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Development of Gharar Parameters Model (GPM): A Conceptual Framework for Shariah Compliance Mitigation in Currency Options

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Abstract

Financial markets are becoming more complex, increasing demand for hedging instruments to mitigate foreign exchange (FX) risk exposures. Currency options are commonly used for effective hedging solutions in conventional finance. However, permissibility in Islamic finance remains widely debated among scholars because of prohibited elements, i.e., gharar (excessive uncertainty), riba (interest), and maysir (gambling). Among these three (3) elements, gharar is the most debated due to the lack of structured parameters to distinguish between gharar yasir (minor uncertainty) and gharar fahish (major uncertainty) in modern derivative contracts. The purpose of the study is to develop the Gharar Parameters Model (GPM) as a conceptual framework for identifying, classifying, measuring and mitigating Shariah non-compliance (SNC) risk in currency options. This study adopts a qualitative method in which classical fiqh literature, contemporary Islamic finance standards, regulatory resolutions and academic literature were extensively analysed. The proposed model provisions harmonise Shariah clarifications on currency options with regard to gharar and, in turn, support Islamic Financial Institutions (IFIs) in enhancing the Shariah governance ecosystem, product innovation framework and SNC risk management practices. Furthermore, the study provides theoretical foundations for future empirical validation and regulatory use in Islamic finance, as well as a linkage to Maqasid al-Shariah, particularly hifz al-mal (preservation of wealth) in the broader context of the Islamic economy.

Keywords: Gharar, Currency Options, Shariah Non-Compliance Risk, Islamic Finance, Derivatives, Hedging, Gharar Parameters Model

Introduction

Different monetary policies, inflationary pressures, changing foreign exchange (FX) rates and geopolitical pressures continue to drive unprecedented volatility in the global financial system. These developments have significantly increased the FX risk exposures of corporations, financial institutions, exporters, importers and investors. Consequently, a diversity of derivative instruments has been developed to support hedging and risk management.

Currency options are one of the derivative instruments that provide flexibility to market participants by giving them the right, but not the obligation, to exercise the right at a pre-determined FX rate (strike price) within or on the maturity date, depending on the FX spot rate. Currency options can hedge downside risk while retaining upside potential, making them one of the most popular hedging instruments in conventional finance. However, the instruments are controversial from a Shariah point of view because of concerns about uncertainty and speculative elements in the contract. Contemporary scholars still debate whether currency options are permissible in Islam and whether they can be structured in a way that does not violate Islamic law. (Emerald Publishing, 2025).

Islamic finance requires avoiding riba, gharar and maysir in all commercial transactions. While a vast body of literature addresses riba and maysir, the concept of gharar is less clear, as classical and modern scholars interpret it differently. (Noh, N. A., & Azelan, A., 2023). The lack of consensus on the parameters that distinguish gharar fahish from gharar yasir leads to inconsistent Shariah rulings and hinders the development of innovative Islamic hedging instruments. (Waemustafa, W., 2016).

Hence, this study proposes the Gharar Parameters Model (GPM), which defines parameters that can be used to identify, classify, quantify and mitigate gharar elements in currency options.

Research Background

Islamic Finance has grown exponentially over the last 5 decades from a niche financial system to a global industry present in more than 80 jurisdictions. Nevertheless, the growth of Shariah-compliant derivatives has been comparatively slow compared with conventional financial markets.

The clear distinction lies in the foundation, nature and purpose of conventional and Islamic finance. Conventional derivatives are generally supported by uncertainty and future contingencies. Islamic finance emphasises certainty, transparency, fairness and asset-backed transactions. Hence, conventional options contracts are often criticised for excessive uncertainty and speculative features that may render them invalid from a Shariah perspective. (AAOIFI, 2023) (AAOIFI, 2024). Nonetheless, ambiguity persists about when uncertainty becomes excessive. This gap requires a structured gharar framework that can objectively assess the element and severity of gharar in currency option contracts at the product structure and features, documentation and transactions stage.

Problem Statement

Three (3) fundamental issues justify the proposed development of GPM. First, no specific structured gharar parameters measure the severity of gharar in derivative contracts, particularly currency options. Classical jurists classified gharar into two categories: gharar fahish (major uncertainty) and gharar yasir (minor uncertainty), but the parameters to distinguish the types and severity of gharar are not adequately adopted in modern financial instruments. (Nehad & Khanfar, 2016)

Second, Shariah decisions vary across jurisdictions because scholars disagree on currency options. Some scholars prohibited currency options altogether, while others approved some structures based on unilateral commitments (wa'ad) for hedging purposes. (INCEIF University, 2024).

Third, IFIs face higher SNC risk when rolling out innovative risk-management instruments for hedging purposes, such as derivatives. In the absence of specific parameters on gharar, Shariah judgements may be highly subjective and widely interpreted, which can limit product development, particularly for currency options.

Research Objectives

The study aims to:

a. Explore the concept of gharar in classical and current Islamic jurisprudence.
b. Identify the elements of gharar inherent in the currency option contracts.
c. Develop structured parameters for identification, classification and measurement of gharar.
d. Establish structured parameters to distinguish between gharar fahish and gharar yasir.
e. Develop Gharar Parameters Model (GPM) to mitigate the SNC risk in currency options.

Literature Review

Concept of Gharar

Linguistically, gharar means uncertainty, deception, ambiguity, hazard and risk. In Islamic jurisprudence, gharar is uncertainty concerning the existence, features, quantity, deliverability, or outcome of contractual subject matter. The classical jurists, such as Imam Malik, Imam Shafi'i, Imam Abu Hanifah and Imam Ahmad ibn Hanbal, have long prohibited excessive gharar because it can lead to injustice and disputes between contracting parties. The prohibition was mainly from Prophetic tradition: "The Prophet prohibited sales involving gharar.

Modern scholars still recognise gharar as ambiguity that materially impacts contractual outcomes and prevents informed consent between contracting parties. (Noh, N. A., & Azelan, A., 2023).

Classification of Gharar

Classical academics usually classify gharar into:

a. Gharar Fahish (major uncertainty), which includes the following characteristics:
- Basic uncertainty.
- The deal outcome is not known.
- Reasonable chance of a disagreement.
- Material impact on the legality of the contract.
- Too much speculative exposure.

b. Gharar Yasir (minor uncertainty), which includes the following characteristics:
- Inevitable uncertainty.
- Limited contractual effect.
- Acceptance of market practice.
- Very low chance of dispute.

- Nature of the supplementary.

Likewise, modern Islamic banking standards comprehend that not all uncertainty invalidates a contract. Only extreme uncertainty that leads to injustice and exploitation is forbidden. (Fatimah, 2025)

Currency Options

A currency option gives the holder the right but not the obligation to buy or sell a specified currency at a specified exchange rate. There are two types of currency options:

a. Currency Call Options – right to buy the foreign currency, but no obligation.
b. Currency Put Options – right to sell the foreign currency, but no obligation.

The buyer pays a premium for the privilege. Conventionally, the premium is seen as a charge for flexibility and risk transfer. But from a Shariah point of view, issues are raised regarding:

a. Validity of premium payment by the options buyer.
b. Sale of rights by the options seller.
c. Uncertainty of exercising the rights by the options buyer.
d. Speculative reasons by the options buyer and seller.
e. No spot change of the currencies between the options buyer and seller.

These have made currency options one of the most contested tools in Islamic banking.

Shariah Non- Compliance (SNC) Risk in Currency Options

SNC risk refers the risk of legal or regulatory sanctions, financial loss or non-financial implications including reputational damage, which an IFI may suffer arising from failure of business and operations; products, transactions, processes and systems to comply with the rulings of the Shariah Advisory Council of Bank Negara Malaysia (SAC), standards on Shariah matters issued by the Bank pursuant to section 29(1) of the IFSA and section 33E(1) of the DFIA, or decisions or advice of the Shariah committee. (BNM-SGDP, 2019)

The SNC risk for currency options arises from:

a) Ambiguity of Contract - uncertainty of rights and responsibilities under contracts.
b) Premium Risk – Shariah permissibility of the option premiums.
c) Ambiguity of settlement - uncertainty of the exercise execution and delivery.
d) Speculation - transactions entered into mainly to profit from volatility in the market.
e) Lack of fundamental economic rationale - transactions are not a part of real economic activities.

There is evidence of the need to develop a structured gharar parameter for detecting, assessing, measuring and mitigating SNC in IFIs, particularly in currency options. (Asia & Semaun, 2025)

Proposed Gharar Parameter Model (GPM)

The model is proposed based on three (3) integrated dimensions.

a. Dimension 1: Identification

i. Parameter 1: Subject-matter certainty
Assessment of currency presence and ownership.

ii. Parameter 2: Certainty of Price
Transparency of the strike price and premium.
iii. Parameter 3: Certainty of Delivery
Ability to perform contractual obligations.
iv. Parameter 4: Certainty of Exercise
Clarity on exercise and maturity period.
v. Parameter 5: Certainty of Purpose
Presence of real hedging motives.

b. Dimension 2: Classification

The identified uncertainty is classified into:

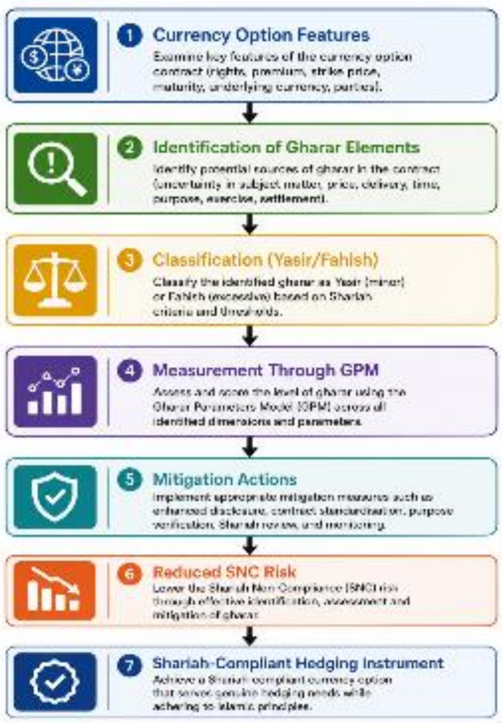
Criteria	Gharar Yasir	Gharar Fahish
Materiality	Low	High
Impact	Insignificant	Significant
Dispute probability	Low	High
Transparency	High	Low
Hedging purpose	Genuine	Speculative

c. Dimension 3: Mitigation

Mitigation measures include:
- Enhanced disclosure requirements.
- Shariah screening mechanisms.
- Hedging purpose verification.
- Contract standardisation.
- Independent Shariah review.
- Continuous monitoring.

Proposed Gharar Parameter Model (GPM)

The conceptual framework proposes:



This framework aligns with contemporary Shariah governance expectations, emphasising proactive risk identification and mitigation in Shariah risk management.

Implications of GPM

The proposed model makes the following contributions:

a. Theoretical Contributions - provides structured qualitative parameters for gharar assessment, classification and measurement.
b. Contribution of Regulation - supports the harmonisation of Shariah standards as a guide for more robust SNC risk management, particularly in currency options.
c. Contributions to the Industry – support the development of innovative Islamic hedging solutions.
d. Contribution to Risk Management - enhances SNC risk assessment frameworks at the regulatory and IFIs.
e. Governance Contribution - improves the effectiveness of Shariah governance.

Conclusion

The current debate on currency options illustrates the need for a systematic approach to separate tolerable uncertainty from intolerable uncertainty. The lack of objective metrics for assessing gharar is a major hurdle for product innovation and regulatory uniformity, even as modern Islamic finance becomes more aware of the need for risk management and hedging products.

The proposed Gharar Parameters Model (GPM) fills this gap as a multidimensional framework for identifying, classifying, measuring and mitigating gharar-related Shariah non-compliance risks in currency option contracts. Combining classical jurisprudential concepts and modern risk management practices, the model serves as a practical tool to strengthen Shariah governance and promote market-sensitive Islamic hedging instruments. Future studies should empirically test the proposed model using expert interviews and real currency option structures and transactions in IFIs.

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