Boards and Islamic Fiqh Councils on Conventional Hedging Instruments

Traditional hedging instruments have sparked extensive jurisprudential debate due to their association with financial derivatives and related Sharīʿah concerns. Consequently, Sharīʿah supervisory boards and international fiqh academies have closely examined these issues to determine their rulings and to establish the

parameters governing hedging in financial transactions. The following presents the main conclusions reached on this subject:

1. The International Islamic Fiqh Academy (Organization of Islamic Cooperation)

In its twenty-third session (Al-Madinah Al-Munawwarah, 19–23 Ṣafar 1440 AH / 28 October–1 November 2018 CE), the Academy issued Resolution No. 224 (8/23), entitled "Hedging in Financial Transactions: Principles and Rulings." The resolution stated that the concept of hedging encompasses a broader scope than prevailing market practices, reaffirmed the prohibition of interest-based structures and risk trading, and stipulated that derivatives—such as forwards, futures, options, and swaps—fall within contractual forms, many of which have been deemed impermissible due to their inclusion of risk trading, prohibited deferment, or excessive uncertainty (gharar fāḥish).The resolution also called for the development of Sharīʿahh-compliant alternatives that achieve the preventive objective without the associated risks. (International Islamic Fiqh Academy, 2018)

This resolution represents a pivotal step in defining the Sharīʿah parameters governing financial hedging. It reflects a systematic approach that seeks to strike a balance between the demands of financial innovation and adherence to the objectives of Islamic law, as manifested in the following dimensions:

i. Broadening the Concept of Financial Hedging: The resolution broadens the concept of hedging beyond common market practices into a comprehensive framework that protects financial transactions from impermissible risks while ensuring the realization of the parties' interests within Sharīʿah limits. It also reflects the juristic council's awareness of the complexity of modern financial markets and the need for a deep understanding of contemporary financial instruments to properly apply Sharīʿah rulings.

ii. Reaffirming the Prohibition of Impermissible Structures through the Establishment of Clear Sharīʿah Compliance Criteria:The resolution highlights the importance of adhering to the objectives of Islamic law, particularly the protection of wealth from exploitation and injustice. It also classifies certain financial derivatives—such as options, futures, and swaps—as prohibited due to their potential to generate excessive uncertainty (gharar fāḥish) and to conflict with Sharīʿah principles. Accordingly, it provides a clear framework for Islamic financial institutions to evaluate products and ensure compliance, thereby promoting legal and economic certainty and preventing financial misconduct.

iii. Encouraging Innovative Sharīʿah-Compliant Alternatives: The call to develop Sharīʿah-compliant alternatives that achieve the preventive objective of hedging without falling into prohibited practices contributes to fostering financial innovation within a framework governed by Sharīʿah principles. It also opens avenues for the utilization of sound contractual forms, such as salam, istisnāʿ, and hedging-oriented murābaḥah. This orientation embodies a reconciliatory approach that balances investor protection with the promotion of legitimate economic activity, while simultaneously reflecting a practical understanding of the principle of

"realizing benefit and preventing harm" as established in Islamic financial jurisprudence.

2. Sharīʿah Supervisory Boards in Islamic Banks

Sharīʿah supervisory boards in Islamic banks adopt a cautious stance toward conventional hedging instruments due to their potential involvement in financial derivatives that may contain elements of ribā, gharar, or excessive speculation, which makes them incompatible with Sharīʿah principles. Accordingly, these boards ensure that hedging instruments are based on genuine, well-defined contracts that comply with Sharīʿah and achieve the objective of mitigating financial risks without violating its guidelines.

Sharīʿah supervisory boards also provide a set of practical guidelines for Islamic banks, including**:** (Al-Zarqa, 1420h,p 45–47)

- Ensuring the independence of contracts when linking multiple financial structures, so that each contract stands on its own without any pre-existing connection to another, thereby avoiding engagement in impermissible practices.
- Developing and adopting Sharīʿah-compliant hedging alternatives, such as parallel salam contracts, which enable effective risk management while fully adhering to Sharīʿah principles.
- Controlling the application of the time value of money, limiting its use to pricing or financial estimates without relying on it as a fundamental accounting measure that could compromise the Sharīʿah compliance of transactions.
- Conducting periodic review and evaluation of new hedging instruments before approval, to ensure their compliance with Sharīʿah rules and the internal policies of the bank.

The guidelines issued by Sharīʿah supervisory boards require that hedging in Islamic financial institutions fully comply with Sharīʿah principles, avoiding ribā, gharar, and maysir, and be based on genuine, well-defined contracts. They emphasize maintaining the independence of contracts when combining financial structures, promote Sharīʿah-compliant alternatives such as parallel salam contracts, and restrict the use of the time value of money to pricing purposes only. The guidelines also stress the need for the periodic review of new hedging instruments to ensure ongoing compliance, ultimately affirming that Islamic hedging is an effective risk management tool grounded in Sharīʿah principles rather than a mere imitation of conventional practices.

Conclusion

Based on the foregoing, it is evident that hedging constitutes a fundamental tool for managing financial risks and maintaining a degree of stability in returns. However, the approach to its implementation differs substantially between the conventional financial system and the Islamic financial system. The divergence in the foundational references of the two systems directly influences the design and performance of hedging instruments, as outlined below:

1- Formation of Hedging Instruments According to Intellectual and Sharīʿah Foundations:

In the conventional financial system, hedging instruments are based on market efficiency and technical performance, allowing for high flexibility and a wide variety of instruments (such as futures, options, and swaps), which enhances their short-term effectiveness in risk management.

In contrast, the Islamic financial system adheres to Sharīʿah principles, which prohibit ribā (usury), gharar (excessive uncertainty), and maysir (gambling), and imposes strict regulations on the nature of financial instruments and contractual arrangements, including murābaḥah, istiṣnāʿ, sukūk, and binding promises (waʿd).

2- Balancing Efficiency, Sharīʿah Compliance, and Financial Stability:

Conventional hedging instruments achieve high short-term efficiency, yet they may be exposed to speculative risks, sometimes transforming hedging from a risk-mitigation tool into a source of financial instability.

Islamic hedging instruments are more conservative and less exposed to systemic risk, while ensuring compliance with Sharīʿah. This enhances long-term financial stability and fosters a safer and more sustainable investment environment, even if their flexibility or diversity is somewhat more limited compared to conventional instruments.

3- Core Differences in Intellectual and Ethical Foundations:

The conventional system primarily evaluates instruments from the perspective of financial performance and technical efficiency, whereas Islamic finance assesses them through the lens of Sharīʿah compliance and the pursuit of both financial and moral sustainability.

Adherence to Sharīʿah does not diminish the effectiveness of hedging; rather, it contributes to long-term financial stability and strengthens confidence in the investment environment.

Recommendations

Based on the findings of this study and the analysis of the fundamental differences between the two financial systems, the following recommendations are proposed to enhance the effectiveness of hedging and ensure its compliance with ethical and Sharīʿah-based frameworks:

1) Emphasize the development of innovative Sharīʿah-compliant hedging instruments that combine flexibility, efficiency, and ethical integrity.
2) Consolidate the integration between fiqh-based scholarship and financial innovation to expand the range of tools available to Islamic financial institutions.
3) Establish regulatory and supervisory frameworks within the conventional financial system to curb excessive speculative practices, ensuring that hedging remains a tool for risk management rather than risk creation, particularly in Arab and Islamic countries where this system is predominantly adopted.
4) Promote collaboration between conventional and Islamic financial institutions to exchange expertise in risk management and jointly

develop hybrid instruments that remain consistent with Sharīʿah principles.

(Note no. 1): Ijārah sukuk are financial instruments issued by a particular entity (referred to as the "issuer") for the purpose of financing the acquisition of tangible assets. These assets are subsequently leased to another party (the lessee) in exchange for a predetermined rental payment. The lease income is distributed periodically to the sukuk holders, who are considered joint owners of the usufruct (beneficial use) of the leased asset. For this definition . (Hāshim, 2023 : 16–20)

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