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**HEDGING BY DERIVATIVES****A CRITICAL ANALYSIS AND SHARIAH ALTERNATIVE**

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**Abstract**

*Despite their importance for financial sector development, derivatives are few and far between in countries where the compatibility of capital market transactions with Islamic law requires the development of Shariah-compliant structures. It is a well-known reality that Islamic finance is governed by the Shariah, which bans some kinds of speculation, but stipulates that income must be derived as profits from shared business risk rather than interest or guaranteed return. This paper explains the fundamental principles of Islamic finance, which includes the presentation of a valuation model that help illustrate the Shariah-compliant ruling of financing through derivative and option arrangement. Based on the current use of accepted risk transfer mechanisms in Islamic structured finance, the paper explore the validity of derivatives and options from an Islamic legal point of view and summarizes the key objections of Shariah scholars that challenge the permissibility of derivatives and options under Islamic law. A shariah analysis of derivatives and its alternatives has also been presented in this paper.*

**Keywords:** *derivatives, options, securitization, Islamic banking, Islamic finance, Shariah compliance, futures, forward sale*

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