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Islamic Hedging Mechanisms for Exchange Rate Risk: A Shariah-Compliant Perspective

Dede Abdurohman
UIN Sunan Gunung Djati Bandung, Indonesia
dede_abd50@yahoo.com

Abstract

This paper explores the development and application of Islamic hedging mechanisms to mitigate exchange rate risk in accordance with Shariah principles. Conventional derivatives, often embedded with interest and speculation, are not permissible in Islamic finance. This study investigates alternative tools—such as wa'd-based forwards, Islamic currency swaps, and tahawwut instruments—by examining their jurisprudential foundations, operational models, and institutional frameworks. Using qualitative data from verified academic and institutional sources, the study finds that Shariah-compliant hedging tools are both viable and necessary for effective risk management. However, their broader adoption is hindered by legal diversity, documentation challenges, and regulatory inconsistencies. Opportunities for standardization, technology integration, and educational outreach are identified as pathways for improvement. This research contributes to the discourse by offering a cohesive framework for understanding Islamic hedging and providing actionable insights for regulators, scholars, and practitioners seeking ethical financial risk management solutions.

Keywords: *Islamic finance, hedging, exchange rate, Shariah-compliant, currency risk management.*

INTRODUCTION

The increasing globalization of trade and investment has led to intensified exposure to exchange rate risk, particularly among businesses and investors operating across multiple currencies. In this context, managing foreign exchange risk becomes a crucial component of financial planning and sustainability. While conventional financial systems offer various hedging instruments such as options, forwards, and futures, these instruments typically involve interest-bearing mechanisms and speculative elements, which are considered prohibited in Islamic finance due to the presence of riba and gharar (El-Gamal, 2006; Obaidullah, 2005). Consequently, Islamic finance institutions (IFIs) face challenges in developing risk management tools that align with Shariah principles while remaining effective in protecting against market volatility.

The rise of Islamic finance as a parallel financial system underscores the importance of constructing instruments that fulfill the dual objectives of economic efficiency and religious compliance. Islamic law mandates transactions to be free from uncertainty and speculation while emphasizing asset-backed structures and transparency (Usmani, 2002, p. 114; Ayub, 2007, p. 218). The challenge lies in adapting traditional risk mitigation mechanisms to fit the Islamic worldview, which prioritizes ethical conduct and socio-economic justice. Accordingly, scholars and practitioners have developed Sharia-compliant alternatives, including wa'd-based contracts and tahawwut frameworks, that attempt to replicate the function of conventional hedging without violating Islamic tenets (Dusuki & Bouheraoua, 2011).

Several Islamic financial institutions have implemented currency hedging tools, but their usage remains limited and geographically uneven due to a lack of standardized practices and divergent jurisprudential opinions. According to the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), derivative contracts are permissible only under specific conditions, yet interpretations differ among scholars and regulatory bodies (AAOIFI, 2015). Moreover, the International Islamic Financial Market (IIFM) has published standardized

documentation for Shariah-compliant hedging tools, yet adoption remains low across jurisdictions (IIFM, 2017). This disparity hinders the broader application and scalability of Islamic hedging mechanisms.

From an empirical perspective, there is a pressing need to assess the effectiveness, legal soundness, and operational feasibility of Islamic hedging transactions. Existing studies often emphasize theoretical compliance or jurisprudential justification but lack comprehensive analyses of practical implementation (Ahmed, 2010; Khan & Ahmed, 2001). Furthermore, the majority of literature has focused on the Islamic banking sector in the Middle East, leaving a gap in understanding how these instruments operate in Southeast Asia and other regions with emerging Islamic finance markets.

Given these gaps, this research investigates Islamic hedging transactions in the context of exchange rate risk management, emphasizing both theoretical foundations and applied mechanisms. Specifically, the study aims to answer the following research questions: (1) How do Islamic hedging instruments align with Sharia principles in mitigating exchange rate risk? (2) What are the key models and mechanisms used in Islamic financial institutions for currency hedging? (3) What challenges and opportunities exist for enhancing the effectiveness and standardization of Islamic hedging tools?.

LITERATURE REVIEW

The literature on Islamic hedging transactions has grown significantly over the past two decades, reflecting both academic interest and practical necessity within the Islamic finance sector. Early studies primarily focused on the incompatibility of conventional derivatives with Islamic legal norms, particularly due to the embedded elements of riba, gharar, and maysir (Chapra, 2000; El-Gamal, 2006). As these prohibitions are fundamental to Islamic financial jurisprudence, scholars have sought alternative frameworks rooted in Islamic contractual theory, such as wa'd, ʿaqd musāwamah, and muʿāwaḍah, to construct risk mitigation tools compliant with Sharia (Usmani, 2002, p. 135; Ayub, 2007, p. 289). This foundational scholarship established the parameters within which any permissible hedging instruments must operate.

Later contributions in the literature began addressing the conceptual viability and operational modeling of Islamic hedging. Authors such as Obaidullah (2005) and Khan and Ahmed (2001) explored the construction of Islamic forward contracts through unilateral promises (wa'd), emphasizing the need for clarity and enforceability. More recent works, including Dusuki and Bouheraoua (2011), have analyzed the tahawwut framework developed by the Islamic Fiqh Academy and the IIFM, which provides standardized templates for Sharia-compliant hedging practices. These models focus on ensuring that risk mitigation occurs through ethical means that align with maqāṣid al-sharīʿah (objectives of Islamic law), especially the preservation of wealth and avoidance of harm.

The literature also reveals a gap in empirical studies that evaluate the performance and adoption of these instruments across different jurisdictions. Most existing works are theoretical, jurisprudential, or limited to case studies in the GCC countries (Ahmed, 2010; Hanif, 2011). A few studies have attempted to quantify the efficiency of Islamic hedging models through simulation or operational data, such as Mohd-Sanusi and Isa (2015), but such analyses remain sparse. Moreover, the existing body of literature tends to overlook the operational challenges related to legal enforceability, market infrastructure, and cross-border application, which are critical to the scalability of Islamic hedging mechanisms in the global financial system.

Theoretical Framework

The theoretical foundation for Islamic hedging transactions rests primarily on the principles of Shariah law as applied to financial contracts. Central to this framework is the prohibition of riba (interest), gharar (excessive uncertainty), and maysir (speculation), which are integral features of most conventional derivatives. These prohibitions are derived from the Qur'an and Hadith and are supported by a vast body of fiqh al-muʿāmalāt (jurisprudence of financial transactions) (Usmani, 2002, p. 99). Therefore, any hedging mechanism within Islamic finance must exclude interest and speculation and must be based on actual asset-backed transactions or risk-sharing arrangements (Ayub, 2007, p. 265).

One of the primary contractual structures used in Islamic hedging is the unilateral promise or wa'd. This is a commitment by one party to perform a particular action in the future, often used in currency hedging to lock in an exchange rate without creating a bilateral obligation that would resemble a conventional forward contract (Obaidullah, 2005). While some scholars argue that a binding wa'd resembles a forward contract and may thus raise Sharia concerns, others maintain that if properly structured and documented, it can be deemed compliant as it avoids gharar and riba by relying on mutual consent and asset delivery (Dusuki & Bouheraoua, 2011).
Another theoretical model is the tahawwut framework endorsed by the Islamic Fiqh Academy and AAOIFI. This model permits specific hedging contracts provided they are structured within defined boundaries, including full disclosure, avoidance of speculation, and linkage to actual economic transactions (AAOIFI, 2015). Under this framework, instruments such as Islamic profit rate swaps and currency swaps are permissible when they are based on tangible transactions and do not involve interest-bearing elements. The IIFM has also developed standardized documentation to facilitate the consistent implementation of tahawwut-based instruments (IIFM, 2017).

Maqāṣid al-sharīʿah provides another critical layer to the theoretical framework, guiding the development and assessment of financial instruments not only by legal form but also by their social and ethical impact. According to Kamali (2008, p. 147), this principle demands that financial tools contribute to economic justice, the avoidance of harm, and the equitable distribution of risk. Islamic hedging instruments are thus evaluated not only by their contractual compliance but also by their ability to uphold these broader objectives. This integrative approach encourages innovations that protect wealth and minimize harm without resorting to impermissible methods.

Previous Research

In 2001, Khan and Ahmed published a foundational study evaluating risk management practices in Islamic financial institutions, identifying the lack of Sharia-compliant instruments as a key barrier to effective hedging. Their study emphasized the need for innovation grounded in Islamic jurisprudence and called for regulatory bodies to provide guidance on acceptable instruments (Khan & Ahmed, 2001).

Obaidullah (2005) extended this line of inquiry by proposing a theoretical model for Islamic derivatives using wa'd-based contracts. His analysis demonstrated how a unilateral promise, when legally binding and documented, could replicate the risk mitigation features of a forward contract without violating Sharia principles. His work laid the groundwork for subsequent contract structures.

Ahmed (2010) analyzed the limitations of Sharia-based hedging in practical contexts. He found that despite theoretical viability, the enforceability of wa'd contracts and operational standardization were major obstacles. This study highlighted the role of legal infrastructure in supporting Islamic financial instruments and the necessity for cross-border regulatory harmonization.

In 2011, Hanif conducted a comparative analysis of conventional and Islamic derivatives, noting that Islamic tools tend to be reactive and underdeveloped. His research indicated that while Islamic contracts are gaining scholarly traction, their market adoption remains limited due to lack of liquidity and investor awareness (Hanif, 2011).

Dusuki and Bouheraoua (2011) provided a Shariah analysis of the tahawwut framework, concluding that it offers a permissible structure for risk management if implemented with transparency and linked to real economic activities. Their study is one of the few to offer both jurisprudential and policy-oriented insights, bridging theory and practice.

Mohd-Sanusi and Isa (2015) contributed an empirical dimension by analyzing adoption trends of Islamic hedging in Malaysian banks. Their findings confirmed that regulatory support and standardized documentation (e.g., IIFM Master Agreements) are crucial for successful implementation. However, even in Malaysia—a global leader in Islamic finance—usage remains limited to a few large institutions.

In sum, while previous research has advanced both theoretical and practical understanding of Islamic hedging, significant gaps remain. Notably, there is insufficient empirical research on adoption rates, operational challenges, and regional variations in implementation. This study aims to fill these gaps by addressing how Islamic hedging instruments can be effectively aligned with Sharia principles while remaining operationally viable and scalable.

METHOD

This research utilizes qualitative textual data derived from scholarly journals, books, regulatory documents, and institutional reports to explore the concept and application of Islamic hedging transactions on exchange rates. The nature of this data is largely descriptive and interpretive, encompassing jurisprudential rulings, theoretical frameworks, and applied models of Shariah-compliant hedging. Qualitative analysis enables a deeper understanding of how hedging instruments are conceptualized within Islamic finance, how they align with Islamic legal principles, and how they are applied across various jurisdictions (Creswell, 2013, p. 45; Al-Qaradawi, 2011, p. 133). As such, the study does not involve numerical modeling or statistical tools, but rather focuses on the interpretative dimensions of financial and religious texts.

The data sources for this study include peer-reviewed international journal articles, authoritative Islamic finance books, AAOIFI and IIFM documentation, and reports from reputable financial institutions such as the IMF and World Bank. These sources were selected based on their academic credibility, relevance to the topic, and publication date (not later than 2018). The selection of Islamic jurisprudential sources, including classical and contemporary scholars, ensures a balanced view that incorporates both traditional fiqh perspectives and modern financial innovations (Usmani, 2002, p. 210; Ayub, 2007, p. 313). Institutional documents, such as those from the Islamic Financial Services Board (IFSB) and the International Islamic Fiqh Academy, further validate the practical relevance of the instruments discussed.

For data collection, a document analysis technique was employed. This involves a systematic review and interpretation of textual data from books, articles, and official Shariah standards. The method is particularly suitable for conceptual and legal research where doctrinal consistency and interpretation of meanings are central (Bowen, 2009; Creswell, 2013, p. 179). Documents were collected using targeted keywords such as “Islamic derivatives,” “currency hedging,” “Shariah-compliant risk management,” and “tahawwut.” These were filtered for scholarly credibility and regulatory alignment using databases such as JSTOR, SSRN, Sinta, and Google Scholar. Primary

Arabic terms were translated and verified using the 1987 Joint Decree of the Minister of Religion and Education.

The data analysis followed a thematic approach, focusing on extracting, categorizing, and comparing concepts and interpretations related to Islamic hedging. Themes were derived both inductively from the literature and deductively from the research questions. This method allowed for the development of thematic categories such as wa'd-based contracts, Shariah interpretation, and operational models across different jurisdictions (Braun & Clarke, 2006; Kamali, 2008, p. 190). Special attention was paid to jurisprudential consistency and the alignment of proposed instruments with both classical and modern interpretations of Islamic commercial law.

In drawing conclusions, the study synthesized thematic findings across doctrinal, theoretical, and practical dimensions. The conclusions aim to bridge the gap between Islamic legal theory and financial practice by evaluating whether existing hedging mechanisms fulfill the objectives of Sharia (maqāṣid al-sharīʿah) while remaining feasible in modern financial markets. Patterns, contradictions, and emerging solutions were highlighted to answer the research questions and propose viable paths for standardization and regulatory adoption (Ayub, 2007, p. 338; Ahmed, 2010).

RESULTS AND DISCUSSION

Islamic hedging transactions represent a dynamic intersection between classical jurisprudence and contemporary financial innovation. As demonstrated in the theoretical and literature review sections, the core of Islamic hedging lies in the reconciliation between risk management and Sharia compliance. Classical fiqh al-muʿāmalāt establishes a strict framework that prohibits speculative and interest-based instruments. However, financial volatility, especially in foreign exchange markets, necessitates effective hedging tools for Muslim investors and institutions (Usmani, 2002, p. 175; El-Gamal, 2006). The development of Shariah-compliant derivatives such as wa'd-based forwards, Islamic currency swaps, and tahawwut structures represents an effort to address this challenge while preserving the ethical and legal framework of Islamic law.

In aligning the research findings with the theoretical framework, the study confirms that principles like gharar, maysir, and riba are fundamental barriers to using conventional derivatives in Islamic finance. However, structured alternatives have been developed by scholars and institutions to address these concerns. The IIFM's Standard Tahawwut Master Agreement (2010) and the AAOIFI's Shariah Standards (2015) serve as critical frameworks in operationalizing these instruments. Yet, adoption has remained uneven, largely due to regional disparities in jurisprudential interpretation and institutional capacity (Dusuki & Bouheraoua, 2011; Mohd-Sanusi & Isa, 2015). These findings echo the research gap identified in the literature review.

Moreover, the study brings forth new expert opinions and practical insights not previously cited, particularly in the context of Southeast Asia. For instance, Islamic financial institutions in Malaysia and Indonesia have experimented with localized Shariah interpretations to accommodate hedging transactions for SMEs and exporters (Hanif, 2011; BNM, 2016). These case studies reveal that pragmatic adaptation within Shariah boundaries can facilitate broader adoption of Islamic hedging tools. Nevertheless, the findings also suggest that legal enforceability, lack of awareness, and absence of unified standards remain persistent challenges.

This research contributes to closing the identified gap by offering a comparative analysis that integrates jurisprudential analysis, institutional practices, and regional adaptation. It adds to existing theory by showing how maqāṣid al-sharīʿah can serve not only as a guiding philosophy but also as an evaluative tool to assess the legitimacy and utility of financial instruments. The results underscore the need for further harmonization between regulatory bodies and Shariah

boards across different jurisdictions to enhance both compliance and practicality.

1. Shariah Compliance in Hedging Exchange Rate Risk

Islamic financial instruments designed to mitigate currency risk must comply with the legal and ethical framework of Shariah, particularly concerning the prohibition of riba, gharar, and maysir. The first research question—how do Islamic hedging instruments align with Shariah principles in mitigating exchange rate risk—requires an in-depth evaluation of their jurisprudential legitimacy. Islamic jurisprudence prohibits most conventional forward and derivative contracts due to uncertainty and the absence of tangible assets exchanged at the time of contract (Usmani, 2002, p. 150; El-Gamal, 2006). Consequently, Islamic finance has developed alternative models that maintain contractual clarity and asset-backed structures.

The most widely discussed structure in the literature is the wa'd-based forward contract. A unilateral promise (wa'd) from one party to purchase currency at a specified rate in the future, without the reciprocal obligation found in bilateral forward contracts, eliminates the mutual binding element that constitutes gharar. Dusuki and Bouheraoua (2011) argue that such a structure is permissible if the transaction is executed with full transparency and is based on real business needs rather than speculation. Their research, endorsed by the International Islamic Fiqh Academy, confirms that binding wa'd arrangements are not only legally valid under Islamic commercial law but also effective in hedging currency risk when executed correctly.

Another permissible structure involves the use of Islamic currency swaps, which are based on asset exchanges governed by muʿāwaḍah contracts such as bayʿ al-sarf (currency exchange). These contracts require simultaneous exchange of currencies, thus satisfying the conditions of taqabud (immediate possession) and eliminating speculative deferment. Khan and Ahmed (2001) emphasize that while such contracts may mimic conventional swaps in function, they diverge in substance due to the requirement of actual asset exchange and avoidance of interest-bearing differentials. As such, Islamic swaps preserve the spirit of Shariah while addressing market needs.

Beyond these instruments, the tahawwut framework established by the IIFM and AAOIFI offers a systematic model for Shariah-compliant hedging. This framework outlines the use of Islamic profit rate swaps, cross-currency contracts, and wa'd-based forwards under defined conditions, including linkage to genuine underlying assets, disclosure of contract terms, and absence of speculative intent (AAOIFI, 2015; IIFM, 2017). These standards provide clarity and reduce interpretive ambiguity, thus fostering broader adoption across jurisdictions. Nevertheless, scholars such as Ahmed (2010) caution that interpretation differences among Shariah boards can still pose challenges to uniform compliance.

Importantly, the concept of maqāṣid al-sharīʿah strengthens the theoretical legitimacy of Islamic hedging. As Kamali (2008, p. 160) suggests, financial instruments that protect wealth (ḥifẓ al-māl) and prevent harm (darʾ al-mafāsid) are not only permissible but encouraged. Currency hedging serves this purpose by safeguarding individuals and institutions from the destabilizing effects of exchange rate volatility. Provided that instruments are structured without prohibited elements, their function aligns with the higher objectives of Islamic law. Thus, compliance is not merely legal but also ethical and purposive.

Some contemporary fatwas also lend legitimacy to Islamic hedging instruments. For instance, the National Shariah Advisory Council of Malaysia has ruled that certain wa'd-based forward agreements are permissible, subject to documentation and risk-based need (BNM, 2016). These rulings serve as important legal precedents and are instrumental in developing case-based jurisprudence in Islamic finance. However, such approvals are often limited to specific

national contexts and may not be accepted in jurisdictions with more conservative interpretations of fiqh.

In conclusion, Islamic hedging instruments can align with Shariah principles if constructed with transparency, real economic purpose, and avoidance of prohibited elements. Models such as the wa'd-based forward and currency swap under bayʿ al-sarf rules represent legitimate alternatives to conventional derivatives. While the IIFM and AAOIFI frameworks provide useful templates, broader consensus and harmonization are needed to ensure consistency in Shariah interpretation across different financial systems. These findings affirm the theoretical foundation laid out earlier and highlight the viability of Islamic hedging as a legitimate risk management tool in a globalized economy.

2. Operational Models and Mechanisms of Islamic Currency Hedging

Addressing the second research question—what are the key models and mechanisms used in Islamic financial institutions for currency hedging—this section explores the practical frameworks through which Islamic financial institutions (IFIs) implement currency risk management. Given the prohibition of speculative and interest-based contracts, Islamic hedging models require innovative contract structures, process transparency, and compliance with Shariah principles while maintaining market efficacy (Ayub, 2007, p. 270; Obaidullah, 2005).

The most prominent mechanism used in Islamic currency hedging is the wa'd-based forward contract. This model is structured as a unilateral promise from one party to buy or sell a currency at a future date, with the actual transaction occurring only when the agreed condition is met. It eliminates mutual contractual obligation, avoiding the gharar associated with bilateral derivatives. Islamic banks in Malaysia and the UAE have employed this model extensively, especially for corporate clients with exposure to import-export risks (BNM, 2016; IIFM, 2017).

Another widely used tool is the Islamic cross-currency swap, structured as a combination of murābaḥah and ʿaqd tabādul al-uṣūl (asset exchange contracts). In this model, parties exchange notional amounts in two currencies using murābaḥah contracts to avoid interest, and periodically settle profits or returns. These are typically documented under the IIFM Master Agreement to standardize terms and reduce legal uncertainty (IIFM, 2017). Such swaps are primarily used by large institutions and sovereign issuers to hedge long-term liabilities denominated in foreign currencies.

Furthermore, Islamic profit rate swaps (IPRS) serve as another mechanism, especially for institutions managing fixed and floating rate exposures. These instruments, often executed through paired murābaḥah or ijārah contracts, replicate the cash flow pattern of conventional swaps without introducing riba (AAOIFI, 2015). The use of IPRS has gained traction in GCC and Southeast Asian countries where regulatory bodies such as the Securities Commission of Malaysia support their adoption.

The IIFM's Standard Tahawwut Master Agreement (STMA) plays a pivotal role in operationalizing these instruments. The STMA provides a legal and Shariah-compliant framework for executing hedging contracts, minimizing counterparty risk and documentation inconsistencies. According to Mohd-Sanusi and Isa (2015), institutions that adopted the STMA reported smoother implementation and increased confidence among stakeholders.

In terms of institutional practice, several Islamic banks have developed proprietary hedging products under the supervision of national Shariah boards. For instance, Bank Muamalat Malaysia offers structured forward solutions tailored to exporters, while Dubai Islamic Bank utilizes a murābaḥah-based hedging structure for interbank FX exposure. These models

demonstrate operational flexibility within Shariah parameters, supporting the view that Islamic finance can offer sophisticated solutions when regulatory and institutional support is present.

Despite these developments, challenges persist. Most notably, operational complexity, regulatory fragmentation, and the absence of universally accepted Shariah rulings hinder widespread adoption. Moreover, many small and medium enterprises (SMEs) in Muslim-majority countries remain unaware or unable to access Islamic hedging tools due to high transaction costs and limited product availability (Hanif, 2011).

In conclusion, the operational mechanisms of Islamic currency hedging rely on structured and standardized models such as wa'd-based forwards, cross-currency swaps, and profit rate swaps. These tools, supported by master agreements and Shariah oversight, provide viable alternatives to conventional derivatives. Nonetheless, broader accessibility and harmonization remain critical to scaling these instruments and maximizing their impact.

3. Challenges and Opportunities in Standardizing Islamic Hedging Tools

The third research question—what challenges and opportunities exist for enhancing the effectiveness and standardization of Islamic hedging tools—addresses the institutional, legal, and market-related factors affecting the broader application of Shariah-compliant risk management instruments.

One major challenge lies in jurisprudential diversity. Islamic law does not have a centralized authority, and interpretations of what constitutes Shariah compliance vary across jurisdictions. For example, while the Malaysian Shariah Advisory Council permits certain binding wa'd arrangements, some GCC-based scholars argue that these arrangements too closely resemble conventional forwards and are therefore impermissible (Dusuki & Bouheraoua, 2011; Ahmed, 2010). This fragmentation undermines investor confidence and impedes cross-border use of Islamic hedging tools.

A second challenge is the lack of standardization in legal documentation. Although the IIFM has provided a unified set of contract templates through the STMA, adoption remains limited. Many institutions continue to draft bespoke agreements, which increases legal ambiguity and raises counterparty risks. Without standardized contracts, enforceability becomes uncertain, especially in jurisdictions lacking specialized Islamic finance courts (IIFM, 2017).

Regulatory asymmetry also poses an obstacle. While some regulators—like Bank Negara Malaysia—have issued clear guidelines on Islamic hedging, others remain silent or apply conventional financial law, which may not adequately accommodate the nuances of Islamic instruments (BNM, 2016). This regulatory vacuum discourages financial institutions from innovating or offering Islamic derivatives, further entrenching reliance on conventional models.

Despite these challenges, significant opportunities exist. The most promising is the growing institutional push for harmonization. Organizations like AAOIFI, IFSB, and IIFM are actively working to unify standards, conduct Shariah audits, and promote best practices. These efforts have already led to broader acceptance of certain contracts and increased collaboration among scholars and financial practitioners (AAOIFI, 2015; IIFM, 2017).

Technological advancements, particularly in financial technology (fintech), also offer avenues for growth. Smart contracts based on Shariah principles could automate hedging processes, increase transparency, and reduce transaction costs. Such innovations could democratize access to Islamic hedging tools, especially for underserved segments like SMEs and retail investors (Hanif, 2011).

Education and capacity building present another opportunity. As the Islamic finance industry

matures, there is a need to train more Shariah scholars, legal professionals, and financial engineers who understand both Islamic jurisprudence and modern risk management. Increased awareness and expertise will help align market demand with Shariah-compliant solutions, enabling a more robust Islamic financial ecosystem (Kamali, 2008, p. 233).

In summary, while Islamic hedging faces structural and jurisprudential challenges, the pathway to broader adoption lies in standardization, technological integration, regulatory support, and capacity building. Leveraging these opportunities will not only improve the functionality of Islamic hedging tools but also enhance the credibility and competitiveness of Islamic finance in the global marketplace.

The findings of this study reveal that Islamic hedging instruments, when carefully structured, can align with the core tenets of Shariah while providing effective protection against exchange rate volatility. The first research question was addressed by analyzing the jurisprudential basis of wa'd-based contracts and Islamic swaps, confirming their compliance under defined conditions. The second question explored operational models, identifying wa'd-based forwards, Islamic profit rate swaps, and cross-currency swaps as the most common tools, supported by master agreements and regulatory guidance. The third question assessed challenges and opportunities, revealing that while standardization and jurisprudential diversity remain obstacles, institutional collaboration and fintech innovation offer transformative potential.

These findings confirm the study's theoretical alignment with maqāṣid al-sharīʿah, demonstrating that risk mitigation can be both ethically justified and legally permissible when grounded in Shariah-compliant principles. Conceptually, the study contributes to the literature by integrating legal theory, financial practice, and institutional analysis into a cohesive framework for understanding Islamic hedging. The original contribution lies in its regional focus and thematic integration, offering a nuanced understanding of how Islamic finance can evolve to meet global risk management needs without compromising its foundational values.

The implications are both theoretical and practical. Theoretically, this study enriches the understanding of how Islamic contracts can adapt to modern financial realities, expanding the boundary of permissible instruments. Practically, the study provides recommendations for regulators, banks, and scholars to enhance documentation, unify legal interpretations, and leverage fintech to increase accessibility. These insights can inform policy, guide training programs, and support the development of inclusive and resilient Islamic financial markets.

CONCLUSION

This study has examined the legal, operational, and institutional dimensions of Islamic hedging transactions in managing exchange rate risk. It confirmed that Shariah-compliant hedging tools, such as wa'd-based forwards and Islamic currency swaps, offer legitimate alternatives to conventional derivatives when properly structured. These instruments align with the fundamental prohibitions of riba, gharar, and maysir, and uphold the higher objectives of Islamic law, including wealth protection and harm prevention.

The research further demonstrated that while operational mechanisms exist and are supported by standardized frameworks like the IIFM STMA, their implementation is hindered by interpretive diversity, limited regulatory support, and lack of market awareness. Nevertheless, significant opportunities exist in harmonizing jurisprudential views, expanding fintech applications, and building institutional capacity.

Based on these insights, this study recommends the development of unified Shariah standards across jurisdictions, greater investment in education and training, and the integration of smart technologies to streamline and democratize access to Islamic hedging tools. These steps will not

only strengthen risk management practices in Islamic finance but also contribute to its sustainability and global competitiveness. Future research should explore empirical case studies and cross-jurisdictional implementation to further refine these tools and frameworks.

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